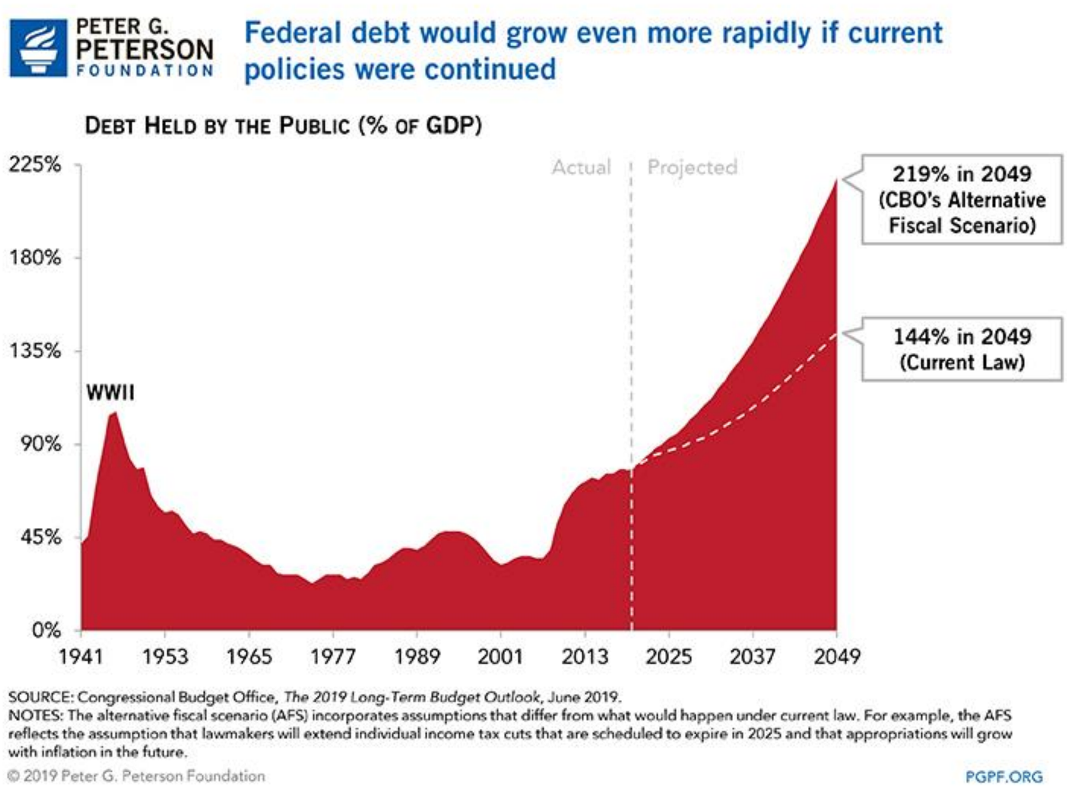
The National Debt's Impacts on Ordinary Americans

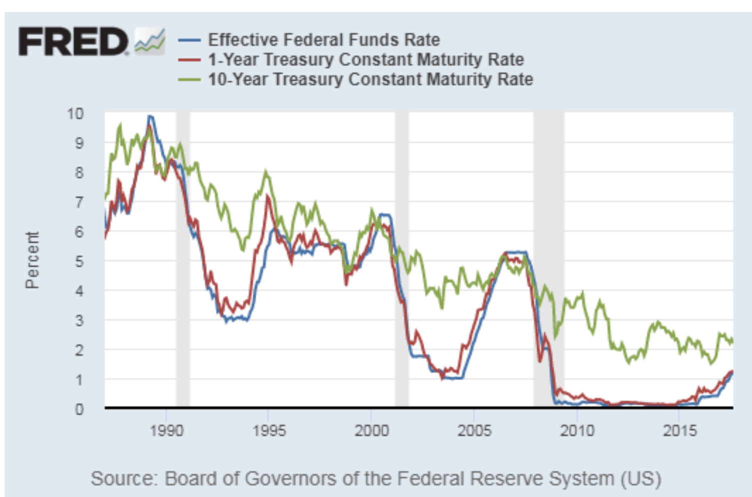
Intuitively, most people know that taking on a very large amount of debt is not a good thing. But, few are concerned about the nation's debt. The debt has been growing steadily for years, without (to most) any apparent negative ramifications. The federal government has been around for many years. It has fixed a larger debt burden in the past—the World War II burden. Surely, it will handle it.

