Just who owns the U.S. national debt?

And is growing foreign investment in the U.S. bad for America?

COMMENTARY
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This week, readers are worried about the about the dangers of the steady rise in U.S. debt – after back-to-back warnings from sources as diverse as Fed Chairman Ben Bernanke presidential candidate Hillary Clinton and investment guru Warren Buffet. Dick in Michigan wants to know just where this borrowed money comes from; Kim in Maryland is worried that foreign lenders like China may be gaining an unhealthy upper hand in its relations with the U.S.

The Bush administration talks about spending a million here and a billion there adding up to trillions for the war. Since the country is so far in debt, where is all this money they are talking about spending, coming from? I know it is borrowed, but from whom?
-- *Dick, Howard City, Mich.*

The money is borrowed from buyers of Treasury securities -- which are basically a big batch of IOUs that are auctioned off every three months. As the auction date approaches, the Treasury figures out how much it will need to pay off old debt and cover the government's latest round of overspending.

When the auction day comes, buyers submit bids in the form of the interest rate they're willing to accept. You can choose to make a competitive bid (you ask for a specific rate) or a non-competitive bid (you agree to accept the average rate of other winning bids.) When all the bids are in, the Treasury starts at the bottom, taking the lowest bids until it has collected enough money to cover that round of borrowing.

The money flows in from all over the place: from individual investors and corporations, pension funds and governments, both in the U.S. and around the world. Basically, anyone with a large amount of cash looking for a safe place to put it is a good candidate for holding U.S. Treasury debt.

So just who are these lenders? As of last June (the latest complete breakdown available), the biggest holder of Treasury debt was the U.S. government itself, with about 52 percent of the total $8.5 trillion in paper that's out there. Most of the government's holdings are massive savings accounts for programs like Social Security and Medicare. Just as you may prefer to keep your Individual Retirement Account in the safe Treasury bonds, the folks who manage the Social Security Trust Fund are looking for a secure investment, too.

That's leaves a little over $4 trillion in public hands. The biggest chunk (about 25 percent of the $8.5 trillion total) is held by foreign governments. Japan tops the list (with $644 billion), followed by China ($350 billion), United Kingdom ($239 billion) and oil exporting countries ($100 billion).

Other big holders of Treasury debt include state and local governments ($467 billion); individual investors, including brokers ($423 billion); public and private pension funds (319 billion); mutual funds ($243 billion); holders of US savings bonds ($206 billion); insurance companies ($166 billion) and banks and credit unions ($117 billion.)

Once issued at auction, Treasury securities enjoy a healthy second life when they're traded in the so-called "secondary market" (aka the "bond market.") The prices of bonds bought on the open market go up and down as the market reacts to changes in demand and news about the economic outlook like inflation. But no matter what you pay for a bond, if you hold it until it matures, the government has to pay back the full amount that was borrowed when the debt was first auctioned and issued.

Why should I invest in US treasuries if in the past I would have made more money in the stock market?
-- *Grant M., Richmond, Va.*

Because you face a substantial risk of losing money in the stock market in the future. It's true that the historical average return on stocks is higher than the current yield on Treasuries. But as mutual funds are required to warn new newcomers: "Past performance is no guarantee of future results."

If you're investing for the long haul and figure you can ride out stock market downturns - and still sleep nights when the market behaves like it did last week - you may be better off with stocks. On the other hand, if you're retired and living on a fixed income or counting on the money being there in a few years - or you just can't stand the idea of losing money - you may not want to take on the added risk of stocks.

Is it true that the Bank of China is gaining, while the American dollar continues to fall? If so, is it even a remote possibility that America will one day be run by foreign government through the power of the dollar? Or are the large purchases of American companies and land already a forerunner to this?
-- *Kim M., Catonsville, Md.*

As a sovereign nation, the U.S. cannot be run by a foreign government – short of an invasion and military occupation. With the current level of U.S. defense spending, we'd put the odds of that at extremely remote to nil.

But relying on foreign governments to maintain our standard of living also comes with certain risks. Sen. Hillary Clinton told CNBC last week she sees "a slow erosion of our economic sovereignty," and she singled out China's big holdings of Treasury debt as an example.

As my MSNBC.com colleague Tom Curry wrote last week, Clinton is making America's dependence on Chinese investors a central theme of her 2008 presidential campaign. When people ask her why the U.S. doesn't get tougher with China on issues like trade, she says, her response has been: "How do you get tough on your banker?"

Foreign investment in the U.S. – in U.S. stocks, bonds, real estate and businesses – isn't necessarily a bad thing. Some observers point out that strong demand for U.S. investment is a sign that the U.S. is still the best place in the world to invest. What matters most is the ongoing strength of the U.S. economy and the federal government's financial health. To the extent that Congress can control spending, eliminate the federal budget deficit and keep the economy growing, we should be fine.

But the current trends aren't promising. At the moment, the U.S. economy is still relatively strong - both unemployment and inflation are relatively low. But growth seems to be slowing and, at some point, the economy could slide into a recession. When that happens, the economy shrinks and so do tax revenues. But Uncle Sam still has to the pay interest on what he's borrowed - just like you don't get a break on your mortgage payment when you lose your job. If we keep spending more and more on interest, the federal budget gets squeezed that much harder when the economy eventually stumbles.

Even though times are relatively good, consumers and the government are piling on more debt. Right now, money is pretty easy to come by; interest rates are low. If that changes, rising rates would create a drag on the economy. And as the cost of paying Social Security and Medicare benefits continues to rise, the national debt monster is going to be even harder to tame.

So far, the consequences of all this are hard to put your finger on. As Warren Buffett pointed out last week in his widely-read annual letter to shareholders (pdf file, page 16), a big reason we can fund our budget and trade deficits is that the U.S. is still an incredibly wealthy country with lots of stock, bonds, real estate and companies to sell. And we got that way because of the hard work of generations that come before us.

And American investors and companies also have investments in foreign countries. But as Buffett noted, last year marked the first time since 1915 that the net balance of this investment turned negative.

"Foreigners now earn more on their U.S. investments than we do on our investments abroad," Buffett wrote to shareholders "In effect, we've used up our bank account and turned to our credit card. And, like everyone who gets in hock, the U.S. will now experience 'reverse compounding' as we pay ever-increasing amounts of interest on interest."

The wealth gap between the U.S. and other countries — even those with huge, rapidly growing economies like China — is still big. That means our credit with the rest of the world should be good for years — if not decades — to come. But no matter how rich you are, borrowing on top of borrowing is not a great long-term financial plan.

"I believe that at some point in the future, U.S. workers and voters will find this annual 'tribute' (of interest payment on the debt) so onerous that there will be a severe political backlash," Buffett wrote. "How that will play out in markets is impossible to predict – but to expect a 'soft landing' seems like wishful thinking."

I heard that the Fed might lower interest rates again in May. Should I wait until then to refinance my home?
-- Alicia M., Idaho Falls, Idaho

Despite a cottage industry devoted to Fed watching, there is no way to know reliably what the central bankers will decide to do until they do it.

But if you could forecast Fed moves, you could probably make enough money in the bond market to skip the refinancing and buy your house with cash.

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