

Congressional Testimony

The Statutory Debt Limit

Simon Johnson, Peterson Institute for International Economics and MIT Sloan School of Management

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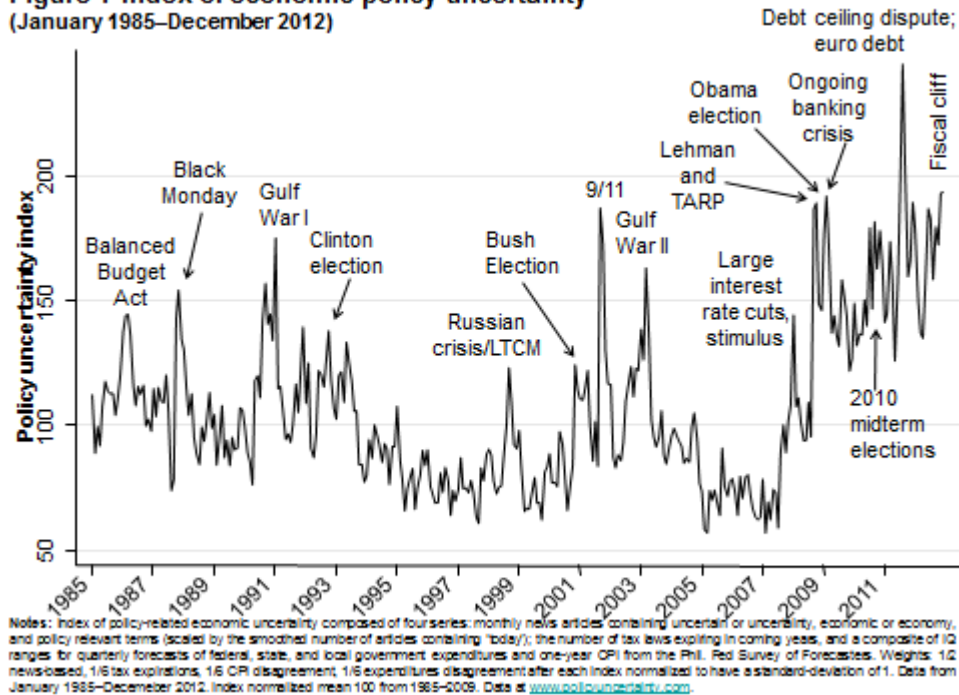
Note: This testimony draws on [White House Burning: The Founding Fathers, Our National Debt, and Why It Matters to You](#), coauthored with James Kwak. [The Systemic Risk Council](#) is a private group founded and chaired by Sheila Bair. All views expressed here are personal.

A. Main Points

- 1) This is a difficult time for the United States and global economy. Financial markets can easily become unsettled. A serious sovereign debt crisis remains unresolved in Europe's euro area. There are serious potential risks on the horizon in countries such as Japan, China, and Brazil. International Monetary Fund (IMF) Managing Director Christine Lagarde warns about a potential "relapse" in the world economy.
- 2) In this context, continuing uncertainty around the US federal budget in general and the debt ceiling in particular is not helpful—and may prove destabilizing both at home and around the world.
- 3) Even a partial shutdown of federal government in the United States would have a significant negative effect on the economy. The private sector—particularly small business—would be greatly damaged by any lack of clarity about when and how the government will pay for goods and services purchased or make the transfer payments promised to citizens.
- 4) In addition, we have seen repeatedly over the past few years that congressional deadlock over fiscal issues worsens uncertainty and makes it harder for the private sector to make sensible decisions—including regarding the consumption of durables and all kinds of business investment.
- 5) Empirical research by Scott Baker (Stanford), Nick Bloom (Stanford), and Steve Davis (Chicago) finds that over the period 1985–2012, policy uncertainty reached its highest peak with the debt ceiling crisis in the summer of 2011.¹ (See figure 1 below; this is reproduced from Baker, Bloom, and Davis, "[Measuring Economic Policy Uncertainty](#)," with permission.)

¹ See their website www.policyuncertainty.com.

