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THE NATIONAL DEBT, THE FEDERAL DEFICIT, AND THE FISCAL DRAG

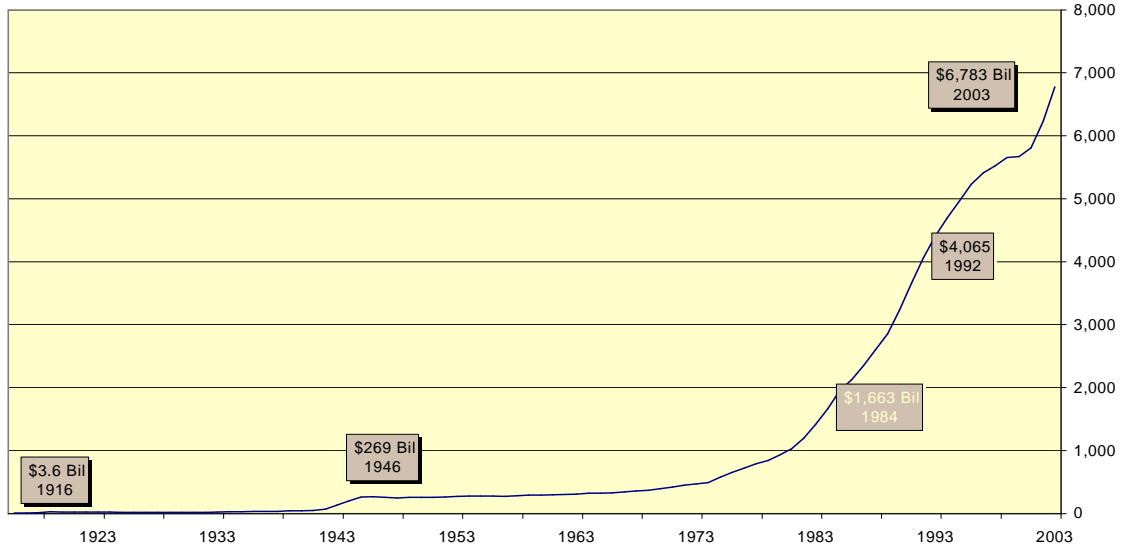
Reminder...

Since the downturn of 1999/2001 that ended 2 years ago (4th Quarter 2001 – 3rd Quarter 2003 Real GDP grew at a better than 3% clip), spending increased following the 9/11 tragedy, and taxes were cut to aid economic recovery; many pundits issued dire warnings of a return to growing deficits that will increase the already several trillion dollar National Debt. This newsletter will analyze these issues in both theoretical and empirical terms in a thorough step-by-step manner. The goal is to create light and not heat.

