The Sovereign Debt Crisis: A Greek Economic Crisis is Coming to America

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It began in Athens. It is spreading to Lisbon and Madrid. But it would be a grave mistake to assume that the sovereign debt crisis that is unfolding will remain confined to the weaker eurozone economies. For this is more than just a Mediterranean problem with a farmyard acronym. It is a fiscal crisis of the western world. Its ramifications are far more profound than most investors currently appreciate.

There is of course a distinctive feature to the eurozone crisis. Because of the way the European Monetary Union was designed, there is in fact no mechanism for a bail-out of the Greek government by the European Union, other member states or the European Central Bank (articles 123 and 125 of the Lisbon treaty). True, Article 122 may be invoked by the European Council to assist a member state that is "seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control", but at this point nobody wants to pretend that Greece's yawning deficit was an act of God. Nor is there a way for Greece to devalue its currency, as it would have done in the pre-EMU days of the drachma. There is not even a mechanism for Greece to leave the eurozone.

That leaves just three possibilities: one of the most excruciating fiscal squeezes in modern European history – reducing the deficit from 13 per cent to 3 per cent of gross domestic product within just three years; outright default on all or part of the Greek government's debt; or (most likely, as signalled by German officials on Wednesday) some kind of bail-out led by Berlin. Because none of these options is very appealing, and because any decision about Greece will have implications for Portugal, Spain and possibly others, it may take much horse-trading before one can be reached.

Yet the idiosyncrasies of the eurozone should not distract us from the general nature of the fiscal crisis that is now afflicting most western economies. Call it the fractal geometry of debt: the problem is essentially the same from Iceland to Ireland to Britain to the US. It just comes in widely differing sizes.

What we in the western world are about to learn is that there is no such thing as a Keynesian free lunch. Deficits did not "save" us half so much as monetary policy – zero interest rates plus quantitative easing – did. First, the impact of government spending (the hallowed "multiplier") has been much less than the proponents of stimulus hoped. Second, there is a good deal of "leakage" from open economies in a globalised world. Last, crucially, explosions of public debt incur bills that fall due much sooner than we expect

For the world's biggest economy, the US, the day of reckoning still seems reassuringly remote. The worse things get in the eurozone, the more the US dollar rallies as nervous investors park their cash in the "safe haven" of American government debt. This effect may persist for some months, just as the dollar and Treasuries rallied in the depths of the banking panic in late 2008.

Yet even a casual look at the fiscal position of the federal government (not to mention the states) makes a nonsense of the phrase "safe haven". US government debt is a safe haven the way Pearl Harbor was a safe haven in 1941.

Even according to the White House's new budget projections, the gross federal debt in public hands will exceed 100 per cent of GDP in just two years' time. This year, like last year, the federal deficit will be around 10 per cent of GDP. The long-run projections of the Congressional Budget Office suggest that the US will never again run a balanced budget. That's right, never.

The International Monetary Fund recently published estimates of the fiscal adjustments developed economies would need to make to restore fiscal stability over the decade ahead. Worst were Japan and the UK (a fiscal tightening of 13 per cent of GDP). Then came Ireland, Spain and Greece (9 per cent). And in sixth place? Step forward America, which would need to tighten fiscal policy by 8.8 per cent of GDP to satisfy the IMF.

Explosions of public debt hurt economies in the following way, as numerous empirical studies have shown. By raising fears of default and/or currency depreciation ahead of actual inflation, they push up real interest rates. Higher real rates, in turn, act as drag on growth, especially when the private sector is also heavily indebted – as is the case in most western economies, not least the US.

Although the US household savings rate has risen since the Great Recession began, it has not risen enough to absorb a trillion dollars of net Treasury issuance a year. Only two things have thus far stood between the US and higher bond yields: purchases of Treasuries (and mortgage-backed securities, which many sellers essentially swapped for Treasuries) by the Federal Reserve and reserve accumulation by the Chinese monetary authorities.

But now the Fed is phasing out such purchases and is expected to wind up quantitative easing. Meanwhile, the Chinese have sharply reduced their purchases of Treasuries from around 47 per cent of new issuance in 2006 to 20 per cent in 2008 to an estimated 5 per cent last year. Small wonder Morgan Stanley assumes that 10-year yields will rise from around 3.5 per cent to 5.5 per cent this year. On a gross federal debt fast approaching $1,500bn, that implies up to $300bn of extra interest payments – and you get up there pretty quickly with the average maturity of the debt now below 50 months.

The Obama administration's new budget blithely assumes real GDP growth of 3.6 per cent over the next five years, with inflation averaging 1.4 per cent. But with rising real rates, growth might well be lower. Under those circumstances, interest payments could soar as a share of federal revenue – from a tenth to a fifth to a quarter.

Last week Moody's Investors Service warned that the triple A credit rating of the US should not be taken for granted. That warning recalls Larry Summers' killer question (posed before he returned to government): "How long can the world's biggest borrower remain the world's biggest power?"

On reflection, it is appropriate that the fiscal crisis of the west has begun in Greece, the birthplace of western civilization. Soon it will cross the channel to Britain. But the key question is when that crisis will reach the last bastion of western power, on the other side of the Atlantic.

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