**Figure 1 Index of economic policy uncertainty
(January 1985–December 2012)**



- 6) This kind of uncertainty makes it harder for employment to recover fully. Repeating a showdown over the debt ceiling every three to six months is sure to prolong the agony of the economic recovery. In fact, this would be one of the worst possible economic policies imaginable.
- 7) Five years after the financial crisis intensified, we remain substantially below full employment levels. This in turn keeps more pressure on monetary policy than is desirable, leading the Fed to engage in ever more experimental measures.
- 8) Relatively low employment depresses tax revenue. This is the major reason our current deficits are so large. We need the economy to recover fully, with jobs for all Americans who want to work. This is the best way to address our short-term fiscal issues.
- 9) In the worst case, a failure to increase the US debt ceiling would seriously and permanently undermine our standing in credit markets, increase interest rates, and worsen the budget deficit. The stock market would also likely fall sharply (and this could well happen, even if interest rates do not spike up.) Any or all of these developments would have an immediate negative effect on all parts of the private sector.
- 10) The debt ceiling impasse in summer 2011 created a degree of uncertainty that was not helpful to job creation. The fiscal cliff standoff at the end of 2012 was another instance of policy induced uncertainty—if the same deal had been reached six months earlier, this would have been much better for the economy than what actually transpired.
- 11) Standard solvency analysis—including, for example, the tools used by the IMF—confirms there is no prospect of an immediate fiscal crisis in the United States. We currently have

“fiscal space,” in the sense that there is strong global demand for Treasury obligations in the foreseeable future.²

- 12) Long-term interest rates are low and remarkably stable. Partly this is due to actions by the Fed through various forms of quantitative easing, but US government securities are also seen as a safe haven for international investors. However, this safe haven status will be jeopardized if markets perceive a significant probability that we will not pay our debts as contracted—or if create the perception that our economy will be thrown into repeated turmoil through regular showdowns over the debt ceiling.
- 13) Over the Congressional Budget Office’s (CBO) 10-year forecast window, with the partial expiration of the Bush-era tax cuts, there is no insurmountable budget problem.³ There is no fiscal emergency over this time horizon.
- 14) Our most important budget problems come *after* the 10-year horizon, because Medicare spending accelerates due to an aging population and increasing health care costs. The real issue here is containing healthcare costs—i.e., cutting Medicare in such a way as to shift healthcare costs onto families is not an appealing solution, particularly as this would likely raise healthcare spending as a percent of GDP.⁴
- 15) We should aim to find a way to control healthcare costs as soon as possible—every year of high healthcare cost inflation makes the problem worse. Our competitors are controlling healthcare costs much more effectively than we are; with the set of advanced countries, the United States stands out as having the worst (highest) projects for rising healthcare costs through 2030 or 2050.⁵
- 16) The United States is in the midst of a significant demographic transition, with the population ageing. We need to invest in education and ensure access to affordable healthcare to everyone if we are to increase productivity as the population ages. Ultimately, this is the only way to ensure that older, retired workers can receive a sustainable level of reasonable benefits (including pensions and healthcare).
- 17) In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. Part of that should include additional tax revenues.⁶ The Bush-era tax cuts reduced revenue to an excessive degree, given the ageing of society. We are still struggling to recover from that flawed way of thinking about our public finances.
- 18) It is striking the extent to which income inequality has increased dramatically since the last tax reform in 1986.⁷ From 1986 to 2006, there was little change in average income for the

² Comparative cross-country estimates are provided in Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Quereshi, *Fiscal Space*, IMF Staff Position Note, September 1, 2010, SPN/10/11.

³ See James Kwak, *The Weirdness of 10-Year Deficit Reduction*.

⁴ For more detail, see the CBO assessment of the budget proposal [put forward by Congressman Paul Ryan](#).

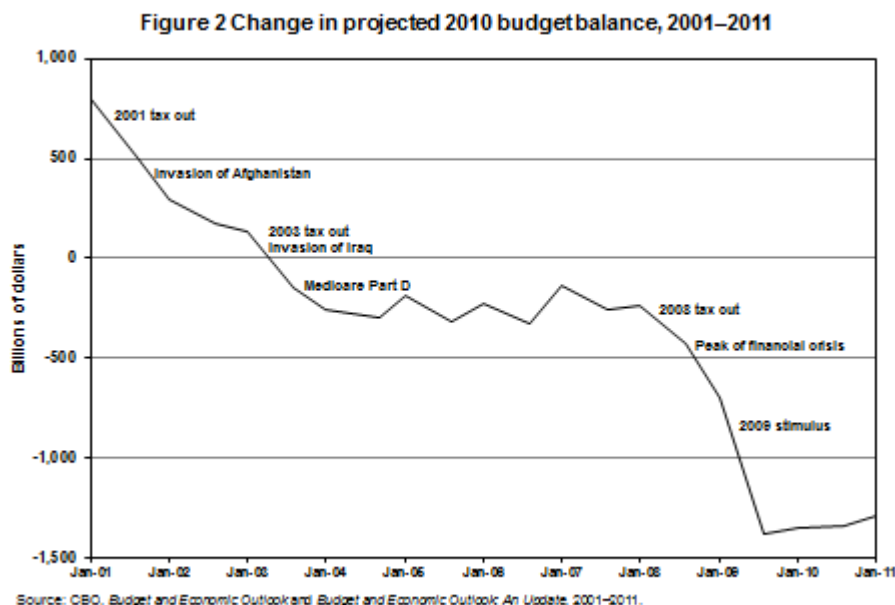
⁵ See the IMF’s [Fiscal Monitor \(October 2012\)](#), Statistical Table 12a, columns 3 and 4.

