ZAIS Insights

August 2019

Deficits Don't Matter Until They Do

Bernhard Eschweiler, PhD
Senior Economic Advisor

Bernhard advises ZAIS on macroeconomic risks and prospects related to credit markets and is a regular contributor to ZAIS Insights.

Deficits Don't Matter Until They Do

- The "budget deal" is a relief, except for the budget.
- There is a need for more public investment, but not fiscal stimulus.
- Low interest rates are no panacea for government debt sustainability.

In the last issue of ZAIS Insights (MMT is Flawed), we made the point that low inflation and interest rates, plus moderate growth, as well as frustration with income inequality and globalization, promote new and less orthodox policy prescriptions.

MMT is an extreme example and, in our view, is unlikely to get mainstream political support.

However, many politicians on both sides of the aisle in Washington D.C. seem to believe that government deficits and debt matter little, or not at all.

The fiscal debate

Last January, the fiscal doves received some intellectual support from economic heavyweights like Olivier Blanchard and Larry Summers.[1]

Both are outspoken critics of MMT and not careless deficit spenders, but both argue that fiscal policy has room to maneuver.

Specifically, they believe that the government can run a deficit, and keep rolling over the debt, as long as economic growth outpaces the interest rate on government debt.

The fiscal deficit debate raises two related questions:

1. Does the US economy need fiscal stimulus?
2. Can the US afford it?

From a cyclical perspective, we believe the economy is currently not in need of fiscal stimulus.

However, from a structural perspective, we believe that more public investment is needed to strengthen a long-term growth foundation.

Further, we believe that more deficit spending is currently unlikely to crowd out private investment or lead to an immediate debt crisis.

In our view, low interest rates do not annul basic fiscal constraints. Instead, the room created by lower interest rates is offset by larger primary deficits.

Thus, we believe it would be better to save extra spending for times when the economy needs it more.

Furthermore, linking debt sustainability with low interest rates may create dangerous temptations for politicians and put more pressure on the Federal Reserve to keep interest rates low.

Future generations may have to pay a high price if fiscal policy becomes too careless in the short term.

Against that background, the new "budget deal" is a relief as it keeps the government working and avoids a possible default, but at the price of unnecessary debt proliferation.

No need for fiscal stimulus…

The current US cycle is not strong, but it has just become the longest cycle post-World War II and is still running.

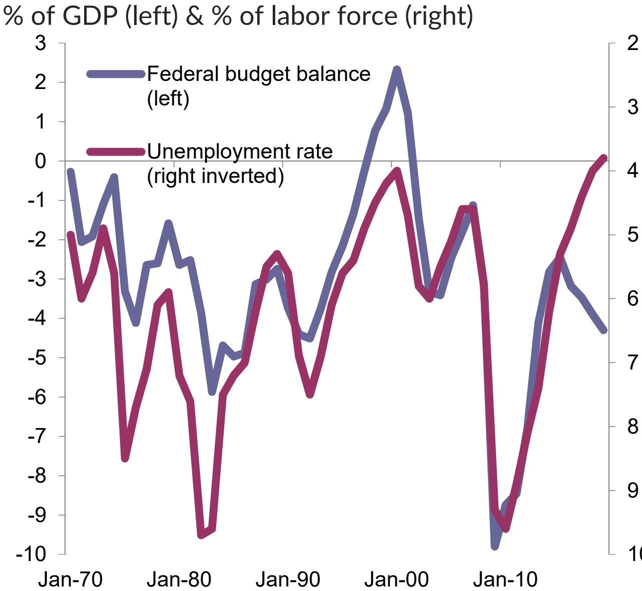
With the unemployment rate below 4%, the economy is more or less at full employment.

The trade conflict with China has reduced growth, yet recession is not imminent, in our view.

Against that background, we believe it would have been prudent to consolidate the budget deficit, as in previous cycles (see Chart 1), and not expand it.

Chart 1: US fiscal balance & unemployment

% of GDP (left) & % of labor force (right)



Source: Federal Reserve Bank of St. Louis[2]

… but more long-term investment

A key feature of the current cycle is slower investment, despite very low interest rates.

