

# 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

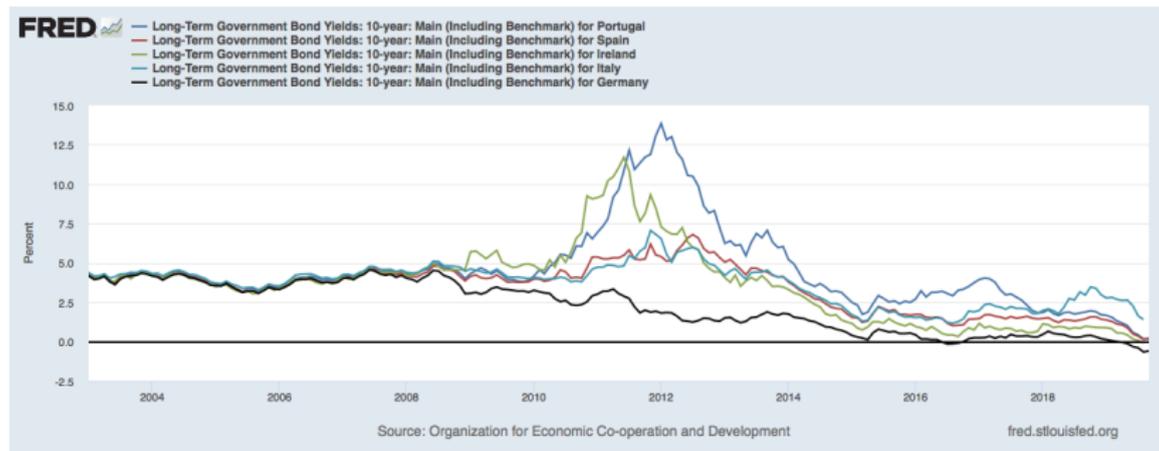
# Financial vs Real Costs

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?

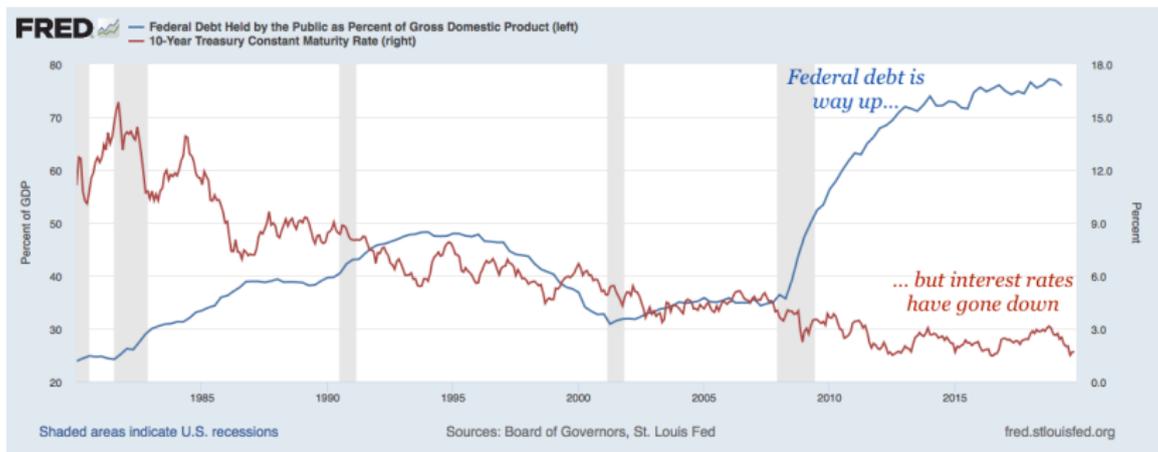
# How Do We Know When Debt Is Too High?

