Perspectives

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DEFICITS AND GOVERNMENT DEBT IN PERSPECTIVE

For the last 20 years, the U.S. Government has been continuously running budget deficits, resulting in huge amounts of government debt being issued. This trend has been greatly exacerbated by the COVID-19 pandemic and the virtual collapse of the U.S. economy. Trillions of dollars of relief aid have been provided by Congress, creating historically large deficits. Deficit spending has been of ongoing concern for many investors, only to be heightened by recent developments. These concerns range from, at worst, the possibility of eventual default on its bonds by the U.S. Government to the moral issue of leaving our children and grandchildren with the burden of paying off this debt. Also, there is the fear that at some point the accumulation of government debt will lead to high levels of inflation, which will be harmful to everyone. While these fears are not totally unfounded, they illustrate that perspective is required when looking at the overall question of government debt. In this article, we will attempt to allay most of these concerns.

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Deficits and government debt fall within the realm of fiscal policy. Perhaps a good starting point is to describe how the government issues debt and pays it off. Assume, for instance, that the government runs a deficit of one billion dollars in a fiscal year. This means that the government has spent one billion dollars more in that year than it has taken in from taxes, its principal source of revenue. In order to cover that shortfall, the government issues either Treasury bills, notes, or bonds. The maturities or due dates on this debt range from 90 days on bills to 30 years on bonds. What happens when those maturities arise? The government simply rolls over the debt by issuing a new set of bills, notes, or bonds. The amount of these issues may be equal to, greater than, or less than the maturing issues. In essence, the government has avoided having to come up with the dollars to repay the debt by issuing new debt. As long as there are enough buyers for the debt, this process goes smoothly and can go on for many years into the future. Looking back in history, it is likely that the accumulation of massive debt to finance World War II was never actually paid off, instead just refinanced continually so that it became a more or less permanent part of the total government debt that keeps getting rolled over. In a sense, government debt is never paid off, except when budget surpluses occur, for then there are fewer bonds issued, and debt shrinks. The proper way to measure the extent of government debt is to compare it to the size of the economy, much like one would consider a person's indebtedness in relation to their assets or income. More on this later.

The process of rolling over debt can only go on if there are sufficient buyers of the debt. Because the debt of the U.S. Government is considered by global investors to be among the very highest quality and most liquid of investments, this has never been a problem and is certainly not at this time. In fact, there is a surplus of buyers currently, which is one of the reasons that interest rates are so low on government debt instruments, and by extension, on all other types of debt. The interest rate on Treasury debt is the benchmark from which all other debt is priced. It is also important to note that a high percentage of U.S. debt is owned by U.S. citizens and institutions. While China and other nations are buyers and holders of U.S. debt, some 70% of all U.S. Government debt is held by domestic individuals and institutions like insurance companies and pension funds. This means that we owe the majority of the debt to ourselves. When these maturities occur and the debt is rolled over, it will be to the same holders of the debt or new ones. If new ones, it doesn't matter, for it is just a moving around of wealth among different groups of citizens of the U.S.

The U.S Government has many advantages in terms of managing its debt, not the least of which is the ability to more or less set the interest rate at which the debt is priced. The Federal Reserve (Fed) is independent of the U.S. Treasury, the issuer of government debt, but through its monetary policy, the Fed essentially sets the price for the new debt being issued. And since the Fed is now conducting policy that results in near-zero interest rates, this is of great benefit to the federal government, for it allows the debt to be financed at extremely low levels of interest. Consider this amazing fact: despite many years of deficits, the debt burden of the government has actually declined as illustrated by the fact that at the end of 2019, federal debt as a percentage of Gross Domestic Product (GDP) was twice its level of 2000, but federal interest payments as a percentage of GDP were actually down. This demonstrates how favorable low interest rates are to the federal government, providing great flexibility in being able to meet the needs of the economy.

We would never say that deficits don't matter, but there are times when they can be used constructively to improve the health of the economy. While the Fed exercises monetary policy to help manage the economy, government employs fiscal policy to do the same. Fiscal policy is nothing more than the use of federal spending to stimulate or limit overall economic activity by either running budget deficits or surpluses. Keep in mind that government spending is one of the four elements that make up GDP, the most basic measure of economic activity. When the government is running deficits, it is increasing spending, adding to overall demand, and boosting growth. Unfortunately, running deficits has become the norm, since the federal government has not had a balanced budget in 20 years. However, reasonable deficits are not all bad, for if deficits are less than the trend in nominal GDP growth, then deficits as a percentage of GDP will be shrinking. This is very important, for it limits the overall indebtedness of the government. Currently, with the extreme conditions of the COVID-19 recession and the need for support for the economy, deficits far exceed nominal GDP growth. If this is a temporary phenomenon, it is acceptable, for it is a proper role of government to step in to help curtail the effects of disaster. This is not to suggest that any and all deficits are immaterial. While there is a definite role for aggressive fiscal policy, on an ongoing basis, discipline should be the rule with regard to the use of deficits.

There is the issue of government debt and inflation. Many assume the two are linked, but for now, the relationship seems tenuous. The underlying thought is that excessive fiscal spending will alter the supply/demand relationship in favor of demand, which will in turn create inflation. We note the experience of aggressive fiscal spending (large deficits) in the aftermath of the Great Recession of 2008/09. A significant stimulus bill was passed on the order of $800 billion, and there were outcries that this was excessive and would surely lead to high inflation. That never happened, and interest rates have remained very low ever since. There is widespread debate among economists as to what level of government debt as a percentage of GDP will lead to significant economic disruption, either in terms of limits to growth or high inflation. With regard to inflation, we are of the opinion that there are many other reasons for inflation being so docile, namely, secular trends such as demographics, technology, excess supply over demand, and income and wealth inequality, all of which in combination overwhelm whatever inflationary tendencies might arise from deficits (see our paper on "Inflation Worries: Real or Imagined?" on our website). We believe the Fed has adopted the correct attitude of waiting to worry about inflation until it see "the whites of its eyes." While we never know what the future holds, there is no evidence of an inflation threat at the present time, and fiscal policy should not be restrained by such concerns.

We are advocates of responsible fiscal policy over the long run. In our view, this would suggest low deficits or balanced budgets when the economy is performing well, but using deficit spending of more major dimensions when there is real economic distress. While current policy may appear reckless to some, our conclusion is that there is little to worry about presently with regard to deficits and government debt. There is no fear of default, the U.S. still has plenty of borrowing capacity, low interest rates only improve overall economic flexibility, and the government can continually finance its debt for years and even generations to come. And, when economic conditions return to a more normal state after COVID-19 is over, deficits should retreat to more normal levels. Fiscal policy is equally as important as monetary policy, and we support its wise use, especially in times of economic crisis when our superior borrowing capacity can be brought to bear on economic problems.

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