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FORECASTING  
CENTER

# Uncle Sam Won't Go Broke

The Misguided Sovereign Debt Hysteria

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## Executive Summary

While some countries deserve to have their creditworthiness doubted, others, including the United States, do not. The United States is not another Greece, and the likelihood of default or any dire consequences from the present run-up of Treasury debt is minimal.

- Nations vary sharply in their capacity to carry public debt. The United States, the United Kingdom, and Japan are all high-debt-capacity nations. All have had debt-to-GDP ratios over 100%, and in Britain's case over 250%, without calamitous consequences.
- Defaults on sovereign debt have never solely reflected high debt levels.
- The when and why of soaring debt matters; when a depression or great war is responsible, then high-debt-capacity nations can accumulate vastly more debt—and later safely bring the debt ratio back down—than widely believed today.
- The U.S. Treasury debt is soaring because of a depression, and the budget deficits have been essential in keeping the depression contained, avoiding a disaster worse than the 1930s.
- During a depression, an economy cannot absorb much if any deficit reduction. History shows deficit-slashing actions during depressions tend to be self-defeating because they so damage the economy that revenue plunges.
- A high public debt ratio in a high-debt-capacity country tends to shrink rapidly for years after the end of a major war or depression. The conditions presently causing high public debt growth in the United States and other advanced economies are not permanent and will eventually reverse, improving government fiscal situations dramatically.
- High public debt does not necessarily imply inflation, especially when the debt is caused by a deflationary private economy. Historically, there has been no connection between inflation and the level of public debt in the United States, the United Kingdom, or Japan.
- High public debt is unlikely to be a drag on future growth or prosperity. Future generations will not bear the burden of current deficit spending, as is widely believed.
- A collection of other items that some people count as public debt—including the social security trust funds and projected shortfalls for Medicare or other programs labeled “unfunded liabilities”—are in fact not public debt. Advanced funding for any such mandates and programs does nothing to ease the potential problems of meeting retiree needs in the future and could make matters significantly worse.

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The Jerome Levy Forecasting Center publishes the nation's oldest newsletter devoted to economic analysis—*The Levy Forecast*.

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“It must, indeed, be one of these two events; either the nation must destroy public credit, or public credit will destroy the nation.”

—*David Hume, philosopher, Essay IX: Of Public Credit, 1752*

Fear of public debt has a long history, but it has waxed and waned over the centuries.<sup>1</sup> In 2010, worries over the magnitude and growth of public debt have surged, stoked by Greece’s fiscal crisis, the increasingly precarious financial positions of various other eurozone nations, the vast volume of Japanese government debt, and extraordinary national government deficits in the United States and the United Kingdom. Developing countries have repeatedly faced questions about their ability to service their public debt during the post-World War II period, but lately the sovereign debt of several developed countries has become a subject of widespread concern. Opinion leaders around the world are increasingly describing the Greek crisis as a harbinger of problems that will visit other countries, including the United States, without drastic changes in fiscal policy.

Indeed, the world has entered an era of heightened risk of public debt default. Nevertheless, many of the predominant fears about excessive public debt have little or no sound basis, including fears about the financial integrity of Japan, the United Kingdom, and especially the United States.

The dangers of soaring ratios of public debt to GDP are the subject of a slew of recent papers from both academic and business economists. These expositions point to rapidly rising risks of alarming outcomes, including default, surging inflation, and extended economic weakness. Although there is no consensus about just how much debt is too much, there is a broad feeling that public debt greater than 100% of a nation’s GDP is in some sense out of control, damaging, and destabilizing. Accordingly, any country with a debt that is greater than two thirds of its GDP and with annual deficits equal to 10% of GDP or more is thought to be on a dangerous course, moving rapidly toward that destabilizing 100% mark.

<sup>1</sup> *Throughout this paper, we will use the term public debt to denote publicly traded central government debt. State and local government and agency debt are excluded.*

The worries about soaring public debt are indeed valid for some members of the eurozone, mainly because these countries do not control the currency in which their debt is denominated. Moreover, some among them, notably Greece, lack effective tax-collecting capabilities and deep domestic public debt markets, among other problems.

However, the dangers of excessive public debt emphasized by recent studies have little validity for mature, stable, financially independent countries with modern economies, especially our own. In fact, for the United States, the United Kingdom, and Japan—all countries that control the currency in which their debt is denominated—the risk of outright default on public debt is for all practical purposes nonexistent. Moreover, for these countries, the fear that rising public debt will in and of itself cause high inflation or hyperinflation is unfounded. Finally, the concern that a high public debt burden will crimp growth is logically flawed and contrary to history; in fact, it has the causation exactly backwards.

## The Surprising Historical Record

### The Debt Level Has Never Been the Sole Reason for Sovereign Default

History is replete with sovereign debt defaults, but when the focus is narrowed to include only strong, stable, long-established governments, the performance record is remarkably good. Defaults that did occur reflected problems that went well beyond high debt levels. In fact, all incidences of default can be ascribed in large part or entirely to one or more of the following conditions: (1) debt denominated in a currency that the government does not control, (2) debt owed in gold, (3) debt owed by a government that is unstable or unable to collect taxes effectively, (4) a small, illiquid domestic market for government debt, and (5) debt owed personally by a king or other supreme ruler rather than by the national government. In the absence of these conditions, public debt ratios have been able to rise without defaults, in some cases to levels well beyond those that various present-day analysts argue would prove disastrous. Presently, not one of these five conditions applies to the United States, the United Kingdom, or Japan.

In the past 60 years, sovereign defaults have occurred only in developing countries, most often in the politically and

economically weaker ones. Even within developing countries, most of the defaults have been on debt denominated in a foreign currency. Among the developing countries that have defaulted on domestic-currency denominated debt, many have been smaller nations that were wracked by civil war or anarchy—including Rwanda, Zimbabwe, Sierra Leone, Congo, and Sri Lanka.

The one case of a large country defaulting on domestic-currency-denominated debt is Russia in 1998.<sup>2</sup> In the lead-up to that crisis and default, the Russian economy was struggling to make the transition from a state-directed, socialist system to a nascent free enterprise system and had been shrinking for several years. The government was heavily dependent on energy exports, and tax collections were limited by a dysfunctional tax code and widespread evasion. The sharp fall in oil prices following the Asian Crisis therefore dealt a serious blow to the economy and to government finances.

