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# THOSE "D" WORDS: DEFICITS, DEBT, DEFLATION, AND DEPRECIATION

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Recent economic commentary has been filled with "D" words: deficits, debt, deflation, depreciation. Deficits—budget and trade—are of the greatest concern and may be on an unsustainable course, as federal and national debt grow without limit. The United States is already the world's largest debtor nation, and unconstrained trade deficits are said to raise the specter of a "tequila crisis" if foreigners run from the dollar. Federal budget red ink is expected to imperil the nation's ability to care for tomorrow's retirees. While public concern with deflationary pressures has subsided, concern continues regarding America's ability to compete in a global economy in which wages and prices are falling. In fact, the current situation is far more "sustainable" than that at the peak of the Clinton boom, which had federal budget surpluses but record-breaking private sector deficits. Nevertheless, it is time to take stock of the dangers faced by the U.S. economy.

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## Deficits

The first danger examined is the "triple threat" of U.S. deficits: private sector, federal budget, and trade deficits. Since 1996, the private sector as a whole (including both households and firms) has been spending more than its income. At the peak of the Clinton economic expansion, private deficits amounted to almost 6 percent of GDP, easily a record. Deficits this large meant that private sector debt was growing much faster than private sector income—a topic for the next section. In any case, as various analyses by Levy Institute scholars warned at the time, an expansion driven by private deficits was unsustainable. As the private sector began to retrench and bring spending into line with income, the economy fell into recession. Quick response by the Federal Reserve, together with well-timed tax cuts and increased spending for security and defense, turned things around. Nearly historically low interest rates encouraged households to borrow against home equity, which fueled consumption and a housing boom and kept private sector spending above income.

While private sector deficits today are much smaller than they were in 2000, we are still in a very unusual situation as a result of continuous deficit spending for the past eight years. It would be an understatement to say that nothing like this has ever happened before. The historical average for private sector balances is a surplus of 2 to 3 percent of GDP and economic downturns typically cause a retrenchment that generates a surplus two or three times higher than average. A simple return to the historical average would open up an aggregate demand gap of $300 to $400 billion. If this occurred, it is very difficult to see how a deep recession with double-digit unemployment could be avoided. Monetary policy cannot provide much thrust because the Fed's target rate is already 1 percent, mortgage rates are near historical lows, and most households have already refinanced to lower mortgage payments and cash out equity.

This brings us to the federal budget deficit, which has reversed course sharply since 2000 by moving from a three-year surplus that peaked at 2.5 percent of GDP to a deficit approaching 5 percent of GDP. Ten-year projections of the budget balance have moved from an accumulated surplus of $5.6 trillion when George W. Bush came to office to accumulated deficits as high as $5 trillion. In recent testimony, Fed chairman Alan Greenspan projected red ink much farther than the eye can see, warning that the present value of future budget deficits is now $44 trillion, due mostly to "unfunded" mandates in the Social Security and Medicare programs. While many analysts, including Greenspan, recognize the important role played by budget deficits in propping up an ailing economy, they warn that we now need to undertake some combination of spending cuts and a rollback of Bush tax cuts to put the federal budget back into a sustainable position.

Finally, the chronic and growing trade deficit has raised two concerns. The first concern is among policymakers who blame the trade deficit for the loss of jobs, especially in manufacturing. The current recovery is "jobless," with a net loss of approximately 2.9 million private sector jobs (which is partially offset by an increase of 700,000 public sector jobs), and some analysts argue that many of these job losses are permanent, due to competition from low-wage countries. The second concern is that the trade deficit requires financing by foreigners, which increases the U.S. external debt and the interest and profit flows going abroad. This deficit then raises the possibility of a flight out of the dollar and a collapse of the exchange rate.

## Debt

Each deficit flow leads to an associated accumulation of debt. For example, the projection of federal budget deficits of $400 to $500 billion per year for the next 10 years means that the outstanding stock of federal government debt will rise by up to $5 trillion. Historically, the federal government has been free from debt only once—in 1837—and private sector debt has grown almost every year. In terms of external debt, the United States was a "debtor nation" in the 19th century, but became a net creditor after World War II. Since the Reagan presidency, however, the United States has become the nation with the largest external debt in the world.

