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DEC. 5, 1991

A BANKER'S VIEW OF THE NATIONAL DEBT

For some time now the nation has been engaged in a great political, economic, moral, and, I must say, uninformed debate about the debt of the United States Government and the annual deficits associated with it.

The wisdom or folly of running deficits depends mostly on the point of view of the debaters. The economic effects tend to be obscured by value judgments on the morality of debt, the Government programs which produced it, and oft repeated statements that sound businesses couldn't spend more than they took in year after year.

When asked about the debt most politicians will quickly say that it is too high; that the deficits must be curbed; that the nation has needs that must be met; that people do not want to pay taxes; and that they personally have always voted for restraint except for spending programs vital to their constituents.

The purpose of this paper is to analyze the debt in the same way that a banker judges a loan request in order to see if such analysis sheds any light on the subject.

The debt began its recent increase in the early 1980s as part of a program popularly called "Reaganomics" or "Voodoo Economics". Mr. Reagan took office with the avowed intention of shrinking the Federal Government domestically. He had reason to think this policy had widespread public support since he elected by a landslide and re-elected by an even larger one. Reagan assumed it would be easy to shrink the government by starving it of revenues as he had done in California. He would reduce taxes , which in turn would reduce spending. Hindsight shows that Mr. Reagan didi not understand the United States Congress, which saw no connection between taxing and spending. Besides taxing and spending programs are handled in different committees.

Some two or three sessions of Congress later this connection was established because the "bond vigilantes", as the investment community named them, were factoring something called "inflation" into the price of government securities and driving interest rates to the highest levels in history. At one time a 4-year Treasury note was issued with an interest rate of 16%.

To reassure the public Congress did a manly thing. It passed the Gramm-Rudman-Hollings Resolution, which stated their intentions to balance the Federal budget by 1991. As we know Congress would have missed this target by at least ten years, so in 1990 it passed a so-called Budget Accord which promised to balance the budget by 1996.

All of this came about in the midst of the frenzy of public fears about the debt. Pundits proclaimed doom in the newspapers; economists worried; businessmen wrote letters to editors; the public told their Congressmen to do something.

Congress agreed on spending reductions and enacted new taxes, placing thes taxes only on the "wealthy", whomever they might be, who were not paying their "fair" share, whatever that might be. Apparently no one thought to consider what increased taxes and reduced spending would do to the economy.

John M. Keynes in 1935 had explained that such actions would shrink the economy (another term for recession). But Keynesian economics had been repealed in the '80s, so Congress was able to ignore this point. One year later, the point having been cruelly made, they are about to reduce taxes.

At this point I have become aware that I run two risks. The first is that this paper will become a long digression on the economic folly of Congress. The second is the danger that I will be charged with violating our strictures against writing a political paper. Let me deal with the second risk first. I want to make it clear that I consider both parties to be equally ignorant, error prone,and ruinously partisan. The only difference is that since there are more Democrats than Republicans, they are more ignorant, more error prone, and more ruinously partisan.

As to the first Risk, Let me return then to my original plan to consider the Federal debt as banker might consider a loan request. Bankers follow certain rules in considering loans. The first rule is to consider the character of the borrower. No loan can be a good one if it is made to someone who will not honor his obligations regardless of circumstances.

In this respect the Federal Debt is of the highest quality. No Congress or administration in our history has attempted to repudiate the Federal Debt. Indeed the United States Government security is the credit-risk-free benchmark for all other debt.

The second consideration is what the banker calls Capacity, or the ability to service the debt. In this respect the Federal Debt, despite its huge size, is at this time no cause for concern. The capacity to service the debt resides in our huge national income. The debt as of the end of 1990 was about 60% of Gross National Product. The deficit for this year will be about 4% of GNP. To put these numbers in perspective the debt at the end of World War II was 130% of GNP. It fell steadily until 1982, when it was 40% of GNP. Since the Federal Budget was in surplus in only two years between the end of World War II and 1990, we can see that the growth of GNP far exceeded the growth of the debt. Indeed it can very well be argued that just as IBM and other well run businesses increased their debt in this same period in order to finance their growth, so the increase in the Federal Debt was necessary to leverage the growth of the economy.

Since 1982 the annual deficit has ranged from just over 6% of GNP in 1983 to a low of 2½% in 1989. The deficit for 1991, as I said, will be around 4% of GNP. Frankly as I did the research for this paper I began to wonder what all the fear about the debt and the deficit is all about.

A third consideration in granting a loan is collateral. Under this heading the banker will consider the purpose of the loan, especially if it will be used to buy assets which will be pledged as security.

The Federal Debt has been used to purchase about every kind of asset imaginable, ranging from Hoover Dam to highways, National Parks, hospitals, military installations, factories, utility systems, atomic plants, NASA, coal and oil reserves, and gold. We are justified in concluding that there is plenty of collateral available even if it is not actually pledged. By the way, the government in its accounts values gold at $42.00 an ounce compared to the current market price of about $350.00. While there is a great deal of guesswork that goes into building a Federal Balance Sheet, informed economists have arrived at an asset value of about $3 trillion for the value of government property. This in itself would pay off our debt of about $2,500 billion to $3,000 billion if it could be sold.

Before we go on we must digress again. When we talk of debt we beg a question. Debt is owed to someone. To whom does the United States owe its debt? The latest figures available were as of June 30, 1988. They surprised me. Of our debt at that time of $2,500 billion, $534 billion or 21% was owned by the United States Government itself; Eleven percent was held by State and Local governments; forty-eight percent was held by banks and other financial institutions, including the Federal Reserve System; thirteen percent was held by foreign individuals and governments; and the rest, about 7%, was held by individuals.

