LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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SHORT-TERM GAIN, LONG-TERM PAIN

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KEY TAKEAWAYS

Despite the potential of a government shutdown this week, our view remains that Congress will agree on legislation to fund the federal government beyond September 30.

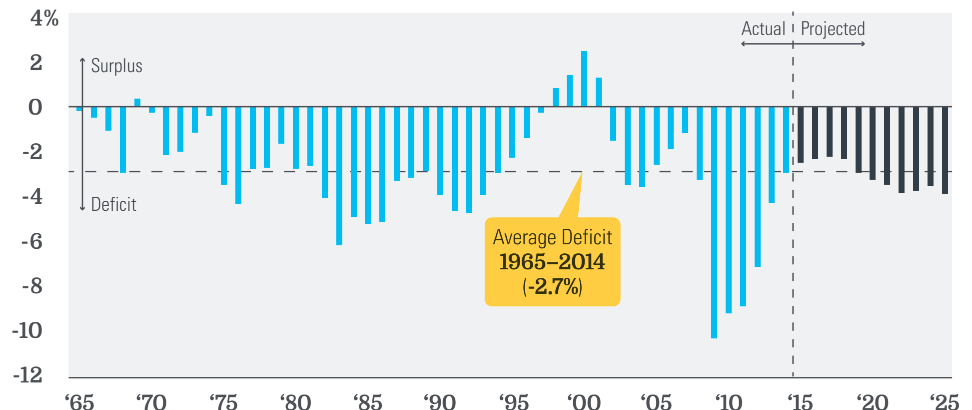
The deficit improvement in the next several years is expected to be driven by an improving economy and the spending constraints put in place by Congress over the past several years.

However, warning signs suggest the near-term improvement in the budget picture is not likely to last without action by policymakers.

The federal government's relatively calm fiscal year (FY) 2015 ends later this week (on Wednesday, September 30, 2015), but the new fiscal year may see fiscal issues returning to the headlines, with a potential government shutdown looming if Congress doesn't vote early this week to fund the government past September 30. Later this year—expected in November or December 2015—the U.S. Treasury will likely hit its congressionally determined borrowing limit, which should also generate plenty of headlines just as Americans are preparing to sit down for Thanksgiving dinner. Our long-held view is that after waiting until the last possible minute, Congress will agree on legislation to fund the federal government beyond September 30, but the risk of at least a partial government shutdown come October 1 remains.

According to a recent report by the nonpartisan Congressional Budget Office (CBO), the United States will likely run a $426 billion deficit in FY 2015, a $59 billion improvement from the $485 billion deficit racked up in FY 2014. As a percent of nominal gross domestic product (GDP), the deficit in FY 2015 is expected to be 2.4%, down from 2.8% in FY 2014 [Figure 1], leaving the public debt-to-GDP ratio—a key metric for global financial markets to assess the creditworthiness of a country—at just under 74% [Figure 2].

1 THE DEFICIT HAS IMPROVED RAPIDLY WITH THE ECONOMY, BUT BY 2025 DEMOGRAPHICS ARE LIKELY TO DRIVE IT HIGHER AGAIN



Source: LPL Research, Congressional Budget Office 09/28/15

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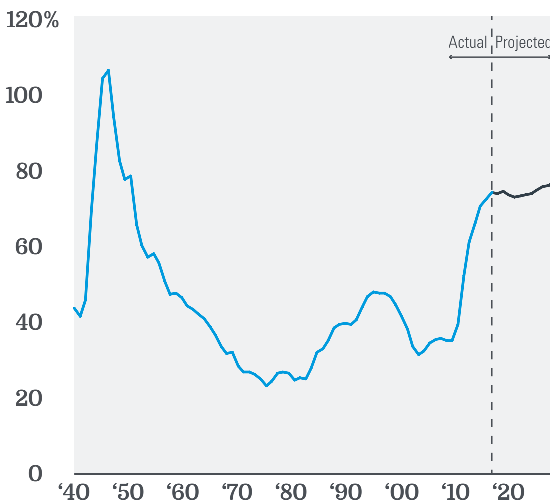
As recently as 2009, the federal deficit clocked in at $1.4 trillion, or nearly 11% of GDP; thus, the nation's fiscal situation has improved dramatically in the past six years, thanks to an improved economy and a combination of higher tax rates and limited spending increases driven by congressional actions like the sequester and the fiscal cliff. Some "one-time" items (e.g., the Troubled Asset Relief Program [TARP] and accounting related to Fannie Mae and Freddie Mac) also helped to reduce the deficit. But because the deficit—and the borrowing to finance the deficit—increased faster than the overall economy, the debt-to-GDP ratio deteriorated from around 50% in 2009 to just under 74% today.

