

On the Fiscal Road to Serfdom

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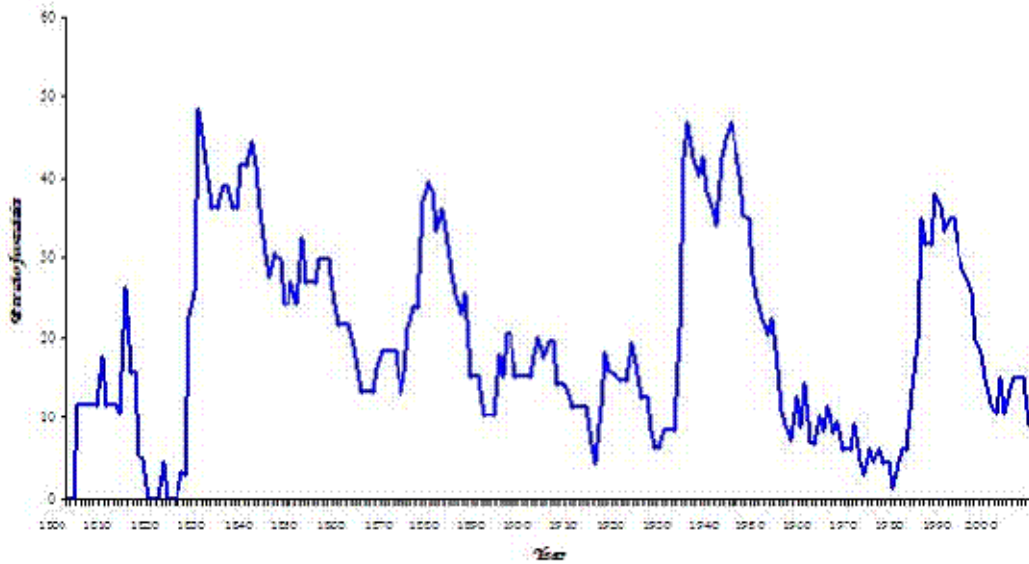
History is littered with examples of major economic and financial crises in countries that have engaged in public spending profligacy. That sad experience should be raising red flags in the United States, where the unsustainable longer-run trajectory of the US public finances is now suggesting the real risk of either a destructive burst of inflation or an outright government debt default. This is particularly the case in today's US context where an ever-increasing portion of the US budget deficit is being financed by foreigners and where entitlement programs threaten over the longer haul to compound an already highly compromised public finance position.

These considerations would suggest that it bears reflecting on (a) what history might teach us about sovereign debt defaults; (b) what special features characterize the present US public finance outlook; and (c) what the end-game might be for a country with unsustainable public finances.

Lessons from History

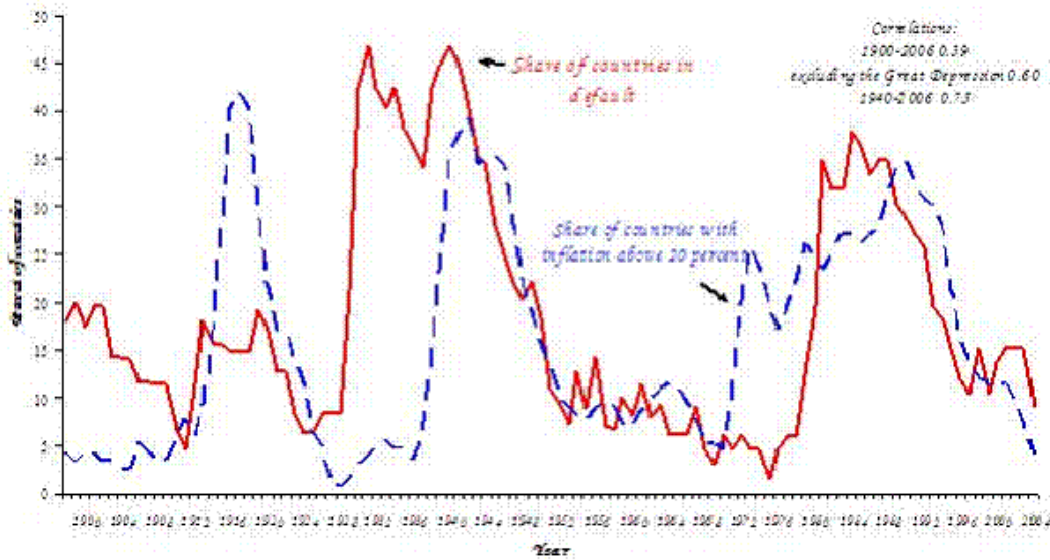
Recent research by Professors Ken Rogoff and Carmen Reinhart on the long run history of external sovereign debt defaults is sobering. In their "Eight Hundred Years of Financial Folly" they show that sovereign debt default is far from an isolated event. Indeed as illustrated by the chart below, they show that over the longer sweep of history, there have been fairly regular episodes where all too many sovereign governments have resorted to defaulting or to restructuring their government debt. By their count, over 40 percent of countries did so in the aftermath of the Great Depression and over 30 percent did the same in the aftermath of the 1980-82 global economic recession.

