An Empire at Risk

We won the cold war and weathered 9/11. But now economic weakness is endangering our global power.

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Call it the fractal geometry of fiscal crisis. If you fly across the Atlantic on a clear day, you can look down and see the same phenomenon but on four entirely different scales. At one extreme there is tiny Iceland. Then there is little Ireland, followed by medium-size Britain. They're all a good deal smaller than the mighty United States. But in each case the economic crisis has taken the same form: a massive banking crisis, followed by an equally massive fiscal crisis as the government stepped in to bail out the private financial system.

Size matters, of course. For the smaller countries, the financial losses arising from this crisis are a great deal larger in relation to their gross domestic product than they are for the United States. Yet the stakes are higher in the American case. In the great scheme of things—let's be frank—it does not matter much if Iceland teeters on the brink of fiscal collapse, or Ireland, for that matter. The locals suffer, but the world goes on much as usual.

But if the United States succumbs to a fiscal crisis, as an increasing number of economic experts fear it may, then the entire balance of global economic power could shift. Military experts talk as if the president's decision about whether to send an additional 40,000 troops to Afghanistan is a make-or-break moment. In reality, his indecision about the deficit could matter much more for the country's long-term national security. Call the United States what you like—superpower, hegemon, or empire—but its ability to manage its finances is closely tied to its ability to remain the predominant global military power. Here's why.

The disciples of John Maynard Keynes argue that increasing the federal debt by roughly a third was necessary to avoid Depression 2.0. Well, maybe, though some would say the benefits of fiscal stimulus have been oversold and that the magic multiplier (which is supposed to transform $1 of government spending into a lot more than $1 of aggregate demand) is trivially small.

Credit where it's due. The positive number for third-quarter growth in the United States would have been a lot lower without government spending. Between half and two thirds of the real increase in gross domestic product was attributable to government programs, especially the Cash for Clunkers scheme and the subsidy to first-time home buyers. But we are still a very long way from a self--sustaining recovery. The third-quarter growth number has just been revised downward from 3.5 percent to 2.8 percent. And that's not wholly surprising. Remember, what makes a stimulus actually work is the change in borrowing by the whole public sector. Since the federal government was already running deficits, and since the states are actually raising taxes and cutting spending, the actual size of the stimulus is closer to 4 percent of GDP spread over the years 2007 to 2010—a lot less than that headline 11.2 percent deficit.

Meanwhile, let's consider the cost of this muted stimulus. The deficit for the fiscal year 2009 came in at more than $1.4 trillion—about 11.2 percent of GDP, according to the Congressional Budget Office (CBO). That's a bigger deficit than any seen in the past 60 years—only slightly larger in relative terms than the deficit in 1942. We are, it seems, having the fiscal policy of a world war, without the war. Yes, I know, the United States is at war in Afghanistan and still has a significant contingent of troops in Iraq. But these are trivial conflicts compared with the world wars, and their contribution to the gathering fiscal storm has in fact been quite modest (little more than 1.8 percent of GDP, even if you accept the estimated cumulative cost of $3.2 trillion published by Columbia economist Joseph Stiglitz in February 2008).

And that $1.4 trillion is just for starters. According to the CBO's most recent projections, the federal deficit will decline from 11.2 percent of GDP this year to 9.6 percent in 2010, 6.1 percent in 2011, and 3.7 percent in 2012. After that it will stay above 3 percent for the foreseeable future. Meanwhile, in dollar terms, the total debt held by the public (excluding government agencies, but including foreigners) rises from $5.8 trillion in 2008 to $14.3 trillion in 2019—from 41 percent of GDP to 68 percent.

In other words, there is no end in sight to the borrowing binge. Unless entitlements are cut or taxes are raised, there will never be another balanced budget. Let's assume I live another 30 years and follow my grandfathers to the grave at about 75. By 2039, when I shuffle off this mortal coil, the federal debt held by the public will have reached 91 percent of GDP, according to the CBO's extended baseline projections. Nothing to worry about, retort -deficit-loving economists like Paul Krugman. In 1945, the figure was 113 percent.

Well, let's leave aside the likely huge differences between the United States in 1945 and in 2039. Consider the simple fact that under the CBO's alternative (i.e., more pessimistic) fiscal scenario, the debt could hit 215 percent by 2039. That's right: more than double the annual output of the entire U.S. economy.

