Is Debt Good *or* Bad?

Answer: It depends.

By Mark Sobel

With sovereign debt continuing its seemingly inexorable rise, debates rage across the globe—are government debt and deficits good, bad, or ugly? Like so much in economics, the answer is "it depends." Of course, a country should fund its spending needs, in particular to defend its people and protect their wellbeing. But is it smart to take on debt to do so?

The Good: Countries with fiscal space wisely added to debt to offset shortfalls in private demand during the global financial crisis and the Covid pandemic. While the case to take on debt in a crisis is clear, there can also be good arguments for doing so when an economy faces output gaps.

But the flip side is that deficits should be restrained when a country is operating above potential. Debt can also be growth-enhancing by funding infrastructure, climate, and other public goods, and helping catalyze private sector investments with high rates of return that might not otherwise be undertaken. Financing investments, particularly amid negative real rates, makes sense.

The Bad: There can be too much of a good thing. Fiscal policy doesn't lend itself readily to fine-tuning. Politicians often seek to fund consumption, rather than long-term growth-enhancing investments. They do so without regard to macroeconomic stabilization concerns or the economic cycle. Higher debt service costs can squeeze fiscal space needed to finance governmental priorities. Running up debts allows the political class to avoid taking responsibility for tradeoffs between restraining spending and raising revenue. The consequences for inflation, growth, and employment can be adverse.

The Ugly: Sometimes debt buildups cause fiscal dominance, forcing central banks to monetize debt, which can ratchet up inflation, cause currency crashes, and eviscerate financial systems.

Adding to the complexities of assessing the good, bad, and ugly:

Mark Sobel is U.S. Chair, Official Monetary and Financial Institutions Forum, and formerly served as Deputy Assistant Secretary for International Monetary and Financial Policy at the U.S. Treasury Department.

The Good: Countries with fiscal space wisely added to debt to offset shortfalls in private demand during the global financial crisis and the Covid pandemic. The Bad: Politicians often seek to fund consumption, rather than long-term growth-enhancing investments. They do so without regard to macroeconomic stabilization concerns or the economic cycle.

■ Debt sustainability, like fiscal space, is difficult to quantify or define. It depends on unknowns, such as market sentiment and a country's future economic performance. Can a country run sound policies and implement reforms? How much debt does it already have? What is the maturity profile and rollover risk? Is debt denominated in local or foreign currency? Can the country tap into a large domestic saving pool?

■ Economists often look at the debt-to-GDP ratio as a proxy for assessing debt sustainability. It is a highly imperfect measure. Particularly in a world of low real interest rates, debt service relative to GDP takes on added importance. U.S. debt held by the public was 44 percent of GDP in 1991 and the debt service ratio 3.2 percent of GDP. Now debt is around 100 percent of GDP, but debt service in 2020 was 1.6 percent of GDP.

■ Country growth rates vary substantially. Rather than focusing exclusively on the debt-to-GDP numerator, raising the denominator can bolster sustainability.

■ Sovereign debt has risen steeply in many advanced economies, yet interest rates have fallen sharply, major central banks have deployed quantitative easing, and countries were still often unable to hit their low 2 percent inflation targets.

■ Economists look at the relationship between the real interest (r) and growth rate (g). If r-g is less than zero, an economy can in principle reduce debt and roll it over more easily. But this assumes the deficit is not rising so quickly as to swamp the gain from r-g<0.

In past years, the International Monetary Fund focused on debt-to-GDP ratios to judge when troubling fiscal dynamics might be emerging. For example, if an advanced economy had a debt-to-GDP ratio around 100 percent or much higher, the Fund was generally uncomfortable. The Maastricht Treaty, which helped usher in the euro in the early 1990s when real interest rates were much higher, saw a ratio over 60 percent of GDP as unhealthy. The use of fiscal space by advanced economies in the global financial crisis and the Covid pandemic sent debt-to-GDP ratios soaring, breaking these conventions. Meanwhile, Japan has long had a debt-to-GDP ratio of 200 percent while facing ongoing deflation.

For emerging markets, a ratio of over 70 percent of GDP often generated IMF concern, though the degree could vary based upon whether the country had a flexible exchange rate and whether debt was denominated largely in domestic or foreign currency. During the pandemic, some emerging markets with sound fundamentals and buffers have been able to cut interest rates, step up fiscal spending, and conduct quantitative easing without generating economic difficulties—an unimaginable thought a few years ago. But emerging markets generally have less fiscal space to pursue quantitative easing than advanced economies and some have already lifted interest rates to contain inflation and currency pressures.