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



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

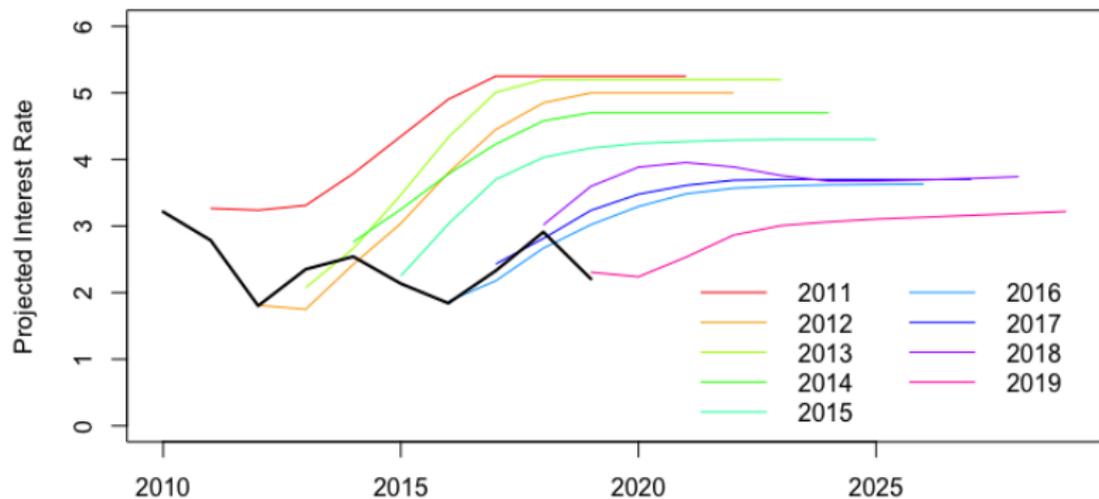
# Debt Has Gone Up, Interest Rates Have Stayed Low



- ▶ 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

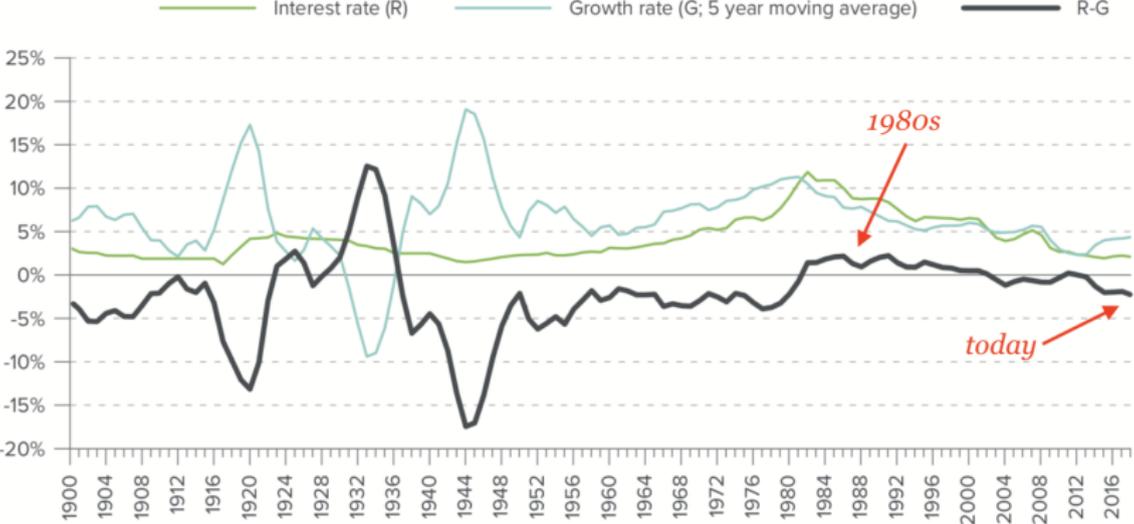
**CBO forecasts for the 10-Year Treasury Bond, 2011-2019**



