U.S. House of Representatives
Committee on the Budget
House Budget Committee 110th Congress Majority
John Spratt, Chairman
207 Cannon House Office Building, Washington, DC 20515 (202) 226-7200 ★ www.budget.house.gov

July 24, 2007

Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?

On June 26, 2007, the House Budget Committee held a hearing titled "Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?" The hearing followed up on a January hearing on the economics of the budget deficit and in particular the short-run financial and longer-term economic risks associated with having foreign investors finance so much of the government's deficit. Below are some highlights of testimony from witnesses at the hearing.

Foreign-Held Debt Has More Than Doubled Since 2001 — According to Treasury Department data, total foreign holdings of Treasury debt have risen from $1.0 trillion in January 2001 to $2.2 trillion by April 2007. Foreign holdings accounted for a little more than a third of total marketable Treasury debt in January 2001, but they now are nearly half of the total. Although Japan is still the largest foreign investor in Treasuries ($615 billion as of April 2007), the holdings of investors from China and the oil exporting countries have risen most rapidly since 2001.

Borrowing from Abroad Is an Economy-Wide Phenomenon and Is Not Sustainable — The growing foreign share of Treasury holdings is just part of a general trend in the U.S. economy: Americans are not saving enough to sustain our own levels of consumption, so a foreign supply of capital is needed to make up the difference. This net borrowing from abroad is called the current account deficit, and all of the witnesses agreed that relative to the size of the economy, this current account deficit is "not sustainable."

Inflow of Foreign Capital Has Disguised the Costs of Budget Deficits — Although the Bush Administration's fiscal policies have run up record deficits, the U.S. economy and the American public have been somewhat sheltered from the usual costs of budget deficits because accommodative monetary policy combined with a steady supply of capital from abroad have kept interest rates fairly low. But because the U.S.'s pace of borrowing is not sustainable, these low interest rates will not be sustainable, either, the witnesses testified. Both the Administration's and the Congressional Budget Office's economic forecast call for a significant rise in longer-term interest rates over the next few years.

Our Debts to Foreign Investors Will Have to Be Repaid — Even when the short-run costs of running budget deficits are low because foreign lending keeps up the supply of capital and keeps interest rates down, the U.S. is still racking up a debt to those foreign investors. Our children and grandchildren will be stuck with the bill in the form of higher taxes or reduced government services – a lower standard of living than they would have otherwise enjoyed. Moreover, those debts will be repaid not to other younger Americans but to foreign interests.

Whether the "Landing" is Hard or Soft, It Won't Be Pleasant — According to the witnesses, the "unsustainability" of the current account deficit will manifest itself in a slowing of demand for U.S. assets (a lower willingness of foreign investors to lend us their savings). That will cause the dollar to fall and interest rates to rise. How sudden and large those changes – or how "hard" the landing – will be depends on how sudden and dramatic the change in the investment position of the foreign investors will be. CBO Director Peter Orszag testified that even with what CBO views as the "more likely," "soft-landing" scenario of a gradual adjustment, CBO also believes the adjustment could ultimately produce large economic costs, perhaps even more severe and long-lived than the costs from a "hard landing."

"Price of Liberty" Is Being Paid Very Differently This Time — Dr. Robert Hormats of Goldman Sachs testified that "the Iraq War is the first significant conflict during which the U.S. has not raised taxes, [nor] cut non-security domestic spending and has relied so heavily on foreign funds to finance its budget deficit." He stressed that "this nation is more dependent on foreign capital during this war than during any in our history." He argued that the country's dependence on foreign funds adds "to the country's vulnerability in the face of a disruption of such funds" and thus works against overall national security.

Best Fiscal Policy Response Is to Encourage National Saving — CBO Director Orszag noted that policymakers cannot directly control the current account deficit, but they can pursue policies that help to reduce that deficit by raising national saving. The most direct and reliable way for Congress to increase national saving would be to increase public saving; in other words, reduce the budget deficit or run surpluses.

The complete testimony of all witnesses is posted on the Budget Committee's website at <http://budget.house.gov/hearings.htm>. The Committee's website also contains more information about foreign holdings of Treasuries and the federal government's deficit.