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RED, WHITE and BROKE?
Why America Will Not Go Bankrupt

By Ali Anari

Since the collapse of Iceland's financial system in October 2008, the Real Estate Center has received emails and phone calls asking whether the United States will be next. In particular, *Tierra Grande* readers have been concerned about the impact of the growing national debt on the economy.

How much debt can the United States take on before the dollar falls, interest rates go up and the specter of hyperinflation becomes reality?

Iceland's Economic Woes

Iceland's gross domestic product (GDP) was about $14 billion in 2006, roughly the same as the GDP of Corpus Christi, Texas.

The episodic rise and fall of Iceland's economy began with deregulation of the banking industry, creation of a domestic stock market and access to international funds in the mid-1990s. After these free-market reforms, the country's companies and banks embarked on a process of creating wealth and debt.

International funds were attracted by offering higher interest rates, and those funds were invested in foreign acquisitions in various industries from food processing to retailing and pharmaceuticals. Iceland's banks did not have any significant holdings in mortgage-backed assets as did U.S. banks. But, by the end of 2008, Iceland's top four banks held foreign liabilities of more than $100 billion, some seven times the nation's GDP.

The collapse of banking confidence at the end of 2008 cut off Iceland's banks from international funds. Iceland's government could not support its banking system because the banking sector dwarfed the government's financial resources.

In October 2008, the Icelandic government took control of the country's three largest banks, suspended trading on the Reykjavik stock exchange, and approached Sweden, Norway, the International Monetary Fund and Russia to secure loans. The country's currency, the krona, fell 50 percent in one week as foreign investors pulled out. Because foreign funds were used for mortgage loans, the currency collapse increased mortgage costs and led to falling house prices. Unlike the U.S. financial crisis that began with decreasing home prices, Iceland's financial crisis may end that way.

If economic stimulus measures succeed in growing the economy, public debt as a percentage of GDP will begin to fall.

U.S. Deficit Rising

For the United States and most other countries, 2008 was a difficult economic year. Total taxes collected in fiscal year (FY) 2008 rose only 1.9 percent from 2007. Falling U.S. tax revenues and stimulus payments associated with the Economic Stimulus Act of 2008 grew the federal budget deficit from 1.2 percent of GDP ($162.8 billion) in FY2007 to 2.9 percent ($454.8 billion) in FY2008.

Consequently, the national debt rose from $8.9 trillion in 2007 to an estimated $9.6 trillion in 2008 or 67.5 percent of GDP. According to Office of Management and Budget estimates, the total federal debt is projected to increase to $12.2 trillion in 2013.

Total national debt consists of two parts: debt held by the public and debt held by the federal government. Public debt consists of marketable securities owned by individuals, banks, corporations, state and local governments, Federal Reserve banks, foreign central banks and foreign governments.

In FY2008, public debt was $5.4 trillion or 56.2 percent of total national debt, accounting for 37.9 percent of U.S. GDP. Marketable securities, which include bills, notes, bonds and Treasury inflation-protected securities, accounted for 89.7 percent of public debt at the end of FY2008. About half of privately held U.S. Treasury securities are held by foreigners.

Federal government debt is "intragovernmental holdings" owed by one federal department to another. Intragovernment debt in FY2008 was $4.2 trillion, or 43.8 percent of total national debt, accounting for 29.5 percent of GDP. The most important item in intragovernment holdings is the federal

old-age and survivors insurance trust fund, which accounted for 50 percent of total intragovernment holdings at the end of FY2008.

Public Debt and Inflation

By historical standards, the current ratio of public debt to GDP is not a record high. In 1946, a year after World War II ended, public debt amounted to 121 percent of the GDP (see figure). Thirty-five years later, in 1980, total federal debt as a percentage of GDP fell to an all-time low of 29 percent.

It is likely that the United States will repeat this rebound. If economic stimulus measures succeed in growing the economy, public debt as a percentage of GDP will begin to fall.

Budget deficits do not necessarily cause inflationary pressure. Whether or not budget deficits lead to higher inflation rates depends on the methods used for financing budget deficits, how the government spends its budget, the mix of monetary and fiscal policy, and the flow of capital into and out of the country.

Governments finance budget deficits by borrowing or printing money. When a government issues and sells commercial instruments (bonds, bills and notes) to finance public debt and the debt is purchased by individuals using money already in circulation, the process is deflationary (leads to lower inflation rates). This is because smaller quantities of money are in circulation to purchase the same amount of goods and services. But when the government prints new money to finance budget deficits, more money is available to purchase the same quantities of goods. The result is increased inflation.

This study analyzed annual time series data on U.S. inflation rates, growth rate of national debt, and growth rate of the ratio of national debt to GDP from 1940 to 2007. The estimated correlation coefficients did not suggest any significant link between national debt and inflation.

Using cross-section data on inflation rates and the ratio of public debt to GDP in 2007 for countries belonging to the Organization for Economic Cooperation and Development (OECD), a correlation coefficient of nearly zero was found for the relationship between inflation rate and the debt-to-GDP ratio. This suggested an insignificant relationship between the two variables. The United States ranked fifth among OECD countries listed by national debt to GDP in 2007 (Table 1).