⁶ For more details on the viable options, see [White House Burning](#), Pantheon, 2012, by Simon Johnson and James Kwak.

⁷ For more details and discussion of what accounts for the increase in inequality, see David Autor and Daron Acemoglu, [Skills, Tasks and Technologies: Implications for Employment and Earnings](#).

bottom 90 percent of wage earners while the top 1 percent experienced a gain of around 50 percent. The gains for the top one-tenth of 1 percent were even higher.

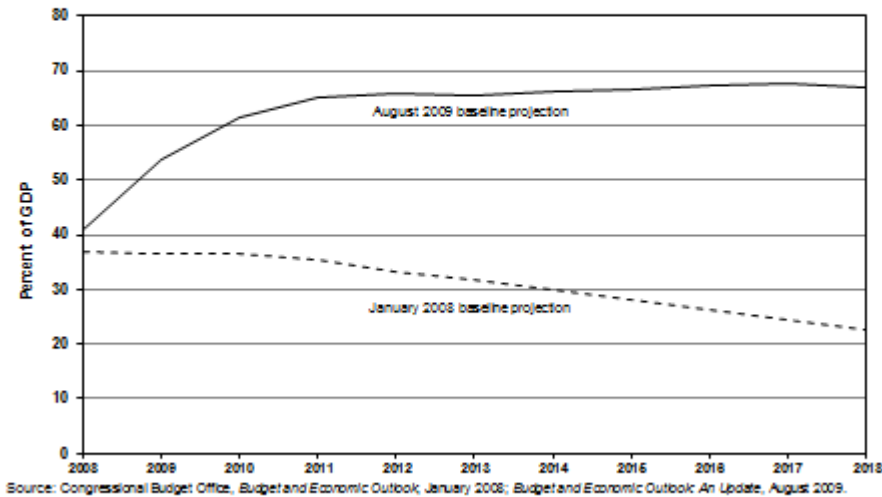
- 19) The returns to higher education have greatly increased over this time period and there are not good income prospects for anyone with only a high school education (or less). If anything, the tax system should lean towards becoming more progressive—and investing the proceeds in public goods that are not sufficiently provided by the private sector, like early childhood education and the kind of preventive healthcare that helps prevent disruption to education (e.g., due to asthma).
- 20) At the same time, we must not lose sight of the very large fiscal risks posed by the nature and structure of our financial system. Our worsening budget picture since 2000 is due to a combination of factors—including large tax cuts, two foreign wars, and the introduction of Medicare Part D. The recent increase in government spending is due almost entirely to the way the financial sector imploded and damaged the rest of the private sector in 2007–08.⁸ (See figure 2 below for the CBO’s assessment of what caused the relative swing in budget projections.)



- 21) To see the fiscal impact of the last finance-induced recession, look at changes in the CBO’s baseline projections over time. In [January 2008](#), the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to \$5.1 trillion by 2018 (23 percent of GDP). As of [January 2010](#), the CBO projected that over the next eight years debt will rise to \$13.7 trillion (over 65 percent of GDP)—a difference of \$8.6 trillion. (For a vivid graphical representation, see figure 3 below.)

⁸ Over the past decade, foreign wars also contributed to increased government spending. But the negative fiscal effect of the financial crisis was much larger than the cost of the Iraq and Afghanistan wars combined.

