Osher Lifelong Learning Institute, Fall 2022

Contemporary Economic Policy Issues

California State University, Dominguez Hills
Fall, 2022

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National Economic Education Delegation

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Course Outline

- **Contemporary Economic Policy**
  - Week 1 (9/19): Economic Update (Jon Haveman, NEED)
  - Week 2 (9/26): Trade and Globalization (Alan Deardorff, University of Michigan)
  - Week 3 (10/3): Cryptocurrencies (Geoffrey Woglom, Amherst College)
  - **Week 4 (10/10): The Federal Debt (Ryan Herzog, Gonzaga University)**
  - Week 5 (10/17): Economic Inequality (Ryan Herzog, Gonzaga University)
  - Week 6 (10/24): Trade Deficit and Exchange Rates (Alan Deardorff, Univ. of Michigan)

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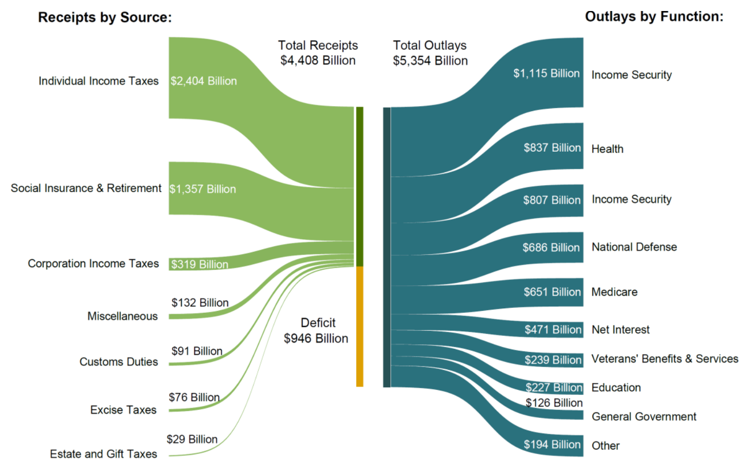
US Government Debt

A Fun Website

- **Brookings Institute**
  - The Fiscal Ship - https://fiscalship.org

The Federal Budget in FY2022: Oct. thru Aug.

IIT, 55%
SST, 31%
CT, 7.2%



Mandatory, 64%
Discret. 29%
Net Interest, 7%

Programmatic Outlays = Mandatory + Discretionary

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Source: Monthly Treasury Report, 8/2022 & CBO, May 2022

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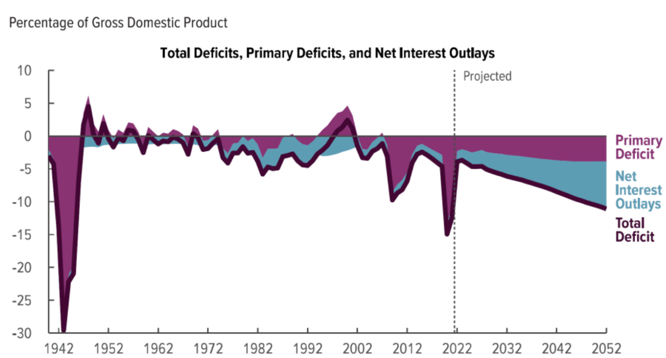
Past and Future of Deficits



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, "The Long-Term Budget Outlook," 7/2022

