# U.S. Debt - A Sword of Damocles

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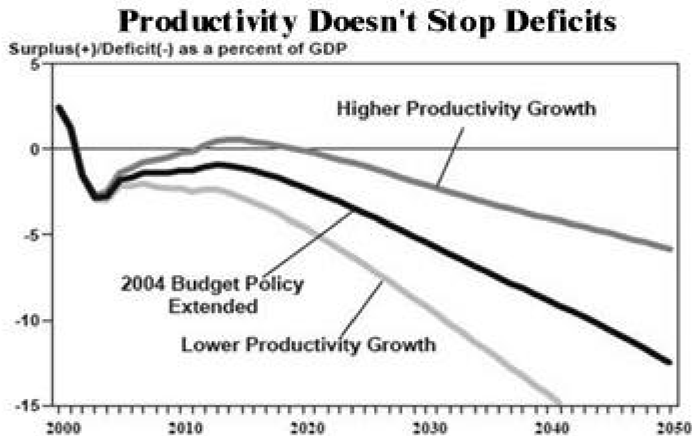
*"While the US productivity numbers are encouraging, one has to be quite concerned about what will eventually happen when the twin deficits -- fiscal and current account -- are reigned in, as eventually they must be. Some day the US current account deficit has to unwind, and when it does, there will be a sharp drop in the US Dollar.*

*"Despite its depreciation over the last year, the dollar still appears overvalued from a medium-term perspective, and the risk that its adjustment may become disorderly, or that it might overshoot, cannot be ruled out."*

-- Kenneth Rogoff, Chief Economist, IMF

For the last 30 years, the 30-year U.S. government bond has been, if you'll pardon the pun, the gold standard of debt. There's no safer investment in the world than a U.S. bond. America has the largest economy in the world, right? And America is the most dynamic economy in the world, right? How could anyone ever doubt the creditworthiness of the U.S. government?




You wouldn't have to look very far to begin having your doubts about Uncle Sam's creditworthiness. First there are the recent federal deficit numbers from the Congressional Budget Office. In its latest report, CBO finds:

The federal government ran a deficit of $402 billion in the first 11 months of fiscal year 2003... CBO anticipates that a small surplus in September will bring the deficit to $401 billion by the end of the fiscal year...

"Receipts for the first 11 months of fiscal year 2003 were about $70 billion, or 4.2 percent, lower than in the comparable period in the previous fiscal year...

"Corporate receipts fell by about $16 billion (or about 14 percent) in the period from October through August, compared with the same period last year.

"Outlays in the first 11 months of 2003 were about 7 percent higher than in the same period last year... "(This even though lower interest costs reduced interest outlays by $15 billion relative to the same period last year. Higher long-term rates will raise federal spending even more.)

In July alone, "the Treasury reported a deficit of $54 billion."

That's the short-term case against the federal government. And when you add in another $87 billion for the reconstruction of Iraq, it's damning. The long-term perspective is even worse.

## Productivity Won't Work

Fed Chairman Alan Greenspan assures us that productivity growth in the economy will allow the United States to grow out of its deficit habit. In his midsummer testimony before Congress, Greenspan said:

"Critical to our nation's performance over the past few years has been the flexibility exhibited by our market-driven economy and its ability to generate substantial increases in productivity. Going forward, these same characteristics, in concert with sound economic policies, should help to foster a return to vigorous growth of the U.S. economy to the benefit of all our citizens."

For all Greenspan's confidence, the Fed ought to compare notes with the White House. For its part, the White House knows that increased productivity is just another way of saying higher unemployment. Worker output per hour tends to increase when output stays the same and the number of workers decreases. That's simple math.

But even from a statistical perspective, the productivity number isn't all it's cracked up to be. Greenspan believes the higher productivity supports corporate profit margins during times of economic stress. He undoubtedly believes that when the economy picks up, firms will start hiring and that at that point, higher-than-average productivity, while desirable, will have filled the gap admirably and not be economically imperative.

But what if firms don't start rehiring because the jobs they've shed have been permanently lost? What if the labor market is undergoing a structural change, as I've contended, that won't be alleviated by campaign promises or lower interest rates?

**$1.5 Trillion in Deficits by 2008**

| | Estimate | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2004–2008 |
| Current baseline deficit | -455 | -458 | -241 | -110 | -78 | -62 | -949 |
| Budget proposals: | | | | | | | |
| Defense and homeland security | .......... | -8 | -19 | -26 | -29 | -43 | -126 |
| Extension of expiring tax provisions | * | -2 | -26 | -50 | -35 | -35 | -150 |
| Strengthening Medicare | .......... | -6 | -10 | -33 | -38 | -43 | -130 |
| Incentives for charitable giving | -* | -3 | -2 | -2 | -2 | -2 | -11 |
| Health tax credits | .......... | -* | -3 | -6 | -8 | -8 | -24 |
| Other proposals | -* | 2 | -1 | -5 | -11 | -14 | -29 |
| Related debt service | -* | -* | -1 | -5 | -12 | -19 | -37 |
| Subtotal, budget proposals | -1 | -17 | -63 | -127 | -135 | -164 | -506 |
| Budget deficit | -455 | -475 | -304 | -238 | -213 | -226 | -1,455 |

* $500 million or less.

If that's the case, you'd expect that even higher than historically average productivity wouldn't be enough to heal the economy. Naturally, this puts even more pressure on government deficits, both in the way of unemployment spending and any efforts to "stimulate" the economy through other spending projects.

