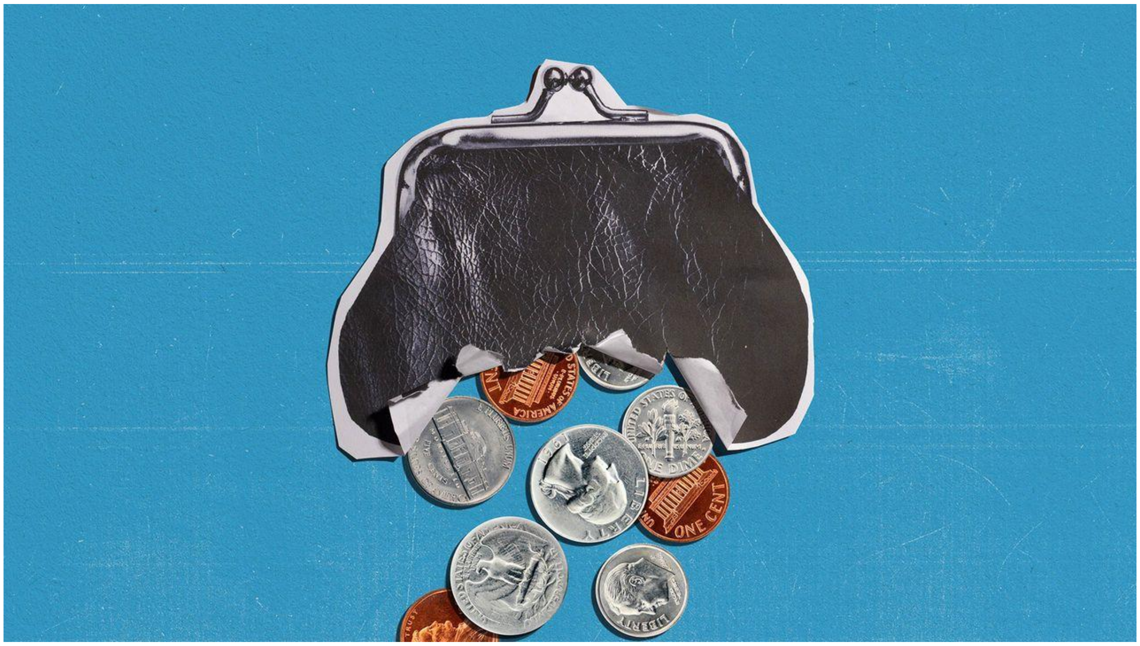
America's reckless borrowing is a danger to its economy—and the world's

Without good luck or a painful adjustment, the only way out will be to let inflation rip



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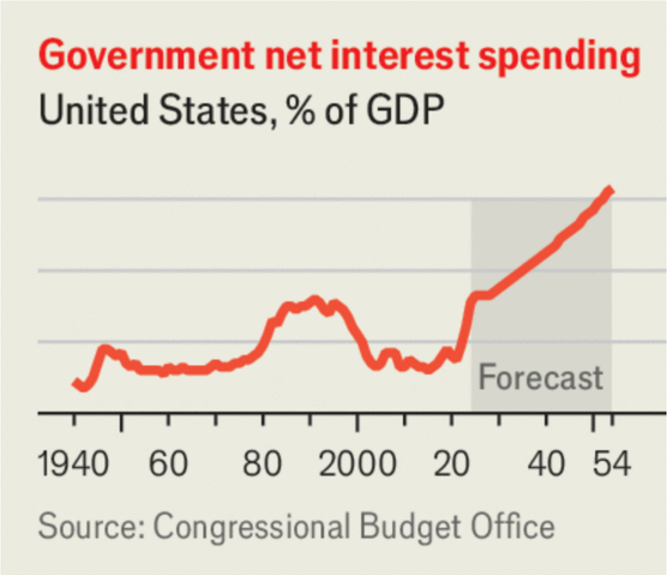
If prudence is a virtue then America's budget is an exercise in vice. Over the past 12 months the federal government has spent $2trn, or 7.2% of gdp, more than it has raised in taxes, after stripping out temporary factors. Usually such a vast deficit would be the result of a recession and accompanying stimulus. Today the lavish borrowing comes despite America's longest stretch of sub-4% unemployment in half a century. The deficit has not been below 3% of gdp, an old measure of sound fiscal management, since 2015, and next year Uncle Sam's net debts will probably cross 100% of gdp, up by about two-fifths in a decade. Whereas near-zero interest rates once made large debts affordable, today rates are higher and the government is spending more servicing the debt than on national defence.

