Think the unthinkable on US debt

Robert Jenkins[1]

Will the US request a bailout? Will the International Monetary Fund grant it? On what terms and conditions? What writedown of US debt will be needed to restore sustainability to its fiscal accounts? What impact will this have on world financial markets?

These are not questions being asked today but they are questions worth contemplating. Thinking the unthinkable is one of the lessons of the eurozone saga. Another is the speed with which complacency can convert to crisis. So although I am not predicting Armageddon, I would like to signal a series of factors that policy makers of all nationalities would do well to keep in mind.

The first is that a small percentage of a big number is a big number. US debt outstanding exceeds $16tn. Each percentage point rise in interest rates adds (over time) $160bn to annual debt financing. Thus a 5 per cent rate rise adds $800bn to the budget deficit and, given compounding, more than $8tn per decade to the national debt.

The second factor is that more than 45 per cent of tradable US debt is held by foreigners. The Japanese are in hock to the Japanese people. The US is in hock to – among others – the Japanese.

Third: sovereign bonds are no longer presumed to be risk-free. Indeed, there is now general awareness that at some level of financing costs, government debt becomes unsustainable. Five years ago, posing the question: "At what interest rate does Italy or Spain's deficit financing become untenable?" to analysts, economists or journalists would have elicited a shuffling of the feet or a shrug of the shoulders. Ask today and the quick reply will be: "Why 7 per cent of course". We have been educated.

Fourth: globally, there are some $20tn of funded pension assets, $60tn of professionally run assets under management and $600tn of various derivatives. The pricing of the related liabilities, expected returns and valuations is tied directly or indirectly to the yield on US Treasuries – all on the assumption that US paper represents a risk-free rate of return. Remove that assumption and we are in a financial world without gravity.

The fifth factor is that sophisticated investors have understood the first four factors. Aside from adjusting exposures at the margin they are exploring two changes, each with profound implications for capital flows. First, they are asking leading investment firms to create a basket of securities that could replace the risk-free properties of US Treasuries of yore. Second, they are considering a shift from bond indices weighted by market capitalisation to benchmarks based on creditworthiness. The former favour US Treasuries, the latter may not. To the extent that these initiatives become trends, capital will flow away from those who borrow

[1] Then member of the Financial Policy Committee of the Bank of England. He writes in a private capacity.

most and towards those who borrow least. Yields will reflect the change. Sounds familiar? Locals in Lisbon can advise.

Sixth, financial repression may have unintended consequences. Aside from the yield-depressing effects of the three rounds of quantitative easing and other central bank operations, there has been a less widely reported liquidity effect. By some estimates, the Federal Reserve now owns all but some $750bn of US debt issued with maturities of 10 years or greater. This suggests the Fed is running into limitations on how much more it can buy while preserving dealing depth; that friendly foreigners have used the Fed's market interventions to shorten the duration of their US holdings; and therefore that America's creditors are less vulnerable than imagined to the threat of market losses – should they wish to exit.

The seventh factor concerns the "ugly sister syndrome". Ever wonder why the euro has been so resilient against the dollar? That the euro has not tanked may say more about the global search for an alternative to the dollar than it does about confidence in Europe's determination to save the single currency. So it is worth considering the degree to which progress on the euro might trigger a crisis in the greenback. When the spotlight shifts from Europe, where will it light?

With the US election behind us, the challenges associated with the looming "fiscal cliff" of planned tax hikes and spending cuts now dominate the debate. The optimum solution would avoid undue belt tightening in the short term combined with credible deficit reduction in the longer term. Alas, a more likely outcome will involve some version of kicking the can further down a shortened piece of road. Here too, the old world holds lessons for the new. Indeed, faced with the prospects of postponement, the market may soon be asking a different question: which is the greater threat – that the US goes over the fiscal cliff or that it does not?