

EconoFact Chats: The Federal Debt and the COVID-19 Recession

Olivier Blanchard, Peterson Institute for International Economics

Published on 8th February 2021

Michael Klein:

I'm Michael Klein, executive editor of EconoFact. A non-partisan, web-based publication of The Fletcher School at Tufts University. At Econofact we bring key facts and incisive analysis to the national debate on economic and social policies. Publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

COVID-19 continues to surge through the U.S. population and its economic consequences, also are ongoing slowing economic growth and causing hardship across the country. The CARES Act helped mitigate the financial effect for many people, but its costs and the effects of the unprecedented economic collapse contributed to an increase in the federal budget deficit and the federal debt, to levels we haven't seen since World War II. The federal debt held by the public is now about equal to one year's national income. The Biden administration has proposed a \$1.9 trillion relief plan, but there has been pushback from many members of Congress, citing the dangers of piling onto the federal debt. What is the cost to the economy, both now and to future generations, of the federal debt?

Michael Klein:

To address this issue, I'm very happy to welcome to the EconoFact Chats, Olivier Blanchard. Olivier is widely recognized as one of the world's leading experts in macroeconomics and fiscal policy. He had a long and distinguished career as a professor at MIT, he is a past president of the American Economic Association, and he served as the chief economist at the International Monetary Fund from 2008 to 2015. Olivier, welcome to EconoFact Chats.

Olivier Blanchard:

Happy to be there.

Michael Klein:

Olivier, your presidential address to the American Economic Association, which you gave in January, 2019 was titled: Public Debt and Low Interest Rates. The focus of that talk was the cost of the public debt, that is the debt of the federal government when interest rates are low, as they were then, and as they continue to be so now. What's the link between interest rates and the public debt?

Olivier Blanchard:

It's very simple, basically if the interest rates are low, then debt is cheap, in the sense that, in order to pay full interest payments on the debt, you have to raise taxes less than you would otherwise. So there is a trivial sense in which low interest rates allow for more debt. And there is a case which corresponds to where we are, which is even more striking, which is the case when the interest rate is less than the growth rate. In this case, and to put it simply, you can actually issue debt and you never have to repay it, you never have to increase taxes again. Let me go through the argument, step by step, which is, suppose that you decrease taxes in a year, you increase spending in a year and so you have a deficit for a year and you do this just for one year.

Olivier Blanchard:

So you have more debt, but you go back to the old level of spending. So what's going to happen if you never raise taxes again, after that? Then debt is going to increase at the interest rate, and accumulated interest payments becomes more and more debt and the economy is going to grow at the growth rate, right? So that the ratio of debt to GDP, to the economy's output, is actually going to decline over time and this will happen, and you will never have to raise taxes again. There is a sense in which it's nearly a free lunch. I hope we discuss the limits this argument further, but the basic point is then, when the interest rate is less than the growth rate, you really have a lot of margin to use that, if you use it for the right things, obviously, which is an important caveat.

Michael Klein:

Let's talk about that then about, can we go too far? You're not suggesting that the government can spend as it wishes and not worry about the debt, are you?

Olivier Blanchard:

No, there is a limit, although the limit is probably very far away. We have the example of Japan, where the debt to GDP is 250% and things are fine. They pay negative rates on the government bonds, so there is a lot of margin. I think the point is that we can have much more debt than we have today, but it's not clear that we should. And we should only have debt if we have good uses for even more spending or less taxes, but if, for example, there is a recession, then it makes a lot of sense to actually have deficits and to help the economy recover.

Olivier Blanchard:

If there is something like COVID, a health crisis, and we need to spend on health and we need to help people who are unemployed, then indeed, that's a very good use of debt. If we invest for the future, for example, we go heavy on green investment then, again, it makes sense to finance some of it, at least, by debt. The argument is, yes, we have a lot of margin, but we should not waste it. We should basically use it and use it wisely, otherwise we'll just waste it.

