

Longview Letter No. 145, 12th July 2024

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US Fiscal Indebtedness: Carry on Regardless

Executive Summary

- In many ways, the US is reinforcing the dynamic that it is an exhausted Empire state. It has lost its (political) ability to ‘take its medicine’. As a result it’s now engaged in many of the typical signs of late stage Empire – money printing (& a debt financed fiat monetary system), political bi-partisanship, high levels of indebtedness, military overreach.
- Without an obvious alternative reserve currency, though, the US’s ability to continue on this fiscal trajectory should continue. It’s when an alternative emerges, or a major shock occurs, that that status is likely to be undermined. In other words, the collapse of the dollar and the loss of its reserve currency status is an unforecastable but inevitable event.

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US Fiscal Indebtedness: Carry on Regardless

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‘Pass the debt parcel’

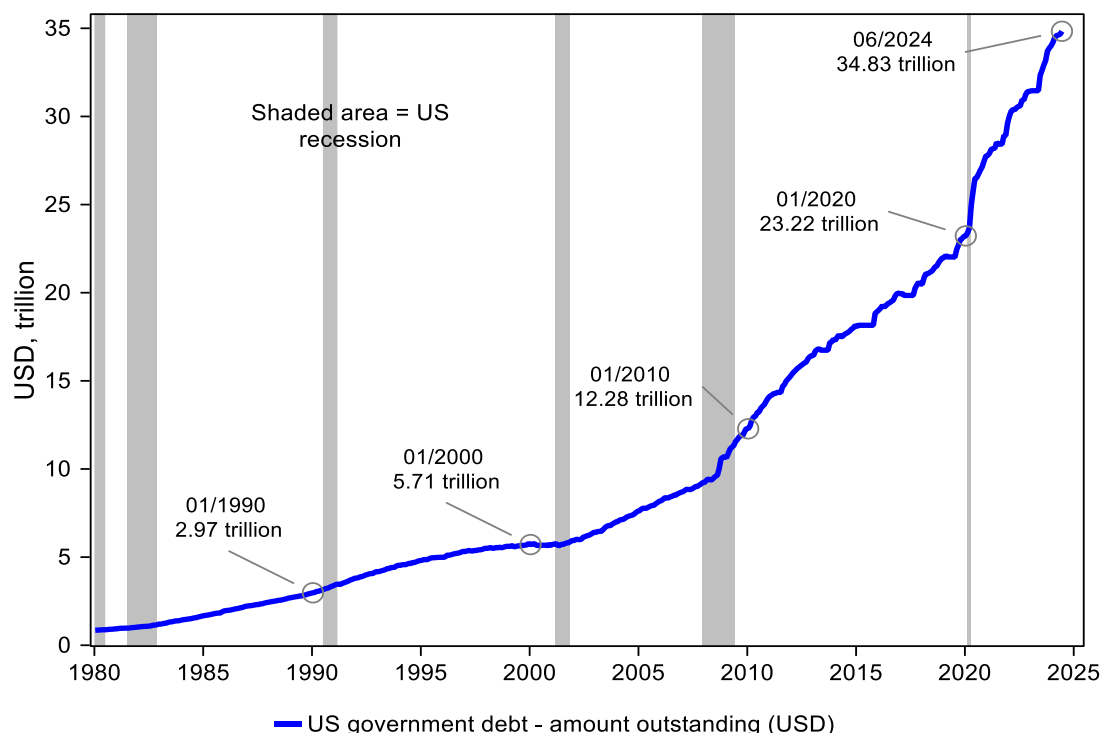
“the global debt pile increased by more than \$15 trillion in 2023, reaching a new record high of \$313 trillion. Around 55% of this rise originated from mature markets, mainly driven by the U.S., France, and Germany. In emerging markets, the debt accumulation was mostly concentrated in China, India, and Brazil. By sector, general governments saw the largest increases in the USD value of outstanding debt, followed by non-financial corporates. Debt outside the financial sector hit \$244 trillion, which is now over \$45 trillion above pre-pandemic levels”

Source: IIF, 21st February 2024;

https://www.iif.com/portals/o/Files/content/Global%20Debt%20Monitor_Feb2024_vf.pdf

The world is awash with debt. As laid out in the IIF’s latest press release above, most of the growth in global debt has come from a few key countries (including the US).

Fig 1: US government debt level (marketable and non-marketable, US\$tn)



Source: Longview Economics, Macrobond

For investors in government debt (and related currencies and equity markets), that raises a number of critical questions. **In particular, does it matter?** Do investors need to worry about the rapid accumulation of US government debt

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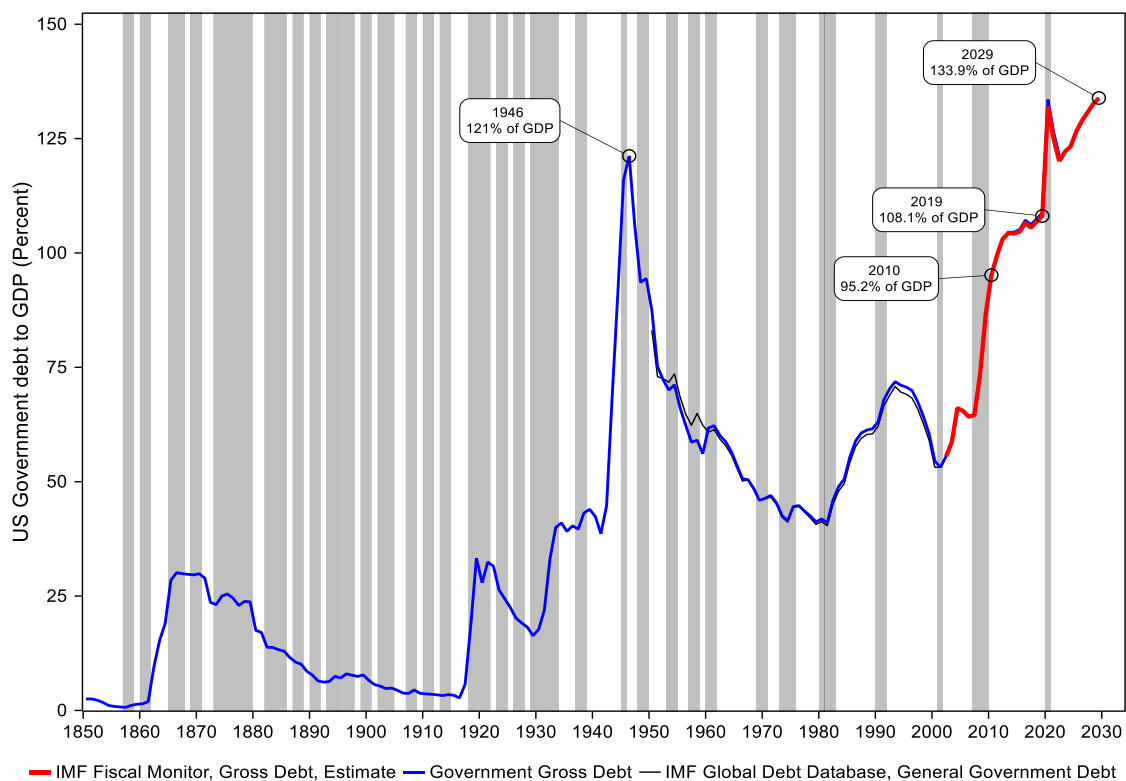
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in the past 15 years (fig 1)? Does it matter that France is electing a left leaning government with (fiscal) plans to spend more? How has Japan managed to run fiscal deficits for 30 years without a crisis? Is that a signal that investors don't need to fret about the US fiscal position? But if it does matter, then when? And what are the triggers/signs to watch out for?

