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National Debt on Pace to Exceed GDP

By David R. Breuhan

I attended a dinner for a conservative organization last summer. Edwin Meese III was the keynote speaker. My question to him was, "Does either political party understand the ramifications of having a national debt approaching 60 percent of the gross domestic product?" He paused and answered, "The debt is a fairly abstract concept in Washington."

Most attention is given to annual deficits, with commentators musing, "When compared to the 1980s, deficits are less as a percentage of gross domestic product." This may be true, but because of the government's inability to control spending, $1 in 1980 buys only 50 cents today. Tax cuts combined with the increasing debt weakens the currency and produces inflation, which is a capital tax.

Deficits are a natural outgrowth of unrestrained politics. For every action, there is an equal and opposite reaction. This axiom from physics is applicable to economics. One need not look toward interest rates for a result of monetary distortion; one must look toward the value of the currency. Since 1913, the Federal Reserve has failed in its primary mission: the maintenance of price stability. Economists and politicians deftly dismiss core inflation as a mere 0.1 percent per month; they cannot explain why we now pay for a car what our parents paid for a house.

The reason is fiduciary credit inflation, created by a fractional reserve banking system, where the Federal Reserve has the ability, through purchases of Treasury debt, to inject credit into the capital markets. Commonly referred to as "open market operations," the result of this Fed action is latent inflation, which is not recognizable for a generation. The Federal Reserve owns $760 billion in what is categorized as interagency debt.

The GDP for 2005 was $12.487 trillion. The average growth of GDP from 2001-2005 was 5.38 percent. The national debt at the end of fiscal year 2005 was $7.93 trillion. The average growth of the national debt during the same time period was 8.11 percent. If left unchecked, the debt will equal GDP in 2023 at $32 trillion. Many factors could alter this. A global trade agreement would increase GDP; a recession would decrease it. Increased revenue to the government would slow the debt. Unchecked entitlements will increase it.

The most important aspects of a currency are that it must be stable and must be neutral, favoring no one. Inflation benefits those who receive the money first, before prices rise, and benefits debtors at the expense of creditors. The world's biggest debtor is the U.S. government.

Since 1913, we have embarked on an inflationary policy and are ruining the currency. By using debt as an instrument of economic stimulus we follow the blind belief that deficits do not matter.

This policy is unwise. This action also violates Warren Buffett's axiom: "Borrowed money is the most common way that smart guys go broke."

Eventually borrowers will seek another vehicle and chase a more secure return. Be it gold, real estate, or other asset class, the government does not understand that all decisions are made on the margin and the risk. Foreigners are especially hurt, when they chance losing principal due to a weakening dollar, even though they are paid interest. Foreigners do not have to sell treasuries to affect the bond market; they need only stop buying them.

The magic of compounding interest is working against the United States. The intersection of debt and GDP is looming in the near future. It merits the attention of all of us.

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