THE AUSTRALIAN ECONOMIC REVIEW
THE UNIVERSITY OF MELBOURNE
MELBOURNE INSTITUTE
The Australian Economic Review, vol. 53, no. 4, pp. 557–565 DOI: 10.1111/1467-8462.12402

Should We Worry about Government Debt? Thoughts on Australia's COVID-19 Response

Chris Edmond, Richard Holden and Bruce Preston*

Abstract

No. While the COVID-19 crisis has required a dramatic increase in debt-financed government spending, in the current conditions the benefits from this debt are unusually high and the costs unusually low. While conditions can change, the Australian Government can right now hedge against these risks by lengthening the maturity structure of government debt, even at the cost of a modest increase in its current servicing costs.

* Edmond and Preston: University of Melbourne, Australia; Holden: UNSW Business School, Australia. Corresponding author: Preston, email: <bruce.preston@unimelb.edu.au>.

1. Introduction

The COVID-19 crisis has lead to an extraordinary turnaround in Australian fiscal policy. Only a year ago, the federal government was forecasting a return from persistent deficits to modest surpluses, around 1 per cent of national income. But in response to the crisis the federal government has sharply increased government spending, in particular spending on the JobKeeper wage replacement program and the JobSeeker unemployment benefits program. Together with a modest decline in tax revenues, this has led to a budget deficit on the order of 10 per cent of national income, an 11 per cent (or approximately $600 billion) turnaround. This deficit is projected to fall to around 6 per cent of national income as JobKeeper and other pandemic support measures are wound back but is still expected to be sizeable for the rest of the decade.

While this debt-financed government spending has been necessary to address the unprecedented public health crisis, and resulting economic crisis, it still raises several fundamental questions. How are we going to service this debt? Should we return to surplus quickly? Do we have the capacity to spend more should circumstances warrant it? Do high levels of debt limit our ability to pursue other government programs? What are the implications of governments all around the world all issuing large amount of new debt at the same time?

In this article we briefly address these issues, with a focus on the *sustainability* of large levels of government debt both under

current economic conditions, which tend to make debt relatively easy to sustain, and under a possible worsening of global economic conditions. We argue that if current debt servicing conditions were to continue then current levels of government debt, indeed even substantially larger levels of government debt, would be sustainable in perpetuity. That said, there are no guarantees in either life or public finance, and it is easy to envisage scenarios that make debt servicing considerably more expensive. In particular, a rise in global interest rates (driven, for example, by increased political tensions in the United States, or by the sheer amount of new government debt issued around the world), would likely lead to rising interest rates in Australia too, increasing debt servicing costs.

Such scenarios do not mean that current levels of debt are unsustainable. But they do imply that prudent fiscal policy should hedge against such risk by lengthening the maturity structure of government debt. We should issue more long-term government debt, accepting slightly higher debt servicing costs today in order to lock in low interest rates for years to come. We should not assume we will always be able to roll over short-term debt at current interest rates.

In Section 2 we argue that the increase in government debt should be sustainable. In Section 3 we identify two key risks to Australian fiscal policy going forward: the risk of premature austerity, and the risk of worsening global economic conditions. Section 4 discusses some broader lessons from the COVID-19 crisis for fiscal policy and monetary policy, stressing that Australian public policy discussion of fiscal policy needs to move beyond its traditional narrow obsession with the headline budget position. Rather, we emphasise that while it is natural that fiscal policy takes the lead in responding to the current crisis, monetary policy still has an important role to play. Section 5 concludes.

2. Fiscal Sustainability

In this section we review the benefits and costs of running large deficits in response to the COVID-19 crisis. In short, current conditions suggest the benefits of additional government spending are unusually high and the costs unusually low. While conditions can change, the Australian Government should take out insurance against a worsening of conditions by lengthening the maturity structure of government debt.

2.1 Benefits of Spending

To begin with, consider the benefits of additional government spending right now. Two broad kinds of spending are of particular significance: (1) additional transfers, as part of the new JobKeeper program and the expanded JobSeeker program (which replaces the old Newstart), that act as *wage insurance*, mitigating much of the decline in worker incomes that would otherwise occur as businesses substantially reduce activity, either in badly affected sectors of the economy like tourism and hospitality or in other sectors affected more indirectly; and (2) more traditional forms of government stimulus intended to buttress private sector demand.

