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Economics Group

Special Commentary

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Did the Nation Overdose on Debt?

Long-term Repercussions of Swelling Government Indebtedness

"You cannot escape the responsibility of tomorrow by evading it today." – Abraham Lincoln

Fiscal year 2009 for the United States government drew to a close on Sept. 30, when the closing bell sounded to the sour tune of a $1.417 trillion deficit (Figure 1). Some perspective: 1.4 trillion is equal to 13 times the number of people who have ever lived, or $4,500 for each and every person living in the United States. The stock of debt held by the public, as a percentage of gross domestic product (GDP) has never been as high during peacetime—the current high was last surpassed during the aftermath of World War II. Wartime spikes in debt levels were temporary, however, and therefore did not permanently damage economic growth prospects. In contrast, the current path of indebtedness shows a permanent venture into economically unfavorable territory.

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For decision-makers, the ratio of the deficit to gross domestic product (GDP) is a talisman of long run fiscal sustainability, or lack thereof. Unfortunately the recent rapid growth of this ratio gives cause for concern. The deficit has reached nearly 10 percent of GDP—more substantial than any time on record (Figure 2). This presents a real challenge to policymakers.

Figure 1

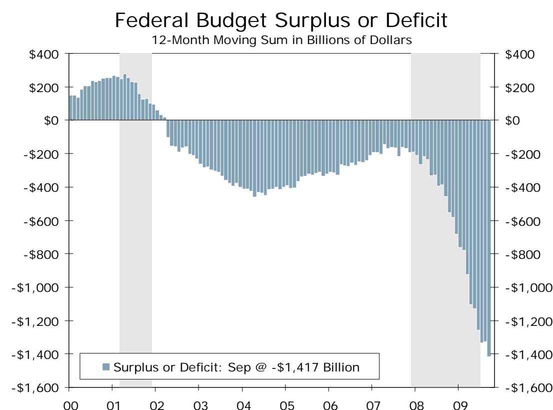
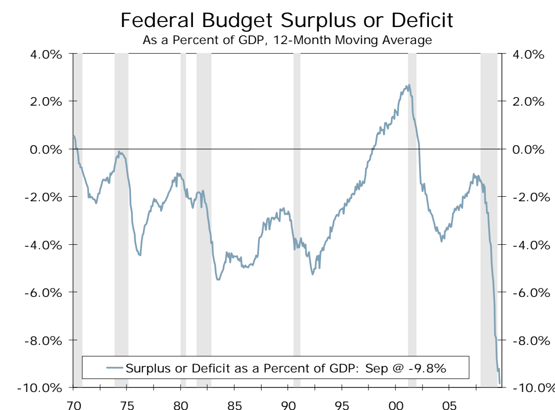


Figure 2



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

International Comparisons: A Benchmark in a Global Economy

While U.S. indebtedness rose to one of the most inauspicious levels in our history this year, a global perspective provides further illumination. The stock of government debt, which is the accumulation of deficits built up over time, remains slightly below the average for member countries of the Organisation for Economic Development (OECD) as a percentage of nominal GDP. Relative fiscal responsibility over the past few decades resulted in a reasonable debt load as

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the United States entered the 21st century. However, U.S. budget management has not necessarily been stellar; the average has been pulled significantly higher by a few notable outliers.[1]

Policymakers who evade the responsibility in the present merely postpone the day of reckoning.

While the United States did not begin the century with an extraordinary amount of debt, recent history exposes a significantly faster pace of debt accumulation (Figure 3). This is not to say all is lost for the United States—10-year Treasury notes are maintaining low yields, implying that there is still a market for additional U.S. debt. However, it is clear that the nation faces difficult choices about the extent of debt servicing responsibility it is willing (and able) to take on and the extent to which it wishes to pass on the debt burden to future generations. Policymakers who evade the responsibility in the present merely postpone the day of reckoning.

