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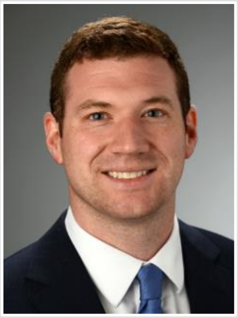

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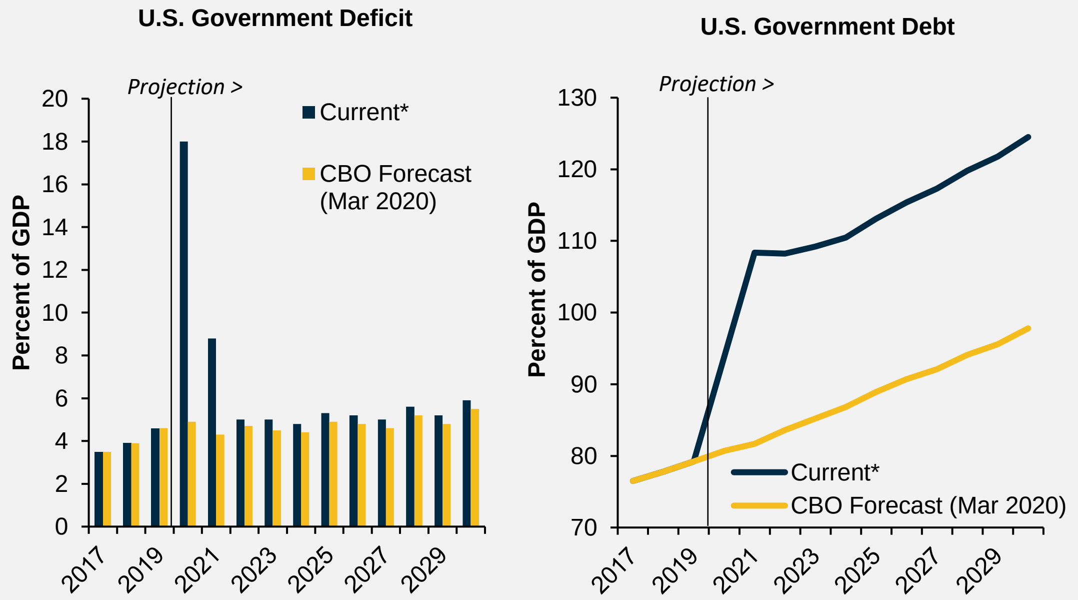
Mounting U.S. Public Debt: How Worried Should We Be?

Desperate times call for desperate measures. Faced with an economic collapse, U.S. policymakers have responded with historically unprecedented vigor. The Federal Reserve has taken steps that were previously unthinkable, including providing support to the high-yield debt and municipal bond markets.

In parallel, Congress has now approved more than $2.5 trillion in fiscal stimulus, equivalent to 12% of GDP, to provide unemployment benefits, funding for small businesses, healthcare equipment to fight the virus, and an airline bailout. This massive fiscal effort comes at a time when the outlook for the U.S. budget was already fraught. As 2020 began, the deficit was running at 4-5% of GDP, and the federal debt was poised for a sustained ascent in line with the country's aging demographics.

With this added stimulus, coupled with so-called "automatic stabilizers," the deficit this year seems poised to reach 18% of GDP, with some analysts whispering even higher numbers. In tandem, the Federal debt will jump to over 100% of GDP and soon surpass its previous post-war peak (Figure 1). To finance this spending, the U.S. Treasury will need to issue a staggering $3-4 trillion of new securities during 2020.

Figure 1: The Projections for Soaring U.S Government Deficits and Debt



Source: PGIM Fixed Income, Haver Analytics, and the U.S. Congressional Budget Office. *Blend of CBO and PGIM Fixed Income projections.

While recognizing the near-term necessity of this spending, we seek to examine the implications of this veritable sea of red ink from a more medium-term perspective. We consider a series of questions that are of central importance for fixed income investors:

- How much Treasury issuance can the market actually absorb?
- Do traditional measures of debt sustainability apply to the United States? How might this application compare to other developed countries and the emerging markets? Will higher debt levels stoke Treasury risk premiums or inflationary pressures?
- Even if the debt can be absorbed, will it inhibit economic growth in the years ahead? For example, will rising interest costs crowd out government spending in other needed areas, or will these deficits prompt increased saving as households worry about future tax hikes and other fiscal-related uncertainties?

