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Possible Economic Headwind?

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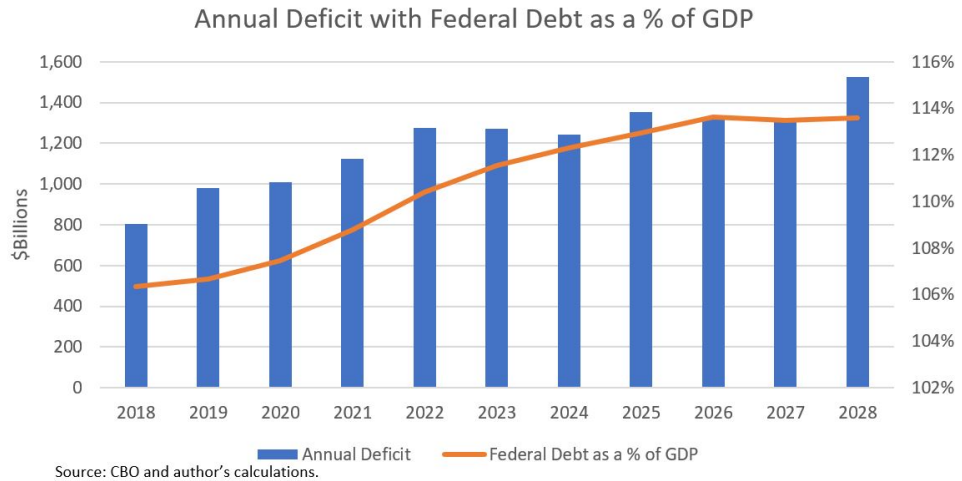
There are many reasons to be optimistic about the economy.

In September, consumer confidence hit an 18-year high.[1] As of October 10, 2018, the Atlanta Fed's GDPNow indicator forecasts 4.2% growth for 2018 Q3.[2] Even my last article, "Is a Recession Probable? 2 Models to Consider," concluded that the likelihood of a recession in the next two years based on yield curve flattening was still relatively low.

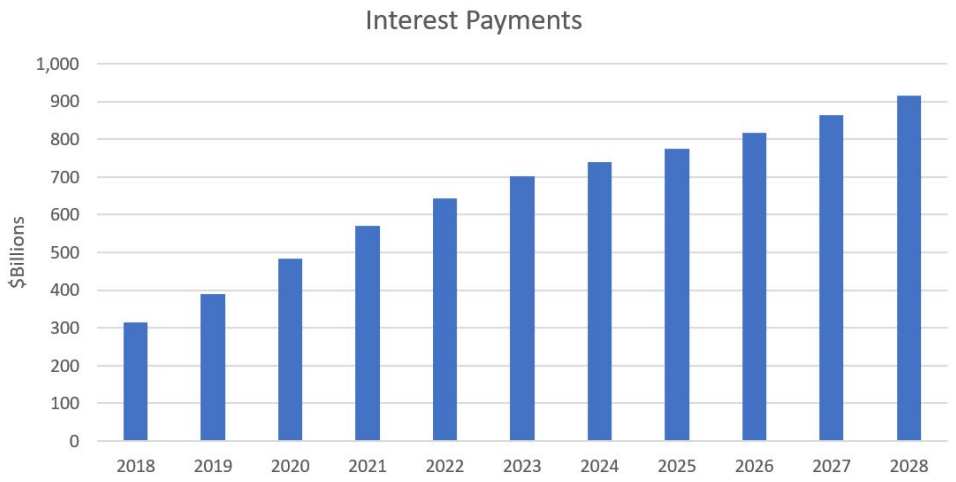
However, as the news cycle is filled with positive economic results, it can be helpful to reflect on some of the economic headwinds that our country faces. To do this, let's look at the most recent ten-year budget projections released by the Congressional Budget Office, a non-partisan federal agency that produces independent analysis concerning government expenditures.[3] The CBO projections that I use to produce the following charts reflect changes due to the passage of the Tax Cuts and Jobs Act of 2017. I have created three charts to put our current budget situation into perspective.

