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US Election and the Elephant in the Room

With the upcoming US elections in full swing, many have joined the political debate for or against their choice of the next president and their respective policies. We would not add more ink to this topic but suffice to say that this will be quite a controversial campaign. Both leading presidential nominees are proposing huge spending increases in coming years – defense and infrastructure for Trump; infrastructure and entitlements for Clinton, to be funded from borrowing. Nobody is addressing the elephant in the room here on fiscal debt and deficits, which will be our focus in this article.

Current growth and fiscal situation

Growth has been tepid since the current expansion began in 2009. Real GDP per capita has grown by a meagre 1.3% annualized, less than half of the 2.7% average expansion since records of the indicator began in 1790. The standard of living (real median household income), has declined during the same period and stands at the same level reached in 1996. One of the most persistent constraints to growth has been the drag from fiscal policy, which is likely to become even more severe in the next decade.

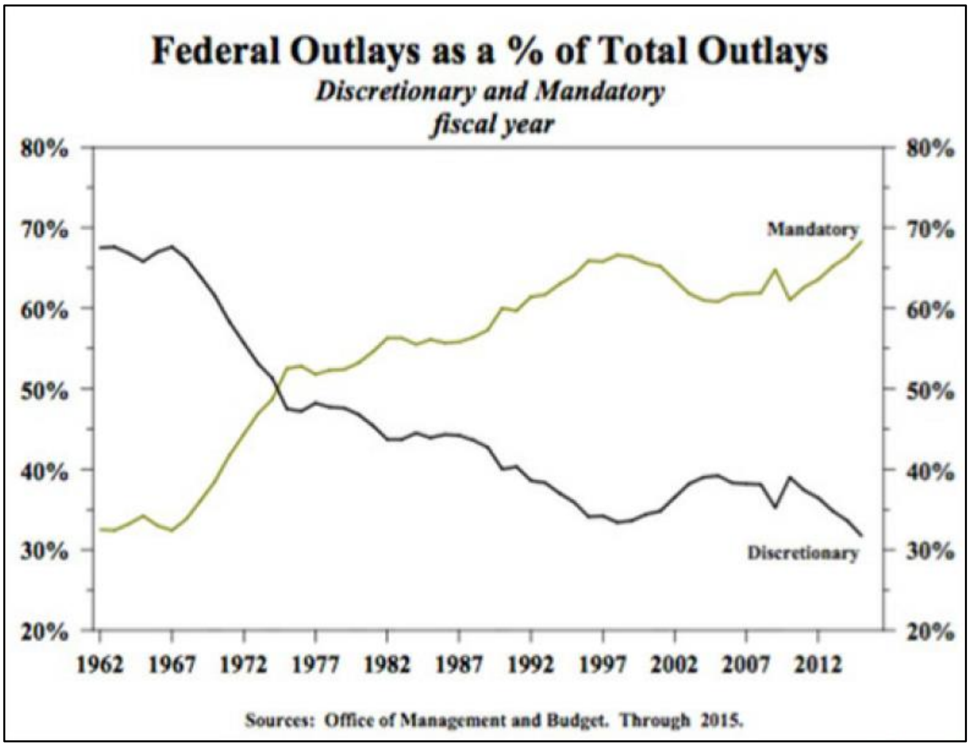
The US federal government ran a budget deficit of $107 billion in August 2016, $43 billion more than in the same month in 2015, according to a statement by the Treasury Department citing higher spending on Medicare and veteran's programs. The Congressional Budget Office now forecasts a fiscal year (ended in September) budget deficit of $590 billion, up 35% compared to $438 billion last year. To put in perspective, the deficit will be 18% of tax revenues and 3.2% of GDP. It is projected to more than double at $1.243 trillion by 2026, which by then will be 25% of tax revenues and 4.6% of GDP.

However, a lot of the government spending does not show up in these figures. US government debt for fiscal year 2016 soared by $1.42 trillion to nearly $19.6 trillion. That $1.42 trillion in additional debt should be thought of as the "real deficit". Deficits are supposed to contract sharply during economic recoveries, but as we will discuss below the macro consequences of ramping up federal debt after the financial crisis are becoming increasingly significant and will result in even slower growth in future.

Fiscal spending crowding

Ilzetzki et al. (2010) suggests fiscal stimulus may be counterproductive in highly-indebted countries and potentially yield negative multipliers. This means for every additional dollar of deficit spending will reduce private GDP by more than a dollar, resulting in a net decline in real GDP. The initial boost from deficit spending is more than reversed over time.

The government expenditure multiplier is likely to become more negative since mandatory components (Social Security, Medicare, veteran's benefits etc.) will increase in proportion of budget outlays. In 2015, the composition was 68% mandatory and 32% discretionary, almost the exact opposite in 1962. Mandatory spending programs are politically popular and highly regarded but federal borrowing to sustain these programs does not generate an income stream for the economy as a whole to pay for these programs. History suggests the continual taking on of such liabilities will eventually cause bankruptcy. The aging of US population will certainly accelerate this over the next decade.



