How the Fed Finances U.S. Debt

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Judy Shelton, a well-known U.S. economist, provided us with an academic explanation by way of an editorial in the Wall Street Journal on Thursday, October 14, 2021, that provides us with a classical interpretation of the evils of money creation. To summarize her article, "Before the debt crisis reaches its next crescendo, it's worth scrutinizing the sleight-of-hand financial arrangements and dodgy accounting principles that foster confusion and hysteria as Treasury bumps up against the federal borrowing limit." The direction of Ms. Shelton's piece was to call into question the whole idea of a budget cap and a restraint on spending that has been set by the government and that causes periodic crises every time the spending limit is approached, and politicians threaten to abrogate their duty to raise that debt limit and cause a mini financial crisis if the government defaults on its debt payments.

Let's remember that in August of 1971, President Nixon took us off the gold standard. This action resulted in the U.S. dollar becoming a fiat currency with a value assigned by financial markets. The advantage was that the U.S. was no longer tied to a gold standard and could use monetary policy as a tool in providing a safety net under the economy when crises threatened the financial system. This new fiat currency had no constraints—except one: the prospect of creating inflation if there was excess printing of money.

The first real test of this new monetary theory took place during the financial meltdown of 2008-2009. The Federal Reserve bought billions of dollars of bonds especially mortgage-backed securities to minimize the chances of a broad-based financial meltdown after the failure of Lehman Brothers, a leading Wall Street brokerage firm. This so-called printing of money produced a resounding rejection by traditional economists claiming that inflation was just one or two years away. Even though the economy bumped along at a 2-3% growth rate for the early 2010s, there was little inflation. The conversation emerged that the level of inflation was uncomfortably below the Fed's target of 2% and that monetary policy should maintain low interest rates until "normal" economic growth resumed. What happened to all those threats of imminent inflation?

As Ms. Shelton pointed out, weird things may happen when the Treasury bumps up against the federal borrowing limit. But we know that, in a fiat currency economy, that limit is set by "fiat" and that the politicians bear the full responsibility of passing legislation to raise the limit or to plunge the economy into a financial crisis. Yet we have observed over many such crises, the government ultimately raises the debt limit to accommodate economic growth. The Fed has no limit on how much money it can provide to insure stable economic growth and moderate if not low inflation after this temporary Covid-induced bulge in pent up demand dissipates. The recent rally in stock prices after a summer swoon is a testament to the fact that financial markets appreciate the role the Fed is playing in financing the federal debt. The world is similarly appreciative. Last week the U.S. dollar hit a new high indicating a lack of inflation. Similarly, gold prices, a typical benchmark of inflation, show no indication that inflation is here.