For low-income countries, often with small financial markets and domestic saving and needing to tap into banks to finance government debt, a ratio higher than 35 percent could be seen as problematic.

Fiscal policy has allocative (the division between private and social goods), distributive (adjusting income and wealth in a society to promote fairness), and stabilization (achieving macro goals such as low inflation, sound and sustainable growth, and balance of payments) functions.

In the global financial crisis and the Covid pandemic, the U.S. executive and legislative branches rightly came together and provided massive fiscal support to stave off far-worse contractions. Whether enough or properly targeted support is another question.

Continued on page 86

Continued from page 43

In more "normal" times, however, there is little U.S. consensus on fiscal policy's allocative and distributive functions, and the stabilization function gets short shrift. Often, given this lacking consensus, Congress is unable to pass budget bills—even though doing so is perhaps its most basic *raison d'être.*

One political party is keen on cutting taxes, especially for the better-off. Though it advocates spending restraint, it is reticent to actually do so. The other party touts the need to promote greater fairness and tackle infrastructure and climate needs, but is wary of reprioritizing other spending and advocates tax hikes for the very wealthy. In both cases, the arithmetic doesn't add up without higher debt.

The United States is easily able to finance its current debt held by the public of around 100 percent of GDP given the depth and liquidity of U.S. capital markets, the dollar's global financing and reserve role, and the U.S. Treasury offering of the world's most valued safe asset. Fed quantitative easing makes the job all the easier.

The upshot is that the stabilization function of fiscal policy seemingly becomes an afterthought. Despite insincere political rhetoric to the contrary, there is little pressure to curb significant deficits in "normal" times and thereby rebuild buffers and fiscal space. When the United States hits the debt ceiling because the Treasury is simply paying the bills mandated by Congress and the executive branch, hypocritical posturing and cries emerge and there are farcical, yet highly damaging, calls to have the nation default and trigger a global financial crisis in the name of fiscal responsibility.

Our political class so far seems unable to tackle America's adverse longer-term fiscal demographic and entitlement issues.

Further, our political class so far seems unable to tackle America's adverse longer-term fiscal demographic and entitlement issues. The Congressional Budget Office estimates that U.S. debt could rise toward 200 percent of GDP under current policy by 2050.

Absent a greater commitment to tackle our fiscal challenges within a stabilization framework, the United States runs a future risk that interest rates might materially rise, the economy could be forced to contract spending too quickly, funding for basic societal priorities could be squeezed, and/ or pressures may emerge on the Federal Reserve to finance the government.

There is little U.S. consensus on fiscal policy's allocative and distributive functions, and the stabilization function gets short shrift.

On balance, should governments take on debt? Is debt sustainable? Is there fiscal space? If the best answer to these questions is a subjective "it depends," can any lessons be usefully drawn to harness the good, and avoid the bad and ugly?

First, advanced economies shouldn't in general fret *per se* about financing current debt loads, especially given low interest rates. They have greater fiscal space and capacity to finance deficits than previously thought. But governments cannot be complacent about the future or assume low rates will last forever. Further, demographic pressures intensify the challenges facing fiscal policy.

Accordingly, advanced economies should use more "normal" periods to gradually reduce deficits and rebuild buffers. They need longer-term plans to cope with the fiscal consequences of aging.

Next, multi-year stabilization frameworks are needed to set the fiscal policy envelope, rather than let debt and deficits be the residual from an inability to gain a consensus on which social priorities to finance.

Further, governments should be far more willing to take on debt burdens to pay for investments, rather than consumption.

Fiscal dominance is to be avoided. That will limit the risk of monetary financing of deficits. Central banks, while operating within a legislatively set accountability framework, should retain instrument independence.

And finally, fiscal rules and guidelines need to be modernized. Reliance on debt-to-GDP ratios is unwarranted, though excess comfort shouldn't be derived from low debt service ratios. Nor should rules or guidance seek such rapid consolidation as to cause contractions.

In the final analysis, the real answer to "it depends" is to stay clear of the bad and the ugly and find the political will to promote the good. ◆