

Public debt: unsustainable and simply unpayable

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Public debt has become a problem worldwide. What is becoming more and more evident is that it is unsustainable and simply unpayable. It could be compared to a giant Ponzi scheme. We see no meaningful debt reductions thus, government will have to raise taxes, which will further suppress the economy, or people and companies will be forced to buy such bonds, or perhaps pension and retirement funds will be seized to continue the game for a while longer.

The whole concept of government debt in the US, whether it's federal, state, municipal, corporate or personal stands on very shaky ground. Debt is serviced with revenues and income and when both are falling it is difficult to service. We have begun to enter a period of slowly rising interest rates. In the US the Fed has managed interest rates to be as low as possible to both aid in a recovery and to keep the financial edifice from collapsing. Over the past six months the bench mark 10-year Treasury note yield has risen from a yield of 2.20% to 2.74% and presently stands at about 3.60%. That 1.4% rise in rates has been offset by GDP growth of 3%. The problem is that such GDP growth has been maintained by growth in debt. The two sources of debt are the Fed and government. The Fed has been buying the government debt by creating money out of thin air. That is called monetization and it causes inflation. The government demand comes from revenues that have fallen and continue to fall, and as a result government issues more debt. The lenders, the bond buyers, sell dilution in the value of debt and in the dollar and as a result demand a higher yield. At this stage you can see how important QE1 and 2 and fiscal stimulus have been over the past 2-1/2 years. Had they not been implemented the economic and financial system would have collapsed. The next question to be asked is will we have to have quantitative easing and stimulus indefinitely? The answer is yes, but unfortunately if that path is followed lenders will demand ever-higher interest rates and the dollar will continue to fall in value versus gold and silver and other currencies. We estimate GDP growth to be 2% to 2-1/4% in 2010, down from 3%, all of which were aided by quantitative easing, the creation of money and credit and fiscal stimulus the result of debt. Without these props there would have been little or no growth, and fairly quickly the economy would have faltered. That would have brought about a classical purge accompanied by a deflationary depression. There will soon come a time the creation of money and credit and fiscal stimulus will no longer work and the system will finally fail. That is inevitable. That will begin to happen when interest rates are rising faster than growth rates. Once that condition exists there is no further hope of servicing debt or creating more debt, because there will be no natural buyers and inflation will be raging if not hyperinflation. The US is not the only country staring into this abyss; most countries around the world have the same problem.

As you probably have already figured out such fiscal and monetary policies of many countries cannot continue. The issuance of new debt has to be curtailed, as well as the growth of future liabilities. On its present course the US is headed toward a deficit in excess

of 100% of GDP in just 1-1/2 years.

These countries have experienced and most still do, profligate government spending, little fiscal restraint and outright criminal behavior. Such action in time cause markets to put pressure on governments to mend their ways. That is where the higher yields come into play and as we pointed out we are already witnessing that. In 1 to 1-1/2 years the cost of carrying debt will begin to reduce GDP, because government debt demands will crowd out private investment. Except for AAA corporations we have already seen that over the past two years, as lenders retain cash and generally refuse to lend to medium and small companies and individuals as well.

A product of these conditions is a perpetuation of unemployment, which we believe is 22.6% presently, for years into the future. In addition, we have had 20 years of free trade, globalization, offshoring and outsourcing that has lost America 8.5 million good paying jobs and the loss of 42,400 businesses. We have extended unemployment, but every month millions fall off leaving them on their own and food stamps. These transfer payments make up 20% of household income, which is also unsustainable. Our guess is that the current extended benefits will be extended further in spite of a projected \$1.6 trillion deficit. Political types prefer an extension to revolution, but the cost is more debt, a falling dollar and rising gold and silver prices. In addition, an end to extended benefits will sap consumption that must be maintained at 70% of GDP in order to keep the economy from failure. Do not forget the US is not the only country with debt problems. In the same league are Greece, Ireland, Portugal, Belgium, Spain, Italy, England and above all Japan, which is more than 200% and growing exponentially. None of these countries are capable of growing out of their debt problems and thus, eventually we see a multilateral default of debt, which will probably entail a 2/3's write off of debt. A jubilee of sorts.

