

Revisiting the Liberal Agenda (January 2005)

Dear Senator Lieberman,

The following is to provide you with a working knowledge of our current floating exchange system, and apply it to a variety of national issues. I hope you find this useful for formulating proposals that utilize our monetary system to advance your economic and social agenda. In fact, that is the very point of a national monetary system!

Sincerely,

Warren Mosler

Social Security

This is an ideal starting point for the understanding of our current monetary system. Today government spends only one way- crediting a member bank account at the Fed.

When you hear terms like 'printing money,' 'money finance,' 'debt finance,' and 'monetization' as well as 'sterilized vs. unsterilized intervention' etc. rest assured that these have NO APPLICATION WHATSOEVER. They are throwbacks to the days of gold standards and also apply to some of today's fixed exchange rate regimes, but NOT to the US today.

When a senior receives a social security payment, it is either directly credited to his bank account or he is sent a check that, when cleared, results in a credit to his bank account. If, for example, he had \$2,000 in his account, and the new payment is \$1,000, all that happens is the Fed changes the balance in his bank's reserve account at the Fed, and the bank simultaneously changes the senior's bank account balance from \$2,000 to \$3,000. **Payment consists of the Fed changing a number.** Operationally, there are no constraints (other than self imposed constraints) to this process. The Fed can just as easily credit \$1,000, \$10,000, or \$10,000,000 regardless of prior or future tax collection, borrowing etc. The process is not constrained by revenue. Yes, excessive payment can cause 'inflation' and currency depreciation, but **government checks will not 'bounce.'** **There is NO solvency issue.** So in the future, should some such government 'reserve fund run out' social security checks will not bounce. Yes, there may be an increase in 'inflation' but that is a totally separate issue. Critics of the social security system can only rightly address 'fairness' issues and attempt to quantify 'inflation' issues. Seniors should know this. So should young people. They should not be frightened by those who errantly proclaim future government insolvency. And those who do should be discredited and dismissed from the debate.

Likewise, when government collects taxes, it debits a member bank reserve account. So if it charges a tax of \$1,000, it reduces a private sector bank account by that amount. The government doesn't 'collect' anything or get 'richer' by this process. Yes, it accounts for the transactions, but that is after the fact record keeping only, not a transfer of resources. Government spending increases private bank accounts, taxing reduces them. In fact, the first macro equation we learn- and the one that the government accountants must balance to or find their math error- is as follows:

Government Deficit = Non Government Surplus

(‘Non government’ includes residents and non residents, business and households, etc.)

When government spends and runs deficits, it credits private bank accounts more than it debits them, thereby increasing the savings of \$US financial assets of the non government sector. In fact, non government savings of \$US financial assets can ONLY increase if the government runs deficits, and they increase by that EXACT amount. The reverse is true of surpluses. Government surpluses NECESSARILY reduce non government savings by that exact amount as well.

Therefore, the projection of a \$5.6 trillion government surplus a few years back was also in fact necessarily projecting a \$5.6 trillion drop in non government savings! For all practical purposes, this was a ludicrous projection, as there is no way private savings can be reduced by that amount without virtually eliminating everyone’s retirement accounts and in the process eliminating private spending, employment, and income. The CBO should have known better. It was a disgrace and remains a black mark on that agency, along with the other economic ‘think tanks’ that failed to point to this accounting fundamental. This includes the Concord Coalition, whose ‘deficit clock’ should be renamed the ‘savings clock’ as the same number represents the savings of the private sector, including US residents and non residents. Yet, far from recognizing this inexcusable error, the same people continue to expound the virtues of government surpluses!

I would suggest having the US Government reaffirm its legal obligation to issue and clear any and all social security checks in a timely manner, regardless of the status of the trust funds. This should becalm seniors who are frightened about government solvency to the point of voting for debilitating ‘fiscal responsibility’ that results in slow growth, excess capacity, and high unemployment.

Fiscal Policy and the Business Cycle

Certain facts stand out once fiscal policy is understood as previously explained. Our last budget surplus ended in 2001, and was reported as the longest surplus since 1927-1930. (Hopefully those dates ring a bell!) In fact, the first six US depressions followed the first six sustained budget surpluses. In 1836, President Jackson actually paid off the federal debt and the worst depression on record followed. The last major nation to allow a budget surplus was Japan, 1987-1992, and they are only now emerging from a decade plus economic nap, and record unemployment. It’s quite simple, **government surpluses drain savings from the economy, eventually destroying it.** And economies do not recover until AFTER there has been a large enough deficit to restore lost equity (and income) and supply sufficient net financial equity to support the next credit cycle.