Figure 3

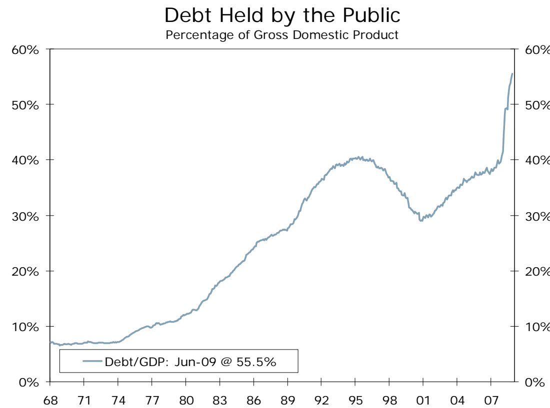
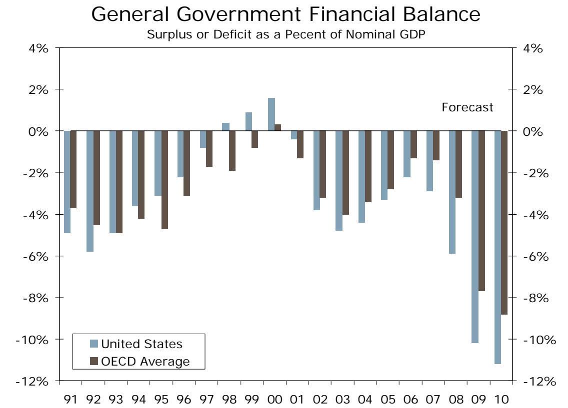


Figure 4



Source: OECD, U.S. Dep't of the Treasury, U.S. Dep't of Commerce and Wells Fargo Securities, LLC

Deficits, the Marginal Contribution to Debt—Wrong Direction

The ratio of the deficit to GDP is a more contemporary indicator that measures the marginal contribution to notional debt and unfortunately those contributions are rising. Owing mostly to the recession and its associated financial implosion, the deficit to GDP ratio accelerated dramatically in fiscal year 2009, and stands well above the OECD average (Figure 4). As a result, some of the financial flexibility of a lower debt load is lost. While the United States is certainly not in the worst position relative to the rest of the world, its fiscal position does not leave room for complacency and free spending, especially given its dependence on capital inflows.

Financing the Deficit—Enabling Factors

The United States benefits from high global demand for dollar-denominated assets, especially in turbulent economic environments.

While U.S. indebtedness has risen this year to one of the most inauspicious levels in history, the reliance on global capital flows for deficit financing makes this issue extraordinary. Most countries cannot afford to carry as much debt as the United States. So what enables the nation to spend what it cannot afford on its own? The deficit is financed through public borrowing, in the form of Treasury securities, be it bills, notes, or bonds, as well as various forms on nonmarketable debt. Thus far, the nation has been able to borrow from the public at relatively low interest rates, making debt servicing (interest expense) a manageable budget item. While this is subject to change, there are several reasons for this historical affordability. The United States benefits from high global demand for dollar-denominated assets, especially in turbulent economic environments when the safety trade (desire for less-risky assets) is in play.

[1] Japan is the most severe outlier with debt amounting to nearly 200 percent of GDP. Japan continues to build debt at a swift clip, and as carrying such debt is an economically tenuous proposition; the OECD has urged Japan to manage revenues and spending in a manner more conducive to fiscal sustainability. Italy and Belgium drive up the OECD average as well, but in recent years have made commendable progress moving toward the average.

