Independent Directors Council
Promoting Excellence in Fund Governance

'Warnings of a Parting Friend': Today's Fiscal Crisis and U.S. National Security

‘Warnings of a Parting Friend’: Today’s Fiscal Crisis and U.S. National Security

National Strategy Forum Speaker Series

Paul Schott Stevens
President and CEO
Investment Company Institute

March 30, 2012
University Club of Chicago
Chicago, IL

As prepared for elivery

Good afternoon. Thank you, Richard, for that generous introduction and for welcoming me to Chicago. It’s a great honor to be here and to have this opportunity to speak to you all today.

As Richard said, the Investment Company Institute is the national association of U.S. mutual funds and other registered investment companies. More than 90 million Americans are mutual fund investors, including half of all US households.

Much of our policy work accordingly focuses on the effect that actions—or inaction—in Washington will have on investors and financial markets.

My remarks today concern a challenge without precedent in the American experience—one that inescapably links the soundness of our investments, the health of our economy, and the very security of our nation. To understand that challenge, our early history provides a good starting point.

‘Disinterested Warnings of a Parting Friend’

The Father of our Country, George Washington, was eulogized as “first in war, first in peace, and first in the hearts of his countrymen.” His remarkable life and accomplishments bear out each of these judgments.

When Washington announced his retirement from public life in 1796, he wrote a letter to “The People of the United States” that set forth what he termed “the disinterested warnings of a parting friend” on matters “all-important” to the future happiness of the nation.

The letter has come to be known as Washington’s Farewell Address. The Address is remembered for Washington’s declining a third term as President, thereby setting a precedent for his successors. It also is remembered for Washington’s admonition against foreign “attachments,” which he warned would “produce a variety of evils.”

But our first President also had parting advice on economic issues for his fellow citizens
and subsequent generations of Americans.

“As a very important source of strength and security, cherish public credit,” he said. By “cherish,” he meant “treat credit as precious”—or, as he hastened to add, “use it as sparingly as possible.”

When Washington left office the next year, the national debt was 82 million dollars—that's "million" with an "M"! It was largely incurred fighting the Revolutionary War. It also included the debts of the states, which Alexander Hamilton agreed to assume in a grand bargain that moved the nation's capital from New York City to the banks of the Potomac.

That $82 million likely represented less than 20 percent of the national economy in that day.

Debt Now

Well…Washington's Farewell Address has been read on the floor of the U.S. Senate every year since 1896. But it has been some years since Washington's successors could say with a straight face that they had used the nation's credit "sparingly."

When President George W. Bush left office in January 2009, the national debt stood at 10.6 trillion dollars—that's "trillion" with a "T"—or about 75 percent of gross domestic product.

Next January, whether President Obama is giving his second inaugural or his own farewell, the debt will stand at more than $16 trillion—103 percent of GDP, and still rising.

That debt of 82 million dollars in 1797? Today, Treasury spends seven-and-a-half times that amount every day—just for interest.

Only once before in American history has the federal debt been larger than the entire economy, and that was at the end of World War II.

Over the next 30 years, fiscal restraint and economic growth reduced the debt-to-GDP ratio to about 25 percent.

Unfortunately, today's projections show debt levels remaining high, even under the most optimistic scenarios.

What do I mean by "optimistic"?

Well, if you are willing to assume that all tax rates return to the levels of the late 1990s…that the "temporary" reduction in Social Security taxes expires…that the alternative minimum tax is allowed to ravage middle-class families…that Medicare slashes its reimbursement to doctors by more than a quarter…and that automatic spending cuts take a major hit on the military budget…then the national debt will fall. It will fall to 89 percent of gross domestic product a decade from now.

But if you think those tax hikes and spending cuts aren't very likely—and every item on that list represents a prior decision by our national leaders to kick the can down the road—then the national debt is projected to hit 120 percent of GDP in the next decade.

As the non-partisan Congressional Budget Office has dryly observed, "The systematic widening of budget shortfalls projected under CBO's long-term scenarios has never been observed in U.S. history."

At the same time, state and local governments are under increasing fiscal pressure. Unlike the federal government, most states are required to balance their budgets every year or biennium—and so you don't see them piling on debt. But those same requirements encourage states to defer costs, as many have, for example, with their pension plans for state and local employees. As a result, the unfunded liabilities of state and local pensions are estimated to be in the trillions of dollars.

Three Grim Factors

Now, these numbers are appalling, and I don't need to embellish them. But let me point out three factors that make an already grim picture even bleaker.

First, our current level of indebtedness puts the United States in a very rough neighborhood internationally.

