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ECONOMIC POLICY BRIEF NOVEMBER 2006

RELYING ON THE KINDNESS OF STRANGERS: FOREIGN PURCHASES OF U.S. TREASURY DEBT

Increasingly, the United States is relying on foreign purchases of U.S. Treasury securities to finance the federal budget deficit. In the short run, borrowing from the rest of the world can moderate the harmful effect of budget deficits on U.S. interest rates. Over time, however, foreign borrowing has to be paid back with interest, and those payments must be made out of our future national income. Increased federal debt owed to China or the OPEC nations can also complicate our economic and foreign policy dealings with those countries.

Trends in federal debt and foreign borrowing

The federal government finances budget deficits by selling U.S. Treasury securities to the public. Until recently, almost all of those U.S. Treasury bonds, notes, and bills were purchased by individuals and institutions within the United States. Treasury securities are a very reliable investment that carry almost no risk of default because they are highly liquid (easy to buy and sell) and backed by the "full faith and credit" of the U.S. government. In the stable inflationary environment of the past two decades, Treasury securities have become a low-risk anchor that most investors want in their portfolios.

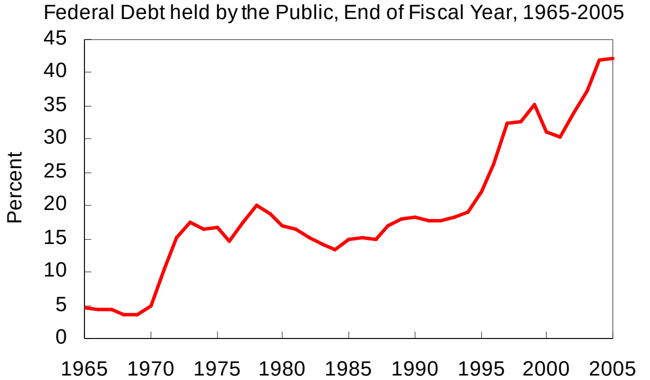
What has changed dramatically in recent years is the extent to which foreign investors, and increasingly foreign governments, have become purchasers of our government's debt. In 1965, foreigners owned just 4.7 percent of outstanding U.S. government debt (Treasury securities), but that figure was 42.1 percent last year, including an increase of 11.8 percentage points just since 2001 (**Chart 1**).

The percentage of federal government debt owned by foreigners rose in the 1990s as well, but as fiscal discipline began to reduce the federal debt (relative to the size of the economy), foreign ownership also leveled off and began to decline (**Chart 2**). With the re-emergence of large federal

Chart 1

Foreign Ownership of Federal Government Debt Has Climbed Above 42 Percent

Foreign-Owned U.S. Treasury Securities as a Percentage of Federal Debt held by the Public, End of Fiscal Year, 1965-2005

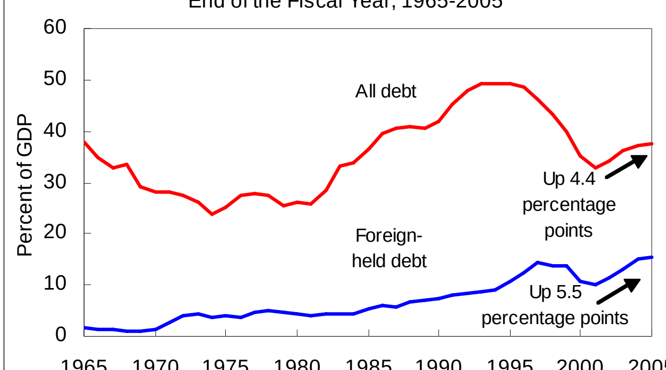


Source: Office of Management and Budget and U.S. Treasury Department.