Sovereign External Debt: 1800-2006
Percent of Countries in Default or Restructuring



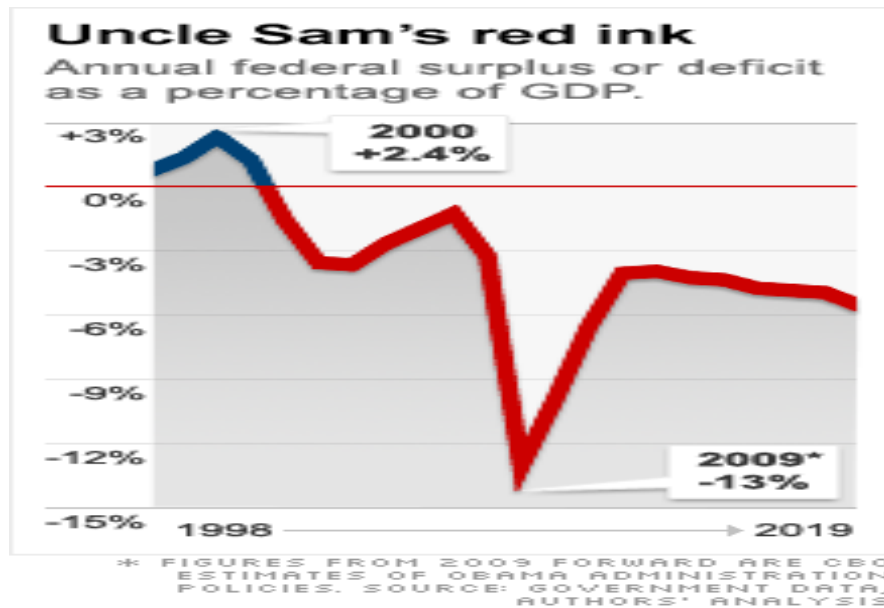
Two further regularities found by Rogoff and Reinhart would seem to be particularly pertinent to today's US context. The first is that those countries most at risk of defaulting on their government debts were those that were overly dependent on capital flows from abroad to finance their government deficits. The second was that sovereign debt default or restructuring tended to be highly disruptive to economic performance in general and to inflation performance in particular.

