Osher Lifelong Learning Institute, Spring 2022

Contemporary Economic Policy

Bradley University
March-April, 2022

Host: Jon Haveman, Ph.D.
National Economic Education Delegation

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Available NEED Topics Include:

- Coronavirus Economics
- US Economy
- Climate Change
- Economic Inequality
- Economic Mobility
- Trade and Globalization
- Minimum Wages
- Immigration Economics
- Housing Policy
- Federal Budgets
- Federal Debt
- Black-White Wealth Gap
- Autonomous Vehicles
- US Social Policy

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Course Outline

- **Contemporary Economic Policy**
  - Week 1 (3/7): US Economic Update & Prospects for Inflation
  - Week 2 (3/14): Climate Change Economics (Sarah Jacobson, Williams College)
  - **Week 3 (3/21): Federal Debt (Geoffrey Woglom, Amherst College)**
  - Week 4 (3/28): Trade and Globalization (Alan Deardorff, University of Michigan
  - Week 5 (4/4): The Black-White Wealth Gap (Jon Haveman, NEED)
  - Week 6 (4/11): Autonomous Vehicles(Jon Haveman, NEED)

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Submitting Questions

- **Please submit questions of clarification in the chat.**
  - I will try to handle them as they come up.
- **We will do a verbal Q&A once the material has been presented.**
- **OLLI allowing, we can stay beyond the end of class to have further discussion.**
- **Slides will be available on Need website(www.NEEDelegation.org)**

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The US Federal Debt

Geoffrey Woglom
Amherst College
Professor of Economics (emeritus)

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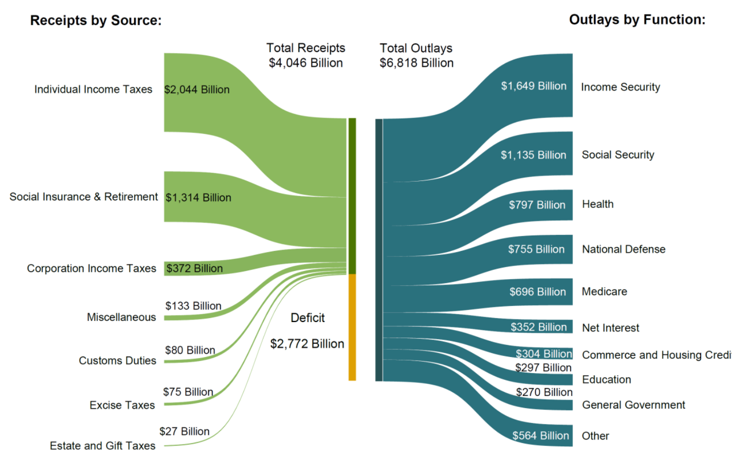
The Federal Budget in FY2021

IIT, 50.5%
SST, 32,5%
CT, 9.0%



Mandatory, 71%
Discret. 22%
Net Interest, 7%

Programmatic Outlays = Mandatory + Discretionary

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Source: Monthly Treasury Report, 9/2021

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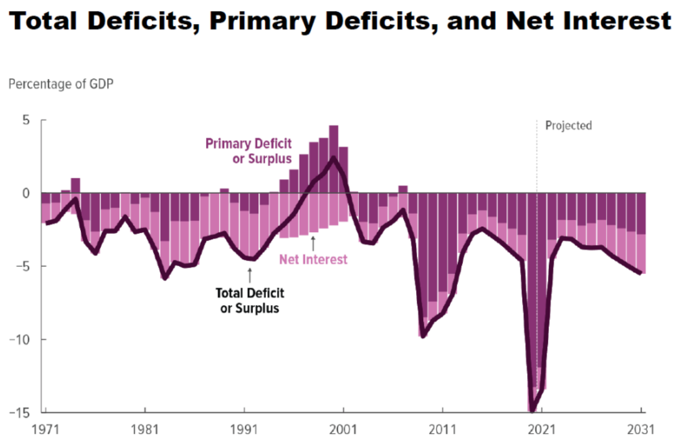
Past and Future of Deficits



Useful Deficit Decompositions:

Total Deficit= (Programmatic Outlays + Interest Expense)-Revenue

=(Programmatic Outlays – Revenue)+Interest Expense

=Primary Deficit + Net Interest

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Source: CBO, Updated Budget and Econo9mic Projections, 7/15/2021