Figure 5

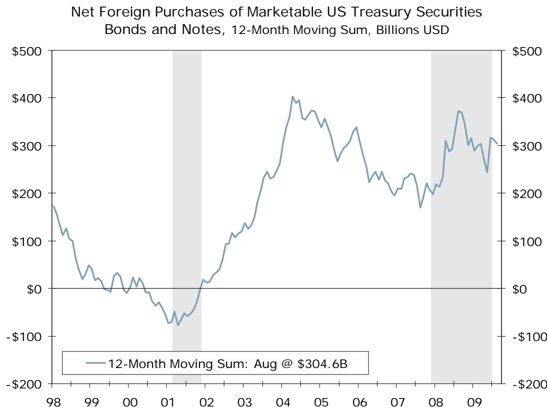
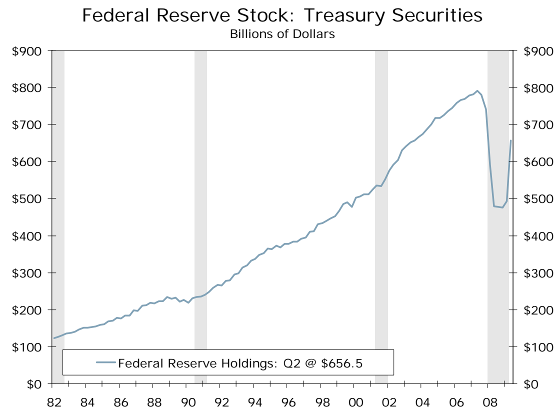


Figure 6



Source: Department of the Treasury and Wells Fargo Securities, LLC

The foremost holders of Treasury securities are foreign investors who hold nearly 50 percent of Treasury securities outstanding.

As fears mounted over the course of the most recent recession, demand for Treasury securities mounted so severely that yields on 3-month bills turned negative at a low point in December 2008. Even in calmer times, however, demand for U.S. debt has held up relatively well (Figure 5). The Federal Reserve holds meaningful quantities of Treasury securities, purchased on the secondary market mainly to control money supply. Net purchases have remained relatively constant except in the past few quarters of severe turmoil (Figure 6). Households and state and local governments hold meaningful quantities as well. However, the foremost holders (and primary market buyers) of Treasury securities are foreign investors, public and private, who held nearly 50 percent of Treasury securities outstanding in the second quarter of 2009 (Figure 7). In other words, U.S. growth is largely financed by foreign investors.

Figure 7

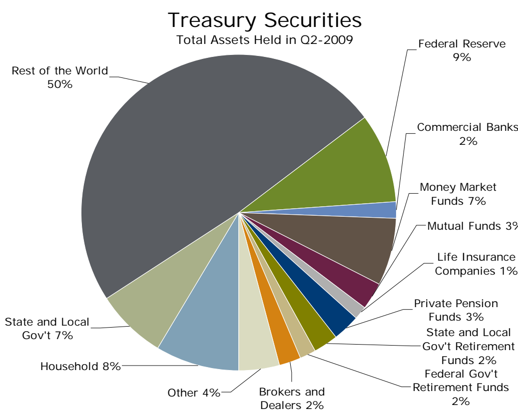
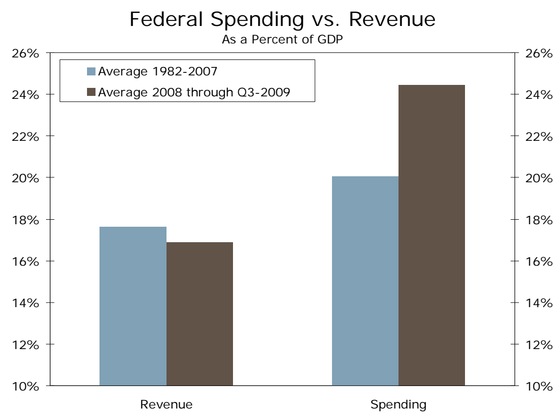


Figure 8



Source: Federal Reserve, U.S. Department of Commerce and Wells Fargo Securities, LLC

The Path to $1.4 Trillion

The severity of the recent economic malaise helped the deficit soar to new heights.