Indeed, whether or not it matters, it is certainly one of the key concerns of investors around the world/usually brought up in meetings (but also one about which nothing is done).

Given the size of the debt, that concern is not surprising. Single-handedly US government debt accounts for 14% of world non-financial debt. On last count there was \$34.8 trillion of outstanding US government debt, up from \$23.2 trillion immediately prior to the pandemic, \$12.3 trillion just after the financial crisis, and as low as \$5.7 trillion at the turn of the millennium (fig 1). With that, US government debt to GDP is now running at 122% of GDP (fig 2) – above its 1946 post WWII peak (although below the UK's WWII peak of over 250%). With fiscal deficits set to stay high, that ratio will continue to trend up. According to the IMF's projections it will reach 133.9% of GDP by 2029. The US's CBO longer term projections forecast a ratio of 166% by 2050. The outcome of the November election, naturally, could accelerate that move higher (with the Trump camp, for example, talking about more tax cuts).

Fig 2: US government debt to GDP (%): 1850 to 2029¹



Source: Longview Economics, Macrobond

¹ NB IMF forecast out to 2029

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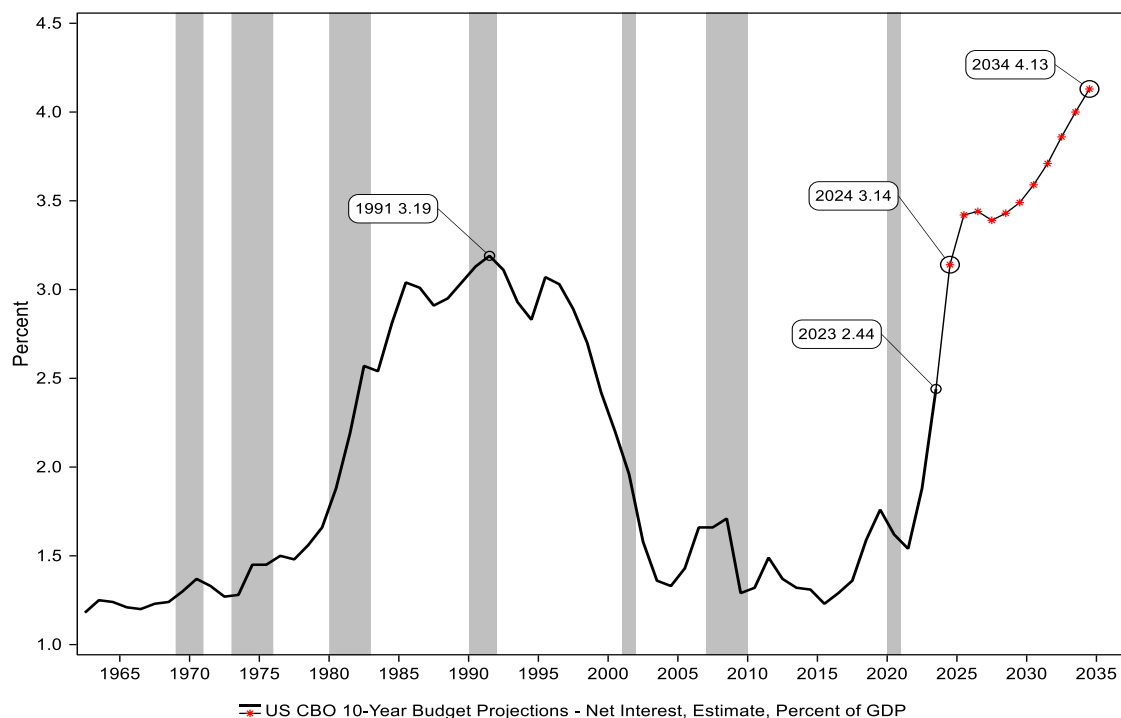
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But does it matter?

Bond markets have tamed UK policy makers (i.e. when Truss was attempting to cut taxes in late 2022); and also tamed the Eurozone (because of its incomplete currency union, overindebted Southern nations post GFC, and associated weak institutional set-up). As of yet, though, those bond vigilantes haven't been minded to tame the US government. Indeed, the ability of the US to print money, reflecting its reserve currency status, has allowed it to smooth over any challenges in the bond market and helped contribute to this idea in markets that America is 'Exceptional', it's different. And, since there's no obvious alternative reserve currency, that ability to print, whenever faced with a challenging bond market, is expected to continue (for now).

As such, other than last year's ousting of the Speaker of the House/McCarthy (by a small handful of fiscal hawks, led by Matt Gaetz), there's little appetite in the US Congress to address the level of indebtedness. Bringing down debt levels is not viewed as a vote winner (not surprisingly). The market, besotted as it is by the MAG7 and continuing new S&P500 record highs, is also increasingly wondering whether the issue matters (to paraphrase one investor, 'we've been talking about a US debt crisis for decades – but nothing ever happens – we're better off ignoring the issue'). However, despite the market's and policy makers' apparent disinterest, the government's debt payments continue to grow. On last count 2024's payments are expected to equal the 1991 peak, and then continue to rise out to the end of the CBO's 10 year forecast period (fig 3).

Fig 3: US government debt interest payments as a % of GDP



Source: Longview Economics, Macrobond

High debt loads, though, (seem) to mean low growth

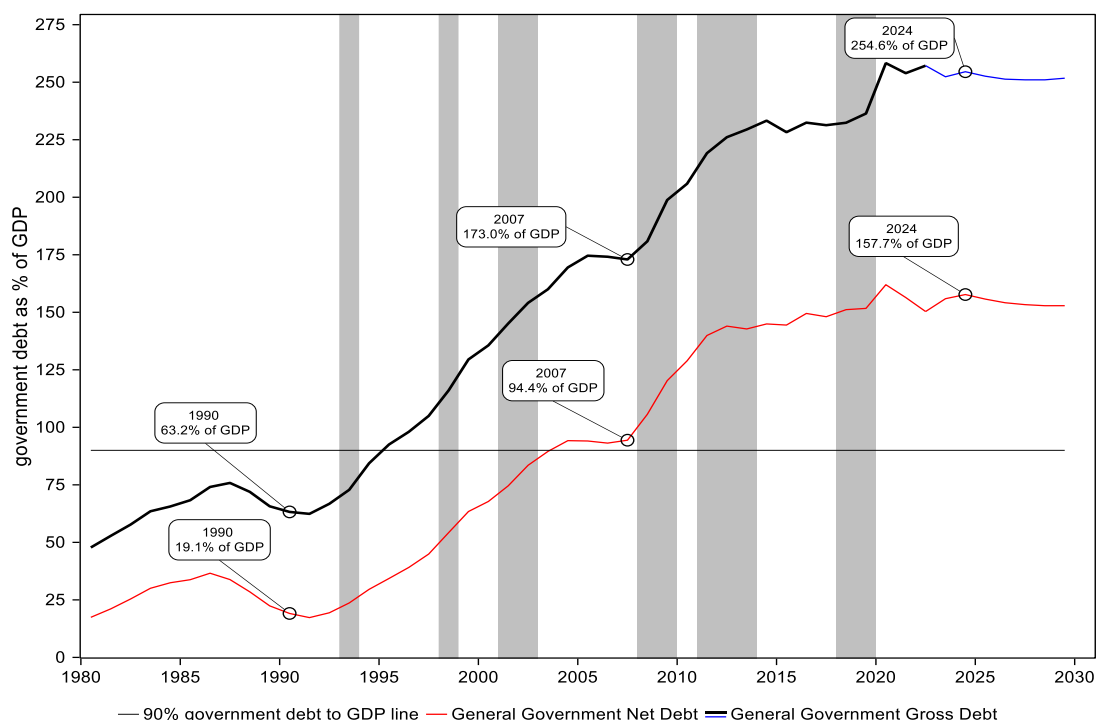
The major Western economies with long term high government debt loads (Italy and Japan) have both had growth issues.

