March 15, 2016

WELLS FARGO SECURITIES

Economics Group

Special Commentary

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2016 Federal Fiscal Policy Outlook Part III: The Land of the Rising Deficits

Executive Summary

In fiscal year (FY) 2016, the Congressional Budget Office (CBO) expects the federal budget deficit to grow relative to the size of the economy for the first time since 2009, once again turning the U.S. into the land of the rising deficits. Japan, an example of a developed nation that has been running budget deficits since the 1990s, currently has a debt-to-GDP ratio of about 245 percent.[1] That nation continues to struggle with rising debt, slow economic growth and deflation. While we do not mean to imply that the U.S. will go the way of Japan, we do think there are important lessons to be learned from Japan's situation. The CBO, in its most recent *Budget and Economic Outlook*, points out many of the adverse effects of continually running large budget deficits, which can lead to a growing national debt as a share of the economy. These effects include greater spending on interest payments, a reduction in national saving—which leads to a lower capital stock and thus lower wages and productivity—and reduced flexibility to respond to fiscal and economic challenges.

In our final report on the 2016 Federal Fiscal Policy Outlook, we focus on the CBO's estimate of the deficit and the mounting national debt. We wrap up with a look at the implications of a worsening debt outlook for the U.S. economy. Our analysis of the CBO's budget outlook shows that the federal deficit will continually rise over the next 10 years from 2.9 percent of GDP in fiscal year 2016 to 4.9 percent in 2026. The result is a rapid pace of growth in the national debt from 75.6 percent of GDP to 86.1 percent of GDP over the same time horizon.

The CBO expects the federal budget deficit to grow relative to the size of the economy for the first time since 2009.

Figure 1

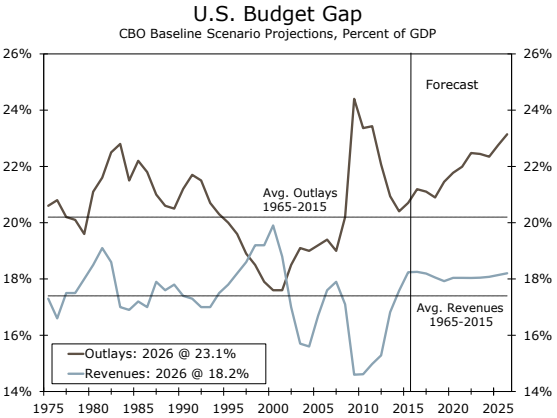
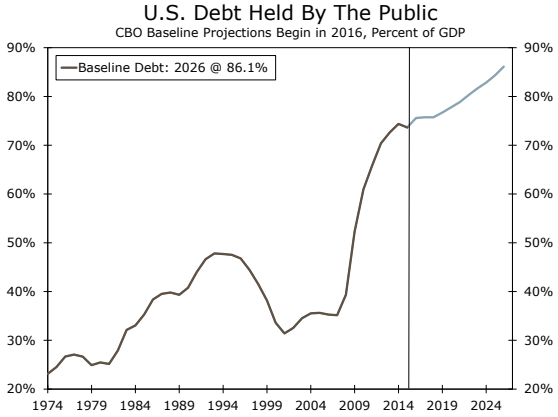


Figure 2



Source: Congressional Budget Office and Wells Fargo Securities, LLC

[1] **Bryson, J.H., Quinlan, T. and Nelson, E. (2016). "Which Countries Have Government Debt "Issues"?" Wells Fargo Economics.**

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Growing Deficits Driven by Entitlement Programs

In our report series on the budget last year, we warned of the return of growing federal budget deficits.[2] The CBO projects that over the course of the next 10 years the federal deficit will grow from 2.9 percent of GDP this year to 4.9 percent in 2026. The challenge for the budget outlook is that while revenues are expected to remain around 18.1 percent of GDP, above the long-run average of 17.4 percent, federal outlays are expected to average 22 percent of GDP over the next 10 years. The result will be a budget deficit of nearly $1.4 trillion by 2026. As we have highlighted in previous reports, the effect of net interest expenses on the deficit is particularly large. If we remove the effects of net interest expenses, known as the primary deficit, the magnitude of higher interest costs becomes apparent. The primary deficit would only rise from 1.6 percent of GDP in 2016 to 1.9 percent by 2026 excluding the effects of higher interest rates and a larger stock of debt (Figure 3).