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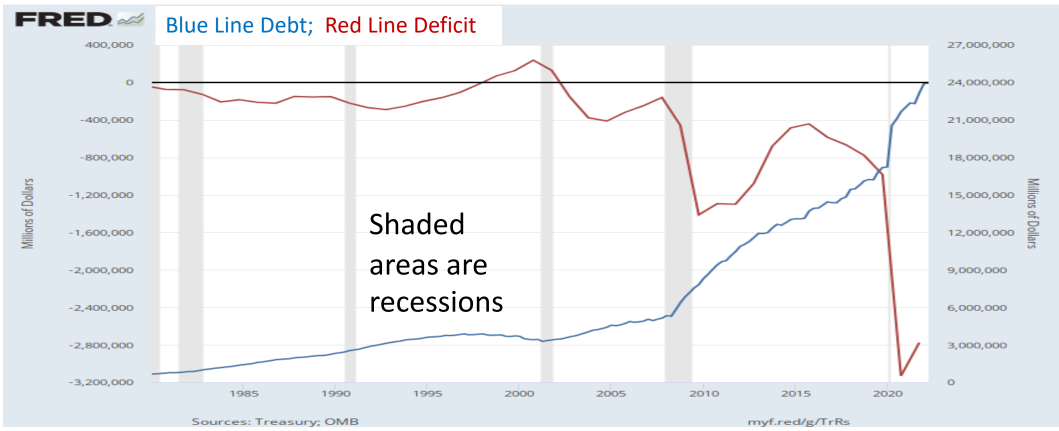
Debt vs. Deficit

The Sum of All Past Deficits Less Surpluses Equals the Debt



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How Does the US Government Borrow?

- **It issues debt.**
  - Treasury marketable securities:
    - Treasury bills, notes, and bonds
    - TIPS: Treasury inflation-protected securities
    - Savings bonds
- **Who buys the debt?**
  - Other federal agencies
  - Individuals and businesses
  - State and local governments
  - Foreign government and individuals
  - Federal Reserve

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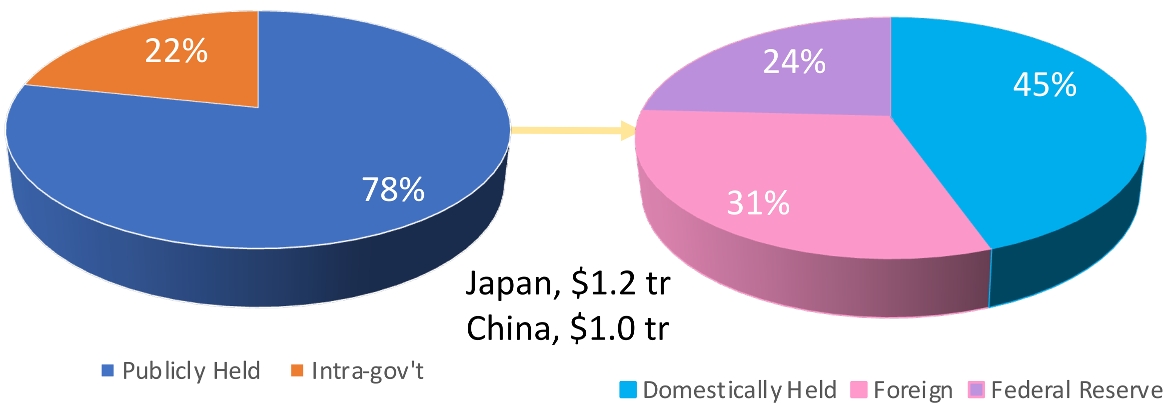
A Breakdown of the Total Federal Debt

Total Public Debt: $30.5 tr, 6/30

Publicly Held Debt: $23.9 tr, 6/30



Japan, $1.2 tr
China, $1.0 tr

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Sources: US Treasury, Federal Reserve Board

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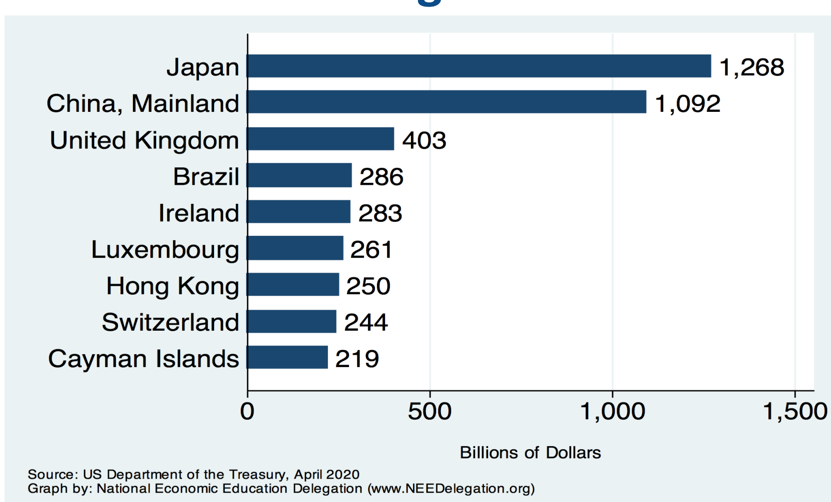
Who Holds Debt to Foreigners



