



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

Courting an Avoidable Financial Crisis

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[LINK TO ABSTRACT](#)

Imagine a story that is a cross between *The Guns of August*, a tragedy in which the princes of Europe blunder into the horror of World War I, and *Catch-22*, a wartime comedy driven by situations of hopeless internal contradiction.

The United States, and other nations around the world, already have sailed far off of their financial and fiscal charts. No one can say with certainty what will happen if we remain on our current course, because we have never been here before. Nonetheless, with a little imagination, one can draw a straight line between a reasonable conception of our current location and a tragic financial meltdown defined by those two classics of fact and fiction. As uncertain as the future is, this scenario arguably can serve as a plausible cautionary tale.

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Before offering tales of the future, however, I should say a bit about how I see the present.

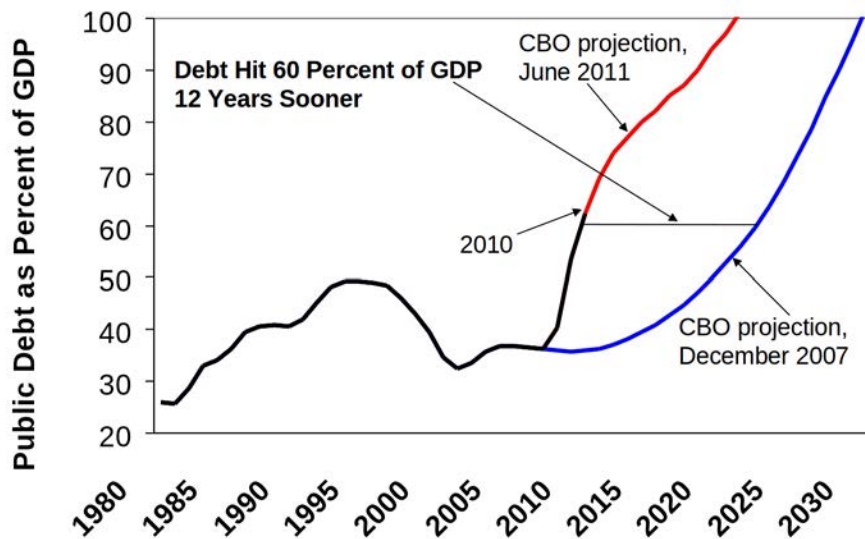
The United States is less central to the financial and economic universe than it was a few years ago. But it is still the closest thing that the global economy has to a flywheel. More than any other nation, the United States could shake the entire world.

1. Committee for Economic Development, Washington, DC 20036.

Today's financial risk arises largely from U.S. fiscal misbehavior.

Four years ago, scholars feared that by 2022 the U.S. public debt would reach 60 percent of the GDP (the European Monetary Union's prudential limit)—driven largely by healthcare costs for the elderly population. That projection is shown in Figure 1 with the blue line.² But, as indicated by the black line³ tracing historical data, that projection has gone out the window. The red line⁴ shows the outlook as of the end of 2010—when the debt had already exceeded 62 percent. Debt continues to rise rapidly—with the worst effects of aging and healthcare costs still looming, as is shown in Figure 2.⁵

Figure 1. Sudden worsening of an already dire problem



Now the Congressional Budget Office projects that, on our current course, the debt will reach the end-of-WWII record level of almost 109 percent by 2023. The new projection is shown in Figure 3.⁶

In 1946 the economy was poised for growth through added labor and capital, and ending the war quickly slashed spending by 30 percent of the GDP, solving the debt problem. Today, the nation has a financially wounded economy subject to intense international competition, with a much larger population in or near

