HOW WAS THE UNITED STATES GOVERNMENT ABLE TO BORROW SO MUCH DURING THE PANDEMIC?

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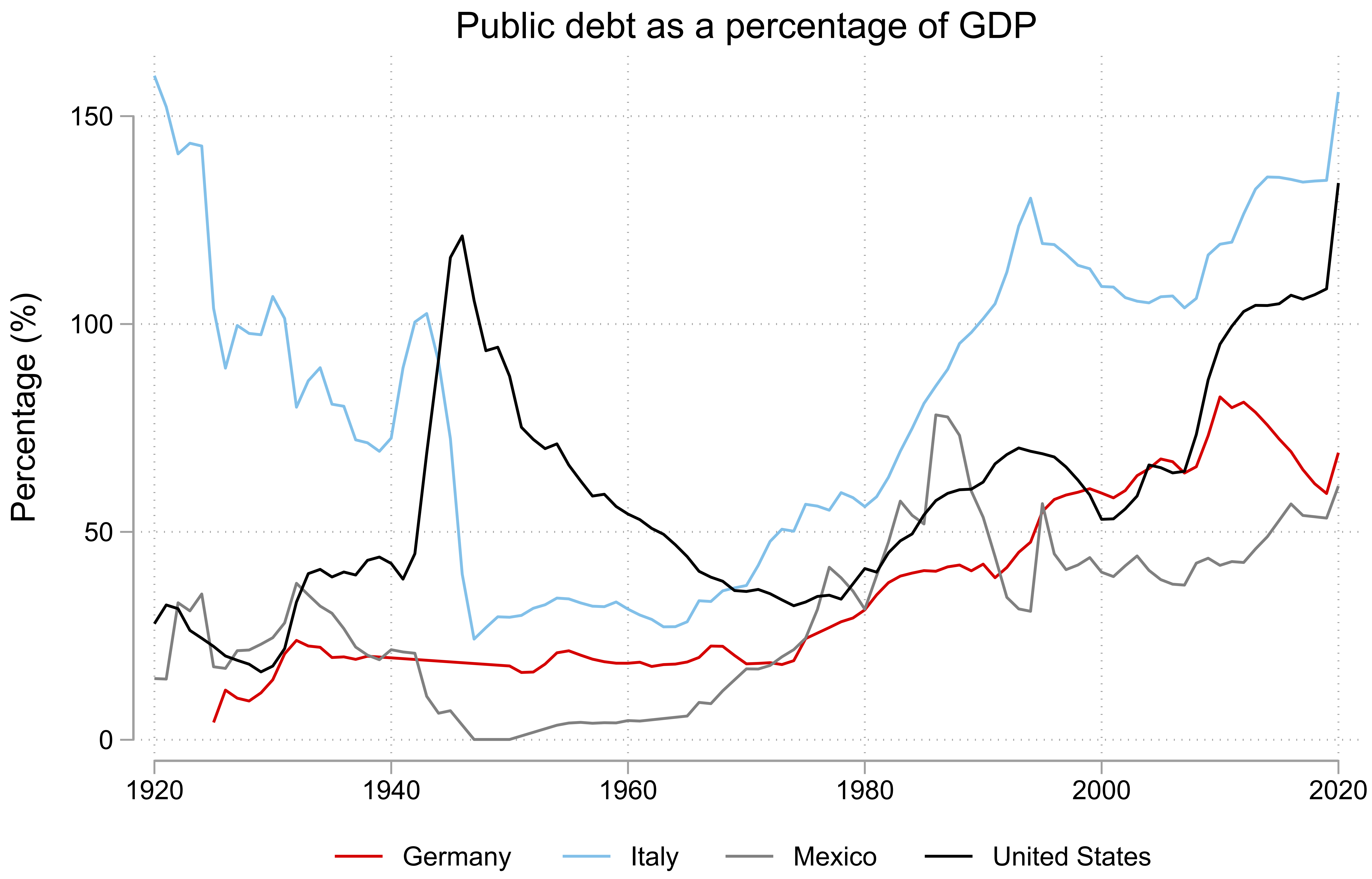
