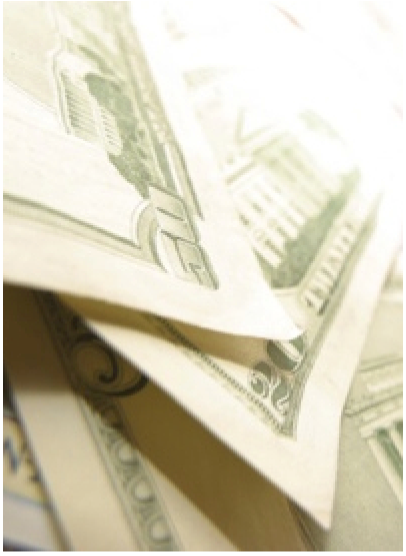
CBO Warns of Greek-style U.S. Debt Crisis



The non-partisan Congressional Budget Office released its most dire warning yet of a looming U.S. debt crisis, openly comparing the U.S. budget situation to the Greek, Irish, and Argentinian debt crises and calling for a 20 percent cut in the size of the federal government. The July 27 report, "Federal Debt and the Risk of a Fiscal Crisis," comes just days after the Obama administration revised upward its deficit projections for fiscal 2010-11 to a two-year total of $2.89 trillion. The CBO had labeled the federal spending path "unsustainable" in a June report.

The pull-no-punches CBO report called for immediate and drastic cuts in federal spending, or equivalent tax increases. The CBO estimated that the cuts needed to be taken now must be "equivalent to roughly 20 percent of all of the government's noninterest spending this year." The CBO noted that delay in fiscal austerity would only make the cuts deeper: "Actions taken later, particularly if there was a fiscal crisis, would need to be significantly greater to achieve that same objective. Larger and more abrupt changes in fiscal policy, such as substantial cuts in government benefit programs, would be more difficult for people to adjust to than smaller and more gradual changes."

The risk of Greek-style debt crisis is a real possibility, according to the CBO. It noted that "a review of fiscal crises in Argentina, Ireland, and Greece in the past decade reveals instructive common features and differences. For all three countries, the crises occurred abruptly and during recessions. However, the crises occurred at different levels of government debt relative to GDP, showing that the tipping point for a crisis does not depend solely on the debt-to-GDP ratio; the government's long-term budget outlook, its near-term borrowing needs, and the health of the economy are also important. All three of those crises illustrate the difficulty of formulating effective policy responses once investors lose confidence in a government." In each of these qualities, the United States most closely matches the Greek government's policies of massive deficits now, no proposals to rein in runaway deficits in the long term, and a deep current recession. In addition, the United States will have a 110 percent debt-to-GDP ratio before the end of next year, the same level Greece had in 2008.

The CBO notes that the United States is currently benefiting from historically low interest rates to borrow for its deficit spending. A fiscal crisis would spike interest costs of financing that debt, as happened in Greece, Ireland, and Argentina. "In all three of those fiscal crises in other countries, sharp increases in interest rates on government debt forced the affected governments to make difficult choices. The U.S. government would also face difficult choices if interest rates on its debt spiked. For example, a 4-percentage point across-the-board increase in interest rates would raise federal interest payments next year by about $100 billion relative to CBO's baseline projection — a jump of more than 40 percent. As longer-term debt matured and was refinanced at such higher rates, the difference in the annual interest burden would mount; by 2015, if such higher-than-anticipated rates persisted, net interest would be nearly double the roughly $460 billion that CBO currently projects for that year." Such a debt crisis that drove interest rates up would drive the deficit up even higher, as happened with Greece, Ireland and Argentina.

The CBO study also analyzes the inflation alternative "solution" to a fiscal crisis:

> An alternative approach is to increase the supply of money in the economy. But as governments create money to finance their activities or pay creditors during fiscal crises, they raise inflation. Higher inflation has negative consequences for the economy, especially if inflation moves above the moderate rates seen in most developed countries in recent years.

The CBO explains that the inflation "fix" would increase interest rates paid on the debt as well as government payouts to programs such as Social Security, increasing the deficit again and bringing the U.S. back to another debt crisis, the CBO concluded:

> Higher inflation might appear to benefit the U.S. government financially because the value of the outstanding debt (which is mostly fixed in dollar terms) would be lowered relative to the size of the economy (which would increase when measured in dollar terms). However, higher inflation would also increase the size of future budget deficits. Specifically, if inflation was 1 percentage point higher over the next decade than the rate CBO has projected, budget deficits during those years would be roughly $700 billion larger.