THE U.S. NATIONAL DEBT AND DEFICIT

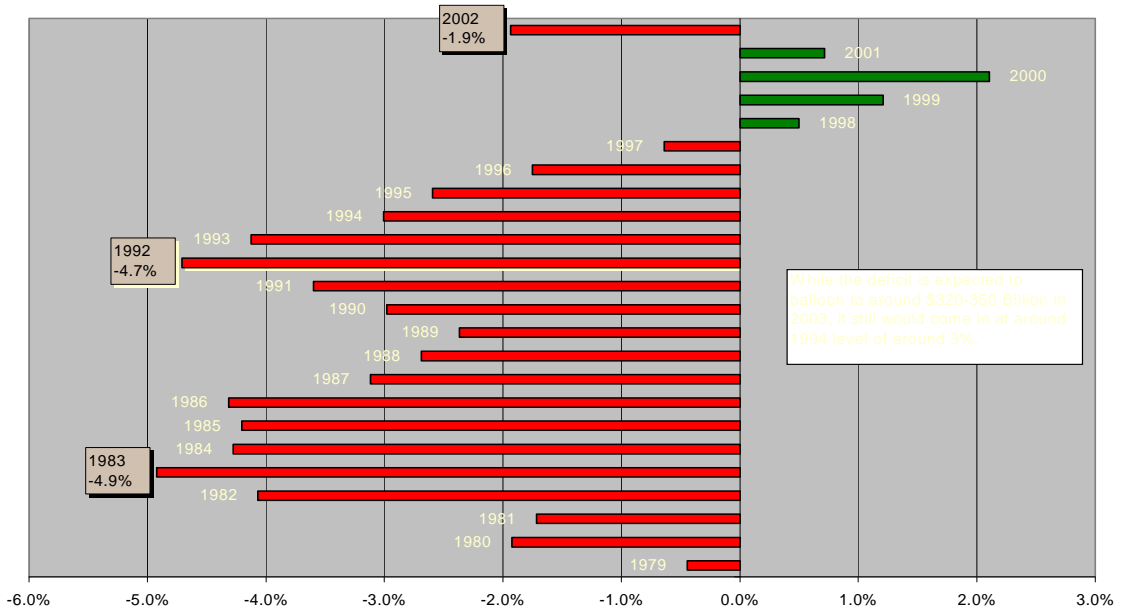
The U.S. National Debt is the arithmetic sum of all budget deficits and surpluses over the history of our nation. When deficits occur, if a national debt exists, that debt increases. Federal budget surpluses decrease our National Debt. The U.S. National Debt was relatively insignificant until the Second World War, going from \$43 Billion in 1940 to \$269 Billion by 1946. It currently is about \$6.9 Trillion (with \$4.0 Trillion held in the form of marketable debt - see the following for detail: [this is your debt!](#)). Throughout much of the post World War II Era, federal deficits were usually the case. This, of course, resulted in a more or less continual rise in national indebtedness.

U.S. National Debt
A Tale of War and Fiscal Spending
Data from the U.S. Treasury
11-15-2003



A budget deficit occurs when government spending exceeds tax revenues. The deficit necessitates borrowing, which increases the government's debt.

Deficit/Surplus as a % of Nominal GDP
Data extracted from Department of Commerce:
Bureau of Economic Analysis November 10, 2003

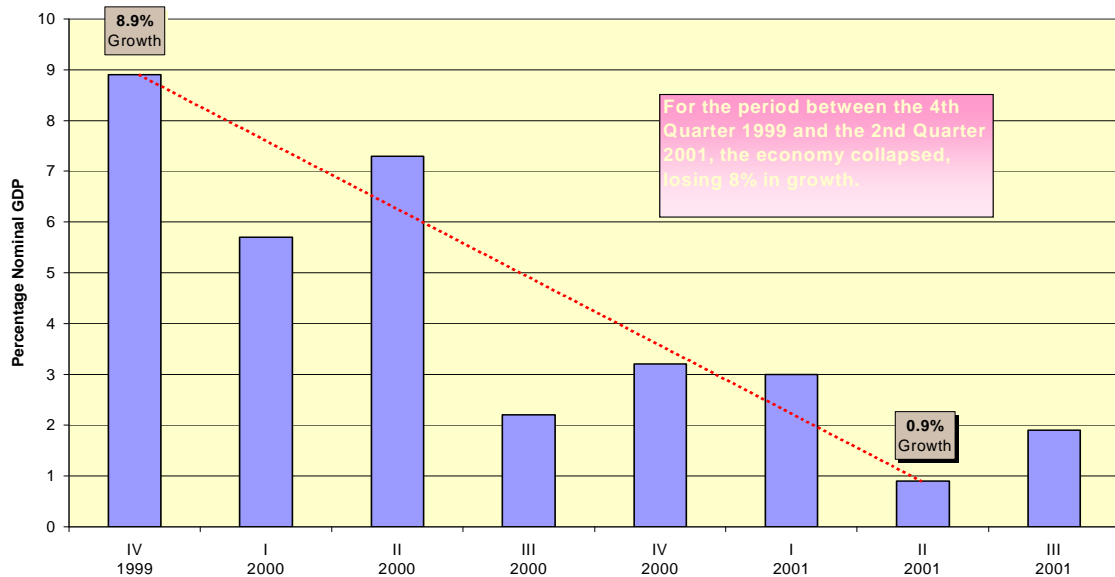


Federal Government borrowing in this country is of two types, non-marketable debt and marketable debt. The latter consists of bills, notes and bonds. Treasury Bills have a maturity of one year or less, usually in multiples of 3

