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Rising Debt in a Growing Economy: Perspectives on America's Fiscal and Economi Dynamic

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Panel with Olivier Blanchard, Beth Ann Bovino, and Kent Smetters
Moderator: Greg IP

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America's economy continues on a lengthy expansion, with low unemployment and interest rates. At the same time, our national debt is at historically high levels, with deficits projected to rise rapidly and indefinitely into the future. Shedding light on the relationship between debt, deficits, interest rates and economic growth, leading macroeconomists will offer perspectives on this unusual fiscal and economic dynamic — offering policy prescriptions to navigate the present and prepare for the future.

This panel discussion with **Olivier Blanchard, Beth Ann Bovino**, and **Kent Smetters** was conducted by **Greg Ip**, chief economics commentator of *The Wall Street Journal,* as part of the 2019 Fiscal Summit.

ANNOUNCER: Ladies and gentlemen, please welcome chief economics commentator for the Wall Street Journal Greg Ip and his panel.

GREG IP: Good morning, and thank you very much. So we meet on a wonderful morning in Washington, and the economy is a little shaky but still looks pretty awesome. Unemployment, 50-year low. This month we entered possibly the longest business expansion in U.S. history. Everything looks great with one exception. The fiscal picture looks terrible. The debt-to-GDP ratio is at a postwar, post-1950s high. And it seems to be headed higher.

We're experiencing fiscal deficits that are normally experienced only during recessions. And so the panel this morning is going to sort of challenge-- it's going to ask that very sort of, like, existential question. Is this something to worry about? If so, why? And is it something not to worry about? And if not, why not?

And to discuss these questions, we are blessed with a terrific panel. On my far left is Kent Smetters. He is a professor at the Wharton School at the University of Pennsylvania, and he is director of the Penn-Wharton Budget Model. Next to him is Beth Ann Bovino. She is U.S. chief economist at S&P Global Ratings Group.

GREG IP: If you're upset that S&P downgraded the United States a few years ago, you can bring it up with her afterwards. And then just to my left is Olivier Blanchard. He goes by many titles. Currently he is senior fellow at the Peterson Institute for International Economics. Before that, he was best known as chief economist at the IMF. Before that, as chairman of the Department of Economics at MIT and doctoral dissertation advisor to approximately 50% of people with Ph.D.'s in this country.

But, Olivier, your most recent title, if I may is enfant terrible of macroeconomics vis-à-vis fiscal policy. And I say that because, as the audience may know, there's been a big rethink going on in economics about the dangers of debt. And you are kind of at the center of that debate.

You gave a speech (I was there) in front of thousands of people at the American Economic Association where you essentially turned conventional wisdom on its head and said that maybe the terrible things we think about with big debts aren't as terrible as we've come to believe. Can you lay out for us your thesis about why we need to rethink some of these assumptions about debt?

OLIVIER BLANCHARD: With pleasure. What led me to choose the topic of the speech I gave at the AEA meetings and to focus on this issue was the decrease in safe interest rates since the mid-'80s, which continued fairly steadily, and has continued, and if we believe markets is going to continue for a long time. We now have rates which are historically extremely low and, even more strikingly, lower than the growth rate. And so I realized this was--

GREG IP: In other words, if there's a growth rate of 4% nominal.

OLIVIER BLANCHARD: Right. We are basically at 2.5%. Well, if you look ten years out, 2.1% now and probably a nominal growth rate of about 4%, right? 3.8%. And I realized this was a very unusual environment. And it was worth just revisiting the basic theory of deficits and debt in that context. So it's a fairly academic paper with clearly substantial implications for policy.

And that's what I did. And if I were to summarize the two conclusions that I drew from that, the first one is the cost of debt is lower. That's nearly trivial. Both the fiscal cost of debt is lower because you pay a low interest rate. So the debt dynamic are more appealing. That's the first one. So lower fiscal cost, lower economic cost of debt.

Because the fact that interest rates are so low is a signal, not a perfect signal, that maybe the marginal product of capital is not that high. So while that crowds out capital, which is the usual argument against that, it may not be very costly if capital is not very productive. So on the first point, the first point is lower cost.

OLIVIER BLANCHARD: The second is this is an environment in which, and that's conceptually different but related, monetary policy has much less room to play. In many countries, monetary policy basically has done everything it can. Interest rates are very close to zero or even negative in some countries. And therefore fiscal policy can do more.

So the benefits of fiscal policy in that environment is that it can do something that monetary policy would have done in another context but can't. So there might be larger benefits to using fiscal expansions in that kind of environment. So lower cost, higher benefits. So this was basically the message.