In Japan, the economy famously suffered its lost decades post the bursting of its late 1980s bubbles (i.e. the 1990s and 2000s). That is, post 1990 its growth rate slowed dramatically from an average of 4.5% per annum in the 1980s to an ~1% average since.

Indeed, the average growth rate for the first two lost decades (i.e. the 1990s and noughties) was 0.95% per annum; the average under Abenomics (2012 – 2019) was not much better at 0.99% (despite 10 years of Yen weakness, and other economic reforms/Abenomics three arrows); while the average from 1990 to present is 0.86%². At the same time, though, whilst economic growth has been anaemic, the government has been running constant fiscal deficits and building up its indebtedness (fig 4).

In other words, growth has been anaemic even though (or perhaps because of³) massive fiscal support.

Fig 4: Japanese government debt to GDP (%): 1980 to 2029



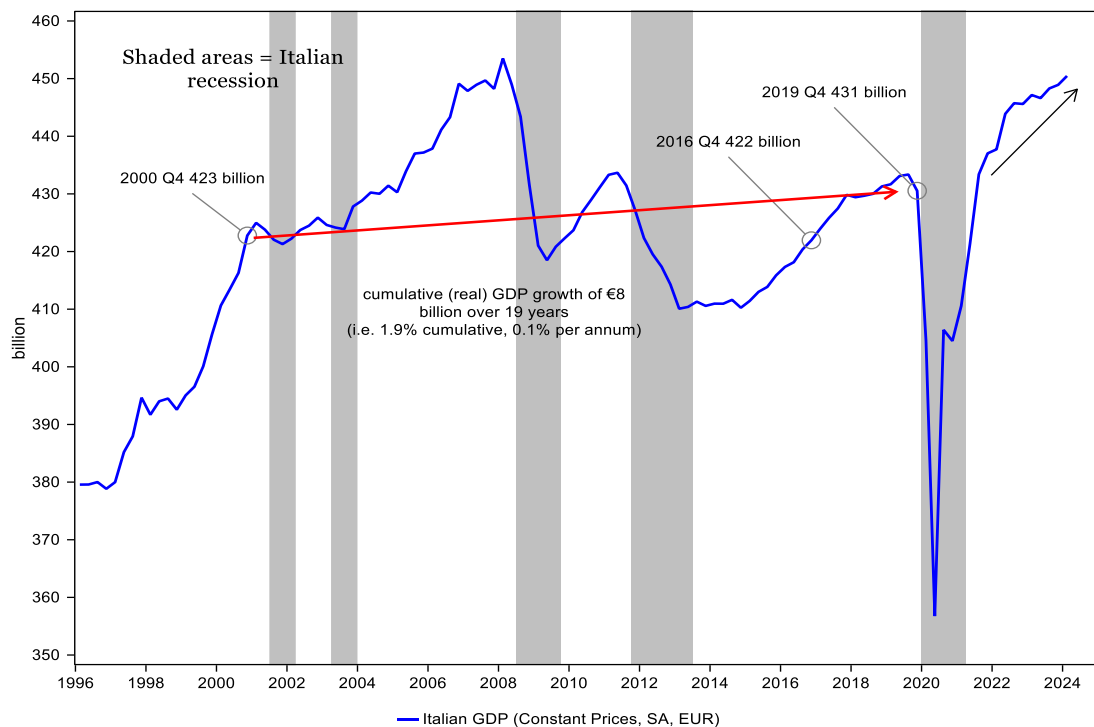
Source: Longview Economics, Macrobond

² NB even if that is adjusted for the challenging Japanese demographics, it doesn't improve significantly. Japanese per capita average real GDP growth since 1991 is 0.89% per annum (according to IMF data).

³ See below for economies with high debt loads that have sought to reduce government debt and ultimately ended up with higher economic growth.

Italy also experienced almost zero cumulative real growth for two decades (i.e. just prior to the pandemic). That is, from 2000 to the end of 2019, annual GDP growth averaged 0.1% per annum. From 2000 to 2016, cumulative real GDP growth was zero (fig 5). Although, since the end of the pandemic, GDP has started trending higher (fig 5).

Fig 5: Italian real GDP level (€ billion)



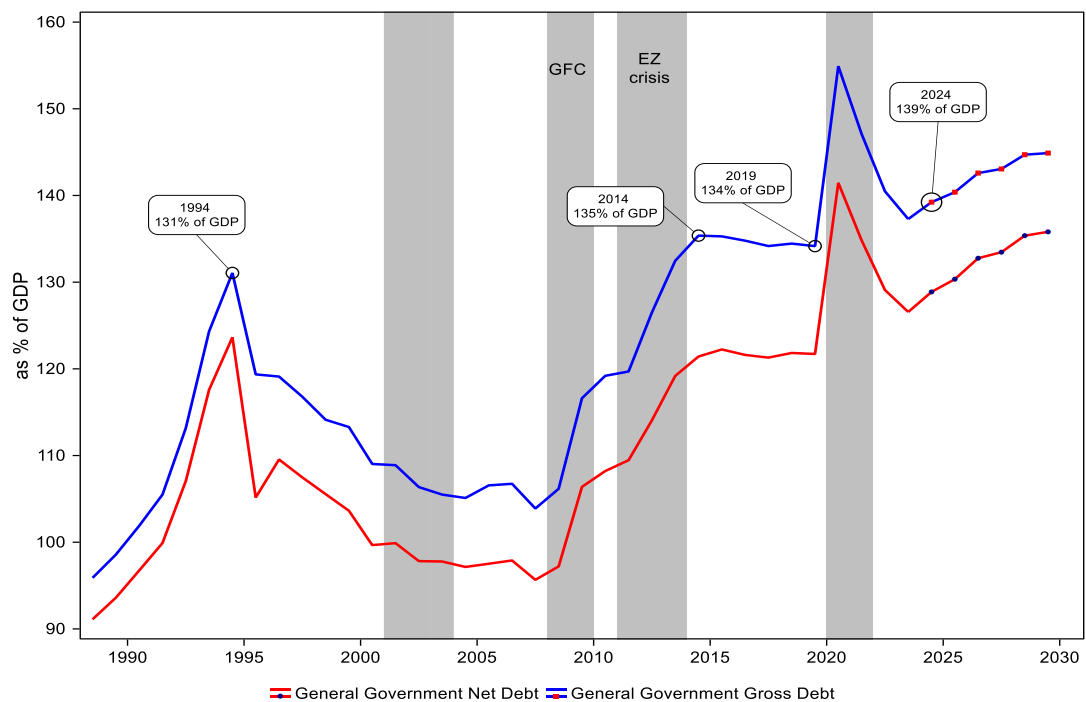
Source: Longview Economics, Macrobond

Those two decades of lost growth, meanwhile, occurred after Italy's government debt to GDP ratio reached over 90% (although not immediately afterwards), and happened despite continued large build-ups of Italian government debt. As fig 6 shows, in 2000 gross government debt was around 110% of GDP. By the end of 2019, it had reached 134%. As such, the build-up of government debt didn't result in any overall economic growth during that period⁴.