Inflation and External Default: 1900-2006



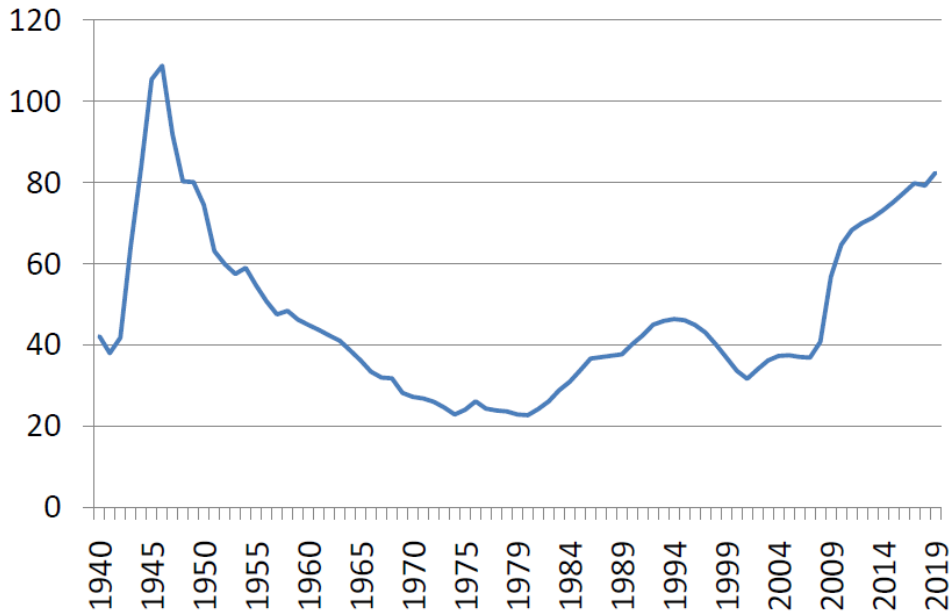
US public finance outlook

Today's US public finances are on an unsustainable path. This is not simply because the US budget deficit is forecast to widen to 13 percent of GDP in 2009 and 11 percent of GDP in 2010 as a result of the combination of a very deep recession and an expansive fiscal stimulus package. Rather, it is because, as estimated by the non-partisan Congressional Budget Office, on present policies the US budget deficit will remain at between 4 percent and 6 percent of GDP even after the US economy has fully recovered from its present economic recession.



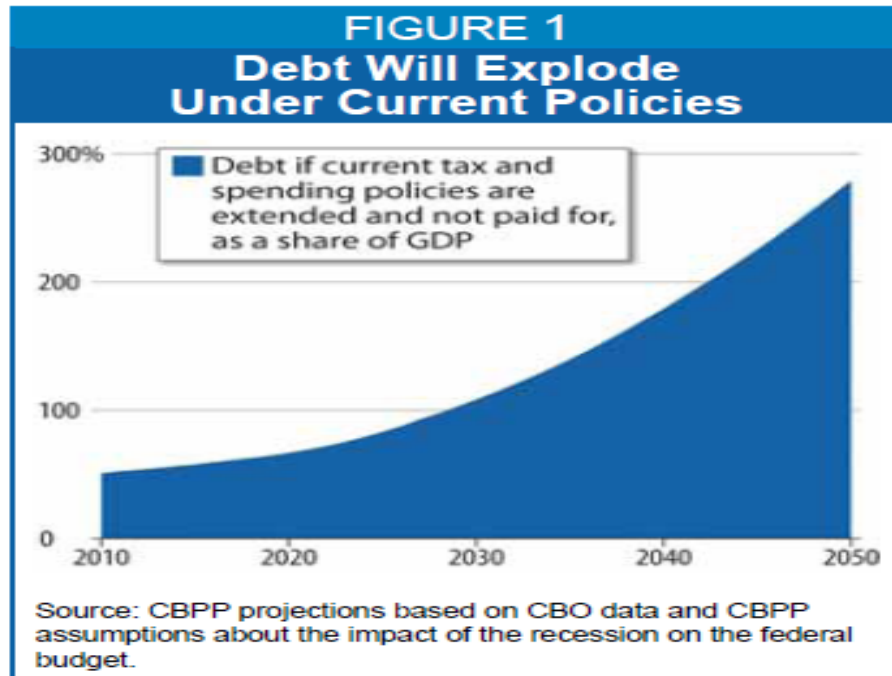
Over the next decade, the US government debt is set to increase at its fastest pace in peacetime history as a result of prospective budget deficits that will be in excess of US\$1 trillion a year over this period. On scoring the Obama Administration's 2009 budget, the CBO estimated that in the absence of policy changes, the net US government debt would approximately double from 42 percent of GDP in 2008 to 83 percent of GDP by 2019. This would take the level of the US government debt way beyond the 60 percent of GDP level considered by the European Maastricht treaty as a prudent level not to be exceeded by an industrialized country.