https://ticdata.treasury.gov/Publish/mfh.txt

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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". 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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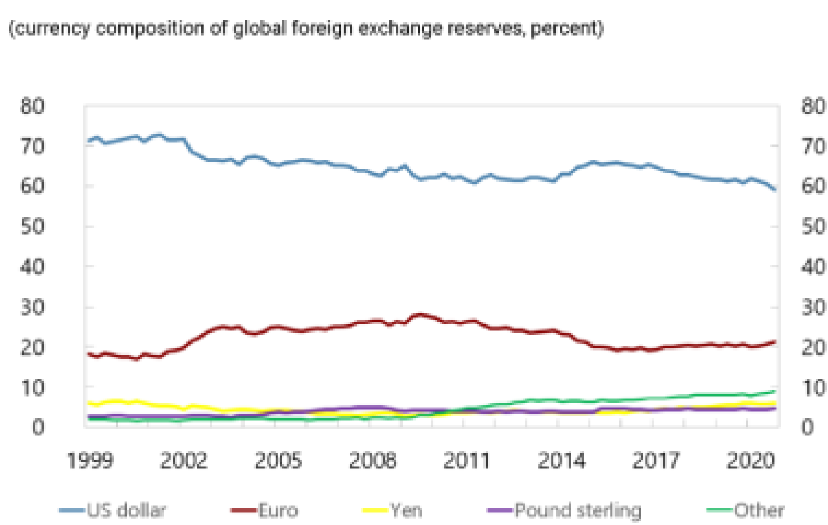
Demand for Dollars by Central Banks



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Source IMF Currency Composition of Official Exchange Reserves

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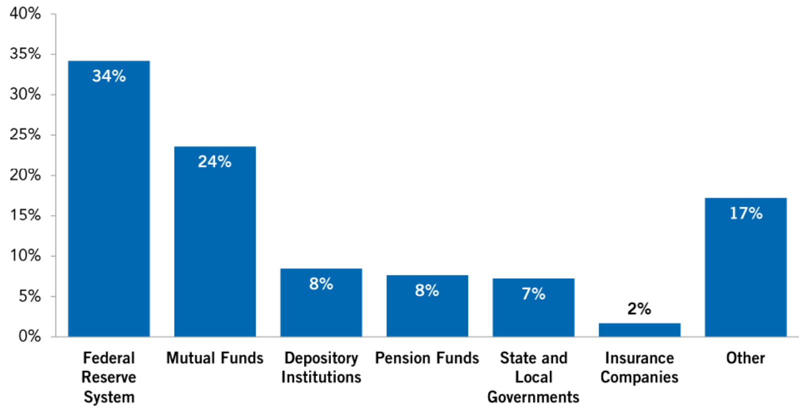
The Federal Reserve owns one-third of domestically held debt

% OF DEBT HELD BY THE PUBLIC OWNED BY DOMESTIC CREDITORS



SOURCE: U.S. Department of the Treasury, *Treasury Bulletin*, September 2021.
NOTES: Data are for March 2021. The Other category is made up of U.S. Savings Bonds and Other Investors.

PGPF.ORG

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Changes since the Pandemic

- **December 2019: Total, 17.2 tr;**
  - Foreign, 6.8 (40%) ; Fed 2.3 (13%)
- **Change to 6/2022: Total, 6.6;**
  - Foreign, 0.7 (11%); Fed, 3.5 (53%)
- **Country Changes:**
  - China, -100; Japan, (81b)
- **Russia:**
  - $9b to $2b

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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 held 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.

