A DEBT CRISIS IN AMERICA:
What It Might Look Like

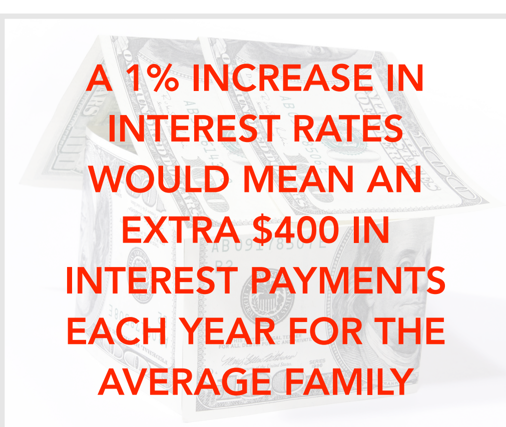
KEY FACTS

- The federal debt today is over $16.5 trillion. That's larger than the entire U.S. economy.
- The government's debt is set to skyrocket in the years ahead. This debt will cause pain for families today and greater hardship when a debt crisis hits.
- Once lenders lose confidence in the federal government's ability to pay its bills, a debt crisis will follow. As a result, the cost of borrowing—for government and families—will increase, making it harder to make ends meet.
- Instead of gradual, sensible reforms, a debt crisis will require sharp cuts in essential services. And it will especially harm the most vulnerable.

Federal finances run in the trillions of dollars and seem remote to the average American. The Federal government's debt exceeds the entire output of the U.S. economy annually, and we have borrowed close to half of this money from foreigners. The Federal government also has made future commitments through Medicare, Social Security and other programs and these commitments don't currently show up on the government's books.

Despite this high level of debt, investors in the U.S. and across the globe view the United States as the safest place in the world to invest their money. As a result, the Federal government pays close to nothing in interest to borrow money. In addition, the U.S. dollar benefits from the U.S. economy's strength and the perception of the U.S. economy and government's financial strength. And, families, workers, and businesses benefit through low interest rates on mortgage, credit card, and business debt.

Because of the relative strength of the U.S. economy and financial position of the government, we tend to take for granted the value of the U.S. dollar, which is the basis of everyday financial transactions in American lives. If the Federal government began to have trouble borrowing money at low interest rates, a debt crisis could hit us. This is the dynamic that is currently playing out in troubled countries like Greece and Spain. A debt crisis in America would not only be devastating at the macroeconomic level, it would also inflict acute pain upon families and businesses.



<u>The Impact on Families and Businesses</u>

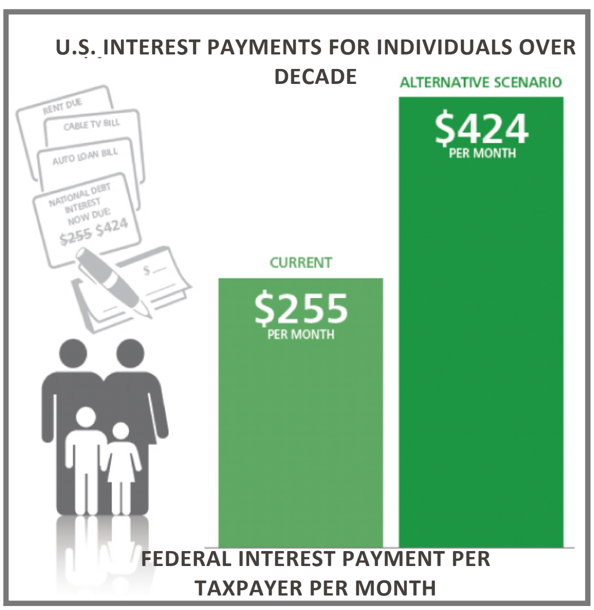
The 2008 financial crisis initially appeared to be a problem for a couple of big Wall Street banks, but it quickly grew into a recession that dragged down the entire U.S. economy. A debt crisis would weaken the economy and limit the ability of the federal government to respond, inflicting acute pain upon families and businesses. Market concern about the U.S.'s fiscal position would initially be manifested in higher borrowing rates on U.S. government debt.

Nearly all consumer-borrowing rates are linked in some respect to longer-term Treasury rates, so a rise in interest rates would increase the economy-wide cost of credit in the U.S. As Treasury rates increased, rates on mortgages, credit cards, and car loans would soon follow. This would most likely come as a shock to most Americans who have grown accustomed to building up a great deal of debt in a climate of historically low interest rates.