# 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 interest 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

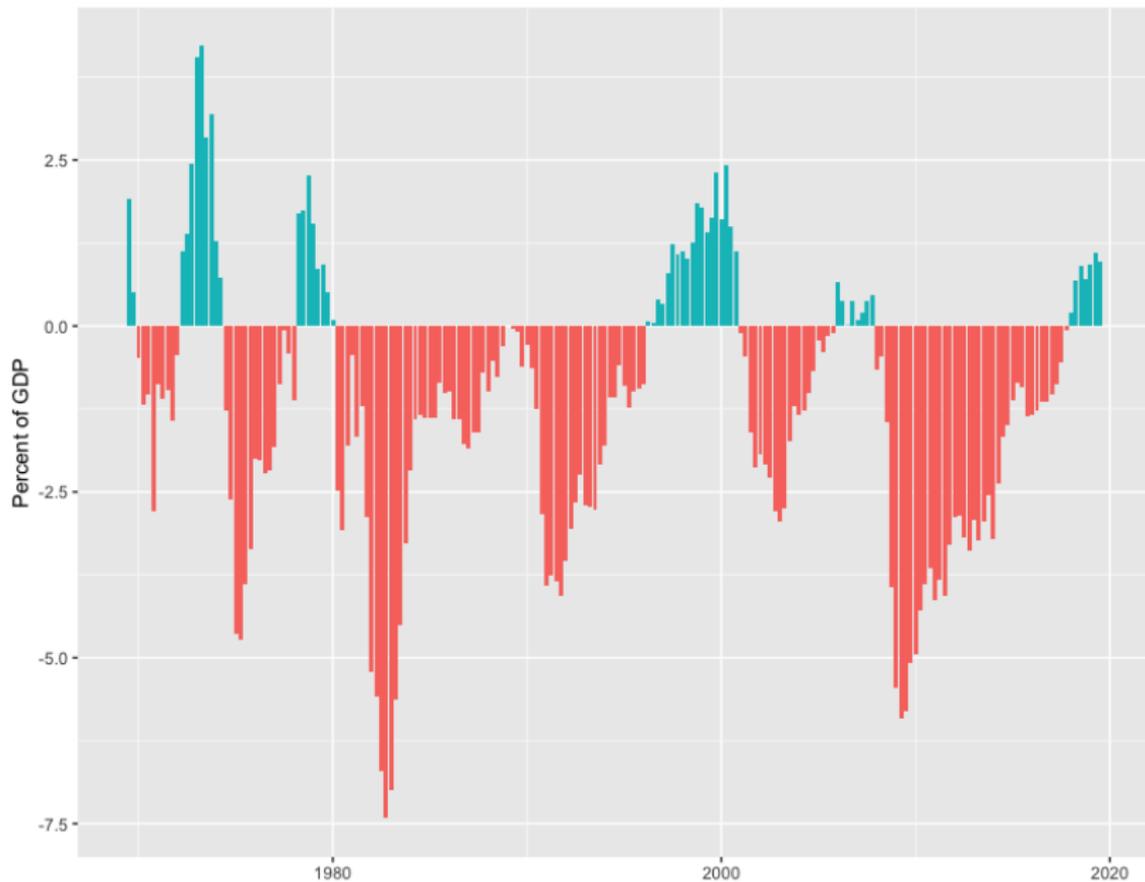


# Real Resources Are the Real Constraint

- ▶ 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

Output Gap (GDP - Potential)