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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: 2022 to 2032

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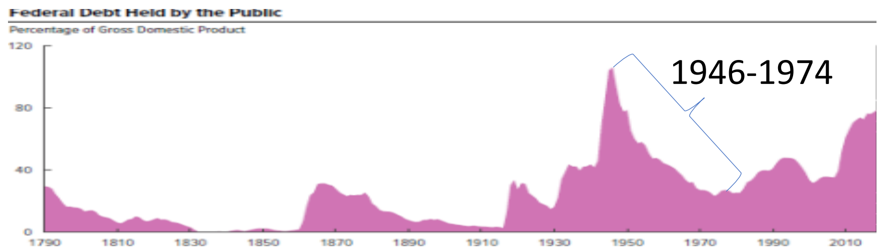
Key Points About the U.S. Relative Debt



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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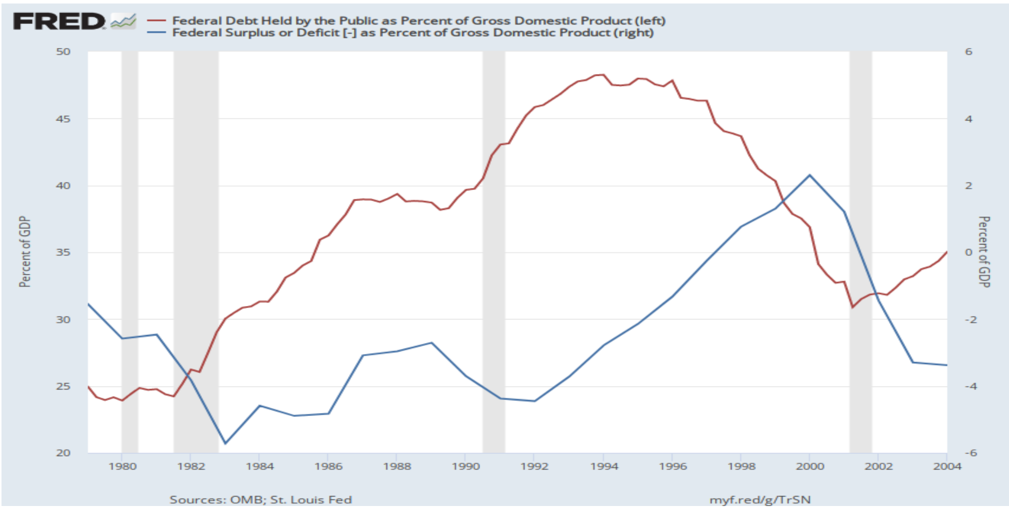
Relative Debt Dynamics

- **Two Parts to the growth rate of the debt:**
  1. The interest rate on the debt.
  2. A portion that reflects a primary deficit (+) or primary surplus (-)
- **Numerical Example: GDP grows at 4%, interest rate is 5%**
  - Interest expense will cause the debt to grow at 5%. Unless there is a primary surplus: Growth in debt is greater than or equal to 5%, greater than GDP growth of 4%, and the relative debt rises.
  - To stabilize the debt, there must be a primary surplus
  - Primary surplus has to be bigger, the higher the relative debt.

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.**

Tax Cuts Don't "Pay for Themselves"



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Traditional View: Debt and Deficits Raise Interest Rates