After the EZ crisis, though, government debt to GDP was flat as Eurozone policy makers imposed stricter fiscal discipline on Italy given the challenges created by the Eurozone crisis. That greater level of discipline lasted up until the pandemic. Deficits then widened significantly on the pandemic and have been consolidating since then (with an IMF forecast expectation of a return to a surplus in the primary balance by 2025).

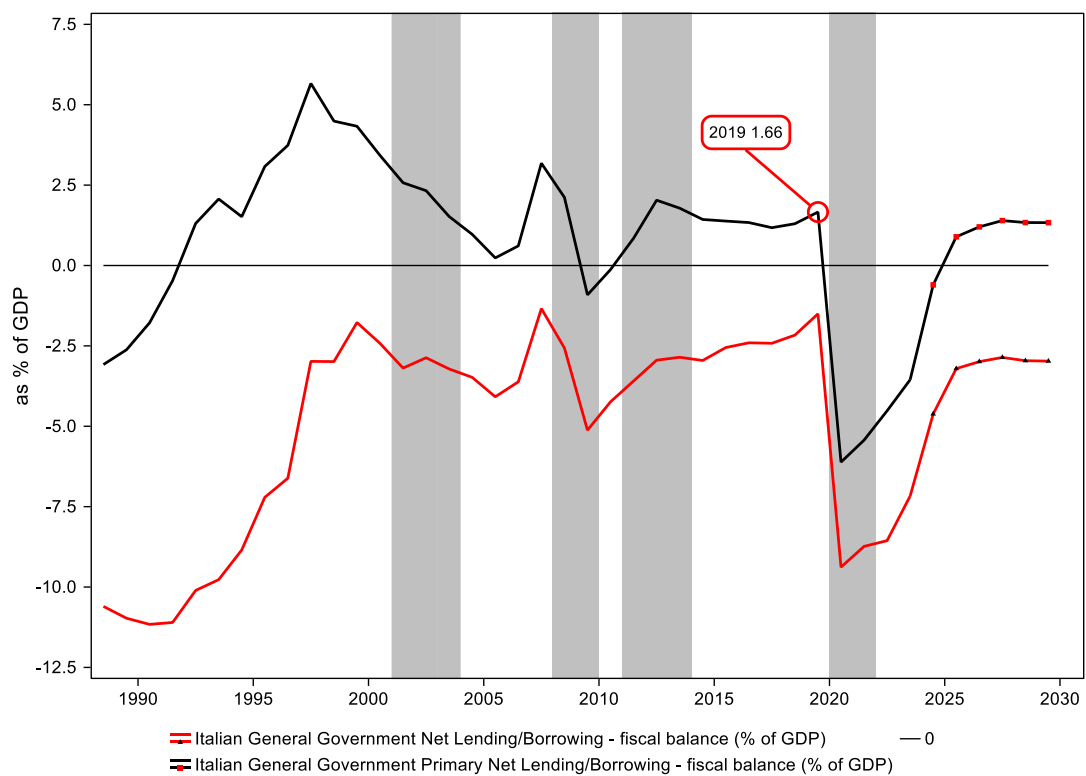
⁴ although since 1992 and up until the pandemic, Italy has run a primary fiscal surplus. As such, the debt build-up is all a consequence of large debt interest payments which push the primary balance into an overall fiscal deficit.

Fig 6: Italian government debt to GDP (both gross and net), %



Source: Longview Economics, Macrobond

Fig 7: Italian primary and overall fiscal balance (% of GDP)



Source: Longview Economics, Macrobond

Rogoff & Reinhart's 90% government debt to GDP rule

Broadening the debate out beyond the experience of Japan and Italy, in 2010 Rogoff and Reinhart published the conclusions of their analysis of the effects on economic growth of too much government debt. For their analysis, they used data from across 44 countries and spanning over two hundred years.

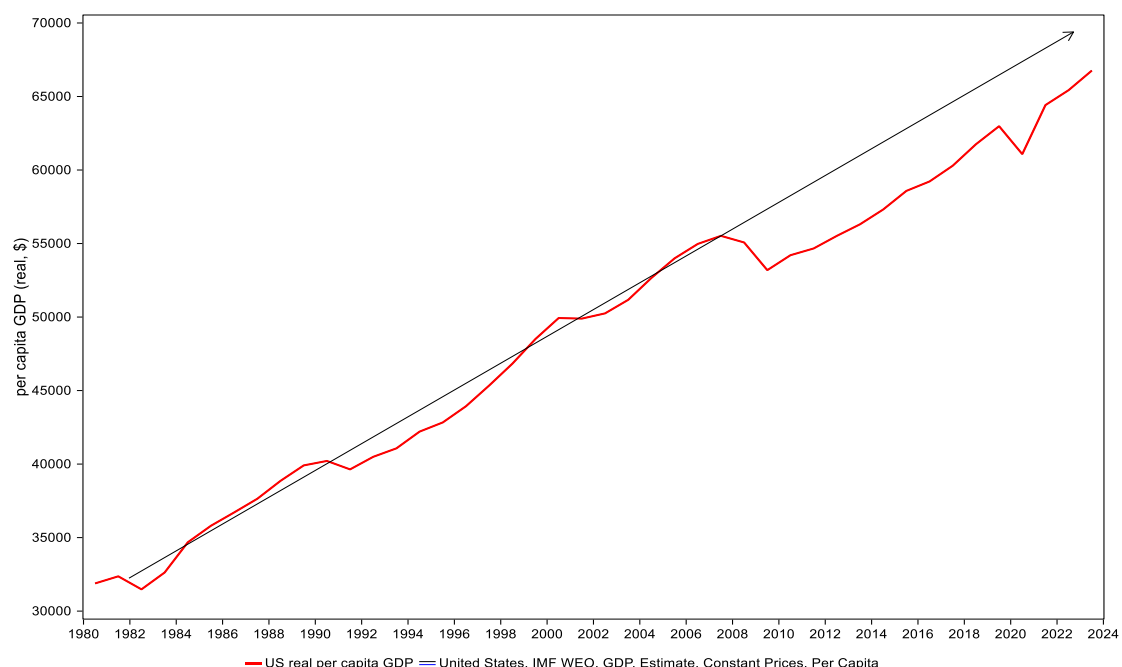
They found that:

“median growth rates for countries with public debt over 90 percent of GDP are roughly one percent lower than otherwise; average (mean) growth rates are several percent lower... the relationship between public debt and growth is remarkably similar across emerging markets and advanced economies.”

Source: Rogoff & Reinhart, January 2010 “Growth in a Time of Debt”;
https://www.nber.org/system/files/working_papers/w15639/w15639.pdf

As soon as the paper was published, their analysis and the ‘90% rule’ became controversial. In particular, there was an accusation that there had been a data error which had distorted the results. At a later date, however, that was addressed by the paper’s authors (with an unchanged conclusion after amending the data error).

Fig 8: US real GDP per capita (real, shown with pre GFC trend)



Source: Longview Economics, Macrobond

Consistent with that 90% rule, since the US economy moved above that 90% government debt to GDP ratio in 2011, its trend growth rate has slowed.