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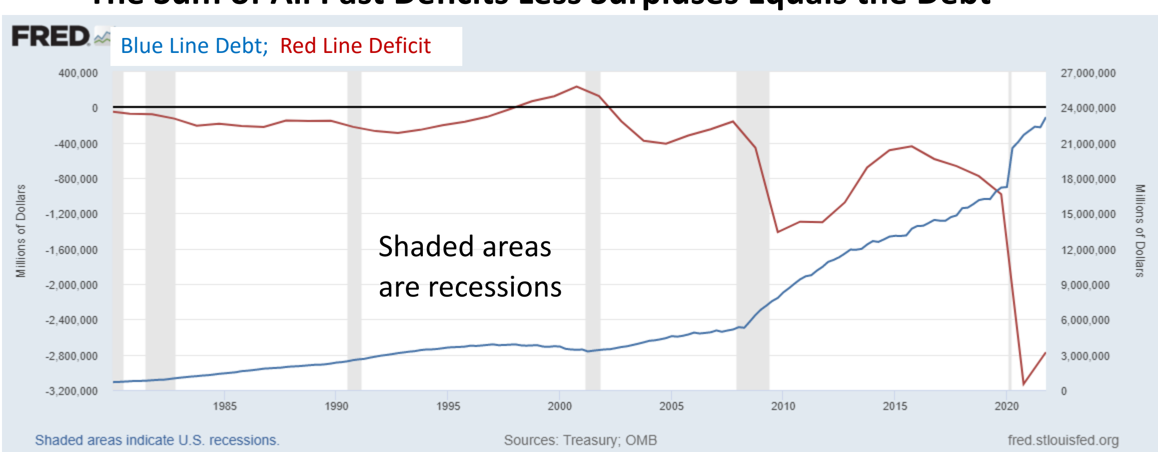
Debt vs. Deficit

The Sum of All Past Deficits Less Surpluses Equals the Debt



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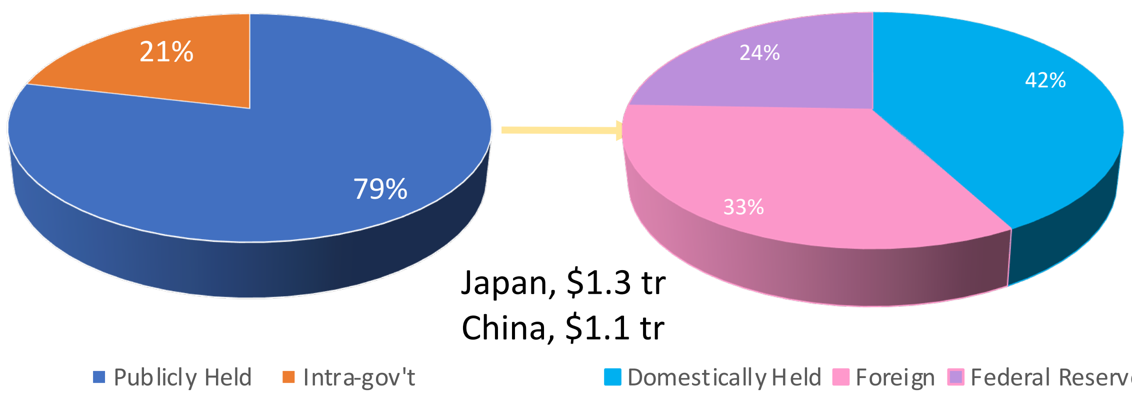
A Breakdown of the Total Federal Debt

Total Public Debt: $29.6 t, 12/31

Publicly Held Debt: $23.1, 12/31



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Sources: US Treasury, Federal Reserve Board

