A SYMPOSIUM OF VIEWS

Is *the* World Undergoing *A* Fiscal/Debt Revolution?

The need to go into debt to support the economy during the pandemic has a broad consensus of agreement. Even after adding 10–15 percent of GDP to debt levels, though, some economists are arguing that the world needs to keep expansionary fiscal policy for at least the next decade. In today's era of ultra-low interest rates, they believe that monetary policy is pushing on a string. They further argue that so long as growth and interest rates are so low, fiscal stimulus is near riskless. The argument claims that it is more appropriate to compare debt stocks to the present value of future GDP or interest rate flows to GDP flows.

This thinking implies, for example, that the reasoning that went into the formation of the Maastricht Treaty or various debt-reduction efforts in the United States is no longer relevant for the advanced economies. Some advocates go so far as to argue that in light of dynamic scoring, borrowing to finance appropriate categories of Federal spending "pays for itself" in budgetary terms based on "reasonable" assumptions. Therefore, some economies may be less constrained by fiscal limits even properly benchmarked because fiscal expansions can raise GDP more than they raise debt and interest payments.

Is the global economics profession truly undergoing such a revolution? Is it—like many revolutions—likely to end in tears, or something to be applauded? Or is it like China's Premier Zhou Enlai said about the French Revolution, too soon to tell?

The opinions of nearly two dozen noted experts.

The old orthodoxy on public debt and deficits has collapsed.

J. W. MASON
Assistant Professor of Economics, John Jay College-CUNY, and Fellow, Roosevelt Institute

The old orthodoxy on public debt and deficits has collapsed not from any new developments in economic theory or research, but from its own incoherence and events in the real world.

Economists had long asserted that high government debt was costly and dangerous, but this opinion never had a solid foundation. There was no logical way to reconcile the claim—central to mainstream macroeconomics—that the central bank can set the economy-wide interest rate at whatever level it chooses, with the idea that sovereign borrowers are at the mercy of fickle bond markets. Nor was there ever a way to reconcile the view that sustained deficits are in themselves inflationary with the idea—again, a staple of textbooks—that inflation depends on demand running ahead of supply.

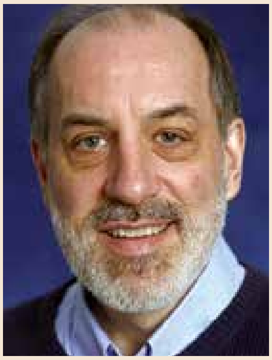
Conventional wisdom said that the central bank should manage demand, while the budget balance was set to stabilize public debt. But this was a political preference dressed up as economics. As a matter of logic, it's just as possible to imagine the opposite assignment, with the budget balance set at whatever level is called for to maintain full employment and price stability, and the central bank holding interest rates low enough to keep public debt under control—as the Fed, for example, did during World War II.

The insistence that debt is a constraint on public spending was always, in Nobel laureate Paul Samuelson's words, a taboo, an "old-fashioned religion" with "myths to scare people into behaving." Like all taboos, this one loses its power once it's been seen broken without consequences. Over the past decade, public debt in many advanced countries rose to unprecedented levels with none of the retribution that was supposed to follow—rising interest rates, runaway inflation, collapsing exchange rates. Meanwhile, central banks' ability to maintain full employment is clearly more limited than we used to believe. Under these conditions, the case for throwing out the old fiscal limits is overwhelming.

A growing consensus among economists on this point does not, of course, remove the institutional barriers to deficit spending that have been built up over the decades, from pay-as-you-go rules to the Growth and Stability Pact. But it does free us to consider two other big questions about public spending.

First, how big is the gap that fiscal policy is expected to fill? How far are the U.S. and other advanced economies from their supply constraints, and how will we know when they start to bind? Second, what substantively are the activities we want the public sector to carry out? Let's say the government can afford to fully replace the incomes of unemployed workers, provide free higher education for everyone, or build millions of units of new public housing: should it do so?

Fears of public debt have been a powerful prop for those who prefer a limited public sector on other grounds. Removing the prop does not make those preferences go away. What is the appropriate scope and role for the public sector? Which activities should be organized around the pursuit of profit, and which are better handled by public employees following democratically agreed-upon rules? Unlike the debate over public debt, where real progress has been made over the past decade, the debate on this question has barely begun.



As it is today, the government can run a Ponzi scheme. But does a free lunch really exist?

LAURENCE M. BALL
Professor of Economics, Johns Hopkins University, and Research Associate, National Bureau of Economic Research

A new view of government debt is rapidly gaining currency. This view holds that levels of debt that once scared economists—100 percent of GDP or more—are benign, because interest rates are low. We once thought that government debt is a burden on future generations because they must pay taxes to service or retire the debt. But if the interest rate on debt (r) is less than the long-run growth rate of the economy (g), as it is today, the government can run a Ponzi scheme. It can issue debt to finance its spending and then perpetually roll over the debt and accumulating interest. With r less than g, the debt naturally falls as a percentage of GDP without the need for new taxes.

Does such a free lunch really exist? Maybe, but let me suggest two reasons for caution.

First, interest rates and growth rates fluctuate and we do not know what the future will bring. While r has been less than g since the 2008 financial crisis, r exceeded g by an average of 1.2 percentage points from 1980 to 2000. Looking forward, the Congressional Budget Office forecasts that nominal interest rates will rise to 4.1 percent in the 2040s, when nominal GDP growth will be 3.5 percent. Largely because r is greater than g, the Congressional Budget Office predicts that government debt in 2050 will be 195 percent of GDP. If that proves true, we will face a choice between painful increases in taxes or the risk that ever-rising debt will eventually spark a financial crisis. Some economists believe the Congressional Budget Office is overly pessimistic about the path of debt, but it is a gamble to assume these economists are right and the Congressional Budget Office is wrong.

Second, a high level of debt damages the economy even if this level is stable and debt is rolled over without higher taxes. The reason is the one stressed in economics textbooks: the crowding-out effect. When savers buy government debt, they use funds that would otherwise be invested in new capital. With less capital accumulation, the economy is less productive and wages and living standards are lower. The crowding out implied by a debt-to-GDP ratio of 100 percent is substantial compared to the total U.S. capital stock, which is valued at 300 percent of GDP.

Some economists suggest that low interest rates mean crowding out is not costly. In their view, if firms are not investing more despite the low cost of borrowing, new investment must not be very productive. However, interest rates on government debt are a poor guide to the economic benefits from new investment. The safety of government debt pushes its return below the return on capital (as measured, for example, by the average return on corporate debt and equity). In addition, the private return on capital is less than its contribution to the economy because firms in many industries have market power. With market power, firms choose levels of output and capital below the social optimum, which implies that the value of a marginal investment project exceeds the cost of capital.

Legislators must develop a framework to get spending under control while also preserving the promises made by the federal government to its citizens.

PAUL RYAN

Former Speaker of the U.S. House of Representatives, and former Chair, House Budget Committee and Ways and Means Committee

Covid-19 has temporarily changed every facet of American life. Our nation’s fiscal policy is no exception, and our debt trajectory has not been immune to the devastating impact—both short-term and long-term—of this virus.

To respond to a once-in-a-century health crisis and a once-in-a-generation economic crisis, the federal government appropriately surged an unprecedented amount of taxpayer dollars to communities so businesses could stay afloat, so front-line workers could deliver care to those suffering, and so Americans could survive significant economic shocks. Though the federal response was far from perfect, because of the actions taken by the Federal Reserve, the Administration, and Congress, our economy—which had been growing steadily prior to the pandemic, thanks to tax and regulatory reform—is positioned to get back on track.

Mitigating the immediate economic turbulence caused by Covid-19 was critical and necessary, but in the long term, lawmakers cannot turn a blind eye to our fast-growing debt and deficits. Interest rates cannot stay at historic lows forever, nor will inflation, and we can’t tax our way out of this problem without cannibalizing economic growth and hurting hard-working families. As it stands, our monetary policy and our fiscal policy are on a collision course.

If the economics profession successfully advances this notion that debts don’t matter (or that they matter much less than previously believed), and if policymakers continue to take the easy path of kicking the can down the road, then this course will surely end in catastrophe.

The advancement of digital and crypto currencies alone will bring a level of accountability to fiat currencies that cannot be ignored, not to mention that the assumptions and projections upon which fiscal stimulus policies rest are rarely realized. Ultimately, a failure to act would impose a painful lesson onto society that will be borne by our children and grandchildren. The kinds of pain that accompany losing reserve currency status, violating society's social contract paid by important entitlement arrangements, and facing the lower living standards that accompany slow growth and debased currencies are just some of what awaits if we travel down this path.

