Abstract : The Stability of Bond Financed Deficits: A Critique of the Literature

A large body of literature has concluded that bond finance of the deficit is unstable because of rising interest payments on the debt. This paper criticizes this literature in detail, focusing on the Blinder – Solow and Sargent – Wallace papers. It argues that conclusions regarding a debt trap under bond finance stem from unrealistic assumptions about the interest rate, and not from the assumption of budget balancein the Blinder- Solow Model, as commonly believed. An adaptive expectations Fisher equation specification for how interest rates respond to the mode of debt financing and to inflation, implies that, in a growth framework, stability under bond finance can be easily achieved.