AIER.ORG

AIER American Institute for Economic Research

BUSINESS CONDITIONS MONTHLY

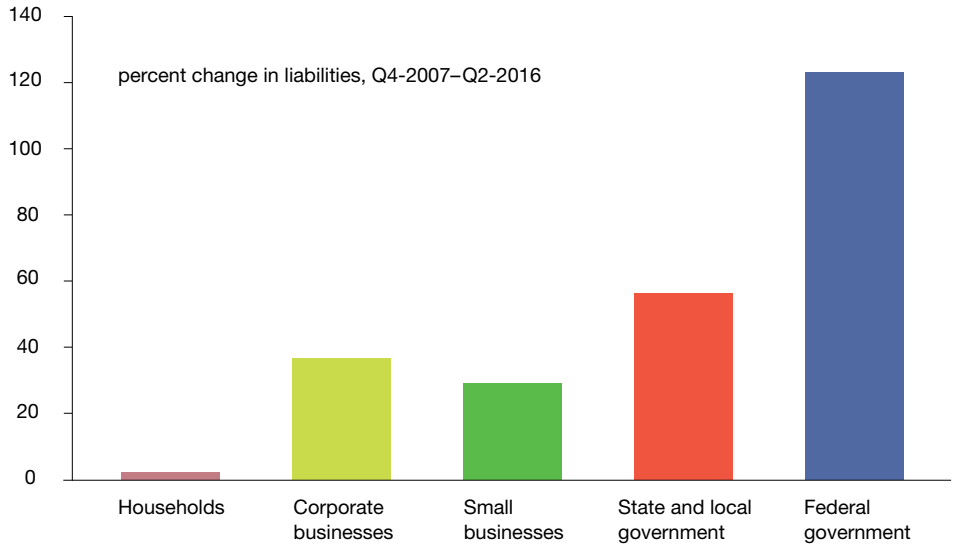
October 2016 Vol. 3 Issue 10

Public-sector debt growth is a risk for the economic outlook

Excessive debt played a major role in the Great Recession, from December 2007 to June 2009. In the seven years since the recession ended, home prices have rebounded, and households have significantly reduced their debt load. Only recently have households begun to increase their overall debt, which has inched up just 2 percent from when the recession began. Debt growth for corporate and small businesses has been more significant, rising 36.5 percent and 29 percent, respectively.

However, neither household nor business debt has grown as much as debt issued by government. Debt growth for state and local government has ballooned 56.1 percent since the end of 2007, while federal government debt is up a whopping 123.1 percent (Chart 1). Given the severity of the recession, some deficit spending is understandable, as a spur to economic growth. However, the torrid pace of debt growth by the federal government may become a significant risk to the economy in the not-too-distant future.

Chart 1. Federal government debt has more than doubled since the Great Recession began, far outpacing state and local government, households, and businesses.



Notes: Small businesses are sole proprietorships, partnerships, and limited liability companies, etc. Businesses exclude financial services.
Source: Federal Reserve (FactSet).

INSIDE THIS ISSUE

Healthy private-sector balance sheets contrast with growing government debt.

To understand the risks associated with debt growth since the Great Recession, debt levels must also be considered. There are numerous ways to measure them. For businesses and households, we measure debt relative to assets. For government, we measure debt relative to the gross domestic product, or GDP, the most common gauge of the economy's output.