The Russian default also illustrates the importance of a large, highly liquid domestic market for government debt. Default becomes politically intolerable when large proportions of the population and of domestic financial institutions hold public debt, but the debt on which Russia defaulted was held only by a relatively small number of domestic investors. The government calculated that defaulting on this debt (not on debt held by foreign lenders) was its least unattractive alternative since the domestic creditors were a weak constituency. Having a large, liquid public debt market is also important to assure stable pricing and to support the government's ability to raise funds whenever it needs them to meet obligations.

Not a single developed country has defaulted in the past 60 years. By contrast, from the mid eighteenth century to the mid twentieth century, many of today's developed countries defaulted, rescheduled, or cut coupon payments on bonds. There is an important difference between the past 60 years and the earlier period: in the earlier period, the incidences of default involved debt denominated in foreign currencies or promising convertibility into gold, whereas in the latter period developed countries have issued debt in a currency that they control (although this is no longer true for the eurozone countries since the adoption of the euro).

<sup>2</sup> Brazil abrogated inflation-linked contracts on public debt in 1986-1987 and 1990, but such abrogation was embedded in the original contract, so it is not a default in the technical sense.

Some argue that a rising public debt ratio can undermine confidence in a country's public debt, causing lenders to balk and forcing the government either to begin borrowing in "harder" currencies or to institute convertibility into gold. Actually, it takes more than rising debt to force such actions. If a nation controls its own money supply, it can always create more money and assure adequate demand for government securities. If investors fear that the currency will weaken, those fears will indeed weaken the currency but will not reduce the money supply or the funds available to purchase the government's debt. After all, any investor selling the country's currency and buying another currency is merely exchanging with another party—money neither disappears nor appears in either currency. Alternatively, if investors fear that inflation will devalue the government's debt, they may eschew bonds and seek to hold only short-term paper, steepening the yield curve, but this will not decrease the money supply or the overall market for government securities. Thus, the government will not be forced to issue bonds that are in harder currencies or convertible into gold.

Thanks to their high or rapidly rising public debt ratios, the United Kingdom, Japan, and the United States have been placed on the list of countries with worrisome sovereign debt. However, the structure and terms of these countries' public debt and the circumstances of the debt growth do not support those concerns. Neither does history—even if public debt ratios rise to levels considered alarming today.

### **Public Debt Ratios in Strong Nations Can Go Much Higher Than People Think— and They Have Before**

In the three centuries since the British Parliament started issuing public debt,<sup>3</sup> the United Kingdom has experienced startlingly high public debt ratios, sometimes persisting for decades, several times (chart 1). The ratio exceeded 260% in 1821, and it exceeded 230% in 1947, yet both times it eventually came back down to moderate double-digit levels.<sup>4</sup>

<sup>3</sup> Before that there was only royal debt incurred personally by kings and queens.

<sup>4</sup> These estimates are based on data published by Christopher Chantrell of UKpublicspending.co.uk. Other estimates show Britain's public debt ratio to have been even higher in these two periods. In his book *A Free Nation Deep in Debt*, James McDonald calculates that the ratio reached 285% in 1821. According to Her Majesty's Treasury, the ratio topped 250% in 1947.

Over the course of those three centuries, the country fought at least three wars that threatened its very existence—the Napoleonic War and the two World Wars—and experienced many financial crises, depressions, and other economic strains. Yet Britain never defaulted—despite its sometimes enormous public debt ratio.<sup>5</sup>

Some have argued that it did in effect default a couple of times by abandoning the gold standard. Even if one counts the suspensions of gold convertibility to be defaults, obviously there is no risk of this kind of default any longer, now that the United Kingdom has no gold standard to abandon. A gold standard means that the government does not really create its own currency, at least not without limit, since it cannot create gold any more than it can create some other country's currency. At the very least one can say that since 1931, when gold convertibility was permanently abandoned, there have been no British defaults on public debt.

Modern Japan does not have the centuries of history with public debt that the United States and the United Kingdom have.<sup>6</sup> Still, the Japanese government has carried debt for almost the entire post-World War II era, and it has carried a debt exceeding 100% of its GDP for a decade (chart 2). Despite all that has happened to Japan's economy and finances during the past 20 years—its two “lost decades”—it has not defaulted. Granted, Japan's public debt ratio continues to climb, and the fact that the government has not experienced a crisis with the ratio approaching 140% of GDP does not say anything about what will happen if it rises to 200% or higher. Still, Japan's experience shows that one needs to be skeptical about warnings of specific thresholds for public debt ratios above which default, inflation, or currency collapse become probable.

<sup>5</sup> Although the United Kingdom never defaulted on its publicly traded debt, it did default on its bilateral loans from the United States incurred in WWI. The loan payments were contingent upon receiving reparations from Germany imposed by the Versailles Treaty, and the United Kingdom stopped payments on its bilateral debt after Germany stopped making reparation payments.

<sup>6</sup> Japan did default on its public debt once, during World War II. However, for the purposes of drawing conclusions relevant to the present situations of developed countries, we focus here on modern (i.e., postwar) Japan for two reasons. First, the extraordinary circumstances of the war clearly contributed to the default in 1942. Second, prior to a fundamental constitutional change in 1947, Japan's sovereignty lay not with the parliament—as it does now—but with the Emperor.

Chart 1  
**Public Debt History in the United Kingdom**

ukpublicspending.co.uk: Public Debt as % of GDP, fiscal years

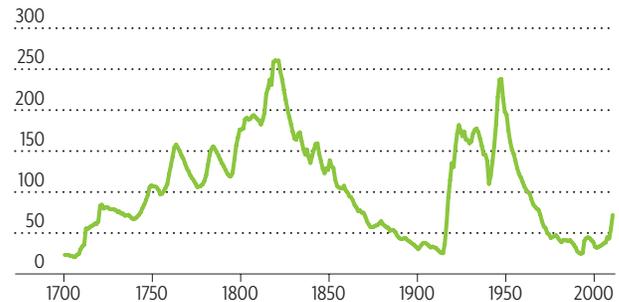
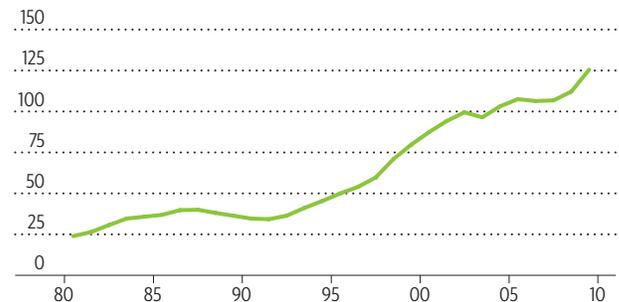


