The Trouble With T-Bills

How our last export industry might bankrupt us

By Charles Hugh Smith

KEYNESIANS CEASELESSLY claim that huge deficits are not just necessary to reboot the economy, they are essentially harmless. And the bond market's acceptance of 2009's unprecedented deficit of $1.4 trillion seems to justify their complacency. Indeed, since the Federal Reserve is committed to maintaining a zero interest rate policy, then the consequences of borrowing trillions and trillions seem modest.

But the "new normal" of trillion-dollar deficits does pose potentially interesting questions: Will this vast issuance of new debt ever exceed demand? What happens if buyers of all this low-yield debt become scarce?

The usual response is that global and domestic investors can never get enough of U.S. Treasury bonds because they are liquid—that is, easy to buy and sell—and are safe, backed by the full faith and credit of the U.S. government.

But Treasury debt, like all other bonds, has two funny characteristics the Keynesians either dismiss or ignore: the government has to pay interest on that debt, and the bond market, not the Fed, sets the interest rates on Treasury bonds.

In actuality, the Fed has only a few levers to pull in controlling interest rates. It sets the Federal Funds Target Rate for interbank lending and recently it has taken to buying mortgages and Treasury bonds directly to keep those rates low. But the ultimate arbiter of Treasury yields is the global bond market, not the Federal Reserve.

If buyers don't snap up bonds with low yields, then the yield has to rise to the point that buyers are enticed to step in. If buyers become scarce, then the interest rate rises, and the federal government has to pay more interest.

Why do we care? For the same reason that the Keynesians suddenly fall silent when the topic of interest rates comes up: rising rates on trillions of dollars of debt would obligate the government to pay a lot more interest than it currently does. That would squeeze spending on other programs and raise interest rates throughout the economy, rippling into mortgages, corporate bonds, credit cards, and other consumer lending.

The Keynesians also never mention what happens to real estate and the stock and bond markets when rates rise: like all interest-sensitive markets, they tank. Real estate tanks because mortgage rates and prices are on a see-saw: when rates rise, prices must drop to maintain the same monthly "nut" (mortgage payment). Stocks tank because investors prefer the safety of high-yielding bonds to risky low-yield stocks. The market for existing long-term bonds also tanks because the market value of a bond is inverse to the yield: when rates fall, long-term bonds at high yields rise in value, and when rates rise, then long-term bonds with low yields plummet. If you can get 8 percent on a new bond today, who wants a bond paying 4 percent for ten years? Answer: nobody, unless the price of the bond falls by half, effectively boosting its yield to 8 percent.

So That Which Cannot Be Spoken among Keynesians is this: borrowing insanely large amounts of money at low yields boosts the odds that buyers will eventually hesitate, which will then drive rates higher, with dire consequences to the asset classes noted above.

In the popular imagination, Federal Reserve Chairman Ben Bernanke's fanciful imagery of helicopters strewing bundles of freshly printed cash over the parched recessionary landscape explains where the government's deficit funding comes from: when it needs more money, it just prints it.

But if it were that easy, why does the Treasury go through all the trouble of selling bonds? Because ours is a credit-based system. The federal government does not just print $100 bills to fund its stupendous deficit. It sells bonds of varying maturities and yields, and investors holding a bond to maturity get their money back—with interest.

To fund the $3 trillion deficit of the past two years, the Treasury has had to sell $3 trillion in new bonds. At the same time, it has also had to replace ("roll over") all the existing bonds that reached maturity in those years. As the old saw has it, a trillion here, a trillion there, and pretty soon you're talking real money.

But who's buying these bonds? For reasons of little interest to anyone but economists and policy wonks, the Treasury has had little trouble finding buyers for those trillions of dollars of new bonds. But as the Wall Street caveat goes, past performance is not a guide to future results, and there are legitimate reasons to ask if buyers of low-yield bonds will always be so abundant.

In 2007, China soaked up about 75 percent of all Treasury bonds issued in 2007. During the Bush deficit years, the Chinese were pleased to buy about $890 billion of Treasury debt. The reason isn't complex: we ran massive trade deficits with China, and they had to park their huge surpluses of dollars somewhere. Treasuries were low-risk and liquid, and buying them helped keep interest rates in America low so consumers could continue extracting home equity to buy Chinese goods.

