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ECONOMY

# The Debt Question Facing Janet Yellen: How Much Is Too Much?

Treasury secretary nominee supports Biden plans that add trillions to U.S. borrowing, a turnabout in economic thinking

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A big question hangs over Janet Yellen this week at her confirmation hearing to become U.S. Treasury secretary: How much debt is too much?

In the past four years, U.S. government debt held by the public has increased by $7 trillion to $21.6 trillion. President-elect Joe Biden has committed to a spending program that could add trillions more in the year ahead. At 100.1% of gross domestic product, the debt already exceeds the annual output of the economy, putting the U.S. in company with economies including Greece, Italy and Japan.

When Ms. Yellen served in the Clinton administration as Chairwoman of the White House Council of Economic Advisers, she was among those who pushed for a balanced budget. Today, she has joined, cautiously, an emerging consensus concentrated on the left that more short-term borrowing is needed to help the economy, even without concrete plans to pay it back. Central to the view is the expectation that interest rates will remain low for the foreseeable future, making it more affordable to finance the borrowing.

The Biden administration will now contend with progressives who want even more spending, and conservatives who say the government is tempting fate by adding to its swollen balance sheet. Ms. Yellen's challenge, if confirmed, will be to keep Democrats together and persuade some Republicans to come along.

Ms. Yellen, who will be a top economic adviser to Mr. Biden, is scheduled to testify Tuesday before the Senate Finance Committee, which will vote on her nomination. She served as top White House economist in the 1990s and Federal Reserve chairwoman in the 2010s. Confirmation of Ms. Yellen as Treasury secretary would make her the first person to achieve such a trifecta of economic leadership roles.

Ms. Yellen would be managing the nation's debt when the economic consensus has flipped. In the 1990s, economists argued that surpluses would push down long-term interest rates and encourage private-sector borrowing and investment. Government borrowing, this view held, crowded out the private sector. The strategy seemed to work. The U.S. saw an economic boom, with the longest expansion on record at the time, fueled by technology investment.

After years of low inflation and interest rates near zero, more economists say the government should be borrowing to keep the economy going because the private sector isn't. With borrowing costs expected to remain low and the pandemic-stricken economy still weak, temporary increases in deficits aren't only tolerable but desirable if they help strengthen the recovery, the thinking goes.


Janet Yellen speaking at the event last month where President-elect Joe Biden named his economic team.

PHOTO: ALEX WONG/GETTY IMAGES

In past times, the Fed carried the load by cutting short-term interest rates, allowing the private sector to borrow cheaply. But it has already cut rates to zero.

Ms. Yellen will tell lawmakers Tuesday that she and Mr. Biden appreciate the scale of the country's debt burden, according to a copy of her prepared remarks reviewed by The Wall

Street Journal. "But right now, with interest rates at historic lows, the smartest thing we can do is act big," she plans to say.

The strongest advocates of this view are center-left economists, including former Treasury Secretary Lawrence Summers. Republicans have implicitly embraced the idea when in power. President Trump ushered in spending programs and tax cuts that pushed debt sharply higher even before the coronavirus crisis. George W. Bush also raised spending, cut taxes and grew deficits. In the minority, the GOP has tended to revert to fiscal conservatism.

## 'Immediate action'

Mr. Biden is embracing the view, as well. On Thursday, he proposed a $1.9 trillion aid package that includes $1,400 stimulus payments to individuals, expanded jobless benefits and paid work leave, aid for schools and hard-hit small businesses and a national vaccination program. Mr. Biden hopes it will be the first in a two-step program, with the second to focus on longer-term investments, such as in green energy and infrastructure.

"Economic research confirms that with conditions like the crisis today, especially with such low interest rates, taking immediate action—even with deficit financing—is going to help the economy," Mr. Biden said after a Labor Department report this month. It showed that employers cut jobs in December, ending seven months of employment gains. A growing economy will make debt more manageable, he said.



Unaddressed are the twin questions of whether there is a ceiling on the U.S.'s debt load and how the country will pay it back, concerns heard mostly on the right. "At some point we'll start paying a price for this," said Michael Boskin, a Stanford University economist. He served as chairman of the Council of Economic Advisers under President George H.W. Bush in the early 1990s, the last time a Republican administration cut deficits.

Mr. Boskin agrees that low interest rates and a weak economy help make the case for limited federal support. He said he favored tax cuts over government spending and warned that immense deficits can't be carried on without limit. "Eventually rates will rise," he said.

Mr. Summers said economists have been predicting rising rates for decades, and yet they kept falling. Even today, he said, rates are as likely to go down as up; in Europe and Japan they are negative.

Some economists have worried that a shock to the U.S. economy could drive investors away from government bonds. Government debt as a share of the economy has more than tripled over the past 20 years. That makes it twice as high, relatively speaking, as it was during the Great Depression and approaching levels seen at the end of World War II, when the government turned the economy into a military machine. Counting bonds that the government issues to its own Social Security trust funds, which economists often discount, the debt is even larger as a share of GDP now.