Policymakers would like a fresh start, but cannot disinherit past spending. Acknowledging the difficulty of the outsized deficit and dependence on foreign investors, how did the U.S. fall into this ever-deepening fiscal hole? The easy answer blames the combination of elevated spending and diminished revenues associated with the financial crisis and economic downturn during fiscal year 2009. During any recession government spending tends to increase in the short run to help fill the gap left by private spending. Concomitantly, receipts fall off because personal income and corporate profits decline as payrolls shrink and consumer and business spending falls. However, the severity of the recent economic malaise helped the deficit soar to new heights (Figure 8). The nation, and arguably the world, barely averted catastrophe as the government propped up the financial system. The Department of the Treasury accounted for nearly $750 billion of spending,

unusually exceeding the Department of Defense and just short of the Department of Health and Human Services, home of Medicare and Medicaid Services.[2] Unusually large spending increases in healthcare and income security spending also contributed significantly. With more than seven million jobs lost, unemployment claims skyrocketed; in addition, more individuals began to meet eligibility requirements for entitlement programs such as food stamps and Medicaid, or felt the need to draw on benefits for the first time. Those already collecting benefits likely began to do so more heavily.

Despite the diminishing effects of short-term deficit drivers, the recession and the financial crisis, a quick bounce back to sustainability is off the table.

Despite the diminishing effects of short-term deficit drivers, the recession and the financial crisis, a quick bounce back to sustainability is off the table. Underlying the cyclical deficit story is the more meaningful long-run factor of entitlements, and a recession serves to accelerate the severity and immediacy of the problem. The primary federal entitlement programs, Medicare and Social Security, already pose serious threats to fiscal sustainability. When considering the future direction of U.S. government indebtedness, the most challenging issues during the recession become even more problematic.

Table 1

Projected Federal Spending and Revenues

(Percentage of Gross Domestic Product)

	2009	2015	2025	2040	2060	2080
Social Security	4.8	4.8	5.6	5.9	5.8	6.2
Net Medicare	3.1	3.6	5.2	8.1	10.9	14.3
Federal Medicaid	1.9	1.8	2.3	3.0	3.4	3.7
Other Primary	15.9	10.6	10.5	10.4	10.3	10.3
Total Primary	25.6	20.8	23.6	27.3	30.4	34.4
Net Interest	1.1	2.8	4.6	9.3	18.2	30.3
Total Spending	26.7	23.6	28.2	36.6	48.6	64.7
Revenues	15.8	18.5	18.8	19.4	20.6	21.9
Deficit (-) or Surplus	**-10.9**	**-5.1**	**-9.4**	**-17.2**	**-28.0**	**-42.8**
Federal Debt	56.6	71.4	111.5	223.2	433.4	716.3

Source: Congressional Budget Office Long Term Alternative Fiscal Scenario, June 2009

Healthcare and Demographics: Long-run Drivers of the Deficit

Entitlement spending will become the crux of future budgetary challenges.

Fiscal discipline has long been honored more in breath than in practice. A longer view shows that economic recovery alone will not restore a balanced budget—there are several long-term trends that will impel the deficit. Entitlement spending will be the primary driver of larger and larger deficits (Table 1).[3] Knowing the areas that will, and already have become problematic, it would seem that the solution would already be in hand. However, balancing the budget and addressing the fundamental issues has eluded decision makers over many decades. Too many competing objectives complicate the process.

Table 1 shows that revenues are shrinking as a percent of GDP, while spending trends are growing strongly and will likely not turn around without making difficult choices. Outlays, and specifically the trend of higher spending as related to the major entitlement programs, Medicare, Medicaid and Social Security, will become the crux of future budgetary challenges. It is widely recognized that these programs are at the heart of the problem because they are growing unsustainably.[4] Medicare in particular, but also federal grants to states for Medicaid, will grow to a combined 18 percent of GDP in the CBO's long-term forecast (Table 1). Social Security adds more than six percent to that figure.

[2] Monthly Treasury Statement, September 2009. U.S. Department of the Treasury.