Then what I've done since then is basically go around the world, and look at the different situations, and pontificate about various countries from Japan to the EU to the U.S. And each country is different. I mean, Japan clearly is an extreme form of that, has negative nominal rates, as the eye can see if you look at the yield curve. Europe is very close also to the minimum. In the U.S., the situation is not quite as bad.
So if I may take a few more minutes to talk about the U.S., what are the implications of what I've said and thought about for the U.S.? I think you have to distinguish between, say, the relatively short run (say the next five, ten years maybe at most) and then the longer run. So in the short run, I think the implication is we have large primary deficits at this point. And the question is: Should we reduce them?

I think all thing equal, if we could reduce them at no cost in terms of output, we should. But the issue is that there is not a whole lot of room, even ignoring the risk of a recession. If we were to have a drastic fiscal consolidation over the next few years, the Fed would probably have to decrease interest rates to offset some of the decrease in demand. And the Fed might find itself again either at the zero lower bound or at a rate that is not very pleasant.

I think we all want the Fed to have a bit more margin to play with than being back at zero. So I think the conclusion for the U.S. is in the absence of a recession, decrease the primary deficits at a rate which does not put into question growth, which basically is a statement about the strength of private demand itself and the ability focus the Fed to decrease interest rates. So I think at best it implies a very slow decrease in primary deficits. If there is a recession, my own view, if we want to come back to this, the Fed doesn't have the ability to really handle a regular, run-of-the-mill recession. And so fiscal policy should be used. In that context, I have no doubt that it has to be used. Yes, it might increase debt, but not a catastrophe. So this is for the next five, ten years.

OLIVIER BLANCHARD: So I think at best it implies a very slow decrease in primary deficits. If there is a recession, my own view, if we want to come back to this, the Fed doesn't have the ability to really handle a regular, run-of-the-mill recession. And so fiscal policy should be used. In that context, I have no doubt that it has to be used. Yes, it might increase debt, but not a catastrophe. So this is for the next five, ten years.

For the longer run, I was at the CBO advisory meeting on Friday. And it's clear that there are trends which are extremely worrisome. And if nothing is done in terms of Social Security or Medicare, various other programs, we are on a trajectory of increasing debt. And I can see no reason for wanting this.

So it's clear here that my advice is very much the same advice I think as the other panel members, which is we have to think now about adjusting for Social Security benefits or contributions and for Medicare and various other aspects of the budget. We have to start now. I have no desire to see debt increase to 150%.

GREG IP: So just to be clear, you're not saying debt does not matter?

OLIVIER BLANCHARD: Debt does matter. The way I've said this, you know, you try to find a percentage which characterizes what you think without people being able to take it one way or the other. I am not an MMT person. I do not agree with--

GREG IP: Modern monetary theory, the idea that you can print your way out of any debt--

OLIVIER BLANCHARD: The way I see it is debt is bad but not necessarily catastrophic. I think that captures where I am.

GREG IP: Kent, let me turn to you now. Of course, your model is sort of a central workhouse model that we use to try and address the extent to which debt is harmful to the economy. And, you know, I'm very familiar with your work. And one of the mechanisms by which it always reminds policy makers about the tradeoffs is the crowding-out effect, is that when you run up the debt, that's money that's not available for private investment. Just how much do you agree with Olivier's broad point here? Do you think that perhaps he minimizes some of these harmful long-run effects?

KENT SMETTERS: So we basically agree with Olivier when it comes to per dollar. Per-dollar debt we agree that the cost per dollar has gone way down relative historic levels. The borrowing rate is quite low. In our model we actually have the real maturity-weighted borrowing rate for government slightly negative right now in our model because--

GREG IP: And how does that compare historically?

KENT SMETTERS: It's much lower than historically. Easily 300 basis points lower than if you go pre-2008. And, Olivier, you mentioned backstage I wasn't allowed to talk about marginal product of capital. But Olivier brought it up.
(OVERTALK)

GREG IP: --window has moved sort of.

KENT SMETTERS: That's right. And, you know, Beth and I both read his textbook growing up. And so if the textbook author is willing to say that. But the marginal product of capital is this idea. It's simply that what is the return to private investors given that they face risk. What do they require to invest in risky capital projects versus something that's safer like government debt?

And we are currently projecting-- we've been using this all the way since the Tax Cuts and Jobs Act and before. Marginal product of capital is about 350 basis points below what pre-2008 simulation studies used to use. In particular, we're right now for 2020 at 5.4%. It does tick up over time. By 2040, it's only gone up to 6.1% on a real basis. So quite a bit lower.

The issue is simply the sheer size of debt. And in particular, we have the sheer the size of debt increasing quite a bit. By 2050, approaching about 190% of GDP. That's about 30% of GDP higher than CBO. There's various reasons why we're a little bit higher. But whether you use our number or CBO's number, the crowding-out effect. That is households are deciding, "Where do I invest my dollar? Do I put it into private capital projects? Or do I buy government debt?"