Given the complexity of these questions, we first look at the rudiments of the conventional case for fiscal discipline. As a general matter, these arguments are compelling. Most countries have been—and will continue to be—well served by seeking to limit their debt and deficits. The question that we turn to in the second section is how relevant these concerns might be for the United States today. Is it possible that the U.S. economy really is different? Considering its unique role as the issuer of the world's premier reserve currency and safe-haven assets, coupled with the disinflationary economic environment and rising demand for safe assets, perhaps the rising indebtedness is less troubling?[1]

Our conclusions are mixed. We believe that higher debt levels can be safely absorbed. The demand for Treasuries is substantial. But the capacity to issue Treasuries cannot be unlimited, and it's not prudent to find out where the limits might be. While the use of fiscal tools in the current situation is altogether appropriate, in the aftermath of the crisis, policymakers should focus on putting U.S. fiscal performance on firmer footing.

The Case for Fiscal Discipline

Macroeconomic theory—and the lessons of economic history—highlight the risks of sustained fiscal imbalances. The need for fiscal restraint is at the core of the IMF's operating philosophy and the assessment metrics used by credit rating agencies.[2] The case for budgetary discipline rests on three pillars.

First, higher levels of debt and deficits have tended to increase a country's vulnerability to crisis. As indebtedness rises, the possibility of a shock that disrupts the capacity to service the debt rises in parallel. At its limits, if countries are unable to repay, they face two options. They either can default or seek to inflate the debt away (assuming that it's denominated in their domestic currency). Both outcomes are painful for bondholders.

For this reason, countries with higher debt levels are often required to pay default premiums to induce investors to hold their debt. And inflation risk premiums may increase as well. Such countries also face a greater likelihood of currency or bank runs, as anxious investors posture to exit at the first sign of trouble. These challenges are non-linear and may manifest themselves with little advanced warning and in unexpected ways.

While these concerns clearly have more salience for developing countries, the European crisis of a few years ago highlights that fiscal issues can come home to roost in more advanced economies as well. The so-called peripheral countries—Italy, Spain, Portugal, Ireland, and Greece—felt market pressures and saw default premiums on their debt rise. To restore confidence, they had to make painful economic reforms on a rapid timetable.[3]

Second, although fiscal expenditure brings a near-term boost to activity, the higher debts and deficits may weigh on growth over the medium term. Rising deficits absorb national saving, which may raise interest rates and crowd out private spending. This drains resources from other parts of the economy that often are better placed to serve as engines of growth and innovation. The banking system is particularly vulnerable to this risk. In many countries, the banks inordinately intermediate between private

[1] We are not inclined to frame our discussion in terms of Modern Monetary Theory, but those issues are broadly similar.

[2] These arguments leave room for the use of fiscal stimulus during a downturn, but highlight the need—once stresses have passed—to address elevated debt ratios.

[3] As part of a monetary union, these countries didn't have access to the printing press and the ability to monetize their debts. Their adjustment would likely have been easier with these additional policy tools, but it may have come at the expense of reduced policy credibility thereafter.

savers and the government, leaving limited capacity to extend credit to the private sector. Another concern is that high debt levels make the budget more vulnerable to rising interest rates, which may amplify fiscal vulnerabilities and increase the burden on tax-paying workers.

Consistent with these observations, economists Carmen Reinhart and Ken Rogoff showed in a benchmark study that in countries where debt exceeded 90% of GDP, subsequent growth tended to be systematically weaker.[4] Of course, if social consensus to address the fiscal imbalance eventually emerges, the necessary policies—some combination of higher taxes and lower spending—will likely also restrain the pace of growth.

Third, as a related matter, high debt levels may constrain so-called “fiscal space” and the perceived flexibility of fiscal tools. This can impede economic performance through several channels. First, it limits the perceived scope to use fiscal policy to support the economy during a recession. In other words, given the risks associated with high indebtedness, countries with heavy debts may be more restrained in using fiscal policy to offset shocks. Second, worries about the accumulating debt might constrain investment in public infrastructure and other types of welfare-improving public goods.

Taken together, these observations provide a persuasive case for fiscal discipline. History broadly teaches that fiscal laxity often leads to disappointing economic outcomes. To paraphrase other work by Reinhart and Rogoff, maybe the situation really is “different” at a given time or for a given country. But, more often than not, such assertions end in tears.