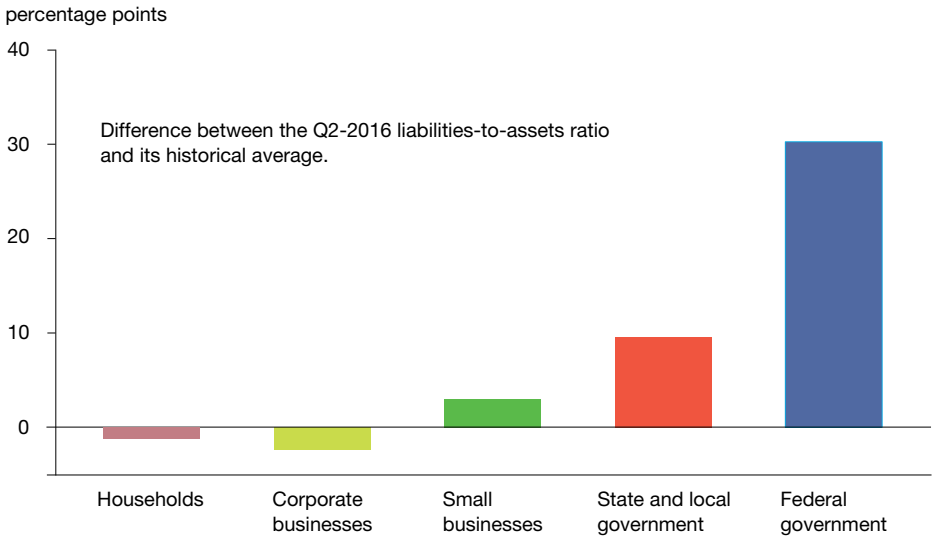
Within the private sector, both households and the corporate segments (we are excluding financial firms from this discussion) have debt-to-asset ratios below their long-term averages. Households have a ratio of 14.2 percent, compared with a long-term average of 15.4 percent. For corporations, the current debt-to-asset ratio is 43.6 percent, lower than the long-term average of 45.9 percent. The non-corporate segment - including small businesses, professional partnerships, and other legal structures - has a ratio of 38.6 percent, slightly above its long-term average of 35.7 percent. Overall, the three non-government segments of the economy have debt ratios that are reasonable by historical standards. These generally healthy balance sheets for the private sector should be considered positive for the economy.

Debt levels for the public sector are far less reassuring. The state and local government debt-to-GDP ratio is 32 percent, more than nine percentage points above the long-term average of 22.4 percent. Even more concerning is the debt-to-GDP ratio for the federal government, at 97.5 percent at the end of the second quarter of 2016, compared with a long-term average of 67.2 percent.

Adding further concern is the projected path of federal debt and deficits. The latest Congressional Budget Office projections show annual budget deficits widening over the next several years, exceeding 4 percent by 2022, compared with an estimated 3.2 percent for 2016.

As the presidential election approaches, greater attention needs to be paid to U.S. fiscal policy. Tax policy, spending policy, and the U.S. fiscal position are critical to the long-term health of the U.S. economy. Ever-increasing government debt will eventually become too big to service, and investors will eventually stop lending to a heavily-indebted borrower, causing a global financial crisis.

Chart 2. Business and household balance sheets are healthy, but public-sector debt ratios are higher than historical averages.



Notes: Small businesses are sole proprietorships, partnerships, and limited liability companies, etc. Businesses exclude financial services. Ratio for state and local government and the federal government is liabilities to GDP.
Source: Federal Reserve (FactSet).

ECONOMIC OUTLOOK

Our Business-Cycle Conditions Leaders index improved significantly in the latest month. The Leaders jumped to 54 in September from 42 in August (Chart 3). September marks their first month above the neutral 50 level since January and follows seven consecutive months in the 38-to-50 range. As we cautioned when our index first fell below 50, one month doesn't make a trend. A single reading of 54 is not enough evidence to suggest the economy is significantly improving. However, we still believe the results over the past eight months are consistent with an overall slow-growth environment and continued economic expansion.

