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A Preventable Crisis: Exploring Fiscal Crisis Scenarios for the United States
April 2010

[T]he fiscal projections for the United States are so stunning that, one way or another, reform will occur. Fiscal policy is on an unsustainable course. The U.S. government must make adjustments in its spending and tax programs. It is that simple. If pre-emptive corrective action is not taken regarding the fiscal outlook, then the United States risks precipitating its own next crisis.
- Thomas Hoenig, President, Federal Reserve Bank of Kansas City (February 2010)[1]

It's important to extinguish a fire when it's still small.
- Ewald Nowotny, Member, European Central Bank Council (March 2010)[2]

Heading Towards a Fiscal Crisis

The current fiscal path of the United States government is unsustainable. For the past forty years, our debt-to-GDP ratio has averaged around 40 percent. This year, it is projected to exceed 60 percent, the highest point since the early 1950s. Under the President's budget proposals, the fiscal situation will continue to deteriorate even as the economy recovers. By the end of the decade, debt is projected to be 90 percent of GDP, approaching our record high of around 110 percent after World War II. Things will deteriorate further as the Baby Boom retirement accelerates. Ten years later, the debt is expected to be well over 150 percent of GDP. By 2050, it is projected to be over 300 percent and still heading upward.

The large and growing debt puts the United States in a perilous position where if we do not act to change the budgetary course, a fiscal crisis in one form or another will surely ensue.

That said, it is not at all clear how exactly such a crisis would unfold—what would prompt it or how it would play out. A crisis could occur as soon as this year, or decades from now. It could begin inside or outside the country. The crisis could be dramatic or gradual. It could come from an economic or another financial shock, or even a political surprise.

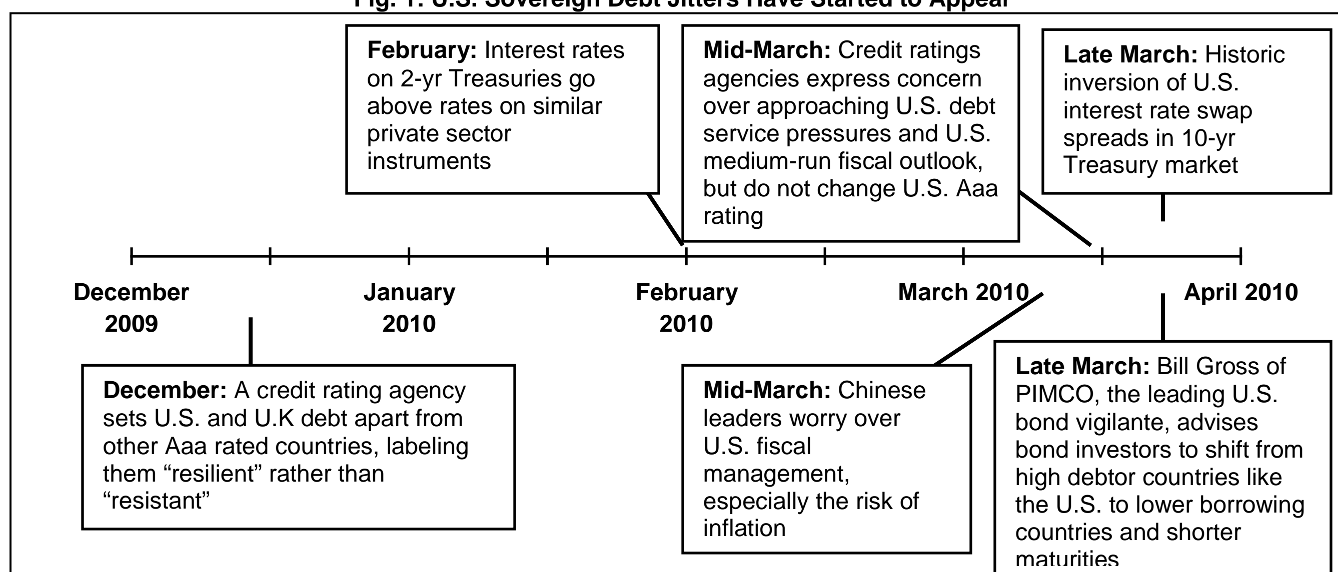
Amidst these uncertainties, we do know that the longer it takes for us to get our fiscal house in order, the more at risk we are and the tougher adjustment will be in the end. Ideally, we would take preventive measures so that we never find out exactly how a U.S. fiscal crisis would play out.