Figure 3

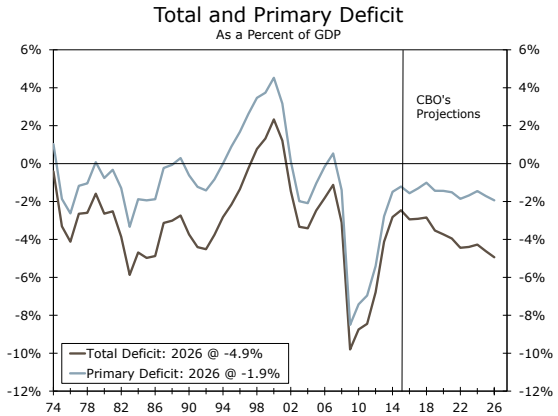
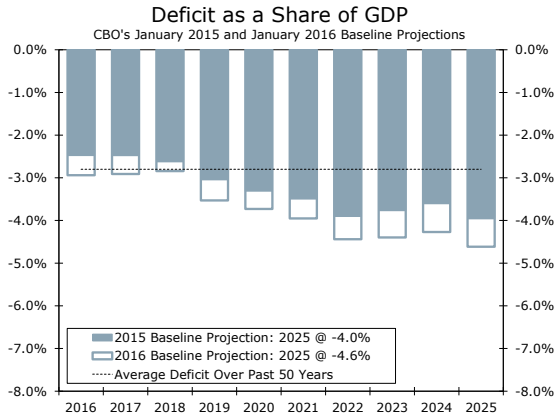


Figure 4



Source: Congressional Budget Office and Wells Fargo Securities, LLC

The deficit projections from the CBO stand in stark contrast to their analysis last year. In the 2015 Budget Outlook, the CBO expected the deficit to widen to roughly 4.0 percent of GDP by 2025 compared to the 4.6 percent estimated in this year's report (Figure 4).[3] The largest difference between this year's report and last year's is a series of legislative changes, namely the extension of a number of tax breaks that modified the magnitude of the budget deficit each year over the next decade. These legislative changes account for about half of the widening in the deficit from the CBO's last baseline projections. Beyond the legislative changes from Congress, the changes to the CBO's economic assumptions, primarily their estimate for slower GDP growth over the next decade, also resulted in larger budget deficits than originally anticipated.

With such large and growing annual deficits, the outlook for the federal debt should be of concern to investors.

Beyond the next 10 years, the CBO sees deficits averaging roughly 6.6 percent of GDP from 2027 to 2036 if current law is left unchanged. Not surprisingly, the primary driver is the rapid growth in the costs of major health care programs and Social Security. With such large and growing annual deficits, the outlook for the federal debt should be of concern to investors.

More Rapid Growth in the Federal Debt: Why Should We Care?

As a consequence of steadily rising deficits in the coming years, the stock of debt is set to increase from its already historically high levels. Debt held by the public, as a share of GDP, has averaged 39 percent over the past 50 years. As of FY 2015, the debt-to-GDP ratio was 73.6 percent, almost double the long-run average. The CBO's baseline scenario deteriorated over the past year due to legislative and economic changes to its projections, and as a result the CBO expects debt as a share of GDP to climb to 86.1 percent by 2026 (Figure 5). Beyond CBO's baseline timeframe and absent any change in current law, the drivers of deficit growth would continue unabated and push

[2] **Silvia, J.E., Brown, M.A. and Miller, M. (2015). "The 2015 Federal Fiscal Policy Outlook, Part III."**
[3] **Congressional Budget Office. (2015). *Budget and Economic Outlook: 2015 to 2025.***

debt higher. Three decades from now, for instance, the CBO projects debt held by the public to equal 155 percent of GDP, a higher percentage than any previously recorded in the United States.

Figure 5

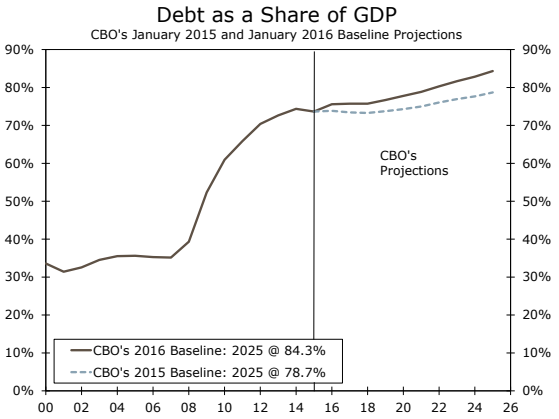
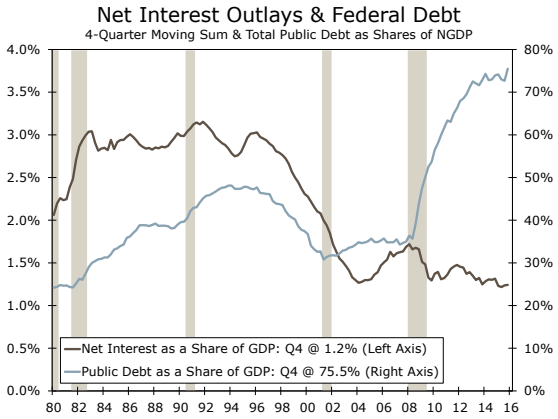


