SKYVIEW PARTNERS®
Advisor financing and banking solutions

Should Explosion in the National Debt Cause Us to Worry?

MAY 2020

John Merante
Chief Economist, SkyView Partners

KEY POINTS

- The COVID-19 pandemic response has thrown the US economy into a recession, with GDP declining and unemployment rising at a pace not seen since the Great Depression.
- Congress has authorized $3.5 trillion in relief spending. Slower growth and higher spending will push the federal deficit to 17.9% of GDP and the national debt to 101% of GDP in 2020.
- Arguments to address the deficit include the crowding out of private investment, excess borrowing that will lead to higher debt servicing costs for the government, and all debt needs to be repaid.
- With interest rates projected to stay below 1% through 2021, the cost of government inaction would likely be more costly to the economy than the cost of rising debt.

WHERE WE ARE TODAY

> *"... Reagan proved that deficits don't matter."*
>
> Vice President Dick Cheney,
> **The Price of Loyalty**, 2004

Prior to the Covid-19 pandemic, the Congressional Budget Office (CBO) projected that the federal deficit would reach $1 trillion in 2020 and average $1.3 trillion between 2021 and 2030. This would have set record levels of Federal borrowing, at a time when the economy was growing. Yet there was little concern about debt levels in either Congress or the White House.

As the repercussions of the pandemic and orders to shelter at home spread across the globe, the economic damages have mounted. On April 24, the CBO projected that in the second quarter the US economy will experience a sharp downturn. This follows on the below consensus reduction of Q1 GDP of 4.8 percent (annualized). In the second quarter of 2020, real GDP is forecasted to experience a quarter-on-quarter decline in real gross domestic product of 12 percent, the equivalent of a decline at an annual rate of 40 percent. This would be a more severe contraction than experienced in any quarter during the Great Financial Crisis.

Following this sharp contraction, the CBO expects the economy to bounce back on the strength of renewed consumer spending, pushing growth to average about 17 percent (annual rate) in the second half of calendar year 2020. Next year, the forecasts project GDP to grow by 2.8 percent, on a fourth-quarter-to-fourth-quarter basis. If realized, real GDP at the end of 2021 would be 6.7 percent below the CBO's January 2020 projections.

The depth and unknown duration of the ongoing recession will dramatically increase both the federal deficit and the national debt. Congress has authorized $3.5 trillion in COVID-19-related disaster relief. The CBO has projected that the federal deficit would reach $3.7 trillion this year and grow from the earlier estimate of 4.6 percent of GDP to 17.9 percent of GDP. The federal debt held by the public will jump from 79 percent of GDP at the end of 2019 to 101 percent of GDP by the end of 2020 and grow to 108 percent of GDP at the end of 2021.

The economy is forecasted to recover in the second half of 2020 and continue into 2021. The deficit for 2021 is estimated to top 9.8 percent of GDP in 2021 as economic growth remains below potential GDP.

It is important to bear in mind that these projections are subject to enormous uncertainty, and the outcomes will depend on global success in containing and reversing the spread of COVID-19.

Table 1

CBO's Economic Projections for 2020 and 2021

	2020				ANNUAL	
	Q1	Q2	Q3	Q4	2020	2021
Real GDP (Percentage change from preceding quarter)a	-0.9	-11.8	5.4	2.5	n/a.	n/a.
Real GDP (Percentage change, annual rate)a	-3.5	-39.6	23.5	10.5	-5.6b	2.8b
GDP (Trillions of dollars)	21.6	19.1	20.1	20.7	20.4	21.3
Unemployment Rate (Percent)	3.8	14.0	16.0	11.7	11.4	10.1
Interest Rate on Three-Month Treasury Bills (Percent)	1.1	0.1	0.1	0.1	0.4	0.1
Interest Rate on Ten-Year Treasury Notes (Percent)	1.4	0.6	0.7	0.7	0.8	0.7

GDP = gross domestic product; n/a. = not applicable.
a. Real values are nominal values that have been adjusted to remove the effects of changes in prices.
b. Data are shown on a fourth-quarter-to-fourth-quarter basis.

Source: Congressional Budget Office https://www.cbo.gov/publication/56335

HOW MUCH DEBT IS TOO MUCH DEBT?

As estimates of the federal deficits and debt continue to grow, some members of Congress, such as Senate Majority Leader Mitch McConnell, have voiced concern about the long-term consequences of the growing amount of debt. These concerns are likely to deepen following the Treasury Department's May 4 announcement that it would borrow just under $3 trillion during the second quarter. This is higher than the previous record borrowing of $1.8 trillion for the fiscal year 2009, and 42 percent higher than the federal government's borrowing for all of last fiscal year.

