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Our National Debt Denial

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Does debt matter? As the Biden administration and its economic cheerleaders prepare ambitious spending plans, a radical new idea is spreading: Maybe debt doesn't matter. Maybe the U.S. can keep borrowing even after the COVID-19 recession is over, to fund "investments" in renewable energy, electric cars, trains and subways, unionized public schools, housing, health care, child care, "community development" schemes, universal incomes, bailouts of student debt, state and local governments, pensions, and many, many more checks to voters.

The argument is straightforward. Bond investors are willing to lend money to the U.S. at extremely low interest rates. Suppose Washington borrows and spends, say, $10 trillion, raising the debt-to-GDP ratio from the current 100 percent to 150 percent. Suppose Washington just leaves the debt there, borrowing new money to pay interest on the old money. At 1 percent interest rates, the debt then grows by 1 percent per year. But if GDP grows at 2 percent, then the ratio of debt to GDP slowly falls 1 percent per year, and in a few decades it's back to where it was before the debt binge started.

What could go wrong? This scenario requires that interest rates stay low, for decades to come, and remain low even as the U.S. ramps up borrowing. The scenario requires that growth continues to outpace interest rates. Most of all, this scenario requires that big deficits stop. For at best, this is an argument for a one-time borrowing binge or small perpetual deficits, on the order of 1 percent of GDP, or only $200 billion today.

Yet an end to big borrowing is not in the cards. The federal government borrowed nearly $1 trillion in 2019, before the pandemic hit. It borrowed nearly $4 trillion through the third quarter of 2020, with more to come. If we add additional and sustained multi-trillion-dollar borrowing, and $5 trillion or more in each crisis, the debt-to-GDP ratio will balloon even with zero interest rates. And then in about ten years, the unfunded Social Security, Medicare, and pension promises kick in to really blow up the deficit. The possibility of growing out of a one-time increase in debt simply is irrelevant to the U.S. fiscal position.

Everyone recognizes that the debt-to-GDP ratio cannot grow forever, and that such a fiscal path must end badly.

How? Imagine that a decade or so from now we have another crisis. We surely will have one sooner or later. It might be another, worse, pandemic. Or a war involving China, Russia, or the Middle East. It might be another, larger, financial crisis. And with the crisis, the economy tanks.

The U.S. then needs to borrow another $5 trillion or $10 trillion, quickly, to bail out financial markets once again, to pay people's and businesses' bills for a while, to support people in dire need, as well as to fight the war or pandemic. But Washington borrows short term, and each year borrows new money to pay off old bonds. So we also need to borrow another $10 trillion or so each year to roll over debts. As bond investors look forward to think about how they will be repaid, they see a country that at best will return to running only $2 trillion or $3 trillion deficits, still faces unreformed Social Security and unfulfilled health-care promises, and whose debt to-GDP-ratio, far from being stable as the rosy scenario posits, is on an explosive upward trajectory.

Imagine also that the U.S. follows its present trends of partisan government dysfunction. Perhaps the president is being impeached, again, or an election is being contested. There are protests and riots in the streets. Sober bipartisan tax and spending reforms look unlikely.

At some point, bond investors see the end coming, as they did for Greece. If they lend at all, they demand sharply higher interest rates. But if rates rise only to 5 percent, our current $20 trillion debt means an additional $1 trillion deficit. Larger debt makes it worse. Higher interest costs rates feed a deficit which feeds higher rates in a classic "doom loop." The Fed is powerless to hold rates down, even if it is willing to buy $10 trillion bonds, since people demand the same high rates to hold the Fed's money. And the Fed cannot end the crisis by raising rates, which only raises interest costs further.

The end must come in sharp and sudden inflation or default. And that is a catastrophe. When Washington can no longer borrow, our normal crisis-mitigation policies disappear — the flood of debt relief, bailout, and stimulus that everyone expects — together with our capacity for military or public-health spending to meet the roots of the crisis.

