LIVING ON BORROWED TIME- AMERICA THE DEBTOR
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"Dysfunction is a function.
If dysfunction is a function,
If dysfunction is a function,
If dysfunction is a function,
Then I must be some kind of
Genius!!!
Genius!!!
With me it's a religion." "Genius", by Pitchshifter

OVERVIEW AND CONCLUSION

Economic experts, political pundits, and marketplace wizards have made much of America's looming federal "fiscal cliff". It has become commonplace to declare that not only for the near term, but also for the misty long run horizon, difficult decisions await the Washington leadership. Of course the nation has assets. However, there has been much less emphasis on America's "debt hole", the enormous indebtedness of America as a whole (not just the federal government situation) as a percentage of nominal GDP.

The debt growth trend in recent decades and its mountainous overall level argue that a culture of debt (and entitlement) exists in the United States. Rising debt as a percentage of GDP preceded its acceleration during the glorious Goldilocks Era that ended around mid to late 2007. Since the so-called recovery began to motor forward in 2009, overall United States indebtedness has not declined much. Though consumer indebtedness has declined modestly in the past few years, federal indebtedness has skyrocketed. Thus in a representative government, people ("we, the people") correspondingly remain very indebted.

How well-functioning has Congress (and many state legislatures) been in the fiscal arena? In recent years, and not surprisingly for a nation of debtors, political guardians (whether via inertia, their partisan squabbling, or their entangled competing interests) have succeeded in postponing significant fundamental improvements in the debt pattern.

And is the President or any of the Congressional Democrats or Republicans in their undoubtedly brilliant "plans" talking of the merit of engineering budget surpluses at any time in the next several years (if ever)? In addition, smoothly singing its mandate hymn, the financial fire-fighting Federal Reserve devotedly has assisted debtors by repressing interest rate yields, printing money (quantitative easing), and other measures. This highly accommodative and sustained central banking liberality not only assists debtors. The Fed thereby provides short term benefits such as boosting GDP, rallying the US stock marketplace, reducing unemployment, and buying time for a fiscal solution. Might there be some long run costs to such supposedly prudent Fed actions? For example, these generally popular Fed policies nevertheless also reflect and encourage the debt culture and delay difficult (responsible) political decision-making and consequently some amount of painful reckoning.

Thus America's debt culture thrives.

Wise collegial political action or a long-lasting burst of greater economic growth possibly may fix the existing severe problem of the near term (and long term) overall US debt situation. The nation's recent political track record, slowing US and global GDP growth, and America's marriage to debt should make political and marketplace observers wary of this viewpoint.

What is the more probable outlook? Perhaps patching over the US's debt problem, particularly on the federal landscape, will occur, thus easing fears regarding the outbreak of a financial disaster. On the federal fiscal front, the passing of and results of the 2012 election may spark bipartisan efforts that result in a temporary fix of existing difficulties. However, as before the election, there is a Democratic President, Democratic Senate, and a Republican House of Representatives. Remember the lyrics of a famous anthem by The Who: "Meet the new boss Same as the old boss" ("Won't Get Fooled Again"). And in the Senate, the Democratic majority is several seats short of the 60 votes necessary to stop legislative debates. Even to induce an attractive temporary fix, it is more likely that fearsome existing debt troubles probably will have to worsen further. And don't overlook the need to raise the debt ceiling again.

Moreover, postponing a fundamental solution for a while (even a rather long while) will not avert a renewed eruption and worsening of the crisis. To spark significant progress in reducing America's national debt to more manageable levels, the ongoing financial crisis probably will have to worsen further. That deterioration scenario, even if delayed for some time, likely will erupt.

DEBT MANAGEMENT

Digging into and organizing Federal Reserve Board statistics reveals much about America's debt levels, trends, and culture ("Flow of Funds Accounts of the United States", Z.1; 9/20/12; data through second quarter 2012, quarterly GDP numbers are annualized).

US total credit marketplace debt at end 2Q12 was almost $55.2 trillion. This is up about two trillion dollars from year end 2008's $53.3tr, 2009's $53.2tr, and 2010's $53.6tr.

