The New View of Government Debt

- Economists no longer see rising government debt as a problem in the way they used to.
- Partly due to new debates in economic theory
- But mainly because of new developments in the economy
  - High public debt has not led to rising interest rates
  - Inflation no longer a problem, instead demand is persistently too low – “secular stagnation”
  - What made sense in the 1990s may not make sense today!
- Today, strong argument that too little public debt is bigger threat than too much

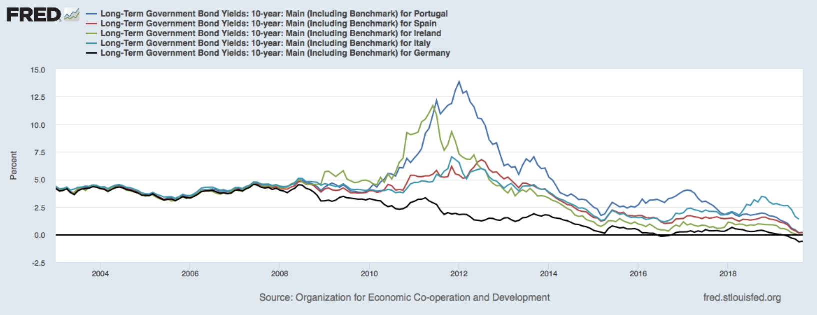
Financial vs Real Costs

Important to distinguish *financial* cost of increased public spending from *real* costs.

- Problem of financing public spending
  - What mix of borrowing and tax increases will produce the dollars in to match the new dollars going out?
  - How much public debt can/should the financial system hold?
- Problem of real resources for public spending
  - Where will the labor, business capacity, raw materials for the spending come from?
  - How close is the economy to potential output?
  - What are the effects of too much or too little demand?

How Do We Know When Debt Is Too High?

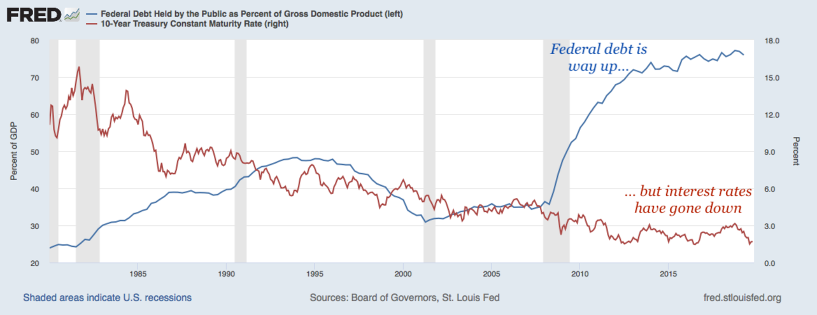
When markets doubt a government can repay its debts, interest rates rise...



Source: Organization for Economic Co-operation and Development

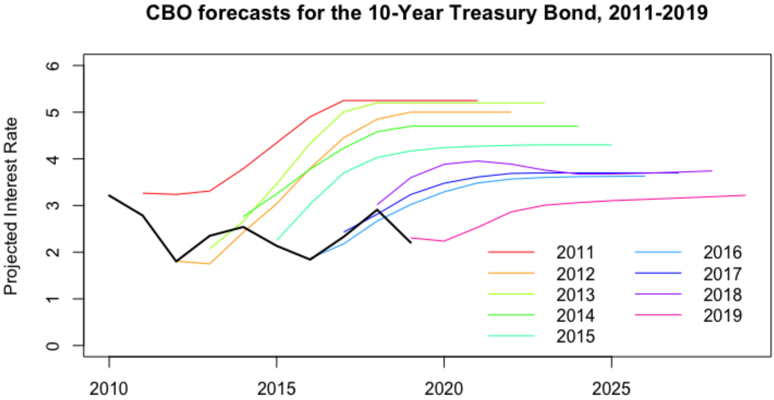
... but a determined central bank can push them back down.

Has Rising Federal Debt Led to Rising Interest Rates?



