

TIME TO REBUILD THE ARK:

Why the U.S. cannot “Grow” out of its Debt. (Update 2011-05)

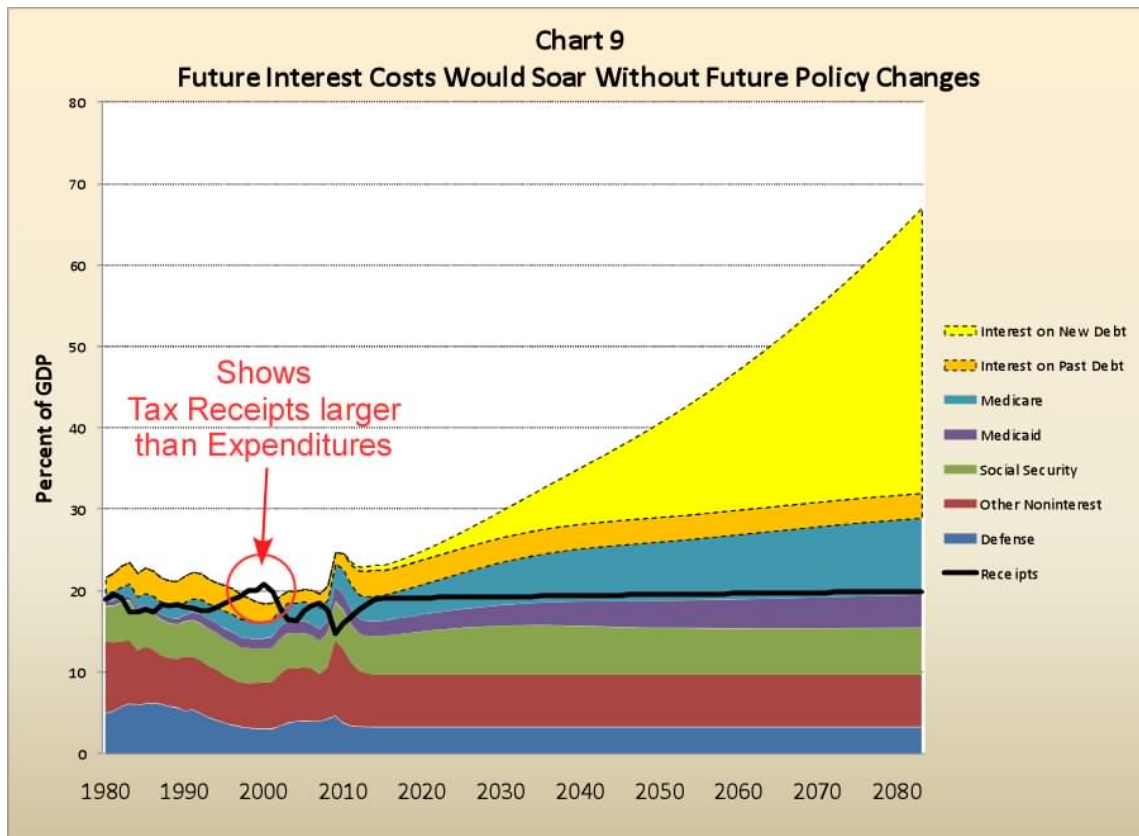
As we watch the European Union struggle with the high debt burdens of several of its members, one ponders if a similar scenario could occur in the US. The US National debt is approximately \$14.3 Trillion and growing. The GDP is estimated at \$14.8 Trillion. America’s Debt to GDP ratio is currently at 97% and climbing. The question is what does this truly mean to the average American and if the Debt is truly a problem, what steps must we take to correct it? This is not about political ideology. These numbers are telling their own story and the story is compelling.

During a discussion about the Deficit over lunch in December, 2009 with one of Colorado’s Congressmen, the Congressman casually stated that the “US will grow its way out of the Debt.” That statement, although sounded rational, raised several flags in my mind. Could it be that easy? This short analysis will discuss the Debt, the reporting of the Debt by the various Governmental Agencies, and outline two scenarios which model the financial impact of the Debt. References to the data and various sources of information are included. You are encouraged to investigate this issue and make your own evaluation of the data. For many people who have never given much thought to the subject, what is contained herein may turn out to be a serious wakeup call.

1. UNSUSTAINABLE PATH

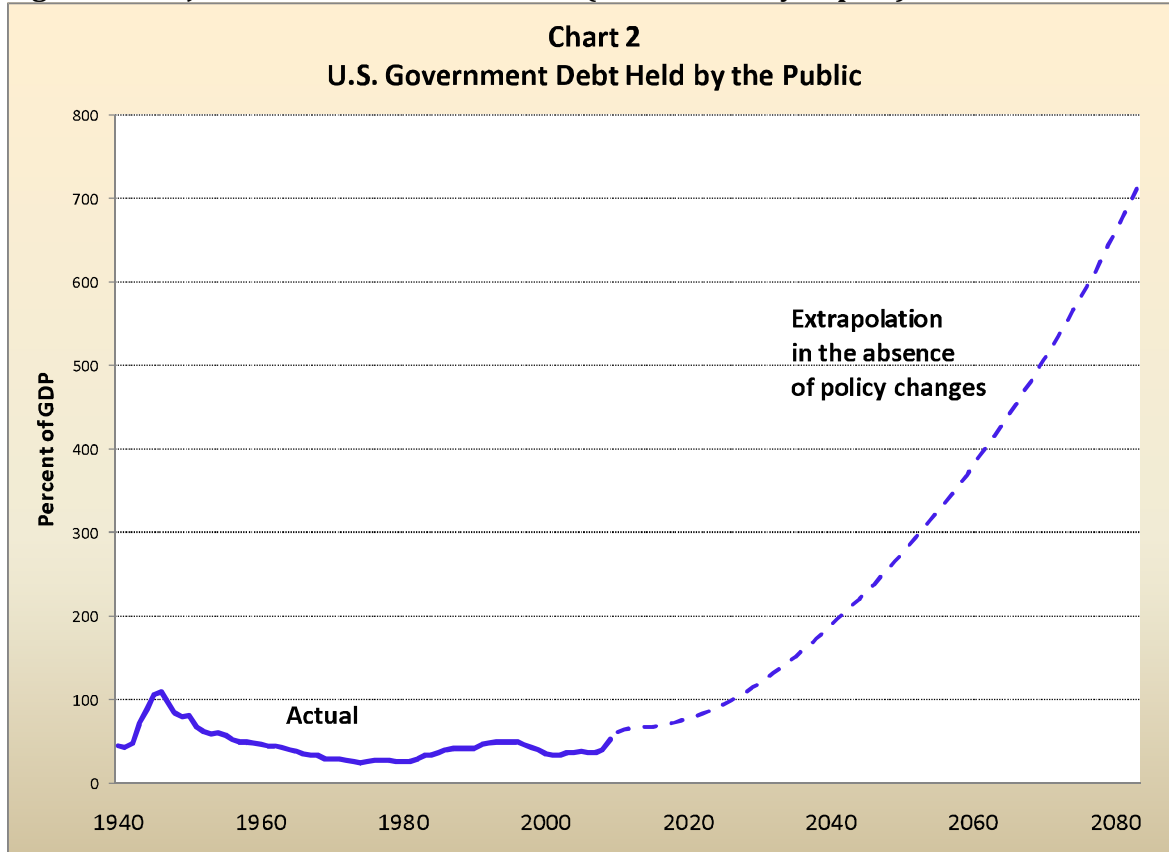
Every Government agency is projecting that the current policy course is unsustainable. Why?

Figure 1: Projected Future Interest Costs on Debt (2010 Treasury Report)



“Spending under current law for Medicare, Medicaid, and Social Security is expected to grow much faster than GDP over the next 75 years as health care costs rise and the population ages. Revenues, on the other hand, are expected to grow only modestly faster than GDP. Together, these two trends imply that without policy changes, the difference between spending and revenues (the budget deficit) will grow larger as a share of GDP.... These estimates illustrate that current policies are not sustainable.” Interest alone on the Debt is projected to soar by both the Treasury and CBO (Figure 1).

Figure 2: Projected Growth of the US Debt (2010 Treasury Report)



During World War II, there was a huge national effort to buy War Bonds to support the War effort. Although times have changed, everyone knows the full scenario shown in Figure 2 is unachievable.

Every agency has stated that the current economic policies of the US Government are charting a course for economic disaster. Apparently, the question is not “if”, but “when”? Getting to the bottom of the “when” issue was the quest of this study.

2. NATIONAL DEFICIT & DEBT

Before we can answer that question, we need some background first. The **Congressional Budget Office** provides Congress with the annual budget and Deficit numbers. The CBO states the US 2010 Deficit was \$1.342 Trillion, with a cumulative debt total of \$8,797 Trillion. (<http://www.cbo.gov/budget/budget.cfm>)

The **Treasury Department** provides “Total Public Debt Outstanding”. One would naturally assume the Treasury would take the CBO’s annual Deficit numbers every year and add them to the prior year’s “Total Public Debt Outstanding” number to arrive at the total US debt number. However, one quickly realizes the reported CBO Deficit numbers are far smaller than those reported by the Treasury for the same time period. As an example, the CBO reported the 2008 Budget Deficit was \$455 Billion while the Treasury reported it at \$1.015 Trillion. As stated above, the Total Public Debt as of the end of fiscal