Annual federal revenue has never exceeded $3.5 trillion. Total federal debt is $24 trillion, and debt owed to the public is $18 trillion. (Approximately 7 trillion is owed to foreign lenders.) The Congressional Budget Office (CBO) expects the debt to increase by $13.6 trillion over the next decade. In the past, CBO has underestimated annual deficits. Actual deficits for 2009-2012 were $5.1 trillion, eleven times those projected by CBO in 2008. As a percent of GDP, CBO expects the public debt to increase from 78.9 percent to 95.1 percent in ten years. The all-time high percentage (119) was experienced in 1946. Relative to revenue and anticipated future revenue, the debt is beyond excessive. While many politicians claim their policies, if enacted, will cause the economy to outgrow the debt, the reality is: Under no realistic set of circumstances can the economy outgrow the debt. A picture tells . . .



The unemployment rate is at a 50-year low. In the past, such a strong economy would have produced balanced budgets and triggered a Fed discount rate of at least 5 percent. (In 2007, it was 5¼ percent.) Roughly a trillion dollar deficit was experienced in 2019. Since 2008, the Fed rate has not exceeded 2.42 percent. Why? It is largely because the federal government cannot stomach traditional interest rates. Historically, Treasury rates have tracked the Fed rate, with Treasury note and bond rates generally being a few points higher. Applying a 7 percent interest rate to $17 trillion of public debt produces $1.19 trillion of interest—34 percent of the $3.5 trillion of highest annual federal revenue. In 2017, Michael Hüther of Stanford University aptly noted: "A government loses its democratic legitimacy if it start[s] paying a too-high share of its tax income on interest."

As noted in the chart that follows this paragraph, the Fed rate indirectly impacts Treasury rates. It also affects other rates. With the debt expected to continue to grow, it appears that low interest rates are here to stay—assuming the Fed rate continues to be the main driver of other interest rates, including Treasury rates. With those low rates, very low CD rates can be expected to continue, thus potentially continuing to drive some investors to more risky, potentially higher yielding investments. Quantitative easing (QE) drove down Treasury rates, reduced federal net interest expense, and drove up the stock market. The wealth gap increased. Other investors, including pension plan trustees and foreigners, also more heavily invested in the U.S. stock market, helping produce a bubble. Historically, bubbles tend to burst. Low interest rates produce high private sector pension plan liabilities. Bursting bubbles and high pension liabilities means money that might have been to paid to employees will instead be paid to the pension plan. Many state and local governments have significantly underfunded post-retirement benefit plans.