There are several reasons behind this phenomenon, including an aging population and the shift from physical to intellectual capital.

However, it has also revealed a shortfall in support for infrastructure and education standards. In our view, more public investment in these areas would have been more prudent than the recent tax cuts, which have done little to revive investment.

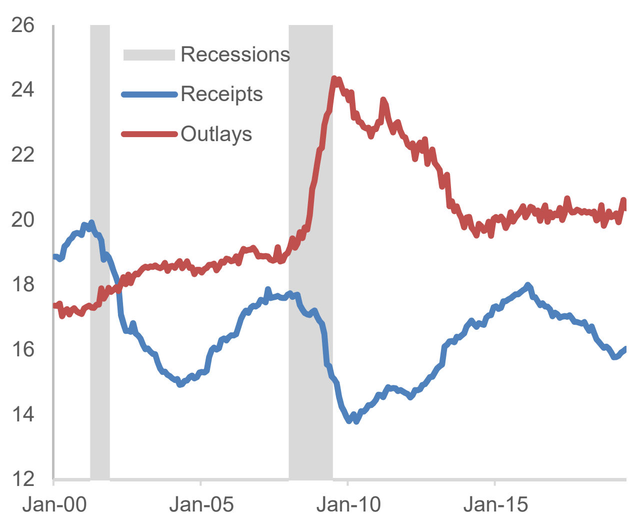
Unpleasant budget prospects

Indeed, the projected increase of the Federal deficit from 2.4% of GDP in 2015, to over 4% in the current fiscal year, is primarily due to a shortfall in revenues. It is not the result of a recession (see Chart 2).

In our judgment, the new "budget deal" raises the deficit and debt limits, but does nothing to reverse the significant divergence between receipts and outlays. Furthermore, it does not prioritize infrastructure and education spending.

Chart 2: Federal receipts and outlays

% of GDP



Source: Federal Reserve Bank of St. Louis[3]

Debt Arithmetic

The change of government debt (ΔD) equals interest payments (I) minus the primary budget balance (P).

(1) $\Delta D = I - P$

Dividing both sides by the level of debt (D) and subtracting from both sides nominal GDP growth (y) results in the % change of the debt/GDP ratio where $d=\Delta D/D$ is the % change of the debt and $i=I/D$ is the effective interest rate paid on the debt.

(2) $d - y = (i - y) - P/D$

Equation (2) can be rewritten by expanding P/D with nominal GDP (Y) where $x=P/Y$ is the primary budget balance in % of GDP and $z=D/Y$ is the debt/GDP ratio.

(3) $d - y = (i - y) - p/z$

The more nominal GDP growth exceeds the effective interest rate on government debt the more the government can run a primary deficit without raising the debt/GDP ratio.

(4) $p = (i - y)*z$

Fiscal tailwinds are nothing new

Fiscal doves think the divergence does not matter, since interest rates are low. Yet, low interest rates, per se, are not enough to create fiscal wiggle room.

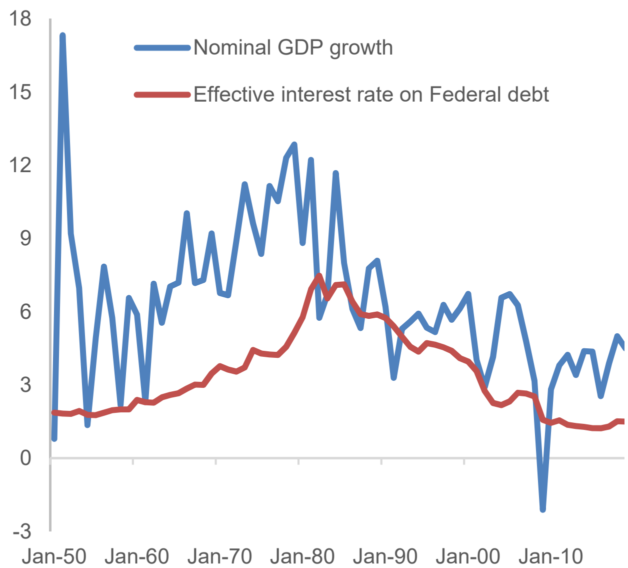
It is critical that nominal GDP growth is higher than the interest rate paid on government debt (see box on Debt Arithmetic above).