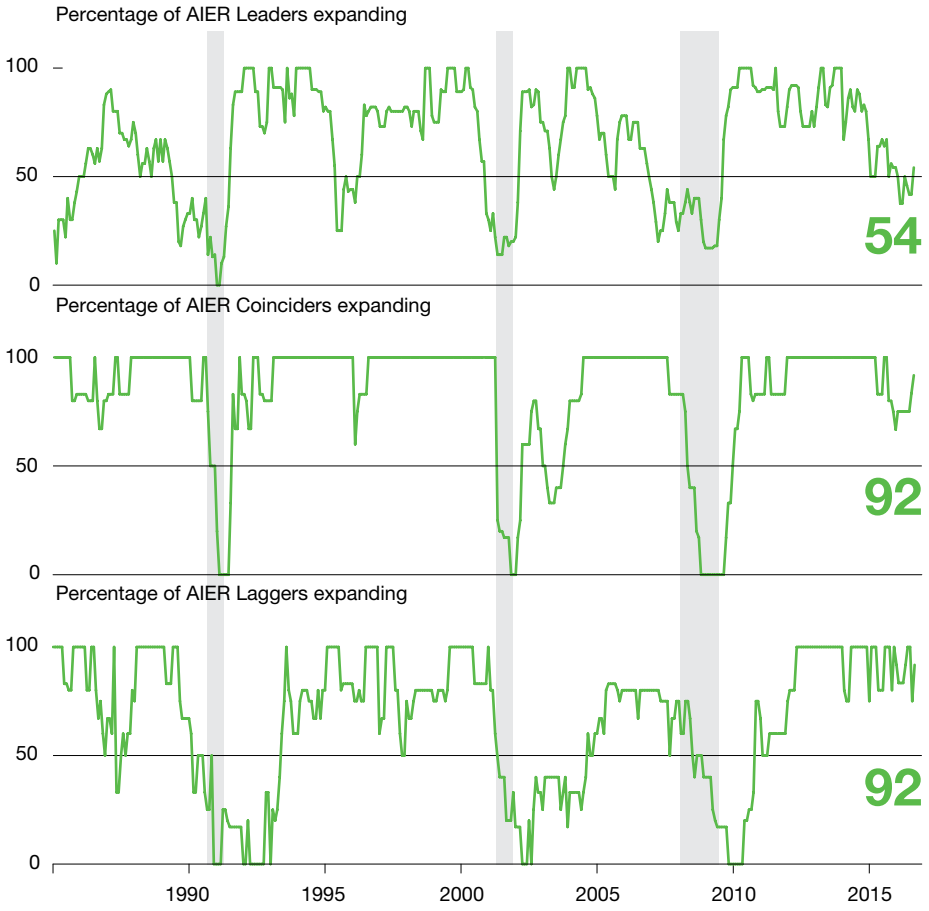
The improvement for September was a result of three indicators turning up, from negative to neutral. They were manufacturing and trade sales-to-inventories ratios; housing permits; and debit balances in margin accounts, amounts borrowed by investors to buy securities. These improvements in different areas of the economy are positive signs.

Among the remaining indicators, we continue to see a pattern consistent with our qualitative assessment of the economy. The labor market remains healthy (initial claims and the average workweek in manufacturing remained favorable) and supports the upward trend in real retail spending. However, consumer expectations and real new orders for consumer goods remain weak. Real stock prices and the yield curve have been favorable, while capital investment-related indicators are soft.

Among our other indexes, the Coinciders moved up to 92 in September from 83 in August while the Laggers index also rose to 92 from 75 in August.

Chart 3. Indicators at a glance

Shaded areas denote recessions.
A score above 50 indicates expansion.



Source: AIER.

The federal debt is projected to reach $23 trillion by 2026. Budget constraints and political divisions make it hard to reduce.

Where's the debate about the federal debt?

We're coming into the final stretch of the presidential campaign and there has been precious little serious discussion about the public debt. Is there a way to approach a discussion of the federal debt that can bring us closer to understanding and addressing the problem, rather than the usual approach, where we line up on opposite sides of the field and yell?

Limiting ourselves to what's on the website of each presidential candidate, only Gary Johnson of the Libertarian Party is speaking directly to the federal debt, with a pledge, if elected, to submit a balanced budget to Congress that addresses the deficit in the current budget, not the long-term debt. The other three presidential candidates do not label the federal debt as an issue. The Republican Party platform does not speak to either the federal debt or federal deficit. The Green Party and Democratic Party platforms argue for reducing the debt through a combination of tax increases and spending cuts.

Yet the nonpartisan Congressional Budget Office expects the debt to reach $23 trillion by 2026, or more than $65,000 per person living in the U.S. As a share of the gross domestic product, the estimate for the fiscal year ended Sept. 30 puts our current debt of about $14 trillion at 77 percent of GDP. It is projected to rise by 2026 to about 86 percent of GDP.

Why debt growth is worrisome

Citizens tend to dislike debt because we often use our own household budgets as a metaphor for national budgets: We live within our means, why shouldn't the government?