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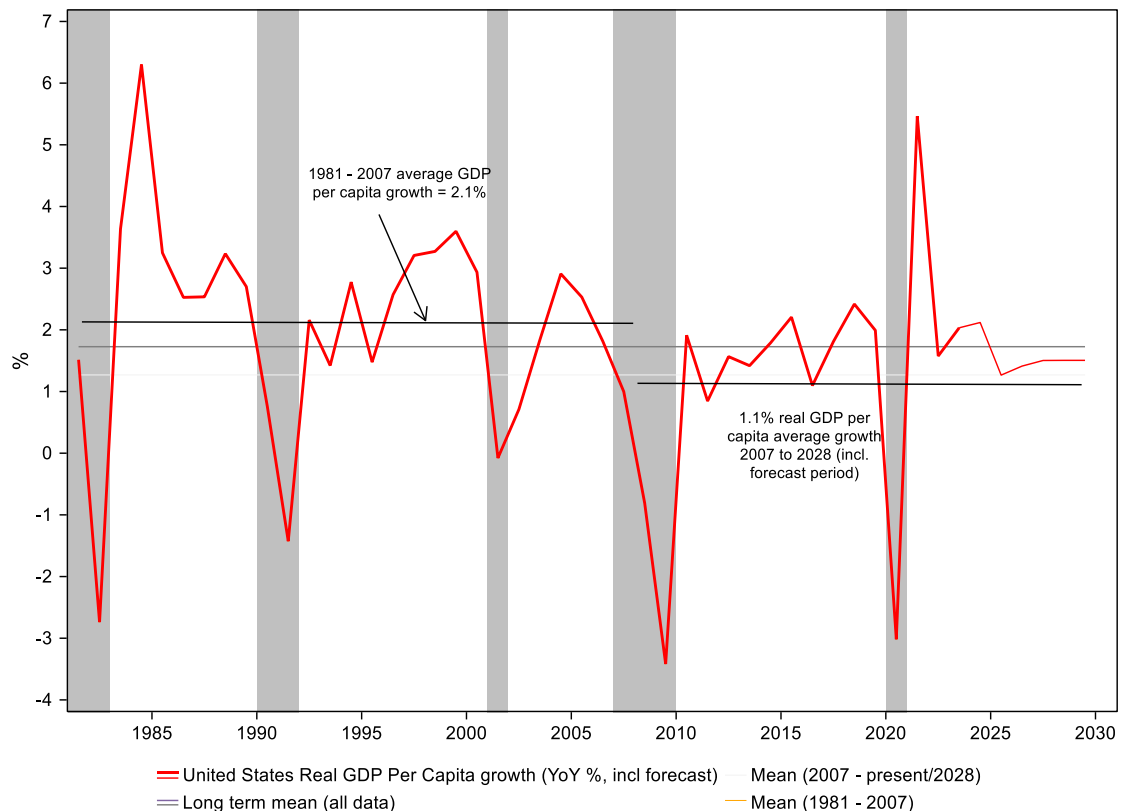
That is, prior to the GFC (from 1981 through to 2007),

“real GDP per capita averaged 2.1%. **Since 2007, it has averaged 1.1%** (almost half as much). Starting from 2009 (to exclude the effects of the GFC), then the rate is only modestly higher (1.2% per annum). Or alternatively, considered from a trend GDP growth perspective (rather than growth rates), the US economy never returned back to trend post the GFC (see fig 9).”

Source: Longview on Friday, 3rd November 2023: “[Boom-Bust; Or American Economic Exceptionalism?](#)”

Interestingly, while that is the case for the US (and certain other major Western countries, like Japan, Italy, as mentioned above), Rogoff and Reinhart’s conclusion doesn’t hold across all countries that have crossed above that 90% government debt to GDP ratio.

Fig 9: US real GDP per capita (real, Y-o-Y %)



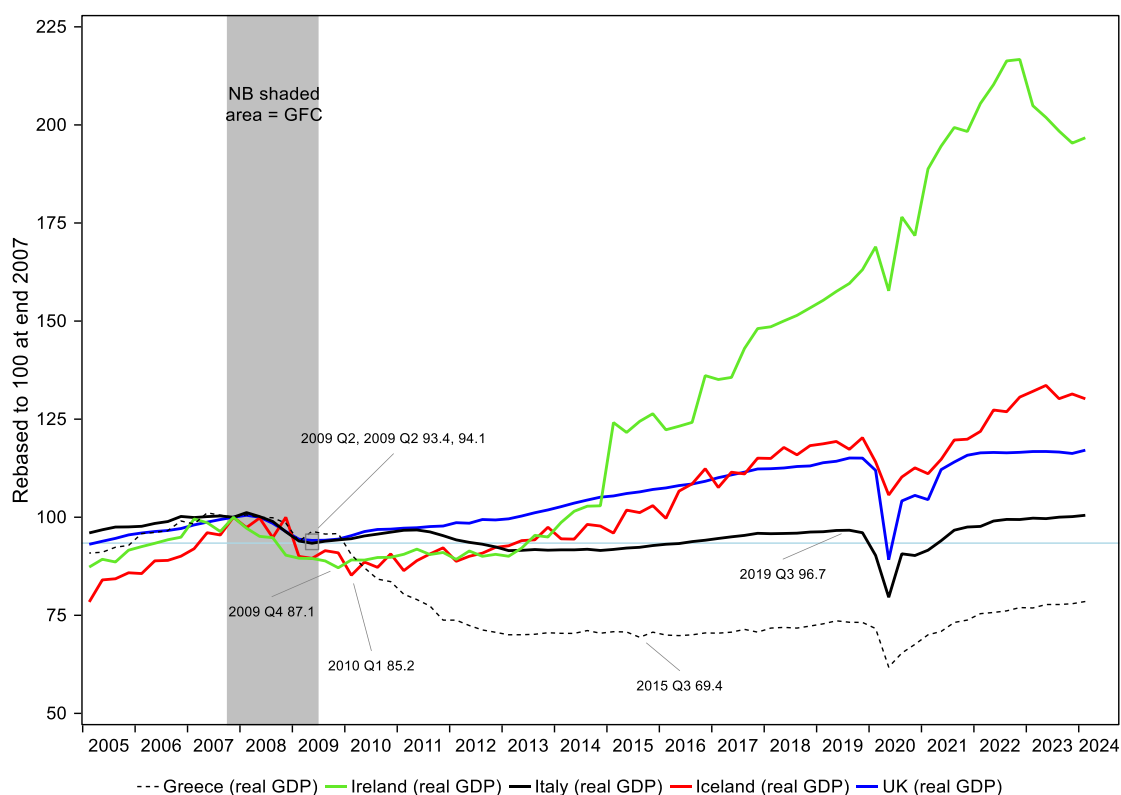
Source: Longview Economics, Macrobond

Countries that Don't Follow the R&R 90% Rule

While Rogoff & Reinhart's statistical study is interesting, what's more intriguing is the outlier data points. That is, those that don't fit the pattern. Indeed 14 years on from publication, the data set has grown considerably and there are many examples of countries which haven't followed the expectations/pattern suggested by the '90%' rule.

Indeed two of the three countries at the centre of the GFC and/or Eurozone crisis, have now significantly surpassed the growth trajectories of countries like the UK & Italy. Iceland, for example, has generated 13% more cumulative real growth than the UK since their respective 2007 GDP peaks ahead of the GFC (& up to Q1 2024). Relative to Italy it has generated 30% more cumulative growth. Ireland's GDP growth is even more impressive than Iceland's, although it's distorted by the Irish tax regime and the booking of international company profits in Ireland. Accounting for those factors (by using GNI instead of GDP), shows that Ireland's cumulative growth is 30% above its 2007 peak (using modified GNI) and 78% using non modified GNI measures. Either way, it's considerably more impressive than the UK & Italy. Greece, meanwhile, is the laggard (reflecting the greater depth of its economic contraction).

