Econ Journal Watch & Mercatus Center at George Mason University Symposium on:

U.S. Sovereign Debt Crisis: Tipping-Point Scenarios and Crash Dynamics

Summary of Articles

	"Some Possible Consequences of a U.S. Government Default" **By Jeffrey Rogers Hummel**	**"The Bond Market Wins"** **By Garett Jones**	**"How a Default Might Play Out"** **By Arnold Kling**	**"Courting an Avoidable Financial Crisis"** **By Joseph J. Minarik**	**"How and Why a U.S. Sovereign Debt Crisis Could Occur"** **By Peter J. Wallison**
Likelihood of Default	• A crisis is bound to occur, and a Treasury default is most likely.	• A default is unlikely. Chronic fiscal contrition is much more likely.	• A negotiated default is more likely than a unilateral default.	• Congressional deadlock will make default more likely, especially if it causes interest rates to rise.	• Default is unlikely, but a political/financial crisis is likely if Congress fails to address growing entitlement programs.
Key Points	• A crisis is certainly bound to occur because promised future outlays vastly exceed projected future revenue. Without a crisis, a political fix is unimaginable. • Unless it seriously affects the currency,	• Currently, low interest rates in the long-term U.S. bond market signal investors are confident that the government will repay its debt. • If it became obvious the government wanted to inflate away the debt,	• Current debt is a relatively small part of the problem; the accumulation of debt in the future is highly problematic. Inflating away the debt is not an option. • Real reform must be made to Social Security and	• The structure of politics has dulled policy makers' awareness of our dangerous U.S. fiscal situation, resulting in political inaction. • To help stave off drastic economic turmoil, both political parties	• Political inaction will cause creditors to lose confidence in the ability of the U.S. to meet its debt obligations without inflating its currency. • Without political consensus on how to address entitlements, their costs will drive the

	inflation cannot remedy the fiscal shortfall. • Today's situation is not novel. Numerous state governments defaulted on their debts in the early 1840s. States made major fiscal reforms that resulted in lasting constitutional changes and a period of sustained economic growth.	the cost of refinancing a government loan (which lasts 5 years on average) would cripple its ability to do so. • Continually negotiated tax increases and spending cuts have the ability to stave off a future financial crisis.	Medicare. Once spending outpaces tax revenues in these programs, the United States will have to begin borrowing. Once interest rates on borrowing become too high, the United States will have to stop meeting its obligations.	must work together to form a viable compromise. • The business community could help stave off default, but distrust of big business is likely to harm the chance of reform. If big businesses begin to fail, small businesses will too.	national debt to 82% of GDP by 2021. • Democrats and Republicans are split on tax increases and entitlement cuts. This stalemate will continue until some crisis occurs.
Possible Tipping Points or Triggers	• When the Hospital Insurance and Social Security trust funds are exhausted, they will have to be financed by general revenue, and investors could demand a risk premium on Treasury securities. • Total federal expenditures are estimated to be 75% of GDP	• To avoid default, politicians will prefer to raise taxes instead of cutting entitlements, but the lack of political will to raise taxes will weaken investor confidence in the U.S.'s ability to service its debts.	• Once creditors see default as realistic, they will demand higher risk premiums for their investments. This will trigger a rapid downward economic spiral as high interest rates will make it difficult for borrowers to meet obligations.	• OPEC choosing to abandon the dollar or further U.S. credit rating downgrades could seriously shake investor confidence. • Higher interest rates would cause investors to demand higher risk premiums. Economic activity would slow, and fear of default would	• At some unpredictable point, the bond markets will no longer believe that the U.S. government will be able to meet both its entitlement obligations and its contracted debts, unless it inflates its currency.

	by 2083, with 40% of GDP going to interest payments.			cause the cycle to repeat.	
Possible Outcomes	• U.S. government debt repudiation would cause $4 trillion in direct, private sector losses—the largest in mutual funds, state and local governments and their retirement funds, and private pensions. • Investors would likely begin to dump Treasuries, and the preferred assets will influence the dynamics of the impending crisis. • Default would reduce future taxes. In a full repudiation, the debtor gains what the creditor loses.	• As bondholders get paid from the gap between government revenues and spending, a battle against tax increases may herald a crash. • Republicans losing power from time to time, thereby allowing the Democrats to raise taxes is the best outcome for bondholders. • Demand for government can increase after tax cuts.	• In a negotiated default, an outside agency would enforce austerity measures, and lenders and borrowers would agree to write down or reschedule debt. • Debt restructuring may result if the U.S. negotiating position is stronger than its creditors. • The U.S. would have to give up some sovereignty and abide by the IMF to continue borrowing in international credit markets.	• Higher interest rates would crush small businesses, thereby disrupting the supply chains of larger businesses and thrusting the nation into double-digit unemployment as businesses fail. • Servicing the debt will cause private and public investment in infrastructure and human capital to drop significantly. • Uncertainty about the future will cause private investment to dry up further.	• This will be a crisis but not a sovereign debt crisis. Inflation political/financial will trigger higher interest costs, higher commodity prices, a lower standard of living, and a serious recession. • The U.S. must decide between meeting its debt obligations with a stable dollar and fulfilling political promises implied by the entitlement system.