OUTLOOK

ECONOMIC DATA AND COMMENTARY

July 2019 • Volume 16 • Number 7

Stabilizing U.S. Debt and Deficit Spending: Why it Matters Now

In its "2019 Long-Term Budget Outlook," released June 25, the Congressional Budget Office warned, "If current laws generally remain unchanged, large budget deficits would boost federal debt to unprecedented levels over the next 30 years." Despite those ominous-sounding words, the CBO report hardly dominated headlines in a country that has grown accustomed to large and rising debt as a regular, if somewhat troubling, feature of American government.

Now a new debate has arisen as to whether the word "troubling" even applies. Proponents of modern monetary theory, including some prominent politicians and economists, suggest that the U.S. government, if anything, should use its powers to print money and spend more, not less, in order to address social, environmental and other challenges facing the country. Deficit hawks counter that sooner or later we'll all pay a steep price for unchecked spending.

To gain perspective, OUTLOOK sat down with economist William Gale, a Brookings Institution scholar and author of the new book, "Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future." Gale discusses modern monetary theory, why eliminating debt entirely may not be possible (or even desirable), and how the country might find a comfortable middle ground between those opposing positions.

OUTLOOK: What's the current state of U.S. debt and what changes do you expect in the coming years?

William Gale: Right now, the debt is high relative to historical levels, with a debt-to-GDP ratio of 78%. The only time our debt has ever been higher as a share of the economy was for a few years around World War II, when the country accumulated massive debt and the ratio peaked at 106%.

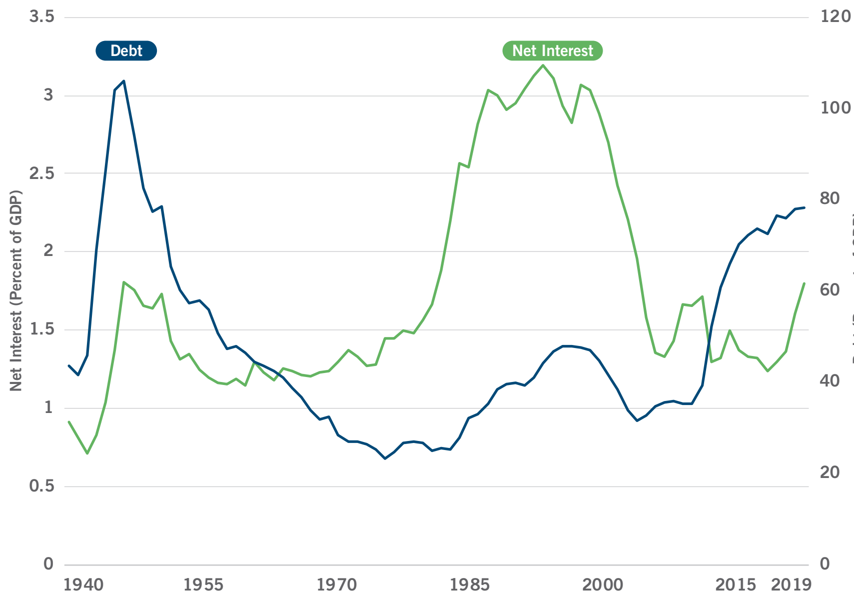
But that time, the debt was paid off fairly rapidly, with about half eliminated during the following 10 to 15 years. Now, in contrast, the U.S. budget is out of balance, and U.S. debt relative to GDP looks like it will continue to rise under almost any set of policy assumptions. Interest rates are low, helping to keep down the level of interest payments on the debt. But the primary deficit, the part of the budget that doesn't include interest, is quite substantial and growing. All projections show the debt-to-GDP ratio continuing to rise – gradually, steadily, inexorably. You can choose your adverb.

This Month's Expert

William Gale is the Arjay and Frances Miller Chair in Federal Economic Policy and a senior fellow in the Economic Studies Program at the Brookings Institution. His research focuses on tax policy, fiscal policy, pensions and saving behavior. He is co-director of the Tax Policy Center, a joint venture of the Brookings Institution and the Urban Institute, and director of the Brookings Retirement Security Project.

