7 Things You Need to Know About the National Debt, Deficits, and the Dollar

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Introduction

There are seven key points about the national debt, budget and trade deficits, and the dollar, that the public needs to understand in order to be well-informed and prepared to choose among various policy options:

1) **The national debt is not literally a generational transfer.** This is easy to see because everyone who holds the debt (government bonds) today will eventually be dead, leaving the possession of the bonds to their children and grandchildren. In other words, the interest on the debt will be paid from some members of future generations to other members of future generations. (We will deal with issues created by foreign ownership below.) The debt can involve a generational transfer only insofar as it slows the economy’s growth, so that it produces less in the future.

2) **The high dollar (not the budget deficit) is what causes the trade deficit and therefore leads the United States to borrow from foreigners.** No one buys foreign made goods at Wal-Mart because the government is running a budget deficit. They buy foreign made goods because a high dollar has made foreign goods cheaper than comparable U.S.-made goods. The high dollar also makes U.S. exports more expensive for people living in other countries.

3) **A large trade deficit requires that we either have a very large budget deficit or extremely low private savings or some combination.** This is an accounting identity. If we are borrowers internationally then we must have very low domestic savings. And we are borrowers internationally because we have an over-valued dollar. In other words, the high dollar requires us to either have large budget deficits or to have low private savings.

4) **The stock and housing bubbles led to an enormous reduction in private saving through the wealth effect.** Research shows that $100 in additional stock wealth will lead to $3 to $4 of additional consumption, meaning that saving drops by this amount. The housing wealth effect is estimated to be $5 to $7 of additional consumption for every $100 of housing wealth.

This means that a $10 trillion stock bubble would be expected to reduce annual saving by $300 billion to $400 billion. An $8 trillion housing bubble would be expected to reduce annual saving by between $400 billion and $560 billion. These bubbles have been the main cause of the low savings rate in the United States over the last 15 years.

5) **During times of economic weakness (like now), deficit spending actually helps the economy to grow.** In such times deficit spending is also likely to increase investment. In this case, deficit spending makes our children and grandchildren richer than if we did not have deficit spending.

6) **High and rising private sector health care costs in the United States are responsible for the bulk of the federal budget deficit problem.** (Government health care programs like Medicare and Medicaid pay for health care provided by the private sector.) If health care costs are not contained, then the economy will be devastated regardless of what we do with the federal budget. If they are contained, then there is no budget problem.

7) **Social Security has a dedicated stream of financing that keeps it fully funded until 2036 according to the most recent projections.** Given this stream of funding, it would be no more justifiable to cut back benefits in the near future than to default on the federal debt.
1) The Burden of the Debt on the Young – It’s Not What the Deficit Hawks Told You

Government debt can either increase or decrease the wealth of future generations. The debt itself is not a measure of the financial impact across generations. What matters is how the debt affects the strength of the economy when the government borrows the money.

It is easy to see that the national debt is not really a measure of intergenerational burden. While the taxpayers collectively can be seen as owing the debt, taxpayers (or at least some of them) also own the debt. This is not a payment across generations; it is a payment within generations.

If the United States let the debt rise to $10 trillion and then left the debt at $10 trillion for 100 years, just paying the interest, then in 2111 some of our children, grandchildren and great grandchildren would be collecting the interest on the $10 trillion, which would be paid from the taxes that the government collects.

This flow of money from taxpayers to bond holders doesn’t on net make people better or worse off 100 years from now. It is simply a redistribution from some members of future generations to other members of future generations. None of the interest is flowing to those of us alive now, since virtually all of us will have passed into history by then.

Whether or not the debt has made future generations poorer will depend on how it was incurred. If we ran up debts so that we could finance schools and colleges, and make sure that our children and grandchildren were well educated, then we probably made them richer than if we didn’t run up debt but left them illiterate. Similarly, if we ran up the debt to construct a modern physical and information infrastructure, then we probably will have made future generations much wealthier than if we had handed them a country that was debt free, but had no Internet and no computers.

In short, the debt is not an accurate measure of whether we have been generous to or short-changed the generations that come after us. The answer to that question depends on the economy and society that we pass on. There are many scenarios in which we would have impoverished future generations, even if we were to hand them a government that is free of debt or alternatively left them very wealthy, even if there is a substantial government debt.

There is an economic argument whereby deficits can reduce the wealth of future generations. If the economy is at its capacity (e.g. everyone who wants to work is already employed), and if we run a large deficit due to additional government spending or tax cuts, then we may be pulling people away from building up the economy’s capacity. Specifically, the government’s borrowing needs can lead to higher interest rates.

Higher interest rates can in turn lead to less investment. If businesses invest less in machinery, computers, and other investment items, then productivity will grow less rapidly. Productivity – how much workers produce in an hour of work – is the main long-run determinant of living standards. (Productivity almost always grows, so the issue is how fast it grows – it is almost impossible to envision a future in which workers are not substantially more productive in 20 or 30 years than they are today.)
If deficits lead to high interest rates, which in turn reduce investment, then they will have slowed the economy’s growth and made future generations less well off than they would have been without the deficits. But it is important to remember that the way deficits can hurt future generations is not directly through the debt burden, but rather because they can reduce investment and therefore slow productivity growth.

