U.S. Debt Expected To Soar This Year

$2 Trillion Increase May Test Federal Ability to Borrow

By Lori Montgomery
Washington Post Staff Writer
Saturday, January 3, 2009; A01

With President-elect Barack Obama and congressional Democrats considering a massive spending package aimed at pulling the nation out of recession, the national debt is projected to jump by as much as $2 trillion this year, an unprecedented increase that could test the world's appetite for financing U.S. government spending.

For now, investors are frantically stuffing money into the relative safety of the U.S. Treasury, which has come to serve as the world's mattress in troubled times. Interest rates on Treasury bills have plummeted to historic lows, with some short-term investors literally giving the government money for free.

But about 40 percent of the debt held by private investors will mature in a year or less, according to Treasury officials. When those loans come due, the Treasury will have to borrow more money to repay them, even as it launches perhaps the most aggressive expansion of U.S. debt in modern history.

With the government planning to roll over its short-term loans into more stable, long-term securities, experts say investors are likely to demand a greater return on their money, saddling taxpayers with huge new interest payments for years to come. Some analysts also worry that foreign investors, the largest U.S. creditors, may prove unable to absorb the skyrocketing debt, undermining confidence in the United States as the bedrock of the global financial system.

While the current market for Treasurys is booming, it's unclear whether demand for debt can be sustained, said Lou Crandall, chief economist at Wrightson ICAP, which analyzes Treasury financing trends.

"There's a time bomb in there somewhere," Crandall said, "but we don't know exactly where on the calendar it's planted."

The government's hunger for cash began growing exponentially as the nation slipped into recession in the wake of a housing foreclosure crisis a year ago. Washington has since approved $168 billion in spending to stimulate economic activity, $700 billion to prevent the collapse of the U.S. financial system, and multibillion-dollar bailouts for a variety of financial institutions, including insurance giant American International Group and mortgage financiers Fannie Mae and Freddie Mac.

Despite those actions, the economic outlook has continued to darken. Now, Obama and congressional Democrats are debating as much as $850 billion in new federal spending and tax cuts to create or preserve jobs and slow the grim, upward march of unemployment, which stood in November at 6.7 percent.

Congress is not planning to raise taxes or cut spending to cover the cost of those programs, because economists say doing so would further slow economic activity. That means the government has to borrow the money.

Some of the borrowing was done during the fiscal year that ended in September, when the Treasury added nearly $720 billion to the national debt. But the big borrowing binge will come during the current fiscal year, when the cost of the bailouts plus another stimulus package combined with slowing tax revenues will force the government to increase the debt by as much as $2 trillion to finance its obligations, according to a Treasury survey of bond dealers and other market analysts.

As of yesterday, the debt stood at nearly $10.7 trillion, of which about $4.3 trillion is owed to other government institutions, such as the Social Security trust fund. Debt held by private investors totals nearly $6.4 trillion, or a little over 40 percent of gross domestic product.

According to the most recent figures, foreign investors held about $3 trillion in U.S. debt at the end of October. China, which in October replaced Japan as the United States' largest creditor, has increased its holdings by 42 percent over the past year; Britain and the Caribbean banking countries more than doubled their holdings.

Economists from across the political spectrum have endorsed the idea of going deeper into debt to combat what many call the most dangerous economic conditions since the Great Depression. The United States is in relatively good financial shape compared with other industrial nations, such as Japan, where the public debt equaled 182 percent of GDP in 2007, or Germany, where the debt was 65 percent of GDP, according to a forthcoming report by Scott Lilly, a senior fellow at the Center for American Progress.

Even a $2 trillion increase would push the U.S. debt to about 53 percent of the overall economy, "only a few percentage points above where it was in the early 1990s," Lilly writes, noting that plummeting interest rates show that "much of the world seems not only willing but anxious to invest in U.S. Treasurys, which are seen as the safest security that an investor can own in a risky world economy."

Still, some analysts are concerned that the deepening global recession will force some of the largest U.S. creditors to divert cash to domestic needs, such as investing in their own banks and economies. Even if demand for U.S. debt keeps pace with supply, investors are likely to demand higher interest rates, these analysts said, driving up debt-service payments, which last year stood at $250 billion.

"When you accumulate this amount of debt that we're moving into, it's not a given that our foreign friends are going to continue on the path they've been on," said G. William Hoagland, a longtime Republican budget analyst who now serves as vice president for public policy at the health insurer Cigna. "There's going to come a time when we can't even pay the interest on the money we've borrowed. That's default."

Others say those fears are overblown. The market for U.S. Treasurys is by far the largest and most liquid bond market in the world, and big institutional investors have few other places to safely invest large sums of reserve cash.

Despite their growing domestic needs, "China and the oil countries are going to continue running large surpluses," said C. Fred Bergsten, director of the Peterson Institute for International Economics. "They certainly will be using money elsewhere, but I don't think that means they won't give it to us."

As for the specter of default, Steven Hess, lead U.S. analyst for Moody's Investors Service, said even a $2 trillion increase in borrowing would not greatly diminish the U.S. financial condition. "It's not alarmingly high by our AAA standards," he said. "So we don't think there's pressure on the rating yet."

But that could change, Hess said. Nearly a year ago, Moody's raised an alarm about the skyrocketing costs of Social Security and Medicare as the baby-boom generation retires, saying the resulting budget deficits could endanger the U.S. bond rating. Even as the nation sinks deeper into debt to finance its own economic recovery, several analysts said it will be critical for Obama to begin to address the looming costs of the entitlement programs and signal that he has no intention of letting the debt spiral out of control.

Failure to do so, Bergsten said, would "create dangers . . . in market psychology and continued confidence in the dollar."