Congress has the power to prevent this collision, but it must act urgently. With the national debt at nearly $28 trillion, legislators must develop a framework to get spending under control while also preserving the promises made by the federal government to its citizens.

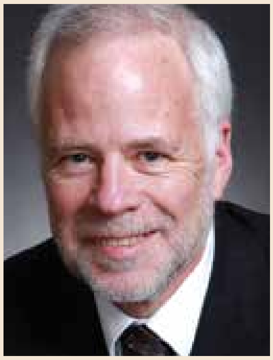
As head of the House Budget Committee, year after year, I offered proposals to balance the budget and pay off the debt. These budgets would pass the House annually before languishing in the Senate.

It has become clear to me that one party will not solve this problem. Compromise and consensus are required. Legislators must no longer view our debt and deficits as a partisan problem, but a math problem.

Fortunately, a framework does exist to address our fiscal policy and do so in a bipartisan fashion. In 1981, President Reagan created the National Commission on Social Security Reform to address urgent issues with Social Security. This bipartisan commission, chaired by Alan Greenspan, was unique in that its members had an agreement on the math (and the size of the problem), had a willingness to compromise (as both sides agreed to mutual sacrifices), and had enforcement mechanisms requiring Congress to take an up-or-down vote on its recommendations.

Recognizing the success of this model, legislators have proposed the TRUST Act, the Time to Rescue United States' Trusts Act, which would create specific bipartisan committees to fix every one of America's trust funds and put them on sound footing. Congress acting in this fashion—and it certainly should do so during the Biden Administration—will instill confidence in the markets and in individuals that the United States will put its finances in order.

The federal government has responded to Covid-19 with solutions that matched the size and scope of the pandemic. But the United States cannot continue spending, printing, and borrowing money that it simply doesn't have. Our fiscal policy has real consequences for real people, as millions of Americans rely on federal safety net programs, which is precisely why lawmakers must embrace a spirit of compromise, utilize models that have worked in the past to address spending issues, and put our fiscal trajectory back on the right track.



The change in the profession's views of deficits and debts is more an evolution than a revolution.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

I would call the change in the profession's views of deficits and debts more an evolution than a revolution.

The Maastricht Treaty, which features in the question, and its so-called Convergence Criteria illustrate the point. At Maastricht, deficits were supposed to be limited to 3 percent of GDP because that was the level consistent with keeping debts at 60 percent of GDP (the level prevailing at the time), given contemporary assumptions about growth rates and interest rates.

Since Maastricht, European interest rates have come down sharply (growth rates more modestly), implying that Europe can hit that same (admittedly arbitrary) debt target while running larger deficits. Had current interest rate conditions already prevailed when European negotiators met at that eponymous Dutch city, surely they would have taken a more relaxed attitude toward deficits and adopted a higher ceiling.

Correspondingly, how relaxed one now feels, viewing the post-Covid fiscal landscape, should depend on how one views the forecast for growth rates and interest rates.

Some conjecture that productivity and economic growth will accelerate because the pandemic has encouraged firms to make use of advances in robotics and artificial intelligence more generally to capitalize on advances in information technology. Others worry that the wrenching post-pandemic adjustment will mean an extended period of slow growth.

In terms of interest rates, if successful containment of the virus is followed by a big party and a surge of consumer spending, then inflation and with it interest rates could rise, although by how much is yet to be seen.

Equally, however, it is also possible that households, having been reminded of the inadequacy of their precautionary savings, will maintain their current higher savings rates for an extended period, putting downward pressure on spending, inflation, and interest rates.

The best way for debt managers to deal with this high uncertainty, of course, is for them to lock in current low interest rates by re-funding current outstanding obligations into very long-term debt.

The much-touted "new thinking" on fiscal policy and debt is actually very thin and little of it is new.

THOMAS FERGUSON
Professor Emeritus, University of Massachusetts, Boston, and Director of Research, Institute for New Economic Thinking

The query requires not a single silver bullet but a shotgun expansion, since it rolls two sets of questions into one. The first concerns the ongoing fiscal/debt revolution. The second, about economic theory, asks whether the old thinking on debt brakes and magic ratios of debt-to-GDP is really obsolete.

Tackling the first is easy. We are indeed living through a debt revolution. Barely a decade after piling on liabilities to meet the Great Financial Crisis, governments are bungling their pandemic responses. Meanwhile, central banks are implementing sweeping new rounds of too-big-to-fail financial market rescues. Many countries—even Germany—openly embrace previously detested "industrial policy." Knowing the central banks have their backs, financial markets, especially in the United States, cheerfully take on vast new mountains of private debt and party like it's the late 1990s.

But the usual macroeconomic justifications for these policies neglect their impact on distribution, leaving ordinary citizens seething. Witness the storming of the U.S. Capitol, the Bernie Sanders/Alexandria Ocasio-Cortez phenomenon, and the GameStop outcry in the United States; recent riots in the Netherlands and Denmark (!); or mass protests in Saxony, Vienna, Italy, India, and other countries.

Spending without piling up debt has a straightforward remedy: raise taxes. Yet most parliaments remain gridlocked. Why? Because stressed-out ordinary citizens aren't ready to swallow new taxes, but neither are the newly rescued rich. The Business Roundtable's response to incoming U.S. President Biden perfectly encapsulates the dilemma of the coming decade. News reports stressed the organization's desire to work with him, but no major changes to the tax code, please.

How this story plays out is already obvious. Recent research shows that outcomes of legislative elections in the United States and France are linear functions of political money. Other studies indicate that in Germany and the United States, only opinion changes among the most affluent citizens (doubtless linked to shifts in lobbying and donations) display regular relations to parliamentary policy shifts.

Passing even modest tax hikes is likely to be bitterly divisive. For the foreseeable future, central banks are here to stay as unelected third houses of parliaments, unenviably tasked with managing economic growth and debt without provoking political explosions.

The much-touted "new thinking" on fiscal policy and debt is actually very thin and little of it is new. In the 1990s, economist Luigi Pasinetti clarified the folly of the proposed Maastricht criteria for public finances and forecast the coming disaster with those. Subsequently, many economists, including more than a few working with the Institute for New Economic Thinking, showed in detail how austerity reduces potential output over time and how absurd theories about Phillips Curve trade-offs lead to big underestimates of real rates of unemployment. Running below full employment for long periods blows big holes in public finances and thus piles on debt.

The new thinking in fiscal policy among mainstream economists, central banks, and finance ministries is finally coming to terms with this literature and the realities of austerity politics. Its champions aspire to run closer to the wind on "inflation" and hope to break legislative stalemates by reestablishing the automatic stabilizers they used to campaign against, while taking advantage of low interest rates.

It pays to read the fine print, though. The recent Peterson Institute statement by Peter Orszag, Robert Rubin, and Joseph Stiglitz frankly acknowledges that the diverse trio has "different perspectives on whether any spending increases or tax reductions enacted today but that extend past the end of 2022 should be offset by other changes in the budget."

Translation: some champions of the new look in fiscal policy continue to think like the many Germans who champion their country's constitutional debt brake for the long run, even as it is temporarily suspended.

Watch out. In an era of zombie banks, beware of zombie movie reruns. Recall that as word came that the Democrats had won both Georgia Senate races, the dollar sold off a bit. Keep your eye on the casket in which the old view of debts and deficits is buried.

The views expressed here are the author's own.

Many worry that a return to higher equilibrium interest rates will cause a fiscal crisis or uncontrolled inflation or both. These fears are overblown.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

The Covid-19 pandemic is forcing a massive fiscal response around the world. Government debt is rising by double-digit percentages of GDP. Yet government bond yields throughout the advanced economies and some emerging economies are lower than before the crisis. With bond yields negative in real terms, the cost of boosting or sustaining output by fiscal policy has never been lower.

Surely nobody doubts the reality of secular stagnation now. Government spending to keep output as close as possible to its pandemic potential is nearly a free lunch. Three key questions remain: Where are the limits to useful fiscal borrowing? How long will secular stagnation be with us? And how can we manage the transition back to normal if and when it occurs?

The answer to the first question is complicated by the existence of both demand and supply aspects of the pandemic. Public health measures restrict the capacity of restaurants and entertainment venues, but patrons may not wish to spend their money on these and some other services even when they remain open. Fiscal policy should aim at supporting unemployed workers and affected businesses as long as needed. But there is no point trying to "stimulate" output that would increase the spread of the virus and it is not yet clear how much, if at all, the economy needs to adjust permanently away from affected sectors.

The large increase in U.S. household saving in 2020 reflects pent-up spending that should enable a rapid return to trend output when the pandemic is under control. In the meantime, affected sectors need continued support. It is difficult to target aid only to those who truly need it. Better to overdo it rather than let people fall between the cracks. The best approach is to make fiscal help conditional on the state of the economy, so that it can end automatically when the pandemic subsides.

Economists are debating the second question vigorously. Some argue that the demographic factors behind stagnation are already retreating. But the more comprehensive studies suggest that stagnation has only plateaued and may not start to retreat for another decade or more. Moreover, one of the main drivers of secular stagnation—slow population growth—is not expected to change at any point in the future.

The third question is the most important. Many worry that a return to higher equilibrium interest rates will cause a fiscal crisis or uncontrolled inflation or both. These fears are overblown. The end of secular stagnation is likely to occur gradually, just as it began gradually. We will experience slightly faster growth and modestly higher inflationary pressures for any given level of policy rates. Fiscal revenues will outperform expectations. Central banks will start to nudge interest rates higher. Generally good economic performance in an environment of rising interest rates will present the natural time to reconsider long-run tax and spending plans.

Of course, there is no guarantee that policymakers will respond correctly. Mistakes will happen. But there is nothing intrinsically disastrous about, and much to welcome from, a return to slightly faster growth and modestly higher interest rates.

Japan tried its own fiscal and debt revolution. The result: the Bank of Japan sooner or later will have to be replaced.

TAKESHI FUJIMAKI
Former Member, House of Councillors, Japan, and former Tokyo Branch Manager, Morgan Guaranty Trust Company of New York

Economists who advocate for a fiscal and debt revolution will disappear with the Bank of Japan which, I think, will be replaced with a new Japanese central bank sooner or later.

The Japanese government's ratio of debt to GDP is 266 percent as of October 2020, by far the largest in the world, much bigger than that of the United States which is about 130 percent, and the European Union at about 100 percent. The Japanese government has not gone bankrupt yet despite this huge debt because the Bank of Japan started its huge bond-buying operations in April 2014 to finance the government's debt. Historically, such debt monetization has always resulted in hyperinflation.

Bank of Japan Governor Haruhiko Kuroda denies that the Bank's operation amounts to debt monetization, saying it is being done for the purpose of getting out of deflation. But we yell fire if the house is burning, whether by arson or accident. As of the end of 2020, the Bank of Japan held as much as ¥535 trillion (US$5.1 trillion), which is more than half of outstanding Japanese government bonds. The Japanese government has issued ¥1,004 trillion (US$9.6 trillion) worth of bonds as of September 2020.

Because of its big bond-buying operations, the Bank of Japan's assets are now about 130 percent of Japan's annual GDP, much higher than the roughly 60 percent of GDP for the European Central Bank and 30 percent for the Federal Reserve. And the Bank of Japan's chance to exit from monetization may have already disappeared, although Japanese people have not recognized its seriousness.

The Bank of Japan cannot do anything when the economy recovers and inflation progresses. This is the biggest problem with the fiscal/debt revolution theory.

If the economy recovers or inflation progresses, the Bank of Japan will need to raise the short-term policy rate to control inflation. One way to do this would be raising the interest rate on banks' current account deposits with the Bank of Japan, like the Fed raised its policy rate from 2015 through 2018. Private banks in Japan have deposited as much as ¥494 trillion (US$4.7 trillion) on current account with the Bank of Japan as of the end of 2020. This is the result of the debt monetization.

If the Bank of Japan raises its short-term policy rate in order to control inflation, it will have to pay ¥4.94 trillion (US$47 billion) for every 1 percent increase in the interest rate. The Bank of Japan's net income for fiscal year 2019 was only ¥1.37 trillion (US$13 billion), so the Bank of Japan will lose money and soon end up with negative net worth. Its reserves are only ¥9.7 trillion (US$93 billion).

If Japan's fiscal deficit is shrinking, a crisis can be averted even if the Bank of Japan has a negative net worth, but that is not the situation now. Governor Kuroda said in the Diet that there would be no problem because when it needs to pay higher interest on the current account, it will receive a greater amount of interest from its bond holdings. But that is not true, because the majority of bonds which it is holding now are long-term, not short-term, bonds. Out of the ¥535 trillion in bonds held by the Bank of Japan, ¥494 trillion (US$4.7 trillion) are long-term bonds. It will not receive a greater amount of interest until those bonds mature and are replaced by higher-coupon bonds.

The asset structure of the Bank of Japan is totally different from what it was twenty-five years ago when it held very few long-term bonds. Moreover, long-term rates will begin to rise as people price in inflation caused by excessive liquidity. It may happen well before central banks raise short-term policy rates. If this happens, the Bank of Japan will face a big problem.

The average yield on its Japanese government bond holdings is only 0.247 percent for the period from April 2019 to March 2020. It may be much lower now because the Bank bought a huge amount of bonds at zero percent in the last year. So if long-term rates go up by only about 0.2 percent, I believe the Bank of Japan will have unrealized losses on its bond portfolio.

At one of the Diet sessions, the Bank of Japan's data indicated that if the yield curve moves 1 percent upwards parallelly, the Bank of Japan will incur an unrealized loss of ¥24.6 trillion (US$236 billion), ¥44.6 trillion (US$428 billion) on a 2 percent move, and so forth.

These were calculated based on data from March 2017, so losses will be much greater given the current size of the Bank of Japan's holdings. Compared with annual tax income of about ¥60 trillion (US$577 billion), you will recognize how large these losses are.

Governor Kuroda says there is no problem, because the Bank of Japan is adopting accrual accounting, so it does not recognize the losses.

But will foreign investors continue to lend if the Bank of Japan begins to carry huge losses on a mark-to-market basis, and has no way of reducing the amount of its bond holdings because the Japanese government's fiscal deficit is so large? I doubt it.

If foreign investors decide to close their account with the Bank of Japan, they will not be able to trade in Japanese government bonds or Japanese stocks. Moreover, foreign investors will not be able to trade in foreign exchange because there will be no way to settle their yen without using the Bank of Japan's current account. The yen will become a local currency and will have no means of exchange with other currencies. The value of the yen will collapse and Japan will experience hyperinflation.

A new Japanese central bank will need to be established in order to regain credibility for the currency. The current yen will be replaced with a new yen with a very low exchange rate. People who own the current yen will suffer greatly.

Either the households or the government will need to pay back the debt. No one else will finance them. The only difference between households and the government is that the government has the right to collect taxes and is able to avoid payment of debt legally, that is, by creating hyperinflation.

History tells us that expanding fiscal policy and monetizing government debt by central banks always results in hyperinflation, especially when accumulated debt becomes too big to be reduced by tax revenue.

People around the world will recall that fact by seeing the collapse of the Bank of Japan.

The Maastricht Treaty and various debt-reduction efforts in the United States are still very important in order to prevent people from suffering from hyperinflation.

What we are witnessing is another stage in the evolution of the Insurance State.

THOMAS MAYER
Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsch Bank Group

What we are witnessing is not a revolution in fiscal policy or even economics, but the beginning of another stage in the evolution of the Insurance State. The late German sociologist Ulrich Beck described the modern society as a "risk society." We tend to minimize risks to our lives as much as possible and insure the rest. Since not all risks can be insured privately, we have created the Insurance State.

The birth of the Insurance State can be dated back to the year 1883, when German Chancellor Otto von Bismarck introduced the first public health insurance. An occupational accident risk insurance and state pension insurance followed before the turn of the century. During the first three decades of the twentieth century, many industrial countries introduced public unemployment insurance. But this did not seem sufficient to protect citizens against economic crises. The experience of the Great Depression in the early 1930s therefore paved the way for insurance against economic downturns through fiscal policy. "Keynesianism" was born. In the 1970s, Keynesianism ran into the quicksand of "stagflation," which led to a brief period of abstinence from public insurance of the economy.