Let's consider the debt held by foreigners. Many people fear that foreign ownership of our debt gives foreigners great power over us. This is not really a danger. Bondholders have no vote. Foreign governments feel entitled to lecture us about our poor management, just as we lecture them; but our government can and does ignore their advice. Foreign holders who really disapprove of us can vote by selling their bonds and then they are no longer holders.

Milton Friedman, the famous economist, is quoted as saying something to the effect that it was a mystery to know why people thaought that Japanese purchases of American bonds was a sign of Japanese strength and American weakness. Actually it speaks of American strength that the Japanese would prefer our bonds over theirs and send us cars and electronic goods to pay for them.

A banker's nightmare is a good borrower who goes sour because he doesn't know when to stop borrowing, because there is a limit to the debt that any income, no matter how large, can support. Is our debt getting too large? Bankers like to compare the financial statements of a borrower with his peers. How do we stack up with other industrialized nations, our peers?

At 60% of GNP our debt ratio is essentially the same as that of Canada, Germany, and Japan. France's debt is considerably lower, that of England and Italy considerably higher. However it is critical that GNP growth exceed the growth of debt; otherwise debt will become too large and debt service will become a problem.

The average interest cost of the Federal deficit is about 6%; however, the total interest bill has tripled since 1980. It may be that the interest cost has peaked because the precipitous decline in interest rates which has occurred over most of this year has brought rates back to levels which prevailed in the mid '70s.

Remember too that our debt is essentially an "internal" debt since only 13% is held by foreigners. Eighty-seven percent of the debt is available to the government to use or to tax if necessary. This power tends to keep the debt service from being a burden.

Of course the debt is not a burden to the United States citizens who own 7% of it directly. They receive far more interest income that the portion of their income taxes which goes to debt service. Many people share in the benefits indirectly through pension and investment funds, although their benefit is difficult to quantify.

Am I saying, then, as some do, that the debt is not a concern at all since we "owe it to ourselves?" Definitely not. The debt owned by individuals is owned by the wealthiest 25% of the population. Seventy-five percent of the people own no government bonds. Debt service then is another form of transfer payment going from the least wealthy to the more wealthy.

What about paying off the debt? Someone has estimated that each household in the United States would owe $30,000 if the debt were paid off equally by households. Most American families don't have this kind of cash on hand. They would have to well their homes, cars, stocks, etc. to raise the money. After paying off the government they would be in penury.

In contrast some people who received a check in payment for their bonds would have bulging bank accounts. In other words paying off the debt would be a gargantuan transfer of wealth from one person to another. Society would be no richer or poorer, just unhappier. Real productive wealth would be unchanged.

From this viewpoint we can see that the charge that the debt is a heavy burden for future generations is untrue. At any time the generation that paid off the debt would receive the benefit of it.

Does the debt hurt our present standard of living? No, it doesn't, provided that the interest paid is taxed and/or reinvested in the economy.

Does the debt crowd out other borrowers, cause inflation, or cause the dollar to collapse versus other currencies? All of these charges have been leveled at the debt.

Inflation is an insidious danger to all societies because it distorts relative wealth, robs persons of the fruits of their labor, and benefits others undeservedly. It is a social problem as much as an economic one. It is caused essentially by the money supply increasing faster than the supply of goods and services. The debt or the deficit will not increase inflation unless the debt is moneytized by the Federal Reserve System increasing bank reserves. If the Fed does not moneytize the debt, interest rates will probably rise but inflation will not.

What about crowding out private borrowers? This danger has some validity in that a rise in interest rates will prevent many people from borrowing. However in the 1980s these fears were not realized.

Neither was the fear that the dollar would collapse. This is a short term danger because a cheap dollar makes our exports very attractive and imports very expensive.

There are some real dangers associated with the debt which the conventional wisdom seldom considers. The most serious danger is the risk that real interest rates will be too high, causing misallocating of resources. This can adversely affect the long term growth of the economy.

What can we do about the debt to insure that these dangers are avoided? Like any prudent borrower Congress can carefully plan the use of debt by establishing long term goals. It appears that the economy performs best if the government's share does not exceed 20% of GNP. The first goal, then, would be to hold our fiscal programs to 20% of GNP. The second goal should be to hold total debt to 40% - 50% of GNP, which seems to be the level at which our economy has grown the best. These goals would be met by setting taxing and spending rates properly.

Tax rates must be set so as to leave as much purchasing power in the consumer's hands as possible because consumer spending very effectively guides business to make appropriate capital expenditures. Also Congress must screen each spending program carefully so as to allocate scarce resources in the most socially and economically effective way.

Setting optimal tax rates and cost-effective spending programs will not be easy because of political and interest group pressure, but in the long run the nation will be better off socially and economically. This kind of taxing and spending discipline will allow the economy to grow faster and will enhance productivity. In the final analysis productivity is the key to economic success. It causes the pie to be larger so that there are more pieces to go around.

Summing up, then, how does this banker view the debt? The United States Government debt has been and still is a good investment. The borrower is in sound shape and debt is not excessive. However there are enough signs to show that a rethinking of taxing, borrowing, and spending priorities is needed. Such rethinking is required from time to time by every sensible user of credit. The Federal Government in this respect is no different from any of us. If the debt is used wisely, it will be an engine of progress for the economy and not cause for concern.

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12/5/91