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The Impact of Debt on Growth in the Economy

By David L. Bahnsen

A tale of two nations:

Debt
Demography
Results
Remedies

Conclusion before the case – how we got here:

- An asset bubble forms for whatever reason – policy errors, a prolonged period of easy money, investor euphoria, human nature, business cycle, etc.

- The bubble bursts and great economic damage is done – profits collapse, wages collapse, jobs collapse – and in really serious situations, a debt-deflation spiral forms

- Governments use Keynesian tool of fiscal spending to offset damage (a “counter-cyclical fiscal punch”), and central banks use monetary policy to soften the pain

Conclusion before the case – how we got here:

- The lower cost of capital incentivizes more borrowing

- The additional borrowing puts more of a drag on growth

- More borrowing and spending means less savings and investment

- All of these things facilitate downward pressure on growth, and all of them have their roots in excessive debt and leverage

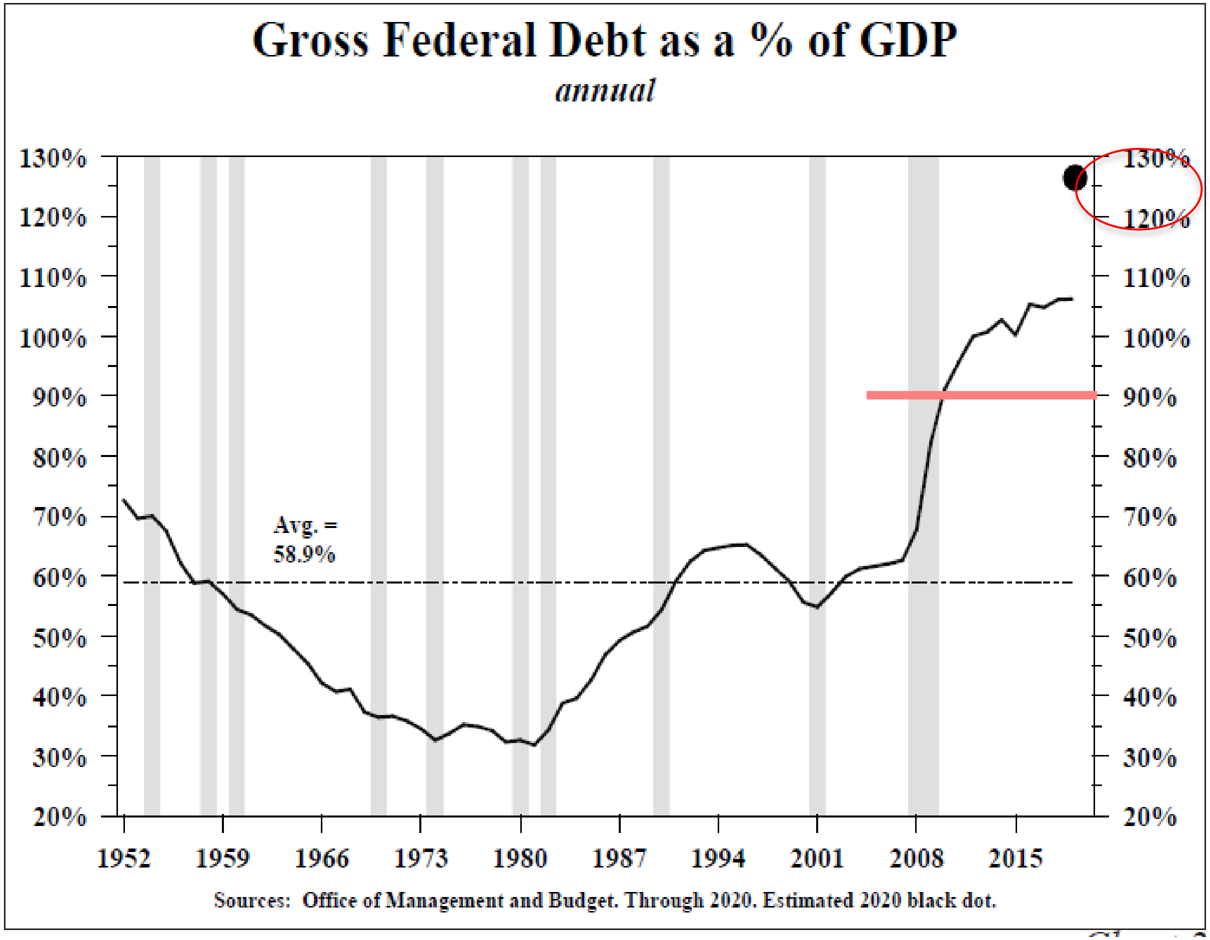
U.S. Debt:

Year	Federal Debt Held By Public as % of GDP
2006	36%
2011	66%
2019	79%
2021	108%+

97% at end of 2023

CBO Projection: 116% by 2034

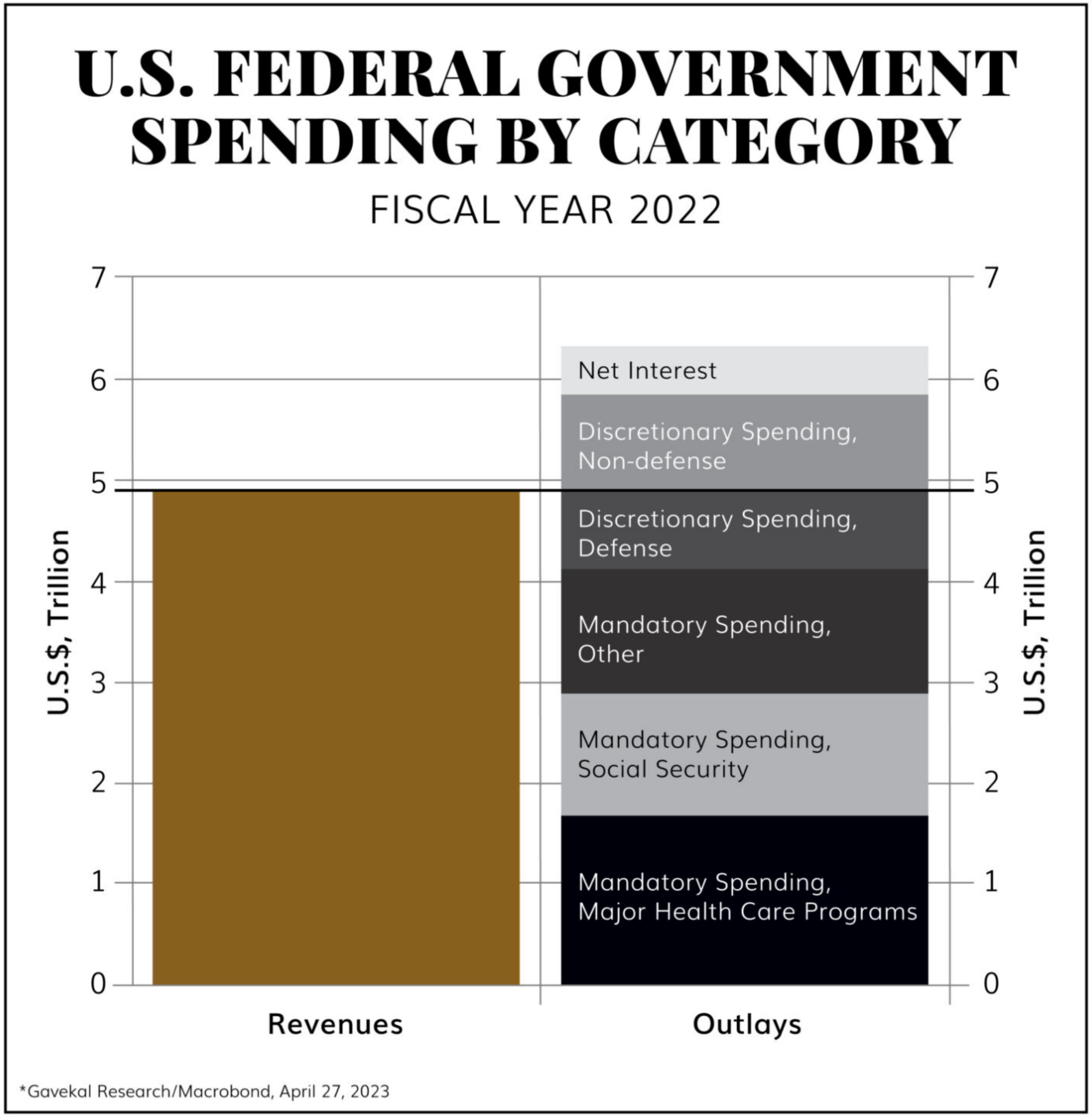
Where are we now?



