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The American Debt Crisis and the Effect on World Capital Markets

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The American Debt Crisis and the Effect on World Capital Markets

Abstract

This is a research of the literature concerning American sovereign debt and possible effects on world capital markets. The American sovereign debt components were analyzed in the context of their present and future implications to worldwide capital markets. The American political situation was examined with possible outcomes of governmental service reduction and/or tax increases for debt reduction. The American political situation was also examined for possible outcomes of American business tax regulatory reforms that could entice businesses to inject capital into the economy spurring possible economic growth and capital formation. Together, these findings suggest that, in the short term, the lack of political will in America concerning the sovereign debt issue will continue to have negative effects on world capital markets and long term inactivity could lead to more serious issues.

Keywords: capital markets, America sovereign debt, taxation, governmental services,

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On August 28, 2012, the American sovereign debt (to be referred to as the debt) topped $16 trillion (Paletta, 2012) and that figure is more than the American Gross Domestic Product (GDP) for 2011 of $15.094 trillion (The World Bank, 2011) and likely will be higher than the GDP for 2012 and into the foreseeable future as forecasted by the White House Office of Management and Budget (The White House Office of Management and Budget- Table1.1). This is not the first time that American GDP was eclipsed by the debt, and it is not as high as it was the three years after the Second World War when it reached an 121.7% of GDP in 1946 (The White House Office of Management and Budget- Table 7.1), but by 1956, the debt was 63.9% of GDP (The White House Office of Management and Budget- Table 7.1). The debt to GPD% continued to decrease, in most years, until it reached a low of 32.5% in 1981 (The White House Office of Management and Budget- Table 7.1). Since 198,1 there has been steady growth, in most years, but until 2008 the debt as a percentage of GDP remained below 70% (The White House Office of Management and Budget- Table 7.1). Since 2008, the debt as a percentage of GDP has increased at an unprecedented rate from 69.7% in 2008 to an estimate of 104.8% for 2012 (The White House Office of Management and Budget- Table 7.1) or 35.10 percent. See chart 1 for a graphic representation of the debt as a percentage of GDP since 1940. By the White House's own conservative account, the budget is forecasted to grow by an additional five trillion dollars by 2017 (The White House Office of Management and Budget- Table 7.1).

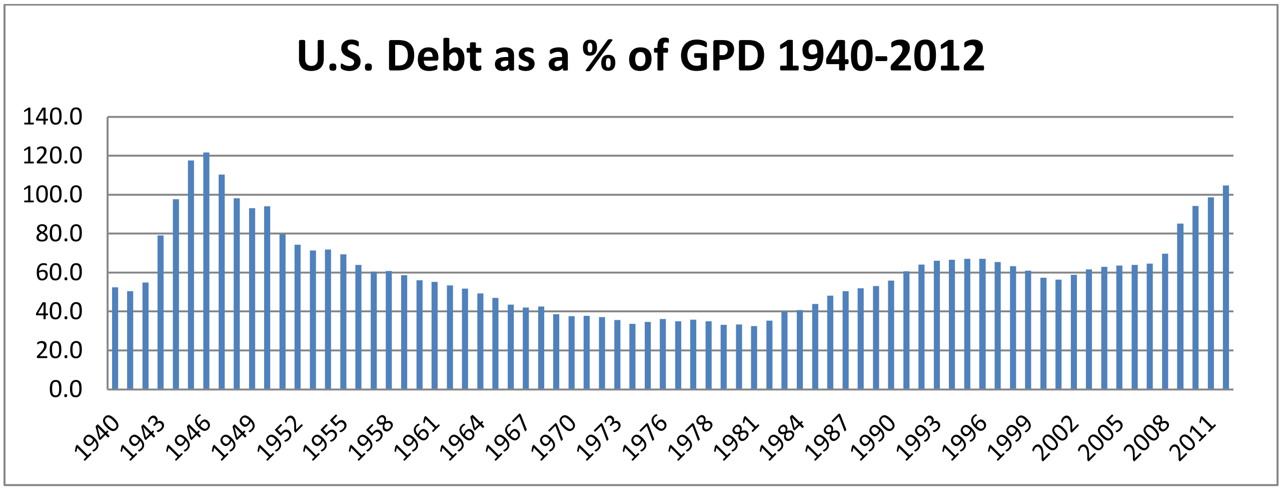

Chart 1 Compiled from Data (The White House Office of Management and Budget- Table 7.1)