If you measure our debt-to-GDP ratio the way most countries do, including
debt held by trust funds and the total debt of state and local governments, the U.S. ranks fourth among the 34 countries in the Organisation for Economic Co-operation and Development, or OECD.

Fourth!

That means our total governmental indebtedness is exceeded only by Japan, Greece, and Iceland. Not exactly models for healthy economies.

The second grim factor is that the federal government has assumed a massive amount of contingent liabilities. I'm talking here about guarantees that the federal government has issued to private borrowers—whether explicitly, as with student loans, or implicitly, through such "government-sponsored enterprises" as Fannie Mae and Freddie Mac.

None of those guarantees appeared on the federal government's books until September 7, 2008. That's when Fannie and Freddie were turned over to a federal conservator. Suddenly, a liability that many in government denied ever owing became quite apparent—at a cost that CBO estimates will exceed $300 billion.

But Fannie and Freddie represent just a fraction of the potential liability: As of last fall, the government had outstanding $2.7 trillion in other direct loans and loan guarantees on housing, student loans, and farm and small business loans.

The third worrisome factor is how our current debt was accumulated—and why it's growing.

As I noted, George Washington saw "public credit" as a "source of strength and security." Historian John Steele Gordon has written that Alexander Hamilton, Washington's Treasury Secretary, "saw the debt as a powerful means of fighting wars, building infrastructure, and getting through economic bad times."

The debt in 1797 was the price of our nation's independence from Britain.

The historic debt levels of World War II were the price of freedom.

By contrast, Gordon notes, "For the last 30 years and more, the national debt has been increasingly used so that no one in Washington ever has to say no to anyone."

Now, it's true that the trillion-dollar-plus deficits of 2008 and 2009 were accumulated as our leaders fought the financial crisis and the subsequent recession. Future economists and historians will have to sort out whether these huge deficits were justified or had the effects that their advocates have claimed for them. However that may be, even the most ardent supporters of fiscal stimulus, beginning with John Maynard Keynes, would tell you that budget deficits incurred to counter a recession are a temporary expedient.

Instead, we have deficits stretching as far as the eye can see. Even under the most optimistic projections, we'll be adding more than $300 billion to the debt every year. If you assume politics-as-usual will prevail, the annual gap between spending and revenue will exceed $1 trillion every year for the next decade—and will hit almost $2 trillion by 2022.

As a famous son of Illinois, Senator Everett Dirksen, might say if he were alive today: "A trillion here, a trillion there—pretty soon you're talking about real money."

What are the major forces driving those deficits? It's not preserving freedom; it's not laying down infrastructure; it's not educating or training the workforce of tomorrow; nor is it scientific exploration or technological research. None of those are the major drivers of debt.

Instead, it's two factors: historically low levels of revenues, and historically high levels of current consumption—spending to support Americans today.

The fastest-growing program in the federal budget is health-care spending, which will grow twice as fast as the economy between this year and 2022.

Close behind is Social Security, which will grow at a rate 28 percent faster than the economy.

Please understand—on many occasions I have expressed strong support, personally and on ICI's behalf, for putting Social Security on a sustainable footing as the foundation of Americans' retirement security for the indefinite future. And I profoundly agree that helping Americans in need is no less than a moral obligation.

But paying our own bills—as a nation, as a generation—that, too, is a moral obligation.

It's one thing to leave our children a debt to pay for an asset that's making their country stronger and providing a return in economic growth. It's another to spend on our own needs and say "charge it to the kids." We are doing precisely what George Washington warned against in his Farewell Address: we are "ungenerously throwing upon posterity the burden which we ourselves ought to bear."

Economic and Security Consequences

What does this unprecedented peacetime build-up of debt mean for our economy and our national security?

Admiral Mike Mullen, the former Chairman of the Joint Chiefs of Staff, minced no words on that score. He frequently said publicly that "the single biggest threat to our national security is our debt."

He liked to point out that interest payments on the debt would soon exceed the Defense Department's budget—creating what he called "a bow wave of debt" that could "run over us in a way where our budget must be cut dramatically."

Admiral Mullen obviously understood economics as well as seamanship—because interest is key to understanding how the federal debt puts our entire economy at risk.

George Washington, in a letter to his nephew Samuel, warned that "There is no practice more dangerous than borrowing money." Why? Because "the interest becomes a moth." An interesting metaphor—Washington the colonial farmer and householder surely knew how destructive a pest the moth can be.

Resources devoted to interest payments are resources that can't be spent on ensuring our national security—or on science, technology, transportation, education, or myriad other purposes. In short, money spent on servicing a growing debt eats away at the fabric of our economy.