months. Treasury Notes range up to around 10 years, and Treasury Bonds as long as 30 years, with a few exceptions. Recently the Treasury announced it would no longer issue new 30-year U.S. Treasury Bond maturities.

The shorter is the average maturity, the greater the amount of debt that has to be refinanced each year, along with the initial financing of new debt resulting from deficits. For years 1998 through 2000, the U.S. Federal Government experienced budget surpluses and the **marketable portion** (see U.S. National Debt by Category) of the National Debt fell by some \$435 billion. But as mentioned above, it was short lived in that beginning with the 4th Quarter 1999 and continuing through the 2nd Quarter 2000, the GDP rate dropped 8%, from 8.9% to 0.9% in nominal terms (in real terms, the GDP drop was even more dramatic, going from 7.1% growth in the 4th Quarter 1999 to -1.6% in 2nd Quarter 2001...totaling an 8.7% decline).

Nominal GDP Collapse (4th Qtr 1999 - 2nd Qtr 2001)
 Note: Nominal rate is used for Government Receipts and Expenditures
 Source - Department of Commerce: Bureau of Economic Analysis



Clarification

We often refer to GDP in terms of Nominal (with inflation) and Real (inflation removed).

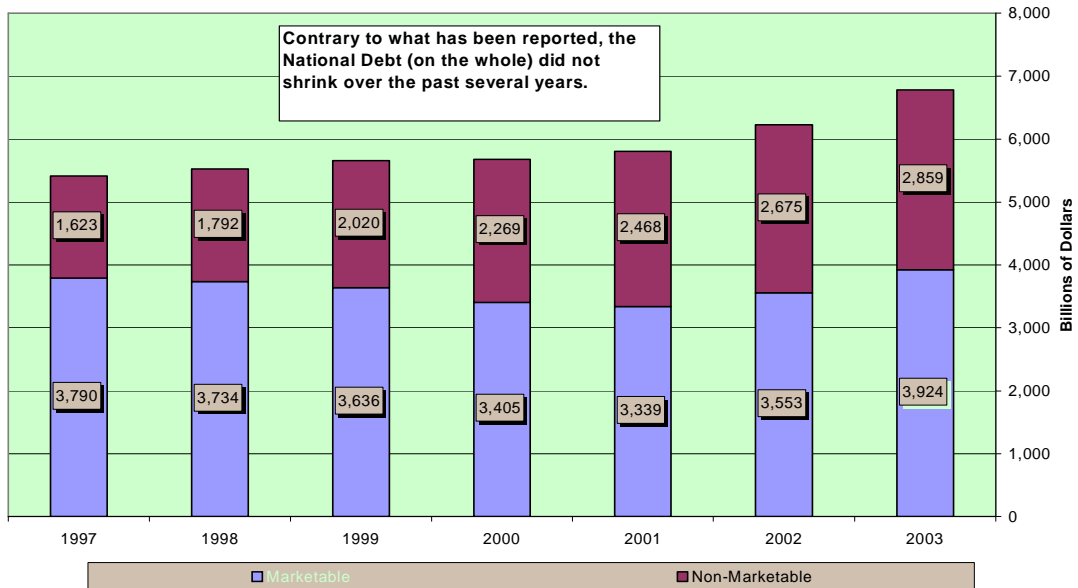
- The use of **Nominal GDP** (sometimes referred to as current-dollars) is primarily used in discussing taxes/government receipts. Government receipts are collected in current-dollars (nominal) and therefore all such measures are in those terms.
- **Real GDP** measures are used to identify economic growth.