Which as Michael Peterson in his opening remarks reminds us, that's really affording consumption today without paying for it today. It's really fast-forwarding consumption. And still, even under these very favorable assumptions-- and, by the way, we also make other technical assumptions that, if anything, are very debt friendly. Very robust international capital flows, things that I don't actually completely believe.

But to err on the side of, if anything, being debt friendly, we still find big crowding-out effects. In particular, by 2040 we're finding that if we could just stabilize the current debt/GDP ratio (not even go back to pre-2008 levels, just the current debt/GDP ratio of around 80%, we could stabilize that going forward), we would have pretty sizable increases in GDP that are, you know, 1%-3% of GDP. By 2050, we're 2%-6% growth in GDP.

If you put that in the context of, like, the Tax Cuts and Jobs Act, we're talking about a change about one to three times bigger than what you would get from a long-term package like the Tax Cuts and Jobs Act. And so far, it's the only policy-- trying to figure out how to stabilize the debt/GDP ratio, relative to other fiscal policies it's still the biggest kicker in terms of stimulating the economy.

GREG IP: So you concur with Olivier that may be a problem but it's not catastrophic. In other words, it does its damage little bit by bit over a very long time?

KENT SMETTERS: It's a death by a thousand cuts. And, you know, the really big issue, too, is that we're doing everything on an outcome for this particular analysis. The risk factor is huge. In particular, what happens if the rest of the world doesn't see the U.S. as that safe, ubiquitous asset? What happens if the Japanese insurance companies decide we're not that safe? What happens if Beth downgrades our debt even more? You know, there--

BETH ANN BOVINO: Funny you should mention that. No. It's a joke.

KENT SMETTERS: You know, right now, you know, places like Japan have a very high savings rate. Places like the United States have a very low household savings rate. I think we have a lot less flexibility relative to other countries.

GREG IP: Beth Ann, that was perhaps not the way you would have wanted to be introduced. But nonetheless, I'm going to follow up on that point. I well remember back in 2011 I was reporting when S&P downgraded the United States debt rating. And I do remember what happened to bond yields. They went down. And today, with the largest, you know, peacetime debt-to-GDP ratio in modern U.S. history, we're looking at real bond yields of around zero.

The bond market vigilantes are either dead, or euthanized, or sedated. And if the bond market's not getting worked up about our debt, why should we? What do you read into the bond market in terms of what we should or should not be worrying about with respect to our fiscal situation?

BETH ANN BOVINO: Well, I mean, markets don't care until they do for one thing. So let's see what happens. They didn't respond to the debt ceiling crisis as well largely because they thought the government would, you know, do the right thing after they've gone through every other option possible. And that probably is the same case this time as well.

In terms of where we are, keep in mind that S&P Global downgraded the U.S. to AA+. That is still very high in terms of investment grade. And there are other factors that went into that. Now, one of the big factors was governance. Basically poor governance. And that really hasn't changed so much even today. I should note that I'm not a rating analyst, but I do work with them closely.

We'd also want to say that we have different factors that are in play with our measure, our overall measure for the sovereign group, for the sovereign debt rating. One of them is the debt. That is actually at the lowest. We have a factor of one to six in terms of one is highest, six is the lowest. The U.S. debt, government debt is at the lowest. It's six. Can't go lower than that.

BETH ANN BOVINO: The fiscal side of things or the flow factor is also at play there. That is still rather low. Not at the lowest it can go. But then there are other factors that go. When we talk about institutions, yes, governance particularly on Capitol Hill, lawmakers on Capitol Hill, gave the sovereign rating a ding. But there are other institutions. The Federal Reserve, for example. Many other institutions in the U.S. government which are still, you know, moving very well.

And then the last thing to keep in mind that is actually a real strength for the U.S. and we don't see it changing anytime soon is the dollar is the reserve currency. Then you think about the money, 60% of world reserves are in the U.S. dollar. And that gives the U.S. a significant amount of cushion going forward.

GREG IP: Well, let me actually address that last point about our institutions, right? And so in fact there's been a lot of discussion the last week or two since the president threatened and then retracted the threat to put tariffs on Mexico because of the immigration issue. You know, there's a variety of other things.

The United States re-imposing sanctions on Iran despite the fact that U.S. allies have not done the same. There's a concern that the U.S. by essentially using these economic tools in a unilateral sense is eventually going to give other countries incentives to work around the U.S. dominance of the global financial system. Britain and France I believe are working on an alternative dollar payment system to continue business with Iran.