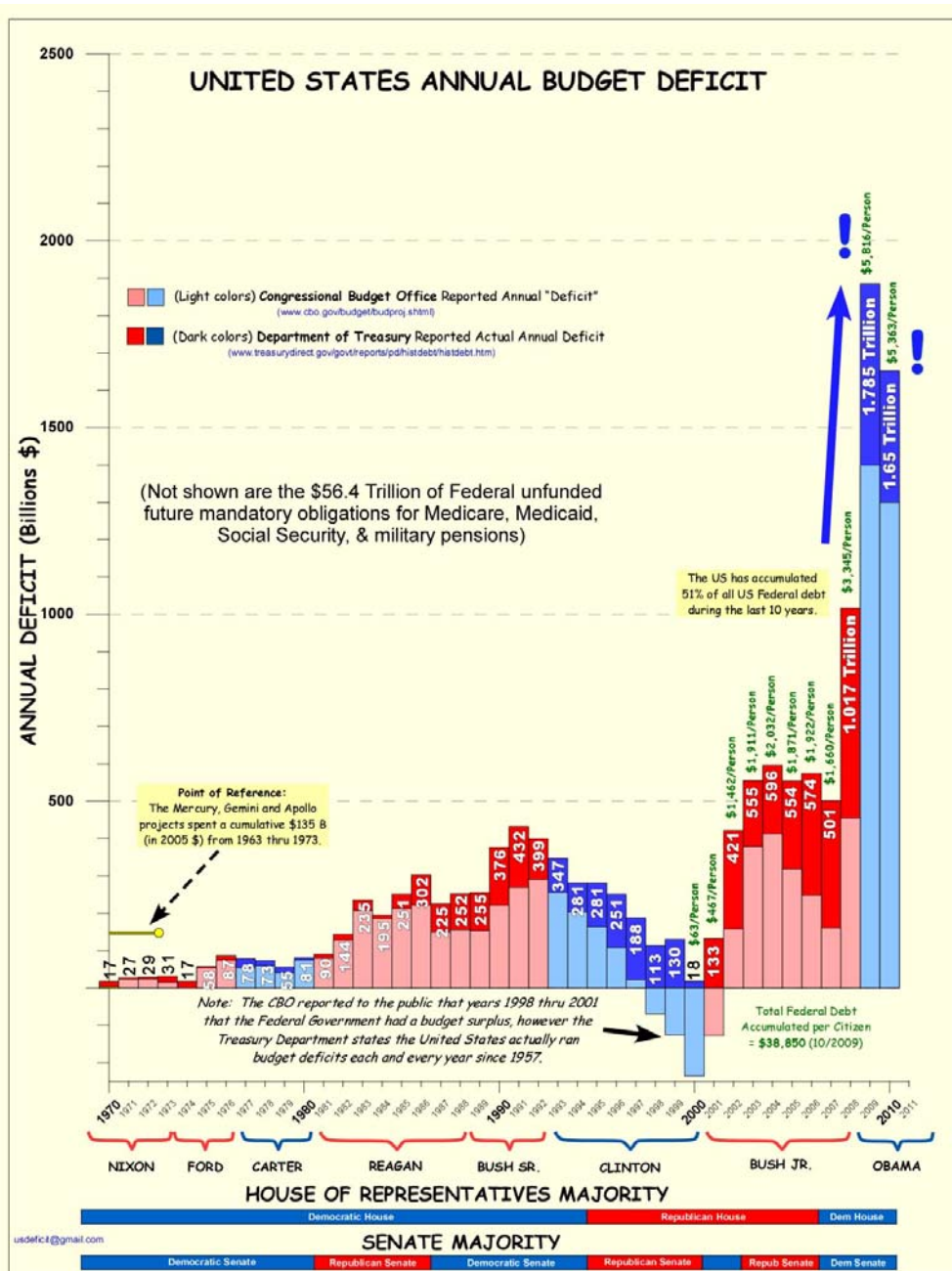
2010, as reported by the CBO, was \$8.797 Trillion, while the Treasury reported it at \$13.562 Trillion. (<http://www.treasurydirect.gov/NP/BPDLogin?application=np>)

Why is there any discrepancy between these two Government sources, let alone of this magnitude?

Figure 3: Current Debt as reported by the Treasury (May 20, 2011)

Current	Debt Held by the Public	Intragovernmental Holdings	Total Public Debt Outstanding
05/19/2011	9,716,152,725,750.72	4,629,358,121,484.54	14,345,510,847,235.26

Figure 4: United States Annual Budget Deficit



Interestingly enough, the term “Deficit”, as used by the CBO, is defined by Congress. The CBO Deficit numbers essentially only include numbers referred to by the Treasury as “Debt Held by the Public”, and do not include “Intragovernmental Holdings”. The difference between these two accounting schemes is visually apparent as seen in Figure 4.

“Debt Held by the Public” is that portion of the debt which is financed by the Treasury through several types of Treasury Securities. These securities are publically traded and purchased by individuals, financial institutions, States, local and foreign governments. Currently China and Japan hold 17% of all US Debt held by the Public. (<http://www.ustreas.gov/tic/mfh.txt>)

“Intragovernmental Holdings” is debt tied to borrowing of the cash surplus within the Social Security & Medicare funds. Until 2010, Social Security was taking in more money than its outlays. Medicare entered into the red in 2007 (Figure 5). For years, the surplus funds were placed into the Social Security & Medicare Trust Funds. In order to decrease the amount of money the Treasury borrows from the public, the Treasury has sucked the surplus cash funds out of the Social Security and Medicare “Lock Boxes” and replaced the cash with non-tradable Treasury IOU’s called “Government Account Series”. Now that SS payroll taxes are less than outlays, SS will start redeeming the Treasury IOU’s to fund the balance. To obtain the needed cash, the Treasury will have to raise the needed funds by selling Treasuries to the public (“Debt Held by the Public”). To say this simply, there are no cash holdings in the SS or Medicare Trust Funds, there are no excess cash reserves stacked up in the Treasury’s vaults, and now that the payroll tax receipts are less than outlays, the Government will have to fund the difference with more Public Debt.

Figure 5: Social Security will fall into Deficit Spending this Decade

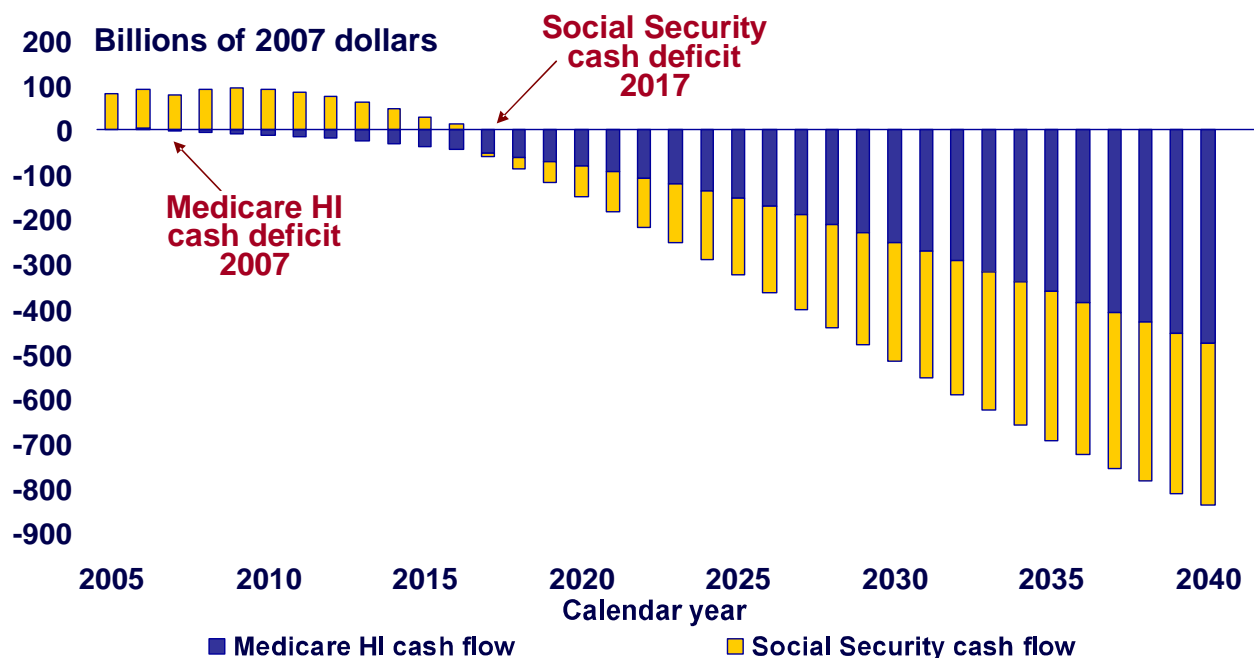
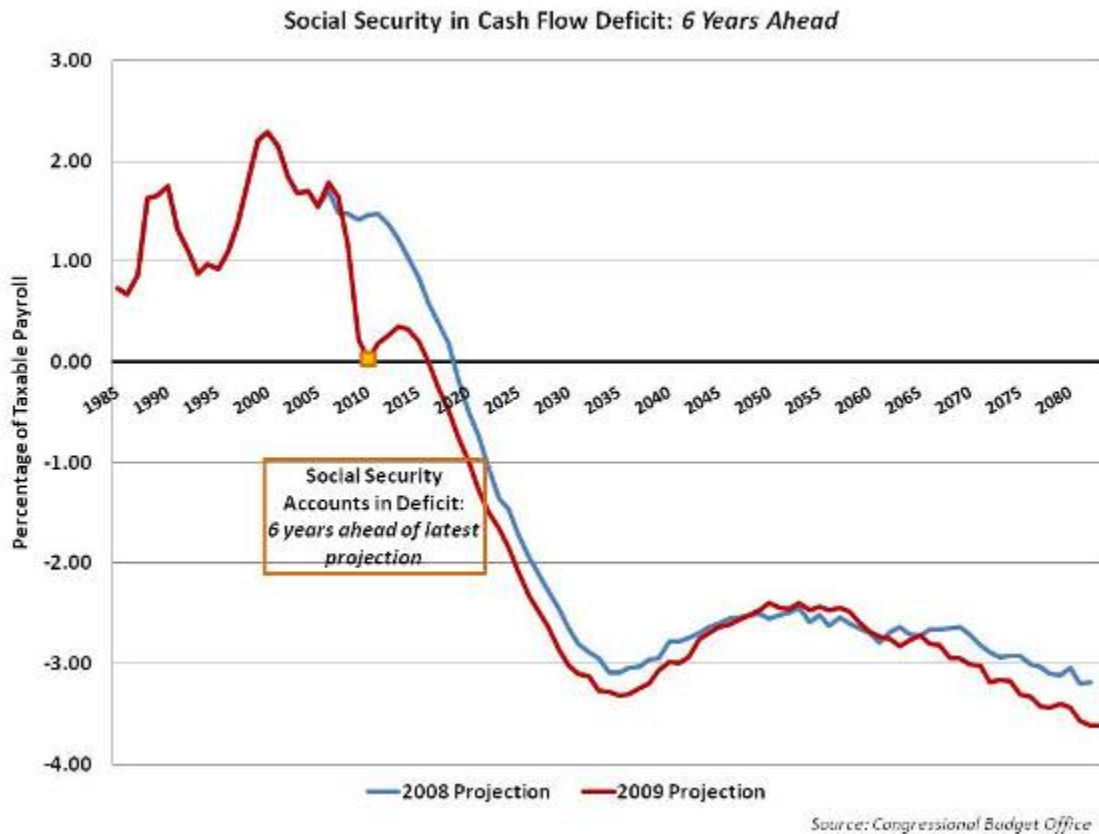


Figure 6 shows the impact of the economic crisis on Social Security payroll taxes. As the result of lower tax collections, Social Security will fall into Deficit spending 6 years ahead of earlier estimates.