During the second half of the 1980s, however, "Greenspanism" emerged. There, monetary policy is tasked with insuring against economic downturns. Since monetary policy operates through the banking sector and capital markets, Greenspanism forced interest rates down on trend, which fueled banking and financial crises. When the policy rates of central banks had reached their effective lower boundary, the power of quantitative easing evaporated. Confronted with the coronavirus pandemic, the Insurance State moved to the next stage. I call it "Keltonism," in honor of Stephanie Kelton, a figurehead of Modern Monetary Theory. Now, central banks create the money, which the Insurance State pays out to its clients.

However, like the sorcerer's apprentice of Goethe, Keltonism is likely to lose control over public debt accumulation and money stock expansion. For contrary to the idea of MMT, the Insurance State will never find a good opportunity to mop up the monetary overhang it has created during the pandemic by raising taxes and lowering spending to cut down government debt. When asset price inflation eventually spills over into runaway consumer price inflation, the Insurance State will reach its next stage. How will it look?

We can only speculate. Perhaps credit or "fiat" money, as it is sometimes called, will turn into legacy money with vanishing purchasing power, and new money will emerge. Perhaps new monies will be issued privately in the form of cryptocurrencies, which will appreciate against legacy credit money. Debtors in legacy credit money will get relief from inflation, creditors will incur losses. Perhaps people will have had enough from the unbounded Insurance State for a while, and we will experience another period of abstinence, like in the first half of the 1980s. But there is no "end of history." At some time in the future, the Insurance State would surely rise again.

Many of those so concerned expressed no alarm about financing the Bush and Trump tax cuts, the most structurally expansionary fiscal policies of the past generation.

ROBERT SHAPIRO
Chairman, Sonecon, and former U.S. Under Secretary of Commerce for Economic Affairs

Our first task is to recognize that the implications of fast-rising national debt depend on economic circumstances and contexts that differ across countries. Further, a ten-year time frame would be an exercise in scenario speculation, since we cannot know how the conditions that create the circumstances and context for fiscal policy will evolve over ten years. My response, therefore, will focus on the likely costs and benefits over the next three to four years of strengthening current U.S. expansionary fiscal policies, as against the likely costs and benefits of reversing those policies.

The answers are straightforward. With output, employment, business investment, and incomes depressed, economies applying neutral or restrictive fiscal policies at a minimum will slow their recoveries. Those effects might not be dispositive if we faced rising inflationary pressures.

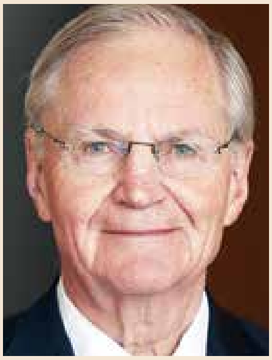
But we do not. Before the pandemic, inflation remained below target after we adopted the highly expansionary tax cuts in 2017, the principal reason the annual budget deficit soared by $400 billion from 2016 to 2019.

In fact, President Biden's rescue program is not expansionary. The $1.9 trillion package includes $935 billion in $1,400 checks to individuals, additional unemployment benefits, and tax benefits for low-income working families and families with children. Those measures do not cover even half of the current pandemic-related losses in personal income: Real personal income in November was 10.5 percent below that of April, the equivalent of a $2.1 trillion decline on an annual basis. The package also includes $680 billion in assistance to state and local governments and schools, which will mainly substitute for state and local spending, plus new spending on the vaccination program and other Covid-19 responses. Economic recovery is unimaginable without that spending. The rest consists of funding for businesses to offset new proposed mandates on the minimum wage and paid sick leave.

President Biden also has ambitious plans for infrastructure, college support, access to health care, and the environment. Looking ahead to 2023 and 2024 when a strong recovery should be in place, there is little economic grounds for concern that it would result in dangerous increases in the structural deficit. In the long run, these plans are all public investments that should raise productivity and growth.

In a shorter term, the issue is how this agenda will be financed. Stating the issue in this way highlights that the concerns of some critics of President Biden's plans are not economic but political. Yes, his plans would expand government's role in healthcare, education, and the environment—and we held a national election to determine Americans' preferences on those matters. For those who oppose it, new elections will be here soon enough. In the meantime, it's disingenuous to cloak a political preference for less activist government in a seemingly neutral economic argument, especially one with little economic basis.

Beyond that, there are concerns about actually financing more spending with more revenues. In a society in which federal revenues have never reached even 20 percent of GDP, claims that the Biden agenda will require economically crippling tax increases seem vastly overstated. Growth, employment, and investment all were stronger in the 1980s and 1990s when federal revenues as a share of GDP were much higher—and wealthy households and profitable businesses may face tax burdens approaching the levels of those prosperous times. Again, those concerns about such financing seem more political than economic, especially since many of those so concerned expressed no alarm about financing the Bush and Trump tax cuts, the most structurally expansionary fiscal policies of the past generation.



It would be dangerous to allow the economy to reach such levels of indebtedness. Markets would begin to impose a rising inflation-risk premium.

WILLIAM R. CLINE

President, Economics International Inc., and Senior Fellow Emeritus, Peterson Institute for International Economics

Federal debt held by the public rose from 35 percent of GDP in 2007 to 79 percent in 2019. With pandemic disaster relief and recession, it reached 98 percent in 2020, and is now on track to reach 113 percent in 2022 even if only half the Biden stimulus had been passed. In September 2020, the Congressional Budget Office projected the ratio would reach 195 percent of GDP by 2050. Even though interest rates have been low in recent years, it would be dangerous to allow the economy to reach such levels of indebtedness. At some point, markets would begin to impose a rising inflation-risk premium, and even a credit-risk premium.

The recent trend toward Fiscal Free-lunch Forever economics is premised on two propositions. First, it is "r-g", the interest rate minus the growth rate, that matters, not the debt-to-GDP ratio. The proposition is that if the interest rate is lower than the growth rate, debt is not a problem. That focus fails to take account of the primary deficit, which the Congressional Budget Office projects at an average of 3.5 percent of GDP in 2022–2030 and 4 percent of GDP in 2031–2050, driven by social security and major health programs.

The second Fiscal Free-lunch Forever premise seems to be that the real interest rate will be zero into the indefinite future. I calculate that the *ex post* realized real interest rate for the ten-year Treasury note was an average of 2.7 percent over the past six decades, with a median of 2.2 percent. The thirty-third percentile was 1.1 percent, so I consider 1 percent to be a prudential minimum for medium-term projections. Indeed, the Congressional Budget Office's statistical model finds that the real ten-year rate rises 2.5 basis points for each percentage point increase in the debt-to-GDP ratio. Its projections accordingly show the real ten-year rate rising to 1.8 percent by 2040 and 2.6 percent by 2050.

When I use 1 percent as the benchmark real ten-year rate by 2024, the ratio of interest payments to GDP reaches 2.7 percent of GDP by 2030 and 4.7 percent by 2050.

(The Congressional Budget Office's projection reaches 8.1 percent by 2050). The average interest burden over the past six decades was only 1.9 percent of GDP, so focusing on the interest burden instead of the debt ratio does not make the long-term debt problem disappear.

Does using the "real interest-to-GDP ratio" instead of the nominal ratio reverse this diagnosis? Deflating both the future stream of nominal interest payments for the numerator and the future stream of GDP for the denominator would not change the time path of the ratio. Deducting each year's inflationary erosion of the stock of debt from interest would place a real metric in the numerator against a nominal value in the denominator.

Is comparison of a stock (debt) in the numerator to a flow (GDP) in the denominator misleading? Not as misleading as obtaining the present value of GDP by discounting at a permanent zero discount rate—making the denominator infinite and the debt burden by definition zero.

Finally, fiscal policy should be particularly careful to avoid locking in permanent new spending streams premised on temporarily low interest rates. Periods of low rates and high unemployment are ideal for discrete infrastructure investments (aside from problems of implementation lags), but new permanent obligations should be financed by permanent tax increases.

Advanced countries have a golden opportunity to take on more low-cost debt to pay for much-needed stimulus and long-term investments in R&D, education, and infrastructure.

MICHAEL MANDEL
Chief Economic Strategist, Progressive Policy Institute, and Senior Fellow, Mack Institute for Innovation Management, Wharton

In February 2007, when I was chief economist at *BusinessWeek* (pre-Bloomberg), I wrote a cover story for the magazine entitled, "It's a Low, Low, Low-Rate World: Why Money May Stay Cheaper Longer Than You Think." Perhaps I should take credit for my prescience in foreseeing the future course of interest rates and the fiscal/debt revolution to come.

