

Barack Obama tests bond markets with mega-deficits

US President Barack Obama faces a stiff battle with Republican foes in Congress after unveiling plans for \$7.2 trillion (£4.5 trillion) of deficit spending over the next decade, and making little attempt to control the spiralling costs of social security and medical entitlements.



Mr Obama aims to cut \$1.1 trillion in fiscal fat over the next decade Photo: AFP

By [Ambrose Evans-Pritchard \(http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/\)](http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/) , International Business Editor

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Mr Obama proposed a budget that will push the this year's deficit to a fresh record of \$1.65 trillion or 11pc of GDP, partly due to payroll tax cuts agreed with Congress last Autumn. It is unprecedented to run deficits on this scale two years into recovery.

While he called it a budget of "hard choices and sacrifices" needed to return the US to a sustainable debt trajectory, the deficit is significantly above the \$1.5 trillion recommended by the Congressional Budget Office (CBO).

Paul Ryan, Republican chair of the House Budget Committee, accused Mr Obama of a "total abdication" of leadership. "I expected more taxes, but I also expected more spending controls or reforms, but we're not getting any of it."

Mr Obama aims to cut \$1.1 trillion in fiscal fat over the next decade. This relies on rosy growth forecasts and falls far short of the \$4 trillion squeeze demanded by his own deficit commission. It would push the US national debt further into the danger zone.

The IMF already expects US gross public debt to double from 62pc of GDP in 2007 to 111pc by 2015, a figure that will now have be revised upwards.

[Barack Obama's 2012 budget: main points \(http://www.telegraph.co.uk/finance/economics/8323747/Barack-Obamas-2012-budget-main-points.html\)](http://www.telegraph.co.uk/finance/economics/8323747/Barack-Obamas-2012-budget-main-points.html)

[Obama's 2012 budget: economists' reaction to deficit curbs \(http://www.telegraph.co.uk/finance/economics/8323702/Obamas-2012-budget-economists-reaction-to-deficit-curbs.html\)](http://www.telegraph.co.uk/finance/economics/8323702/Obamas-2012-budget-economists-reaction-to-deficit-curbs.html)

[Obama unveils \\$3.73 trillion budget \(http://www.telegraph.co.uk/finance/economics/8323849/Barack-Obama-budget-to-cut-deficit-by-1.1-trillion.html\)](http://www.telegraph.co.uk/finance/economics/8323849/Barack-Obama-budget-to-cut-deficit-by-1.1-trillion.html)

[Barack Obama: 2012 budget is a 'down payment' \(http://www.telegraph.co.uk/news/worldnews/northamerica/usa/barackobama/8324345/Barack-Obama-2012-budget-is-a-down-payment.html\)](http://www.telegraph.co.uk/news/worldnews/northamerica/usa/barackobama/8324345/Barack-Obama-2012-budget-is-a-down-payment.html)

The White House proposes a 5-year freeze in discretionary spending. This covers just an eighth of federal spending. Mr Obama has chosen not to court political fate by slashing entitlements, chiefly the trio of social security, medicare, and medicaid that ratchet ever upwards.

House Speaker John Boehner said the long-term cuts were not nearly enough. "We're broke. Let's be honest with ourselves," he said, calling for every area of spending to be examined.

The Republicans could resort to the 'nuclear option' of shutting down the US government if Mr Obama refuses to meet them half way, but such Capitol Hill poker has to be played carefully.

The US Treasury market gave a muted reaction to the spending details yesterday, but some analysts fear this may be the calm before the next storm.

Ten-year yields have already jumped 120 basis points since October, partly on concerns over fiscal laxity. It remains unclear whether bond vigilantes will tolerate such extreme deficits once the Fed's quantitative easing (QE) ends in June..

"The US is pushing its luck," said Stephen Lewis from Monument Securities. "Markets sense that Obama is reluctant to cut spending before the election in 2012. The Fed may have to stop QE because the policy of asset purchases is pushing up commodity prices, and when that happens the bond markets could react in a very negative way."

Mr Obama plans a big shift in energy policy, cutting subsidies for the oil and gas industry and rotating money into solar, wind, and other green energy sources. While he hoped to overhaul the US corporate tax system by closing loopholes and cutting the 35pc rate, there was no clear timetable.

Defence spending will increase this year by \$22bn to \$671bn to cover Afghanistan, and cyberwarfare threats, before facing a squeeze from 2013 onwards.

Nobel economist Paul Krugman said the Obama plan is "much less awful" than Republican austerity, arguing that the economy is not yet strong enough to withstand fiscal tightening. This is becoming a minority view outside Keynesian academic circles.

The CBO warned last month that debt interest is "poised to skyrocket" without drastic cuts. Fresh borrowing will reach \$12 trillion over the next decade on current policies, pushing public debt to nearly 140pc under IMF measures. Even if Washington faces up to the crisis by raising taxes a third, debt interest costs will still jump from 1.5pc to 3.3pc of GDP.

While countries such as Japan can draw on a reservoir of domestic savings to cover big debts, the US has no such luxury. The savings rate is just 5.3pc. The US relies on Japan, China, and other foreigners to finance 40pc of its debt.