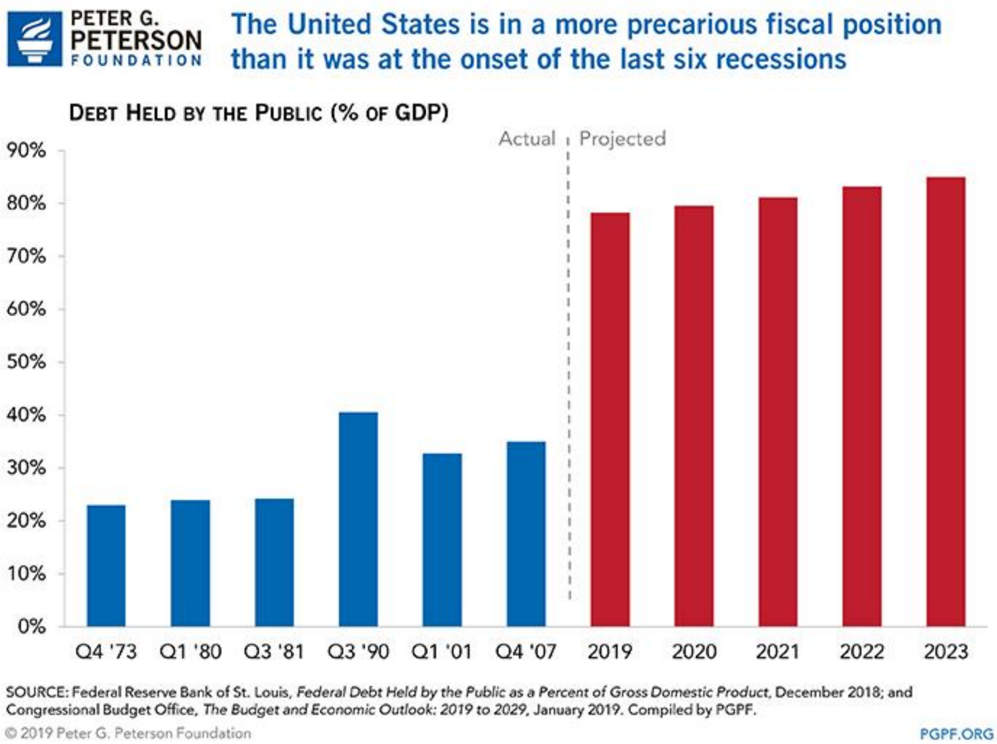


The U.S. alleviated its World War II debt through higher taxes on the wealthy, very significant growth and inflation. From 1944 through 1981, the highest tax rate never dropped below 70 percent. For 1950-1955, real GDP growth averaged 5.7 percent. For 1961-1968, the average real growth rate was 5.2 percent. From 1968 to 1982, the average consumer price index (CPI) increase was 7.4 percent. For 1946-1948, it was 10.2 percent. A 7.4 percent inflation rate will substantively cut a debt in half in less than a decade. It will do essentially the same thing to a low interest-bearing CD. Few can now fathom such tax rates, growth or inflation.

Tracing the history of the U.S. since World War II, low Fed and Treasury rates have ordinarily been experienced while the debt was relatively high, and higher rates have been experienced when the debt was relatively low. In 1981, when the Fed rate hit almost 20 percent and the 10-year Treasury note rate broke 15 percent, the public debt-to-GDP ratio was a post-World War II low of 30.6 percent. In 1954, when the public debt-to-GDP ratio was 70 percent, the federal funds rate hovered around 1 percent, while 5 and 10 year Treasury note rates were below 3 percent. Recent low Fed and Treasury rates are well known. A December 16, 2017 article in *The Wall Street Journal* is titled "Big Deficits Create Headache for Fed." In the article, Mark MacQueen, a bond manager, is quoted: "The Fed cannot defend trillion-dollar deficits year after year after year." Yet, history shows the Fed has accommodated Congress.

Most economists believe the next recession is coming soon. (A Nov. 30 – Dec. 1, 2019 article in *The Wall Street Journal* titled "Stocks Projected to Slow," noted that 34.2, 29.3 and 14.6 percent of economists surveyed believe a recession will hit in 2020, 2021 and 2022, respectively.) In the past, significantly reduced interest rates coupled with significant deficit spending has been the prescription. If a recession hits, aside from bubble-busting, the already low Fed rate will immediately drop to zero percent. Notwithstanding statements of Janet Yellen, negative interest rates may be attempted. Assuming Treasury rates continue to follow the Fed rate, the low potential yields on Treasury notes will induce massive refinancing of federal debt "on the cheap." The Treasury Department has recently been floating the idea of issuing 50 and even 100 year bonds. The plan may succeed. Unlike in the past when interest rate cuts helped spur economic growth, the impossibility of a significant interest rate cut stimulator means deficit spending and quantitative easing, etc. will be the remedies used (by Congress) to help the nation dig out. Both major parties will desperately want to control that spending—and maximize it.

The following chart shows how the U.S. is much more in debt (relative to GDP) than it was prior to past recessions:



Concerning probabilities, an unlikely but plausible event during the next recession that necessitates a major federal outlay (e.g. a pandemic) in addition to the recession deficit spending could cause a tipping point to be hit. While impossible to exactly quantify, it would seem the odds of that happening are 10-15 percent. (Note: $5.1 trillion of deficits existed for 2009-2012.) The future anticipated growth of debt (noted in the first chart) increases the odds.

If an unlikely but plausible event necessitating a major federal outlay is not experienced during the next recession, the ability of the Treasury Department to inexpensively refinance the existing debt will inspire Congress to borrow more. More than 60 percent of federal spending is on entitlements. It's no secret that the two major parties are, like major parties in prior republics, competing to give away more and take less. Only something potentially very bad in the near term that is highly likely to take place might take them and the public away from this mindset. Unfortunately, markets don't give "almost maxed out" tipping point credit warnings to governments. Recalling 2008, a chain of events can happen in a very short period of time (i.e. one afternoon), to cause a panic.

I believe there is roughly a 50 percent chance, with or without an event necessitating a major federal outlay, that the limit will be hit within 15 years. What the limit being hit looks like is difficult to say. In his 2014 book titled *Dead Men Ruling*, former Assistant Deputy Secretary of the Treasury Eugene Steuerle said: “Nations that face exploding debt levels or the kind of problems outlined above [relating to the United States’ financial problems] often refuse to pay their debts and declare bankruptcy. Because so many nations depend on the U.S. dollar to stabilize world markets, a U.S. default could prompt not just a U.S. crisis, but a global depression.”