Chart 2  
**Public Debt History in Japan**

Japan Ministry of Finance: Public Debt as % of GDP



The United States, like the United Kingdom, has been successfully meeting its public debt obligations throughout its history. During 234 years of existence, the United States has been through many traumatic vicissitudes—depressions, the Civil War, two World Wars, and several smaller wars. Its public debt ratio has risen to well over 100% and then dropped back to a fraction of that (chart 3). Through it all, it has never rescheduled a debt repayment, missed an interest payment, or defaulted in any other way on its public debt.<sup>7</sup>

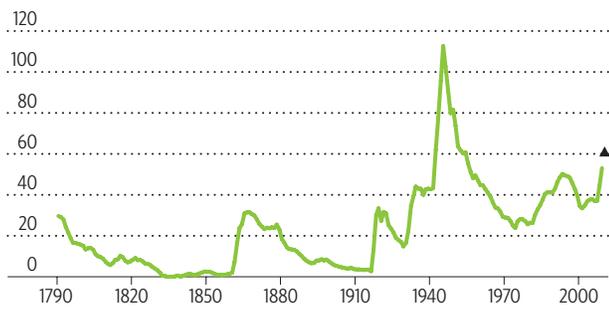
Just as some analysts count the British suspensions of gold convertibility as defaults, some argue that the abrogation of

<sup>7</sup> In 1790 a portion of the interest was deferred for 10 years. However, the original underlying debt was not federal debt as commonly understood today. It was incurred during the Revolutionary War, largely by the states. The power of the Congress to issue debt did not exist before the adoption of the Constitution in 1788, and even that power was contested. The deferment of interest was actually part of the process by which the federal government took over the obligations of states' war debt.

Chart 3

### Public Debt History in the United States

Treasury Debt Held by the Public as % of GDP  
 Courtesy of CBO, with OMB projection for 2010



the gold clause by the U.S. government in 1933—which voided gold clauses in private and government contracts—constituted default.<sup>8</sup> However, the public debt burden was neither unmanageably large by historical standards nor the main cause of the abrogation. Rather, the motivation for the legislation reflected the inherent vulnerability of a gold-convertibility-based monetary system to abrupt swings in global gold demand, supply, and hoarding behavior. In any case, regardless of how one views the discontinuation of the gold convertibility of the dollar, U.S. public debt today no longer carries any promise of convertibility into gold, so, like the United Kingdom, the United States cannot default by violating such a promise.

Defaulting on public debt denominated in the country's own currency would be an act of such willful malfeasance and disengagement from markets, citizens, and other countries that most governments, and especially stable democracies, have eschewed it. Under the circumstances, it is difficult to envision conditions that would cause the United States, the United Kingdom, or Japan to default.

Still, default is but one feared outcome of soaring public debt, although perhaps the scariest. Laying aside the risk of default, there remains widespread fear of severe economic consequences of the expanding debt.

<sup>8</sup> *The United States was among the last countries to get off the gold standard in the 1930s. Efforts in Europe to raise gold led to a rapid contraction of the U.S. money supply, aggravating the crash of the early 1930s. Washington had an urgent need to prevent the outflow of gold in order to regain control over the money supply.*

## Soaring Public Debt Does Not Imply Inflation

### Public Debt Is Not Inflationary When Caused by a Deflationary Private Economy

Many investors, policymakers, and economists take it as fact that soaring government debt inevitably leads to inflation. This fear comes in several versions. Sometimes the emphasis is on the prospect of a stealth default by the government as inflation shrinks real debt service payments; sometimes it is on the consequences of serious future inflation for the economy as a whole. Many analysts assert that spiraling public debt growth will force central banks to monetize the government debt and that this action will assure worsening inflation. Others argue that central banks will choose to pursue policies of high inflation in order to chip away at the debt burden.

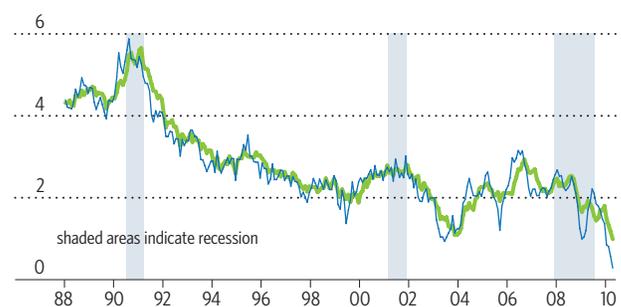
In fact, deflation, not inflation, is the danger during the next several years in the United States and most of the world's advanced economies. Moreover, the fears of inflation are based on flawed logic and contrary to the historical record.

In the United States and many other developed countries, as in Japan in the 1990s, the macrofinancial circumstances that are presently causing the continuing, large deficits will also keep the economy unusually weak and disinflationary even as monetary policy remains accommodative. Deflation has already been a problem in Japan for over a decade, and it is not far away in the United States, where inflation, measured using the core CPI, was well below 1% and falling in the latest six months (chart 4).

Chart 4

### Core Inflation in the United States

CPI-U All Items Less Food and Energy  
 year-over-year % change (thick line), 6-month annualized % change (thin line)



The economic malaise in much of the developed world, as in Japan during the past twenty years, is deeper and longer term than most analysts and policymakers recognize. Throughout the private sector in these countries, a powerful, underlying trend of balance sheet contraction will persist for a number of years, likely for about a decade in the United States. Private balance sheet contraction makes it impossible for the private sector to function on its own, since balance sheet expansion is necessary for an economy to generate net business profits. These economies will keep functioning, however, because huge government deficits will effectively pump profits into the private economies,<sup>9</sup> providing enough boost to keep them from collapsing but in all likelihood not enough to achieve prosperity until the long balance sheet adjustment is finally completed.