Gale's most recent book is "Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future" (Oxford University Press, 2019). His writings have appeared in leading publications including *Financial Times, The New York Times, The Wall Street Journal* and others. Prior to joining Brookings in 1992, he was an assistant professor in the Department of Economics at the University of California, Los Angeles, and a senior economist for the Council of Economic Advisers under President George H.W. Bush. Gale attended Duke University and the London School of Economics, and received his Ph.D. from Stanford University in 1987.

DEBT AND NET INTEREST AS A SHARE OF GDP, 1940-2019



Sources: Congressional Budget Office (2019b); Office of Management and Budget (2019)

OUTLOOK: At what point in our history did deficit spending and long-term debt become normal?

Gale: Before World War II, we had deficits only during recessions or wars, and we paid down the debt shortly thereafter. Then after World War II until about the mid-1970s, the non-interest part of the budget was usually in surplus.

Today's situation began around 1981, when Ronald Reagan cut taxes and raised defense spending. That was the first time we ever had rising debt during peacetime prosperity, but for a variety of reasons that has remained the norm ever since.

OUTLOOK: Modern monetary theory, which has become quite popular recently, seems to suggest that ever-rising levels of deficit spending and debt are not a problem. How would you describe this idea?

Gale: One problem with modern monetary theory is that it's not well defined. But the basic idea is that because the government prints its own currency, it literally never has to default – and so deficit spending never becomes a problem.

> "What we need to do is stabilize the debt, and we can do that with small deficits if interest rates stay low. If interest rates get high, we'll need surpluses."

OUTLOOK: Why has it gained such momentum recently? Are there potential benefits?

Gale: People seem to be attracted by the notion of a painless way to deal with what they would like to do in terms of spending. Most people think of themselves as being responsible, and in the past it wasn't considered responsible to say the government can just spend and spend. But now it seems to be more popular to come right out and say it. I think people want to do what they want to do, and don't want to consider the costs.

It's true that fiscal policy that involves deficit spending can help the economy in the short run. It can solve problems. But just printing money eventually leads to inflation, and the idea that you can do it painlessly reflects what I would characterize as a nonchalance about the impact of inflating the currency. Most economists don't share that nonchalance.

OUTLOOK: At the other end of the spectrum, some suggest the government should operate without deficit spending, and by eliminating the U.S. debt.

Gale: That's not realistic, and it wouldn't be a wise approach, either. There's nothing magical about a balanced budget. What we need to do is stabilize the debt, and we can do that with small deficits if interest rates stay low. If interest rates get high, we'll need surpluses. But the notion that we should have no debt, or we should run no deficits – that doesn't make sense economically.

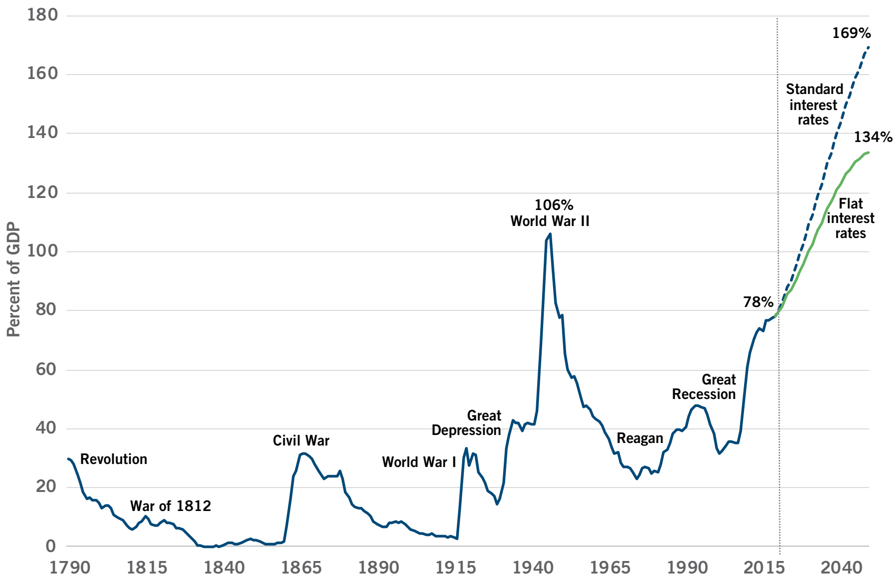
There are advantages to having government debt. It lets us conduct monetary policy, it gives investors a safe asset, it helps the nation conduct trade. There's no evidence that small amounts of debt impede a country's economic performance, and in some ways, having debt seems to help that performance.