Figure 6: The 2008 Economic Meltdown Accelerated Social Security Deficit Date (CBO)



“Miscellaneous Budget Exclusions” are those Federal expenditures not reported by the CBO Budget numbers and may or may not show up under the Intragovernmental Debt category.

Specific exclusions which do not show up in either debt number are those financial outlays to bail out Fannie Mae and Freddie Mac, as outlined in the Housing and Economic Recovery Act of 2008. At the time the conservatorship was put in place, the obligations were just over \$5 Trillion. Most of these funds have been repaid. However, all of these monies are **excluded from all** Debt numbers reported by both the CBO and the Treasury.

In addition, the Temporary Liquidity Guarantee Program guaranteed large amounts of obligations by banks, mutual funds and certain corporations. These guarantees are off-balance sheet and therefore are also excluded in the calculation of federal debt.

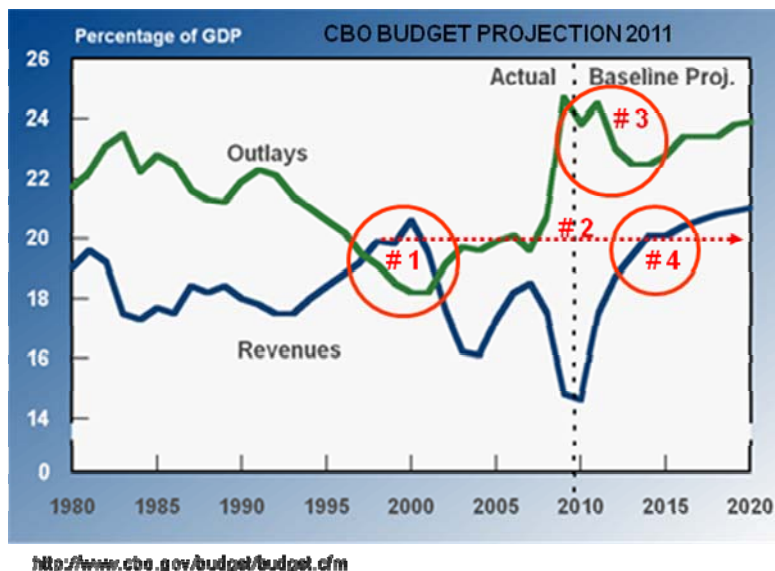
“Supplemental Appropriations” are passed by Congress in “emergency” situations and are exempt from Congressional Budget enforcement rules. Disaster relief is one example. However, the Supplemental Appropriations option has been historically misused by Congress. As example, most of the costs of the Iraqi and Afghanistan wars have been funded by Supplemental Appropriations and have not shown up in the CBO Budget and deficit numbers. CBO estimates that appropriations for operations in Afghanistan and Iraq since 2001 through February 2008 total \$752 billion. President Obama was requiring the costs of the war to be included within the 2010 Federal Budget. (<http://cbo.gov/ftpdocs/89xx/doc8971/Letter.2.1.shtml>)

Since there are insufficient tax receipts to cover the CBO's reported budget, all of the Intragovernmental Holdings, Miscellaneous Budget Exclusions, Supplemental Appropriations and Earmarks are all funded by debt. Even more interesting, even though all four categories listed above are funded 100% through debt, all such debt is specifically **excluded** from the CBO deficit numbers.

During many years since 1996, the Treasury annual deficit numbers are 2X larger than the Deficit numbers as reported by the CBO. A quick way to evaluate whether an analysis is using CBO or Treasury deficit numbers is to always look at year 2000 (see Figure 1, Figure 7). The CBO reports the US tax receipts exceeded expenditures (the US was paying down the debt). The Treasury shows the US actually ran an \$18 Billion deficit that year (Figure 4). Anytime an analysis shows tax receipts were greater than expenditures in year 2000, you will immediately know the CBO's numbers were used and only a fraction of the actual Debt and a fraction of the actual spending were incorporated in that analysis.

A person quickly realizes, after working with Government accounting data, that Government accounting and statistics are often set up to mislead you. In most cases, the Government attempts to paint a rosier picture than reality (Figure 7).

Figure 7: The CBO Budget Projection 2011



1. Tax Revenue never exceeded expenditures
2. Projected % of GDP Tax Revenues are equal to the Clinton "Glory Days" Era
3. "Future Outlays" underestimate actual expenditures
4. No mid-decade global oil-price recession

(CBO forward-looking budget projections, 2011. Note the "surplus" shown for year 2000.)

3. DEBT TO GDP RATIO

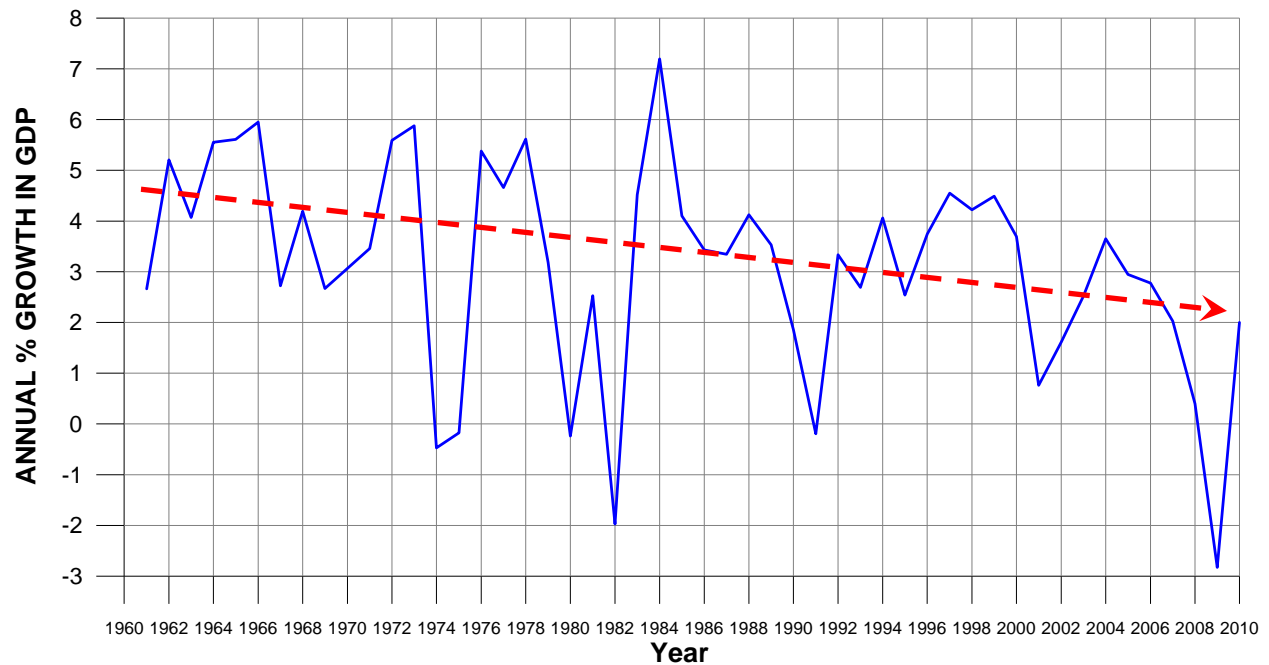
100% of all US Governmental Public Debt is interest-only cumulative debt and will never be paid off. When a Treasury note matures, the outstanding principal is paid off with new debt. This is why you never see a reduction in US Debt. The US Debt always continues to grow.

However the Debt to GDP ratio does vary. What is GDP? The **Bureau of Economic Analysis** reports real GDP as "The market value of goods and services produced by labor and property in the United States", minus inflation ("real GDP"). The BEA reports real GDP to make sure that GDP can be most accurately compared year-to-year (<http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>). At the end of WWII the Debt to GDP ratio was greater than 100% (Figure 9). During the years following, the GDP grew significantly while deficit spending during the same period was nearly eliminated. The Debt to

GDP ratio declined, falling to the low 30's by the mid-1970's (Figure 9). This relationship is known as "Growing out of the Debt". The question is "Can we do it again?"

The **Government Accountability Office** has estimated that **double-digit GDP growth would be required for the next 75 years to grow out of the Debt.** <http://www.gao.gov/cghome/d08446cg.pdf> Figure 8 shows the annual percentage growth of the U.S. GDP from 1960 to 2010. As seen, the U.S. Annual GDP growth has been declining and now averages around 2% (World Bank data, Figure 8).

Figure 8: Annual % Growth in the US GDP (World Bank Data)



