Nov 3 2009, 4:05 pm **by Megan McArdle**

Should I Learn to Stop Worrying and Love the Deficit?

For a while now, I (and practically everyone else) has been saying that the deficit is making us nervous. Not the current deficit, but the future ones. I don't think that we should run any deficits outside of national emergencies, and while I think the current economic mess qualifies, I don't think 2019 does.

Economically speaking, I think an economy growing as fast as ours can sustain a budget deficit in the neighborhood of 3% of GDP almost indefinitely. To be clear, I don't think we should sustain such a budget deficit--if we want programs, we should pay for them ourselves, not ask our kids to. But it is possible to run such a deficit without fiscal crisis or economic stagnation.

But three percent is around the ceiling of sustainable deficits. Six percent is well above that ceiling. At six percent, your debt service burden starts growing much faster than your tax revenues.

On the other hand, the markets don't seem to care, as Paul Krugman points out:

> And right now, deficit-phobia has quickly congealed into the latest CW. You can see it in editorials (not from the Times, I'm happy to say, but almost everywhere else), in what the talking heads say, even in supposedly objective news reporting. Not a day goes by without my reading some assertion that "markets are anxious/jittery/worried about the deficit" -- an assertion based on no evidence whatsoever. (Long-term interest rates on US debt are near historic lows; CDS spreads show no concern about default.)

Matt Yglesias adds:

> It's really maddening that at the same time preposterous idea like strong forms of the Efficient Markets Hypothesis continue to be respectable that people seem unwilling to trust financial markets to *accurately convey the beliefs of participants in financial markets*. I would add to Krugman's observations the fact that we have Cato's Chris Edwards blaming anticipating inflation for the lack of private investment when the TIPS spread shows that markets aren't anticipating inflation.
>
> Right now economic conditions are bad. And the budget deficit is high. So I find it understandable if the man on the street chooses to conclude that the budget deficit is causing or contributing to the bad economic situation. But people writing about these matters ought to know better--interest rates are low and markets are assessing both default risk and inflation risk as low. So what about the deficit is supposed to be causing the problem?

I join with Messrs Yglesias and Krugman in a number of points:

1. The current budget deficit is not causing our economic problems. There may be other administration policies that are contributing, but this is not one of them.

2. Demand for government bonds is robust

3. There are good and powerful reasons to run a deficit in the current recession

Nonetheless, I'm worried about our future budget deficits. And I think a number of market participants are also worried. Why?

For one thing, I don't think the TIPS spread tells us much, for reasons I've gone over before: as long as we have an independent central bank, default risk is greater than inflation risk. And since the market would treat any significant moves to abrogate the independence of the Fed as equivalent to actually inflating the debt away, the government can't regain control of the Fed without triggering the crisis that inflation is supposed to avoid.

As for the debt itself, America's debt right now has a number of idiosyncratic factors pressing on its price: dramatically heightened worries about the rest of the world's economies, and lower inflation expectations. So it's hard to say that the markets aren't pricing in default risk (though equally hard to argue that they are).

If not, why not? Well, a number of factors make US debt demand pretty sticky. The Chinese central bank, for example, wants to keep its currency from rising against the dollar, for reasons you've all heard a million times. That means it wants to buy a lot of US government debt (and quasi US debt, like--oops!--Fannie and Freddie securities). Regulated entities that need to buy securities which meet strict criteria. Unsophisticated and stodgy investors who pour their money into government bond funds.

The economic policy folks at the Bush administration had to spend a bit of time reassuring folks like the Chinese that really, nothing to worry about, we'll keep that deficit under control. I've no doubt the Obama administration is doing the same. And in truth, the prospect of a default is so horrendous that there's some reason to believe that of course we'll do something before it gets out of hand. I'd say, in fact, that this is more likely than not--though I don't know *how much* more likely.

What worries us doomsayers is that when you have that kind of sticky demand, it deludes you into thinking that everything is fine. Sticky demand can, and does, come unstuck eventually. When it does, great big chunks of demand for our debt will flow out of the market all at once. And when you have a lot of debt that you have to roll over every year, that's a bad thing.

Maybe I'm just a nattering nabob of negativism. But when I talk to professionals who invest in government bonds, they don't tell me they think everything is fine. They tell me they're worried about the deficit.