HIGHLIGHTS

Levy Economics Institute of Bard College

Public Policy Brief

Highlights, No. 111A, 2010

DEFICIT HYSTERIA REDUX? WHY WE SHOULD STOP WORRYING ABOUT U.S. GOVERNMENT DEFICITS

YEVA NERSISYAN and L. RANDALL WRAY

Introduction

When it comes to federal budget deficits there appear to be only two respectable positions. The first is the "deficit hawk" position: deficits are never acceptable because they lead to complete crowding-out. The second is the "deficit dove" position: deficits are probably acceptable for the short run, and perhaps even necessary to save the economy from another Great Depression. However, the benefits we receive today are partly offset by costs in the future, when we will need to tighten our belts in order to repay the debt. Even President Obama has argued that today's deficits will impose a heavy burden on our grandchildren (*Economic Report of the President* 2010), and that is why he has proposed budget freezes for the year after next.

New and influential research by Carmen Reinhart and Kenneth Rogoff (2009a, 2009b) purports to show that economic growth slows dramatically—by at least one percentage point—once the gross-debt–to-GDP ratio crosses the threshold of 90 percent. President Obama's proposed budget will soon cross that line, with the debt-to-GDP ratio reaching 103 percent by 2015.[1] This would drop per capita GDP growth in the United States by over half from a long-run potential of 2.5 percent per year. At that pace, living standards would rise so slowly that improvement would barely be noticed—good-bye, American dream.

The full text of this paper is published as Levy Institute Public Policy Brief No. 111, available at www.levyinstitute.org.

YEVA NERSISYAN is a fourth-year interdisciplinary Ph.D. student in economics and math and statistics at the University of Missouri–Kansas City. Senior Scholar L. RANDALL WRAY is a professor of economics at the University of Missouri–Kansas City and director of research at the Center for Full Employment and Price Stability.

Copyright © 2010 Levy Economics Institute

ISSN 1063-5297
ISBN 978-1-931493-98-7

In this brief, we argue that today's deficits do not burden future generations with debt that must be repaid, nor do they crowd out private spending now or in the future. Neither the Reinhart and Rogoff findings nor the conventional "hawk" and "dove" views apply to the situation of the United States, or that of any other nation that operates with a sovereign currency. Our economy faces such strong headwinds that it requires a huge fiscal expansion, meaning even larger, and perhaps more prolonged, deficits than those now projected. Thus, it is more important than ever to explain why sustained budget deficits do not threaten our future.

Deficit and Debt Facts

There is much misinformation surrounding federal budget deficits and debt measures. Budget deficits add to the outstanding stock of debt on a dollar-for-dollar basis. Gross debt (versus public debt) is highly misleading because it includes the debt held in federal government accounts: debt the government owes itself, including securities held in civil service and military retirement funds, Social Security, Medicare, and unemployment and highway trust funds. The relevant debt figure is the amount of Treasuries held by the public.[2] During World War II, the government's deficit reached 25 percent of GDP and raised the publicly held debt ratio to more than 100 percent—much higher than the 73 percent forecast for 2015.

When federal government debt is held by the public, the government liability is exactly offset by nongovernment sector assets, and interest payments by the government generate income for the nongovernment sector. While it is often claimed that deficit spending today will burden our grandchildren, in reality we will leave them with government bonds that represent net financial assets and wealth. If the decision is to raise taxes and retire the bonds in, say, 2050, the extra taxes are matched by payments made directly to bondholders in 2050. And if taxes are not increased later, we will simply leave future generations with Treasury debt that is a net asset in their portfolios, and any payment of interest provides net income to bondholders.

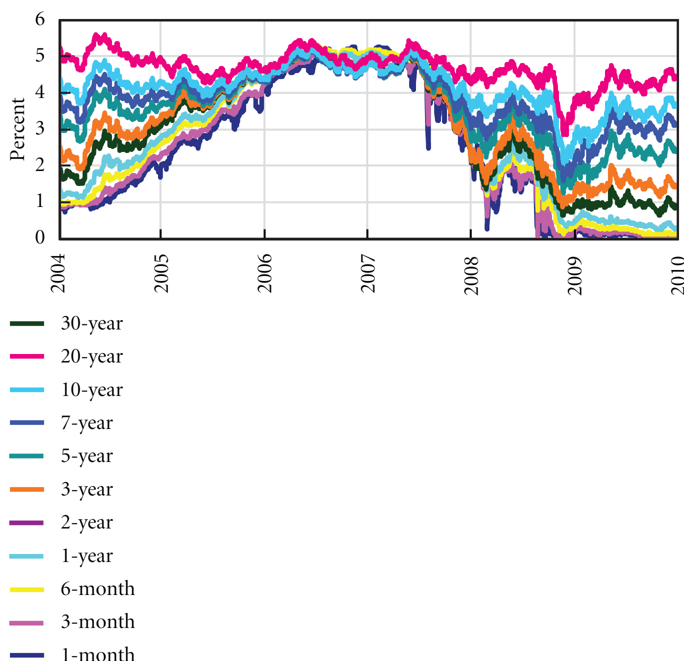
Keeping the inherited debt is exactly what generations of Americans have done. Except for one brief period, from 1835 to 1837, when sufficient taxes were imposed to retire all the federal government debt, we have adopted the more prudent approach of growing the economy and reducing the debt ratio rather than raising taxes or slashing spending.

Financial sector holdings of Treasuries had been on a downward trend before the current global crisis, when a run to liquidity led financial institutions to increase purchases. These holdings act like a buffer: when foreign demand is strong (weak), U.S. financial institutions reduce (increase) their share. If a run to liquidity is feared, the exchange rates of countries thought to be a riskier investment than the United States face depreciation. It is rational for any country trying to peg its currency to the dollar to increase its official holdings in response to a global financial crisis.

There is a link between U.S. trade deficits, foreign trade surpluses, and foreign accumulation of U.S. Treasuries. In a sense, it is the United States' willingness to simultaneously run trade and government budget deficits that provides other countries the wherewithal to "finance" the accumulation of Treasuries. It makes no sense to talk of China "lending" to the United States without also taking into account China's desire for net exports. Indeed, the following matters are all linked (possibly in complex ways): the willingness of China to produce for export and to accumulate dollar-denominated assets, the shortfall of Chinese domestic demand that allows the country to run a trade surplus, the readiness of Americans to buy foreign products, the high level of U.S. aggregate demand that results in a trade deficit, and the factors behind a U.S. government budget deficit. And, of course, it is even more complicated than this, since other nations, as well as global demand, are also involved. But we believe that the current situation will persist much longer than presumed by most commentators. The complex linkages between balance sheets and actions will ensure that transitions are moderate and slow.

Figure 1 shows (daily) yields on Treasuries of different maturities. There was a shocking convergence of yields across the maturity structure when the Federal Reserve pushed overnight interest rates toward 5 percent. While many have blamed the Fed for the real estate bubble because it supposedly kept rates too low, the figure shows that the Fed raised short-term interest rates sharply, but its action did not result in higher long-term rates. Instead, maturity spreads narrowed. When the crisis hit, the Fed quickly lowered short-term interest rates, but long-term rates refused to decline by much. This reflects the "run to liquidity" that is a feature of all financial crises.

Figure 1 **Daily Treasury Yield Curve Rates, 2004–10 (in percent)**



Source: U.S. Department of the Treasury

How Sustainable Are Budget Deficits?

Critiques of President Obama's proposal to stabilize the debt-to-GDP ratio at an acceptable level once the economy recovers are based on the supposition that projected deficits are too large to be sustained. Various indicators have been proposed: maximizing the debt-to-GDP ratio (as do Reinhart and Rogoff), and the Maastricht criteria, or, ensuring that the government debt service does not grow faster than GDP.

If we define government "income" as tax revenue, then a speculative position would be one in which tax revenue covers all current spending, including interest payments, but debt cannot be retired—the definition of a balanced budget. However, new debt could be issued each year, as long as additional interest payments plus additional government spending increase only as fast as government "income." In this way, government could use its capital account to issue debt and "pay for" investment-type spending. This is a common "deficit-dove" proposal, whereby government acts like a firm by keeping a separate capital account.

