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The Global Government Debt Bubble Threatens the Economy

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President Barack Obama and top Congressional Democrats are leading the world toward a new global government debt bubble. The United States appears headed toward a multi-trillion-dollar increase in publicly traded federal debt in just the next two years, with much more to come. Other nations appear to be following suit.

This debt explosion is likely to raise interest rates significantly for government debt, thereby increasing interest costs for future generations. More troubling at the moment, this policy will increase interest rates for all private debt such as home mortgages, consumer loans, and business loans. The near-term consequences of this debt bubble will be a deeper recession, a longer recession, and a weaker eventual recovery.

The Debt Bubble Groweth. By the end of 2008, the federal government had about $6.4 trillion in publicly traded debt—the net accumulation of all debt issued by the government since the founding of the republic. The Congressional Budget Office (CBO) forecasts a deficit for 2009 of $1.2 trillion, excluding any effects of a stimulus bill or other new spending. The stimulus plan is still evolving, but the total under consideration at the moment is about $900 billion, some of which will be "injected" into the economy in 2009, some in 2010, and some in later years.

In addition, the Obama Administration appears intent on using the second $350 billion in Troubled Asset Relief Program (TARP) funds. Combining the baseline deficit with expected stimulus spending and the TARP funds, total federal borrowing in 2009 will likely increase the national debt by at least $1.9 trillion to $8.3 trillion.

While forecasting federal borrowing beyond 2009 is speculative, the combination of current law programs plus the stimulus—and without any additional borrowings for additional financial market interventions or other new spending—suggests at least another $1.6 trillion of new government debt, bringing the total of publicly traded federal debt to $9.9 trillion by the end of 2010.

A common means of putting such figures into perspective is to compare them to the size of the economy. At the end of 2008, the ratio of federal debt to GDP was about 44.9 percent. Under the assumptions here about new issuance and using the CBO forecasts for nominal GDP, debt at the end of 2009 will be about 57.9 percent, an increase of 13 percentage points in just a single year. By the end of 2010, the debt-to-GDP ratio will have reached 67.9 percent for a two-year increase of 23 percentage points.

Driving the Recession Deeper. The consequences of this government debt bubble for future outlays for federal interest expense—and therefore

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for the long-term budget picture—are significant. Yet, this debt's effects on interest rates will have severe economic repercussions in 2009 and 2010.

Analysts have argued for years over the effects of deficits and debt on interest rates. Recent research has led to a tentative consensus on the matter, especially when budget deficits and government debt issuance are in the common ranges of $200 to $400 billion, or 1–4 percent of GDP and the national debt is moving up or down by a tenth of a percent of GDP or two.[1]

According to this consensus, an increase in the debt-to-GDP ratio of 1 percentage point could be expected to increase long-term interest rates by between three and five basis points, or between 0.03 and 0.05 percentage points. This modest effect resulting from modest deficits is the basis for repeated conservative claims in the past that modest deficits were of little consequence.

Expected federal borrowing for 2009 and 2010 will be far from modest, and the consequences will be significant for interest rates—and potentially crippling for the economy. Using just the consensus estimates, the projected increase in the debt-to-GDP ratio for 2009 alone will raise interest rates by between 0.39 and 0.65 percentage points. In today's terms, the average mortgage rate at the end of January was about 5.33 percent on a conforming loan mortgage. At the end of 2009, if nothing else occurs, this rate would be between 5.75 and 6 percent.

Using the consensus estimates, by the end of 2010 interest rates will be up another 0.3 to 0.5 percentage points, for a total increase due to the government debt bubble of 0.7 and 1.1 percentage points.[2] That would mean that today's mortgage rate of 5.33 percent would be between 6 percent and 6.4 percent. Such increases in interest rates would significantly weaken the economy further and delay for many months any hope of significant recovery.

Does the Consensus Hold True with Massive Debt? These estimates of the interest rates effects of the coming government debt bubble are likely to be understated for three separate reasons.