2. Data from Table 7.1 in Office of Management and Budget (2011).

3. Data from Figure 1-2, Alternative Fiscal Scenario, in Congressional Budget Office (2007).

4. Data from Figure 1-2, Alternative Fiscal Scenario, in Congressional Budget Office (2011).

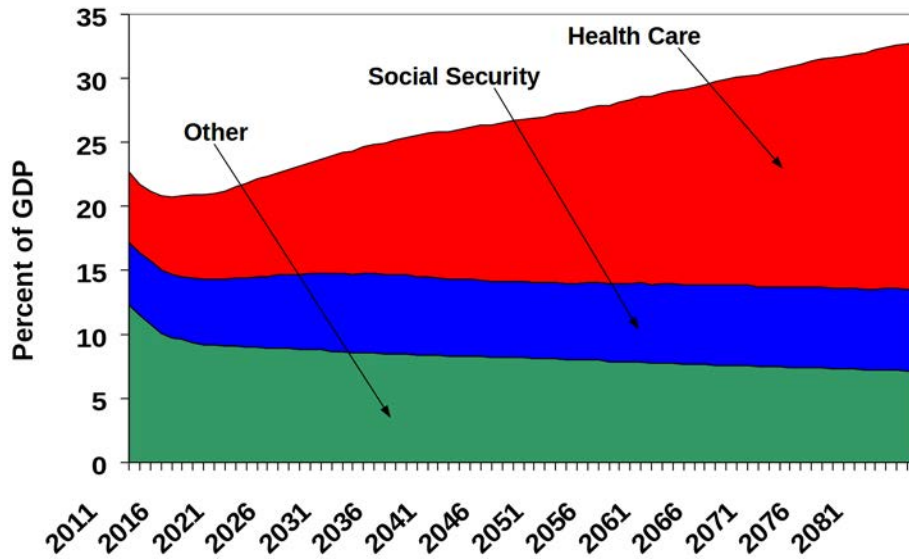
5. Data from Figure B-1, Alternative Fiscal Scenario, in Congressional Budget Office (2011).

6. Data from Table 7.1 in Office of Management and Budget (2011).

dependency in retirement, and defense spending near the low post-World War II levels. The risks are far greater and the remedies are far from obvious.

By international comparison, the United States now has the ninth highest public debt burden among OECD members.⁷ All eight nations with larger debts are widely cited as being in trouble, as are several nations with lower debt burdens.

Figure 2. Non-interest spending growth



Faced with today’s crisis, our political leaders show many of the attributes of those who stumbled, unaware or uncomprehending, into World War I. They evidence ideological certainty and enmity between the political parties.

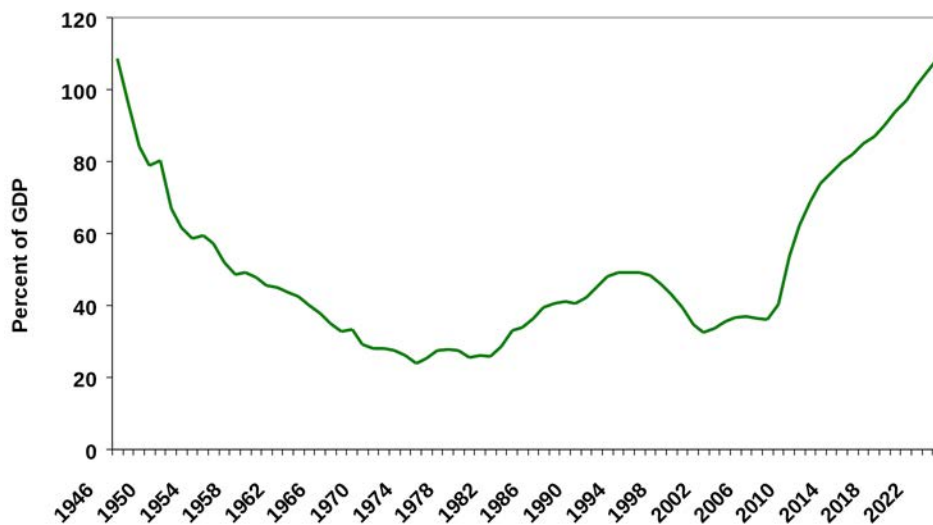
Politicians’ behavior has shown a lack of intestinal fortitude, ranging from an unwillingness to present the electorate with bad news that is obvious to experts, to a willingness to take risks with the well-being of the nation in the hope of political gain. Candidates often either refuse to acknowledge the seriousness of our financial and fiscal problems or promise that they can be solved without pain (or even through self-indulgence). Also, it is clear that our elected policymakers are far from expert on these issues.

To be sure, these problems are not the sole responsibility of our elected leaders, who are responsive to popular opinions that are often uninformed or

7. Annex Table No. 32 ([link](#)) in Organisation for Economic Co-operation and Development (2011). The text references 2010 rather than later years, which rely on projections. For 2011 and 2012, the OECD data rank the United States as having the seventh-highest debt burden.

misinformed. In a stage of technological evolution beyond the rowdy 20th century mobs who cried for a war whose consequences they did not understand, unschooled ideologues using the new 24/7 Internet often confirm and reinforce each other's misperceptions. In a moment of decision, a loud and foolish minority could intimidate its nation's leaders into fundamental miscalculation and missteps, including a refusal to accept constructive compromise to avoid a crisis.

