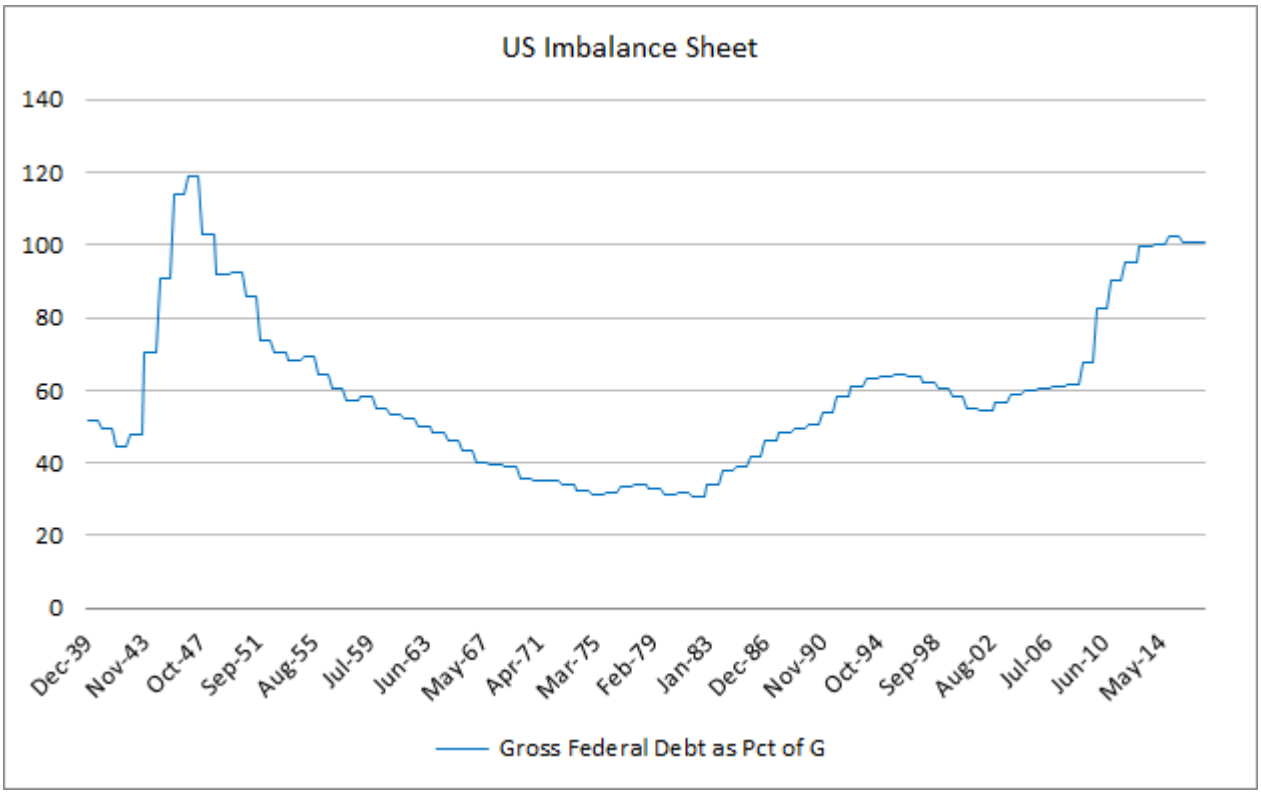
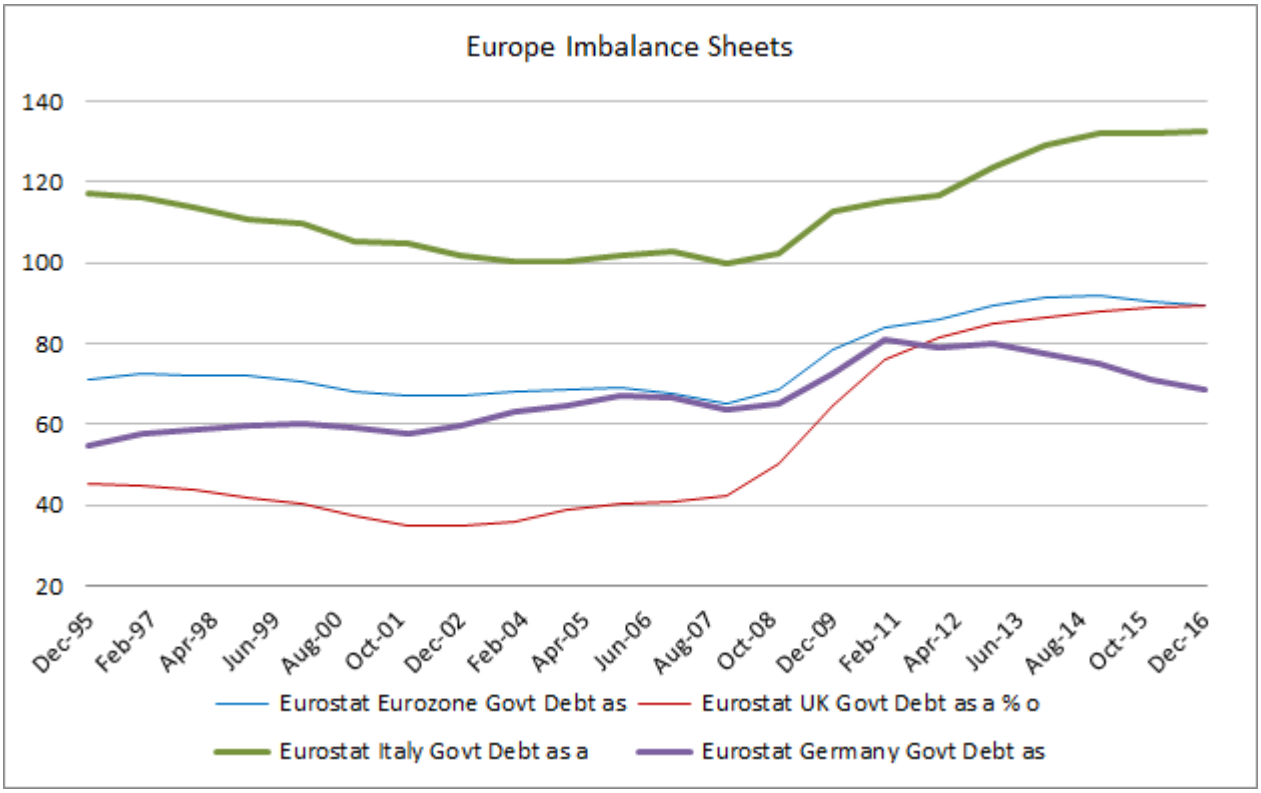
# Imbalance Sheets: US Debt and Fed Policy