Yes, the U.S. prints its own money and Greece does not. But that fact only means that a crisis may end in sharp inflation rather than chaotic default. And it is not obvious that the U.S. government will choose inflation over default. Will Congress really prioritize paying interest to, as it will see them, Wall Street fat cats, foreign central bankers, and "the rich" who hold U.S. debt, over the needs of struggling Americans? Will our elected officials really wipe out millions of voters' savings in a sharp inflation rather than devise a complex haircut for government debt? Don't bet on it. But if bond investors smell a haircut coming, they will flee all the faster.

No, interest rates do not currently signal such problems. But they never do. Greek interest rates were low right up until they weren't. Interest rates did not signal the inflation of the 1970s, or the disinflation of the 1980s. Nobody expects a crisis, or it would have already happened.

Yes, worriers like me have warned of such a crisis for a long time, and it hasn't happened yet. Well, California rests on a fault and hasn't suffered a devastating earthquake in 100 years. That does not prove earthquakes can no longer happen, or that those who warn of earthquakes are chicken littles.

Is not the dollar a "reserve currency," which foreigners are delighted to hold? Yes, but as with all currencies, foreigners will only hold dollar debt in finite quantity and only so long as they

perceive U.S. debt to be super-safe. The opportunity does not scale, and trust once in doubt vanishes quickly.

Yes, Washington incurred a bit over 100 percent debt to GDP during World War II, debt which it successfully paid off. But the circumstances of that success were sharply different. By 1945, the war and its spending were over. For the next 20 years, the U.S. government posted steady small primary surpluses, not additional huge deficits. Until the 1970s, the country experienced unprecedented supply-side growth in a far less regulated economy with small and solvent social programs.

We have none of these preconditions today. What's more, we are starting a spending binge with the same debt relative to GDP with which we ended WW II. And the United States after WW II was one of only two or three episodes in all history in which such large debts were mostly paid off without large inflation or default.

A smaller reckoning may come sooner. Three quarters of this year's deficits were financed by Fed money creation, not by selling Treasury securities, following market trouble in March when foreigners sold a lot of Treasuries rather than buy them as usual in times of trouble. Basically, the Fed printed money (created reserves) and handed it out, and people are sitting on that money in the form of vastly increased bank deposits. When the economy recovers, people may want to invest in better opportunities than trillions of dollars of bank deposits. The Fed will have to sell its holdings of Treasury securities to mop up the money. We will see if the once-insatiable desire for super low-rate Treasury securities is really still there. If not, the Fed will have to raise rates much faster than their current promises.

What can be done? First, spend wisely, as if debt actually has to be paid off. It does. Even if the interest rate remains below the growth rate, that channel for reducing the debt-to-GDP ratios takes decades. When a fiscal reckoning comes, it will require a swifter reduction in debt. That will mean either sharply higher, European-style middle-class taxes or lower spending. Since taxes ruin economic growth — most of Europe has incomes 40 percent lower than the U.S. — most of the adjustment will have to come from spending. The sooner we do it, the less painful it will be.

Second, borrow long. Our government is like a dysfunctional, endlessly bickering, indebted couple, buying a too-big house in the boom of 2006. Should they take the 0.5 percent adjustable rate mortgage, or the 1.5 percent 30-year fixed rate mortgage? The former looks cheaper. But if interest rates rise, they lose the house. Our house. They should lock in the rate!

It is perhaps beyond hope that politicians will ignore such low rates and foreswear borrowing and blowing an immense amount of money. But if the U.S. borrows long term, then it is completely insulated from a debt crisis, in which rising rates feed higher deficits which feed higher rates. Avoiding a debt crisis for a generation really is worth an extra percent of interest cost.

Cutting spending, reforming taxes and entitlements, and saying no to voters who want bailouts and to a progressive army that wants immense spending programs is the tough job of politicians,

one which they will likely fail to do. But the incoming Treasury secretary pick, the talented and sensible Janet Yellen, can choose all on her own whether the country borrows short or long, and thereby avoid a debt crisis for a generation.

If I get to whisper two words in her ear, they will be these: Borrow long.

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