Figure 3. A longer-term view: Debt approaches World War II levels



Some candidates for office may themselves know better but believe that electoral success is impossible unless they make unrealistic commitments. U.S. politicians will not receive credit for solving a problem that many refuse to believe they have—sometimes out of sheer ignorance, sometimes schooled by widely propagated but baseless ideology. Perhaps some more-understanding candidates say what is necessary to achieve election now, hoping or planning to educate and change the views of the electorate later.

The U.S. business community might be expected to play a leadership role, and to educate and stabilize the public. However, popular opinion of the business community is low, fairly or unfairly, because of the scandals of the late 1990s and business's alleged role in the financial crisis of 2007-2009 and the resultant popular hardship. Business is perceived by many to earn large profits disproportionately from foreign operations while unemployment is high at home, and to sit on large reserves of cash that could be used to finance investment in plant and equipment.

From business's perspective, there is diverse opinion about policy options, at least in part because in this economic environment there is a wide range of threats to different firms. Large businesses that can sell fixed-rate bonds in the open market can capitalize on the current low interest rates and may perceive little or no downside based on their experience of past economic cycles. Their leaders may in fact fear the consequences of a potential remedy to the fiscal problem more than the downside of the problem itself. On the other hand, smaller businesses that must borrow from banks at variable interest rates face the danger of a spike in rates. But small businesses have less expertise and less voice and influence.

Expectations tend to be formed from past experience. But because the major economies have sailed off of the historical charts, big businesses might be in more danger than they realize. They could be caught out if a meltdown causes serious and unexpected economic dislocation that reduces demand from consumers and from smaller businesses, which remain at the mercies of potential large waves in the credit markets. Those vulnerable smaller businesses could be important links in larger firms' supply chains. And a lock-up even to very-short-term financing on the part of apparently solid firms—like the freezing of the commercial paper market in the 2007-2008 crisis—could extend the damage of a meltdown much further into the ranks of the reputedly invulnerable larger businesses.

Yet another potential set of players is the credit rating agencies. The standing of the rating agencies themselves is controversial in the wake of the financial crisis of 2007-2008, in which they arguably overlooked serious risks. This puts the agencies under pressure to react more quickly in the future, which might heighten financial-market anxiety about potential sovereign risks. A prototype could be Standard & Poor's downgrade of U.S. Treasuries after the recent brush with the nation's statutory debt limit, despite the creation of an extraordinary congressional process to achieve future deficit reduction.

And then there is Europe. Problems of collective crisis decision-making within an EMU structure that was constructed on the implicit assumption that there would be no crises have left Europe's financial wounds to fester. Although many resisting member nations have legitimate concerns from their own parochial viewpoints, Europe may suffer because it has failed for so long to face up to and divide the admittedly enormous costs of solving the crisis.

Elsewhere, the authority to price oil gives OPEC a role strangely analogous to that of the ratings agencies. An OPEC decision that the dollar no longer serves its purpose as a reliable medium of exchange could prompt other nations to shift their reserves into other currencies, weakening the reserve status of the dollar. Such a decision could destabilize the world financial markets.

To this moment, most parties, in the United States and around the world, are behaving much as did the princes of Europe in the last century: as though it is pre-

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ordained that this story will have a happy ending. The political parties in the United States, and the nations in the EMU, are driving hard bargains through an apparent conviction that all must be well in the end. But a happy ending is not guaranteed. The world can find itself the victim of one or more Catch-22 dilemmas. The United States easily could find itself with an exceedingly weak economy and too much debt to respond to it. The United States would be like the dysfunctional smaller indebted countries on which developed nations have imposed painful fiscal consolidation. But in this case, it is the flywheel of the global economy that must endure an abrupt demand slowdown, with no other country nearly large enough to maintain global stability and growth.

And what will happen if, at the same time, Europe is caught on the horns of a dilemma between two unimpeachable moral principles: that poorer nations should not be called upon to bail out their richer neighbors; and that each nation in a community must sacrifice to prevent a cataclysm that could sink all of them? How will decisions be improvised within the monetary union when its set of rules provides no guidance?

* * *

Put all of the foregoing together—the potential for actions with unintended consequences, creating internal contradictions and vicious cycles—and you can see how decision-makers could stumble into a financial meltdown.