Most analysts recognize that debt, by itself, is not necessarily a bad thing. Knowing that a household or firm owes $100,000 really does not tell us much. Two ratios are important, however: the portion of income flows required to service outstanding debt and the ratio of debt-to-income flows. Unfortunately, there is no purely objective way to gauge whether either ratio is excessive. An economic unit could conceivably devote 99 percent of income flows to debt service, although this would leave little income for other purposes and would be highly risky (a slight reduction of income or a small increase of financing costs would cause immediate insolvency). Hence, conventions and rules of thumb establish prudent debt-service

ratios. In the United States, household debt-service ratios tend to rise to just above 14 percent during economic expansions before households retrench, borrow less, and retire some debt. Prudent debt-to-income ratios are just as hard to establish, and the private sector's debt-to-income ratio has trended upward since World War II. In expansions, the ratio rises more quickly, while in recessions, the rising trend of the ratio slows or halts temporarily. Economists have often argued that a steadily rising debt-to-income ratio is unsustainable, and, indeed, almost any trend ultimately appears unsustainable if carried to logical extremes.

Debt ratios for the federal government are generally calculated somewhat differently. Because government "income" is somewhat discretionary (the government can raise tax rates) and the government is said to have the option of printing money to finance its spending, government debt ratios are typically measured relative to GDP rather than relative to government income. Hence, the relevant ratios are government interest payments or sovereign debt relative to GDP. Again, there is no consensus regarding the proper ratios—some European government interest payments have reached 10 percent of GDP, and Turkey flirts with interest payments nearly three times that level. Government debt-to-GDP ratios have reached 60 percent in the United States and well above 100 percent in some European nations. Again, economists tend to proffer a sustainability constraint, i.e., the government debt-to-GDP ratio should not exhibit a rising trend, although this is at least as arbitrary as the imposition of a constraint on the private sector.

Finally, things become no clearer when it comes to external debt. Analysts frequently lump all external debt together, although two distinctions should be made: (1) there is a difference between public sector and private sector debt; and (2) it matters whether the external debt is denominated in the domestic currency. From the perspective of the individual consumer or firm, it matters little whether the domestic currency–denominated debt is held by domestic or foreign creditors, and all that I said earlier concerning private sector debt applies to the case where debt is held by foreigners.

When foreigners hold domestic currency–denominated government debt, government interest payments go to foreign creditors. Again, which debt ratios are appropriate is not clear. Some governments issue debt denominated in a foreign currency, typically the dollar, and this is more problematic than domestic currency–denominated debt. In this case, neither tax revenues nor GDP are the appropriate denominators for the debt or debt-service ratios because GDP and taxes are mostly realized in the form of domestic currency. Rather, the source of foreign currency used to service such debt is a trade surplus, or borrowing on the capital account. If either source dries up, the ability to service such debt is called into question. While this is a concern for many nations, it does not apply to the United States because all federal government debt and almost all private sector debt are denominated in dollars.

## Deflation

Having recently examined deflation in detail (Wray 2003; Wray and Papadimitriou 2003), I will not devote much space to this issue. It is sufficient to note that deflationary pressures at home and abroad are real and that falling prices and wages can quickly generate rising debt burdens, because almost all debt payment commitments are fixed in nominal terms. While I do not believe that the likelihood of a 1930s-style debt deflation process is high, the costs would be so great that policymakers should remain on guard. In any case, even if most prices remain steady, domestic and global demand will likely remain depressed with high unemployment and excess capacity in most economies and across many sectors. While a few commentators fret about the dangers of inflation, I do not believe that their fears should be taken seriously.