## Debt Dynamics

U.S. interest rates have been falling for decades...

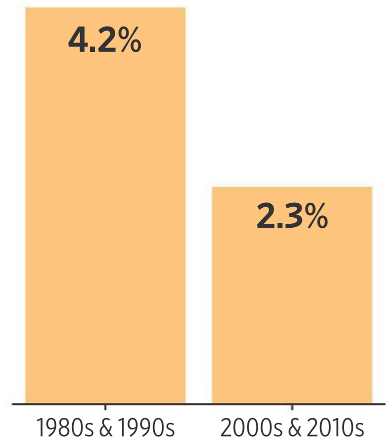
**10-year U.S. Treasury note interest rate**


...as rising global savings pour into U.S. debt...

**Savings as share of GDP**

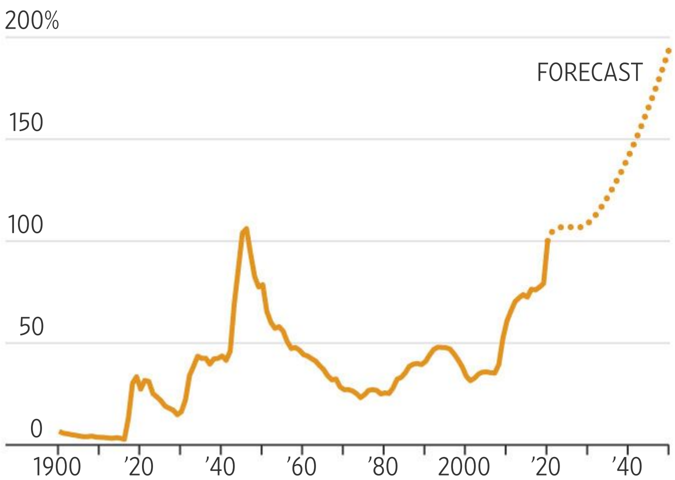

...and domestic investment slows...

**Average annual change in private U.S. investment**

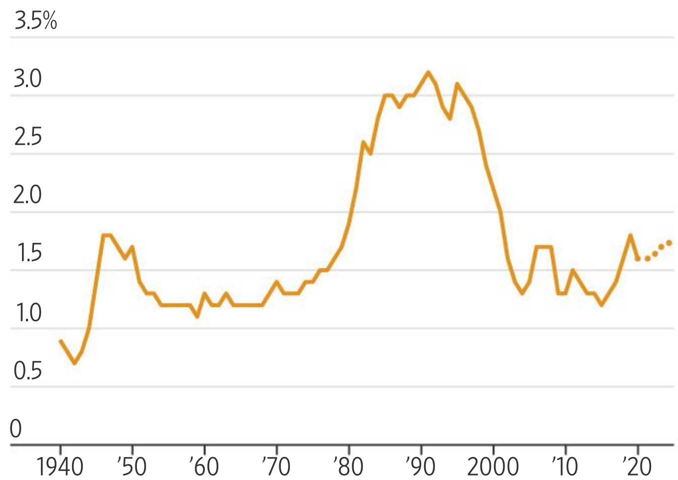



...so while government borrowing has boomed, the cost of servicing the debt remains modest.

**Debt as a share of GDP**




**Federal interest as a share of GDP**




Sources: Sources: Federal Reserve (rate); International Monetary Fund (saving); Commerce Department (investment); Congressional Budget Office (debt and interest as a percentage of GDP)

Yet, through economic shocks in the past 20 years, investors have flocked to Treasury securities, seen as a haven in times of trouble. With the help of Fed interest-rate cuts and bond purchases, not only are U.S. short-term interest rates near zero, the government's borrowing cost for newly issued 30-year debt is below 2%. While U.S. debt is growing faster than the economy, the level of debt "is far from unsustainable," Fed Chairman Jerome Powell, a Republican who served in the George H.W. Bush Treasury Department, said Thursday.

Despite a $4 trillion increase in debt last year, a 25% increase, interest payments on that debt declined by 8%. The Congressional Budget Office projects rates will stay low for much of the next decade, and that interest costs as a share of GDP will be lower than it forecast before the pandemic.

In an Aug. 13 briefing with Mr. Biden and Vice President-elect Kamala Harris, Ms. Yellen made the case that ultralow interest rates and low inflation gave the government the capacity to keep borrowing to fight the pandemic's economic fallout.

The President-elect's spending plans represent a shift from the 1990s, when Ms. Yellen was Mr. Clinton's top economic adviser, and Mr. Biden was a senator supportive of the president's fiscal policies.

Back then, inflation was still seen as a threat. Yields on 10-year Treasury notes exceeded 6% for most of the 1990s, as did borrowing costs for even the most creditworthy companies. Large government debt and deficits, the thinking went, would push rates higher and crowd out private investment.

President Clinton speaking in May 1997 about his balanced budget plan. From top left, Deputy Treasury Secretary Lawrence Summers; Vice President Al Gore; Janet Yellen, chairwoman of the Council of Economic Advisers; Mr. Clinton; and Frank Raines, director of the Office of Management and Budget.