Forecasting anything that far ahead is not about predicting the future. Everything hinges on the assumptions you make about demographics, Medicare costs, and a bunch of other variables. For example, the CBO assumes an average annual real GDP growth rate of 2.3 percent over the next 30 years. The point is to show the implications of the current chronic imbalance between federal spending and federal revenue. And the implication is clear. Under no plausible scenario does the debt burden decline. Under one of two plausible scenarios it explodes by a factor of nearly five in relation to economic output.

Another way of doing this kind of exercise is to calculate the net present value of the unfunded liabilities of the Social Security and Medicare systems. One recent estimate puts them at about $104 trillion, 10 times the stated federal debt.

No sweat, reply the Keynesians. We can easily finance $1 trillion a year of new government debt. Just look at the way Japan's households and financial institutions funded the explosion of Japanese public debt (up to 200 percent of GDP) during the two "lost decades" of near-zero growth that began in 1990.

Unfortunately for this argument, the evidence to support it is lacking. American households were, in fact, net sellers of Treasuries in the second quarter of 2009, and on a massive scale. Purchases by mutual funds were modest ($142 billion), while purchases by pension funds and insurance companies were trivial ($12 billion and $10 billion, respectively). The key, therefore, becomes the banks. Currently, according to the Bridgewater hedge fund, U.S. banks' asset allocation to government bonds is about 13 percent, which is relatively low by historical standards. If they raised that proportion back to where it was in the early 1990s, it's conceivable they could absorb "about $250 billion a year of government bond purchases." But that's a big "if." Data for October showed commercial banks selling Treasuries.

That just leaves two potential buyers: the Federal Reserve, which bought the bulk of Treasuries issued in the second quarter; and foreigners, who bought $380 billion. Morgan Stanley's analysts have crunched the numbers and concluded that, in the year ending June 2010, there could be a shortfall in demand on the order of $598 billion—about a third of projected new issuance.

Of course, our friends in Beijing could ride to the rescue by increasing their already vast holdings of U.S. government debt. For the past five years or so, they have been amassing dollar--denominated international reserves in a wholly unprecedented way, mainly as a result of their interventions to prevent the Chinese currency from appreciating against the dollar.

Right now, the People's Republic of China holds about 13 percent of U.S. government bonds and notes in public hands. At the peak of this process of reserve accumulation, back in 2007, it was absorbing as much as 75 percent of monthly Treasury issuance.

But there's no such thing as a free lunch in the realm of international finance. According to Fred Bergsten of the Peterson Institute for International Economics, if this trend were to continue, the U.S. -current-account deficit could rise to 15 percent of GDP by 2030, and its net debt to the rest of the world could hit 140 percent of GDP. In such a scenario, the U.S. would have to pay as much as 7 percent of GDP every year to foreigners to service its external borrowings.

Could that happen? I doubt it. For one thing, the Chinese keep grumbling that they have far too many Treasuries already. For another, a significant dollar depreciation seems more probable, since the United States is in the lucky position of being able to borrow in its own currency, which it reserves the right to print in any quantity the Federal Reserve chooses.

Now, who said the following? "My prediction is that politicians will eventually be tempted to resolve the [fiscal] crisis the way irresponsible governments usually do: by printing money, both to pay current bills and to inflate away debt. And as that temptation becomes obvious, interest rates will soar."

Seems pretty reasonable to me. The surprising thing is that this was none other than Paul Krugman, the high priest of Keynesianism, writing back in March 2003. A year and a half later he was comparing the U.S. deficit with Argentina's (at a time when it was 4.5 percent of GDP). Has the economic situation really changed so drastically that now the same Krugman believes it was "deficits that saved us," and wants to see an even larger deficit next year? Perhaps. But it might just be that the party in power has changed.

History strongly supports the proposition that major financial crises are followed by major fiscal crises. "On average," write Carmen Reinhart and Kenneth Rogoff in their new book, *This Time Is Different*, "government debt rises by 86 percent during the three years following a banking crisis." In the wake of these debt explosions, one of two things can happen: either a default, usually when the debt is in a foreign currency, or a bout of high inflation that catches the creditors out. The history of all the great European empires is replete with such episodes. Indeed, serial default and high inflation have tended to be the surest symptoms of imperial decline.

As the U.S. is unlikely to default on its debt, since it's all in dollars, the key question, therefore, is whether we are going to see the Fed "printing money"—buying newly minted Treasuries in exchange for even more newly minted greenbacks—followed by the familiar story of rising prices and declining real-debt burdens. It's a scenario many investors around the world fear. That is why they are selling dollars. That is why they are buying gold.