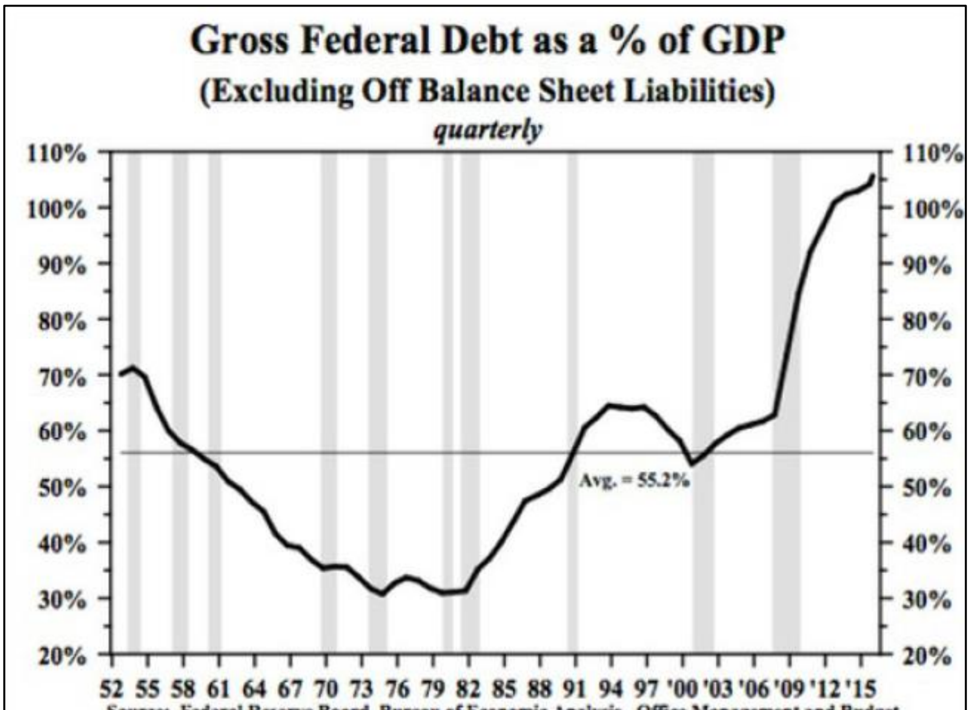
Infrastructure spending, on the other hand could serve to reverse or halt the trend to a more negative multiplier, only if it is substituted for transfer payments. However, the proposals are calling for new infrastructure spending on top to existing government programs. The result: a bigger federal sector and according econometric evidence will contract economic activity (Bergh and Henrekson, 2011). Specifically, "an increase in government size by 10% is associated with a 0.5% to 1% lower annual growth rate". This suggests increase in federal spending will slow US economy future growth.

Federal debt overhang

Researchers have shown that debt curbs economic growth even at low levels of government debt-to-GDP, and the magnitude of impact increases as debt ratio moves higher; a nonlinear effect. Explanations for this drag are likelihood of less private saving and misallocation of the limited amount of private saving, resulting in reduction of real investment in the private sector and deterioration of productivity growth.

Simply put, consumers save less as the government takes on more debt to support household income. Since federal entitlements are promised, retirement or contingency reserves are not necessary. The saving rate is thus lower and real investment drops as the former is a major component of the latter. Productivity, profitability and economic growth become weaker as a result without private investment. If the policy response to poor growth is more debt, the structure of the economy becomes more delicate, which overtime causes demographics to deteriorate, a common pattern in highly indebted countries. This negative feedback loop should be viewed as symptoms that originated with deficits and debt rather than growth headwinds many economists have alluded to.

Reinhart et al. (2012) identified the 26 major public debt overhang episodes in 22 advanced economies since the early 1800s, characterized by public debt-to-GDP levels exceeding 90% for at least five years to eliminate purely incidental increases in debt and those caused by wars. They found that public debt overhang reduce the economic growth rate by slightly more than a third, compared to normal times. The average duration of these episodes shockingly lasted 23 years. The US has currently met the criteria for slowing growth with government debt exceeded 90% of GDP in 2010 and continued to move higher since then.



Source: Federal Reserve Board, Bureau of Economic Analysis. Office Management and Budget. Through Q1 2016.

Status Quo All Over Again

The Committee for a Responsible Federal Budget (CRFB) estimates that total debt will grow by $9 trillion over the next decade. On top of this, it would grow by $200 billion under Clinton while $5.3 trillion under Trump. From the perspective of fiscal policy and economic growth, choosing between the two candidates represents a Hobson's choice: either a slow or quick oblivion. It would take enormous political will to tackle the fiscal situation and reduce mandatory spending. This will mean upsetting the apple cart - less entitlement benefits and painful adjustments for everyone; essentially political suicide. Hence, we would conclude that US economic growth would continue to be disappointing for the coming years and investors' expectations should be ratcheted down.

Your Helvetic Team Singapore

Sources:

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