During this period of contained depression, it will be all but impossible for inflation to strengthen.<sup>10</sup> Any short-term progress creating jobs notwithstanding, in all likelihood unemployment will stay troublingly high, pay raises will continue to fade, private credit quality will remain impaired, and overcapacity will continue to plague much of the business sector. In essence, the strong fiscal and monetary medicine will not overheat the economy and create inflation because the normal profit sources of the private sector are severely depressed.

### Central Banks Cannot Always Create Inflation at Will

There is a popular misconception that central banks can create inflation anytime they want to. Belief in this power comes from a misunderstanding about central banks, the money supply, and the inflation process. The Econ 101 view that the central bank directly controls the money supply, which directly affects the price level, implicitly informs mainstream analysis and discussions. There are two problems with this view. First, the central bank has no direct means of controlling the broad money supply. What it can control is the monetary base.<sup>11</sup> The broad money supply is market determined, and the relationship between the monetary

<sup>9</sup> See *Where Profits Come From*, Jerome Levy Forecasting Center, 2008.

<sup>10</sup> *We have written extensively about the contained depression. For a review of the inflation issues, see our report, Widespread Fear of the Wrong Kind of Price Instability.*

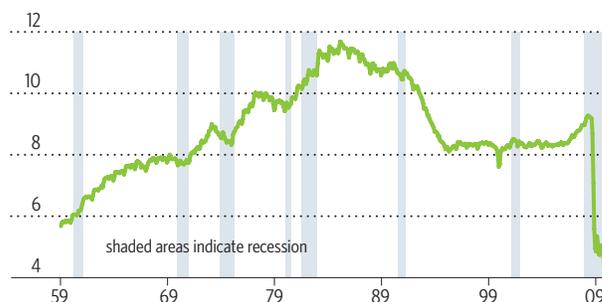
<sup>11</sup> *In reality, the Fed (and most other central banks) currently targets interest rates and lets market demand determine the monetary base (although with quantitative easing, the Fed has targeted the monetary base as well).*

base and the broad money supply is unstable (chart 5). Second, even if we allow that the central bank can crudely affect the money supply, the money supply's influence on pricing is fickle.

Indeed, under the institutional arrangements prevalent in most developed countries, central banks have far greater ability to bring high inflation down (albeit painfully) than to ratchet up inflation from a minimal level, let alone turn deflation into inflation. Central banks do not participate in the market for goods and services and therefore do not directly influence demand; that would constitute fiscal policy. They can only indirectly affect economic activity by influencing credit creation with monetary policy. Hiking interest rates aggressively can halt credit creation, bring recession and rising unemployment, and thereby depress inflation. On the other hand, lowering interest rates will not spark credit creation unless the private sector is willing and able to take on more debt and banks are willing and able to expand their loan portfolios.

Chart 5  
**Monetary Base and Money Supply: Unstable Ratio**

Federal Reserve: Ratio of Money Stock (M2) to Monetary Base



In particular, in the presence of asset price deflation, goods and services price deflation (actual or feared), chronic overcapacity, widespread private sector debt service problems, and impaired bank balance sheets, lowering interest rates alone will do little to encourage credit creation to finance demand. These conditions apply to the current situations in the United States and the United Kingdom and have applied for many years in Japan. In the United States, the Federal Reserve has been pushing on a string. A near-zero federal funds rate and colossal excess reserves failed to encourage private credit growth over the past year. In the United Kingdom, the Bank of England cut rates to 0.5% and has undertaken extensive purchases of long-term government debt. As for the Bank of Japan, it has been pushing on a string for long enough to accumulate miles

of slack, and as much as the Japanese would love a little inflation, the Bank of Japan has been unable to achieve it.

### There Is No Connection between the Level of Public Debt and Inflation in the United States, the United Kingdom, or Japan

If the connection between monetary policy and inflation is weak during a period of severely underutilized resources and deflation, the relationship between public debt and inflation is even more tenuous. David Hendry, who has conducted extensive econometric research using long time series in the United Kingdom, concludes that, “Essentially there is almost no relationship I can find, having tried over many years, between [public] debt/GNP and growth, unemployment, or inflation over 1860-2000.”<sup>12</sup> Even a casual perusal of the data bears out the lack of relationship between the public debt ratio and inflation (charts 6, 7). The U.S. postwar experience also debunks the notion that high levels of public debt cause inflation. The peak U.S. public debt ratio of 109% in 1946 was followed by a decade of 2.8% average annual inflation (based on the GDP deflator). The inflation of the late 1960s and 1970s occurred well after the public debt ratio had already fallen steeply and was near its lowest levels in the postwar period. Now, the public debt ratio is at its highest level since shortly after World War II, and inflation has been melting away with deflation threatening.

<sup>12</sup> Quoted by Tim Harford. *Financial Times Undercover Economist Blog*. March 1, 2010. See also Hendry, DF (2009) “Modeling UK Inflation, 1875-1991,” *Journal of Applied Econometrics*, 16, 255-275; and Castle, JL and Hendry, DF (2009) “The Long-Run Determinants of UK Wages, 1860-2004,” *Journal of Macroeconomics*, 31, 5-28.

Chart 6  
**U.S. Debt Versus Inflation**

Treasury Debt Held by the Public as % of GDP (OMB)  
10-year Average Inflation: GDP Deflator

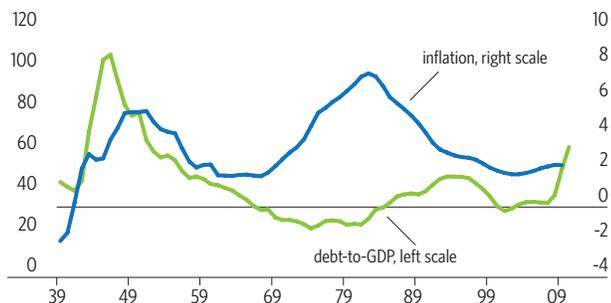
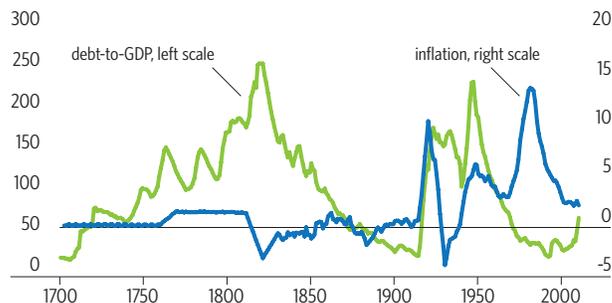


Chart 7  
**UK Debt Versus Inflation**

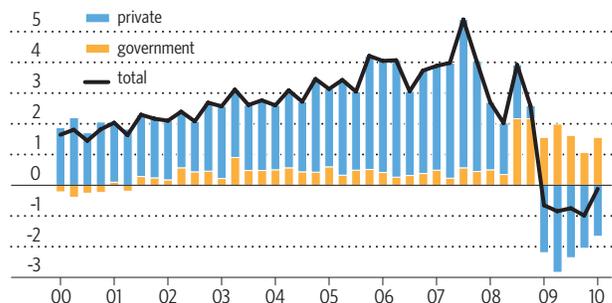
ukpublicspending.co.uk: Public Debt as % of GDP, fiscal years  
10-year Average Inflation: GDP Deflator



Outside of wars, large run-ups in public debt in advanced countries have generally occurred during depressions (contained or otherwise), when the private sector has been deleveraging. The increase in government debt is generally swamped by the decline in private debt, and the resulting net contraction in the economy’s debt outstanding creates deflationary conditions. This has been the experience in Japan recently, in the United States during the 1930s, and in the United States thus far in the current contained depression. As fast as the federal government has been jacking up the supply of Treasury securities over the past year, the supply of private debt has been shrinking even faster—total net debt issuance in the United States has been negative for five quarters in a row (chart 8). Although this pattern may be broken occasionally, the trend is likely to continue for a long time as households and firms continue to reduce their debt and see their asset holdings decline.

Chart 8  
**Total Debt is Declining in the United States**

Credit Market Liabilities, Private Sectors and Government  
\$ trillions, quarter-to-quarter change, seasonally adjusted, annual rate



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## What Will Happen to Inflation after the Contained Depression Is Over?

Could we see a surge in inflation a decade down the road? Perhaps, but it will not be because government debt caused it or the government stealthily engineered it. The biggest inflation threat will be the effect of a secular revival of rapid demand growth on scarce resources. In all probability, the end of the contained depression will bring an era of private sector balance sheet revival, involving not only robust growth, strong tax revenues, and shrinking public debt but also strong investment, which will lead to productivity gains. Those productivity advances, along with deflationary expectations ingrained during the contained depression, will tend to offset the inflationary pressures of rising resource prices. Most likely, deflationary conditions will give way not to galloping price increases but to moderate inflation.

## High Public Debt Will Not Be an Albatross around the Economy's Neck

### Conditions Causing High Public Debt Are Not Permanent and Will Eventually Reverse

Everyone knows from experience and common sense that, for households and businesses, owing ever more money with dubious prospects of paying it back is bad. Most people are quite sure that the same holds true for their national government. Even if the mounting debt does not lead to default or cause inflation, people may have the sense that this debt is a financial and ethical sin that is bound to lead to some kind of negative consequence. It seems that almost everyone believes that the public debt is an obligation we transfer to our children and grandchildren, a theft from their future, an albatross around their necks dooming them to years of poor economic performance, an assurance that they will someday have to pay onerous tax rates, or some other manner of terrible legacy. Let anyone forget this alleged intergenerational curse, plenty of economists, politicians, columnists, business leaders, not-for-profit organizations, and citizens from all walks of life regularly repeat it as unqualified truth.

Yet, these notions are almost all false. This is not to say that there cannot be too much debt, ill-advised debt, or troublesome debt (more on that below), but rather that the belief that soaring public debt is necessarily harming the country's future is simply

wrong. These views reflect misunderstanding of the causes and effects of present deficits, who owes what to whom, what can be passed from one generation to another, what is paid back, and how in the case of a national government—unlike that of a business or a household—revenues and expenditures are linked.

In analyzing the consequences of these deficits, one should start with the reasons they exist in the first place. The present, large deficits in the United States, Japan (chart 9), and the United Kingdom (among other countries, although not everywhere) are directly related to the macroeconomic conditions that characterize these times: specifically, severe weakness in the private sector's profit-generating process reflecting an inability to significantly expand private balance sheets. In short, overexpanded private balance sheets—reflecting overcapacity, overindebtedness, and overpriced assets—lead to weak investment, credit contraction, and asset deflation. The resulting downward spiral in economic and financial conditions plays havoc with government revenue and creates extreme pressures for both additional social safety net spending and for bailouts of the financial system to prevent its collapse. The resulting increased deficit represents a shift of wealth (in the form of public debt) from the public sector to the private sector, with much of the net addition to private sector wealth accumulating in the business sector in the form of profits.<sup>13</sup> If not for this massive expansion of the government deficit, there would be a total collapse of business profits and a severe depression.

Active efforts at budget balancing during a contained depression are counterproductive. They undermine profits and cause further business retrenchment, more layoffs, more business failures, more credit problems, and new declines in government revenues, as history has plainly shown.<sup>14</sup>

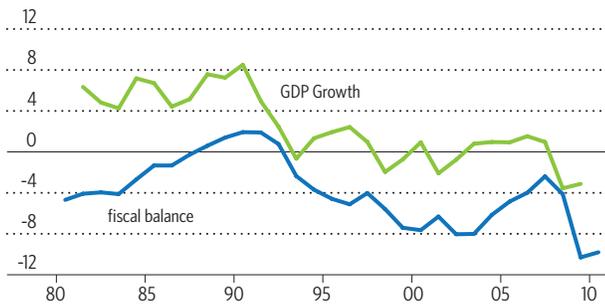
<sup>13</sup> See *Where Profits Come From*, Jerome Levy Forecasting Center, 2008.

<sup>14</sup> History provides many examples of fiscal tightening measures in a depression or contained depression, and the effects have been disastrous. In the United States during the 1930s, the federal government raised taxes on two separate occasions. The first tax hike, which took effect in 1932, aggravated and likely extended the horrific recession of 1929-1933, and the second, which was passed in 1935 and became effective in 1936, helped trigger the severe recession of 1937-1938. Furthermore, these measures so worsened the economic situation that they failed to narrow the government deficit. During Japan's two lost decades, it has on more than one occasion taken steps to slash its deficit. The 1997 consumption tax increase was an important factor in prematurely aborting a recovery, and years of large government deficits ensued. Another attempt at deficit reduction that backfired was the 2001 fiscal reform.

Chart 9

**Japan: Lost Decades Have Produced Big Deficits**

IMF: Japan: General Government Fiscal Balance as % of GDP  
 Japan Ministry of Finance: GDP, year-over-year % change



Just as it is critical to recognize the role of the troubled condition of the private sector in the creation of large government deficits, it is equally important to recognize that this condition is not permanent: depressions do not last forever, and forces for a secular boom will arise after the contained depression. For only so many years can debt contract, asset prices decline, and net fixed investment remain negative or minimally positive before the pressures become overwhelming to ramp up investment, to buy up cheap assets, and to begin conservatively to expand credit again. Technology keeps advancing and society’s needs keep evolving while the existing stock of structures, equipment, and software becomes more decrepit, more out of date, and less able to meet demand. Rates of return therefore rise on new capital investment, and rates of return on other assets are more attractive because prices have fallen, but still investment lags as pessimism bred in the depression discourages risk taking. Thus, the pressures for investment continue to mount until, finally, private investment—the most important source of profits in a healthy economy—begins its revival, increasing profits, business expansion, and, slowly, general optimism. Depression-era cautiousness gradually eases and credit flows faster to support expansion. Instead of the vicious cycle of collapse that prevails early in a depression, the economy now enjoys a virtuous cycle of rising investment, rising profits, improving cash flow, rising asset prices, rising employment, improving income, rising demand, and incentives for still more investment.

Nothing is inevitable, but these forces for a secular boom after a depression will arise and eventually dominate unless the basic institutions of the economy are destroyed. A new era of prosperity will be born and will tend to last for decades, punctuated by occasional recessions that give way to rapid recoveries.

**Once Private Sector Balance Sheets Are Ready to Expand Again, the Government Fiscal Situation Will Improve**

The key point here is that the condition of the private sector, especially its financial condition and its ability to generate its own profits, has an enormous influence on the size of the government’s surplus or deficit. As the economy moves into a new era of investment, stronger profits, and robust growth, incomes will grow, tax revenues will pick up, and deficits will tend to become much smaller, possibly even vanish. Government spending cuts will be less likely to destabilize the economy and thus backfire.

Once the rate of economic growth surpasses the rate at which the public debt is growing, the public debt ratio will shrink; the government does not have to pay down debt to reduce its debt burden in relation to GDP. For example, in the first 10 years of the postwar era, the U.S. public debt-to-GDP ratio came down sharply from 109% to 52%, even though the actual debt outstanding declined by less than 10%. The sharp, 10-year decline in the debt ratio was achieved even while the government was running deficits half the time and on average had a surplus that was less than a percentage point of GDP. Had Washington not paid down a cent of its public debt, the debt ratio still would have declined to 57%. Surging investment, profits, and growth shrank the debt ratio while making balancing the budget not only possible but relatively easy.

Furthermore, the historical record for strong, financially independent countries with effective tax collection shows that strong economic growth has generally enabled governments to restore fiscal health without large tax increases. After the contained depression, tax rates will have to rise to shrink the deficit to a modest size only if the government expands spending significantly faster than the then rapidly growing GDP. Policy does matter, but policy is not the real problem behind the deficit now.

## Future Generations Are Not Bearing the Burden of Current Spending

Still, even if growth helps shoulder the burden, will not future generations have to pay for today's deficit-financed consumption? No. The living standard of Americans in the future will reflect the volume of goods and services they produce and the size of the population. If our government consumes more in the present by running deficits to buy each American a hamburger once a week, those extra hamburgers are not plucked from the future and sent back on a time machine, reducing the future supply of hamburgers or anything else.

But wait, say the economics textbooks, if through deficit spending we consume more now, less of our output will go into investment, thereby reducing our ability to produce goods and services in the future. However, this relationship assumes that the economy is always at full employment and society is producing as much as it can, so consuming more must reduce investment. This assumption is unrealistic on several counts. Most obviously, there is nothing about our present deficits that is reducing private investment; there is vast slack in the economy, and business does not want to invest because of weak sales expectations, overcapacity, and overweight balance sheets. Moreover, if not for the deficits, the condition of the economy would have been far worse, and there would be even less investment.

Another argument for why a high public debt ratio is dangerous is that if the government consumes a great deal on credit, it will force the economy to be a net importer to make up the difference, increasing the government's borrowing from foreigners. Again, this is necessarily the case only when the economy is operating at full capacity, so that the only way more goods and services can be available is to buy from the rest of the world on credit. Clearly, the economy is not operating at full capacity in the United States—or in Britain or Japan. Moreover, there is no clear relationship between government deficits and trade deficits. The United States ran a growing trade deficit during the 1980s when it also ran proportionately larger federal deficits than in previous decades, giving rise to the “twin deficits” theory. Yet the trade gap widened even more during the 1990s as the federal deficit vanished. Japan generally ran a trade surplus during the past two decades as its

public debt mounted. Trade deficits reflect myriad influences. All in all, it is extremely difficult to conclude that the federal government's deficit spending is mortgaging our children's future to foreigners.

## History Refutes the Theory That High Public Debt Thwarts Growth

The notion that a large public debt will inhibit growth in countries like the United States is simply unsupported by experience. Both American and British history not only fail to show that high public debt is a drag on growth, but actually show that peaks in debt have been precursors to unusually strong economic growth (charts 10, 11). The United Kingdom became a dominant world power with public debt ratios between 100% and 200%, and it grew fastest when the public debt ratio was highest.<sup>15</sup> U.S. history is equally telling. The all-time peak in the Treasury debt ratio in 1946 was followed by a period of strong growth. On the other hand, the two troughs in the public debt ratio, in 1974 and in 2001, were followed by the 10-year periods with the lowest growth rates in the past half century. We are not suggesting that the high public debt ratio itself causes strong growth; actually, circumstances that cause high debt—major wars and depressions—can shrink private balance sheets and create forces for new eras of strong private investment and growth. But we will not make this argument here; we are simply asserting that the record contradicts the idea that high debt causes weak growth.

<sup>15</sup> David Hendry, 2009.