How Would a Crisis Play Out?

Experts agree that we will be in a crisis when we can no longer service our debt obligations. However, we will probably never face this scenario; more likely, a tipping point will come earlier, related to perceptions that the risk of holding our debt has risen.

Because investors are forward-looking, expectations are important. In an influential paper, Robert Rubin, Peter Orszag and Allen Sinai argued that a basic shift in market expectations and loss of confidence at home and abroad can occur when large deficits are projected far into the future; and that the impact of a change in expectations might be worse and more sudden than expected.[3]

Fig. 1: U.S. Sovereign Debt Jitters Have Started to Appear



There are a number of different crisis scenarios:

***Scenario 1:* The Gradual Crisis – We muddle along**

We stay the current course and try to muddle through. Our massive borrowing leads to less capital available for productive private investment, which lowers economic growth. Increasing debt service payments—particularly when interest rates return to normal—squeeze out other areas of the budget. The steady crowding out of government spending on programs that boost the economy, such as spending for education, infrastructure and innovation, will hurt our competitiveness. Without an abrupt crisis, there is no impetus for policymakers, who delay taking action, to strategically think about how to spend

[1] Thomas Hoenig, President, Federal Reserve Bank of Kansas City, "Knocking on the Central Bank's Door," Remarks to the Peterson-Pew Budget Reform Policy Forum, Washington, D.C., February 16, 2010, p.10.

[2] "ECB's Nowotny Says Governments May Face Threat of 'Debt Spiral'," *BusinessWeek.com,* March 15, 2010.

[3] See Robert E. Rubin, Peter R. Orszag, Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," January 4, 2004.

limited government resources without hurting growth. Instead, excessive borrowing and the gradual erosion of government investment dampen standards of living in the U.S.

A gradual fiscal crisis can be more dangerous than a fiscal emergency because the causes and damage are not obvious (although the adjustment required is probably easier to bear). A gradual fiscal crisis can appear in ways that may be difficult for the taxpayer to connect to our fiscal imbalances. For example, as crime worsens, roads deteriorate, or public transport becomes increasingly unreliable and unsafe, the public may not understand, and could further devalue government as ineffective or inefficient. In reality, limited resources and poor resource allocation are robbing the taxpayer of high quality public finance. Without a crisis that is easy to understand and galvanizes action, it is harder politically to make the case for overhauling the budget. Ultimately, we lose investor confidence and Scenario 2 kicks in.

Scenario 2: **The Political Risk Crisis – Political calculations trump risk threats**
Because policymakers continue to posture for political gain, they fail to agree on steps to get our fiscal house in order before the situation gets even worse as the Baby Boomers transition into their retirement years. The Inside-the-Beltway view continues to be that better fiscal management is not worth the political price politicians would have to pay. Those trying to improve our fiscal situation are attacked and risk losing their seats in or control of Congress and the White House. When leaders from the two parties try to make changes, they are savaged by a polarized media and outside organizations. Our political leaders follow rather than lead the public conversation, thereby losing the opportunity to turn the situation. Rather than tackling our fiscal challenges, politicians make them worse by expanding medical and retirement safety net programs for Baby Boom senior citizens, who increasingly dominate the political scene. Anti-tax fever also grows while citizens continue to demand government services.

As a result, more budget resources are shifted from children to seniors, and from investment in programs boosting future growth. Government functions become less efficient, and the fiscal gap widens. Politicians are bolstered in their actions by their strong belief that the United States can delay or avoid fiscal adjustment because it has more running room than other countries with similar problems: demand for dollar-denominated assets will remain high because our major trade partners are conducting even worse fiscal policies and foreigners will prefer to hold dollars, the unchallenged world reserve currency.

The scenario worsens when creditors lose confidence in U.S. fiscal management. Our creditors increasingly demand large risk premiums on purchases of their debt, sharply lower their purchases of our debt, or, in the worst case, stop buying our debt if the shift occurs suddenly. Credit ratings agencies lower our sovereign credit rating.

U.S. interest rates rise from market pressures. At the same time, the dollar begins to fall, as capital shifts elsewhere and U.S. domestic savings cannot fill the gap. If currency shifts are rapid, the Federal Reserve raises interest rates to defend the dollar and keep the lid on imported inflation from the dollar's depreciation. The economy goes into a severe recession as interest sensitive sectors are hard hit. Our fiscal situation deteriorates further: our countercyclical automatic stabilizers kick in (including a rise in unemployment insurance spending) and revenues slow or decline. Because investors are worried about our debt, we cannot easily finance more borrowing.