Unfortunately, the ink on the cover was barely dry (yes, we still used ink then) when the subprime mortgage market started to unravel, leading into the Great Financial Crisis.

That experience left me with a jaundiced "yes, but" attitude when it comes to long-term forecasts of low rates. With the global economy still slowed by the pandemic, governments in advanced countries certainly have a golden opportunity to take on more low-cost debt to pay for much-needed stimulus and long-term investments in research and development, education, and infrastructure. This spending, done wisely, will help pull the global economy out of recession while raising the expected long-term growth rate.

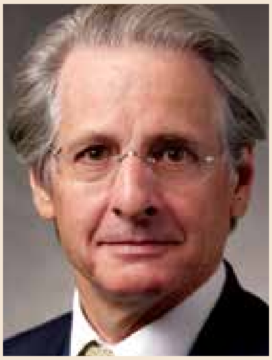
Nevertheless, I worry that excess levels of debt will aggravate future financial instability and potentially lead to worse financial crises in the future. So higher expected growth needs to be balanced out against greater instability.

How much debt is too much? Answering this question is difficult, since the appropriate size of the short-run Covid recovery package depends on the duration of the global pandemic. Consider an "ugly" scenario where the virus mutates into more virulent forms faster than vaccines and treatments can keep up. In that case, the need for government support for the economy will increase at the same time that future expected growth will slow, making it harder to pay future debt servicing costs.

An alternative scenario would lead to vaccine manufacturing ramping up and extinguishing the pandemic quicker than expected. In that case, excess stimulus could lead to an inflationary surge. It's a reflection of the uncertain times that the "ugly" scenario and the inflationary scenario seem equally likely.

Another key question is whether the current private sector investment funk will come to an end. For example, the time seems ripe for companies to start making the massive financial commitments required to create a new global transportation infrastructure based on electricity and other low-carbon fuels. The "physical" industries such as manufacturing, construction, healthcare, agriculture, and even government are increasingly investing in software and hardware to achieve the productivity gains needed to compete globally and lower costs domestically.

Finally, the successful development, testing, and manufacture of multiple Covid vaccines suggests that the Biotech Century, which has been beckoning for nearly twenty-five years, may finally have arrived. This sprint shows what can be done with an expedited regulatory process that prioritizes safety while embracing uncertainty. In a recent report, I proposed that President Biden appoint a high-level "Biopharma Regulatory Improvement Council" to institutionalize the lessons learned in the pandemic about the bio development and approval process. These changes could create ample new investment opportunities, and lift the global economy, productively, out of the current low rate environment.



We have a dishonest political leadership that would offer benefits beyond what it is willing to ask voters to finance.

MILTON EZRATI
Contributing Editor,* The National Interest, *Chief Economist, Vested, and author,* Thirty Tomorrows: The Next Three Decades of Globalization, Demographics, and How We Will Live *(Thomas Dunne, 2014)

Certainly some, in the service of a political/social agenda, would use the pandemic emergency to bring about such a "revolution"—jettison constraints on government spending growth and the expansion of debt. They may get their way. Publics in both the United States and Europe seem at the moment to be in no mood for spending constraints of the sort previously imposed in different ways in both places. I hope such a "revolution" does not take place, for over the longer run it would end in tears.

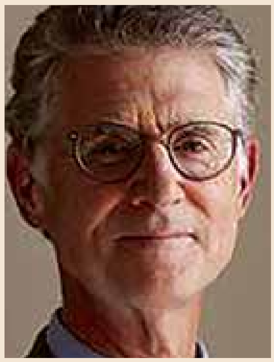
A continual fiscal/debt "revolution" would differ in kind from the decision to use government spending and debt to offset the economic impact of the pandemic and the steps taken to contain it. Widespread support for such policies in the present circumstance rest on firm foundations in just about every economic school of thought, Keynesian, classical, even Austrian. (I leave out Marxist because it is more of a religious belief than a school of economic thought.)

The emergency demanded fiscal action, because the virus and the constraints put in place to combat it had rendered normal market-based solutions inapplicable, and for that reason, among others, they had also rendered monetary solutions weak at best. The alternative to spending and debt use was economic collapse.

To be sure, there is a question of intergenerational equity involved. Because the recent spending was financed by debt, future generations will pay the bill. But just as in the case of debt financing for a major, existential war, economic logic can support the burden shifting. After all, the measures to contain the virus, just as the action to win an existential war, benefit future generations. It would be unfair to ask the generation that copes with the pandemic (or fights the war) to pay for it as well.

But emergency responses say little about the need for constraints on ongoing spending and debt use of the sort imposed before the pandemic. A nation that finances with debt on an ongoing basis undermines rather than secures its future. It is saying that on an ongoing basis it wants greater benefits than it is willing to pay for in taxes, a higher standard of living than it could otherwise afford. It speaks to a dishonest political leadership that would offer benefits beyond what it is willing to ask voters to finance. Since economic growth will presumably enable future generations live better than the present generation, some debt growth is acceptable but not if it outpaces economic growth.

Such a situation is unsustainable. It ultimately will result in inflation, default, contempt for the political authorities that promote it, and most likely all the above. This risk is why prior to the pandemic, both the United States and Europe in various ways and with only some success appropriately took action to contain spending growth and debt use. If the special circumstances of the pandemic allow a movement away from such constraints—the "revolution" of the question—the future will include all these evils.



Simply assuming that government spending "pays for itself"—without credible estimates of the impact on productivity—is not analysis, but folly.

PETER R. FISHER
Clinical Professor, Tuck School of Business at Dartmouth College, and Former Under Secretary of the U.S. Treasury for Domestic Finance

A strong fiscal response to the abrupt decline in output caused by the pandemic was, and remains, both necessary and desirable. But open-ended fiscal expansion simply because current interest rates are low is likely to end in tears. A simple comparison of debt quantities—stocks or flows—to GDP is misleading and misguided.

There are three important conditions for fiscal sustainability: first, if the sovereign can run a primary surplus, rather than a primary deficit; second, if outlays are directed toward productive investment, rather than consumption; and last, if real interest rates are low. Focusing on the United States, a score of one out of three is not good.

The U.S. government is running a primary deficit and, without a significant increase in federal tax revenues, will continue to do so indefinitely. Before the pandemic, federal outlays were already massively skewed toward direct support for consumption. Even if we now make significant and desirable increases in federal infrastructure investment, under any plausible projection of U.S. retirement and health care costs, outlays will continue to be dominated by support for consumption rather than investment in the coming decades. The likely inertia in both the primary deficit and our spending patterns casts more than a little doubt on the "reasonable assumptions" of the new debt optimists. Confronting and reversing these two trends will be the central challenge to making fiscal policy both sustainable and usefully supportive of long-term growth.

Real interest rates are, indeed, low. But of the three conditions for fiscal sustainability, interest rates are the most likely to change, are most capable of changing rapidly, and have more room to rise than fall.

Economist Rudi Dornbusch's famous observation that "things take longer to happen than you think they will, and then they happen faster than you thought they could" is not just an observation about economics. It is a recognition of our limited capacity to understand both causal inference and time. Simply assuming that government spending "pays for itself"—without looking under the hood for credible estimates of the impact on productivity—is not analysis, but folly. Rationalization and wishful thinking might yet create a revolution in fiscal policy, but it is unlikely to be either happy or enduring.

It is dangerous to assume that a low interest rate environment will persist into the indefinite future.

ANNE O. KRUEGER

Senior Research Professor of International Economics, Johns Hopkins School of Advanced International Studies, and former First Deputy Managing Director, International Monetary Fund

Despite a much-increased debt-to-GDP ratio, the interest rate has remained very low since the global financial crisis. There are several reasons for this. Because the rate of inflation is low, any given nominal interest rate is equivalent to a much higher real rate than in earlier years. A nominal interest rate of, say, 1 percent in 2020 is equivalent to a nominal interest rate over 4 percent during the 1990s, when inflation averaged above 3 percent. Moreover, there was still some slack in the economy after the Global Financial Crisis of 2007–2009, and just as that seemed to be being absorbed with low rates of unemployment, the pandemic struck and with it another recession. Low nominal and real interest rates are clearly warranted.

That does not mean the rate of inflation will stay low forever, either in nominal or real terms. The higher the level of debt, the greater the problem if inflation accelerates. There would then be a conflict between tightening monetary policy (and letting the interest rate rise in both nominal and real terms) to cool inflation, and reducing the fiscal deficit with a rising debt-servicing burden. For example, U.S. debt was just over 100 percent of GDP at the end of fiscal 2020 and rising, although debt-servicing costs remained low because the interest rate was around 2 percent.

