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Memorandum

To: Interested Parties
Subject: Be Wary of Mischaracterizations of Olivier Blanchard's Debt Report
Date: 1/16/2019

A recent lecture by outgoing American Economic Association president and MIT professor Olivier Blanchard has been misinterpreted by some to suggest that the debt does not matter. For instance, New York Times columnist Paul Krugman used his remarks to suggest there should be little concern over the country's high and rising national debt.

In reality, Blanchard's findings should do little to assuage the fears of those worried about unsustainably rising debt.

Blanchard shows that nominal debt can rise continuously in the context of a growing economy, and that "primary balance" is sufficient to ensure a declining debt-to-GDP ratio – suggesting the country could sustainably run small primary deficits. Both are reasonable conclusions that CRFB has long maintained.

Sadly, the United States is very far from primary balance. This year alone, the federal government is projected to run a deficit of nearly $1 trillion (4.6 percent of GDP). Deficits would have to fall to below $400 billion (1.8 percent of GDP) for the government to be in primary balance.

Due largely to rapid projected growth of pre-committed health and retirement spending – without sufficient growth in scheduled revenue – structural deficits are projected to persist and debt will grow over time. Without significant policy change, debt is projected to rise unsustainably.

In this memo, we explain that:

- **Blanchard does not argue for more debt**. He is clear that "the trajectory of deficits under current fiscal plans is indeed worrisome" and has shared with us that "current US deficits are unjustified."
- **Blanchard confirms that small deficits are sustainable, not large deficits.** His paper shows that a budget in "primary balance" (where revenue covers non-interest spending) or small primary deficit is sustainable. This year, the federal government is projected to run a $600 billion (2.8 percent of GDP) *primary deficit* – well above sustainable levels.
- **Major deficit reduction is needed to achieve sustainability.** It would require nearly $5 trillion of spending cuts and/or tax increases to stabilize the debt over the next decade and $5.5 trillion to restore primary balance. Long-run deficit reduction must be even larger, due to rising health and retirement costs.
- **Blanchard's suggestions of lower welfare cost of debt are theoretical.** Blanchard's research suggests that crowding out from debt may have a smaller welfare cost than previously believed, but notes ambiguous effects and calls for more research.
- **Rising debt remains a threat.** While Blanchard shows a debt spiral is unlikely with the budget in primary balance (or small primary deficit), U.S. debt continues to rise unsustainably because the government has pre-committed spending far in excess of tax revenue. Without adjustments, the result will be slower income growth, higher interest payments, reduced fiscal space, increased interest rates, and a small but increasing risk of fiscal crisis.

Blanchard Does Not Argue for More Debt

- In his introduction and conclusion, Blanchard highlights that his "***purpose in the lecture is not to argue for more public debt, especially in the current political environment***."
- Blanchard clarified to us by email his message that "High public debt is not catastrophic. But, still, it is not good."
- Blanchard's focus is on debt levels today, currently at 78 percent of GDP. He maintains that "the trajectory of deficits under current fiscal plans is indeed worrisome" and shared with us by email that "***current US deficits are unjustified"***
- Blanchard shares the mainstream view that larger deficits are justified during a recession. However, it does not follow that the U.S. should run large structural deficits in today's economy.

Blanchard's Research Confirms that Small Deficits are Sustainable, Not Large Deficits

- As most economists and fiscal policy experts have argued (CRFB included), the United States and other governments can sustainably run deficits *so long as* ***debt is growing slower than the economy***. Achieving fiscal sustainability, therefore, requires a stable or declining debt-to-GDP ratio, not balancing the budget or paying off the national debt.
- Blanchard shows that historically and currently, interest rates on U.S. debt have been lower than the economic growth rate – this means the government can run deficits up to "primary balance."
- In other words - If the budget is balanced, except for interest payments, debt will decline relative to the economy. Under current interest and growth rates, debt would remain stable even with small primary deficits.
- However, ***the U.S. is a long way from primary balance***. This year, it will run a primary deficit of about $600 billion (2.8 percent of GDP).
- Blanchard suggested to us that the aim could be a small primary deficit, keeping the debt to GDP ratio constant. This allows for, say, a 1% primary deficit.* ***Not a 2.8% primary deficit***."
    - We estimate that under CBO's projections, a primary deficit of 1 percent would keep the debt ratio stabilized this year, but the primary deficit could only be 0.2 percent of GDP for the rest of the decade to maintain a stable debt-to-GDP ratio through 2028.

