
Are Concerns over Growing Federal Government Debt Misplaced?

By Randall Wray Tue, Jan 4, 2022

'Let's put both affordability and solvency concerns to rest: the question is never whether Uncle Sam can spend more, but should he spend more,' writes our guest columnist Randall Wray of the Levy Economics Institute at Bard College.



If the global financial crisis (GFC) of the mid-to-late 2000s and the COVID crisis of the past couple of years have taught us anything, it is that Uncle Sam cannot run out of money. During the GFC, the Federal Reserve lent and spent over \$29 trillion to bail out the world's financial system, and then trillions more in various rounds of "unconventional" monetary policy known as quantitative easing.

During the COVID crisis, the Treasury has (so far) cut checks totaling approximately \$5 trillion, often dubbed stimulus. Since the Fed is the Treasury's bank, all of these payments ran through it—with the Fed clearing the checks by crediting private bank reserves. (To see the original version of this article, go to levyinstitute.org.)

As former Chairman Ben Bernanke explained to Congress, the Fed uses computers and keystrokes that are limited only by Congress's willingness to budget for Treasury spending, and the Fed's willingness to buy assets or lend against them—perhaps to infinity and beyond. Let's put both affordability and solvency concerns to rest: the question is never whether Uncle Sam can spend more, but should he spend more.

If the Treasury spends more than received in tax payments over the course of a year, we call that a deficit. Under current operating procedures adopted by the Fed and Treasury, new issues of Treasury debt over the course of the year will be more-or-less equal to the deficit.

Every year that the Treasury runs a deficit it adds to the outstanding debt; surpluses reduce the amount outstanding. Since the founding of the nation, the Treasury has ended most years with a deficit, so the outstanding stock has grown during just about 200 years (declining in the remainder). Indeed, it has grown faster than national output, so the debt-to-GDP ratio has grown at about 1.8% per year since the birth of the nation.

If something trends for over two centuries with barely a break, one might begin to consider

it normal. And yet, strangely enough, the never-achieved balanced budget is considered to be normal, the exceedingly rare surplus is celebrated as a noteworthy achievement, and the all-too-common deficit is scorned as abnormal, unsustainable, and downright immoral.

First the good news. The government's "deficit" is our "surplus": since spending must equal income at the aggregate level, if the government spends more than its income (tax revenue), then by identity all of us in the nongovernment sector (households, businesses, and foreigners) must be spending less than our income. Furthermore, all the government debt that is outstanding must be held by the nongovernment sector—again, that is us. The government's debt is our asset.

Since federal debt outstanding is growing both in nominal terms and as a percent of GDP, our wealth is increasing absolutely and relatively to national income. Thanks Uncle Sam!

But the dismal scientists (economists) warn that all this good news comes with a cost. Deficits cause inflation! Debt raises interest rates and crowds out private investment! Economic growth stagnates because government spending is inherently less efficient than private spending! All of this will cause foreigners to run out of the dollar, causing depreciation of the exchange rate!

With two centuries of experience, the evidence for all this is mixed at best. Deficits and growing debt ratios are the historical norm. Inflation comes and goes. President Obama's big deficits during the GFC didn't spark inflation—indeed, inflation ran below the Fed's target year after year, even as the debt ratio climbed steadily from the late 1990s to 2019.

The initial COVID response—that would ultimately add trillions more to deficits and debt—did not spark inflation, either. (Yes, we've seen inflation increasing sharply this year—but as I noted, the evidence is mixed and many economists, including those at the Fed, believe these price hikes come mostly from supply-side problems.)

Interest rates have fallen and remained spectacularly low over the past two decades. Anyone looking only at those 20 years could rationally conclude that interest rates appear to be inversely correlated to deficits and debt.

While I do believe there is a theoretically plausible case to be made in support of that conclusion, the point I am making is that the evidence is mixed. And if you were to plot the growth rate of GDP against the deficit-to-GDP ratio for the postwar period, you would find a seemingly random scatterplot of points. Again, the evidence is mixed at best.

Finally, the dollar has remained strong—maybe too strong for some tastes—over the past 30 years in spite of the US propensity to run budget deficits, and even trade deficits for that matter. Both of these are anomalies from the conventional perspective.

So, while there are strongly held beliefs about the negative impacts of deficits and debt on inflation, interest rates, growth, and exchange rates, they do not hold up to the light of experience. When faced with the data, the usual defense is: Just wait, the day of reckoning will come! Two centuries, and counting.

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