You Are What You Owe

Why power built on debt is no power at all

BY SEBASTIAN MALLABY

Americans are forever grumbling about government gridlock. But the whole game changes when a credit-rating agency begins to echo them. On April 18, Standard & Poor’s, one of those mysteriously powerful firms that grade the financial strength of bond issuers, announced that it was starting to wonder whether the mighty U.S. government could be counted on to repay its creditors. It was a big moment: the first time in seven decades of monitoring Uncle Sam that S&P had sounded such a warning. “The sign of political gridlock was a key determinant in our outlook change,” explained an S&P executive. "Twilight in Washington, read a Financial Times caption.

While there were certainly analysts who regarded the timing of the downgrade as somewhat political (S&P itself has recently been under pressure from the government for its part in the financial crisis), few questioned its fundamental merit. The Congressional Budget Office projects that within 12 years, federal debt could reach 100% of GDP, putting the U.S. deeper in the hole than bankrupt Ireland or Portugal; the bond raters from S&P have good reason to be worried. America’s largest creditor, China, which has been wagging its finger about the state of U.S. finances for the past three years, took the opportunity
recently to urge the U.S. to adopt more “responsible measures” to protect investors. This came on the back of a hand slap from the International Monetary Fund (IMF) just a few weeks prior. The IMF had rebuked the U.S. for its lack of a “credible strategy” to stabilize its debt—an indignity once reserved for poor countries.

Having survived the melodrama of the threatened government shutdown, Americans are waking up to the fact that the real budget battles lie ahead. The shutdown derby produced a budget that will supposedly cut $38 billion from this year’s federal spending. But the real cuts will be far smaller and will scarcely dent the national debt of $14.2 trillion. Republican budget hawks in Congress, championed by the House Budget Committee chairman, Representative Paul Ryan of Wisconsin, are now demanding cuts measured in the trillions—and threatening to not raise the permitted federal-debt ceiling unless they get them. That would force the Treasury to cease borrowing once the ceiling is reached this summer, causing chaos in government programs and a renewed recession.

Even assuming that Ryan and his followers don’t resort to this nuclear option, the questions that worry the credit raters at S&P will remain ominously unanswered. How will the U.S. get a grip on its vast debt, which makes it the world’s largest debtor after Japan? Do the nation’s leaders have the courage to cut health entitlements or Social Security? Will they close popular tax loopholes like the mortgage-interest deduction? Relative to the grand issues of statecraft—war and peace, the battles against AIDS and climate change—these bean-counting problems may sound mundane. But they nonetheless present a defining challenge for today’s generation, with far-reaching consequences for the U.S.’s standing in the world. Indeed, history speaks unnervingly on this matter: power that is built on debt is often power that will crumble.

Consider a pair of cautionary tales from Egypt. A century and a half ago, Egypt was a New World wonder. The U.S. Civil War had destroyed cotton exports from the American South, causing an eightfold jump in prices that greatly enriched Egyptian growers. The country’s ruler, the khedive Ismail Pasha, splurged so enthusiastically on railways that Egypt, which then encompassed modern Sudan as well as parts of Libya and Eritrea, boasted more miles of track per habitable acre than any other country. In 1869, Egyptians celebrated the opening of the Suez Canal, an engineering marvel that sliced through the right shoulder of Africa. Notables from as far afield as London and St. Petersburg flocked to witness a ceremonial procession of ships down the canal led by Empress Eugénie in the French imperial yacht. The festivities stretched over three weeks, in a sort of 19th century cross between the schmooze fests of Davos and the bacchanalia of the Rio Carnaval.

But even before the French Empress sailed through the canal, the Confederate surrender at Appomattox was bursting Egypt’s bubble. With the end of the Civil War, cotton prices began to fall, and the khedive’s ostentation could be sustained only by promiscuous borrowing. From 1867 to 1875, Egypt’s national debt skyrocketed from £3 million to £100 million; meanwhile, cotton prices kept falling to pre–Civil War levels. The debt became unrepayable.

