

Countdown to Catastrophe

BY LEONARD E. BURMAN

It's 2030. China has just invaded Taiwan, and things do not look good for the island. Taiwan's longtime protector, the United States, has responded with passionate rhetoric and a barrage of UN Security Council resolutions – which China has vetoed. But a military response is out of the question. China might counter by cutting off America's lifeline of foreign capital, tanking the dollar and crippling the economy. And, truth be told, it is not clear that the U.S. Navy, much diminished by decades of penny-pinching, could put up much of a fight against the world's pre-eminent superpower.

I'm not saying that's our future; there are alternative (though equally ugly) possibilities. When America's ballooning federal debt becomes unmanageable, we might simply refuse to honor our obligations, triggering a worldwide financial collapse and an economic downturn that would make the recent unpleasantness seem like a walk in the park. Or we might create enough money to pay back our creditors, domestic and foreign, triggering a hyperinflation reminiscent of failed states like the Weimar Republic in the 1930s (or, more recently, Zimbabwe) that would wipe out the savings of anyone caught holding wealth in dollars.

The bottom line here (and I do mean bottom): while nobody knows exactly how or when catastrophic budget failure will play out, disaster is assured unless the federal government reins in its profligate ways.



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THE BAD NEWS

The Great Recession has provided a taste of budget deficits to come. In the 2009 fiscal year, the U.S. Treasury borrowed \$1.4 trillion, nearly 10 percent of GDP, and it is expected to borrow even more this year. Those giant deficits are financing a massive effort to avoid a repeat of the Depression of the 1930s – something most economists believe to be a good investment. But the borrowing will hardly end when the economy recovers. President Obama’s 2010 budget projects almost \$9 trillion in additional deficits in 2011-20. By 2020, trillion-dollar deficits will become the norm even in years of solid economic growth and low unemployment, rather than an unpleasant aberration linked to a deep recession.

Absent wrenching changes in fiscal policy, things will only get worse after that. The retirement of the baby boom generation and the growth of health costs at a rate far faster than the growth of GDP mean that government spending on Social Security, Medicare and Medicaid (which pays for most nursing-home care for the elderly) is likely to explode. By the nonpartisan Congressional Budget Office’s reckoning, spending on those three programs alone is expected to reach 18 percent of GDP in the year 2040. That is the average level of revenues, measured as a portion of GDP, that the federal government has collected over the past 50 years. So, in this scenario, there would be nothing left to pay for everything from defense to interest on the debt. Thus, unless those entitlement programs (and other spending) can be drastically curtailed

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or taxes raised significantly, large and growing deficits are a certainty.

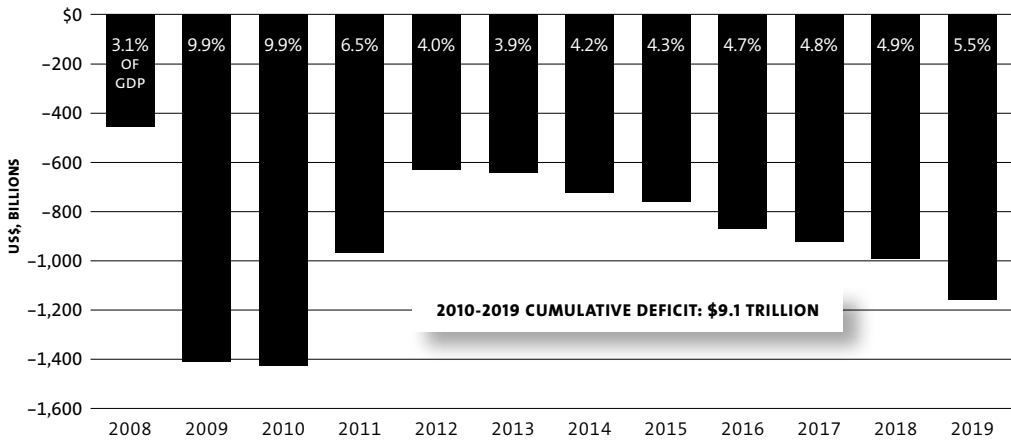
But the auguries aren’t good. Both political parties have become advocates of low taxes. President Obama’s State of the Union address was a veritable panegyric to the virtues of tax cuts (although he is willing to raise taxes a bit for the rich in general, and rich bankers in particular). And now that Republicans have become defenders of spending every last dollar that Medicare recipients are currently promised, the prospect of reining in entitlement programs seems more remote than ever.