And then you mentioned the Federal Reserve. You know, there's been a lot of concern about the president's, you know, very vociferous criticism of the Fed. He's been at it just in the last day or two about some of the people he has contemplated nominating to the Federal Reserve. How much should we worry about the institutions of the United States, which are currently (as you say) a strength of the rating, actually turning into a weakness?

BETH ANN BOVINO: I mean, so the Federal Reserve certainly holds and very tightly holds to the fact that they are an independent body. And I think that will still hold. They hold that very tightly, and they continue to make that point. I do think that while, you know, the president's tweets on the Federal Reserve and on Chair Powell adds much more confusion to markets. It actually adds to the worry of credibility in terms of market impressions.

I don't think the Fed has changed their position because of that. I know there's an argument. "Did the Fed decide to lower rates or decide to stay on hold because of what President Trump is saying?" I don't think that was the case at all. Although I do think that the market turbulence could be at play in terms of the Fed's decision. And is the market turbulence tied to some of the actions on Capitol Hill? Most likely so. So you're seeing kind of a circular effect there. But I do think that the institutions, particularly the Federal Reserve, still stand strong.

GREG IP: Let's turn the--

BETH ANN BOVINO: I'd also want to add though, remember, the two nominees also didn't ever meet as well. So.

GREG IP: Olivier, did you want to add something?

OLIVIER BLANCHARD: Yeah. On the risks, I mean, there are always risks when you have high debt. The investors will basically get scared and run away. And sudden stops we've seen in many Latin American countries. And I worry about it. So two points here. The first one is: How do you decrease this risk?

And if you basically embark on a fiscal consolidation, which may have effect on output, and you decrease that from, say, 120 to 118 (which implies quite a bit of fiscal consolidation) and you do it in a year, it's not going to basically change very much objectively the risks.

The other is that, you know, what do you if the investors suddenly wake up, to use the usual expression? And I think here the last country in which this is likely to happen is the U.S. because for the moment there is no fundamental problem with debt sustainability or debt default. Debt service is still low. This is an issue far in the future.

And the U.S. bond market will remain the deep liquid market that people want to be in for quite a while. So there are risks, but I'm not sure that they are very large for the U.S. And I'm not sure that major fiscal consolidation starting now would actually decrease this risk very much.

GREG IP: Well, as you say, starting now. So actually let's bring that to the here and now. Because at the end of this fiscal year in September, the temporary relief from the budget caps expires. And on current law, there will be a significant contraction in discretionary spending. There are significant fights ahead on Capitol Hill about what to do about that.

What in your view, Olivier, should we be doing? Should we allow that type of consolidation to occur right now? I mean, the economy is, after all, growing. I mean, Keynes did say the time for austerity is the boom, not the bust. This kind of feels like a boom.

OLIVIER BLANCHARD: Again, you know, the very recent issue is: Are we heading to a recession? If we are heading into a recession, then almost surely you don't want to have fiscal consolidation at that time. But leaving this aside, suppose if the economy continues to basically have the same level of private demand, if you basically have a fiscal consolidation, say, of 1% of GDP, this implies that the Fed in terms of offset it would have to decrease the rate by 100, 150 basis points.

OLIVIER BLANCHARD: I don't know if Kent and my panel members would agree with that. But we would get very close, then back to very, very low rates. I would be a bit worried. So I think if there is no wave (?) of recession, I would probably decrease the primary deficit a bit. But not much. Not as much as is implied by just letting these things end.

GREG IP: Beth Ann, what do you think? Should those budget caps be allowed to bind once again? What are the risks?

BETH ANN BOVINO: So are we talking about the--

GREG IP: So if recall correctly--

KENT SMETTERS: Debt ceiling.

BETH ANN BOVINO: The debt ceiling.

GREG IP: Well, not just the debt ceiling. But I believe that there are budget caps that have been put in place as part of the--

(OVERTALK)

BETH ANN BOVINO: Oh yeah. Yeah, that. Gosh.

GREG IP: And we are now--

KENT SMETTERS: To resolve the last debt ceiling--

BETH ANN BOVINO: Yeah, yeah. Back in the day. Gosh. So, I mean, but they're rather small from when I think about it. When you're talking about the budget caps that would go into place, they're rather small. So in terms of where we are, kind of back to what Olivier was saying, that we do see a slowdown in the expansion. The question is: Is it a soft patch or quicksand?

Right now, we still think it's a soft patch. We're seeing growth slowing in 2019. It's going to feel like a quicksand to some. But it looks like it's slowing to still above trend growth at around 2.4% this year, slowing further in 2020. I think that in terms of what we can expect from Capitol Hill, you know, you could see a small kind of consolidation.

But rather, you don't need to move too quickly I suspect right now. We'll see what lawmakers say on that. Given that we are seeing a bit of a slowdown, we see the Fed worrying, we also see the trade dispute adding even more fuel to the fire, I suspect now would be a time to kind of take a break.