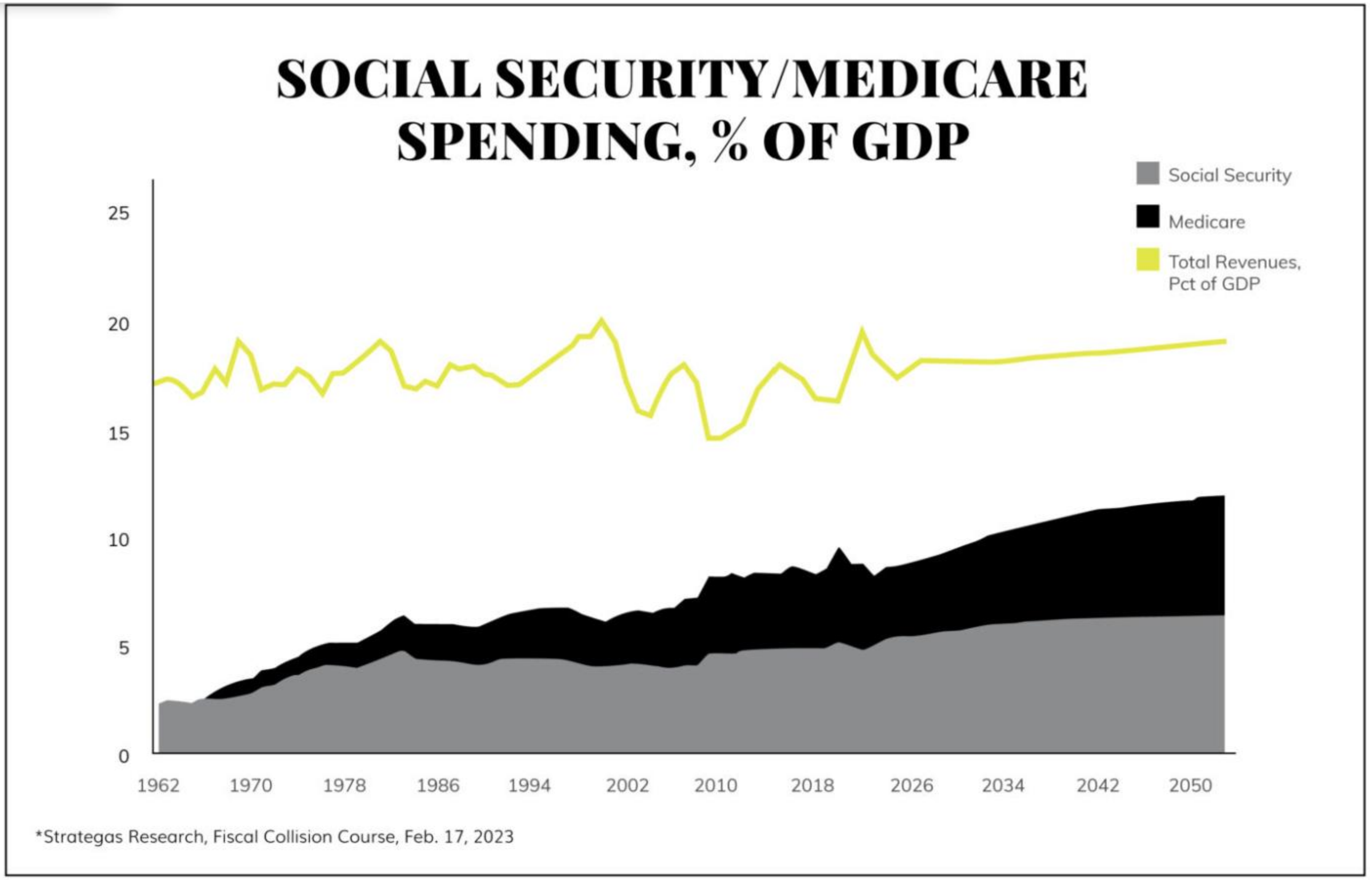
As of May 6, 2024, it is 123%

$33.2 trillion vs. $26.97t GDP

What to cut?

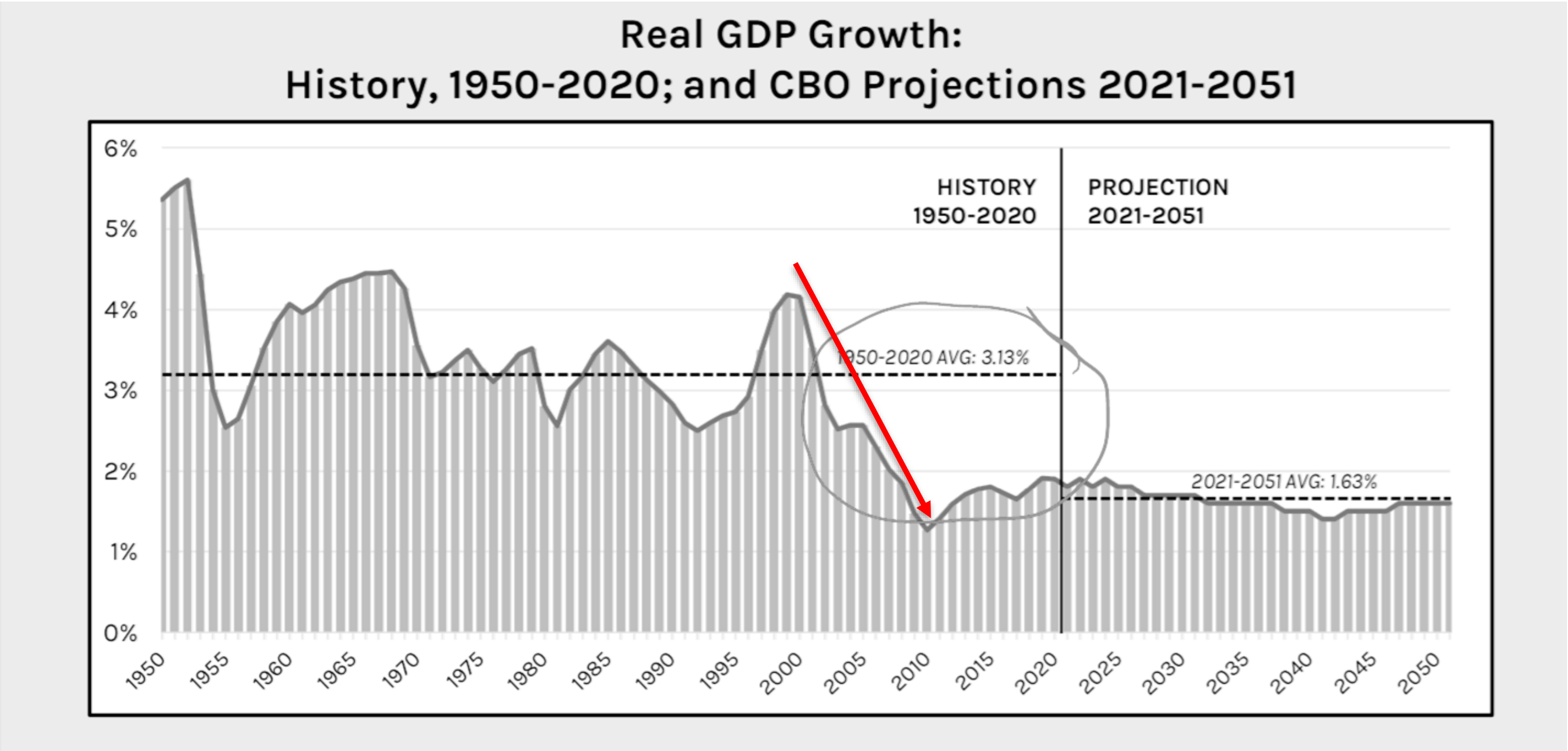

U.S. FEDERAL GOVERNMENT SPENDING BY CATEGORY
FISCAL YEAR 2022
Net Interest
Discretionary Spending, Non-defense
Discretionary Spending, Defense
Mandatory Spending, Other
Mandatory Spending, Social Security
Mandatory Spending, Major Health Care Programs
U.S.$, Trillion
7
6
5
4
3
2
1
0
Revenues
Outlays
*Gavekal Research/Macrobond, April 27, 2023