In fact, judging by the chart below, the Bush administration has already quietly gutted Greenspan's claim. Its report on the budget for 2004 shows that even with higher-than-average productivity numbers, the Federal deficit will still get larger, just at a little bit slower pace than normal productivity growth.

The same report makes the simple observation, supported by the table below, that by the Bush administration's own projections, the federal deficit will have grown to $1.4 trillion by 2008 -- or 10% of GDP -- nearly twice its current percentage of GDP.

The report goes on to call this kind of deficit exactly what it is, "unsustainable." It's unsustainable because spending keeps rising. From the report:

"These long-run budget projections show clearly that the budget is on an unsustainable path, although the rise in the deficit unfolds gradually. As the baby boomers reach retirement age in large numbers, the deficit is projected to rise steadily as a share of GDP. Under most scenarios, well before the end of the projection period for this chapter rising deficits would drive debt to levels several times the size of GDP."

What's the big spending culprit? Social Security and medicine. The big three government entitlement programs -- Social Security, Medicare, and Medicaid -- account for 45% of all federal spending, excluding interest on the debt. That's an increase of 30% since 1980.

The Bush administration concludes that "by 2040, when most of the remaining baby-boomers will be in their 80s, these three programs could easily account for two thirds of non-interest federal spending." When three programs account for two-thirds of all government spending (before defense and interest expense), it doesn't leave much room to pay foreign bondholders. But it gets worse.

The White House's own projections show, "under an extension of current law formulas and the policies in the budget, almost all of the budget would go to these three programs alone. That would severely reduce the flexibility of the budget, and the government's ability to respond to new challenges."

"Severely reduce" is, of course, a severe understatement. More likely is that once the true nature of the government's debt debacle dawns on bond investors, they will cease buying government bonds. Economist Paul Krugman (whose politics are ridiculous) gets his description of the scenario right:

"There are three things that can happen... you can either have big tax increases, roll back the whole Bush program and then some; or you can sharply cut Medicare and Social Security, because that's where the money is; or the U.S. just tootles along until we actually have a financial crisis where the marginal buyer of U.S. Treasury bills, which is actually the Reserve Bank of China, says, we don't trust these guys anymore -- and we turn into Argentina...

"Now we're back in twin deficits territory, and there are two related issues, the solvency of the federal government and the solvency of the United States per se, and both of them are now somewhat in question...

"... I think that what happens when the world loses faith in the United States as a place to invest is that the dollar plunges... what happens is a plunge in the dollar when they start cashing in, and a spike in U.S. interest rates."

Who are the "they" Krugman refers to? And what's the "twin" deficit?

## The "Other" Deficit

America's other famous deficit -- and the one that could be responsible for a crash in the dollar and a hike in interest rates (a sell-off in bonds), is the current account deficit -- the biggest portion of which is the trade deficit.

At last count, the current account deficit stood at nearly $500 billion and just shy of 5% of U.S. GDP. This is "undiscovered country" by economic standards. The only way to prevent a huge trade imbalance from weakening your currency is if you import foreign capital faster than you import foreign goods.

In other words, if you're buying more than you're selling, you can make up the imbalance if foreigners decide to pour back their money into U.S. assets. And this is what foreigners have been doing for quite some time now, in both U.S. bonds and dollar reserves.

China and Japan have been running large trade surpluses with the United States -- mostly by keeping their currency low relative to the dollar. In the process, they've accumulated a combined $544 billion in U.S bonds, not to mention hundreds of billions in dollar reserves.

As long as China and Japan buy U.S. bonds and accumulate dollar reserves, the U.S. current account, theoretically anyway, does not face an imminent and dramatic readjustment.

Indeed, NO ONE seems to want a readjustment. A readjustment means a crashing dollar. For the United States this would certainly make American exports more competitive. But it's probably the last thing the Bush people want in election year, explaining why cheap imported goods in the United States are suddenly more expensive -- and why dollar "weakness" is good for U.S. manufacturers.

And the Chinese aren't eager to see their currency "strengthen" against the dollar. This is a case where strength actually makes Chinese exports more expensive. And Chinese exports have been the engine of Chinese growth. They are fine with the status quo.

## Twin Time Bombs

The net effect of America's two big deficits will certainly take the form of a falling dollar. The only questions are

how far and how fast.

On the one hand, Uncle Sam is spending more and more. This is clearly unsustainable, even with more "productivity" growth. And yet there's not a single politician in America willing to cut spending right now. Raise taxes maybe. But if anything, the government is only likely to spend more. More on defense. More on Social Security. More on a Medicaid benefit. This will eventually put bondholders into the unprecedented position of questioning the creditworthiness of U.S. bonds.

And on the other hand, the fate of the entire dollar standard now rests with the U.S. consumer. As long as he keeps spending money on foreign goods, foreigners are happy to rack up big trade surpluses and invest dollars back in the U.S. markets. The current currency regime is basically satisfying to everyone except the U.S. manufacturing sector, which is fast disappearing but still commands political leverage (watch the Bush decision on steel tariffs to see just how much).

The IMF and G-7 would love nothing more than to talk down the dollar without causing a rise in long-term U.S. interest rates. This way, the era of dollar-centric world growth can be peacefully laid to rest without causing too much disruption. But something must change. And it must change soon.

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