[3] The Congressional Budget Office's Long Term Budget Outlook, published in June 2009, includes an alternative fiscal scenario to account for highly likely assumptions about future legislation, for example, the AMT provisions made each year in Congress and complete expiration of the Bush tax cuts, which in our view makes it more accurate than the baseline forecast.

[4] Current economic and financial conditions and the federal budget. Ben S. Bernanke, Federal Reserve Chairman. Testimony in Washington, D.C. June 3, 2009.

Figure 9

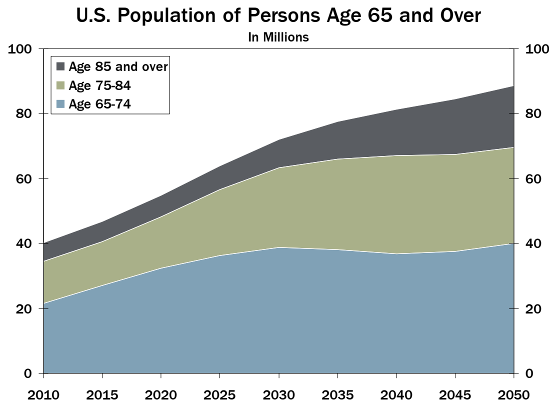
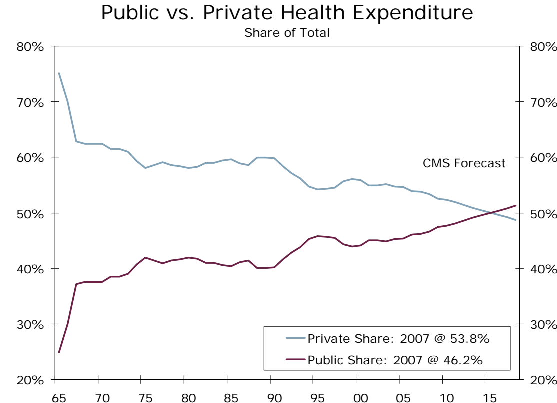


Figure 10



Source: U.S. Dep't of Commerce, U.S. Dep't of Health & Human Services and Wells Fargo Securities, LLC

The rapid growth of such programs is the result of two fundamental facts, the aging of the U.S. population and rising healthcare spending. The retirement of the Baby Boom generation will exert pressure on Social Security as well as Medicare as the largest demographic cohort begins drawing on benefits (Figure 9). In addition, public health expenditures on Medicare and Medicaid continue to spiral upward—a trend exacerbated by the aging population as medical spending spikes dramatically for the elderly (Figure 10). Healthcare cost increases, which significantly outpace the general price level, reinforce the upward pressure on spending. With outlays growing rapidly, a balanced budget through reduced spending is highly unlikely.

Without major changes to the tax code, revenues will not deliver a balanced budget.

Receipts Cannot Provide a Simple Long-run Cure

Unfortunately for policymakers, receipts do not improve the fiscal outlook either. What will revenues look like over the long run? Tax receipts will rise slightly as a percentage of GDP, but will fall well short of spending growth. Indeed, farthest out on the forecast horizon, spending becomes three times the amount of revenues (Table 1). This future outcome is extremely unlikely, but shows the perilous direction of current policy. Taxes are an undesirable solution because high tax rates inhibit economic growth by diminishing the returns of employment, investment and saving. Despite these revenue roadblocks, "something's gotta give." In the long run, revenues and spending continue to move farther apart, and the budget gap gets ever-wider. Without major changes to the tax code, revenues will not deliver a balanced budget.

National Saving and Economic Implications of Fiscal Imbalance

The accumulation of real and financial assets is an integral contributor to long-run economic growth.