This type of growth in spending without increased economic growth and/or an increase in taxation is not sustainable in the long-run and as more capital is taken out of the private sector to be used by America, there is less capital to be used for other ventures. Since 2008, world-wide government debt has increased from 55 percent of global GDP to 69 percent in 2011 (Charles Roxburgh, 2011).To contextualize the growth in the American debt, in 2010 all world-wide debt amounted to $158 trillion, an increase of $5.5 trillion from the previous year (Charles Roxburgh, 2011, p. 5). Government debt accounted for 80 percent of the increase in borrowing and government debt grew by 12 percent (Charles Roxburgh, 2011, p. 5). Of that $4.4 trillion (5.5 * .80= 4.4) (Charles Roxburgh, 2011) global government debt, $1.29 trillion (The White House Office of Management and Budget- Table1.1) or 29 percent of that was American debt.

The extraordinary increase in the debt relative to GDP occurred primarily because of four events. The world-wide economic crisis hit America exceptionally hard and by most economic indicators the recovery still continues to be slower than any other postwar recovery (Walker, 2012). There was a contraction in the American economy at annual rate of 6.3 (Bureau of Economic Analysis, 2009) in the fourth quarter of 2008 and without deficit spending stimulus there was danger of slipping into a depression. Secondly, because of the poor economy, a stronger and more expensive social net was needed, which added to budgetary pressures. Thirdly, the continuation of the tax cuts initiated under the previous administration added to the deficit as the cooling economy and less taxable income decreased tax receipts from $2.567 trillion in 2007 to $2.104 trillion in 2009 (The White House Office of Management and Budget- Table1.1). Finally, the wars in Iraq (2003-2011) and Afghanistan (2001- present) were paid for with deficit spending, unlike the Korean conflict (1950-53) and the Vietnam war, which were paid for with higher taxes and little effect on the deficit. For the sake of comparison, all of the following data are in 2011 inflation adjusted dollars- The highest tax rates on income at the $380,000 Married Filing Jointly level was 62 percent during the Korean Conflict, 73 percent during the Vietnam War, 38.6 percent during the Afghanistan War, and 35 percent during the Iraq War. Please note that the American tax system for many of the years from 1948 until 1964 had many marginal rates above the ones given above with the highest marginal tax rate for Married Filing Jointly taxpayers, being 91 percent on income above the $3 million (on average) in 2011 inflation adjusted dollars (Tax Foundation, 2011).

SIFMA places the value of all outstanding American bond issues at $37.46 trillion (Securities Industry and Finacial Market Association (SIFMA), 2012) or 24 percent of the $158 trillion global bond total (Charles Roxburgh, 2011, p. 3). The World Bank places a value of $15.64 trillion or 35.18 percent of the global stock capitalization (The World Bank- Market Capitilztion, 2011), are in US stocks and there are other data to suggest 35.18 percent is conservative.

The American Debt Crisis and the Effect on World Capital Markets

A direct comparison between the American economy and the troubled economies of Greece, Spain, and Portugal might be a stretch, but there are similarities. As the distressed Spanish economy saw debt as a percentage of GDP rise to 68.5 percent (Eurostat newsrelease euroindicators, 2012) and unemployment rise to 24.6 percent (The Telegraph, 2012), their borrowing costs also increased to 6.50 percent (BARTHA, 2012). The American debt as a percentage of GPD now stands above 100 percent and the official government calculated U-3 unemployment rate is 7.8 (Bureau of Labor Statistics, 2012) with the U-6 unemployment rate at 14.7 percent for September 2012 (Bureau of Labor Statistics- Alternative Measures, 2012).