Roughly three-quarters of household debt is home mortgages while the rest is credit-card debt, auto loans, and margin debt. It turns out that roughly *half* of all that debt is in the form of variable-interest-rate loans, meaning that a sudden increase in Treasury bond rates would lead to higher borrowing costs for consumers relatively quickly. **According to the current level and composition of household debt, estimates suggest that an interest-rate increase of just 1 percentage point would lead to over $400 in yearly interest payments for the average family.[1]** Given that a serious debt crisis could lead to a sharp increase in Treasury rates, the added interest costs for the typical family could easily exceed $1,000 per year or more. To a new homebuyer, a 1-percentage-point increase in mortgage rates (which are currently at their lowest rate on record) adds as much as 19 percent to the total cost of a home.[2] As household-borrowing costs spiked, growth in overall consumer spending, which accounts for nearly 70 percent of GDP, would decline.

Higher borrowing costs would also be a serious impediment for businesses. The corporate sector has roughly $11.5 trillion in loans that will mature over the next five years.[3] A sharp rise in interest rates over this period would lead to lower business investment as companies faced a much higher hurdle for profitability on potential expansion plans. Businesses would be doubly squeezed because their funding costs would rise just as demand for their products (particularly consumer-durables bought on credit like cars, home furnishings, etc.) would slip. The inevitable result would be less business expansion and higher unemployment. As Harvard Business School professors Richard Vietor and Matthew Weinziert write, "Capital markets will visit the sins of the public sector upon the private one. If the cost of borrowing rises for the U.S. government, it will rise for private-sector borrowers as well."[4]

Even absent a spike in interest rates, federal borrowing is poised to affect individuals and businesses. In a last year entitled "The Untold Story of America's Debt," Deloitte LLP, a tax, audit and consulting firm, illustrated what debt and interest payments might mean for the average taxpayer since the buildup in debt will likely mean higher taxes or benefit reductions in future. If current federal interest payments were allotted to taxpayers (including those who file but pay no income tax), they would equal about $255 *per month*. Under Deloitte's scenario—in which growth is slightly lower than expected, interest rates are slightly higher than expected, and current tax and spending policies are extended—that amount is expected to jump to $424 per month for each taxpayer over the next decade.[5]



---

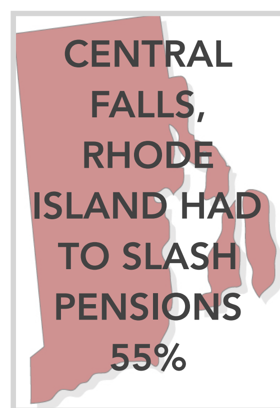
[1] Center for American Progress: "Payment Due: The Effects of Higher Interest Rates on Consumers and the Economy" September 20, 2004
[2] *New York Times*, "Interest Rates Have Nowhere to Go but Up," April 10, 2010
[3] "The Untold Story of America's Debt," Deloitte LLP, June 2012
[4] Ibid, page 10
[5] The Untold Story of America's Debt," Deloitte LLP, June 2012, page 15d

A Debt Crisis Would Hurt Those Who Depend on Government First and Worst

Probably the greatest impact would be on those who depend on the federal government for assistance. The federal budget is dominated by programs that provide transfer payments to individuals. While defense spending dominated the federal budget for most of its history, Social Security at over $800 billion this year is the largest program in the budget. Most of this spending on direct assistance to individuals is mandatory spending and not subject to annual approval each year. This spending automatically rises during recessions, and Congress frequently augments it. For example, during the recent recession, unemployment assistance grew by more than four-fold, rising from $32 billion in FY 2007 to $152 billion in FY 2010.

At $2 trillion annually, this mandatory-spending category amounts to 60 percent of federal spending. When discretionary programs such as education and job training ($100 billion annually), housing ($40 billion annually), and veterans' health care are added ($60 billion), the federal budget is dominated by programs that provide assistance to individuals.

During the recent financial crisis, the federal government was able to borrow funds to continue providing assistance to these individuals and meet other responsibilities. In a debt crisis, not only would the crisis weaken the economy, it also would curtail the ability of the government to borrow funds and finance spending for those who depend on it for assistance. One need not look to Europe to find examples of forced austerity. There are examples in the United States, where municipalities have gone bankrupt and have been unable to provide basic services. In Central Falls, Rhode Island, for instance, pensions have been slashed by up to 55 percent for retirees. Stockton, California has seen crime rates skyrocket as the city has been forced to lay off 25 percent of their police force in the face of increasing pension costs.



A debt crisis would limit the federal government's ability to roll over debt—much less to increase debt to finance existing benefits. While Greece and Spain have experienced a debt crisis, an economy in a deep recession, the imposition of austerity programs, and civil unrest, they have had the European Union and the IMF provide financing to buy them time. If the U.S. encountered a debt crisis, it's unclear whether other countries would provide interim financing. Even if other countries wanted to assist the U.S., they might not have the capacity to do so. The Greek economy, for example, amounts to about $300 billion annually—compared with a $16 trillion U.S. economy. In other words, the federal-budget deficit for the first two months of this year amounted to $292 billion, enough debt to finance the entire Greek economy for a year. No one else can bail us out, but we still can save ourselves. In fact, if we take action now, we can kick our economy into high gear—and put ourselves back on the path to prosperity.