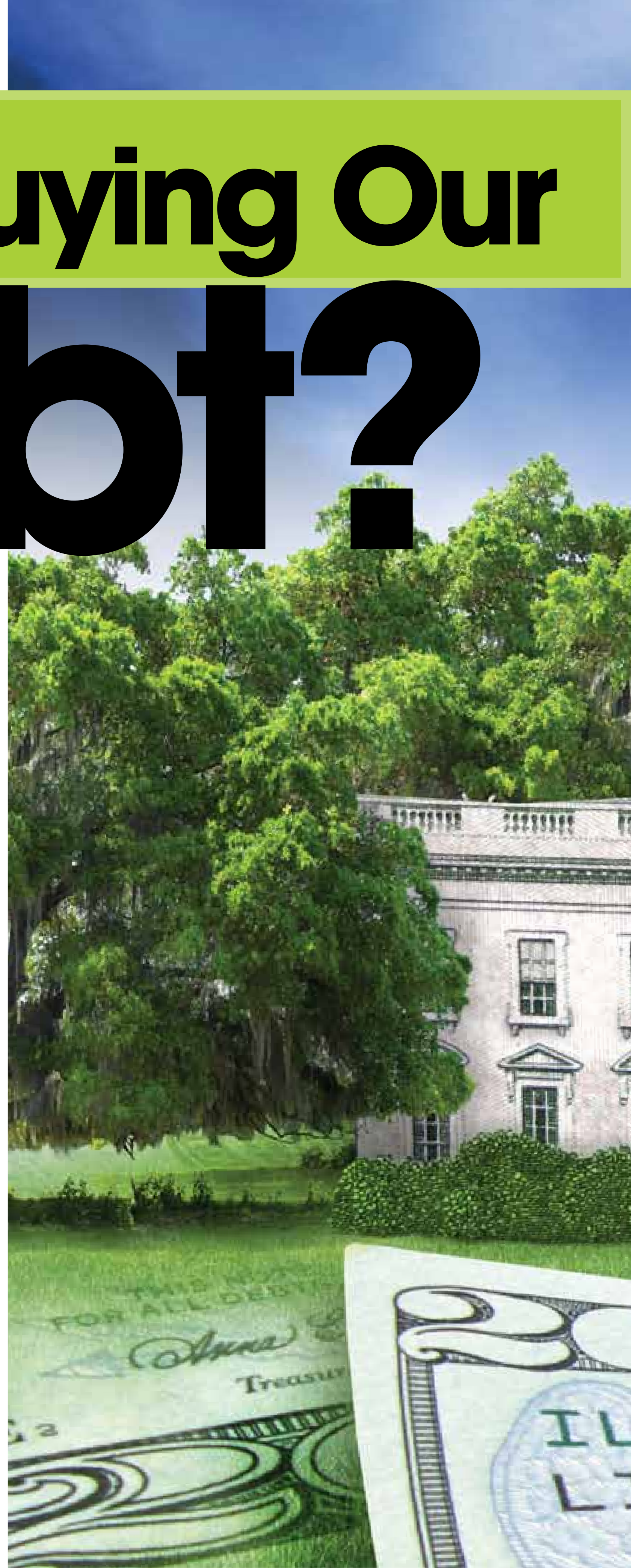
Who's Buying Our Debt?

By Troy Anderson



As the national debt recently surpassed $13 trillion – about 92 percent of gross domestic product – U.S. Representative Jeb Hensarling (R-Texas) says the "debt super-cycle" needle is now in the "red zone."

Hensarling, a member of the National Commission on Fiscal Responsibility and the second-ranking Republican on the House Budget Committee, recently heard testimony that when a nation's gross debt reaches 90 percent of GDP, that economic growth is expected to begin to slow about one percent per year.

In practical terms, Hensarling says this means that millions of jobs will not be created and that Americans will forgo billions of dollars in income, creating a vicious cycle of lower government revenues and more borrowing at ever-increasing costs – a phenomenon some have described as a "debt super-cycle."

"We are looking at the largest national debt in our nation's history," Hensarling told Congress recently. "As a percentage of our economy, it rivals that of World War II. And it's only due to get worse. Today, we're borrowing 41 cents on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the dollar, mainly from the Chinese, to send a bill to our children and grandchildren."

At a time when the economy is picking up steam, Hensarling and other elected officials and financial experts are expressing growing concerns about the nation's ballooning debts and the large amount of money that the federal government is borrowing from China, Japan, England, and other nations.