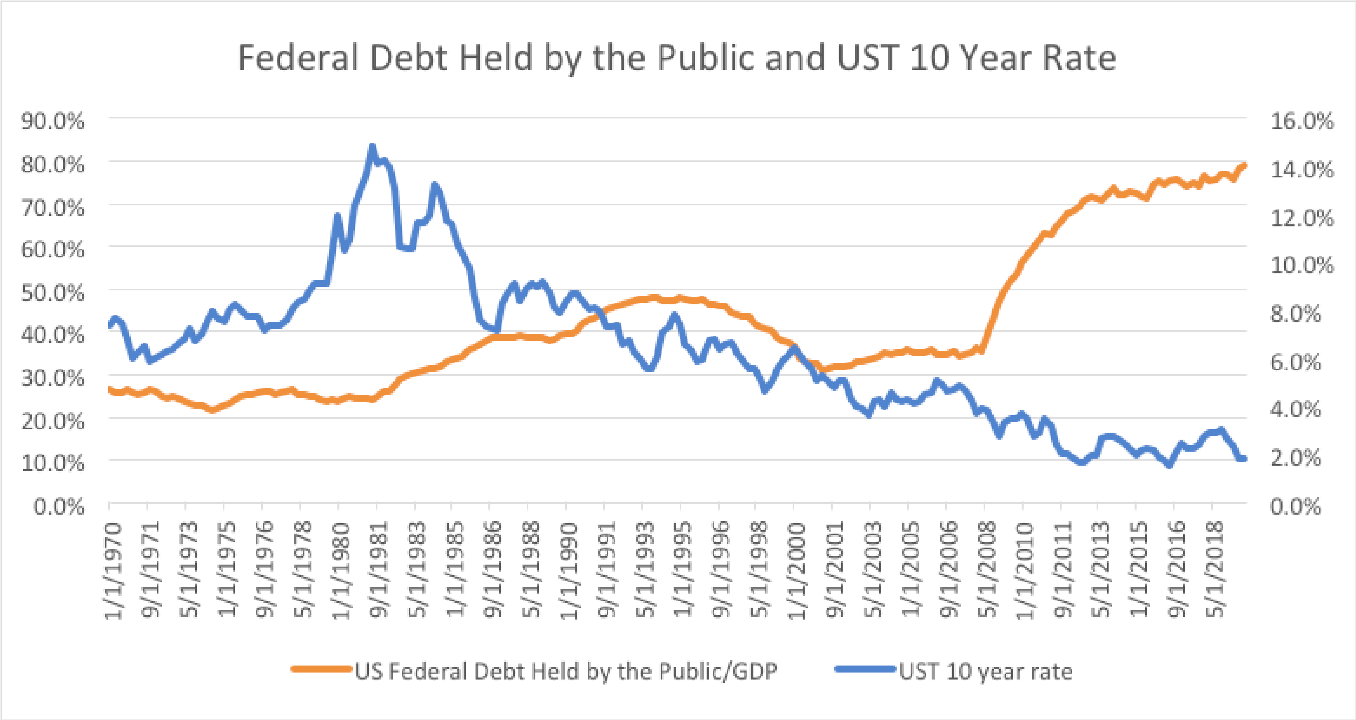
> *"The emergency is beginning to recede. And we need to think about the long-term consequences of racking up this amount of debt."*
>
> Senator Mitch McConnell, *The Wall Street Journal*, April 22, 2020

Opponents of unfunded spending cite three major threats of increasing deficits, even as the economy enters a recession.

1. Government borrowing crowds out private investment, lowering future income.
2. Higher interest payments lead to large tax hikes and spending cuts.
3. All debt must be repaid; by borrowing, we are burdening future generations.

The concerns around both crowding out of private investment and the cost of higher interest payments are based on the relationship between growing government debt and higher interest rates. While there was a clear correlation between higher debt levels and higher interest rates from 1970 to 1986, this correlation began to breakdown in 1987 as expected inflation stabilized around 4% or lower.

Figure 1



Source: Federal Reserve Bank of St Louis, FRED

While the increase in the supply of bonds continues to put upward pressure on rates, several factors have offset this pressure and keep interest rates low, including slower economic growth related to slower population growth and lower productivity growth, and an aging population more weighted to higher savings-age cohorts.

