THE U.S. DEBT CHALLENGE: A FEW THOUGHTS ON OUR NATIONAL DEBT AND DEFICITS

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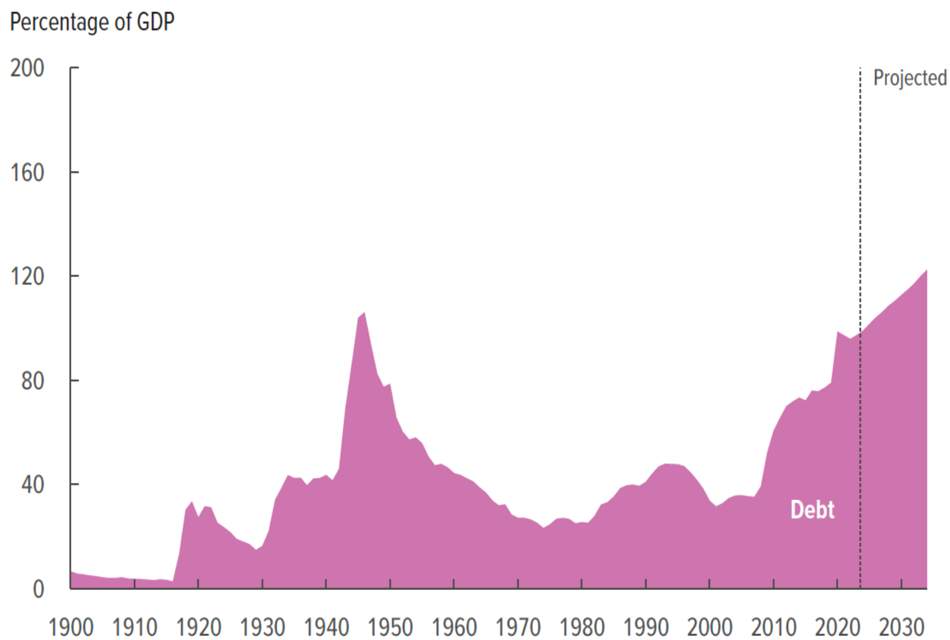
The Congressional Budget Office (CBO) updated its ten-year budget estimates in June, and the outlook is concerning. The budget deficit for 2024 is now estimated to come in at $1.9 trillion, growing to $2.8 trillion per year by 2034. As a percentage of GDP, debt held by the public will rise to 122% from the current 99%, which is sharply higher than the 35% just before the financial crisis. In dollar terms, total debt held by the public has exploded from just over $5 trillion in 2009 to nearly $28 trillion at the end of Q2 2024.

Federal Debt Held by the Public

Debt held by the public rises in each year, from 99 percent of GDP in 2024 to 122 percent in 2034—higher than at any point in history.