Economists tend to dislike deficits because government borrowing means the public sector is bidding against the private sector for financing and "crowding out" private borrowing. They also argue that higher debt results in lower growth. These economists point to 90 percent (debt-to-GDP) as the threshold level for stifling growth. Others have challenged this research. Still others argue that when a country can borrow in its own currency and have independent monetary and currency policies, it typically avoids debt-induced financial crises. Another group of economists argues that national exposure to currency risk will trigger debt default and financial crisis.

If after all of this debate, one still wants to bring down annual deficits and the cumulative debt, the federal budget must include less spending, more revenue, or a combination of the two. Constraints on the spending side, however, make the math problem more difficult, and current political divisions make the political solution harder.

First, let's look at why the math is hard. Some federal expenditures are "mandatory" and some are "discretionary." In the language of the federal budget, mandatory spending is baked into laws. Mandatory spending accounts for over 60 percent of all federal budget outlays, and Social Security and Medicare account for three-quarters of all mandatory spending. When Congress passed laws to create these programs, it established eligibility requirements and benefit levels. All who are eligible receive Social Security and Medicare. The only way to reduce spending is to change who is eligible, the composition of benefits, or some combination of the two (for a discussion of eligibility and benefits in Medicare see AIER's Research Brief, "The Federal Budget: Constraints Limit the Options," https://www.aier.org/research/federal-budget-constraints-limit-options).

In the absence of such changes, the expenditure path is set. Social Security and Medicare spending now accounts for just over 13 percent of GDP; by 2026 it will be another percentage point higher. The aging population and rising health care costs account for this increase.

These projections are based on economic growth forecasts that put average annual real GDP growth at just above 2 percent through 2018, falling slightly to an average of about 1.7 percent through 2020 and then averaging about 2 percent from 2021 through 2026. To benchmark these forecasts against recent history, GDP grew at 1 percent in the first half of 2016.

What role does the business climate play?

A recent Harvard Business School study comes at these data from another perspective: What if we want to increase GDP growth? From 1950 to 1969, real GDP averaged annual growth of just over 4 percent; from 1970 to 1999, just over 3 percent; and from 2000 to 2009, just under 2 percent. This long-term decline in output as measured by GDP was accompanied by a long-term drop in productivity, slower job growth, declining workforce participation, and a slowdown in business formation. Researchers at the Harvard Business School combined these facts with results of their annual competitiveness survey of HBS alumni. (See http://www.hbs.edu/competitiveness/research/Pages/research-details.aspx?rid=81). These business leaders are worried by the decline in U.S. output and attribute it to the waning competitive advantage of the U.S. vis-à-vis the rest of the world. They assert that a "competitive nation is one in which firms succeed in domestic and global competition while lifting the living standards of the average citizen."

They offer their readers a hard-nosed look at strengths and weaknesses of the U.S. economy and focus on the elements that combine to make the business environment favorable and one in which U.S. businesses can thrive. They list five macro elements that are all functioning far below capacity.

Macro elements

Macroeconomic policy
Political health
Legal structure
Tax code
K-12 education system

In addition, they list eight elements that they label as "micro," which are more properly understood as areas where process improvement would likely result in higher productivity and require that local, regional, and state leaders from the public, private, and nonprofit sectors work in collaboration.

Micro elements

Mechanisms for university-private sector partnerships
Enhanced entrepreneurial culture
Skilled labor
Innovative infrastructure
Strengthened inter-industry linkages at the regional level
Adaptive capital markets
Sophisticated firm management
Quality health care relative to costs

Some of these will look familiar, like sound federal budgetary, interest rate, and monetary policies; the protection of property rights; and a corporate tax code that attracts and retains investments. Others may be a surprise, such as the lack of stigma for business failure, which is part of the context and culture for entrepreneurship, or the need for regional economic clusters and supporting institutions with effective collaborative capacity.

The overarching point is that the HBS researchers challenge us to think about the connection between our business environment, slowing productivity, and flagging output. An alternative way to approach the GDP-to-debt ratio is to pay attention to GDP output and consider if we have undermined our competitive advantage. Have we done all that we can to improve the business climate?

To bring this back to the election, ask your candidate: What are the three things you're going to do to improve U.S. competitiveness? And if I want to evaluate you on this in three years, what outcomes can I expect to see?

