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The Fiscal Trap

Quantitative easing won't solve our deeper problem.

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Fed chairman Ben Bernanke concedes that, while necessary, a new large purchase of government bonds by the Fed to help cover the deficit will not completely solve our problem of slow growth. Many in the markets and around the world express the same sentiment in a more negative way—saying this latest round of "quantitative easing" won't work. Only time will tell, and our best guess is that, because it is only modestly effective by itself, quantitative easing will probably be part of Fed policy for quite some time. One reason we must hope that quantitative easing is not too successful is that its near term success would mean a catastrophe for government finances.

By the Fed's reckoning, a successful quantitative easing policy will return us to a more normal economic environment with fairly low but stable inflation, similar to the inflation environment of the last two decades. But a normalization of inflation will also mean a normalization of interest rates. And normalized interest rates will mean much higher interest payments, especially by the world's biggest debtor: the government of the United States.

Consider the math. This year the government will pay $200 billion in interest on debt held by the public (i.e., non-U.S.-government institutions) of $9 trillion. The average interest rate paid on the debt is 2.2 percent.

To simulate what will happen going forward, assume for the sake of argument some moderate reductions in future deficits from ending higher-end tax cuts, limiting the growth in discretionary spending to the rate of GDP growth, and cutting defense. Under these assumptions, the debt held by the public will rise to $13.1 trillion by 2015 and $16.7 trillion by 2019.

But if interest rates remain at current levels, interest payments will still be relatively manageable: $290 billion in 2015 and $355 billion in 2019.

Now suppose quantitative easing is "successful" in the way the Fed intends, taking inflation close to the average 2.4 percent rate of the last two decades and government borrowing costs back to their two-decade average of 5.7 percent. To get an idea of what happens to the budget, assume this transition happens over three years, so that by 2013 interest rates are back to "normal." This "return to normal" will mean the government's interest costs will rise to $847 billion by 2015 and $1.15 trillion by 2019.

The increase in annual interest costs in 2015 alone—$557 billion—is nearly six times the additional revenue that is supposed to be collected by letting the higher end of the Bush tax cuts expire, the centerpiece of the current fiscal policy debate in Washington. The increase in interest costs in 2019—

$795 billion—is two-and-a-half times the value of all the Bush income tax cuts of 2001 and 2003 that are due to expire. On the spending side, just the extra interest cost from a quantitative easing "success" would swamp, say, the entire defense budget for the rest of the decade. No plausible increase in taxes or reduction in spending could fill a gap of that magnitude.

Interest rates could also rise for a variety of other reasons. Much faster real economic growth could have the same effect. An additional point of real growth for five straight years would help by raising revenue by about $450 billion over five years, but a parallel increase in real rates would raise interest costs by $700 billion over the same period. The higher real rates and larger deficit would likely put a lid on the sustainability of any growth spurt. Alternatively, an increase in borrowing costs caused by international creditors' demanding higher real yields is also possible. One of the leading possible causes of such a rate spike would be a loss of faith in the dollar as creditors could demand higher yields to offset currency depreciation.

This is the nature of our developing fiscal trap, and those familiar with Japan will recognize a lot of similarities. There, debt is so large that even at rates way below American levels, interest payments consume a quarter of all tax revenue. A switch in Japan from modest deflation to modest inflation, with a corresponding rise in rates, would lead to debt service costs consuming the entirety of tax revenue.

Our situation is not nearly as dire—yet. But a continuation of quantitative easing without significant moves toward a balanced budget would land us in Japan's shoes within five years. Currently quantitative easing makes shrinking the deficit easier by holding down borrowing costs. It also offsets some of the economic contraction that deficit reduction may cause. But unless we get control of the deficit, quantitative easing will eventually lead to higher inflation or a loss of confidence in the dollar, or both. At that point, the resulting higher borrowing costs will swamp any of the current supposedly dramatic deficit reduction plans that are on the table.

That is why immediate action on the deficit is required.

The co-chairs of the president's deficit commission came up with a plan to stabilize both taxes and spending at 21 percent of GDP over time. The plan would raise the tax share of GDP from its current artificially low level of 14.6 percent to 19.3 percent by 2015 while bringing down the spending share from 23.8 percent to 21.4 percent. Even though taxes make up the majority of the deficit reduction, the improved efficiency from the tax reforms being proposed would likely offset the drag on growth. And, despite some knee jerk comments in opposition to the proposal from some on the left, both the tax code and the Social Security system are made more progressive in the process. While one can quibble with the details, thoughtful people across the political spectrum could support this plan.

But action is needed immediately. Even the sweeping reforms the commission is suggesting will be overwhelmed if borrowing costs rise. We can either act or slide Japan-like into a deflationary future with rising unemployment. We can live well for a bit longer, with high deficits covered by printed money, but then pay the consequences through ruinous inflation and a loss of faith in the dollar. Either way, the fact is that this is probably our last chance to escape our fiscal trap.

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