We use these terms often, not as tool to confuse, but in their proper context for purpose of analysis.

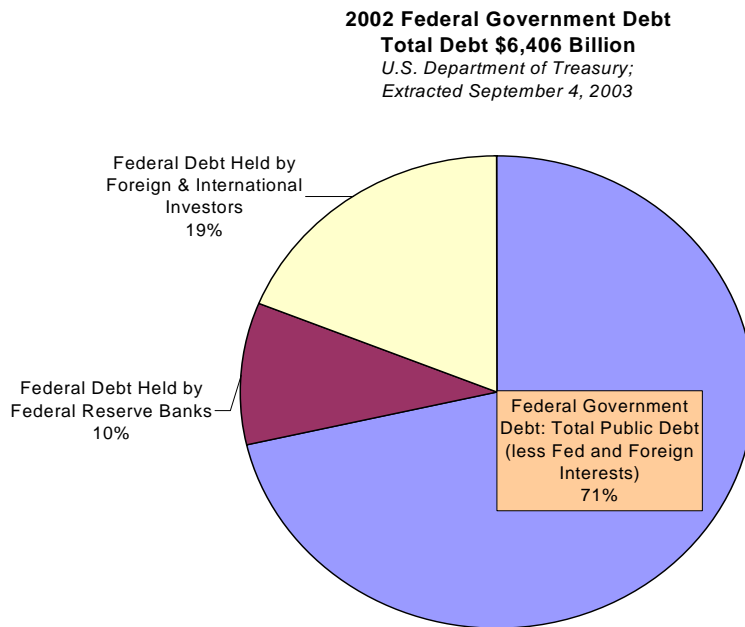
Non-marketable debt is issued to the Trust Funds the Federal Government administers, such as the Social Security Fund and the Railroad Employees Trust Fund. Other special issues occur often related to problems arising out of occurrences such as the oil shocks of the 1970s. Also included in the non-marketable category are savings bonds.

The **marketable** issues can be purchased by anyone. They are usually sold at auctions by competitive bidding but smaller amounts can be acquired by non-competitive bids. One of the major buyers is the Federal Reserve System, since it conducts its Open Market Operations in U.S. Government marketable securities and Federal Agency securities.

U.S. National Debt By Category
(Marketable and Non-Marketable)
Data from the U.S. Treasury
11-15-2003



It is important to note (and will be discussed further in future newsletters) that the FED operates almost exclusively in the secondary markets – it buys and sells securities in much the same manner as the ordinary trader would. The



FED currently owns around 10 percent of the marketable U.S. Federal Debt from this activity.

Since U.S. Federal Government spending resulting from the Great Depression and the Second World War, etc., has exceeded taxes for the most part, these deficits have accumulated and contributed to an awesome national debt.

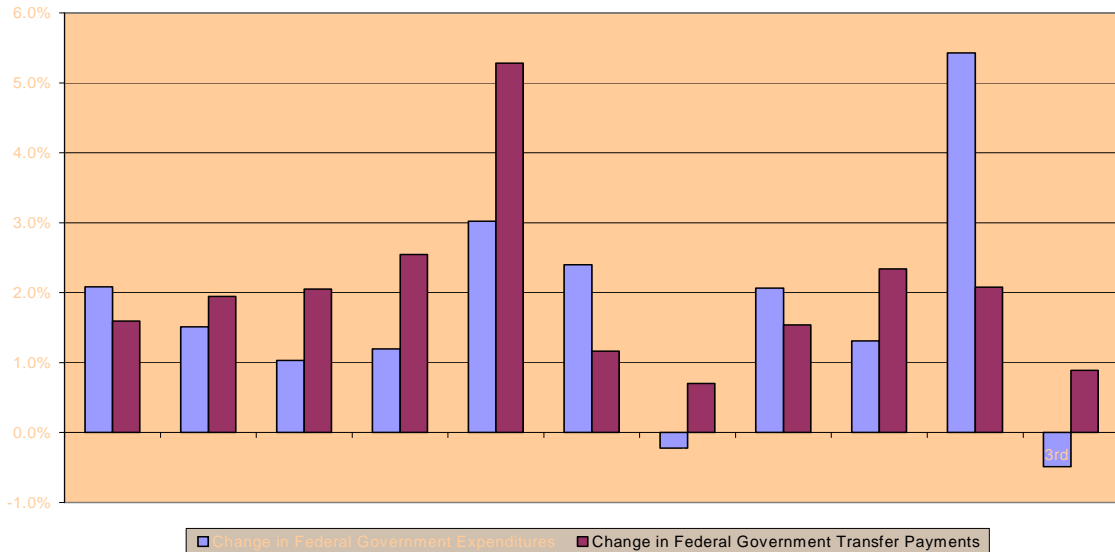
Government spending comes in two flavors:

- (1) *Collective Consumption and Investment* is one of the reasons for government spending. Included in this category are expenditures such as transportation, education, and defense.

- (2) The other type of spending, more prevalent at the federal level, is *Transfer Payments*. Included in transfer payments are expenditures such as Family Income Allowances, Social Security Benefits, Medicaid, and Medicare. We will revisit transfer payments in future newsletters - including discussion on the rationale for the placement of Interest on the National Debt in this category.

In recent years, transfer payment spending has usually accounted for more than 60 percent of all Federal Government spending. Transfer payments by the government results in receipts issued to the public that were not currently earned; that is no productive resource, such as labor, was currently supplied (and in many cases was never supplied). In order to fund transfer payments, the government must tax others and or borrow as required. Transfer payments increase a household's disposable income just as taxes decrease the same disposable income of households.

Government Expenditures and Transfer Payments
change from preceding Quarter
data extracted from Department of Commerce:
Bureau of Economic Analysis November 10, 2003



Since government spending of either type increases aggregate demand, it then stimulates the economy to a higher level of activity. Government spending on goods and services add directly to aggregate demand while transfer payments add to disposable income and thus add to aggregate demand.

On the other hand, taxes raised to finance government spending depress the level of economic activity by reducing the *Disposable Income* of the households paying the taxes. The result of lower Disposable Income is a reduced aggregate demand for the nation's goods and services. If taxes are insufficient to fund all the spending of the government, borrowing occurs to fund the deficit. This borrowing puts upward pressure on interest rates and reduces spending sensitive or responsive, in a negative way, to rising interest rates in the private sector such as in the demand for new housing.

This is why many argued that federal budgetary deficits stimulate economic activity to higher levels or if that activity is already pressing capacity (near full employment), inflationary pressures begin to appear. Federal budgetary surpluses tend to depress the level of economic activity either in nominal or cur-

rent dollar terms, resulting in disinflation or even deflation, or in real terms, a fall in real output to lower levels of growth or even negative rates, a recession.

