

The Debt Dilemma

Today, few topics generate as much public controversy as budget deficits and the federal debt. There are deficits and debt at all levels - personal, corporate and sovereign. Although some economists argue that the controversy is unwarranted, others seem to think otherwise. Even the public has joined in protest as witnessed by the rioters in the streets of Greece and the rise of the Tea Party activists in the United States. But the real debate is around the question of what amounts are appropriate for our nation and what we need to do to get there.

The federal debt represents the cumulative effect of all prior budget deficits and surpluses. A budget surplus allows the federal government to pay bondholders and therefore reduce the federal debt. Conversely, a budget deficit increases the size of the federal debt by the amount of the deficit. Today, U.S. federal debt stands at nearly 90 percent of its gross domestic product. The Federal Reserve and foreign ownership own about 42 percent each, with the rest owned by domestic investors.

Historically, debt helped to expand businesses, improve returns and enhance lifestyles. Social attitudes continued to change as we moved from the Depression and associated savings in the 1930s, to the advent of plastics in the 60s, with a "buy now, pay later" mentality. The 1980s and 90s produced steady growth with low unemployment and inflation, which helped mask the steady rise in debt levels. By early 2000, we were paying for imports with deficits financed by the same countries selling us services, oil and other commodities.

Low interest rates in the early 2000s fueled more borrowing. Hedge funds and private equity operators used debt aggressively around the globe; homeowners consolidated debt via home equity lines of credit further mortgaging their futures; highly leveraged investment banks had record low levels of equity on their balance sheets; bankruptcy was easy and a socially accepted norm.

On the heels of this came the Lehman Brothers failure. And this set in motion the dismantling of an overheated economic engine. The spigot of credit closed; global growth

became snail paced; unemployment grew and as a result, there was more borrowing to finance basic needs. Private debt reshaped itself to public debt. The major bailouts began, and new federal spending initiatives, such as healthcare reform, continued to mushroom. The federal debt now stands over 13 trillion dollars and keeps growing every day.

Concerns have come up regarding the level and amount of debt. Most of the debts are at very low rates as compared to historical levels. Year-end net interest payment should be around 207 billion dollars. But debt service may triple in 10 years, as present bonds keep rolling over! Foreign governments are purchasing more of our debt. Most are major trading partners. They could influence what our policymakers do. If our ratings get affected, would investors stop buying our debt? The U.S. has traditionally been the haven of safety in times of uncertainty. Projected federal spending for healthcare costs and retirement costs will eat up 50 percent of total spending in a few years, saddling us with commitments for years.

And such is the quandary. We need to grow globally and grow quickly. Population demographics may help us since we have a relatively young population. Structural reforms will be necessary to increase productivity. A low tax burden is essential to be globally competitive. Larger tax hikes will sap economic growth. A global rebalancing is necessary as developing nations, which can support deficits, have large surpluses, while developed nations, who should have surpluses, have significant deficits.

Financial booms and busts have occurred throughout our history, and they have happened as a result of policy mistakes, irrational human behavior, greed, and a lack of sacrifice, to name a few. In this instance, many were aware of the unsustainability of the economic engine, but no one took preemptive action to soften the blow.

Hedge funds and private equity operators used debt aggressively around the globe.

In the new normal age of the present, unpredictability of the future overrides all assumptions of efficient markets and stabilizing markets. Most predictions of the future and probabilities of the actions of greater than six billion people are subjective at best, with hope and fear at the extremes.

The global economy needs a drastic makeover in fiscal policy. Mere tweaks will not be enough. Policy makers around the world will have to make crucial decisions quickly to restore order to public finances. Let us hope that the crater already dug by some is not too deep. ❄

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