1. **Crowding Out via higher interest rates:**
   1. Private: less investment and over time to a smaller capital stock and reduced future output.
   2. Government: primary surplus needed to stabilize the debt is larger; i.e., less programmatic outlays or higher taxes
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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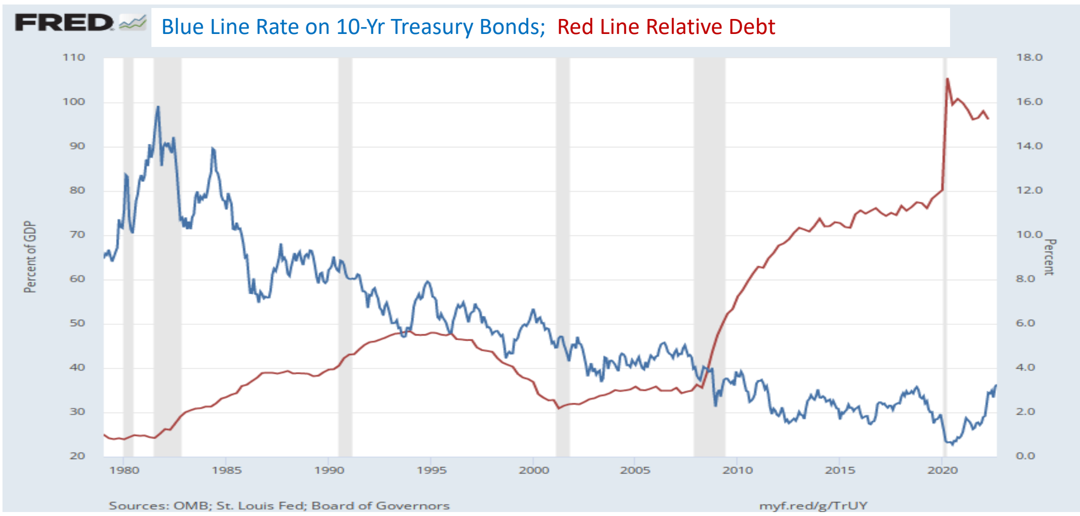
The Dog that Didn't Bark; Rising Interest Rates?



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Not All Debt Is Created Equal

- **Some debt can reduce the availability of investment funds to other borrowers.**
  - Often referred to as "crowding out" private investment
- **Intragovernment debt is (important) bookkeeping.**
  - This debt **DOES NOT** crowd out private investment.
- **Debt held by the public**
  - This debt **MIGHT** crowd out private investment.
- **Most analyses of debt focus on federal debt held by the public.**

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Questions

- Let's take a short break for questions

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."

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 is needed 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!**
- **Remember our example with GDP growth of 4%. Now assume the interest rate is 3%. Relative debt will fall with a primary balance of zero!**
- **Blanchard does believe that the relative debt must be stabilized**
  1. At some point current deficits must be reduced.
  2. But it may not be crucial at what level of debt we stabilize.

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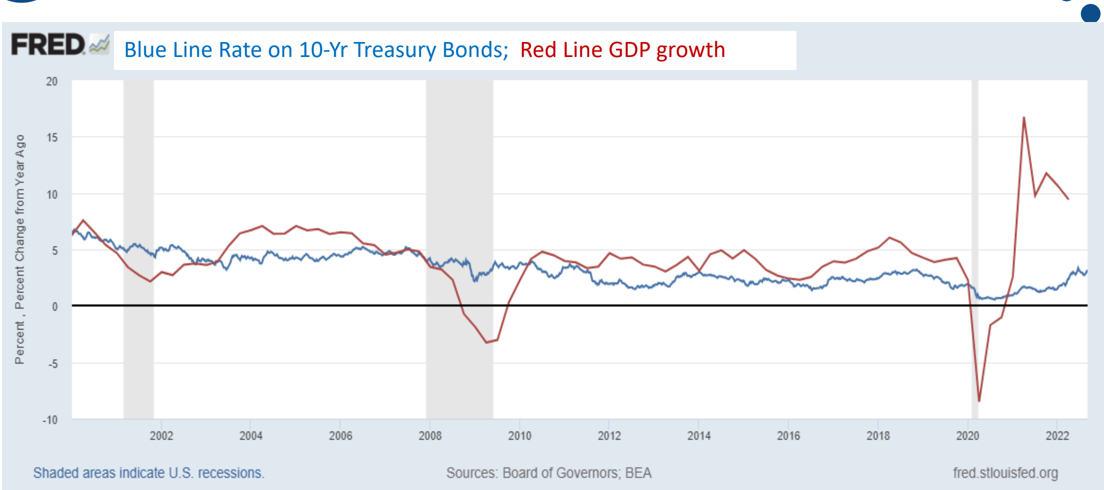
Blanchard's Evidence