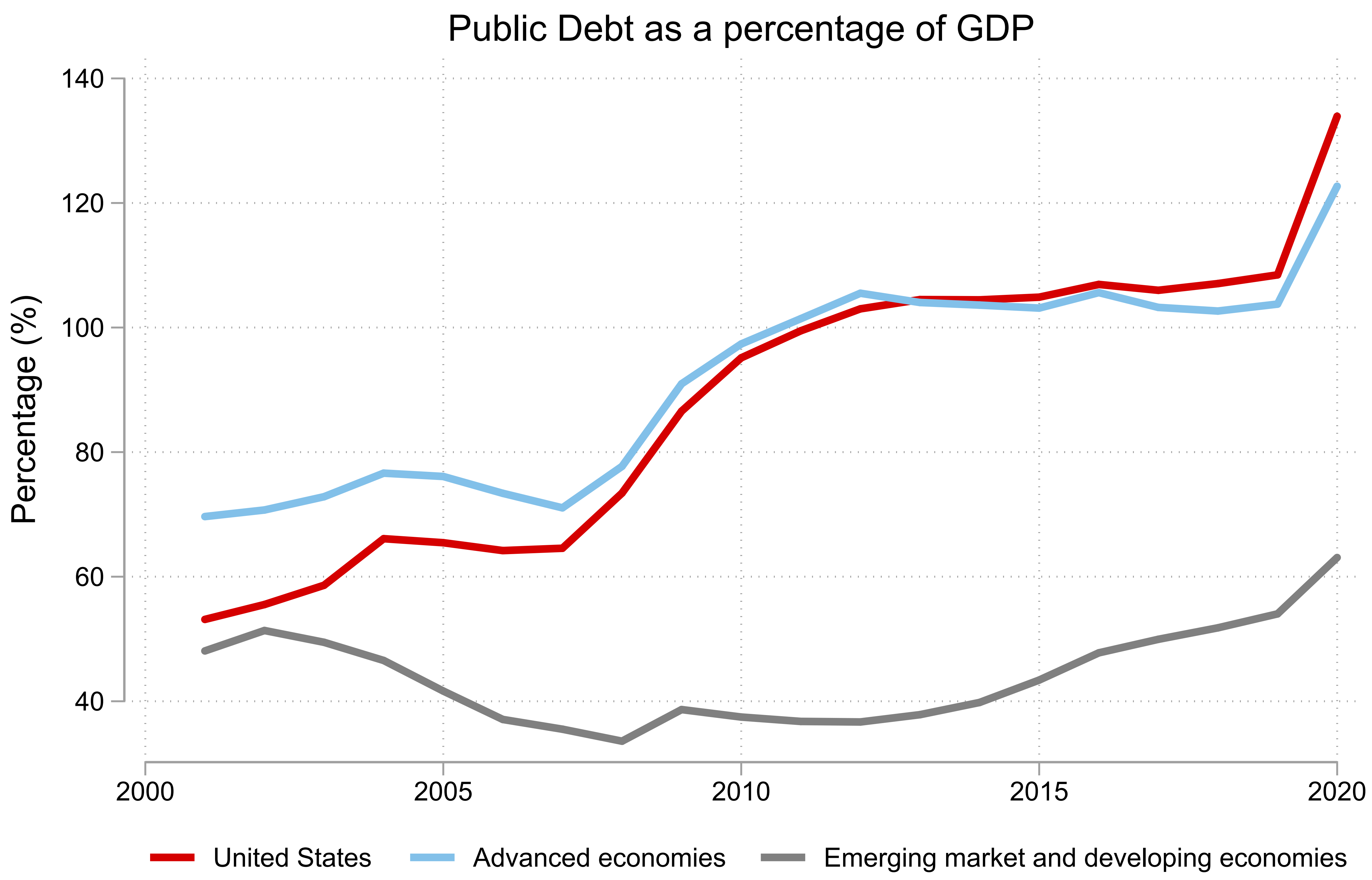
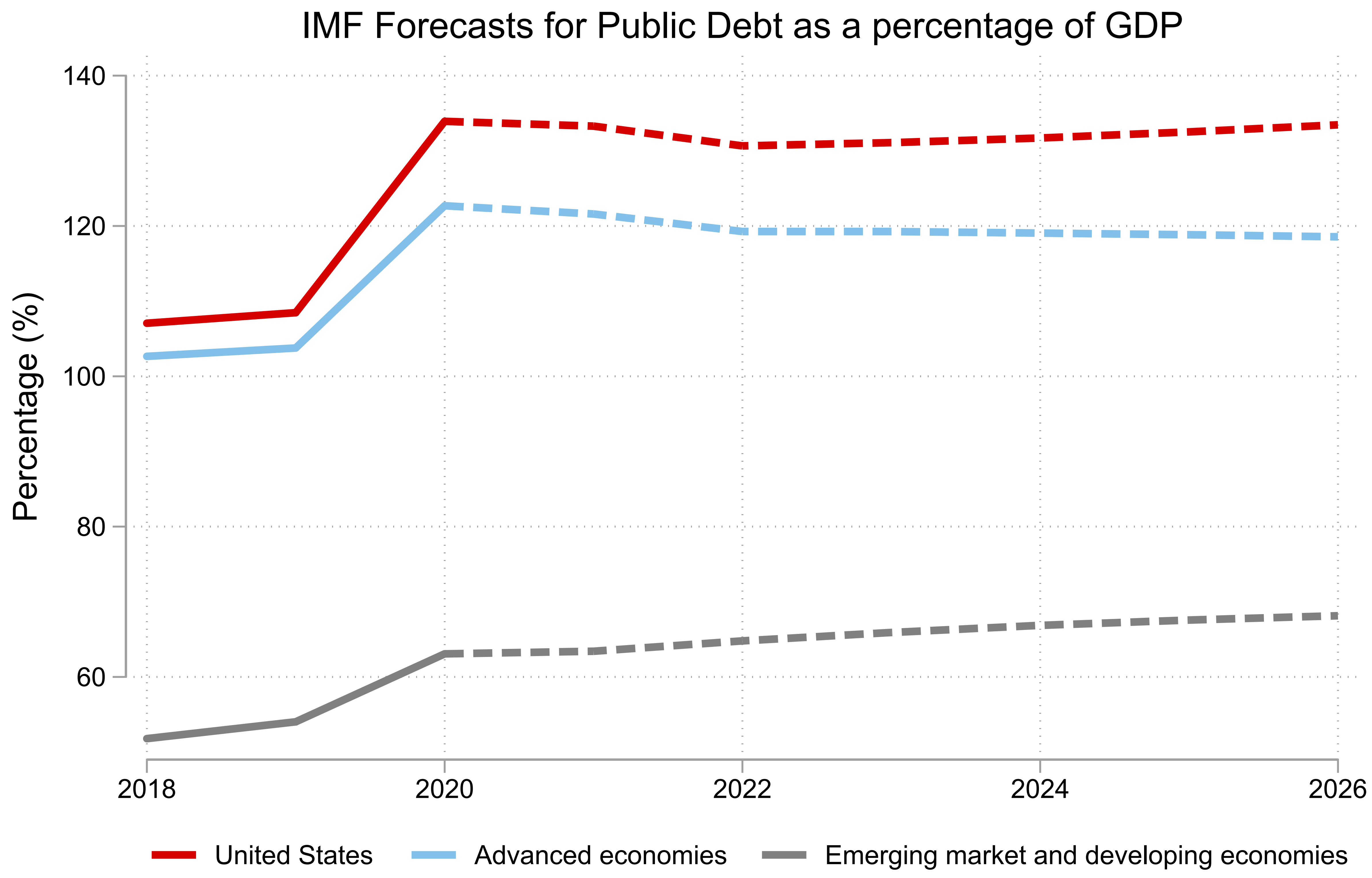
The rise in public debt