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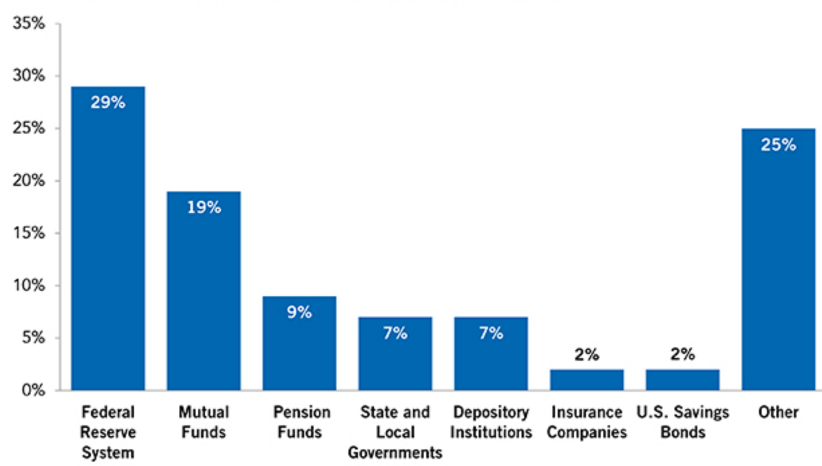
The Federal Reserve owns almost one-third of domestically held debt

% OF DEBT HELD BY THE PUBLIC OWNED BY DOMESTIC CREDITORS



SOURCE: U.S. Department of the Treasury, *Treasury Bulletin*, December 2018. Compiled by PGPF.

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PGPF.ORG

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Not All Debt Is Created Equal

Intra-governmental debt is important bookkeeping.

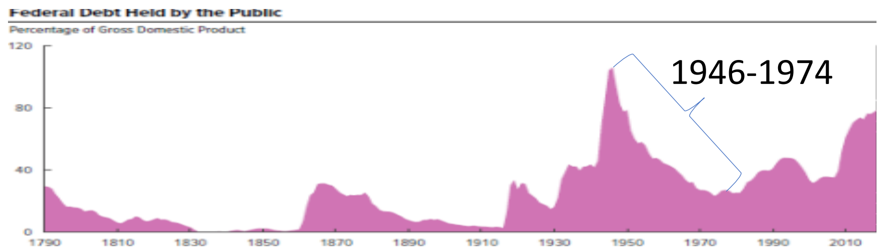
- This debt **DOES NOT** require funding on credit markets

- **Debt held by the public**
  - This debt is funded by borrowing on credit markets and competes with private funding.
- **Most analyses focus on the publicly debt *relative* to GDP because:**
  - To the extent that debt and deficits have burdens these burdens depend on the size of the debt ***relative*** to the size of the economy.

CBO: Budget Analysts in Chief

- **The Congressional Budget Office was founded in 1974 to provide Congress with information about the budgetary implications of legislation.**
- **Two kinds of Reports**
  - Cost Estimates or "Scoring"
    - H.R. 486 Ukraine Religious Freedom Support Act
    - Build Back Better Scoring.
  - Projections of Debt and Deficits – The Budget and Economic Outlook: 2021 to 2031

Key Points About the U.S. Relative Debt



1. **Relative debt peaked during WWII (106%) - followed by a steady decline until the 1980s.**
2. **Prior to 1983, relative debt rose purposefully (wars, recessions, public investment) and then fell.**
3. **What can we learn from the 46-74 period, where the relative debt fell continuously?**

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Debt Dynamics

- **The relative debt fell *in spite of* deficits in 21 of the 29 years, with the debt increasing by 42%. How?**
- **1946-1974, deficits caused the debt to grow, but not as fast as the economy was growing.**
- **While the debt grew by 42%, GDP (nominal) grew by 550%**

You don't need a surplus to reduce the *relative* debt:
You just need GDP to grow faster than the debt

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Relative Debt Dynamics

- **Two Parts to the growth in the debt:**
  1. The interest rate on the debt.
  2. A portion that reflects a primary deficit (+) or primary surplus (-)

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Traditional Views of the Cost of the Debt

- **First a non-issue: There is no analogy between household and government debt.**
  - The government does not have to pay back the debt.
  - Maturing government bonds are paid by issuing new bonds.
- **Economist View of the Debt circa 1980, very little cost because relative debt was falling. That changes in 1983.**

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Traditional View: Debt and Deficits Raise Interest Rates

1. **Crowding Out:** **Higher interest rates lead to less investment and over time to a smaller capital stock and reduced future output.**

2. **Foreign Borrowing: Higher interest rates lead to foreign capital inflows or foreign borrowing. With foreign borrowing, some of our GDP is paid to foreigners as interest.**