The measure of the deficit’s impact on the living standards of future generations is not the size of the debt in dollars or even the size of the debt relative to the size of the economy. The impact of the deficit on future living standards would be reflected in the rate of productivity growth. If the deficit has actually hurt the living standards of future generations, then it would be because deficits lead to slower productivity growth than the country would have otherwise seen.

In fact, even as the economy has run up substantial deficits in recent years, productivity growth has been strong for most of the last 16 years. Productivity has grown at an average annual rate of 2.6 percent in the years from 1995 through the 1st quarter of 2011. This means that for each hour of work, we are getting 51.1 percent more output today than we did in 1995. In principle, if the country as a whole is spending the same percentage of its time working in 2011 as in 1995, then we can be enjoying a standard of living that is 51.1 percent higher than in 1995.1

While there is an issue that a greater share of the economy’s output might be diverted to foreigners because of the foreign debt (see below), we still derive more income each year from our ownership of foreign assets than foreigners do from their ownership of U.S. assets. At the moment at least, we are still in the process of making our children much wealthier than we were, in spite of our $14 trillion debt.

2) If You Don’t Like the Trade Deficit and Borrowing from Foreigners, Then You Think the Dollar is Too High

In an international economy, there is a second way that a budget deficit can reduce the living standards of future generations. It can cause the country to run a trade deficit, which in turn leads it to borrow money from abroad. As a result, a portion of the U.S. capital stock (shares of stock, government bonds, home mortgages etc.) will be owned by foreigners rather than people in the United States.

This means that the income from these assets (e.g. dividends on shares of stock, interest on government bonds, or mortgage payments) will be sent to people living in other countries rather than people in the United States. Since these income flows will be going overseas rather than to our children and grandchildren, they will be less wealthy than if we had not run trade deficits and incurred debt to foreigners.

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1 This is not exactly true because there are some differences between the way productivity growth is measured and the way that improvements in living standards are measured. For a discussion of this, see Baker, Dean. 2007. “The Productivity to Paycheck Gap.” Washington, D.C.: Center for Economic and Policy Research, http://www.cepr.net/documents/publications/growth_failure_2007_04.pdf.
While budget deficits can lead the United States to run trade deficits, they do so by pushing up the value of the dollar. No one buys imported clothes at Wal-Mart because the government is running a budget deficit. If people buy imported clothes at Wal-Mart, then it is because imported clothes are cheaper than comparable U.S. made clothes.

The main factor that determines how cheap or expensive imported clothes are is the value of the dollar. If the dollar rises in value by 10 percent against other currencies, then all the goods that we might import from other countries suddenly cost us 10 percent less than before the rise in the dollar. This will cause us to buy more imported goods.

Similarly, if the dollar rises in price by 10 percent against foreign currencies, then this will make U.S. exports cost 10 percent more for people living in other countries. Therefore, people living in other countries will buy fewer exports from the United States.

If we buy more imported goods and sell fewer exports, then our trade deficit increases. The way that an increase in the trade deficit can be tied to a budget deficit is that a budget deficit can lead to higher interest rates, as discussed in the previous section. Higher interest rates make dollar-denominated assets like government bonds or bank deposits more attractive for foreigners. If foreigners invest more money in U.S. bonds, bank deposits, and other assets, it will cause the dollar to rise.

So it is possible for a budget deficit to lead to a trade deficit, as claimed by the deficit hawks, but only by causing the dollar to become over-valued. The value of the dollar is the main factor determining the trade deficit. Those who are concerned about the trade deficit must want to lower the value of the dollar. There is no other plausible mechanism for reducing the trade deficit.

3) The Trade Deficit Requires Either Large Budget Deficits or Low Household Saving

By definition, total national saving is equal to the trade surplus. When we have a trade deficit, that means that the country on the whole is on net a borrower. This just logically follows from the notion that if we are buying more from abroad than we are selling, then we must borrow to cover the difference. This means that either the public sector must be borrowing, meaning that we have government budget deficits, or the private sector must be borrowing, which would correspond to a situation where we had very low household savings.

In the last decade we have seen both scenarios. We currently have very large government budget deficits. In this case, the government is doing the borrowing that corresponds to our trade deficit. However, before the collapse of the housing bubble, when budget deficits were relatively low, it was the private sector that was doing most of the borrowing. This was due to the consumption boom that resulted from the $8 trillion in housing bubble-generated wealth. Consumers spent based on this illusory bubble wealth, sending the household saving rate to zero. There was a similar situation.

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2 In reality, the relationship is somewhat more complex because changes in currency price are not typically passed through one to one.
at the end of the 1990s, when the wealth created by the stock bubble led to another consumption boom that caused the saving rate to fall to what was at the time a record low.

