Long-Term Debt Drama and Political Inaction

President Nixon's cancelation of the gold standard in 1971 catalyzed a U.S. government spending spree that continues today. The lack of a standard limitation legitimized the country's authority to print money with the insurance of the "full faith and credit" of the government, rather than with redeemable gold. Leaders now seek to spend on popular plans for the sake of political gain, and recent contention among Congress and the White House has hindered any sort of long-term resolution. As a result, U.S. federal debt accumulation of about $18 trillion ranks the highest in the world.

Deficit Deceit

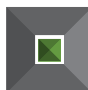
Based on the most recent Treasury Department estimates (as of Oct. 15, 2014), the federal government ran a budget deficit of about $483 billion in fiscal-year 2014 ended Sept. 30, about $197 million lower than in 2013. The deficit represents about 2.8% of GDP, below the 40-year average. The Congressional Budget Office (CBO) estimates revenues increased by about 9% this year as a result of higher tax receipts, which might suggest an increase in wages for workers. In addition, discretionary spending, particularly for defense, decreased for the year, according to the CBO. Many economists, political scientists, and news agencies have touted these trends as signs of improved policies, a healthier economy, and shrinking deficits to come.

When asked in a recent PBS interview with Gwen Ifill, Treasury Secretary Jack Lew explained:

> "The president came into office and took tough action. He stabilized the economy. He put in place an economic program to create growth. He put in a program to reform our financial markets and over a period of years worked with Congress on a bipartisan basis to put in place a balanced set of measures to reduce our deficit."

But while the deficit will decline into next year, a smaller deficit in 2014 only means that national debt accrual is "less bad" than before. The debt has grown so large that even drastic cuts to the deficit (like in 2014) no longer improve the debt-to-GDP ratio. While a lower deficit sounds encouraging in the context of an unbalanced balance sheet, deficits still build upon the dangerous debt heap. In addition, the CBO believes deficits going forward will likely expand amid slow economic and revenue growth and an uptick in spending.

Despite the currently low deficit-to-GDP ratio, the CBO estimates a fiscal-year 2014 debt-to-GDP ratio of about 74%, more than twice than at the end of 2007 and the highest since 1950. The CBO also believes the ratio could grow through 2024 under current policies. Debt accumulation could continue to rise amid an economy that can't keep pace.



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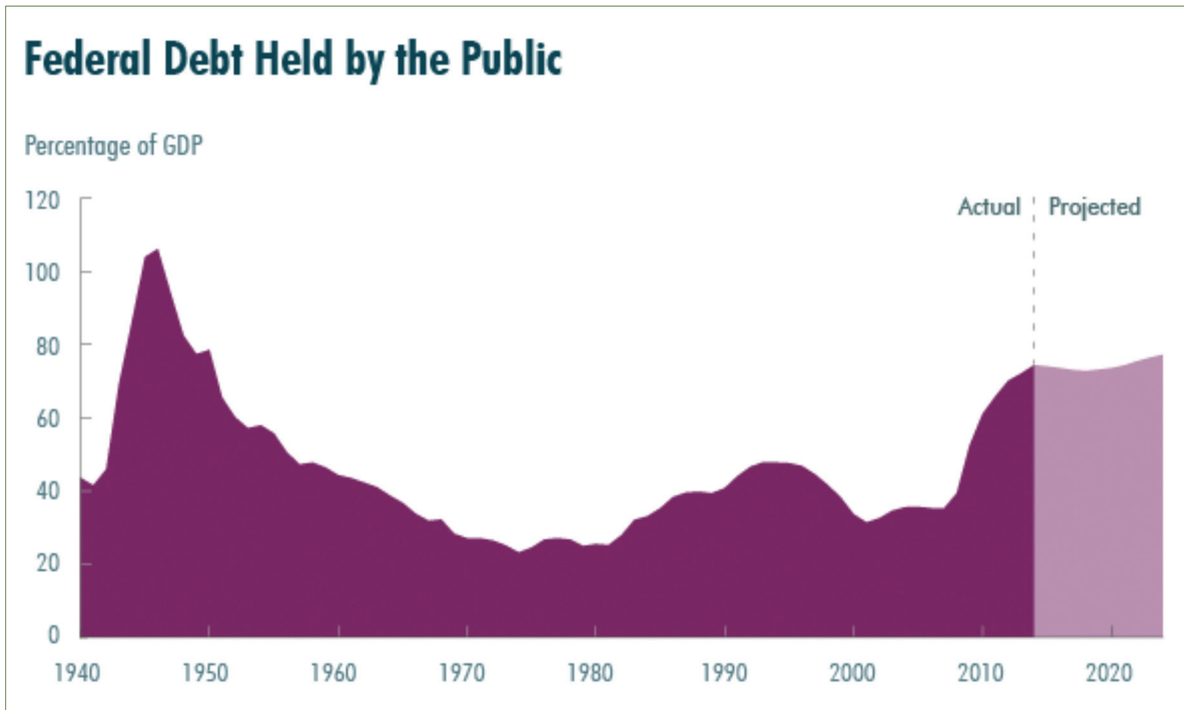

Congressional Budget Office, 8/14

Meanwhile, total spending increased (under current CBO projections) by about 1% this year, particularly as a result of higher Medicaid and Social Security costs. The aging population and current lack of policy resolution present the most difficult challenge to the budget dilemma. The CBO expects (as of Aug. 27) annual spending on Social Security to increase by 80% between now and 2024, while outlays for all major health programs could rise by more than 85%. While wars and financial crises have certainly added to the total, ongoing entitlement spending could undermine economic improvement for the long term.