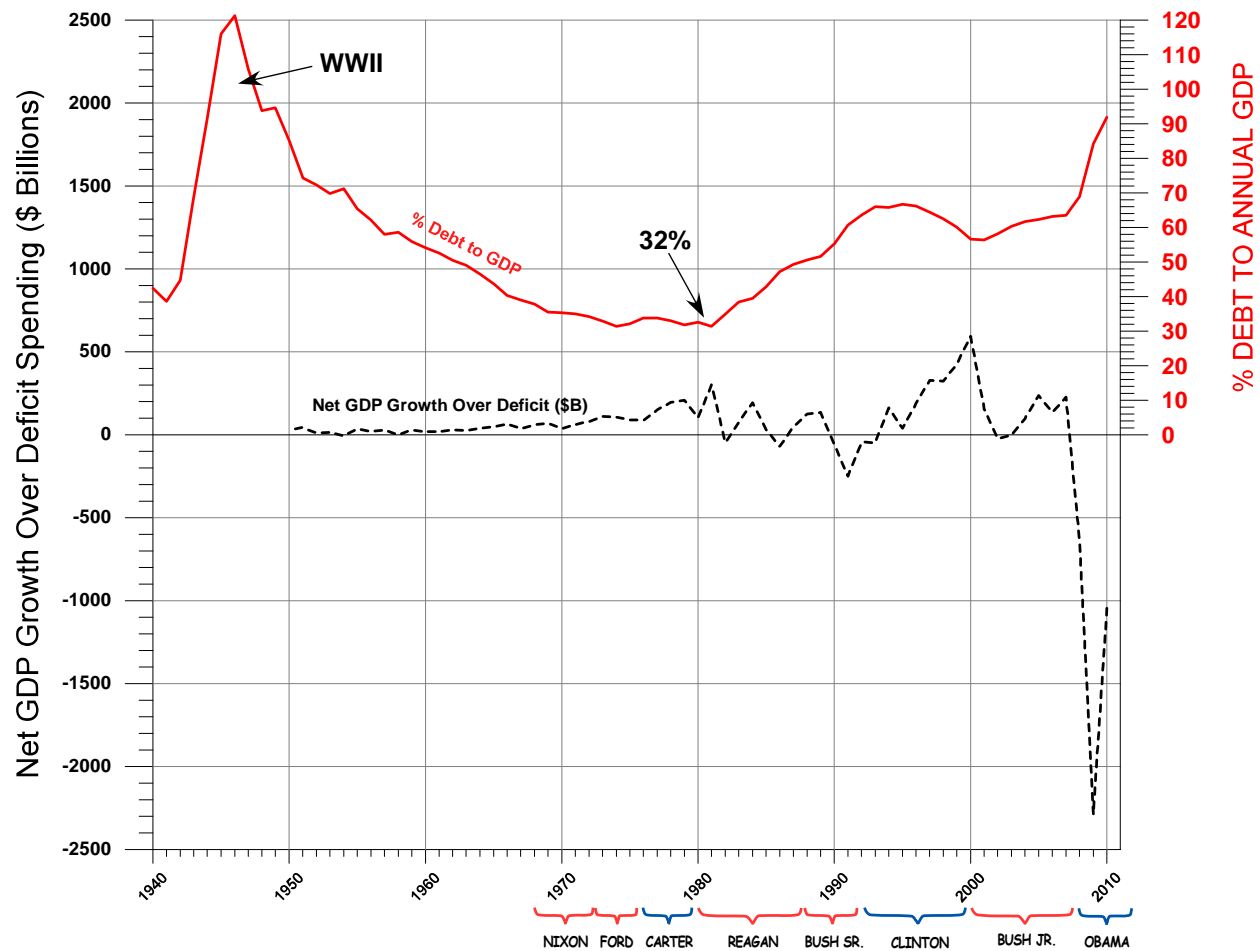
(Data: <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>)

("Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2000 U.S. dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources." Source: World Bank national accounts data, and OECD National Accounts data files.)

Also noted in Figure 9 is the "Net GDP Growth over the Deficit Spending" curve. The GDP will usually grow with increased Deficit Spending, however, if the annual GDP growth is less than the deficit spending, then the % Debt to GDP ratio will rise. As seen in Figure 9, the "Net GDP growth over Deficit Spending" was in the positive and averaged \$100 Billion/year from 1980 to 2008 (ignoring the 2008 financial collapse). This means if the Deficit Spending was \$1.63 Trillion dollars in 2010, it will take 16 years of Net GDP growth (\$100 Billion/year) just to get back to where we started at the beginning of this fiscal year (ignoring the interest on the \$1.6 T).

It is clear the US will not be able to "grow out" of the debt.

Figure 9: Percentage of Debt to GDP (<http://www.bea.gov/national/index.htm#gdp>)



4. GROWTH OF THE MONEY SUPPLY

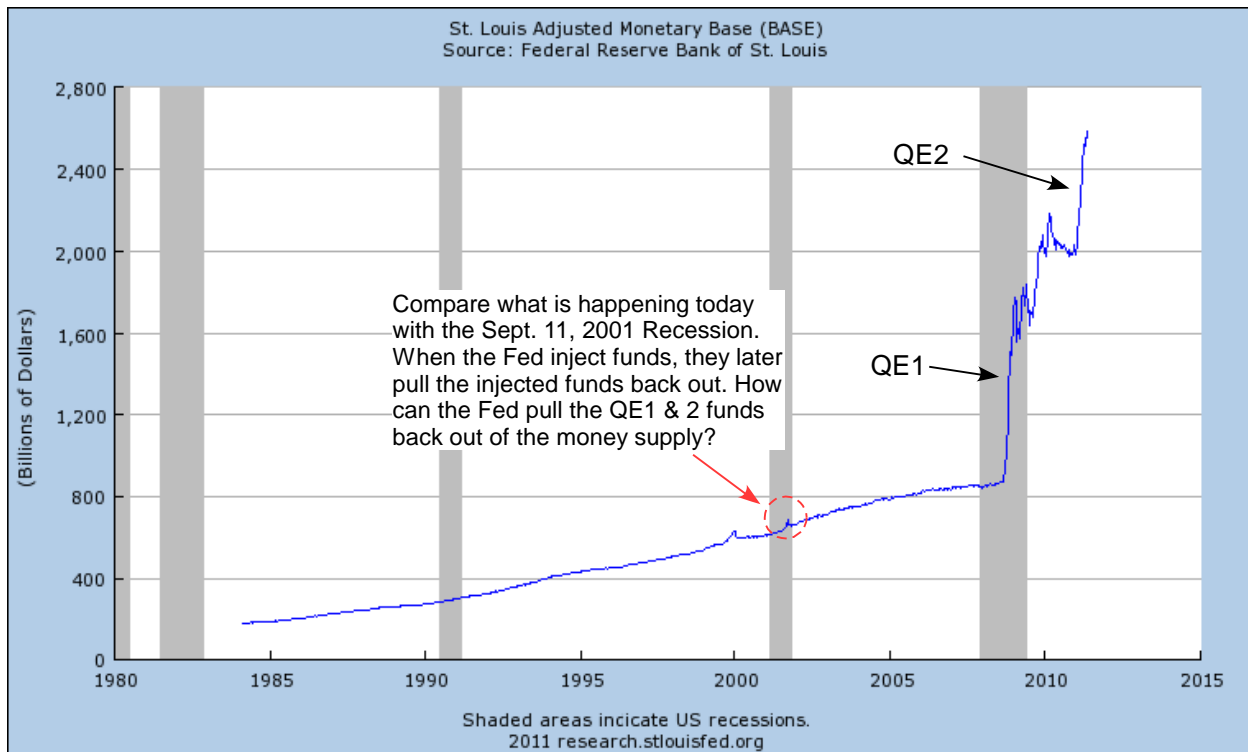
The **Federal Reserve** is responsible for setting the monetary policy of the United States, and maintaining the stability of the financial system. Since October, 2008, The Fed has nearly tripled the U.S. monetary base (Figure 10). The Fed increased the money supply as a reaction to the seriousness of the 2008 Economic Collapse. Compare the Fed’s 2008 recession response with the 2001 recession response (Figure 10). One would naturally think the tripling of the monetary base would lead to the devaluation of the Dollar, or obvious inflation. So far interest rates remain at near historic lows.

However, prices of certain commodities have more than doubled during this time period, including oil, gold, copper etc., while deflation is occurring with housing and some equities. So what is happening?

$GDP = M * V$, where M is money supply and V is Velocity of money (the rate in which money is lent and moves through the economy). The monetary base doubled in 2009, and yet the GDP fell, which seems to indicate that the velocity of money had to significantly decrease. As Tom Zaneccia states in a private memorandum he wrote “Currently, banks can borrow from the Fed at near zero interest rates and reinvest the proceeds in US Treasury securities yielding 3% to 4%. There is no incentive to lend from an investment perspective as there is significantly less risk investing in Treasuries versus individual or commercial loans. In addition, as one bank owner we know states, “the contradictory demands to increase loans while bank regulators continue to take harder looks at loans adds another layer of

paralysis.” This is the policy problem for the Fed. They have increased money supply substantially. Normally, banks would then multiply the money by lending it out, increasing velocity. But that is not happening. Bank lending has fallen percentage wise the most in almost 70 years and is still falling at about 15% annualized in 2010.” Ouch.

Figure 10: Monetary Base of the US from 1980 to 2011



<http://research.stlouisfed.org/fred2/series/BASE>

It is anticipated that the US Budget deficit will be \$869.9 Billion for the first 7 months of 2011. The Fed will be spending \$600 Billion on QE2 Treasury purchases over the same time period, effectively funding 69% of the deficit. Who will continue to fund the deficit going forward? It is a very good possibility the Fed will have to follow up QE2 with QE3. In addition to all of this, Figure 10 appears to be screaming “inflation” (the devaluation of the USD) is on the horizon.