Here, the "sustainability" condition would depend on the relation between the interest rate paid and the growth rate of tax revenue and other spending, but it would allow the government debt to grow at the rate of GDP. For an open-ended economic unit, a speculative position would appear to be quite safe, although rising interest rates or a fall in tax revenues (and increased social spending) in a recession could turn a speculative position into a Ponzi position by producing large deficits. The question is, is there anything wrong with the U.S. government engaging in what appears to be Ponzi finance?

Is a Government Like a Household?

Discussions of government budget deficits often begin with an analogy to household budgets. A sovereign government, however, bears no obvious resemblance to a household. First of all, the U.S. federal government is 221 years old (dating to the adoption of the Constitution), and no head of household has such a long lifespan: there is no "day of reckoning" or final piper-paying date for the sovereign government.

Corporations that are going concerns can and do allow their outstanding debt to grow year-over-year, and long-lived firms do spend more than their incomes on a continuous basis. The key, of course, is that they attempt to balance their current account and keep a separate capital account. As long as firms can service their debt, the debt can always be rolled over rather than retired. This is why some deficit doves advocate capital accounts for government.

Households do not have the power to levy taxes, issue currency, or demand that taxes be paid in the currency they issue. Rather, households (and firms) are users of the currency issued by a sovereign government, which has the constitutionally provided right to name the money of account. The ability of the U.S. government to impose dollar taxes and other obligations (e.g., fees and fines), and to require those taxes and obligations to be paid in dollars, gives priority to the use of dollars within its sovereign territories that no other currency enjoys.

With one brief exception, the federal government has been in debt every year since 1776. There have been seven periods of substantial budget surpluses and debt reductions, followed by six periods of depression. One finds that every significant reduction of the outstanding debt, with the exception of the Clinton surpluses (which were followed by the Bush recession), has been followed by a depression. Moreover, our less serious downturns in the postwar period have almost always been preceded by a reduction of the federal budget deficit.

The most important point is that the U.S. government is the sole issuer of the dollar, which is always accepted in payment and is nothing more than an IOU. A sovereign government makes payments (including interest payments on its debt) by issuing its own IOUs. This is why we ultimately conclude that the notion of "Ponzi finance" does not apply to government because, unlike private debtors, it can always service its debt by issuing more of its own debt. This is a key to understanding why perpetual budget deficits are "sustainable" in the conventional sense of that term.

How a Sovereign Government Really Spends

The United States has been operating on a sovereign monetary system ever since it went off the gold peg in 1973. If a government issues a currency that is not backed by precious metal or pegged to another currency, then it cannot be constrained in its ability to "finance" spending by issuing currency. If true, then a sovereign government doesn't need tax and bond revenues in order to spend. We argue that modern sovereign governments spend by crediting bank accounts (and simultaneously crediting the reserves of banks). Taxes result in debits of bank accounts, so budget deficits lead to net credits and budget surpluses lead to net debits. A government surplus (deficit) has to equal the nongovernment sector's deficit (surplus).

The U.S. government normally sells Treasuries more or less equal in volume to its budget deficit. When the value of Treasury checks to the private sector is greater than the value of private sector checks used to pay taxes, the private sector receives net income and accumulates wealth. Every time the Treasury spends, bank reserves are credited—as long as the nonbank sector does not withdraw cash from its accounts. If banks already have the quantity of desired reserves (which would be the normal case), Treasury spending creates excess reserves in the system. In order to provide a substitute for the excess reserves and hit its target rate, the Fed sells Treasuries to the private sector, thereby transforming the wealth held in the form of bank deposits and reserves into Treasury securities. Sales of Treasuries should be thought of as a monetary policy operation that accommodates portfolio preferences of banks and their customers. If the nonbank public prefers bank deposits, then banks will hold an equivalent quantity of reserves, cash, and Treasuries (government IOUs), distributed according to bank preferences.

A government budget surplus has exactly the opposite effect on private sector income and wealth. A shortage of cash and reserve balances forces the private sector to sell Treasuries to the Fed in order to obtain the desired reserves. The Fed then adds reserves to the bank deposits it holds, simultaneously reducing the Treasury's deposit by returning the Treasuries. This retirement of government debt must take place as a result of government surpluses, which destroy nongovernment sector income and wealth, forcing households to borrow in order to maintain living standards.