If stabilization and growth have to be based on continued creation of money and credit and monetization then the system has to eventually collapse. It is no more a solution than extended unemployment benefits, federal government spending and hiring and food stamps. It throws the problems into the future at a terrible cost. In spite of this largess unemployment won't improve and the monetary and fiscal effect on the economy will lessen. We call it the law of diminishing returns. Last year we saw 3% growth, or so we are officially told, and this year we believe it will be about 1% less at 2% to 2-1/4%. The effectiveness of the policy is losing momentum and strength. The next question is will a \$1.7 trillion QE3 with \$850 billion in additional fiscal spending be able to maintain 1% growth. Our answer is we do not think so. This fading monetary and fiscal policy will be accompanied by ever falling government revenues, unless ever more debt is created. Are you getting the feeling that governments are running around in circles with no solution in sight? If you are you are correct. The only answer is to purge the system and the sooner the better. The longer the problems are extended and individuals will be faced with unemployment and under employment and that means borrowing and the use of credit cannot be extended and that means the economy cannot grow. Even if spending cuts and higher taxes were implemented the economic and financial affects would not be felt for 6 months to a year. Government has waited too long.

Projections for the future are very difficult if for no other reason than we do not know where interest rates will be. We assume they will be higher, but how much higher? We just do not know. We can tell you that in 1980 official inflation was 14-3/8% and the long bond yield was over 20%. Will that be repeated, we do not know, but we can say we could see something

close to that. If we have hyperinflation we could see 30% inflation. Who knows – we won't know until we approach getting there. Are we going to look like the German Weimar Republic of the early 1920s or today's Zimbabwe? We don't know but it is certainly possible and near the edge of probability.

What really gets our attention is that elitists that control all this really believe they can retain control. If they cannot they figure they will just have another major war, like they always have had. They know what we now. They know deficits are going to further rise precipitously, unless there are major policy changes, spending cuts and higher taxes. Even if the proper steps were taken we are probably looking at 30 or more years of depression. Debt cannot be kept within bounds, just look at what is going on today. The elitists have no intention of radically changing their ways. There will be more of the same until the system ceases to function.

We have written about rising interest rates in the whole spectrum of government and corporate bonds. The average has been 100% to 150%. Official rates have been raised in Brazil, India and China. In the US, bond buyers have already been pricing in yield increases, which they feel are necessary to offset inflation losses. Unfortunately for buyers they have not gotten nearly enough yield to compensate and are losing money on return and currency depreciation versus other currencies, but particularly versus gold and silver. In order to offset real losses, real yields will have to rise and they will. The first step for the US 10-year note should be a move upward from 3.60% to 4% to 4.25%. That should happen this year. The next move in 2012 should be to 5% to 5.60% and the second move from 5.60% to about 7%. Mind you these are very conservative estimates. Any recovery in housing will be impossible with prices falling another 15% to 20%. Anyone with an ARM will be a dead duck. That means about a 60% plus failure rate. Bumping along the bottom could take 8 to 30 years and as we mentioned before government could end up with most of the housing eventually causing a process of nationalization.

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These higher rates, which are inevitable, will raise havoc on the Federal budget and its debt service. Average maturities are 4.5 years – a very foolish move that began some 15 years ago. This means even if taxes are raised and the budget deficit cut, they will only serve as a damper on costs, which would lead to dollar depreciation and default. Worse yet, who will want to buy bonds and in particular US dollar denominated bonds as gold and silver are soaring and profits are falling along with the stock market? The Fed is buying and monetizing at least 80% of treasuries now. That means they will have to buy them all, including some from nations such as China, Japan and Middle Eastern owners. Long-term bond holders will be looking at 30% losses and the stock market 50% plus losses. The

monetization process at this point will produce inflation from 14% to 40%, which could well be accompanied by hyperinflation. That hyperinflation could come quickly once inflation passes 14-3/8%, which it officially hit in 1980. At that time 30-year T-bond rates were more than 20%. We do not know exactly what the numbers will be, but we do know they will be terrible. Some time along the way the US will be forced to default and then China will own a goodly part of the US. We also believe that a major world war will be in progress. Again as a diversion from the massive economic and financial problems plus revolutions worldwide, which could short circuit having another world war. We do not know how these events will roll out, but we do know they are probable.

Higher interest rates will cause major problems for banks, private equity funds and hedge funds. The cost of borrowing and using leverage will be prohibitive. Many banks and funds will go under. Defaults will abound and cash flow to bond holders will diminish making outflows greater than inflows. This process of losses will in part mirror what we saw in the early 1930s, not only in reduced value but also in the doubling of gold prices and the increase in gold and silver shares of more than 500%. This also will be accompanied by a complete collapse in living standards.

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