



The US Federal Debt

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7


7

What Does the US Govt. Budget Look Like?

2019 Budget Summary (in billions)

Revenue		Outlays	
Income Taxes	\$1,718	Mandatory	\$2,735
Payroll Taxes	\$1,243	Discretionary	\$1,336
Corporate Taxes	\$230	Interest	\$376
Other	\$271		
Total	\$3,462	Total	\$4,447

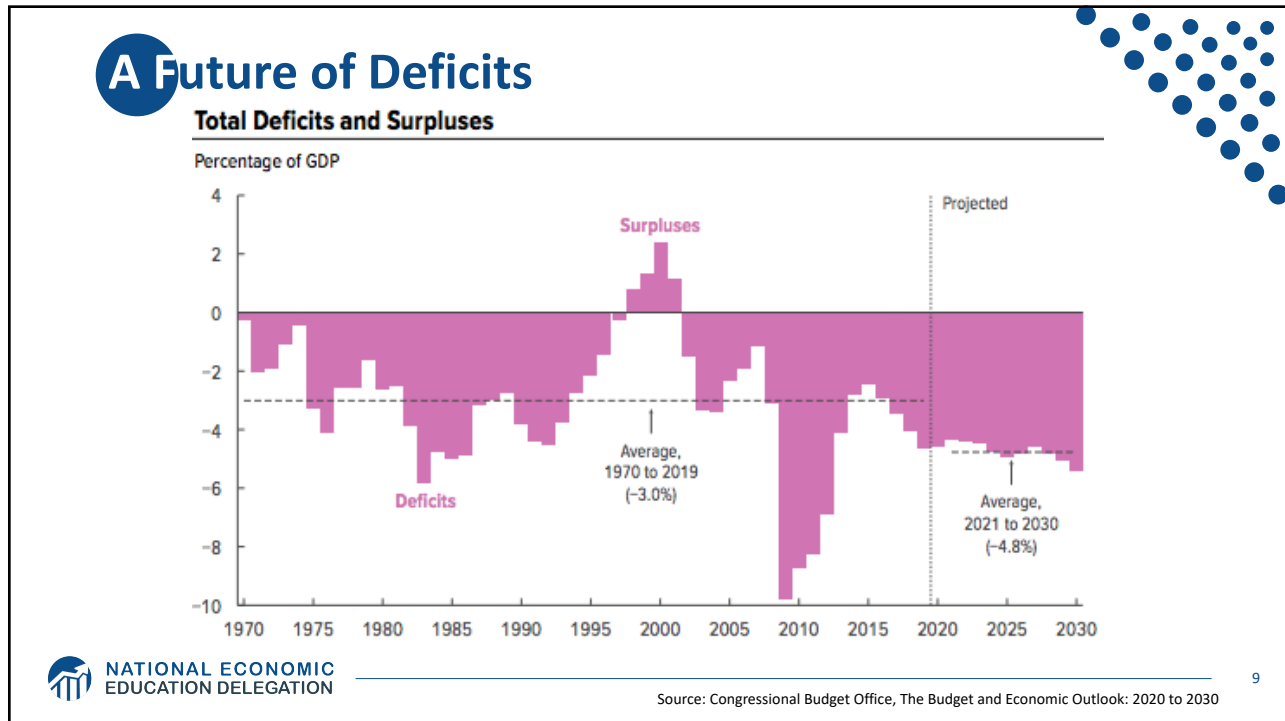
Budget Deficit \$984 Billion

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Source: Congressional Budget Office, The Budget and Economic Outlook: 2020 to 2030

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9

Of Debt, Deficits, and Surpluses

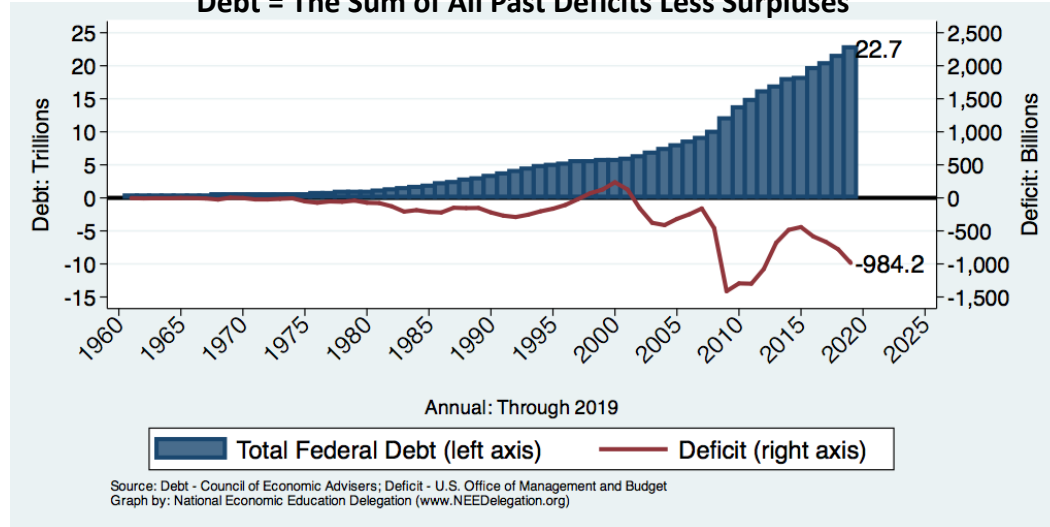
- **FLOW**
 - **Deficit:** The excess of outlays over revenues in a year.
 - **Surplus:** The excess of revenues over outlays in a year.

- **STOCK**
 - **Debt:** The accumulation of debt over time.
 - The sum of all past deficits and surpluses.

10

Debt vs. Deficit

Debt = The Sum of All Past Deficits Less Surpluses



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11

11

How Does the US Government Borrow?

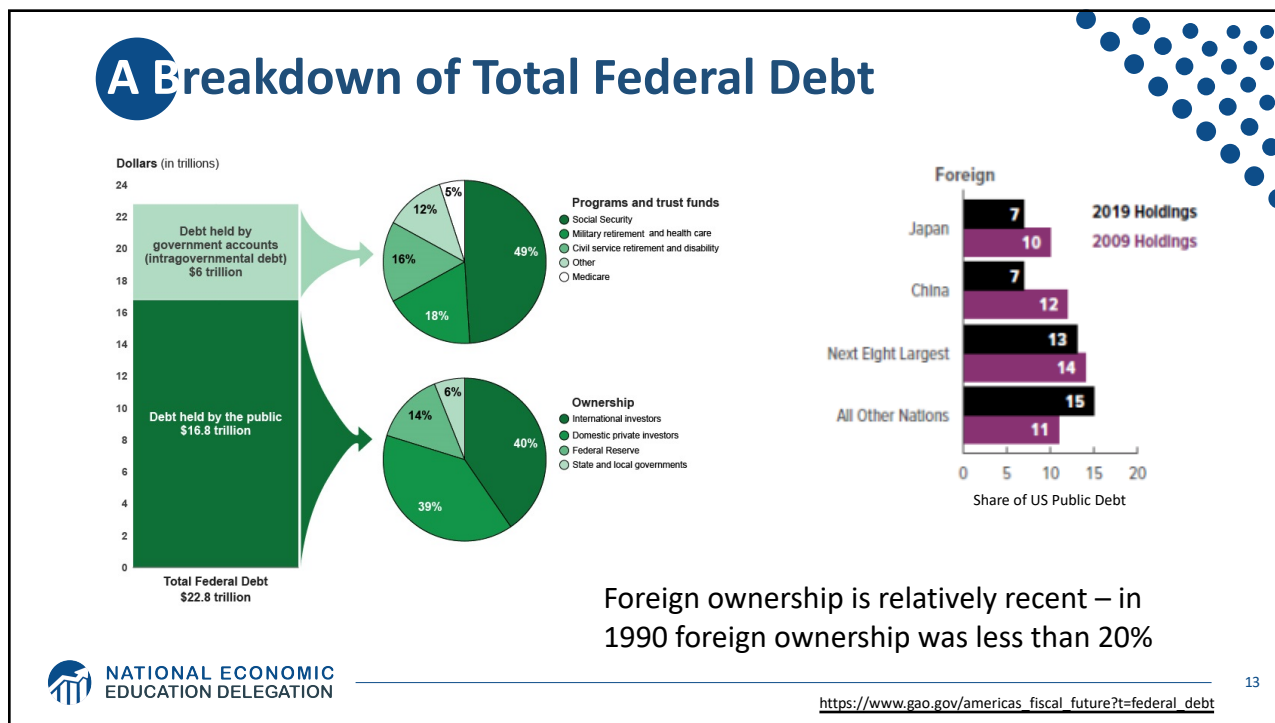
- **It issues debt.**
 - Treasury marketable securities:
 - Treasury bills, notes, and bonds
 - TIPS: Treasury inflation-protected securities
 - Savings bonds
- **Who buys the debt?**
 - Other federal agencies
 - Individuals and businesses
 - State and local governments
 - Foreign government and individuals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



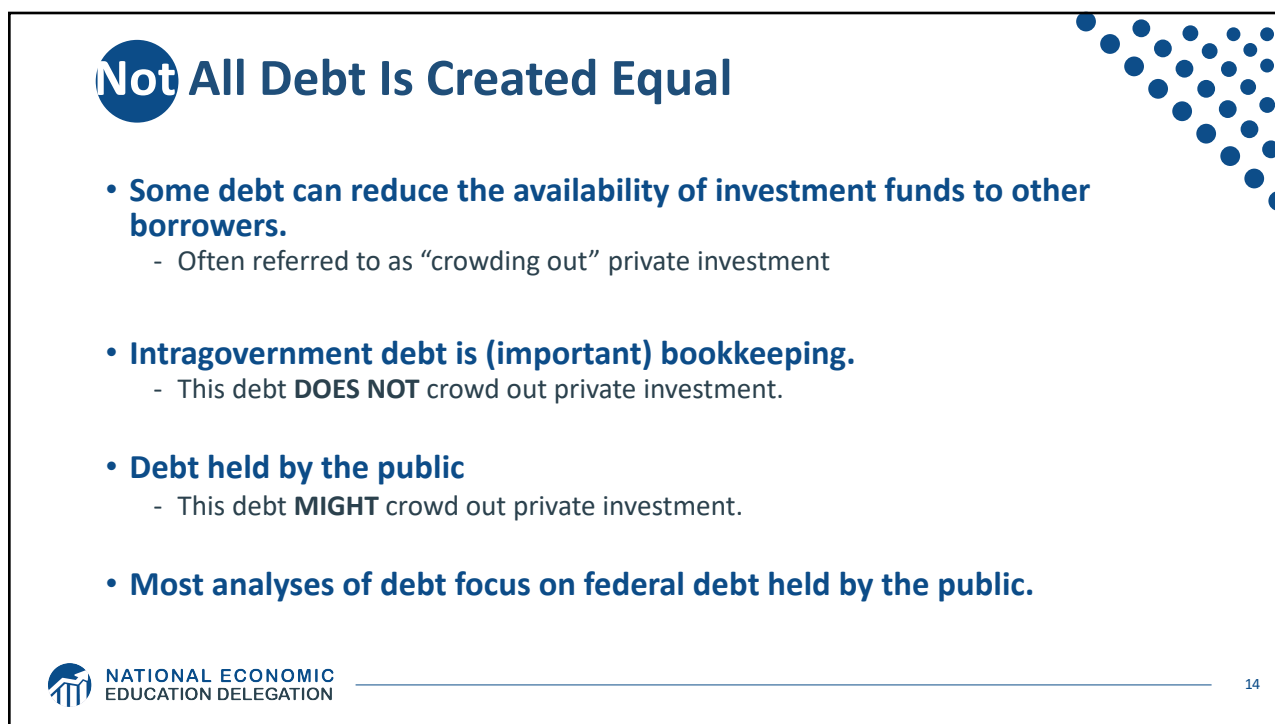
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12