In addition, growth of global trade and capital flows has led to an increase in foreign demand for US government debt instruments, while growth in domestic demand for safe assets as well as conventional and unconventional monetary policy have all contributed to keeping US interest rates low.

Although expectations for higher debt and deficits are well-known and should be priced in, the yield on the UST 10-year note has stayed below 1% since late March and the CBO expects this yield to remain low into 2021.

While the collapse of the economy and increased spending authorization will result in significantly higher deficits, the decline in interest rates means that the cost of servicing the debt is expected to fall.

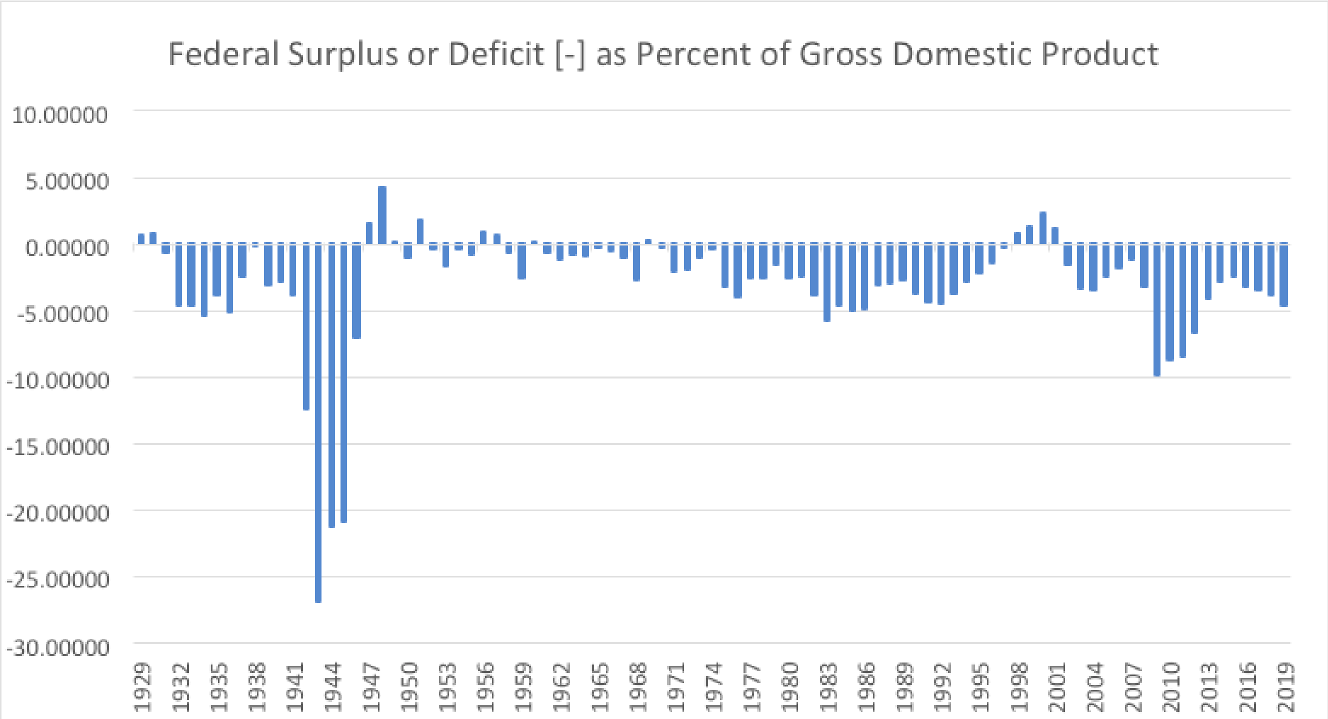
DOES ALL DEBT NEED TO BE REPAID?

> *"So banks and governments are cleaning up their ledgers after years of abuse. Everyone owes too much, is the consensus, and we're in for a few years of pain. But Faye thinks: Okay. That's probably the way it ought to be. That's the natural way of things. That's how we find our way back. This is what she'll tell her son, if he asks. Eventually, all debts must be repaid."*
>
> Nathan Hill, The Fix 2016

The fact that the government must repay its debt is a commonsense extension of the reality that households face. Mortgage debt or consumer debt must be repaid. If this is also true for the federal government, then spending would need to be cut and taxes would be higher in order to extract more dollars from the economy, leaving less for spending, investing, and saving. But what is true for households or businesses is not necessarily true for governments.