Start with a budget-process deadlock in the United States. The two political parties refuse to compromise, each believing that the American people are on their side, and that if they only stand firm until the next election, they will win a strong majority and be able to address the problem “our way.” An election is always near, with a two-year Congressional cycle, and political leaders are reflexively optimistic—the prospects are based on their own performance, which they naturally believe is correct—at least until the very last days before an election, when the losers begin to see the handwriting on the wall.

Think of the pre-election deadlock in policymaking. Presidential candidates make competing promises to solve the budget crisis without pain. Candidates rule out significant tax increases and painful benefit cuts. Now, from outside of domestic politics, comes a flow of adverse events. The markets could conclude that neither party has retained the flexibility needed to address the budget crisis in the following four-year term. If market players conclude that they cannot wait that long for action, they could begin to lose confidence. Another scenario that might test confidence would be if an election that was expected to anoint one party to take decisive action instead results in divided government and likely continued gridlock.

Suppose that some development—whether started by politics, the beginnings of an economic recovery, signs of inflation, or a decline of the dollar—sends U.S. interest rates up from their current record lows. The cost of servicing the federal government’s debt begins to rise. OPEC makes a gesture or a concrete step away from the primacy of the dollar as a pricing denominator. Every credit rating agency, trying to safeguard its own reputation in the aftermath of the crisis of 2007-2008, does not want to be the last to recognize publicly the growing risk in Treasuries. Actions by OPEC and the ratings agencies heighten the initial anxiety.

Developments in Europe accelerate the hike in U.S. interest rates. Ironically, that could happen in opposite ways. Resolution of Europe’s debt crisis could send investors around the world from the dollar to the euro.

Or, on the other hand, a deepening of the European crisis could raise fears about the soundness even of U.S. financial institutions, and thereby raise the risk premia in interest rates. Such adverse developments in Europe could for a time enhance the safe-haven status of dollar investments. However, because they would weaken the dollar’s fundamentals, that apparent favorable development could be only temporary.

And so in due time, U.S. public finances are caught in a vicious cycle. Rising interest rates raise the federal government’s debt-service cost, which increases the risk premia on Treasury interest rates, which raises debt-service costs still further. Higher interest rates extend to private borrowing costs, which slows economic activity, which increases the federal government’s budget deficit. In another Catch-22 contradiction, the drop in economic activity is not cushioned by a fall in interest rates to match the fall in the demand for credit. Rather, the fall in activity triggers a massive growth of fear of default risk, and so interest rates rise rather than fall, accelerating the vicious cycle. Perhaps this crossing over in the effects on interest rates would constitute a true “tipping point.”

It would seem reasonable to expect that investors would respond to such signs of internal contradiction in the markets with a “rush for the exits” on Treasury securities. But because a collapse of the financial bedrock of Treasuries would reach into an almost incalculable range of other assets and financial institutions, this result could become utter panic. So just as in the 2007-2008 crisis, we would see emergency overnight meetings of business, finance and government seeking to ward off dire developments at the moment of the next market opening.

Minute-by-minute movements in the financial markets could invade the real economy over a time span of weeks and months. Business failures could start from the bottom of the firm-size continuum and roll upward. Smaller businesses financed with variable-rate loans could see their debt-service costs rise to beyond their cash flows and be forced to shut their doors, or at least reduce sharply

employment and proprietors' incomes. This would not only cut consumer demand, but also disrupt the supply chains of larger firms. A mass of smaller dominoes could begin to topple or at least hobble apparently invulnerable larger ones. Larger firms might need to rush to consolidate with and shore up their smaller business partners, a task that would be difficult to execute and could arouse anti-trust assaults. A nation that flirted with double-digit unemployment in the wake of the 2007-2008 crisis should not consider itself immune to a labor market that is far worse.

If Europe escapes its own current debt crisis, it would suffer collateral damage as the shrapnel of a U.S.-centered meltdown sprays around the world. The failure of U.S. financial institutions weakens institutions elsewhere, and other economies must absorb the indirect shock. The apparent safe-haven status of the dollar provides a layer of protection from a run on our currency. But once that layer begins to crack because of growing fear of default risk, the mass of dollar-denominated securities held in reserve merely extends the downside. Relative to a hypothetical similar nation whose currency was not the world's reserve, there are more investors in U.S. dollars, of whom only a few are needed to trigger a panicked rush for the exits, from which there would be more dollars whose full weight would fall onto the international currency and asset markets and pressure U.S. financial institutions, including the Treasury itself. It could give sad confirmation of the adage that "the bigger they are, the harder they fall."