12

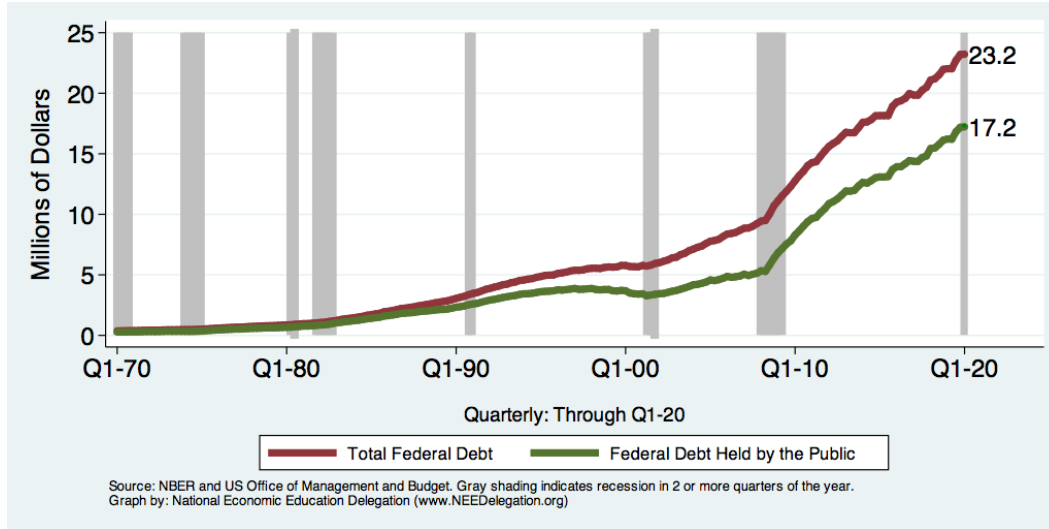


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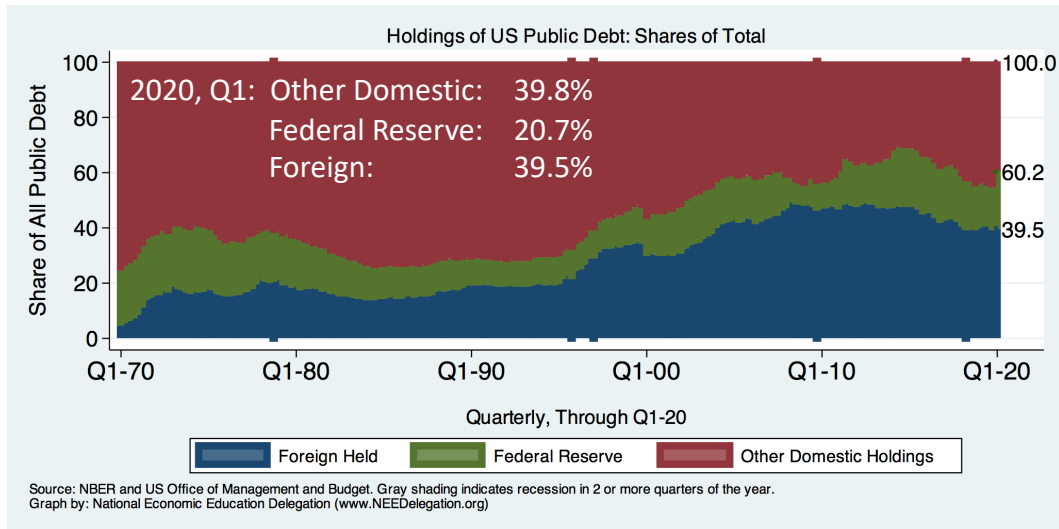
14

Two Measures of the Debt



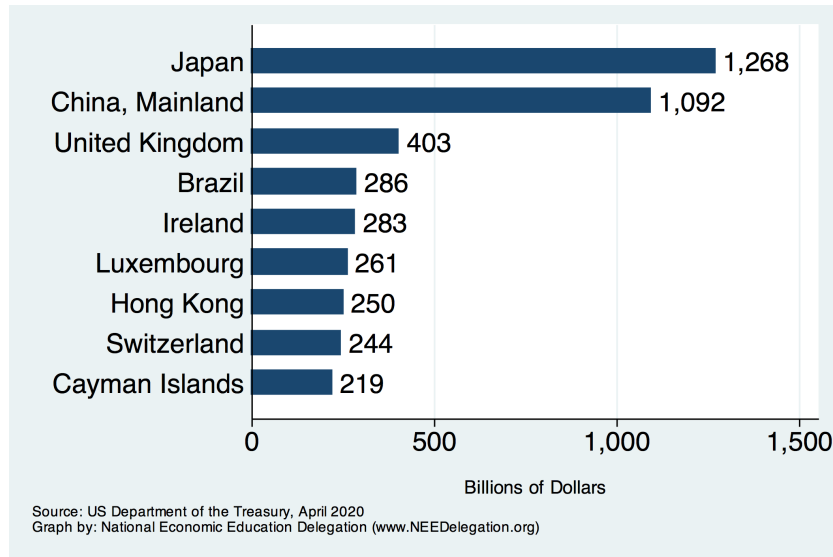
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Trends in US Debt Over Time



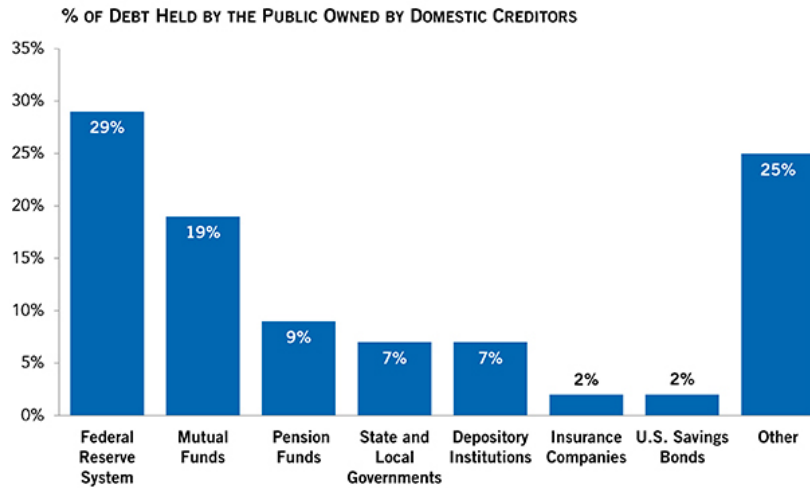
16

Who Holds Debt to Foreigners



17

PETER G. PETERSON FOUNDATION The Federal Reserve owns almost one-third of domestically held debt



SOURCE: U.S. Department of the Treasury, *Treasury Bulletin*, December 2018. Compiled by PGPF.
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18

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: HR 6036 VA Family Leave Act of 2020
 - Projections of Debt and Deficits: The Budget and Economic Outlook, 2020 to 2030



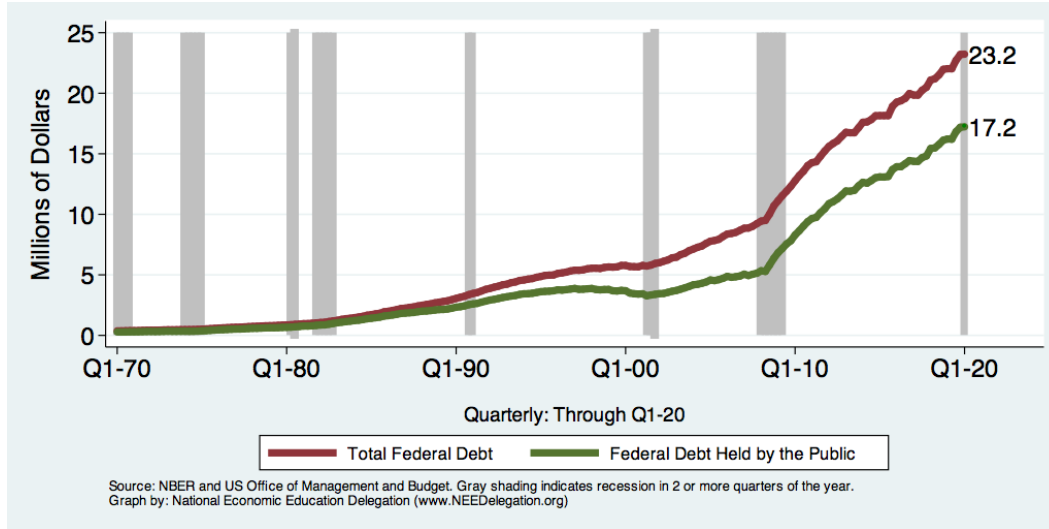
The All-Important *Relative* Debt

- CBO analyzes the 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.

	Total Public Debt	Relative Debt Debt/GDP
United States	\$17.0 Trillion	80%
Greece	\$0.4 Trillion	176%

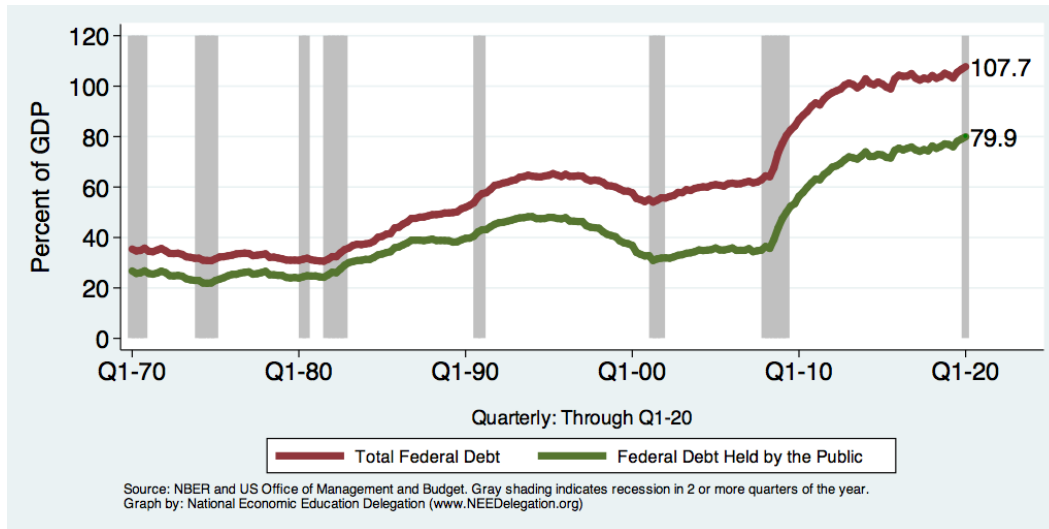


Two Measures of the Debt



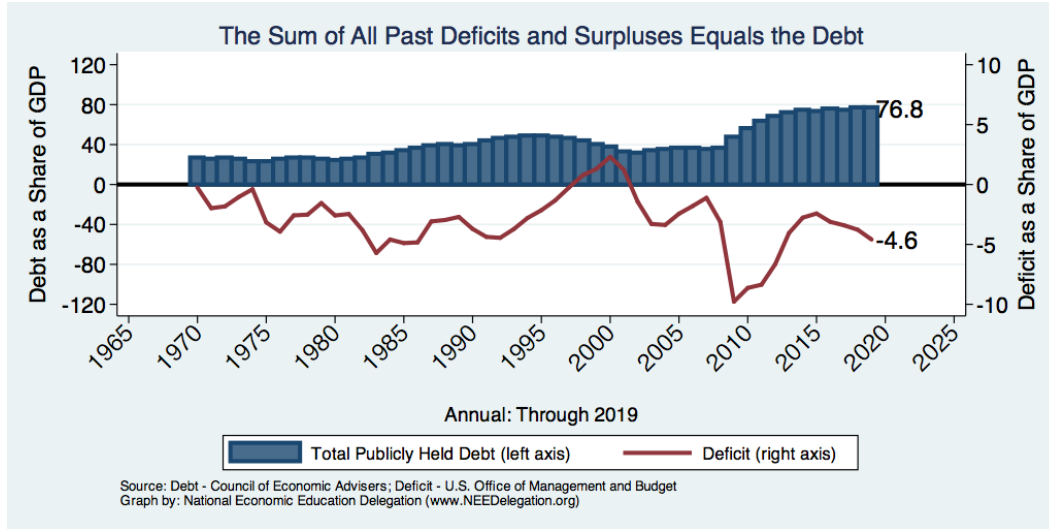
21

Two Measures of RELATIVE Debt



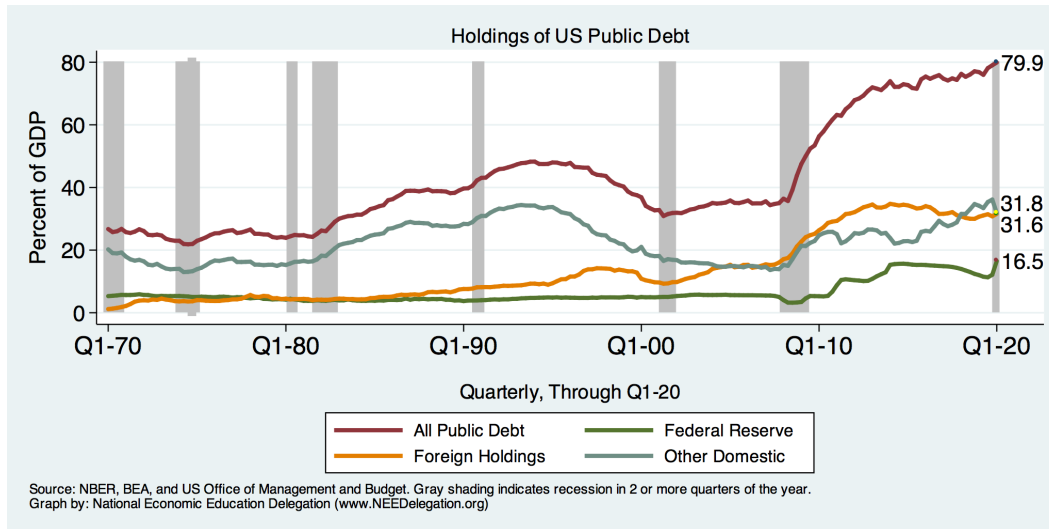
22

Relative Debt and Deficit



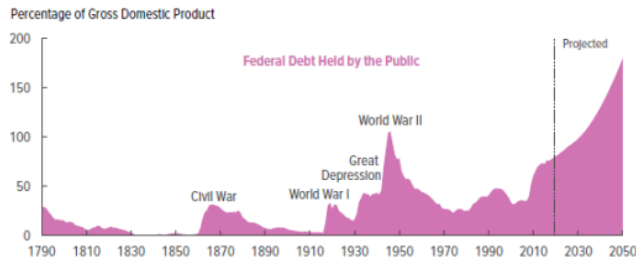
23

Summary: Who Holds US Public Debt?



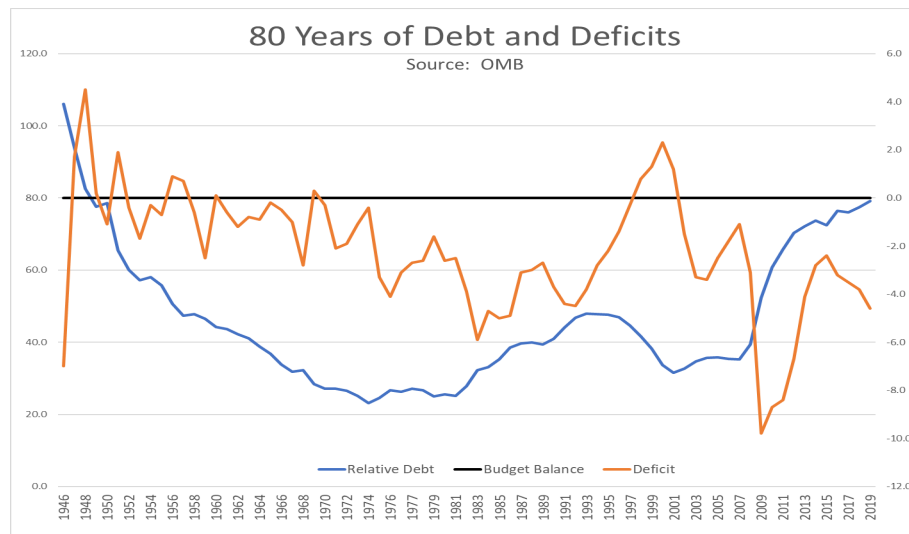
24

Key Points About US Relative Debt



1. Prior to 1983, relative debt rose purposefully (wars and recessions) and then fell.
2. Relative debt peaked during World War II, followed by a long decline.
3. Relative debt has been and is expected to rise for the next 30 years w/o a strategic purpose.

The Post-WWII Fall in Relative Debt



Debt Dynamics

- **Surprising (?) Facts**

- From 1945 to 1979, relative debt fell from 100% of GDP to 25% of GDP.
- During this period, the federal budget was in surplus only once, in 1969.

- **Relative debt is a fraction: Debt/GDP; fractions fall if:**

- The *numerator* falls (budget surplus)
- The *denominator* rises (nominal GDP growth)
- The *denominator* **grows** faster than the *numerator*

27

Two Measures of the Deficit

- **(1) Primary deficit = current programmatic outlays – revenues**

- **(2) Total deficit = primary deficit + interest**

- **Interest on the debt is**

- The part of the total deficit that is due to past deficits.

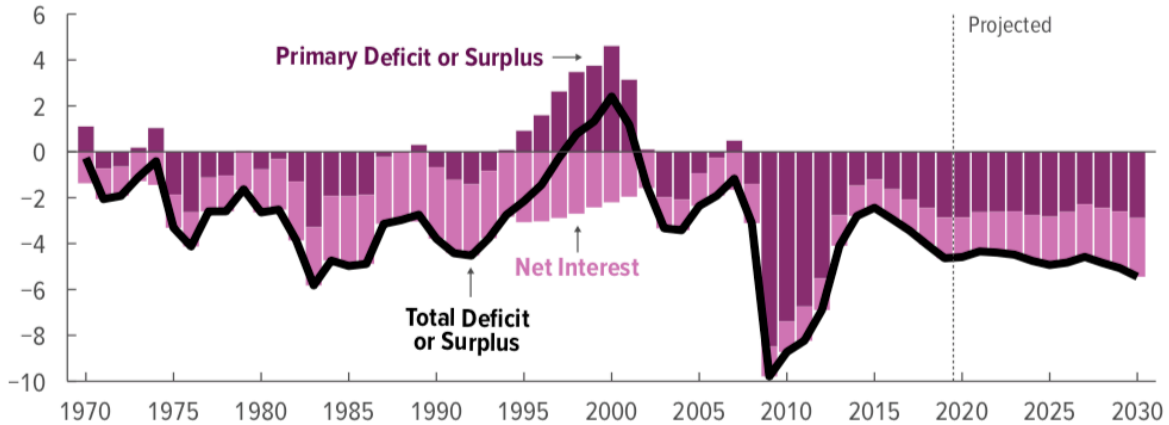
- **This distinction becomes important for understanding:**

- The future course of relative debt.
- The costs borne by future generations because of the debt.

28

Rising Debt Levels Due to a Future of Deficits

Percentage of Gross Domestic Product



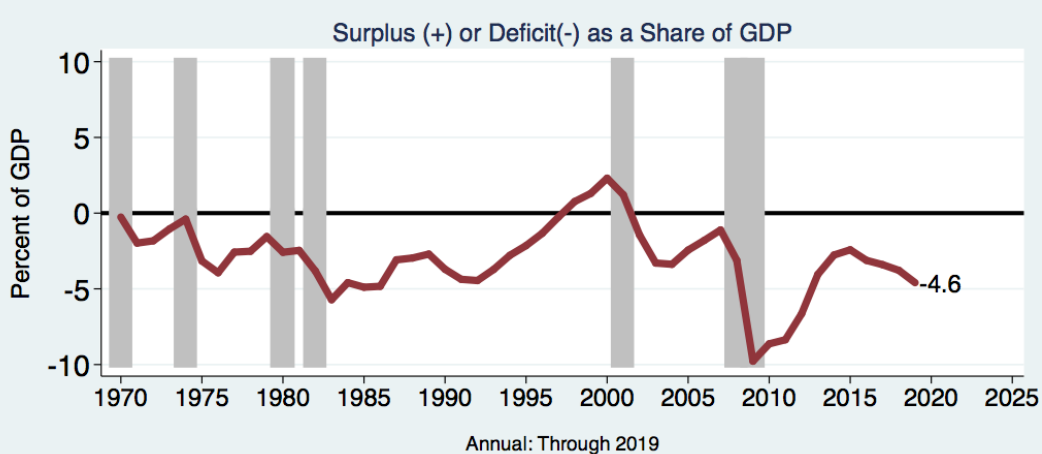
This graph was done before Covid-19

Source: Congressional Budget Office, The Budget and Economic Outlook: 2020 to 2030

29

29

Deficits and Recessions



Source: NBER and US Office of Management and Budget.
 Gray shading indicates recession in 2 or more quarters of the year.
 Graph by: National Economic Education Delegation (www.NEEDelegation.org)



30

30

How to Think About the Debt

31

Perspectives on Increased Debt

- **Government borrowing crowds out private capital and investments.**
 - Weakened by the ability to borrow from other countries.
- **Does debt impose a burden on future generations?**
 - Does it inevitably have to be paid off?
- **In time, debt service might crowd out other government spending.**
 - Diminishing policy priorities in the budget.
- **Is it reasonable to borrow at low interest rates for investment?**
 - For example, for infrastructure.