## Depreciation

In 2003 there was much talk about the possibility of continued and, perhaps, uncontrolled depreciation of the dollar. This was linked to concerns about the U.S. trade deficit. In fact, what actually occurred was mostly a recovery of the euro, which had depreciated sharply relative to the dollar after monetary union. To a lesser extent, the dollar was adjusting after a period of overvaluation probably linked to the New Economy boom and very high demand for U.S. equities. In recent months, the dollar's slide relative to the euro has halted, and much of the fear of depreciation seems to have subsided. Still, there are fears that the unsustainable growth of trade deficits that must be financed by increased "borrowing from abroad" by the U.S. government will continue to exert downward pressure on the dollar. The worst-case scenario is a run out of dollar assets,

which collapses the dollar's value—a U.S. "tequila crisis" that would subject the world's largest economy to a bailout by international lenders.

## An Alternative View

Scholars at the Levy Institute have taken advantage of the pioneering sectoral analyses of Hyman Minsky and Wynne Godley to understand the relationships among the financial balances of the government, private, and foreign sectors. The private sector balance equals the sum of the government and current account balances.

At the peak of the Clinton boom, the overall government budget was in surplus (about 1.5 percent of GDP). This surplus, added to the current account deficit (about 4 percent of GDP), generated a total private sector deficit of about 5.5 percent of GDP. For the reasons discussed above, I argued at the time that a private sector deficit of this magnitude would not be sustained. As private sector spending slowed, tax revenues fell relative to government spending and generated a reversal of the government's budget. In addition, the collapse of equity markets eliminated taxable capital gains and executive bonuses, eroding government revenues further. On top of this, the Bush tax cuts and spending increases by the federal government led to a large and growing budget deficit, which allowed the private sector to move closer to a balanced budget. However, the growing trade deficit partially offset the benefits of the federal budget deficit, as did spending cuts by local and state governments (whose revenues also fell as the economy slowed and capital gains taxes fell rapidly).

All of these trends could have been and, indeed, were predicted. The current relationships among the three sectoral balances are more sustainable than they were in 2000. The truth is that the federal budget's constraint is far "softer" than the constraints faced by the private sector—a point on which virtually all analysts agree. Our government's current deficit-to-GDP ratio is not high compared with past ratios or those achieved in other nations. The government debt-to-GDP ratio is relatively low compared to U.S. postwar experience and with ratios commonly achieved in other nations. Indeed, few commentators are concerned with the current ratios; rather, the focus is on projections of what might happen over the next decade, or five to ten decades in the future.

Not only are these projections likely to be incorrect, but more important, I believe they are wrongheaded. The future size of the U.S. federal budget deficit (or an increase of the debt), whether or not measured as a ratio of GDP, does not provide useful information by itself. Over any given period, such as a year, there is a "proper" fiscal stance, but this does not depend on any preconceived notion of the sustainable deficit or debt. Rather, the appropriate fiscal stance depends on the private sector's desired level of spending, given its income and the external balance. Assuming that the U.S. trade deficit continues at 4 or 5 percent of GDP and the private sector wishes to balance spending and income, it will be necessary for the overall government balance to be in deficit at 4 or 5 percent of GDP. Because state governments really do face "hard" budget constraints, it is up to the federal government to run the deficits.

What happens if the federal government hesitates to relax its budget, based on some out-of-paradigm belief about fiscal responsibility? Then a demand gap opens up, as the private sector finds that its income is less than expected, and sales, employment, and tax revenues fall. A government budget deficit is created, but at a lower overall level of activity and higher unemployment. My argument is that the government budget balance is, to a large extent, nondiscretionary. During the Clinton boom, the high propensity to spend in the private sector, taken together with "fiscally responsible" budgeting adopted after the Gramm-Rudman-Hollings Act (1985), created large federal budget surpluses. In the last half of the 1990s, this might have been close to the proper fiscal stance, as private spending was sufficiently robust to move the economy closer to full employment than it had been in a quarter century. Ultimately, the best indicator of the necessary budget adjustment is involuntary unemployment: if there are people without jobs who want to work (or workers with part-time jobs who want to work more hours), then the fiscal stance is too restrictive. By this measure, the Clinton surplus was less restrictive at the peak of the economic boom than is Bush's current deficit at 5 percent of GDP.