There is no way to escape the simple accounting identity that national savings is equal to the trade surplus. This means that if we want the budget deficit to be brought down, and we don’t want to see private savings collapse, as they did during the years of the stock market bubble and the housing bubble, then we must want to see the trade deficit fall. This in turn means that we must want to see the dollar decline since there is no other plausible mechanism for bringing about large reductions in the trade deficits.

4) The Stock Market and Housing Bubble Caused People to Stop Saving

The immediate factor that led households to consume more and save less before the Great Recession was the ephemeral wealth created first by the stock market bubble and later the housing bubble. The wealth effect from stocks and housing has been well documented. According to research from the Federal Reserve Board and elsewhere, households consume an additional 3-4 cents annually for every dollar of additional stock wealth they own. At the peak of the stock bubble in 2000, there was approximately $10 trillion in stock bubble wealth. This would have led people to consume an additional $300-$400 billion a year compared to a situation in which there was no stock bubble. This would have lowered the saving rate in 2000 by between 4 and 6 percentage points, roughly the size of the actual falloff in the saving rate from the pre-stock bubble days. In other words, the stock bubble of the 1990s was the main factor causing households to reduce their saving.

The same thing happened with the growth of the housing bubble in the early 2000s. The wealth effect for housing is estimated at between 5 and 7 cents for every dollar. This means that the $8 trillion housing bubble would have led to an increase in annual consumption of between $400 billion and $560 billion. This also would have lowered the saving rate by between 4 and 6 percentage points.

In short, most, or all, of the decline in the savings rate before the Great Recession was attributable to the wealth effects associated with the stock and housing bubbles. Those who are concerned about the failure of families to save for the future should have been concerned about the growth of these bubbles, which led to sharp declines in saving rates.

4 The calculation of bubble wealth is the difference between the stock market at its 2000 peak value and the value that it would have had if stock prices were at the long-term average for the price to earnings ratio of 15 to 1.
5) During a Period of Economic Weakness, a Budget Deficit Can Increase Growth and Make the Economy Wealthier

While a budget deficit can in principle lead to higher interest rates and therefore reduced investment and lower productivity growth when the economy is operating near capacity, it can also help to boost the economy when the economy is facing a downturn. During a recession, the main problem facing the economy is a lack of demand. If the government can boost demand through either increased spending or cutting taxes (and thereby increasing consumption), then it can increase output and employment.

Higher output can lead businesses to invest more. This will increase productivity growth and make future generations richer. Similarly, if the government spends money building infrastructure, or in other areas that can increase productivity (e.g. education, energy conservation or research), then budget deficits can help to make future generations richer. In fact, well-targeted investment can increase productivity growth even when the economy is not in a recession.

It is important to note the point in a business cycle when the government runs a deficit. Budget deficits during a recession are likely to lead to both short-term and long-term benefits to the economy.

6) Projections of Exploding Private Sector Health Care Costs Are the Reason for Huge Budget Deficits

The federal government pays for almost half of the country’s health care costs through Medicare, Medicaid, and other health care programs. Almost all of the payments in these programs go to private sector health care providers (hospitals, doctors, nursing homes etc.). The government projects that private sector health care costs will rise far more rapidly than the economy grows. This assumption leads to projections of massive deficits in the next few decades.

While these projections of exploding health care costs imply that budget deficits will be a huge problem, if the United States can contain its health care costs, then budget deficits will be very manageable as shown in Figure 1.

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In other words, the real problem facing the country is a broken health care system. If health care costs continue to grow at the projected rate, then future generations will see relatively little gain in their living standards, even if we eliminate all government spending on health care.

The health care system in the United States is uniquely inefficient. We pay far more per person than other rich countries, yet we rank near the bottom by outcome measures like life expectancy. If the United States could make its system as efficient as that of other wealthy countries, there would be no budget deficit problem. As Figure 2 shows, the government would show large surpluses for the indefinite future if per person health care costs were the same in the United States as in other wealthy countries. 7

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7 CBO (2009) and World Bank, World Development Indicators. See http://www.cepr.net/calculators/hc/hc-calculator.html for more details.
7) Social Security Has Its Own Designated Funding Stream

There are many people who want to cut Social Security. While people are free to advocate whatever they like, it is important to note that Social Security has its own dedicated stream of funding with the Social Security tax. This tax, along with the interest and principal on government bonds purchased with tax revenue, is projected to leave the program fully solvent through the year 2036.8

This means that there is little reason to be cutting benefits in this program any time for several decades. In effect, workers have already paid for their benefits. Of course, if the government were in a sufficiently desperate situation then we would have to consider defaulting on the obligation to the country’s workers by defaulting on the government bonds held by the Social Security system; but then it would also be reasonable to consider defaulting on the other government bonds held by investors. Investors could much more easily survive a partial default (e.g. 80 cents on the dollar) than most Social Security beneficiaries.

As noted above, if we fix the health care system, the long-term deficit problem is easily manageable. However, if the deficit problem ends up being sufficiently severe (presumably because we failed to fix the health care system), then there would be no justification for cutting Social Security without also making holders of the national debt share in the pain.

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