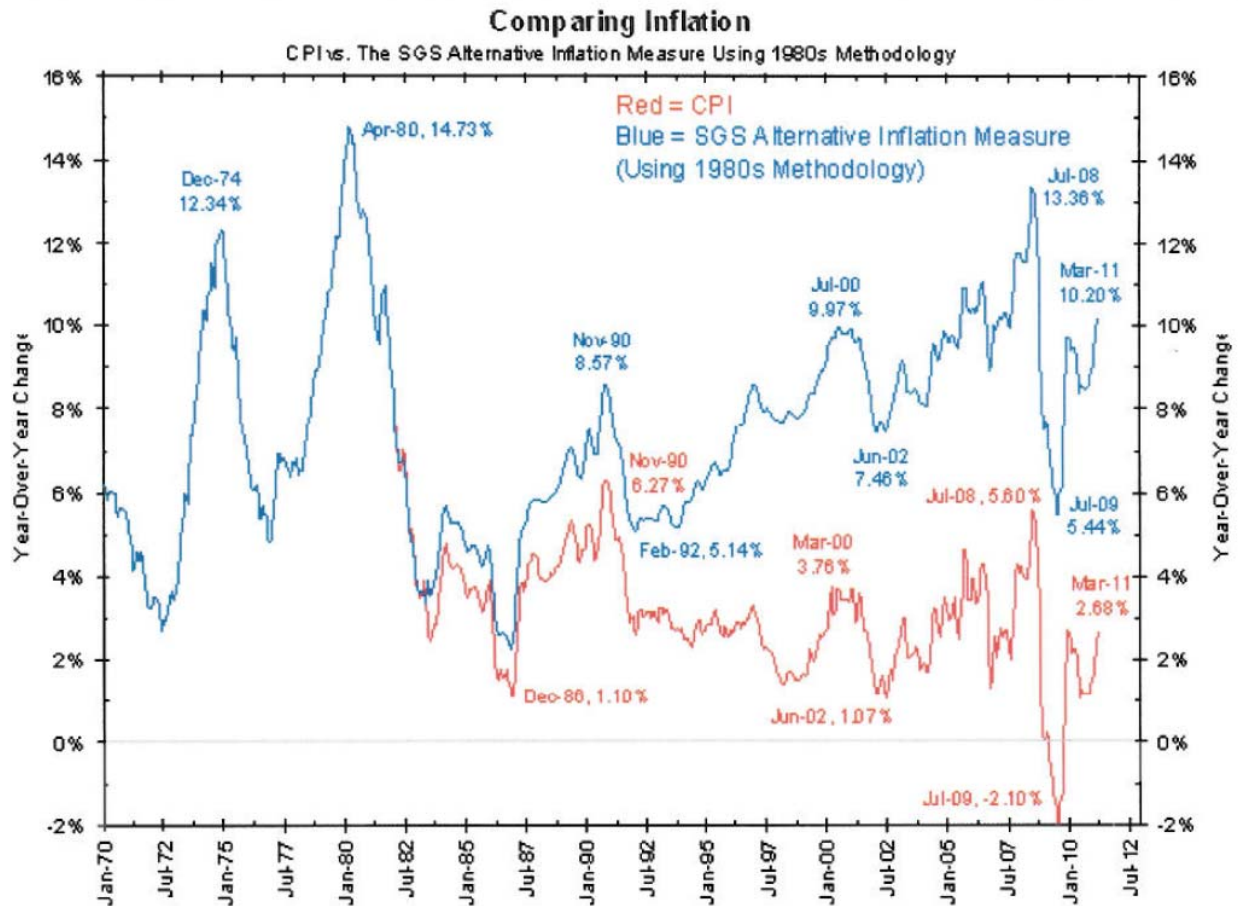
5. INFLATION

The **Bureau of Labor Statistics** produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services called the “Consumer Price Index” (CPI). The CPI provides both government officials and the public insight into inflation. The reported inflation for the month of April, 2011 was 0.4% (on a seasonally adjusted basis), and 3.2% on a non-seasonally adjusted basis (<http://www.bls.gov/cpi/>). According to the BLS, inflation is very low.

Interestingly enough, the CPI does not include food and energy. For everyone who has purchased food and gasoline over the last year, inflation of those commodities is very apparent. Regardless, as long as the Federal Government is consistent how they calculate the CPI each year, we can rate this year’s inflation relative to all years prior.

According to a study published by Shadow Government Statistics, the Federal Government has not been consistent how they calculate the CPI since 1980. There have been at least 42 changes in the calculation over the last 30 years, starting with 1981 through 2007. The effect of those changes is readily seen on Figure 11 below.

Figure 11: Current Inflation Calculated Using 1980 Methodology



http://www.shadowstats.com/alternate_data/inflation-charts

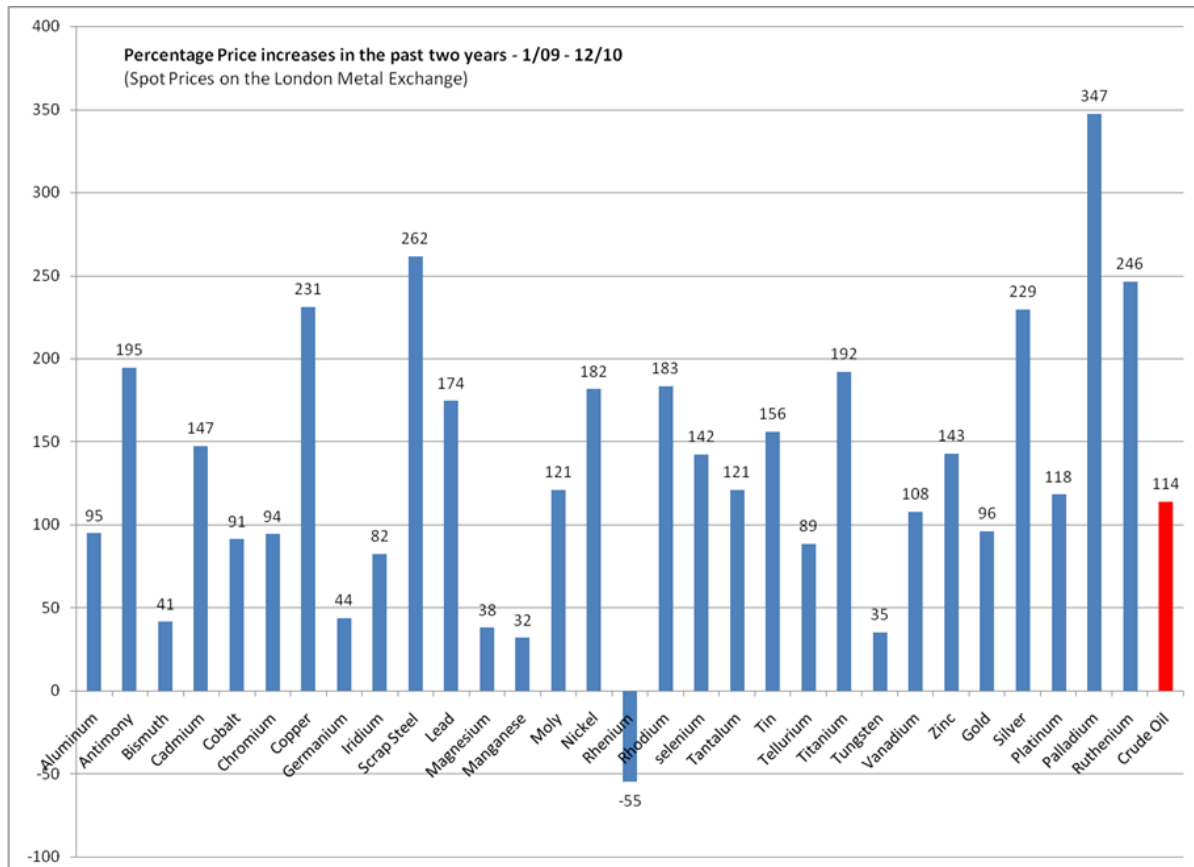
If this study is correct, and if the annualized real GDP growth for 2011 is approximately 2%, yet “real” inflation is close to 10%, the U.S is experiencing a contraction in GDP of approximately 5% in 2011. The implications are huge. Real GDP growth needs to be 3% or greater to stimulate significant job creation. In addition, the costs of those goods and services the Government purchases, including a significant portion of entitlement spending, are increasing with inflation, while tax receipts, which are tied to a percentage of the GDP, are effectively dropping.

Inflation is occurring in a host of commodity prices. Dr. Vince Matthews, Director of the Colorado Geologic Survey, has been tracking the prices of various commodities. Figure 12 illustrates the price increases experienced with an assortment of metals. The ripple effects of increased commodity prices are being felt by consumers in the cost of finished goods, and smaller lower weight serving sizes.

If inflation is approximately 10%, why are savings accounts yielding less than 1% interest? If inflation is 10%, why are Treasury yields averaging 3.2%? What would happen to U.S. interest payments on the

Debt if the average interest were 5%? 12%? This Study will attempt to model those two interest-rate scenarios.

Figure 12: Percentage Price Increases for Metals (Years 2009 & 2010)



Vincent Matthews, State Geologist and Director, Colorado Geological Survey, 2011

5. TWO ECONOMIC PROJECTION SENARIOS

The CBO provides Congress with a forward looking projection of the budget. The budget is broken down into three basic areas: Mandatory expenditures (Social Security, Medicare, Medicaid, and Military retirement etc.); Discretionary Expenditures (Defense, roads, education, subsidies etc.); and interest on the Debt.

As stated in Section 2 herein (“National Deficit & Debt”), items like Supplemental Appropriations, Earmarks, Miscellaneous Budget Exclusions, and all Intragovernmental Lending are specifically *excluded* from the CBO numbers and projections. Excluding these items makes the CBO projections deceptive and overly optimistic. The goal of this evaluation was to attempt to create a more realistic forward-looking prediction.

However, in an effort not to diverge far from the CBO numbers, only the projected Tax Receipts and the projected interest rates on the Debt were modified.

A) Variable 1: Future Tax Receipts

The CBO estimated the U.S. real GDP for the years 2011 to 2019. Projected tax receipts are based upon a percentage of the projected real GDP. The annual growth of the real GDP, assumed in the CBO's projection forecasts are:

2011	2.8475%
2012	4.0620%
2013	5.9740%
2014	6.3112%
2015	4.9014%
2016	4.7112%
2017	4.5638%
2018	4.3877%
2019	4.2830%

Are the CBO numbers realistic or optimistic? If they are optimistic, future tax receipts will be overstated.

A Study published by Reinhart and Rogoff in 2010 shows the relationship of Government debt to GDP. As government borrowing grows, the rate of growth of a country's GDP drops. When a country's Debt to GDP is at or above 90%, the average growth rate of their GDP drops to below 2% (Figure 13).

FIGURE 13: A study completed of more than 250 historical crises in 66 countries details the relationship of government debt to GDP:

Real GDP growth as level of government debt varies

Select advanced economies (1790-2009)

	Central (federal) government debt/GDP			
	Below 30%	30% to 60%	60% to 90%	90% and above
Average	3.7	3.0	3.4	1.7
Median	3.9	3.1	2.8	1.9
Number of observations	866	654	445	352

Select emerging market economies (1900-2009)

	Central (federal) government debt/GDP			
	Below 30%	30% to 60%	60% to 90%	90% and above
Average	4.3	4.1	4.2	1.0
Median	4.5	4.4	4.5	2.9
Number of observations	686	450	148	113

(Source: "Growth in a Time of Debt" by Carmen M. Reinhart and Kenneth S. Rogoff as of January 7, 2010)

If this is true, then as an advanced economy, the U.S. GDP cannot be expected to have long-term growth much higher than 2% going forward. With the Federal Government borrowing so much money from the private sector, how can commercial lending build to support 6% real GDP growth? Future GDP predications are the essential ingredient when formulating future tax receipts predictions.

Therefore, it was clear that one key criterion needing to be modeled was the annual growth rate of the GDP. The annual growth rate was lowered from the CBO's 4% to 6% growth projections down to 2.72%. Decreasing the GDP lowers the projected tax receipts, and hence raises the projected deficit.

B) Variable 2: Future Interest Rates Prediction

The CBO estimated the future interest rate on the debt to average 3.2% in 2010 and increase to 3.8% by 2019. Most people suspect interest rates are going to rise due to the doubling of the money supply and the huge projected deficit spending. In order to attract investor money to the increasing Treasury sales, higher interest rates will be required by the investor. Currently interest rates are extremely low as investors flee European debt to more secure havens, and also due to bank purchases. As the U.S. debt continues to climb, Treasury securities will most likely look less favorable.