The short-run impact of this government spending is likely to be high. At times of full employment, additional government spending tends to crowd out private-sector spending, driving up interest rates, which in turn undermines the effectiveness of the stimulus. But in current conditions with the economy far from full employment and interest rates low, crowding-out effects are likely to be small.[1] In other words, the fiscal policy multiplier, the dollar increase in national income from each dollar of government spending, will be larger than in normal times.

This is not just conjecture on our part. A substantial literature spells out the economic conditions required for large fiscal multipliers. To take a couple of key examples, using state-of-the-art econometric techniques, Auerbach and Gorodnichenko (2012) and Caggiano et al. (2015) show that fiscal policy is far more effective in deep recessions than in normal times.

So long as the pandemic rages, public investment in public health, especially testing,

tracking and isolating, will have extremely high net social returns. But there are good reasons to expect high net social returns to other public investments too, especially under our current low interest rate conditions. Securing a strong, sustained recovery from the COVID-19 recession will require ongoing investments to limit scarring 'hysteresis effects' for workers who experience prolonged detachment from the labour force and/or who need to retrain for new jobs with new skill requirements. The Australian economy is going to experience an extended period of adjustment, and there are likely to be strong social benefits to making the necessary adjustments as painless as possible.

2.2 Are Debts Sustainable?

While there are good short-run and longer-run reasons for this large increase in government spending, such spending comes at a cost.

What is the right way to think about these fiscal costs? From a public finance point of view, we should think about the deadweight losses of distortionary taxes used to finance government spending. Such distortions are certainly important and there are good reasons to think Australia could meaningfully reduce such deadweight losses by shifting to a less distortionary system.

But at the macroeconomic level, the more important consideration is whether the fiscal costs are sufficiently large so as to make the overall amount of government debt *unsustainable*. A useful way to think about debt sustainability is the difference $r - g$ between the interest cost of servicing the stock of debt outstanding, r, and the growth rate of national income, g. This difference measures the cost of maintaining a constant government debt to income ratio in perpetuity. A higher r increases the cost of servicing existing debt. A higher g decreases the cost of servicing existing debt. This is because as the economy grows outstanding debt becomes a smaller fraction of the overall size of the economy. In effect, productivity growth and population growth expand the tax base.

If $r > g$, then holding the debt to income ratio constant requires higher taxes either now or in the future (but structured so that the present values add up). In this sense, $r > g$ means the implicit cost of servicing the stock of outstanding debt is relatively high. If $r = g$, no changes in taxes are required in order to hold the debt to income ratio constant. But if $r < g$, then even holding the level of taxes fixed, the debt to income ratio will decline over time. In this sense, $r < g$ means the implicit cost of servicing the stock of outstanding debt is relatively low. Put differently, $r < g$ means the government could cut taxes or increase spending and still keep the debt to income ratio constant.

In short $r < g$ means government debt pays for itself. As an example, at the end of World War II, Australia's gross government debt was around 120 per cent of national income, compared to about 30 per cent of national income before the COVID-19 crisis.[2] Over subsequent decades, gross debt declined to a low of around 8 per cent of national income (just before the 2008 financial crisis) despite the Federal government running headline deficits in almost every year. This explains why it is generally unhelpful to discuss a given deficit in terms of 'when it will be paid off' or the need to 'run future surpluses to balance the budget over time'. A debt to income ratio can be stabilised without significant surpluses so long as g is high relative to r.