GREG IP: So I guess the central question is: So even if you don't want to, like, get the debt-to-GDP ratio down, on current law and current policy, it's going to go up. So some austerity would be necessary just to stabilize the debt-to-GDP ratio. We could start this fall by allowing the caps to bind partially or completely. Kent, a key question is: Should we? Should we at least now aim to at least stabilize the debt-to-GDP ratio?

KENT SMETTERS: Yeah. So I actually am one of the few economists that like things like budget caps, you know, and having this annual or semi-annual discussion about the debt ceiling and things like that simply because it forces that conversation. Normal economists think, "These caps are so arbitrary. Why would we impose those on ourselves?"

I think it's good to have those conversations. The real issue that, you know, keeps me up at night is the issue that we know Social Security and Medicare, Medicaid, especially in terms of long-term care are facing enormous pressures right now. When I think about retirement adequacy in the United States, if I thought those programs were fully funded, I wouldn't be really worried about retirement adequacy, all the baby boomers going into retirement. 10,000 a day, you know, up until around 2035.

The real issue is that if we don't make some sacrifice now, where is the room in the future for trying to deal with some of these shortfalls and the significant risk in these programs as well? And so I would actually be cutting spending more and more over time. I agree. You can have a compounding effect. If we are reducing spending, we can get a compounding effect from that.

Do we have to be super aggressive about it? No. No, we don't. But we should I think start in that path of thinking very seriously how to deal with the shortfalls in a lot of these programs. You know, right now I think capital markets are pricing in the idea that we are going to figure it out somehow. And it's not going to require monetization of the Fed.

It does remind me though of some of the risks that both panelists have brought up. Fifteen years ago or so Ken Rogoff and I were brought in by a company called Lehman Brothers (they were the biggest fixed income house at the time) to talk with their fixed income investors. And I gave my spiel on where the economy was headed and where I thought the debt situation even then was headed because it was fairly predictable.
And, you know, a lot of Lehman Brother fixed income investors were like, you know, "We like this idea of rational expectations." And that's speaking our language up here. If you look at Olivier's textbook, rational expectations, forward-looking markets, and so forth. And then Ken and I asked them to define what they meant by rational expectations.

KENT SMETTERS: And they said, you know, "We jump when everybody else jumps." And it was just the opposite of rational expectations. It was very myopic expectations. And that's the thing that scares me about fixed income markets. I agree with Olivier that the U.S. is very big. 4% of the world's population, 25% of the world's capital stock.

The argument is: Where is the money going to go? Other countries are screwed up, too. So I agree were not going to have an Asian currency crisis and things like that. But it's the slow burn, the slow impact on capital formation. Even things like even TFP eventually could affected by this depending on what model you believe. And it's that slowness, that we could really be stuck in this kind of lost generation for generations and generations if we don't take action today even on a moderate, you know, compounded basis.

GREG IP: Olivier?

OLIVIER BLANCHARD: So two things. I think we should not make a fetish of a debt-to-GDP ratio. The debt is your stock, GDP is a flow. What matters more is debt service. This could increase if interest rates increase. But that's at a fairly low level historically. So I don't think we should just say we have to really keep the debt-to-GDP ratio constant--

KENT SMETTERS: I agree.

OLIVIER BLANCHARD: We have to--

BETH ANN BOVINO: Yeah.

OLIVIER BLANCHARD: --think about what we do. If it implies a small increase in debt for debt to GDP, okay. And in that context, I fully agree I think with both of you, which is that Social Security is basically the elephant in the future room. And we have to start now--

KENT SMETTERS: And Medicare.

OLIVIER BLANCHARD: But these reforms typically kind of, you know, don't have very short-run implications for the budget. You basically plan a set of changes which will affect future generations. But it has to be done in advance. And this is how the successful ones have happened. So I'd be perfectly happy if there is a recession or even if there's no recession if the debt-to-GDP ratio increases a bit but we do something on Social Security.

BETH ANN BOVINO: I have to add to one more thing. It's hard to say "happy with a recession." But I would say that one of the things that would be I think a positive would be moving away the story on Capitol Hill from the debt ceiling towards something that's a bit more productive or a lot more productive. Say, moving towards pay as you go, something that was in place a long time ago. That would be something that probably would comfort markets here and abroad and would be a positive.

GREG IP: Thanks. By the way, I'll be taking any questions you have in a few minutes. I think you can email them to me. And I can pick them up here. But I just wanted to sort of, like, stay on this issue of the possibility of a crisis. Because, Olivier, even in your articles, though you're sort of, like, downplaying the catastrophic nature of debt, you do say there are circumstances in which the interest rate to below the growth rate situation we have now, it can flip, you know?