A look at national saving illuminates the underlying economic consequences of U.S. indebtedness. Though infrequently discussed, national saving, or the sum of private and public saving, is a concept that is vital to replenishing and expanding the capital stock of the United States and therefore to economic growth. National savings are funds assumed to be available for investment; it is what remains after the private sector fulfills tax obligations and consumption needs (personal saving) plus the difference between government receipts and expenditures (budget balance), which we have established is an enormous negative. The accumulation of real and financial assets is an integral contributor to long-run economic growth, as returns on such assets determine future national income. In the following equation, personal saving signifies private sector saving, and the budget balance represents public saving.

$$\textit{National Saving} = \textit{Personal Saving} + \textit{Budget Balance}$$

Limited national saving translates into limited financing of investment, which sacrifices income, productivity increases, higher living standards and future economic growth. However, the United States, with negative national saving, invests heavily in capital goods. The financing gap shows the difference between internally generated funds and capital expenditures (Figure 11). Much investment cannot be financed domestically and therefore funds must be borrowed from abroad. The recent declines in the financing gap reflect diminished capital expenditures as businesses

hesitate to make spending commitments in continuing economic uncertainty, and not an increase in internally generated funds.

The Catch-22 of borrowing from abroad is that while it enables spending beyond the means of the nation in the short run, it is at the expense of future national income.

The United States has avoided coming to terms with low national saving largely because of the affordability of borrowing. This policy is not without consequences, however—the nation only receives part of the benefit from capital investment with borrowed funds. In other words, the returns on the nation's capital must be shared with the debt holders, mostly the rest of the world, in the form of interest payments. Forgone is part of the benefit to the nation of a higher standard of living, higher level of employment and increased personal income. The Catch-22 of borrowing from abroad is that while it enables spending beyond the means of the nation in the short run, it is at the expense of future national income.

Figure 11

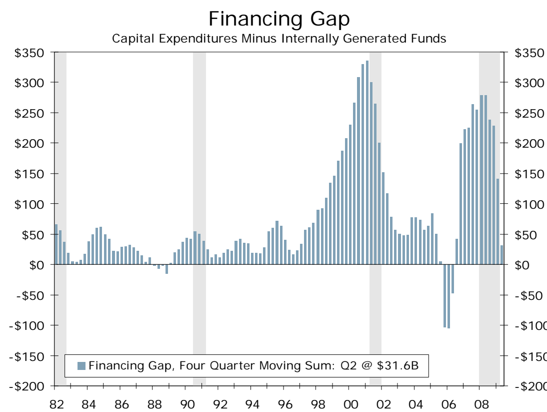
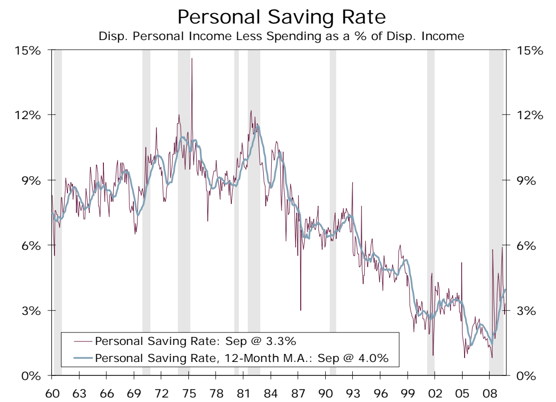


Figure 12



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

Budget Balance Drives the Trend: Personal Saving Little Help

Even without vastly greater debt levels, changes in the appetite for U.S. debt could increase the interest payments to levels deleterious to economic growth prospects.

