The Economy

The Misguided Hysteria Over Public Debt

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The federal fiscal policy debate is being overwhelmed by a sense that America must slash its deficit now, before it is too late. Actually, the United States is in no danger of a Treasury debt crisis and can carry far more debt than people believe without dire consequences.

An increasing share of lawmakers and the general public cite rising public debt as one of the country's biggest problems. Dismal pronouncements abound, including that the government deficit will inevitably result in slower economic growth, higher inflation, or higher taxes. Active deficit cutting is proposed as the responsible—if painful—solution.

Unfortunately, many who argue for rapid deficit reduction base their case on a slew of fallacious generalizations about the consequences of high public debt and the reasons for our deficits. In reality, nations vary sharply in their capacity to carry public debt. America's debt-carrying capacity is extremely high, and attempts to sharply cut the deficit during the next few years would be a disaster.

There is a broad sense that public debt at or above 100 percent of a nation's gross domestic product is out of control, and for many countriesGreece being the poster child—this is the case. But this is not so for the United States, Japan or the United Kingdom. Still, with U.S. Treasury debt held by the public equal to 60 percent of GDP and rising rapidly, America is often getting grouped with countries in which high public debt ratios are causing major problems.

These other countries did not get into trouble because of debt ratios alone. They had some combination of the following conditions that limited their capacity to carry debt: a lack of government control over the money supply of the currency in which most of its debt is denominated; debt owed in or convertible into gold; the lack of a long history of political stability and an effective means of tax collection; the lack of a large, liquid market for government debt; and debt owed personally by a king or other ruler. None of these conditions applies to the United States.

Public debt ratios of countries with high debt capacity have risen well above 100 percent. America and Japan have had debt-to-GDP ratios over 100 percent, and Britain over 250 percent, without calamitous consequences. The record shows that in strong, advanced countries like these, a high public debt ratio does not necessarily lead to rising inflation or slower economic growth.

In both America and Britain (the high-debt-capacity countries with the longest history of public debt), there is no visible relationship between the public debt ratio and inflation. For example, the peak U.S. public debt ratio of 109 percent in 1946 was followed by a decade of low inflation.

Similarly, history fails to show that high public debt is a drag on growth for America or Britain; in fact, peaks in the public-debt ratio have been precursors to unusually strong economic growth. That's because circumstances that cause high debt—major wars and depressions (America is in a "contained depression" now)—can shrink private balance sheets and create forces for new eras of strong private investment and growth.

Sadly, discussions about the implications of rising public debt are riddled with many other misplaced fears as well: that there will be insufficient savings to absorb the continued massive issuance of public debt securities; that the public debt ratio can only be lowered by onerous future tax hikes; that the U.S. government is reliant on China to finance deficit spending or that China's continued willingness to buy Treasury debt is in grave danger.

Understanding these issues will be crucial for successful policymaking in the years ahead. A continuing, steep rise in the U.S. public debt ratio is virtually unavoidable until overcapacity, excessive debt, and broadly deflating asset values no longer cripple the private sector.

For now, slashing the deficit would be hurtful to the economy and self-defeating. Such well-meaning but wrong-headed action would cause renewed recession and plunging tax revenues.

The good news is that, despite what the alarmists contend, the country can handle it.

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