Federal debt as % of GDP

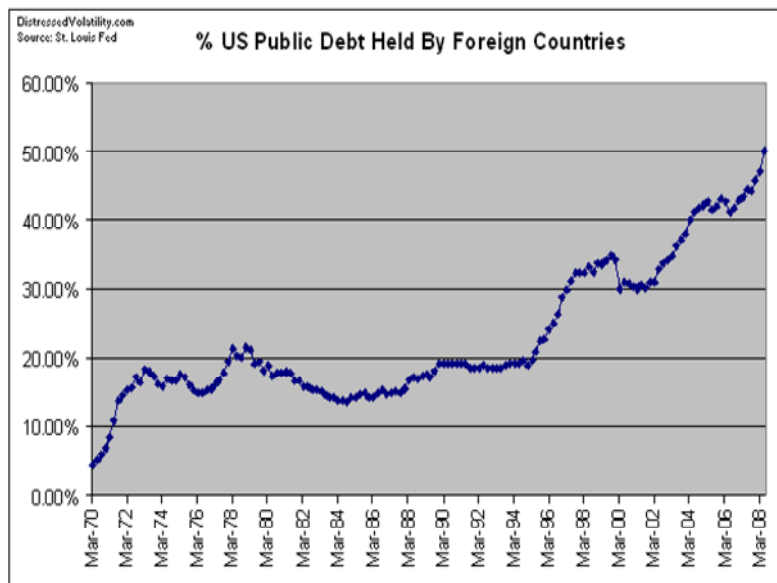


Disturbing as the CBO debt projections over the next decade might be, there are at least two reasons to believe that they underestimate the true level to which the US government debt will rise over the next decade. The first is that the CBO projections are based on relatively optimistic assumptions about the speed of recovery and the pace of US long-run potential economic growth. The second is that they do not include President Obama's costly spending initiatives in the areas of universal health coverage and energy and education reform. Adjusting the CBO's estimates, for these factors would take the US government debt level by the end of this decade to well over the 100 percent of GDP level considered by Standard and Poor's to be an inappropriate level for a AAA-rated sovereign credit.

The prospective more than doubling of the US government debt over the next decade could not be occurring at a worse time. For it comes on the eve of the veritable projected explosion of the Medicare, Medicaid, and Social Security programs as the US demographic picture turns decidedly for the worse. As estimated by the International Monetary Fund, the combined cost of these programs will approximately double from around 8 percentage points of GDP a year at present to 16 percentage points of GDP a year by 2050. As a result, in the absence of bold measures to scale back the size of these entitlement programs, the US government debt is set to increase to around 300 percentage points of GDP by 2050.



A further reason for deep concern about the prospective sharp increase in US government debt over the next decade is the very large degree to which that deficit will have to be financed by foreigners. The proportion of the government deficit financed by foreigners has already increased to an unprecedented 50 percent. At the same time, foreign central banks alone are presently sitting on US\$2 ½ trillion in US Treasury bonds and they are becoming increasingly vociferous about their discomfort about the trajectory of the US public finances. In this context, a failure by the Obama Administration to seriously start redressing the US budget deficit would seem to invite the real risk of a dollar crisis that could be destabilizing for US financial markets and that could complicate the financing of the government deficit.