Michael Klein:

So the three things that you're mentioning in a recession, which we're in now, in a health crisis, which we're in now, and looking to the future for things like infrastructure, education, and health. All of those are pointing towards having a deficit that is big and consequently, a debt, which is the accumulated deficits, as you mentioned, which is big as well. In your view now, is the government spending too little or too much? Especially if we think about, for example, the Democrats' plan of \$1.9 trillion.

Olivier Blanchard:

I actually think it's too much, so I'm very much in favor of doing what's needed and there two things which are needed, well, three things. The first one is spend as much as we can on getting more vaccines, more tests, and more healthcare. That costs money but by macroeconomic standards, that's actually not terribly expensive. The second is we have to protect people who have lost jobs, at least temporarily and that costs money as well and the third is that we should try to push demand up, so that we produce more and there are more people employed. I think when you make the sum of all these needs, which are real and have to be satisfied, you don't get to 1.9 trillion, you get to a smaller number. I'm now going to guess a number, but I'm not going to give you a number, I'm going to guess a number, but I would say that 1 trillion is probably what's needed.

Olivier Blanchard:

And I worry that if we spend 1.9 trillion, then we are going to increase demand by so much that we'll get overheating. The economy will not be able to actually increase production enough to satisfy that demand. And then we may get inflation, but not just one or 2% more than now, but substantially more. We may force the Fed to react by adjusting rates up, in order to slow down the economy and acting faster and stronger than they really want to and I think we should avoid that. So I'm all in favor of a big package, but my big package number is closer to 1 trillion, not 1.9.

Michael Klein:

As you point out the distribution of that money, not just the aggregate amount, is also important. For example, you mentioned vaccines, a safety net. We know that state and local governments, which can not by law run deficits are also hurting at this time. These are things that you're advocating, but not overdoing it, in other words.

Speaker 3:

Yeah. On this, I didn't mind the idea of a \$2,000 checks, which was 600 in the last package and would be 1400 in this one, because it's really giving money to a lot of people who actually don't need it and I just don't see the point. Last year we did it, we had to do it in a hurry and there was no way to do it much better, I thought it was fine. This time we have more means to do it better and to give it to the people who actually need it.

Michael Klein:

Right, in the spring there are administrative hurdles that you have to jump over and things got so bad, so fast that it made sense then, I guess. Olivier how long can we afford to run big deficits? Are there warning signs that we should look at? Are there targets, or indicators where once they start to blink red, we should be worried.

Olivier Blanchard:

The answer to your question is, I think we can run large deficits if needed for at least a couple of years or more, but I'd say a couple of years. The reason I think this, is I think the interest rates are going to remain very low for the next few years. The markets are absolutely convinced and I see no reason why central banks would suddenly want to increase rates, except in the scenario we discussed earlier. I think there is room, but we should indeed look for signals.

Olivier Blanchard:

The fact that I believe this, doesn't imply that investors believe it and if investors start worrying, we have to decide whether they're right to worry or they are wrong. They could be wrong, in which case the Fed or the ECB can intervene and keep the rates low, but they might see things I don't see. I think that looking indeed at how investors ask for, what we call risk premia, on the long rate, on the rates on long bonds, is indeed something that we should do, but my sense is looking at the arithmetic, looking at the forecast and the uncertainty associated with the forecast, we can definitely afford very large deficits, for example, in 2021 if COVID turns out to be worse than we thought a few weeks ago.

Michael Klein:

You mentioned in your presidential address that there could be a sudden loss of confidence by investors. That's what you're alluding to now, I guess. It would make them reluctant to buy U.S. Government debt and force interest rates to rise. That was written at the beginning of 2019 and I guess you're not seeing

signals still that investors are concerned about things. Although lately we've seen some increase in long rates, isn't that correct?