Japan, with the highest national debt-to-GDP ratio, had the lowest inflation rate in 2007. Italy and Belgium had debt-to-GDP ratios higher than the United States but lower inflation rates. France, with a debt-to-GDP ratio close to that of the United States, had an inflation rate half that of the United States (Table 1).

Table 1. Public Debt to GDP, 2007

Country	Public Debt/GDP (Percent)	Inflation Rate
Japan	173.0	0.1
Italy	113.0	1.8
Greece	100.8	2.9
Belgium	92.2	1.8
United States	73.2	2.9
France	72.5	1.5
Germany	64.8	2.3
Canada	63.0	2.1
United Kingdom	58.7	2.3
Australia	14.2	2.3

Source: Organization for Economic Cooperation and Development

Public Debt and Exchange Rate

Any discussion of the impact of national debt on the international value of the U.S. dollar should take into consideration the fact that the dollar has been in a unique position since it became an international reserve currency. The U.S. dollar became a reserve currency in 1944 when 44 nations signed the Bretton Woods agreement, and the U.S. government committed to redeem international dollar reserves at a fixed rate of $35 per ounce of gold. The U.S. government took advantage of the position of the dollar as a reserve currency and printed dollars to finance its trade and budget deficits in the 1960s and 1970s until it abandoned backing the dollar with gold in 1971.

After the collapse of the Bretton Woods System, most developed countries adopted a system of managed currency floating against other currencies. Developing countries adopted a system of fixed currencies, most of which were pegged to the U.S. dollar. Their currency's value depended on the value of the U.S. dollar.

The floating of currencies and lifting of restrictions on the movement of capital in the 1980s made conditions ripe for repeated financial crises in the international financial system. The most notable crises occurred in Mexico in 1994–95, Asia in 1997, Russia in 1998, and the collapse of Long-Term Capital Management (founded by Nobel Prize winners in economics) in 1998.

But the U.S. dollar managed to retain its position as the most dominant international reserve currency despite these upheavals. In 2007, the U.S. dollar accounted for more than 63 percent of official foreign exchange reserves. The only serious challenger to the dollar's position as the international reserve currency came from the euro, which increased its share of official foreign exchange reserves from 17.9 percent in 1999 to 26.5 percent in 2007.

Table 2. Foreign Holdings of U.S. Treasury Securities, September 2008

Year	$Billion	Percent of Total Debt
1997	1,230.50	22.7
1998	1,224.20	22.2
1999	1,281.40	22.7
2000	1,057.90	18.6
2001	1,005.50	17.3
2002	1,200.80	19.3
2003	1,454.20	21.4
2004	1,798.70	24.4
2005	1,930.60	24.3
2006	2,027.30	23.8
2007	2,237.20	24.8
2008	2,862.00	28.5

Source: Treasury Bulletin, December 2008

International demand for the U.S. dollar consists not only of foreign demand for U.S. goods and services but also demand for the U.S. dollar as a reserve currency. Another kind of demand for the U.S. dollar comes in the form of foreign holdings of U.S. Treasury securities by foreign governments and central banks as interest-bearing reserve accounts. The percent of U.S. Treasury securities held by foreigners increased from 22.7 percent of the U.S. total national debt in 1997 to 28.5 percent in 2008 (Table 2).

As the U.S. federal debt increases, there is growing concern that the dollar might collapse if foreign buyers of U.S. Treasury securities lose interest in holding U.S. dollars. But such

a scenario is unlikely given that 62.6 percent of U.S. Treasury securities held by foreigners are held by foreign governments and central banks, not by individuals. It is in the interest of foreign governments to prevent a dollar collapse to protect the value of their U.S. Treasury holdings and to keep their exports competitive.

China and Japan, for example, hold more than 40 percent of the U.S. Treasury securities held by foreigners. They are important trade partners for the United States and are keenly interested in preventing a dollar collapse. As long as dollar reserves account for two-thirds of the world's reserve currency, the possibility of a dollar collapse is remote.

One reason the dollar has retained its position as the dominant reserve currency is the lack of alternative reserve currencies. Foreign countries that want to sell their Treasury securities must determine where to invest their proceeds. The euro is currently more a political unit than an economic one. Any changes in the composition of reserve currencies are expected to be gradual.

The U.S. economy is the largest in the world. The GDP of France is equal to the GDP of California, the GDP of Canada is equal to the GDP of Texas. The United States, unlike individuals, has an infinite life expectancy and can roll over its national debt generation after generation by issuing new debts to replace old ones. The ratio of national debt to GDP in 2008 was not at a historic high and was much lower than that for Japan.

One person's interest payment and interest expense is another person's interest receipt and interest income, and in the case of U.S. Treasuries, most of the interest is paid to U.S. citizens because the bulk of the national debt is held by U.S. citizens, companies and local and state governments.

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THE TAKEAWAY

Despite escalating concerns about the rising deficit, the United States has had much worse debt-to-gross-domestic-product ratios in the past and has bounced back. The U.S. dollar is valued not just as a currency to purchase goods and services but also as an international reserve currency held by central banks and foreign governments. If the dollar fails, their foreign asset holdings would erode as a result.

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