- Old seesaw: gold standard and short-lived deficits made debt very safe
- Gone after 1960 because: (i) welfare state, (ii) great inflation, (iii) persistent deficits
- Steady rise of debt

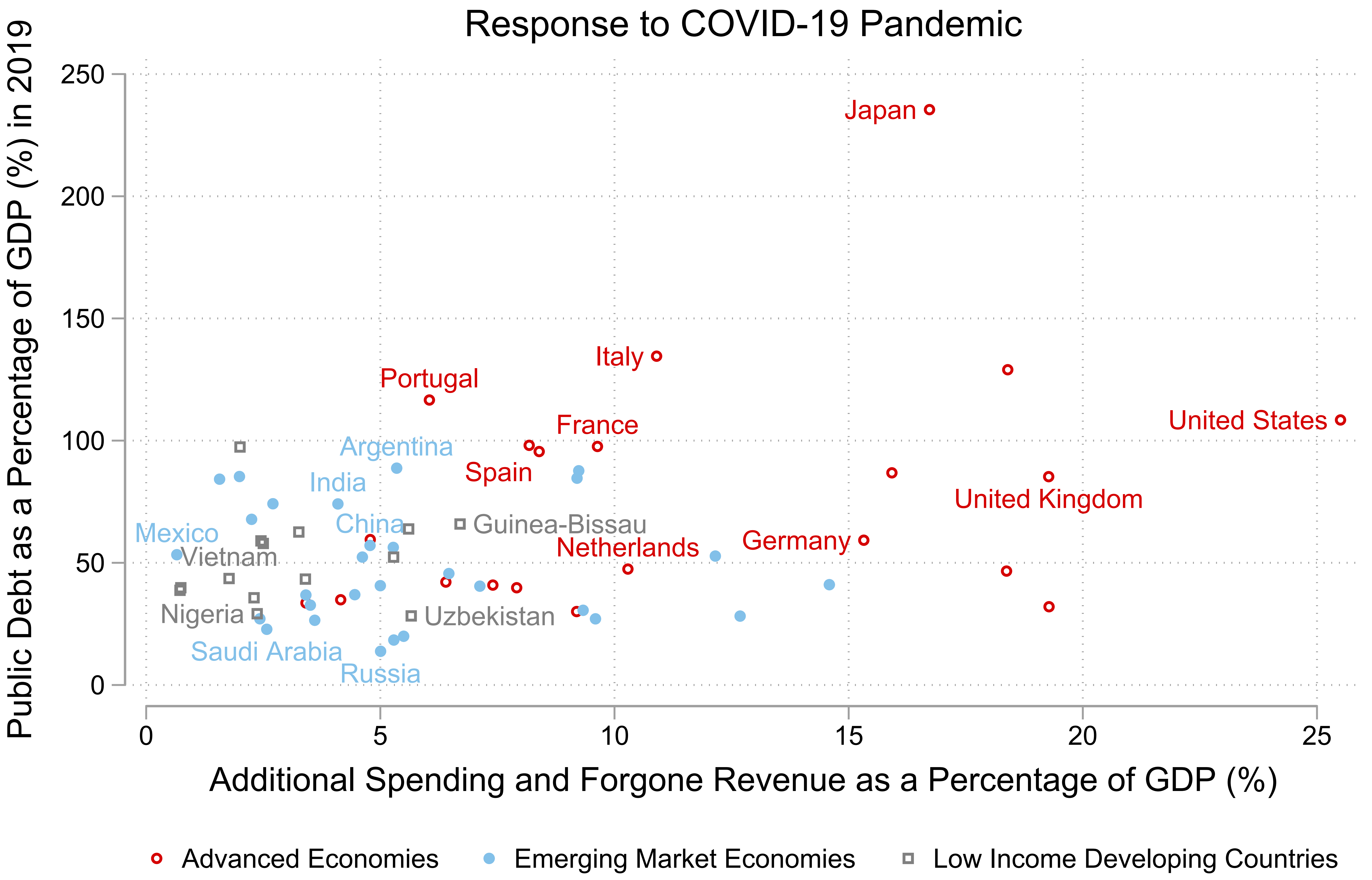
XX1st century debt dynamics





- Steady rise, no fall, stepping up a ladder
- Conditional on no shocks, no fall in the debt

Public borrowing during the pandemic



- In 2020, good reasons for deficits: tax smoothing, stimulus, social insurance.
- Ability to borrow: those with more debt were able to borrow more. No signs of debt capacity.
- Appetite for it: excess savings (and the Fed)