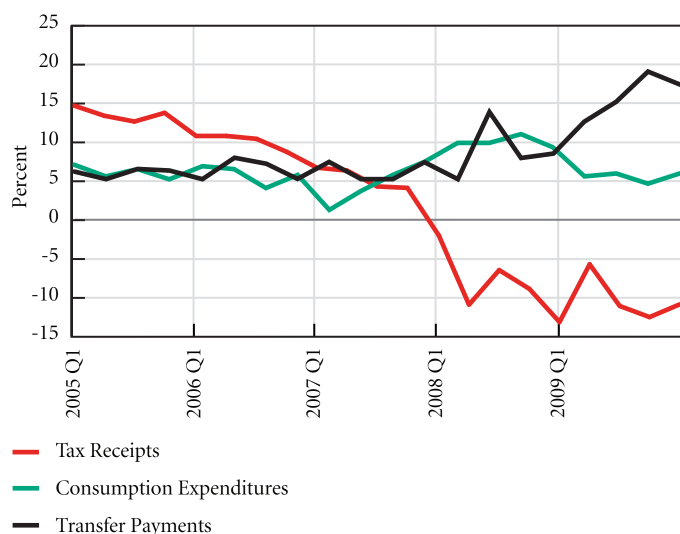
The Three Sector Balances and the Impact of Government Surpluses

Based on the work of Distinguished Scholar Wynne Godley, it is useful to divide the macroeconomy according to its three main sectors: domestic government, domestic nongovernment (or private), and the foreign sector. According to Godley's aggregate accounting identity, the deficits and surpluses across these three sectors must sum to zero.

As evidenced by the current crisis, private sector borrowing on the scale seen after 1997 is not sustainable. The Clinton surpluses had to result in a downturn, just like every sustained budget surplus in U.S. history. And just as surpluses precede recessions, large (nondiscretionary) budget deficits almost always result from recessions because of automatic stabilizers. When the economy slides into recession, tax revenues fall as economic activity declines. Social transfer payments, particularly unemployment benefits, increase automatically as more people lose their jobs.

Despite all the conservative uproar against Obama's stimulus plan, the largest portion of the deficit increase has come from automatic stabilizers rather than from discretionary spending (Figure 2). These stabilizers, not the bailouts or stimulus package, are the reason why the U.S. economy has not been in an economic free fall comparable to the Great Depression. When the economy slowed, the budget automatically went into a deficit, placing a floor under aggregate demand. With the current stabilizers in place, the budget cannot be balanced, and attempts to do so will only damage the real economy as incomes and employment fall.

Figure 2 Federal Government Tax Receipts, Consumption Expenditures, and Transfer Payments,* 2005Q1–2009Q4 (in percent)



*Growth rate relative to the same quarter of the previous year
Note: Tax receipts data unavailable for 2009Q4

Sources: BEA; authors' calculations

Government Budgets and Self-imposed Constraints

Guided by flawed economic thinking, governments worldwide have imposed constraints on their fiscal capacity to fully utilize their labor resources. However, a sovereign government doesn't need to sell bonds in order to spend because it can simply tell its central bank to credit its account by as much as it needs prior to writing checks on that account. Alternatively (and much more sensibly), the central bank and treasury can be consolidated, so that the treasury can credit bank accounts along with its spending.

Bond sales are a completely voluntary and self-imposed operation for a sovereign government. Bonds are merely an interest-earning alternative to low-earning reserves, and they are used by the Fed to hit its interest rate target. A central bank could simply pay interest on reserves (as Canada has done for a long time and the Fed is now doing) and the government dispense entirely with selling bonds and worrying about debt ceilings.

Over time, budget deficits lead to reserve growth that is offset by growth of the Treasury's liability to the Fed (the Fed's asset). Congress (or the Fed) can set the interest rate on the Treasury liabilities held by the Fed that are used for accounting purposes. Since Fed earnings above a 6 percent return go directly to the Treasury, the Treasury in effect would pay most of the interest to itself. The rest would go to the Fed to help cover the costs of paying interest on reserves at the overnight rate chosen by the Fed. This would greatly simplify procedures, make the operations more transparent, and allow everyone to stop worrying about federal government debt. Since reserves are not counted as debt, there would be no publicly held debt.

