Mitchell's Musings 4-25-11: Default, Dear Brutus, Is Something S&P Can't Evaluate

Daniel J.B. Mitchell

There were big headlines last week when the Standard & Poor's rating service issued a warning about a possible future downgrading of US Treasury securities. Not surprising, some of the reaction was grumbling about rating agencies that totally missed the mortgage fiasco. But others saw the warning as reasonable and a Good Thing. The *New York Times*, for example, ran an editorial entitled "Good Advice from S&P." In fact, the text of the editorial was more qualified than the title suggests. The thrust was that default was not imminent but it would be a good idea for the U.S. eventually to deal with its large deficits. So S&P should be thanked for bringing the issue to our attention. (See http://www.nytimes.com/2011/04/20/opinion/20wed2.html)

Actually, the advice was not so good. S&P normally looks at securities issues by private entities and sub-national governments in terms of whether those entities and governments can repay what they have borrowed. Private entities and sub-national governments cannot create money. They borrow in currency created by someone else. So it is possible for them to run into trouble and not have enough of that currency to repay – or repay on schedule. The same is true for national governments that have surrendered their currencies, e.g., those in the Euro zone. In that respect Greece, which has had recent financial problems, is not different from, say, a city in the U.S. It is also possible for national governments that have their own currencies, but that borrow in other countries' currencies, to find themselves unable to repay. Think Mexico – which borrowed in dollars - and its various peso crises.

The U.S., however, can create dollars and it borrows in dollars. A Treasury bond is a promise to pay back interest and principle in dollars. Even the inflation-adjusted Treasuries are ultimately promises to pay back in dollars. So the U.S. can't default on the grounds that it doesn't have enough dollars. It always can have enough dollars to pay what it owes *unless* it makes a political decision not to do so. Such a political decision could be, for example, not raising the debt ceiling, an issue that is about to come up. However, S&P is not in a position to evaluate such a political decision using the usual financial indexes it analyzes when it evaluates more typical securities.[1]

Now some will argue that if the U.S. continues in its large federal deficits – and if it then monetizes the resulting debt – that process will be inflationary and inflation was really S&P's concern. S&P, in that interpretation, feared that while the U.S. would repay, the repaid dollars would be worth a lot less than today. But if that were the basis of its concern, S&P should be downgrading every security – public and private – that is currently denominated in dollars. (Presumably, however, it should not downgrade

[1] I am not alone in pointing out the problem of applying usual S&P analysis to Treasuries. Only two days before the *New York Times* ran its editorial, a more enlightening view appeared on its own website. See http://www.nytimes.com/roomfordebate/2011/04/18/is-anyone-listening-to-the-standard-poors/ignore-the-raters?

inflation-adjusted Treasuries.) But S&P did not threaten all dollar-denominated securities with downgrades.

Others might argue that what S&P was worried about was a chain of events running from the federal deficit to dollar devaluation relative to other currencies. But, again, if that were the case, S&P should be downgrading all securities denominated in dollars. (Presumably, if dollar devaluation were the actual worry, even inflation-adjusted Treasuries might be downgraded.)

I know that it is very unsettling for folks to think of money as something created and not "real." After all, people strive for money; they even murder for money. But in the end, in modern monetary systems, money is a social convention. People accept dollars in payment because they know others will accept them. I know that if you pay me in dollars, I can take those dollars to the grocery and buy my daily bread. There is a long chain of historical explanations about why in the U.S. people nowadays "think in" dollars while in Japan people "think in" yen and about how those two currencies – and all others – arose. For those interested in such matters, you can easily investigate online what "dollar" means, e.g., http://hotword.dictionary.com/dollar-joachimsthaler-origin/. But the bottom line is that it was unhelpful to have S&P confuse the issue of Treasury risk. Such confusion can lead to political responses that in turn can produce pressures for inappropriate monetary and fiscal policy.

None of the above should be taken to mean that it is a Good Thing over the long run for the U.S. to run large federal deficits. Such deficits are a form of dissaving in the public sector. That dissaving, combined with low rates of household saving, is part of the story of why the U.S. runs large trade deficits. And it is trade deficits about which S&P – if indeed it were worried about dollar devaluation – should be highlighting. It is the trade deficit that produces large holdings of dollars abroad. As previous posts on this blog have emphasized, it is the trade deficit that undermines U.S. manufacturing and the potential for good jobs in that sector. And it is those large holdings of dollars abroad - and their potential to create a run on the dollar and the next financial crisis -that could threaten jobs throughout the economy.