How has it come to this? The costs of wars, a global financial crisis and pandemic, unfunded tax cuts and stimulus programmes have all piled up. Both Republicans and Democrats pay lip service to fiscal responsibility. But the record of each side in office is of throwing caution to the wind as they indulge in extra spending or tax cuts. The biggest economic decision facing the next president is how generously to renew Donald Trump's tax cuts of 2017, a step that will only worsen America's dire fiscal trajectory.



This profligacy cannot go on for ever—at some point, interest costs will rise to intolerable levels. The binge must therefore come to an end in some combination of three ways.

The least painful is that good fortune comes to the rescue. Until recently, falling global real interest rates contained the cost of servicing debts even as these grew in size.

Today Japan just about manages with net debts about half as big again as America's, relative to gdp, thanks to near-zero rates. If inflation is defeated and real interest rates fall back from their present highs, America could be off the hook, too. Another source of relief could be productivity growth. If it surges, say because of artificial intelligence, America could outgrow its debts.

Yet good luck cannot be assumed. The most responsible way for politicians to end the budget binge would be to correct course as the interest bill rises. The imf estimates that America will need to cut spending, excluding debt interest, or raise taxes by 4% of gdp to stabilise its debts by 2029. It has managed a similar adjustment before, between 1989 and 2000, when "bond vigilantes" were said to have cowed Washington into submission.

The trouble is that the circumstances were then well-suited to belt-tightening. The end of the cold war yielded a peace dividend: falling defence spending accounted for fully 60% of the fiscal adjustment. As a share of the population the labour force climbed to an all-time high. A real-wage boom made the pain of higher taxes more bearable. But today war and rising global tensions are pushing defence spending up and baby-boomers are retiring in droves.

That leaves the third and most worrying option: making creditors pay. America would never be forced by the markets to default, because the Federal Reserve can act as a buyer of last resort. Fiscal laxity could cause inflation, though, which would mean bondholders and savers taking a big real-terms hit.

One way this could happen is if a populist like Mr Trump were to take control of the Fed. His advisers have floated ideas for influencing monetary policy that include appointing a pliant chairman and giving Congress oversight of interest rates. Mr Trump likes low rates; if they were combined with a growing deficit, inflation would surge.

Even if the Fed kept its independence, it could become impotent if Congress allowed debt to rise without limit. When the government's response to rising interest rates is to borrow still more to service its debts, then tight money can stoke inflation rather than containing it—a feedback loop with which Latin America is all too familiar and which mavericks say is already under way in America. Their doomsaying is premature, but higher rates can feed into the budget very quickly. After accounting for the Fed's balance-sheet, the median dollar of debt is on a fixed interest rate only until June 2025.

A less stable America would cause pain at home because of higher interest rates, more uncertainty and an arbitrary redistribution from creditors to debtors. But the costs would also be felt globally. The dollar is the world's reserve currency. Through it America provides a unique service: a supply of plentiful assets backed by a vast economy, the rule of law, deep capital markets and an open capital account. No other asset can perform this role today. Even if the dollar attracted a risk premium to compensate for the danger of inflation, the world would probably have to keep using it.

A world whose reserve currency was being debased, however, would be a poorer one. Capital would be more expensive everywhere; the global financial system would be less efficient; and investors would be on a constant search for a viable alternative to the greenback, with the threat of a chaotic transition if one ever emerged. America's fiscal mess is home-made. But make no mistake: it is the whole world's problem. ■

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