What Does This Mean for the United States?

While the discussion in the previous section necessarily gives us pause, the story for the United States has some unique features, which may mitigate the risks from rising debt levels. Over the past decade, the demand for Treasuries has been substantial, as manifest by the steady decline in yields; inflation and inflation expectations have persistently surprised on the downside; and the United States continues to enjoy a unique status as supplier of the world’s safe-haven assets. These factors don’t guarantee that a significant ramping up of Treasury issuance can be smoothly absorbed, but we believe that investors’ willingness to hold Treasuries is significant. In this section, we examine several of these mitigating factors in more detail.

Our sense is that the sources of demand for U.S. Treasuries are likely to remain robust in the years ahead. The global financial crisis and now the coronavirus shock have reminded investors that the world is a risky place. The United States benefits from being the issuer of the leading reserve currency. And Treasuries serve as the ultimate safe-haven asset. In addition, as the world experiences a demographic transition with more of the population preparing for, and entering, retirement, the demand for safe long-duration assets is likely to expand further. These factors should continue to support the bid for Treasuries in the years ahead.

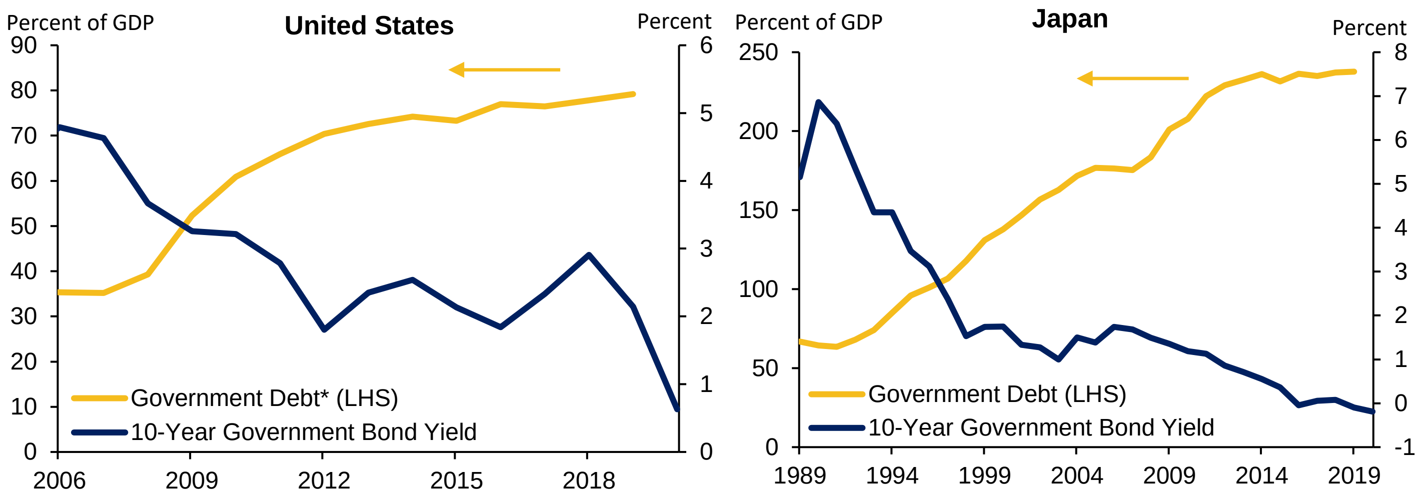
Beyond these structural drivers, we see several other sources of Treasury demand. First, tightening regulatory requirements have given commercial banks incentives to hold assets that are safe and liquid. Second, as a related matter, financial institutions internalized the lessons from the global financial crisis and have managed their balance sheets more conservatively. The coronavirus shock is likely to further amplify these incentives. Third, Treasury yields are historically low for the United States but, even now, remain well above yields for Japan and Europe. Fourth, the Federal Reserve has provided a sizable bid for Treasuries in the secondary market as it has sought to ensure market functioning through crisis episodes and boost inflation.[5]

Rising debt levels may yet upend these broad-based sources of demand for Treasuries, but we’ve observed no signs of that to date. As shown in Figure 2, since the global financial crisis, the United States has seen much higher levels of public debt than before the crisis, but Treasury yields have trended down. Similar to Japan’s experience, higher levels of U.S. debt have been associated with markedly lower Treasury yields.

