President Obama loves his teachable moments, and he’s going to get a new one when the new Congress is sworn in next January. During the midterm elections we were constantly told that business and households were so terrified of the higher future tax burdens associated with the budget deficits that they were not investing or spending. Our “spendthrift” government, then, was responsible for killing economic growth (even though most of the spending was a continuation of Bush’s policies). The spending led to the refrain (heard endlessly as the election results poured in) that the “socialistic” fiscal stimulus the government had implemented to save the economy from depression actually undermined growth, and that fiscal restraint (“living within our means as a household does”) was the key to growth.

Well, it’s “put up or shut up” time for the fiscal austerian brigade. What are they going to cut? And how are those purported cuts going to lead us back to economic prosperity? When one hears political figures such as Congressman Eric Cantor (R-VA) discussing the need for government “to go on a diet,” one wonders if he actually considers that his party’s end objective, if attained, will simply transfer debt back to private households and businesses.

To have a “teachable moment” you need a teacher who’s on top of his material. The president’s Wall Street tutors have shown themselves to be economic quacks. They are as responsible
as anybody else for “driving this economy into a ditch”—the metaphor frequently invoked by Obama during the midterm election campaign.

So let’s try to give the president a fresh tutorial. God knows he’ll need it when he’s discussing these matters with the likes of Senator-elect Rand Paul (R-KY).

When the government runs a surplus, the nongovernment sector has to run a deficit, and vice versa. There are distributional possibilities between the foreign and domestic components of the nongovernment sector, but, overall, that sector’s outcome is the mirror image of the government balance. This is a fundamental reality of bookkeeping.

So the president can start by pointing out that when the new GOP Congress and its Tea Party allies argue that the government sector should be in surplus, this is tantamount to saying that the nongovernment sector should be in deficit. The fact is, US net exports are not strong enough today to simultaneously support both a reduction in private debt and a public surplus, while pushing growth to its full-employment level. If the foreign sector is in deficit, the national accounting relations mean that a government surplus will always be reflected in a private domestic deficit—which is precisely what happened in the 1990s.

It’s simple: if there is a current account deficit (which we have in the United States today) and both the government and private domestic sectors implement plans to generate surpluses (i.e., reduce spending and pay down debt), there will be a shortfall in aggregate demand that will generate cuts in output and income. These income shifts drive the budget toward or into deficit and stifle private sector plans to save, so that, eventually, the actual balances add to zero.

But neither the government nor the domestic private sector will be achieving their plans. Cutting government spending now means that growth will slow, as automatic stabilizers kick into gear and tax revenues fall farther. Deficits will go higher. Consequently, the attempt to force people to “live within their means,” if one could call it that, indicated that he wasn’t going to take on the Republicans but would, rather, try to find common cause. Negotiation ultimately implies a willing partner on the other side. Fat chance. If the president’s tactics had been used by King Solomon (whose wisdom is usually recalled in the famous incident in which two women came before him with a baby, each claiming to be the mother), the child in question would have been cut in half in the spirit of “bipartisan compromise.”

The showdown moment will come soon enough. We’ve got the expiration of the Bush tax cuts coming up at the end of the year. The president might well extend the tax cuts permanently, or he and his party might insist that the provision only applies for those earning less than $250,000 annually. What if the GOP doesn’t compromise? Gridlock means taxes go up next year, further draining aggregate demand.

And what about the debt ceiling? Congress is due to vote on raising this question early next year. Although many of us have long argued that a sovereign government faces no operational constraint in terms of spending money, it is also clear that we have imposed many legal constraints, which do create potential solvency issues for the United States. America’s institutional arrangements still reflect gold-standard arrangements throughout.

Consider the simple example outlined in the October 19, 2010, Winterspeak Blog:

“So, suppose the Treasury account hits zero, and it writes another check. Will the check bounce?

“Back in the days of the gold standard, the Treasury account hitting zero would mean there was no gold left in the vault. If the Treasury promised someone more gold, it could not deliver. The check would, indeed bounce”—and the central bank would be forced to raise rates in order to attract gold and fund future spending.

But we are no longer on a gold standard. The Treasury must adhere to agreed debt ceilings, along with laws mandating that the Treasury issue bonds to “fund” all government expenditures, in order to clear its check. We could easily circumvent this requirement. Winterspeak: “Let the Treasury account go into the negative (overdraft)” at its “bank”—the Federal Reserve. “The Fed would need to let the Treasury account have a ‘-’ in the spreadsheet cell that tracks its number.

“Currently, this is illegal.”

However, in the past, when the Treasury did not have sufficient deposits at the Fed, it temporarily circumvented this problem by selling bonds to special depositories, which were allowed to buy the bonds by crediting the Treasury’s deposit. The Treasury would then transfer its deposit to the Fed before spending. This would normally result in a reserve debit from the
accounts of those banks, but the Fed would allow a “float” (i.e., postpone the debit) since subsequent Treasury spending would restore the reserves. This expedient, however, may have only days left. If the new Congress does not raise the debt ceiling, or if it changes the law mandating that we “fund” our expenditures via bond sales (which is more possible), “it means that the US Govt will have decided to bounce its own checks. Its next decision, one presumes, will be to dissolve itself entirely” (ibid.).

That’s the legal constraint. It’s dumb, but it’s real. It also means, for example, that around $80 billion of spending power will be withdrawn from the economy as the temporary extension of unemployment insurance expires. That might fire up the GOP’s base, but it could well prove to be a fleeting pleasure. Consider the possibility that Rand Paul (to give the most obvious example) leads a filibuster preventing debate on allowing the government to raise the debt ceiling. How will the billionaire economic rentiers who have funded the Tea Party candidates react when one of their own actually acts on principle and potentially creates a new financial crisis? In the event that Congress is unable to raise the debt ceiling, it effectively forces the US government to default on its debt. Sure, the markets might take it in their stride for a few days. But after a few weeks, will they remain sanguine?

Sound improbable? Well, reread your history of the 1994 “Contract with America” Congress led by Speaker of the House Newt Gingrich (R-GA). Under Gingrich’s direction, Congress decided to default on US government debt by refusing to raise the debt ceiling. (The only reason the government did not default was because Treasury Secretary Robert Rubin was able to make payment from an account balance hitherto undisclosed to Congress.) Just about every time the self-imposed debt ceiling is about to be breached this issue arises, yet nobody ever considers the possibility that US bonds would stop being “money good.” Normally, there’s a good reason for this: after members of Congress dutifully wring their hands and declaim the burden the administration is placing on future generations, the debt limit is invariably increased. This could well change, given the fanaticism of some of our new congressmen and senators.

Will Obama be in a position to do something about it? Will he explain that bond sales are a completely voluntary and self-imposed operation for any sovereign government? Probably not, especially if one is to judge from his postelection press conference, when he talked about deficit reduction. The president better figure something out soon, because his next “teachable moment” is just around the corner.

Reference