The Shadow Cast by US Debt

Carmen M. Reinhart discusses how history teaches that large public and private debt impedes economic growth, a lesson that the United States must heed in the years ahead.

Edited transcript, recorded February 18, 2011.

Steve Weisman: It's budget season, and Washington is dealing with steps to curb the American overhang of debt. This is Steve Weisman at the Peterson Institute for International Economics and with pleasure I welcome Carmen Reinhart, new senior fellow here at the Institute, for her first Peterson Perspectives interview. Thanks for joining me, Carmen.

Carmen Reinhart: Thank you for having me.

Steve Weisman: Carmen, there's a lot of talk in Washington about the dangers of mounting US debt, especially after the financial crisis, but also driven by the commonly understood demographic and spending factors. How would you characterize how precarious the United States' situation is now? How are global markets perceiving it?

Carmen Reinhart: I think that there is ample reason to be concerned about the level of indebtedness in the United States, both public and private. Let me say something as background. Going into the crisis, private debts -- notably that of households and financial firms -- had surpassed any historic markers that we could point to, by a huge margin. And significant debt overhangs still exist notably in the household sector but also in the financial industry. So right now the only sector that isn't weighed down by that overhang is in financial businesses.

Now the public debt, which has been the focal point of so much attention since the budget was released, is at levels that we had not seen since the end of World War II. And the end of World War II were the all-time historic highs since 1790.

So there are well-founded concerns about issues raised by this debt burden. By the way, when I say government, this really means government in its narrowest sense. It doesn't take into account the contingent liabilities that we have accumulated in Social Security or the contingent liabilities that are still out there in the financial industry.

So I would divide the concerns into two parts which we can discuss. One is the concern over an imminent Greek-style sovereignty crisis and the other is just the more general concern that overhangs have dark consequences for growth.

Steve Weisman: Let's talk about the sovereignty issue first. You were in Davos. Obama Administration officials, including Treasury Secretary Geithner, were somewhat upbeat in saying that the United States was getting its arms around the problem. What's your reaction?

Carmen Reinhart: I think that, in praise for the budget that has come out, I will certainly say that the budget is based on a realistic sober assessment of economic prospects. It's not forecasting a Pollyannaish strong sustained recovery, especially in employment. So it's predicated on fairly reasonable economic assumptions. I'll say more about that later. But in terms of really tackling the debt, it's really quite modest. And saying that we are capping net debt at around 77 percent GDP still leaves gross debt at historic highs.

In my work with Ken Rogoff, we identified gross debt thresholds of around 90 percent as being associated historically with lower growth outcomes. And we are past that already. And I would add that one area where the budget is very modest in its achievements, to put it gently, is in its spending cuts, which are largely concentrated on non-defense discretionary spending, which is about 12 percent of total spending. Of course that leaves the big question, "What about the other 88 percent of spending?"

Steve Weisman: You mentioned that you thought the economic assumptions were reasonable in the short term. Tell me a bit more about that.

Carmen Reinhart: For some time, market participants by and large, and Administration and the Federal Reserve, had been forecasting a more standard recovery from the financial crisis. In my work with Ken Rogoff on the aftermath of financial crises and also in the work that I did with Vincent Reinhart for the Jackson Hole Symposium, a big message that emerges is that recessions following severe financial crises are deeper and more protracted, notably in employment recovery and also in the recovery—or more accurately lack thereof--in housing markets.

In the Jackson Hole work, it goes beyond saying that the immediate recession after a crisis is more severe, more protracted. It basically concludes that the decade following a financial crisis is characterized by lower growth and a higher unemployment rate – and this is advanced economies; this is not an emerging market comparison – than the decade preceding the crisis. A big reason for that subpar performance is huge debt overhangs, public and private.

Steve Weisman: So coming back to the Administration's and Fed's forecasts, are they being overly optimistic?

Carmen Reinhart: I think they have gradually moved in the direction that is more consistent with the less v-shaped, more gradual recovery in employment. So I would say that right now the budget assumptions are predicated on reasonable estimates of what could happen.

Steve Weisman: Let me come back to the private sector debt situation, both commercial and household. I thought that there were some signs that household and commercial sectors were deleveraging or reducing their debt. Did I misunderstand?

Carmen Reinhart: No you didn't; not at all. Household debts peaked in 2008. But let me say this about deleveraging. You can measure deleveraging on a flow basis. That is, "Are they taking on new credits? Are they taking on new debts?" You can also look at the inherited stock of debt relative to income.

Now, we have a problem with the inherited stock of debt in that for households, for example, they have faced a housing price decline in real terms of about 30 percent. But loans and debts on a widespread basis remain at book value. So that still leaves this unresolved debt overhang that is being resolved only very sporadically and gradually through foreclosures.

Likewise, the financial industry has been presented with the gift of forbearance, coupled with government guarantees and zero interest rates. So it's not too bad to carry all those dead weight assets on their balance sheets. But realistically, the market value of those debts is nowhere near what they appear to be.

So these kinds of delays in write-downs of bad debts are part of the reason why recoveries are more meager and take so long after a financial crisis. In effect, the deleveraging process historically for all the severe post-War crises -- not all, but for a substantial number of the severe financial crises -- the deleveraging process for the private sector takes about seven years.

Steve Weisman: Carmen Reinhart, thanks very much.

Carmen Reinhart: Thank you.