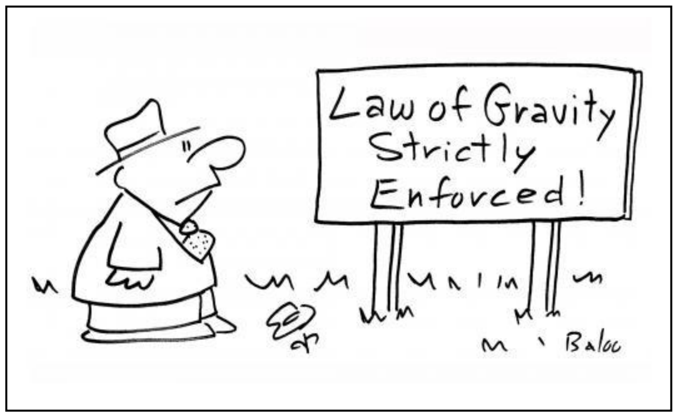
Mitchell's Musings 10-14-13: No Law of Nature is Involved

Daniel J.B. Mitchell

Let's start with some observations.[1] In a modern monetary system, currency is not "backed" by some physical commodity. Back in the day, there were monetary standards based on gold or silver. Not anymore. As we have noted in prior musings, money is a social and political creation. You accept dollars in payment (for your labor or anything you sell) because you know that others will accept those dollars. If you were in Japan, you would accept yen. If you were in Britain, you would accept pounds. If you were in France, you used to accept francs. But then the "authorities" told you that from now on the currency to accept was the euro. And knowing that everyone else would do it, you then accepted the euro.



In the U.S., the authority that issues money – which you accept – is the Federal Reserve. The Federal Reserve – the U.S. central bank – is a creation of Congress. Congress, in turn, had the power to create the Federal Reserve because of constitutional provisions providing for federal regulation of the currency. **There are rules about what the Fed can do or not do. But these are not laws of nature like gravity. They are instead human creations.**

Since the federal government can create money – a power it has delegated to the Federal Reserve – it cannot really run out of money to pay its debts. In fact, it cannot run out of money to do anything. It's true that in olden times when money was gold, the King had to borrow or raise money from taxation, say, to go to war. And it is true that state and local governments *within* the U.S. (and now countries within the euro-zone) can run out of money because they lack the power to create it. But it isn't true of the federal government.

Since there is no natural law limiting the federal government's access to money under our modern monetary system, there can't be a natural law limiting its debt or, more particularly, its ability to pay its debt service. The debt and debt service are denominated in dollars. So any limits on them are artificial creations of human laws.

[1] There is an ongoing flow of events surrounding the topic for this week. Please note, therefore, that this musing was posted the morning of October 10, 2013.

All that said, the Treasury does have a bank account at the Federal Reserve.[2] And like your checking account, Treasury receipts (from tax inflows, borrowing, etc.) are deposited in that account and payments from it are deducted from it. When the Treasury account balance runs low (because of seasonal factors affecting inflows and outflows and because the federal government is running a deficit apart from seasonality), the Treasury borrows by issuing securities and depositing the proceeds in its account. The borrowing's proceeds replenish the account balance.

So what happens if the balance were to fall below zero? If your checking account balance falls below zero, your bank can do one of two things. It can bounce your checks. Or it can loan you the money through some kind of overdraft procedure. (Many people have some kind of overdraft protection on their checking accounts.)

Yours truly is not a lawyer. But there have been discussions that the President could invoke various constitutional powers to pay debt service above the artificial debt ceiling. There have been stories about platinum coins that could be issued that would circumvent the debt ceiling. I have no expertise or judgment on such strategies from a legal perspective. But let's assume that the President - on some rationale - ordered the Treasury to keep writing checks for expenditures, including debt service, which crossed the debt ceiling and/or pulled the account balance below zero. Would the Fed bounce the checks?

Again, **there is no natural law that would prevent an overdraft**. The Fed might be concerned about creating money beyond its money supply creation targets to accommodate the federal government. But it could mop up the "extra" money created by allowing an overdraft simply by selling from its existing holdings of Treasury or other securities.

Would the Fed have a rationale for allowing such an overdraft? The Fed essentially has two long-term goals: limiting inflation and fostering economic growth. And it has a short-term goal of preventing chaos in financial markets. A default on the debt could create such chaos. Maybe you could argue that markets would somehow adjust to the default in some smooth way. But seeing what the effect would actually be is an experiment the Fed might well not want to run.

If the default triggered a run on the dollar, prices of traded good would be pushed up measured in dollars, i.e., there could be at least temporary inflation. And financial turmoil would be bad

[2] *"The major items on the liability side of the Federal Reserve balance sheet are Federal Reserve notes (U.S. paper currency) and the deposits that thousands of depository institutions,* ***the U.S. Treasury****, and others hold in accounts at the Federal Reserve Banks."* Source: http://www.federalreserve.gov/monetarypolicy/bst_frliabilities.htm.

for real economic growth – which is already anemic. Unemployment – although falling since the Great Recession – remains high. And the low employment-to-population ratio and labor force participation rate add to the indication of an overly-soft labor market. In short, the Fed would have a three-fold rationale for allowing an overdraft: preventing financial chaos, preventing inflation, and fostering economic expansion.

Of course, no one outside the Fed knows what the Fed would do if default threatened. I'm sure there has been contingency planning at the Fed. But it may be that even top officials there don't know for sure at this point what they would do. For outsiders, however, the important point is that what the Fed would do is a human decision. Like the debt ceiling itself, no law of nature is involved.