The Role of Government Securities

It is clear that government securities are not needed to ‘fund’ expenditures, as all spending is but the process of crediting a private bank account at the Fed. Nor do government securities remove wealth, as someone buying them takes funds from his bank account (which is a \$US financial asset) to pay for them, and receives a government security (which is also a \$US financial asset). One’s net wealth is the same whether you have \$1 million in a bank account or a \$1 million Treasury security. In fact, a Treasury security is functionally nothing more than a time deposit at the Fed.

About 10 years ago 'Soft Currency Economics' was written to reveal that government securities function to support interest rates and not to fund expenditures as generally perceived. It goes through the debits and credits of reserve accounting in detail, to the point that government, when the Fed and Treasury are considered together, is best thought of as spending first, then offering securities for sale. Government spending adds funds to member bank reserve accounts. These accounts do not pay interest. So if securities are not offered for sale, it's not that government checks bounce, but that interest rates fall to 0. This is because when banks have excess reserves, they offer them in the fed funds market; if the government doesn't offer new securities, the excess supply of reserves in the fed funds market quickly drives the fed funds rate to 0. Government securities offer interest bearing alternatives to non interest bearing reserve accounts, and thereby 'support' interest rates at the Fed's target rate.

In the real world, we know this must be true. Look at Turkey- quadrillions of lira of deficit spending (above 25% of GDP- as high as US deficits during WWII), interest rate targets often at 100%, inflation nearly the same, continuous currency depreciation, no confidence whatsoever, yet 'finance' in lira is never an issue. Government lira checks never bounce. If they relied on 'funding' (that is, borrowing from the markets) to sustain spending (as some would presume they do), they would have been shut down long ago. Same with Japan- 140% total government debt to GDP, 7% annual deficits, downgraded below Botswana, and yet government yen checks never bounce, and 3 month government securities fund near 0%. Again, clearly 'funding' is not the imperative.

The US is often labelled 'the world's largest debtor.' But what does it actually 'owe?'

For example, assume the US government bought a foreign vehicle for \$50,000. The government has the car, and a non resident has a bank account with \$50,000 in it, mirroring the \$50,000 his bank has in its account at the Fed that it received for the sale of the car. The non resident now decides that instead of the non interest bearing demand deposit, he'd rather have a \$50,000 Treasury security, which he buys from the government.

Bottom line- the US government gets the car, the non resident holds the government security. Now what exactly does the government owe? When the \$50,000 security matures, all the government has 'promised' is to replace the security held at the Fed with a \$50,000 (plus interest) credit to a member bank reserve account at the Fed. One financial asset is exchanged for another. The Fed exchanges an interest bearing financial asset (the security) with a non interest bearing asset. That is the ENTIRE obligation of the government regarding its securities. That's why debt outstanding in a government's currency of issue is never a solvency issue.

Deficits and Interest Rates

Japan has clearly demonstrated that deficits per se do not cause higher interest rates. Rates go wherever the Central Bank says they will go. End of story.

Taxation

What is the point of taxation, as taxes are not needed to 'finance' spending? Taxes, at the macro level, serve to cause people to offer real goods and services for sale to get the thing needed to comply with tax liabilities. This allows the government to spend its otherwise worthless currency. So in this sense taxes are the very source of value for a floating exchange rate currency. The currency can be considered tax driven. Without taxes, the currency would have no value, much like Confederate \$.

How High 'Should' the Deficit Be?

When 'inflation' is 'low,' unemployment 'high,' and the output gap growing, the deficit is probably way too small. The economy is screaming for more net financial assets that, as previously explained, only government deficit spending can provide. When unemployment is very low, prices rising, and excess capacity at a minimum the deficit is probably too high. But solvency is never the issue. The economy is the issue.

During the last two recessions the economy did not improve in a meaningful way until after the deficit reached about 5% of GDP. This time around the deficit is now at about 5% of GDP and at best the economy is showing some tentative signs of improvement. But this time around it may take a higher deficit to turn the economy, as the previous surplus deeply eroded savings, and the non resident desire to save \$US financial assets is very high as well, as evidenced by our trade deficit.