Fig 10: Real GDP level (rebased to 100 in 2007)



Source: Longview Economics, Macrobond

Successful Crisis Recovery Countries

Two of those three countries, in particular, which were at the heart of the GFC (2007 – 09) and/or the EZ crisis (2009 – 2012), have bucked the R&R rule about poor growth and high government indebtedness.

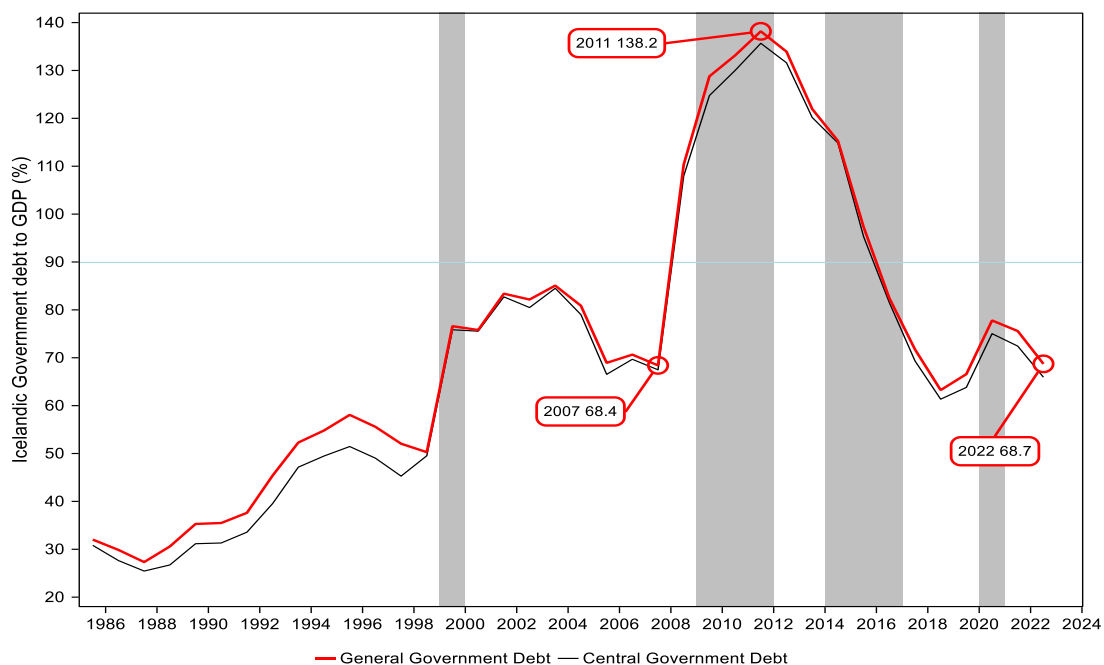
That is, two of the three have (or did have) high government debt to GDP yet have returned to a path of strong economic growth (with falling government indebtedness).

Those two countries are Iceland and Ireland, while Greece is the laggard (we could also include Spain).

Iceland

Take the case of Iceland: It was one of the worst affected economies in the 2007 – 2009 financial crisis. Its banking system sat at the heart of the global financial shock. Its economy contracted by 15% from 2007 through to 2010, while its government debt soared from 68% debt to GDP (2007) to 135% (by 2011). In that sense it was firmly above the 90% government debt to GDP ratio after the financial crisis.

Fig 11: Icelandic government debt to GDP ratio (gross & net)



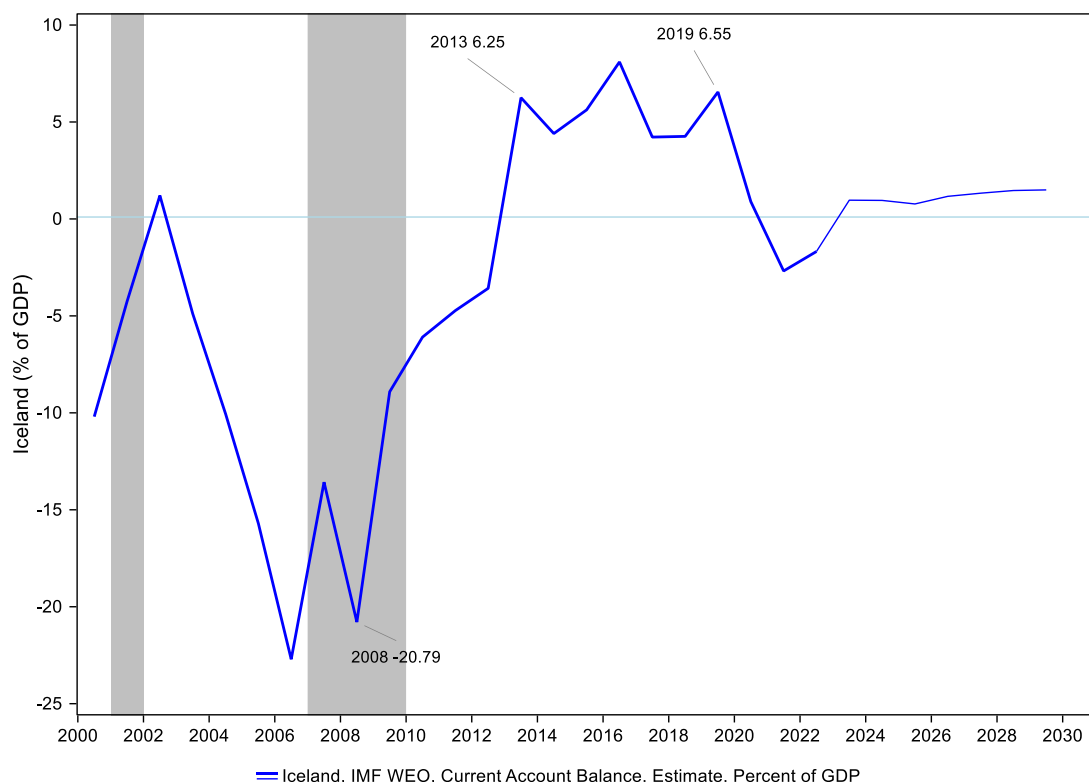
Despite that its economy has averaged real GDP growth since 2011 of 3.2% per annum (including a major contraction during the pandemic). Excluding the pandemic, it grew at 3.4% per annum (2011 to 2019). Its government indebtedness has also fallen markedly (from a peak of 138% of GDP in 2011 to

68% by 2022 – fig 11), and the economy has shifted from a major current account deficit (record 22.7% of GDP in 2006) to a surplus by 2013 (6.2% of GDP), see fig 12.

The government's primary fiscal balance was back in surplus by 2012/13 (from a large 13% of GDP deficit level in 2008). That was achieved by a major reduction in government spending relative to the size of the economy (i.e. from a peak of 63% of GDP in 2008, down to 43% in 2015, i.e. initially austerity, but then more recently because of a growth recovery, i.e. rising GDP).

As part of that recovery plan, along with enforced IMF austerity measures, there was also a major devaluation of the currency. From its pre-crisis level through to 2010 (at which stage it started to stabilise), the Icelandic Krona fell by 57%. In between (especially in October 2008), it was significantly worse. That devaluation, along with austerity, were the key reasons the current account balance swung from massive deficit to sizeable surplus in 7 years.

