The Heritage Foundation
LEADERSHIP FOR AMERICA

ISSUE BRIEF

No. 3971 | JUNE 18, 2013

Soaring National Debt Remains a Grave Threat

Alison Acosta Fraser and J. D. Foster, PhD

Federal government debt has nearly doubled since President Barack Obama took office and is projected to increase 50 percent over the next decade—and then rise rapidly thereafter—under existing policies.[1] As federal debt has soared, so have concerns about America's future.

Used properly, debt can safely finance private and government investment in productive capital to support economic growth. But too much debt can ruin a family, a business, or a nation.[2]

Fiscal Outlook Bleak. Some in Congress and the media argue that the recent improvement in the deficit means no more need be done this year to rein in spending. While deficits have improved somewhat due to the fiscal cliff tax increases and discretionary spending cuts from the Budget Control Act, this improvement is transient. By the end of the decade, the deficit will again approach $1 trillion as entitlement spending takes off.

Recent progress on the deficit is also woefully inadequate. Debt will continue to soar over the next decade: Debt held by the public will increase from $11 trillion in 2012 to $19 trillion in 2023. Debt subject to the legal debt limit—which includes debt owed to federal trust funds such as Social Security's—will swell by $9 trillion, reaching $25 trillion after a decade. The result is highly likely to eventually spur exceptionally high interest rates and a slower economy.

This paper, in its entirety, can be found at
http://report.heritage.org/ib3971

Produced by the Thomas A. Roe Institute for Economic Policy Studies

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

U.S. Debt Levels Dangerous and Becoming More So. Recent and projected growth in U.S. government debt poses a serious hazard to the nation. Clearly, high levels of government debt mean that substantial government resources must go toward paying interest on that debt, often called servicing the debt. And a growing body of research supports the economic theory that high levels of debt relative to the size of the economy, sometimes called the debt ratio, eventually lead to unusually high interest rates and slower growth.

One traditional explanation relating government debt ratio and interest rates, referred to as "crowding out," observes that government borrowing subtracts from domestic saving available to private borrowers, who then bid up the price of their borrowing, which, of course, is the interest rate they pay. That works in a closed economic system, but that is not the way the world works today.

Rather, the ability to tap into foreign savings by borrowing from abroad, as the U.S. is doing, appears largely to defuse this simple crowding-out effect at moderate debt ratio levels. This may explain in part the U.S.'s currently low interest rates. However, the foreign appetite for any nation's debt is not unlimited. At some point, U.S. debt issuance would become so great relative to foreign demand that market resistance would drive up U.S. interest rates just as though the conventional crowding-out effect were in full force.

Rising Debt, Rising Interest Rates: The Developing Consensus. The relationship between interest rates and government debt issuance depends on many factors, yet one abiding conclusion stands out: When debt gets high enough or rises fast enough, markets notice and interest rates rise.

A team of prominent economists recently delved[3] more deeply into the influence borrowing abroad has on the interest rate effects of government borrowing by including in the analysis a nation's current account deficit—essentially the net value between the value of what a nation exports and the value of what it imports.[4] Their results strongly suggest that the ability to borrow from abroad at moderate levels of debt likely reduces borrowing costs as expected, but the advantages of being able to borrow abroad rapidly dissipate as foreign bond buyers respond more quickly by demanding higher interest rates as either the debt share or the current account deficit increases.

The authors further observed that interest rate problems "can arrive quickly and dramatically once the debt loads and current-account deficits get sufficiently high."

Rising Debt and Slowing Economies. A growing body of evidence supports the view that high levels of debt are associated with reduced rates of economic growth.[5] This message has been clouded by revelations of substantial methodological flaws in the widely cited work of Carmen Reinhart and Kenneth Rogoff.[6] However, subsequent work corrected the flaws and reaffirmed the fundamental conclusion regarding the dangers of excessive debt.

Heritage's Salim Furth notes that "in the end, all of [the] corrections and critiques show that countries with debt above 90 percent of GDP grow on average 2.0 percent less per year than low-debt countries and 1.0 percent less per year than countries with debt levels between 60 percent and 90 percent of GDP."[7]

The U.S. government debt ratio has already risen dramatically and is expected to grow rapidly late in the decade. The literature accords with theory in suggesting that a high and rapidly rising debt ratio should increase interest rates and weaken the economy. Yet interest rates remain near historic lows, and the economy, while disappointing, is growing.

Two key factors suggest that the traditional relationships between debt and interest rates and economic growth will resume. First, the Federal Reserve's policy of quantitative easing is intended to push down long-term interest rates. But the Fed is already planning to phase out this program.

Second, persistent extreme uncertainty in global financial markets has heightened the safe haven aspect of the United States, which consequently lures vast sums of foreign capital from riskier locales, thus pushing down U.S. interest rates. However, at some point, as foreign tensions subside and the U.S. debt ratio rises, the attractiveness of U.S. debt to foreign lenders will decline. The likely outcome for both factors suggests that the recent period of abnormally low interest rates will end.

A Nation at Risk, a Clock Ticking. The U.S. economy is slowly recovering, but President Obama's massive deficits, soaring debt, and tepid support for reforms to render America's entitlement programs affordable pose a grave economic threat.

Recent welcome yet inadequate progress in the deficit combined with currently low interest rates

1. See Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 2013, http://www.cbo.gov/sites/default/files/cbofiles/attachments/44172-Baseline2.pdf (accessed June 7, 2013).
2. For a full discussion of the issues raised here, see J. D. Foster, "The Many Real Dangers of Soaring National Debt," Heritage Foundation *Backgrounder* No. 2814, June 18, 2013, http://www.heritage.org/research/reports/2013/06/the-many-real-dangers-of-soaring-national-debt.
3. David Greenlaw et al., "Crunch Time: Fiscal Crises and the Role of Monetary Policy," U.S. Monetary Policy Forum, February 22, 2013, http://dss.ucsd.edu/~jhamilto/USMPF13_final.pdf (accessed June 7, 2013).
4. The current account deficit is a part of the balance of payments—tracking the flows of goods, services, income, and saving across a nation's border. The balance of payments does, in fact, balance, and thus there is a counterpart to the current account called the capital account, which measures the net inflows of saving, which in turn is the real subject of interest here, as we are concerned with the source of saving (foreign or domestic) used to finance budget deficits and domestic investment.
5. See Salim Furth, "High Debt Is a Real Drag," Heritage Foundation *Issue Brief* No. 3859, February 22, 2013, http://www.heritage.org/research/reports/2013/02/how-a-high-national-debt-impacts-the-economy.
6. Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt," *American Economic Review*, Vol. 100 (May 2010), http://scholar.harvard.edu/rogoff/publications/growth-time-debt (accessed June 7, 2013).
7. Salim Furth, "Debt and Growth in a Time of Controversy," Heritage Foundation *Issue Brief* No. 3926, May 1, 2013, http://www.heritage.org/research/reports/2013/05/does-debt-hurt-growth-growth-in-a-time-of-debt.

despite rising debt are beguiling policymakers and the nation about the risks stemming from America's irresponsible fiscal policy, lulling them into complacency. Not merely the calm before the storm, economic conditions brought about by developments abroad and monetary policy at home have effectively anesthetized financial markets against the risks of U.S. fiscal profligacy. The anesthesia, however, will prove temporary. Interest rates will almost certainly rise past the normal levels now forecast, and the economy will suffer—all largely due to budget deficits now being incurred and to the inaction to address the even greater, entitlement-driven deficits in the years immediately ahead.

*—**Alison Acosta Fraser** is Director of and **J. D. Foster, PhD**, is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*