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Payback Time

Wave of Debt Payments Facing U.S. Government

By EDMUND L. ANDREWS

WASHINGTON — The United States government is financing its more than trillion-dollar-a-year borrowing with i.o.u.'s on terms that seem too good to be true.

But that happy situation, aided by ultralow interest rates, may not last much longer.

Treasury officials now face a trifecta of headaches: a mountain of new debt, a balloon of short-term borrowings that come due in the months ahead, and interest rates that are sure to climb back to normal as soon as the Federal Reserve decides that the emergency has passed.

Even as Treasury officials are racing to lock in today's low rates by exchanging short-term borrowings for long-term bonds, the government faces a payment shock similar to those that sent legions of overstretched homeowners into default on their mortgages.

With the national debt now topping $12 trillion, the White House estimates that the government's tab for servicing the debt will exceed $700 billion a year in 2019, up from $202 billion this year, even if annual budget deficits shrink drastically. Other forecasters say the figure could be much higher.

In concrete terms, an additional $500 billion a year in interest expense would total more than the combined federal budgets this year for education, energy, homeland security and the wars in Iraq and Afghanistan.

The potential for rapidly escalating interest payouts is just one of the wrenching challenges facing the United States after decades of living beyond its means.

The surge in borrowing over the last year or two is widely judged to have been a necessary response to the financial crisis and the deep recession, and there is still a raging debate over how aggressively to bring down deficits over the next few years. But there is little doubt that the United States' long-term budget crisis is becoming too big to postpone.

Americans now have to climb out of two deep holes: as debt-loaded consumers, whose personal wealth sank along with housing and stock prices; and as taxpayers, whose government debt has almost doubled in the last two years alone, just as costs tied to benefits for retiring baby boomers are set to explode.

The competing demands could deepen political battles over the size and role of the government, the trade-offs between taxes and spending, the choices between helping older generations versus younger ones, and the bottom-line questions about who should ultimately shoulder the burden.

"The government is on teaser rates," said Robert Bixby, executive director of the Concord Coalition, a nonpartisan group that advocates lower deficits. "We're taking out a huge mortgage right now, but we won't feel the pain until later."

So far, the demand for Treasury securities from investors and other governments around the world has remained strong enough to hold down the interest rates that the United States must offer to sell them. Indeed, the government paid less interest on its debt this year than in 2008, even though it added almost $2 trillion in debt.

The government's average interest rate on new borrowing last year fell below 1 percent. For short-term i.o.u.'s like one-month Treasury bills, its average rate was only sixteen-hundredths of a percent.

"All of the auction results have been solid," said Matthew Rutherford, the Treasury's deputy assistant secretary in charge of finance operations. "Investor demand has been very broad, and it's been increasing in the last couple of years."

The problem, many analysts say, is that record government deficits have arrived just as the long-feared explosion begins in spending on benefits under Medicare and Social Security. The nation's oldest baby boomers are approaching 65, setting off what experts have warned for years will be a fiscal nightmare for the government.

“What a good country or a good squirrel should be doing is stashing away nuts for the winter,” said William H. Gross, managing director of the Pimco Group, the giant bond-management firm. “The United States is not only not saving nuts, it’s eating the ones left over from the last winter.”

The current low rates on the country’s debt were caused by temporary factors that are already beginning to fade. One factor was the economic crisis itself, which caused panicked investors around the world to plow their money into the comparative safety of Treasury bills and notes. Even though the United States was the epicenter of the global crisis, investors viewed Treasury securities as the least dangerous place to park their money.

On top of that, the Fed used almost every tool in its arsenal to push interest rates down even further. It cut the overnight federal funds rate, the rate at which banks lend reserves to one another, to almost zero. And to reduce longer-term rates, it bought more than $1.5 trillion worth of Treasury bonds and government-guaranteed securities linked to mortgages.

Those conditions are already beginning to change. Global investors are shifting money into riskier investments like stocks and corporate bonds, and they have been pouring money into fast-growing countries like Brazil and China.

The Fed, meanwhile, is already halting its efforts at tamping down long-term interest rates. Fed officials ended their $300 billion program to buy up Treasury bonds last month, and they have announced plans to stop buying mortgage-backed securities by the end of next March.

Eventually, though probably not until at least mid-2010, the Fed will also start raising its benchmark interest rate back to more historically normal levels.

The United States will not be the only government competing to refinance huge debt. Japan, Germany, Britain and other industrialized countries have even higher government debt loads, measured as a share of their gross domestic product, and they too borrowed heavily to combat the financial crisis and economic downturn. As the global economy recovers and businesses raise capital to finance their growth, all that new government debt is likely to put more upward pressure on interest rates.

Even a small increase in interest rates has a big impact. An increase of one percentage point in the Treasury's average cost of borrowing would cost American taxpayers an extra $80 billion this year — about equal to the combined budgets of the Department of Energy and the Department of Education.

But that could seem like a relatively modest pinch. Alan Levenson, chief economist at T. Rowe Price, estimated that the Treasury's tab for debt service this year would have been $221 billion higher if it had faced the same interest rates as it did last year.

The White House estimates that the government will have to borrow about $3.5 trillion more over the next three years. On top of that, the Treasury has to refinance, or roll over, a huge amount of short-term debt that was issued during the financial crisis. Treasury officials estimate that about 36 percent of the government's marketable debt — about $1.6 trillion — is coming due in the months ahead.

To lock in low interest rates in the years ahead, Treasury officials are trying to replace one-month and three-month bills with 10-year and 30-year Treasury securities. That strategy will save taxpayers money in the long run. But it pushes up costs drastically in the short run, because interest rates are higher for long-term debt.

Adding to the pressure, the Fed is set to begin reversing some of the policies it has been using to prop up the economy. Wall Street firms advising the Treasury recently estimated that the Fed's purchases of Treasury bonds and mortgage-backed securities pushed down long-term interest rates by about one-half of a percentage point. Removing that support could in itself add $40 billion to the government's annual tab for debt service.

This month, the Treasury Department's private-sector advisory committee on debt management warned of the risks ahead.

"Inflation, higher interest rate and rollover risk should be the primary concerns," declared the Treasury Borrowing Advisory Committee, a group of market experts that provide guidance to the government, on Nov. 4.

"Clever debt management strategy," the group said, "can't completely substitute for prudent fiscal policy."

This article has been revised to reflect the following correction:

Correction: November 24, 2009

An article on Monday about ballooning debt payments for the federal government misspelled, in some copies, the surname of an economist who noted that the bill for debt service would be even higher were it not for current low interest rates. He is Alan Levenson, not Levinson. And a chart with the continuation of the article misstated, in some editions, the size of debt payments due within a year that are currently paying no more than 1 percent in interest. It is $1.9 trillion, not $2.5 trillion.