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The U.S. doesn't face a fiscal crisis

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The Congressional Budget Office recently released its "2017 Long-term Budget Outlook" in which it projected that "if laws generally remain unchanged" ongoing annual budget deficits would cause U.S. federal debt held by the public as a percent of U.S. gross domestic product ("GDP") to balloon to 150 percent in 2047 from 77 percent today.

The report includes the dire warning that the "prospect of such large and growing debt poses substantial risks for the nation." Specifically the CBO believes if the national debt rose to the level it is projecting it would "hurt the economy" and "increase the likelihood of a fiscal crisis" in "which investors become unwilling to finance a government's borrowing unless they are compensated with very high interest rates."

The CBO states that the resulting jump in interest rates "would reduce the market value of outstanding government securities, and investors could lose money. The resulting losses for mutual funds, pension funds, insurance companies, banks and other holders of government debt might be large enough to cause some financial institutions to fail, creating a fiscal crisis."

Scary indeed.

The Congressional Budget Office is a nonpartisan entity that produces "independent analyses of budgetary and economic issues to support the Congressional budget process."

The fact that the CBO is nonpartisan does not mean the organization does not have a point of view, a theoretical bias about how the global economy and financial system operate. It does.

The CBO believes large budget deficits require the federal government to borrow more money from the private sector to finance the deficit. It writes, "If the government borrowed more, more of people's savings would be used to buy Treasury securities, and thus private investment would be crowded out."

In other words, there would be less private savings, including bank deposits, that businesses could borrow in order to invest in productivity-enhancing projects because so much money would be sitting in government bonds.

The CBO writes, "With less investment in capital goods — factories and computers, for example — workers would be less productive. Because productivity growth is the main driver of growth in people's compensation, decreased investment also would reduce average compensation per hour, offering people less incentive to work."

The CBO's view (and that of many economists) is that a limiting constraint on the economy is the amount of money. They believe a higher federal debt level means the government sucks up

an increasing percentage of the limited money supply, leaving less for the private sector to save and invest.

If there really is a limited supply of money then the federal government could indeed crowd out private sector investment as annual budget deficits reduce private sector savings, leading to higher interest rates.

Michael Tanner, senior fellow at the Cato Institute, writes in his book “Going For Broke,” “Government borrowing tends to crowd out private investment, because a dollar borrowed by the government is a dollar no longer available for private use.”

Tanner compares the federal government to a family sitting around the kitchen table discussing their household budget and realizing they spend more than they bring in and that they have been “borrowing the rest and living off credit cards for years.” That same family has not put anything away for unexpected expenses and has promised to pay for their children’s college tuition and will have responsibility for their aging parents.

He writes, “If the U.S. government were a family, that’s pretty much the situation it would find itself in.”

Except the U.S. government isn’t a family. It is a sovereign entity with its own currency, printing press and a central bank that oversees a private banking system that has the ability to create an endless supply of money.

Former Federal Reserve Chairman Ben Bernanke wrote in 2002, “Under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation. ... The U.S. government has a technology, called a printing press (or, today, its electronic equivalent) that allows it to produce as many U.S. dollars as it wishes at essentially no cost.”

Bernanke also wrote, “Money ... is special; it is not only a zero-interest liability, but also a perpetual liability.”

Written across every piece of U.S.-issued paper currency are the words “Federal Reserve Note.” A note in this context is a debt instrument issued by the Federal Reserve, the U.S. central bank.

Does this paper note pay interest? No. Can you turn it into the Federal Reserve and redeem it for gold or some other form of payment? No.

If you brought a bag full of $100 dollar bills to the Federal Reserve, it would either exchange it for more cash or credit your bank account for the same amount. In other words, dollars are perpetual liabilities of the federal government as issued by its bank, the U.S. Federal Reserve.

Columbia University economist Michael Woodford wrote, “A government that issues debt denominated in its own currency is in a different situation from that of private borrowers, in that its debt is a promise only to deliver more of its own liabilities. (A Treasury bond is simply a promise to pay dollars at various future dates, but these dollars are simply additional government liabilities, that happen to be noninterest-earning.) There is thus no possible doubt about the government’s technical ability to deliver what it has promised.”

How does the federal government create money? It spends.

Pavlina R. Tcherneva, of the Levy Economics Institute, wrote, “When the Treasury spends, nongovernment entities who receive the income also receive brand new bank deposits; this is because when the Fed clears the government expenditures, it credits private bank accounts with reserves.”

Government spending creates new bank deposits for the private sector. The government doesn’t have to go find the money. The money is created through an accounting entry cleared by the Federal Reserve. Bank deposits like paper currency are also perpetual liabilities, although in the case of bank deposits the bank may elect to pay some interest.

When the government issues a Treasury bond, all that is happening is noninterest-bearing notes, or dollars, are converted into interest-bearing notes. The federal government is exchanging one liability for another liability. No money is raised. The money creation occurs when the government spends and new bank deposits are created.

Likewise, when commercial banks make loans they also create new bank deposits ,which is a liability of the bank, while offsetting it on their accounting books with a new asset called a loan receivable.

All this money creation is evidence the money supply is unlimited. And if the money supply is unlimited then federal spending cannot crowd out the private sector, and the risks of a fiscal crisis sparked by rising interest rates is overblown.

We can look to Japan as an example of the flexibility credible federal governments have in dealing with a large national debt. Japan has a significantly larger national debt than the U.S. Yet Japan has some of the lowest interest rates in the world because the Japan Central Bank is not only buying up debt with newly created money, reducing the national debt burden, but it has successfully capped the interest rate on its 10-year bond at 0 percent.

The constraint on federal governments that issue their own currency and have debt denominated in that currency is not their ability to create money. The constraint is they cannot create too much money without risking inflation.

There are always limits, but the amount of money in the world is not one of them, which means the federal government cannot crowd out the private sector.