So which situation best describes Australia? To take one recent estimate, Barro (2020) finds that Australia's long-run r for government bonds is around 3.3 per cent per year while long-run growth g in real GDP is around 3.4 per cent per year, suggesting $r - g$ is around –0.1 per cent per year. More generally Mehrotra (2018) shows $r < g$ holds for many countries over long periods of time. Using data over the period 1870–2013 he shows that while the $r - g$ differential displays some variability, on average real interest rates are below average growth rates. This evidence is also supported by various studies that estimate long-run real rates for different economies. Del Negro et al. (2019) provide

evidence that long-run real rates in the United States have fallen from about 2.5 per cent per year in the early 1980s to around 0.5 per cent in recent years. Because of the United States's role in the global financial system, this decline in real rate is also observed for many advanced economies. For Australia, McCririck and Rees (2017) estimate that the long-run real rate has declined from 2.5 per cent per year to 0.8 per cent in 2017. Taking these numbers together with even the most pessimistic assessment of future growth rate makes $r < g$ for the foreseeable future, suggesting that current debt to income ratios are indeed sustainable.

For this reason, Blanchard (2019), and others, have argued forcefully for a significant expansion in government spending, funded by debt—even in countries with substantially higher levels of indebtedness than Australia. Of course, historical interest rates may not be good predictors of future interest rates. The conditions that have given rise to low interest rates need not persist. But right now investors appear to place low probability on a substantial increase in rates. The Australian Government can currently borrow at 1 per cent at 10 years and at 1.75 per cent over 30 years.

None of this says that government debt is without costs. But current economic conditions make those costs relatively small given the insurance we need to provide to the citizens of Australia in the face of an unprecedented economic and public health crisis.

3. Risks for Fiscal Policy Going Forward

We now briefly discuss two significant risks for fiscal policy going forward: (1) the risk of *premature austerity*, specifically the risk of trying to reduce the budget deficit too quickly relative to the state of the economy; and (2) the risk of *worsening global economic conditions*. The former is under the control of Australian policymakers. The latter is beyond the control of Australian policymakers, but we can still choose fiscal policy settings to give ourselves as much insurance as possible against worsening global conditions.

3.1 Premature Austerity

The first and most direct concern is that Australian fiscal policy might tighten too quickly. The government's response to the COVID-19 crisis has led to a sudden large increase in the government deficit. Even though Australia's baseline fiscal position coming into the crisis was relatively sound, with modest levels of gross debt relative to national income and low levels of net debt relative to national income, the political narrative around 'debt and deficits' has, unfortunately, been a feature of Australian public debate for decades. In this climate, it doesn't seem far-fetched to imagine the government will come under considerable pressure to return the government deficit to surplus relatively quickly.

A premature return to austerity, with cuts in government spending and/or increases in taxes would in turn hold back consumer and business spending, discouraging job creation, leaving employment and hours-worked low and unemployment high with wages growing slowly if at all. By holding back the overall economy, such policies can, in fact, be counterproductive from a debt sustainability point of view. After all, the quicker the economy recovers, the less we will end up having to spend on programs like JobKeeper and JobSeeker. Rather than worrying about the headline deficit, we should take advantage of low interest rates and use expansionary fiscal policy to drive the economy back to full employment. We should start to think about bringing the deficit down when unemployment is low and wages are growing briskly. Not before.

Given the current state of the pandemic in Australia—broadly under control—going forward we should be fairly optimistic about the prospects of economic recovery, absent some unforced domestic policy error. But in a small open economy like Australia we cannot ignore events abroad.

3.2 Worsening Global Conditions

There are two broad ways in which events in the global economy might worsen and thereby make the conduct of fiscal policy in Australia more difficult. First, the economic downturn in the rest of the world could become deeper and/or more protracted, reducing the demand for Australian exports, especially commodities, thereby slowing the rate of recovery in Australia. Second, while global interest rates (and inflation) are currently low, it is not difficult to think of scenarios where global interest rates rise substantially over the next few years.

Most economies are still struggling with the direct effects of the pandemic on economic activity and the indirect economic effects of temporary measures to suppress the virus. While many economies are beginning to show signs of economic recovery relative to the heady days of March–April–May 2020, this recovery is far from assured. At the time of writing, across Europe and the United States we are seeing a dramatic increase in COVID-19 cases, in positive test results, and hospitalisations. Once again both the direct effects of the pandemic and the indirect effects of public health measures are likely to reduce economic activity, preventing the recovery from being as robust as it otherwise could be. This reinforces a key lesson: one of the most important aspects of economic policy in the COVID-19 crisis has been bringing the pandemic under control. Absent such control, economic activity is on a very unstable footing.

