There's No National 'Ponzi' Scheme

By Kerry Pechter *Thu, May 26, 2022*

Are our grandchildren doomed to inherit all of our debts, and nothing else? Such pessimism ignores the obvious fact that our grandchildren will inherit our assets along with our debts.

Since 1981, the US national debt has risen from just under $1 trillion to more than $28 trillion. Over the same period, the yield on 10-year Treasury securities fell from 15.84% to, at one point, 1.19%. Since heavy debtors typically pay more to borrow, this makes no sense.

The prominent Harvard economist N. Gregory Mankiw examines this apparent contradiction in a new essay, "Government Debt and Capital Accumulation in an Era of Low Interest Rates." A government may be able to service a growing debt at low rates for certain period, he concludes, but eventually there will be hell to pay.

"If the government in a dynamically efficient economy observes a safe rate much below the average growth rate and *tries to run a Ponzi scheme by issuing a lot of debt and rolling it over forever, it is gambling*," Mankiw writes. (Emphasis added.)

"The policy may well work, but it might not. And the circumstances in which it fails are particularly dire. The big losers are the generations alive when the scheme fails, who must endure either a debt default or higher taxes."

Welcome to the long-running debate between economists and politicians who predict that "our grandchildren" will spend their lives paying off the debt we've run up, and others who disagree—but who can't seem to explain exactly why they disagree.

Ponzi is a pejorative and provocative word. A "Ponzi scheme," named after Charles Ponzi, a 1920s con man, and practiced on grand scale by the late Bernard Madoff, is a swindle where the initial investors in a fake business venture are paid back with money from new investors rather than with legitimate profits or revenue.

Such schemes are both illegal and unsustainable: Gullible new investors become harder to find. (Unless they are simply trying to launder ill-gotten money.) The original investors stop receiving dividend checks. The fraud is exposed. The last to "invest" lose all their money.

In comparing deficit financing by the US government to a Ponzi scheme, Mankiw suggests no one, not even a large sovereign government can keep borrowing to the point where it has to borrow to pay the interest on its own debt. Eventually the consequences of recklessness in the public sectors—default, deflation, higher interest rates, higher taxes, or some combination of them—will damage the private economy.

Social Security is often compared to a Ponzi scheme, since new payroll tax revenues (and interest on its surpluses) constitute its only income. But the comparison isn't justified. Social Security is old-age insurance, not a business venture, and mandatory payroll taxes are not so much investments as insurance premiums. And as we all know, insurers raise premiums all the time; it doesn't mean they're at risk of failure. But I digress.

Mankiw warns that some future generation of Americans could get stuck with paying down today's national debt. "A yet-to-be-born generation does not know whether it will arrive during a lucky or unlucky time, and it may want to share that risk with other generations. This intergenerational risk sharing can be achieved with well-designed fiscal policy. How this risk sharing interacts with debt policy is, I admit, still not completely clear to me," he writes.

Mankiw reaches a four-fold conclusion:

- The decline in real interest rates around the world over the past several decades is not a mystery. It appears to be the result of an increase in world saving, a decline in world growth, and possibly an increase in market power.
- Because interest rates are so low, greater government debt is most likely not problematic from a budgetary standpoint. The government can probably roll over the debt and the accumulating interest forever, in essence letting growth take care of the debt.
- There is an outside chance that this Ponzi scheme of perpetual debt rollover will fail. That possible outcome is especially dire because the failure makes an already-bad state of the world even worse.
- Even if the perpetual debt rollover succeeds, the increased debt issuance could still crowd out capital. If the economy's capital stock is less than the Golden Rule level [i.e., when the supply of capital exceeds the level that maximizes consumption], as appears to be the case, this reduction in capital accumulation will, in the long run, depress not only labor productivity and real wages but also the resources available for consumption.

The reckoning, that is, must come sooner or later.

Another perspective

But is Uncle Sam actually running a swindle? Are our grandchildren doomed to inherit all of our debts? Such pessimism ignores the obvious fact that our grandchildren will inherit our assets along with our debts. The government creates debt and assets simultaneously.

The indictment that America’s current path is unsustainable (unless the government’s creditors let it roll over debt indefinitely at interest rates below the economy’s growth rate) may have been expressed best by former UK prime minister Margaret Thatcher. “Sooner or later the government runs out of other people’s money,” she famously said.

Thatcher seemed to believe that the government relies on borrowing and taxing private wealth to finance its activities. She and Mankiw don’t seem to have considered the fact that the US government creates net new money (or, if it does, it only makes us all poorer by diluting the existing money supply).

The late economist Wynne Godley wrote, “The government cannot have experienced any difficulty with regard to ‘financing’ [its] deficits. It has created more money by running the deficit; money has also been created by bank lending to finance increases in inventories” (*Macroeconomics*, 1983, p 132).

It’s well known that businesses borrow money (“credit money”) into existence from banks, while simultaneously generating financial assets (loans) for banks. Business owners then spend that money into the general economy, creating the pool of money from which they’ll draw revenue and pay back the banks.

Similarly, the federal government borrows money into existence from the big Wall Street “primary banks” (or from the Fed, in a pinch), releases that money into the general economy, and relies on the general pool of money—its source of taxes and new borrowing—to pay its bills and finance its debt.

We often hear about the $28 trillion in national debt. No one seems to worry about the net $16.8 trillion in credit money that banks have loaned and remains unpaid. In modern US history, the US banks’ stock of outstanding credit has only gone up, never down. Yet no one imagines a day of reckoning when all of those loans will be closed out. No one hopes for such an event; it would only mean that $16.8 trillion disappeared from the economy.

The same is true with government debt.

Were it any other way, our debt would have strangled us a long time ago. Instead, the economy has grown, as has personal wealth. The government could in theory eliminate new spending, apply all taxes to retiring debt, and balance the US budget. Then we would have our purgative reckoning. But to what purpose? We’d be out of debt, but the economy would be a whole lot smaller.