Figure 3 Increase in national debt due to financial crisis



- 22) Most of this fiscal impact is not due to the Troubled Asset Relief Program (TARP)—and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57 percent is due to decreased tax revenues resulting from the financial crisis and recession; 17 percent is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the “automatic stabilizers” in the United States are relatively weak); and another 14 percent is due to increased interest payments on the debt—because we now have more debt.⁹
- 23) We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk.¹⁰ The fact that this is not currently scored by the Congressional Budget Office does not reduce this risk or make it any smaller.
- 24) In effect, a financial system with dangerously low capital levels—hence prone to major collapses—creates a nontransparent contingent liability for the federal budget in the United States.¹¹ This can only lead to further instability, deep recessions, and damage to our fiscal

⁹ See also the May 2010 edition of the IMF’s cross-country fiscal monitor for comparable data from other industrialized countries, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for one-tenth of the increase in debt in advanced G-20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

¹⁰ See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.

¹¹ See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive,” Stanford University, March 2011 (revised), <https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf>. See also

balance sheet, in a version of what senior officials at the Bank of England refer to as a “[doom loop](#).”

25) The remainder of this testimony reviews in more detail: the catastrophic outcomes likely if there is any kind of default on US government debt; why spending cuts—either from a government shutdown or from some other form of immediate austerity—will be contractionary in the current US context; and why the US fiscal balance sheet and efficient provision of public goods remain threatened by a dangerous financial system.

B. Effects of Defaulting on US Government Debt

The consequences of any default on the US debt would, ironically, actually increase the size of government relative to the US economy.

The reason is simple: If the government defaults, this will destroy the private credit system as we know it. The fundamental benchmark interest rates in modern financial markets are the so-called risk-free rates on government bonds. Removing this from the picture—or creating a high degree of risk around US Treasuries—would disrupt many private contracts and all kinds of transactions.

In addition, many people and firms hold their “rainy day money” in the form of US Treasuries. The safest money market funds, for example, are those that hold only US government debt. At least, these are the funds perceived as safe—if the US government defaults, all these funds will “break the buck,” meaning that they will be unable to maintain the principal value of money that has been placed with them.

The result would be a flight of capital—but to where? Banks will have a similar problem; many of their balance sheets will be destroyed by the collapse in US Treasury prices (the counterpart of an increase in interest rates on such debt, as bond prices and interest rates move in opposite directions).

There is no company in the United States that would be unaffected by a government default—and no bank or other financial institution that could provide a safe haven for savings.

There would be a massive run into cash, with everyone withdrawing as much as possible from their banks. Imagine the lines at ATM machines and teller windows—something we have not seen on a grand system since the Great Depression.

And private credit would disappear from our economic system, which then gives the Federal Reserve an unpleasant choice. Either it can step in and provide an enormous amount of credit directly to households and firms—very much as the central bank, Gosbank, did in the Soviet Union. Or the Fed can stand idly by while GDP falls 20 to 30 percent, the kinds of decline we have seen in modern economies when credit suddenly dries up.

With the private economy in free fall, consumption and investment would decline sharply. Our ability to export would also be down—foreign markets would likely be affected also and, in any case, if firms trying to export cannot get credit then most likely they cannot produce.

Government spending would contract in real terms, without a doubt. But what would fall more—government spending or the size of the private sector? Almost certainly the answer is the private sector, because this is so dependent on credit to buy its inputs. Think about the contraction that happened in fall 2008 but multiply by 10.

The government, on the other hand, in the last resort has access to the Federal Reserve and can therefore get its hands on cash money to pay wages. With the debt ceiling not increased, this would require some legal sleight of hand. But the alternative would clearly be a collapse of US national security—the military and the border guards have to be paid; the transportation system needs to operate, and so on.

Issuing money in this situation would almost certainly be inflationary but, the Fed would reason, perhaps not—because we have never been in this situation before, credit is now imploding, and the desperate credit expansion measures in fall 2008 proved not to be as bad as the critics feared.

This is what a US debt default would look like. The private sector would collapse, unemployment would quickly exceed 20 percent and, while the government would shrink, it would also remain the employer of last resort.

Anyone who does not want to raise the debt ceiling is playing with fire. Some people expressing this position are also advocating a policy that would have dire effects—and do the exact opposite of what they want to the structure of our economy. The government would become more important, not less important.

C. Spending Cuts Would Be Contractionary

Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."¹²

The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today

If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the US is currently perceived as one of the lowest risk countries in the world—hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the US today due to fiscal concerns, these are mostly about the longer term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 3 percent below its pre-crisis level. The US still has a significant "output gap" between actual and

¹² *World Economic Outlook*, October 2010, Chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases.

potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the United States today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of quantitative easing to bring down interest rates on longer term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again—for example because fiscal contraction involves laying off government workers.

Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency—thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy contraction. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control—and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

The available evidence, including international experience, suggests it is very unlikely that the United States could experience an “expansionary fiscal contraction” as a result of short-term cuts in discretionary federal government spending.

D. The Real Dangers and Costs of Fiscal Crisis

The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. There is no precise debt-GDP level at which a crisis is triggered, but with net debt relative to GDP in or above the range of 90 to 100 percent, a country becomes much more vulnerable to external shocks—particularly if it is relying on foreign investors to buy a substantial part of its debt.

If any shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect—as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious—or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

It is important not to oversimplify fiscal concerns into precise cut-offs for “dangerous” debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

Greece ran into trouble in 2010 with gross debt relative to GDP of 142 percent; its debt levels in 2006 and 2007 were around 105 percent. This is a classic case of too much debt by any measure—although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece.

Portugal faced a fiscal crisis with gross debt at 90.6 percent of GDP in 2011, but its debt was only 62.7 percent in 2007. The issue for Portugal is low achieved and expected growth relative to

fiscal deficits—the markets have become unwilling to support debt that continues to increase as a percent of GDP.

Ireland, another euro area country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on-balance sheet government debt was low (25 percent of GDP in 2006–07 for gross debt) but there was a big build up in off-balance sheet obligations—in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and supporting the economy during severe recession has pushed up gross debt to 114 percent of GDP in 2011 and debt levels will reach at least 125 percent (in our estimates, even higher) before stabilizing.

Compared with other industrialized countries, Japan stands out as an extreme. Government debt—relative to GDP is expected to reach 229.1 percent in 2011 (on a gross basis) and rise to 250.5 percent in 2016. On a net basis—taking out government debt held by other parts of the public sector—the equivalent figures are 127.8 percent in 2011 and 163.9 percent for 2016. But nearly 95 percent of Japanese government debt is held by residents—and, at least for the time being, Japanese household and business savings remain high.

Countries with greater reliance on foreign savers, such as the United States (where nonresidents held over 30 percent of general government debt in 2010) and the United Kingdom (nonresidents held 26.7 percent of general government debt in 2010) need to be much more careful. Within the euro area, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40 to 90 percent of all outstanding government debt (mostly held by other euro area financial institutions).

The increase in debt relative to GDP in industrialized countries from 2007 to 2011 was about 28 percent (of GDP; unweighted average across countries, as calculated by the IMF)—most of which was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

Seen in that context, the increase in the US gross debt—from 62.5 percent of GDP in 2006 to 98.6 percent at the end of 2010 and 107.2 percent at the end of 2012—was very much in line with experience in other countries.¹³ But the current trajectory of debt now, rising to 114.2 percent in 2016, is on the high end (the average debt-GDP for industrialized countries is projected to rise by about 7 percent over this period.)

In terms of net general government debt held by the private sector, at the end of 2012, the United States was around 83.8 percent of GDP—up from 48.2 in 2007. This is not yet at a dangerous level but the future projections are not encouraging—this number will rise to 89.6 percent in 2016 and 89.4 percent in 2017, according to the IMF. And in the Congressional Budget Office's longer term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050.

The role of the US dollar as the world's preeminent reserve currency means there is a strong demand for our government securities in the foreseeable future. In 1948 and in 1968, world holdings of US dollar assets in the form of reserves were worth about 2 percent of GDP. Now

¹³ These gross and net debt numbers are taken from the IMF's [Fiscal Monitor, October 2012](#), Statistical Table 4. The 2012 data are a forecast.

world reserve holdings of dollar assets are worth at least 15 percent of GDP—and some would put this as high as 30 percent of GDP.

But it is not clear how far this will carry us—particularly as alternative reserve assets typically develop in a diverse world economy with competing national interests. It would be wise to undertake medium-term fiscal consolidation. Rising healthcare costs and a weak tax base could well undermine our long-term potential growth.

In addition, the United States continues to face very large implicit liabilities in the form of implicit support available to the financial sector, both directly—if “too big to fail” global banks get into trouble—and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis.

If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector executives and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage. If sharp spending cuts follow that reduce public services (e.g., government-funded education), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.

There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for “too big to fail” global financial institutions. Such firms are likely to damage themselves with some regularity—their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce.