The Unaddressed Debt Problem

For 16 days this month, parts of the federal government shut down as Republicans and Democrats in Congress reached a stalemate over federal spending, the debt limit and the costs of Obamacare. Hundreds of thousands of federal workers were forced to stay home. National parks and monuments where shuttered. And much of the business of Washington ground to a halt.

But a deal to raise the country’s debt limit and re-open the government was reached just hours before the federal government’s borrowing authority was set to expire. The battle, however, lay bare the reality of our nation’s fiscal situation: The government spends hundreds of billions of dollars more than it takes in each year. The national debt is about 75 percent of Gross Domestic Product – a height usually reserved for brief periods after major wars.

According to economist Douglas Holtz-Eakin, we’re on an unsustainable trajectory. Holtz-Eakin, who served as the director of the Congressional Budget Office from 2003 until 2005, is the founder and president of the American Action Forum, a nonprofit Washington think tank whose mission he has described as introducing “center-right, conservative economic ideas in the national debate.” OUTLOOK recently talked to Holtz-Eakin about the shutdown, its impact on the broader economy and where we go from here.

Outlook: How damaging do you think the government shutdown was to the U.S. economy?

Douglas Holtz-Eakin: I think the damage to the overall economy was minimal. It was only a partial shutdown of the government, and even for the parts that were shut down, we promised federal workers that they would get back pay. We just paid them later, and the same is true for a lot of government spending. It’s going to occur, just later than planned. So you won’t see any big overall impacts. If there’s going to be a durable impact, it will be to consumer confidence.

Outlook: What about effect on GDP?

DHE: My best guess for the quarter is zero effect because it will correct itself within the quarter. The shutdown was only 16 days. Had it gone longer it would be a different story, but it was short enough that there’s not going to be an overall impact.
About this article

Douglas Holtz-Eakin is the founder and president of the Washington think tank American Action Forum, and a commissioner on the congressionally-chartered Financial Crisis Inquiry Commission, charged with examining the causes of the 2008 financial crisis. Prior to starting the forum, Holtz-Eakin has served as director of the Congressional Budget Office, which provides budgetary and policy analysis to Congress, and, in 2001-2002, as chief economist of President’s Council of Economic Advisers. His academic career has included teaching at Columbia University and Syracuse University, where he became Trustee Professor of Economics at the Maxwell School, chairman of the department of economics and associate director of the Center for Policy Research.

Outlook: What about damage to consumer and investor confidence?

DHE: That’s more important. In 2011, when we did the debt ceiling fight, it had a lasting impact and it hurt growth. It has more to do, I think, with running up to the debt limit. That scares investors and that gets translated to consumers.

Outlook: The battle over the federal budget is now “resolved” – but only temporarily. What do you expect will happen when we reach the debt ceiling again early next year?

DHE: Right now, the debt ceiling is supposed to be reached by February 7. But by then, Treasury will have again rebuilt its ability to do “extraordinary measures.” For example, it will again be able to raid federal employee pension funds instead of issuing new debt. That means we don’t actually have a hard stop at February 7. Once again, we’ll get some warnings about the date at which they really run out of flexibility but my guess is that both sides have learned from this episode that in the end, you can’t go over that line. We won’t see it run up nearly as close to the deadline as we did this time.

Outlook: Why do we always seem to bump into the debt ceiling every few months now versus in the past?

DHE: It’s the size of the extensions. You can raise the debt ceiling by however much you want, but during this protracted, bareknuckle fight that conservatives have had with the Obama administration over fiscal matters, they just haven’t raised it very much. They could have raised it a lot but politically that’s very unpopular.

It has always been politically charged to raise the debt limit but in the “good old days” the House would use a parliamentary trick called the “Gephardt Rule” to ensure that they never actually had to vote on a debt ceiling increase. Over in the Senate, the guys who were up for re-election voted no, the ones who were there for a while voted yes and it went to the President. Even in those days they would say, ‘Honest, we won’t do this again,’ because the American public doesn’t like the idea of debt, and that’s the bottom line.
Outlook: So in previous debt ceiling battles, the House never actually had to put their names on a vote?

DHE: That’s right. They never actually had a vote on the debt ceiling. However, in 2010, the House adopted rules where they vote on everything. And the politics of that are much more volatile.

Outlook: At the end of the day, the shutdown was part of a much broader argument about the size, role and cost of federal government. Talk about the scale of the U.S. federal debt and the dangers it poses for the nation, today and in the future.