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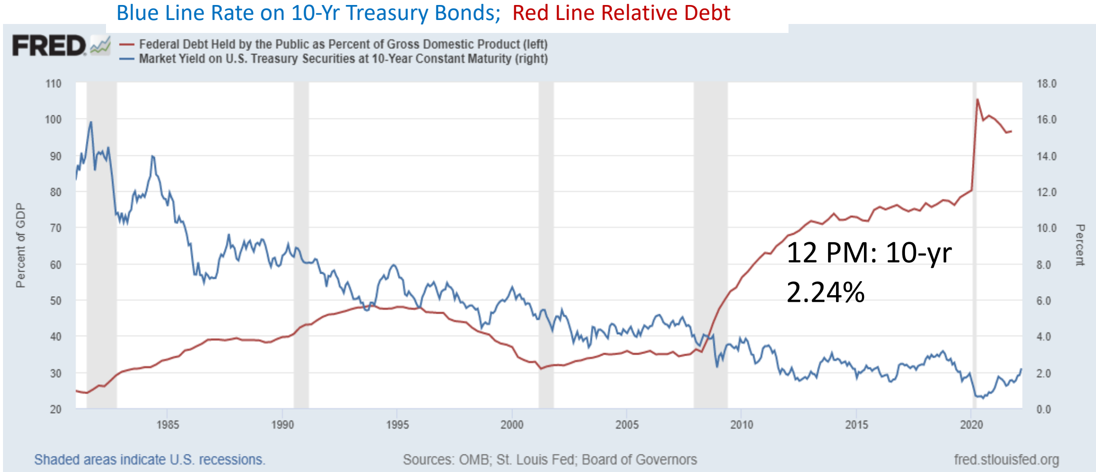
The Dog that Didn't Bark; Rising Interest Rates?

Blue Line Rate on 10-Yr Treasury Bonds; Red Line Relative Debt



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Olivier Blanchard's Presidential Address to the AEA 1/2019

"If the future is like the past [with low interest rates],…the issuance of debt without a later increase in taxes may well be feasible. Put bluntly, public debt may have no fiscal cost."

But,

"My purpose…is not to argue for more public debt, especially in the current political environment. It is to have a richer discussion of the costs of debt…than is currently the case."

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What the Traditional View Got Wrong

- **Assumed that the interest rate was *greater* than the growth in GDP**
  - In order to stabilize the debt, government must run a primary surplus.
  - The bigger the debt, the larger the required primary surplus.
- **More debt today means a higher primary surplus in the future, i.e., higher taxes and/or less programmatic outlays.**

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New View: Almost a Free Lunch

- **If the interest rate is *less* than the growth rate of GDP, then Debt to GDP can be stabilized with a (small) *primary deficit:* programmatic outlays can be less than revenues!**
- **Blanchard does believe that the relative debt must be stabilized**
  1. At some point deficits must be reduced.
  2. But it may not be crucial at what level of debt we stabilize.

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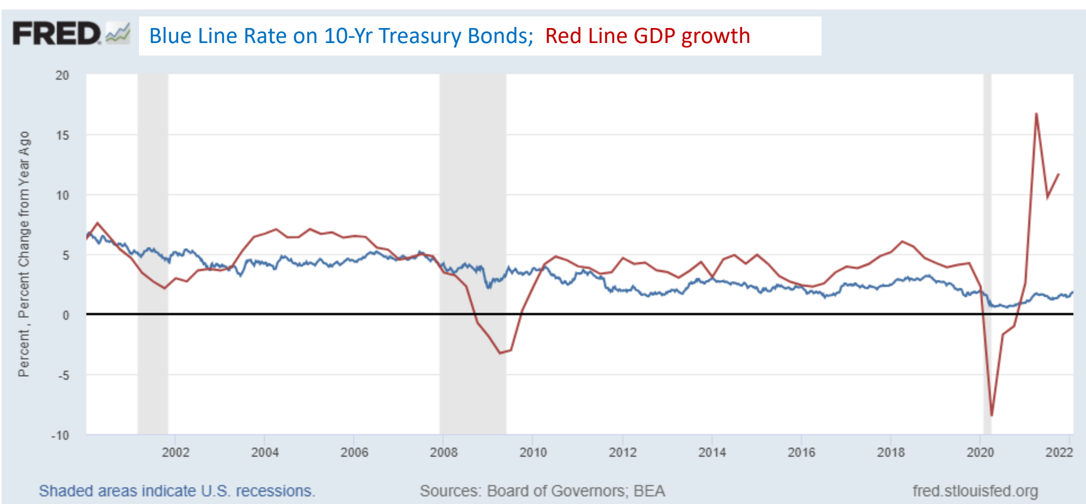
Blanchard's Evidence



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But Why Must the Relative Debt Be Stabilized?