On the other hand, if Europe's debt morass deepens and the aversion to sovereigns extends to their securities and the euro, then damage from the initial explosion itself will be felt on both sides of the Atlantic, spreading even wider cracks in an expanding web.

But the essential difference between prospects today and recent past (and smaller) financial crises lies in the role of the United States. In financial tremors since the Great Depression, the United States served as an unquestioned safe haven. It was bedrock to the financial world and a flywheel for the global economy, providing gyroscopic stability. Now, the United States is at or near the epicenter of a potential financial shock. If it is not the prime mover of that shock, it would be only because Europe has become even more unstable. Every other economy around the world is significantly short of the stature of the United States as a potential safe haven. Japan has financed its own debt, but that debt is excessive. China's financial institutions are in no position to take the global lead. At no time in living memory has the world's perceived safe haven, the issuer of the reserve currency, been a leading or primary cause of a global financial crisis. This chilling reality is the reason why economists now begin to ask about the nature of a financial meltdown.

And if conditions deteriorate along the lines of our scenario, financial actors will be truly at sea—and off the existing charts. There will be no safe haven—with

only the most active and sophisticated investors in a sense bartering outside of the existing currency system, hot-potato style, with precious metals and other commodities. Instead of searching relatively thoughtfully for the highest return, financial actors will be rushing frantically for any measure of stability and safety, often in unproductive assets. This measure of panic may to some extent drive investors to explore productive opportunities in the developing economies, outside of the current orbit of sovereign risk, but because those economies disproportionately exploit export opportunities in the now-disrupted developed world, they too will be weakened. Such an unprecedented scenario brings to mind the largest one-day percentage drop in the U.S. stock market (almost 23 percent, part of a drop of more than one third in four months, with volume double the previous record). “Black Friday,” October 19, 1987, was ascribed by some commentators to fear of excessive U.S. reliance on foreign capital—much the same condition as is exacerbated by our fiscal imbalance today. In 1987, the economy was growing comparatively robustly. Given the recent financial crisis, the persistent economic slowdown, and the continuing issues in Europe, it is hard to consider that catastrophe as an upper bound on the potential damage today.

In a situation like this, respect for and credibility of government and the Federal Reserve will be critical. However, this disrupted environment will only pull further at the cracks in the foundations of those institutions, which already were opened wide by the calamity of the 2007-2008 financial crisis. Far-from-expert political actors will prey on that lack of respect, to the detriment of both policymaking itself and the efficacy of even the wisest decisions in an environment of profound uncertainty and even panic.

To this moment, public dialogue in government has been mainly destructive rather than constructive. There are many thoughtful members of Congress, in both parties, who communicate continuously and privately across the political aisle, and who earnestly seek responsible compromise to slow the buildup of debt. However, the loudest voices come from the political extremes, who reach office in gerrymandered districts dominated by the ideological wings, financed by a campaign-contribution system that is awash in undisclosed individual and corporate money. Every honest misstatement and misstep is broadcast for political advantage, poisoning the electoral environment and making pursuit of the public good an almost unforgivable offense. Too many in the public are caught up in partisan frenzy rather than in supporting advocates of nuanced solutions to our complex problems. In this political atmosphere, our elected policymakers may be too slow to appreciate the danger of a developing meltdown and to show cooperation in addressing the fundamental problems and thereby to calm the public.

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Amidst such short-term anxiety and even panic, fostering long-term economic growth will fall far down the to-do lists of governments. But ballooning debt-service costs clearly will crowd out much of both private business investment and potentially productive public investment in both physical infrastructure and human capital. So in another Catch-22-style contradiction, governments will not be able to pursue what they will need the most to save their nations' futures. Private investment will be further constrained because lending by and among stressed financial institutions will lock up, from fear of unknown and unknowable default risks.

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A U.S. financial meltdown today is eminently avoidable. The wealthiest nation on earth, despite a painful economic slowdown, maintains the wherewithal to pay its bills. The open question is whether it maintains the will and the wisdom.

The purpose of this rhetorical foray beyond our charts of fiscal policy and finance cannot be to make an accurate prediction. Rather, it must be to ensure that no prediction of the nature of a financial meltdown will ever be tested. The objective is to bring the sovereign princes, as it were, to their senses before they blunder and dare their way into an irresolvable Catch-22 of unthinkable financial contingencies.

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