Goldman Sachs Exchanges

Is a US fiscal crisis ahead?

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Allison Nathan: Is America in fiscal trouble? Concerns about the US deficit have surged, but worries about the fiscal situation of the United States are nothing new. So, is this time really different?

I'm Allison Nathan, and this is Goldman Sachs Exchanges. Each month, I speak with investors, policymakers, and academics about the most pressing, market-moving issues for our Top of Mind report from Goldman Sachs Research.

This month, I spoke with two people who have long worried about the US fiscal trajectory: economist Ken Rogoff, a professor at Harvard University, and historian Niall Ferguson of Stanford's Hoover Institution and Harvard's Belfer Center. Both agree this time is different and are worried about the US fiscal situation today.

So, I started by asking them why that is. Here's what Ken Rogoff had to say.

Ken Rogoff: I think the big change is that global long-term real interest rates have risen, in my opinion, they've normalized. The whole stuff about lower forever, secular stagnation was always wildly overblown, and I've been debating this for over a decade. Saying that, if you look at the longer-term behavior of real interest rates, they go in cycles, but there's a lot of regression to mean, and no one should have ever planned on their being low forever. So, a lot of what you're calling fiscal concerns is a much broader movement towards higher interest rates. That has to do with, well, certainly higher global debt is a piece of it, but I would also say global fragmentation, geopolitical uncertainty, the need to build energy to accommodate AI, remilitarization of the world, and the costs of that.

So, I think long-term bond rates will continue to creep up, not go down. The whole idea that many people still have that they're going to go back to the pre-pandemic levels, I think is dreaming, that's just not going to happen.

And the rise in interest rates is affecting everything. It's not just public debt; it's affecting all markets, but particularly for countries that have gotten used to not just not paying down their debt, but running it up and up and up. Particularly the United States, but pretty much everyone.

Allison Nathan: But is this all about the rise in real interest rates, or do we have deeper issues?

Ken Rogoff: We'd feel a lot better if rates were just lower. That's the biggest piece of it. But of course, in the United States our debt is much higher now. There may be people who say it's irrelevant, but actually when you're a large debtor and interest rates go up a lot, it affects you a

lot. So, we're much more vulnerable to higher interest rates.

Allison Nathan: And here's Niall Ferguson on why this time is different.

Niall Ferguson: I've been warning for 20 years that the United States is on an unsustainable fiscal path, and there are times when people like me have felt like the boy who cried wolf. But one of the lessons of history is that great power like the United States, which is the number one military power in the world which has the privileges of issuing the reserve currency, which is issuing securities that are seen as risk free, it can light a lot of matches in the dynamite room and get away with it. But at some point, the sentiment shifts. And I think we've seen a shift in sentiment this year, and it's been quite a dramatic one. In the sense that investors really since it was clear that President Trump was going to wage a much more aggressive trade war than in his first term, began not only to reduce their holdings of U.S. Treasuries, but also to move away from the dollar, so we had the very unusual shift of yields somewhat upwards on bonds and the dollar down.

And you can see that although the debt relative to GDP, depending on how you measure it, is roughly where it was after World War II. The really concerning thing is that we're spending more on interest payments on the debt than we're spending on defense. And if you spend more on interest payments than, than on defense, you probably won't be super and powerful for much longer. And, that I called Ferguson's Law earlier this year. That's a kind of simple heuristic, but it seems to me, is better than looking at debt to GDP.

So that's the issue that I think we should focus on. The United States has throughout its time as the dominant

global superpower, or empire or hegemon, you can call it what you like, had this ability to spend really quite large shares of gross domestic product on its military. But now the fiscal constraints are becoming meaningful. And here's the key point: If you just look out 10 or 20 years, and make reasonable assumptions about growth and interest rates, the way the Congressional Budget Office does. You've got to assume that with every passing year, the US is spending a little bit more on interest payments relative to defense until by about 2040 or maybe a little later than that, the interest burden is 2X the defense budget. That's the trajectory that we are on right now.

Allison Nathan: So when and how would a crisis manifest? Here's Ken Rogoff's take.

Ken Rogoff: I would point to the old saying Rudy Dornbush said it very eloquently, but I think it goes back to Herbert Simon, which is, financial crises take longer to happen than you think they should and when they do, they unfold faster and harder than you think they could.

And I think we're looking at some sort of end game to this over the next few years.