Fig 12: Icelandic current account balance (as % of GDP)



Source: Longview Economics, Macrobond

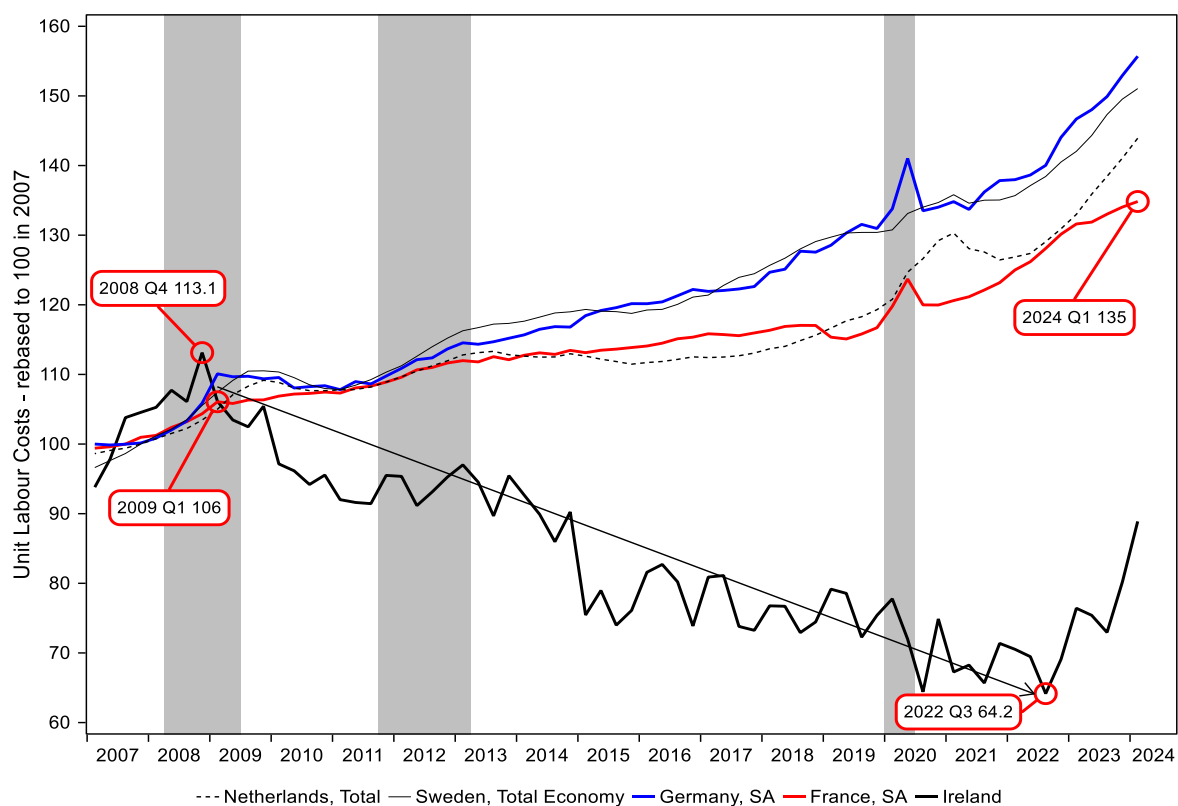
Ireland

Ireland was, and remains, in a currency union (i.e. the Euro area). As such it can't devalue its currency to support its recovery. It had to devalue internally, via austerity and a major devaluation of wages and asset prices. House prices fell by 57% between 2007 and 2013 (in both real and nominal terms); unit labour costs (wages divided by productivity) almost halved between 2008 and 2022 – see fig 13. At the same time, other key countries in the Euro area experienced significant increases in ULCs. On a relative basis, therefore, Ireland became much more competitive relative to other Eurozone countries, especially Northern European ones.

(NB Spain and Greece also devalued relative to Northern Europe, although not as dramatically).

As a result, its current account deficit (which peaked at 6.5% of GDP in 2007) had moved back into surplus by 2013; government indebtedness peaked in 2013 at 120% of GDP (and then fell rapidly to 44% by 2022); while its fiscal balance moved from a peak deficit of 30% of GDP (primary balance in 2010) to surplus by 2015.

Fig 13: Unit labour costs – various EZ countries (rebased to 100 in 2007)



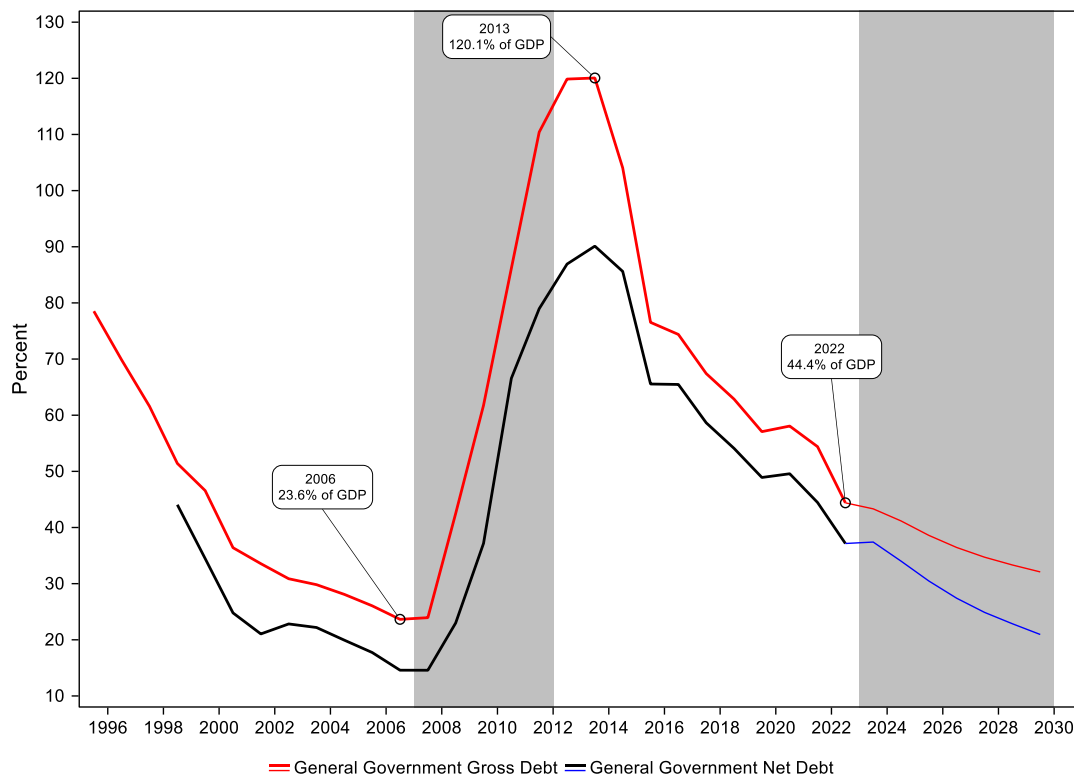
Source: Longview Economics, Macrobond

Greece

Greece, like Ireland, also remained in the Euro currency area through its crisis phase (although was close to leaving at one point). As a result, it also had to devalue internally, while at the same time austerity was forced upon it by the IMF/other Eurozone countries. Its economic contraction was more severe (with real GDP falling by around 30% peak to trough in 2015). Since then, though, and despite a still high government debt load, the economy has been growing at a reasonable rate.

Overall, therefore, rebasing real GDP to 100 at the peak in 2007, both Iceland and Ireland have generated more cumulative GDP growth than the UK & Italy since that time. Greece, though, reflecting the depth of its slowdown, remains below the UK & Italian level (although is now growing faster).

