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America can carry this deficit

Panic among policymakers about the high level of government debt is misplaced. The real economic menace is budget-slashing

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US treasury secretary Timothy Geithner talks to Federal Reserve chairman Ben Bernanke prior to their testimony before the House financial services committee. Photograph: Matthew Cavanaugh/EPA

The federal fiscal policy debate is being overwhelmed by a growing sense that America must slash its deficit now, before it is too late. Actually, the United States is in no danger of a treasury debt crisis and can carry far more debt than people believe without dire consequences.

Unfortunately, many who argue for rapid deficit reduction base their case on a slew of misunderstandings and fallacious generalisations about the consequences of high public debt. In reality, nations vary sharply in their capacity to carry public debt.

There is a broad feeling that public debt near 100% of a nation's GDP or greater is out of control, and for many countries – Greece being the poster boy – this is the case. But this is not true of the United States – or Japan or the United Kingdom. Still, with US treasury debt held by the public equal to 60% of GDP and rising rapidly, the United States is now frequently grouped with countries in which high public debt ratios have caused or are causing major problems.

These other countries did not get into trouble because of high public debt ratios alone. They had some combination of the following conditions that limited their debt-carrying capacity: first, a lack of government control of the money supply of the currency in which most of its debt is denominated; second, debt owed in or convertible into gold; third, the lack of a long history of political stability and an effective means of tax collection; fourth, the lack of a large, liquid market for government debt; and fifth, debt owed personally by a king or other supreme ruler. Not one of these conditions applies to the United States.

Public debt ratios of countries with high debt capacity have risen well above 100%. The United States, the United Kingdom and Japan have all had debt-to-GDP ratios over 100%, and in Britain's case, over 250%, without calamitous consequences. The record shows that in strong, advanced countries like these, a high public debt ratio does not necessarily lead to rising inflation or slower economic growth.

In both the US and the UK (the two high-debt-capacity countries with the longest history of public debt), there is no visible relationship between the public debt ratio and inflation. For example, the peak US public debt ratio of 109% in 1946 was followed by a decade of low inflation.

Similarly, both American and British histories fail to show that high public debt is a drag on growth; in fact, peaks in the public debt ratio have been precursors to *unusually strong* economic growth. This is not to suggest that the high public debt ratio itself causes strong growth; rather, circumstances that cause high debt – major wars and depressions (the United States is in a "contained depression" now) – can shrink private balance sheets and create forces for new eras of strong private investment and growth.

Sadly, discussions about the implications of rising public debt are riddled with many other myths and misplaced fears as well: that there will be insufficient "savings" to absorb the continued massive issuance of public debt securities; that the central bank will always be able to generate inflation to lower the real debt service burden; that the public debt ratio can only be lowered by onerous future tax hikes; and so on.

Understanding these issues will be crucial for successful policymaking and private-sector decision-making in the years ahead. A continuing, steep rise in the US public debt ratio is virtually unavoidable under *any* policies until overcapacity, excessive debt, and broadly deflating asset values no longer cripple the private sector – although there are certainly better and worse ways to run deficits until then.

For now, slashing the deficit would be hurtful to the economy and self-defeating. Such well-meaning but wrong-headed action would cause renewed recession and plunging tax revenues. Until the private economy completes the multiyear balance sheet adjustments underlying the current depression, federal debt will continue to swell.

The good news is that, despite what the alarmists contend, the country *can* handle it.