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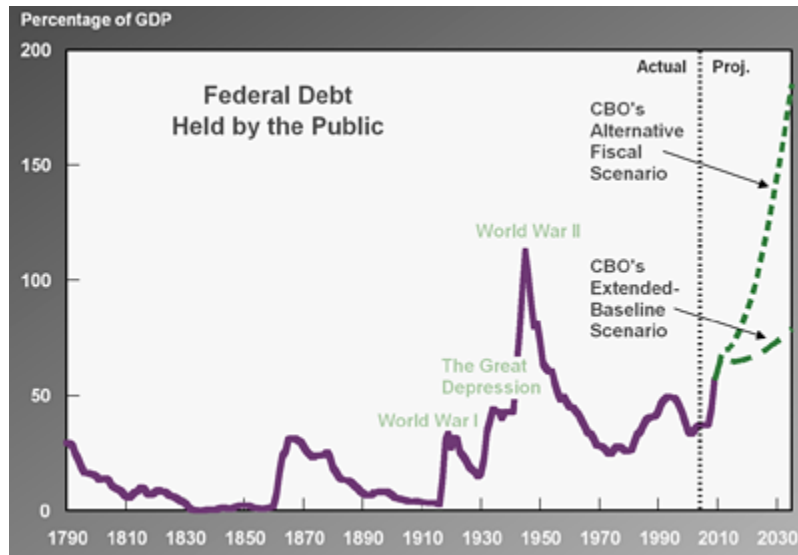
Federal Debt and the Risk of a Financial Crisis

In fiscal crises in a number of countries around the world, investors have lost confidence in governments' abilities to manage their budgets, and those governments have lost their ability to borrow at affordable rates. With U.S. government debt already at a level that is high by historical standards, and the prospect that, under current policies, federal debt would continue to grow, it is possible that interest rates might rise gradually as investors' confidence in the U.S. government's finances declined, giving legislators sufficient time to make policy choices that could avert a crisis. It is also possible, however, that investors would lose confidence abruptly and interest rates on government debt would rise sharply, as evidenced by the experiences of other countries.

Unfortunately, there is no way to predict with any confidence whether and when such a crisis might occur in the United States. In a [brief](#) ("[Federal Debt and the Risk of a Fiscal Crisis](#)") released today, CBO notes that there is no identifiable "tipping point" of debt relative to the nation's output (gross domestic product, or GDP) that would indicate that such a crisis is likely or imminent. However, in the United States, the ratio of federal debt to GDP is climbing into unfamiliar territory—and all else being equal, the higher the debt, the greater the risk of such a crisis.

Over the past few years, U.S. government debt held by the public has grown rapidly. According to CBO's projections, federal debt held by the public will stand at 62 percent of GDP at the end of fiscal year 2010, having risen from 36 percent at the end of fiscal year 2007, just before the recession began. In only one other period in U.S. history—during and shortly after World War II—has that figure exceeded 50 percent.

Further increases in federal debt relative to the nation's output almost certainly lie ahead if current policies remain in place. The aging of the population and rising costs for health care will push federal spending, measured as a percentage of GDP, well above the levels experienced in recent decades. Unless policymakers restrain the growth of spending, increase revenues significantly as a share of GDP, or adopt some combination of those two approaches, growing budget deficits will cause debt to rise to unsupportable levels, as shown in the figure below. (For more details, see CBO's recent report [The Long-Term Budget Outlook](#).)



Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2020 (with adjustments for the recently enacted health care legislation) and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

Although deficits during or shortly after a recession generally hasten economic recovery, persistent deficits and continually mounting debt would have several negative economic consequences for the United States. Some of those consequences would arise gradually—but a high level of federal debt, combined with an unfavorable long-term budget outlook, would also increase the probability of a sudden fiscal crisis prompted by investors' fears that the government would renege on the terms of its existing debt or that it would increase the supply of money to finance its activities or pay creditors and thereby boost inflation. The resulting abrupt rise in interest rates would create serious challenges for the U.S. government. For example, a 4-percentage-point across-the-board increase in interest rates would raise federal interest payments next year by about \$100 billion; if those higher rates persisted, net interest costs in 2015 would be nearly double the roughly \$460 billion that CBO currently projects for that year. Such an increase in rates could also precipitate a broader financial crisis because it would reduce the market value of outstanding government bonds, inflicting losses on mutual funds, pension funds, insurance companies, banks, and other holders of federal debt.

Options for responding to a fiscal crisis would be limited and unattractive. The government would need to undertake some combination of three actions. One action could be changing the terms of its existing debt. This would make it difficult and costly to borrow in the future. A second action could be adopting an inflationary monetary policy by increasing the supply of money. However, this approach would have negative consequences for both the economy and future budget deficits. A third action could be implementing an austerity program of spending cuts and tax increases. Such budgetary adjustments, in the face of a fiscal crisis, would be more drastic and painful than those that would have been necessary had the adjustments come sooner.

This brief was prepared by Jonathan Huntley of CBO's Macroeconomic Analysis Division.

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