Moving forward, no limit to public borrowing

- Tempting to draw that conclusion. See it in Europe's response to energy crisis

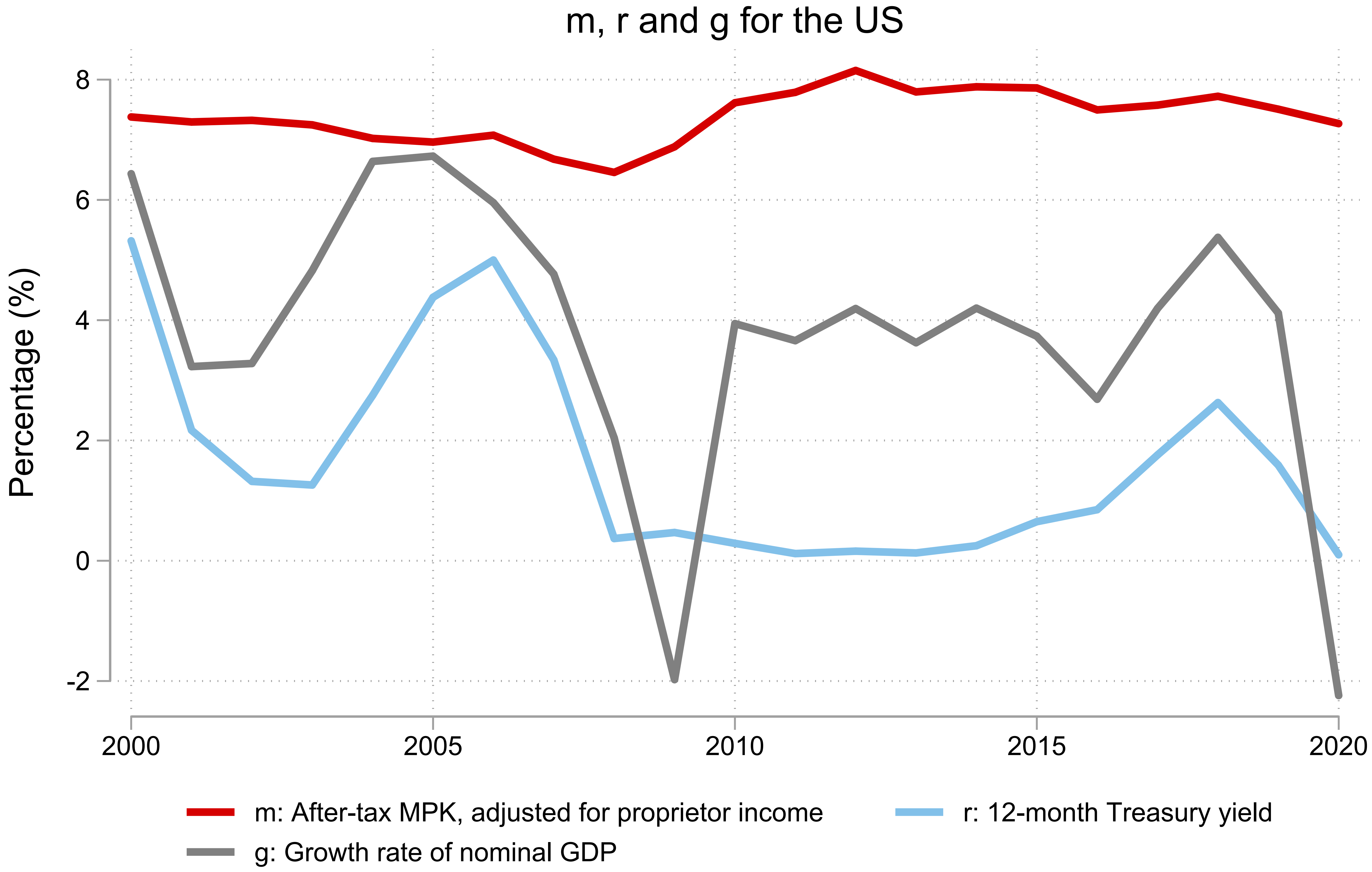
- Laws of accounting:

Increase Public Debt = Primary Deficit + Return Debt + Debt Revenue

- Debt Revenue arises from return on public debt (r) being below return on private investments (m). United States always had it.

- ***Debt revenue:*** *The discount the government gets in borrowing rate relative to other borrowers in the economy. It saves future taxes to repay a debt that grows at a lower rate than market rate. Can be realized if make public loans at market rates. Can be implicit if fund a transfer, households can borrow less, they will have debt revenue left over after paying taxes to pay public debt in the future.*