At some point, the limit will likely be hit. Perhaps the federal government could react to by immediately balancing the budget thereafter, with relatively little harm. That seems very unlikely. If a panic ensues upon hitting the limit, a huge market loss would likely follow. Consider all of the baby boomer retirees and the impact on their spending habits of a significant loss in stock markets’ values. A repeating downward spiral of lost value, followed by reduced spending, is foreseeable. Imagine a lit match falling on dry hay in an old wooden barn. Interest rates will rise, driving down the value of stocks and bonds. With the huge federal debt load, unlike 2008, a federal bail-out won’t be an option.

A “default” in the form of a bankruptcy-like reorganization (if that is what Mr. Steuerle envisioned) is highly unlikely, as markets would explode. Rather, money printing to prevent such from ever happening is much more likely. But, in the event of a market-crushing panic, a bankruptcy-like reorganization might be the best option.

It is also very possible that the limit could not be hit but the U.S. becomes like Japan—“Japanification”—a dead economy. I think the odds of this happening are 35-40 percent. Other possibilities exist.

As a mature economy, the U.S. won’t be able to grow its way out of the problem. And, solving much of the matter with taxes is now impractical. To significantly reduce the debt-to-GDP ratio (as the Fed and Congress want to do), absent a reorganization, very substantial inflation would be necessary. As noted below, the Fed would likely try to save the day through quantitative easing, thereby reducing interest rates and debt, while creating inflation. As of January 2020, the public debt is roughly ten times the cash in circulation.

None of what is coming should come as a surprise. In 2007, when total federal debt was less than $9 trillion, the Government Accountability Office (GAO) said: “GAO’s current long-term simulations continue to show ever larger deficits resulting in a federal debt burden that ultimately spirals out of control."

Aside from the possibility of a collapse, payment of interest produces absolutely no return on tax dollars paid. And, a 2010 World Bank study concluded that countries whose debt-to-GDP ratio exceeds 77 percent for a prolonged period experience slowing of growth. Other reputable studies with similar results exist. (Japan's debt-to-GDP ratio exceeds 200 percent; its economy has been in the doldrums for decades.) Reduced growth means reduced job opportunities and economic benefits for individuals.

Making matters more complex are the similar financial problems of many foreign countries. Watering down of currencies, with trade implications, can be expected. Politically, it's easier to print when it's necessary for a country to remain competitive.

Could a black swan exist? Some have suggested selling oil and gas rights, as well as other federal government assets, to help solve the problem. A thorough analysis of the matter shows selling them would help very little.

The Fed and the Treasury Department will eventually be cornered. At some point, the Fed will need to decide if it will attempt to practice QE in a major way, possibly producing inflation akin to the 7.4 percent average experienced from 1968-1982, while simultaneously reducing net interest expense. It could rationalize doing so in light of its three-pronged statutory objective (stable prices, low unemployment and moderate long-term interest rates) on the theory that a collapse would result in huge unemployment and potentially huge inflation. In contrast, large inflation would produce unstable prices, but it could possibly produce low unemployment and moderate long-term interest rates. One might think the existence of Treasury Inflation Protected Securities (TIPS) would discourage a money print bail-out. However, as of August 31, 2019, they comprised only 9 percent of the public debt.

How much money would need to be created to reduce the public debt-to-GDP percent to 50? GDP is approximately $21 trillion. Public debt in 2020 is roughly $18 trillion. A reduction to $10.5 trillion (i.e. 21 x .50) would require a $7.5 trillion reduction. In January 2020, roughly $1.75 trillion of U.S. cash existed. So, cash of over four times existing cash would be needed.

Inflation is a tax on savings. The Constitution does not allow for such a tax by the Fed. However, Congress (that can tax) created the Fed, and it's unlikely any federal appellate court would practically permit a legal challenge.

The wealthy will be more able to deal with inflation than others, exacerbating the wealth gap. Loss of the middle class is another way for a republic to collapse. A depression coupled with a wealth gap increase could spell the end of the U.S. system of government.

None of this is news to those knowledgeable of world history. In September 2011, then-Joint Chiefs of Staff Chair Admiral Mike Mullen said: "I've said many times that I believe the single, biggest threat to our national security is our debt." Someone (often credit is attributed to Scottish scholar Alexander Fraser Tytler) once said: "A democracy cannot exist as a permanent form of government. It can only exist until the voters discover they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising the most from the public treasury, with the result that a democracy always collapses over loose fiscal policy . . . followed by a dictatorship."

While no one can predict exactly what will happen, ultimately, the laws of finance will rule. Those laws provide that the riskier a debtor is, the more it must pay in interest and the more security it must provide. And, those laws will overpower whatever power the Fed and any federal institution may possess. Unbelievably, it's still not too late to prevent what seems inevitable.