In a politics-as-usual scenario, with no changes in the current policy of low taxes and unrestrained entitlement growth, the federal debt is projected to reach 100 percent of GDP by 2023. By 2038, it would reach 200 percent of GDP.

Note, moreover, that these CBO projections – as bleak as they seem – rest on wildly optimistic assumptions. They presuppose that interest rates on government securities will remain historically low, and that the economy will grow at a historically healthy clip. Indeed, in these projections, the average real interest rate (the nominal rate less the rate of inflation) actually falls from 4 percent to 3 percent from 2013 to 2024 and remains there throughout the period – this in spite of the projection that the annual deficits will increase steadily from 2013 onward.

That relatively rosy chain of events is unlikely to pan out. Bill Gale (Brookings Institution) and Peter Orszag (the current White House budget director) estimated back in 2004 that interest rates go up by 0.4 to 0.7 percentage points for every one percentage point increase in the deficit as a portion of GDP. By that calculation, one would expect rates to increase by at least four percentage points between 2013 and 2083. So interest payments on the debt – and thus the average annual

CBO DEFICIT PROJECTIONS FOR OBAMA'S BUDGET



SOURCE: CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2010* (June 2009); "Monthly Budget Review," Fiscal Year 2009 (November 6, 2009)

federal deficit – will almost certainly be far, far higher than CBO is projecting.

The CBO also assumes that GDP growth will resume its long-term trend rate after the current recession is just a bitter memory. If interest rates respond as Gale and Orszag predict, however, growth will surely stagnate because businesses will find it much more expensive to finance capital investments, and households will have to stretch to borrow money to buy houses and cars. Carmen Reinhart (University of Maryland) and Kenneth Rogoff (Harvard) estimate from the experience of other economies that debt in excess of 90 percent of GDP cuts growth by an average of 1.3 percentage points annually. Using that gloomier projection, GDP in the United States in 2073 would be just half of the CBO's current projection.

As Herb Stein, President Nixon's economic adviser, famously put it, "If something cannot go on forever, it will stop." And one must wonder how the tautology applies here. Perhaps, if government borrowing noticeably increased interest rates, the debt would become salient to voters in their daily lives, and politi-

cians and policymakers would respond. That happened in 1983: interest rates soared and voters connected the higher borrowing costs with growing deficits. Wall Street complained to Ronald Reagan that high interest rates were stifling investment, and he reacted by supporting a significant tax increase to reduce the deficit.

The first President Bush and President Clinton sustained the fiscal restraint, but George W. Bush aggressively pushed tax cuts and new spending initiatives (notably for homeland security, defense and the Medicare prescription drug entitlement) even as deficits soared. And in contrast to the early 1980s, credit markets sent no clear signal of distress – in large part because a flood of capital from overseas (from both private investors and central banks eager to maintain the exchange value of the dollar) kept interest rates near historical lows. Deficit finance seemed almost free of political or economic consequences, while tax increases or significant program cuts entailed clear political risks.

Although they criticized Bush's fiscal stewardship in general terms, both Barack Obama

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and John McCain failed to offer plausible plans for stanching the cash hemorrhage. Obama promised to extend most of the Bush tax cuts and to enact a host of other populist tax breaks and spending programs. McCain, for his part, was more restrained on spending, but the enormous tax cuts he proposed would have blown an even bigger hole in the budget. The candidates were plainly convinced that there was no gain to be had in specifying how they would manage ongoing deficits.

President Obama has since said the right things (though in general terms) about the long-run fiscal problem, and he did make the gesture of supporting a freeze on some forms of spending in his 2010 budget. But there are good economic reasons for staying deep in the red in the near term – big deficits are needed to recover from the recession – and even more potent political reasons to tread cautiously in this arena.