32

Not All Borrowing Is Bad!

- **Two good reasons to borrow:**

1. During a temporary crisis
 1. Recession
 2. War
 3. Pandemic
2. Productive public investment
 1. Infrastructure
 2. Education



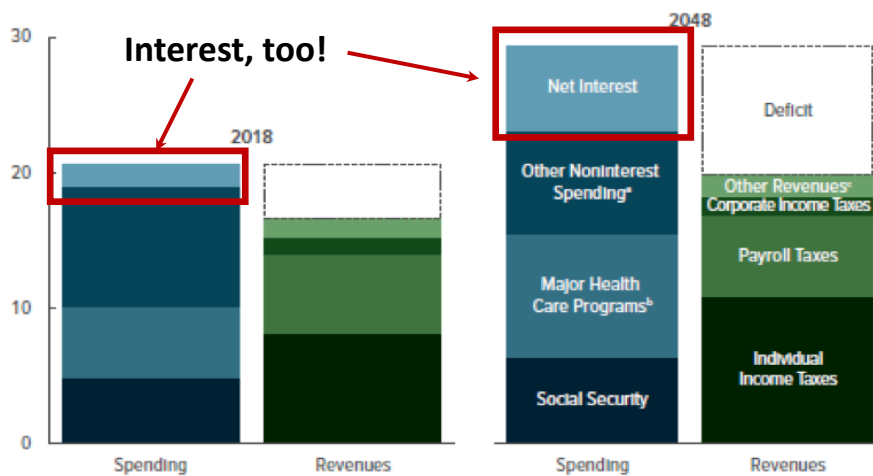
- **These deficits do not permanently increase relative debt.**

- Great Depression, WWII
- Public investment expands GDP and tax revenue

33

Spending to Grow Much Faster Than Revenue

Percentage of Gross Domestic Product

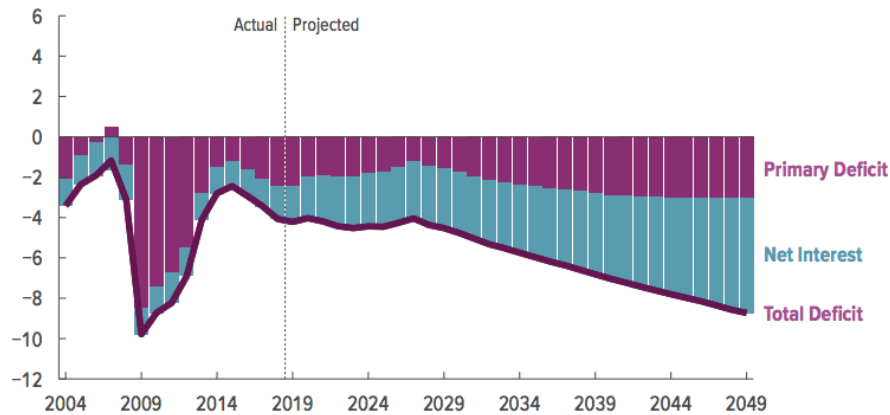


Source: Congressional Budget Office.

34

Interest Will Grow as a Share of the Deficit

Percentage of Gross Domestic Product



Deficits grow from 4.2 percent of GDP in 2019 to 8.7 percent in 2049, driving up debt. Net spending for interest on debt accounts for most of the growth in total deficits.

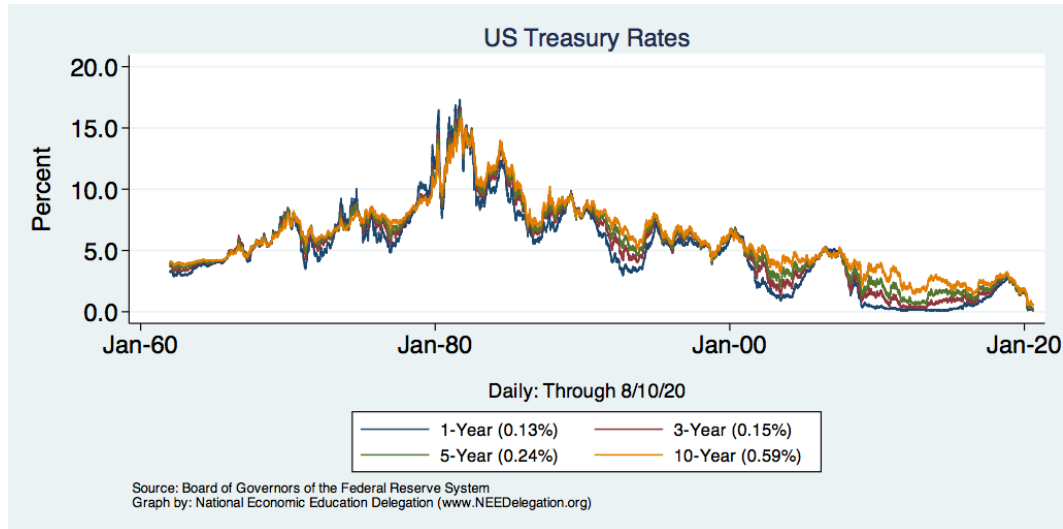
35

Is The Debt a Problem Today? (Pre-COVID 19)

- Currently borrow about \$100 billion each month with little difficulty.
- Very little evidence of "crowding out."
- Interest rates are very low, less than 1% on 10-year notes.

36

Interest Rates Are Historically Low



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37

37

So, Why Worry About it?

• If debt become too high:

- Investors might start questioning the creditworthiness of the US government.
 - o Problem: Nobody knows how high is too high.
- It becomes more difficult to borrow in times of crisis.
 - o War, severe recession
 - o "Fiscal space"
 - Impossible to measure how much we have.
 - Clearly, we have less now than in 2007.
- Could start to crowd out investment by consumers and businesses.
 - o Not currently a problem. No idea if/when it might become one.
- Could be inflationary.



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38

38

So, Why Worry About It?

- **If debt continues to grow:**

- Interest payments will grow with it.
 - 8% of spending in 2018.
 - 22% of spending in 2048.
 - Less room for using the budget for policy priorities.
 - 40% of payments go to other countries.
- The longer we wait to address it, the harder and more disruptive addressing it will be.
- Interest rates might increase.



39

Growth in Relative Debt

- **Remember:**

- the denominator of relative debt is GDP
- the numerator is debt

- **The denominator grows at the rate of growth of GDP.**

- **The numerator grows with:**

- the *interest rate* on the debt plus (or minus)
- the effect of the primary deficit (surplus)

- **Notes:**

- relative debt can fall, even with chronic deficits, if they cause the debt to grow more slowly than GDP.
- Relative debt can rise with a surplus if interest rates increase enough.



40

Economists' Views on the Debt Evolve



41

Traditional View: A Non-Issue

- **The analogy between household and government debt is inaccurate.**
 - The government does not have to pay back the debt.
 - Retirees cash in maturing bonds, which are financed with new bond issues sold to younger people.
 - Interest on the debt is essentially paid by the young to their parents.
 - When the young are old, their young will do the same for them.



42

Reagan's Experiment in Supply-Side Economics

- **Tax cuts were supposed to be “investments.”**
 - Lower marginal tax rates, and people will work more/harder and save.
 - Higher GDP will raise tax revenue to pay for the deficit.
- **Sadly, in 1981-89, debt rises from 25% to 40%.**
 - For the first time, relative debt rises during a nonrecessionary peacetime.
 - Reignites concern about debt and deficits.
- **Failed experiment?**



Traditional View: Four True Costs

- **Crowding out:**
 - The Treasury's borrowing needs compete with private borrowers, so debt and deficits raise interest rates.
- **Higher interest rates lead to foreign capital inflows or foreign borrowing.**
 - With foreign borrowing, some of the interest on the debt goes to foreign countries.
- **Larger primary surpluses are needed to stabilize the relative debt.**
 - The larger the relative debt, the bigger the needed primary surplus.
 - Thus higher taxes or programmatic outlays must be reduced.
- **Government bias toward higher inflation**
 - GDP grows if either prices rise or real output rises.



Traditional View: Cost 1

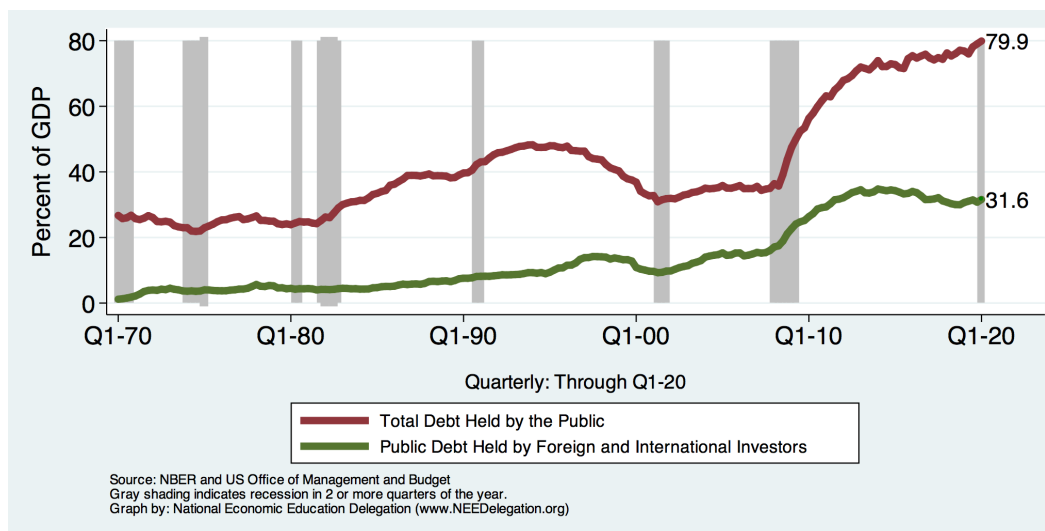
- **Rising debt reduces investment.**

- Deficits and debt raise aggregate demand.
 - Direct government spending.
 - Lower taxes lead households to spend more.
- To offset this increase in demand, the Fed has to raise interest rates, reducing investment and future GDP.
- By causing interest rates to rise:
 - debt and deficits *“crowd out” investment.*



