OPINION

Demand for U.S. Debt Is Not Limitless

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In 2011, the Fed purchased a stunning 61% of Treasury issuance. That can't last.

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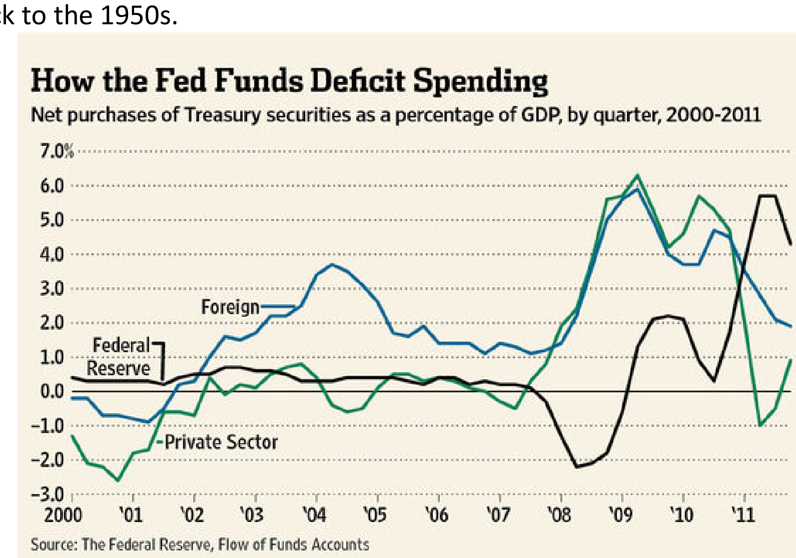
The conventional wisdom that nearly infinite demand exists for U.S. Treasury debt is flawed and especially dangerous at a time of record U.S. sovereign debt issuance.

The recently released Federal Reserve Flow of Funds report for all of 2011 reveals that Federal Reserve purchases of Treasury debt mask reduced demand for U.S. sovereign obligations. Last year the Fed purchased a stunning 61% of the total net Treasury issuance, up from negligible amounts prior to the 2008 financial crisis. This not only creates the false appearance of limitless demand for U.S. debt but also blunts any sense of urgency to reduce supersized budget deficits.

Still, the outdated notion of never-ending buyers for U.S. debt is perpetuated by many. For instance, in recent testimony before the Senate Budget Committee, former Federal Reserve Board Vice Chairman Alan Blinder said, "If you look at the markets, they're practically falling over themselves to lend money to the federal government." Sadly, that's no longer accurate.

It is true that the U.S. government has never been more dependent on financial markets to pay its bills. The net issuance of Treasury securities is now a whopping 8.6% of gross domestic product (GDP) on average per annum—more than double its pre-crisis historical peak. The net issuance of Treasury securities to cover budget deficits has typically been a mere 0.6% to 3.9% of GDP on average for each decade dating back to the 1950s.



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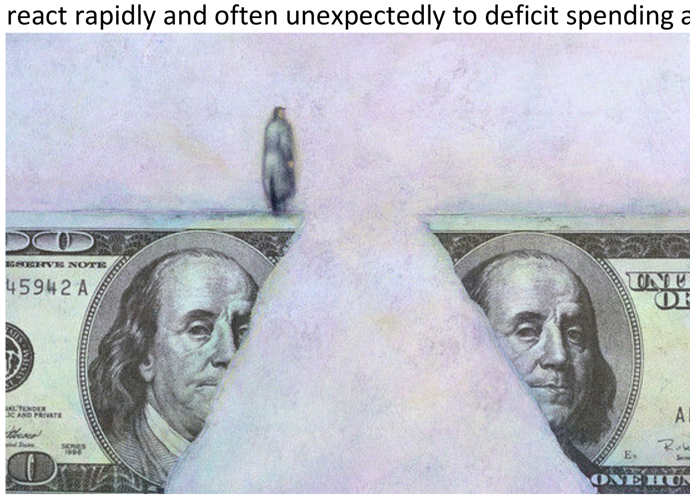
But in recent years foreigners and the U.S. private sector have grown less willing to fund the U.S. government. As the nearby chart shows, foreign purchases of U.S. Treasury debt plunged to 1.9% of GDP in 2011 from nearly 6% of GDP in 2009. Similarly, the U.S. private sector—namely banks, mutual funds, corporations and individuals—have reduced their purchases of U.S. government debt to a scant 0.9% of GDP in 2011 from a peak of more than 6% in 2009.

The Fed is in effect subsidizing U.S. government spending and borrowing via expansion of its balance sheet and massive purchases of Treasury bonds. This keeps Treasury interest rates abnormally low, camouflaging the true size of the budget deficit. Similarly, the Fed is providing preferential credit to the U.S. government and covering a rapidly widening gap between Treasury's need to borrow and a more limited willingness among market participants to supply Treasury with credit.

The failure by officials to normalize conditions in the U.S. Treasury market and curtail ballooning deficits puts the U.S. economy and markets at risk for a sharp correction. Lessons from the recent European sovereign-debt crisis and past emerging-market financial crises illustrate how it is often the asynchronous adjustment between budget borrowing requirements and the market's appetite to fund deficits that triggers a shock or crisis. In other words, budget deficits often take years to build or reduce, while financial markets react rapidly and often unexpectedly to deficit spending and debt.



Decisive steps must be implemented to restore the economy and markets to a sustainable path. First, the Fed must stabilize and purposefully reduce the size of its balance sheet, weaning Treasury from subsidized spending and borrowing. Second, the government should be prepared to lure natural buyers of Treasury debt back into the market with realistic interest rates.

If this happens, the resulting higher deficit may at last force the government to make deficit and entitlement reduction a priority. First and foremost, however, we must abandon the conventional wisdom that market demand for U.S. Treasury debt is limitless.

Mr. Goodman is president of the Center for Financial Stability and previously served at the U.S. Treasury.

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