The persistence of low interest rates in the US since the financial crisis is something new. However, interest rates being lower than nominal GDP growth is not new.

With the exception of recessions, the effective interest rate paid on Federal debt has been lower than nominal GDP growth since the 1950s (see Chart 3 below). On average, the difference was a good three percentage points.

Chart 3: Interest rate and nominal growth

% p.a.

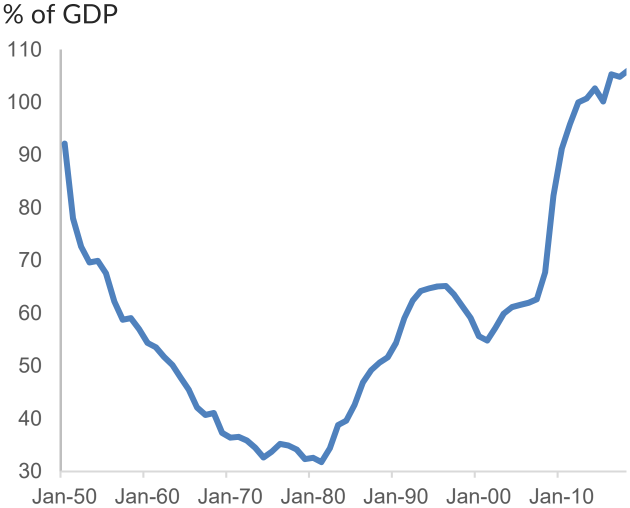


Source: Federal Reserve Bank of St. Louis[4]

However, the difference was much larger between the 1950s and 70s. This, plus a disciplined fiscal policy helped reduce the debt/GDP ratio by roughly 60 percentage points until the 1970s (see Chart 4).

Chart 4: Total federal debt

% of GDP



Source: Federal Reserve Bank of St. Louis[5]

The gap narrowed significantly in the 1980s and 90s, mainly as nominal GDP growth declined faster than interest rates, which combined with tax cuts and more military spending during the Reagan years, caused the debt/GDP ratio to rise.

Since 2000, the gap has widened as interest rates fell more than nominal GDP growth. The gap now stands roughly at the long-term average of approximately three percentage points.

The fiscal wiggle room is exhausted

The financial crisis caused an inevitable blow to the budget, when it boosted the debt/GDP ratio to nearly 100% (see Chart 4).

Since then, however, the debt/GDP ratio has continued to creep higher, despite the favorable gap between interest rates and nominal GDP growth.

In other words, we believe the fiscal wiggle room already has been fully exhausted by larger primary deficits.

This is of concern to us, because the economy was doing well in recent years and a fiscal boost was not necessary.

Japan is not a desirable blueprint

The rising debt/GDP ratio has, so far, not pushed up interest rates and crowded out private investment.

For fiscal doves, this means it is acceptable to run higher deficits and pile up more debt.

Some point to Japan, where government debt is approaching 240% of GDP and yet interest rates remain low.

However, the situation in Japan depends critically on the involvement of the Bank of Japan, which has purchased about half of the outstanding government bonds.

It is not clear how the situation in Japan will ultimately play out but, we believe, it is not a script the US should try to follow.

Tailwinds can become headwinds

Indeed, there is political pressure on the Fed to keep interest rates low.

This pressure will increase as the sustainability of government debt depends on low interest rates, and will tempt politicians to ignore traditional fiscal restraints further.

Moreover, there is no guarantee that interest rate and growth conditions will continue to be so favorable.

A recession would, at least, cause a temporary disruption. For instance, Italy, which is different from the US in many ways, illustrates how favorable growth and interest rate conditions before the financial crisis have turned into powerful fiscal headwinds.

