CAPITAL ACCOUNT | By Greg Ip

# Low Rates Take Sting Out of a Big Deficit

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The Trump administration has compared the pandemic to a war, so it seems fitting it is overseeing levels of borrowing last seen in World War II.

With a fourth pandemic relief package, this one worth $484 billion, passing the House on Thursday, this year's budget deficit should hit $3.8 trillion, or 18.6% of gross domestic product, the highest since 1945, according to the Committee for a Responsible Federal Budget, a nonpartisan watchdog group. It predicts the federal debt, the net total of previous deficits, will hit 106% of GDP in 2022, matching the record set in 1946.

That's starting to worry some in Washington. The added debt could "threaten the future of the country," Senate Majority Leader Mitch McConnell said Wednesday.

The usual fear is that high government debt leads to a crisis or excessive inflation. But there's little risk of the first, and nothing inevitable about the second. It depends on choices to be made by the Federal Reserve and, indirectly, Mr. McConnell, since he has some say in who sits on the Fed.

In a debt crisis, investors worry the debt reaches levels the country may be unable to repay. They refuse to buy its bonds, sending interest rates sky high, which simply adds to the burden of the debt.

But right now, the opposite is happening. The Fed's target federal-funds rate is effectively zero, and 10-year Treasury yields are below 1% for the first time. Don't expect this to quickly reverse when the pandemic is over. Private investment relative to saving was weak prior to the pandemic, and that imbalance could worsen. Five years from now, markets expect the fed-funds rate will be just 1%, half of what it expected in early 2019, according to Cornerstone Macro, an investment firm.

This doesn't mean all that added debt is necessary or being put to its best possible use. It does mean it's not doing much harm. "Interest rates have been trending down for 30 years," said Doug Elmendorf, a former director of the Congressional Budget Office who is now dean of the Harvard Kennedy School. "That doesn't just make it manageable to have more debt. It's a signal that the economic costs of that debt, in terms of crowding out private borrowers, is particularly low."

In early March, the CBO predicted the debt would be 89% of GDP in 2025 and interest on that debt would cost about 2% of GDP. The Committee for a Responsible Federal Budget now projects the debt will be 107%, yet interest will still be just about 2%. Never rule out a debt crisis, but it looks no likelier now than before the pandemic.

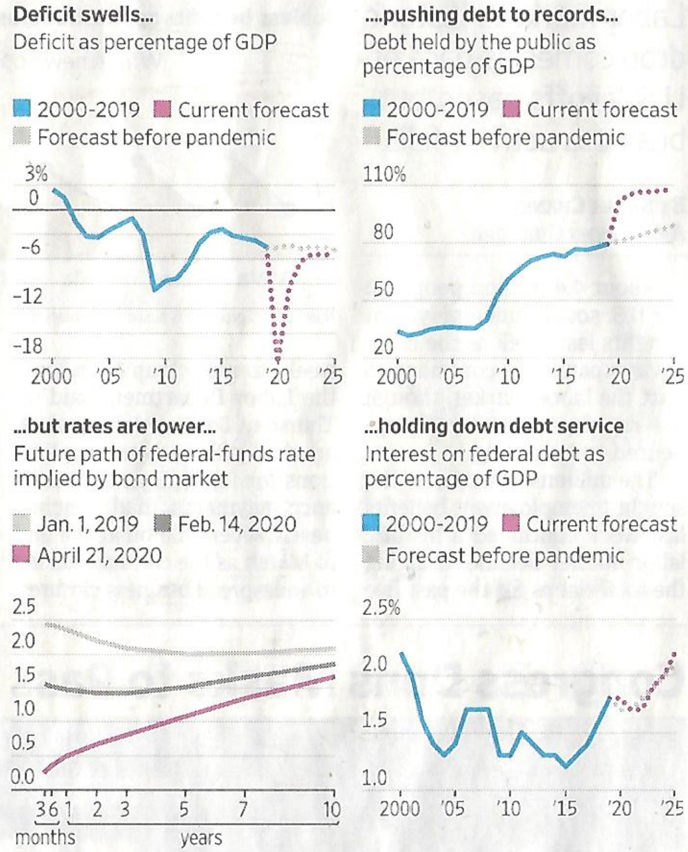
The threat of debt crises has often been invoked to justify cutting spending or raising taxes, even when the economy is weak. But it's based on flimsy evidence: There's little precedent of an advanced economy that controls its own currency being unable to borrow (eurozone members like Greece don't control their currency).

So long as the Fed can print dollars, it can lend as many of them as it needs, ensuring the federal government can always borrow. So far this year, the Fed has bought about $1.6 trillion in Treasury debt to tamp down stress in the markets, in the process effectively financing 40% of this year's deficit. (It doesn't pay for this with paper money; it pays by issuing reserves—electronic money—to commercial banks.)

This delights some on the left who think the Fed should finance all deficits this way, obviating the need for higher taxes. It horrifies some on the right who think it eliminates any restraint on government spending and will lead to inflation.

Both attach too much significance to Fed bond buying. It doesn't save the Treasury much money. And printing money by itself doesn't cause inflation. That requires

The boost to the debt from new spending due to the pandemic is offset by lower interest rates.




Sources: Congressional Budget Office (historical and pre-pandemic projections), Committee for a Responsible Federal Budget (current projection), Cornerstone Macro (expected federal-funds rate)

spending and investment to reach the point that the economy overheats, sending prices and wages up. Or the public has to expect higher inflation, which can be self-fulfilling.

Right now, there's not much evidence of it. Inflation-protected securities currently suggest inflation will be just 1.5% in five to 10 years. But it can't be ruled out. Businesses need to alter domestic operations to reduce Covid-19 risk and reconfigure supply chains over concerns the U.S. depends too much on foreigners for vital supplies. That reduces efficiency and adds costs.

Right now, the Fed would love a little more inflation, which has persistently fallen short of its 2% target. But what if it's headed well past 2%? The Fed knows what to do: raise rates and cool the economy.

But with debt so high, that would dramatically boost the cost of servicing the debt. The White House could pressure the Fed to keep rates low. There's precedent. Beginning in 1942 the Fed put a ceiling on Treasury yields to help finance the war. It took nine years to exit the arrangement. Then, from 1966 to 1973, it was slow to raise rates in part because of opposition from Presidents Johnson and Nixon, and inflation took off.

Could it happen again?

"As long as people like [current Fed Chairman] Jay Powell are in charge, I don't worry too much," said Olivier Blanchard, former chief economist at the International Monetary Fund. "But suppose [President] Trump is re-elected and he puts someone in charge at the Fed who is more inclined to yield to pressure. You could see how the Fed does not increase interest rates enough, we get overheating, inflation, de-anchoring of inflation expectations. The probability of all these things happening is very small. But it's not quite zero."