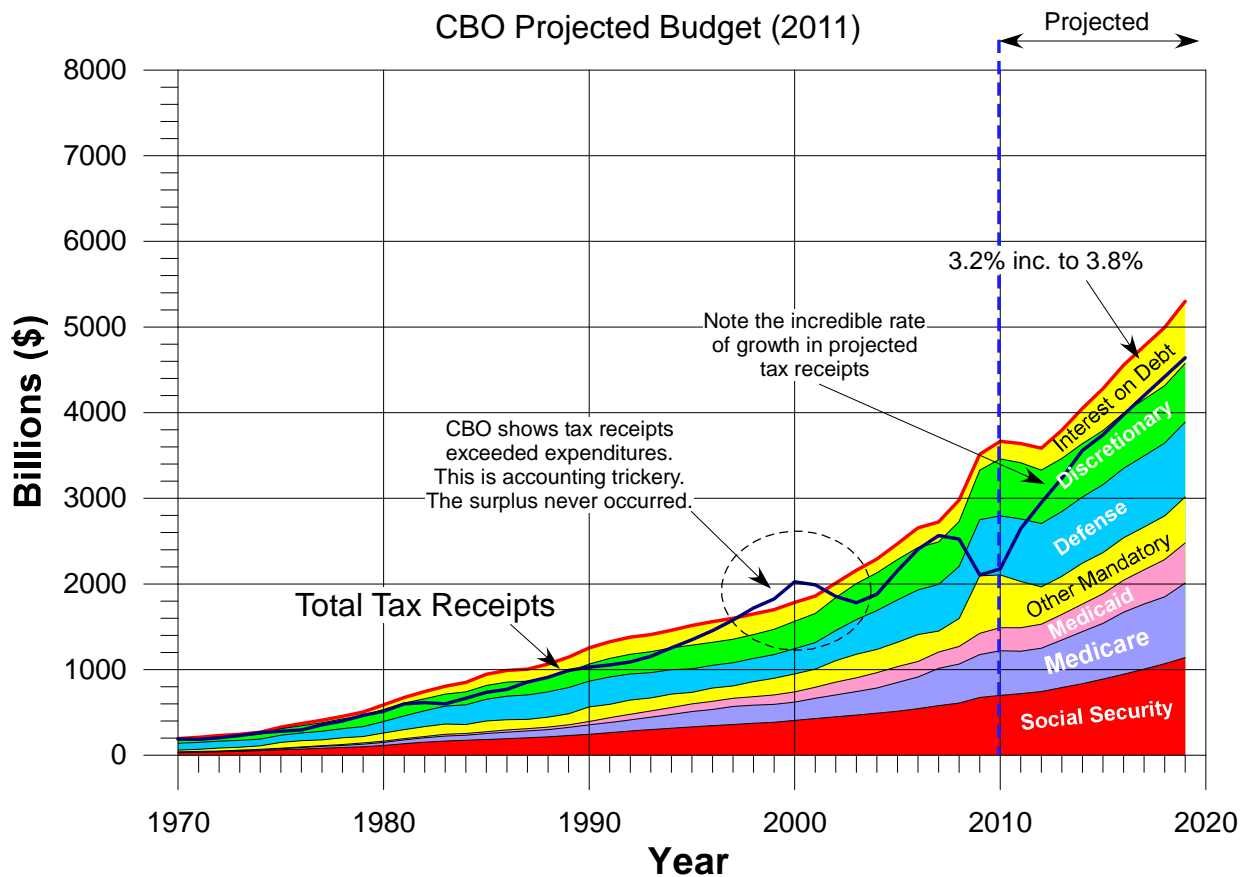
Interest rates were the second key criterion to be specifically modeled. Interest rates were increased from 3.2% in 2010 to 5.4% in 2019. A high inflation scenario was added by taking interest rates from 3.2% in 2010 to 12% in 2019. The high inflation scenario is not realistic because it is almost impossible to model tax receipts accurately. Regardless, the impact of high inflation is very apparent and illustrates why the Feds are working to keep interest rates down.

SENARIO 1: THE CBO BASE-CASE FORECAST

The CBO Budget, interest rate, and tax receipt projections, combined with the historic CBO debt data were used to compile the Scenario 1 projection. In essence it shows a stable future with tax receipts staying up with growth in spending (Figure 14).

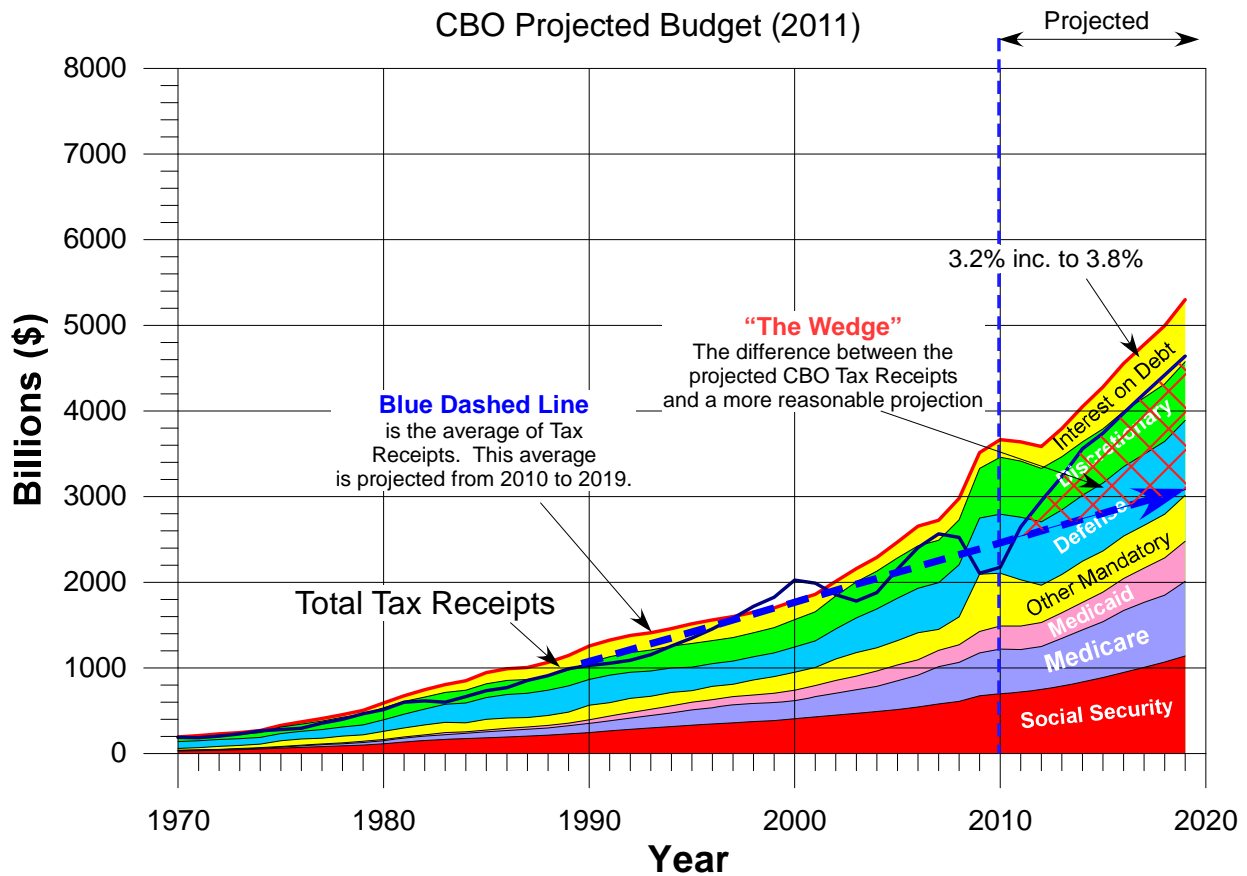
Before you get too excited, one must realize that \$300B to \$500B of additional annual expenditures are missing, including the Intragovernmental borrowing, Supplemental Appropriations and earmarks. It also includes GDP growth rates not seen in recent history, and requires the continuation of near historic low interest rates on the debt. This is the only scenario which displays a stable forecast for this decade. The Budget numbers used herein do not include the projected budget and deficit costs of the new ObamaCare entitlement program (free healthcare for over 30 million people living in the U.S.).

Figure 14: CBO-Based Projected Budget and Tax Forecast



Study the Tax Receipt revenue projection for years 2011 to 2019 on Figure 14 for a minute. Does the CBO projection look realistic, or does it look optimistic? (To further illustrate the optimism of the CBO Tax Receipt projections, go back and relook at the CBO projection on Figure 7.) If we were to make a straight line Tax Receipt projection based off of the historic data, the Tax Receipt projection for years 2011 to 2019 might look as shown on the next Figure 15.

Figure 15: Is the CBO Tax Receipt Projection Realistic or Optimistic?



This straight-line projection requires an annual Tax Receipt growth of 2.72%, which is still nearly 1% higher than 1.7% average growth suggested by the Rogoff study. The difference between the projected CBO Tax Receipts and the straight-line Tax receipts is called “The Wedge”. The difference between these two tax receipt scenarios (The Wedge) would have to be borrowed, and the interest paid on that additional debt added to the Interest on Debt expenditures.