Allison Nathan: And so when you say we're nearing an end, are you basically saying that you think we're on the verge of a crisis, a debt crisis. How would you define that?

Kenneth Rogoff: Well, there are different kinds of crisis, I think in advanced countries actually defaulting on debt is extremely unlikely. When it hits here, it can unfold in the form of inflation. It will happen in conjunction with a shock. I don't know where it'll come from, but there are certainly many kinds of shocks that would both hurt growth and raise inflation. And it's going to be more painful than the post-pandemic inflation because

although everyone complained and it caused a lot of political problems, there was relatively minor adjustment in bond markets in terms of inflation expectations. Certainly, the Michigan expectations adjusted a lot; business inflation expectations adjusted less than consumer, but if you look at the bond markets and look at inflation premium, they're pretty small. When it happens again, there will be a much bigger adjustment. I mean, I think the bond markets underrate the possibility of inflation at this point.

Financial repression is another mechanism for containing the interest rate rise by basically forcing people to hold more debt, which creates a larger part of demand. Japan has done that big time, Europe has done it a lot. You know, I don't know what form it will take. It depends on the shock. It will depend on how the government reacts. But, regardless, I don't think the current fiscal dynamics are sustainable.

Allison Nathan: Niall Ferguson is focused on the geopolitical ramifications.

Niall Ferguson: Any power that pursues a fiscal policy that allows the cost of its debt to become double the cost of its armed services is clearly open to challenge, and it's time we face that and stop telling ourselves stories about the US being number one and always being number one. I have looked at this as an historian, taking the story back really to the very origins of public debt itself. The Romans didn't have public debt. Public debt came around in the modern form, in the Italian Renaissance, and was first really a crucial part of a global power when 16th and 17th century Spain was running quite a complex system of long-term and short-term debt. And it crosses the Ferguson's law line; starts to spend more on interest payments than on defense in the 17th century, and pretty quickly Spain finds itself facing multiple

challenges to its empire, including from the Dutch Republic. The story repeats itself with the Dutch Republic in the 18th century. It also repeats itself with France, ancient regime France in the 18th century which finds the cost of its debt is substantially more than it can spend on its navy, and therefore it suffers defeats at the hands of Britain. I could go on; it's the Ottoman Empire in the 19th century, it's the Austria-Hungarian Empire. Finally, in the late 20th century comes around and Britain succumbs to Ferguson's law and the United States is just the latest great power or empire to find itself in this fiscal jam.

It can get out of it. There's no inexorable force that obliges us to keep increasing the debt and reducing the resources available for national security. We can fix this, but it calls for leadership, and it calls for sacrifice. There are going to have to be some things that we cannot do if we are to maintain our capacity to deter our enemies, and deterrence is really crucial here. The lesson of the 20th century is that deterrence is much, much more economically preferable to actually fighting a major war. If Britain had been able to deter Germany in 1914, and again in 1939, then Britain would not have ended up exhausted and declining in the later part of the 20th century. In the same way, if the US fails to deter China, then it has a choice between a very big war or folding. That's not a great choice for the President of the United States to face.

Allison Nathan: But the dollar's dominant global role has long underpinned arguments that the US is less vulnerable to debt crises. So, I asked both Rogoff and Ferguson if that provides any comfort today. Here's Ken's view.

Ken Rogoff: It gives us extra cushion, but we've used a lot of the cushion. Let's say foreigners hold maybe 25 to

30% of our debt. So, okay, so we can have 25 to 30% of GDP more debt, maybe even 50% more debt, but not a 100% more, not something that goes on forever.

And dollar dominance is going to be diminished. We lost a huge amount of market share in the global currency world during the 1970s, don't think it can't happen. Since 2015, but really over the last few years, China has been moving pretty aggressively to move away from the dollar. I mean, it's really happened a lot the last few years. Asia is half the dollar bloc, and so it's part of our market. I see us as heading at least in a decade or two towards a world which is more tripolar with the dollar on top but not colonizing as much of the world. The dollar never took back Europe; we had Europe after World War Two. We never took it back after the fall of the Bretton Woods system; Europe went its own way. But while that was going on, India globalized, Latin America globalized, Africa sort of globalized, and the dollar was dominant in all those places. That's the market, and that market is going to shrink. The euro is going to take some of it, but much more of the renminbi because I mean African and Latin American countries don't trust the United States any more than they trust China. So, I think we'll see moves in that direction, and it's not just about reserve holdings, it's not just about the denomination of trade, it's also about the global financial flows. So, I don't see the dollar as being suddenly replaced by the renminbi. In fact, I don't know what world yet that's going to happen, but we are diminished. And it's not just the renminbi and the euro, it's also crypto. They're all causing the dollar to fray at the edges.