Figure 6



Source: U.S. Dept. of the Treasury, U.S. Dept. of Commerce, CBO and Wells Fargo Securities, LLC

It might be easy to dismiss the worsening fiscal landscape as only marginally different than last year's already grim outlook from the CBO. Yet, the change in the budget outlook since just last August amounts to $1.5 trillion more in debt over the 2016-2025 period, an amount greater than total discretionary outlays (defense and nondefense) in FY 2015. Furthermore, we, like the CBO, believe a large and growing national debt would have significant negative consequences for both the budget and the economy. As outlined above and in previous reports, net interest costs are set to soar in the coming years, and a rising stock of debt exacerbates this problem. Under this scenario, net interest costs will consume a larger share of the budgetary pie. As a result, other categories of federal spending, including discretionary outlays that contribute directly to government spending in GDP and transfer payments used by U.S. households to consume, would be squeezed out under CBO's current budget assumptions.

Federal borrowing reduces total saving in the economy over time.

The CBO points out that federal borrowing reduces total saving in the economy over time, which leads to a lower capital stock and less wage and productivity growth than if federal borrowing was lower.[4] While this long-run, supply side dynamic has implications for growth, there are also short-run implications for the demand side. It will take lower spending or higher taxes to deal with the growing debt, which would be a form of fiscal tightening.[5] Were it to occur, this development could exert headwinds on overall economic growth. The short and long run economic effects of federal debt rising faster than expected are additional challenges for an economy currently in a slow growth environment.

A large national debt also affords lawmakers less flexibility to respond to unexpected events. In the event of an unanticipated challenge, such as an economic crisis, lawmakers would have less flexibility to pull various policy levers. Consider, for instance, that on the eve of the Great Recession in 2007 debt as a share of GDP was 35.2 percent, less than half its current level. Understanding the economic challenges that may arise as a result of a worsening fiscal outlook is key for decision makers.

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[4] Congressional Budget Office. (2016). *Budget and Economic Outlook: 2016 to 2026.*

[5] The government's budget constraint, as defined in Romer, D. (2006). *Advanced Macroeconomics, Third Edition*. pp. 561 McGraw-Hill Irwin, is $\int^{\infty}_{t=0} e^{-R(t)}[T(t) - G(t)]dt \geq D(0)$ Where D(0) represents the stock of real debt outstanding, T(t) represents real government taxes and G(t) represents real government spending at time t. R(t) represents the real interest rate at time t so $e^{-R(t)}$ represents the value of a unit of output and revenues at time t discounted back to time t=0. Thus, the identity states that the current stock of debt must be less than or equal to the present value of future budget surpluses.

Conclusion: The Outlook Continues to Get Worse

Over the course of our three reports on the federal fiscal policy outlook, we have discussed the economic assumptions behind the CBO's fiscal policy projections, analyzed the factors that will affect revenues and outlays over the course of the next 10 years and concluded with a summary of how the imbalance between revenues and outlays will affect the deficit, debt and economy.

We have seen the importance of economic assumptions on the fiscal outlook. As the CBO continues to revise down its view of long-run potential GDP growth, the pace of federal revenue growth also slows in its budget outlook. Revenues will also be influenced by firms attempting to lower their tax liabilities or leaving the country to avoid higher taxes. Outlay growth continues to rise faster than the pace of nominal GDP growth, driven in large part by increased spending on Social Security, health care and interest on the national debt. Federal deficits are set to rise relative to the size of the economy for the first time since 2009 and will continue to rise over the next decade. The result is a growing level of debt, which can have serious implications for the federal budget, U.S. economy and decision makers.

Many policymakers agree that federal fiscal policy is on an unsustainable course.

There are three major adverse consequences of the composition of federal spending and the growing level of debt over the next 10 years. First, spending on entitlement programs and net interest will crowd out other forms of federal spending, thus we expect only minor contributions to GDP growth from federal government spending over the next 10 years. Second, the growing stock of debt will begin to crowd out private sector investment and, over the long-term, result in a lower stock of capital in the economy and by extension slower productivity and wage growth. This pattern of slower economic growth, in our view, can be seen in the many challenges facing Japan today. Finally, there is no clear answer at what point the debt-to-GDP ratio will result in global investors demanding higher returns on U.S. debt instruments. That said, should interest rates on U.S. Treasuries rise to reflect a "political uncertainty" premium and/or a greater risk premium due to the amount of federal debt outstanding, the result could create serious fiscal sustainability issues for the federal government. The CBO continues to tell the same story each year of these consequences. Many policymakers agree that federal fiscal policy is on an unsustainable course; however, in the current political environment it seems unlikely that policymakers will address these issues.

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