And today, that moth is voracious. Interest costs on the debt are projected to grow by almost 10 percent a year—three times as fast as the economy. By 2022, $1 out of every $40 in goods and services that Americans produce will be devoted just to paying interest on the national debt—even under the CBO's baseline forecast.

What happens if inflation and interest rates rise above that forecast?

Well, take the case of last year's Congressional "Super Committee" exercise, which focused all of the capital's attention on finding $1.2 trillion in savings over the next 10 years. The Super Committee failed, and so now Congress is facing the prospect of automatic spending cuts, or "sequestration," to realize that savings.

One-point-two trillion dollars sounds like an awful lot—and it was quite enough to tie our political leadership into knots.

But if the average financing cost that Treasury pays on the debt should turn out to be just six-tenths of 1 percentage point higher than projected, that $1.2 trillion in savings will vanish.

What could drive those rates up? Well, our creditors could lose confidence in us—just as the creditors of certain European countries have lost confidence in them. When creditors get nervous, they demand a higher return on their money.

More and more today, America's creditors are overseas. Of the federal debt held outside the government, $5 trillion—just about half —is owned by—and owed to—foreign investors.

More than one-fifth of that amount is held by Chinese investors, followed closely by Japanese holders. And those foreign holdings are growing.

In a world where capital flows freely, there's nothing inherently wrong with foreign investment. The U.S. economy was built on foreign capital—the canals and railroads that knit together our vast continent drew heavily on financing from London and elsewhere. Conversely, in both world wars, the American market was vital in helping Great Britain and other countries stay afloat.

The United States today has significant advantages in borrowing abroad, because our dollar is the world's reserve currency. Around the world, it's still viewed as a symbol of strength and stability. Foreign investors are willing to take dollars because of their confidence in America's commitment to growing its economy and servicing its debt.

But the longer our debt spree continues, the more that faith can be undermined.

We are abusing the privilege granted by the dollar's reserve status; we are squandering the good credit built over the last century.

As foreign holdings of U.S. debt grow, the risk grows that we are glutting the market. Foreign investors' appetite for the seventh or eighth trillion-dollar batch of Treasury securities isn't likely to match their interest when the debt held overseas was far less.

And sentiment can change quickly. History teaches us that financial markets can turn on a dime, that today's favorite investment can be tomorrow's laughingstock.

If that happens to the dollar and U.S. debt, we could face a financial and economic crisis that would make the bursting of the tech and mortgage bubbles seem like mere blips.

Soaring interest rates would drive up the debt burden, forcing the Treasury to try to sell more bonds and bills into a market increasingly reluctant to buy. Such a crisis would create enormous pressure to restrain our budget and control our debt—and in very short order.

We've seen this tragic cycle play out in Greece over the last few months, with all the ugly social consequences that forced fiscal austerity entails.

But Greece has 300 million fewer people than the U.S., and its economy is only 2 percent the size of ours. Greece also is part of a much larger economic union, the Eurozone, whose members have strong incentives to come to Greece's rescue.

Just ask yourself: If we were in Greece's shoes, who would rescue us?

That scenario is what you might call the "noisy breakdown."

What's perhaps even more likely is the "quiet default"—inflation.

Since 2008, the Federal Reserve has printed money to take onto its own balance sheet some 1.2 trillion dollars of federal debt.

Unless the Fed can unwind this position with extraordinary skill, its actions could have inflationary consequences.

Inflation is the most insidious tax of all. It destroys the value of savings. It changes economic incentives to emphasize short-term gains and discourage long-term investments. It wipes out debts—and impoverishes creditors.

Once inflation takes root, ridding the economy of its damaging effects is a long and painful process. We saw that in this country in the 1970s, when climbing prices combined with stagnant growth. It took the punishing back-to-back recessions of 1980 and 1982 to start to reverse that course and lay the groundwork for renewed prosperity.

What Is to Be Done?

Now, given the clarity and urgency of our predicament, you might think that all of America's leaders would be consumed with the drive to scrutinize spending, examine tax options, reduce the build-up of debt, and make sure that the government does not outgrow the economy. You'd expect to hear every day about new measures to bring our budgets closer to balance.

You're not hearing that? No, I didn't think so.

Inside the Capital Beltway, a sense of urgency does not appear to be widely shared—certainly not widely enough.

George Washington gave the first State of the Union address at Federal Hall in New York City on January 8, 1790. President Obama renewed that tradition just last January. If you carefully searched the 7,000 words of his speech, you would not know that the fiscal state of our Union is so dire, nor would you find a plan for addressing the burden of debt that we are amassing for our children.

Of course, few in his audience on Capitol Hill were eager to point out that omission.

I'm not an elected official, and I'm not in a position to offer such a plan. But I would like to leave you with a sense of urgency on the need to address the risks posed by our burgeoning debt—and with three principles that our nation must embrace as we do so.