The rate paid on reserves (and on short-term government bills) is a discretionary-policy variable. The rate on Treasury debt is set relative to the Fed's overnight target rate. This result holds no matter how big the deficit or how much government debt is issued, so long as its maturity is short enough to be a close substitute for overnight interbank lending. This means that the government doesn't need to allow the markets to determine the interest rate it pays on its debt. The Fed could actually set interest rates of different maturities if it were willing to deal in bonds of different maturities—exactly what banks do with their certificates of deposit.

This leads us back to the concern about foreign holders of debt: the foreign holder could decide to exchange its dollar reserves for other currencies. But the decision to sell products to the United States is not independent of the decision to accumulate foreign currency. We are skeptical that the interest rate paid on foreign currency reserves is as important as the decision to export or accumulate foreign currency.

In conclusion, there is no financial constraint on the ability of a sovereign nation to deficit spend.

Countries with Nonsovereign Monetary Systems

To intensify their scare tactics, deficit hawks use Greece as an example of what awaits the United States if it doesn't tighten its fiscal belt. But in doing so, the hawks fail to distinguish or understand the differences between the monetary arrangements of nonsovereign (Greece) and sovereign (United States) nations.

Eurozone countries face two types of problems. First, they have given up their monetary sovereignty by abandoning their national currencies and adopting a supranational one. And by divorcing fiscal and monetary authorities, they have relinquished their public sector's capacity to provide high levels of employment and output. Nonsovereign countries are limited in their ability to spend according to taxation and bond revenues. Moreover, no U.S. state has a budget deficit relative to GDP that comes close to that of Greece or Italy, yet individual

U.S. states are already meeting market resistance to new borrowing precisely because they are nonsovereign.

Second, the eurozone countries have agreed to abide by the Maastricht Treaty, which restricts budget deficits to only 3 percent of GDP and debt to 60 percent of GDP. Countries such as Greece that exceed the limits are punished with high interest rates that drive them into a vicious death spiral, with further credit downgrades as deficits continue to rise. Greece has been forced to cut its budget deficit in a recession, slashing public sector wages and pensions—and further decreasing tax revenues.

There are two real solutions for eurozone members facing default. First, they could exit the eurozone, regain monetary sovereignty, and run budget deficits that are large enough to achieve full employment. The second and preferred solution is to create a supranational fiscal authority within the eurozone, an agency similar to the U.S. Treasury, that is able to spend like a sovereign government. Alternatively, countries could be allowed to have overdrafts in their European Central Bank accounts that enable them to spend euros like a sovereign government (see Mosler 2010).

We need to clearly distinguish between foreign- and domestic-denominated debts. A sovereign government's debt denominated in its own currency cannot be subject to default risk nor can it cause slow growth, as it represents a nongovernment sector's net financial wealth. The Reinhart and Rogoff finding that debt ratios above 90 percent of GDP are correlated with lower growth provides no guidance for policymakers and is not applicable to sovereign nations. Furthermore, we cannot find any conclusions in their book that are relevant to the current U.S. situation.

Notes

1. This is the total outstanding debt ratio. The relevant figure is the portion held by the public, which reaches only 73 percent.
2. There is the belief that the debt owned by Social Security should be counted because it reflects a future obligation of government to future beneficiaries. However, the government is obliged to repay this debt whether or not Social Security owns Treasuries, and it will meet its obligations in exactly the same manner whether or not it holds Treasuries (see Wray 2005).

References

Economic Report of the President. 2010. Washington, D.C.: U.S. Government Printing Office. February.

Mosler, W. 2010. "The Eurozone Solution for Greece Is a Very 'Clever Bluff'?" The Center of the Universe Blog, March 15.

Reinhart , C., and K. Rogoff, 2009a." Growth in a Time of Debt." Draft paper prepared for the *American Economic Review Papers and Proceedings*. December 31.

———. 2009b. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, N.J.: Princeton University Press.

Wray, L. R. 2005. "Social Security's 70th Anniversary: Surviving 20 Years of Reform." Policy Note 2005/6. Annandale-on-Hudson, N.Y.: Levy Economics Institute of Bard College. September.