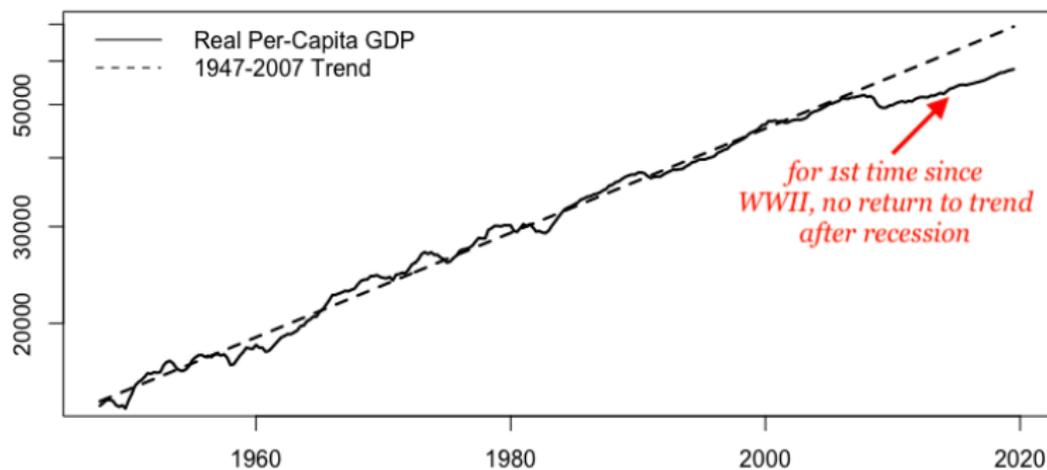


# Official Measures Probably Understate Potential - 1

- ▶ 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

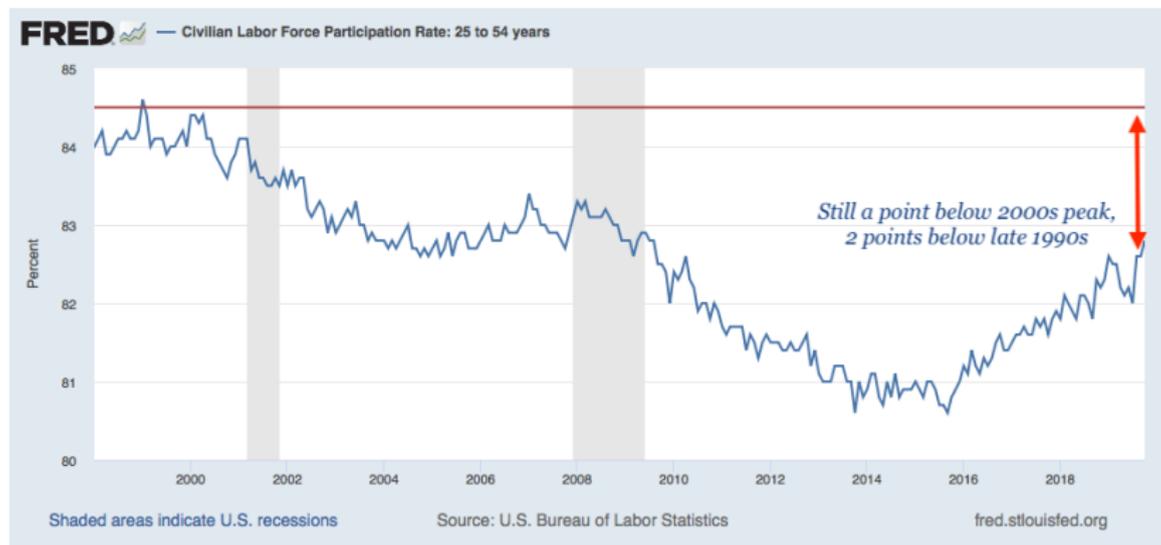
# Official Measures Probably Understate Potential - 2

