

Setting Fire to Your Own House: How Congress Created the Debt Ceiling Dilemma

Prior to the December negotiations for the current fiscal year budget, the Congressional Budget Office (CBO) issued a forecast that the US Government budget deficit for the fiscal year 2010-11 would come to less than \$700 billion.

However, in order to gather enough votes for the passage of the budget, the Obama administration was forced to agree to an extension of the Bush tax cuts for all levels of income in exchange for an extension of Federal unemployment benefits and a series of tax breaks for businesses. These agreements added \$858 billion to the 2011 budget deficit, raising the projection for 2011 to almost \$1,480 billion. As a share of the US economy, the deficit is predicted to be 9.8 percent, second only to the 10 percent recorded in 2009 and up from 8.9 percent in 2010. One would have to go back to the spending of World War II to find the deficit as a larger share of GDP.

Seven months later, the same politicians who voted for the larger deficit are now threatening to deny the Government the means to finance the same. The debt ceiling, beyond which the Government cannot issue securities for payment of goods and services, is predicted to be maxed out on or about August 2. The specter of a Government which willingly approves excess spending and refuses to provide the wherewithal to make good on the same is threatening the country's credit rating, funding availability and world standing.

There is a legitimate issue to be raised regarding Government spending. There is also a legitimate issue to be addressed regarding Government taxation. However, the debt ceiling is not the appropriate forum for this discussion. It would be far more appropriate to discuss this in the appropriations process prior to the adoption of a budget.

The reason such discussions are not held is due to the fact that during the appropriations process, politicians have to go on record supporting a level of spending or taxation. By challenging the deficit ceiling increase, a politician can be against Government spending in general without having to take a stand on any one program or issue.

Overlooked in this fracas is the debate that is not happening: what do people want the Government to do and how is the fairest way to fund the same? Various programs have a great deal of popular support. Some come with significant price tags. Voters have to realize the implications of whatever programs are desired and accept the responsibility for collectively funding the same.

Take two examples: the Government subsidizes ethanol to the tune of about \$6 billion per year. For a country with a population of 330 million, this comes to about \$18 per person per year. There is also an indirect cost to Americans as ethanol demand pushes up the cost of corn which is used for feed in the food supply. There is also some argument as to what net contribution ethanol makes to the energy supply, given the amount of energy used in the growing and processing of corn and transport of ethanol by truck to gas stations for blending.

A second example is the funding of National Public Radio and the Corporation for Public Broadcasting (PBS). The \$240 million cost is about 72 cents per person per year. The services provide an independent source of information not influenced by advertising or the consolidation of news sources. Like any news organization, these two sources are not universally endorsed by all voters. The question is whether they benefit the majority of voters and keep news sources of even those who oppose them honest.

Two impressions are given in these examples. First, debate on merits is lacking in the current situation. Second, discretionary spending cuts such as those described above will not be enough to close a \$1.4 trillion budget deficit. At some point health care and Social Security will have to be put on the table for discussion. Efforts to do so in the past have usually resulted in the killing off of the messenger. There can be no real hope for budget deficit reduction unless these two programs are either reduced in terms of eligibility and/or benefits or taxation rises to a level that insures their funding.

Against the backdrop of the game of chicken being played with the debt ceiling, polls show that the chief concern of American voters is not the deficit but the lack of stronger job creation. Cutting the deficit will kill off jobs as funds that previously went to economic activity are instead filtered into deficit reduction. The Democrats were accused of being out of touch pursuing health care reform instead of job creation issues in 2010. Those who advocate for the debt ceiling reduction before the economy is back on its feet may be met with a similar fate in 2012.

The Economy

Economic activity has entered a period of deceleration, which is not the same thing as decline. It is simply accelerating at a slower rate.

The adverse impact of the Japanese earthquake will continue to be felt until probably the end of August. Gasoline prices, which are currently down about 24 percent since their peak last spring, will provide discretionary dollars to those who will most likely spend them. Finally, the rest of the developing world, unburdened by the debt issues of the developed world and growing from small bases, continues to rack up economic growth in the neighborhood of 6 percent per annum. These countries are beginning to attract domestic goods and services in increasing quantities and will provide the cleanest form of economic stimulus to the US. Exports provide demand without requiring domestic credit expansion to fund.

Inflation

One issue that has come up is the need to tackle the deficit to reduce the potential for inflation, given that the Government prints money to pay for expenditures in excess of receipts.

This potential does exist, but it requires a far stronger economy to bring about. Presumably the Federal Reserve will begin draining money from the financial system in advance of such a level of economic activity. They can do so in several ways, including selling off their portfolio of securities acquired when they were trying to pump funds into the economy after the meltdowns of 2008.

The most likely source of inflation going forward is foreign competition for goods and resources. As foreign economies expand, their demand for industrial raw materials and energy will set the price for the rest of the world. Such inflation is difficult to address domestically as it originates elsewhere.

Interest Rates

Interest rates will go up at some point. There seems to be a consensus that money market funds will yield in the neighborhood of 1-1.5 percent by the end of 2011 and perhaps as much as twice that in 2012. Much will depend on the level of economic activity needed to bring this about.

On the longer end, loan demand will be driven by housing and the Federal Reserve's efforts to wind down their securities purchase program. The most recent pronouncement from the Federal Reserve is to make no additional bond purchases, but invest the current funds as bonds mature. When the program is wound down interest rates should rise in earnest.

The Stock Market

Stocks have entered their second annual summer swoon. A combination of low volume and political theater is serving to keep investors diverted from more promising developments both domestically and internationally.

With Japanese auto output resuming in September, look for stronger economic numbers in the fall. There will also be stronger consumer spending as gas prices moderate until year-end.

The sectors to watch are: exporters, firms with strong foreign operations, and those with more competent management.

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