

History will rue US and Europe debt woes

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Will 23rd-century historians look back on today's fiscal follies with the same mixture of bemusement and disdain with which we now view the financial affairs of 18th-century French kings? Policymakers throughout the world are trying to find ways to stabilise government debts, now approaching record postwar levels. As US legislators fumble towards a budget deal, there is the laudable bipartisan [Bowles-Simpson](#) commission report. But too many remain sceptical of the need for prompt action at all.

Throughout industrialised nations, debate continues over how fast to withdraw post-financial crisis stimulus. Too many want to follow the lead of the US, which has consistently increased its dependency on debt finance. Too few follow the UK, whose government aims to stabilise debt-to-income levels over several years, while also scaling back a crisis-accelerated explosion of government spending.

Normalising fiscal policy in the long aftermath of a deep financial crisis is a delicate task. The key is to see the bigger picture. Even if today's government bonds seem pristine by the standards of pre-revolutionary France, future scholars will see our tax systems as Byzantine labyrinths funnelling money to powerful interests, creating staggering inefficiencies. They will surely be incredulous to see pensions and health insurance financed via Ponzi schemes as transparently unsustainable as the 1700s South Sea bubble. And will they believe that, back in the 21st century, there was no mechanism for putting insolvent financial institutions into bankruptcy?

According to my recent research with Carmen Reinhart, debt-to-income ratios are already at, or near, postwar highs across advanced economies. Many are close to the roughly 90 per cent debt-to-income threshold which, historically, begins to be associated with lower growth. And this does not account for the adverse demographic trends or hidden debts that inevitably jump on to the books when a crisis unfolds.

Unusually low interest rates currently keep the carrying costs of these debts modest, and make it seem as if the day of reckoning is far off. Sadly, debt can be worked off only slowly, while rates can rise suddenly. Such a rise, if sustained, would be extremely painful for the national budgets of many countries, including those [struggling in Europe](#). Research on sovereign default shows that markets also seldom anticipate problems in advance. By the time they lose confidence, it is too late: the option to tighten from a position of strength has evaporated.

Those who would be blasé about government debt must remember that the world is complex and unpredictable. Consider the tragedy that has befallen Japan, whose long-term debt trajectory was already dubious, even before the tsunami. True, spreads on eurozone periphery bonds are already high. But this is because it is clear that there will have to be some large and significant debt restructurings, even if eurozone officials prefer to insist default is unthinkable. And as yet, the markets have not even begun to think about what might, and could, happen elsewhere – even in the US.

Seen from the future, this lack of caution will look foolish. How could they think themselves advanced economies, the future student will ask, when their governments kept such opaque accounts, and gave only minimal co-operation to international agencies attempting to review them? Nonetheless, there are a range of reforms we could introduce today to ward off history's judgment.

Simplifying tax systems, stripping away tax expenditures (a device the French kings would have admired), and lowering marginal rates are vital. Entitlement growth must be contained. Long-term productivity can be enhanced by improving education. The potential gains from applying technology and private competition are also staggering, especially if public education is rightly construed to include libraries, the internet and public media.

At the core of contemporary financial crises, however, are financial systems that remain primitive relative to classroom constructs of perfect markets. The lesson from the financial crisis is that we must become less reliant on crude, non-indexed debt. More sophisticated instruments indexed to measures of economic performance (such as those proposed by Yale's Robert Shiller) are an idea, though these may also need strong independent fiscal councils to monitor government data claims.

Look on the bright side. If things are going so well in the 23rd century that future historians have the luxury of thinking us primitive, humanity must have done something right. But it would be even better to give them some reason to note our wisdom today. It is going to take many years of determined effort and huge reform to close the gaping window of vulnerability out of which the US and Europe now find themselves staring. And it would surely be better if the 21st century was looked back on as a halcyon period of financial stability future generations struggled to emulate.

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