Keep your powder dry

If the US government would like to improve its fiscal position, while the economy is doing well, we would prefer it to shift its priorities to infrastructure and education, in the near term, and keep its powder dry for the next recession.

Unfortunately, we believe the "budget deal" does little for the economy where it most needs it, and makes it vulnerable when the next recession strikes.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com.

---

[1] Olivier Blanchard; Public Debt and Low Interest Rates; January 2019 https://www.aeaweb.org/aea/2019conference/program/pdf/14020_paper_etZgfbDr.pdf

Laurence Summers; Who's Afraid of Budget Deficits? January 2019 http://larrysummers.com/2019/01/28/whos-afraid-of-budget-deficits/

[2] Federal Reserve Bank of St. Louis Categories below:

Federal Surplus or Deficit [-] as Percent of Gross Domestic Product (FYFSDFYGDP):

Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget, Federal Surplus or Deficit [-] as Percent of Gross Domestic Product [FYFSDFYGDP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FYFSDFYGDP, July 16, 2019.

Civilian Unemployment Rate (UNRATE): U.S. Bureau of Labor Statistics, Civilian Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE, July 16, 2019.

[3] Federal Reserve Bank of St. Louis Categories below:

U.S. Department of the Treasury. Fiscal Service, Total Federal Receipts [MTSR133FMS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MTSR133FMS, July 16, 2019

U.S. Department of the Treasury. Fiscal Service, Total Federal Outlays [MTSO133FMS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MTSO133FMS, July 16, 2019.

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDP, July 16, 2019. Converted to monthly data by ZAIS.

[4] Federal Reserve Bank of St. Louis Categories below:

U.S. Office of Management and Budget, Gross Domestic Product [FYGDP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FYGDP, July 16, 2019.

Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget, Federal Outlays: Interest as Percent of Gross Domestic Product [FYOIGDA188S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FYOIGDA188S, July 16, 2019.

Council of Economic Advisers (US), Gross Federal Debt [FYGFD], retrieved from FRED, Federal Reserve Bank of St. Louis;

https://fred.stlouisfed.org/series/FYGFD, July 16, 2019.

[5] Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget, Gross Federal Debt as Percent of Gross Domestic Product [GFDGDPA188S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDGDPA188S, July 16, 2019.

Important Information

Confidentiality

The information presented herein has been prepared and provided by and is confidential and proprietary to ZAIS Group, LLC, ZAIS Group (UK) Limited and their affiliates and subsidiaries (collectively, "ZAIS"). Accordingly, this material is not to be reproduced in whole or in part or used for any purpose except as authorized by ZAIS, is to be treated as strictly confidential and is not to be disclosed directly or indirectly to any party other than the recipient. By accepting receipt of this document, the recipient agrees to comply with this restriction and confirms its understanding of the limitations set forth in these disclaimers.

Source of Information

Unless otherwise noted, the source of information for the charts, graphs, and other materials contained herein is ZAIS. The charts, tables, and graphs contained in this document are not intended to be used to assist the reader in determining which securities to buy or sell or when to buy or sell securities. Additional information is available upon request.

Nature of Information Provided

This information has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or instrument or to participate in any trading strategy which may or may not be made available. Any such offer of securities would, if made, be made pursuant to definitive final private offering documents, which would contain material information not contained herein (including certain risks) or material that differs from the information contained herein and to which current and prospective investors are referred. Any decision to invest should be made solely in reliance upon such private offering documents. In the event of any such offering, this information shall be deemed superseded, amended and supplemented in its entirety by such private offering documents. Information contained herein does not purport to be complete and is subject to the same qualifications and assumptions, and should be considered by investors only in the light of the same warnings, lack of assurances and representations and other precautionary matters, as disclosed in an applicable private offering memorandum and subscription agreement. No representation or warranty can be given with respect to the terms of any offer of securities conforming to the terms hereof. There is no guarantee that the strategies set forth herein will be successful. The information should only be considered current as at the date specified herein and is subject to change at any time and without notice. Statements made herein that are not attributed to a third party source reflect the views and opinions of ZAIS.