45

The International Appetite for US Treasuries



46

2005: The International Dimension to Debt

- **Interest on foreign-held debt reduces US residents' welfare.**
 - Interest payments go to other countries.
- **When the Fed raises interest rates, the exchange rate of the dollar rises, causing:**
 1. Increases in the trade deficit
 2. Foreign borrowing.
- **Sharp increases in interest rates and the cost of imports raises the possibility of a fiscal crisis or a "run on the dollar."**



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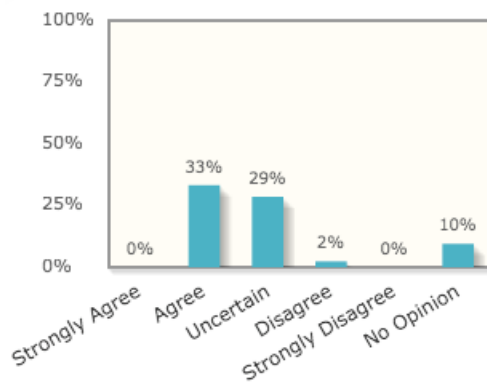
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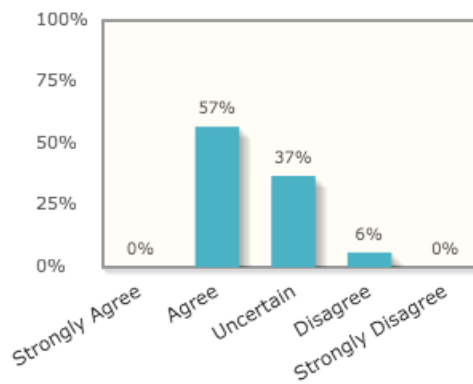
General Agreement Among Economists

If the US reduced its fiscal deficit, then its trade deficit would also shrink.

Responses



Responses weighted by each expert's confidence

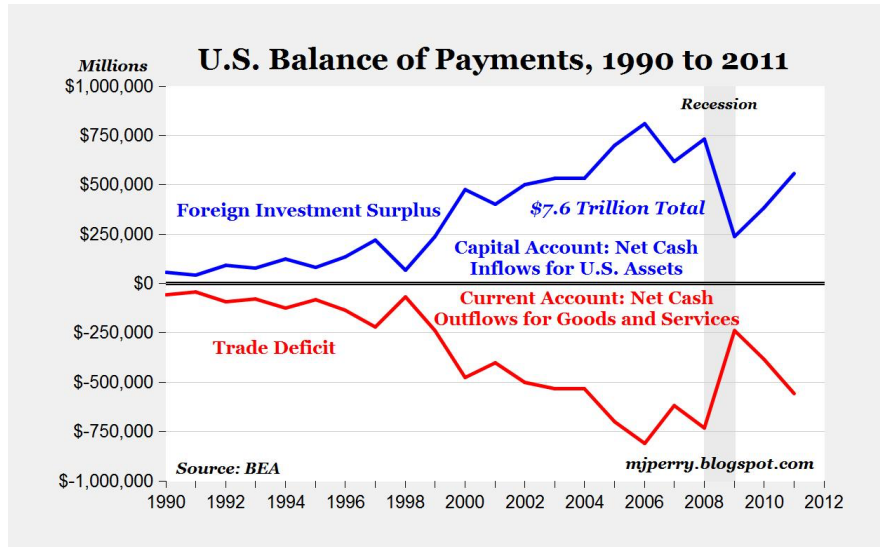


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48

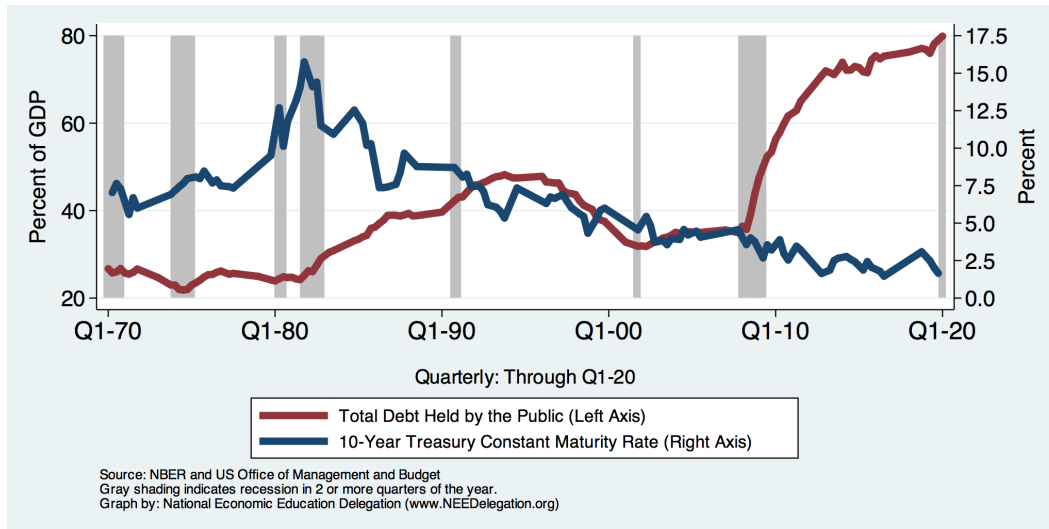
48

Trade and Investment Flows Balance Out



49

Costs 1-2: The Dog That Didn't Bark



50

Traditional View: Cost 3

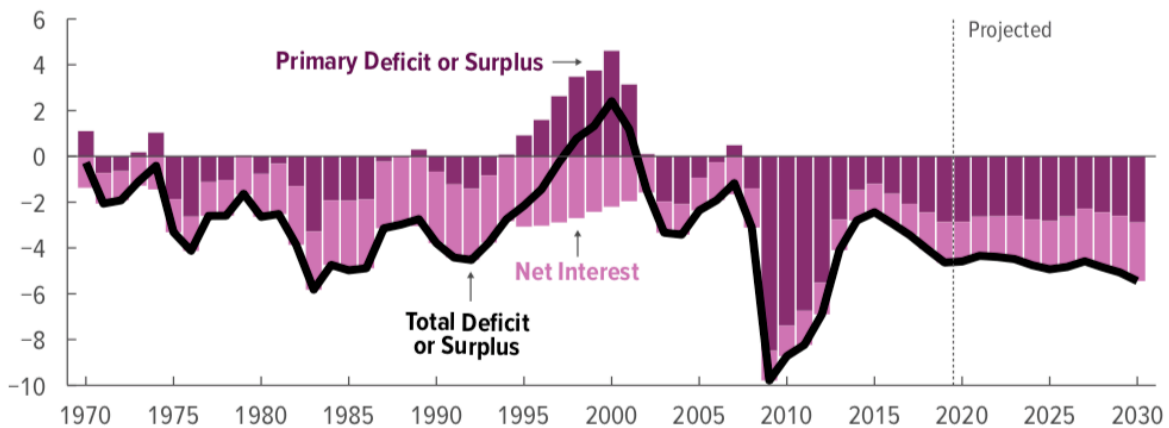
- **Rising debt reduces budgetary options.**

- More debt means higher interest costs.
- Therefore, greater relative debt:
 - o requires a bigger primary surplus to stabilize the relative debt.
- Larger primary surplus means either higher tax rates or less government spending:
 - o "crowding out" of outlays and/or tax cuts.

51

Cost 3: No Primary Surplus Since 2007!

Percentage of Gross Domestic Product

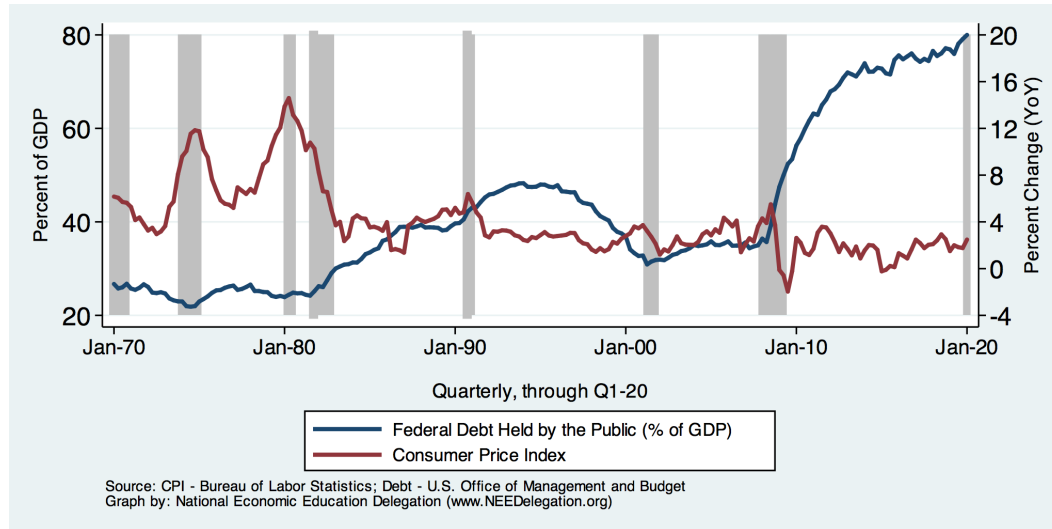


This graph was done before Covid-19

Source: Congressional Budget Office, The Budget and Economic Outlook: 2020 to 2030

52

Cost 4: Anybody See Any Inflation?



53

Maybe Debt Isn't a Problem After All: MMT

- **Stephanie Kelton provided a prominent and recent exposition of modern monetary theory in a *NY Times* op-ed on June 6, 2020:**
 - "Learn to Love Trillion-Dollar Deficits."
- **Modern monetary theory**
 - US Treasury borrows in its own currency and therefore cannot default.
 - As opposed to countries, such as Greece, which borrow in euros.
 - Example: How did we "find the money" for the recent increase in the deficit of about \$1.9 trillion?
 - Answer: The Fed purchased \$1.7 trillion = 89% of financing
 - More generally, MMT argues that we can always find the money to increase federal spending.



54

MMT's Free Lunch

- The only limit on deficit spending is when 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.”
 - First part, acting boldly, is important and likely true.
 - Second part, invest boldly, is suspect.



55

A More Reasonable, But Still Optimistic View

Olivier Blanchard:

- Emeritus Professor at MIT
- Chief Economist at the IMF, 2008–2015
- President of the American Economic Association, 2018



56

Presidential Address, January 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.”

