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U.S. SOVEREIGN DEBT CRISIS:  
TIPPING-POINT SCENARIOS AND CRASH DYNAMICS

# How and Why a U.S. Sovereign Debt Crisis Could Occur

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[LINK TO ABSTRACT](#)

The purpose of this paper is not to predict whether the U.S. *will* face a sovereign debt crisis, but only to outline what is the *most likely* way that such a catastrophic event might occur. Although there are many possible ways that the U.S. could suffer a sovereign debt crisis—a collapse of the Euro, a pandemic of some kind, or an earthquake in California come to mind—these events are either hard to connect directly to a U.S. debt crisis or are highly unlikely to occur. For that reason, this paper will focus on what I believe is the most likely source of a debt crisis: the failure of the U.S. political system—how it might occur, how the U.S. government and public will react, and what steps will ultimately be taken to address it.

Before proceeding, there is one important issue to consider. In a true sovereign debt crisis, a country cannot meet its debt obligations, largely because it does not have enough of the currency in which its debt is denominated. This, for example, is Greece's problem today. That is very unlikely to happen to the U.S., for the simple reason that its debt is denominated in its national currency, the dollar, and if more dollars are needed to meet the country's contracted debt they can simply be printed by the Federal Reserve. In extreme conditions, the U.S. may be compelled to denominate its debt in some other currency, perhaps the Euro or the Chinese Yuan, but this would imply a huge change in the position of the U.S.

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in the world, and—given the far weaker positions of Europe and China—it is hard to imagine that this could happen in the foreseeable future. Well before that, as discussed below, there would be an upheaval in the U.S. political system—caused by the failure to control its outstanding debt—that will set the country on a course to address the debt problem. Accordingly, this paper will consider not an actual default on U.S. debt, but a serious loss of creditor confidence in the ability of the U.S. to meet its debt obligations without inflating its currency.

## **A Simplified Description of the American Polity**

The U.S. constitutional system consists of two political branches, an executive and a legislative, and a non-political and independent judicial branch. The legislative branch is divided into a House of Representatives, representing the citizens by population, and a Senate, representing the citizens by their states of residence. There is no requirement that the executive and legislative branches be controlled by the same party and it often occurs that they are divided between the two parties, with one party holding the presidency and another with majorities in one or both of the legislative bodies. In that case, it can be politically difficult to achieve a consensus on action, because one of the branches or bodies will not go along.

The U.S. has only two main political parties—the Democrats and the Republicans—and today they are sharply divided along philosophical or ideological lines. Each has a strong support base in the population, which is sharply divided along the same lines. The Republicans generally believe in smaller government, less-regulated markets, low taxation, free trade and a freer rein for business. They expect that such policies will stimulate supply-side responses that will increase government revenues, reduce deficits, and strengthen economic growth. Democrats generally believe in a strong government safety net, government assistance for important or promising industries and disadvantaged groups, and a more steeply progressive tax system that will mitigate what they believe to be sharp income inequality in the country. They expect that higher spending and higher taxes will stimulate demand, keep deficits in check, and result in strong economic growth.

The political parties can each claim the support of about one-third of the population. The remaining third consists of independents, who belong to neither party but shift between the parties in somewhat unpredictable ways, aligning sometimes with the Republicans and sometimes with the Democrats. The

independents are like a shifting cargo in a ship's hold, moving this way and that as the ship of state makes its way through heavy seas. In 2006 and 2008, they liked the Democrats; in 2010 they liked the Republicans. Until independents settle on a direction for the country, its fiscal course will be unpredictable. Yet the independents are the least interested group in setting a course for the future. They simply want the parties to agree and get on with it. What looks like party bickering to the independents is serious business to the parties' respective bases.

I outline this very simplified view of the American polity in the early 21<sup>st</sup> century to underscore that there is very little basis for compromise between the parties, and little indication that independents are capable of or interested in determining what direction the country should take over the long term. As long as the government and the electorate are divided in this way, changes in the country's overall fiscal direction will be extremely difficult to achieve.