Suppose that inflation accelerates to, say, 5 percent. The nominal interest rate would then need to be at least 5 percent to prevent a negative real rate. If the average maturity of the debt were five years, a needed increase in the nominal rate of 1 percentage point would result in an annual increase in interest-servicing costs of the debt of 1 percent of GDP over the following five years. And that would not increase the real interest rate, which would be needed.

Added to prospective increases in fiscal expenditures for demographic reasons, the impact of such a sustained increase could be huge unless taxes were raised rapidly to finance the added interest burden.

The debt ratio rises unless the rate of nominal growth of GDP exceeds the interest burden of the debt plus the fiscal deficit as a percent of GDP. The fact that the American fiscal deficit was above that rate before the pandemic already meant that the increased fiscal expenditures (which were clearly warranted) enlarged the debt-to-GDP ratio even further.

While additional expenditures during the pandemic have been needed, the resulting higher debt-to-GDP ratio would result in a conflict between the goals of full employment and stable prices if inflationary pressures intensify at a later date. It is dangerous to assume that a low interest rate environment will persist into the indefinite future.

With needed increases in health and retirement-related expenditures, the challenge will be to reduce the fiscal deficit as a percentage of GDP significantly below the rate of growth of nominal GDP once the pandemic is brought under control and economic growth accelerates.

The events of 2020 demonstrated yet again that increases in the quantity of money can crush any recession.

TIM CONGDON

Chairman, Institute of International Monetary Research, University of Buckingham

Fiscal policy—virtually moribund as a policy instrument in the Great Moderation during the twenty-five years to the Great Financial Crisis of 2007 and 2008—returned to the center of the stage in the coronavirus crisis of 2020. In that sense, at least we are now living in a public debt revolution. The resurrection of fiscal policy has come at the expense of monetary policy, which—according to such commentators as Paul Krugman in his *New York Times* column—is no longer effective.

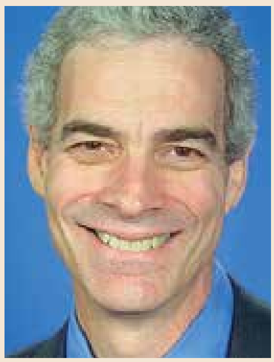
Claims of monetary policy ineffectiveness are of two kinds. The first arises when the central bank rate—invariably a very short-term rate of interest—is at or close to zero, and cannot go lower. Central banks seem to be stymied by this "zero lower bound." The second, which goes back to economist John Maynard Keynes' 1936 *General Theory,* asserts that—in a so-called "liquidity trap"—increases in the quantity of money do not reduce "the rate of interest." By this phrase, Keynes meant the yield on bonds, particularly the yield on long-maturity bonds.

Obviously, the zero lower bound and the liquidity trap are distinct. Nevertheless, a refutation of both can be developed in a mere one paragraph of exposition. This begins by noting that increases in the quantity of money can certainly be engineered by central bank purchases of assets from non-banks, as in the operations that have become known as "quantitative easing." Once money is created in this way, it affects demand and output not only through the bond market, but also directly in markets for goods and services, and indirectly through all asset markets.

As far as the direct mechanism is concerned, a straightforward example is provided by a cash-strapped corporate sector. Suppose balance-sheet strain is causing companies to slash capital spending and inventories. If the central bank increases the quantity of money, more cash circulates around the economy. Some will reach companies, easing the pressures on them to cut investment. A positive effect on aggregate demand follows, whether the central bank rate is minus half a percent or 15 percent. In other words, money expansion helps the economy regardless of the level of the central bank rate. The constraint of the zero lower bound can always be overcome.

The fallacy in the liquidity trap is even more banal. Investors are constantly balancing their money holdings against all non-money assets, including equities and real estate as well as bonds. When the quantity of money rises, that causes investors to step up their purchases of equities, buildings, and structures, and so stimulates asset price inflation. Last year, 2020, offered a vivid illustration of the potential power of these forces. On the evening of March 15, the U.S. Federal Reserve announced that it would in short order acquire $500 billion of government securities and $200 billion of agency-backed mortgage securities in a possibly unlimited quantitative easing program. Over the next three months, the S&P 500 index rose by almost 30 percent, with undoubtedly favorable effects on the American and world economies.

The Covid-19 crisis may have been accompanied by a re-activation of fiscal policy. But the case for that re-activation has nothing to do with the supposed inadequacies of monetary policy. Indeed, the events of 2020 demonstrated yet again that increases in the quantity of money can crush any recession.



The current revolution in government finances ignores the lessons of history.

MICKEY D. LEVY

Chief Economist for the Americas and Asia, Berenberg Capital Markets

Indeed, following decades of persistent government deficits and rising debt, the acceptance and promotion of more deficit spending among many economists has evolved into a "revolution" in practice and thinking.

Associated is the widespread acceptance and promotion that central banks buy and hold sizable portions of the government debt. This dramatic evolution in government finances is concerning and threatens sustainable healthy economic performance.

Moreover, the excessive focus on deficits overlooks the important impact of how government spending allocates national resources. Obviously, future generations will bear the costs, but current performance is also adversely affected.

The two biggest fears in the 1970s when deficit spending during peacetime economic expansion first became prevalent were that deficits would cause higher inflation and higher interest rates. The fact that inflation has receded and bond yields have hovered near historic lows, particularly following the financial crisis of 2008–2009, has added to the chorus arguing that high persistent deficits are positive and without risk.

U.S. Secretary of the Treasury Janet Yellen has echoed the argument that because low interest rates have kept the government's debt service costs low, more deficit spending is favorable. Of course, this presumes that interest rates will stay near historically low levels and is dangerously backward looking. It is a politically motivated rationale in support of more near-term fiscal stimulus at all costs. Once the economy normalizes following the pandemic, which is in the cards even without more short-term stimulus, interest rates will also normalize, raising debt service costs.

More importantly, the current focus on deficits and debt service costs misses the critical point: government spending and tax policies allocate national resources and are important determinants of economic performance. In many ways, the allocation and magnitude of government spending is more important than how the spending is financed. Whether government spending supports income that fuels more current consumption, or is directed toward investment, research and development, or building human capital that adds to productive capacity, is critical to sustainable potential growth.

The excessive focus on deficits has pushed these more important fiscal issues to a back seat. Along with ultra-loose monetary policy, deficit spending has facilitated more government spending aimed at current consumption. Even if debt service costs stay low, this is costly in terms of economic growth.

There is an inverse correlation between the magnitude of government spending and economic growth. Also, there is a long history that links deficits and inflation, and monetary policy plays a critical link in that correlation. These links will re-emerge. The current revolution in government finances—in practice and in thinking—ignores the lessons of history.

In the United States, a high and rising share of government spending is for entitlement programs (so-called "mandatory programs") that provide income support, and smaller shares for investment activities that add to productive capacity. The depressing impact on longer-run potential growth is obvious, and current spending on infrastructure, education, and research and development is already being squeezed.

The fiscal and monetary debate needs to be refocused, and infused with economic common sense.

The new theory is a concentrated bet that inflation will not come back.

MARC SUMERLIN

Managing Partner, Evenflow Macro, and former Deputy Assistant to the President for Economic Policy and Deputy Director, National Economic Council

The new theory is a concentrated bet that inflation will not come back. Many monetary theorists would like higher inflation, but the results of last year's Fed Listens events show that the people prefer zero inflation. If the central bank is on the sidelines in a few years because inflation is higher than the people want, the bond market will find itself in a different equilibrium and debt service costs will be much higher. Debt to GDP remains a good indicator because it tells us if the new debt is in fact paying for itself. If GDP increases by more than the new spending, as many multiplier estimates imply, the debt-to-GDP ratio would go down.

A safer compromise idea between the new and old theory would be a move to a capital budget, which would allow unlimited spending on physical investments and research and development. If the global macro environment changed, and the old constraints of inflation and higher interest rates return, the investment spending would still be generating returns, minimizing the future cost of the aggressive fiscal policy.

It is also important to keep in mind a couple of salient points about managing the economy through aggregate demand. Fiscal expansion boosts the growth rate of the economy for about a year; after that, the fiscal impulse turns flat or negative. Keeping the growth rate high requires an ever-expanding deficit. Policymakers also forget that even more aggregate demand is generated by the larger private sector. Policies that expand the public sector while increasing regulatory constraints and taxes will net out into moderate growth.