I haven't been in the relevant room since I worked in Clinton's Treasury, but I can imagine a discussion among Obama's advisers going something like this:

Mr. President, if you raise taxes or cut popular programs, you and your party will be defeated in the polls and the bad guys will take over. The bad guys do not share your priorities and they do not care about the deficit. Therefore, you cannot effectively deal with the deficit; all you can do is undermine your agenda.

Conclusion: it is impossible to deal with the deficit, so don't even try.

I suspect that Republicans willing to entertain a compromise on taxes to reduce the deficit are hearing a similar message. Certainly McCain, whose program was fiscally responsible when he ran in the Republican presidential primaries in 2000, became convinced that prudence had no political traction in 2008.

So if the pretzel logic of pandering politi-

cians prevents leadership on the issue, what about the financial markets? Shouldn't they start pricing the risk of fiscally driven inflation into interest rates in their bids for freshly minted Treasury bonds? Probably, but I'm not certain they will. Remember, the markets are led by the same geniuses who staked the future of their firms on the premise that housing prices could only go up.

There's an analogy between the market for government bonds and the market for mortgage-backed securities. Specifically, it is tempting to assume that the U.S. government will always be able to roll over its debt when the debt comes due. And while endless deficits imply growth in the amount of interest that must be paid out as a portion of tax revenues and GDP, the payments will remain manageable for decades at a real interest rate of 3 or 4 percent. So bond buyers can be lulled into believing that, while the gravy train may someday stop, there's still time to profit from the ride.

This creates the potential for a classic bubble in the market for government bonds. As long as interest rates remain low, the bonds are safe – which seemingly justifies the low rates. The bubble bursts when something causes investors to worry about the risk of default, and the prospect becomes self-fulfilling.

A small perceived risk that Washington won't make timely payments on the debt would cause investors to demand higher interest rates on new bond issues. But higher interest payments mean higher deficits and a greater risk that the Treasury would be forced to default on its obligations – which in turn would increase interest rates further, creating a vicious cycle. In the extreme, investors might decide overnight that the government couldn't possibly repay its debts and lending would skid to a halt. (The subprime mortgage market in 2008, flourishing one day and dead the



next, is a great example of how this happens.)

At that point, we would face a crisis. Even if Washington remained absolutely committed to meeting its obligations to its creditors, it wouldn't be able to sell bonds in private financial markets. That would leave the Treasury with the unpleasant option of printing money – in modern terms, this means selling bonds to the Federal Reserve and increasing the reserves of the banking system – and thereby spiking inflationary expectations.

There are other courses of action that could produce this kind of bubble in the market for Treasury securities. For example, in economists' "herd" models, everyone might know the market is experiencing a bubble,

but there is a market leader who thinks he or she can make more money before the bubble bursts. Others follow, until the leader pulls out. At that point, the bulls all turn to bears and the market collapses.

A further complication is that the herd leader may well be China – holder of roughly \$800 billion in Treasury IOUs and another half-trillion in federally guaranteed securities. Now, China has motives, other than the prospect of profit, for lending to the United States. Our borrowing pays for our imports from China – purchases that sustain economic growth and create jobs in that Asian country. Other investors in dollar securities have, to date, concluded that China is stuck in this

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dysfunctional relationship with America. But if China signaled a change of heart – either because it feared taking big losses on its holdings of Treasury bonds or because it decided that the Chinese economy had reached the level of diversification to make do without U.S. export markets – investors would rush for the exits.

Most disconcerting is the prospect that China, or some other large creditor in Asia or the Persian Gulf, might decide to use our financial dependence for strategic advantage. The Chinese, for example, might use their leverage to demote the United States from the ranks of the financial superpowers, figuring the political gains were worth the costs of losses on its bond holdings and temporary disruption in its export markets.

PAYING THE PIPER

We might look to history for analogies. My favorite: In 400 BC, Dionysius of Syracuse (a Greek colony on Sicily) was proving to be fiscally irresponsible. He liked parties, gold and palaces (not to mention costly military adventures), and eventually found himself unable to pay his debts. He commanded his citizens, on pain of death, to turn in their one-drachma coins. He then stamped them as two-drachma coins and repaid citizens with the debased currency. Other profligate rulers achieved similar ends by shaving metal from the edges of coins or by diluting gold with base metals in order to expand the money supply.