The U.S. National Debt Clock – a Web-based site at www.usdebtclock.org that tracks the nation's financial condition – estimates the gross national debt to now total more than $13 trillion – or about $120,000 per taxpayer. The annual federal budget deficit is $1.4 trillion, up from $455 billion in late 2007 when the global recession began.

"To put that in perspective, our income this year is about $2 trillion from taxes," says Robert Wiedemer, president of the Washington, D.C.-based Foresight Group and author of the 2006 book *Aftershock: Protect Yourself and Profit in the Next Global Financial Meltdown*. "That's all taxes – Social Security, personal and corporate taxes. So we're borrowing almost our entire income every year and spending it. The deficit is the annual amount we're borrowing and adding to our credit card debt – the $13 trillion."

Historically, the government incurs debt when it borrows from the public – Federal Reserve Banks, foreign governments, and corporations – to finance budget deficits. Most of this debt is held by these entities in the form of U.S. Treasury securities. In addition to this debt, the government also has outstanding intragovernmental debt involving Social Security and Medicare. The sum of these debts equals the gross national debt, which is subject to a statutory ceiling. Since 2009, Congress has raised the ceiling on this debt from $10.6 trillion to $14.3 trillion as the nation has borrowed money to stimulate the economy and prevent an economic depression.

The Budget Office Report

In a recent report by the Congressional Budget Office, the authors wrote that the federal budget is now on an "unsustainable path, with debt moving to unprecedented and crippling high levels."

Under the most "highly optimistic" scenario, the CBO estimates public debt – which doesn't include intragovernmental debt – will rise from 62 percent of GDP this year to 84 percent in 2040, and to 107 percent by 2080. This scenario assumes that former President Bush's tax cuts will expire this year as scheduled, that all savings in the health care bill will be sustained over the two decades, and that tax revenues will eventually exceed 30 percent of GDP. Under a more realistic scenario, which does not make these assumptions, the CBO expects public debt to rise to 87 percent by 2020, 233 percent by 2040, and 854 percent by 2080. To address this problem, the CBO is recommending gradual tax increases and spending cuts.

Without these changes, Maya MacGuineas, director of the Fiscal Policy Program at the New America Foundation in Washington, D.C., says future generations will pay the price through a weaker economy, a lower standard of living, less growth potential, and a loss of leadership in the world.

"Both spending and revenues are climbing well beyond historical levels," MacGuineas testified during a recent hearing before the National Commission on Fiscal Responsibility and Reform. "However, spending is growing much faster. The expanding differential will cause a dangerous debt spiral, leaving interest payments highly vulnerable to rate increases and squeezing out other important areas of the budget."

Getting control of the federal budget, MacGuineas testified, is critical for reassuring credit markets that the U.S. will continue to be a safe place in which to invest. Sovereign debt jitters can easily spread across the Atlantic and hit American markets at any point if the nation doesn't put in place a credible plan to reduce the nation's debts to more reasonable levels, MacGuineas testified.

The Peterson-Pew Report

In the report by The Peterson-Pew Commission on Budget Reform entitled "Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt," the authors warned that the U.S. has never experienced debt burdens as high as the current projections. The authors observed that other nations with these types of huge debt burdens have suffered chronic fiscal and political crises.

"With shares of debt held by foreign owners rising to nearly half, a loss of confidence by international creditors could precipitate a financial crisis," the Peterson-Pew report states. "As we have seen with many other nations, growing dependence on international financing can make the nation vulnerable to shocks and a vicious spiral of currency declines and spikes in interest rates. Whether the debt build-up leads to an abrupt, external shock, or a gradual erosion in our economic performance, the growing debt will jeopardize the American living standard and U.S. economic leadership."

In its most recent report, U.S. Treasury officials calculated that foreign holdings of U.S. securities totaled $9.6 trillion. The 10 largest holders included China, $1.5 trillion; Japan, $1.3 trillion; the United Kingdom, $788 billion, Cayman Islands,

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$650 billion; Luxembourg, $578 billion; Belgium, $415 billion; Middle East Oil Exporters, $353 billion; Ireland, $348 billion; Canada, $337 billion; and Switzerland, $328 billion.

"Our concern is that we are relying on the savings of groups outside our country that may have different interests than the U.S.," says Anne Vorce, project director for the Fiscal Roadmap Project of the Committee for a Responsible Federal Budget and the policy director for the Fiscal Policy Program of the New America Foundation.

