Rising rates could threaten recovery

Massive U.S. borrowing binge poses challenge to Fed, Treasury
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As the U.S. Treasury continues to churn out hundreds of billions of dollars of fresh debt, officials are confronting one of the thorniest problems since the financial crisis began.

Who's going to buy all this paper? And if demand dries up, how much higher will interest rates have to go to attract new buyers?

The question is not just academic. When the crisis first hit last fall, investors worldwide sought shelter in U.S. Treasuries, and interest rates plunged. That helped to shore up battered banks and restart the housing industry with low mortgage rates

But now, as the financial crisis seems to have waned and the global economy shows signs of recovering, interest rates have begun rising, or "backing up." Any further rise in rates could throw cold water on the economy, boost the cost of mortgages and other loans and push back the recovery that many forecasters are looking for before the year is over.

"Along with declining home prices, those (lower) interest rates were key to reviving housing demand," said Thomas Higgins, chief economist with the Los Angeles investment management firm Payden & Rygel. "That's a key risk for the latter part of the year. We know where the crisis began, and it began in housing. And we need housing to recover."

Fed officials say they are committed to keeping rates low, but it remains to be seen how far it can defend its target in the global money market. The central bank typically manages only short-term lending rates used by banks for overnight loans. Since the financial crisis hit last fall, the Fed has embarked on a bold experiment to push down longer-term rates by wading into the multitrillion-dollar global market for Treasuries.

The Fed's task is made more complicated by the hundreds of billions in fresh debt paper the Treasury is churning out to finance the economic stimulus package, plug the growing hole in the federal budget and roll over the huge pile of past government borrowing that comes due every quarter. To attract investors to buy those bonds, the Treasury pays interest rates based on the lowest bids at auction. If investors demand higher rates, the cost of all long-term borrowing goes up.

"The government is keeping these rates lower and there are no legitimate, long-term real buyers of size to handle these auctions and the mortgage product that's being produced to try to stimulate the economy," said Rich Berg, CEO of Performance Trust Capital Partners. "So (rates are headed higher) unless Uncle Sam is going to finance the whole thing for the next 20 years, which is not going to happen."

That's one reason Treasury Secretary Timothy Geithner went to China this week: to drum up continued demand for U.S. debt. The worry is that if China loses its appetite for Treasuries, rates could move even higher.

"We actually have some experience of what happens when China stops buying because China stopped buying agency bonds and Freddie and Fannie bonds last fall, and for a brief period (rates) on agencies went up significantly," said Brad Setser, a fellow at the Council on Foreign Relations and recent author of a paper, "If the Dollar Plummets." "And those rates only came down when the Fed started buying. So if you lose a big buyer, it does have an impact on the market.

As suggested by Setser's paper, foreign investors and governments are also worried about the impact of the surge in U.S. borrowing on the value of the dollar. A falling dollar can hurt the value of existing Treasury holdings.

In his trip to China, Geither also sought to reassured Chinese leaders that the U.S. is serious about paying down this new borrowing quickly and that the Chinese government's $760 billion investment in dollar-denominated debt is safe.

But concerns about the dollar have been growing in Beijing for some time. Earlier this year, Chinese leaders wondered out loud about long-term damage on the dollar from the borrowing binge and suggested the world needs a new "reserve" currency for global trade. (That view was echoed Tuesday by Russian Prime minister Dmitry Medvedev in an interview with CNBC.)

In the short run, China faces a difficult choice, say analysts. If it holds back on buying Treasuries, it risks accelerating the decline in the dollar's value. That would both reduce the value of existing dollar holdings and force the value of its own currency, the yuan, to rise. A stronger local currency would make China's exports more expensive abroad, stifling growth of the country's manufacturing-based economy.

But over the longer run, said Setser, the huge flow of dollars between the two countries may not be sustainable.

“China no longer seems confortable subsidizing American (borrowing and) consumption — and in the process subsidizing Chinese exports,” he said. “From the American point of view, the binge of borrowing that the U.S. went on from 2002 to 2008 — borrowing that China in no small part financed — didn’t end out too well. So both parties, I think, are recalibrating their interests. But in the short run, they’re still stuck in the marriage because the cost of getting out is quite high.”

The recent signs of global economic recovery also have revived fears that inflation may return as demand increases for raw materials like oil and other commodities. Oil prices have nearly doubled from their lows in just the past three months. Gold prices are approaching record highs.

Inflation worries also push the dollar lower and interest rates higher.

“As the economy has started to look like it's at least no longer in free fall, people are looking forward to what happens when we emerge from the recession,” said Michelle Girard of RBS Greenwich Capital. “You see more people focus on the inflationary consequences of all the liquidity that the Fed has put into the system.”

The Fed also risks falling into a vicious cycle as it serves as the buyer of last resort for U.S. Treasury debt. As rate pressure rises, the Fed has to buy more Treasuries to prop up prices and keep a lid on long-term interest rates. To pay for those Treasuries, the central bank issues more Federal Reserve notes, aka cash. That extra cash increases the risk of inflation, and the cycle continues.

Most economists expect that the economic recovery, when it comes, will be weak until the housing market works through a glut of unsold homes and employers create enough new jobs to make a dent in the nearly 6 million positions lost since the recession began.

“We lost $20 trillion of net worth just over the past year and a half,” said David Rosenberg, chief economist at Gluskin Sheff & Associates. “So we have this severe trauma in the household balance sheet. There is definitely going to be lingering impact from that, whether we're in a technical recession or not, for the next several years.”

Those households will have an even tougher time getting back on their feet if rising interest rates boost the cost of borrowing to buying a new house or car.