When will the US "debt bomb" explode?

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While the continued escalation of share values on Wall Street has prompted claims that the growth of information technology has transformed the US into a “new economy”, there are growing concerns that the share market boom is being funded by rising indebtedness which, sooner, rather than later, could spark a major financial crisis, leading to a severe recession.

In recent weeks reports from US private economic think tanks such as the Levy Institute and the Federal Markets Center as well as the London-based Lombard Street Research group have all highlighted the unsustainable nature of the boom, pointing to the growth of international debt and the ever-widening US balance of payments deficits.

This week the Economic Policy Institute published a major report by economist Robert Blecker under the title “The Ticking Debt Bomb” which set out to demonstrate why the US financial position was unsustainable.

Blecker pointed out that while increasing numbers of observers were hailing the “new economy” there were a number of indicators which “regularly cast a pall over these otherwise sunny times.”

“Month after month, year after year, the US trade deficit sets new records. And as the United States borrows to cover the excess of its imports over its exports, the US position as the world's largest debtor grows by leaps and bounds. Closely related to both of these trends is the drop in the US private savings rate, which forces the country to continue borrowing from abroad in spite of the shift from a deficit to a surplus in the federal budget balance.

“In fact, the US economy's current prosperity rests on the fragile foundations of a consumer spending boom based on a domestic stock market bubble, combined with foreign bankrolling of the US trade deficit. If present trends continue, the growth in the US international debt will not be sustainable in the long run. No country can continue to borrow so much from abroad without eventually triggering a depreciation of its currency and a contraction of its economy. The rising trade deficit and mushrooming foreign debt are thus warning signals of underlying problems that—if not corrected—could bring the US economic boom crashing to a halt in the not-too-distant future.”

Blecker's report draws out the steady growth of US indebtedness over the past 15 years and the rapid worsening of its financial position since the end of 1997. From a position of balance in 1983, continued borrowing to cover chronic balance of payments deficits in the 1980s transformed the US from the world's largest creditor into its biggest debtor. At the end of 1997 total US debt stood at $1.22 trillion. But after the exclusion of gold reserves held by the US Treasury and the direct foreign investment of multinational corporations, both of which are non-liquid assets, the net financial debt, comprising the difference between the value of US liquid financial assets (such as corporate stock, government securities and other bonds) owned by foreigners and the value of similar foreign assets held by Americans, the net financial debt of the US was $1.57 trillion.

While the US became an overall net debtor in the mid-1980s, total investment income still remained positive into the 1990s because the rate of return on direct investment (in which the US is a net creditor) exceeded the rate of return on financial investments (in which the US is a net debtor).

“However, in the last few years the sheer volume of the net financial debt has begun to overwhelm the difference in rates of return, and the net investment income balance has been negative since 1997.”

According to Blecker's predictions net financial debt will rise to just over $2 trillion in 1999, to $2.34 trillion in 2000, expanding to a “mammoth $4.36 trillion by 2005 (or an estimated 36.4 percent of gross domestic product at that time).”

Under what he calls a “worsening trade deficit scenario” in which the underlying trade deficit rises to 4 percent of GDP in 2000 and thereafter rises slowly to 5 percent in 2005, Blecker warns that the net financial debt would explode to $5.45 trillion or 45.5 percent of GDP while the current account deficit would blow out to $750 billion or 6.3 percent of GDP, levels of debt that would “almost guarantee the outbreak of a financial panic.”

Blecker points out that while the notion of an eventual US financial crisis “may seem far-fetched at a time when the US economy is the envy of most of the world” recent economic history is “full of episodes in which confidence in a particular economy has changed dramatically and quickly—witness the 1994-95 crash in Mexico, which followed the pre-NAFTA euphoria about the booming Mexican economy, or the rash of crises in East and Southeast Asia in 1997-98, which followed many years of touting Asia's ‘miracle' economies and emerging financial markets.”

“These experiences show that spending booms fueled by overly optimistic expectations can lead to the creation of unsustainable financial positions, including speculative bubbles in asset markets and real overvaluation of exchange rates, eventually leading to a revision of expectations and an inevitable crash.”

And, as he goes on to note, the US has not been immune to crises of confidence in the past. In 1978-79, the US financial system was hit by a rapid loss of confidence in the US dollar, which led to an intervention by the then Federal Reserve chairman Paul Volcker who rewrote the Carter administration's budget, hiked interest rates to 20 percent and brought on the deepest recession in the US in the post-war period.