57

What the Traditional View Got Wrong

- **Stabilizing relative debt, debt/GDP, requires that the growth rate in debt equal the growth rate of GDP.**
- **The growth rate in debt has two parts:**
 1. The growth rate in interest on the debt, or just the interest rate.
 2. A contribution due to the primary surplus (–) or deficit (+).
- **The traditional view assumes that the interest rate on debt is greater than the growth rate of GDP**
 - So, 2 must be negative to offset excess of 1.
 - i.e., debt stabilization requires a primary surplus.

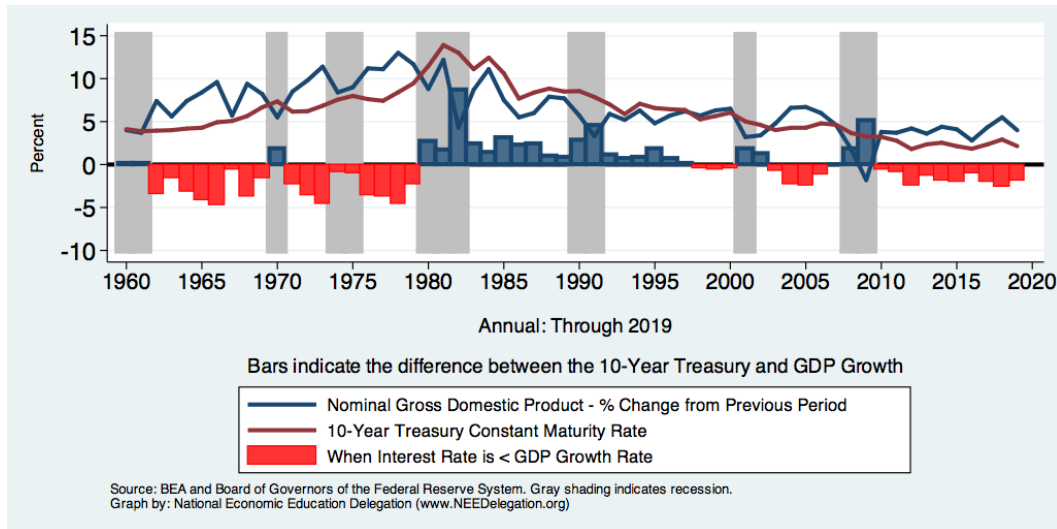
58

An Almost Free Lunch

- If the interest rate is *less* than the growth rate of GDP, then the contribution from the primary budget can be positive, or
- Debt to GDP can be stabilized with a (small) primary *deficit*.
- Blanchard is not MMT (when the crisis is over)
 1. Relative debt must be stabilized.
 2. Primary deficit must be reduced.
 3. But the level of debt at which we stabilize may not be crucial.

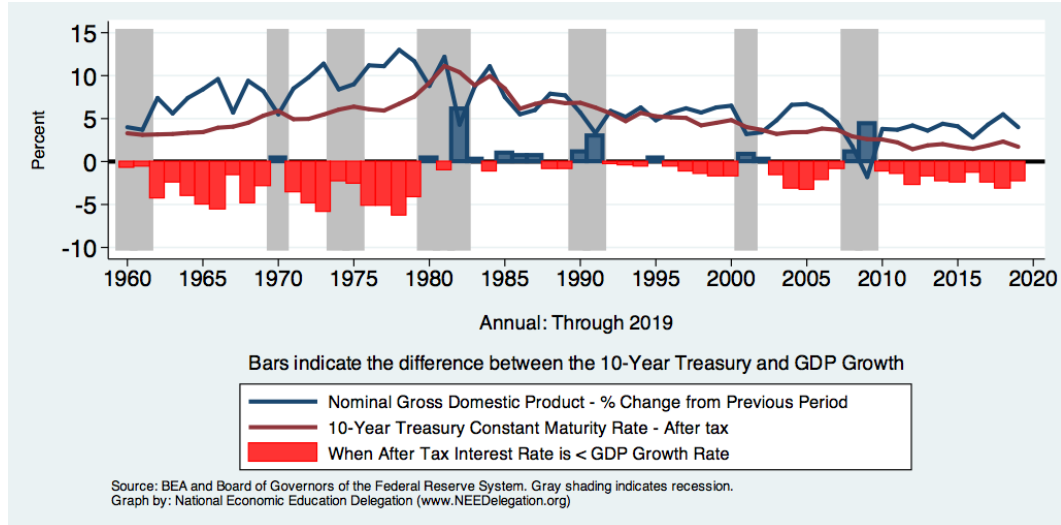
59

Evidence?



60

But Interest on the Debt Is Taxable



61

The Key: Stabilization of Relative Debt

- **Stabilization of relative debt might forestall the consequences of chronic deficits.**
- **Problem: The US federal debt is in no way stable.**
- **W/o stability, interest rates might rise, causing crowding out of:**
 - policy priorities
 - domestic investment
- **Budget surpluses are not necessary, but budget control is.**



62

A New and Possibly Catastrophic Cost

- **MMT is right that, for practicable purposes, the US cannot default on its debt, but ...**
- **International investors can still lose if the exchange rate of the dollar falls.**
- **Remember, foreign holdings of public debt are 40 percent of the total.**

63

Why Do Foreign Investors Buy US Treasuries?

- **Market for Treasuries is the deepest, most liquid capital market in the world.**
- **The US economy has a history of political and economic stability.**
- **We enjoy “an exorbitant privilege” (French President Valéry 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

64

Fiscal Crisis, or a Run on the Dollar

- **With an exploding relative debt, what happens if foreigners lose confidence in the stability of the dollar?**

- **CBO (*Federal Debt: A Primer*, March 2020):**

because the United States currently benefits from the dollar's position as the world's reserve currency and because the federal government borrows in dollars, a financial crisis—similar to those that befell Argentina, Greece, or Ireland—is less likely in the United States.

Although no one can predict whether or when a fiscal crisis might occur or how it would unfold, the risk is almost certainly increased by high and rising federal debt.

- **Crises of confidence, in addition to being unpredictable, happen very quickly.**



What Is a Fiscal Crisis?

- **Increased perception of risk in government debt.**

- **Potential manifestations:**

- Sudden major increase in interest rates
- Plunging exchange rates

- **Why?**

- Increased expectation of default

- **Potential results:**

- Dramatic budget reforms may be quickly necessary to stave off actual default.
- Recession from declines in:
 - o investment (interest rates)
 - o consumption (interest rates)
 - o Government spending
- Higher interest bill on existing debt

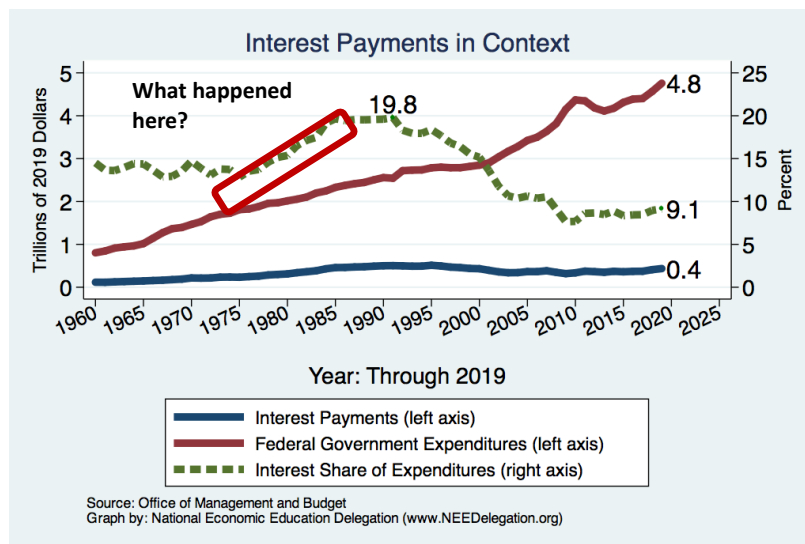


Bottom Line: We Need to Worry about the Debt

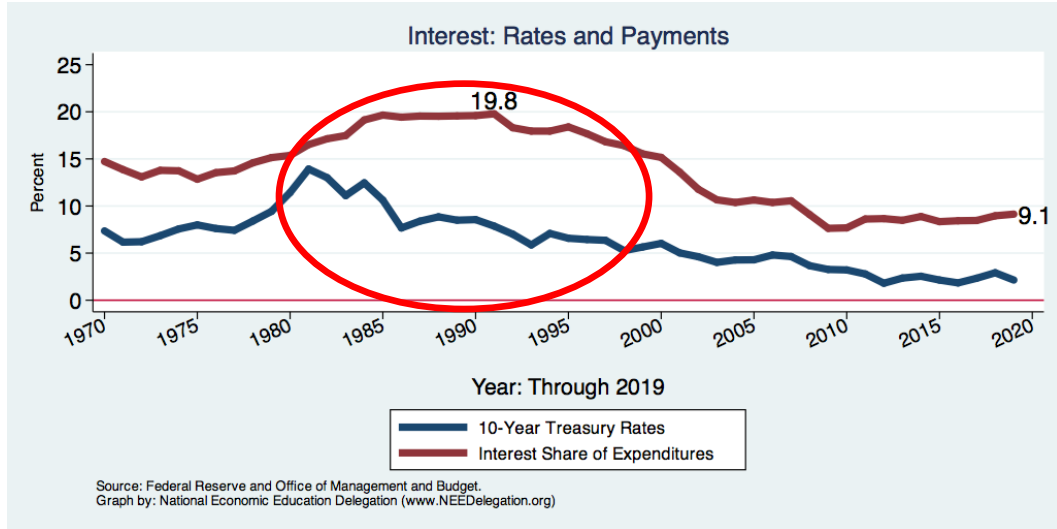
1. Interest rates will not stay this low forever.
2. A fiscal crisis should be avoided at all costs.
3. Stabilizing relative debt would substantially reduce the possibility of a crisis.
4. The good news is we might be able to stabilize relative debt without a primary surplus.

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

History: A Cautionary Tale of Interest Rates?