*** This was written in October 2003. The fiscal adjustments (tax cuts, etc.) that took effect in the 3rd quarter of 2003 were equal to a federal deficit of about 8% of GDP due to the retroactive rebates. Subsequently the economy improved, as evidenced by GDP growth and employment growth. Unfortunately, the deficit again has been allowed to decrease, and is now annualizing at only about 3% of GDP, so I expect a return to a weak economy and a return to the theme of 'deflation.' ****

Here's how that works. If on balance, Americans purchase foreign goods/services, we use up some of our 'purchasing power.' That can mean we don't have enough purchasing power left over to buy all of our own goods/services we can produce at full employment, UNLESS government runs sufficient deficits to make up for this shortfall. So the negative trade gap allows us to enjoy either lower taxes or the benefits of higher government spending, so we can consume BOTH whatever we can produce AND whatever the foreign sector wants to (net) send to us. The economic fundamental is that exports are a real cost and imports are a real benefit. Economically, scripture notwithstanding, it's better to receive real goods and services than to give them!

Our well being depends on appropriate policy response. Current circumstances allow us to run much higher deficits to sustain sufficient aggregate demand to close our output gap. That means lower taxes or more government spending is in order.

The current trade gap is a reflection of non resident desires to net save \$US financial assets. The only way the foreign sector can do this is to net export to the US and keep the \$US either as cash or securities. So the trade deficit is not a matter of the US being dependent on borrowing offshore, as pundits proclaim daily, but a case of offshore investors desiring to hold \$US financial assets. To accomplish their savings desires, they vigorously compete in US markets, selling at the lowest possible prices, and attempt to drive down their own domestic wages in their drive for 'competitiveness,' all to our advantage in real terms! If they lose their desire to hold \$US, they will either spend them here or not sell us products to begin with, in which case that will mean a balanced trade position. Yes, this process could mean an adjustment in the foreign currency markets, but it does NOT threaten a financial crisis for the US.

The trade deficit is a boon to the US. There need not be a 'jobs' issue associated with it. Fiscal policy can ensure Americans have enough spending power to purchase both

our own full employment output and anything the foreign sector may wish to sell us to meet their savings desires.

Our steel industry, on the other hand, is important as a matter of national security. However, I would suggest that steel tariffs be eliminated and instead defence contractors be ordered to use only domestic steel. This will ensure a domestic steel industry capable of meeting our defence needs, with defence contractors paying a bit extra for domestically produced steel, while at the same time lowering the price for non- strategic consumption which would currently be mostly imported steel.

Using a Labour Buffer Stock to Let the Markets Decide the Optimum Deficit

To ensure a 0 'output gap' and substantially reduce unemployment the government can offer an \$8 per hour job to anyone willing and able to work. To execute this program, the government can first inform its existing agencies that anyone hired at \$8 per hour doesn't 'count' for its annual budget expenditures. Additionally, these agencies can advertise their need for \$8 per hour employees with the local government unemployment office, where anyone willing and able to work can be dispatched to the available job openings. This job will include full benefits, including health care, vacation, etc. These positions will form a national labour 'buffer stock' in the sense that it will be expected that these employees will be prone to being hired by the private sector when the economy improves. As a buffer stock program this is highly countercyclical- anti inflationary in a recovery, and anti deflationary in a slowdown. Furthermore, it allows the market to determine the government deficit, which automatically sets it at a near 'neutral' level.

In addition to the direct benefits of more output from more workers, the indirect benefits of full employment should be very high as well. These include reduced crime, reduced domestic violence, reduced incarcerations, etc. In particular, teen and minority employment should increase dramatically, hopefully breaking the current employment morass.

Interest Rates and Monetary Policy

It is the realm of the Federal Reserve to decide the nation's interest rates. I see every reason to keep the 'risk free' interest rate at a minimum, and let the market decide the subsequent credit spreads as it assesses risk.

