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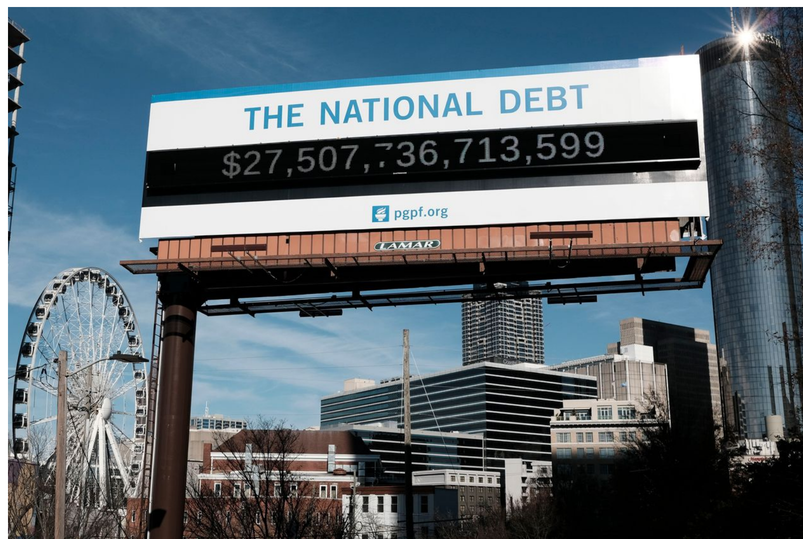
THE NUMBERS

U.S. Debt Is at a Record, but the Risk Calculus Is Changing

Some say the traditional debt-to-GDP ratio is no longer meaningful



A sign in Atlanta showed the total U.S. debt nearing $28 trillion in December. Publicly held federal debt accounts for nearly $22 trillion of that sum.

PHOTO: JOHN ARTHUR BROWN/ZUMA PRESS

By

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April 16, 2021 5:33 am ET

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The U.S. said show me the money, and the world did.

Federal debt—incurred when the government sells Treasury bonds, bills, notes and other securities to help cover its costs—recently hit an all-time high, thanks in part to foreign investors who are happy to park their cash in the U.S.

The securities are attractive because of their safety and stability. The government has never failed to pay back its lenders the full value of the securities when they mature after a fixed period: 20 or 30 years for Treasury bonds; two to 10 years for notes; and as long as 52 weeks for bills.

The transactions provide the government with infusions of cash and—as long as the dollar remains the global reserve currency—offer individuals and institutions a safe way to sock away their wealth.

“One thing economists and people in general have miscalculated is the massive global appetite for the U.S. dollar and U.S. dollar-denominated debt,” said David Andolfatto, a senior vice president of the Federal Reserve Bank of St. Louis. “This demand has exploded in the last 30 years.”

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About a third of the debt is now held abroad in countries such as China, Japan and the U.K., Mr. Andolfatto said, and the continued demand helps explain how the U.S. has been able to run up record-setting obligations without (so far) suffering any repercussions.

This year, the federal government’s publicly held debt is projected to hit 102% of the country’s gross domestic product—the monetary value of all finished goods and services made in the country in a year. It would be the highest debt-to-GDP ratio since 1946, according to the Congressional Budget Office.

At the same time, the annual deficit is expected to reach $2.3 trillion, or 10.3% of GDP, the second-largest shortfall since 1945, behind last year’s record high of $3.1 trillion, or 14.9% of GDP.

Traditionally, such eye-popping ratios would trigger fears of skyrocketing inflation and the potential for the government to respond by raising taxes or cutting spending.

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But it isn't clear what level of debt-to-GDP ratio truly represents fiscal prudence, or financial risk, particularly because the current levels exceed thresholds that were previously considered safe.

When the European Union formed in 1993, it said member countries should have a debt-to-GDP ratio no greater than 60%. A World Bank study in 2010 suggested the ratio shouldn't exceed 77%. The same year, two Harvard economists famously concluded—in a paper that was later found to have serious errors—that a debt-to-GDP ratio above 90% was too risky.

But this year's long-term budget outlook published by the Congressional Budget Office declared that the debt-to-GDP ratio has no set tipping point at which a crisis becomes likely or imminent.

Japan seems to be testing the limits. In 2019, its debt was equal to about 230% of its GDP, according to Fitch Ratings.

This doesn't necessarily mean the debt-to-GDP ratio was never useful.

In the past, when most Treasury securities were held domestically and the demand for debt was stable, the traditional debt-to-GDP ratio might have made sense, Mr. Andolfatto said.

Now, not so much.

"Suddenly, the world has changed," he said. "The debt-to-GDP ratio today can be much higher without the same inflationary consequences or interest-rate consequences because the global demand has been elevated."

That demand offsets traditional fears that a high debt-to-GDP ratio will lead to rising costs, falling wages and the Federal Reserve raising interest rates to cool off those inflationary pressures.

> **'The debt-to-GDP ratio today can be much higher without the same inflationary consequences or interest-rate consequences because the global demand has been elevated.'**
>
> — David Andolfatto, Federal Reserve Bank of St. Louis

Still, it seems like there should be a way to simply assess the size of the debt…right?

William English, a finance professor at Yale and a former economist at the Fed, suggested looking at the country's ability to service the debt.

"If you think about a household with a mortgage, it isn't clear that you want to look at the size of the mortgage relative to income," Mr. English said. "Instead, you want to look at the mortgage payment. How much must you spend each year to service the mortgage?"

Last year's interest payment on the federal debt was about $345 billion, or 1.6% of GDP.

Mr. Andolfatto argued for yet another measure: "Inflation should be the metric we use."

According to that argument, if inflation causes the GDP to grow at a faster rate than interest, as it generally has in recent years, the country can afford to take on more debt. If the economy slows down, and GDP grows at a slower rate, the opposite would be true.

So, when it comes to judging the size of the national debt, which matters more—an interest payment of less than 2% of GDP? This year's projected debt-to-GDP ratio of 102%? Inflation? Or some other measure?

"The question is to what use are you putting the borrowing?" Mr. English said. "If you're building an economy that's stronger, that's growing faster and so on, then a pretty high level of debt could be both desirable and sustainable. It's hard to have a clear rule."

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Appeared in the April 17, 2021, print edition as 'As Debt Grows, the Risk Calculus Changes.'

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