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LEVEL OF ECONOMIC ACTIVITY, NOT SIZE OF DEFICIT OR DEBT, SHOULD BE MAIN CONCERN IN DEBT CEILING DEBATE, NEW LEVY STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y. — As the deadline for raising the U.S. federal government debt limit arrives, the debate has once again been dominated by the belief that the size of the debt is simply too large to be financed and that the government risks bankruptcy, while the favored solution remains spending cuts as opposed to tax increases. Exploring historical congressional hearings on the debt ceiling from the 1940s and '50s, a new paper from the Levy Economics Institute of Bard College finds insightful discussions that deal with practical and theoretical issues missing from the current partisan debate. Levy Institute Senior Scholar Jan Kregel argues that among the main lessons made clear by these earlier deliberations is that the government can finance the debt at any rate it desires without losing control over interest rates as a tool of monetary policy, and that the issue is not how to finance the debt but whether the size of the debt to be financed will be compatible with the stable expansion of the economy.

In 1943, a year after the United States entered World War II and more than a year before the Normandy invasion, Congress faced unpredictably large war expenditures exceeding the prevailing debt limit, and engaged in debates over what was expected to be a historic increase in government debt. In his new Policy Note, *Wright Patman's Proposal to Fund Government Debt at Zero Interest Rates: Lessons for the Current Debate on the US Debt Limit*, Kregel explores Representative Wright Patman's proposal during these debates to bypass the private financial system and place all government debt directly with the Federal Reserve Banks at no interest in order to limit the size of the accumulated debt.

"Today, this proposal sounds radical, if not wrongheaded," writes Kregel. "Discussion of the size of the government debt is now dominated by the idea that government spending is constrained by the necessity to convince bond market investors (sometimes called vigilantes) to buy government securities—and this means interest rates high enough to attract demand." But while Patman's proposal would seem to be based on a

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misunderstanding of the operation of financial markets and a sure recipe for government default and/or inflation, Kregel shows how Patman marshaled support for his proposal not only on constitutional grounds, but also by referencing the expertise of Federal Reserve and U.S. Treasury officials on the subject of the operation of the US financial system. The essential lesson from these discussions, Kregel contends, is that the government deficit and outstanding debt should be determined by the level of economic activity, not the size of the outstanding debt or deficit and whether or at what rate it can be financed. “In the context of the current discussion of the increase in the debt limit, it seems clear that the economy is not facing the risk of rising prices—indeed, the Fed is doing its best to prevent deflation,” he writes. “The size of the debt and the deficit should not be the major concern in the debate over raising the debt limit.”

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Policy Note 2014/2: *Wright Patman’s Proposal to Fund Government Debt at Zero Interest Rates: Lessons for the Current Debate on The US Debt Limit*

To read the full text of this policy paper, please visit:
http://www.levyinstitute.org/publications/?docid=1992

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