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Exploding debt threatens America

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Standard and Poor's decision to downgrade its outlook for British sovereign debt from "stable" to "negative" should be a wake-up call for the US Congress and administration. Let us hope they wake up.

Under President Barack Obama's budget plan, the federal debt is exploding. To be precise, it is rising – and will continue to rise – much faster than gross domestic product, a measure of America's ability to service it. The federal debt was equivalent to 41 per cent of GDP at the end of 2008; the Congressional Budget Office projects it will increase to 82 per cent of GDP in 10 years. With no change in policy, it could hit 100 per cent of GDP in just another five years.

"A government debt burden of that [100 per cent] level, if sustained, would in Standard & Poor's view be incompatible with a triple A rating," as the risk rating agency stated last week.

I believe the risk posed by this debt is systemic and could do more damage to the economy than the recent financial crisis. To understand the size of the risk, take a look at the numbers that Standard and Poor's considers. The deficit in 2019 is expected by the CBO to be $1,200bn (€859bn, £754bn). Income tax revenues are expected to be about $2,000bn that year, so a permanent 60 per cent across-the-board tax increase would be required to balance the budget. Clearly this will not and should not happen. So how else can debt service payments be brought down as a share of GDP?

Inflation will do it. But how much? To bring the debt-to-GDP ratio down to the same level as at the end of 2008 would take a doubling of prices. That 100 per cent increase would make nominal GDP twice as high and thus cut the debt-to-GDP ratio in half, back to 41 from 82 per cent. A 100 per cent increase in the price level means about 10 per cent inflation for 10 years. But it would not be that smooth – probably more like the great inflation of the late 1960s and 1970s with boom followed by bust and recession every three or four years, and a successively higher inflation rate after each recession.

The fact that the Federal Reserve is now buying longer-term Treasuries in an effort to keep Treasury yields low adds credibility to this scary story, because it suggests that the debt will be monetised. That the Fed may have a difficult task reducing its own ballooning balance sheet to prevent inflation increases the risks considerably. And 100 per cent inflation would, of course, mean a 100 per cent depreciation of the dollar. Americans would have to pay $2.80 for a euro; the Japanese could buy a dollar for Y50; and gold would be $2,000 per ounce. This is not a forecast, because policy can change; rather it is an indication of how much systemic risk the government is now creating.

Why might Washington sleep through this wake-up call? You can already hear the excuses.

"We have an unprecedented financial crisis and we must run unprecedented deficits." While there is debate about whether a large deficit today provides economic stimulus, there is no economic theory or evidence that shows that deficits in five or 10 years will help to get us out of this recession. Such thinking is irresponsible. If you believe deficits are good in bad times, then the responsible policy is to try to balance the budget in good times. The CBO projects that the economy will be back to delivering on its potential growth by 2014. A responsible budget would lay out proposals for balancing the budget by then rather than aim for trillion-dollar deficits.

Top officials are calling for a powerful systemic risk regulator. But the US government is the most serious source of risk

"But we will cut the deficit in half." CBO analysts project that the deficit will be the same in 2019 as the administration estimates for 2010, a zero per cent cut.

"We inherited this mess." The debt was 41 per cent of GDP at the end of 1988, President Ronald Reagan's last year in office, the same as at the end of 2008, President George W. Bush's last year in office. If one thinks policies from Reagan to Bush were mistakes does it make any sense to double down on those mistakes, as with the 80 per cent debt-to-GDP level projected when Mr Obama leaves office?

The time for such excuses is over. They paint a picture of a government that is not working, one that creates risks rather than reduces them. Good government should be a nonpartisan issue. I have written that government actions and interventions in the past several years caused, prolonged and worsened the financial crisis. The problem is that policy is getting worse not better. Top government officials, including the heads of the US Treasury, the Fed, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission are calling for the creation of a powerful systemic risk regulator to reign in systemic risk in the private sector. But their government is now the most serious source of systemic risk.

The good news is that it is not too late. There is time to wake up, to make a mid-course correction, to get back on track. Many blame the rating agencies for not telling us about systemic risks in the private sector that lead to this crisis. Let us not ignore them when they try to tell us about the risks in the government sector that will lead to the next one.

The writer, a professor of economics at Stanford and a senior fellow at the Hoover Institution, is the author of Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis