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Seeds of A Sovereign Debt Crisis Planted

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The U.S. and Global economies have undergone a fiscal/debt revolution of huge import from which there will be no turning away!

The main catalysts are the failure over a very long period for ultra-easy monetary policy, i.e., zero interest rates and increased central bank balance sheets, to achieve full employment and price stability and the collapse and depressions of the U.S. and world economy on the unprecedented External Shock of 2020—the Coronavirus Pandemic.

The U.S. and country-after-country already are well along the road of hugely increased central government deficit and debt-financed outlays to offset the impotence of the easy monetary policy on overcoming disinflation and deflation and a Shock-induced cratering of economies around-the-world.

Monetary policy of near zero and negative interest rates and Quantitative Easing (QE) that has built up central bank balance sheets to unprecedented highs have served mainly to inflate asset prices and to increase inequality of income and wealth, not yet strong economic growth, full employment and increased price inflation—a "Liquidity Trap" like the 1930s.

As a consequence of shifting thrust to fiscal stimulus in the U.S.—an unadulterated Keynesian deficit and debt-financed fiscal government spending stimulus fully accommodated by essentially zero short-term interest rates—upon a return to a post-Pandemic time whatever growth acceleration and move toward full employment has occurred will be accompanied by unprecedented high deficits and debt relative to GDP.

In the case of the U.S. the fiscal stimulus in 2020 was over $3 trillion, mostly transfers, approximately 10% to 15% of GDP. This was an unheard-of magnitude associated with U.S. Government debt relative to GDP of over 130%, a record-high. Yet another $1 trillion-or-so of stimulus is likely in 2021, bringing the total to almost 25% of GDP over two years and the debt-to-GDP ratio perhaps to 150%.

In the understandable near-term rush to fiscally support the economy and save lives, little thought has been given to the aftermath—when economies grow strongly again, unemployment rates fall, price inflation picks up, and interest rates rise.

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The seeds of a huge debt overhang from dealing with the Pandemic and what as a result eventually will be a hugely burdensome debt service relative to GDP will eventually lead to a U.S. sovereign debt problem, a weaker dollar, and global investors eschewing U.S. securities.

The timing of this inevitability is what is uncertain—not the sovereign debt crisis itself. It certainly is not to be expected any time soon. But with the promise of rising and higher inflation encouraged by monetary policy's Forward Guidance and federal government deficit-to-GDP ratios in double-digits, debt service burdens as inflation and interest rates rise will spiral, budgets have to be reduced, and the economy weakened.

Much has to happen first—fledgling recoveries sustained, labor markets tightening, demand-pull inflation picking up, long-term interest rates moving higher, and debt service burdens becoming burdensome. But the seeds of this process are now already well-planted!

If, before such a time, preventive actions are not taken to slow the rise in deficits and debt, that is calibrating fiscal policies so as to achieve a glide path for the economy and stable-to-declining debt-to-GDP and debt interest service ratios, the current crises, to be followed by good times, will soon thereafter be followed by bad times.

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