In estimating how likely an economic shock triggered by the growing debt could be, the Peterson-Pew report explains, no one knows for sure. It says U.S. securities are still attractive for several reasons, including America's political stability and its long history of economic growth.

"However, the United States is now more reliant on overseas investors and central banks than in the past," the authors wrote. "As the federal debt grows over the next 10 years, especially without a concrete plan to reduce it, foreign creditors may shift their investments to other nations."

Attracting Foreign Investors

This kind of shift could reduce the value of the dollar and force the U.S. Treasury to offer higher interest rates to attract borrowers. As an ever-growing proportion of debt is held outside U.S. borders, some experts fear that if international markets lose confidence in the United States' ability to manage its debt, they may decide to stop lending it money at current levels. This could cause the American economy to falter, with U.S. securities losing their value as investors flee to alternatives.

"We could find ourselves in a circumstance not unlike that of Greece or Argentina, where investors lose confidence in the ability of the U.S. government to make it debts payments," says Marvin Phaup, project director of the Federal Budget Reform Initiative at the Pew Charitable Trusts.

Despite these dire warnings, Dana Johnson, the chief economist at Comerica Bank in Dallas, says he's confident that the federal government will get a handle on its debts as the economic recovery continues and tax revenues increase.

"I think as the economy recovers we are going to see a strong demand for credit from both the business and household sectors," Johnson says. "I think we are going to have a sustained recovery in 2011 and beyond. As that recovery is sustained and people grow more confident that we are not headed for a double-dip recession, you will see businesses increasing hiring and increasing inventories."

Johnson also expects to see more families borrowing money to buy vehicles, homes, and durable goods. As incomes increase in the private sector, government tax revenues will grow too.

"In all likelihood, we'll see elected officials take steps to reduce the budget deficits at the federal, state, and local levels as stronger tax revenues emerge," Johnson says.

The Texas Edge on Recovery

During this time, Johnson says the Texas economy will continue to recover at a moderately faster rate than the rest of the nation.

"I think Texas continues to have a very vibrant business community and it seems to be attracting a lot of businesses and households that are continuing to move here," Johnson says. "Texas is experiencing stronger growth in its economy as a result of that. The energy sector is doing well in Texas. Texas also has a somewhat larger manufacturing sector than most states, and so far the recovery has been the strongest in manufacturing. I think Texas will outperform the nation over the next year."

Patrick Duffy, president of Colliers International in Houston, says he, too, has a great deal of faith in the U.S. and believes the economic recovery in Texas will outperform the rest of the states.

But unless the federal government changes direction in its strategy of trying to "tax and spend our way out of this problem," Duffy says the nation will experience a prolonged and very challenging economic environment in which the private sector will have great difficulty expanding and creating jobs.

While he's concerned about the amount of money the federal government is borrowing from China, Japan, England, and other nations, Duffy says U.S. banks and pension funds are also significant holders of U.S. debt. Many of these banks, Duffy says, are borrowing from the Federal Reserve at 0.25 percent interest and investing that money in U.S. treasuries and earning 2.5 to 3 percent interest.

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The Peterson-Pew Commission has recommended that federal officials begin to phase in spending cuts and tax increases in 2012, and stabilize the debt at 60 percent of GDP by 2018.

"If I can borrow $10 billion from the Fed at 0.25 percent and buy $10 billion in treasuries at 3 percent, I'm making a 2.75 percent profit on money I borrow from one branch of the federal government and lend back to another branch," Duffy says. "It's crazy. They are just printing money, which is a huge problem because it sets us up for an inflation run."

As the federal government continues to borrow trillions of dollars, Duffy says at some point investors will question how safe the securities are, and the Federal Reserve will increase interest rates to keep attracting those investors. Meanwhile, all this money tied up in U.S. securities won't be going into the private sector. That money might otherwise have been invested in corporate and municipal bonds.

"Everybody is competing for the same dollars, so the investment dollars that are being sucked into the U.S. Treasury to cover the deficit spending aren't going to be available to either the private sector or local and state governments," Duffy says. "As we compete for those funds, interest rates will have to go up to attract funds to something other than treasuries. That is a huge problem because it's sucking the liquidity out of the more productive side of the economy – the private sector."