Recently, the Chinese have become circumspect about buying Treasuries, and their statements have been backed up by action: they've been lightening their load of T-Bills. Some of this is the result of lower trade surpluses. They have fewer dollars to park. But they also seem rather keen on trading their dollars for things like oilfields in Africa rather than T-Bills.

At this juncture, it is helpful to place the $1.56 trillion 2010 deficit in context. According to the most recent statistics issued by the Treasury, China holds $889 billion and Japan holds $765 billion. That comes to $1.65 trillion. So to fund the current year's deficit, both China and Japan would have to nearly double their Treasury holdings in just one year. Since both have stopped adding to their gigantic hoards, that seems unlikely. Even if China were to convert its entire trade surplus with the U.S. into T-Bills, the $227 billion 2009 surplus is only 14.5 percent of the 2010 deficit.

How about those rich oil-exporting nations? They have continued buying modest quantities of Treasury debt, increasing their holdings to $218.4 billion in January from $207.4 billion in December 2009. (Whoopie, a big $11 billion!) But even if those countries doubled their holdings in 2010, the additional $218 billion would only cover 14 percent of the U.S. deficit.

So forget non-U.S. buyers. Can't we fund the deficit with domestic purchases of Treasuries? The evidence is not very promising. In a recent *Newsweek* piece entitled "Empire at Risk," historian Niall Ferguson stated that American investors were net sellers of Treasuries in the second quarter of 2009, and that bond mutual funds bought $142 billion Treasuries, and pension funds and insurance companies together purchased a mere $22 billion. That $164 billion is roughly 10.5 percent of the 2010 deficit.

But aren't Americans saving more now? True, but the deficit completely dwarfs U.S. households' newfound thrift. According to the Bureau of Economic Analysis, our savings rate jumped to 4.3 percent in 2009 from a profligate 1.7 percent in 2007, with Americans stashing $471 billion in 2009 compared to $178 billion in 2007. Even if every dollar saved by all 130 million U.S. households were put into Treasuries, that would only soak up 30 percent of the 2010 deficit.

You see where this is going. There don't appear to be enough foreign or domestic buyers to absorb the $1.56 trillion in Treasury bonds needed to fund the 2010 deficit. No wonder Morgan Stanley's analysts have concluded that there could be a shortfall in demand for $598 billion later this year.

Ferguson noted that the Federal Reserve was a major buyer in 2009, and presumably the Fed will continue acting as the "buyer of last resort." But as political scrutiny of the Fed's secretive actions intensifies, it doesn't take much imagination to foresee that the Fed's role as savior of soaring trillion-dollar deficits may be questioned and eventually curtailed.

Even if the Fed sopped up a staggering $500 billion in T-Bills, and domestic buyers snapped up another $500 billion, that still leaves $560 billion of new bonds to sell, plus the billions of dollars of maturing bonds that have to be rolled over into new debt. And let's suppose that by heroic efforts, the entire 2010 $1.56 trillion deficit is taken up without a murmur. Then the Treasury will have to gear up to sell 2011's trillion-dollar deficit.

Budgets released by wishful thinkers in the White House forecast a reduction in future deficits, but there is little evidence of the powerful economic boom and rising tax revenues that would be required to reduce structural federal deficits.

What if investors sell other assets to put the cash into Treasuries? According to the BEA, U.S. households have a net worth of about $52.9 trillion, down from $63.9 trillion in 2007—a decline of $11 trillion. About $33 trillion of these assets are financial (stocks, bonds, and other securities) and $20 trillion are business and real estate assets. Stock holdings account for about $11.3 trillion.

Since the 2009 and 2010 deficits alone require almost $3 trillion in new Treasury debt, a few more years of trillion-plus dollar deficits will quickly reach the once unimaginable sum of $10 trillion. So what happens to the market value of assets such as stocks or real estate if there is massive sell off to raise trillions to buy T-Bills? The value of those assets would fall dramatically—it's simple supply and demand.