And it has in the past. It flipped in the United States in the '60s and '70s. It flipped in Italy just a year or two ago. So, first of all, how seriously should we take that risk? Number two: Are there any sort of warning signs or sort of, like, fundamental changes that we should be especially careful about encountering because those are the kinds of things that would actually foreshadow sudden change in the interest-rate-to-growth relationship and the onset of all these dangerous dynamics?

OLIVIER BLANCHARD: Yes. No, I've worried very much about this. And R minus G to be technical can flip sign, right? The question is why. So I can think of three reasons. The first one is that we accumulate so much debt. And Kent is right that this increases the equilibrium rate. And that goes above. This would be a very slow process. And there would be time to adjust. But we'd have to adjust.

The second is that, to be perfectly frank, we do not-- at least I do not. I don't want to talk for the profession. We've had this steady decrease in the interest rates in the mid '80s,, continuing a bit more in the crisis, but, you know, continuing now. And we have no explanation. Or another way of saying this: We have ten explanations. And I worry a bit.

So I'm comforted with the idea that the trend is so strong that it's likely to continue. But even then, I'm not sure I understand exactly what's behind it, whether it's a demand for safe assets, or a different type of investment, or intangibles, all these things which have been discussed. I think it could turn around. So I do not exclude the possibility that the equilibrium interest rate, if you want to use that word, would go up.

Again, I think it would be a slow process, in which case, you know, if it happened and you invite me again in five years and R is higher, I will basically say, "Well, I have the same approach, but the numbers are different. And therefore you have to reduce debt."

The third one, which I think is the most relevant for most countries, particularly in Japan but I think in the U.S., is, again, kind of a sudden stop Latin American thing in which the investors suddenly wake up and say, "End of the world. We sell." Now, what's interesting in this case is if the investors are scared for no reason except that-- if the other ones are scared and you want to get out before they do, that's something that the Fed can deal with.

OLIVIER BLANCHARD: I mean, in Japan one of the main reasons why they're able to maintain these very low nominal rates is the BOJ (the Bank of Japan) has said, "I will maintain the low rate at that level. If you sell bonds, I'll buy them." So when you have a big player like the BOJ in front of you, then you are not terribly worried about the rate going up because you know they are going to buy.

So if it's a liquidity issue, a certain stop issue, not a fundamental sustainability issue, then I think the Fed would probably be able to avoid it. So first reason: There will be time to adjust. Second reason: There will probably be time to adjust. Third, which is a sudden stop, a sudden increase in rates, I think the Fed could avoid it.

GREG IP: Well, it's interesting you bring up Japan because earlier you made a reference to modern monetary theory. And for those who aren't familiar with the term, it's essentially an idea that's been kicking around for a number of decades which basically says that, "We can borrow and spend as much as we wish to get the economy to full employment because we control our own currency. So we can't go broke."

And there are those who argue that Japan is exactly proof of this concept. So, Kent, let me put the question to you. Given that our central bank can buy as much debt as it wishes and in fact has done so for the last few years, does that in some sense neutralize the bond vigilantes and mean that we really don't have to worry about some of the ill effects that we've been talking about?

KENT SMETTERS: Certainly there is potential for a little bit of that. I mean, but what we've seen in the last several decades is baby boomers obviously saving a lot for retirement. And it's not just the amount of savings that's gone up. Sometimes people call this a capital bulge. But it's also they change their portfolios as they get closer to retirement towards safer debt.

And so that's what a lot of models are missing, is that shift in portfolios retirement. But when it comes to monetary theory-- and unfortunately I'm used as a poster child by one of the main advocates. My previous comments where they take nonadjacent quotes and put them next to each other.

But the fact of the matter is the debt has been a big issue in various states in the United States. California, New Jersey. We're seeing that crowd-out at the public policy level of things that they cannot afford because they're trying to deal with the big debt shortfalls in those states. And so modern monetary theory I think is missing the point.

And that is the statement is that we can keep on printing money until we have inflation. But the problem there is that when inflation comes, it's way too late. I had Alan Greenspan on campus about a month ago. We were talking about this, a little bit the modern modern theory. And he agreed that, you know, the problem with inflation is that it's not like you can just turn off the hose at that point. It's too late at that point.

KENT SMETTERS: And it's not like you just undo the switch. And so I think, you know, focusing still on being fiscally restrained, maintaining a proper deficit, you know, a float ratio. Yes, there are times when monetization can be useful if you believe in some type of traps that you may be in in the economy. Japan, if anything, was too slow monetizing some of its debt years ago. But that's certainly not going to deal with a 190% debt/GDP ratio without creating massive inflation.

GREG IP: Right. So we used to talk about fiscal dominance, the risk that anything the central bank tried to do in terms of controlling inflation would be overwhelmed by the need to finance budget debt. And we can actually do sort of, like, an instrumental variable approach here.