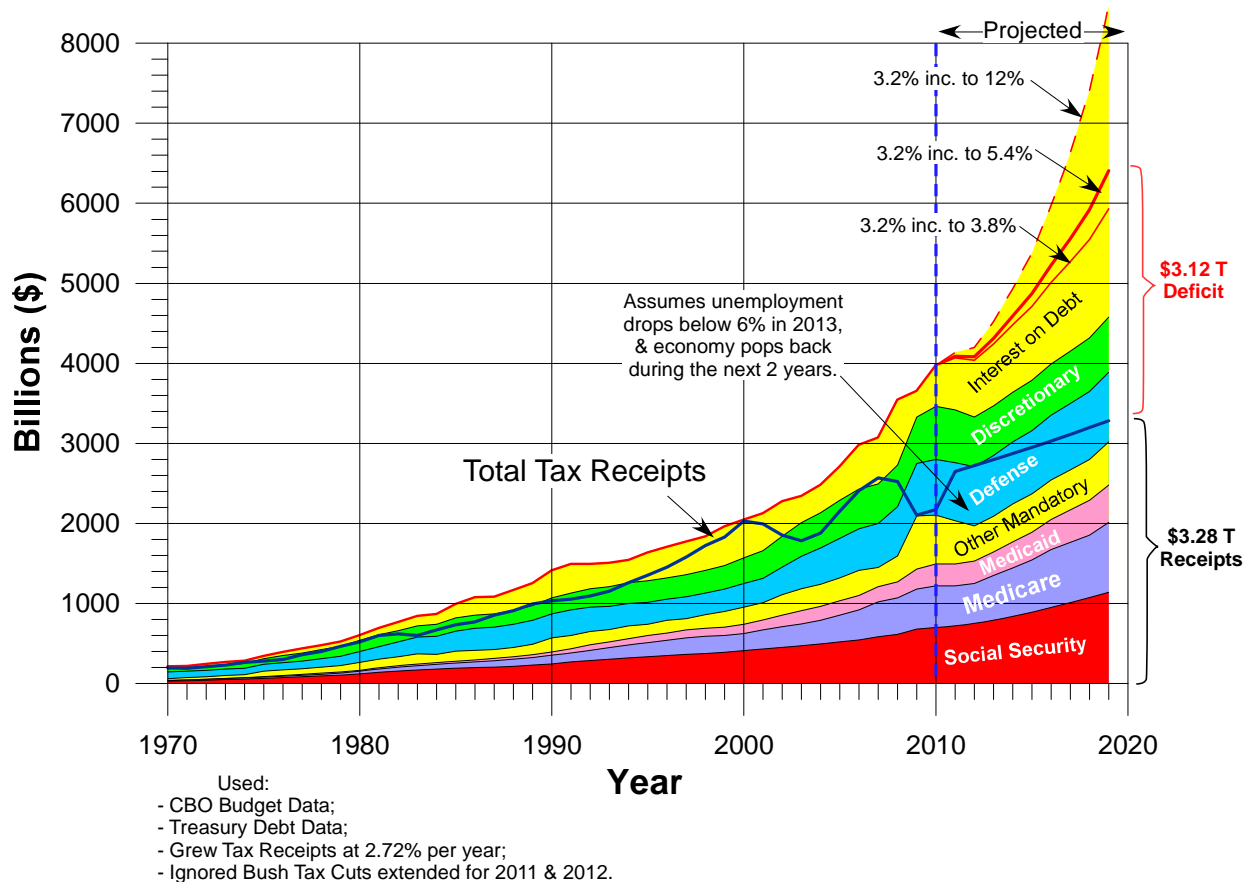
SCENARIO 2: THE 2% GDP GROWTH AND VARIABLE INTEREST RATES FORECAST

The CBO Budget, 2.72% tax receipt growth projections, and interest rates, combined with the historic Treasury debt data were used to compile the Scenario 2 projection. Reducing annual GDP growth to 2.72% has a chilling effect on the projected Deficit. By 2020, the projected annual budget deficit would be more than twice the annual tax receipts and growing.

The impact of the various interest rate scenarios is also shown in Figure 16. In the event significant inflation occurs, the impact on the interest payments on the debt would be devastating.

Regardless of which interest rate scenario is employed, the failure to increase annual real GDP growth to levels above 4% will lead to serious economic repercussions this decade and implies a potential future currency crisis for the dollar.

Figure 16: Projected Interest Rate Sensitivities



Before you completely embrace the Scenario 2 projection, realize this Scenario only shows what could happen if Congress does not step in and significantly cut expenditures, and if the economy remains effectively stalled at 2% growth. Currently there is a growing bi-partisan effort to address this problem in a more realistic fashion than just cutting \$38B out of the budget.

Since the Dollar acts as the “Global Currency”, the world community will tolerate more from the U.S. than from a country like Greece. That said, there are still financial limits, and the unsustainable growth in expenditures over tax receipts must be taken seriously and dealt with quickly.

6. CAN WE TAX OUR WAY OUT?

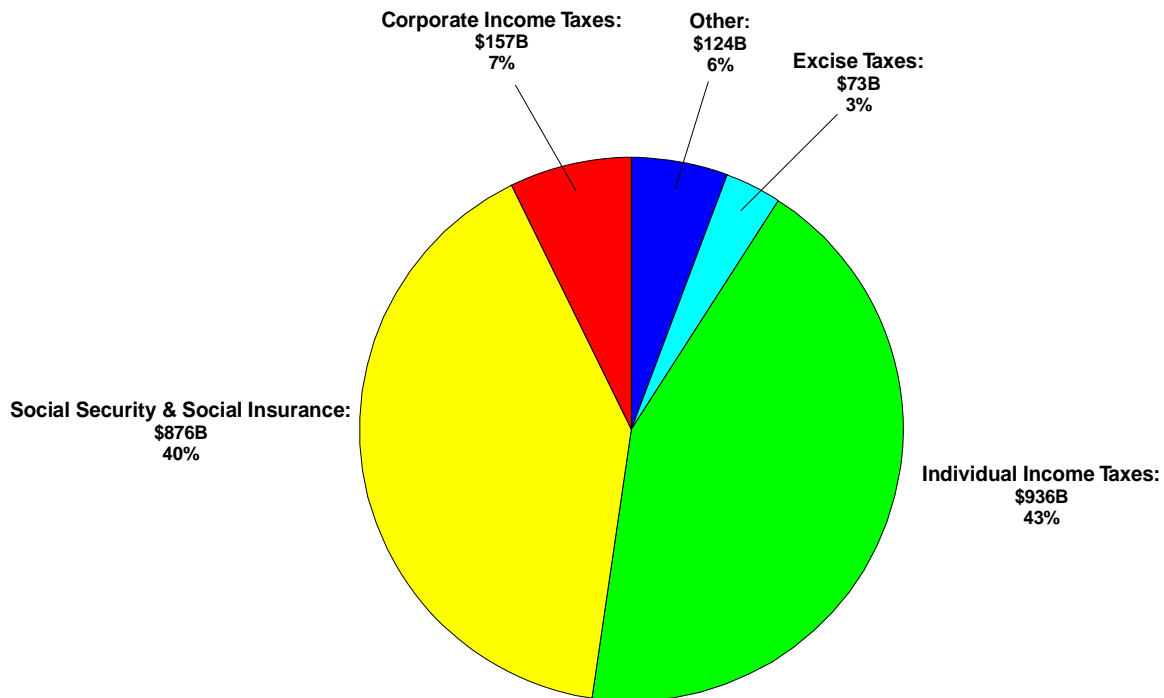
Personal Income Taxes provide between 43% to 45% of the total annual tax receipts received by the Government (Figure 17). It is estimated that 2010 Personal Income Tax receipts will be approximately \$0.936 Trillion. The Treasury is estimating the 2010 deficit will be \$1.63 Trillion. The Federal Government would have to more than double Personal Income Taxes to balance the budget this year.

Increasing taxes usually has a negative effect on GDP growth. More often than not, the Federal Government will provide tax relief during times of economic downturns to help spur the economy. So what does the Fed need to do?

The Bush Tax Cuts were extended another 2 years. It is estimated that the annual loss in Federal tax revenue from extending the Bush Tax cuts is approximately \$400B/yr.

Former GAO Director David Walker stated: *"Some people think that we can solve our financial problems by stopping fraud, waste and abuse or by canceling the Bush tax cuts or by ending the war in Iraq. The truth is, we could do all three of these things and we would not come close to solving our nation's fiscal challenges."* (http://en.wikipedia.org/wiki/United_States_federal_budget#cite_note-92)

Figure 17: U.S. Federal Receipts by Income Source, 2010 (in Billions of Dollars)



<http://www.whitehouse.gov/omb/budget/Historicals>

According to the Tax Policy Center, *"About 47 percent will pay no federal income taxes at all for 2009. Either their incomes were too low, or they qualified for enough credits, deductions and exemptions to eliminate their liability. The result is a tax system that exempts almost half the country from paying for programs that benefit everyone, including national defense, public safety, infrastructure and education. It is a system in which the top 10 percent of earners -- households making an average of \$366,400 in 2006 -- paid about **73 percent of the income taxes** collected by the federal government."* (<http://finance.yahoo.com/news/Nearly-half-of-US-households-apf-1105567323.html?x=0&.v=1>)

The U.S. fiscal problem is far larger than the Bush Tax Cuts and will require a combination of both tax increases coupled with significant spending cuts with both discretionary and mandatory budgeted items. All Americans, including the middle class, will need to shoulder this burden. To say this in other terms, to effectively tackle this problem by significantly raising taxes on everyone and decreasing entitlement spending may mean political suicide.

Can we tax our way out without large associated spending cuts? The answer is clearly no.

7. CAN WE INFLATE OUR WAY OUT?

During 2009 & 2010, tax revenue was only sufficient enough to cover the entitlement programs. All Discretionary programs, Defense and 100% of the interest on the debt was funded by debt (Figure 14).

Inflation may certainly help with the existing debt service, however how do you inflate out of future Defense, education, highways and bridges, etc? In addition, since the U.S. is making interest-only payments on the Debt, and as the retiring Treasuries are refinanced with new Treasuries, those new Treasuries will be paying at the higher interest rates. Hyperinflation is not a choice.

8. TIPPING POINTS

The question is what can you do about it? If Congress is unwilling to seriously tackle the Deficit problem, economic upheaval is probable in our future. The crisis will probably commence as the result of a sell-off in U.S. Treasuries. This will occur at the point in time when the market realizes the U.S. cannot service the debt. The question is “when”? Scenario 2 (Figure 16) indicates that without policy changes, it could occur this decade, and perhaps sooner rather than later. Some items to look for are:

1. Low GDP growth numbers below the CBO forecasts. This will mean tax revenues will be less than the CBO projected;
2. Higher interest rates on Treasuries. Higher rates mean higher deficit spending on interest payments. Higher rates usually lead to lower equities and a retreat of the stock market;
3. Unemployment numbers remaining high. Unemployment expenditures will stay high and tax revenues will be lower (see Figure 14, year 2009 “Other Mandatory”);
4. Oil prices spiking above \$100/BBL. High oil prices act like a tax and usually drive the world’s economies into recession.

The moment investment capital becomes spooked, everything can change almost overnight. It is like trying to catch a falling elephant. The key is to recognize the signs before it happens.

At the point in time the market realizes the U.S. will be unable to service its debt, life as we know it will change.