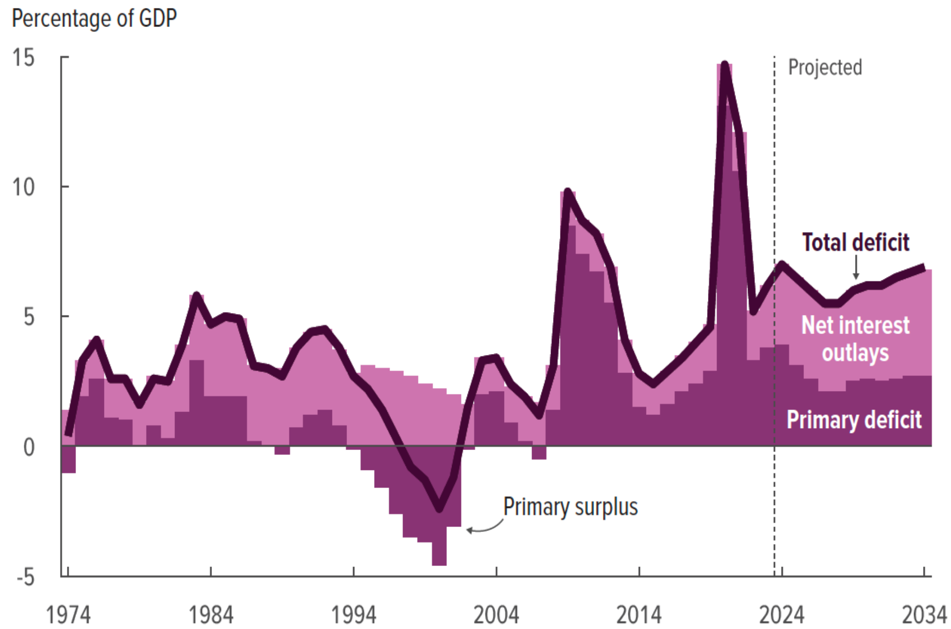
Source: Congressional Budget Office

RISING DEFICITS AND THE GROWING BURDEN OF NATIONAL DEBT

Much of the increase in deficits is due to growth in mandatory spending programs, primarily Medicare and Social Security, which means that absent reforms, these programs will continue driving deficits exponentially higher. More recently, the effects of ballooning deficits, combined with higher interest rates on new and maturing federal debt, have poured fuel on the deficit fire. In fact, in 2024, the CBO estimates the federal government will spend more on interest expense than on the military, which is currently the largest discretionary program in the federal budget. While the likelihood that the Fed will begin lowering rates later this month might help marginally, very few expect rates to reapproach the near-zero levels from just a few years back. So, servicing our growing national debt will be an increasingly heavy lift, likely crowding out other priorities.

Total Deficit, Net Interest Outlays, and Primary Deficit

In CBO's projections, the total deficit—the amount by which outlays exceed revenues—equals 6.9 percent of GDP in 2034. By that year, net interest payments grow to 4.1 percent of GDP and account for about one-sixth of all federal spending. The primary deficit (which excludes those payments) equals 2.7 percent of GDP in 2034.



Source: Congressional Budget Office

THE U.S. DOLLAR'S GLOBAL ADVANTAGE AMID RISING DEFICITS

The U.S. is not alone. Essentially, every other developed Western economy is approaching deficit levels that could become a crisis. This happens when a government can no longer find enough buyers for the debt it must issue to fund operations, and/or the interest rate required to entice buyers becomes prohibitive. While that day may come, the U.S. has significant advantages over most other indebted countries, which should buy us more time and hopefully offer more options for managing our way through.

Our biggest advantage is that the U.S. Dollar is the only true reserve currency in the world. The Euro has the size to challenge the Dollar, but the European Union (EU) structure puts the Euro at a disadvantage. Specifically, there is no mechanism to nationalize European government debt since they don't have a Treasury market. While denominated in Euros, each EU member country issues its own debt to fund its budget. Some are in better shape; others narrowly avoided defaulting back in 2009, which had the potential to splinter the EU and portend a crisis for the Euro.

While China may insist on greater use of its currency, the Yuan, for trade within its circle of influence, it stands no chance of challenging the Dollar, absent significant reform that would allow holders of Yuan to trust the Chinese government, their financial systems, and their courts to protect private property rights and free capital flows.

FOREIGN DEMAND FOR U.S. DEBT: A KEY BUFFER IN A CRISIS

Buyers of government debt come in two flavors: domestic and foreign. In the event of a debt crisis, foreign holders would likely be the first to abandon a country's debt. However, a side benefit of being the world's reserve currency (and a country that runs a large trade deficit) is that most major foreign countries and their banking systems need to hold U.S. Dollars. This means there is a natural foreign demand for dollar-denominated debt. While that demand could certainly slow or a large buyer such as China could "go on strike," it is hard to envision that happening on a large scale without a realistic alternative.

CAN THE U.S. PAY OFF ITS DEBT?

At present, the U.S. is comfortably capable of meeting its debt obligations. The current cost is the potential that excessive debt/spending could keep inflationary impulse burning longer and put a floor under interest rates. Yet even under the CBO's assumptions for 2034, a debt-to-GDP ratio of 120+ percent by itself doesn't imply imminent doom.

The problem is that if 2034 approaches and we have done nothing to change the trajectory of our growing debt, foreign and domestic markets will force some form of reckoning. It would likely start with Congress passing painful spending caps and higher taxes. If that doesn't work, the most common way to deal with unsustainable debt is to simply print money, assuming you can – again, not an option for individual countries in the EU. This would result in higher inflation and a weaker currency. Taken to excess, money printing essentially becomes a form of devaluation or default. It is not the most likely scenario for the U.S., but it is not a zero-probability event.

The bad news is that the U.S. is on an unsustainable fiscal path. Both political parties know it, but neither seems capable of addressing it. The good news is that we are likely many years away from the effects of those debt levels materially affecting the real economy. In fact, deficit-financed fiscal stimulus is a short-term plus for the economy. That is until the bills come due.

DISCLOSURES