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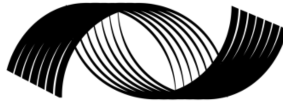

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Is Trillion the New Billion?

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Executive Summary

Not so long ago, $1 billion seemed worth worrying about – as Everett Dirksen, the late senator from Illinois, was supposed to have said, “A billion here, a billion there, and pretty soon you're talking real money.” Today, another trillion-dollar commitment by the Federal Reserve makes headlines for only a day or two, and a projected federal budget deficit exceeding $1 trillion is widely viewed with equanimity. Are we courting disaster in this indifference to inconceivably large sums? Or have the extraordinary challenges faced by the economy today fundamentally altered the arithmetic of government finance? The answer is yes – and yes.

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Is Trillion the New Billion?

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The answer is yes – and yes.

Massive intervention by the Fed and the Treasury aimed at short-circuiting financial panic has left Washington on the hook for as much as $7.5 trillion (and counting). But the final bill will almost certainly be a small fraction of that figure. By the same token, record-breaking budget deficits aren’t evidence of recklessness because they represent claims against economic resources that would otherwise go to waste during the recession. Indeed, if twelve-figure deficits spare us millions of layoffs and increase productivity in the bargain, the benefits will surely exceed the enduring costs of adding trillions to the government debt.

Once the economy recovers, though, two plus two will again make four: every extra dollar in deficits will once again become a dollar less that’s available to invest. And the new-found enthusiasm for waving the fiscal wand in times of trouble could make it that much harder to tackle out-of-control federal budgets down the road.

Smaller Than Meets the Eye

Start with the good news. It’s true that the Fed and Treasury have been throwing money at Wall Street with the goal of preventing financial markets from seizing up. And it’s also true that initiatives ranging from the huge loan to AIG to the takeover of Fannie Mae and Freddie Mac have generated potential government liabilities exceeding the current, publicly held federal debt. But (happily) the numbers vastly exaggerate the true risk to taxpayers.

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They include, for example, the $1.5 trillion the FDIC could lose in the impossible event that every bank in the country went belly up and left no assets to cover insured deposits. Or consider the Fed's Commercial Paper Lending Facility, which stands ready to loan up to $1.8 trillion to businesses that would otherwise borrow in private markets to cover their short-term liquidity needs. To be eligible, the commercial paper must receive high credit ratings, and much of it would therefore be fully collateralized. It would take a downturn of Great Depression magnitude to put more than a small fraction of the $1.8 trillion at risk.

Getting a handle on the actual magnitude of the losses that Washington will, in the end, have to absorb is not easy. The market value of all housing in the United States is expected to fall by about $2 trillion in 2008 – on top of a $1.2 trillion loss in 2007. Those numbers far exceed the likely losses in mortgages, however: Standard & Poor's estimates that $180 billion will eventually be lost on subprime mortgages originated through the middle of 2007.

Factoring in likely losses on other debt during the recession, the economy-wide write-offs could be many times larger. But the government's portion will be a modest part of the total. To put the issue in perspective, FDIC Chair Sheila Bair's mortgage subsidy proposal, designed to keep 1.5 million families in their homes, has an estimated price tag of "just" $24 billion.

The Almost-Free Lunch

The other shoe about to fall is the Obama administration's economic stimulus, which is now expected to add as much as – you guessed it – another $1 trillion to the deficit over two years. Here, too, though, the real impact will be less than meets the eye. Most economists agree that budget deficits matter much less (or not at all) during recessions because the spending they create doesn't displace other claims on production. Indeed, deficit spending can ripple through the economy, increasing output by considerably more than the government outlay.

Deficit spending does, of course, add to the federal debt, creating a future liability for the taxpayers in the form of added interest payments. But on the other side of the ledger is all the output that would have been lost forever during the recession if the government hadn't borrowed more and, one hopes, invested the proceeds in ways that increased productivity. Imagine how much better off Americans would have been in 1939 – and how much larger the economy would

have been – if (as many people mistakenly assume) the pump had been primed during the Depression.

All that said, there still may be a substantial price to pay for the apathy toward the scale of initiatives aimed at righting the economy. For one thing, there's ample evidence that Washington can't easily dial back budget deficits. Congress didn't cut spending in the last seven years to offset revenue losses from tax cuts. Far from it: the very fact that the resulting deficits didn't seem to have economic consequences has made it harder for politicians to ask anyone to make sacrifices in the name of fiscal rectitude.

This reluctance to make hard choices will mean that subsidies for a host of initiatives ranging from alternative fuels to mortgage guarantees will probably be around long after they have outlived their usefulness. It may also be reflected in the unwillingness of state and local governments to adjust to a world in which emergency aid is no longer forthcoming from Washington.

Long-Run Versus Short-Run

But the most enduring impact of inoculation against deficit anxiety may well be Washington's failure to face up to the long-brewing crisis over the funding of government medical insurance and pensions. It's no secret that Social Security and Medicare will eventually overwhelm the budget. Just last week the U.S. Treasury estimated that these two programs were $43 trillion in the hole – that is, it would take a one-time injection of $43 trillion today to make up the difference between expected future costs and revenues. And the longer the delay in raising revenue or paring program costs, the greater the sacrifice that will be needed.

When it comes to fiscal math, a trillion may, indeed, be the new billion. That's OK for now. Actually, it's better than OK: failure to open the fiscal and monetary spigots to quench the financial panic and stimulate spending could set back growth for a generation. The real concern is that, once Americans learn to stop worrying and embrace trillion-dollar financial initiatives, it will be very, very hard to put the genie back in the bottle.