Chart 10  
**U.S. Debt Versus GDP Growth in Next 10 Years**

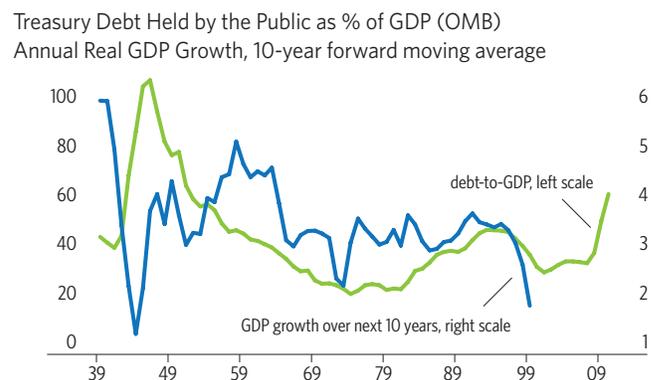
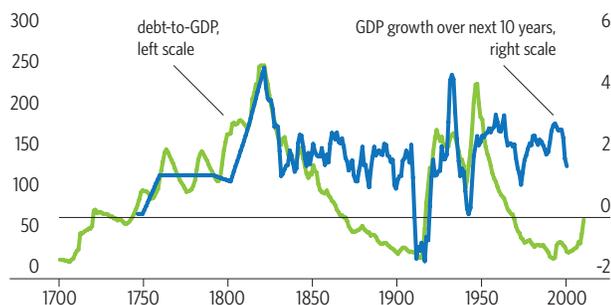


Chart 11

### UK Debt Versus GDP Growth in Next 10 Years

ukpublicspending.co.uk: Public Debt as % of GDP, fiscal years  
Annual Real GDP Growth, 10-year forward moving average



### “Debt Held by the Public” is the Right Measure of Public Debt

The correct measure of U.S. public debt is Treasury debt held by the public. This measure does not include Treasury debt held by the Federal Reserve or by any other entity within the federal government. The debt held by the public entails rigid legal obligations that must be serviced with timely interest payments and repaid upon maturity. Since our concern is the ability of the federal government to manage and service its debt, these are the liabilities that matter.

Many people believe that other items count as public debt. They most often cite Treasury debt held in federal trust funds, especially in the Social Security trust funds. As a result, their calculation of the public debt is much higher. At the end of March 2010, according to the U.S. Treasury, the outstanding debt of the U.S. government held by the public was \$8.3 trillion, which equals about 57% of GDP. If the money that the Treasury “borrowed” from trust funds is counted, the total rises to \$12.9 trillion, which equals 88% of GDP. However, since the debt held by trust funds is owed by one part of the federal government to another, neither this debt nor any of the associated interest payments has an impact on the overall position of the federal government.

Still, the argument goes, the government owes the balance in the trust fund to citizens—whether that balance is in cash, bonds, or bookkeeping entries with no financial assets backing them up. But, the government does not owe that balance in the same way it owes citizens the interest and principal on a

Treasury bond they hold. Since its inception in 1935, Social Security’s eligibility restrictions, revenue collections, and benefit calculations have been altered repeatedly and remain subject to adjustment at the discretion of the government. Indeed, any social program of that scale, including Medicare, that attempts to provide stable or rising real benefits virtually has to be subject to change. Otherwise, the government may find that meeting the obligations requires unacceptable sacrifices by the pre-retirement population.

Here is why such a problem could arise. Although the Social Security program is presumed to provide a specific level of real benefits to recipients by indexing payments to inflation, the government cannot guarantee real future benefits to a great proportion of the population because the economy simply may not be able to deliver. The inability to guarantee real benefits is inescapable no matter how much the government saves in a trust account or anywhere else.

An extreme example illustrates the point. Suppose some sort of disaster wiped out much of the nation’s productive capacity and reduced GDP to less than what the retirees were promised. No matter what was in the Social Security trust fund, it could not buy what did not exist. While such a scenario is unlikely (at least we hope so), a plausible danger is that the economy’s real output—the proverbial economic pie—will grow too slowly to support the standard of living currently promised to future retirees as the ratio of active workers to retirees declines.

In fact, pouring assets into a trust fund, while seemingly sound financial management, is a mirage. It does not solve the problem and can create new ones. The fund does provide a procedure for distributing the economic pie between social security recipients and active workers, but it does nothing to make the pie bigger to accommodate the retirees’ claims. Meanwhile, the trust fund reinforces the mistaken notion that retirees’ future benefits have already been put aside for them, guaranteeing them real consumption that may or may not be feasible.

The truth is that no matter how it is financed, Social Security (as well as Medicare) is a pay-as-you-go program when it comes to providing the real goods and services retirees buy with their benefits. Neither hamburgers nor healthcare can be put into a time capsule now for the future. If 20 years from now the economy cannot support the standard of living presently

guaranteed to retirees while maintaining the standard of living active workers expect, then something will have to give, and none of the alternatives will be attractive. The government will either have to reduce retiree benefits, significantly raise taxes on workers to pay for retiree benefits, or meet the obligations to retirees without raising those taxes, resulting in inflation that would lower workers' real wages. In this situation, if everyone understood that (1) the system is a pay-as-you-go system and (2) there is not enough economic pie to meet everyone's expectations, they might better understand and accept the need for compromise than if the issue were distorted by the belief that Social Security benefit recipients had legal entitlements to their own money saved in the trust fund and protected from inflation.

No matter how much or how little financial value is squirreled away in a trust fund, no matter whether the federal government has been running surpluses or deficits, the size of the future economic pie is going to determine the standard of living of the average American. As the proportion of workers who are retired increases, the standard of living will come under downward pressure as each working American has to produce goods and services for him- or herself and for a growing proportion of the consumption of a retired worker. If worker productivity rises smartly, it may neutralize or outweigh this effect, and per capita purchasing power will hold up or even rise for active workers while retirees get what present policy grants to them. However, if productivity cannot keep pace, the average standard of living will have to fall. Social Security, Medicare, and other programs, whether they are supposed to be funded for the future or not, will in fact change and evolve to conform to the economic realities of future periods.<sup>16</sup>

*16 Costs for both Medicare and Social Security are projected to skyrocket and cause the federal deficit to balloon in the coming decades, reflecting the growing proportion of retirees in the population. However, long-run estimates of government budgets are rarely close to the mark, often not even in the same ballpark. Recall, for example, that in the year 2000 people were concerned about the dwindling supply of government paper. Ten- and especially twenty-year or longer projections can be completely misleading; they are typically based on linear projections of current trends that are often mathematically unsustainable. The fact that medical cost inflation has run ahead of general price inflation almost uninterruptedly for more than 50 years does not mean that the pattern is immutable. The pressure to find savings will only grow in the future. Technological changes have enormous potential to dramatically alter the delivery of medical care services. In any event, if society cannot afford to continue a long-term trend, then one way or another, it will not.*

Retiree programs pose large challenges, but fiscal “rectitude” now will have little bearing on the country’s ability to address these challenges. Whatever decisions the country makes in the future about dividing its economic pie between active and retired workers or between the sick and the healthy, they will have nothing to do with public debt.

