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Debt burden tests global investments

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President-elect Barack Obama will be testing the limits of the global markets' ability to absorb U.S. government debt by piling an $800 billion stimulus plan on top of more than $1 trillion in new obligations already scheduled this year.

Wall Street analysts worry that China, Japan and other nations that readily helped finance U.S. debt in the past won't have the willingness or wherewithal to buy what will amount to three to four times the previous yearly record of Treasury-issued debt of $455 billion. Some analysts predict a calamity such as the failure of a U.S. bond auction, which could drive interest rates sharply higher just as the economy is struggling to recover.

Others are less worried, but evidence is mounting that the debt burden could rise to unmanageable levels. The mere mention by Mr. Obama in a news conference last week that the U.S. could run deficits exceeding $1 trillion for several years sent a shudder through the Treasury bond market, where those deficits must be financed, sending interest rates temporarily higher.

A bond auction failed last week in Germany, which has comparatively little debt to finance, raising concerns about whether the United States faces similar problems on a much larger scale. Wall Street rating agencies Moody's and Standard & Poor's Corp. said they are closely watching the surge in debt and the willingness of foreign investors to finance it.

"Fiscal risk has noticeably increased," said S&P analyst Nikola G. Swann, while "the country's exposure to a change in international investors' willingness to add to their portfolio of U.S. dollar assets grows with each year."

On Thursday, the Senate Budget Committee will hold a hearing on the so-called debt bubble and is expected to ask a panel of economists about the ability of world markets to finance the growing U.S. obligations.

"In a world where you are running a deficit profile of staggering proportions, it all comes down to the confidence of foreign investors," said Alex Jurshevski, CEO at Recovery Partners, a distressed investment boutique, who expects the Treasury to borrow as much as $2 trillion more this fiscal year to finance its bank bailout program as well as budget deficits that are burgeoning as a result of the recession and the massive stimulus Mr. Obama is planning.

A flight to safe-haven Treasury bills since the fall has made it easy thus far for the nation to finance its increased debts, but analysts say that trend is abnormal and should not be taken for granted. Moreover, when as much as $2 trillion in new debt in the next year is combined with $4.3 trillion of outstanding debt that is coming due and must be rolled over, Treasury will have to find buyers for $6.3 trillion of debt, Mr. Jurshevski said.

"This is unparalleled," and will test the "entente cordiale" the United States has with China, Japan and other Asian and oil-producing nations that in the past have purchased about half of outstanding U.S. debt in a tacit exchange for U.S. consumers buying their products, Mr. Jurshevski said. The unstated agreement has enabled the U.S. to run gigantic budget and trade deficits with little consequence because the financing has been readily available.

China, the largest holder of U.S. debt, has invested about $1 trillion of its foreign reserves in U.S. bonds, but the yearly addition to its reserves from export earnings is expected to drop to $177 billion this year from a high of $415 billion last year. That leaves the Asian giant with much less money to invest at a time when new U.S. debt is potentially quadrupling. With its economy deteriorating fast, China also has a massive stimulus program as well as social welfare and unemployment programs to finance at home.

Oil-exporting states like Russia and Qatar that were brimming with surplus revenues as oil hit a record high of $147 a barrel in July also have seen their economic fortunes and revenues nose-dive in the past six months as the price of oil fell to as low as $30 per barrel.

As the financial reversal set in during the second half of last year, China, the oil states and other foreign investors started selling off some of their U.S. holdings of Fannie Mae's and other mortgage and corporate bonds, in a move that helped precipitate the September U.S. financial crash. The Treasury temporarily benefited as those investors - along with investors fleeing stricken stock and commodity markets - parked their money in T-bills and other short-term debt instruments that are considered the equivalent of "cash" on Wall Street.

But now that the surplus nations are also in severe economic downturns with critical needs to fund at home, Mr. Jurshevski questions whether they will be able or willing to take on exponentially more U.S. debt - particularly at the near-zero yields that Treasury instruments are offering. He thinks that some attempted auctions of U.S. debt will fail to find buyers, and that will force up interest rates across the board as the Treasury ups the ante to attract investors.

Ian Campbell, an analyst with Breakingviews.com, said the failure of a German 10-year bond auction on Jan. 7 should serve as a warning to the United States and Britain, which also is heaping unprecedented amounts of debt into the markets in an effort to revive its economy and banking system. Germany was unable to find buyers for one-third of its bond issue, even though its budget is close to balance.

"The U.K. and U.S. have deficit-spent, consumed and imported their way into trouble, and now are planning an ill-afforded government spending and tax cut binge to get them out of it," driving their public debt to post-World War II highs well over 8 percent of economic output, Mr. Campbell said. "Are investors ready to take it?"

Moody's Investors Service this week said the difficulty Germany and a few other European governments have had issuing bonds shows that heavy borrowing plans on both sides of the Atlantic will test the limits of the debt markets.

"Issuance of government debt and government-guaranteed debt at all levels of the rating scale is rapidly swelling," said Arnaud Mares, Moody's senior vice president. "The proposition that the highest-rated governments are totally immune to liquidity risk is being put to the test."

After the German auction failure, Moody's suggested that governments may have to offer a mix of more short-term debt versus long-term debt to satisfy investors' appetites for instruments where they can put their money for a few months while they wait out the turmoil in global stock markets. But Mr. Jurshevski said the skewing of fast-rising government debt toward short-term bills that must be rolled over every few months poses dangers in itself.

The only alternative for the U.S. if investors balk at buying Treasury bonds, analysts say, may be for the Federal Reserve to buy the debt - a prospect recently raised by Fed Chairman Ben S. Bernanke. The central bank would finance its purchases of U.S. debt by printing money. But that would scare off foreign investors even more, analysts say, as the flood of dollars into the economy and markets raises the risk of setting off inflation once the economy recovers.

Some economists say that Americans will start saving more and purchasing more of their own bonds, enabling the U.S. to finance its own deficits after depending heavily on foreigners for decades. The paltry U.S. savings rate recently has ticked up from near zero to about 2.8 percent.

Richard Berner, chief economist at Morgan Stanley, said he expects the savings rate to surge to 6 percent this year, but ironically that would occur only as a result of Americans saving a substantial share of the $300 billion tax cut Mr. Obama is planning.

Peter Schiff, president of Euro Pacific Capital, said he expects the Fed to absorb all the debt, creating a big inflation problem for the U.S. in the long run. The mere suggestion by Mr. Bernanke that the Fed will buy U.S. debt has set off a speculative frenzy, with investors snapping up Treasuries and hoping to sell them to the Fed in the future, he said.

Mr. Schiff faulted Mr. Obama for not telling the public of the dangers of so much borrowing, while touting the benefits of the stimulus legislation.

"The truth is that the only way out of this mess is less government, more savings and increased production. Obama's plan will prevent all three," he said. "He intends to force-feed more consumer spending and debt into an economy already suffering from an excess of both."