Major Deficit Reduction is Needed to Achieve Sustainability

- In some countries, primary balance can be easily achieved by setting revenue and (non-interest) spending annually. But the majority of federal spending (and nearly all taxes) are on auto-pilot; and the U.S. is *already* very far from primary balance.
- Restoring primary balance (on average) over the next decade would require $5.5 trillion of primary deficit reduction – the equivalent of an 11% spending cut or 13% tax increase. Stabilizing the debt as a share of GDP would require $4.7 trillion of deficit reduction.
- ***Population aging and rising health care costs are driving up spending faster than revenue, leading to a rising imbalance, even with low interest rates.***
- CBO projects primary deficits will rise to 3.3 percent of GDP by 2048 under current law and 5.4 percent under CBO's Alternative Fiscal Scenario.
- The increase in primary deficits is driven by the 5 percent GDP increase in Social Security and health spending, largely due to commitments made to today's workers and retirees. For the reasons above, substantial changes to the tax code and entitlement programs would be necessary to bring deficits to the "sustainable" levels described by Blanchard.
- Krugman argues that economic growth "gradually melts the snowball" of debt. It would, except that the snowball continues to roll downhill and accumulate new snow.

Blanchard's Suggestions of Lower Welfare Cost of Debt are Theoretical

- Part of Blanchard's paper focuses on the consequences of debt, and suggests the "welfare costs of higher debt may be lower than has been assumed." In large part, Blanchard argues that welfare costs caused by "crowding out" public investment is lower than most believe.
- Blanchard discusses a number of reasons why this insight may or may not be correct – and notes that future research should continue to study the possibilities.
- A lower economic cost of debt would imply an increased desirability to borrow for high-return public investments or to combat a recession. Unfortunately, today's borrowing is largely to fuel current consumption in the context of a healthy economy.
- CBO and others continue to estimate that rising debt will slow economic growth. CBO's work is informed by a literature review of existing academic research.

Rising Debt Remains a Threat

- CBO projects debt will rise from 78 percent of GDP today to 152 percent of GDP in three decades under current law, and 210 percent under its alternative scenario.
- Rising debt crowds out investment and slows income growth
    - CBO projects GNP per person will be $6,000 lower per year by 2048 (in today's dollars) under current law as compared to if debt were reduced to its historic average.
- Even with low interest rates, rising debt means rising interest costs
    - CBO projects interest costs will exceed Medicaid costs by 2020, defense by 2023, and all non-defense discretionary spending by 2025, and be the largest federal spending program before 2050. This leaves little room for other priorities.
- Rising debt reduces fiscal space
    - While it is wise to borrow more when the economy is weak, the politics and economics of issuing substantial new debt is more difficult when debt is approaching the size of the economy; rather than if debt were closer to its historic average (debt was 35 percent of GDP prior to the Great Recession)
- Rising debt could push up interest rates
    - CBO projects interest rates will rise by about 2 percent over the next 30 years under current law, and more under their alternative scenario – in part due to rising debt.
    - Interest rates are projected to exceed the economic growth rate by around 2040 under current law and 2035 under the Alternative Fiscal Scenario. If this occurs, the U.S. would no longer be able to sustainably run primary deficits.
- A fiscal crisis remains unlikely for now, but higher debt levels make it increasingly possible
    - Markets continue to assign no risk premium to U.S. Treasuries. Even a small spike in interest rates could lead to a panic, a selloff of current bonds, and a global financial crisis. While this event is unlikely, it grows both increasingly possible and increasingly damaging as debt rises.

Blanchard's research implies that governments can and in some cases should borrow as long as deficits are sufficiently small and close to primary balance. While this conclusion may be true, it says little about the United States today – which is running large primary deficits and has made commitments that, left unchanged, will result in growing deficits over the years to come. While Krugman and others may misinterpret Blanchard's paper to justify further borrowing, substantial deficit reduction is needed to achieve fiscal sustainability and avoid the consequences of a high and rising debt.