Socialism, US-style

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Near the end of his term in office US president George W. Bush said: "I'm abandoning free-market principles to save the free-market system." But he had already significantly increased the size and scope of the federal government. His last act was to bail out General Motors and Chrysler. That trend is continuing in spades under President Barack Obama and the democratic majority in Congress.

Federal spending in fiscal 2009 will approach 28 per cent of gross domestic product, and the US budget deficit is expected to be nearly US$2 trillion, or about 13 per cent of GDP. During the next decade, the US government will issue nearly US$10 trillion of new debt to cover its planned spending programmes over and above expected tax revenues.

The downside of fiscal stimulus is that someone must pay for it. Britain is learning that lesson with the recent announcement that its triple-A credit rating could be downgraded unless government profligacy is reversed. The US is in a slightly better position, but the vast expansion of US deficit spending, the Federal Reserve's decision to monetise federal debt, and the trillions of dollars of unfunded liabilities in social security and Medicare, pose a danger to those who have put their trust in US sovereign debt.

There is little doubt that a bubble exits in the market for US government debt. As interest rates rise, which they must once the economy begins to recover and the Fed shrinks its balance sheet by selling assets, Treasury securities will tumble.

Although there is little risk that the US government will default on its obligations, there is a much better chance that the cost of financing massive new debt over the next decade will put a further burden on the federal budget as rates rise.

If Congress pressures the Fed to keep long-term rates down, to help fund the deficit spending, markets would bid up nominal interest rates to reflect the higher expected inflation. The Fed's announcement that it will buy long-term government bonds - under its policy of "quantitative easing" - puts a question mark on its commitment to price stability in the face of a prolonged recession.

After the 2001 recession, the Fed kept interest rates too low for too long. Cheap credit was gobbled up by the housing market, which was fuelled by government-sponsored enterprises designed to foster widespread US homeownership.

It is essential for US economic growth and stability that the Fed does not succumb to political pressure to peg long-term interest rates and to help finance fiscal deficits through the printing press. US public debt now stands at about US$7 trillion, or nearly 47 per cent of GDP. That figure is expected to rise to 77 per cent by 2013. If intergovernmental debt is included (for example, the IOUs in the Social Security Trust Fund), US gross national debt is about US$11 trillion today and will be more than double that in a decade. If the projected deficits in social security and Medicare are included, the total explicit and implicit US sovereign debt far exceeds 100 per cent of GDP today and will continue to mushroom in the future - unless fundamental reform occurs.

No wonder China, as the largest holder of US Treasury securities, is starting to worry about the wisdom of accumulating nearly US$800 billion in US government debt. It is ironic that one of the unintended consequences of China's development strategy has been to help promote excessive US government spending. Conversations around China have now shifted from discussing "capitalism with Chinese characteristics" to puzzling over "socialism with American characteristics".

Eventually, China would benefit from more open capital markets and a floating exchange rate, along with market-determined interest rates and a more independent central bank aimed at long-term price stability. The official accumulation of dollar reserves could then end - and, with it, the indirect policy of promoting US government growth. That would be good news for future stability and **prosperity** (SEHK: 0803, announcements, news) in both China and the US.

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