... *WHAT*

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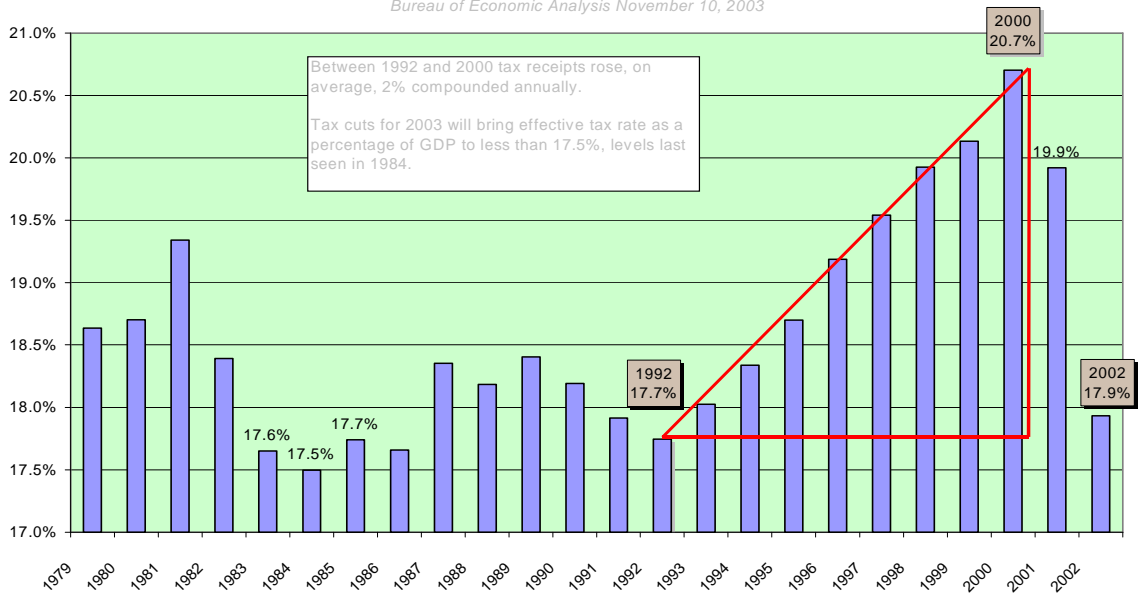
DRAG!!!

FISCAL AND MONETARY POLICY – TWIN POLICY DISASTERS

In the first issue of this newsletter, we argued that there were two major occurrences leading to recession:

(1) Significant rise in federal receipts as a percent of National Income...

Tax Receipts as a Percentage of (Nominal) GDP
 Data extracted from Department of Commerce:
 Bureau of Economic Analysis November 10, 2003

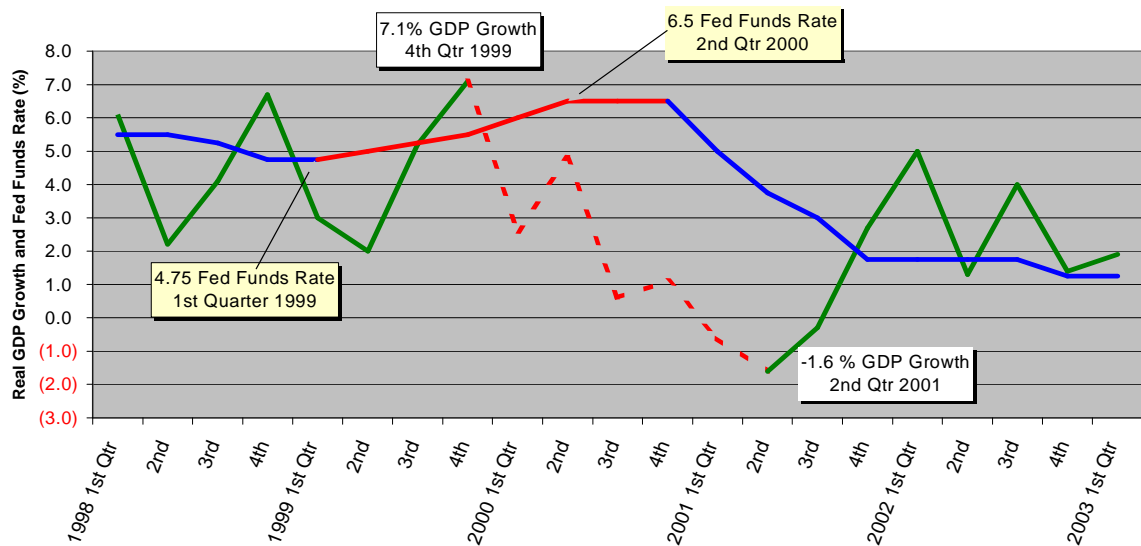


(2) ...and the FED's change to a monetary policy of restraint, leading to rising short-term interest rates.