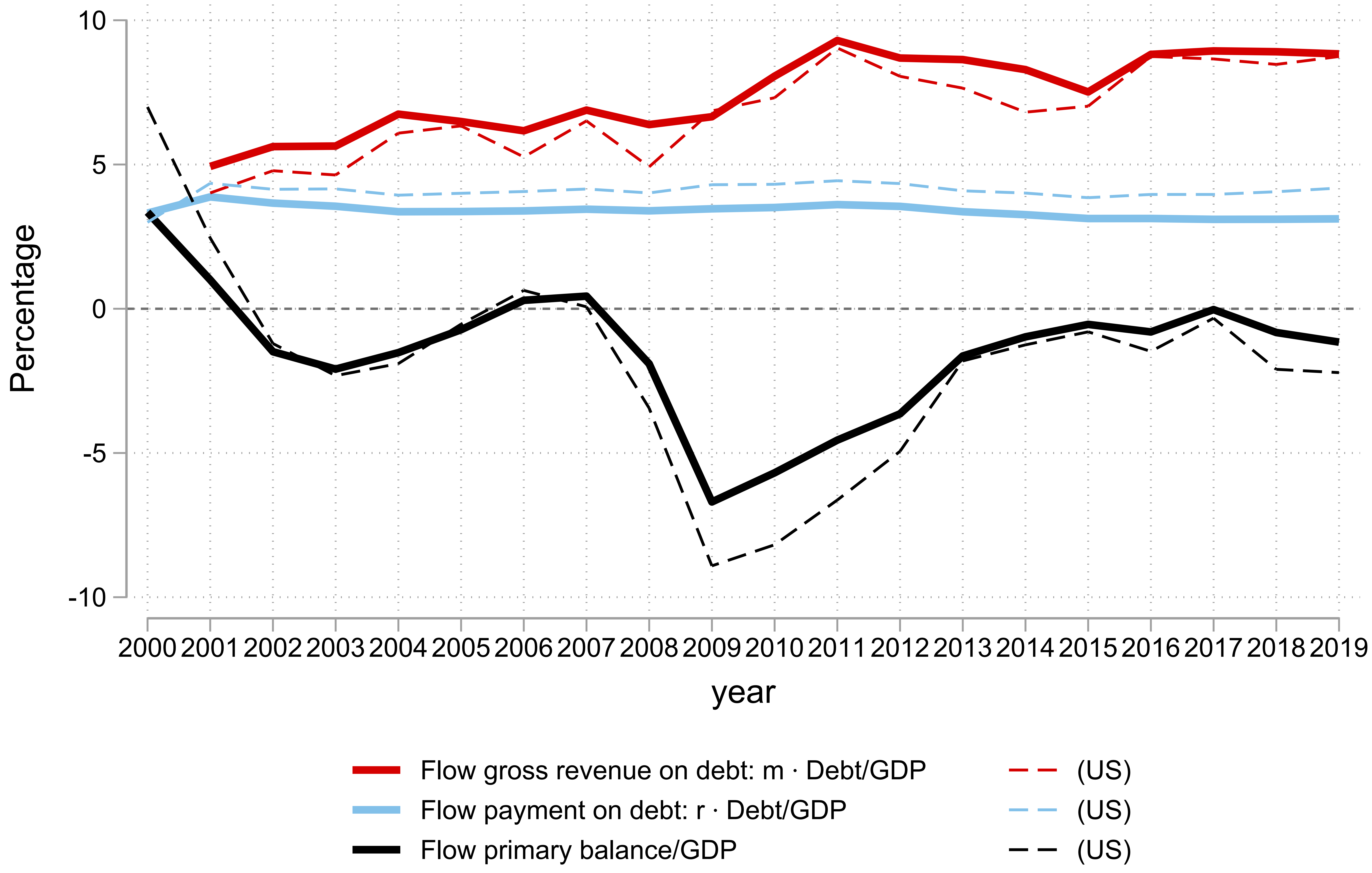
The gap in returns: the specialness of debt



- Government debt relative safety
- Government debt relative liquidity
- Government debt as good collateral
- Government debt as store of value for foreigners