- Interest rate on 10-year Treasury bond recently hit 1.7 percent, lowest rate in history of US
- If financial markets were worried about debt sustainability, rates would be going up, not down

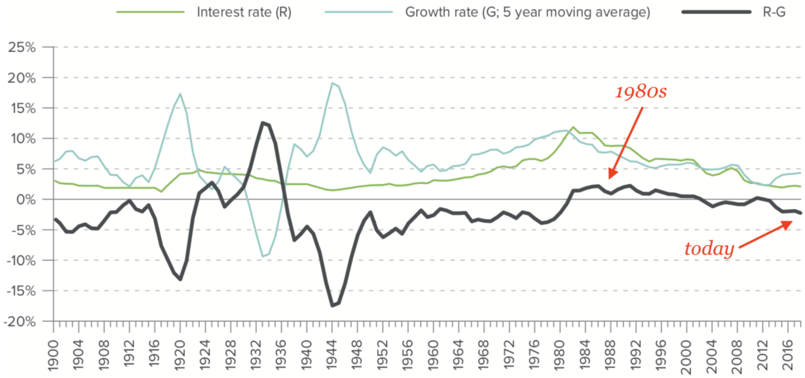
Predictions of Rising Rates Repeatedly Proved Wrong



With Interest Rates Low, Debt Can’t “Snowball”

- The math of government debt depends on whether the interest rate is greater or less than the growth rate
- When interest rates are *above* GDP growth rates
    - Persistent deficits cause the debt-GDP ratio to rise without limit
    - To stabilize the debt-GDP ratio, deficits in one year have to be offset with surpluses later
- When interest rates are *below* GDP growth rates
    - The debt ratio will stabilize eventually even if the government runs deficits forever
    - A temporary deficit has no lasting effect on the debt-GDP ratio

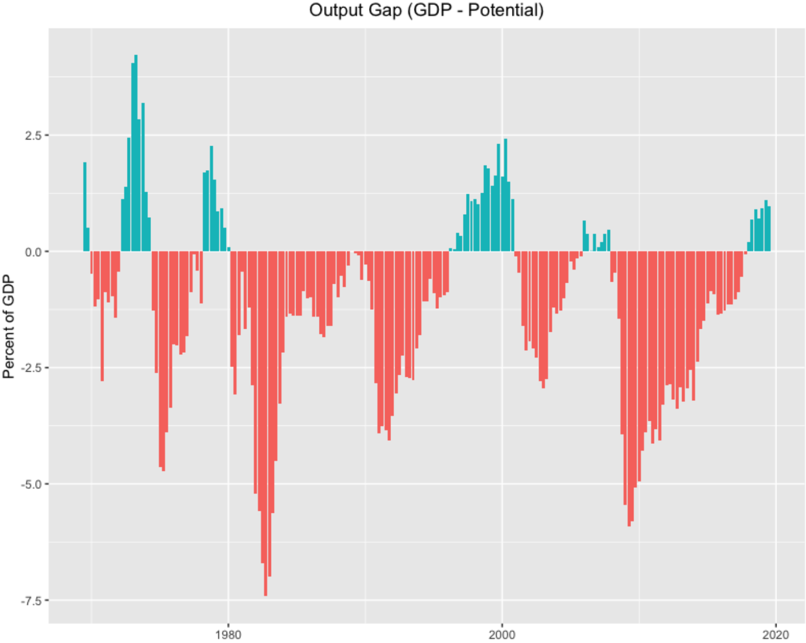
Except for the 1980s-1990s, US Interest Rates Are Normally Below Growth Rates



Real Resources Are the Real Constraint

- There is no limit to how many dollars the federal government can spend
- But there is a limit to the goods and services it can buy
- Difference from household or business, which *does* worry about how many dollars it can spend, but does *not* worry about whether the economy can produce things for it to buy
- Real resources may or may not be problem in practice, depending on whether the economy is at **potential**

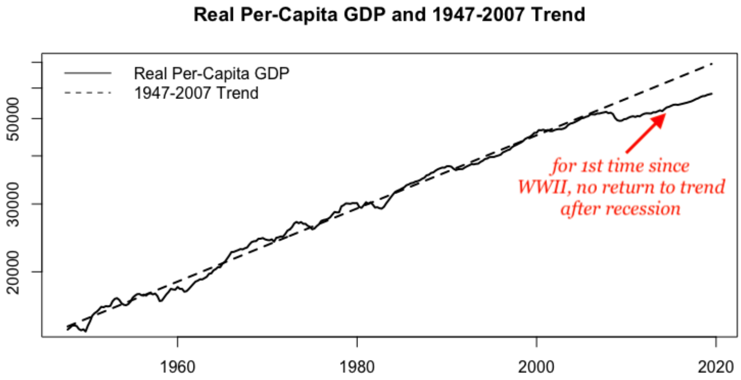
By Official Measures, GDP Is Usually below Potential