Although total credit marketplace debt as a percentage of nominal GDP peaked at end 2009 at 380.9 percent, it has slipped only modestly since then, with 2Q12's at 354.1pc. Walk through some history. It was about 160pc in 1975, climbing to just over 250pc in 1995 and almost 300pc in 2002. Thus end 2Q12 indebtedness not only remains quite near its pinnacle, but also even well above the already high 2002 level at the dawn of the blessed Goldilocks Era. Thus deleveraging (debt reduction) on a national (overall) basis has much more distance to travel despite some improvement in the household sector.

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Many optimistic surveyors stress that total household debt as a percentage of GDP has descended modestly since the end 2007 (and 2008) highs of just under $13.7 trillion. This sum totaled 97.7 percent of nominal GDP in 2007, diving to about 85.8pc at end 2011 and 83.1pc (around $12.9tr) at end 2Q12. However, even though as a percentage of GDP this 2Q12 sum approaches 2002's 79.3pc ($8.4tr), such indebtedness remains hefty. It soars well beyond 1980's fifty percent and 1995's 65.3pc.

The financial arena debt situation on the surface looks more reassuring now than four years ago. The domestic financial sector's debt at end 2Q12 was about 88.9 percent ($13.9 trillion), about the same percentage as 2001's. This indeed slumps from end 2008's 119.8pc pinnacle relative to GDP ($17.8tr) and 2004's 100.4pc. Unfortunately for promoters of stories that the financial territory is in rather fine shape from this vantage point, domestic financial arena debt remains substantial from the historical viewpoint. It towers over 1985's 29.9pc and 1995's 57.0pc.

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The US federal borrowing extravaganza coupled with the rescue efforts by the Federal Reserve mechanics probably has generated much of the nation's GDP improvement since the dreadful depths of the global economic disaster. American is not an island, either. Many other nations in varying fashions likewise embraced America's deficit spending and highly accommodative central banking policies.

Debt (leverage) helped to propel the Goldilocks Era. Encouraging a ravenous national debt appetite looks like a source of the recent economic "recovery". To some extent, in recent years during the ongoing international economic crisis, US household and domestic finance debt apparently has shifted into the federal government debt ledger. So "The Nation" (which represents "us") is more indebted, and thus so are we from that standpoint.

As a percentage of nominal GDP, federal government debt at end 2Q12 was 71.3pc ($14.1 trillion). This stands far above the 36.5pc of nominal GDP ($5.1tr) at the sunset of the Goldilocks Era in 2007. It floats far above 2001's 32.9pc and 1979's 25.7pc. Moreover, note its steady ascent since 2007. End 2008 was 44.5pc, 2009 was 55.9pc (breaking through 1993's 50.0pc barrier), 2010's 64.7pc (despite the vaunted recovery) and 2011's 69.3pc.

The country's state and local debt peaked as a percentage of nominal GDP at 21.1pc (nearly $3.1 trillion) at end year 2010. However, although this measure edged down to 19.3pc at end 2Q12, end 2Q12's $3.0tr burden remains about 2010's height. These percentages of recent years hover well above 2000's 12.4pc ($1.2tr) bottom.

The overall US governmental debt (combined federal and state/local) has flown steadily upward over the past decade. The end 2Q12 level was 90.5pc of nominal GDP, with end 2011's 89.3pc. These recent figures dwarf 2001's 45.5pc of nominal GDP and greatly exceed 2008's 64.7pc (which broke through 1991's 64.3pc roof).

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For recent US governmental analysis related to the fiscal cliff and deficit reduction, see the Congressional Budget Office's "Economic Effects of Policies Contributing to Fiscal Tightening in 2013 and "Choices for Deficit Reduction' (11/8/12). Note also "An Update To The Budget and Economic Outlook: Fiscal Years 2012 To 2022 (8/21/12). For the US and other nations, the International Monetary Fund's "Fiscal Monitor" (October 2012) provides worldwide data on overall governmental debt and budget deficit trends.