PHOTO: JOYCE NALTCHAYAN/AGENCE FRANCE-PRESSE/GETTY IMAGES

The Clinton administration restrained spending and raised income taxes on wealthy households, balancing the budget in 1998 for the first time since the 1960s. Fiscal discipline helped produce "a strong, investment-driven recovery," Ms. Yellen wrote in 1999.

## New lesson

Starting under President George W. Bush, something unexpected happened. Deficits and government debt rose because of increased spending and tax cuts, but interest rates kept falling.

“I spent most of my career worrying about the effects of government debt, and as I’ve been doing that, interest rates have been falling point by point by point,” said Douglas Elmendorf, who worked with Ms. Yellen at the Council of Economic Advisers in the late 1990s.

There are different theories about why that happened. One is that China’s emergence as an economic power, and the growing wealth of its citizens, created a surge in global saving. Former Fed chairman Ben Bernanke called it a global “saving glut.” Global savers put aside 26% of their money in 2020, up from 24% in 2000, according to the International Monetary Fund. Much of the trillions of dollars in new saving flowed into the U.S. Treasury market.

At the same time, U.S. private-sector investment slowed for reasons economists are still sorting out. Explanations include an aging population and diminishing investment in big machinery as the economy became more service oriented and factories moved to China. In the 1980s and 1990s, private-sector U.S. investment grew 4% a year on average, adjusted for inflation. Since 2000, as interest rates tumbled, private investment growth averaged 2% a year.

By the time Ms. Yellen became Fed vice chairwoman in 2010, battles over large budget deficits consumed Washington once again. Tea Party Republicans, alarmed by surging debt levels, pushed for strict spending curbs as the U.S. recovered from the 2007-2009 financial crisis. “The challenge for U.S. policy makers will be to craft a strategy that puts our fiscal policy on a sustainable path in the longer term while helping support the recovery in economic activity in the near term,” Ms. Yellen said at her 2010 confirmation hearing for Fed vice chairwoman.

Washington went in the opposite direction. Discussions about the long run went nowhere. Short-term spending cuts helped tame deficits for several years but weighed on growth by pulling money from the military and public projects.


Janet Yellen testifying on Capitol Hill in July 2015, when she was the Federal Reserve chairwoman.

PHOTO: MANUEL BALCE CENETA/ASSOCIATED PRESS

Ms. Yellen and others concluded austerity came too soon, stunting the recovery and keeping unemployment higher than it needed to be. Aside from a fracking boom that kicked off in energy states, private investment sagged.

## Free lunch

The pandemic has pushed Washington's tolerance for debt to new levels. Congress last year authorized trillions of dollars in new spending to combat the virus, pushing deficits well beyond records set in the last recession.

Some economists point out that in the long run, interest rates tend to be lower than the economy's growth rate. The IMF studied data for 55 countries over 200 years and found that more than half of the time, interest rates were lower than growth rates, on average, by 2.4 percentage points in advanced economies and even more in developing economies. That suggests most countries can run modest budget deficits and still reduce the cost of servicing that debt as their economies grow.

Among the skeptics is Valerie Ramey, an economist at the University of California San Diego. She said some economists see the gap between interest and growth rates as a "free lunch," enabling more borrowing, but that it was more like a "free snack." The gap tends to be relatively small over time, and now it is trivial compared with the growth of U.S. debt.

"What we are having here is just gluttony in terms of what the government is doing," she said.

The IMF study's authors have another warning about running large deficits. Fiscal-policy crises that push interest rates sharply higher tend to come out of nowhere, even when rates are low. "Market expectations can turn quickly and abruptly," the authors, Paolo Mauro and Jing Zhou, concluded.

While economists on the left and right acknowledge the government has more capacity to borrow than once thought, there is still no consensus on the limits of borrowing over the medium- to long-term, which is a key question facing Ms. Yellen and the Biden administration.

Mr. Summers and Jason Furman, who served as chairman of President Obama's Council of Economic Advisers, said policy makers should focus on the cost of borrowing rather than debt levels. The U.S. can afford to borrow more as long as net interest payments on the debt are expected to stay below 2% of output over the next decade, they argue. In the most-recent fiscal year, interest payments totaled 1.6% of output. By comparison, in the early 1990s the payments hovered around 3%.

Long-run challenges remain. Even before a new spending plan is launched, U.S. debt is on track to double to nearly 200% of GDP by 2050 because of soaring Social Security and Medicare promises, according to the CBO. Ms. Yellen has said such high levels can't be sustained. Mr. Biden has proposed tax increases on high-income households to pay for some of his economic policy proposals, which include investments in clean energy and health care. But there is little appetite in Washington for cuts to Medicare or Social Security.

**Corrections & Amplifications**
Janet Yellen's last name was misspelled as Yellin in a photo caption with an earlier version of this article. (Corrected on Jan. 18, 2021)

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