Since government securities function to support interest rates, and not to finance expenditure, they are not necessary for the operation of government. Therefore, I would instruct the Treasury to cease to issue securities longer than 90 days. This will serve to lower long term rates and support investment, including housing. Note that the Treasury issuing long term securities and the Fed subsequently buying them, as recently proposed, is functionally identical to the Treasury simply not issuing the securities in the first place. I would also instruct the Federal Reserve to maintain a Japan like 0% fed funds rate. This is not inflationary nor does it cause currency depreciation, as Japan has demonstrated for over 10 years. Remember, for every \$ borrowed in the banking system, there is a \$ saved. Therefore, changing rates shifts income from one group to another. The net income effect is 0. Additionally, the non government sector is a net holder of government securities, which means there are that many more \$ saved than borrowed. Therefore lower interest rates mean lower interest income for the non

government sector. It is only if the propensity to consume of borrowers is substantially higher than that of savers that the effect of lower interest rates be expansionary in an undesirable way. History has shown this never to be the case.

Lower long term rates support investment, which encourages productivity and growth. High risk free interest rates support those living off of interest payments (rentiers) thereby reducing the size of the labour force and consequently reducing real national output.

I would also recommend that the Treasury explicitly guarantee the debt of the FHLB and FNMA. This will serve to reduce their funding costs which will entirely be passed through to qualifying homebuyers. There is no reason to give investors today's excess funding costs due to the uncertainty over today's indirect guarantees, when in all likelihood the government would support its housing agencies in the national interest. Furthermore, an explicit guarantee eliminates the risk of a liquidity crisis, thereby reducing the risk of an actual loss.

More on Taxation

The most regressive taxes are the payroll taxes. Unfortunately, the myth of the necessity of the social security trust funds keeps them from being touched. They are one of the first taxes to consider for elimination. This would lower costs for business which would keep prices down and increase income for workers.

The income tax is also a source of concern due to the very high compliance costs. These include all of the record keeping, accountants, lawyers, courtrooms, most of the insurance industry, a substantial offshore sector, etc. etc. I estimate the real compliance costs of this tax are somewhere in the range of 5-15% of GDP.

Sales taxes act as millions of self imposed tariffs that discourage trade within our borders and reduce our standard of living as benefits of comparative advantage and specialization of labour are punished and discouraged.

I think the most efficient tax we have is the real estate tax. It can be made progressive as much as desired and can be designed to do things like minimize energy usage as well. It is readily enforceable at low cost, and the infrastructure is already in place at the local level. In theory, a Federal real estate tax could entirely replace the Federal income tax and sales taxes as well.

Other Issues for Consideration

Strategic Stockpiles-

When families lived on farms, it made sense to store perhaps a year or more of food for emergencies, crop failures, etc. Today with families living in cities, they save \$ for emergencies. However, in the event of actual shortages of food and other strategic supplies, saved money will not do the trick. It becomes a matter of public purpose to insure there are actual strategic reserves for emergency consumption. Currently we have a strategic oil reserve. This should be extended to stores of other necessities for the purpose of emergency consumption. The purpose should not be to support special interest groups, but to provide the consumer with real savings of actual consumables for rainy days.

Medical Savings Accounts

This is a proposal to give everyone an account that has perhaps \$5,000 in it to be used only for medical purposes. At the end of each year, any unspent funds remaining in the account are paid to that individual as a 'cash rebate' when filing his tax return. Anything above \$5,000 would be covered by catastrophic insurance. This proposal implements incentives for people to minimize medical expenses, frees up physician time previously spent in discussion with insurance companies, and reduces insurance company participation in the process. This will greatly reduce demands on the medical system while substantially increasing the supply of available doctor /patient time, while making sure all Americans have coverage. To make sure preventative measures are taken, the year end rebate can be dependant, for example, on the individual getting an annual check up, and/or any medical testing the govt. would like to require.

'NOTE- I HAVE SUBSEQUENTLY ADDED TO THIS PROPOSAL THAT THE REBATE FOR UNSPENT FUNDS SHOULD NOT EXCEED PERHAPS \$3,000. THIS WILL PROVIDE INCENTIVES FOR PEOPLE TO USE AT LEAST \$2,000 OF THEIR FUNDS EACH YEAR SINCE THOSE ARE NOT SUBJECT TO REBATE. THIS MEASURE INSURES EVEN PEOPLE IN DIRE NEED OF INCOME AND ALSO IN NEED OF MEDICAL CARE HAVE AT LEAST \$2,000 THE WILL SPEND.

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