Debt revenue

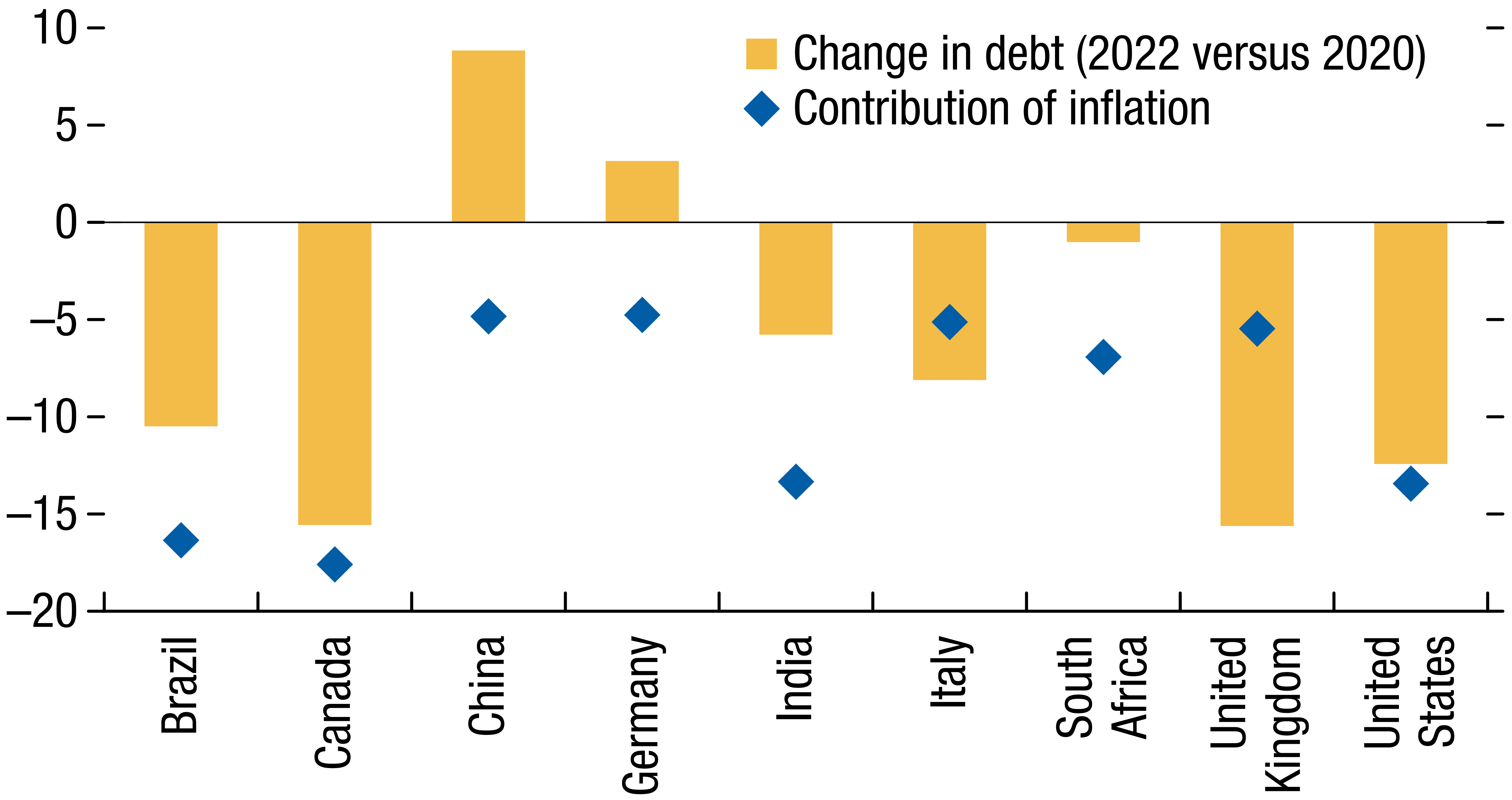
Figure 1: The flow budget components as a ratio of GDP for the G-7 countries and the US



- We paid for rising debt by selling the services that debt provided.
- Across the world demand rose for safety, liquidity, convenience of US Treasuries
- But these have a limit

First limit: inflation

Figure ES.3. Effect of Inflation Shock on the Debt Ratio, Selected Countries, 2022 versus 2020
(Percent of GDP)