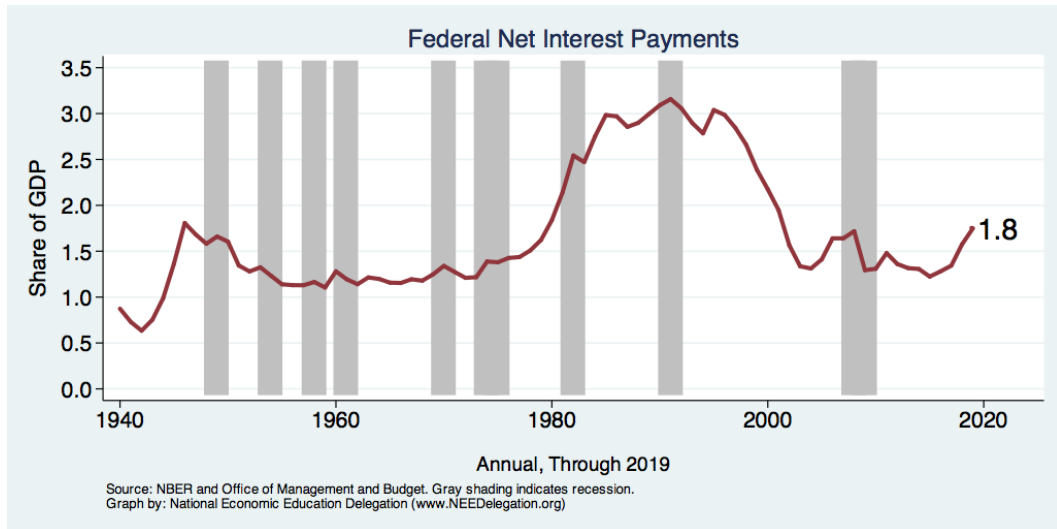


Interest Payments and Interest Rates

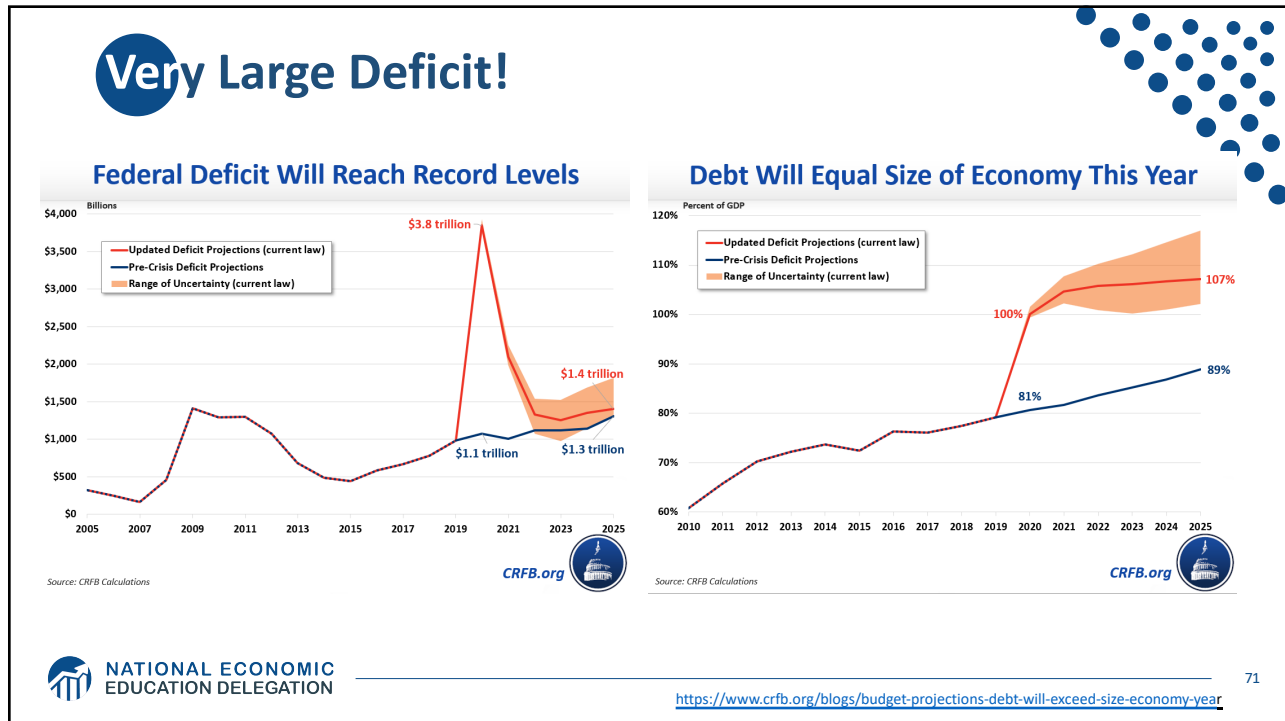


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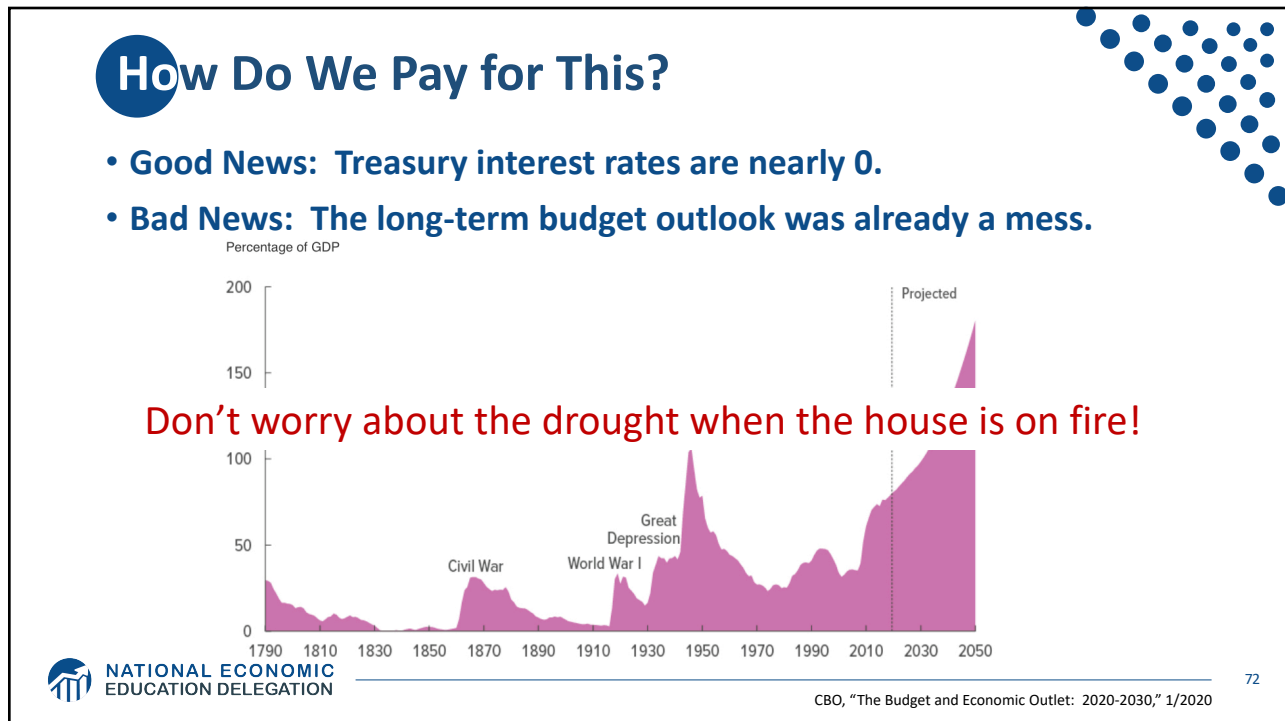
Rising Interest Expenses?



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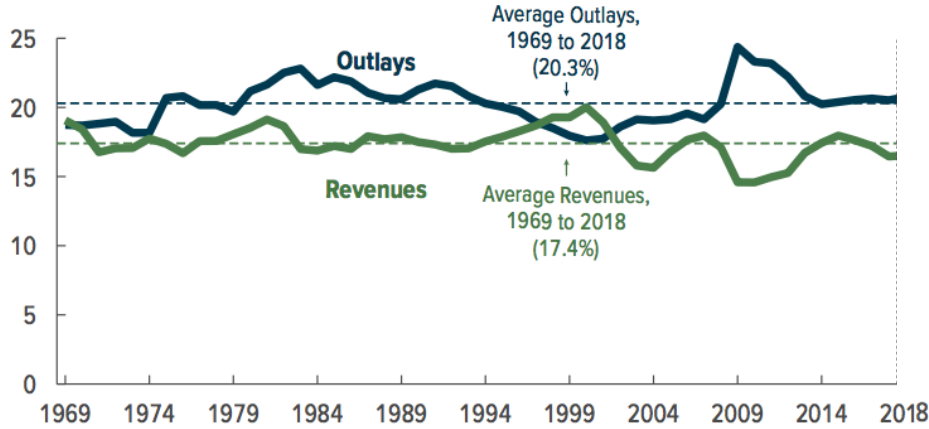
71



72

Why Has the Federal Debt Risen So Much?

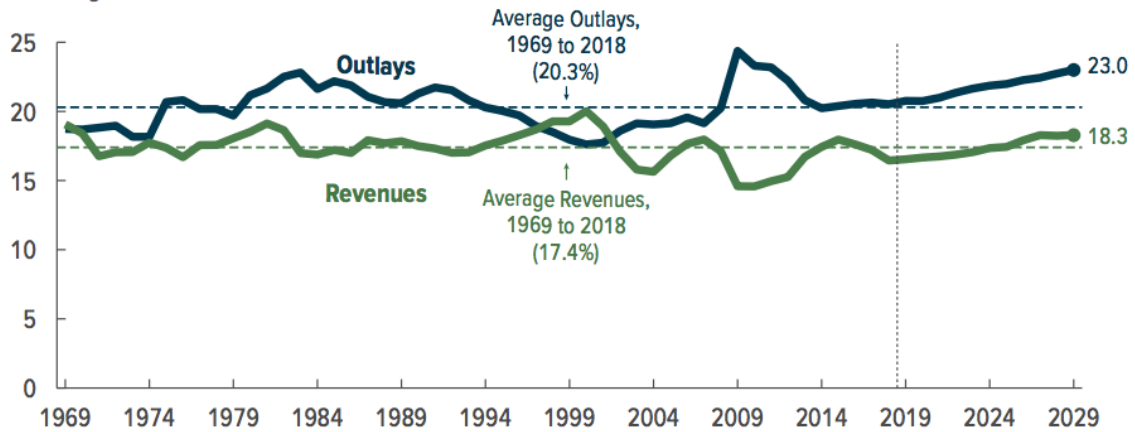
Percentage of Gross Domestic Product



73

Why Has the Federal Debt Risen So Much?

Percentage of Gross Domestic Product



74

Why Has the Federal Debt Risen So Much?