And in addition to these external factors, there are these internal factors, and I think the debt problem, which I think will ultimately end up in another burst of inflation,

also will serve to undermine the dollar lower confidence. That's what happened in the 70s. I also think Federal Reserve independence, which many people take as sacrosanct, is not. It's not in the Constitution. It could disappear in a week if Congress were supportive of it. We use sanctions a lot. That's absolutely incentivizing the Chinese. It's incentivizing the Europeans to break free.

Allison Nathan: Niall Ferguson generally agrees.

Niall Ferguson: I think we shouldn't tell ourselves just so stories about the reserve currency status. The idea of exorbitant privilege, that was a French term used to characterize the dollar status in the 1960s, is a bit misleading because if there really was a tremendous privilege to being the issuer of the reserve currency, wouldn't US borrowing costs be like really low? I mean, wouldn't the US have some kind of premium relative to less powerful countries that didn't have that privilege? But, when you look at it, actually US borrowing costs are above those of the European Union countries. And that's a little strange. So I think if one is really looking at this the right way. Then the privilege of issuing the reserve currency has been somewhat eroded over time because, frankly, the United States has exploited it to excess.

We can't be complacent about dollar dominance when the only thing that's really stopping the Chinese currency being a proper challenger to the dollar is that the Chinese have capital controls, and as long as that's the case, people will prefer dollars to RMB on the whole. But the world today has other contenders besides the dollar. The euro, which some American economists thought would fail, didn't fail and a lot of transactions and a lot of instruments are now in euros. So, I think this story about the exorbitant privilege of the dollar has somewhat been overdone and on close inspection it's not as compelling as it might have been 50 years ago.

Allison Nathan: So then, what will it take to avoid a fiscal crisis? Rogoff believes voters hold the key.

Ken Rogoff: What we need to have is voters think that it's acceptable to bring down deficits. That's what we need. Right now, neither party can stay in power by trying to bring down deficits.

Allison Nathan: And Ferguson sees a few ways out of the US fiscal problem.

Niall Ferguson: There are potential ways out of these problems. If it's true that artificial intelligence is going to create a productivity boom by allowing all of us to do what we do much better, and perhaps with fewer people, then The United States, which is certainly one of the leaders in AI, might get the kind of productivity benefit that Britain got from the Industrial Revolution.

Another interesting argument is that the cost of defense may go down. The really super expensive hardware of the late 20th century, these precision missiles and the first generation of drones, that's all giving way to much cheaper stuff. Drone swarms are just cheap compared with aircraft carriers. And so, one other solution to the problem is that we may be on the brink of a new revolution in military affairs that brings the cost of national security down. So, I don't think it's necessarily the case that things can only get worse. And indeed, one of the lessons of history is you've got to be ready for discontinuities. That the trend is often a delusion.

What we love Drawing straight lines into the future, it's what economists excel at. We drew all kinds of lines prior to 2020 that got a huge kink in them when a huge pandemic swept the world. So, I think we should always remember how non-linear and surprising history is. And if any country is positioned to take advantage of artificial

intelligence and translate AI into greater efficiency, it ought to be the United States. I have been saying for years that the inefficiencies and excessive costs of the federal government mainly reflect the failure to implement technological solutions to problems like healthcare or collecting taxes.

At some point you might have thought we'd be incentivized to fix that. So, I think there are ways out of this. The Obstacles are not technological. The obstacles are political.

It's a political economy problem that the two-party system produces budgets that never balance. That is bizarre when you consider the United States has been so successfully economically in the last 20 years, it has clearly exceeded expectations in terms of growth. It's left the Europeans in the dust and the Chinese can't catch up.

Why then are we running these deficits? That's the question future historians will ask.

Allison Nathan: So Rogoff and Ferguson are worried about US fiscal sustainability and think the US may be headed for a crisis ahead. And my main takeaway, a crisis is not inevitable, but finding the political will to address the US fiscal problem may be difficult. So, even if some people have long been warning about a crisis that has yet to come, this time really may be different.

Let's leave it there. My thanks to Niall Ferguson and Ken Rogoff. And thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan.

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