"U-3 Total unemployed, as a percent of the civilian labor force (official unemployment rate)

U-6 Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force (Bureau of Labor Statistics- Alternative Measures, 2012)."

The average market yield on U.S. Treasury securities at 10-year constant maturity in 2011 was 2.78 percent, but it has been as high as 13.92 percent in 1981 and a similar rate to Spain of 6.57 percent in 1995 (The Federal Reserve, 2011). The American government bond market has been viewed as a safe haven, even with the 2011 credit rating downgrade (Goldfarb, 2011), and this has continued to keep American government bond interest rates at low levels.

The question that arises from these data- can it reasonably be expected that the American government bond interest rates will continue this low? The answer is, not likely, as these are the lowest rates in fifty years. The average market yield on U.S. Treasury securities at 10-year constant maturity in 1962 was 3.95 percent and was never lower than this rate until 3.66 percent in 2008 (The Federal Reserve, 2011). With every 1 percent increase in interest to the current rate, the American government will incur another $160 billion in interest expense on the current $16 trillion debt. If the interest rate on American government debt rose only to the level of Spain's pre-austerity level of 6.57 percent, an increase of 3.79 percent from the 2011 levels, this would be an increase of $606.4 billion in interest expense.

The 2011 American budget had mandatory spending of $2 trillion excluding interest expense on the debt of $227 billion and discretionary spending, including military, of $1.3 trillion (Congressional Budget Office, 2011). The 2011 receipts of $1.74 trillion (The White House Office of Management and Budget- Table1.1) did not cover the mandatory spending demands. This type of spending is not sustainable long-term. If the increase of 3.79 percent occurred as posited earlier and this was added to the $227 billion of interest on the debt from 2011, then the new figure would be $833 billion- almost half of the present receipts. This would not happen instantly as longer term bonds with lower interest rates would come due and be replaced with higher interest ones over a period of years, but it is reasonable to believe that American bond market interest rate will increase. Of course the American economy could grow increasing tax receipts and reducing the need for more debt.

The effect of the balance sheet debt is one of at least two major variables to the long-term health of the American economy, the other being the off-balance sheet debt which now stands at between the most conservative of government estimates in 2011 of $33.83 trillion (Financial Report of the United States Government, 2011, p. 48) and a more liberal estimate of $52.2 ($61.6 which included $9.3 trillion of Federal debt) trillion of unfunded obligations or $448,800 per American household(52.2/ 61.6* 528,000- subtracting the federal debt component from the original figure)(Cauchon, 2011) and possibly more according to other sources. This debt is comprised of Social Security, Medicare, Military retirement/disability benefits, Federal

Employee retirement benefits, and State, local government obligations. These are monies that have been promised, but unlike balance sheet debt, there is no obligation to pay. The American government, in theory, could choose to stop funding these programs, but this would prove to be politically disadvantageous.

The present political climate in America is one of inactivity. There is little political will to deal with the debt issues. The two major political parties find little to compromise on as the democrats are intransigent on cutting government spending and the republicans refuse to discuss raising taxes. Both must occur sooner rather than later as America cannot continue to increase spending on programs that cannot be paid for while taking tax cuts that China and other countries are paying for through deficit spending. As of July 31, 2012, foreign governments held $5.35 trillion (U.S. Department of the Treasury- International Holdings, 2012) of the $15.93 trillion total (The Department of the Treasury- Monthly Debt Statement July, 2012). Two countries China and Japan, hold more than $1 trillion of our debt each or 42% of the foreign total. Some other notables are Brazil- $253 billion, Taiwan- $196 billion, Switzerland- $190 billion, and Russia- $154 billion (U.S. Department of the Treasury- International Holdings, 2012).