What followed was a lesson in how quickly debt can compromise a nation’s sovereignty. In 1875 the cash-strapped khedive sold Egypt’s stake in the Suez company to the British, who acquired the financial and geopolitical crown jewel at the distressed price of £4 million. The following year, Egypt defaulted on its debt, and in 1876 it was forced to accept a government whose main function was the Finance Minister himself was British. In 1882 a British military intervention sealed Egypt’s fate as a colony in all but name. In the language of imperial statecraft, it became a “veiled protectorate.”

Thus ended the first installment of the lesson taught by Suez. To nervous Americans today, the second installment is more subtle but also more chilling. By the middle of the 20th century, Britain, the superpower that had seized the advantage in Egypt’s debt crisis, was suffering one of its own, brought on by unsustainable borrowing to fight two world wars. Its leaders still believed they bestrode the world. But their power was illusory. After World War II, Britain was deeply in debt to the U.S., an advantage President Eisenhower used to extract various political concessions, including the surrender of the Suez Canal back to Egypt. (He wanted to keep Egypt’s new leader Colonel Gamal Abdel Nasser happy and avoid pushing him into the Soviet camp.) The dollar replaced the pound as the global reserve currency. And the U.S. replaced Britain as the pre-eminent global power.

The Suez humiliation marked the end of Britain’s imperial pretensions. As the historian Niall Ferguson has written, “It was at the Bank of England that the Empire was effectively lost.” Harold Macmillan, then British Chancellor of the Exchequer, confessed that Suez had been “the last gasp of a declining power,” adding that “perhaps in 200 years the United States would know how we felt.”

But today, a mere 55 years later, the question for Americans is whether those 200 years are up already. The alarming debt of more than $14 trillion fails to take into account the $3 trillion owed by state and local governments, not to mention a further $1 trillion or more of shortfalls in state and local pension systems. Politics being what it is, the feds may ultimately bail out the localities—in which case the national debt could end up even bigger than projected.

It’s not just the sheer amount of debt that is so worrisome. After all, the U.S. debt is dwarfed by Japan’s, which comes to more than 200% of its GDP. But while the Japanese government borrows overwhelmingly from its own people, the U.S. government cannot; Americans just don’t save enough to make that possible. Instead, like Britain in the twilight of its empire, the U.S. finances a still ambitious foreign policy with loans from foreigners. And its top creditor is, of course, a
America's top creditor is a populous and rising power that does not necessarily sympathize with U.S. objectives

It's not difficult to imagine a scenario in which China uses its financial muscle against the U.S., just as the U.S. used its muscle against Britain. Consider a confrontation over Taiwan, long a potential flash point because of Beijing's insistence that the de facto independent nation is legally part of China. Beijing's leadership, seeking to get its way without a shooting war it would lose, looks to unconventional weapons. It considers cyberattacks on U.S. servers but recognizes that digital vandalism would be viewed as an act of deliberate aggression—and that the Pentagon might retaliate. So it turns to a lever that seems proper and legal. An obscure technocrat at China's central bank announces sales of U.S. Treasuries.

It would be hard for the U.S. to protest such an action. Under American law, the Chinese freely bought U.S. government debt; they are equally at liberty to sell it. But the selling would have cataclysmic consequences for the U.S., because the Chinese government owns an estimated $1.2 trillion worth of U.S. Treasuries, or 14% of the total held by investors. If China announced a plan to sell off this stake gradually—or even if it stopped buying Treasuries at its customary pace—other players in the bond market would see that Treasury prices were headed downward. Every gunnyslinger on Wall Street would shoot his way toward the exit.

The immediate impact would be ugly. As investors fled Treasuries, the government's borrowing cost would skyrocket. Some of the fleeing investors would take money abroad, so the dollar would plummet. And these first-round effects would be trivial compared with the larger psychological impact, for even more than the Lehman Brothers crash of September 2008, a Treasury meltdown would cause cardiac arrest in the heart of the economy.