## All Fiscal Programs Are Not Created Equal

My argument should not be interpreted as a call for simple pump priming—not all demand stimulus is the same—since tax cuts have different impacts on employment and the economy than do spending enhancements. Furthermore, the types of tax cuts and spending programs also matter. The Bush tax cuts have been largely targeted to upper-income households and nonwage income. The employment-multiplier effects of such tax cuts, as expected, have been fairly small. This does not necessarily mean that these tax cuts were bad policy, although some of the capital gains tax cuts probably fueled asset sales (to take advantage of lower rates) and depressed equity prices. Moreover, inheritance tax cuts might have undesirable impacts on the concentration of wealth over generations. Still, whatever the wisdom of the Bush tax cuts, future relief ought to be targeted toward lower-income families. For this reason, I support a reduction of the payroll tax, which would likely have large multiplier effects on employment in terms of the demand side (stimulating consumption) and the supply side (increasing incentives of employers to hire and workers to work).

Not all government spending is equal with regard to employment creation, either. Foreign wars probably do not create as many jobs as an equivalent level of spending on domestic infrastructure or education. Direct job creation by government, such as New Deal-type public service employment (PSE) programs, has been demonstrated to create more jobs for the buck than alternative government programs. Public subsidies for private employment have been far less effective, for obvious reasons—they tend to lead to substitution rather than net job creation. Worker training programs enhance the desirability of certain workers but tend to redistribute jobs rather than create new ones. Direct and indirect support for high-tech and R&D programs creates high-paying jobs for the highly educated (which can cause some "trickle-down" job creation), but these workers are rarely jobless. Thus, a renewed "Star Wars" program would likely need a much greater amount of federal government spending to create the same number of jobs than a much smaller direct-employment program. Finally, government spending and tax policies can be distortionary, which is something to consider when formulating fiscal stimulus programs. Targeted tax breaks or employment subsidies, as well as specific government projects like Star Wars, will direct resources into favored activities, with job creation mostly an afterthought.

## Quelling the Fear of Inflation

This leads me to one of the greatest fears about demand stimulus and government deficits—inflation. Our late colleague, Hyman Minsky, always worried about the inflation potential of social spending programs—"welfare," unemployment benefits, or Social Security—that add to demand without directly creating jobs. Indeed, Minsky complained that these programs effectively pay people not to work. By contrast, direct job creation that puts people to work doing useful things can add to national output and raise living standards without generating much inflationary pressure. A stimulus package that promotes "hiring off the top" (e.g., a government program that creates demand for highly skilled engineers) will generate wage inflation, at least for highly trained workers, long before jobs trickle down to those with the least education and training. A jobs program that "hires off the bottom" and pays the minimum wage to all who are ready and willing to work will create hundreds of thousands, perhaps even millions of jobs, without generating significant inflationary pressures.

I say this recognizing that the problem today is deflationary, not inflationary, pressures. If policy becomes focused on maintaining a fiscal stance consistent with full employment, however, then inflation fears will eventually arise. I believe that inflationary pressures can be held in check. First, competitive pressures in our open economy will hold down wage and price pressures for products that can be produced abroad. Maintaining relative stability of wages paid in PSE programs will provide a wage floor without pushing up market wages. Indeed, to the extent that PSE workers can be hired away by the private sector, they will operate as a "buffer stock," because private employers can recruit them at a markup over the program wage. Further, as discussed above, high employment can be maintained with lower levels of government spending and, indeed, lower aggregate demand.

Finally, as Minsky always argued, a direct job-creation program can provide full employment even in a low-growth economy. The prevailing wisdom is that high growth is necessary so that a "rising tide" can "lift all boats." History shows that, while it is true that the boats at the bottom do somewhat better when the economy grows rapidly, the effect has been vastly overstated. Forty years after the beginning of the War on Poverty (with its heavy emphasis on rising tides and training and education for the poor), there has been relatively little progress in reducing poverty. Further, Minsky argued that a high-growth

strategy favors private investment and generates growing financial fragility and instability. The evidence of the past 40 years confirms Minsky's fear that financial crises would become increasingly common and severe as a result of high-growth strategies. A lower-growth, high-consumption, full-employment strategy that could result from direct job creation would entail potentially lower inflation. Minsky also argued that if inflation reared its ugly head in such a regime, appropriate policy should constrain wage increases at the upper end of the pay scale rather than raise the unemployment level of low-skilled workers.