The fiscal responses were appropriate but will gradually be normalized. There is no revolution.

JAMES E. GLASSMAN
Head Economist, JPMorgan Chase & Co., Commercial Bank

The aggressive fiscal response to the Covid-19 health crisis, for example that has in the blink of an eye driven the debt-to-GDP level from 75 percent to 100 percent, is not the dawn of a new fiscal revolution. The fiscal responses were appropriate but will gradually be normalized, because the U.S. and global economies are rebounding quickly from the upheaval caused by the pandemic.

It makes perfect sense to use fiscal tools aggressively in the face of a pandemic, particularly when businesses are locked down in order to manage the burden on hospital systems. Fiscal actions can provide more immediate help to furloughed workers and shuttered businesses than monetary actions—cutting interest rates.

But this is a temporary shock that will end as the global population is vaccinated, a process that is well under way and that will accelerate as more vaccines emerge from trials. Interest rate pressures caused by surging debt levels relative to GDP are temporarily dampened by large-scale asset purchases by key central banks aimed at holding down long-term interest rates. But these monetary actions will not be sustained as economies recover from the pandemic, as they currently are, otherwise they would lead to severe financial imbalances.

Aggressive use of fiscal policy in moments like these that many have implemented does not mean that governments can ignore fundamental imbalances between revenues and outlays when the health crisis passes. Governments cannot rely on central banks to fund these imbalances—Modern Monetary Theory—and expect them to promote financial stability and stable inflation. So the "feeling of the moment" will prove to be a passing fad. Indeed, prudent government policy would aim to restore fiscal discipline to ensure the efficacy of its fiscal tools in the event of similar crises in the future.

A return to fiscal restraint will be particularly critical in coming years for most of the developed economies that are seeing a natural slowdown in underlying growth related to their aging workforces. For Europe, Japan, Russia, and the United States, this is a legacy of World War II that created baby boom generations everywhere. This demographic drag is making it increasingly difficult to raise the revenues needed to pay for pay-as-you-go promises of health care insurance and social security systems. These growing burdens, which will exacerbate inter-generational tensions, can only be resolved by scaling back the promises, raising taxes, or pursuing pro-growth policies to counterbalance demographic drags. The first two options are politically untenable. The third is sensible and not without precedent—recalling the post-World War II U.S. debt burden that fell from 100 percent of GDP to 20 percent by the late 1960s amid an economic boom.

The logic underpinning dynamic scoring is certainly economically sensible, even if the scoring is subject to debate, because fiscal actions that promote good economic outcomes of course beget stronger revenues. Nonetheless, the bigger impediment to public investment, like infrastructure investment, arises from the artificial constraints imposed by commingling such activity with other budget programs rather than relying on the return on such investment versus the financing costs. For example, there is a broad consensus that the economic and welfare return to infrastructure investment, which enjoys bipartisan support, could justify a massive investment. Yet it seems to be held back by worries about the impact of such a project on the federal budget deficit.

The fiscal eruptions caused by the pandemic do not mark the beginning of a revolution in the ideas about the role of fiscal policy. The benefits of fiscal discipline will reemerge when this chapter on pandemics shortly ends.

National debt should neither be demonized nor recklessly overstretched.

MICHAEL HÜTHER
Director, German Economic Institute

Ten years after the global financial crisis, the Covid-19 pandemic triggered a new stress test for economic policy. A decade ago, it was widely accepted that the increased public debt caused by the crisis needed to be brought back into line with economic performance. Sustainability—based on the debt ratio—should be secured with the help of regulations such as the German debt brake or the European Fiscal Compact.

The pandemic hit developed economies in times of "demographic dominance" in the capital markets. The aging of the population, as in the OECD countries, has ended the phase of capital scarcity. As a result, unlike ten years ago, not only the United States but also Europe is faced with the fact that the risk-adjusted real interest rate is lower than the macroeconomic dynamic. In this state of "dynamic inefficiency," societies can consume more today without having to forego future consumption or restrict the scope of future generations. At the same time, the debt-to-GDP ratio decreases over time, even if we settle interest payments with new debt. That leads to temptations.

The pandemic's fiscal burdens are only beginning to emerge. According to estimates by the International Monetary Fund in the *Fiscal Monitor* (January 2021), the debt ratio in the advanced economies will be 20 percentage points higher this year than in 2019; in the United States and Japan the increase will reach 24 percentage points, and in the eurozone 15 percentage points. As a reflex of an "exceptional emergency" (the pandemic), this development is compatible with most debt rules. Paying off these debts in a cyclical-neutral manner is often the challenge.

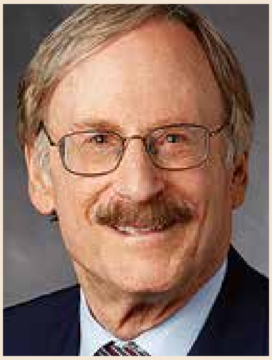
There are some indications that the demographic dominance will continue to have an effect and depress interest rates. It is also to be expected that there will continue to be a high preference for the liquidity and security of investments, so that the liquidity premium will remain high.

A further current challenge is to determine the right level and use of government loan funding. The need for investment in public infrastructure plays a particularly important role in terms of climate policy goals. Investments not made today for this purpose burden future generations with higher risks than the debt resulting from additional public investments—especially with the low interest rate level.

However, it is also true that the door is not open for unrestrained debt financing of state tasks, regardless of investment content. It would be a mistake to deduce this from the current relationship between the risk-free interest rate and macroeconomic dynamics. The "dynamic inefficiency" seems to open all financial barriers. Many overlook how, irrespective of the risk-free interest rate, risks can be associated with national debt, which future generations will have to face.

We are far from a fiscal revolution because the capital markets will continue to keep an eye on whether and how states use credit financing. A post-Keynesian license should not be derived from the current interest rate situation. In addition, given the major transformation tasks and aging societies, it will be much more challenging to simply grow out of a high debt level in the next decade.

Much more attention must be paid to the effectiveness of government investments, with a good, digitized administration providing the framework for this. That is why it remains unchanged after the pandemic and in view of the demographic dominance that national debt should neither be demonized nor recklessly overstretched.



Historically, most huge debt buildups are followed by serious problems.

MICHAEL J. BOSKIN

Hoover Institution Senior Fellow and Professor of Economics, Stanford University, and former Chair, President's Council of Economic Advisors

There certainly has been a need for considerable humanitarian relief for those families, workers, and businesses that have been heavily impacted by the Covid-19 crisis, including by government lockdowns. We should all support policies that help reduce their short-run economic pain for them and/or help speed the recovery at reasonable long-run cost.

Moving beyond the current recession, the notion that ever-larger deficits and debt are benign and should be used to finance major new spending initiatives is gaining support. The argument is that government borrowing costs are below the growth rate and we can continually roll over the debt, indefinitely. But historically, most huge debt buildups are followed by serious problems—sluggish growth, inflation, a financial crisis, or even default. We cannot be sure when problems will occur, at what debt-to-GDP ratios, and for which countries. Indeed, in the 1980s and 1990s, many economists underestimated how elastic the supply of capital to the United States had become. And the United States has the advantage of being the global reserve currency.

But as I have written more technically elsewhere, there are many reasons why the "debt-financed spending is free" argument is risky and/or wrong. Among them, more public debt eventually will push rates higher, crowding out investment. The higher the debt, the bigger the temptation to inflate. While unlikely in the near term, markets have often missed large changes in interest rates. Fiscal capacity will be needed in the next crisis. Another advanced-economy debt surge makes it harder for many poor countries, with limited debt capacity, even to respond to the Covid-19 crisis, on which they lag considerably. And elected officials with a "debt is free" excuse will exercise even less discipline on spending.

Policymakers should refrain from easing the budget constraints.

GUNTHER SCHNABL
Professor of Economic Policy, Leipzig University

The coronavirus crisis has led to a sharp increase in public debt levels in all industrialized countries, supported by immense government bond purchases by central banks. As officially measured consumer price inflation has—so far—remained low, central banks are encouraged to expand their mandates. The European Central Bank aims to bridge the deep economic split in the euro area. This is unlikely to be successful for three reasons.