DHE: The debt held by the public is 75 percent of GDP – roughly double what it was five years ago, and it’s at height we typically only see after fighting a war. That is, in and of itself, troubling. But the really problematic thing is that if over the next decade, if we don’t change course, we’ll issue another $7 trillion in federal debt. And that number will go north yet again. Indeed, over the long term it heads north inexorably. We’re on an utterly unsustainable trajectory.

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And the political problem that comes with that trajectory is the fact it’s driven by large, so-called entitlements, such as Medicare, Medicaid, the Affordable Care Act, Social Security, Farm Bills, unemployment insurance. Those have been walled off from cuts or reforms by Democrats. Meanwhile, Republicans figure that once these sequestration caps that are in place begin to starve defense spending and other non-defense spending to the point where it becomes unpalatable for Democrats, they’ll make a deal on entitlement cuts. But so far they haven’t. They’ve said you’ve got to raise taxes and Republicans have said no. So we’re stalemated.

Outlook: Can you reduce the debt without touching entitlements, which Democrats protect, or military spending, which Republicans protect?

DHE: No. You probably don’t have to do much to the defense budget, but politically it has to be on the table. But the real key with the debt is that you can’t grow your way out of it. There’s no magic growth pill that will allow us to grow fast enough. You can’t tax your way out of it either. In the end, this is a spending problem that has to be dealt with. It’s been politically impossible to get Democrats in particular, but Congress in general, to come to terms with that. Since the year 2000, we’ve created two new huge entitlements: the Medicare Prescription Drug Program and now the Affordable Care Act. We’re going the wrong direction.

U.S. NATIONAL DEBT AS A PERCENTAGE OF GDP

Source: BEA, CBO, Treasury Direct
We are the best looking horse in this glue factory so financial markets haven’t really forced the U.S. to come to terms with its fiscal problems.

Outlook: How much of our spending is covered by tax revenues? How much of it is borrowed, and how does that compare to the past?

DHE: Right now there’s about a $600 billion dollar deficit this year – down from more than $1 trillion last year. But that’s about a sixth of the budget that is no longer covered by tax revenue. That puts pressure on taxes to go up.

Outlook: How long much longer will Congress be able to kick the can down the road before the debt becomes a bigger problem?

DHE: There are two answers. If you look at budget projections from the Congressional Budget Office, we can tread water – where deficits and debt are roughly constant shares of GDP – until 2016 or 2017, which means we can get through this president’s second term. Then, all the lines head north pretty quickly. So, that could be the moment. Or, the financial markets might start taking a look those trend lines and start getting nervous. That has not happened yet, largely because everyone else is in much worse shape. We are the best looking horse in this glue factory so financial markets haven’t really forced the U.S. to come to terms with its fiscal problems. But they might. You can’t rule that out.

Outlook: Obamacare remains a lightning rod for conservatives who see it as a vast new entitlement program. How big do you think the costs for Obamacare will be once the program is actually up and running?

DHE: When it’s fully phased in, it’s estimated that it will cost about $2.5 trillion for 10 years. It’s a large new spending program with a big expansion of Medicaid. Now, not all the Medicaid expansions have happened yet and the startup is very rocky. If people, particularly young healthy people, don’t actually buy the insurance the prices for the older, sicker ones will have to go up and they might jump out of the system too. And then it could go into a death spiral and it’ll be a colossal failure. For many people the penalty is going to be minimal compared to the cost of the coverage and they’ll just pay it. For any young person, say a 30-year-old male who doesn’t smoke, is in perfect health and makes more than $25,000 a year, if they do the arithmetic, they pay the penalty and walk away.
Outlook: When do you expect the Fed to begin tightening monetary policy and returning us to a more normal monetary environment?

DHE: I never thought the Fed would begin to taper in 2013, that is, ease off on pumping billions of dollars into the economy by buying bonds. If you believe the policy is working and you have stated that you will begin to taper when you see evidence of improvement in the labor market and economic growth, well, then you’re not going to taper this year. But they began to convince me in September that they were going to do something, and I thought they’d have to do that point for their own credibility. However, they turned around and said exactly what I’ve always been thinking: It doesn’t look that good on the ground so we’re not going to taper.

So, they’re not going to do it this year and new Fed chair Janet Yellen is going to be careful about not doing it prematurely. There may be some modest tapering somewhere in 2014 but I don’t see a full exit until at least 2015.