The financial crisis of the late 1970s flowed from the collapse of the Bretton Woods fixed exchange rate system in 1971-73 after Nixon removed the gold backing from the US dollar, and the subsequent decision to allow the dollar to depreciate in order to improve the US trade position. The high-interest rate regime initiated by Volcker restored confidence in the dollar, but led to a widening trade gap (as US exports become more expensive and imports cheaper) and growing international indebtedness.

Now the crisis of confidence in the US dollar which erupted 20 years ago threatens to re-emerge in an even more explosive form because of the far more extensive holdings of US debt internationally. Whereas the problems in the late 1960s, which led to the scrapping of the Bretton Woods fixed exchange rate system, were caused by the large holdings of US dollars by foreign central banks, "the problem in the late 1990s is an accumulation of large amounts of US financial assets of all kinds—including private holdings of stocks and bonds as well as official central bank reserves (which are largely held in the form of US Treasury securities). This situation runs the risk of creating a fear of dollar depreciation that could again become a self-fulfilling prophecy, only this time not so much through the actions of foreign central banks but through those of private international investors and banks (both domestic and foreign)."

The extent of the potential crisis can be seen from the dramatic increase in foreign holdings of US securities since the end of 1995. In the past three years, the value of foreign holdings of non-Treasury securities has escalated from around $900 billion to around $2 trillion while foreign holdings of the nearly $1.3 trillion worth of US Treasury securities at the end of 1998 accounted for almost 35 percent of all Treasury obligations at that time, about double the percentage in the early 1990s.

Blecker warns that if a crisis of the dollar develops and the Federal Reserve Board seeks to counter it by raising interest rates this could have devastating economic consequences.

"With consumer debts rising to record levels in relation to household income, a rise in interest rates would increase household debt service burdens and could push financially strapped families over the edge into bankruptcy (especially if unemployment begins to rise as a result of higher interest rates). The same is true for corporations that have become highly leveraged—regardless of whether they borrowed for productive investments or for mergers, acquisitions and buyouts. If interest rates spike upward while sales growth slackens and cash flow shrinks, highly indebted firms could become illiquid and the risk of corporate bankruptcy would increase. And if personal and business bankruptcies rise, banks that have lent heavily to consumers and corporations could be in serious trouble—as they were in the Asian crisis countries. Furthermore, the existence of complex derivative contracts and unregulated hedge funds has allowed investors to create highly leveraged financial positions that could be difficult to unwind without significant losses in the event of a general financial panic in the US."

Making an estimate of the effect on the US of a dollar crisis, Blecker points out that "some simple calculations reveal that a serious economic depression could easily result."

Assuming that the current account deficit was $270 billion and that half of this gap was eliminated by the fall in the dollar's value (by cutting imports and boosting exports), it would require a 6 percent decline in real national income to close the rest of the payments deficit. "This would be an adjustment on the order of magnitude of what has been felt in the crisis countries such as Brazil, Mexico, Korea and Thailand in recent years, and much larger than the drop in any recent US recession."

Of course, the impact on the global economy would be far more severe than even these figures indicate because of the role played by the US economy in recent years as the so-called "consumer of last resort." It estimated that with growth in Japan virtually stagnant and European growth averaging around 2 percent per annum, the US economy has accounted for between one third and one half of the increase in world demand in the recent period.

Warnings of a major financial crisis as a result of increased debt are also set out in an article by the Massachusetts Institute of Technology economist Rudi Dornbusch published in the July 2 edition of the *Australian Financial Review*.

Dornbusch notes that value of Wall Street stocks is almost twice gross domestic product, far more than ever in history, and at least 25 percent higher than at the peak of the Japanese financial bubble in 1989.

While holding out the prospect for a so-called "soft landing"—a slowdown rather than a recession—Dornbusch poses the question of what will happen if interest rate rises fail to halt the rise in the stock market.

"Then the going will be much rougher: first interest rates will rise a lot and then, on top, the stock market will tumble. High rates and a deep fall of stocks—20 or 30 percent—will surely put the US economy close to zero growth or worse."

In an article published in May he pointed to the escalation of debt in Japan. The Japanese public debt is now 130 percent of GDP and the value of pension liabilities is calculated to be 107 percent of GDP, combining to make the largest public debt liability in the world, both in relation to the size of the Japanese economy, and absolutely.

In the past weeks, financial institutions such as the International Monetary Fund and the Federal Reserve Board have pronounced the Asian financial crisis as over. But according to Dornbusch: "The financial crisis of the past two years was merely a manoeuvre for the big one that is now coming—US adjustment to slower growth and more reasonable asset prices and then, later, the Japanese debt crisis."