Elephant in the room

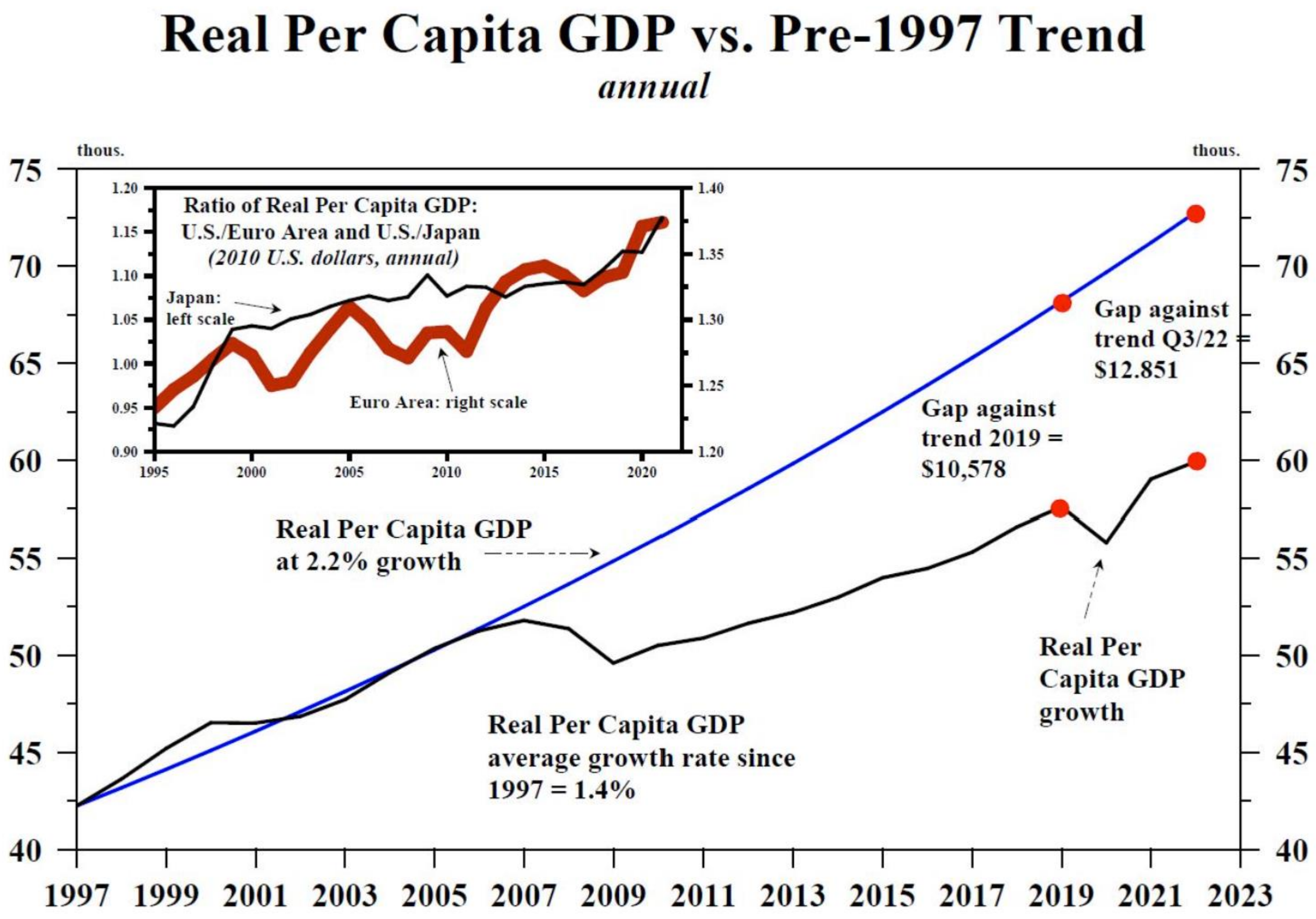


Making Growth the Sacrificial Lamb

Cause & Effect



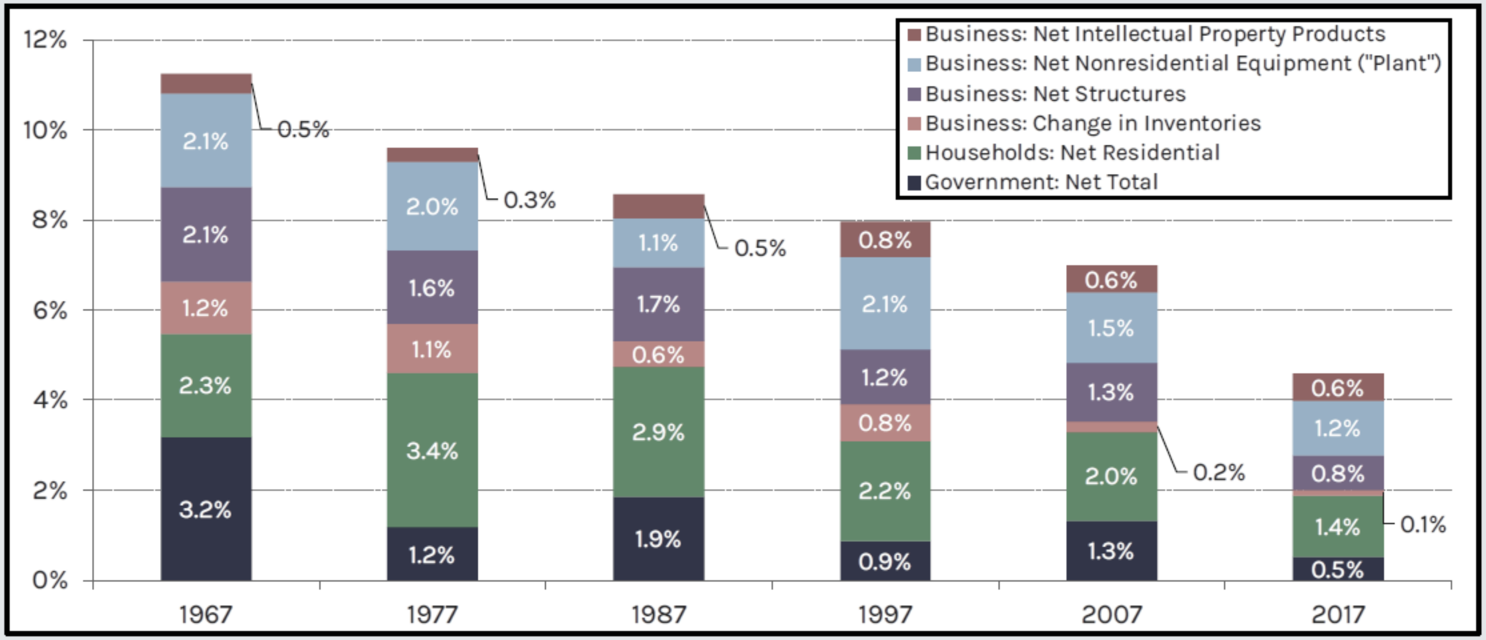
Cause & Effect



Sources: Bureau of Economic Analysis. Through Q3 2022. Last plot is Q1-Q3 avg.

