

Market alarm as US fails to control biggest debt in history

US Treasuries last week suffered their biggest two-day sell-off since the collapse of Lehman Brothers in September 2008. The borrowing costs of the government of the world's largest economy have now risen by a quarter over the past four weeks.



Market alarm as US fails to control biggest debt in history Photo: EPA

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Such a sharp rise in US benchmark market interest rates matters a lot – and it matters way beyond America. The US government is now servicing \$13.8 trillion (£8.7 trillion) in declared liabilities – making it, by a long way, the world's largest debtor. Around \$414bn of US taxpayers' money went on sovereign interest payments last year – around 4.5 times the budget of America's Department of Education.

Debt service costs have reached such astronomical levels even though, over the past year and more, yields have been kept historically and artificially low by “quantitative easing (QE)” – in other words, Federal Reserve Chairman Ben Bernanke's virtual printing press. Now borrowing costs are 28pc higher than a month ago, with [the 10-year Treasury yield reaching 3.33pc](#) last week, an already eye-watering debt service burden can only go up.

Few on this side of the Atlantic should feel smug. The eurozone's ongoing sovereign debt debacle has pushed up Germany's borrowing costs by 27pc over the last month – to 3.03pc. The market has judged that if Europe's Teutonic powerhouse wants the single currency to survive, it will ultimately need to raise wads of cash to absorb the mess caused by other member states' fiscal incontinence.

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While the UK isn't ensnared in monetary union, gilt yields have also spiralled 18pc since the start of November – to 3.55pc. British Government debt is officially £1.05 trillion. We are fast approaching a debt-to-GDP ratio of 100pc, compared to 30pc just a decade ago. If you add off-balance-sheet liabilities to Government estimates, including the bank bail-outs which disgracefully remain “off the books”, the UK already owes more than an entire year's national income. In the medium-term, this is surely incompatible with a Triple AAA credit rating.

Even with gilt yields ultra-low, courtesy of British QE, the UK is still spending £42bn a year servicing sovereign debt – up 50pc since 2008. The Coalition is talking tough about reining-in the annual budget deficit, but our burgeoning debt stock means interest payments are anyway set to reach £70bn – twice the defence budget – by 2015. And those numbers rest on low gilt-yield assumptions that will be blown out of the water if this recent bond market implosion is the start of a trend.

Some say that [growing signs of a US economic recovery are positive for stocks](#), which means money is being diverted out of Treasuries, so lowering their price, which pushes up yields. That's wishful thinking. Sovereign borrowing costs have just surged in the US – and therefore elsewhere – because a politically-wounded President Obama caved-in and extended the Bush-era tax cuts, combining them with a \$120bn payroll tax holiday.

Lower taxes, and the certainty of lower taxes, may bolster business investment and growth. That's the logic employed by those painting last week's global yield spike in a positive light. Government borrowing costs rose in America and elsewhere, they say, as a re-bounding US economy is now drawing investors' cash away from sovereign bonds and towards more productive uses.

The reality is, though, that the market is increasingly alarmed at the rate of increase of the US government's already massive liabilities. America's government debt is set to expand by a jaw-dropping 42pc over the next few years, reaching \$19.6 trillion by 2015 according to Treasury Department estimates presented (amid very little fanfare) to Congress back in June. Since then, government spending has risen even more. So US debt service costs, like those of many other Western nations, are expanding rapidly in terms of both the volumes of sovereign instruments outstanding, and the yields on each bond.

The new worry in the market is that this latest round of tax cuts could add another \$1 trillion to the US deficit, on top of the already horrendous numbers produced in June. With opinion now deeply split about the wisdom of yet another round of QE, bond investors are getting increasingly worried that the Fed will turn off the funny-money and the sugar-rush will fade. Meanwhile, the US has very few plans – and none of them remotely credible – to get to grips with the biggest debt in history.

America has lately been very happy for small eurozone members to endure most of the adverse publicity related to the sovereign bond crisis. But, as of last week, the Western government debt debacle has entered the big league. We're going to hear a lot more about the US government's borrowing costs over the coming months – and the related “contagion” of other countries' treasury bills, as America's funding issues focus attention on the scale and ratcheting interest costs of sovereign debts in other large economies too.

Until now, market attention has oscillated between the eurozone and the States, with one region's debt instruments benefiting from the woes of the other. Last week marked a turning point. Western sovereign instruments were hammered across the board – with traders making little distinction between the debts of Germany or Japan. There's a

lot more of this to come.

Investors en masse are parking ever more cash in alternative asset classes, such as commodities, other tangible assets and emerging market sovereign debts. The pool of money available to finance Western government borrowing is, in relative and maybe even in absolute terms, starting to shrink. This is extremely worrying – not least because of the industrialised world's demography. Our ageing population means that higher future borrowing requirements are practically guaranteed, even if our politicians become paragons of fiscal virtue – which, of course, they won't. As one economist I admire recently quipped: "Expecting today's Western leaders to run fiscal surpluses is like expecting dogs to stockpile sausages".

Just a few months ago, it was only newspaper scribblers like me, and other naturally dissenting voices, who dared to be openly critical of grotesquely irresponsibly policies such as QE. Yet increasing numbers of important voices are now saying that, in fact, the Emperor has no clothes. Last week the patience of many bond traders snapped too. That marked a very important moment.

The US will continue to run a budget deficit of in excess of 10pc of GDP for at least another year. This is in marked contrast to most other advanced economies, where the fiscal axe is now being swung, with consolidation now beginning in earnest. The danger is that the bond markets won't care – and almost all Western sovereign instruments will become burdened with a big risk premium, even the bonds of those countries which have actually bitten the bullet and started to impose serious fiscal reforms. If ministers in Britain and Germany would like to know in advance what this feels like and the domestic political havoc it can cause, they should talk to their Irish counterparts.

Over the coming months, the world's appetite for dollar assets will be very severely tested – perhaps very close to destruction. America boasts the world's reserve currency, of course, but its ability to borrow from the rest of the world is not without limit. Last week's US tax move poses great dangers. There is little point in a fiscal giveaway that's cancelled out by higher rates. All you end up with is even more sovereign debt. Upgraded growth forecasts don't cause yield spike like that we saw last week – and it's absurd to suggest that they do. There's a new mood in the bond markets – a mood of zero tolerance.

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