- **Stephanie Kelton provided a prominent and recent exposition of Modern Monetary Theory in her June 6th 2020, *NYTimes* op-ed, "Learn to Love Trillion-Dollar Deficits."**
  - US Treasury borrows in dollars and therefore cannot default (as opposed to Greece).
  - Example: How did we "find the money" in FY 2020 to increase in the deficit by about $1.9 trillion?
  - Answer: Fed open market purchases of $1.7 trillion provided 89% of the financing.
  - More generally, she argues that we can always find the money to increase federal spending

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MMT's Free Lunch

- **The only limit on deficit spending is if it leads to too much spending thereby increasing current inflation.**
- **Recognizing this fact, "…could free policymakers not only to act boldly amid crises but also to invest boldly in times of more stability."**
- **Too bad the second part isn't true. Ans, the recent rise in inflation suggests even Dr Kelton should be worried about the debt**
- **We rely on foreigners to hold a substantial portion of our debt and they can loose if the exchange value of the dollar falls**

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Why do Foreigners Buy US Treasuries?

- **Market for Treasuries is the deepest, most liquid and safest capital market in the world.**
- **US economy has a history of political and economic stability.**
- **We enjoy "An exorbitant privilege" (Valery Giscard d'Estaing): The dollar is the largest international reserve currency.**
  - Most trade transactions are quoted in dollars, e.g., oil.
  - With some exceptions, foreigners borrow in dollars. E.g., Yankee bonds

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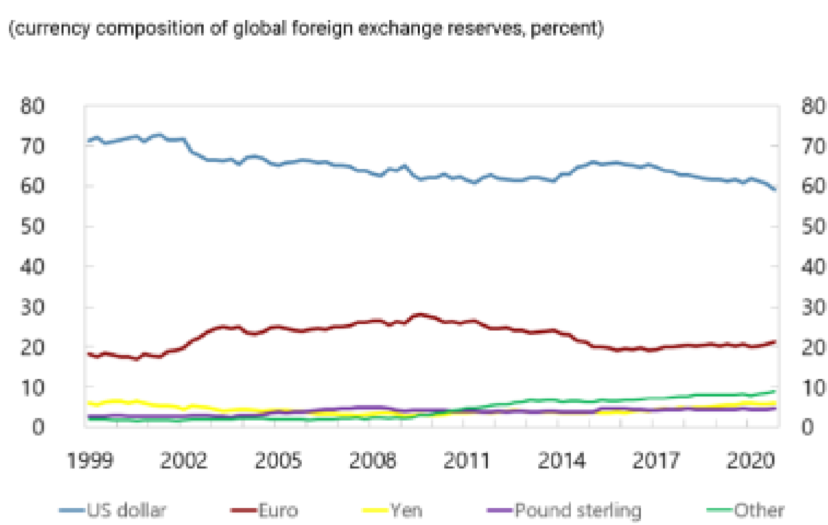
Demand for Dollars by Central Banks



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Source IMF Currency Composition of Official Exchange Reserves

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What If Foreigners Lost Confidence in the $

CBO, *The 2020 Long-Term Budget Outlook*, 9/2020

The risk of a fiscal crisis appears to be low in the short run despite the higher deficits and debt stemming from the pandemic…. Nonetheless, the much higher debt over time would raise the risk of a fiscal crisis in the years ahead.

What would a Fiscal Crisis Look Like?

Foreigners lose confidence in the dollar and sell Treasuries in exchange for assets denominated in their own currency,

1. Sale of Treasuries raises interest rates, worsening our fiscal outlook.
2. Trading of Foreign for US assets lowers US exchange rate.
   a. Raising the price of imports thereby increasing inflation.
   b. Lowering the foreign currency returns on all US assets, exacerbating 1.

Could the Fed Bail us Out?

1. It could buy Treasuries and prevent the rise in interest rates.
2. Insufficient foreign assets to prevent the fall in the exchange rate,

Bottom Line: We Need to Worry about the Debt

1. Interest rates may not stay this low forever. In fact, economist don't really know why they have fallen to such low levels over the past 20 years
2. A fiscal crisis should be avoided at all costs.
3. The good news is we may be able to stabilize the relative debt without a running a surplus.