The Collapse of the Economy 2000-2001

Interest Rate Hikes (Fed Funds) from 4.75% in 1st Quarter 1999 to 6.5% in 2nd Quarter 2000

GDP Data from Bureau of Economic Analysis:
 Fed Funds Data from Federal Reserve Board



The “twin policies” brought the nation’s economy to its knees: witness a positive growth of 7.1 percent to a three-quarter long recession, where the GDP collapse bottomed out at a negative 1.6 percent (real GDP).

The Third Component

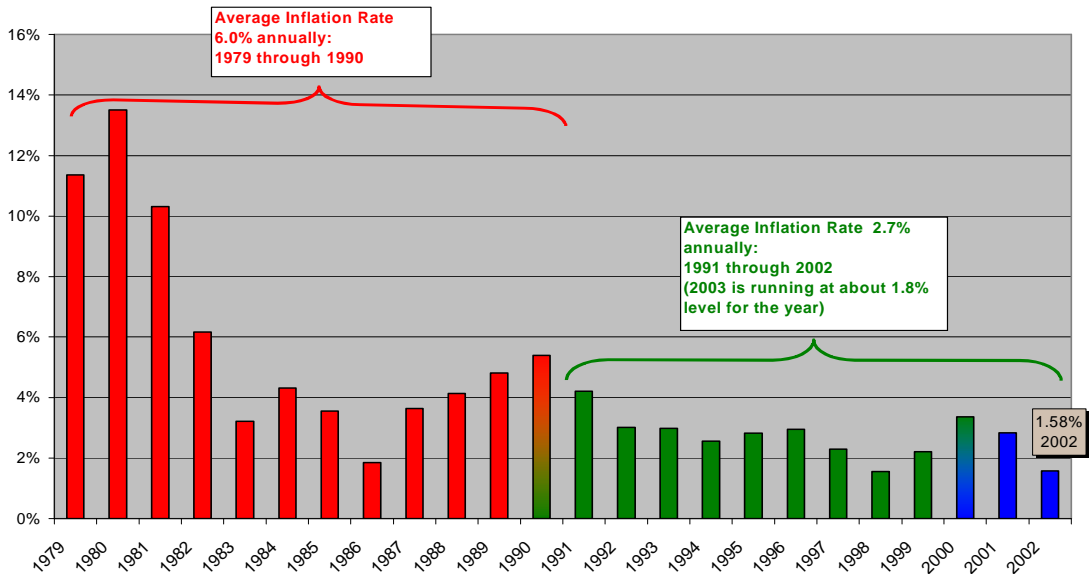
The third underlying and ongoing factor contributing to the collapse of the economy was the persistent trade deficit problem. Of course this issue plagues us still, dampening an otherwise remarkable recovery (remember from you economics classes, imports depress). There are indications that this problem shall be addressed in the future.

In other issues of this newsletter, it is argued that the increase in competition in a growing number of markets is providing anti-inflationary pressures and the role of fiscal and monetary policies to limit inflationary outbreaks is increasingly less needed now as compared to 20 or 30 years ago.

CPI Change (1979 - 2002): *The New Paradigm*

A Continuing Bias toward Low Inflation

All City Average: Base Year 1982-1984 = 100
 Department of Labor: Bureau of Labor Statistics