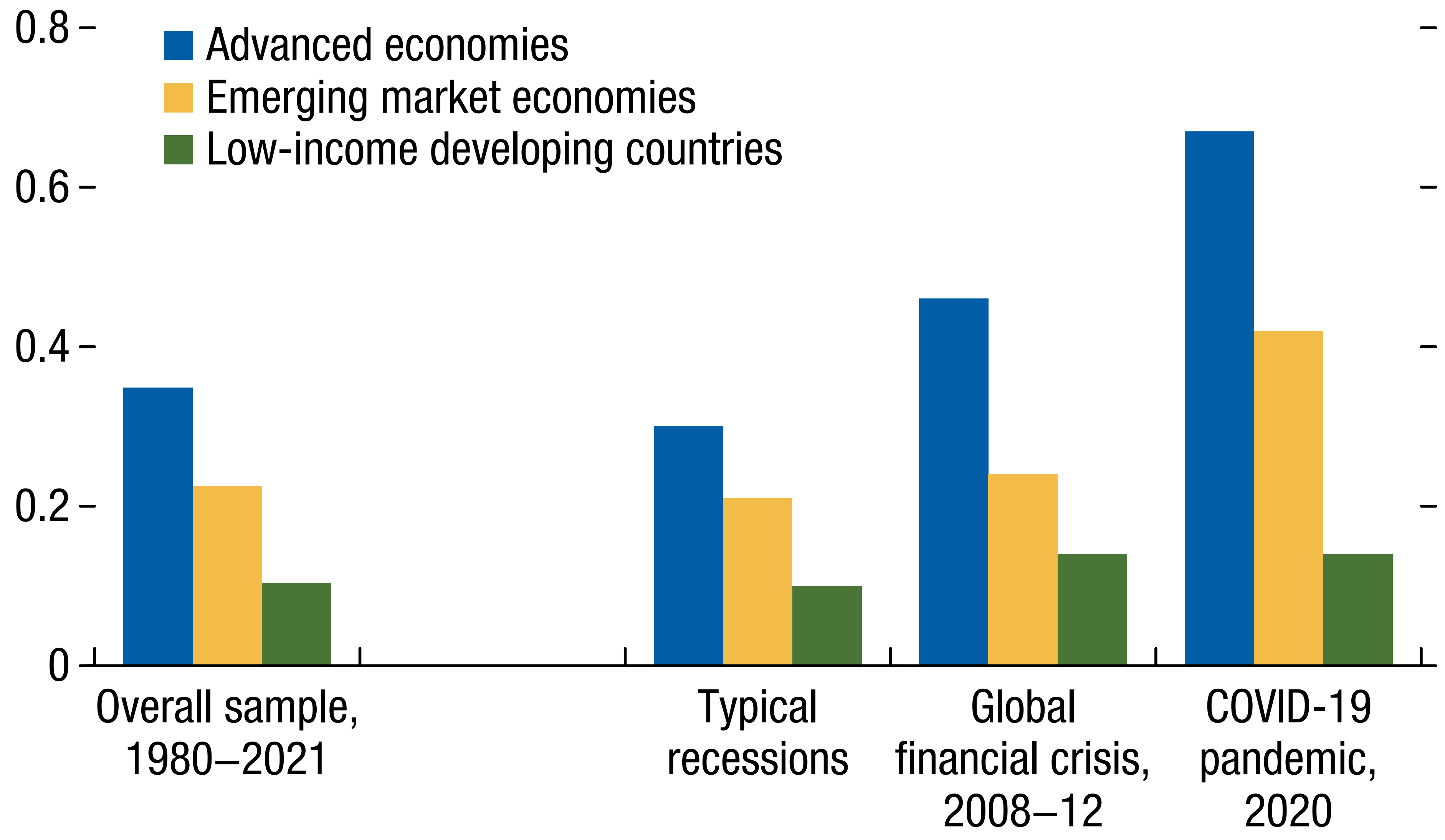
Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Price stability keeps debt sustainable

- Keeps main source of risk on debt returns low
- Long-run prediction: independent inflation-targeting central banks maximize debt revenue.
- Application: Gains of 2022 are done, now come losses from risk premium
- Trade-off: Delay raising rates in short run to keep ***m-r*** high in short run can erode long-in specialness

Second limit: fiscal caution needed

Figure 1.2. Fiscal Responses in Large Crises
(Estimated coefficients)



Source: IMF staff estimates (see Online Annex 1.1).
Note: The figure shows the average of time-varying coefficients by country income groups, based on panel regressions estimated on the sensitivity to GDP growth of the deficit-to-GDP ratio from 1980 to 2021. Typical recessions are defined as periods when individual countries' growth rates are below their own average levels over the previous three years.

- **Can borrow while people think you are safe**
  - US exorbitant privilege as the safe harbor
  - Justified to have more aggressive deficits, but also to pay debts faster once crisis over
- **Public debt crowds out and in private debt**
  - Financial development lowers debt revenue
  - Crowd out: Financial repression as coerced debt, raise debt revenue, present biases
  - Maximizing debt revenue is not maximizing social welfare

Conclusions

- **Increase in public borrowing in 2020 was culmination of a long trend**
  - Debt had been rising for a long time, and appetite for it grew during pandemic

- **Able to do it because debt revenue had rises**
  - ***m-r*** gap from store of value, safety, collateral, liquidity had risen

- **Fiscal capacity should not be taken for granted and will be shrinking**
  - Reinforce commitment to price stability, have the fiscal rectitude of having surpluses in non-crises times