You can look at Argentina versus Japan. Japan's debt to GDP is actually higher than Argentina's, and the Bank of Japan monetizes more of it than the Central Bank of Argentina. The Central Bank of Argentina has a huge inflation problem and debt sustainability problem, and Japan does not. Why is it? Why do some countries become Japan and some become Argentina?

OLIVIER BLANCHARD: So I'm going to use this to actually say what I think about MMT, which I've been waiting to do for a long time. So I think there are two parts to it. The emphasis on fiscal policy as being a useful tool I buy. This doesn't make them unique. I mean, most of us would buy that. The notion that you can finance this by money is wrong, is plain wrong.

We do it in the U.S., but what does the Fed do? It basically buys bonds, and it issues reserves. Now, that's money. But there is interest on reserves. So, in effect, if you consolidate the government between the Treasury and the Fed, it's just a transformation. And basically what they are doing is issuing debt, right? So in that context, they are not issuing money.

If they issued money at zero rate, right, then we would have hyper inflation. But we are basically issuing a new form of debt, which is bank reserves, which is basically costly to the Treasury and the Fed taken together. So my view is you can do fiscal policy. You can finance it by debt. But the notion that for some magical reason you can do it for money is wrong.

There is one exception to this, which is Japan. Which is when you're at zero, debt and money are the same thing. And so you pretend you are issuing money, right? But in effect, it's as if you were issuing debt. Today on which Japan has to basically pay a positive interest rate on bonds, it will have to pay a positive interest rate on the money. Otherwise, people will not hold it or there'll be hyperinflation. So MMT is right for half and wrong for the other.

GREG IP: So how do we know which half we're going to be in?

OLIVIER BLANCHARD: If we go back to zero rates, then indeed in this case we will be able to finance the deficit for money. We'll be Japan.

GREG IP: All right. That's the first time I've heard us being like Japan being described as a good thing. Okay. I have an audience question here I'd like to ask everybody about. And it's a good one. "What do you guys think about the enormous economic cost of climate change? And how should those costs change our budget?"

Indeed, it's kind of relevant because we were just talking about modern monetary theory. One of the things advocates of modern monetary theory want to do with all that money that we print is to finance a Green New Deal. What do you think about that, Kent?

KENT SMETTERS: Yeah. It's not clear what the Green New Deal is, but I'll say two things. One is that there's probably no area where there's more agreement amongst liberal and conservative economists, and that is on carbon. And in particular, the need for something like a carbon tax or some type of tradable permits to deal with carbon.

When you have conservatives like Marty Feldstein and liberals on the other side who are agreeing on this issue, you know, I think everybody needs to kind of take notice on this. At the same time, as we know, it's really challenging for a country by itself to deal with carbon because it's what we call the world's perfect (UNINTEL). It doesn't really matter where it's produced. It's not like sulfur. It really doesn't matter where it's produced.

And then you have this classic prisoner's dilemma game where you want everybody else to deal with carbon and not yourself. And so we're stuck in this dominant strategy equilibrium where no one wants to actually deal with it. Well, we know how to try to deal with these problems. That's using treaties, using things like that.

They have not always been effective, but that is really the only solution that we have, is to try to come up with rational international treaties and to try to coordinate our taxation of carbon or at least our levels of carbon. So I don't think there's any question.

But the difference I would have with the Green New Deal-- there's also I think pretty broad agreement amongst economists, both liberal and conservative, that the government shouldn't be prescriptive of saying, "Here's how industry is going to deal with carbon. You're going to buy scrubbers, and you're going to do this, use these high-efficiency machines."

KENT SMETTERS: Leave it to the market to decide how to do it. The government decides the target of carbon, whether it's usable tradable pollution rights or trying to figure out the right carbon tax. But then leave it to the market to figure out how to hit those targets. And where I think the Green New Deal deviates and really goes back to in some sense a really old, 1950s, '60s, you know, pollution-type control is the command and control of heavy prescription on exactly how to achieve those goals.

BETH ANN BOVINO: I was going to add that, you know, kind of in line with what Kent was saying, that you need to have many players (particularly the two big players, U.S. and China, who are, you know, the most pollutant I guess you could say of the world) involved. When we saw the U.S. move away from the Paris Accord, when we saw a number of policy actions that had been softened or unwound that were tied to environmental concerns, it's certainly an issue and a concern.

However, I would say that one positive we're seeing is that, as Kent had mentioned, markets seem to be involved. You're seeing businesses say they want to have the green stamp of approval. You also have certain businesses having to change, say, their emissions standards in order to get business from EU or even California for that matter. So there are ways that, you know, you're starting to see the movement into a much more cleaner world. Still maybe not as fast as we should go, but you are starting to see some movement, particularly on the market side.