Fig 14: Irish government debt to GDP (%)



Source: Longview Economics, Macrobond

Conclusion

The evidence laid out above seems to suggest that there are two distinct outcomes for countries with government debt to GDP ratios above 90%. There are those that reform (and typically eventually return to a good GDP growth path); and those that aren't forced to reform, with subsequently lower trend productivity and GDP growth (and associated problems/politics).

1. Those that aren't forced to reform:

There are a number of developed economies, like Japan, Italy, France and the US, which for various reasons haven't been forced to enact major structural economic reforms and were able, through policy, to offset significant parts of their economic downturns during the crisis phase. As a result these economies are now less competitive and have shifted to lower growth trajectories. That has mostly occurred as their government indebtedness levels have reached around the 90% debt to GDP threshold (although that level is not precise). These economies don't have any outside forces pushing them to reform. As such, they continue to use the government's balance sheet to help drive growth.

Italy, in some ways is a slightly special case, given that it did have some problems during the last phase of the Eurozone crisis (2012) and has, subsequently, held its government debt to GDP ratio flat (through to the pandemic). It didn't, though, require a direct bailout because of the actions of the ECB printing money and standing behind government bond spreads. In Italy's case, it's the ECB that now disciplines its policy makers (by managing those government bond spreads) and not the bond market. Added to which, Italy has run primary fiscal surpluses almost every year for the past three decades (except since the pandemic).

2. Those forced to reform:

The other category is countries which have had government debt to GDP ratios above 90% - usually because of a crisis – but which have been forced to reform either by financial markets, the IMF and/or other countries in the EZ (which are lending them money). These countries, like Iceland, Ireland and Greece, suffer from internal devaluations and austerity but eventually return to a fast growth path. That is, they buck the 'R&R 90%' rule. Both Ireland and Iceland, for example, have experienced rapid falls in government indebtedness.

3. The Challenge:

The two groups above, therefore, illustrate that the R&R 90% rule should be further finessed into; i) countries that don't reform when government debt levels are high (with resulting slower trend growth); & ii) countries that do reform (with eventual re-acceleration of growth rates).

The challenge, though, is that there are very few, if any, examples of countries choosing to undergo (severe) austerity measures and bring their deficits (fiscal

and/or current) back into surplus. Both the UK & US, for example, have run almost constant current account balances since the 1970s. Having said that, the UK clearly suffered a shock under Truss which has since influenced policy makers (e.g. with Jeremy Hunt laying out a cautious fiscal path and the new Chancellor Reeves largely matching that caution - so far).

As such, the question remains – how will the US & French debt trajectory be resolved?

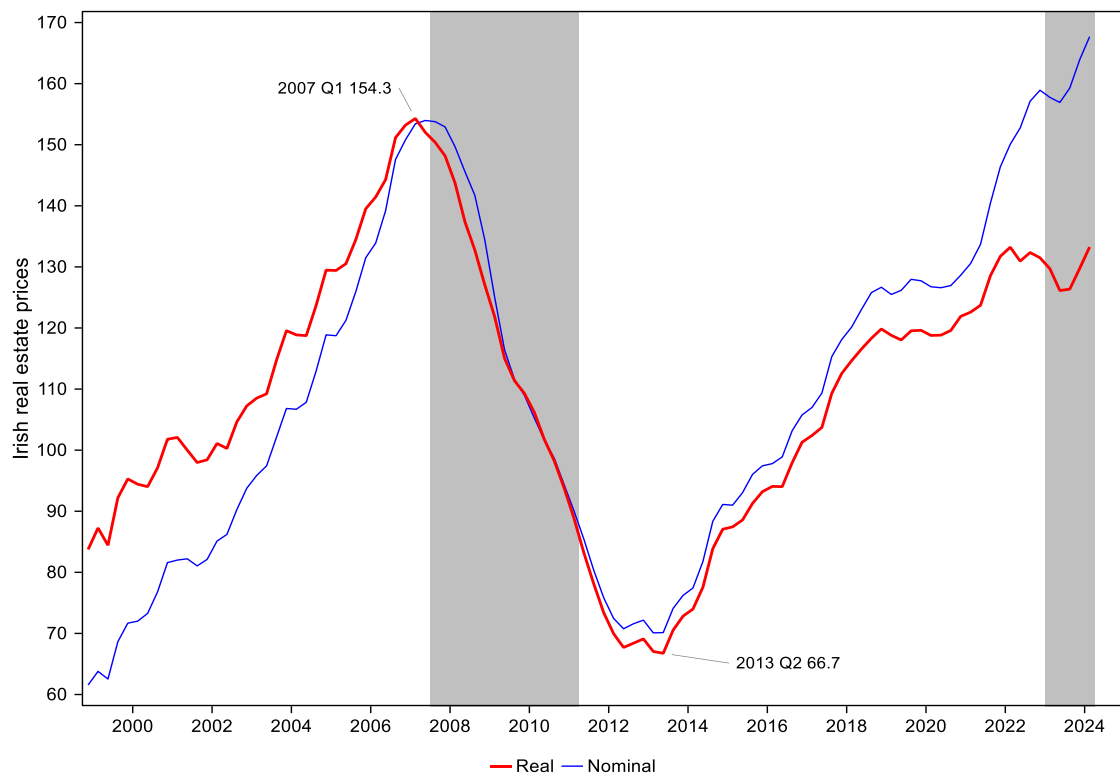
Indeed, shifting to lower growth trajectories brings other problems. In particular, it means there is less (government) money to deal with crises and payoff the voters/population (whether through tax cuts or spending hikes). High indebtedness also usually drives lower productivity growth, as policy makers print money to fund that indebtedness. Lower productivity growth then means lower average living standards (and lower real income growth for the bottom income groups in particular), which, in turn, drives divisive populist politics.

In the case of the US, though, it's getting away with it for now.

However, in many ways, it's reinforcing the dynamic that it is an exhausted Empire state. It has lost its (political) ability to 'take its medicine'. As a result it's now engaged in many of the typical signs of late stage Empire – money printing (& a debt financed fiat monetary system), political bi-partisanship, high levels of indebtedness, military overreach, etc. (see Longview Letter No. 74, July 2013 "[Is Western Secular Bear Market Over?](#)" for detailed analysis). Without an obvious alternative reserve currency, though, the US's ability to continue on this fiscal trajectory should continue. It's when an alternative or a major shock occurs, that that status is likely to be undermined. Until then, the portfolio manager mentioned earlier is probably correct. To quote the 90s band the 'Beautiful South' - we should just 'carry on regardless'. **In other words, the collapse of the dollar and the loss of its reserve currency status is an unforecastable but inevitable event.** When will it happen? Nobody knows, but increasingly it seems clear that it will happen.

With respect to **France**, it remains within the Euro area currency and therefore subject to the European Commission's fiscal rules. They, however, have had no meaningful impact since their initial Maastricht criteria iteration (and subsequent variations). They are also changed to suit the political whims of the major economies in the Euro area. More significantly, though, it's the ECB which stands behind the French spreads over Bunds. In which instance, it's the ECB which has the ability to discipline French policy makers as when it chooses (although ironically the ECB is currently run by a French politician). Added to that, the likely 'cohabitation' in French politics (left leaning government/centrist President) is likely to create deadlock. For now, therefore, French fiscal profligacy is unlikely to create a problem for the wider Euro area.

Fig 15: Irish house price index (real and nominal)



Source: Longview Economics, Macrobond

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