Coming Soon: The Bill for the Massive U.S. Debt

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Americans could be in for a rude awakening in coming months when they discover the true scope of the massive national debt racked up by the U.S. government.

In fact, the $1.6 trillion deficit expected for 2010, which is above 10% of gross domestic product (GDP), is only the beginning.

Since the current economic crisis began in late 2007, the U.S. Federal Reserve has tripled the size of its balance sheet, creating enormous amounts of new money by lending to hundreds of ailing banks and buying up more than $1 trillion of questionable asset-backed securities.

But that's only a small part of the story. Since the beginning of the crisis, the Fed has lent, spent, or guaranteed $11.6 trillion, including underwriting the entire system of mortgage finance in the United States, a system that currently shows a nearly $1 trillion loss.

And none of these figures include any of U.S. President Barack Obama's stimulus packages, which means the actual deficit next year might grow to $2 trillion - around 15% of GDP.

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

The ramifications of this debt, which is bound to grow larger, will have a profound effect on investors - not the least of which is the imminent decline of the dollar.

The Spiraling National Debt

Right now, without counting future unfunded liabilities like Social Security or Medicare, our national debt tops $12 trillion. There are roughly 100 million American households. That's a national debt of roughly $120,000 per family.

In order to keep the government functioning, Congress just increased the federal debt ceiling to $12.5 trillion. And the party isn't over yet.

In an effort to keep mortgage interest rates low, the Fed pledged this month to buy yet another $500 billion of Fannie Mae (NYSE: FNM) and Freddie Mac (NYSE: FRE) guaranteed mortgage securities.

But all that spending has a price. And the bill is about to come due.

The White House estimates that the government will have to borrow about $3.5 trillionmore over the next three years. On top of that, the U.S. 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% of the government's marketable debt - about $1.6 trillion will mature in the next 12 months.

That leaves the government in the same undesirable position as a lot of people who took out adjustable rate mortgages (ARMs) - forced to refinance short-term debt at higher interest rates for the long term.

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

The United States will spend almost $400 billion on interest to service our existing national debt. Currently, the United States takes in roughly $2 trillion in taxes, half of which come from income taxes. So the interest on our debt is already consuming 20% of all tax receipts, or 40% of all income taxes.

The White House estimates that the government's tab for servicing the debt will exceed $700 billion a year in 2019, even if annual budget deficits shrink drastically. Other forecasters say the figure could be much higher.

To amplify that figure, 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, according to ***The Times***.

Then, there's the cost of the health insurance legislation and the potential cost required to reform Social Security and Medicare.

As noted last week in ***Money Morning's*** Martin Hutchinson , the healthcare bill alone will significantly increase federal healthcare spending by about $185 billion in 2019, according to the Congressional Budget Office (CBO).

It will also involve about a $100 billion increase in taxes by in 2019, the CBO said. And even though the bill relies on slashing Medicare growth for funding, "it is unclear whether such a reduction in the (Medicare) growth rate could be achieved"

And who knows how much the bill could really cost.

"No one (in Congress) can explain to me what's in the bill, and for Congress to vote on a bill that they don't understand whatsoever, you got to question...what kind of government we have," New York Mayor Michael Bloomberg told ***The Huffington Post***.

Americans have now doubled down on debt. The government's debt has almost doubled in the last two years alone, as Americans' personal wealth sank along with housing and stock prices.

So where will the money come from? Total domestic savings in the United States are only around $600 billion annually. If we all put every penny of our savings into U.S. Treasury debt, we're still going to come up nearly $3 trillion short.

All this debt might not constitute a crisis if the United States were still financing its own debt. But the United States has been a net debtor to the world since 1985. And today, foreigners own 44% of all the country's short-term debt, or about $880 billion.

Since the expansion of the Fed's balance sheet got started in earnest last fall, the value of the dollar has fallen about 15%. The faster the money supply grows, the more likely the value of the dollar will continue to fall.

It seems highly unlikely the level of deficit spending can continue without sparking a run on the dollar as foreign governments begin to sell U.S. Treasury bonds. The only real question is at what point U.S. creditors will finally decide they can't finance any more of the nation's deficit spending because it's simply not worth the risk.

China has routinely called on the United States to rein in its soaring budget deficit and spare the dollar any further losses.

"We have lent a huge amount of money to the United States," Chinese Premier Wen Jiabao said earlier this year. "Of course we are concerned about the safety of our assets. To be honest, I am definitely a little bit worried. I request the United States to maintain its good credit, to honor its promises and to guarantee the safety of China's assets."

As an alternative to U.S. debt China has already begun the process of diversifying its reserve holdings away from the dollar. And China isn't alone, other emerging markets are going the same route.

"It's time to sell U.S. Treasuries," Kim Heeseok, the head of investments for South Korea's government pension service, recently told ***Bloomberg News***,

Similarly, to protect their nest eggs, investors will have to be very good at managing their assets. Fortunately, there are several ways for investors to protect themselves

Goldman Sachs Group Inc.'s (NYSE: GS) London economic team recommends going long the "BRIC" markets of Brazil, Russia, India and China, while going short equity indexes of the G-7 nations, including the United States.

Investors could also turn to commodities, such as gold and silver, which stand to gain in value as the dollar weakens