

NOTE

A Leaking Boat

Bharat Jhunjunwala writes:

President of the United States has to obtain permission from the US Congress to borrow monies from the market. Previously approved limit was 14 trillion dollars which was to get exhausted on August 2nd. The US Government needed to borrow more to keep afloat. All works of the Government such as defense expenditures and even policing would come to a halt in absence of approval from the Congress to borrow more. Fortunately, a deal has been reached between President Obama and the Republicans to increase the borrowing limit. It has been agreed that Government expenditures will be trimmed by \$1 trillion. Further \$1.5 trillion will be saved by removing tax exemptions. These changes will take place in the next ten years, beginning 2013. For now, it is business-as-usual. The current pattern of government expenditures will continue.

The debt of the US Government has been increasing exponentially. The debt increased by about \$200 billion per year during 1997-2002. It increased by about \$500 billion per year during 2002-08 and further by \$1.6 trillion per year during 2008-11. The US debt will increase by \$16 trillion in the next ten years if the present trend continues. The agreed reduction in expenditures of \$2.5 trillion is small in comparison. The debt will yet increase by about \$13.5 trillion even after the proposed reductions are made. Present debt is about \$14 trillion. This will increase to about \$27.5 trillion after the agreed cuts in expenditures are made. It is obvious that the agreement will scarcely help solve the debt problem.

The basic problem is that revenues of the US Government are less and expenditures are more. First reason for this is absence of new commercially viable technological inventions. US companies made huge profits in the last sixty years after World War II from selling frontline products like jet airplanes and Windows software and American companies paid huge taxes to the Government from these incomes. They are paying fewer taxes nowadays in absence of such innovative products. Second reason for fewer revenues of the Government is that American companies have started producing goods abroad, thanks to globalization. Ford Motor Company and General Motors, for example, are producing cars in India. Reduced production in the US means fewer taxes paid at home. Third reason is increased expenditures on wars in Iraq and Afghanistan. Although President Obama has resolved to bring back the troops from Afghanistan but the huge military expenditures will only escalate given the arms race with China and other emerging countries. The Government is forced to borrow ever increasing amounts to bridge the gap between revenue and expenditure so caused.

The agreement between Obama and the US Congress will push the US into deeper problems. Global investors have been alerted about the hollow state of US Government finances due to this lingering dispute between Obama and the Congress. Investors are afraid that the US may not be able to repay its debt in future if another row takes place between them. Bonds issued by the US Treasury were close to default in July 2011. Such may happen again. As a consequence, investors have become wary of buying bonds issued by the US Government. Rating companies have indicated that they are considering downgrading US Government debt. Chinese rating company Dagong has

already downgraded US Government Bonds from A+++ to A+. This means that investors should take care in investing in these bonds. Investors will be reluctant in buying them. As a result the US Government will have to offer higher interest rates. That will lead to larger interest burden and increase indebtedness. Global investors were keen to invest in the US till recently thinking that it safe to do so. The US dollar has served as a global reserve currency since the Second World War. People had huge confidence that their money is safe in the US banks. It's no more!

The Pacific Investment Management Company is the biggest private holder of US Government Bonds. It has started selling these Bonds and has taken a decision to exit from these investments. It is likely that the same would be done by other investors. As a result there is a good chance that there will be a glut of Bonds in the market with few takers. It will be difficult for the US Government to raise monies from the debt market in this condition. □□□