The World Won't Buy Unlimited U.S. Debt

by Peter Schiff via rialator - Wall Street Journal *Saturday, Jan 24 2009, 8:17pm*
international / social/political / other press

> Barack Obama has spoken often of sacrifice. And as recently as a week ago, he said that to stave off the deepening recession Americans should be prepared to face "trillion dollar deficits for years to come." But apart from a stirring call for volunteerism in his inaugural address, the only specific sacrifices the president has outlined thus far include lower taxes, millions of federally funded jobs, expanded corporate bailouts, and direct stimulus checks to consumers. Could this be described as sacrificial?

What he might have said was that the nations funding the majority of America's public debt -- most notably the Chinese, Japanese and the Saudis -- need to be prepared to sacrifice. They have to fund America's annual trillion-dollar deficits for the foreseeable future. These creditor nations, who already own trillions of dollars of U.S. government debt, are the only entities capable of underwriting the spending that Mr. Obama envisions and that U.S. citizens demand.

These nations, in other words, must never use the money to buy other assets or fund domestic spending initiatives for their own people. When the old Treasury bills mature, they can do nothing with the money except buy new ones. To do otherwise would implode the market for U.S. Treasurys (sending U.S. interest rates much higher) and start a run on the dollar. (If foreign central banks become net sellers of Treasurys, the demand for dollars needed to buy them would plummet.)

In sum, our creditors must give up all hope of accessing the principal, and may be compensated only by the paltry 2%-3% yield our bonds currently deliver.

As absurd as this may appear on the surface, it seems inconceivable to President Obama, or any respected economist for that matter, that our creditors may decline to sign on. Their confidence is derived from the fact that the arrangement has gone on for some time, and that our creditors would be unwilling to face the economic turbulence that would result from an interruption of the status quo.

But just because the game has lasted thus far does not mean that they will continue playing it indefinitely. Thanks to projected huge deficits, the U.S. government is severely raising the stakes. At the same time, the global economic contraction will make larger Treasury purchases by foreign central banks both economically and politically more difficult.

The root problem is not that America may have difficulty borrowing enough from abroad to maintain our GDP, but that our economy was too large in the first place. America's GDP is composed of more than 70% consumer spending. For many years, much of that spending has been a function of voracious consumer borrowing through home equity extractions (averaging more than $850 billion annually in 2005 and 2006, according to the Federal Reserve) and rapid expansion of credit card and other consumer debt. Now that credit is scarce, it is inevitable that GDP will fall.

Neither the left nor the right of the American political spectrum has shown any willingness to tolerate such a contraction. Recently, for example, Nobel Prize-winning economist Paul Krugman estimated that a 6.8% contraction in GDP will result in $2.1 trillion in "lost output," which the government should redeem through fiscal stimulation. In his view, the $775 billion announced in Mr. Obama's plan is two-thirds too small.

Although Mr. Krugman may not get all that he wishes, it is clear that Mr. Obama's opening bid will likely move north considerably before any legislation is passed. It is also clear from the political chatter that the policies most favored will be those that encourage rapid consumer spending, not lasting or sustainable economic change. So when the effects of this stimulus dissipate, the same unbalanced economy will remain -- only now with a far higher debt load.

If any other country were to face these conditions, unpalatable measures such as severe government austerity or currency devaluation would be the only options. But with our currency's reserve status, we have much more attractive alternatives. We are planning to spend as much as we like, for as long as we like, and we will let the rest of the world pick up the tab.

Currently, U.S. citizens comprise less than 5% of world population, but account for more than 25% of global GDP. Given our debts and weakening economy, this disproportionate advantage should narrow. Yet the U.S. is asking much poorer foreign nations to maintain the status quo, and incredibly, they are complying. At least for now.

You can't blame the Obama administration for choosing to go down this path. If these other nations are giving, it becomes very easy to take. However, given his supposedly post-ideological pragmatic gifts, one would hope that Mr. Obama can see that, just like all other bubbles in world history, the U.S. debt bubble will end badly. Taking on more debt to maintain spending is neither sacrificial nor beneficial.

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