Hoisington

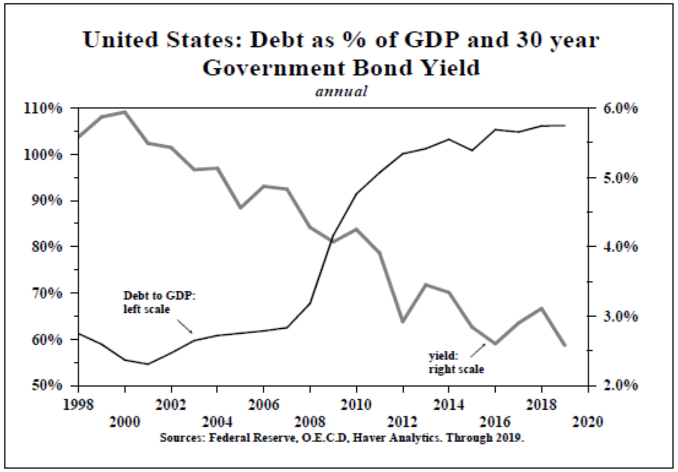
Net Domestic Investment As a % of GDP, by Type (Selected Years)

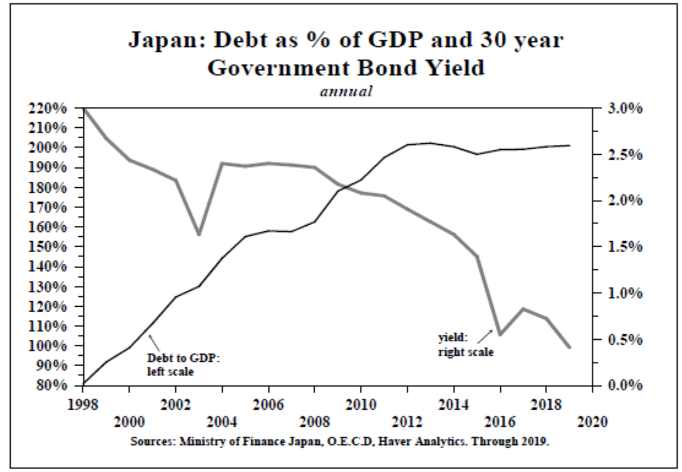


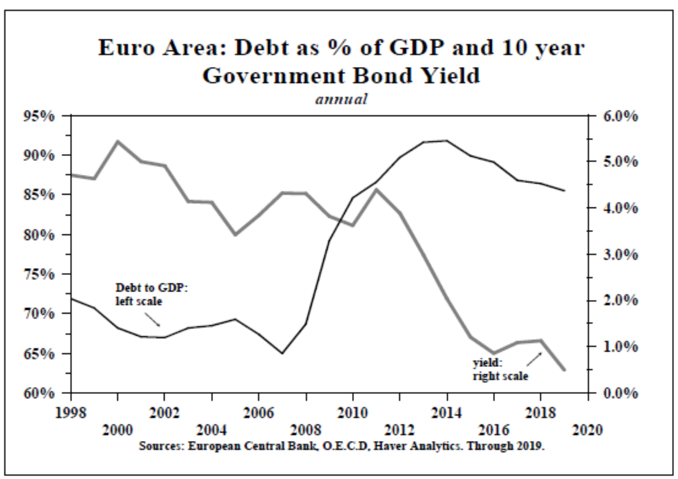
I knew Algebra would come in handy!

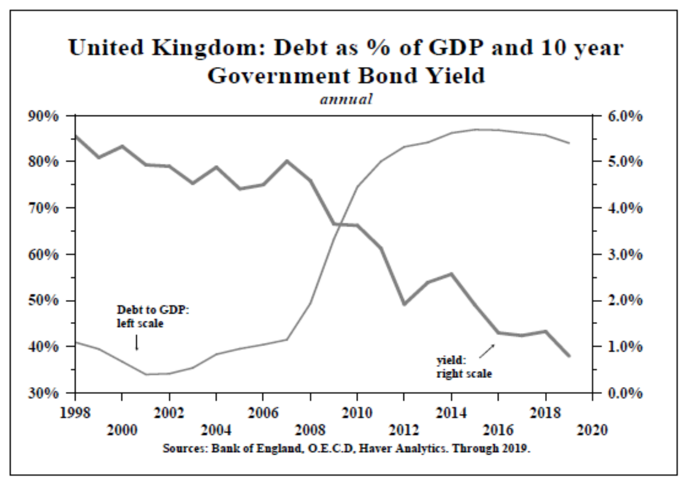
- $I = S_p + S_g$
- Investment = National Saving (household + government)
- Less aggregate savings = less investment
- Less investment = less productivity
- Less productivity = less growth

