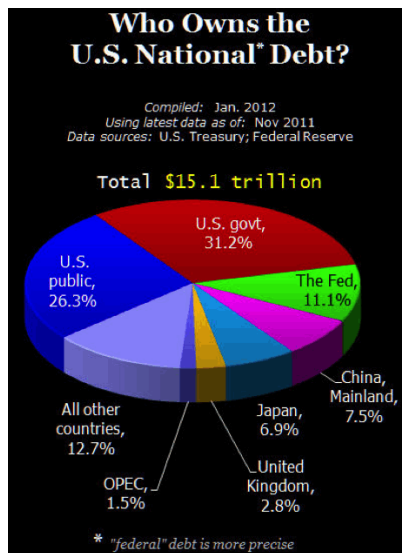


Why Growth Matters More Than Debt

By Editor Test Wed, Aug 29, 2012

The author explains why the national debt shouldn't terrify us. This article first appeared last January in The American, the publication of the American Enterprise Institute.



The U.S. federal debt recently eclipsed \$15 trillion, and is still climbing. That has generated headlines and raised a lot of questions. How should we behave towards China, supposedly our biggest creditor? Has the debt burden become unsustainable? How will our kids and grandkids ever pay off the debt we've been accumulating? The answers contain some surprises.

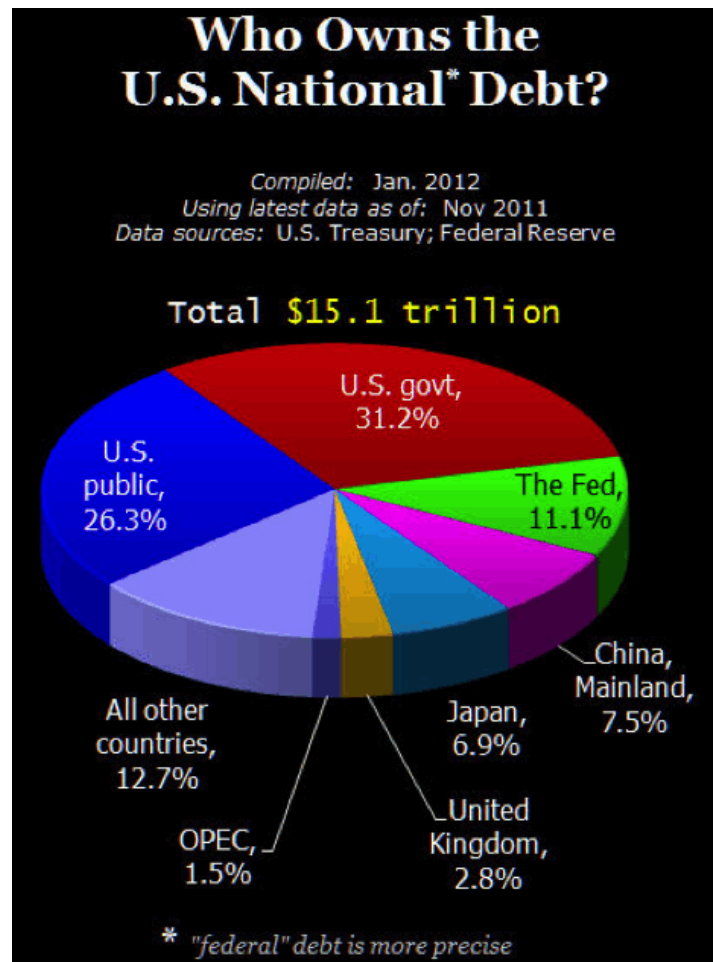
A total federal debt of \$15 trillion means debt owners currently hold assets totaling \$15 trillion in Treasury bonds, bills, and notes. Let's examine who owns those assets.

Who owns the debt?

A pie chart is a convenient way of showing how those assets break down by owner. At the time of this writing, the latest official numbers are for December 2011. (The official numbers are updated monthly: The Treasury summarizes our debt position; the Fed estimates the magnitude of foreign holdings by country and reports its own holdings of Treasury securities.)

The United States' two largest creditors are U.S. citizens and the U.S. government. (Yes, the U.S. government owes itself a substantial sum of its own money; for years, Uncle Sam's social insurance fund has been using its surpluses to purchase special bonds from Uncle Sam's general fund.)

What does the pie chart reveal? At least one fact stands out: China's holding of the total federal debt comes in a distant fourth—behind the U.S. government, the U.S. public, and the Federal Reserve. Interestingly, China and Japan have been neck-and-neck for years as the two *foreign* entities most desirous of exchanging their export-derived U.S. dollars for interest-bearing U.S. Treasury securities.



How will we pay China (and Japan) back?