Official Measures Probably Understate Potential - 1

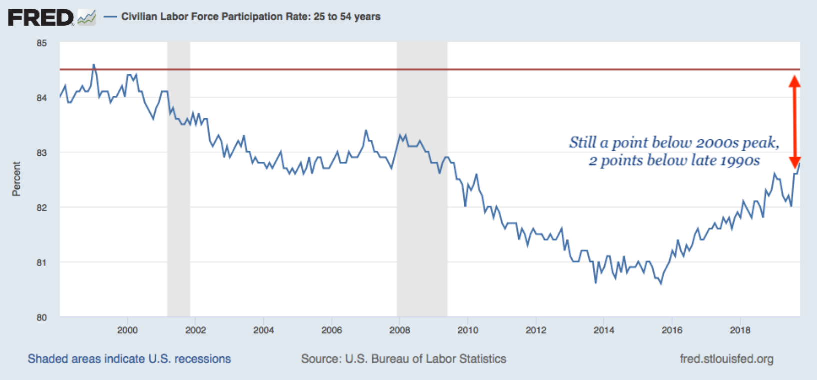
- Is the economy really operating above potential today? If so, we should see...
  - High and/or rising inflation
  - Accelerating wage gains
  - Above-trend GDP growth
  - Widening trade deficit
  - Fed raising rates
- None of this is happening.
- Arguments for “secular stagnation”, “global savings glut” suggest demand may fall short of supply for indefinite future

Official Measures Probably Understate Potential - 2



- Unlike previous business cycles, there was no period of fast growth in the recovery from the 2007 recession
- GDP is now 15% below pre-2007 trend
- At least some of this gap is due to ongoing weak demand

Official Measures Probably Understate Potential - 3



- Labor force participation still low by historical standards, even adjusting for age
- Large # of nonworking prime-age adults suggests official unemployment rate understates slack in labor market

Economics of Government Spending and Debt Look Different in Stagnant Economy

- When output below potential, government spending mobilizes unused capacity, rather than crowding out private spending
- Public spending raises private incomes and production, in addition to direct benefits
- If there is “hysteresis” – changes in demand affect potential output – gains even bigger
  - Temporary overheating leads to faster growth in long run
  - Demand shortfalls even more costly - permanently reduce laborforce and productivity growth, not just current output
  - Economists increasingly believe hysteresis is real and important
- Secular stagnation implies we need more public spending all the time, not just in recessions

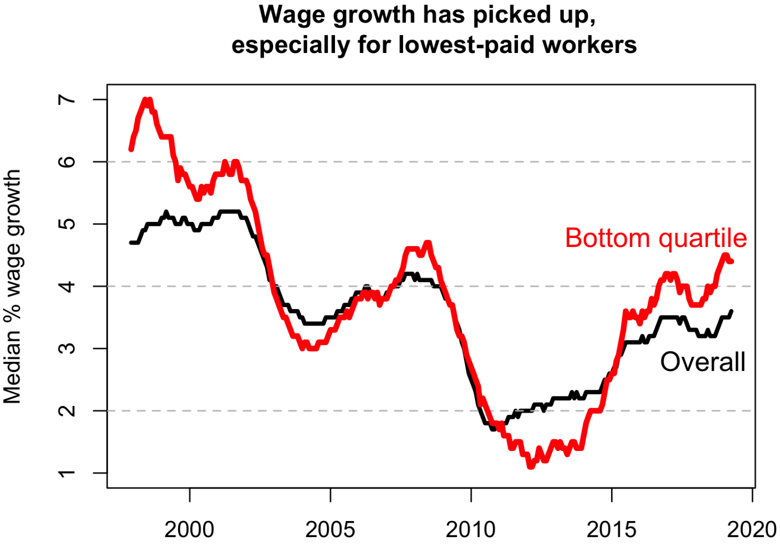
Policy Today Needs to Plan for Future Recession

- Even if economy close to potential today, near-certainty of recession sometime in next decade
- Lesson from 2007-2009 suggest we should want higher spending before recession starts
  - Conventional monetary policy not strong enough to offset large negative demand shock
  - ... and Fed will even less space to cut rates this time
  - Fiscal policy works - empirical evidence is overwhelming
  - ... but cannot be ramped up quickly (few "shovel-ready" projects)
- Risks not symmetric – deep downturns more dangerous than overheating
- Starting with stronger demand makes it less likely that negative shock will turn into deep slump