Nothing more consistent than what increased debt has done to bond yields







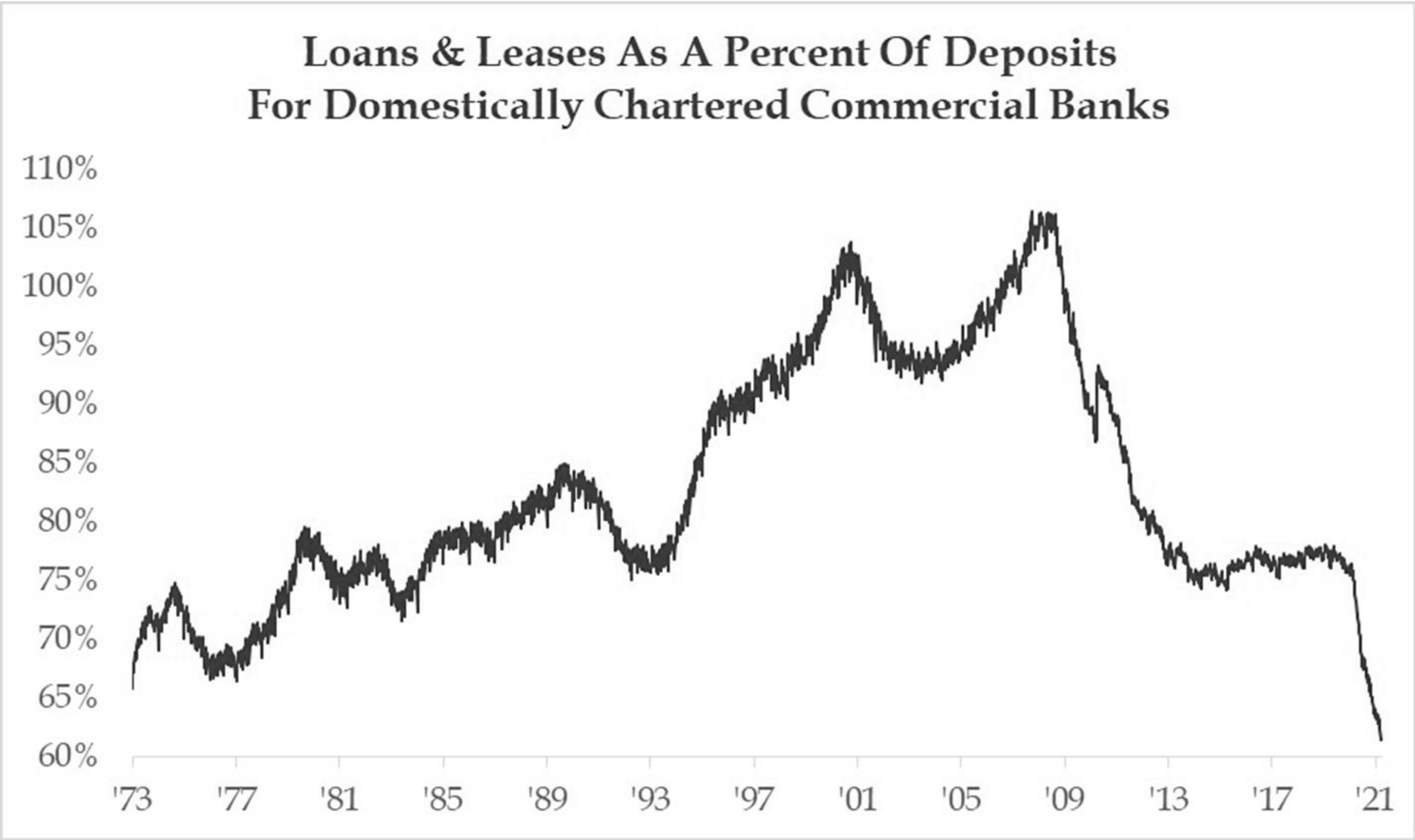


Plan B: Monetary Medicine

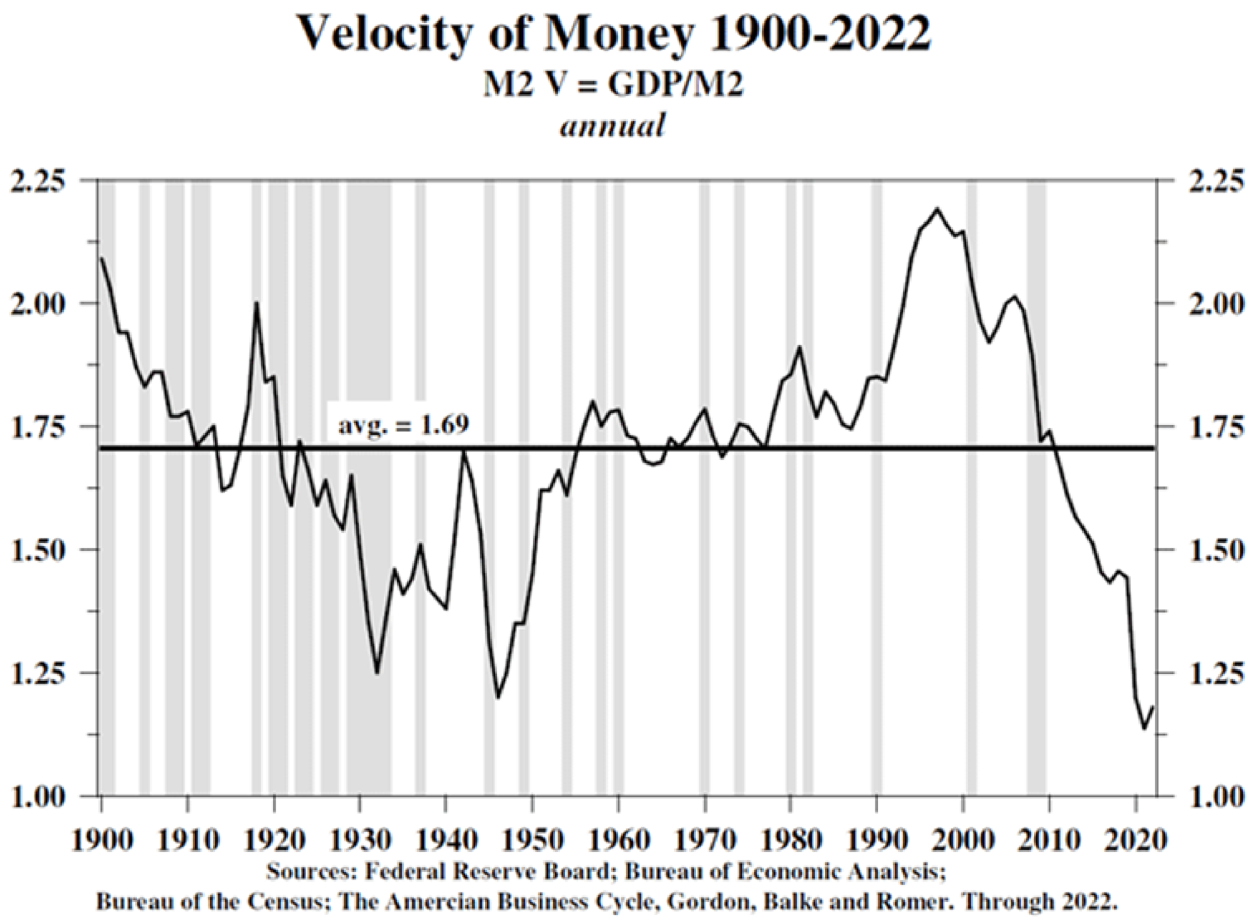
(1) Facilitate the fiscal

(2) Stimulus tool in its own right

LOAN DEMAND HAS COLLAPSED



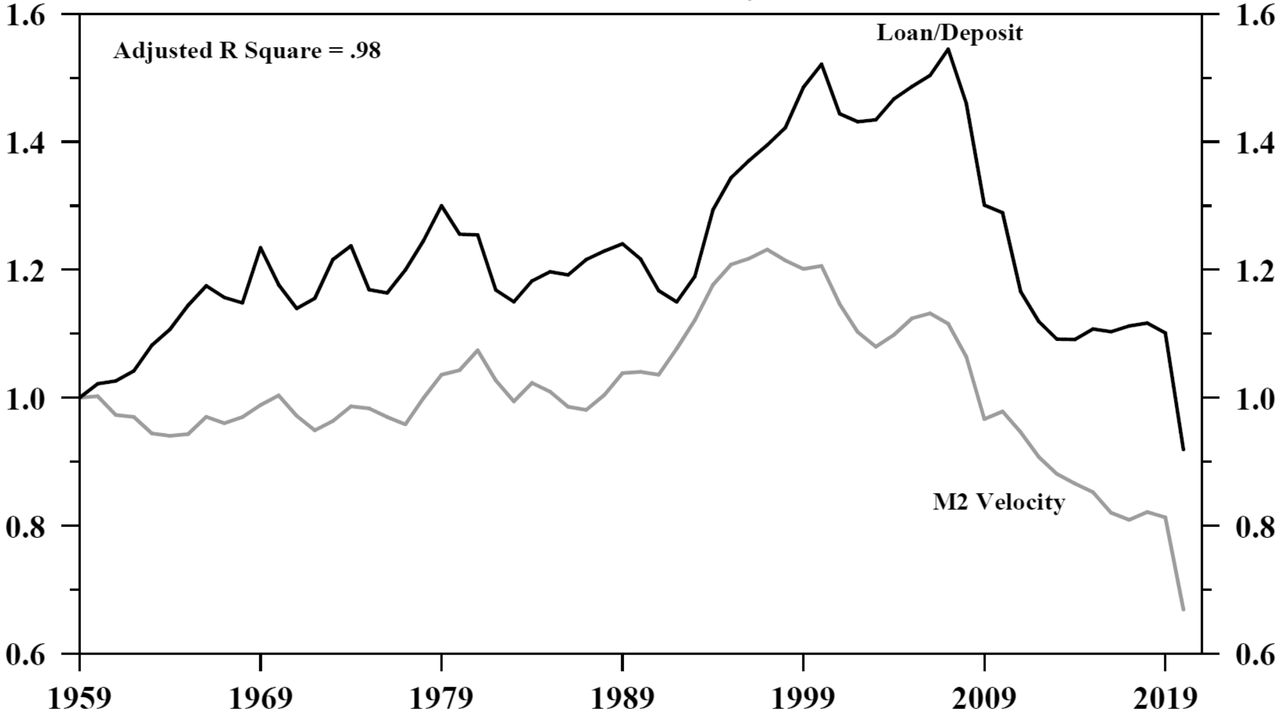
MV=PT


Velocity of Money 1900-2022
M2 V = GDP/M2
annual
2.25
2.00
1.75
1.50
1.25
1.00
avg. = 1.69
1900 1910 1920 1930 1940 1950 1960 1970 1980 1990 2000 2010 2020
Sources: Federal Reserve Board; Bureau of Economic Analysis;
Bureau of the Census; The Amercian Business Cycle, Gordon, Balke and Romer. Through 2022.

WHY HAS IT DONE THIS? CHICKEN OR EGG?

Money Velocity and The Commercial Bank Loan/Deposit Ratio (1959-2020)

indexed annually



Sources: Federal Reserve Board. Through 2020.