The concern is that when the debt gets as large as the U.S. debt has become, it can crowd out significant amounts of capital, or impose big burdens on future generations.

OUTLOOK: Do economists have a tipping point for that? What's a healthy amount of debt, and when does the amount become problematic?

Gale: It's really hard to say what's too much debt. It depends on a country's politics, the strength of the rule of law, whether the country has a history of paying or defaulting on its debt, what the economic growth prospects look like and what the projected debt profile looks like. You can't just say, "Well, if debt gets to X% of GDP, there will be a crisis." That's not how investors think – and again, debt becomes a problem when it crowds out capital. But there is a lot of literature showing that high debt reduces economic growth.

DEBT-TO-GDP, 1790-2049



Source: Author's calculation; Board of Trustees (2019); Boards of Trustees (2019); Congressional Budget Office (2010, 2019b, 2019c); Office of Management and Budget (2019)

OUTLOOK: Do you feel we're now at that tipping point?

Gale: Yes, I think we are. We're way beyond the amount of debt needed to conduct international trade and run monetary policy. And to those who say there's a demand for safe assets and that the U.S. Treasury should provide more of them – you can do that without adding more debt. The government could issue safe assets, in the form of U.S. Treasury bonds, but instead of adding to the national debt, it could use the proceeds from selling those safe assets to invest in the stock market or in other riskier assets.

OUTLOOK: Do you have a figure in mind for a healthy, sustainable debt-to-GDP ratio?

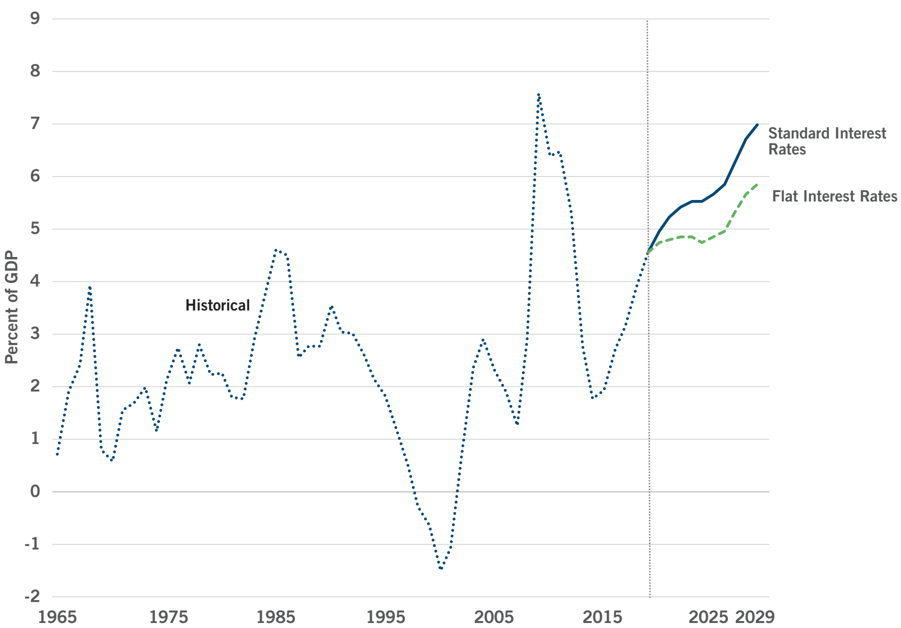
Gale: In my book, I argue that we should aim for a long-term debt target of 60% of GDP, which is slightly lower than the current level and is based on interest rates that would rise about one-and-a-half percentage points from today's rates over the next 30 years.

