US debt ceiling crisis: a self-inflicted wound

Why would any government ever want to do default, given that the economic consequences of such an act would be disastrous for itself, its own people and even the global economy?

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As the world anxiously awaits the outcome of negotiations between the Democrats and Republicans over raising the debt ceiling in return for an agreement on future spending cuts by the Biden government, it is perhaps a good time to reflect on what really is 'national debt'.

To begin with, it is critical to distinguish between countries which issue their own fiat (inconvertible) currencies like the US, UK, India, Japan, Canada, and so on from those that do not, in particular, Eurozone member states as well as a small number of others which adopt a fixed exchange rate. This essay discusses national debt of the former group of countries, a majority in the world today.

To understand a country's central or federal government (referred hereon as government) 'borrowings' denominated in its own sovereign fiat currency as 'debt' like those of non-central government (referred hereon as non-government) entities including state governments, local governments, corporations and households is fundamentally flawed and is consequently the root cause of an equally flawed debate.

Suppose an individual borrows Rs.100 from a friend to buy a cup of tea, which she promises to repay the next day. What exactly has she borrowed and what must she repay? She borrows the financial liability of the government or more precisely, its institution the Reserve Bank of India (RBI) – the Rs.100 promissory note signed by the Governor of the RBI – in exchange for her own promissory note to her friend (the loan). When repayment or closure of the loan becomes due, she must give back to her friend a promissory note issued by the government. Inability to do so results in debt default. Unfortunately, she cannot (re)issue her own promissory note in final settlement or closure of the debt.

What about the government? First and foremost, it borrows its own promissory notes, which no other institution but its own issues (say, dollars in the US or rupees in India). Calling this 'debt' is problematic because no other entity in an economy 'borrows' its own financial liabilities. Second, repayment is made *only* in its own fiat currency, i.e., in its own financial liabilities. Once again, no other entity can make a *final* settlement of its debt with its own promissory notes (keeping aside demand deposits at banks). In some cases, it is possible for non-government entities to roll over debt temporarily with issue of new promises to pay but this is not final settlement.

This immediately raises the question as to why a government needs to borrow its own financial liabilities in the first place? Why not just issue new ones? And most importantly, why does the non-government sector even accept these promissory notes?

Modern Money Theory (MMT) provides answers to these questions. It is because a sovereign government is able to impose and enforce tax payments or other obligations owed to it only in its own fiat currencies. However, unless the government first spends its promissory notes (say, dollars or rupees) into existence, which people accept in exchange for resources that they possess, primarily labour, there is no way for the government to collect them back as taxes. Spending creates money, taxes destroy money. If the government were to seek a balanced budget, it could simply tax all that it has spent. This would mean that the non-government sector is left without any money, a medium of exchange as well as a financial asset. No state would want such a situation. However, if the government considers that the quantum of money or purchasing power remaining with the non-government sector is inflationary, it could issue bonds (or 'debt') to postpone its utilization for purchase of goods and services in return for an interest payment as incentive.

The 'debt' or financial liabilities of the government is at the same time a financial asset of the non-government sector. The $31 trillion dollar US national debt is nothing but financial assets of non-US government entities – held by its own citizens as well as by foreign governments and non-government entities. It is also the safest financial asset held by the non-government sector since it is backed by the power of the government to issue fiat money to repay its debt and not by physical assets. It is no wonder then that a cursory glance at national debt of economically sovereign states always show a constantly increasing volume of debt even though the debt to GDP ratios may rise or fall. Debt repayment by the state or writing off the financial liabilities of the government in effect means writing off the financial assets of non-government entities.

A debt ceiling by an economically sovereign government is a *self-imposed* constraint on itself. As Treasury Secretary, **Janet Yellen** had put it some months ago, the US is 'flirting with the self-inflicted crisis.'

And debt default can only happen if a government *chooses* to do so.

But why would any government ever want to do so given that the economic consequences of such an act would be disastrous for itself, its own people and even the global economy?

Let's consider a few consequences of a US debt default. Asset values on the balance sheets of non-government entities from individuals to corporations would plunge, resulting in widespread bankruptcies, destruction of businesses and a collapse into recession or even a depression. Bank balance sheets – which hold massive amounts of government debt – would also implode. What we saw in the Silicon Valley Bank (SVB) crisis with just a fall in market price of government securities will seem like a mere blip compared to US government debt default where asset values of government securities fall to zero.

Globally, confidence over the dollar as international reserve currency, which is already being questioned, will be irreparably damaged. Even as some may argue that this could be a positive event, there will undoubtedly be immediate and severe repercussions on international trade and capital flows.

All this would only mean that fiscal policy kicks in as an automatic stabilizer wherein tax collections fall while government spending on social security and other benefits surges, widening the US fiscal deficit and raising its debt to GDP ratio with both an increasing numerator and falling denominator.

While a complete debt default by the US government will never happen, even a small default could open the window of uncertainty. In fact, it is quite farcical for a (struggling) hegemonic power like the US to make the world anxiously wait for some unknown X-date just when countries (including the US) are trying to put their economies back on track in the aftermath of the Covid-19 pandemic and ongoing Ukraine-Russia war.

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