Impending Interest

The government has kept interest rates near zero by adding to their own debt, creating a borrowing environment void of high interest rate payments. The end of the Fed's bond-buying program could result in higher rates, and therefore higher spending on interest for the government. In addition, the country's ability to print money to make payment may be unsustainable, and markets could choose to react to this insolvency. Conway Wealth Group believes rates could eventually rise, leading to a higher debt-to-GDP ratio and the possibility of further constraints to growth. This could initiate a cyclical effect of slow economic growth and higher debts.

Unpopular Solutions

We believe leaders will need to implement drastic policy change to systematically reduce the debt (not just short-term deficits). However, many methods are politically unpopular or initially detrimental to the economy. As Global Financial Data Chief Economist Dr. Bryan Taylor explains in a report, "The burden of government debt is born by government employees, taxpayers, and bondholders. Above all, politics determines who bears the costs." (See Global Financial Data: "Paying Off Government Debt").

To avoid another crisis, we believe policymakers will need to discard political incentives to focus on the true risk of looming debt. To paraphrase Dr. Taylor, governments in the past have

limited political negativity surrounding deficit reduction by growing their way out, which shrinks the debt-to-GDP ratio.

But many economic leaders, including the CBO, don't anticipate enough growth in coming years to manage higher spending or rising rates. The clearest method is to rebalance the ledger—to either cut costs or raise revenues (or both)—and subsequently create a surplus. Both of these strategies entail huge political risk. On one side, leaders could cut spending on entitlements. This would require a massive overhaul to current laws, as the government has already made promises to our aging population. On the other side, leaders could raise revenues through tax hikes, which could have a ripple effect on consumer spending and the broader economy. Despite the political disincentives, a balanced budget is probably the best long-term approach to debt reduction.

However, there are certainly more drastic approaches with fewer outright political hindrances, for which leaders don't have to pass laws. The U.S. could choose to default on its obligations, thereby passing the bill to Treasury bondholders. However, the Fed's ability to print money and the dramatic political and economic implications of default render this solution highly unlikely. Instead, the government could choose to manipulate fundamental inputs to the economy in order to reduce debts behind the scenes. Some economists believe that the Fed's quantitative easing policy has facilitated low-cost interest for the sake of a lower federal debt burden, as part of a form of debt reduction known as "financial repression" (coined in the 1970s by Stanford economists Edward S. Shaw and Ronald I. McKinnon).

This process seems to offer a more viable solution to politically conscious monetary policymakers. In a paper titled, "The Liquidation Of Government Debt," economists Carmen M. Reinhart and M. Belen Sbrancia explain:

> "Given that deficit reduction usually involves highly unpopular expenditure reductions and (or) tax increases of one form or another, the relatively 'stealthier' financial repression tax may be a more politically palatable alternative to authorities faced with the need to reduce outstanding debts."

Indeed, the government has initiated similar strategies in the past. After the end of World War II, the U.S. successfully reduced debt by facilitating low nominal interest rates and inflation.

Reinhart and Sbrancia explain:

> "…at the closure of the second great war, we witness a combination of very low nominal interest rates and inflationary spurts of varying degrees across the advanced economies. The obvious result, were real interest rates—whether on treasury bills, central bank discount rates, deposits or loans—that were markedly negative during 1945-1946."

Financial repression through high inflation (devaluing the dollar by printing money) and low interest rates could result in cuts to real returns on government bonds, leaving the true burden of the debt on bondholders. Although potentially enticing to leadership looking to avoid political retribution, these tactics are packed with complex risks. We believe policymakers will ultimately return to the table and balance the budget for the sake of the country.

Without reform, particularly regarding entitlement spending, Washington could drive the economy toward another crisis. Unfortunately, little urgency currently exists among investors and policymakers, especially amid positive media coverage regarding the dwindling deficit. Hopefully, leaders will begin to cooperate to determine a cohesive approach to tackling the problem while the economy improves in tandem. While political stagnation remains the greatest hindrance, the U.S. has faced and successfully managed debt burdens in the past. If Washington can better align its spending with economic growth—particularly in technologies and infrastructure—we anticipate some exciting opportunities ahead. In the meantime, long-term investors should remain steadfast. With these risks in mind, our portfolios reflect the goals of each of our clients. We are very confident in how we are currently positioned.

Sources

- Congressional Budget Office: “An Update to the Budget and Economic Outlook: 2014 to 2024.”
- Congressional Budget Office: “Monthly Budget Review for September 2014.”
- Global Financial Data: “Paying Off Government Debt,” Dr. Bryan Taylor.
- National Bureau of Economic Research: “The Liquidation of Government Debt,” Carmen M. Reinhart, M. Belen Sbrancia.
- PBS News Hour: “Shrinking U.S. deficit shows stability amid market jitters” (video).

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