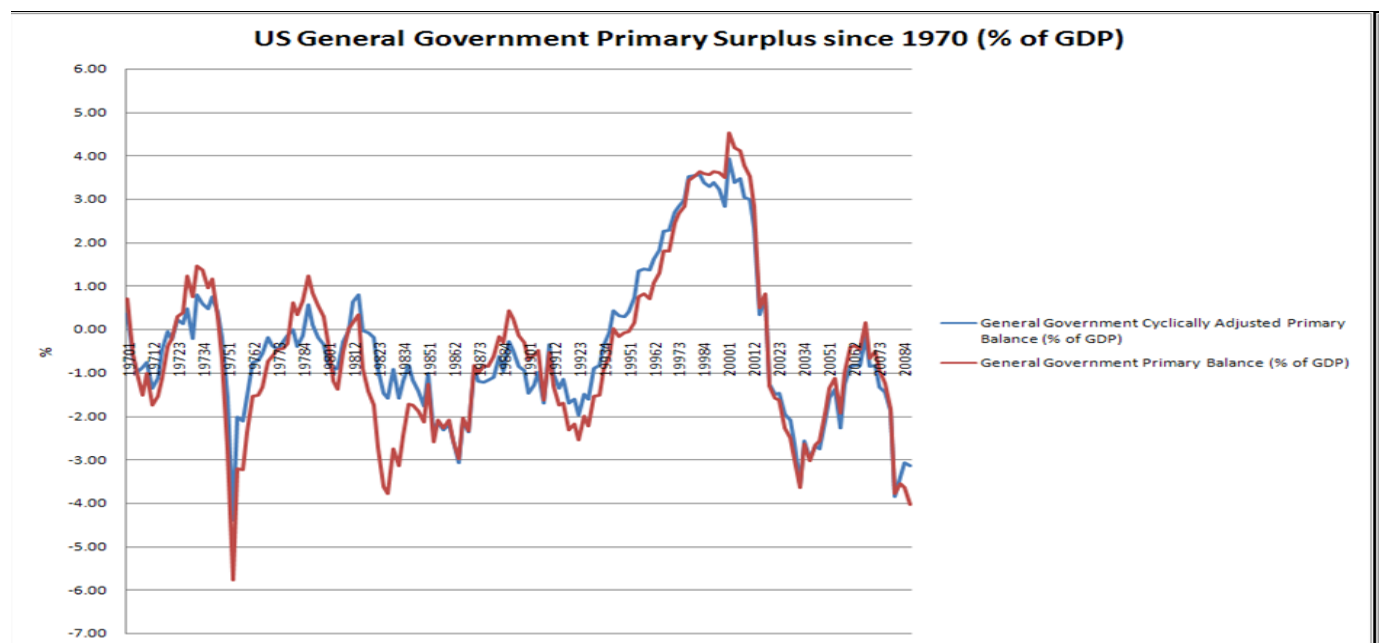


The End Game

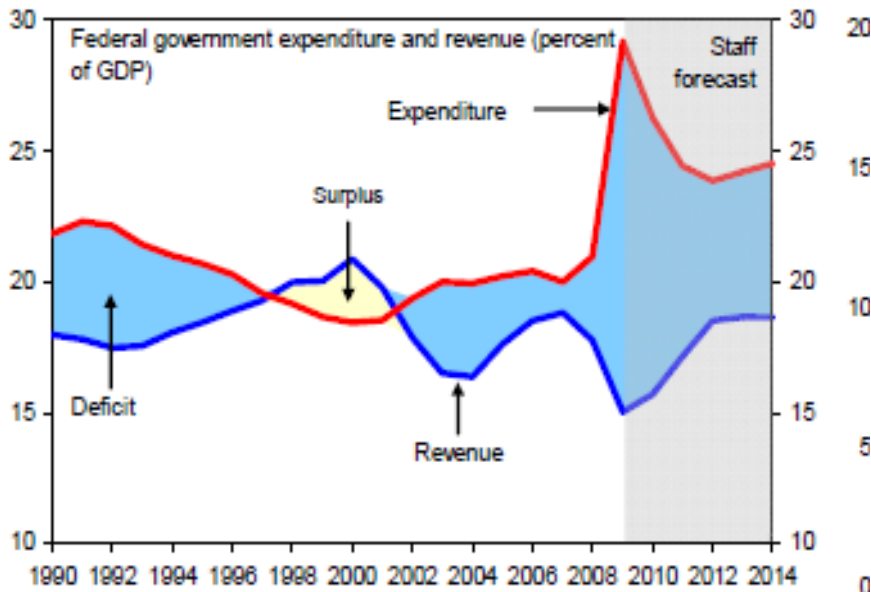
Herb Stein famously said that if something cannot go on forever it will stop. His insight certainly applies to an unsustainable fiscal position. In the present US context, the only two real questions are when and how the end to the lack of fiscal sustainability might occur. On the issue of timing, one can reasonably say that the end-game is likely to occur earlier the wider the budget deficit becomes; the higher the level that the public debt reaches; the greater becomes the government's dependence on foreign sources of financing; and the less convinced markets become about the government's intent to seriously redress the public sector imbalances.

