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Bernanke: Curb The Borrowing Binge

By Matthew Craft,

Federal Reserve Chairman Ben Bernanke urged Congress and the Obama administration to curb rising government borrowing. Bernanke acknowledged that spending was needed to pull the economy out of a recession but said long-term economic health required controlling budget deficits.

"Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth," he said.

The Fed chairman noted that rising yields on Treasury notes reflected worries over government debt levels as well as more hopeful signs: a reversal of the flight to safety that lifted Treasury bonds last year and optimism about the economy. The government relies on bond buyers to cover federal deficits.

Yields on benchmark 10-year notes yielded 3.55% after Bernanke's talk, down from 3.64% on Tuesday. A gauge of bond buyers' inflation expectations also fell.

Reading from prepared comments before the House Budget Committee on Wednesday, Bernanke warned that soaring medical costs and retiring members of the baby-boom generation made the challenge all the more urgent. The Obama administration estimates that the government deficit will hit $1.8 trillion this year. Bernanke said the ratio of public debt to output could move from 40% before the financial crisis to 70% in 2011.

Without changes to Medicare and Social Security, Bernanke said, these benefit programs will increase from 8% of GDP in the present time to 10% by 2020. "With the ratio of debt to GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands."

Concerns over government bond sales and inflation concerns have recently swayed bond markets, pushing Treasury yields higher. Though he expects the economy to recover by the end of the year, Bernanke believes that sustained high unemployment, among other factors, should dampen inflation. He expects inflation to decline from its pace in 2008. Excluding food and energy, prices increased 1.8% last year, compared with 2.4% in 2007.

Judging by one measure, investors expect roughly 2% annualized inflation for the next decade, in line with what some economists consider acceptable. The yield spread between 10-year Treasury inflation protected securities and 10-year bonds dropped to 1.94 percentage points Wednesday afternoon.

Daniel Alpert, a managing director at Westwood Capital in New York, told *Forbes* that Bernanke made it clear the credit quality of the United States could become a concern. There is a legitimate worry that the worldwide appetite for U.S. government debt won't last.

The flood of bonds sold by governments around the world could prove troublesome for corporate issuers needing to refinance debt. In a presentation on Tuesday, analysts from debt research firm CreditSights warned of an "increased competition for capital" raising costs for borrowers. (See "Competing For Capital.")

Conversely, a decline in deficit spending buoyed corporate bond markets before 2007, argued Louise Purtle, CreditSights' chief strategist. A diminished supply of government bonds left the world "awash in liquidity that was on the hunt for a home." As a result, investors stretched for yield -- another culprit behind the credit bubble.