US lurching towards 'debt explosion' with long-term interest rates on course to double

By Philip Aldrick
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In a 2003 paper, Thomas Laubach, the US Federal Reserve's senior economist, calculated the impact on long-term interest rates of rising fiscal deficits and soaring national debt. Applying his assumptions to the recent spike in the US fiscal deficit and national debt, long-term interests rates will double from their current 3.5pc.

The impact would be devastating by making it punitively expensive to finance national borrowings and leading to what Tim Congdon, founder of Lombard Street Research, called a "debt explosion". Mr Laubach's study has implications for the UK, too, as public debt is soaring. A US crisis would have implications for the rest of the world, in any case.

Using historical examples for his paper, New Evidence on the Interest Rate Effects of Budget Deficits and Debt, Mr Laubach came to the conclusion that "a percentage point increase in the projected deficit-to-GDP ratio raises the 10-year bond rate expected to prevail five years into the future by 20 to 40 basis points, a typical estimate is about 25 basis points".

The US deficit has blown out from 3pc to 13.5pc in the past year but long-term rates are largely unchanged. Assuming Mr Laubach's "typical estimate", long-term rates have to climb 2.5 percentage points.

He added: "Similarly, a percentage point increase in the projected debt-to-GDP ratio raises future interest rates by about 4 to 5 basis points." Economists are predicting a wide range of ratios but Mr Congdon said it was "not unreasonable" to assume debt doubling to 140pc. At that level, Mr Laubach's calculations would see long-term rates rise by 3.5 percentage points.

The study is damning because Mr Laubach was the Fed's economist at the time, going on to become its senior economist between 2005 and 2008, when he stepped down. As a result, the doubling in rates is the US central bank's own prediction.

Mr Congdon said the study illustrated the "horrifying" consequences for leading western economies of bailing out their banks and attempting to stimulate markets by cutting taxes and boosting public spending. He said the markets had failed to digest fully the scale of fiscal largesse and said "current gilt yields [public debt] are extraordinary low given the size of deficits".

Should the cost of raising or refinancing public debt in the markets double, "the debt could just explode", he said, adding that it would come to a head in "five to 10 years".

Articles by: **Philip Aldrick**