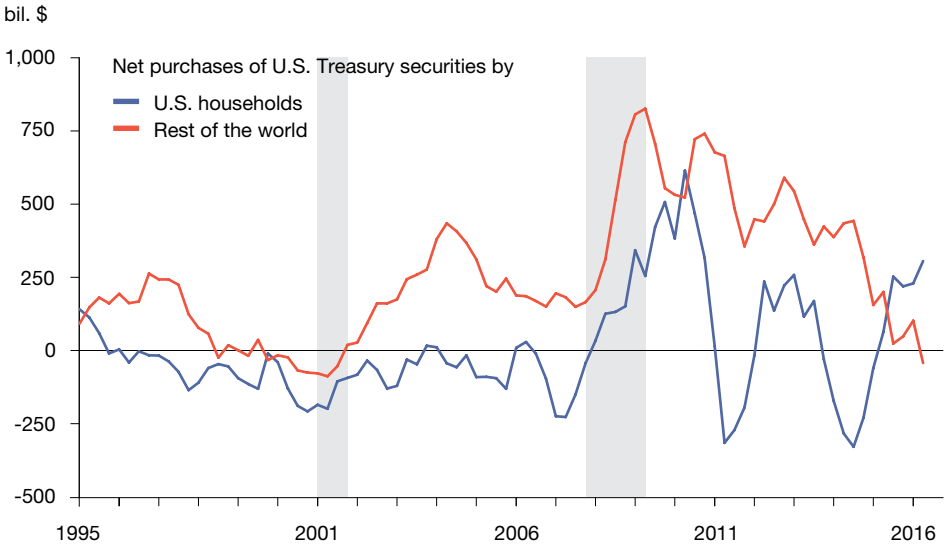
FIXED INCOME

Ongoing federal government deficits have required the U.S. Treasury to issue substantial amounts of U.S. debt to finance government spending. As of the second quarter, U.S. Treasury debt outstanding totaled $15.4 trillion. Of that, $13.4 trillion, or 87 percent, is marketable debt, or bonds and securities that may be bought by the public. The largest block of marketable debt, or 47 percent, is owned by foreign buyers. Among foreign holders, China and Japan have 38 percent, the largest holdings, at about $1.2 trillion each. Their combined holdings of $2.4 trillion account for about 18 percent of all marketable U.S. Treasurys outstanding. Third on the list of foreign debt holders is Ireland, with just $270 billion, or 2 percent of marketable debt outstanding.

Foreign purchases of U.S. Treasury securities have slowed after a surge in buying during the recession. The slowdown has accelerated sharply over the past two years, culminating in net sales of Treasurys in the second quarter of 2016 (Chart 4). On average over the past year, about 16 of the top 36 holders of Treasury debt have been net monthly sellers. The largest, China, has been a net seller in eight of the past 12 months, while number two, Japan, has been a net seller for six of the past 12 months. Continued weakness in foreign demand for U.S. Treasury securities may become a problem for the Treasury, the Federal Reserve, and the economy.

If domestic purchases can't take up the slack from weaker foreign demand, then rates on those bonds could rise sharply. The positive development is that just as foreign demand has been fading, demand for U.S. Treasury debt has been picking up among U.S. households. Households have been relatively strong net buyers of Treasury debt over the past year (Chart 4), adding about $300 billion to household balance sheets.

Chart 4. While foreign governments were selling Treasurys in the second quarter, households were buying.