## **A Scenario for Crisis: Divided Government after 2012**

Unless the government takes active steps to make substantial reforms, the current course is likely to lead to a political crisis. This is shown by the projections included in the Congressional Budget Office's August 2011 update of its *Budget and Economic Outlook*. In that analysis, made after the August agreement to avert the debt ceiling, CBO projected that if current *law* is followed the annual deficits between 2011 and 2021 will average about 1.8% of GDP and the debt in 2021 will be about 61% of GDP—about where it is now. But if current *policies* are followed, the average deficits over the same period will be 4.3% of GDP, and the debt in 2021 will be \$8.5 trillion greater in 2021 than it is today, constituting 82% of GDP (Congressional Budget Office 2011b).

Current *policies* include no change in either the laws or policies applicable to the major entitlements—that is, outlays under Social Security, Medicare, and Medicaid. These will continue to grow as required by current law. The entitlements are by far the most important drivers of government spending and obligations. Although CBO did not include entitlement growth projections in its August 2011 updating report, it has done such projections in the past.

Current policies also include the continuation of the so-called Bush tax cuts for all taxpayers, continued deferral of the alternate minimum tax (AMT), and continued deferral of the cuts in physician reimbursements under Medicare (the so-called Doc Fix). If the government is divided, none of the changes will be allowed to go into effect. And even with undivided government, changes are not

guaranteed: The Democrats had complete control of the government after 2008 and still did not repeal the Bush tax cuts, allow the AMT to go into effect, or cut Medicare reimbursements. All of these actions would be perceived by many to be costly to the middle class and thus are politically unpalatable for either party.

The scenario I envision for a U.S. sovereign debt crisis runs as follows: Neither the Democratic nor the Republican Party is able to gain complete control of the U.S. government in any election for the indefinite future. Control of the House of Representatives, the Senate and the presidency remains split, with at least one House of Congress in control of a party other than that of the president. Each party would then be in a position to prevent the government from stopping the growth in the country's debt. As a result, there is an indefinite period of electoral stand-off between the parties on how to reduce or stop the growth of spending, especially on the promises to the public concerning various popular government benefits, known as entitlements—Social Security, Medicare and Medicaid.

Although a compromise is possible in theory, I suggest that, *in the absence of a crisis*, the electoral benefits that flow to each party by attacking the positions of the other will make compromise unlikely. For example, when the Republicans in the House adopted a budget that included a new system for controlling the costs of Medicare, the Democrats saw this as a path back to a House majority, not as something to build on for the control of the country's growing debt. This isn't to say that a compromise will not happen before a crisis occurs; strong presidential leadership could bring the country together behind a debt solution before a crisis, but I assess this as less likely than a continuation of the gridlock that exists today.

In its *Long-Term Budget Outlook* of June 2011, before the agreements made in August to avert the debt limit, CBO estimated that if current policies are continued the cost of the government's total spending by 2021 would be 26% of GDP, and at that point the total debt would be 101% of GDP. On the same assumptions, by 2041, total spending would be 37% of GDP and the U.S. debt would exceed 200% of GDP. Taking account of CBO's estimates and projections based on the spending cuts made by the August 2011 agreement, the debt-to-GDP ratio in 2021 will be 82%. According to CBO, the cumulative entitlement costs for the 20-year period 2022-2041 will total \$78 trillion (Congressional Budget Office 2011a).

There is of course no way to know whether a debt-to-GDP ratio of 82% (estimated by CBO for 2021 after the August agreements) will be the tipping point that would put the U.S. on a path to a sovereign debt crisis, or whether some other (higher or lower) percentage will be necessary to put the U.S. at the brink. Perhaps that tipping point has already passed. Everyone would agree, however, that as the U.S. budget deficits grow after 2011, and as spending driven by entitlement costs becomes a higher and higher percentage of GDP, the U.S. is on an unsustainable path.

At some point—we don't know when—the financial markets will come to the conclusion that there is no way for the U.S. to meet its contracted debt obligations (the debt issued by the Treasury), as well as its promises to the American people in the entitlements programs, without inflating the currency—i.e., reducing the purchasing power of the dollar in terms of the goods it will buy.

