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Written by Bob Adelmann on February 16, 2010

Will the U.S. Be Able to Pay its Debts?

An Associated Press writer says “the crushing weight of its debt threatens to overwhelm everything the federal government does,” even under the best-case scenario. This theme of unsustainable debts and deep holes has been reviewed elsewhere on this site, and it’s small comfort that it is now making headlines in the controlled mainstream media:

> The government already has made so many promises to so many expanding "mandatory" programs [that] just keeping these commitments, without major changes in taxing and spending, will lead to deficits that cannot be sustained.
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> Take Social Security, Medicare and other benefits. Add in interest payments on a national debt that now exceeds $12.3 trillion [and it] will gobble up 80 percent of all federal revenues by 2020.

And this is just the tip of the iceberg. Unfunded liabilities which are not considered by such watchdog agencies as the Congressional Budget Office, the Peter G. Peterson Foundation, or the Tax Foundation are at least four times that $12 trillion number, with some estimates exceeding $100 trillion. In addition, according to the *Investors Business Daily*, “The proposed budget over the next decade will double the [official] national debt.”

Congress recently rejected a “bi-partisan deficit commission” that could have forced Congress to face reality and vote “up” or “down” on its recommendations to reduce the deficit. And hypocrisy over the matter reigns supreme (pun is intended) from the highest levels of government when Obama on Sunday told his audience:

> In the end, solving our fiscal challenge — so many years in the making — will take both parties coming together, putting politics aside, and making some hard choices about what we need to spend, and what we don’t.

Earlier that week Obama signed legislation raising the debt limit to $14 trillion, to allow continued borrowing by the government.

All of which leads some to wonder, “When is the day of reckoning?” According to James Paulsen, of Wells Capital Management, that day is some long distance in the future. In his February 2nd clients’ newsletter, Paulsen gleefully announced that the “Current Real GDP Recovery Looks as Strong as the 1975 and 1982 Recoveries!” His newsletter then analyzes the numbers from the economy and compares them to those two previous periods of recovery from recessions, and concludes, “The 2009 recovery is thus far tracking quite closely with these historically ‘strong’ recoveries.”

He went on to analyze Inventory Cycles and announced that “inventory restocking may become and remain a sizable and persistent force in boosting real GDP growth.” His final conclusion: “Real GDP growth is thus far matching two of the strongest expansions in the last 50 years!”

In the latest issue of *Barrons*, Paulsen presented a longer version of his positive outlook in a question-and-answer format.

> *Why are you confident that you're right and the conventional wisdom wrong?*
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> Policy responses in terms of fiscal and monetary stimulus have been unprecedented because officials, too, became panicked. Ever since Lehman went down [in October 2008], we've seen 10% annualized monetary growth. The federal budget deficit has gone from a $350 billion annual rate to over $1.5 trillion. Short-term interest rates have been taken to effectively zero. Long-term rates are near postwar lows. The dollar has fallen significantly and the price of oil cut in half. These changes, collectively, *while they may spur inflation a couple of years out* [emphasis added] have had a more-than-favorable impact, short term. Corporations these days are sized as if depression could ensue any day. They've purged payrolls, lopped off underperforming operations, cut costs, slashed inventories, held back on capital spending and boosted productivity.

Conclusion? "[We're] going to see big jumps in the coming months…including hiring."

After reviewing some statistics that favor his position, Paulsen was then asked the Big Question:

> *Do the huge budget deficits as far as the eye can see concern you?*
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> I don't think we're in an Armageddon situation. We've run large deficits as a percentage of GDP in the past, such as in 1975, when the deficit blew out to 6.5% of GDP and people thought the world had come to an end. If you look back in U.S. economic history, the five years after the deficit peaks invariably have torrid growth.

The unstated expectation, of course, is that the United States can grow its way out of the debt it has incurred. However, with current deficits running better than 10 percent of GDP and growing, some consider such expectations to be exceedingly optimistic. Rudolph Penner, former head of the Congressional Budget Office says, "The fundamental problem is that we have…three very large programs…that are growing faster than tax revenues and faster than the economy," which is creating an "unsustainable federal budget deficit."

The *Economist* magazine reviewed a proposal by Representative Paul Ryan (R-Wis.), who has a Freedom Index rating of 95, as an "ambitious alternative" to solve the problems overtaking the U.S. economy. In its February 11th issue the magazine said, "Mr. Ryan's plan seeks to tackle the deficits…[by] limiting government spending as a share of the economy. He accomplishes the task by dint of a broad simplification of America's tax code and [its] health care system." By changing Medicare benefits into a "system of vouchers" to purchase private insurance, it would "invigorate the health-insurance market by drawing more people into it and by removing hidden subsidies. Social Security…would be cut back for today's younger workers, who would then be allowed to divert a share of their payroll-tax contributions into private retirement accounts." And Ryan would simplify the tax code by reducing it to two brackets, replace corporate taxes with a consumption tax, and eliminate the capital gains tax altogether. According to his plan, the government budget would ultimately go into surplus which would begin to reduce the federal debt. The *Economist*'s analysis concludes:

> [Ryan] deserves credit for an honest and daring proposal. Tellingly, his plan has faced criticism from both parties. Republican leaders have been careful to distance themselves from the slashing of programmes dear to one of their core constituencies. If nothing else, Mr. Ryan has reminded everyone of the hard choices that will soon have to be made.