First, the government bond purchases by the European Central Bank encourage debt. Since the European sovereign debt crisis, government bond purchases have become an indispensable lifebelt for the euro. As a side effect, the euro area's general government debt has risen to roughly 100 percent of GDP, far beyond the Maastricht limit of 60 percent. This puts into question the Treaty on the Functioning of the European Union, which aims to restrict government debt (Article 126), to prevent the European Central Bank from financing public debt (Article 123), and to avoid bailouts of overindebted member states (Article 125). As a consequence, the trust of the public in the European Central Bank is low, and perceived inflation is more than 5 percentage points higher than officially measured inflation.

Second, there is little hope that the national fiscal stabilization measures and the €750 billion EU Next Generation Fund will deliver a sustained recovery. Persistently low interest rates, the European Central Bank's corporate bond purchases, and the Targeted Longterm Refinancing Operations are discouraging European enterprises from increasing efficiency, as financing costs are depressed. Together with the proliferating public credit guarantees and the suspension of insolvency laws, the number of zombie enterprises will increase further. Productivity growth is depressed.

Third, the redistribution effects of public policy interventions are likely to destabilize Europe politically. Everlasting low interest rates continue to drive up stock and real estate prices, which makes wealthy people richer. In contrast, the European middle class sees its savings at banks slowly melting away. Sluggish productivity growth in Europe has brought the real wages of an increasing number of people under pressure, while government bond purchases by the European Central Bank help to keep transfers for unemployed and pensioners stable. In particular, young people in Europe who are about to enter the labor market and plan to build up wealth are suffering.

Huge imbalances in the Eurosystem's TARGET2 payments system indicate that the southern European countries have become dependent on credit and transfers from the north. Prior to the common currency, the stability-oriented monetary policy of the Deutsche Bundesbank had caused a persistent appreciation pressure on the German mark, which forced German enterprises to continuously improve their competitiveness. The resulting productivity gains allowed Germany to over-proportionally contribute to the financing of the common European institutions.

Now, as growth in the northern part of the euro area is fading due to zombification and restrictive lockdown measures, redistribution within Europe is becoming a zero-sum game, making distribution conflicts more likely. Therefore, policymakers should refrain from easing the budget constraints for governments and enterprises. As this would trigger structural reforms, and productivity growth would be reanimated, wages could rise again. The achievements of the European integration process could be safeguarded. The European youth would face a brighter future.

If demand-side "stimulus" could deliver on its promise to accelerate real growth and inflation, the added debts would have to be rolled over at higher interest rates.

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Over the past five years, cyclically adjusted government deficits rose from 2.6 percent to 15 percent of potential GDP in the United States, from zero to

16.5 percent in Canada, from 4.3 percent to 14 percent in the United Kingdom, and from 4.3 percent to 12.7 percent in Japan, according to International Monetary Fund estimates. Such structural budget deficits are less problematic, though, than the cumulative impact of repeated large deficits on the public debt.

When pondering when debt may exceed what taxpayers are willing and able to bear, we commonly compare the stock of debt to the flow of income (GDP). In questions about private solvency, by contrast, we instead compare liabilities with assets. The ratio of debt to assets varies with the denominator, and not just the numerator.

While the United States added trillions to taxpayer liabilities in recent years, corporate and individual taxpayers also added trillions to their assets—thanks to soaring stock market capitalization. Larger government debts seem less threatening when those debts are backed by more taxpayer collateral.

Similarly, the habit of comparing a stock of accumulated debt to the flow of current GDP may prove less useful than comparing the flow of government interest expense with GDP.

Publicly held U.S. debt rose from 40.5 percent of GDP in 1990 to 99.3 percent in 2020. Yet federal interest expense fell from 3.1 percent of GDP to 1.6 percent. Although the ratio of stocks to flows suggests a heavier load, the ratio of interest outlays to incomes has gotten lighter.

Central bankers afflicted with provincial hubris might imagine they deserve credit for the falling interest rates that made growing debts so much easier to service. But bond yields are determined in global markets, and their co-movements are highly synchronized through arbitrage. Interest rates have been falling because global real growth and inflation have slowed for years, shrinking both the real return on capital and the inflation risk premium.

A prolonged downtrend in global real growth and inflation has made it easy for major countries to manage growing debts, so far. But what about the future?

The *Wall Street Journal* reassures us that, “The Congressional Budget Office projects … that interest costs as a share of GDP will be lower than it forecast before the pandemic.” Yet such forecasting flexibility only demonstrates that projections react to current news rather than predicting future news.

In his American Economic Association Presidential address, Olivier Blanchard reassures us that “the ten-year rate has been lower than the [NGDP] growth rate for four out of seven decades.” Yes, but the ten-year rate was above the GDP growth rate between the fourth quarters of 1979 and 1997, between the fourth quarter of 2000 and the first quarter of 2003, and between the first quarter of 2008 and the first quarter of 2010. If the debt-ridden future could be safely assumed to be as tranquil as 1950–1970—when the debt-to-GDP ratio was falling—then perhaps we could take more comfort from pre-Nixon history.

Proponents of endless, extravagant, debt-financed transfers and public payrolls always predict their policies will speed up real growth, regardless of how often such predictions fail. But faster real growth, if it happened, would be inconsistent with unchanged ultra-low real interest rates.

The U.S. Federal Reserve promises to keep interest rates near zero in order raise inflation above 2 percent. But higher inflation is also inconsistent with unchanged rates.

If apologists for perpetual demand-side “stimulus” could ever deliver on their promises to accelerate real growth and inflation, the added debts incurred at their urging would have to be rolled over at higher interest rates—possibly much higher.

If actions are not taken to slow the rise in deficits and debt, the current crises, to be followed by good times, will soon thereafter be followed by bad times.

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The U.S. and global economies have undergone a fiscal/debt revolution of huge import from which there will be no turning away!

The main catalysts are the failure over a very long period of ultra-easy monetary policy, that is, zero interest rates and increased central bank balance sheets, to achieve full employment and price stability, and the collapse and depressions of the U.S. and world economies on the unprecedented external shock of 2020—the coronavirus pandemic.

The United States and country after country already are well along the road of hugely increased central government deficits and debt-financed outlays to offset the impotence of the easy monetary policy on overcoming disinflation and deflation and a shock-induced cratering of economies around the world.

Monetary policy of near-zero and negative interest rates and quantitative easing has built up central bank balance sheets to unprecedented highs. This has served mainly to inflate asset prices and increase inequality of income and wealth, not create strong economic growth, full employment, and increased price inflation—a "liquidity trap" like the 1930s.

As a consequence of shifting the thrust to fiscal stimulus in the United States—an unadulterated Keynesian deficit and debt-financed fiscal government spending stimulus fully accommodated by essentially zero short-term interest rates—upon a return to a post-pandemic time, whatever growth acceleration and move toward full employment has occurred will be accompanied by unprecedented high deficits and debt relative to GDP.

In the case of the United States, the fiscal stimulus in 2020 was over $3 trillion, mostly transfers, approximately 10 percent to 15 percent of GDP. This was an unheard-of magnitude, associated with U.S. government debt relative to GDP of over 130 percent, a record high. Yet another $1 trillion or so of stimulus is likely in 2021, bringing the total to almost 25 percent of GDP over two years and raising the debt-to-GDP ratio perhaps to 150 percent.

In the understandable near-term rush to fiscally support the economy and save lives, little thought has been given to the aftermath—when economies grow strongly again, unemployment rates fall, price inflation picks up, and interest rates rise.

The seeds of a huge debt overhang from dealing with the pandemic and what as a result eventually will be a hugely burdensome debt service relative to GDP will eventually lead to a U.S. sovereign debt problem, a weaker dollar, and global investors eschewing U.S. securities.

The timing of this inevitability is what is uncertain—not the sovereign debt crisis itself. It certainly is not to be expected any time soon. But with the promise of rising and higher inflation encouraged by monetary policy's forward guidance and federal government deficit-to-GDP ratios in double digits, debt service burdens will spiral as inflation and interest rates rise, budgets have to be reduced, and the economy weakens.

Much has to happen first—fledgling recoveries sustained, labor markets tightening, demand-pull inflation picking up, long-term interest rates moving higher, and debt service burdens becoming burdensome. But the seeds of this process are now already well-planted.

If, before such a time, preventive actions are not taken to slow the rise in deficits and debt, that is, calibrating fiscal policies so as to achieve a glide path for the economy and stable to declining debt-to-GDP and debt interest service ratios, the current crises, to be followed by good times, will soon thereafter be followed by bad times. ◆