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At end August 2012, major foreign holders of US Treasury securities owned roughly $5.4 trillion of them (US Treasury; TIC Report, 10/16/12). Foreign official holdings represented about seventy-two percent of this. The two largest holders are Mainland China (about $1.15tr) and Japan ($1.12tr). End October 2012's outstanding publicly held UST debt is around $11.4tr (US Treasury, "Monthly Statement of the Public Debt of the United States"). The $5.4tr in UST grasped by major foreign holders thus is a substantial 47.4pc of this.

How eager will overseas holders of US Treasury securities be to keep on bolstering America's debt structure? Suppose they reduce their net buying, or become net sellers, at some point amidst the US fiscal problem? Or would an ominous cut in this net acquisition (or a dreaded net liquidation) itself help to ignite or magnify that crisis? Certainly foreign owners of UST, despite the US dollar being a reserve currency and still-flickering “flight to quality” concerns, do not like low nominal yields (or negative real ones).

What if the United States dollar begins to depreciate significantly again? The broad real trade-weighted dollar is not far from July 2011’s record low around 80.5 (monthly average; for the period since 1973). That yardstick rose to 86.2 in June 2012, but slipped to 83.9 in October 2012.

STATES OF AFFAIRS

“And I don’t want to waste more time
I’m in a New York state of mind…
It comes down to reality
And it’s fine with me ‘cause I’ve let it slide…” Billy Joel, “New York State of Mind”

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Though any worsening of the national debt crisis probably will appear in the federal domain, do not forget the fiscal pit in other branches of government. Further deterioration in the state and local government realm could increase worries and difficulties that spread beyond that field. Look at the state and local fiscal pit. The “Report of the State Budget Crisis Task Force” (July 2012) examined the financial condition of California, Illinois, New Jersey, New York, Texas, and Virginia, six heavily populated states. The report states that although each state varies in detail, “a common thread runs through the analysis, supported by information available for states generally.”

The study underlines: “Certain large expenditures are growing at rates that exceed reasonable expectations for revenues”. These include Medicaid, underfunding of pension funds for state and local workers, and unfunded liabilities for health care benefits for state and local government retirees. Plus “The capacity to raise revenues is increasingly impaired” (narrow, eroding tax bases and volatile tax revenues). In addition, “The Federal budget crisis will have serious spillover effects on state and local governments, and state actions will have spillover effects on local governments”.

Moreover, “State budget practices make achieving fiscal stability and sustainability difficult”. Even though almost all states have balanced budget requirements, “’revenue’ and ‘expenditure’ are not defined terms. The use of borrowed funds, off-budget agencies, and the proceeds of asset sales are not uncommon practices, often rendering balanced budgets illusory.”

“The conclusion of the Task Force is unambiguous. The existing trajectory of state spending, taxation, and administrative practices cannot be sustained. The basis problem is not cyclical. It is structural. The time to act is now.”(pp1-3; see also pp22-24). Does this echo the federal situation?

To what extent, if at all, will the US federal government rescue a given state? Foreigners, including central banks, are not likely to do so.

CREAKY CORPORATE CREDITWORTHINESS

The decaying US government fiscal situation in recent years has some parallel in the long run decline in US corporate creditworthiness. “US companies slide down ratings scale”, notes a headline lurking in the back pages of the Financial Times (10/25/12. p22). The article states: “The average credit rating of US companies, at its lowest level in modern times, could fall further as corporate managers take advantage of rock-bottom interest rates to pile more debt on to their balance sheets."

The article refers to a new report by Standard & Poor's, which has rated US firms since the 1920s. The study states that large borrowers increasingly are choosing to live without the "A" grade credit rating that lenders used to expect. "The median rating on non-financial companies"- so this discussion is not about the banking system- "has fallen to double-B-, from an average A rating in 1980. Then 50 per cent of big companies rated by S&P had a rating of A- or higher. Only 8 per cent do today." Although 2010 and 2011 were the first years since 1997 in which S&P upgraded more firms than it downgraded, the S+P analyst expects that trend to reverse. In any event, since 2000, 101 companies have exited the A rated category, some due to the two recessions, others from structural changes in their industries. However, "the most common reason is management sacrificing the rating for the sake of shareholder returns."

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