Opinions

Certain information contained herein represents ZAIS's current reasonable opinion and is based on unaudited and forecast figures which have been derived from multiple sources and have not been subject to specific due diligence. The information has been provided in good faith but is not guaranteed and is subject to uncertainties beyond ZAIS's control and should not be relied upon for the purposes of any investment decision. ZAIS makes no representations or warranties and accepts no liability whether in contract, tort or otherwise for (1) the information not being full and complete, (2) the accuracy of any opinion, (3) the basis on which any comparison has been drawn or the facts selected to make such comparison and (4) the assumptions underlying any opinions. ZAIS does not undertake to update its opinions. No opinion of this nature can be, and this information does not purport to be, full, complete, comprehensive or to contain all relevant information. Statements made herein that are not attributed to a third party source reflect the views and opinions of ZAIS.

Forward-Looking Statements

These materials may contain statements that are not purely historical in nature but are "forward-looking statements". In some cases, you can identify forward-looking statements by terms such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "plan," "potential," "should" and "would" or the negative of these terms or other comparable terminology. These forward-looking statements include, among other things, projections, forecasts, estimates or hypothetical calculations with respect to income, yield or return, future performance targets, sample or pro forma portfolio structures or portfolio composition, scenario analysis, specific investment strategies or proposed or pro forma levels of diversification or sector investment. These forward-looking statements are based upon certain assumptions, some of which are described herein. Prospective investors are cautioned not to place undue reliance on such statements. No representation is made by ZAIS as to the accuracy, validity or relevance of any such forward-looking statement and the recipient agrees it is solely responsible for gathering its own information and undertaking its own projections, forecasts, estimates and hypothetical calculations. Actual events are difficult to predict, are beyond ZAIS's control, and may substantially differ from those assumed. All forward-looking statements included herein are based on information available on the date hereof or such date specified and ZAIS does not assume any duty to update any forward-looking statement contained herein. Some important factors which could cause actual results to differ materially from those in any forward-looking statements include, among others, the actual composition of the investment portfolio, any defaults to the investments, the timing of any defaults and subsequent recoveries, changes in interest rates, changes in currency rates and any weakening of the specific obligations included in the portfolio. Accordingly, there can be no assurance that estimated returns or projections can be realized, that forward-looking statements will materialize or that actual returns or results will not be materially lower or higher than those presented. The value of any investment, and the income from it, may fall as well as rise. Accordingly, there can be no assurances that an investor will receive back all or any of the original capital invested. Further, the eligible investments may be leveraged and the portfolio of eligible investments may lack diversification thereby increasing the risk of loss.

ZAIS Group (UK) Limited. ZAIS Group (UK) Limited is a company registered in England with number 08908933 and whose registered office is c/o Dixon Wilson, 22 Chancery Lane, London WC2A 1LS, United Kingdom. ZAIS Group (UK) Limited is authorized and regulated by the Financial Conduct Authority in the United Kingdom. ZAIS Group (UK) Limited's authorization by the FCA does not imply a certain level of skill or training. Investors will not benefit from the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors, nor from the Financial Services Compensation Scheme in the United Kingdom. Nothing herein excludes any liability which ZAIS is not permitted to exclude by applicable law.

ZAIS Group (UK) Limited. ZAIS Group (UK) Limited is a company registered in England with number 08908933 and whose registered office is c/o Dixon Wilson, 22 Chancery Lane, London WC2A 1LS, United Kingdom. ZAIS Group (UK) Limited is authorized and regulated by the Financial Conduct Authority in the United Kingdom. ZAIS Group (UK) Limited's authorization by the FCA does not imply a certain level of skill or training. Investors will not benefit from the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors, nor from the Financial Services Compensation Scheme in the United Kingdom. Nothing herein excludes any liability which ZAIS is not permitted to exclude by applicable law.

Regulatory Registrations and Authorizations. ZAIS Group, LLC's registrations with the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”), and ZAIS Group (UK) Limited's authorization by the United Kingdom's Financial Conduct Authority (“FCA”), does not imply a certain level of skill or training.