Yet from where I am sitting, inflation is a pretty remote prospect. With U.S. unemployment above 10 percent, labor unions relatively weak, and huge quantities of unused capacity in global manufacturing, there are none of the pressures that made for stagflation (low growth plus high prices) in the 1970s. Public expectations of inflation are also very stable, as far as can be judged from poll data and the difference between the yields on regular and inflation-protected bonds.

So here's another scenario—which in many ways is worse than the inflation scenario. What happens is that we get a rise in the real interest rate, which is the actual interest rate minus inflation. According to a substantial amount of empirical research by economists, including Peter Orszag (now at the Office of Management and Budget), significant increases in the debt-to-GDP ratio tend to increase the real interest rate. One recent study concluded that "a 20 percentage point increase in the U.S. government-debt-to-GDP ratio should lead to a 20–120 basis points [0.2–1.2 percent] increase in real interest rates." This can happen in one of three ways: the nominal interest rate rises and inflation stays the same; the nominal rate stays the same and inflation falls; or—the nightmare case—the nominal interest rate rises and inflation falls.

Today's Keynesians deny that this can happen. But the historical evidence is against them. There are a number of past cases (e.g., France in the 1930s) when nominal rates have risen even at a time of deflation. What's more, it seems to be happening in Japan right now. Just last week Hirohisa Fujii, Japan's new finance minister, admitted that he was "highly concerned" about the recent rise in Japanese government bond yields. In the very same week, the government admitted that Japan was back in deflation after three years of modest price increases.

It's not inconceivable that something similar could happen to the United States. Foreign investors might ask for a higher nominal return on U.S. Treasuries to compensate them for the weakening dollar. And inflation might continue to surprise us on the downside. After all, consumer price inflation is in negative territory right now.

Why should we fear rising real interest rates ahead of inflation? The answer is that for a heavily indebted government and an even more heavily indebted public, they mean an increasingly heavy debt-service burden. The relatively short duration (maturity) of most of these debts means that a large share has to be rolled over each year. That means any rise in rates would feed through the system scarily fast.

Already, the federal government's interest payments are forecast by the CBO to rise from 8 percent of revenues in 2009 to 17 percent by 2019, even if rates stay low and growth resumes. If rates rise even slightly and the economy flatlines, we'll get to 20 percent much sooner. And history suggests that once you are spending as much as a fifth of your revenues on debt service, you have a problem. It's all too easy to find yourself in a vicious circle of diminishing credibility. The investors don't believe you can afford your debts, so they charge higher interest, which makes your position even worse.

This matters more for a superpower than for a small Atlantic island for one very simple reason. As interest payments eat into the budget, something has to give—and that something is nearly always defense expenditure. According to the CBO, a significant decline in the relative share of national security in the federal budget is already baked into the cake. On the Pentagon's present plan, defense spending is set to fall from above 4 percent now to 3.2 percent of GDP in 2015 and to 2.6 percent of GDP by 2028.

Over the longer run, to my own estimated departure date of 2039, spending on health care rises from 16 percent to 33 percent of GDP (some of the money presumably is going to keep me from expiring even sooner). But spending on everything other than health, Social Security, and interest payments drops from 12 percent to 8.4 percent.

This is how empires decline. It begins with a debt explosion. It ends with an inexorable reduction in the resources available for the Army, Navy, and Air Force. Which is why voters are right to worry about America's debt crisis. According to a recent Rasmussen report, 42 percent of Americans now say that cutting the deficit in half by the end of the president's first term should be the administration's most important task—significantly more than the 24 percent who see health-care reform as the No. 1 priority. But cutting the deficit in half is simply not enough. If the United States doesn't come up soon with a credible plan to restore the federal budget to balance over the next five to 10 years, the danger is very real that a debt crisis could lead to a major weakening of American power.

The precedents are certainly there. Habsburg Spain defaulted on all or part of its debt 14 times between 1557 and 1696 and also succumbed to inflation due to a surfeit of New World silver. Prerevolutionary France was spending 62 percent of royal revenue on debt service by 1788. The Ottoman Empire went the same way: interest payments and amortization rose from 15 percent of the budget in 1860 to 50 percent in 1875. And don't forget the last great English-speaking empire. By the interwar years, interest payments were consuming 44 percent of the British budget, making it intensely difficult to rearm in the face of a new German threat.

Call it the fatal arithmetic of imperial decline. Without radical fiscal reform, it could apply to America next.

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