U.S. government securities are revered in the financial world as the risk-free asset. They are the modern equivalent of gold; they are the safe haven in times of trouble. Indeed, when Lehman imploded, capital flooded out of private-debt markets and into Treasuries; similarly, after the 9/11 attacks, Treasuries rallied briskly. But if China were to engineer an inverse crisis, in which the customary lifeboat became the source of the storm, a different order of panic might ensue. There would be nowhere to hide; nobody would trust anybody. When you hear that sober Wall Street types have stockpiled food and ammunition in hideouts in the deep woods, this is the Armageddon they imagine.

Think of it this way: for the past century or so, governments have been the ultimate guardians of their financial systems. They have guaranteed bank deposits, provided emergency lending when fearful citizens have hoarded cash and cleaned up disasters ranging from the savings and loan blowout of the 1980s to the wreckage of the recent crisis, in which it's becoming clear that the feds saved many more banks—both at home and abroad—than was realized. A crisis in the U.S. government-bond market would signify that the most powerful of all sovereigns had run into trouble. Who would then save the savior? The answer, perhaps, is no one.

Not all experts agree that China could use its financial clout to threaten the U.S. with mayhem. Some argue that by driving down the value of Treasuries, China would be shooting itself in the foot, since it holds more than $1 trillion of them. But this objection misses the point that states inevitably inflict losses on themselves when they get into fights; if they calculate that the losses suffered by their adversaries will be more severe, they may decide that aggression will pay off for them. Unfortunately, China could afford to take a hit to its bond portfolio, whereas the U.S. could ill afford another Lehman-scale crash. A Chinese threat of financial attack would therefore be credible.

Of course, history never quite repeats itself. The humiliation of Ismail Pasha in the 1870s may seem as distant as a fairy tale. Beijing is not about to install a Chinese Finance Minister in Washington. Britain in the 1950s was considerably more vulnerable than the U.S. is today: its government debt, relative to GDP, was roughly four times as large, and it lacked the shock absorber of a flexible exchange rate. Even so, history clearly offers important cautionary tales. For a while in the past century, the U.S. supplied the loans that paid for British foreign policy, even though it had no love for imperialism. And for a while in this century, China bought the bonds that financed adventures such as the Iraq war, even though it opposed them. It's unwise to presume that U.S. debts won't catch up with us, when Britain's did. Already, China is complaining about the U.S. dollar's status as the global reserve currency. When the biggest owner of an asset announces to the world that it would like to stop buying, that asset's prospects look shaky.

It is not too late for the U.S. to get a grip on its debt—and to limit its vulnerability to foreign rivals. From his perch on the House Budget Committee, Ryan has already laid out his plan, involving aggressive restrictions on the future growth of health programs. Senate reformers, led by a bipartisan group known as the Gang of Six, favor a more mixed approach: drawing on the report of last year's widely praised presidential budget commission, the Senators would combine restrictions to health programs with other spending cuts and tax increases. President Obama, for his part, has proposed cutting $4 trillion from deficits over the next 12 years, though he has been vague on how he would do that. All sides agree that the deficit is a problem; they even agree on the rough size of the challenge. If they could hammer out a deal, the credit raters' warnings would soon be forgotten.

In the end, the debt question is thoroughly political. Not fixing it will have huge political consequences: it will spell the decline of the superpower that has guaranteed the safety of international sea lanes, provided the world's reserve currency and supported causes from free trade to the battle against global diseases. By the same token, fixing the debt will require political courage—the courage to not just put forth a solution but also compromise with opponents.

Courage, of course, is not what our elected leaders always have. But the debt question, surely, should drive them to summon all they've got. Lawrence Summers, Barack Obama's chief economic adviser until recently, put the challenge in blunt terms. "America not meeting its debt obligation is like allowing a child with matches to sit in a room full of dynamite," he remarked. "I continue to find it close to inconceivable that elected policymakers would allow such a risk." Let's hope his former boss has heard him.

Mallaby directs the Maurice R. Greenberg Center for Geoeconomic Studies at the Council on Foreign Relations