### Is There Nothing Wrong with Soaring Public Debt?

There certainly is something wrong with soaring public debt for countries without a strong capacity to carry sovereign debt. Moreover, for any country, including the United States, soaring public debt can be ill-advised. In normal times, meaning when private balance sheets are not in a depressionary contraction, the private economy can more or less generate the profits needed for business to prosper and to provide enough jobs for a high rate of employment (except during brief periods of cyclical weakness). Too much deficit spending during such times can overheat the economy, straining available capacity and leading to labor shortages and inflationary pressures on wages and resource costs. Such an overheating has occurred only once since World War II. During the late 1960s, deficit spending to finance the Vietnam War and the Great Society programs did overheat the economy, widening profit margins and tightening labor markets, thereby bidding up compensation rates. Moreover, since the deficit spending accompanied government redistribution of resources from upper- and middle-class workers to the war effort and to the poor, it created dissatisfaction with real wages and thus even more pressure for inflationary pay increases.<sup>17</sup>

Certainly, deficit spending, like any government spending, can be criticized when it represents a foolish use of resources. Still, even wasteful deficit spending stimulates the economy. In a depression, it would be better to have wasteful deficit spending that helped contain the damage than to have none, but it would be better still to have deficit spending for productive purposes.

In political discussions and in federal budgeting, government spending is generally considered public consumption, but some purchases are really public investment, providing assets that will

*17 Had the deficits just reflected tax cuts instead of escalating military and social spending, inflation still would have picked up, but real wages would have been more satisfactory and perhaps the pay increases more muted.*

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have benefits years into the future. Just as it is generally viewed as unwise for a household to go substantially into debt paying for groceries and rent but justified for it to borrow to purchase a car or house, government borrowing to pay salaries or buy paper towels for restrooms in federal buildings is not the same as borrowing to build a government office building or to fund a new bridge. It is hard to talk about mortgaging our children's future if the debt they will inherit is accompanied by highways, water systems, hospitals, aircraft carriers, and other assets that will provide benefits.

Indeed, the ideal fiscal policy during a depression would involve massive government investment. As long as a huge volume of debt is going to accumulate, why not use it to repair and enhance infrastructure, advance science, modernize military hardware, improve education, and so forth? Combining the public need for investment and the need for economic stimulus would lead to much sounder fiscal policy.

## Conclusion

The swelling public debt of the United States is already a major cause of national worry, a heated political issue, and the reason for a cacophony of calls to action from academe, Wall Street, cocktail parties, populist political gatherings, and, of course, many members of both houses of Congress. The next few years are almost sure to bring more contentious debate, with the noise level rising even higher. Other nations are embroiled in similar controversies. Yet, at home and in many countries around the world, many are mistaking a symptom for the disease; indeed, the swelling public debt is not only a symptom but also a tonic that ameliorates the disease.

Public debt is growing not so much because of bad policy (although in some cases policy or other circumstances also bear heavy responsibility) but because of profound developments in the private economy, problems that will endure for a number of years but not forever. While the mounting debt will lead to crises in some countries, as it already has in Greece, we have seen why other countries, including the United Kingdom, Japan, and, most of all, the United States, have far greater capacity than widely believed to carry debt and to eventually bring down their high public debt ratios. Whatever the practical limit of the public debt ratio in countries with a high capacity

for carrying debt, it appears based on experience to be higher than 200% of GDP, perhaps much higher.

Nevertheless, widespread fear of growing public debt is likely to persist. The analysis we have presented above is based on a financial macroeconomic view that involves variables and relationships that do not appear in the conventional economic framework. Conventional macroeconomics, which lacks even the concept of balance sheets, provides no way to examine the implications of changes in the size of balance sheets for wealth, profits, or cash flow. One should therefore expect continued consternation and confusion about the state of the economy and the public debt (and, incidentally, increasing dissatisfaction with the state of economics). Periodic attempts to tame the deficit are almost inevitable, yet such efforts will tend to be self-defeating and will largely or entirely backfire.

How well the United States or any other country copes with the economy during this period of rising public debt will depend on several factors, including luck. Two factors in particular warrant attention.

The first is whether the government can establish a program of strong public investment. Although the government makes no distinction when budgeting between capital spending and operating (consumption) outlays, Washington has the information to look at the budget as two separate accounts with reasonable accuracy. Although considerable controversy surrounds the definition of public capital, Congress and the White House should establish a goal of increasing spending on specific capital programs to support the economy during the contained depression while working to bring consumption outlays, including personal transfer payments, into better balance with revenue. As the contained depression ends, capital spending programs, such as overhauling the country's long-neglected physical infrastructure, could taper off, leaving the country with improved highways, bridges, and water systems as private investment begins to pick up. Investment in public infrastructure, military hardware, technology research, environmental cleanups, or education would still lead to rising debt, but there would be reason for people to believe that the government had better control over its consumption and its long-term budget situation. The public would also see that the government had provided valuable assets that would last well into the future along with the debt.

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The second factor concerns the U.S. current account deficit. This deficit represents a direct flow of profits out of the country, and it greatly increases the need for government stimulus to keep the economy going. If the United States can reduce its current account deficit substantially, it will also reduce its dependence on federal deficit spending. However, it will prove difficult to increase exports relative to imports with turmoil around the world, especially with many countries less able—and in some cases unable—to contain their own depressions. Foreign demand will tend to be weak, and the dollar may stay strong because of the United States's relative stability. Trade politics will invariably become more contentious. Even if the U.S. government took a more enlightened approach to its budget during the contained depression, the international trade challenge would be formidable, especially with Hooverism sweeping so much of the globe.

The contained depression era is one of grave financial, economic, and political risks. Yet, ironically, one of the issues that most concerns people, the rising public debt, is probably one of the last things Americans should worry about.

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