In that framework, interest payments on the national debt would be about 2.4% of GDP. If interest rates didn't rise, then we could have the same level of payments with debt that is 100% of GDP. But given the uncertainty about interest rates, I think the right thing to do is to get on a path that takes us close to those numbers. Then, as interest rates adjust, we can make further adjustments.

OUTLOOK: Could the situation with the U.S. debt and deficit become a crisis, similar to what happened in the eurozone early this decade?

Gale: I don't think a crisis is likely. In part that's because the U.S. dollar is the reserve currency, and whenever there are financial problems in other parts of the world – even when that trouble originated here, as it did during the financial crisis – people want to own U.S. debt, because that's a safe place to invest. That's one reason interest rates remain low, because there's strong demand for U.S. debt.

FULL-EMPLOYMENT DEFICIT AS A SHARE OF GDP, 1965-2029



Source: Author's calculation; Congressional Budget Office (2019a, 2019b)

OUTLOOK: How did the United States get into our current debt situation?

Gale: The financial crisis of 2007 through 2009 boosted the debt substantially, mainly by reducing tax revenues when the bottom fell out of the economy. But that addition to the debt has been layered on top of a more or less permanent imbalance between what we want to spend and what we want to pay in taxes. In the future, yet another layer will come from higher payments for Social Security, Medicare and Medicaid. All of these factors are going in the wrong direction, with the sole exception of interest rates.

Often, people discount forecasts stretching out 15, 20 or 30 years because of uncertainty about what may happen over such a long time. But in terms of shifting the trajectory of government spending, a few decades isn't very long, and predictions about U.S. debt depend more on demographics than on economic variables. Demographics are easier to predict – if we know how many 50-year-olds we have today, we can make a pretty good guess about how many 70-year-olds we'll have 20 years from now.

OUTLOOK: Are there other measurements that show there's a problem?

Gale: There's something called the full employment deficit, which is now on the order of 5% of GDP. It has been higher than that only once or twice in our history – during the 2001 financial crisis, and maybe in the early 1980s.

The actual budget deficit goes up and down with the state of the economy – it's countercyclical. When the economy's doing well, the deficit will be smaller because growth will generate more tax revenues. And spending on programs such as Medicaid might go down if unemployment drops.

OUTLOOK: What is the full employment deficit, and what does it tell us?

Gale: The full-employment deficit is essentially the federal deficit, controlling for the state of the economy. It removes automatic stabilizers from the deficit projections and estimates what the deficit would be if the economy were operating at full capacity. It is helpful for providing an index of fiscal policy that is independent of the state of the economy.

> "To bring U.S. debt into a better balance, the most obvious thing is to restore long term solvency to Social Security and Medicare."

OUTLOOK: Does the level of U.S. debt affect the inflation rate? Why has inflation remained low even as our debt increases?

Gale: Debt can be financed with lower spending, higher taxes or the creation of money. Traditionally, we haven't financed a whole lot of our debt with the creation of money, but in other countries governments have done that, and that can lead to inflation and default. That's one of the concerns people have about modern monetary theory.

OUTLOOK: What effect do tax cuts have on our debt picture?

Gale: There's no question that the big recent tax cut is reducing revenue below what it would otherwise have been.

So on one hand you have the people who like modern monetary theory and say government spending is no problem, because you just finance it by printing money. On the other hand are those who say tax cuts are no problem, because they won't cause revenues to fall. I think the 95% of people in the middle understand that both of those claims are specious, and that if something sounds too good to be true, it probably is.

OUTLOOK: What reforms would you recommend to help bring the U.S. debt back into a better balance?

Gale: The most obvious thing is to restore long-term solvency to Social Security and Medicare. But government spending is rising even with no changes in government programs, just because of the way the population is shifting. So we also need to raise taxes. The most obvious candidates are consumption taxes such as value-added taxes and a carbon tax. A carbon tax might raise about 1% of GDP, but a value-added tax could raise 3% or 4% of GDP.

OUTLOOK: What could we do to bring Social Security into solvency?

Gale: For Social Security, it's a matter of adjusting benefits and taxes. You would probably have to raise the age of full retirement, increase the payroll tax cap and fix the way Social Security calculates inflation.

With respect to retirement age, you want to be sure to take care of people who can't retire later. But life expectancy has gone up, especially for middle- and high-income households. And we've already been adjusting the full retirement age for the past 20 years or so, and that has been fine.

The payroll tax cap needs to be adjusted because of the widening distribution of income. The rich have done really well while others have done less well, and that means a larger proportion of overall income is above the cap and not being taxed.

"People point to lots of potential risks related to U.S. debt. China, cryptocurrency, the fact that the Fed is trying to unwind its portfolio, state debt is going up. But nothing really adds up to a smoking gun..."

In terms of inflation, it's really a matter of getting things right. Let's use correct inflation measurements for federal programs. That would allow the government to adjust benefits in a way that better reflects price changes in the economy. For example, in Fiscal Therapy, I propose that the government uses the "chained CPI" measure to calculate annual Social Security benefit increases. The chained CPI measure controls for the fact that people substitute away from goods that experience large increases in prices, whereas the current inflation measure holds constant a certain basket of goods when analyzing overall consumer prices.

OUTLOOK: And Medicare?

Gale: I think there are two big things the government could do. One is to introduce premium support – basically to give beneficiaries an amount of money to spend on premiums, and to have various Medicare plans compete for those premiums. That competition should reduce costs. The other is to let Medicare negotiate drug prices. Medicare pays more for the same drugs than the Veterans Administration or Medicaid does, and there's just no good reason why that should be the case.

OUTLOOK: China owns a significant amount of U.S. debt. Is there any concern that the current trade tensions might affect China's appetite for U.S. Treasuries?

Gale: Well, a trade war certainly doesn't help, and the Chinese have already been divesting U.S. debt for the past 12 to 18 months. But I don't think China will dump all of its Treasuries, and I don't think the impact would be all that big if it did.

People point to lots of potential risks related to U.S. debt. China, cryptocurrency, the fact that the Fed is trying to unwind its portfolio, state debt is going up. But nothing really adds up to a smoking gun that is either going to cause a financial crisis, or is going to cause politicians to act.

For anything to happen legislatively, the parties have to trust each other to implement any agreement that they come to. Agreed-upon changes would have to happen over time, and both parties will have to be ready to participate or at least to let it happen. So the parties have to talk to each other and like each other and trust each other. The lack of trust we have now is a major obstacle.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 6/30/19. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Bloomberg and Blue Chip Economic Indicators

				U.S. Treasury Securities	
2019	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q2	1.70%	3.20%	2.38%	1.76%	2.01%
Q3	2.00%	2.20%	1.98%	1.93%	2.21%
Q4	1.90%	2.10%	1.71%	2.02%	2.31%
2020	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	1.80%	2.20%	1.56%	2.07%	2.37%
Q2	1.70%	2.00%	1.45%	2.07%	2.39%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	2.37%	2.02%	1.74%	1.77%	1.84%	1.96%
0.25	2.00%	1.81%	1.65%	1.72%	1.81%	1.94%
0.50	1.89%	1.72%	1.68%	1.71%	1.81%	1.95%
0.75	1.72%	1.64%	1.65%	1.75%	1.85%	1.98%
1.00	1.60%	1.60%	1.62%	1.73%	1.84%	2.00%
1.50	1.56%	1.62%	1.69%	1.80%	1.91%	2.04%
2.00	1.67%	1.59%	1.71%	1.83%	1.94%	2.06%
2.50	1.71%	1.66%	1.77%	1.89%	1.99%	2.10%
3.00	1.74%	1.72%	1.83%	1.95%	2.05%	2.15%
4.00	1.77%	1.87%	1.96%	2.06%	2.14%	2.22%
5.00	1.90%	1.99%	2.07%	2.18%	2.22%	2.28%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

