March 13, 2021

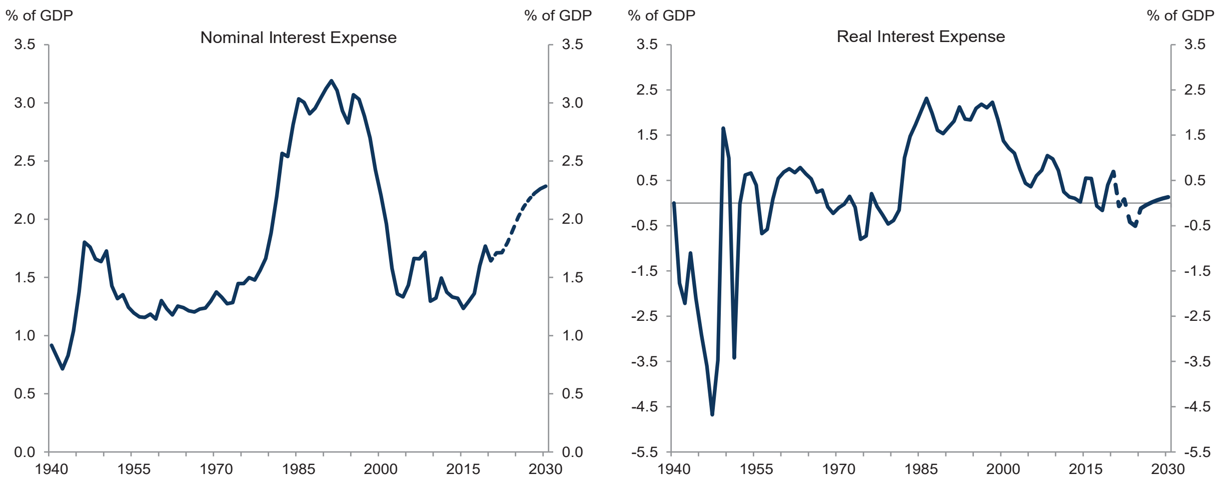
INSIGHTS

FISCAL DEBT - A DEEPER LOOK

The story that is still dominating the headlines is the passage of the $1.9 trillion stimulus bill. According to the Congressional Budget Office (CBO), America's federal debt is set to exceed the size of the US economy (GDP) in 2021 for only the second time since the end of World War II. As of March 1, before the latest stimulus bill, the national debt stood at $21.9 trillion.

However, since much of this new debt has been issued at historically low interest rates, economists believe that investors should not compare the absolute debt level to GDP. The cost of servicing that debt (interest expense) compared to GDP, and specifically inflation-adjusted (real) interest expense may be a better analysis. The chart below, courtesy of Goldman Sachs, shows that when adjusting this interest expense for inflation, the debt servicing cost is actually in line with historical averages. While the level of the debt is historically high, average interest rates on Treasury debt are historically low, and multiplying them together implies roughly average interest expense as a share of GDP. Additionally, as old debt matures and is refinanced at lower rates, the cost of servicing that old debt will fall.

Exhibit 2: Interest Expense as a Share of GDP, a Better Measure of the Debt Burden, Remains at a More Historically Normal Level



Source: Office of Management and Budget, Goldman Sachs Global Investment Research

As long as the United States is able to grow its GDP at higher rate than the interest rate on its debt, the existing debt will slowly be paid off over time – assuming any excess fiscal revenues are used to pay off the debt instead of finding new avenues of spending.

There is a further caveat. Traditional debt statistics mostly ignore massive future entitlement obligations, such as Social Security and Medicare, which are on an upward trajectory. For the math shown above to work, politicians must reform Social Security before the Social Security trust funds become depleted in 2035, adding a further fiscal burden to the US Treasury.

Matt Jones, JD, CFP
President

David Trent
Managing Principal

Some information is derived from First Trust Portfolios, Morningstar, Charles Schwab, and Value Line. Reproduction or distribution of this material is prohibited and all rights are reserved.