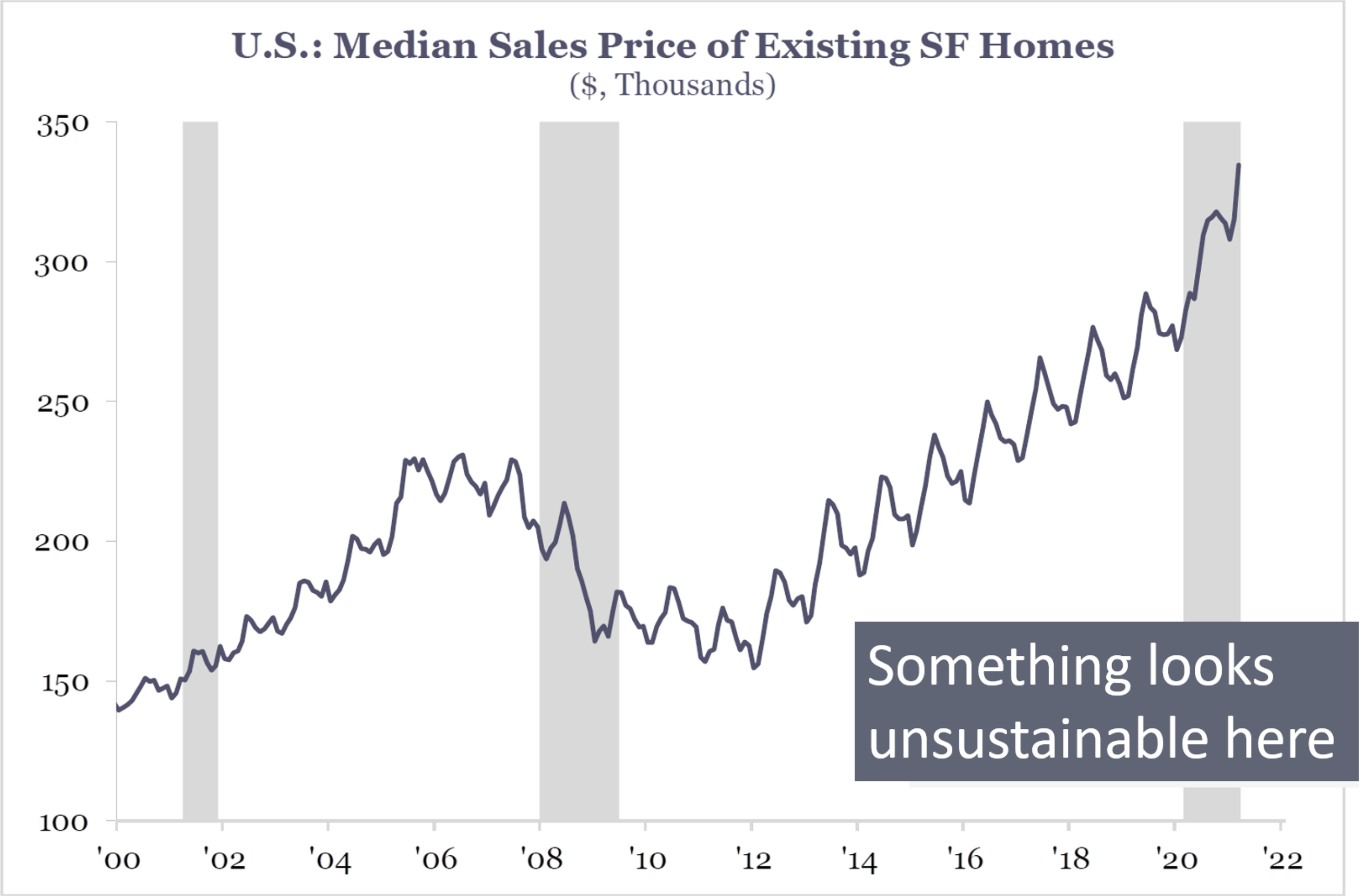
The sin of monetary intervention:

Malinvestment
Distortion
Speculative Frenzy

NOT

Inflation

Market Distortions



Fostering Instability

(1) Interest rates that are unnaturally high slow economic growth as resources are diverted from productive activity to interest payments.

(2) Interest rates that are unnaturally low create rampant speculation.

(3) The natural rate is that which neither slows nor accelerates economic activity and is found in the growth rate of nominal GDP

(4) Central banks favor unnatural looseness, not unnatural tightness.

(5) And this leads to financial instability.

What we learn from Japan in all this

Japan's Track

(1) The government has borrowed so much money they need very low rates on the debt

(2) Very low rates on bonds keep foreign investors and/or domestic savers away

(3) A lack of foreign investors and domestic savers to fund the bond market makes the central bank have to do more

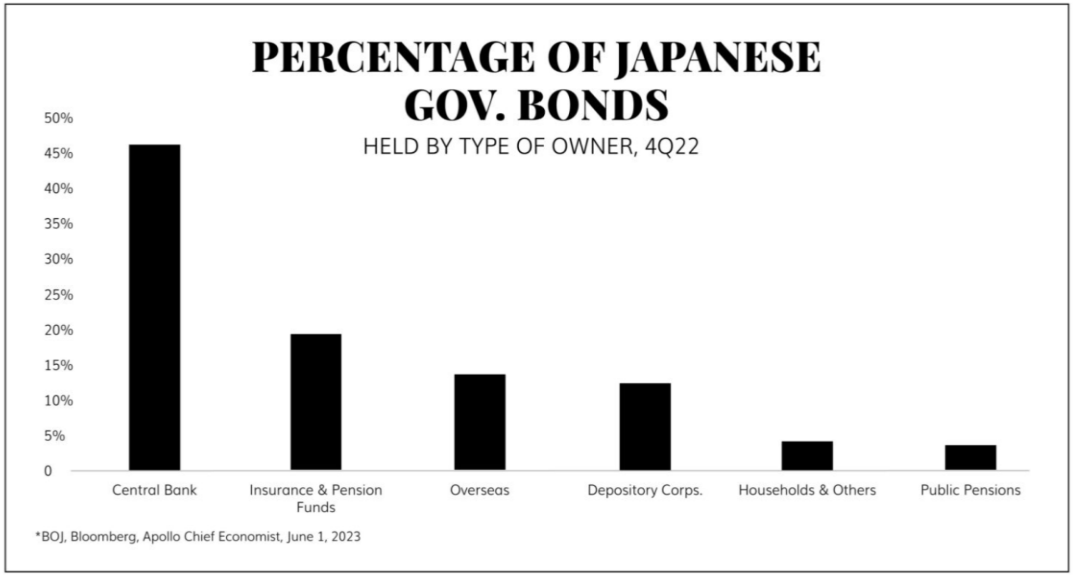
(4) The more the central bank does, the more interest rates are kept near zero

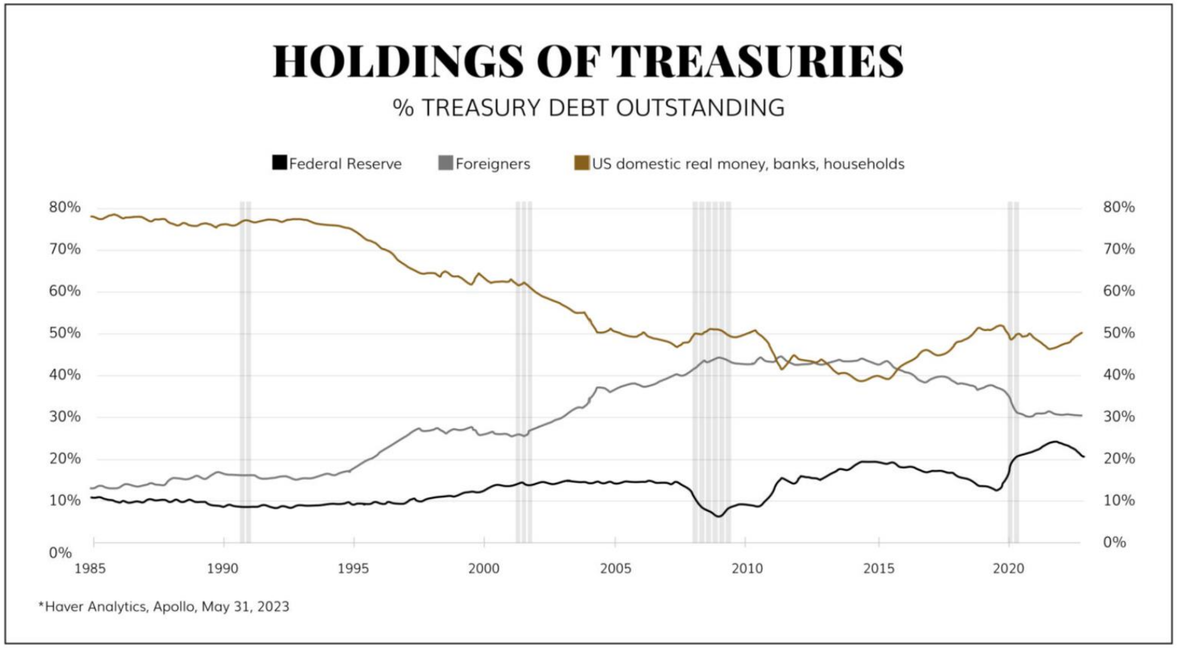
(5) A lack of capital flows means a lack of investment, a lack of productivity, and a lack of growth