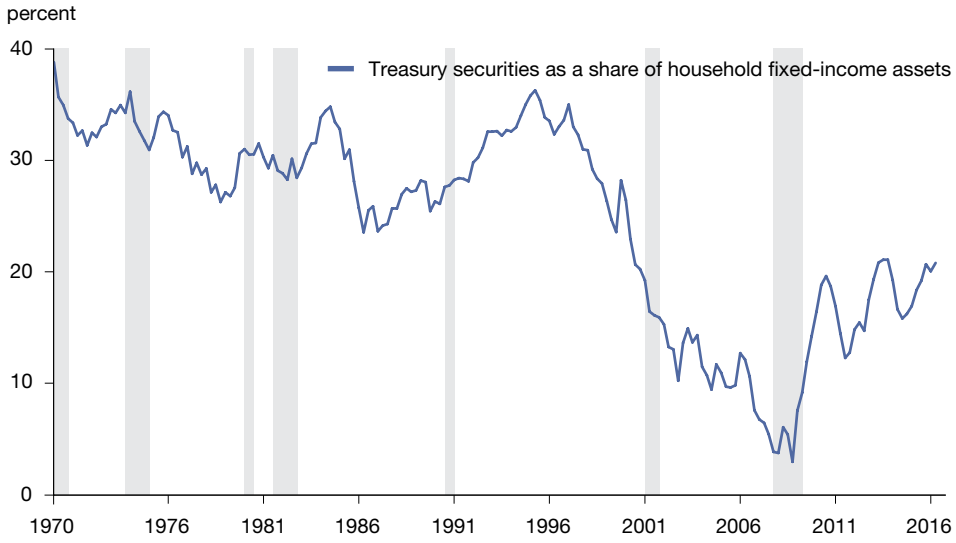
Note: Shaded areas denote recessions.
Source: Federal Reserve (FactSet).

U.S. household balance sheets are in relatively good shape. Household net worth hit a record high $89.1 trillion in the second quarter. Total assets are at a record $103.8 trillion, while liabilities stand at $14.7 trillion. Nonfinancial assets, primarily real estate and consumer durable goods, totaled $31.4 trillion, or about 30 percent of total assets. Financial assets accounted for $72.3 trillion, or about 70 percent. The combination of healthy balance sheets and a relatively strong job market is a primary reason we expect the current economic expansion to continue.

Credit-market instruments—including debt securities such as Treasurys, municipal securities, corporate bonds, mortgage bonds, and student loans—directly held by households (as opposed to assets held indirectly, through life insurance and pensions, for example) account for about 7 percent of total household financial assets. Treasury securities make up about 21 percent of that, an allocation that has risen sharply since hitting a low of about 3 percent in the middle of the recession. Such a dramatic increase might raise doubts about the ability or desire of households to continue buying Treasury securities.

However, from a longer-term perspective, Treasury securities have typically accounted for a significantly higher portion of household balance sheets: From 1970 to 1999, they accounted for 25 to 35 percent of credit instruments. In light of the federal government's likely need to increase its sales of securities and the fading foreign demand, household demand will be critical in the coming years.

Chart 5. Treasury securities previously accounted for a higher portion of household balance sheets.



Note: Shaded areas denote recessions.
Source: Federal Reserve (FactSet).

CAPITAL MARKET PERFORMANCE

(Percent change)

	Sep. 2016	Latest 3M	Latest 12M	Calendar Year 2015	2014	2013	Annualized 3-year	5-year	10-year
Equity Markets									
S&P 1500	-0.2	3.4	13.1	-1.0	10.9	30.1	8.6	14.0	5.3
S&P 500 - total return	0.0	3.9	15.4	1.4	13.7	32.4	11.0	16.4	7.2
S&P 500 - price only	-0.1	3.3	12.9	-0.7	11.4	29.6	8.8	13.9	5.02
S&P 400	-0.8	3.7	13.4	-3.7	8.2	31.6	7.6	14.7	7.5
Russell 2000	0.9	8.7	13.7	-5.7	3.5	37.0	5.2	14.2	5.6
Dow Jones Global Index	0.5	5.0	10.0	-4.0	2.1	20.8	3.2	8.5	2.4
Dow Jones Global ex. U.S. Index	1.1	6.4	7.4	-6.6	-5.5	13.3	-1.5	3.9	-0.1
STOXX Europe 600 Index	-0.2	4.0	-1.4	6.8	4.4	17.4	3.3	8.7	0.0
Bond Markets									
iShares 20+ year Treasury bond	-1.7	-1.0	11.3	-4.2	23.6	-15.9	29.2	2.6	4.4
Dow Jones corporate bond index total return	-0.5	0.9	9.0	-0.2	7.7	-1.5	18.9	5.6	6.8
Commodity Markets									
Gold	0.3	-0.6	15.9	-12.1	0.1	-27.3	0.2	-4.5	8.1
Silver	2.3	5.3	26.4	-13.5	-18.1	-34.9	-3.2	-9.2	5.2
CRB all commodities	-0.3	-2.7	-1.1	-14.4	-3.8	-5.7	-4.9	-4.4	1.6

