Aviator Update – May 2023
Lindsey Lawrance

AVIATOR CAPITAL

Raising the Ceiling

During what's been a quiet month in finance-land, the biggest story has been the latest U.S. "debt ceiling" saga. I expect you realise this isn't anything new. And it will happen again in a few years.

As often happens during this recurring saga, the goings-on tend to amplify the voices of some… how do we put it… "mis-informed" market commentators:

"The U.S. is bankrupt…"
"Foreign nations are working on a new system to replace the U.S. dollar in trade…"
"Complete collapse of this Ponzi is imminent!"
"Inflation is being deliberately created by rich politicians to inflate away the debt…"

It's well worth revisiting what this whole debt ceiling thing is all about as well as addressing some of these common narratives.

Brief word of warning before we begin… Today's missive is a little more detailed than normal with the main focus being on "balance of payments" accounting identities. I hope you stick with me – this stuff is important - I'm passionate in my view that all investors need to have a modest understanding of these sorts of things, lest we get led astray by narratives that simply aren't true.

Also understand that whilst there's a modest dose of "opinion" in here, much of this is "fact". A surplus in one area must mean an equal and offsetting deficit in other areas. Whilst the way in which global imbalances are "equalised" is more convoluted than the simplistic illustrations presented here, the end result (everything in balance) is fact, not just a theory.

A brief history

The "debt ceiling" dates back to 1917 where it was created by the Second Liberty Bond Act. The intent is pretty simple (and fairly sensible) – to limit the amount of debt the government of the day can issue. To force "fiscal responsibility".

Note that it is completely "self-imposed" – whilst its intent is fairly sensible, there's absolutely no functional reason for its existence. Nothing bad would happen if today's government legislated to scrap the ceiling completely. (No, it wouldn't result in the world losing confidence in the U.S. dollar - for reasons described below.)

Since its inception, the ceiling has been raised about a hundred times. Yes, about once every year!

In practice, when the ceiling is reached, the U.S. treasury isn't allowed to issue any new bonds to finance the government's operations. If more money is needed than it has via tax receipts, things shut down – government employees don't get paid, services stop…

For most of recent history, the U.S. federal government has run a deficit – spent more than it collects. This is the reason for a rising debt and the need to constantly increase the debt ceiling. Given this, it's very much debatable whether the intent of imposing "fiscal responsibility" is ever really achieved.

In recent years, given the increasingly dysfunctional state of U.S. politics, raising the debt ceiling has increasingly become more of a carnival sideshow – politicians from both major parties need to co-operate to agree to increase the ceiling so it's a great time to push your party's agendas!

As news of a deal breaks, we hear about some of the demands:

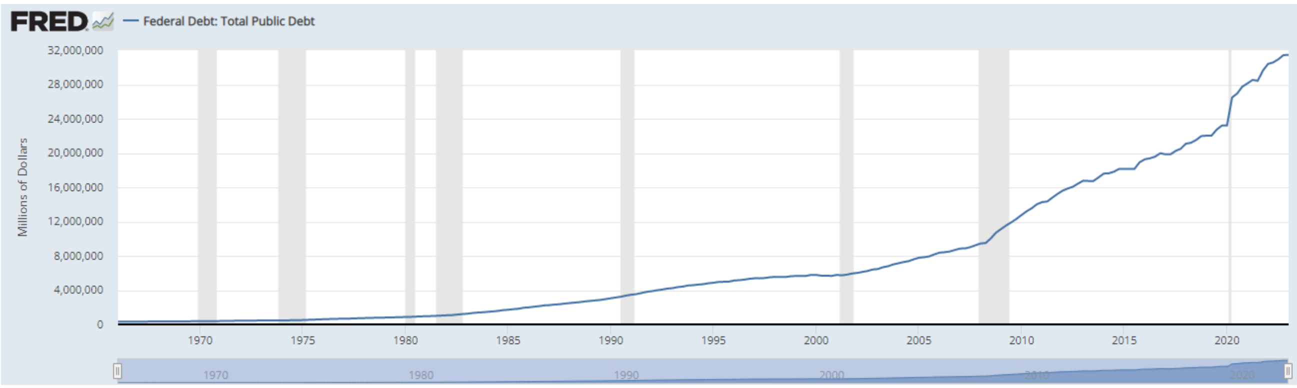
- Republicans wanted all spending categories to reduce… except defence!
- Democrats were seeking a modest tax provision on the wealthy – something the Republicans were against it!
- Republicans sought provisions to make it harder to get welfare payments.
- There were some compromises reached about making rules easier for energy projects to be approved because, well… that's relevant to federal debt, right?

As its being announced so far, the deal reached doesn't actually mean the debt ceiling will be lifted. They have agreed to "suspend" the debt ceiling till 2025 (after the next presidential elections).