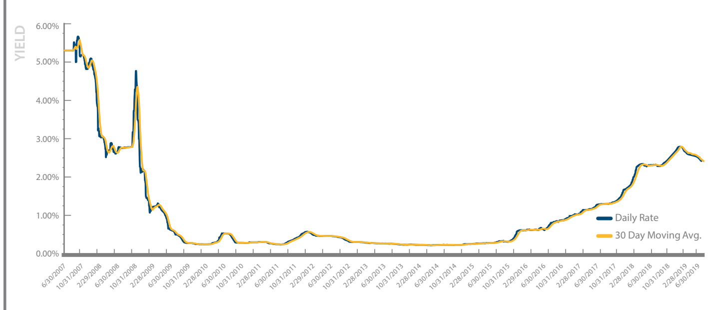
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	5	5	5	5
180	5	5	6	6
365	5	5	13	12

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

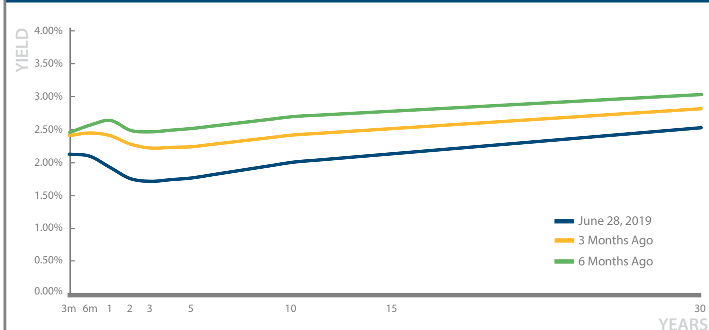
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve depicts the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity and for potential default risk.

TREASURY YIELD CURVE



COBANK UPDATE

CoBank No Barriers Warriors Program Delivering Results

Each year, CoBank sponsors up to 50 rural veterans with disabilities to experience the No Barriers Warriors program, inviting our customers to nominate deserving veterans in their areas. This year, 17 customers nominated 57 veterans, many of whom went on to participate in the program. In June and July this nomination process reached fruition with rural veterans attending the No Barriers Summit and participating in the first expeditions of 2019.

In June, eight CoBank-sponsored veterans and three caregivers participated in the veterans track at the No Barriers Summit, an annual event that brings together No Barriers participants following many paths but all striving to overcome the challenges and obstacles in their lives. The event delivered inspirational and motivational sessions, experiential activities and the opportunity for participants to build their community. Attendees took part in activities such as rock climbing, hiking and a team-building version of “The Amazing Race” event involving both veterans and civilians.

At the two July expeditions, 21 participating veterans travelled to the No Barriers Warriors Basecamp facility in Colorado and challenged themselves with rafting, climbing and hiking activities. Each expedition incorporated adventure, curriculum and physical challenges, pushing participants both mentally and physically, and introducing them to what is called the “No Barriers Life.”

Participants gained significant benefits from the expeditions, with one participant saying, “No Barriers gave me a great stepping stone on how to move forward on improving myself. Before coming here I was focused on the past but No Barriers showed me how to get out of my comfort zone and face my problems and now I am going to focus on the present and the future.”

About CoBank

CoBank is a $138 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit www.cobank.com.

Another participant said, "The experience that was provided was like no other. Placing physical obstacles to help represent emotional barriers is a great way to build confidence. The bonds that are created remind you of a time when things mattered. This program reminds you that you are not alone in your struggles."

The CoBank/ No Barriers Warriors program will continue in August with two, more rigorous, back country expeditions planned for veterans with less restrictive physical disabilities.

"CoBank and its customers have been instrumental in connecting us to a segment of the veteran population that we may not have otherwise," says John Toth, director of No Barriers Warriors. "Through CoBank's support, we've positively impacted 150 veterans and their families so far, achieving our common purpose of introducing veterans to the No Barriers life."