The components of national saving are fundamental to the fiscal outlook. The size of the budget balance makes it the dominant part of the equation. Interest payments, an unavoidable consequence of spending borrowed money, are set to grow rapidly, along with debt (Table 1). Deficit financing obligations also have the potential to constrain economic growth, beyond the dangerous trends already discussed. Currently, high global saving rates and the demand for virtually risk free investments such as Treasury notes mean that that United States can borrow at low rates. In addition, countries with large current account surpluses tend to store their wealth in dollar-denominated assets, supporting demand for U.S. debt. However, global saving rates and Treasury demand are both liable to change without notice, which would drive interest rates higher and the dollar lower with limited influence by U.S. policymakers. In recent months the dollar as reserve currency has already been called into question, though the dollar can be supported by the government if it is to remain the world's currency. Even without vastly greater debt levels, changes in the appetite for U.S. debt could increase the interest payments to levels deleterious to economic growth prospects. Beyond the burden of interest payments themselves, the true price tag includes opportunity costs—paying off creditors and sacrificing other uses of the funds. Financing the deficit takes away from other spending needs and desires, such as healthcare, national defense or alternative energy. Those industries will forgo the benefit of additional government spending as funds are dedicated to unproductive interest payments. Strong economic growth will help make financing debt more manageable, but if conditions are deleterious to growth, the United States could wind up in an insurmountable fiscal hole. The saving rate will establish a baseline well above pre-crisis levels, but not enough to decrease the need to borrow for capital expenditures.

Personal saving, the other variable in the national saving equation, is difficult to forecast. The saving rate fell precipitously for about 25 years before the most recent economic and financial crisis, but some have postulated that there is a sea change afoot. Tight credit and a slow and tenuous recovery lead us to conclude the saving rate will establish a baseline well above pre-crisis

levels, but not enough to decrease the need to borrow for capital expenditures. All but the safest stores of wealth, cash and government bonds, took severe hits during the fallout. Net worth fell by $14.2 trillion in fewer than two years. Concurrently, credit continues to tighten for consumers, which induces reliance on saving for big purchases, including higher down payments for homes. Further, rising rates of unemployment scare individuals into saving should they join the ranks of the unemployed in the future—the 90 percent of the labor force still employed is saving lest they need to draw on their savings for living expenses in the future. A cautious consumer saves, and consumers have many reasons to remain wary as the recovery slowly unfolds. Unfortunately, the increases in the budget deficit overwhelm increases in private saving, so despite the higher path of personal saving, negative national saving looks to be the rule for the foreseeable future.

Conclusion: Benchmarks for Decision-Makers

There are serious sustainability concerns that arise when considering an outsized long-term fiscal deficit. The concern is twofold; both the *outsized* and the perceived *long-term* nature of the deficit are problematic. Were it only one of these and not both simultaneously, the apprehension would be considerably diminished. While the budget gap will narrow in the near term as emergency spending slows during the economic recovery, the long term trend does not show a return to fiscal discipline, rather the destruction of it. The prevention of such an outcome lies in the hands of both policymakers and the electorate.

While the budget gap will narrow in the near term, the long term trend does not show a return to fiscal discipline, rather the destruction of it.

In the near term, with the disaster averted, it is essential to restore fiscal balance, turning off the liquidity pipes before the nation is awash in an even greater flood of debt. Swift policy action by fiscal and monetary authorities likely helped avert another Great Depression. This includes difficult choices about entitlement programs, and how much of a state-sponsored safety net is appropriate. With that, tax rates that ensure long-run fiscal sustainability can be determined, recognizing the disincentives and antigrowth effects of overly high taxes. The deficit was expanded in part to put a floor beneath the crumbling economy and prevent an outright collapse of the financial system, extreme actions taken in a time of crisis. Chairman Bernanke acknowledged in a recent speech: "…Maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance."[5] Oct. 1 marked the beginning of fiscal year 2010. While it is unlikely another year like 2009 will be recorded in the near term, the long-term outlook demands attention. Relying on demand for safe dollar-denominated assets, high rates of global saving and the dollar as the world reserve currency are assumptions too tenuous upon which to rest a nation's fate. Abraham Lincoln's words can easily be applied to the fiscal outlook. The longer the United States postpones making important decisions about spending, and aligning taxes accordingly, the more severe the eventual shock of returning to fiscal sustainability will be, and the worse the outlook for economic growth becomes.

[5] Current economic and financial conditions and the federal budget. Ben S. Bernanke, Federal Reserve Chairman. Testimony before the Committee on the Budget, U.S. House of Representatives, Washington, D.C. June 3, 2009.

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