Chart 2

Foreign Holdings Have Grown Faster than the Overall Federal Debt since 2001

Debt Held by the Public and Foreign-Owned Debt at the End of the Fiscal Year, 1965-2005



Source: Office of Management and Budget and U.S. Treasury Department.

budget deficits under President Bush, both the federal debt and foreign ownership of that debt have increased sharply. As a share of GDP, debt held by the public rose by 4.4 percentage points between 2001 and 2005. The value of foreign-owned securities as a share of GDP rose by an even larger 5.5 percentage points.

Impact of foreign debt purchases on U.S. interest rates

With the re-emergence since 2001 of large federal budget deficits and a growing federal debt, the debate over the economic consequences of budget deficits and debt has been rekindled. Vice President Cheney famously declared that "deficits don't matter," but that is not the consensus among economists. The standard argument is that federal debt competes with private investment for the pool of available domestic private saving, which drives up interest rates and discourages investment.

Some have argued that because interest rates have remained historically low in the current deficit environment, such "crowding out" has not occurred. Others recognize, however, that foreign purchases of U.S. debt, including U.S. government debt, have provided an interest rate "safety valve." For example, Federal Reserve Chairman Ben Bernanke has argued that this safety valve effect is the result of a "global savings glut," which has created an environment in which foreigners are acquiring U.S. government debt and other U.S. securities because they lack sufficiently profitable investment opportunities in their own country. A larger number of purchasers creates a greater demand for government debt, which allows the Treasury to pay a lower interest rate. As the ads for a prominent on-line mortgage broker say, when more banks compete for your business, you're better off.

Although foreign purchases of U.S. Treasury debt have almost certainly played a role in mitigating the interest-rate effects of large and persistent federal budget deficits, the deficits themselves are not benign. The adverse consequences of the budget deficits are evident in the sharp decline in U.S. national saving. Unlike the 1990s, when the federal budget was moving into surplus and U.S. national saving was rising, U.S. national saving has fallen since 2001. U.S. investment has not been "crowded out" directly by higher interest rates, but an increasing fraction of that investment has been financed by foreign borrowing rather than our own saving.

The low interest rates of the 1990s were achieved in part because of sound U.S. fiscal policy, while the low rates of today have occurred despite an irresponsible U.S. fiscal policy. The difference is that today's rates are beholden to the decisions of foreign governments and other foreign investors—decisions that we have no control over and very little ability to influence. If the United States does not begin to take steps to reduce its unsustainable dependence on foreign borrowing in an orderly way, there could be a run on the dollar that could precipitate an international financial crisis and a sharp increase in interest rates.

The impact of foreign debt purchases on future generations

Just as there will be costs if foreign investors decide to stop financing our deficits to the degree they do now, there will also be costs if they continue to do so. When private investment in the United States is financed by foreign borrowing rather than our own saving, the return on that investment goes to the foreign investors and does not add to U.S. national income. Similarly, government interest payments to foreign bondholders are, by definition, going abroad rather than staying in the United States.

Each Treasury bond sold to a foreign investor today represents a commitment to send a portion of our future national income abroad rather than make it available domestically for investment. In passing on federal debt to our children and grandchildren, we are committing them to sending interest payments abroad for years to come. In fiscal year 2006, net interest payments on the federal debt were $227 billion. With foreign holdings equal to 42 percent of the total debt held by the public, interest payments to foreigners were roughly $100 billion in 2006 alone. That annual commitment to pay interest to foreigners will grow even larger without a dramatic reversal of the recent trends toward a rising federal debt and reliance on foreigners to purchase that debt.