1. They assume no additional government spending, whereas President Obama and the Democratic congressional leadership have signaled large increases in new spending on infrastructure, health care, the environment, and education. The expected, partly funded expansion of the State Child Health Insurance Program (SCHIP) is a good example of such new spending.[3]
2. The consensus forecasts for interest rate effects from issuing government debt derive from data on relatively small changes in government debt as a share of GDP. Larger changes in the debt-to-GDP ratio pose significantly greater issues for credit markets, so the interest rate response likely increases more than proportionally.
3. The consensus estimate for interest rate effects also implicitly assumes that governments around the world are largely following their own normal fiscal policies. In contrast, the global recession has caused deficits to balloon almost everywhere, and governments worldwide are considering their own massive programs to stimulate their economies. So the United States will be offering this great wave of federal debt to the credit markets while most other countries will be doing the same. Because interest rates are set on global markets, this even larger global wave of government debt is likely to have much greater interest rate effects than would be the case if the United States were acting alone.

An Effective Alternative Approach. The global economy is sliding into a deep and potentially

1. See Eric M. Engen and R. Glenn Hubbard, "Federal Government Debt and Interest Rates," National Bureau of Economic Research *Working Paper* No. 10681, August 2004; Thomas Laubach, "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," Board of Governors of the Federal Reserve System, May 2003, at *http://www.federalreserve.gov/pubs/feds/2003/200312/200312pap.pdf* (January 30, 2009).
2. Figures may not add precisely due to rounding.
3. Dennis G. Smith, "SCHIP Bill: Top 10 Changes for Congress to Consider," Heritage Foundation *WebMemo* No. 2244, January 26, 2009, at *http://www.heritage.org/Research/HealthCare/wm2244.cfm.*

prolonged recession. Not only will the stimulus bill developing in Congress be ineffective in helping the economy but it will actually further weaken the economy by putting additional upward pressure on interest rates. There is an effective, three-part alternative.

1. Eliminate (or, at the very least, delay) the threat of a massive tax hike bearing down on the economy in 2011, and then cut marginal income tax rates on individuals and businesses further to energize the productive processes in the U.S. economy. The growth effects from the tax relief would more than offset the incremental pressures on interest rates from the higher resulting deficits.[4]
2. Aggressively reduce federal spending in 2009. Numerous studies of federal spending have highlighted programs that are inappropriate, wasteful, or ineffective. Congress should cut spending now, not increase it, to take immediate pressure off of credit markets by reducing the magnitude of federal funding in 2009 and to signal to credit markets that the U.S. government has not entirely thrown in the towel on fiscal responsibility. Cutting spending could thereby reduce the upward pressure on interest rates.[5]
3. Take immediate action to reduce future spending in the major entitlement programs, especially Medicare, Medicaid, and Social Security. President Obama has stated his intention to take action on these wildly unsustainable programs. In the past, entitlement reforms have been couched in terms of improving the long-term fiscal picture. Taking action on these programs today by aligning tomorrow's promised benefits with available resources would be another powerful signal to credit markets, thereby restoring the credibility of United States government's fiscal policy and further relieving the upward pressure on interest rates.

Do the Opposite. The U.S. economy and the global economy are sliding into a deep recession demanding effective policy responses. The prevailing policy response has been to increase spending and further increase the amount of debt the federal government must sell to progressively more worried capital markets. The effect of this policy will be to increase the already significant upward pressure on interest rates that threatens to make the recession worse.

Congress and the President should do the opposite of what they apparently intend: They should cut taxes on productive activities, not increase them. They should cut spending, not increase it. And rather than increase entitlement spending as they intend with the SCHIP expansion, they should reduce future entitlement benefits to give credit markets some confidence that U.S. policymakers have not entirely abandoned fiscal discipline.

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4. See Senator Jim DeMint (R–SC), "An American Option: A Jobs Plan That Works," Heritage Foundation *Lecture* No. 1108, January 29, 2009, at *http://www.heritage.org/Research/Economy/hl1108.cfm*; J. D. Foster and William W. Beach, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, at *http://www.heritage.org/Research/Economy/wm2191.cfm.*
5. See Daniel J. Mitchell, "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, at *http://www.heritage.org/Research/Budget/bg1831.cfm.*