But while the pandemic naturally looms large in any such discussion, it isn't the only concern. Just as a domestic turn to austerity could undermine Australian economic recovery, so too could a global turn to austerity. Suppose for example that European economies turn to austerity as they did following the 2012 European sovereign debt crisis. A widespread adoption of tight fiscal policy in Europe or in other major economies could easily slow down their recovery thereby slowing down the Australian recovery. And of course the effects of such a global turn to austerity would be all the larger if our major trading partners are still struggling to bring the pandemic under control.

Why might we see this kind of global turn to austerity?

This brings us to the second main way that global economic conditions could make the conduct of fiscal policy in Australia more difficult: a global rise in interest rates. It is not so difficult to imagine interest rates on government debt rising around the world in ways that discourage expansionary fiscal policy both in Australia and around the world.

Just because interest rates on both short-term and long-term government debt are low right now, there is no guarantee that they will stay low. The current low level of interest rates is driven by a confluence of factors. First, the 'global savings glut'—unusually high levels of private sector savings around the world—that increases the supply of savings and puts downward pressure on interest rates. Second, the 'productivity slowdown'—the unusually slow rate of productivity growth in major economies—that in turn leads to low investment demand, that is, low demand for savings, which puts further downward pressure on interest rates. Third, a crisis-driven 'flight to quality'—temporarily elevated demand for assets like government debt that offer a safe return, at least in nominal terms, that look especially attractive to risk-averse investors in times of heightened uncertainty.

The 'savings glut' and the 'productivity slowdown' are usually thought to be slow-moving, long-run features of the global economy and new developments on that front, for example, a gradual reduction in private sector savings over the course of the recession, are unlikely to lead to sudden changes in interest rates. But there are other determinants of interest rates that can change relatively quickly.

Just as a 'flight to quality' reflects a sudden increase in demand for government debt, pushing down interest rates relatively quickly, the sudden unwinding of such positions can lead to the reverse, pushing up interest rates just as quickly. More generally, to the extent

that government debt comes to be seen as less safe as an investment vehicle, interest rates around the world will tend to rise. To be clear, while major governments that are able to issue debt denominated in their own currency can never default in nominal terms, in *real terms*, which is presumably what ultimately matters to investors, inflation risk acts in an analogous manner. Thus for major economies the underlying risk that might lead to higher interest rates is in effect the risk that inflation might rise appreciably (for governments that cannot borrow in their own currency, there are of course additional sovereign default considerations).

Notice that it need not be inflation in Australia that is of concern here. An increase in inflation risk for the United States (relative to Australia) that leads to reduced demand for US government debt could depress demand for government debt as an asset class more broadly, leading perceptions of inflation risk elsewhere to effectively spill-over to Australia, driving up interest rates here also. In principle our floating exchange rate should act as a cushion against this, in this scenario leading the Australian dollar to appreciate relative to the US dollar, but (1) that appreciation would create its own adjustment issues for the Australian economy, and (2) in practice such exchange rate adjustments are rarely so clean as to cushion the domestic economy entirely.

This in turn raises the question of why inflation might increase substantially in major economies like the United States. At the time of writing this seems faintly absurd, given just how low inflation is around the world. But these things can change quickly.

One way we could see a significant rise in US inflation and interest rates is if the United States experiences a period of substantial political tension, for example, a congressional deadlock, that prevents fiscal policy from operating in conventional ways. Such political tensions matter not just in their own right but also because they undermine the long-run 'fiscal backing' of the economy—for example, the capacity to raise government revenue via taxation—that ultimately determines how much inflation results when the government issues more debt. A protracted congressional deadlock or other political dysfunction that undermines the long-run fiscal capacity of the United States could lead to higher US inflation and higher interest rates both in the United States and around the world, thereby constraining fiscal policy in Australia too.

3.3 Managing Interest Rate Risk

It is precisely because of this global 'tail risk' that Australian policymakers should be acting prudently right now, lengthening the maturity structure of Australian government debt (even at the expense of slightly elevated interest expense in the short run) so as to help Australia lock in relatively debt servicing costs now and giving us more flexibility to respond to future shocks.