Impact of foreign debt purchases on relations with other countries

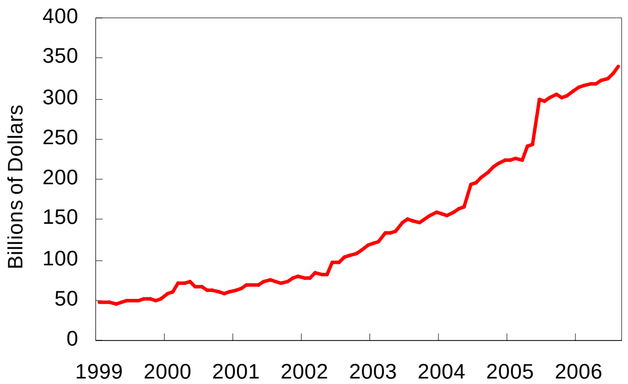
Foreign ownership of Treasury securities increased from $1.0 trillion in January 2001 to $2.2 trillion in August 2006. Over that period China increased its holdings from $61.5 billion to $339 billion, a staggering 450 percent increase

(**Chart 3**). The OPEC nations, which include Venezuela, Iran, Saudi Arabia, Libya, and the United Arab Emirates increased their holdings from $48.5 billion to $104.8 billion, with most of that increase coming in the past two years (**Chart 4**).

Chart 3

China's Holdings of U.S. Treasury Debt Have Risen 450 Percent Since January 2001

China's Holdings of U.S. Treasury Securities, 1999-2006



Source: U.S. Treasury Department

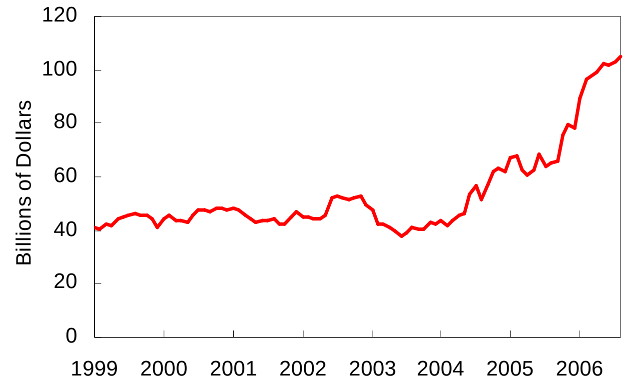
Those countries have purchased U.S. debt in pursuit of their own economic interests, but in doing so they have created potential problems for the U.S. economy. For example, the very large volume of China's lending to the U.S. government greatly complicates the prospects for more balanced trade between the two countries. U.S. exporters have become increasingly frustrated by China's failure to adjust the value of its currency. China's policy of intervening in the foreign exchange market to keep the value of its currency from rising too rapidly relative to the dollar has made U.S. exports to China more expensive and China's exports to the United States cheaper than either would be under a better aligned currency. But a significant change in China's currency carries with it serious implications for China's purchases of U.S. debt. China's very large Treasury bond purchases support its current currency policy. If that policy changes, China has much less reason to sustain its current level of bond purchases and the United State will have lost a source of demand that has helped to keep interest rates low in the U.S. debt market.

In the case of the oil countries, Americans have become doubly indebted in recent years, first as consumers and second as taxpayers. After a long period of rising gas prices, a growing number of consumers appear to be financing their gas purchases by carrying credit card debt. Now that prices have moderated somewhat, we can expect this form of debt financing to decline. However, Americans are stuck with a

Chart 4

OPEC's Holdings of U.S. Treasury Debt Have Doubled in the Past Two Years

OPEC Holdings of U.S. Treasury Securities, 1999-2006



Source: U.S. Treasury Department

second debt as a result of the rise in oil prices due to the fact that the OPEC countries have used oil revenues to purchase U.S. Treasury securities.

Conclusion

President Bush wants to claim credit for reducing the federal budget deficit. But a temporary decline in the size of annual deficits has done very little to reverse the problems caused by a ballooning federal debt, one that is increasingly carried by foreign lenders, including the Chinese government and OPEC. Our reliance on China and other nations to finance our debt is the result of a deliberate policy by the Bush administration, one that reversed course from the end of the Clinton administration and has favored deficit financing of tax cuts and federal spending over a prudent fiscal policy. It will take years of sound fiscal policy to reduce our reliance on foreign lenders and return the federal debt to a prudent level. Unfortunately, the Bush administration and the Republican Congress have been unwilling to start the process of undoing the damage they have already done.