(6) A lack of growth means more government spending and borrowing

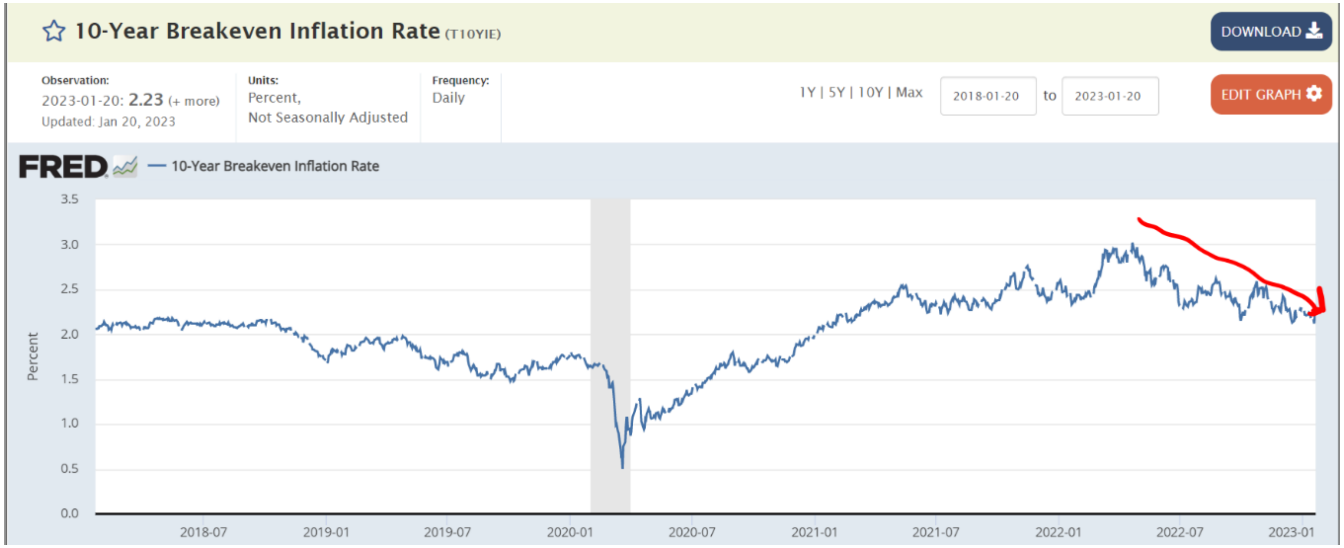
(7) More government spending and borrowing means the need to keep rates low, which means … (start this chart all over again)

Japan vs. U.S.
All a matter of time?

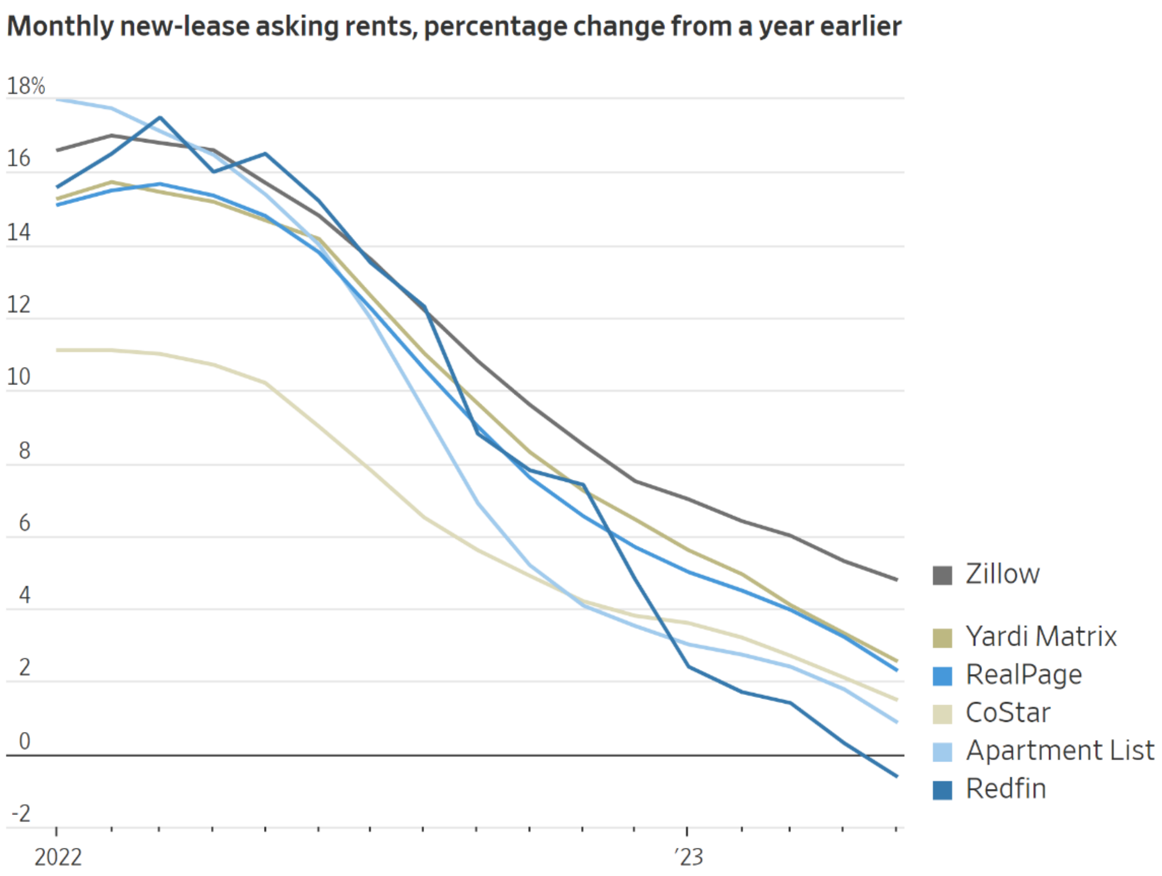




Inflation now?