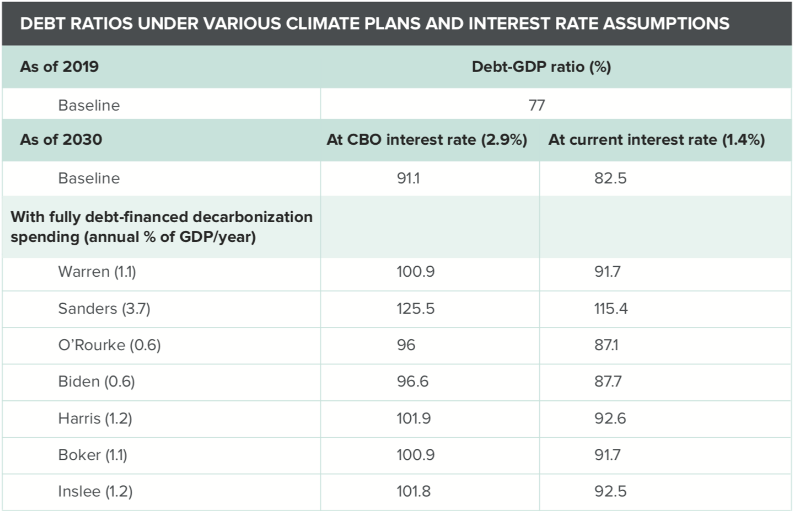
There Are Good Reasons to Want “Too Much” Demand

- Strong labor market needed to raise wages
- Tight labor markets favor those at back of hiring queue
  - One point fall in overall unemployment rate = 2 point fall for African-Americans
  - Only when measured unemployment is below 4 percent, as today and in late 1990s, do low-wage workers get above-average wage gains
  - Need years more of strong demand to recover lost ground
  - If we are not willing/able to run economy hot, labor share of income will never rise
- “High-pressure” economy also favors innovation, new business formation, investment

When Labor Market Tight, Low-wage Workers Catch Up



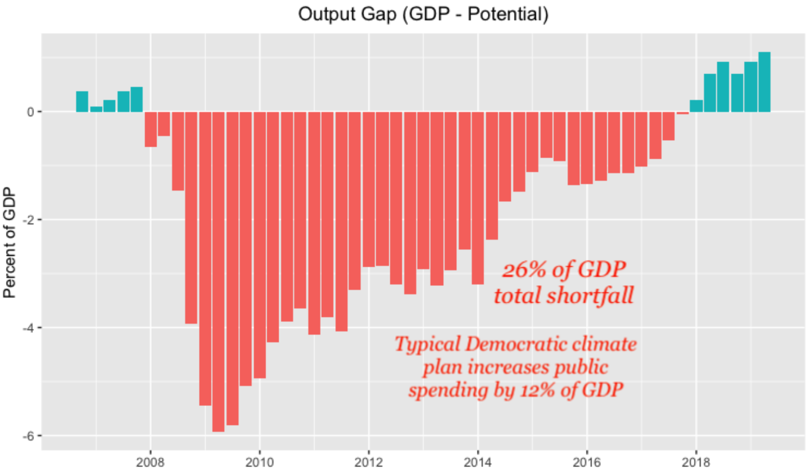
Carbon Plans Would Only Modestly Increase Debt



DEBT RATIOS UNDER VARIOUS CLIMATE PLANS AND INTEREST RATE ASSUMPTIONS

As of 2019	**Debt-GDP ratio (%)**	
Baseline	77	
As of 2030	**At CBO interest rate (2.9%)**	**At current interest rate (1.4%)**
Baseline	91.1	82.5
With fully debt-financed decarbonization spending (annual % of GDP/year)		
Warren (1.1)	100.9	91.7
Sanders (3.7)	125.5	115.4
O'Rourke (0.6)	96	87.1
Biden (0.6)	96.6	87.7
Harris (1.2)	101.9	92.6
Boker (1.1)	100.9	91.7
Inslee (1.2)	101.8	92.5

Carbon Plans May Not Raise Demand Enough



26% of GDP total shortfall

Typical Democratic climate plan increases public spending by 12% of GDP

Carbon Plans May Not Raise Demand Enough

- By official measure, cumulative demand shortfall over 2008-2017 was 26 percent of GDP
  - True gap probably bigger
- Huge cost not only in foregone output but in increased poverty, economic insecurity, disrupted lives
- Most candidate decarbonization plans call for total public spending around 11-12 percent of GDP
- So even if paid for entirely in debt, would still have been only half the stimulus needed
- So from macroeconomic perspective, should not be asking: Can we afford to spend this much?
- Should be asking: Is the spending in these plans enough?

Thank you.