By contrast, one can be a lot more specific about how the end game might occur. In principle, there are only three possible end-games for an unsustainable fiscal position. The first and optimal end-game is for the government to adopt bold expenditure reducing and revenue enhancing measures that might in a credible way return the public finances to a sustainable path. The second end-game, and the one to which the US itself effectively resorted in 1931 when it devalued the dollar against gold, is for the government to default directly on its debt obligations. The third end-game is for the government by design or by default to resort to the monetary printing press to inflate away its debt obligations.

In today's US context, the government would need to credibly commit to bold fiscal measures equivalent to at least 5 percentage points of GDP in order to convince markets that the budget was being placed on a sustainable medium-term path. After all, the government is presently running a primary budget deficit (namely a deficit that excludes interest payments) of around 4 percentage points of GDP. Moreover, public expenditures are set to remain at around 25 percent of GDP over the next decade, while in the absence of policy changes, entitlement program expenditures are set to balloon after 2014.



Economic strains will increase the federal government fiscal deficit...



The Obama Administration gives little indication of bold measures to redress the US public finances. While it does pay lip service to the need for sound long-run public finances, it is as yet to commit itself to concrete measures to cut spending or to raise taxes that might give credence to its intention to restore fiscal sustainability. Nor is it making any real commitment to tackle the looming escalation in public spending on the entitlement programs. Indeed, rather than seeking to radically prune public spending, the Administration seems to be embarked on expansive long-run spending programs on health, energy, and education that will further compromise an already highly tenuous budget position. In the area of health care reform alone, the CBO estimates that the Administration's initiatives could cost US\$1 ½ trillion over the next decade. Similarly far from contemplating meaningful tax increases, President Obama is sticking to his campaign promise of not raising taxes on 95 percent of US taxpayers.

Against the backdrop of a deteriorating US budget deficit outlook, in March 2009, at the depth of the crisis, the credit default swap market was pricing in a 10 percent probability that the US government would default over the next five years. While in principle the US government could default on its sovereign debt, there are compelling reasons to think that it will choose not to go down that path. Amongst the more important of these reasons is the very high immediate cost that a default would impose on the US economy. It would do so in large measure by dislocating domestic financial markets as the solvency of US financial institutions holding US government bonds would be called into question. A US government default would also run the risk of causing a breakdown in globalization as foreign governments would likely retaliate against a US government reneging on its obligations.

An equally compelling reason why the US government would choose not to default on its debt is that, unlike the case of many other countries, practically the entirety of the US government debt is in local currency. As such, the US government always has the option of

issuing its own currency to service its debt. And one would suppose that it would choose to do so in order to avoid the large and immediate cost of defaulting on its obligations.

While attempting to inflate away the government's debt might delay the country's day of reckoning, one would hope that the government will not underestimate the long-run cost of such a course of action. Unless the government was to engineer a sudden and unanticipated inflationary burst, one would expect that, in anticipation of a pick up in inflation, market participants would both shorten the duration of their government debt holdings and demand higher interest payments on longer dated debt to compensate them for the risk of inflation. This would imply that inflation would have to rise to very high levels for an extended period of time to make any dent on the government's debt to GDP ratio. If there is anything that we should have learnt from our experience with high inflation in the 1980s, it is the damage that it does to the overall long-run economic performance and the particularly heavy burden that it places on the weakest members of our society. We should also have learnt how difficult it is to wring inflation out of an economy once inflationary expectations have become untethered.

Conclusion

The US public finances now appear to be on an unsustainable path as is underlined by the prospective largest peace-time run up in the US public debt over the next decade. Historic experience both in the United States and abroad should be reminding us of the heavy toll that such a run-up could exact on the US economy's long-run performance. It should also be suggesting the prudence of the early definition of a credible medium-term strategy to place the US public finances on a more sustainable path, and that strategy should be fully backed by the commitment to concrete spending reducing and revenue enhancing measures.