GREG IP: If I could--

OLIVIER BLANCHARD: Can I just--

GREG IP: Oh sure. Yeah.

OLIVIER BLANCHARD: --piggyback, right? So I think there is the issue of how we get coordination. Let's leave this aside. And I don't want to go into the specifics of the Green-- how is it called? Green?

GREG IP: Green New Deal.

OLIVIER BLANCHARD: Yeah. The question is: If we are going to do something (I thought that was your question), could we finance it by debt? It seems to me that, indeed, if we are going to do a whole lot for future generations, then it's not inconceivable that we can actually leave them a bit less capital and use debt.

If there is a intergenerational aspect to this, if we say it's about climate change and we spend a lot of money doing things now, it may make sense to have a bit more debt. There is a cartoon which you may have seen in which we went to 2050 and the world has come to an end. You know, it's 100° everywhere. And somebody says, "But, you know, we did leave you debt." I think that captures the fact that if we do something for future generations, that maybe part of it should be borne by them.

KENT SMETTERS: And just to add, I think this is where I also agree with Olivier on this. It's the explicit debt/GDP ratio is a limit for flows with stocks. But also, there's a lot of implicit debt that's not captured by this through pay-as-you-go programs. But there's also this debt called a carbon debt that we're leaving to future generations which we're not figuring out what the monetary value is. We should be trying to add up all that implicit, explicit, carbon debt, and everything else and figuring out what's the right tradeoff between that.

GREG IP: Well, I think another way of thinking about this problem is that let's say that we all agree that we have a little bit more fiscal room than we used to think, okay? So all else equal, we have an extra dollar of debt that we can put on the economy. Does it matter what we use that dollar for? Are there positive--

KENT SMETTERS: Yeah.

GREG IP: --return projects and negative return projects? Let me just go down the panel. What would you tell the policy makers? If you're going to use that extra dollar of fiscal room, what would you use it for?

KENT SMETTERS: Yeah. I mean, absolutely. If we're really trying to afford consumption today, then that is not a great use.

GREG IP: And what would be some ways of consumption today?

KENT SMETTERS: Yeah. Well, anything that we're using. Even a payroll tax cut that just stimulates consumption today. It's not really being saved. Things like that. But what I would be using it if I did have to use a dollar of debt would be for things that have high ROI to the future that are going to pay them back. And that could be some public infrastructure projects, which we have to be careful because we've done a lot of modeling of that.

And you really have to pick the right projects. It's very hard politically to do that. But things like if I could truly get an international agreement on carbon that I believed in, that would be something that I would be willing to invest that dollar in.

GREG IP: Beth Ann?

KENT SMETTERS: On me in terms of where we could see some change to that dollar that we have-- well, first, I wanted to say mentioned very incidentally by Kent when he was talking about Japan in terms of the demographic issues in Japan, that's also in the U.S. Demographics are a big play. It's one of the reasons why we have a lower or longer potential growth forecast because baby boomers are leaving the market, retiring.

And that actually means slower growth, lost productivity, slower growth. It also explains the that future baby boomers are putting money into more safer assets, particularly on treasuries, for example, or safer bond assets, pushing downward pressure on interest rates as well. But there's another factor to demographics that is also at play.

BETH ANN BOVINO: We have the prime age workers, people of prime age who many of them had left the workforce. This was happening way before the financial crisis. This is something that for men of prime age you saw them I'd say leaving the labor participation rate for men of prime age. You started to see that drop. I believe it actually reached close to 10% decline several years ago from where it was.

And this was something that was a long-term trend where it was very high in the late '70s and it slowly, slowly came down. We see many women leaving the workforce as well of prime age. And so these are demographic factors. How do we bring these people back into the workforce? So I'm wondering using that money, one thing I could see helping in terms of to retool the workforce.

Because I do think automation, technological change is at play, making some of these workers' skills obsolete. How do we retune these workers so that they can compete and work in a much more automated environment? That I think would be a possible good use for that money.

GREG IP: Final thoughts, Olivier? If you had an extra dollar--

(OVERTALK)

OLIVIER BLANCHARD: Yeah, I completely agree. I mean, if we need primary deficits to sustain demand, we should use them for the right thing. And public investment, understood, you know, as maybe more education--

BETH ANN BOVINO: And they have to buy--

(OVERTALK)

OLIVIER BLANCHARD: --professional training, and all that is the way to go.

GREG IP: Terrific. Thanks very much. We're out of time. Excellent insights. For the rest of the audience, please remember I think polling questions. You were asked to answer polling questions. And please be back at 10:25 for the next session. All right. Thank you very much.

* * *END OF TRANSCRIPT* * *