Most existing government debt is of short maturity (the thickness of markets for short-term government debt means longer-term debt tends to face something of an illiquidity premium), a sudden rise in global interest rates would mean a sudden rise in the cost of servicing the stock of debt outstanding as the government rolls over its short-term positions.

The government can lengthen the maturity structure of government debt, issuing more 10- and 20-year debt, trading off the certainty of slightly higher interest servicing costs in order to lock in insurance against the possibility of having to roll over short-term debt at substantially higher rates in the future. Indeed even this may be too short sighted. It seems worthwhile exploring whether there is market appetite for even longer-term 30-year government debt. Long-term debt issues have been subscribed to by central banks and pension funds from Japan and the Euro area. Australia's low debt, considerable fiscal space, and its relative success in containing the public health crisis will surely make it an attractive place to invest, especially relative to other countries that entered the crisis with worse fiscal conditions and are so far experiencing deeper

recessions and more protracted difficulties managing the COVID-19 pandemic.

We now turn to some broader lessons for macroeconomic policy in Australia.

4. Broader Lessons for Macro Policy in Australia

The COVID-19 pandemic and the need for dramatic fiscal interventions has drawn attention to the fact that public policy discussion of fiscal policy in Australia has been impoverished for years. While the academic literature on fiscal policy has become ever more sophisticated, precious little of that thinking has trickled down to the opinion pages.

4.1 We Need a New Approach to Fiscal Policy

It is well past time that analysis of fiscal policy is put on a more serious footing. For too long, discussion of fiscal policy has been obsessed with the headline budget deficit. We should move on from the view that a deficit (or surplus) is any guide to good economic management let alone any kind of end unto itself. We should judge macroeconomic policy by its ability to deliver good outcomes for the Australian people, not interim financial statements.

In our view, there are four key elements of a new approach. First, a broad-based acknowledgment that fiscal policy is a tool that can achieve desirable ends and that fiscal policy plays a necessary role in stabilising the economy. In the short run we need aggressive fiscal stimulus to get us out of recession. In the medium run, fiscal policy should be deployed (with monetary policy, more on this below) to achieve price stability and full employment. Second, a separation of the budget into 'ordinary' and 'emergency' expenditures that formally recognise the special role of the new discretionary spending programs. The government should continue to use the emergency budget as needed to ensure a recovery is achieved. Any need to demonstrate fiscal prudence should be confined to the province of the ordinary budget. Third, a recognition that even within the ordinary budget there is an important distinction between the 'cyclical' component, which is necessarily affected by automatic stabilisers and ordinary amounts of discretionary spending, and the underlying 'structural' budget balance that reflects the long-term fiscal position. Fourth, a commitment not to raise taxes against debt issued for emergency expenditures for 30 years if financed by 30-year debt. Taxes should only be raised to cover interest payments.

A discussion of fiscal policy in these terms provides several benefits. It clarifies the purpose of these expenditures, tying them to desired outcomes. And if the recovery from the coming downturn takes longer than anticipated, it will help frame and build a case for further action.

In the longer term it will clarify what part of ongoing government debt is attributable to the economic policy response of a once-in-a-century event and what part is attributable to other government decisions. It will clearly identify the spending that was required to ensure the economic livelihood of current and future generations, an obligation we must all bear together. And it will avoid future political point scoring over the state of the budget, permitting sensible policy action to bring down debt, should that be required.

4.2 Monetary Policy Must Do Its Bit Too

In this article we have focused on the role of fiscal policy in stabilising the economy. In more ordinary times, we would expect monetary policy to play that role. We have focused on fiscal policy because in general fiscal policy is more powerful (albeit more clumsy) than monetary policy. That makes fiscal policy the go-to tool in a deep, protracted crisis such as we are facing right now. It makes monetary policy (which is more nimble but less powerful) the go-to tool for managing more routine economic fluctuations.