We have no choice: dramatic and draconian fiscal adjustment is forced on the United States. Essential government services are cut dramatically, state funds are curtailed, taxes are increased sharply, and entitlement spending and funding are tightened. Our underlying basic growth slows and living standards are lower.

Scenario 3: **Catastrophic Budget Failure – An abrupt crisis occurs**

If low interest rates lead to continued debt accumulation and then suddenly, creditor preferences shift, we could experience a "catastrophic budget failure" as set out in a recent paper by Len Burman of the Maxwell School at Syracuse University and his colleagues at the Tax Policy Center.[4]

Under this scenario, at some point financial markets or foreign lenders decide we are no longer a good credit risk, possibly due to debt affordability concerns. They conclude the United States cannot escape basic economic and financial "laws of gravity" forever. They stop buying our debt securities or demand dramatically higher interest rates due to increased perceived risk. With the sudden shift and large rise in interest rates, the economy goes into a severe recession. ("The longer it takes for the crisis to occur, the worse it will be.") Unlike the past two years, we cannot, however, borrow to stimulate the economy because the crisis was caused by excessive debt and lost confidence. "In the extreme case, the U.S. may not be able to borrow at any interest rate."[5] Creditors concerned with hyperinflation or even default will not buy U.S. debt.

A variation on this scenario is that we are lured into complacency for other reasons: other countries' fiscal and economic situations look even worse or investors (including the world's central banks) still regard the United States as the preferred market and a safe haven. Plus, when the U.S. current account deficit resumes widening with the U.S. growth recovery, our leading trade partners continue to accumulate dollar reserves quickly rather than allow their currencies to appreciate. Those dollars are invested in Treasury instruments, which sustain strong demand for our debt. Politicians ignore warnings of fiscal peril and global imbalances because a U.S. fiscal crisis has never

[4] Leonard E. Burman, Jeffrey Rohaly, Joseph Rosenberg, Katherine C. Lim, "Catastrophic Budget Failure," TPC-USC Conference, "Train Wreck: A Conference on America's Looming Fiscal Crisis," January 15, 2010.

[5] Passages quoted are drawn from Burman, *op.cit*., pp.13,9.

occurred. As Fred Bergsten recently warned, while we have long worried that foreigners might eventually not finance our external deficits, it might be even worse if they do.[6]

Scenario 4: **Inflation Crisis - Higher debt is managed through inflation**
U.S. policymakers cannot agree on a responsible fiscal policy. Over time, central bank independence has been diminished by increasingly aggressive and public Congressional oversight of its monetary policy decisions or by political appointees to the Fed Board who remain close to the political leadership of a particular party. Under strong political pressure, the Fed accommodates the higher debt: it does not raise interest rates despite signs of increasing inflationary pressures. Our creditors (especially foreigners) become increasingly worried about real losses on their dollar-denominated assets. They demand sharply higher risk premiums on their Treasury purchases to compensate for inflation but also sharply and rapidly reduce their holdings of U.S. government assets.

In the end, the adjustment of inflation expectations by our creditors wipes out any immediate advantages from an attempt to inflate our way out of debt. We face a sharp fall in the dollar, a rapid pick-up in inflation from the Fed monetization plus the impact of the dollar's fall on imports, a dramatic rise in interest rates, and a severe recession. These conditions force us into dramatic deficit reduction because we cannot finance our fiscal position, but fiscal consolidation at a time of recession worsens matters. For the weakest among us - seniors and others on a fixed income (including the poor) - inflation erodes purchasing power unless offset by indexation (unaffordable at a time of budget crisis). Fiscal consolidation will require spending cuts that will hurt safety net programs. Business investment incentives will disappear and tax rates will rise, as policymakers search for revenue. Household taxes rise and government services are reduced.