At the end of World War 2, the federal debt reached $249 billion, or 113 percent of GDP. To repay the debt, the government would have needed to run surpluses, but in the 25 years following the war, the government ran budget surpluses in only 8 years and the national debt grew to $371 billion. Faster economic growth, however, pushed the debt-to-GDP ratio down to 35 percent.

Figure 2



Source: Federal Reserve Bank of St Louis, FRED

The US Government has not needed to pay off its debts because investors have been willing to refinance them. This happy state of affairs is dependent on continued economic growth and the US being able to borrow at interest rates lower than the growth rate.

SO WHEN SHOULD WE WORRY ABOUT THE DEBT?

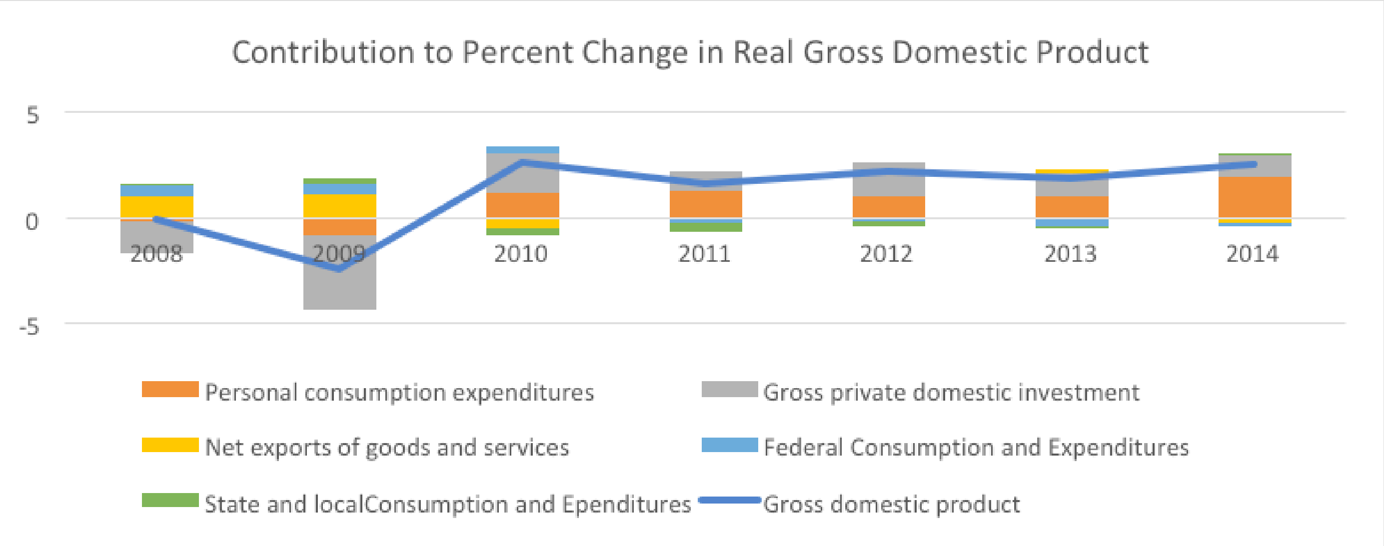
There is no clear level of national debt to GDP that causes a crisis. The US level previously reached 112%, while the UK debt level after World War 2 exceeded 200%. Japan's current debt-to-GDP ratio tops 240%. Of these, only Japan has seen slower growth, but the weaker Japanese economy is related to an aging and declining population as well as stop-and-go fiscal and monetary policies.

> *"Give me chastity and continence, but not yet."*
>
> Saint Augustine

With interest rates expected to stay below 1% over the coming two years, robust fiscal stimulus that boosts aggregate demand will speed up the recovery and lessen the rise in the debt-to-GDP ratio over time. Fighting the recession now will not make the long-run fiscal challenge worse, while doing too little will result in still lower growth and a higher debt burden.

This was the US experience after the Great Financial Crisis as the recovery slowed when the Federal stimulus programs ended in 2010, and balance budget requirements forced state and local authorities to cut spending as tax revenues fell.

Figure 3



Source: Department of Commerce, Bureau of Economic Analysis

GATHER WHILE YE MAY

This is not an argument that there is no debt level at which investors will not demand higher yields, but we remain far from such levels. The cost frugality in a recession is high in terms of lost production and employment. The time to reduce borrowing is when the economy is growing at or above potential.

"The boom, not the slump, is the right time for austerity at the Treasury."

John Maynard Keynes (1937)
Collected Writings

SKYVIEW PARTNERS®

Advisor financing and banking solutions