Just a Thought – Treasury yields and margin calls

Turmoil in financial markets, such as now with the announcement of US tariffs, appear in two arenas: stock markets and government bond markets. The former are far less significant for the economies as a whole, or for governments, than the latter. This explains why.

1. When recessions, or fear of them, hit economies investors (private, but also overseas public investors, such as the governments of China and Japan) usually turn to the safest bets, sovereign debt in the form of Treasury bonds or 'gilt-edged', so-called because when these security notes were issued as pieces of paper they were literally gilt-edged, very fitting for a 'sovereign' debt. These carry a fixed rate of interest over the duration of the security. So, a $100 bond would be sold by the central bank/treasury for say $96 and repaid at $100 when it reaches its maturity date. (On 31st March 2023 the 20-year US Treasury bond was issued with a fixed rate of interest of 4.75%; the 10-year bond was at 4.58%.) If other investors want to enter the market by buying second-hand bonds, the price may go up to $98 and the yield then falls to 2%. What is remarkable (and alarming for the US government) about the current situation is that capital flight also affected the bond markets, prices fell and yields therefore went up. This means the effective rate of interest in the US rose, initially from 4% to around 4.5%.
2. On average over $910 billion Treasuries are traded every day and over $28 trillion are currently outstanding - https://www.sifma.org/explore-issues/treasury-market-structure/ Japan and China between them hold around 13% and 8% of US bond market. If they sold off their bonds the market would crash through the floor. Japan it is understood is the first trading partner of the US wishing to negotiate tariffs with Donald Trump. To the contrary, China and the US are currently facing off each other. It is unlikely that China will pull the trigger, partly because that would be escalation as in a 'war' and partly because China would take a hit as prices fell, but it always has a loaded gun.
3. But what is really at stake is confidence in the US government being able to meet its bond obligations in the uncertain future. The spread of uncertainty is a genie out of a bottle. The financial world has been changed inexorably. If tariffs reduce the trading capacity and the incomes of US trading partners, they will be less likely and less able to buy US Treasuries in the future, and will look for other ways to hedge against inflation and to find safe havens for their own sovereign funds. This won't be an absolute process, but a relative shift that could end up creating a much more diverse global financial system.
4. If this should happen, the idea floated at the Bretton Woods conference by John Maynard Keynes in July 1944 for a composite world trading currency could be resurrected. At the time the US vetoed the idea as it would undermine the US dollar as the world's trading currency. This gave the US a huge economic and financial advantage (as Britain enjoyed in the nineteenth century with the pound sterling) because the value of the dollar was thereby

guaranteed whatever domestic policies the US adopted. The problem now is that if US policy is to change and let the dollar's value fall to be more competitive in global markets, the US Treasuries market would collapse because to sustain it with higher interest rates (yields) would keep the dollar strong. That would encourage imports. More imports means more consumption and less savings, so the financial gap is made up of capital inflows. That is basically the situation of the USA since 1945. If the policy is to raise revenues through tariffs and reduce other taxes such as income tax and sales taxes, then again it contradicts any policy to devalue the dollar. But a falling dollar is a consequence of the current bizarre policies coming out of America.

5. Is it conceivable that tariff revenues could be used to cut other taxes? It seems not. Income tax alone in the US in 2023 was over $2 trillion or 58% of total imports at $3.8 trillion. So, tariffs would need to be at 58% of all imported goods. Only by a huge increase in imports could a lower tariff raise sufficient funds. The impact of tariffs has the opposite effect.
6. Finally, EMDEs (Emerging Market and Developing Countries) are particularly vulnerable to financial distress. What are known as 'margin calls', which means accounts of overseas countries, such as African countries, held by creditors, such as private US banks, need to maintain a certain level of assets (their margins) to remain credit-worthy or suffer either crippling rises in the interest they have to pay back on loans, or default, or turn to the IMF to bail them out. Interest rates on margin calls in Africa have very recently risen to 10%-15%. They are not in a good position to respond to US tariffs on their exports by offering to buy more imports from the US. As an aside, the cutting of USAID to EMDEs has hit the ability of American farms to export their surplus food stocks, thereby hurting both parties, serious food shortages in the EMDEs and the loss of farm sales that were subsidised by the US government.
7. 101 economics in financial markets will be writing up all this as history. Another aspect of never let a good crisis go to waste.