Scenario 5: **External Crisis - A dollar or trade crisis leads to a fiscal crisis**
When the economy recovers in a few years, our current account deficit (which had narrowed during the recession) resumes widening to record levels. In a scenario associated with C. Fred Bergsten and Stephen Marris, large external deficits pose substantial risks to the US economy.[7] Capital inflows slow abruptly as investors see better risk-return opportunities elsewhere, decide the risks of the U.S. market are too high, and/or try not to be the last out of dollars, as the fundamental effects from the trade deficit push down the dollar. A sudden stop in lending lowers the dollar, increases inflation and interest rates, and brings on a hard landing for the United States and the world economy. Fiscal adjustment is forced upon us.

Scenario 6: **Default Crisis - A series of events lead to a default**
The U.S. delays fiscal adjustment this decade due to paralysis in the political system. We are however able to continue financing our huge deficits by paying large interest premiums to investors to buy our debt. Fortunately, the U.S. market and the dollar

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[6] C. Fred Bergsten, *op.cit.*, p.21. See also Burman, *ibid.*, p. 6.
[7] See Stephen Marris, *Deficits and the Dollar: The World Economy at Risk*, 1987.

continue to be relatively attractive. However, our need to pay higher interest rates increases debt service and crowds out public and private spending. We are able, with difficulty, to maintain this situation, but a tipping point finally comes when Baby Boom retirement accelerates and puts increased strains on the budget. Politicians finally agree on a multiyear fiscal consolidation plan and changes to retirement and health programs.

The adjustments needed to get our fiscal house in order are larger than those we would have needed ten years earlier. However, when the pain from fiscal adjustment becomes too great, political pressure forces a U-turn in U.S. economic policy. A new administration defaults or attempts to renegotiate our debts. Burned creditors stop buying U.S. debt or demand onerous interest premiums. Domestic interest rates jump to record levels, the economy sharply contracts, and taxpayers are a lot worse off. Severe fiscal consolidation is forced upon us.

Flashpoints for a Crisis and the Rise of Risk

While these scenarios are difficult to envision as we still can borrow at extremely favorable rates, the current economic and financial crisis has brought forward the risk of a fiscal crisis. The country has a number of points of vulnerability:

Debt leverage and affordability. A country which increases its leverage by issuing more debt as a share of GDP, as is the case in the United States, becomes increasingly vulnerable to a "shock" (an unexpected event). Recent research by Carmen Reinhart and Kenneth Rogoff also suggests that countries with gross government debt over 90 percent of GDP have "notably" lower growth.[8] Our gross debt is expected to hit the 90 percent threshold this year.[9] In terms of affordability, Moody's has warned that our Aaa rating will be at risk if debt service rises as projected.[10]

Low domestic savings and dependence on foreign capital. Countries that have sufficient domestic savings to finance their debt are less vulnerable than those that must attract considerable foreign capital—such as the United States. Because of our low domestic savings, we need foreigners to buy our Treasury instruments in order to sustain a reasonable growth path. All told, foreigners currently hold about half of U.S. debt, up from a third one decade ago. The largest foreign holders of U.S. public debt are China and Japan, followed by the oil exporters, the U.K., Brazil and Hong Kong.[11]

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[8] Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt," *National Bureau of Economic Research Working Paper 15639*, January 2010, pp. 22-23.

[9] These finding have been widely interpreted to apply to "debt held by the public" rather than "gross debt". Reinhart and Rogoff cite "gross debt". Depending on which concept is used, we are projected to hit the 90 percent debt threshold either this year ("gross debt") or 2020 ("debt held by public").

[10] "U.S., U.K. Move Closer to Losing Rating, Moody's Says (Update 1)," Bloomberg.com, March 15, 2010.

[11] U.S. Department of the Treasury, "Major Foreign Holders of Treasury Securities," April 15, 2010.

Our large current account deficit. Linked to our capital inflow problem and so importantly related to our fiscal deficit, our large trade deficit outlook is considered unsustainable and a likely crisis flash point.[12] Given basic trends, the dollar must eventually fall until trade flows shift to a more sustainable balance. If the dollar's decline is sudden and large, there would be severe fiscal consequences, particularly as many of our creditors are foreign and thus exposed to currency risk.