Strengthening Credibility Worldwide

To wrest control of the federal debt, the Peterson-Pew Commission is calling on Congress and the White House to take immediate action to stem the growing federal debt. The Commission has recommended that federal officials develop a credible debt stabilization plan this year, begin to phase in spending cuts and tax increases in 2012, and stabilize the debt at 60 percent of GDP by 2018. The 60 percent debt threshold is an international standard – regularly identified by the European Union and the International Monetary Fund as a reasonable debt target. To meet these goals, the Commission recommends that policymakers shrink the annual deficit by two percent a year, to less than one percent by 2018.

"We take a variety of considerations into account when setting this threshold, including what we believe to be politically achievable, the right balance between economic recovery and fiscal considerations, and the standards used by other industrial nations," the Commission report states. "From a financial perspective, the United States must persuade credit markets that it is serious about the debt reduction. Global markets are more likely to embrace a plan if the goal has international credibility."

In his recent "Long-Term Budget Outlook" report, CBO Director Douglas Elmendorf says the aging population, retirements of baby boomers, and rapidly rising health care costs are expected to significantly increase outlays for Social Security benefits and sharply increase federal spending on health care programs.

"Unless revenues increase at a similar pace, such spending will cause federal debt to grow to unsustainable levels," Elmendorf says. "If policymakers are to put the nation on a sustainable budgetary path, they will need to let revenues increase substantially as a percentage of GDP, decrease spending significantly from projected levels, or adopt some combination of those two approaches."

But rather than taking serious action to address the looming debt crisis, Phaup says very little is being done at the moment.

"If anything, the debate is whether or not we should spend more and tax less in order to stimulate the economy, rather than taking the opposite step of reducing spending and increasing taxes," Phaup says.

Vorce says the White House and Congress need to immediately adopt a multi-year deficit reduction plan to get the nation's fiscal house in order.

"We think, because the size of the problem is so large, that everything has to be on the table," Vorce says. "We are talking about spending cuts, tax increases and addressing our longer-run problems like entitlement spending. But we think any measures need to be credible and probably back-loaded so they don't weaken the economy sooner rather than later. If the financial markets think the U.S. is credibly going to put its fiscal house in order with a long-term horizon and not weaken the economy now, but do it gradually, then we think this will make a huge difference."

A Bipartisan Commission

President Obama's recent creation of the blue ribbon, bipartisan National Commission on Fiscal Responsibility and Reform is a good step in this direction, Vorce says. The Commission is charged with addressing the nation's unsustainable debt burden. It is expected to make recommendations by December 1 to Congress to balance the budget and achieve annual deficits of three percent of GDP by 2015.

"Over the past year, we've had to take emergency measures to prevent the recession from becoming another depression," Obama said at the Commission's first meeting. "And at a time when millions of people are out of work, we'll continue to do what it takes to spur job creation while investing in a new foundation for lasting economic growth. But the emergency measures have added about $1 trillion to the deficit over the next 10 years. As a result, even as we take these necessary steps in the short term, we have an obligation to future generations to address our long-term structural deficits, which threaten to hobble the economy and leave our children and grandchildren with a mountain of debt."

As a way to require Congress to control its "dangerous spending appetite," House Republicans recently introduced the Spending, Deficit and Debt Control Act. The act would create a legally binding federal budget, with enforceable limits on spending and deficits, and would force Congress to address the entitlement spending crisis and budget for long-term liabilities.

In the House Budget Committee, Hensarling says the members have identified $1.3 trillion in savings to help spur job creation. The proposals including canceling unused bailout funds and unspent stimulus funds, cut and cap discretionary spending, and reform Fannie Mae and Freddie Mac.

A Mandate in November

In recent months, federal spending and the $13 trillion national debt have become major issues in the run-up to the November congressional elections, at which time Republicans hope to wrest control of Congress away from the Democrats. Republicans have blamed the slow economy on the record deficits and debt, while Democrats have argued that cutting spending too soon could short-circuit the tenuous economic recovery.

Duffy says the November elections will speak volumes as to what voters want.

"If a clear message is sent to Congress that they want this insanity to stop, the next question for the people who get elected will be whether they actually cut back on spending, or if they will behave in the way politicians have behaved for 60 years or more and say one thing and do something else," Duffy says. "I'm optimistic a message will be sent in November and I hope that message is acted upon by our elected representatives. If it's not, I think it's going to be a very difficult environment for a long time in the U.S. and the world economically." **N**

Troy Anderson, an award-winning newspaper reporter based out of Southern California, freelances for a variety of national and regional magazines.