[4] *“Growth in a Time of Debt,” American Economic Review, May 2010.*

[5] *An important caveat is that the Federal Reserve Act prohibits the Fed from purchasing new securities at issuance in the primary market.*

Figure 2: A Similar Experience in Japan and the U.S.



*Source: PGIM Fixed Income and Haver Analytics. *Federal debt held by the public.*

The persistently subdued performance of inflation should also continue to support the demand for Treasuries. Since the global financial crisis, inflation has consistently run below the Federal Reserve's 2% target, despite the Fed's stimulative policies and enlarged balance sheet. While the deep roots of this soft performance are hard to pin down, it seems to reflect a reduction in the underlying vibrance of the economy—in line with aging demographics, among other factors. Intensified price competition due to increased global integration and technological advances also appear to have played a role.

This shortfall in inflation is a global phenomenon. In Japan, the central bank's balance sheet is larger relative to GDP the than in the United States and the level of public debt is much higher, but the Bank of Japan continues to fall well short of its 2% target. The European Central Bank is struggling with stubbornly low inflation as well. Stated bluntly, central banks haven't been able to create inflation despite their best efforts. In such an environment, the risk of rising inflation expectations on fears of debt monetization seems remote. Even if the Fed agreed to monetize the debt, it's not clear that such action would leave an appreciable imprint on inflation expectations.[6]

As a separate issue, there is little evidence that public debt or fiscal expenditure is crowding out private spending. Rather, causality seems to have run in the opposite direction—public spending has been stepped up explicitly to offset weakness in private spending. This was true during the global financial crisis, and it also characterizes the current episode. In addition, President Trump's 2017 tax cut, another major fiscal initiative, was explicitly designed to *stimulate* private spending, particularly investment.

All of this public support has come in an environment with entrenched low interest rates. As such, the government's borrowing does not seem to have put a pinch on the cost or availability of credit for the private sector.

Another concern is that higher debt levels may reduce the flexibility of fiscal policy, effectively sidelining valuable tools. For better or for worse, such fears have not generally constrained policy in recent years. The Administration pushed through its sizable tax cut earlier in Trump's term, and large-scale fiscal stimulus has been

[6] A case can be made that some kind of sustained monetization of fiscal deficits—essentially helicopter money—may be one of the most powerful tools remaining for the Fed in achieving its inflation objective. In this sense, some increase in inflation expectations would actually be welcome. A corollary to these points is that the Fed can safely step into the market and purchase Treasuries in extreme circumstances with little risk to its broader objectives, which is exactly what it has done in the current episode.

quickly implemented in the current episode. That said, infrastructure spending may be an exception. Worries about indebtedness seem to have limited support among some in Congress for a large-scale public investment package.

Concluding Thoughts

To date, higher U.S. public debt levels and increased Treasury issuance have been smoothly absorbed. But the challenging question is what this means for the sustainability of U.S. fiscal policy in the future. Does this performance necessary suggest that substantially higher levels of indebtedness and issuance are feasible?

On the one hand, we judge that the factors that have supported the demand for Treasuries and flexibility of U.S. fiscal policy are likely durable. In the search for safe long-duration instruments, investors have few other choices. The demand for such assets is likely to be on a rising trajectory in the years ahead with the aging of the U.S. and global populations. Ultimately, this debt is backed by the tax and seigniorage power of the United States, and the U.S. economy remains uniquely positioned in terms of its size and productive capacity.

All of this leads us to conclude that higher debt levels are likely to be feasible. Although some uncomfortable hiccups might occur during issuance, this debt should be digested over time without sustained economic or financial disruptions. And, in the near term, the debt that has been incurred to fight the coronavirus will be successfully absorbed.

On the other hand, these sanguine statements are probabilistic in nature. We believe that more debt can be absorbed—perhaps substantially more debt—but there is likely to be a limit at some point. And it wouldn't be prudent to find that point. We draw an analogy to driving down a steep mountain road. A skilled driver does not attempt to approach the cliff's edge in order to highlight his expertise along any remaining space. Rather, the driver seeks to stay as far away from trouble as possible. Similarly, it simply is not prudent to explore fiscal boundaries.

The upshot is not that we should avoid using fiscal tools in the current, dire situation, but once the crisis is in the rearview mirror, U.S. policymakers should work to stabilize and gradually bring down U.S. debt ratios.

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