The scenario few are willing to entertain is also a function of supply and demand: if the Treasury has to constantly raise rates to entice buyers, the interest paid by the government could quickly devour a major chunk of the federal budget. And what then? Either spending is cut or taxes are raised.

Stupendous deficits have pernicious consequences. We accept the Keynesian fantasy at our peril. ■

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How Liberals Kill

Harold Koh learns to love bomb power.

By Chase Madar

AT THE END OF MARCH, Harold Koh, top lawyer at the State Department, used his keynote address at the annual confab of the American Society for International Law to make an announcement: the use of Unmanned Aerial Vehicles to kill suspected terrorists is legal. The drone strikes in Pakistan and Afghanistan are lawful because, Koh delineated, they are done only in national self-defense, their proportionality is always precisely calibrated, and they carefully discriminate civilians from combatants.

There's both more and less to it than that, but the legal argument itself is of minor importance. What matters is that Koh said it. Harold Hongju Koh: renowned human rights advocate; leading theorist of international law (which, the ASIL conventioneers would happily have told you, is much more civilized than mere national law); until last year dean of Yale Law School and therefore unofficial pope of the American legal system, and former director of the school's Orville H. Schell Jr. Center for International Human Rights; Obama appointee accused by Glenn Beck and likeminded screamers of wanting to smuggle Sharia law into U.S. courts. All of which is to say, if a liberal lion like Harold Koh says drone strikes are lawful, what more do you need to know?

Koh's lecture—warmly applauded by the conventioneers—demonstrates once again the amazing elasticity of international law when it comes to the prerogatives of great powers. Koh's lecture also demonstrates the accommodating suppleness of several international lawyers who, once strong critics of George W. Bush's anti-terror policies, now see things differently from inside the Obama administration.

For Harold Koh had been one of the strongest and most prestigious voices raised against the post-9/11 policies of Bush and Cheney. From his throne at Yale Law, he inveighed against the unlawful use of torture, against the unlawful invasion of Iraq, against the unlawful detentions at Guantanamo. (He has argued that the U.S. risks a permanent spot on the "axis of disobedience" for its chronic flouting of international law.) If it had been W. intensifying the drone strikes in Central Asia, one can easily imagine Koh condemning this practice as another brazen violation of international law. What happened?

It was inevitable that Koh would dutifully come up with legal rationales for whatever the Obama administration decided to do. Part of this is the nature of his job; part of it is to be found plainly written in his own scholarship.

First, running the Legal Advisor's Office at the U.S. State Department does not mean full freedom of action. In the words of the late international law eminence Tom Franck, at State the legal culture "is that of the defense counsel when it finds ways to justify, post hoc, the client's actions, rather than that of an expert advising the client to choose the best legally-permissible course of action." In short, the primary function of State Department lawyers is to come up with legal rationalizations that can pass the smell test. On some small issues, they may have a policy role, but on the big issues—making war, use of drones, setting up prisons outside the reach of any law—their voice is faint, even negligible. Liberals who expected that Harold Koh, the scourge of waterboarding, would bring a human rights sensibility to major foreign-policy issues were going to be disappointed.

Then there is Koh himself. He gained fame in lefty circles for his work to free and grant legal-immigrant status to Haitian refugees warehoused at Guantanamo—yes, it's been a detention camp before—in the early '90s. But Koh's foreign-policy views and opinion of America's rightful role in the world fit snugly into the Beltway consensus. Israel and Palestine? According to Koh, America was an honest broker in this conflict until Bush and Cheney disengaged in 2001, "with consequences akin to removing adult supervision from a playground populated by warring switchblade gangs." One might question the aptness of this metaphor since America gives $3 billion dollars a year in military aid to one of these "switchblade gangs," a patronage relationship that, in the eyes of the world and the parties in conflict, has always disqualified us from being neutral arbiters.

As for Afghanistan, like most international jurists Koh barely bothered to justify the 2001 invasion as a no-brainer exercise of legitimate *jus ad bellum*. Wasn't Osama bin Laden there somewhere? That the 9/11 hijackers received much of their indoctrination and train-