• Expenditures:

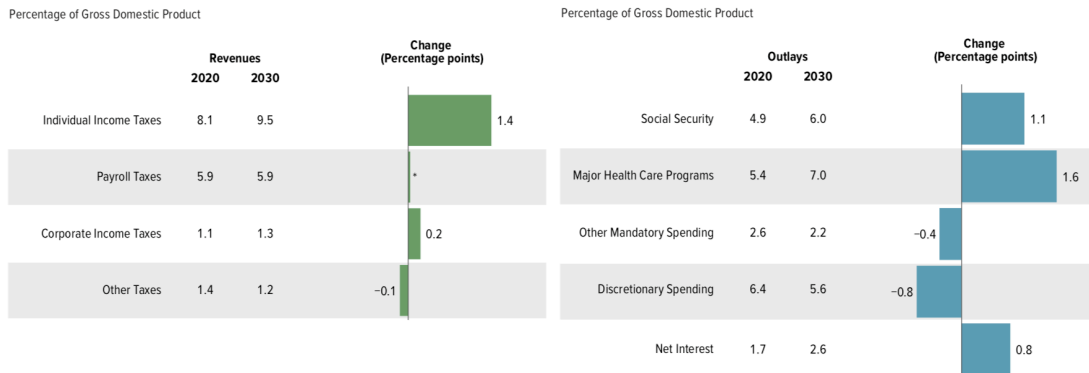
- Social Security
- Health-care costs
- Economic stimulus
 - o In particular, during the Great Recession.
- Military engagements overseas

• Revenues

- Declining income tax revenues
 - o Stagnant wages
 - o Tax cuts
- Social security
 - o Declining revenues
- Corporate income taxes

75

Growth in Outlays Exceeds Revenue



76

Bottom-Line Takeaways

- Herb Stein, an expert on fiscal policy and the chairman of the Council of Economic Advisors under Richard Nixon, is famous for observing: **“If something cannot go on forever, it will stop.”** A rising and accelerating ratio of debt to GDP cannot go on forever.
- We have a choice largely between:
 1. Fiscal crisis.
 2. Reductions in the primary deficit.



OK: Relative Debt Cannot Grow Forever, But

- Does it matter at what level we stabilize relative debt?
- Relative debt stops growing:
 - when the growth of debt is less the growth in GDP (on average).
- Arithmetic: growth rate of the debt equals the interest rate plus the effect of the primary surplus or deficit.
- The bigger the relative debt, the smaller the effect of the primary surplus or deficit.

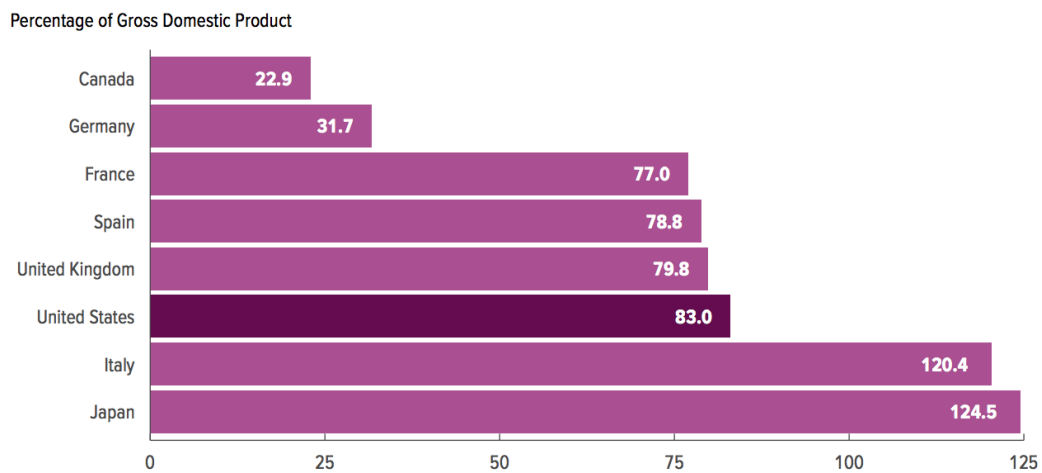


CBO on the Possibility of a Fiscal Crisis

- Moreover,
 - because the United States currently benefits from the dollar’s position as the world’s reserve currency and
 - because the federal government borrows in dollars,
 - a financial crisis—similar to those that befell Argentina, Greece, or Ireland—is less likely in the United States.
- Although no one can predict whether or when a fiscal crisis might occur or how it would unfold, the risk is almost certainly increased by high and rising debt.

Other Countries Have Higher Debt Levels

Debt of Selected Countries at the End of Calendar Year 2018



Source: Congressional Budget Office, using data from the Organisation for Economic Co-operation and Development.

Takeaways (Continued)

- After the virus is defeated, some combination of spending cuts and tax increases must be enacted.
- The particular combination of spending cuts and revenue increases is a political question.
- But high debt levels should not deter:
 - Productive infrastructure investment.
 - Fiscal responses to crises.
- Given the fiscal challenges of an aging population and climate change, it is better to do this sooner rather than later.



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81

81

Bottom Line

- Question is not **WHETHER** the US will have to act...
but **WHEN**.
- Some combination of the following **WILL** be necessary:
 - Raising taxes
 - Cutting spending
 - Reining in health-care costs



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82

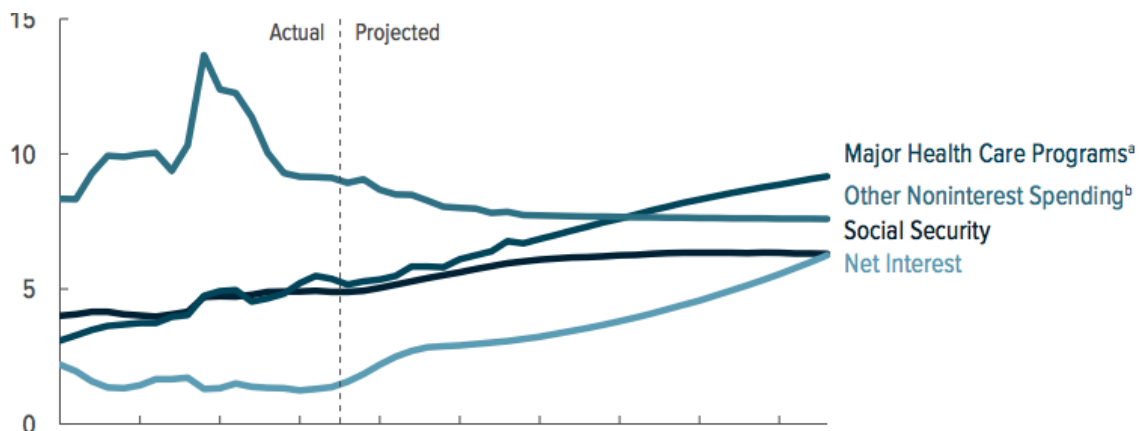
82

Are There Reasons to Wait?

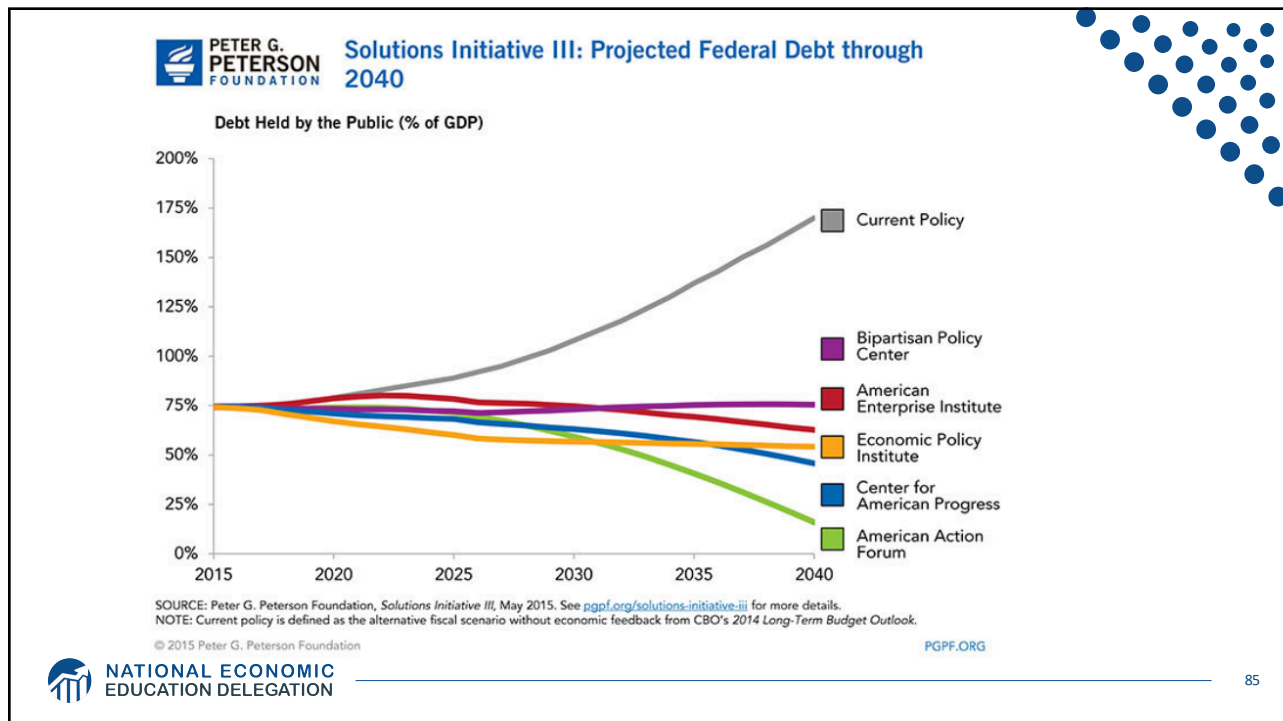
- **Very little evidence of:**
 - Crowding out
 - Inflationary impact
- **Uncertainty about the future**
 - Economic growth might render action today unnecessary.
- **There are a great many investments to be made by the govt.**
 - Infrastructure
 - Education
 - Much, much more ...

83

What Are the Primary Drivers Going Forward?



84



85

There Are Other (Bad/Costly) Solutions

- **Financial repression**
 - Using regulation to force down interest rates.
- **Paying the interest by printing money.**
 - Risks inflation, hyper or otherwise.
- **Or defaulting on the debt.**
 - This will forever raise the cost of government borrowing.

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86

Summary: The Debt

- **The jury is (sort of) out on the debt.**
- **Conventional wisdom is being challenged:**
 - Previously: inflationary and crowd out private investment
 - New assertion: these things don't matter for a country that can borrow in its own currency.
- **Upshot?**
 - This is a policy choice.
 - The cautious approach is to rein in the debt.
 - The cautious approach may lead to slower economic growth.



Summary: Address the Debt?

- **Risks:**
 - Inflation
 - Slower economic growth
 - o Higher interest rates
 - o Crowding out
 - Default
- **Reasons to wait:**
 - Interest rates are very low
 - Lots of important investments to make
 - Economic growth may take care of it



Bottom-Line Takeaways

- **Relative debt must be stabilized, so it is imperative to reduce primary deficits after the virus has been defeated.**
- **Given the fiscal challenges of an aging population and climate change, it is better to do this sooner rather than later.**
- **But high debt levels should not deter:**
 - Productive infrastructure investment.
 - Fiscal responses to crises:
 - “When the house is on fire, you don’t worry about being in a drought; you just put it out.”



Thank you!

Any Questions?

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91

Thank you!

Any Questions?

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92

92