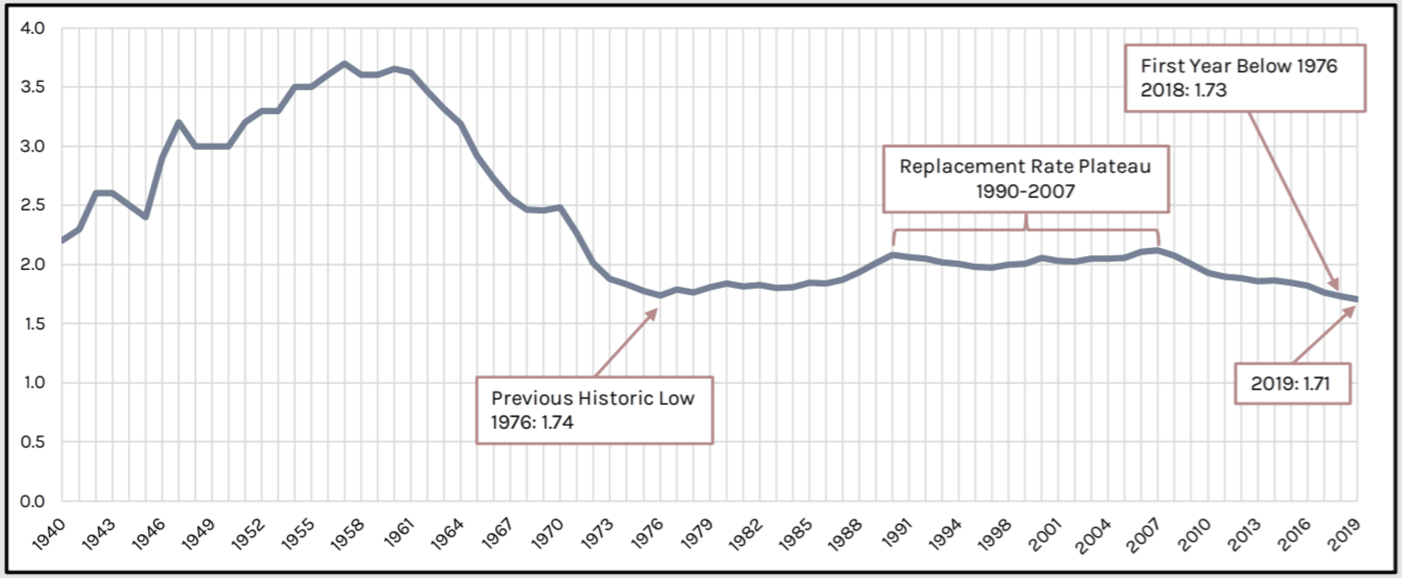
Inflation now?



Note: Some measures include single-family home rentals in addition to apartments.
Source: the companies

FERTILITY: DROPPING TO ALL-TIME LOWS

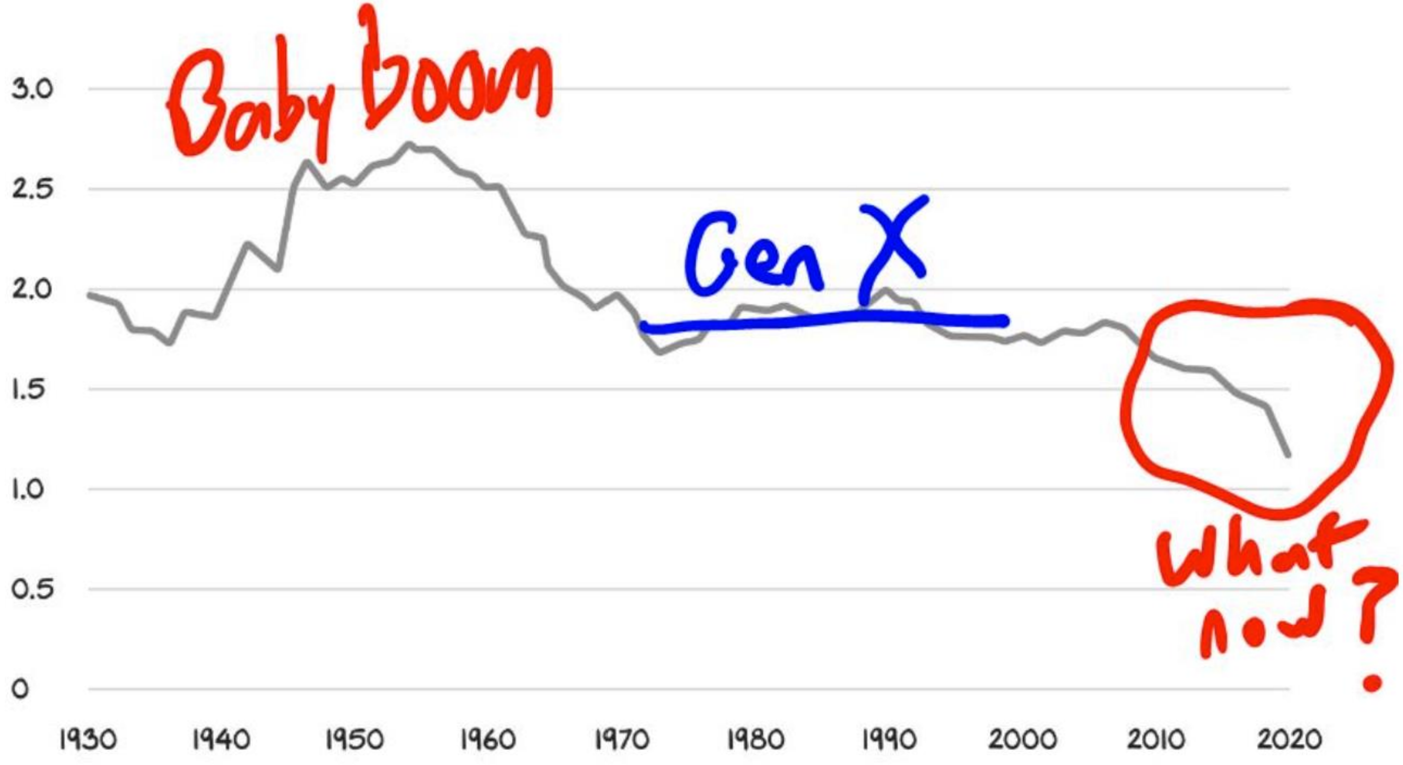
US Total Fertility Rate, 1961-2019



- 600,000 fewer births in 2019 than 2007
- 1.78 birthrate in 2022

NUMBER OF BIRTHS PER DEATH

U.S.



SOURCES: WALL STREET JOURNAL, CDC

In summary:

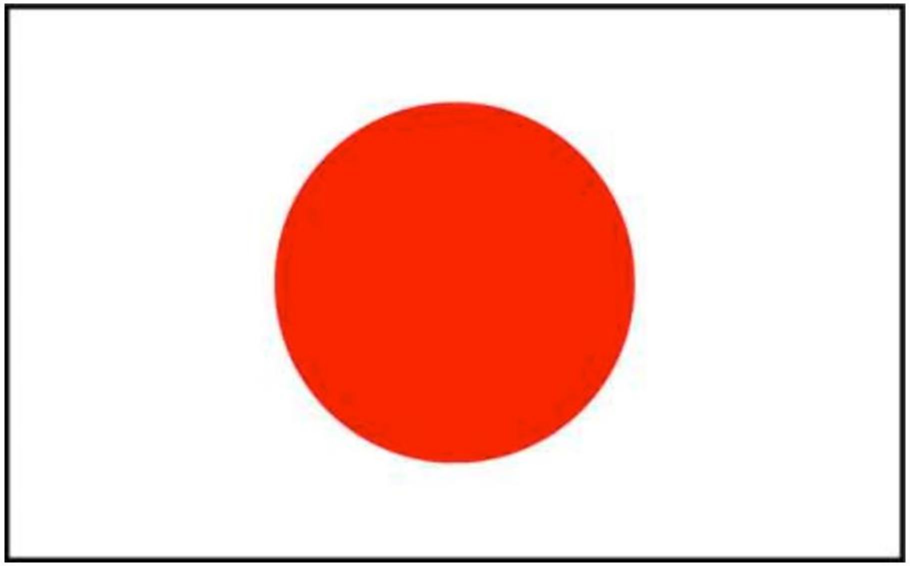
It is a mess!!

Excessive indebtedness leads to policy actions that put more downward pressure on growth

Which leads to more fiscal and monetary measures that exacerbate further …

Debt = Low Growth = Policy Actions that create more debt and lower growth

What will be done?



What can be done?

- Repentance
- Living within our means – balanced budget
- Fed as lender of last resort vs doctor of business cycles

What can be done?

- A Congress that does its job
- Strong self-government creates less expensive federal government with direct inverse relationship

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