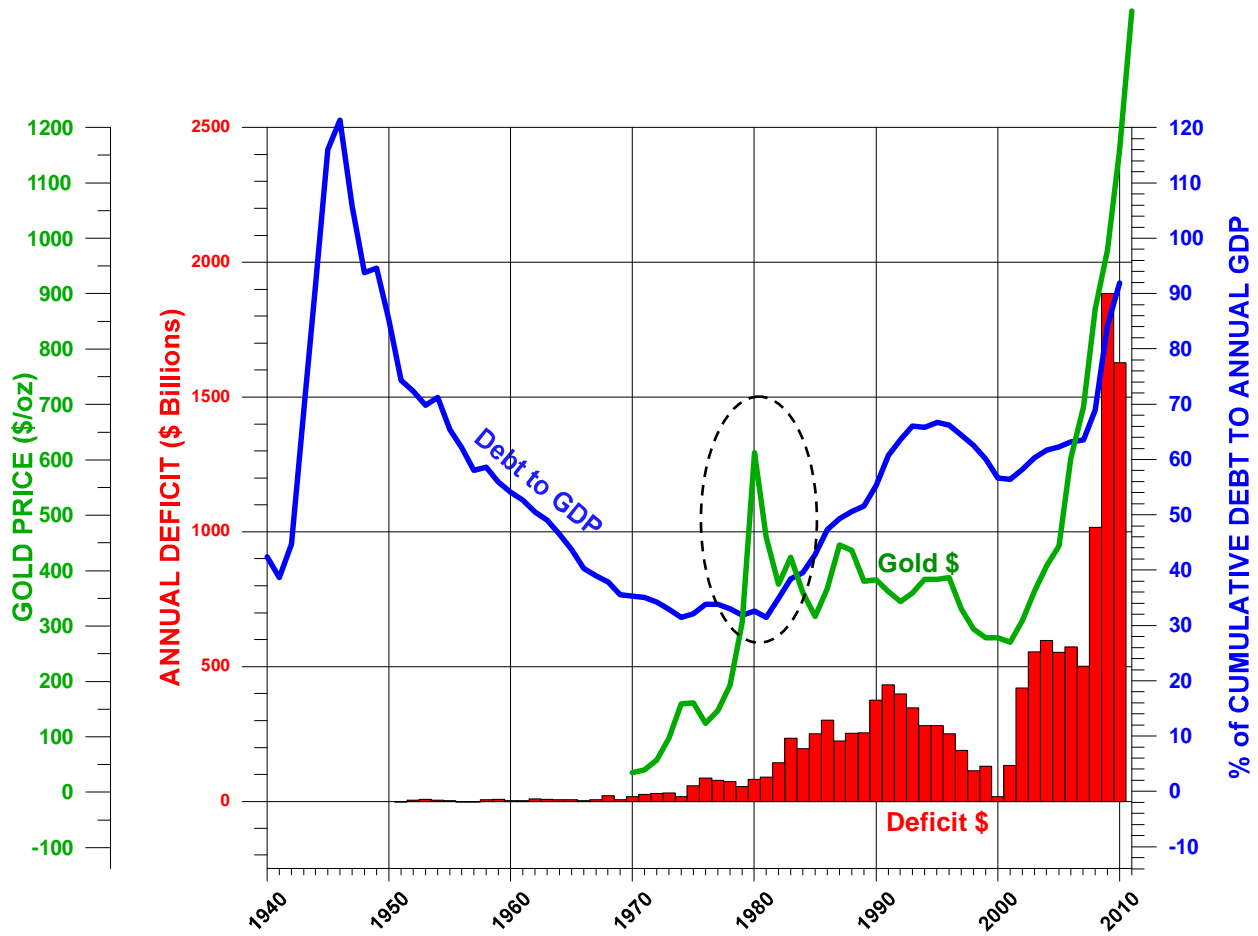
9. CONCLUSION: REBUILDING THE ARK

If you are unable to change the course of Washington, you must prepare personally. This is not about political ideology. The numbers speak for themselves. Not sure what to believe? Study the data and make your own evaluation.

As for investments, I have decided not to make any recommendations for obvious reasons. Sit down with your financial planner and see if you agree with your investment portfolio. There are always good investment opportunities, however one must carefully manage your portfolio and adjust to the times. As an example, if you think inflation might be on the horizon, do you want to be locked into long-term low fixed-interest Treasuries or Municipal bonds? Are those companies, whose products or services are reliant upon Federal subsidies to be commercial (i.e. wind and solar), still good investment opportunities? What will happen to equity P/E ratios if inflation starts to creep in? Are hard assets good

investment opportunities? What types of debt should you not be carrying? These, and a host of other questions, need to be addressed with your financial advisor, sooner rather than later.

Figure 18: Price of Gold appears to be Tracking Deficit



(Note the Jimmy Carter "bubble")

10. FINAL EXAM: "DON'T BELIEVE EVERYTHING YOU READ AND HEAR"

When it comes to the Federal Deficit and Budget, always evaluate the validity of what you read and hear. The Federal budget numbers are set up to deceive and there are plenty of mullets in the public, press and on the news the CBO preys upon. This paper provides the basic understanding and tools you need to avoid being sucked into opinions of those who have not completed their homework. As an example, what is wrong with the following (Parade Magazine, March 28, 2010)? The answer to that question should now be immediately obvious to you. If not, you need to go back and closely re-read this paper.

It's your future. Good luck to us all.

ECONOMY

Does America Owe Too Much?

Critics of government spending are voicing alarm about the growing national debt. In January, the U.S. public debt was \$7.5 trillion—about 53% of the country's total economic output, also known as gross domestic product (GDP). By comparison, Japan's debt-to-GDP ratio was 192% and Saudi Arabia's was 20% in 2009, according to the latest figures available. Economists use the ratio of public debt to GDP as an indicator of a country's economic health. So what do these numbers mean? Is America's debt level dangerous?

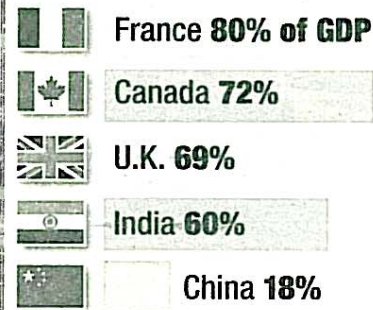
The short answer is, "No, but it might be soon." A recent study from the National Bureau of Economic Research found that public-debt levels become perilous when they reach 90% of GDP. By that point, interest rates may be higher as investors demand

greater returns on federal bonds, while massive interest payments detract from key government functions. "The interest can get so burdensome that the country can't afford to repair its highways or educate its children or provide other essential services," says Isabel Sawhill of the Brookings Institution. "You become a much weaker nation."

According to the Congressional Budget Office, U.S. public debt could approach 100% of GDP by 2020, given current spending levels and obligations for entitlement programs like Medicare, Medicaid, and Social Security.

Debt Around the World

America's public debt is now 53% of GDP. Here's how other countries stack up.



Source: CIA World Factbook; figures based on 2009 estimates

Do you fear that our national debt will hurt our economy? Vote at Parade.com/debt

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Additional Data Links:

<http://www.cbo.gov/budget/budproj.shtml>

<http://www.cbo.gov/budget/budget.cfm>

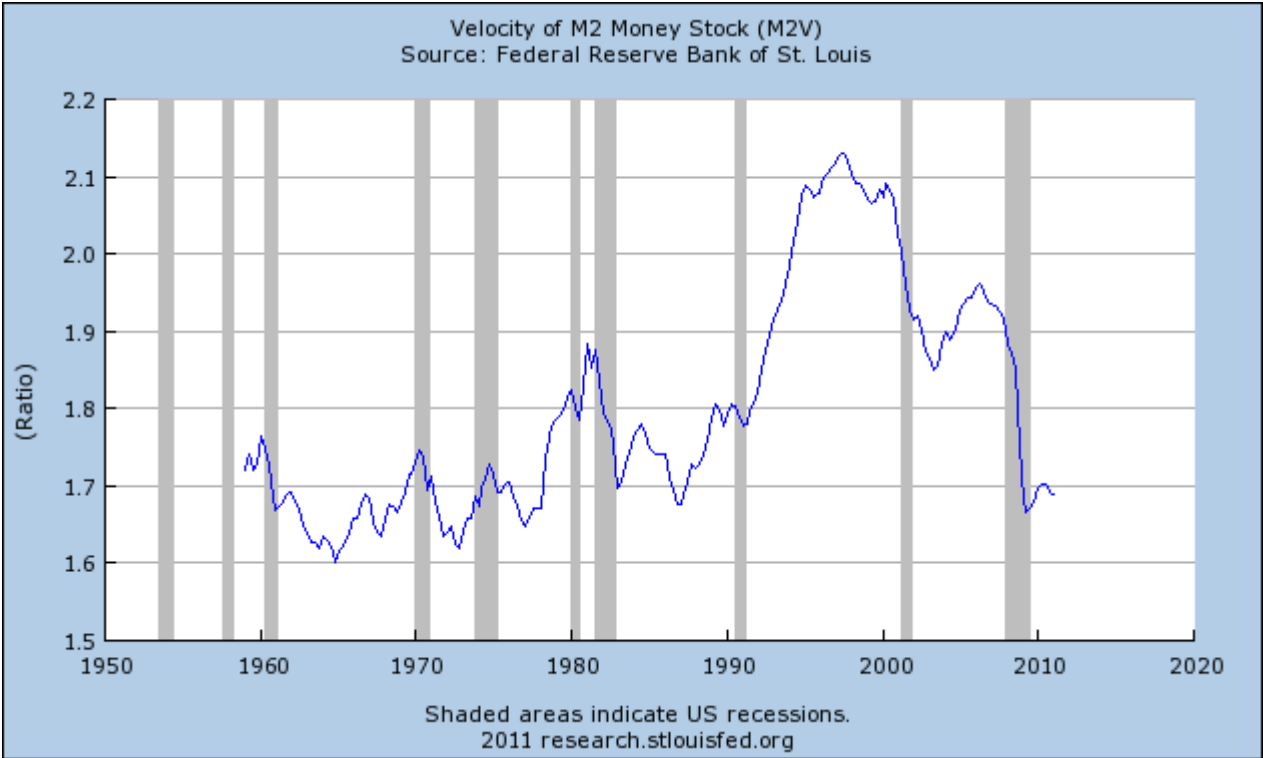
http://www.cbo.gov/ftpdocs/108xx/doc10871/Historicaltables2010Jan_forweb.XLS

<http://www.bea.gov/national/index.htm#gdp>

<http://www.publicdebt.treas.gov/>

<http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>

Velocity of M2 Money Stock (M2V)



<http://research.stlouisfed.org/fred2/series/M2V>