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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. And, the recent rise in inflation suggests even Dr Kelton should now 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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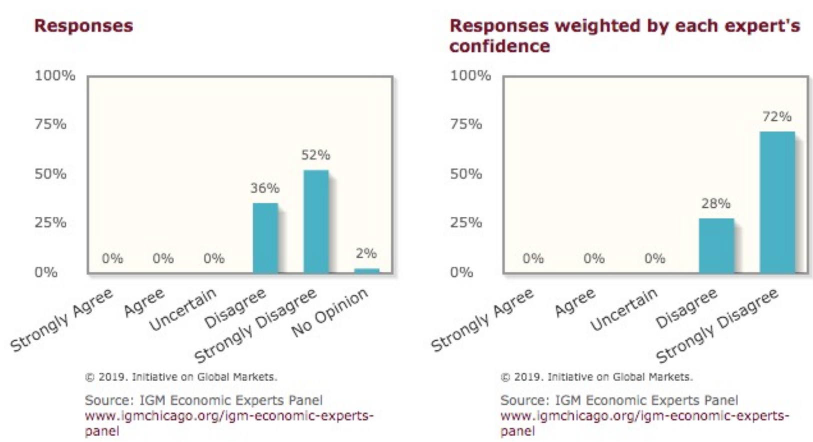
Don't Just Take My Word for It

Question A: Countries that borrow in their own currency should not worry about government deficits because they can always create money to finance their debt.



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CBO on the Costs of "High and Rising Debt"

1. **The interest expense portion of the deficit will rise, including payments to foreigners.**
2. **Crowding out of private investment.**
3. **"The likelihood of a fiscal crisis in the United States would increase."**
4. **Slow erosion of confidence in the U.S. dollar as an international reserve currency leading to higher interest rates.**
5. **Policymaker constraint in using deficit-financed fiscal policy to respond to unforeseen events.**

CBO, "Budget and Economic Outlook: 2022-2032," May 2022, pp15-16.

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 have started to increase. 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.
4. Inflation isn't all bad, debt is nominal.

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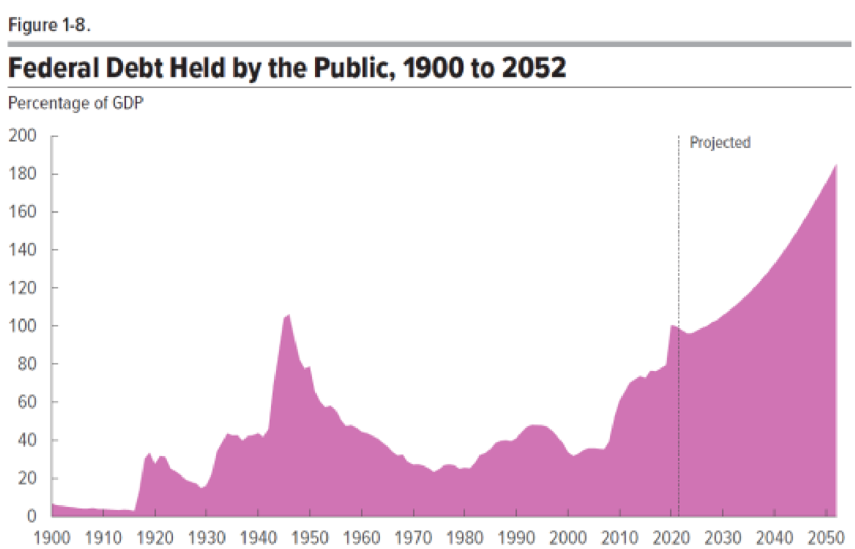
But is this Problem Impossible?