Financial sector linkages. While not necessarily driven by fiscal issues, a financial sector crisis can have huge fiscal implications, as we have just seen. Experts are concerned that financial innovations as now managed and regulated have increased risk. They worry that the increased complexity of counterparty risk chains (including hedge funds and other nonbanks) makes critical linkages impossible to track.[13]

Political risk. If no serious attempt to tackle our fiscal problems is considered likely, political risk worries will rise among our creditors – well before our actual capacity to service our debts is in doubt. We may, in fact, already be near that point. With our policymakers at a hyper-politicized stalemate over the direction of fiscal policy and no end in sight, the credibility of U.S. fiscal management is on the line. Our creditors are increasingly concerned the leading economy in the world cannot handle its problems through rational fiscal discourse and management, and might turn to time honored – and failed – policies of inflation or default when we cannot muster the courage to take sensible fiscal steps. If a political solution is not forthcoming, our creditors will initially demand higher risk premiums to protect themselves against possible inflation or higher interest rates. Down the line, they will stay away from our debt.

Playing Chicken with a Crisis

Some top economists argue that the U.S. can "afford" even more debt awhile longer because its debt service will still remain quite manageable.[14] They also expect that the United States can avoid adjustment longer than fiscal policy norms might suggest because the dollar is the world's reserve currency. The arguments are that our creditors are more likely to hold onto dollar-denominated instruments for global liquidity objectives; and that we have more fiscal running room because our financial markets and economy are expected to remain relatively attractive to global capital.

These arguments miss critical points, however. They overestimate how much risk our creditors are willing to assume, and underestimate the eventual rise of attractive investment alternatives to dollar-denominated assets. Other countries, faster growing

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[12] C. Fred Bergsten, "The Dollar and the Deficits," *Foreign Affairs*, November/December 2009.

[13] Maurice Obstfeld and Kenneth Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes," November 2009, p.4.

[14] Paul Krugman, "Debt is a Political Issue," *nytimes.com*, March 5, 2010; "Stiglitz: Don't Worry About Record High U.S. Debt," *Moneynews.com*, February 24, 2010.

and/or with sound fiscal management (which may well become a competitive advantage for others), will offer more appealing opportunities over time. While certain countries are often cited to show that high sovereign debt ratios can be sustained without crisis (Italy, Belgium, Japan now), these countries—unlike the United States—can finance their debt through their substantial domestic savings. Moreover, these high debt countries have experienced lower private investment, which hurts basic growth in the end.

Many governments facing similar circumstances to the United States over the next generation have tried to avoid fiscal adjustment by running higher inflation to reduce their debt burden. Though appealing, this strategy hurts the economy and its citizens (particularly those on a fixed income). It also further weakens a country's fiscal position, as creditors demand higher interest rates on debt to offset expected higher inflation. Ultimately, it fails as creditors adjust risk premiums to reflect inflation expectations.

Left unchecked, the fiscal policy failure of the United States will undoubtedly hurt our global position:

> **C. Fred Bergsten, director of the Peterson Institute for International Economics:** "The US government's continued failure to responsibly address the fiscal future of the United States will imperil its global position as well as its future prosperity. The country's fate is already largely in the hands of its foreign creditors, starting with China but also Japan [and] Russia … Unless the United States quickly achieves and maintains a sustainable economic position, its ability to pursue autonomous economic and foreign policies will become increasingly compromised."[15]

> **Niall Ferguson, author of the "The Ascent of Money: The Financial History of the World":** "[E]mpires are complex systems that sooner or later succumb to sudden and catastrophic malfunctions … [M]ost imperial falls are associated with fiscal crises [, many of which] were marked by sharp imbalances between revenues and expenditures, as well as difficulties with financing public debt. Alarm bells should therefore be ringing … [for the United States}."[16]

A dangerous mindset already appears to have set in with some policymakers that it would be better to experience a fiscal crisis to force action, than to take tough political preventative measures. Moreover, while most economists consider the worst case scenario (default) to be unthinkable for the United States, we unfortunately live in an era where the unthinkable has become thinkable. From an economic perspective, we should of course not wait for a full-blown crisis to act. Steps to put the U.S. fiscal house in order need to be taken sooner rather than later, once the recovery is on more solid footing. History is full of examples of how adjustment is tougher and more costly under crisis conditions.[17] While there are many questions about how exactly a crisis would unfold, there is no question that we should not wait to find out.

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[15] C. Fred Bergsten, *ibid*., p. 22.

[16] Niall Ferguson, "Complexity and Collapse: Empires on the Edge of Chaos," *Foreign Affairs*, March/April 2010, p.30.

[17] See Fiscal Roadmap Project, Committee for a Responsible Federal Budget, "Deficit Reduction: Lessons from Around the World," September 2009; and "Fiscal Turnarounds: International Success Stories," February 2010.