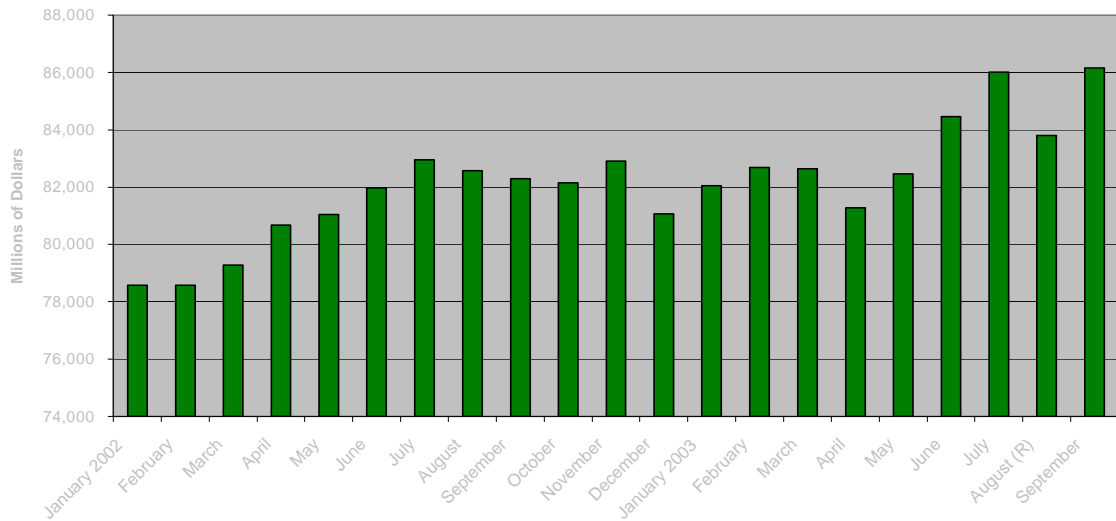


CURRENT ACCOUNT (CONTINUED)

As we began discussing in the last newsletter, the U.S. Current Account Deficit is continuing to rise. Focusing on the Trade Balance portion of the Current Account, it is currently at \$41 Billion for the month of September. While exports are picking up, imports are continuing to rise as well. This phenomenon, where imports rise during recovery and expansion is known as the *Locomotive Effect*.

The Good...

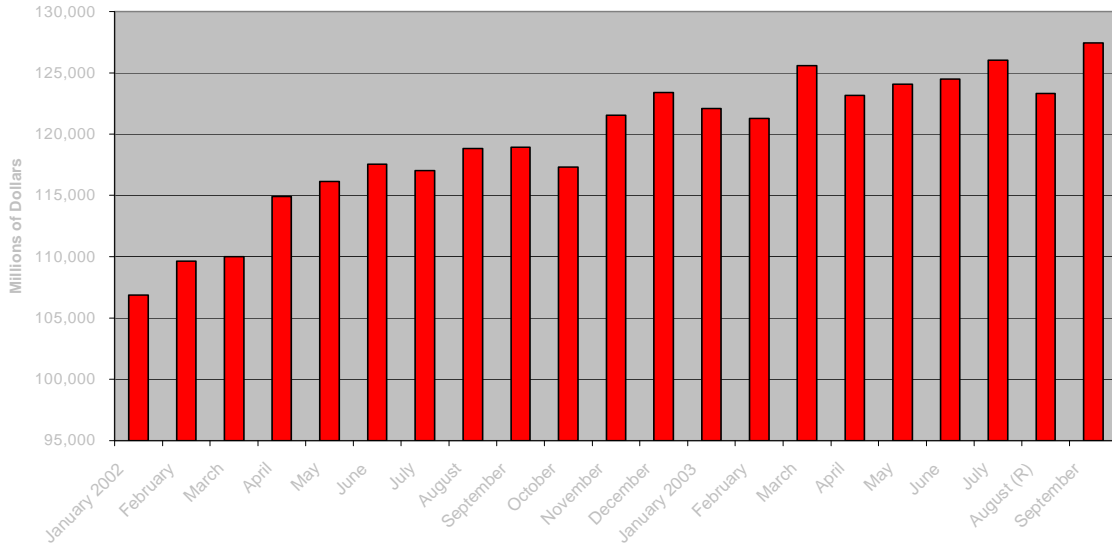
Locomotive Effect: Increase Exports
during Economic Recovery/Expansion
(more catching up than with Imports)
Extracted from Department of Commerce
November 13, 2003



The Bad...

Locomotive Effect: Increase in Imports during Economic Recovery/Expansion

Extracted from Department of Commerce
November 13, 2003



The Ugly...

Locomotive Effect: Increase in Trade Deficit during Economic Recovery/Expansion

Extracted from Department of Commerce
November 13, 2003