That is a misleading question, because every time one of their U.S. Treasury securities matures, we really do “try” to pay them back—with (non-interest-bearing) U.S. dollars. We are *obligated* to redeem their maturing securities with dollars; otherwise, we would be in default—a scenario that has never, and should never, happen. But the Chinese and Japanese debt holders have been turning right around and exchanging those dollars, in the open market, for *brand new* U.S. Treasury securities. In effect, we keep trying to pay them back, but they won't let us; they'd rather hold interest-bearing T-bonds than non-interest-bearing dollars. It's their choice, and they've been consistently rolling their maturing T-bonds over into new T-bonds.

So the proper question is not how will we pay the foreigners back but rather how do we propose to maintain China and Japan's *desire* to buy low-interest Treasury securities from us? The answer: A healthy, robust, growing economy is the only way to maintain their confidence in the long run. If they ever started losing confidence in our economy's prospects, their appetite for acquiring U.S. Treasury securities would be likely to wane, creating upward pressure on our interest rates; that in turn would not help our “debt burden”—which is explained in the section below.

Our priority should not be how to pay them back, it should be how to get our economy growing again.

How much of a burden is the debt?

Because of our large and (historically) robust economy, the worldwide demand for U.S. Treasury securities has been huge; investors view the T-bond as the world's safe haven. Therefore, rolling the debt over (as described above)—instead of paying it down—has never been a problem. Because the debt has always been rolled over, the debt principal has *not* been a burden to taxpayers. The “burden” the taxpayers must bear has always been the *interest* on Treasury securities—*not* the principal.

Specifically, the debt “burden” is directly indicated by the “interest bite”: the *portion of tax receipts required to cover the interest on the debt*. When the interest bite is increasing, the debt is becoming less sustainable; conversely, when the interest bite is decreasing, the debt is becoming *more* sustainable.

What makes the interest bite grow or shrink? The debt level is just one of three primary factors. A second factor is the *interest rate* demanded by the buyers of T-bonds; for example, when they demand only 1 percent interest, the “burden” of any given level of debt is 80 percent smaller than it would have been had they demanded a whopping 5 percent.

The third factor affecting the interest bite is the level of *tax receipts*. For any given tax-rate structure, the larger the economy and the more people who are working and paying taxes, the larger the government's tax receipts—and the lower the debt burden, i.e., the interest bite. A strong economy strengthens our ability to sustain any given debt level.

In summary, there is upward pressure on the “debt burden” when the interest rate rises, the debt level increases, or tax receipts fall. Conversely, there's downward pressure when the interest rate falls, the debt level decreases, or tax receipts increase.

And with that, it is time to answer the question, how big is our debt burden today? The graphic below shows the answer.



In recent decades, the interest bite has been as high as 19 percent and as low as 9 percent. The chart above shows how the interest bite has tracked for the last 13 years, through December 2011. Mildly surprising is the fact that the current interest bite is no higher than it was ten years ago.

Why is today's debt burden—as measured by the “interest bite”—*lower* than the headlines and political rhetoric make it sound? Because even though the debt level is currently growing at a rapid pace, the interest *rate* on the new debt we've been issuing is as close to zero as it has ever been. A near-zero interest rate results in a near-zero interest bite on any level of debt. That's the good news, but it carries with it an ominous qualification: when the debt level is skyrocketing, as it is today, any increase in the interest rate will quickly cause the interest bite to skyrocket as well—unless it's offset by additional tax receipts generated by a rapidly growing economy.

In short, today's relatively low debt burden is merely indicating that we have at least some runway left before it starts challenging the recent high of 19 percent; we would be well advised to use that runway for getting the private sector economy back to robust growth rates. The intent of extraordinary fiscal and monetary interventions by the government is to stop the bleeding in the short run, but the long run depends on the private sector's economic health.

'It's the economy, stupid'

Notably, everything about keeping the debt burden at an acceptable level ultimately depends on the health of our economy. Can we count on China, Japan, the United Kingdom, and OPEC to continue rolling their maturing T-bonds into new T-bonds? Can we count on continued low interest rates due to the T-bond's reputation as a safe haven? We can if the economy gets back on track. If it does, we can expect the debt burden—the “interest bite”—to remain at an acceptable level, presumably somewhere between today's 10 percent level and the recent high of 19 percent.

Again, all of those factors depend on the size, health, and growth rate of our economy. The bond market's judgment as to the U.S. government's creditworthiness depends on it, and the bond market "knows" that growing the U.S. economy is far more important than shrinking the number of outstanding U.S. Treasury securities—i.e., than "paying down" the federal debt. In short, what's important for the sustainability of our creditworthiness is not the debt level; instead, what's far more important is to keep the debt *burden*—the "interest bite"—inside the guardrails.

The 1992 Clinton campaign had it exactly right: "It's the economy, stupid."

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