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CBO, "Budget and Economic Outlook: 2022-2032," May 2022

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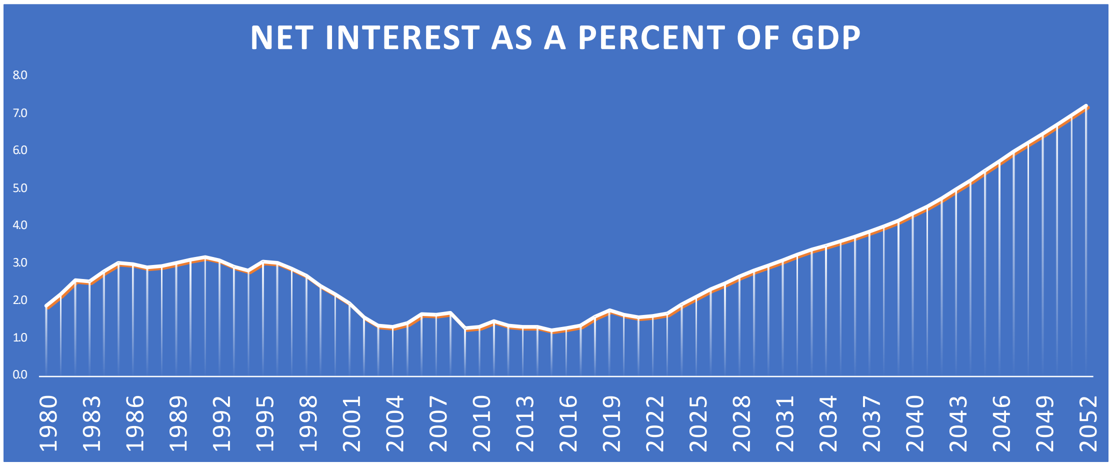
CBO Baseline Projection



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CBO, "Budget and Economic Outlook: 2022-2032," May 2022

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Unfortunately, The Required Changes are Big!

- **To Stabilize the relative debt at the current level of 100% of GDP:**
  1. Deficit in 2025 needs to go from projected 4.7 % of GDP to 2.9% and be maintained at the 2.9% level.
  2. This amounts to reducing the deficit by over $500 billion ***per year***.

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CBO, "2020 Long-Term Budget Outlook, " Sep 2022

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Any of these Options Sound Good?

Options to Reduce the Federal Deficit

Pick 10!

CBO will publish a new volume of budget options at the end of this year.

Among the options that CBO has previously examined, 13 would have reduced the deficit by at least $500 billion over the next 10 years:

- Reduce the Department of Defense's Budget
- Increase Individual Income Tax Rates
- Impose a 5 Percent Value-Added Tax
- Eliminate Itemized Tax Deductions
- Impose a Tax on Greenhouse Gas Emissions
- Impose a Tax on Financial Transactions
- Increase Excise Taxes on Motor Fuels and Index for Inflation
- Increase the Maximum Taxable Earnings for the Social Security Payroll Tax
- Increase the Payroll Tax Rate for Social Security
- Increase the Payroll Tax Rate for Medicare Hospital Insurance
- Establish Caps on Federal Spending for Medicaid
- Reduce Federal Medicaid Matching Rates
- Reduce Tax Subsidies for Employment-Based Health Insurance

Major Takeaways: Talking Points

- **The current trajectory of federal debt is unsustainable.**
- **Given the historically low interest rates, we can afford to wait until after the crisis to act.**
- **After the crisis, we must enact plans to reduce the future (primary) deficits.**
  - These are driven by Medicare and Social Security spending.
- **The longer we postpone action, the greater the probability of a "fiscal crisis."**

Bottom Line: We Need to Worry about the Debt

1. Interest rates will not stay this low forever.
2. A fiscal crisis should be avoided at all costs.
3. Stabilizing relative debt would substantially reduce the possibility of a crisis.
4. The good news is we might be able to stabilize relative debt without a primary surplus.

But (after the pandemic is over) we must substantially reduce primary deficits.

Thank you!

Any Questions?

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