The current public debt levels in the US have risen from 60% of GDP to over 100% since 2008. World War II saw public debt levels rise from 45% to 120%. The latest crisis control has cost the US government half of the cost of WWII.

US Federal Debt as % of GDP:



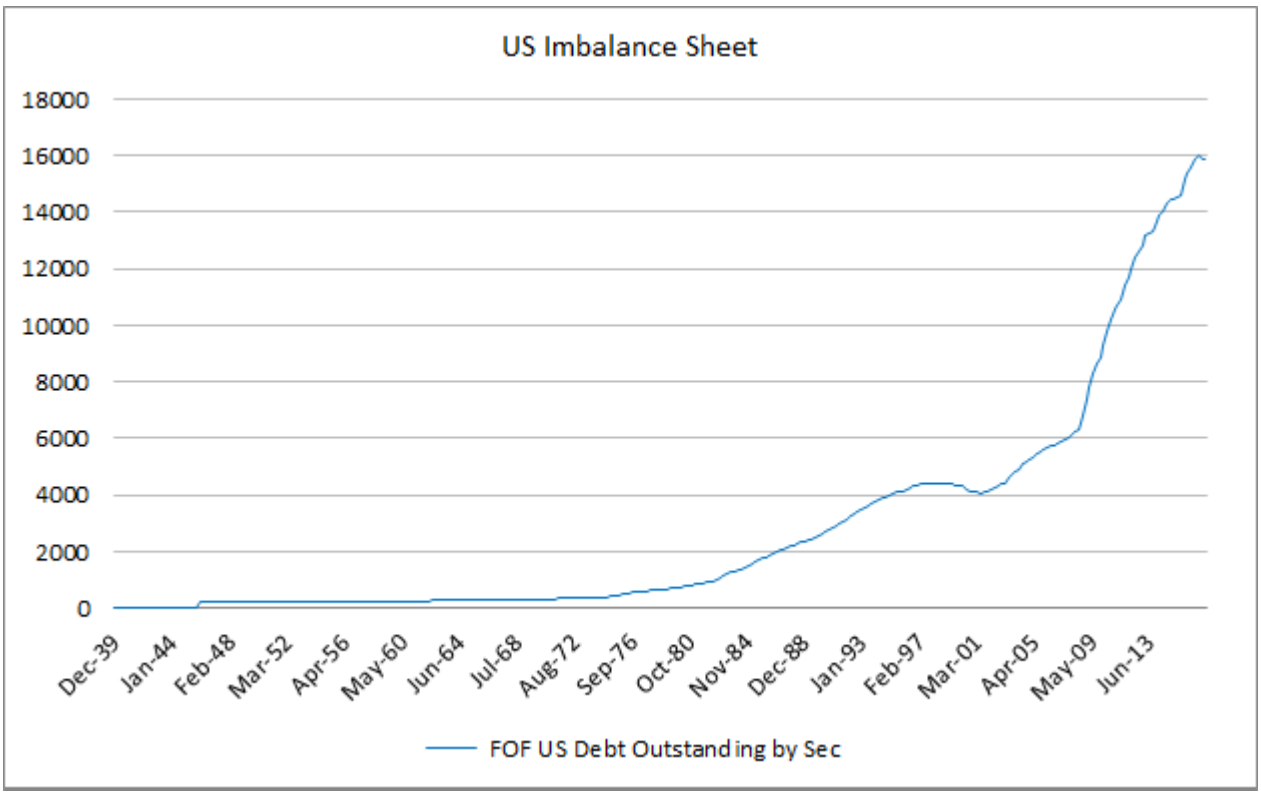

2008 bailouts cost European governments as well. Some countries managed to rein in their balance sheets but others have just kept going (Italy and the UK). Don’t bring up Japan. They are leading by miles with national debt at 2.5X GDP.




What does a government do in a financial crisis? Bail out the financial system, which includes the banks and their expensive managers and executives, since a failure of the financial system would inflict serious damage on the real economy, on output, employment and wages. Some compare this to Wall Street using Main Street as a human shield. And how does a government fund it?

Like this:

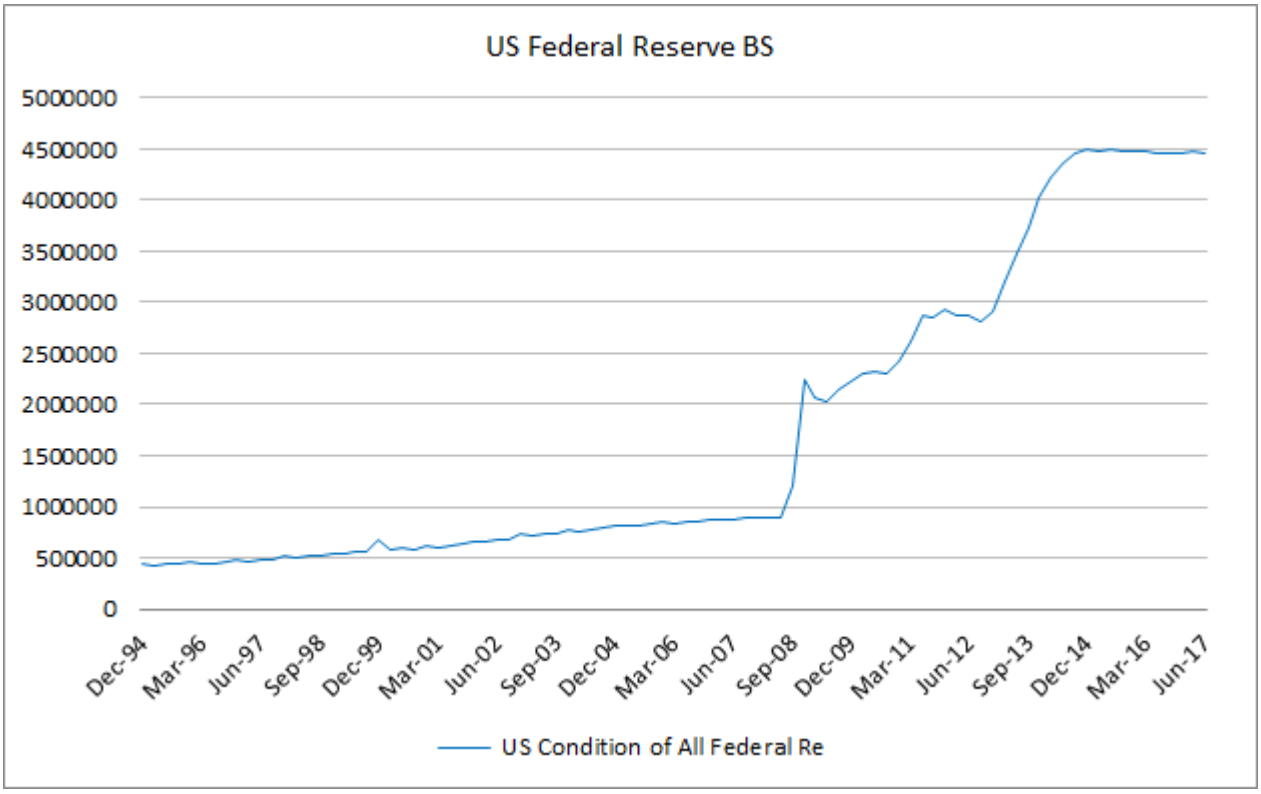
US Federal Debt Outstanding:




Thank goodness cost of debt was manageable. Imagine if the bond vigilantes had sold off US treasuries. But how does a government hold down the cost of borrowing?

Like this:

US Fed Balance Sheet:

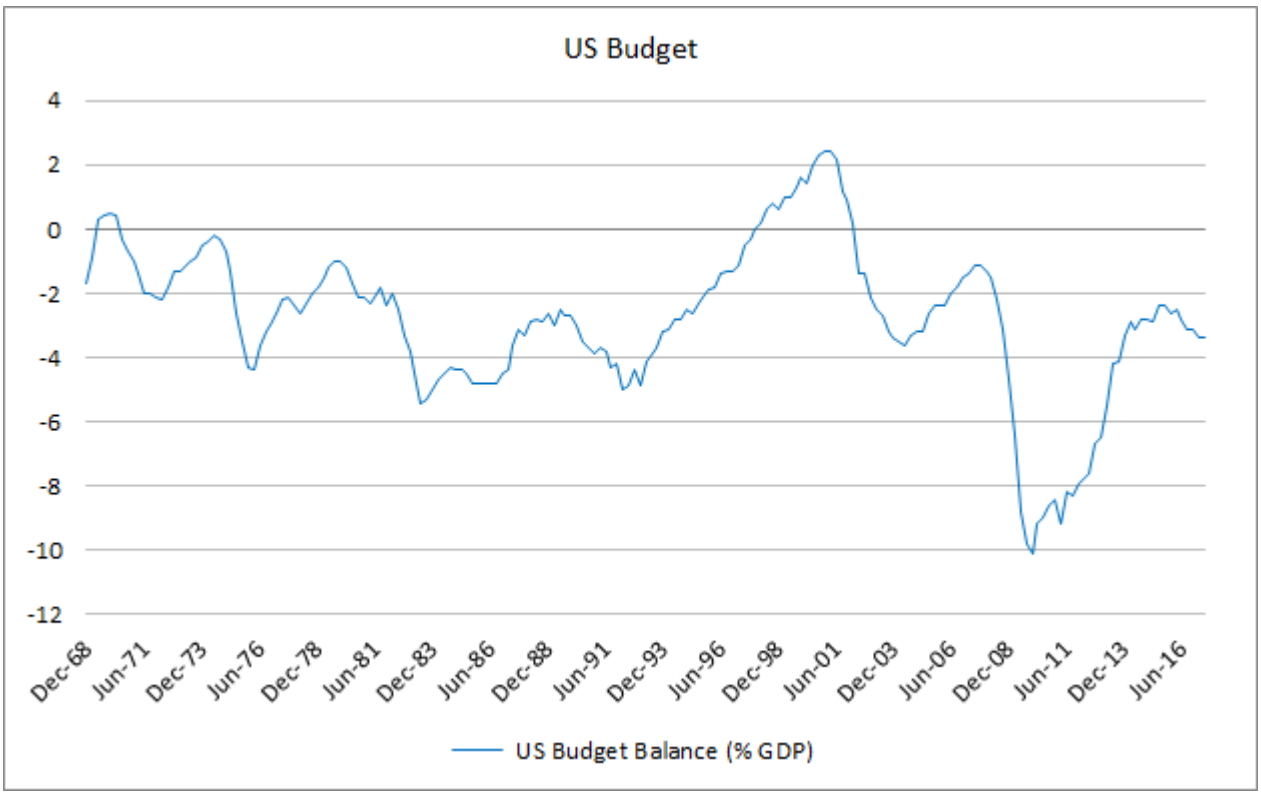



If you face a buyers' strike, there is nothing like buying your own bonds yourself. If you give it a scientific sounding name like quantitative easing (QE) and support it with academic research and the endorsement of renowned academics, it likely to appear less fraudulent.

9 years after the crisis and the economy has picked up and the justification for accommodative policy is receding. The Fed has begun (in 2015) to raise rates gradually and is considering normalizing its balance sheet. To what extent and how quickly can it normalize its balance sheet? It increased its balance sheet from just under a trillion USD to 4.4 trillion USD in the last 9 years. There will be limits to how much and how quickly it can reduce its balance sheet.

Here is one reason:

US Budget Balance as % of GDP:




If the current President's plans to cut taxes and spend on infrastructure and defence are successful, the deficit will deepen, and it will need to be financed with more debt issuance.

The US needs to inflate away its national debt. However, rising inflation could threaten its long term funding costs which would force the Fed to remain underwriter for US treasuries. Ideally, the US would like to see asset inflation so that its asset to liability ratio improves in real terms, but low CPI inflation so that funding costs don't rise excessively. This has been precisely what the economy has experienced these past 9 years. It is either a fortuitous coincidence or exceptional management by the Fed and Treasury.

Best guess predictions:

The Fed will raise rates gradually. They will also pay attention to market credit spreads which determine the actual cost of funding for the real economy.

The Fed will want buoyant asset markets as this debases the

national debt. The Fed will therefore be sensitive to equity market and credit market stability, not just real economy data.

The Fed will go quite slowly in reducing its balance sheet. It cannot afford for interest rates to rise too far as it will impact the debt service costs of the government. Bond yields are likely to be range bound. The trading range and cycle will be influenced by central bank guidance and high frequency data.

There is significant risk from inflation. If inflation picks up it could impact the ability of the government to refinance itself.

Long term fundamental problems which will have to wait:

There does not appear to be any intention to decrease the national debt. This places the government under constant financial pressure which means it cannot invest in infrastructure or undertake reform which may have short term costs.

The size of the national debt puts pressure on the Fed and Treasury to keep rates low which in turn encourages the private sector to borrow and increases the level of leverage in the economy. If rates are artificially suppressed both government and private debt levels will not have a reason to recede.