CONSUMER FINANCE RATES

(Percent)

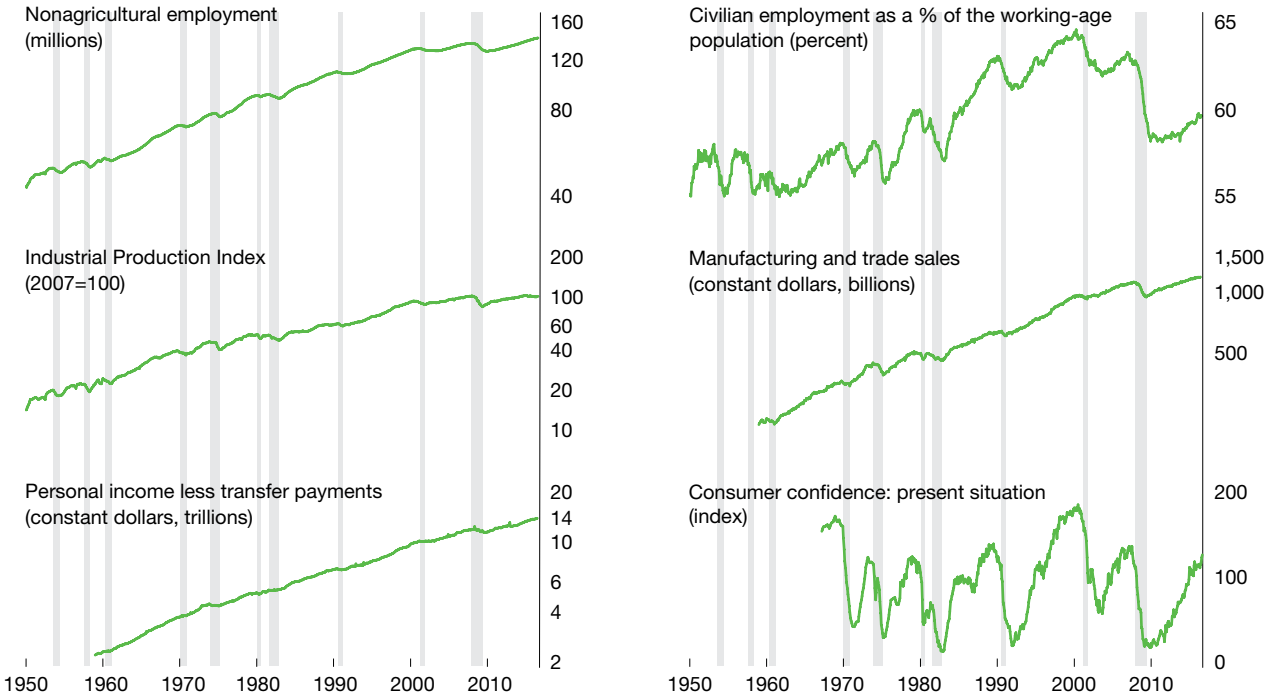
	Sep. 2016	Latest 3M	Latest 12M	Average For Year 2015	2014	2013	Average Over Period 3-year	5-year	10-year
30-yr. fixed mortgage	3.9	3.9	3.9	3.9	4.2	4.1	4.1	4.2	4.2
15-yr. fixed mortgage	3.0	3.0	3.0	3.0	3.2	3.2	3.1	3.3	3.3
5-yr. adjustable mortgage	3.2	3.2	3.2	3.2	3.4	3.2	3.3	3.2	3.2
Home-equity loan	4.8	4.8	4.8	4.8	5.4	6.1	5.4	5.7	5.7
48-month new car loan	4.2	4.2	4.2	4.2	4.2	4.4	4.3	4.7	5.9

Sources for tables on this page: Bankrate Inc., Barron's, Commodity Research Bureau, Dow Jones, Federal Reserve, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, FactSet.