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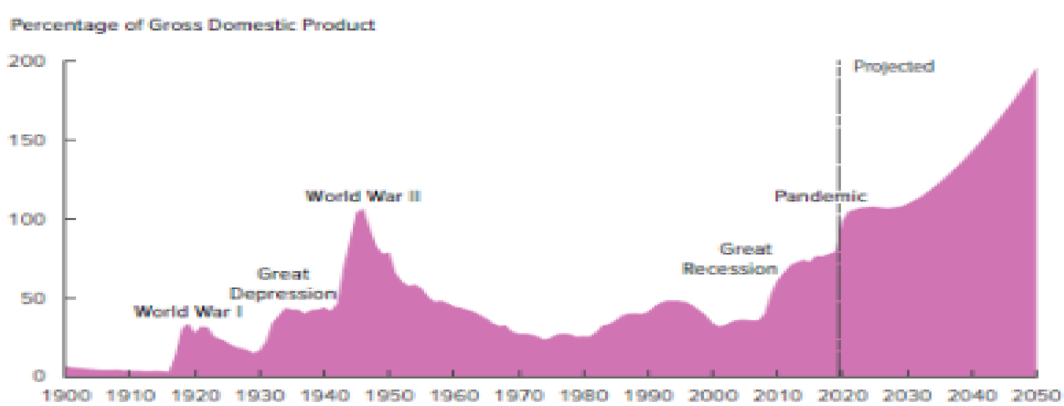
But is this Problem Impossible?



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CBO to the Rescue (*The 2020 Long-Term Budget Outlook*, 9/2020):

First a note on CBO projections:

- The "baseline projections" (such as on the previous slide) are based on the law as currently written; they are ***not*** forecasts of what will happen.
- E.g., The 2017 tax cuts that reduced personal and estate taxes will be phased out in 2025.

But, CBO is allowed to project alternate scenarios:

CBO (9/2020) suggests deficits in 2025 be reduced from 5 to 2.1 percent of GDP, but it won't be easy: about $700b or 2.9% of GDP

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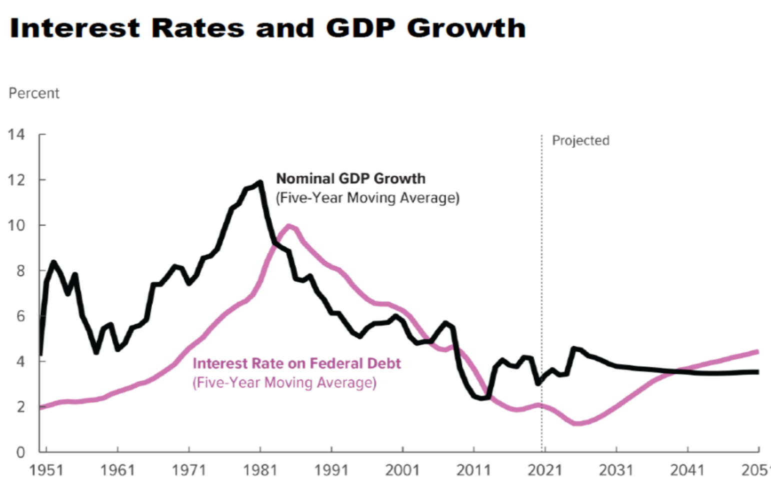
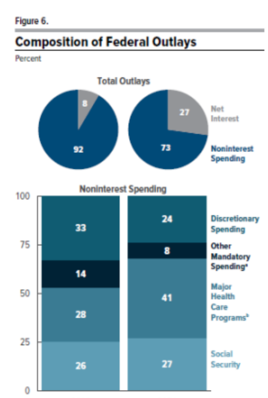
We Have a Little Time: CBO's Crystal Ball



But, it won't be easy



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What about Infrastructure and BBB?

- **Infrastructure $1.2t - terrible reporting**
  - Net New Spending $415b over *10 years.*
  - But infrastructure can be good borrowing
- **Build Back Better: CBO Scoring**
  - $160b over ten years.
  - Robert Byrd and Reconciliation Games.
  - Effect on Deficit in the first 5 years: +$750b ; Last 5 years -$590!

Trade and Globalization

Alan Deardorff
University of Michigan

Questions?

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