The first chart below characterizes a familiar issue: the budget deficit. The bars on the chart represent the annual deficit that the federal government is projected to run, while the line represents total federal debt as a percentage of GDP. We are projected to run a $1 trillion deficit by 2020 and a $1.5 trillion deficit by 2028. Under current policies, federal debt will reach over 113% of GDP by 2028, up from about 106% today. Studies have shown that high debt levels relative to GDP can be a drag on economic growth.[4]



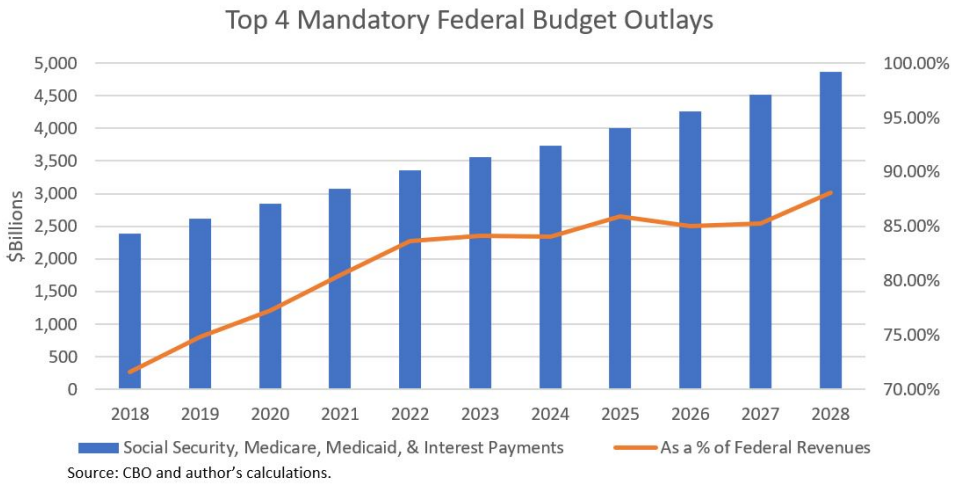
Source: CBO and author's calculations.

With these sizeable debts and deficits come increasingly expensive debt service payments that the government owes. The below chart shows how interest payments on outstanding government debt will balloon from about $315 billion to about $914 billion in the next decade, an increase of over 190%.



Source: CBO.

One issue with having such large interest payments is that it locks up portions of the government's revenue with mandatory payments, taking away discretionary funds. In fact, mandatory payments already use up a significant portion of the government's annual revenue. The below chart takes the sum of the largest mandatory payments that the government makes (Social Security, Medicare, Medicaid, and Interest Payments on Debt) to display both their total dollar value as well as representing the sum as a percentage of total federal revenue. Not only are these four items projected to cost over $4.8 trillion annually by 2028, they will consume over 85% of federal revenues.



Source: CBO and author's calculations.

While the economy may be expanding at a pace not seen since the Global Financial Crisis, it is interesting to note that the expansion has not alleviated the reality of long-term economic headwinds associated with high debt levels. Rather than taking advantage of a strong economy to reduce debt levels, if the CBO projections hold true, the problem is only going to worsen. Having the vast majority of revenues taken up by mandatory payments all but ensures continued budget deficits into the future, leading to an increasingly high debt to GDP ratio, higher interest payments, more of the federal budget being tied up by non-discretionary spending, and the cycle repeating itself.

Nobody can predict exactly how our nation's budgetary constraints will play out, but it is important not to lose sight of them, especially when the economy is strong.

Sources

1. Torry, Harriet. "U.S. Consumer Confidence Hits 18-Year High." The Wall Street Journal. https://www.wsj.com/articles/u-s-consumer-confidence-rose-in-september-1537885594 (accessed 3 October 2018).
2. "GDPNow." Federal Reserve Bank of Atlanta. https://www.frbatlanta.org/cqer/research/gdpnow.aspx (accessed 10 October 2018).
3. "Budget and Economic Data." Congressional Budget Office. https://www.cbo.gov/about/products/budget-economic-data#3 (accessed 3 October 2018).
4. For a study on how debt levels can be a drag on economic growth, see: Reinhart, Carmen M. and Rogoff, Kenneth S. "Growth in a Time of Debt." NBER Working Paper Series. (2010). http://www.nber.org/papers/w15639.pdf

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