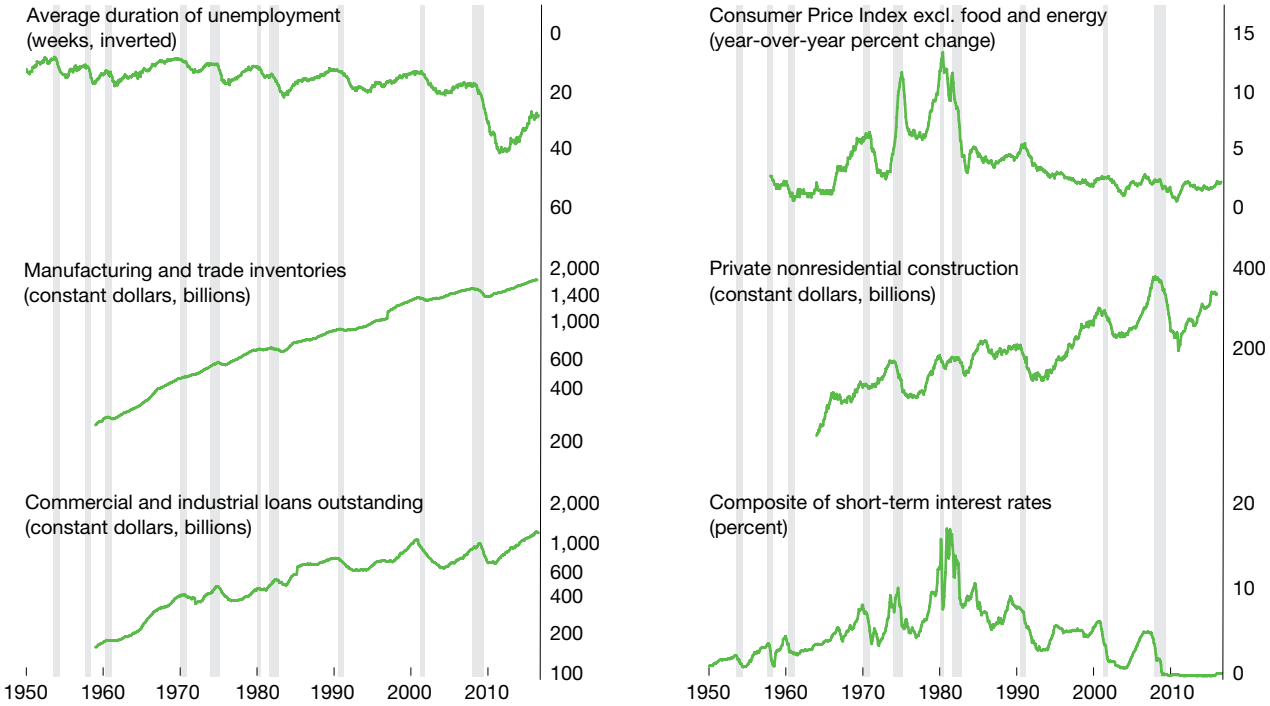
LEADERS (1950–2016)

Sources for Appendix: Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Federal Reserve, New York Stock Exchange, Standard & Poor's, The Conference Board, University of Michigan, U.S. Census Bureau.
Note: Shaded areas denote recessions (FactSet).

COINCIDERS (1950–2016)



LAGGERS (1950–2016)



AIER American Institute for Economic Research

250 Division Street
Great Barrington, MA 01230

Economics for Everyone

The American Institute for Economic Research produces unbiased, expert insight and analysis that enable people to protect their economic and financial interests and those of the nation.

Our Impact

AIER is a reliable source of information people need to make sound economic and financial decisions, avoid costly mistakes, and support sensible public policy solutions.

Become a Member

Help AIER improve economic and financial literacy in America.

visit **www.aier.org**

call **1.888.528.1216**

BUSINESS CONDITIONS MONTHLY

Research

Robert Hughes – Economy, Investing

Rosalind Greenstein – Policy

Theodore Cangero – Data Scientist

Lucinda Weiss – Managing Editor

Rachel Shabani – Graphic Designer

To contact AIER by mail, write to:

American Institute for Economic Research
PO Box 1000
Great Barrington, MA 01230

Find us on:

Facebook
facebook.com/AmericanInstituteForEconomicResearch

Twitter
twitter.com/aier

LinkedIn
linkedin.com/company/american-institute-for-economic-research

For more information or to donate, visit: www.aier.org

ISSN 2376-0516 (print)
ISSN 2376-0524 (online)