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Experts float debt-bubble fears

By: Eamon Javers
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With the news this week that the national deficit passed the $1 trillion mark in June — and could be heading toward an astonishing $2 trillion by the end of the year — some economists are worried about a potentially devastating new problem for the American economy: a debt bubble.

Most Americans are not used to thinking about the U.S. deficit as an asset that investors can buy. But in many ways, it is. And just like the markets for any other commodity, debt markets can experience bubbles, too.

Financial bubbles happen when investors pour money into a given asset class, driving prices up at an unsustainable rate. The problem with bubbles is they inevitably pop, sending prices spiraling downward and destroying the wealth of investors who are caught with their money in the market at the moment it collapses.

Bubbles are a sign of a kind of financial mania, as investors ignore ever-growing risks in pursuit of ever-higher, and more irrational, profits. They were in full effect in the 1990s, when the Internet stock surge drove the Dow Jones over the 11,000 mark by January 2000. The resulting stock market crash vaporized nearly $8 trillion in wealth.

In the 2000s, the housing market saw an asset price bubble of its own — and the ensuing crash last year took much of the rest of the economy with it, wiping out an astounding $50 trillion in global wealth.

Some think it's happening all over again, this time in the global debt market, and it could have crippling consequences for the long-term future of the U.S. economy. If the debt bubble bursts, interest rates would soar, with a potentially devastating impact on U.S. productivity, wage growth and employment.

"We're looking at continuous monstrous issuances of federal debt, and it is only a matter of time before appetites are filled up," said Tad DeHaven, a budget analyst at the CATO Institute, a libertarian think tank. "There's a finite amount of debt that the market's willing to purchase."

"The debt bubble continues to inflate," said J.D. Foster, a former official in the Bush administration's Office of Management and Budget who is now a senior fellow at The Heritage Foundation. Foster predicts that the global market's appetite for American and other government debt will erode as governments continue to shovel bonds at less and less willing investors. "Who knows the whims of mass psychology?" said Foster. "You know it's going to happen; you just don't know when."

Although fear of a debt crash is generally most acute on the political right, at least one prominent liberal — former Clinton administration Secretary of Labor Robert Reich — thinks there is a "kernel" of concern that's "plausible."

"At some point, global investors are going to get nervous about U.S. borrowing and demand higher interest rates on their loans to Uncle Sam," he said. "There's no question

that large projected deficits will spook global investors, and they will either dump dollars or demand higher interest rates."

But Reich says the concern is not immediate and that high deficits are a short-term necessary evil as the government confronts the worst recession since the Great Depression. "I'm not particularly worried right now," Reich said. In his view, the government simply has to spend money now to keep the economy going. "Economies are like bicycles," he said. "If you stop, they fall over."

To understand the argument, you need to understand that the way the government finances its debt is largely by selling Treasury bills — government bonds that have to be repaid — to investors. The bigger the deficit, the more T-bills the government needs to sell and the more buyers it needs to find around the globe.

For now, that's no problem: Investors have been flocking to buy Treasuries because the collapse in value of nearly every other investment has made Treasuries, which are always deemed as among the safest investments in the world, even more appealing. That's driven Treasury yields to historic lows and is allowing the United States to borrow huge sums for relatively little cost.

But that doesn't always have to be the case. The bond market, like everything else, works on the law of supply and demand. And as the government increases the supply of Treasuries to finance its profligate ways, demand could contract — and suddenly, if investors decide they simply don't want to buy any more of the stuff.

What sustained the housing bubble was the raw faith that home prices never go down. It could be that a similar faith is sustaining the debt bubble: that the United States will always pay its debts. What's unknowable now is the psychology of the market: What prompts thousands of people to suddenly get the same idea in their head at the same time?

If that happens, the government would be forced to raise interest rates, perhaps dramatically, to entice new buyers into Treasuries by paying them a higher premium to accept higher risk. An interest rate hike would, in turn, affect the cost of borrowing in the rest of the economy, driving up rates for home mortgages and business borrowing, slowing the national economy with every percentage increase.

"It will deplete the vitality of our economy. Productivity and wage growth will be much lower over time," said Foster.

The housing bubble itself grew out of the collapsed Internet bubble; the Fed kept interest rates and borrowing costs extremely low, even as investors surged into real estate as a refuge from equities. And in the same way, a debt bubble could be growing out of the collapse of the housing market; the government has resorted to a surge of debt-fueled spending to help stave off economic decline, which could unintentionally fuel a bubble.

That spending binge seems to be opening up a political weakness for the president. A Gallup Poll released July 15 found that political opposition to President Barack Obama seems to be coalescing around the spending issue; 24 percent of people who disapproved of Obama cited federal spending as the reason for their disapproval. And according to Gallup, overall approval for Obama is trending slightly downward, ending at 59 percent in the most recent survey.

The good news, historically speaking, is that other governments in the past have been even more debt ridden than the United States is now. The ratio of debt to gross domestic

product for the United States today, said Richard Sylla, a professor of economics at New York University, is about 80 percent. That's not even a historic high for this country: The ratio was 120 percent after World War II. And today, the debt ratio is even higher than that in Japan, Belgium and Italy, he said.

The bad news is that countries almost never pay off their debts entirely, and debts typically only get bigger. Over the past several hundred years, Sylla can think of only two countries that paid off their debts: Venezuela in the 1920s and Romania in the 1980s.

In Romania, the brutal communist dictator Nicolae Ceausescu implemented a severe austerity program to help pay off the country's foreign debt, and it nearly starved the Romanian population, which responded by overthrowing his regime. The debt was finally paid off in full shortly before Ceausescu was executed by a firing squad in 1989.

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