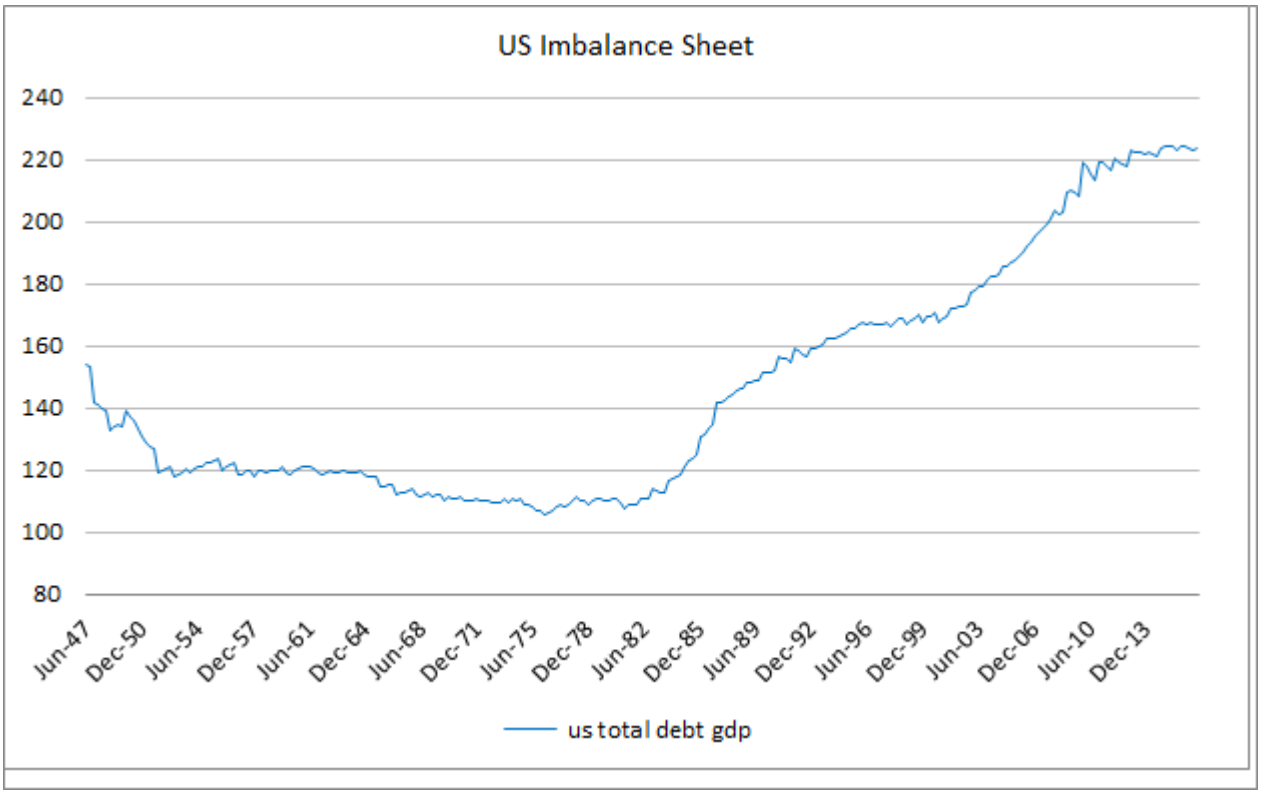
With a persistently high and increasing or non-receding level of debt, both the private sector and the government has every motivation to keep rates contained or low. Low rates provide the government and the private sector every motivation to borrow more.

The above feedback loop implies that interest rates will be kept low until such time it is impossible to keep them low. But what could precipitate such an eventuality?

Possibly, inflation accelerates, in which case the Fed will have to be extra vigilant, a stance which could invert the yield curve, a position associated with recessions. A recession could throw asset inflation in reverse thus increasing the relative size of the total debt. Any loss of confidence could also throw asset markets in reverse with similar effect.

A loss of confidence could introduce a risk premium into US treasuries, currently a remote concept, but such is the modern economy that most assets and markets derive a significant portion of their value from confidence.

Not about to be paid down soon:




- all chart data sourced from Bloomberg