But the primacy of fiscal policy in the current crisis should not absolve the Reserve Bank of Australia (RBA) from doing its part. Monetary policy needs to be set both now, and

in the future, to properly support fiscal policy. Inflation plays a vital role in the state of government finances, through its influence on nominal income growth. For example, higher nominal income growth lowers outstanding nominal government debt as a fraction of nominal income.

To give a sense of the numbers, if average inflation runs at 1.5 per cent per year rather than the 2.5 per cent per year, the overall price level in the economy would be roughly 10 per cent lower. The cost of under-shooting the target is that the real value of public debt, as a fraction of national income, is then 10 per cent higher. And that is before taking into account revenue implications from lower nominal growth (bracket creep, etc).

Of course, the RBA's options are limited right now. Short-term interest rates are effectively zero and can go no lower. Long-term rates are also at historic lows. And while the RBA has resisted calls for negative interest rates, it is hard to believe further reductions in the cash rate will prove more effective than fiscal policy.

But even so *there is* more the RBA can do. For one, it can be much more transparent about its plans for future policy. At some future time, whether it be 12 or 24 months, the RBA will have greater traction on economic activity and inflation. It will face the choice of whether to raise rates to more normal levels, or to continue its low interest rate policy.

The RBA should do the latter and promise inflation, more than it is probably comfortable with. Promising to over-shoot the target band will raise inflation expectations and lower real interest rates. Doing so will buttress the recovery from this recession, supporting economic growth. It will also greatly improve the state of government finances.

How much inflation should it generate? The RBA should generate average inflation of 2 to 3 per cent over a long window, say ten years. This will place a clear boundary on how much inflation is appropriate. Given the sustained period of undershooting the inflation band, this would require a sustained period of overshooting the band in the future.

Such a policy might sound unusual. But after an extensive review of policy strategy and process, the Federal Reserve in the United States recently adopted average inflation targeting as its formal policy objective. There is no reason the RBA could not do the same. This approach will both make monetary policy more effective and will also help deliver fiscal goals.

5. Conclusion

The COVID-19 crisis has required a dramatic increase in Australian government debt. In the current conditions, the benefits of issuing more government debt are unusually high and the costs unusually low. While conditions can change, the government can right now hedge against these risks by lengthening the maturity structure of Australian government debt, even at the cost of a modest increase in its current servicing costs.

The COVID-19 crisis draws attention to the fact that Australian public policy discussion of fiscal policy has been too focused on interim *instruments* like the headline budget position and not on the actual economic outcomes that are or should be the actual *goals* of policy-making. We hope that one silver lining from the the current crisis is that Australian public policy debate develops a more balanced understanding of the uses of fiscal policy both for stabilisation policy over the business cycle and to lay the foundations for longer-term prosperity. Adjacent to this, we hope that the public policy debate begins to have a proper understanding of the role of monetary policy in supporting fiscal policy.

Endnotes

1. The Reserve Bank of Australia is committed to low interest rates for at least the next three years.

2. Conceptually speaking, net government debt would be the more relevant concept. International comparisons of government debt tend to focus on gross debt because of cross-country accounting differences in the valuation of government assets.

References

Auerbach, A. J. and Gorodnichenko, Y., 2012, "Fiscal multipliers in recession and expansion", Fiscal Policy after the Financial Crisis, NBER, pp. 63–98.

Barro, R. J. 2020, "*r* minus *g*", NBER working paper 28002.

Blanchard, O. 2019, "Public debt and low interest rates", *American Economic Review*, vol. 109, no. 4, pp. 1197–1229.

Caggiano, G., Castelnuovo, E., Colombo, V. and Nodari, G. 2015, "Estimating fiscal multipliers: News from a non-linear world", *Economic Journal*, vol. 0, no. 584, pp. 746–776.

McCririck, R. and Rees, D. 2017, "The neutral interest rate", *RBA Bulletin*, pp. 9–18.

Mehrotra, N., 2018, "Implications of slow productivity growth for debt sustainability," Federal Reserve Bank of New York working paper.

Del Negro, M., Giannone, D., Giannoni, M. P. and Tambalotti, A. 2019, "Global trends in interest rates", *Journal of International Economics*, vol. 118, no. C, pp. 248–262.