The Effects of Growing Federal Debt on the United States’ Economy

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Summary: In today’s low interest rate environment, the cost of federal debt is lower than it used to be. However, long-run concerns loom. PWBM projections show that policies that reduce federal debt over time produce more economic growth than current policy.

Link to video.

Introduction

At the Peter G. Peterson Foundation’s 2019 Fiscal Summit: Building America’s Future PWBM Faculty Director Kent Smetters joined Olivier Blanchard of the Peterson Institute for International Economics and Beth Ann Bovino of S&P Global Ratings Services for a panel titled “Rising Debt in a Growing Economy: Perspectives on America’s Fiscal and Economic Dynamic.” Greg Ip of the Wall Street Journal was the moderator. He began the discussion by describing Blanchard’s most recent publication as l’enfant terrible of macroeconomics and fiscal policy. Blanchard is at the center of a broad debate in economics that is reconsidering the dangers of public debt. In short, given trends in economic growth, interest rates, and the marginal product of capital, Ip summarized that “maybe the terrible things that we think about with big debts aren’t as terrible as we’ve come to believe.”

Rethinking the Costs of Debt

Blanchard began by summarizing his January 2019 American Economic Association (AEA) Presidential Address, where he focused on the costs of public debt in a low interest rate environment. Interest rates for assets that are considered “safe” have decreased since the mid-1980’s. In particular, interest rates for U.S. federal debt are below the growth rate of the U.S. economy. This has led to the conclusion that the costs of debt are lower and the benefits higher than previously considered. Persistent low interest rates directly decrease the cost of servicing the federal debt. In addition, persistently low interest rates in the face of rising federal debt may signal that the marginal product of private capital is low in relationship to the marginal product of public capital. Thus, the cost of federal debt crowding out private investment and slowing economic growth may be lower than previously thought.

Blanchard summarized his position by stating that “debt is bad, but not necessarily catastrophic.” However he also noted that, “for the long run, it’s clear that there are (fiscal) trends that are extremely worrisome.... I have
no interest in seeing debt going to 150 percent of GDP.” The short term cost of debt is low, but “there are always risks when you have high debt.” Smart changes to programs such as Social Security and Medicare often take a long time to implement. Therefore, changes are best made sooner rather than later and made slowly to avoid economic pain.

Smetters agreed that the cost per dollar of debt has decreased significantly relative to historical levels. Yet, he emphasized that the long-term effects of elevated debt levels are serious. Smetters mentioned that PWBM incorporates a low interest rate environment in its projections along with several “debt-friendly” assumptions. However, PWBM mentioned that the sheer size of federal debt will reach 190 percent of GDP by 2050. Even with low borrowing rates, stabilizing the debt-to-GDP level at its current value could increase GDP in 2050 by one to three times more than the projections PWBM previously provided for the 2017 Tax Cuts and Jobs Act. Therefore, restraining the nation’s debt is more urgent than what Blanchard described, as we risk “death by a thousand cuts.”

Bovino approached the debt issue from an investor’s perspective. The US credit rating was downgraded by one notch from AAA to AA+ in 2011. However, she emphasized that 60 percent of global reserves are currently in US dollars, which gives the nation a large advantage. Considering the reaction of investors to rising federal debt, Bovino stated, “The markets don’t care – until they do.” Later, Smetters agreed by noting that, “when inflation comes, it is way too late,” to begin stabilizing debt. Overall, Bovino highlighted the perceived reliability of the Federal Reserve and the American financial system.

**Japan and Modern Monetary Theory**

In addition to challenges facing the US economy, the panelists discussed Modern Monetary Theory (MMT) and Japan’s experience over the past few decades. MMT has received attention recently by challenging conventional beliefs about the appropriate level of public debt and deficit spending. The theory states that federal government spending is resource constrained, but not financially constrained. Ip mentioned Japan, which has run fiscal deficits while experiencing low inflation and interest rates. However, other countries, such as Argentina have experienced the opposite results.

Economists are broadly in agreement that fiscal policy can be a useful tool to spur growth during economic downturns. However, Blanchard noted his view on where MMT differs from the conventional wisdom: “the notion that you can finance this by money is wrong – plain wrong.” Blanchard pointed out that in the US, the Federal Reserve buys bonds and issues reserves. Although reserves are technically money, there is interest on reserves, so reserves are really a different form of debt. There is only one scenario in which financing by money and debt is equivalent: when the nominal rate paid on government debt is zero, as in Japan today.

**Conclusion**

The panelists agreed that the short-term costs of debt are manageable but will become a more pressing issue in the long run. Since it takes time for policy changes to have an impact on the economy, it is important to take advantage of the current economic situation. Ip asked, “Does it matter what we use debt for?” Smetters replied that increased debt may pay off if spent on high return on investment (ROI) projects, such as well designed infrastructure programs and, possibly, carbon emission-related projects, although those projects are often hard to target in the political process. Bovino indicated that policies designed to bring people back into the workforce and increase their productivity may pay off. Blanchard agreed with both Smetters and Bovino, and emphasized investing in infrastructure and human capital.