Real Per-Capita GDP and 1947-2007 Trend



- ▶ 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

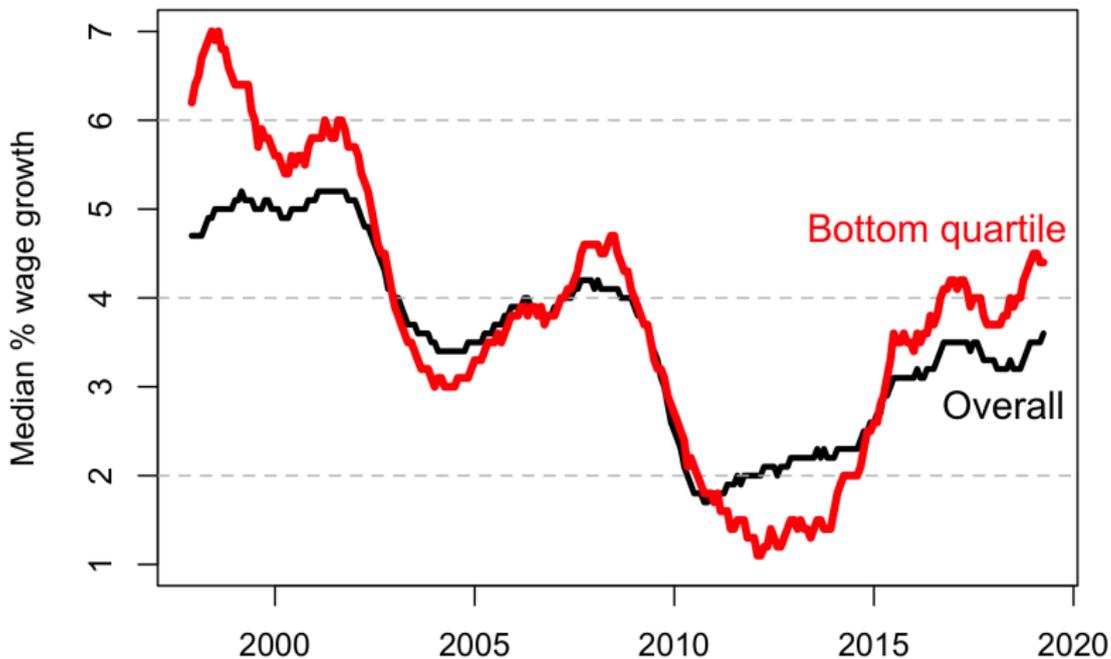
- ▶ Even if economy close to potential today, near-certainty of recession sometime in next decade
- ▶ Lesson from 2007-2009 suggest we should want higher spending before recession starts
  - ▶ Conventional monetary policy not strong enough to offset large negative demand shock
  - ▶ ... and Fed will even less space to cut rates this time
  - ▶ Fiscal policy works - empirical evidence is overwhelming
  - ▶ ... but cannot be ramped 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

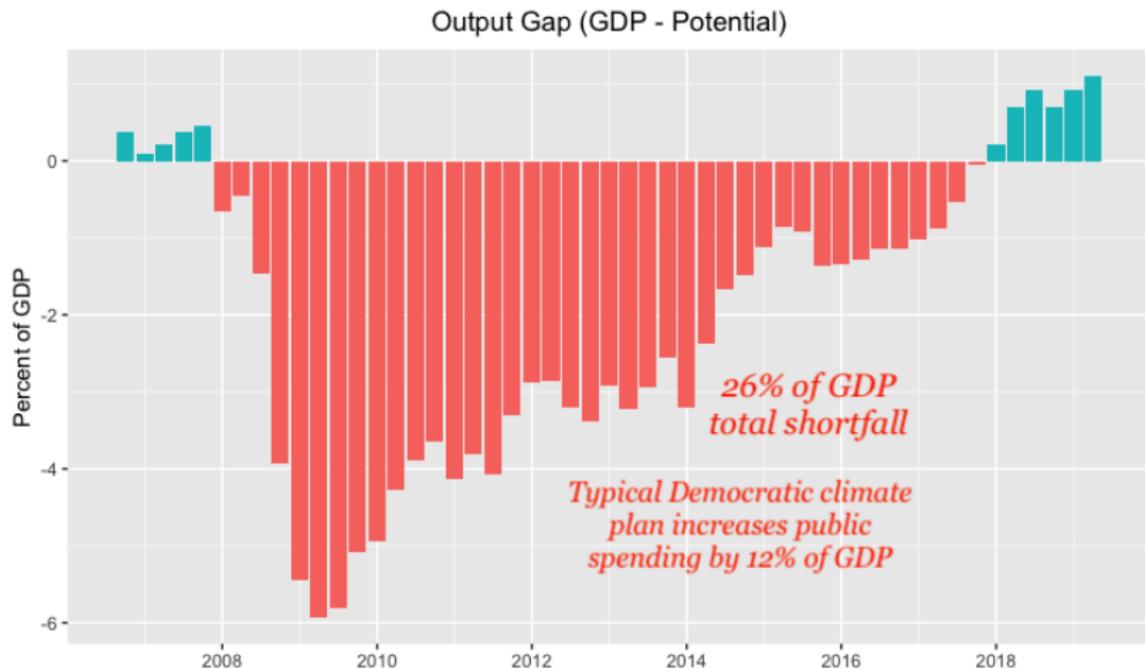
**Wage growth has picked up, especially for lowest-paid workers**



# 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 Probably Don't Raise Demand Enough



# Carbon Plans Probably Don't 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.