Outlook: If you were sitting in the White House, what steps would you take to address the debt and deficit spending?

DHE: First, we know across the board that sequester – these automatic spending cuts to most everything but entitlement programs – is bad policy. It doesn’t allow you to choose your spending priorities wisely and it attacks the wrong part of the budget – the part that’s a shrinking share of overall spending. We need to deal with the entitlements, which grow rapidly and are an increasing share of spending. So, I’d say let’s have a trade: For every dollar of increased discretionary spending you want, we’ll find entitlement reforms, or cuts, to match. You should also get a real tax reform done to help the economy grow as rapidly as possible. If I’m in the White House, I’m doing tax reform, entitlement reform, and nothing else.

Outlook: And do you think politically that can ever get done?

DHE: There’s no evidence of it so far. The President isn’t spending any political capital on tax reform, and I don’t see it being a priority. As for entitlement reform, he put in his budget a fix that gives a more accurate measure of inflation but it also lowers the pace of increase in Social Security benefits. It would also lower the rate at which income tax brackets are raised, and you raise some tax revenue. And the left went radioactive over this. It’s a tiny proposal – a technical fix – but it’s now politically off the table from both sides really.

The overall issue of the debt requires presidential leadership. It requires the President to disappoint Democrats by reducing entitlement spending and to explain to them that this is how it’s going to go. And he’s shown no interest in doing that.
Outlook: Are you optimistic or pessimistic that we will be able to make progress addressing this problem in the next few years? Why?

DHE: I am pessimistic. This requires a change in the style of presidential leadership that we will only get if he decides he needs another legacy and/or big changes in the composition of Congress. But remember, even if there were vast Republican majorities in the House and the Senate, the president is not going to just say fine, I’ll do it. It’s going to require a fair representation of Democratic ideas. Any solution would have to be bipartisan enough to get through.

Outlook: Look ahead 10 years. What is a realistic best-case scenario? What is a realistic worse-case scenario?

DHE: The best case scenario is that President Obama decides to have a second term legacy and pushes for a tax reform-entitlement reform package. That would directly control debt and improve economic growth. The worst case scenario is gridlock through his second term, poor economic growth, and higher worldwide interest rates that make the carrying cost of the debt much higher. That is a recipe for downgrade and financial market skepticism about the U.S.
Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 9/30/13. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market’s view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

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<th>Year</th>
<th>GDP</th>
<th>CPI</th>
<th>Funds</th>
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<th>10-year</th>
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Costs are stated in basis points per year.

FORWARD FIXED RATES

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<th>Forward Period (Days)</th>
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<th>5-yr</th>
<th>10-yr</th>
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<td>365</td>
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<td>83</td>
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RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

<table>
<thead>
<tr>
<th>Cost of Forward Funds</th>
<th>Average Life of Loan</th>
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<tr>
<td>2-yr</td>
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<td>365</td>
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Short-term interest rates

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.
About CoBank
CoBank is a $93 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation’s rural economy. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank’s web site at www.cobank.com.

Sharing Success Application Deadline Nears

The deadline to apply for CoBank’s 2013 Sharing Success matching-grant program is fast approaching.

CoBank announced earlier this year that it had renewed its $3 million program, and that it would match charitable contributions made by cooperative customers through November 30 or until the fund is exhausted.

The bank will match donations on a dollar-for-dollar basis, from a minimum of $1,000 up to a maximum of $5,000 per customer. CoBank first launched the program in 2012 in conjunction with the International Year of Cooperatives.

Cooperatives interested in participating should contact their CoBank relationship manager soon for an application and detailed program requirements. Last year, more than 600 cooperatives took part in the program. Their donations went to a wide variety causes, including local fire departments, homeless shelters, food banks and veterans’ programs.

“We’re delighted that our board agreed to renew Sharing Success this year, and we hope even more customers will take advantage of the program in 2013,” said Bob Engel, CoBank’s chief executive officer.

“The principles of concern for community and cooperation among cooperatives are central to the cooperative model,” Engel said. “The Sharing Success program has been so successful because it embodies both of these important ideas. We look forward to working with our customers in order to help people in need and strengthen their local communities.”

For more information about the program, or to download an application, please go to www.cobank.com/sharingsuccess.

The City of Bode, Iowa, Fire Department bought a new attack pumper with the help of Sharing Success.