



The Week

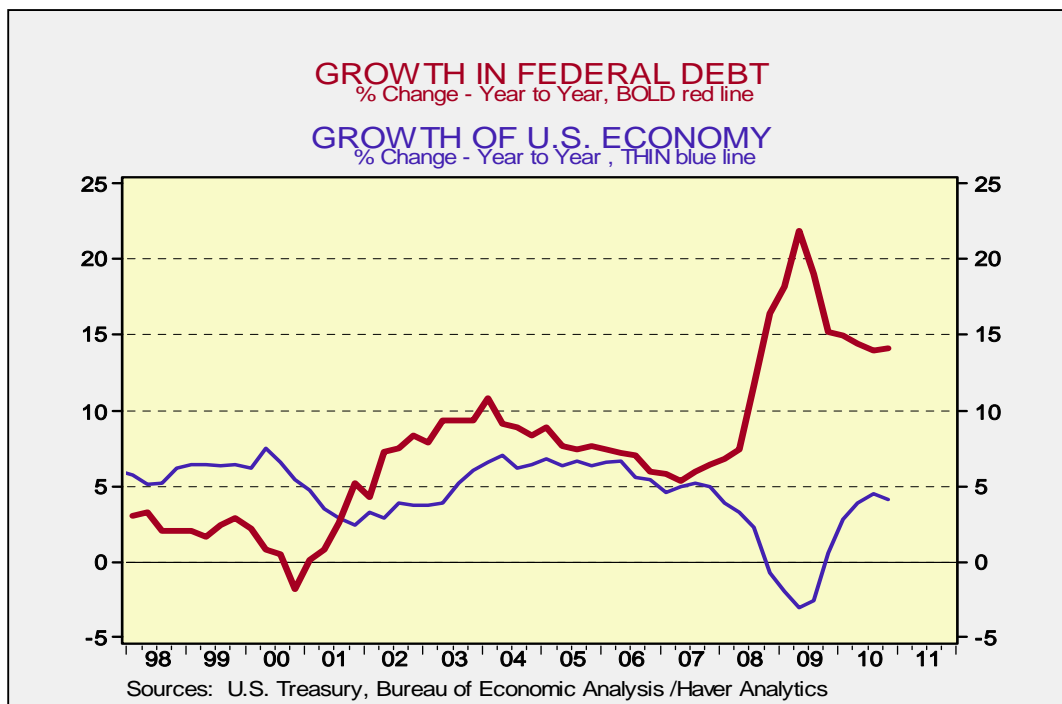
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Dealing with the deficit will not be easy

Many investors worry that our country is headed for another financial crisis because of its growing national debt. We agree that the United States has a serious debt problem that needs to be addressed soon. However, a crisis can still be avoided. This report looks at what is being done to control the deficit this year and what must be done in the future to prevent the current situation from getting worse.

The accumulated debt of the federal government from decades of spending more than it receives in revenue has finally grown to be almost equal to the annual output of the entire U.S. economy. In other words, total debt outstanding is close to 100% of our gross domestic product (GDP). This is not a crisis now, but it could be within a few years if the government does not take action to reduce the deficit and slow the growth of the debt.

A good analogy of the current debt situation is to think of the United States as a car with worn brakes. This is a problem but not a crisis. After all, you can still drive a car with bad brakes. However, at some point, there is a risk that the brakes could fail causing the car to crash. The good news is a crash is not inevitable despite the gloomy projections by some pessimists. The brakes can be repaired, thus preventing an accident. Unfortunately, the repairs will not be easy, and sacrifices may be necessary.



This week's chart shows the growth rate of federal debt compared to the growth rate of the economy in current dollars (not inflation adjusted dollars). During the past few years, the debt has been growing much faster than the economy. That's because the government was spending a lot of money to help boost economic growth during the 2008-2009 recession.

In a previous report, we explained that reducing the deficit will not reduce the debt. As long as the government is running a deficit, it will need to borrow more money and the debt will increase. In order to reduce the debt, the government would need to run a surplus and use the excess revenue to pay down the debt. This is highly unlikely. Nevertheless, the government can restrain the debt as a percent of GDP from rising further by reducing the deficit substantially.

So what is the government doing to control the deficit? Unfortunately, the answer is not much at this point. Democrats are proposing to cut spending by a few billion dollars this year. A billion dollars is a lot of money, but the deficit is projected to be \$1500 billion or \$1.5 trillion in 2011. This means that saving a few billion dollars would reduce the deficit by less than 1%. The Republican proposal would cut more, about \$60 billion this year. But even this would not do much to reduce a \$1.5 trillion shortfall. Unfortunately, the deficit needs to be cut by several hundred billion dollars to make meaningful progress toward controlling the debt.

So what must the government do to prevent the current debt situation from getting worse? In recent testimony before Congress, Fed Chairman Bernanke explained that the government needs to reduce the growth rate of its debt and bring it in line with the growth rate of the economy. If the debt and the economy both grow at the same rate, the debt-to-GDP ratio will not go any higher. Of course, this does not pay down the debt. The debt will continue to increase. But if the debt is growing at the same rate that the economy expands, the country could afford its debt and a debt crisis would be unlikely. In other words, now that the economy is doing better, the government needs to reduce the deficit in order to slow the growth rate of government debt.

If we assume that the U.S. economy can expand 2.5% each year after inflation and also assume that inflation is only 2.5% each year, the U.S. economy including inflation would increase about 5% each year. If the government hopes to prevent the debt problem from getting worse, it must also slow the growth rate of government debt to 5% each year. With both the economy and debt outstanding equal to about \$14 trillion last year, a 5% increase would be equal to about \$700 billion. In other words, the government would need to reduce the yearly deficit to less than half its current rate. Any deficit that would be greater than \$700 billion would cause the debt-to-GDP ratio to increase.

This analysis shows what the government needs to do to prevent the debt problem from getting worse. Unfortunately, it does not show how the government can do it. The government will need to cut much more spending than it is currently discussing and/or increase taxes in order to reduce the deficit and fix the brakes on the car. This will not be easy. In fact, the contentious debate over the very small spending cuts proposed for this year suggests that both parties would rather keep driving the car with worn brakes and hope that nothing happens until the time is right to make bigger deficit cuts.

Last week, Congress extended its temporary spending authority for two weeks while both parties tried to rally support for their proposals. The government may still shut down later this month if the two parties cannot reach a compromise on spending cuts. In any case, it looks like Congress lacks the will to address the deficit problem seriously this year while unemployment is high. But Congress cannot put off the tough decisions much longer. If the government cannot present a credible plan to reduce the deficit, investors could demand higher interest rates on government debt. This would not be good for the economy or the financial markets. Fortunately, we still have some time to address the deficit situation. Therefore, we remain positive on the economy this year. However, we are near-term cautious on the equity markets given the debate over the deficit, along with rising oil prices and Middle East turmoil. We do not expect the deficit to create a financial crisis this year. But the risk of brake failure would increase next year if Congress does not get serious about reducing the deficit at that time.

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