The first principle is candor. A great nation is honest with itself about its priorities.

Today, we fail that test.

Every year, our lawmakers play the "baseline budgeting" game. To make the budget numbers look relatively benign, Congress passes a slew of laws that are projected to save money. When one of those laws actually pinches some constituency, Congress suspends it—but only temporarily, because lawmakers need to keep the appearance of savings in "the outyears."

Here's an example. Medicare's payments to physicians are supposed to be driven by a formula enacted in 1997. Every year since 2002, Congress has set aside the payment cuts dictated by that formula—an annual ritual called "the doc fix." But Congress won't repeal the formula because that would add hundreds of billions to the deficits projected over the next decade.

In other words, Congress pretends that Congress will not do what Congress knows perfectly well it will do.

This process of willfully ignoring political reality is the difference between a "baseline" projection that shows the national debt shrinking by 10 percent and the far more likely scenario
in which it grows 20 percent.

Our nation's leaders owe it to us to take the debt threat seriously and deal with it in all candor and frankness. On these vital issues, it is not too much to expect that each of our political leaders will, as George Washington said, display "firmness and virtue enough to maintain … the most enviable of all titles, [that] of an honest man."

The second principle is that the most promising solutions to our fiscal problems will be multi-faceted and will require compromise.

In his Farewell Address, George Washington warned posterity about the dangers of "faction" and "party dissension."

It was the duty of “a wise people to discourage and restrain” such impulses, because partisanship, he said, “serves always to distract the public councils and enfeeble the public administration. It agitates the community with ill-founded jealousies and false alarms, [and] kindles the animosity of one part against another….”

Washington’s words were extraordinarily prophetic of the ills that afflict our contemporary political system. Today, the quest for partisan advantage—on all sides—prevents our leaders from building the national consensus needed to make difficult choices on a host of issues, but none more decidedly than on our burgeoning fiscal crisis.

Neither party’s hands are clean.

The consequences of this environment—the distraction, weakness and animosities that George Washington cautioned against—dismay our friends around the world.

They also embolden our rivals. The Central Committee of the Chinese Communist Party opined in October 2011 that these circumstances reflect a “profound institutional crisis” in which the pre-eminence of America’s political and economic model is coming to an end and giving rise to a new Chinese order.

We all can—we all must—help prevent such a crisis.

The “force of public opinion,” Washington advised, must be brought to bear “to mitigate and assuage” this debilitating spirit of partisanship. That is a job for you and me and for us all.

In truth, neither of our great political parties has a monopoly on wisdom or integrity, patriotism or national interest. On issues like fiscal policy today that are so critical to our long-term prospects as a nation, there should be no aisle to cross.

Rather, we must insist that our political leaders stand shoulder to shoulder, work side by side, put their heads together—and that they act before their hands are forced by our own sovereign debt crisis.

My third and final principle for dealing with our budget and debt challenges is that solutions must be equitable in the broadest sense.

Here again, George Washington’s Farewell Address offers sage advice.

Washington pointed out that “avoiding…the accumulation of debt” requires “shunning occasions of expense.” But he also observed that “you should practically bear in mind that towards the payment of debts there must be revenue; that to have revenue there must be taxes; [and] that no taxes can be devised which are not more or less inconvenient
and unpleasant.”

To put this in modern terms, spending cuts alone will not put our budget right—but neither will tax increases.

Instead, it is essential to focus on policies that promote sound, long-term economic growth and that promote balance between the promises that government makes and the resources that the private economy can provide to meet them.

The sharp increase in government spending that we have seen in the last five years cannot be sustained—but neither can the low level of revenues. Both need to return to something closer to their post-war norms.

Candor, compromise, and equity—without these principles, we can have little hope of solving the fiscal crisis before us.

Taken together, they can form the basis for constructive efforts to place our nation once again on a sound footing of prosperity and strength.

Closing

Sadly, George Washington’s retirement was all too brief—he passed away in December 1799, just three years after he bade farewell to public life. But the prospect of returning to his beloved Mount Vernon was for him a very happy one.

He anticipated finding there “the sweet enjoyment of partaking, in the midst of my fellow-citizens, the benign influence of good laws under a free government [—] the happy reward … of our mutual cares, labors, and dangers.”

The freedom and economic opportunity we enjoy today are a precious legacy of the cares and labors of George Washington and his contemporaries.

Our own cares and labors in confronting today’s dangers—in particular our unprecedented fiscal crisis—will have much to say about how that legacy is passed on to future generations of Americans.

I am confident that if we heed the warnings of our “departed friend,” we will not fail.

Thank you for your attention.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.