

# Budget Deficit:

## Do they Really Matter?

Jeremy Silva, Capital Restoration LLC

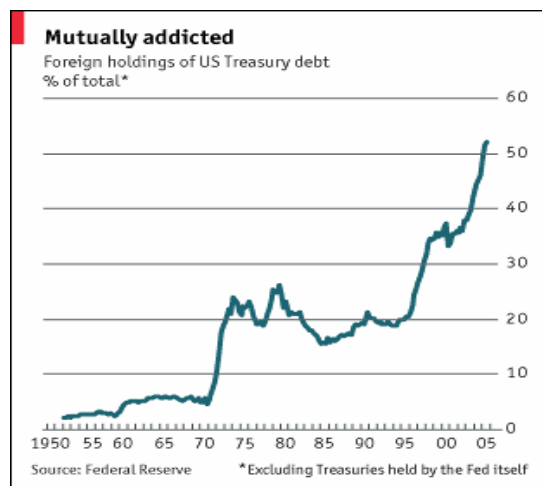
\$8.5 Trillion and growing – what is the governments credit score?

The US Treasury report on September 13<sup>th</sup> showed that the federal government ran a deficit of \$64.6 Billion in August. With the fiscal year ending on Sept. 30<sup>th</sup>, the annual figures are expected to show a yearly deficit of \$260B. This brings the national debt to slightly over \$8.5 Trillion dollars. The effects of this level of debt burden must be considered and may show reason for concern.

When analyzing deficit economics, the question usually arises as to whether deficits are always bad. The answer is not always. Government deficit spending can serve a useful purpose, mainly to spur a flagging economy like in Japan in recent years. The key is that this spending must be productive to have lasting effects. Most economists agree that the US spending is largely consumption based and does not, therefore, have these long term benefits. Of course, there are costs to having debt and these costs can have the reverse effect. When government borrowing gets too large, it can crowd out private borrowing and raise interest costs. Therefore, one needs to look at the federal government's borrowing numbers to achieve a clearer picture of the situation.

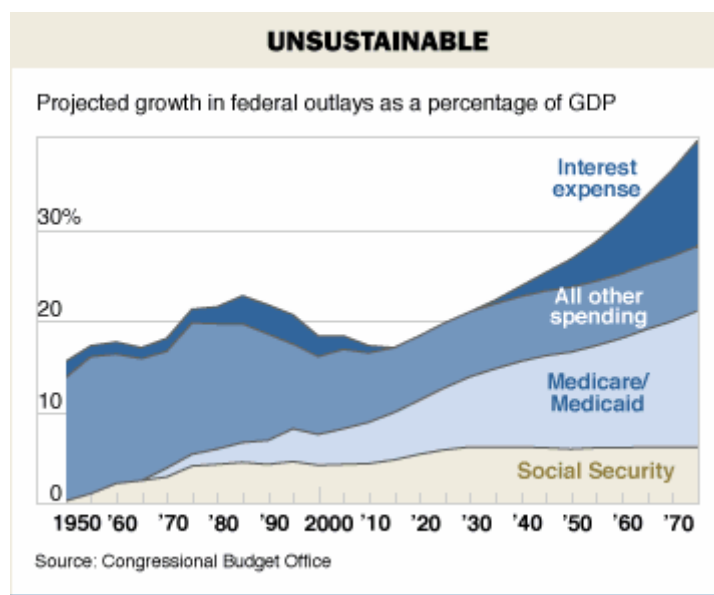
For the last year, the difference between the cash inflow and outflows of the Treasury will be around \$260 Billion. However, this number does not account for the internal movements within the federal system. The Treasury will borrow \$300 B from govt. trust funds like Social Security and govt. employee pension accounts. (\$177B from SSA and \$111B from other accounts)<sup>1</sup> The Treasury is allowed to pay interest to these funds with IOU's payable some time in the future. Including these IOU's the actual deficit would be around \$560 Billion.<sup>2</sup>

All this debt should have an effect on the financial markets higher interest rates. One might very well ask why the treasury markets have not driven up rates. Surely, someone must be willing to buy all this debt. The answer lies overseas.



Foreign ownership of federal debt has tripled in the last 10 years and stands at 25% of total outstanding debt.<sup>3</sup> The central banks of Japan and China have been the biggest buyers of this debt with China seeking to park the \$1 Trillion<sup>4</sup> of foreign reserves that they have accumulated. This buying has helped to keep US rates low in recent years as they swallow the excess borrowing. However, our creditors are showing signs of discomfort. In order to buy Treasuries, some governments sell domestic bonds at home increasing interest rates for their own citizens. Recent statements by foreign central banks have led some to believe they may try to diversify their foreign reserves away from US dollars. They need to tread carefully since any overt policy statement in such a direction can cause turmoil in the financial markets. The weakening US dollar has been worrisome but at least it has been orderly and calm. Should these foreign central banks decide to change policy and not buy our debt the resulting drop in the dollar would mean a certain and long recession.

Finally, the deficit picture would not be complete without a peek at the future. Recent years have seen a hot political debate in the country regarding social security reform and privatization. Arguments have raged in the political arena about whether the social security system will go bankrupt in 2040, 2075 or never. The correct answer appears to be that it may not matter at all. The health care costs problem will sink us long before the social security problem emerges. Peter Fisher, Under Secretary of the Treasury, said in a 2002 speech, *"The Financial Report of the United States shows that the real budget-buster is health care. Medicare and Medicaid account for two-thirds of that \$26 trillion shortfall. For many years, health care costs have been rising faster than economic growth, at one percent more than GDP annually for a decade. For the past two years, partly due to the recession, the gap has been five percent. This is not sustainable."*<sup>5</sup>



Economists predict that this will be the defining issue of the next 10 years. Therefore, it is unusual to see the political storm of a debate on social security in 50 years when the elephant in the room is the medical cost crisis that may drive the country into recession in only the next decade. In ten years, will we still be asking if budget deficits matter???

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<sup>1</sup> “Digging us Out of the Deficit with Holey Math”, Allan Sloan, Washington Post, Sept. 12, 2006

<sup>2</sup> “Digging us Out of the Deficit with Holey Math”, Allan Sloan, Washington Post, Sept. 12, 2006

<sup>3</sup> <http://www.fms.treas.gov/bulletin/b2006-3ofs.doc> “Ownership of Federal Securities” Sept. 2006, US Treasury

<sup>4</sup> “Central Banks Favor U.S. Agency Debt Over Treasuries”, Michael McDonald, Bloomberg, Sept, 4, 2006

<sup>5</sup> “Beyond Borrowing: Meeting the Government’s Financial Challenges in the 21st Century”, Remarks of Under Secretary of the Treasury Peter R. Fisher to the Columbus Council on World Affairs Columbus, Ohio November 2002 <http://www.ustreas.gov/press/releases/po3622.htm>