## External Constraints

We are left with concerns about the trade deficit. From sectoral analysis, we know that if the trade deficit closes, the overall fiscal stance could be tighter and, if the trade deficit grows, the fiscal stance would need to be relaxed for a given private sector balance. As discussed above, one of the fears associated with trade deficits is the loss of jobs. Once the fear of government deficits is removed, policy can tackle unemployment problems created by imports. The best policy response to a trade deficit is to create jobs, not to block imports. In some cases, retraining might be necessary, together with temporary income replacement for people losing jobs to foreign competition. However, it must be emphasized that, from the vantage point of the U.S. economy as a whole, imports are a benefit while exports are a cost—net imports mean we get to consume more than we produce.

There is a great deal of confusion over the relationship between trade deficits and international "flows" of currency, reserves, and finance. For example, it is often claimed that the United States needs foreign savings in order to finance its persistent trade deficit, which results from "profligate U.S. consumers living beyond their means." Such a statement makes no sense for a sovereign nation operating on a flexible exchange rate. When viewed from the vantage point of the economy as a whole, a U.S. trade deficit results when the rest of the world (ROW) wishes to accumulate dollar assets. The ROW exports to the United States reflect the "cost" imposed on citizens of the ROW as they obtain the "benefit" of accumulating dollar-denominated assets. From the perspective of the United States as a whole, the net benefit of the trade deficit is the net imports that Americans enjoy. In contrast to the conventional view, it is more revealing to think that the U.S. trade deficit finances the net dollar savings of the ROW rather than to think that the ROW finances the U.S. trade deficit. If and when the ROW decides that it has a sufficient stock of dollar assets, then the U.S. trade deficit will disappear.

There are two reasons that a tequila crisis is exceedingly unlikely: (1) the United States operates a floating exchange rate regime, so speculative pressures cannot build in anticipation of a policy change to devalue its currency; and (2) many countries peg their currencies against the dollar (or go even further with currency boards), so it is unlikely that these countries will suddenly decide to run down their dollar reserves. In addition, many governments and firms outside the United States have dollar-denominated liabilities and an almost insatiable demand to obtain dollars to service their debts. Furthermore, managed money all over the world attempts to maintain a substantial portfolio position in dollar assets. None of this means that an orderly depreciation of the dollar is impossible, but it does diminish the probability of a run on the dollar.

## Further Policy Recommendations

In addition to the policies discussed above, I advocate a substantial increase in federal funding for state and local governments—$150 billion per year, perhaps—with a countercyclical component. Unlike state and local governments (as well as households and firms), the federal government can spend countercyclically without regard to its revenues. The federal government spends by crediting bank accounts and taxes by debiting them. Hence, it does not and cannot use tax revenues to finance its spending. Free of financial constraints that are faced by other levels of government, the federal government can concern itself with the economy's real problems: unemployment, hunger, poverty, homelessness, fiscal crises at the state and local government levels, decaying public infrastructure, inadequate health care for the uninsured, and low-quality education in many urban school districts.

The fear-mongering by zealots who point to looming financial crises supposedly occasioned by "$44 trillion of unfunded baby-boomer retirements" should be dismissed out of hand. Rather, policymakers ought to reassure senior citizens that their promises can and will be kept. If we have learned anything from Japan's decade-long malaise,[1] it should be that, once the population loses faith that its government will provide for its future, private savings can never be high enough. Even with

substantial trade surpluses and budget deficits reaching 8 percent of GDP, households and firms in Japan struggle to run larger budget surpluses, which is a rational response to a climate of uncertainty and fear about the future. I puzzle over the attempts by some policymakers to create a similar environment here.

## Note

1. Japan finally appears poised for recovery, as more than a decade of budget deficits seems to have overcome the headwinds of fear and uncertainty by filling private portfolios with safe government bonds.

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