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LEVY INSTITUTE SCHOLAR QUESTIONS UNSUSTAINABLE DEBT ARGUMENT IN NEW POLICY PAPER

Levy Senior Scholar James K. Galbraith Takes Issue with Interest Rate Assumptions behind Congressional Budget Office's Forecast for Federal Debt-to-GDP Ratio

ANNANDALE-ON-HUDSON, N.Y.— As policymakers in a divided U.S. Congress continue to fight over federal budget spending and, more immediately, an agreement on raising the federal debt ceiling, policymakers appear to agree on one thing: that the federal budget debt is on an "unsustainable path" and federal spending must come down. A new policy paper from the Levy Economics Institute of Bard College disagrees. In his new Policy Note, *Is the Federal Debt Unsustainable?*, Senior Scholar James K. Galbraith argues that the Congressional Budget Office's (CBO) forecasts for the federal debt-to-GDP ratio—upon which much of the "unsustainable path" arguments are based—are faulty. Furthermore, he contends that running big deficits while having a large public debt is something the United States has done almost without interruption since the 1930s.

In particular, Galbraith takes issue with the CBO's assumptions for real interest rates on U.S. public debt. It is these assumptions that are behind the agency's warning that the federal-debt-to-GDP ratio will rise relentlessly, passing 300 percent by midcentury. "In its baseline forecasts, the CBO simply assumes that short-term interest rates will rise to around 4.5 percent nominal—or 2.5 percent real, given their low-inflation forecast—within five years," writes Galbraith. "It's a bizarre assumption. It would also be economically disastrous, since rising rates would clobber the stock, bond, and what remains of the housing markets. The CBO just assumes the disaster wouldn't happen—but it obviously would, and it's plain that their interest rate assumptions are inconsistent with everything else in their forecast."

With inflation low, Galbraith argues that consistently negative average real rates on all

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public debt are possible—just as they were, on average, between 1945 and 1980. Assuming a modestly negative real interest rate on public debt of -1 percent, and a 2 percent rate of inflation, the projections would be much different: "Even if the primary deficit stays at a 'shockingly' high 5 percent of GDP, every year, *forever*, the debt-to-GDP ratio no longer rises without limit! Instead, it stabilizes at below 130 percent of GDP. This is not far above the highest historical value, 122 percent, reached in 1946. That's a high value, and it may be unattractive. But it is *stable."* Galbraith stresses that the CBO's assumption that the United States must offer a real rate of interest on the public debt that is higher than the real growth rate by itself creates an unsustainability that is not otherwise there. It also goes against economic logic and is belied by history. "Changing that one assumption completely alters the long-term dynamic of the public debt," he writes. "By the terms of the CBO's own model, a low interest rate erases the notion that the US debt-to-GDP ratio is on an 'unsustainable path.'"

In Galbraith's view, the prudent policy is to "*keep the projected interest rate down. Otherwise, stay cool.* There is no need for radical reductions in future spending plans, or for cuts in Social Security or Medicare benefits, to achieve this. Do not change the expected primary deficit abruptly. Let the economy recover through time, and do not worry if the debt-to-GDP ratio rises for a while," he writes. "If we follow the present fiscal *and monetary* path for 15 or 20 years—and if that path achieves an acceptable rate of growth and return to high employment, with positive but low inflation—we'll see a debt-to-GDP ratio higher than now but still within our own postwar experience and that of other wealthy, stable, prosperous countries. At that time, it may well be that the primary deficit will *already* be below the value required for a stable debt-to-GDP ratio, since the threshold will be higher, and tax revenues rise as incomes recover. And in that case, the ratio of debt to GDP, having risen, will start a gradual decline, as it did consistently from 1946 to 1980. It did this, back then, for exactly the same reasons: a high initial ratio and a low real interest rate. The present panic over this issue will be proven groundless."

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Policy Note 2011/2: *Is the Federal Debt Unsustainable?*

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