The capital market's realization that the U.S. cannot meet its obligations without inflation could be dramatic—signified, for example, by a sharply higher interest rate at a Treasury auction of its ten year notes. Alternatively, the rate on government securities or wholesale prices could gradually creep up over a period of months until a trend becomes indisputably clear. At that point, which could be next year, 10 years from now, or even later, a form of U.S. debt crisis will ensue. For the reasons outlined above, this will not be an actual default but rather a period of devastating inflation that will have the following effects:

- The dollar will fall in relation to other currencies. Foreign goods, therefore, will become more expensive for Americans, reducing the relatively high standard of living obtained by importing low-priced products from emerging markets.
- Interest on newly issued Treasury debt will rise substantially, adding significantly to the budget deficit and the need for yet more borrowing.
- An upward price-wage spiral will begin, with workers demanding higher compensation to make up for the falling purchasing power of their wages.
- Prices of commodities such as oil, food and gold will also increase as producers also try to maintain the purchasing power of their inflating dollars.
- Prices of tangible assets of all kinds—land, gold, diamonds, art—will rise faster than the price level generally as individuals and businesses try to hedge against inflation by acquiring real assets that will inflate in value.
- Social Security recipients and other entitlement beneficiaries whose benefits are tied to inflation will receive higher benefits, again increasing outlays.
- Physicians will demand higher allocations of funds from Medicare in order to treat Medicare patients, and in the absence of such increases Medicare patients will be turned away by doctors in what will be called a doctors' strike.
- As inflation accelerates, rising dollar incomes will result in substantially higher taxes as a percentage of income, as more and more middle

income earners encounter the progressivity of tax system at higher dollar incomes.

- Higher costs of consumption will come immediately, but wages will lag, causing a sharp downturn in demand. The U.S. will enter a deep recession, perhaps a depression, with unemployment rising to levels not seen since the 1930s.
- Investment returns on such things as bank deposits and payments from public and private pension programs—including Social Security—will lag far behind prices, causing great privation for those on fixed incomes. At some point, foreign producers of commodities may refuse to accept dollars in payment for goods or services. If there is no alternative, they may demand gold, silver or a stronger currency (perhaps the Chinese Yuan or the Euro if it survives the current turmoil in Europe) as a medium of exchange. If there is no stronger currency, the world's trading system will stagnate, with associated declines in the standard of living for people everywhere.

## Politics in the Crisis

These momentous events will make clear that the U.S. must choose between meeting its contracted debt obligations with a stable dollar or fulfilling the political promises implied by the entitlement system. It cannot do both. Just as many U.S. states and localities have begun to pull back from—or attempt to reduce—their future pension obligations, the federal government will finally be required to confront the same issue. The parties will have different approaches to addressing this reality, consistent with their ideological positions. The Republicans will want to increase economic growth by cutting taxes and to strengthen the dollar by cutting entitlement spending; the Democrats will want to increase taxes so as to fulfill the promises of the social programs as nearly as possible.

What will the independents do? It is conceivable that they would split in a way that prolongs divided government, but, following my cargo analogy, I will posit that, in a real crisis, they swing decisively to one party or the other.

If that party is the Democrats, the country will turn sharply left. Taxes will be increased to meet social policy obligations including the entitlements, which will not be seriously cut. Military spending will also be cut. Regulation will increase, and large portions of the economy that have been weakened by the recession may be nationalized or otherwise brought under political control. This will also increase government revenues. If the party that is given the mandate is the Republicans, the country will turn sharply right. The Republicans will cut taxes, keep military

spending largely where it was, and cut back sharply on entitlement spending by raising the age of eligibility, reducing payments to those already eligible, and changing the structure of Medicare so that it is no longer a single-payer system.

Accordingly, unless the U.S. political system can get control of entitlement spending before the trigger event occurs, the question that will ultimately be presented to the voters is whether they want to pay the government's contracted debt by increasing taxes or by cutting entitlements. It will eventually become clear that both cannot be done without substantial and painful inflation.

## References

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## About the Author



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