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The Growing Debt Bomb

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Facing a one- to three-year countdown

Assume you had put much of your savings into U.S. government bonds and then you learned the following. In just the last eight months, the Congressional Budget Office estimates of the amount of additional federal debt to be held by the public grew by an astounding $4 trillion for the 2010-19 period; and that the amount of federal debt held by the public grew from $5.9 trillion to $7.5 trillion in just the last 12 months.

In addition, you learned that the federal government (i.e., taxpayers) now owns (primarily through Fannie Mae and Freddie Mac) or insures (through the Federal Housing Administration and other government programs) about 80 percent of the $14.6 trillion of home mortgages outstanding in the United States. Last week, Congress passed a bill requiring all student loans be made by the federal government rather than banks, which means the taxpayers will be 100 percent liable for any student loan defaults.

You also learned that the Federal Deposit Insurance Corp. is considering tapping its Treasury credit line for up to $500 billion. It needs to do this because of the high number of bank failures and because each bank account is insured by the government (i.e., taxpayers) up to $250,000. The president and many in Congress are calling for a roughly $1 trillion health care bill - paid for by additional debt and/or more taxes, which will further slow economic growth, eventually leading to even more debt.

Finally, you also became aware of the following facts: Federal government expenditures are growing far faster than the economy, and thus the government is becoming a larger and larger share of gross domestic product. Obviously, this cannot continue forever because eventually the government would totally drive out the private sector.

The entitlement programs (i.e., Social Security, Medicare, Medicaid, etc.) all continue to grow faster than the economy, and they will take more than 100 percent of all federal tax revenue this year, requiring that virtually all of the other government spending programs, including defense and interest payments on the debt, be funded by more borrowing.

You are also aware that the government cannot tax its way out of the deficit situation, because increasing income tax rates on the upper income people will both slow the economy and cause them to find legal or illegal ways to avoid the tax increase, and the politicians have pledged to not increase taxes on those making less than $250,000, which includes all but a very few Americans.

Even if the politicians break their pledges not to increase taxes, they still cannot solve the deficit problem as long as they refuse to cut back on the growth in Social Security, Medicare, and Medicaid - because any new tax revenue will be quickly absorbed by the growth in spending. The best that any tax increase could do is delay the explosion of the debt bomb by, perhaps, a couple of years while further weakening the economy and job growth.

Now suppose you are not an individual bondholder but the Chinese government official responsible for the Chinese economy, and you know your government holds about $1 trillion in U.S. government securities. You have watched Congress and the administration become less and less fiscally responsible - more spending, more taxes, and more debt.

Then suddenly the administration puts punitive tariffs on your tire manufacturers while at the same time refuses to approve the trade treaties with Colombia, Panama and South Korea that have been negotiated.

You understand that these foolish and destructive actions by U.S. government officials indicate it does not understand the importance of free trade in fostering economic growth, and seem to be intent on replicating the mistakes of the 1930s.

The Chinese are not stupid, and they have been vocal in saying they are concerned that U.S. policies will lead to a further fall in the dollar and higher rates of inflation, both of which undermine the value of their investment in U.S. government securities.

The Chinese are now trying to diversify their holdings - and their recent activity in buying large quantities of tradable commodities is probably, in part, a hedge against a falling U.S. dollar. Thus, at the same time, the U.S. government needs to sell trillions of dollars of new bonds. It is by its own actions driving away foreign purchasers of bonds, which can only result in higher interest rates in the United States, which will further slow economic growth.

What is particularly frightening is that neither political party has offered a serious plan to defuse the debt bomb. The Democrats are just piling up more debt as if there were no limit, and the Republicans, to date, are only proposing measures to reduce the increase, rather than reverse it. When the debt bomb explodes - within the next one to three years - expect to see record high real interest rates and/or inflation, coupled with a collapse of many "entitlements." It will be like the neutron bomb, the buildings will be left standing, but the people will not.

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