In their wonderful compendium of budget-disaster stories, Reinhart and Rogoff found that, through history, expanding the money supply (“monetizing the debt”) was the favored response to a debt crisis. There are less crude ways of doing this than the method chosen by Dionysius. And while the

Federal Reserve would, of course, not willingly give up its ability to contain the money supply as a means of maintaining price stability, it might not have a choice.

The alternative, default on debt payments, would be a disaster for the member banks of the Federal Reserve System since they hold their reserves in Treasury securities. So default would very likely cause a systemic financial market collapse. Ironically, the “riskless asset,” rather than subprime mortgages or other high-risk investments, would be the culprit.

While creating money “works” in the limited sense that it makes it possible to pay off government creditors, the cost of the resulting inflation should not be underestimated. All owners of assets that paid returns in fixed amounts of dollars (including all U.S. financial institutions) would experience a decline in wealth. Indeed, financial institutions would suffer much greater losses than in the 2008 financial crisis, and the insolvent federal government would be powerless to help them. The “wealth effect” of depreciating asset holdings would significantly cut domestic consumption, compounding the recessionary impact of the tax increases and spending cuts that would be necessary to cope with the budget deficit.

Since most business contracts create obligations in dollars and lack provisions for adjustments for inflation, many firms would suffer huge losses and many would fail. More generally, the economy would become far less efficient at delivering the goods and services that people value most because the price signals that drive resource allocation would lose their utility.

Whether we defaulted on the debt explicitly, or implicitly through inflation, further borrowing would become impossible or prohibitively expensive. Washington would thus suddenly need to start paying bills upfront.

The longer it takes for the crisis to manifest, the greater the tax increases and spending cuts needed to manage the task because the structural budget deficit is growing all the time. For example, in 2030, the primary deficit (the deficit not including interest) will amount to about 6 percent of GDP – almost one-third of total federal tax collections under current law.

Since either default or runaway inflation would impose huge costs on all lenders, they would be tempted to try to work out some sort of concessionary payment arrangement for the Treasury.

Other governments and international agencies would probably agree to lend us money for a while in exchange for guarantees that we would slash spending and raise taxes to eliminate the large structural deficit. This, after all, is what the United States and the International Monetary Fund have done on numerous occasions as the price of financial bailouts for other countries. But the resulting fiscal adjustments would themselves magnify the short-term economic damage. Indeed, massive spending cuts and tax increases on top of a financial crisis would be a recipe for a recession or depression. Combined with sharp reductions in borrowing (and in access to foreign capital), this would translate into a large drop in U.S. demand for imports, which could easily spread the economic crisis to the rest of the world.

In any event, the United States might simply decide that the economic and political costs of default or hyperinflation were less than the costs of the draconian fiscal tightening required by our lenders. So an acceptable workout arrangement might not be feasible.

Reinhart and Rogoff's survey of past debt crises suggests that they lead to slower growth and higher unemployment for several years – a bleak enough outcome. However, it is not

clear how relevant the historical experience would be to a debt crisis of this severity in an economy that produces one-fifth of the world's GDP and is home to the world's largest financial markets. It could easily take a generation or longer to recover from the disaster.

Neither liberals nor conservatives would be able to take solace in this outcome. Yes, government would be radically downsized and out-of-control entitlement programs

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would finally come under the knife, fulfilling a wish of the Tea Party crowd. But the eviscerated government would have to generate higher taxes than we have ever paid in this country. Indeed, such a denouement might provide the answer to the question: When will the United States follow the lead of Europe and adopt a massive value-added tax? And if senior citizens, who will make up a growing and very powerful voting bloc, resist major cuts to Social Security, Medicare and Medicaid, we could experience taxes so high they would make even Scandinavians revolt – at the same time that other priorities like national defense, education, infrastructure and services to working-age families and children were gutted.



WHEN WILL THE CRISIS OCCUR?

It would be nice to pinpoint a date when our fiscal policy is slated to pass from reckless and irresponsible to crippling and irreparable. But there is no magic threshold. It depends on the era and doubtless other factors, including the attitudes of the big creditors.

