US Macroeconomics

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Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

Poor Fiscal Dynamics and Even Worse Remedies

United States marketable debt is currently $27 trillion or 95% of GDP. Troublingly, **the nonpartisan Congressional Budget Office (CBO) projects that debt will grow to nearly $48 trillion over the next decade, which is enough to push debt to GDP to a record high 122%.** Why should we care? Work from Reinhart and Rogoff shows that when debt rises to 90% or more, future annual rates of GDP growth could be cut in half (see here). What can we do to get the fiscal trajectory on a more sustainable path?

Faster economic growth would be a start but is unlikely to be enough on its own as government spending is the bigger culprit. For example, during the second half of the Clinton Administration, the economy boomed and spending slowed. Real GDP grew at a 4.3% annualized rate, enough to push federal revenues as a share of GDP up to 20% in 2000, an all-time high. Meanwhile, federal outlays slowed to just under 18%. The combination produced a record 2% budget surplus relative to GDP. This is the best approach for fiscal repair.

However, current CBO projections show revenues rising from around 17% at present to 18% of GDP by 2034 which is reasonably optimistic considering the long-term average revenue share of GDP is 17%. Conceivably, revenues could grow faster with intelligently designed supply-side initiatives, thus imitating the results of the late 1990s. Substantial tax increases that are expected to raise revenues could be self-defeating as they likely would dampen capital formation and damage productivity growth. Consequently, revenue collection would fall well short of expectations and living standards would suffer.

Today's problem is less about too little revenue and more about too much spending. **According to the CBO, federal spending is expected to rise to a historically high 25% of GDP over the next 10 years**. This is why the budget deficit averages over 6% of GDP for this period. But since this forecast does not assume recession, the projected fiscal deterioration is likely to be even worse because downturns lead to less revenues and more spending. Budget deficits tend to rise several points when the economy shrinks, so bond investors could easily see a budget deficit that is around 10% of GDP when the next downturn inevitably occurs.

This is why **some economists think monetization is the only way to reduce the stock of debt**. It could happen one of two ways. The Fed could monetize the debt through quantitative easing, thereby raising the inflation rate and nominal GDP growth. In turn, the size of the existing debt falls relative to the size of the economy. This has happened many times before with disastrous economic implications. Or the Fed could reduce the debt through an accounting gimmick, which effectively would be an indirection form monetization. Here is how it would work:

The Federal Reserve holds nearly $7 trillion in fixed income securities that are split between treasuries ($4.4 trillion) and mortgages ($2.3 trillion). The Fed could swap its mortgage holdings for treasuries, enabling it to have an all government securities portfolio. **Since the Fed and Treasury are both part of the government, the former could theoretically forgive the latter, thus wiping away what is owed**. This would lower outstanding debt to a more manageable 70% of GDP. Of course, there is obvious caveat. What would prevent this from happening again? The answer is nothing. Debt monetization would become a political grab bag.

In light of current fiscal dynamics, the Treasury yield curve ought to be much steeper, reflecting the potential for higher inflation over the intermediate term. Right now, investors are not troubled by such a possibility. However, history is replete with examples of how seemingly obvious phenomena are ignored by financial markets until all of a sudden they are not.

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