PRESIDENT'S MESSAGE

European Sovereign Debt Crisis: A Wake-up Call for the U.S.

In recent years, many countries' deficit-to-GDP (gross domestic product) and debt-to-GDP ratios rose as governments increased their borrowing on international credit markets to finance spending. For some European countries in particular, the ratios reached far beyond those considered sustainable. Consequently, these countries—including Greece, Ireland and Portugal—saw their borrowing costs rise dramatically as markets began questioning the countries' ability and willingness to repay their debt.

Although the U.S. continues to have low borrowing costs, the U.S. deficit-to-GDP and debt-to-GDP ratios are nearly as high as those of some of the countries that have had difficulty borrowing. The current European sovereign debt crisis serves as a wake-up call for the U.S. fiscal situation.

Borrowing in international markets is a delicate matter. A country cannot accumulate unlimited amounts of debt; there is such a thing as too much debt, and it occurs at the point where the country is indifferent between the temporary benefit of defaulting and the cost of not having continued access to international credit markets. Markets understand that at some high level of debt a country has a disincentive to repay it, and, therefore, markets will not lend beyond this point.

Interest rates alone are not the best way to determine whether a nation is borrowing too much or to evaluate the probability of a debt crisis. Witness Greece and Portugal—two of the latest countries to face this borrowing limit: Interest rates tend to stay low until a crisis occurs, at which time they rise rapidly. Today, the U.S. has low borrowing rates, but these low rates should not be comforting regarding the likelihood of hitting the debt limit.

So, what is the limit for debt accumulation? While it can be difficult to evaluate, research has found that once a country's gross debt-to-GDP ratio surpasses roughly 90 percent, the debt starts to be a drag on economic growth.[1] In general, the European countries that continue to have poor economic performances are the ones that borrowed too much and are beyond this ratio. Over the past couple of years, they have tended to have relatively high (and frequently increasing) unemployment rates and low or negative GDP growth. Of course, slower growth tends to exacerbate a country's debt problems. In contrast, countries that have not carried too much debt—in particular, Germany and some of its immediate neighbors—have tended to have relatively low (and frequently decreasing) unemployment rates and positive GDP growth.

The U.S. gross debt-to-GDP ratio is higher than 90 percent, and projections indicate that it will rise further. Now is the time for fiscal discipline in order to maintain the credibility in international financial markets that the U.S. built up over many years. Failure to create a credible deficit-reduction plan could be detrimental to economic prospects. Furthermore, as the European sovereign debt crisis has shown, by the time a country reaches the crisis situation, fiscal austerity might be the best of many unappealing alternatives. Returning to more normal debt levels will take many years, but the economy would likely benefit if the U.S. were to get on a sustainable fiscal path over the medium term.

Some people say that the U.S. cannot reduce the deficit and debt because the economy remains in dire straits, but the experience of the 1990s suggests otherwise. During the 1990s, the U.S. had substantial deficit reduction, and the debt-to-GDP ratio declined. The economy boomed during the second half of the decade, which helped to reduce the debt more quickly. While reviving economic growth would also help now, temporary fiscal policies and monetary policy are not the best way to do that. Having a credible deficit- and debt-reduction plan in place would likely spur investment in the economy, as it did during the 1990s.

James Bullard
President and CEO

[1] For example, see Cecchetti, Stephen G.; Mohanty, M.S.; and Zampolli, Fabrizio. "The Real Effects of Debt," in *Achieving Maximum Long-Run Growth*. Presented at the 2011 Economic Policy Symposium, Jackson Hole, Wyo., Aug. 25-27, 2011.