There is a perfect storm on the horizon that may force political action in dealing with the American shortfall as the debt ceiling is approached sometime in December (Sahad, 2012), Sequestration on January 1, 2013 (Bennett, 2012), and the end of the Bush era payroll tax cuts scheduled to end by the end of 2012 (Patrick Temple-West, 2012). Any of these three items if left unchanged could prove to be disastrous to an economy on the precipice of recession, but all three coming to a nexus at once will force some type of political action. This will not occur until after the election as Americans are no different from Greeks, Spaniards, or Portuguese- they don't want to be told that they must receive less while paying more and any politician wanting to get re-elected would be less than erudite in being forthcoming with such information.

The last battle over the debt ceiling and budget ended in a downgrade of the US credit rating (Riley, 2011) by S&P. Moody's is now warning the US of a possible credit rating downgrade if the budgetary shortfall and debt ceiling issues are not dealt with by the new fiscal year (Inman, 2012). If Moody would downgrade the United States' credit rating this would likely cause America's cost of borrowing to increase as the interest rate would be driven up based upon more risk.

Sequestration was agreed upon in the last budget/debt ceiling battle in the congress and was part of the BCA (Budget Control Act) passed in August 2011. If no other legislation is passed to counteract this act, then on January 1, 2013, automatic cuts of $109 billion will occur with equal amounts ($54.5 billion) being taken out of discretionary domestic (exempts most spending on entitlements like Social Security and Medicaid) and military spending (Khimm, 2012). This seems like a small amount, but it will especially prove difficult the economies around Washington D.C. of Virginia and Maryland as there would be a loss of direct and indirect government employment.

The Congressional Budget Office forecasts that allowing the current tax cuts to continue into 2013 will amount to $562.4 billion less in tax receipts (Congressional Budget Officce-Expiring Tax Provisions (XLs), 2012). Tax cuts are easy to dole out, but much more difficult to reign in and it is doubtful that congress will allow all of the tax cuts to lapse. If congress does not act by January 1, 2013, most Americans will be paying higher taxes.

There is at least one other option that could help alleviate the budget deficit: making the tax code for businesses and individuals flatter with fewer loopholes and lower rates. There is over $2 trillion in cash and cash equivalents on the balance sheets of American Nonfinancial businesses (FEDERAL RESERVE statistical release, 2012, p. 69). This cash could help rejuvenate the economy adding more jobs and a broader tax base, but companies are taking a wait and see attitude because of the uncertainties of the regulatory, political, and economic environment.

In conclusion, the literature demonstrates that the continued American government rate of deficit spending is not sustainable, and if continued, will have a negative effect on the global market as 35.18 percent of global stock capitalization is in American stocks and 24 percent of global bonds are American issue. Further, the measures needed for deficit reduction will not be easy or painless, as we have seen with the recent troubles in Europe concerning the austerity measures in Spain, Portugal, and Greece, all much smaller economies than the American economy. The budget woes in Europe have rocked the capital markets on a day-to-day basis as the S&P 500 in 2011 and from April forward in 2012 had regular 1 percent or more swings (Gibson, 2012). On the other hand, care must be taken as the global economic recovery has slowed according to the IMF:

> "The recovery continues, but it has weakened. In advanced economies, growth is now too low to make a substantial dent in unemployment. And in major emerging market economies, growth that had been strong earlier has also decreased. Relative to our April 2012 forecasts, our forecasts for 2013 growth have been revised from 2.0 percent down to 1.5 percent for advanced economies, and from 6.0 percent down to 5.6 percent for emerging market and developing economies. (The International Monetary Fund, 2012)"

Raising taxes and/or cutting services may do more damage in the long run by slowing or reversing growth in the American economy and thereby causing more global harm than good. The better option would be to flatten the tax code and take out the loopholes so that businesses would bring some of their offshore cash and the excess cash and cash equivalents to strengthen their existing businesses in an effort to jumpstart the economy with little government intervention. America must also make some long-term decisions about the off balance sheet liabilities as these could cause more issues than the deficit for the future financial and social stability of the Republic.

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The American Debt Crisis and the Effect on World Capital Markets