Olivier Blanchard:

There should be some increase in long rates, in countries in which there's this very strong fiscal package, like the U.S. or the election of Joe Biden, clearly increased the rates, but it's just a little bit. I think if you sit down at this point, really, there is no qualm of debt sustainability. There is just, given that the rates are so low and are going to remain very low, the burden of the debt, the fiscal burden of the debt is very low, so I don't worry. If for some reason the investors, again, got worried for no good reason, then I'm quite sure that the Fed could intervene and basically be on the buy side, if the investors are on the sell side. This is what the ECB has done with respect to Italy and it has worked and I think the same thing would be done to our countries if it happened.

Michael Klein:

So you're bringing up the case of Italy and as I mentioned at the outset, you served as a chief economist at the IMF. When you look around the world now, are you as sanguine about the debt levels of other major industrial countries or emerging market countries as they likewise face the same kind of economic downturn that we're seeing in the United States?

Olivier Blanchard:

You must make a distinction between advanced economies and emerging markets. Advanced economies, I think, have all this space they need, to spend where they need to spend now. This includes Italy, this includes Spain, so I'm not worried, I think that they can do it. When it comes to emerging markets, it's more complicated. Some governments have less credibility, so investors worry that they are going to do stupid things. A lot of the debt is held by foreign investors. They tend to run much faster away from debt of a particular country [if] they have doubt[s]. So I think the emerging markets have much less room and surely some of the poor countries have very little room, they need help. They cannot have large levels of debt. Nobody will buy it in the quantity, which is needed. So I think that it is essential for the IMF, for example, to be there and help.

Michael Klein:

Olivier, when you were at the IMF, when you served as chief economist there, you were there during the great recession and from my understanding, you and your team in the research department, were largely responsible for the IMF shifting its views about supporting a global fiscal stimulus. To me that's very interesting because it speaks to the way in which economic research has a direct effect on policy. What did your experience at the IMF demonstrate to you about policymakers willingness to listen to the advice of economists? Especially in the case of the IMF at that time, when it went against the standard historical views of an institution.

Olivier Blanchard:

It's hard to get policymakers to channel their mind. You can do it with very strong facts and I think that in the end we were very convincing in 2010 and 11, that the multipliers, the strength of fiscal impulse or the adverse effects of fiscal austerity, were very strong and I think that collated, they listened, not with pleasure, but they ended up listening. You can have an effect, you have to keep trying. I think the circumstances in which you have more of an effect, is when the policymakers are scared or lost. I think that happened in 2009, in the U.S. where we were able. I think we were part of a team at the time to actually do lot of things.

Olivier Blanchard:

I think it happened in the COVID crisis. Governments spent in 2020 much more than they ever intended to do. When they are scared, they are more willing to listen and if you give advice, which seems right, they listen and sometimes they do the right thing.

Michael Klein:

Yeah, I was at treasury at that time, we saw each other in Washington sometimes and we were trying to make the case to other countries, that they should have more fiscal stimulus and when I was at treasury, I drew on your work at the IMF, to present it to the treasury secretary and others there. That was pushing on an open door for the U.S. treasury was, I know, not the case for other countries. I imagine you're not, though, advocating we should create scary situations so economists can have more sway in the world, but we can be opportunistic about it, right?

Olivier Blanchard:

I think so, I'd be perfectly happy with less scary situations than we've had in the last decade.

Michael Klein:

Right, I'd rather live in boring times and not be heard as much, I suppose, and clearly as one of the foremost macroeconomists in the world, you have a voice, but I'm sure you would like a quiet life at times as well.

Olivier Blanchard:

I'm perfectly willing to retire if things quiet down.

Michael Klein:

Olivier, I wish you a soon to come retirement, if that's the case. Although given the events of what's going on, I'm afraid you're going to have to stay busy for some time and the fact that you are is very much appreciated by myself and others who follow macroeconomics and understand the important contributions that you've made.

Olivier Blanchard:

Thank you.

Michael Klein:

Thanks very much for speaking with me.

Olivier Blanchard:

Thank you.

Michael Klein:

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