

# Macro Comment

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## Can we turn the debt trajectory?

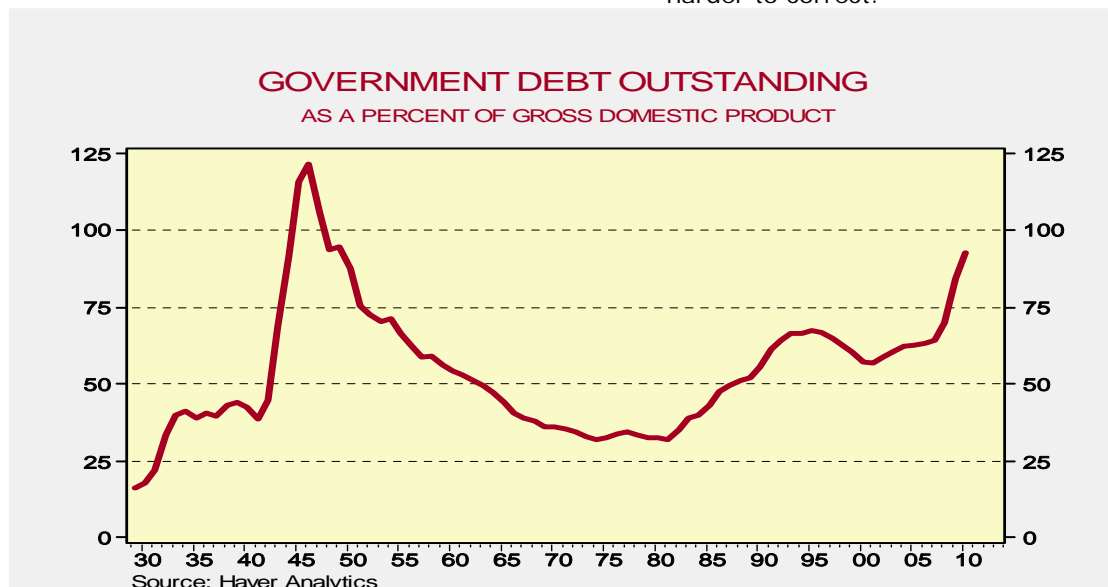
The debt ceiling standoff is not just about this year's budget. It's a debate about the size of the government and the long-term trend in government finances. During the past decade, the United States has spent more than it has received in revenue, running yearly deficits which must be financed by issuing more debt. As a result, the amount of debt outstanding has grown substantially. Credit rating agencies are threatening to downgrade the credit rating of the U.S. government if this problem is not corrected. The big question is what would it take to change the debt trajectory?

Most Americans do not usually pay a lot of attention to deficit debates in Washington. However, this summer, the fight over raising the debt ceiling seems to be attracting as much attention as the debates over going to war. Similarly, concerns about the outcome of the debt ceiling negotiations have increased significantly as the August 2 deadline approaches.

If you listen to lawmakers you will probably hear them say that they would like to reduce the debt but they still need to raise the debt ceiling. That's because they are not saying that they are going to reduce the debt by paying it off. They are talking about reducing the rate at which the debt increases. U.S. government debt will go up under all of the plans being proposed. The difference is whether the debt goes up slow or fast.

The U.S. economy can afford more government debt as long as the economy is expanding at a healthy pace. It is not the absolute amount of debt that the government owes that is important. What matters is the amount of debt that the government owes in relation to the size of the economy. A large country producing a lot of goods and services can afford more government debt than a small country much like high-income individuals can afford more debt than low-income individuals.

The problem that we have gotten into during the past ten years is the government has increased its borrowing faster than the economy has expanded. Consequently, the debt-to-GDP ratio has increased to the highest level since 1949. Rating agencies are worried that without significant changes in government finances, this rising trajectory could overburden the U.S. economy, making it even harder to correct.



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This week's chart looks at a history of U.S. Treasury debt as a percent of gross domestic product (GDP). It shows that during World War II, this ratio of debt to GDP increased sharply as the government issued war bonds to finance the deficit. However, the ratio of debt to GDP turned down after the war and continued to decline until hitting a low in 1981.

Looking back, the amount of government debt outstanding did not drop much during the post-war period. Instead, the trajectory of the debt-to-GDP ratio turned down because the government limited its borrowing at the same time that the economy grew larger and stronger. As a result, the debt burden as measured by the government's debt as a percent of GDP declined and America prospered.

Looking ahead, Congress and the Administration will need to reduce the yearly government deficits substantially in order to turn the debt-to-GDP ratio trajectory down again. If our \$15 trillion GDP grows by 5% a year, including real growth and inflation, the government could only afford to add about \$750 billion in debt each year in order to keep the debt-to-GDP ratio from increasing. This year, the government is adding almost twice that amount of debt. If the government continues to run \$1.5 trillion deficits each year and the economy grows by 5%, the debt as a percent of GDP ratio would increase to about 120% in ten years from approximately 95% this year. This is why the credit rating agencies are threatening to downgrade U.S. government debt.

The government could still afford to borrow some money in future years, just not a lot of money. In order to reduce the debt trajectory, the government would need to reduce the yearly deficits substantially. Fortunately, that can happen as the economy expands and deficits decline.

The current Congressional Budget Office (CBO) projections for debt and GDP growth during the next 10 years have the debt-to-GDP ratio peaking slightly above the current level in the next year or two. Then the trajectory declines to about 88% of GDP ten years from now. These are based on the current CBO baseline projections for the deficit and GDP growth. The CBO projections show government debt increasing by more than \$6 trillion over the next ten years while GDP increases by almost \$9 trillion. If Congress and the Administration can reduce the growth in debt by cutting deficits even more than currently projected, the debt trajectory could decline even faster.

This analysis shows that the government has a real opportunity to make a fundamental difference in the trajectory of debt relative to GDP during the next decade, if lawmakers are willing to reduce budget deficits.

During the next week, Congress and the President are likely to push the debt ceiling debate down to the last minute. Nevertheless, we continue to believe that the most likely scenario is for a last-minute deal that avoids a default on government debt. If the government cannot reach an agreement by the August 2 deadline, we would expect the government to cut services and delay some payments in order to conserve cash necessary to make upcoming debt payments. The longer Congress and the Administration fight over this issue, the greater the risk of stock market weakness.

If no agreement is reached by August 2, we believe the stock market could decline 10% or more until lawmakers finally reach an agreement. Moreover, we continue to believe that a bearish scenario, like the failed 2008 vote to provide funds during the financial crisis, is very unlikely because the economy is expanding today whereas it was in recession in 2008.

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