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Debt Is Good

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Paul Krugman

Rand Paul said something funny the other day. No, really — although of course it wasn’t intentional. On his Twitter account he decried the irresponsibility of American fiscal policy, declaring, “The last time the United States was debt free was 1835.”

Wags quickly noted that the U.S. economy has, on the whole, done pretty well these past 180 years, suggesting that having the government owe the private sector money might not be all that bad a thing. The British government, by the way, has been in debt for more than three centuries, an era spanning the Industrial Revolution, victory over Napoleon, and more.

But is the point simply that public debt isn’t as bad as legend has it? Or can government debt actually be a good thing?

Believe it or not, many economists argue that the economy needs a sufficient amount of public debt out there to function well. And how much is sufficient? Maybe more than we currently have. That is, there's a reasonable argument to be made that part of what ails the world economy right now is that governments aren't deep enough in debt.

I know that may sound crazy. After all, we've spent much of the past five or six years in a state of fiscal panic, with all the Very Serious People declaring that we must slash deficits and reduce debt now now now or we'll turn into Greece, Greece I tell you.

But the power of the deficit scolds was always a triumph of ideology over evidence, and a growing number of genuinely serious people — most recently Narayana Kocherlakota, the departing president of the Minneapolis Fed — are making the case that we need more, not less, government debt.

Why?

One answer is that issuing debt is a way to pay for useful things, and we should do more of that when the price is right. The United States suffers from obvious deficiencies in roads, rails, water systems and more; meanwhile, the federal government can borrow at historically low interest rates. So this is a very good time to be borrowing and investing in the future, and a very bad time for what has actually happened: an unprecedented decline in public construction spending adjusted for population growth and inflation.

Beyond that, those very low interest rates are telling us something about what markets want. I've already mentioned that having at least some government debt outstanding helps the economy function better. How so? The answer, according to M.I.T.'s Ricardo Caballero and others, is that the debt of stable, reliable governments provides "safe assets" that help investors manage risks, make transactions easier and avoid a destructive scramble for cash.

Now, in principle the private sector can also create safe assets, such as deposits in banks that are universally perceived as sound. In the years before the 2008 financial crisis Wall Street claimed to have invented whole new classes of safe assets by slicing and dicing cash flows from subprime mortgages and other sources.

But all of that supposedly brilliant financial engineering turned out to be a con job: When the housing bubble burst, all that AAA-rated paper turned into sludge. So investors scurried back into the haven provided by the debt of the United States and a few other major economies. In the process they drove interest rates on that debt way down.

And those low interest rates, Mr. Kocherlakota declares, are a problem. When interest rates on government debt are very low even when the economy is strong, there's not much room to cut them when the economy is weak, making it much harder to fight recessions. There may also be consequences for financial stability: Very low returns on safe assets may push investors into too much risk-taking — or for that matter encourage another round of destructive Wall Street hocus-pocus.

What can be done? Simply raising interest rates, as some financial types keep demanding (with an eye on their own bottom lines), would undermine our still-fragile recovery. What we need are policies that would permit higher rates in good times without causing a slump. And one such policy, Mr. Kocherlakota argues, would be targeting a higher level of debt.

In other words, the great debt panic that warped the U.S. political scene from 2010 to 2012, and still dominates economic discussion in Britain and the eurozone, was even more wrongheaded than those of us in the anti-austerity camp realized.

Not only were governments that listened to the fiscal scolds kicking the economy when it was down, prolonging the slump; not only were they slashing public investment at the very moment bond investors were practically pleading with them to spend more; they may have been setting us up for future crises.

And the ironic thing is that these foolish policies, and all the human suffering they created, were sold with appeals to prudence and fiscal responsibility.

David Brooks is off today.

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