That said, nearly one-fifth of countries that have defaulted or required debt restructuring had external debt of less than 40 percent of GNP, and more than half of countries experiencing debt crises had debt levels below 60 percent of GNP. Thus, 60 percent might be viewed as a rough threshold.

It's true that the United States amassed a debt of 109 percent of GDP by the end of World War II, which we were able to pay

down fairly quickly and without great trauma. However, the process was helped along by an enormous peace dividend: Simply removing millions of soldiers from the federal payroll and slashing spending for war materials created fiscal surpluses. Moreover, the fiscal retrenchment had a relatively modest impact on aggregate demand because the end of war-time rationing led to an explosion of private spending on houses, cars and the like. Even so, there was a recession in 1946, which was probably precipitated by the sudden cut in government spending.

In contrast, the next time our debt hits 100 percent – 2023 by CBO's projections – the government will be spending 23 percent more than it takes in before counting interest.

Draconian and unprecedented spending cuts or similarly disruptive tax increases would be necessary to eliminate such an imbalance. And a highly contractionary fiscal policy would most likely push the economy into a very deep recession, which would further depress revenues and increase demands for government services and transfer payments (for example, unemployment insurance and food stamps). Thus, our economy will be much more vulnerable the next time our debt hits 100 percent of GDP.

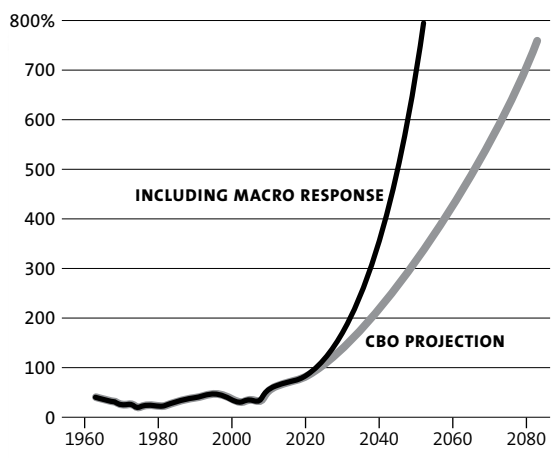
CAN WE AVOID BUDGET CATASTROPHE?

President Obama and his senior advisers are clearly concerned about the long-term budget situation, and recent opinion polls suggest that the public would support a more prudent fiscal policy – at least until the sacrifices the change entailed were spelled out. Jens Henriksson, who served several ministers of finance in Sweden as that country dealt with its own debt crisis, advises that liberals could signal commitment by offering to cut spending, and that conservatives could do likewise by offering to support tax increases. For example, the president could offer to pare spending by a dollar for every dollar that taxes increase. But for better or worse, America is not Sweden.

The president promises to establish a blue-ribbon commission to make recommendations on deficit reduction. The idea is to provide bipartisan cover for politically unpopular tax increases and spending cuts. But most Senate Republicans (along with a good number of Democrats) have already rejected the idea of setting up a deficit commission, and Republicans have vowed to reject the recommendations of any commission the president sets up on his own.

Perhaps the public would be galvanized to sacrifice by tangible evidence that the debt is weakening America's capacity to project

PROJECTIONS OF DEBT HELD BY THE PUBLIC PERCENTAGE OF GDP



SOURCE: Congressional Budget Office and author's calculations

power and to influence the behavior of other countries. Some would argue that this is already happening: President Obama soft-pedaled human rights issues during his first visit to China, reportedly because he was reluctant to alienate America's largest creditor.

Distressingly, none of the possible courses of events in which Americans wake up one day and decide that enough is enough – that treasured entitlements, including Medicare and Medicaid, must be trimmed and that taxes must be raised in order to protect the economy (and our grandchildren's living standards) from deep decline – seem very plausible. That suggests it might take a traumatic event – a debt crisis that delivers a one-two-three punch in the form of inflation, deep recession and the collapse of the dollar – to alter the politics of deficit reduction.

Like the proverbial frog that fails to jump out of the soup pot as the temperature slowly rises, Americans seem terrifyingly unwilling to act until the pain of debt can no longer be ignored. As the frog learns in its final moments, by then, it's too late. **M**