Looking ahead, the CBO expects, and we concur, the deficit will shrink over the next three fiscal years (2016, 2017, and 2018), and by late this decade will decline to around 2.2% of GDP, which would be the lowest deficit-to-GDP reading since 2007 (1.1%), prior to the onset of the Great Recession (as shown in Figure 1). At that point, the debt-to-GDP ratio will be little changed from the FY 2015 reading of around 74%. But beginning in the last few years of this decade and into the first half of the 2020s, the CBO expects the deficit will begin to widen again. And by 2025, the deficit is expected to hit $1 trillion, or 3.7% of GDP, pushing the all-important public debt-to-GDP ratio to nearly 77% of GDP (as shown in Figure 2). According to the CBO and also in our view, the improvement in the deficit in the next several years is expected to be driven by an improving economy and the spending constraints put in place by Congress over the past several years. As noted in the section below, the deterioration expected after FY 2018 is largely driven by demographics.

2 **THE DEBT-TO-GDP RATIO HAS RISEN DESPITE IMPROVEMENT IN THE DEFICIT, BUT REMAINS STABLE FOR NOW**



Source: LPL Research, Congressional Budget Office 09/28/15

WARNING SIGNS

Some warning signs exist in the otherwise positive budget picture that has developed over the past six fiscal years. If policymakers continue to ignore these signs, the near-term improvement in the budget picture is not likely to last. In FY 2015 to date (October 2014 through August 2015), federal spending on Social Security, Medicare, and Medicaid—the three largest mandatory spending categories in the federal budget—is up a combined 8%, more than double the pace of nominal GDP growth (3.7% in the four quarters ending in the second quarter of 2015). Federal spending on Social Security benefits is up 4%, whereas spending on Medicare and Medicaid is up a combined 11%.

Most of the deficit deterioration over the next 10 years is structural, as spending on mandatory programs such as Social Security, Medicare, and Medicaid far outstrips the pace of GDP growth, mainly due to an aging population. The CBO projects that tax receipts targeted for use by those programs will only grow at the same pace as the overall economy over the next 10 years or so. Thus, the risk is that Congress and the general public will be distracted by the rapidly improving near-term budget outlook and will not address the longer-term structural budget problem quickly enough to head off a worsening long-term budget deficit.

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The good news is that the deficit, debt, and the pace of federal spending are not on the market's radar screen currently. The stable debt-to-GDP ratio over the remainder of the decade (as forecast by the CBO) also provides a window for Congress to address the underlying structural problems in the budget, which have been masked—and indeed overwhelmed—by the improving economy and the near-term spending constraints imposed by Congress on nondefense discretionary spending. Any action to address these underlying issues in the budget are unlikely until after the 2016 presidential and congressional elections, but recent history suggests that Congress likely won't act until a crisis is already underway. Oddly enough, the biggest risk is that the recent improvement in the deficit (and relative stability in the debt-to-GDP ratio) allows complacency to set in among policymakers in Washington.

The structural and demographic problems that will drive the deficit over the next several decades remain in place, and the longer policymakers wait to address them, the more difficult they become—and the more painful the solution. ■

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The economic forecasts set forth in the presentation may not develop as predicted.

Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

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