Cold Turkey for Thanksgiving? No Thanks.

By Editor Test *Wed, Oct 24, 2012*

Let me channel, for a few paragraphs, the ideas of Warren Mosler, Stephanie Kelton and other proponents of Modern Monetary Theory—which is not a theory so much as a clearer understanding of the way our financial system actually functions.

When politicians talk about the importance of balancing the budget, about preventing the U.S. from becoming another Greece and about weaning ourselves from Chinese lenders, I get a bit jumpy.

Statements like that suggest a lack of understanding about how a sovereign currency works, and it identifies those politicians as people who could lead us into a spiral of uncontrolled deflation.

Inflation is not my first preference. It sickens me that a ride on the New York subway, a U.S.-made Pendleton wool shirt, and a private college education all cost about 10 times what they did when I was 18 (to name a few homely examples). But I don't necessarily want to see the value of my house or my investments drop in half next year.

Which is exactly what a sudden, bracing return to "sound money" and "balanced" federal budgets would mean. Anyone who tells you otherwise is either ignorant or trying to fool you.

Conventional wisdom says that the stock market would soar if people invested in corporate paper instead of government paper, and that less federal spending means more spending on Main Street. According to that line of thinking, the U.S. monetary system is a zero-sum game.

But, after three years of reading about our system, I no longer believe that it works that way. Let me channel, for a few paragraphs, the ideas of Warren Mosler, Stephanie Kelton and other proponents of Modern Monetary Theory—which is not a theory so much as a clearer understanding of the way our financial system actually functions.

As everyone knows, local banks create money out of thin air when they grant lines of credit. We seem to agree that that's not a bad thing—as long as you don't overdo it. As everyone may also know, the banks' bank—the Fed—also creates money out of thin air. That's not a bad thing either—as long as you don't overdo it.

Sure, we've overdone it. For decades. But now is not the time for the Fed and the Treasury Department and the U.S. Congress to suddenly under-do it. Yes, we're collectively sitting on a somewhat rotten limb. But we shouldn't necessarily saw off that limb. And not on the basis of misconceptions.

One of the myths in our politics and our economy—a myth that both presidential candidates seem to honor, more or less—is that the private sector funds the government through taxes that are, as some people like to put it, "confiscatory."

Not so. Under our financial system, the federal government funds the private sector by spending money into existence. Then it reverses the process and extinguishes part of the money by collecting federal taxes.

As the investor/writer Warren Mosler puts it, “The funds to pay taxes and buy government securities come from government spending.”

There’s a related myth that we’re in the hole to Chinese lenders. Not true. We aren’t running up a suicidal credit card balance with the Chinese. We pay dollars to the Chinese for inexpensive goods. With some of those dollars, the Chinese buy U.S. Treasuries. The Chinese, in effect, hand us the money with which we will repay them.

When I chat with my neighbors over the back fence, they often segue from complaining about federal taxes to complaining about local property taxes. They don’t see the fundamental difference between the two. Local taxes are the dues we pay to live in a community and use public services. Local governments don’t issue the currency that we use to pay them.

But our federal government, by definition and design, is different.

Financially, it operates counterclockwise to the local government and the private economy. As the chart from economist Stephanie Kelton on this page shows, when the federal government runs a deficit, the private sector experiences a surplus. And when the federal government runs a surplus (as it did at the end of the Clinton administration) a private sector deficit soon follows.

Many people will find it difficult to accept the notion that the run-up in asset prices over the past 30 years—all that “wealth creation” that Boomers plan to retire on—was largely financed by the enormous run-up in federal debt over the past 30 years.

Believe it. It can’t be otherwise. Every debt has a corresponding asset. And vice-versa. If we balance the budget and shrink the federal debt, we shrink everyone’s assets.

Don’t get me wrong: The current monetary situation isn’t healthy. We’re merely enjoying the false health of a well-supplied addict. But I, for one, would rather not eat cold turkey this Thanksgiving.