

# Why US federal debt will just keep on rising

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**T**HE US Congressional Budgetary Office (CBO) published its long-term budget outlook a few weeks ago. It paints a steadily worrying deterioration of federal deficits. After a few years in calm waters, the budget deficit will rise more than growth every year, leading invariably to a hike in the share of federal debt measured to gross domestic product (GDP).

The main reason for this trajectory is an ageing population, rising healthcare costs, and an expansion of federal subsidies for health insurance causing spending for some of the largest federal programmes to increase relative to GDP. Interest rates can be expected to rebound in coming years from their current unusually low levels, raising the government's interest payments'.

This is how it looks for the coming 25 years; in case readers hope the picture improve after 2039, the CBO stands ready with a cold bucket of water: "Beyond the next 25 years, the pressures caused by rising budget deficits and debt would become even greater unless laws governing taxes and spending were changed. With deficits as big as the ones that CBO projects, federal debt would be growing faster than GDP, a path that would ultimately be unsustainable."

Many people – politicians, economists and businessmen – are mired in conventional thinking saying that it does not matter. US cannot default, the US dollar is an international reserve currency and as a last resort Washington can just print money. The CBO does not share this kind of complacency, but states: "How long the nation could sustain such growth in federal debt is impossible to predict with any confidence. At some point, investors would begin to doubt the government's willingness or ability to pay its debt obligations, which would require the government to pay much higher interest costs to borrow money. Such a fiscal crisis would present policymakers with extremely difficult choices and would probably have a substantial negative impact on the country."

It is a widely held point of view that continuous deficits at a high level and rising debt relative to GDP does not really harm the US economy. But again the CBO does not shy away from taking the bull by the horns:

◆ "The large amount of federal borrowing would draw money away from private investment in productive capital in the long term, because the portion of people's savings used to buy government securities would not be available to finance private investment. The result would be a smaller stock of capital and lower output and income than would otherwise be the case, all else being equal (despite those reductions, the continued growth of productivity would make output and income per person, adjusted for inflation, higher in the future than they are now).

◆ "Federal spending on interest payments would rise, thus requiring higher taxes, lower spending for benefits and services, or both, to achieve any chosen targets for budget deficits and debt.

◆ "The large amount of debt would restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns or financial crises. As a result, those challenges would tend to have larger negative effects on the economy and on people's wellbeing than they would otherwise. The large amount of debt could also compromise national security by constraining defence spending in times of international crisis or by limiting the country's ability to prepare for such a crisis."

So what is going to happen? It seems clear that the US cannot or will not bring the federal debt under control. In reality this amounts to some kind of default – let us call it technical default with a country having the economic clout to service and reduce its debt but refuses to do so.

The US Treasury offers a recipe for the US to wriggle its way out of the trap by an ingenious outside edge. It is quite simple and in other circumstances and for other countries it would be labelled for what it is – namely restructuring of debt to alleviate the burden on the debtor. According to press reports the US treasury envisages to issue ultra-long bonds and 50 years' duration has been mentioned.

Acting now with the low current interest rate, the US benefits greatly by issuing long-term bonds. At end-July the yield for 10-year bonds was 2.5-2.6 per cent. This is historically low and for a country with high debt and a dismal debt/deficit outlook, tantalising to strike as long as it lasts. The beauty from the US point of view is that hiking inflation to, say, above 5 per cent may be politically harmful, but not to 2 or 3 per cent. Figuring in trend growth of 2 per cent makes nominal GDP grow at 5 per cent – double the nominal interest rate making the real interest rate negative, a boon for the debtor. Real purchasing power would be eroded and over 50 years this would amount to a substantial reduction in real debt.

## Real burden of repayment

Taking a look at how the world economy and the US economy can be expected to perform over the next 50 years, bonds with such duration are synonymous with a shift of repaying debt from the debtor to the creditor. The real burden of repayment takes the form of reduced future consumption and through this scheme, the US transfers it to the creditors. Not only that. As future growth, inflation and interest rate cannot be known, the risks are also transferred from the debtor to the creditor.

There may be some in the market who welcome 50-year bonds, preferring to tell shareholders and investors that we know where we are and that long-term bonds are preferable to short-term ones needing constant renewal. But they may not be many.

The main question is how the large international holders of US treasury bonds – mainly China and Japan – will look at this. Japan as an ally and dependent on US to come to its defence in case of an armed attack, may adopt a more obliging attitude than China. But Japan is also approaching a crunch time for its own debt as the balance of payments is forecast to swing from surplus to deficits in a few years' time. China is not interested in seeing and even less provoking a major financial crisis for the US – it still needs the US economically and politically – and may therefore be open to help, but for a price and within certain limits.

It is highly unlikely that China underwrites a blank cheque to bail the US out and equally unlikely that after having worked hard to accumulate assets will allow the US to shift the burden of debt repayment from debtor to creditor. So do not count on China to buy into this scheme however attractive the US treasury may try to make it look – it is attractive, certainly, but for the US, not for the creditors.

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