Marching toward a debt crisis

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Experts agree that soaring federal debt is trouble. Federal Reserve Chairman Jerome Powell said last week, “I’m very worried about it . . . It’s a long-run issue that we definitely need to face, and ultimately, will have no choice but to face.” The Congressional Budget Office (CBO) reported in June that our growing debt could trigger a global financial crisis if interest rates spike.

Powell said it is a “long-run issue,” but he is wrong. With debt spiraling upwards, a crisis could surprise us at any time because economists are lousy at forecasting. All 50 forecasters in a Wall Street Journal poll last Fall missed the recent sharp change in interest rates. CBO and most other forecasters missed the economy’s plunge into the Great Recession a decade ago.

The Great Recession was centered around rising mortgage debt, which triggered domino effects across the economy as financial institutions, households and businesses retrenched. The private sector learned its lesson from the recession and current household and business debt levels are manageable.

The problem today is federal government debt, which is growing by almost $1 trillion a year. Under its alternative scenario, CBO projects that debt held by the public will double as a share of gross domestic product (GDP) from 78 percent today to 157 percent by 2040. The agency says rising debt is “unsustainable,” so either Congress makes large reforms or there will be a crisis.

Federal debt is the highest in our peacetime history when compared to GDP, and it will soon eclipse the all-time peak in World War II. Including state debt, our government debt is 9th highest among 33 high-income nations.

Before Greece plunged into a fiscal crisis a decade ago, its debt was 121 percent of GDP. Our federal-state debt is already 110 percent and will soon hit that Greek level. The higher our debt goes, the more likely it will induce a Greek-style crisis because interest rate hikes will impact a larger pile of borrowing.

We’ve been lucky in recent years—interest rates have remained low because of Federal Reserve policies, ample global savings and reduced borrowing by foreign governments. But those factors can change. High-saving nations such as China may become more spendthrift and reduce the

global savings pool and European governments may increase borrowing to pay for the rising costs of their entitlement programs.

Fiscal environments can turn dramatically. The Clinton administration ran surpluses and optimistically projected that federal debt held by the public would soon be paid off. Finance expert James Grant noted, “The nil public debt that Bill Clinton projected for 2015 turned out to be $18.2 trillion instead. War, politics-as-usual, and a pair of recessions, including the Great Recession, took him by surprise—as they did so many others.”

So while debt projections already look scary, we’ll probably be hit by surprises that make the outlook even worse, such as recessions, wars, higher interest rates or a new president in 2021 who wants spending on a Green New Deal or Medicare for All.

We are on a budget death spiral similar to what Canada faced in the 1990s. As deficits soared, interest costs began devouring their federal budget—rising from10 percent of total spending in the mid-1970s to 30 percent by the mid-1990s. The high debt scared away investors and the economy struggled. Canada’s federal debt was downgraded by the ratings agencies, and a Wall Street Journal editorial called the country a “basket case” and “an honorary member of the Third World” for its bleak outlook.

The Canadian story has a happy ending because leaders were jolted to their senses and made gutsy decisions to slash spending. They cut defense, business subsidies, farm aid, welfare, grants to lower governments, federal jobs and much else. Federal debt plunged from 67 percent of GDP in 1996 to 34 percent by 2006. Defying Keynesian predictions, the large spending cuts revived the economy and launched the nation on a long boom.

American leaders used to know how to reduce debt. Debt spiked during every war over the past 230 years but was always paid down afterwards. After the Civil War, for example, the government ran surpluses 28 years in a row, causing debt to plunge from 31 percent of GDP down to just 7 percent.

Today we are at peace yet the debt is soaring. The profligacy is so scary because our leaders don’t seem to have the guts to make tough spending decisions like Canada did. We’re marching into a fiscal crisis and few of our leaders seem to care about debt or know how to tackle it.

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