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The Responsible, the Timid, and the Ugly on Inflation

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A three-way donnybrook will determine our economic future

For the past year, the Federal Reserve has been the largest single purchaser of U.S. government securities, buying well more than half of all new debt. The Fed calls this program quantitative easing (QE2), or what normal people would call printing money. The Fed has stated that this program will stop in June. Who is going to purchase all of the new government debt when the Fed stops?

As can be seen in the accompanying table, the Fed has now become the largest single holder of U.S. government securities, followed by China and Japan. Foreign holders account for almost half (47 percent), and these foreign holdings coupled with the Fed holdings account for more than 60 percent of our debt. U.S. individuals, companies and other private U.S. institutions now are the minority holders of the debt.

Who holds U.S. Government Debt

Major debt holders	Holdings
Federal Reserve	13.9%
Chinese	12.2%
Japanese	9.3%
Oil Exporters	2.3%
Total Foreign Holders	47.0%

Sources: Federal Reserve, U.S. Treasury

The Fed will stop purchasing government securities because of its growing concern about inflation, which is caused by printing too much money. (Note: For every dollar the U.S. government spends, it now borrows 41 cents - obviously unsustainable.) The Chinese and other foreign holders of U.S. government debt are well aware of the increasing probability of higher U.S. inflation and the corresponding further decline in the dollar. Since September, the Chinese have been gradually reducing their holdings of U.S. government securities (i.e., becoming net sellers). The Japanese had been net buyers of U.S. government debt, but they also will now likely become net sellers as they will need funds for rebuilding.

Again, who will fill the Treasury bond-buying gap left by the withdrawal of the Fed, the Chinese and the Japanese? Other potential foreign buyers are equally aware of the growing risk of holding U.S. debt and are more likely to be net sellers than buyers, given the failure of the Obama administration and the Senate Democrats to propose a serious budget that would reduce the long-term debt. Potential domestic and foreign buyers of government debt will almost be certain to demand higher interest in exchange for purchases in the coming months. Having to pay more interest on the government debt will deepen the fiscal problem and, sooner than one may think, the situation could begin to spiral out of control, as it has done in other countries.

The U.S. financial future is likely to be determined over the next few months as the struggle among “the responsible,” “the timid” and “the ugly” comes to a climax. The leader of the “responsible” is Rep. Paul Ryan, Wisconsin Republican and chairman of the House Budget Committee. He understands the danger the United States is facing and has put enormous constructive effort into fashioning a budget plan for 2012 that finally deals with the “entitlement” problem. The Ryan plan would bring the nation to a sustainable fiscal situation through a combination of pro-growth tax policies and necessary spending rate reductions and cuts. Many of the new Tea Party members of the House of Representatives are likely to line up with Mr. Ryan. There is also a small number of Republican senators, such as Rand Paul of Kentucky, Pat Toomey of Pennsylvania, Marco Rubio of Florida and Jim DeMint of South Carolina, who understand the problem and are willing to take the necessary stand against spending, even on entitlements.

The “timid” include many of the old-guard Republicans and some moderate Democrats who may partially understand the coming fiscal collapse. But when it comes to making the hard choices about specific spending cuts, the timid almost always find a way to say yes, cut spending, but not that spending or not yet. The timid can also be counted on to say they are for a compromise where tax increases are included in the solution. They fail to admit that major tax increases will slow growth, making it even harder to cut spending. When the government is growing faster than the private sector, as it has done for the past few years, there is no tax increase solution (this is a matter of arithmetic, not ideology). A spending problem demands a spending solution.

Finally, there is the “ugly” crowd. These are the folks who either deny the problem or argue that it can be solved by taxing “rich people.” They are the ones who either do not or choose not to understand economic reality. They fail to admit that even a 100 percent tax on the rich would still not produce enough tax revenue to meet the ugly’s spending plans. Democratic politicians such as Sen.

Charles E. Schumer of New York and Rep. Barney Frank of Massachusetts go before the cameras to denounce people like Mr. Ryan, who are actually trying to solve problems but the duo never offer a comprehensive workable solution of their own.

Bondholders and potential bond buyers will be watching this play among the responsible, the timid and the ugly. If the responsible largely win, the bondholders are likely to stay and interest rate increases will be moderate. If the timid win, many of the bondholders will likely reduce their holdings and long-term interest rates will rise rapidly, giving another blow to the housing and other industries, perhaps causing another recession. If the ugly win, bondholders will flee, interest rates will soar and a renewed recession, or worse, is all but a certainty.

If the American public understood the struggle, the ugly would lose. But all too few fully understand what is at stake because when it comes to economic policy, the establishment media tend to laud the timid and the ugly but not the responsible.

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