"Suspend"? Yes. Basically, they have agreed that the government can ignore the debt ceiling and the fight over raising it will be taken up again in 2025. What a joke…

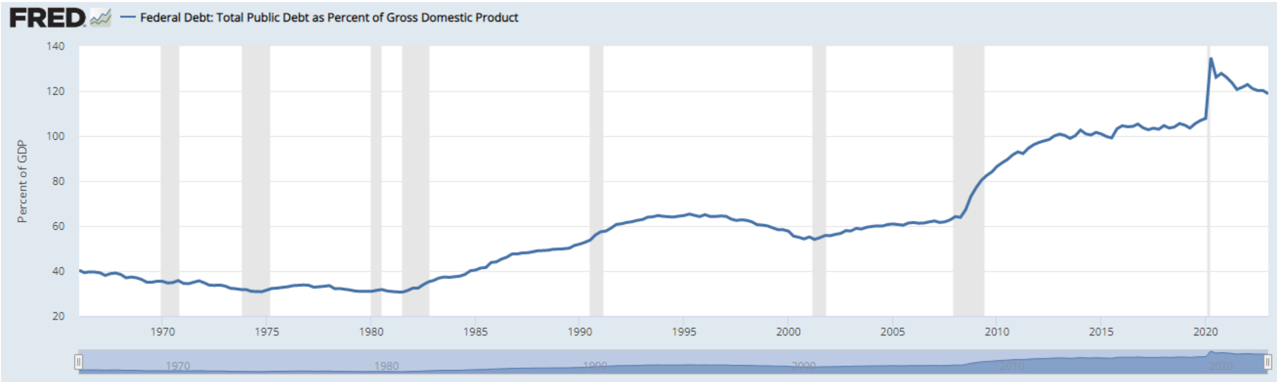
It's a big number

This is what the U.S. government debt history looks like:



A relentless rise. Currently, it sits at around US$31.5 trillion.

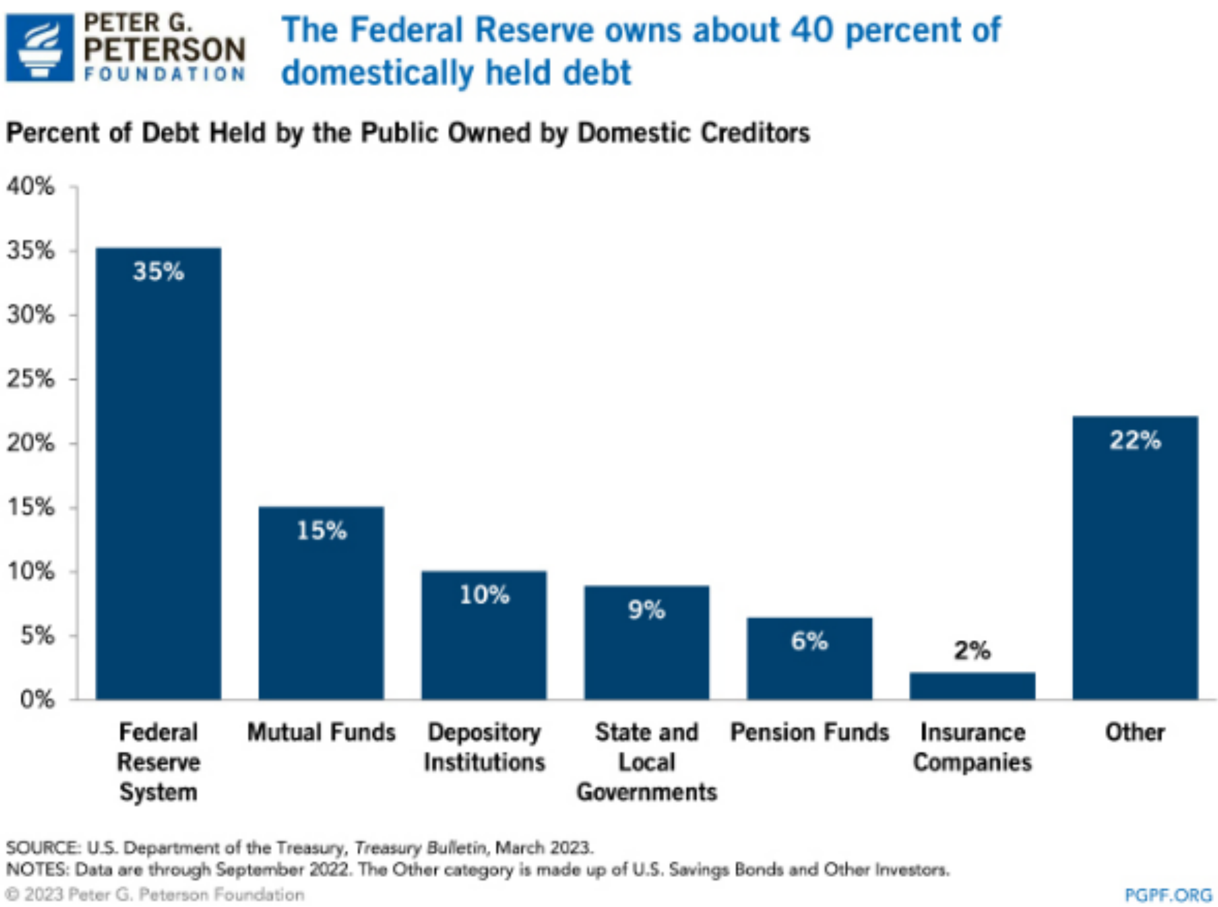
Its perhaps a bit more relevant to compare the debt to the size of the underlying economy. Here's what it looks like compared to GDP:



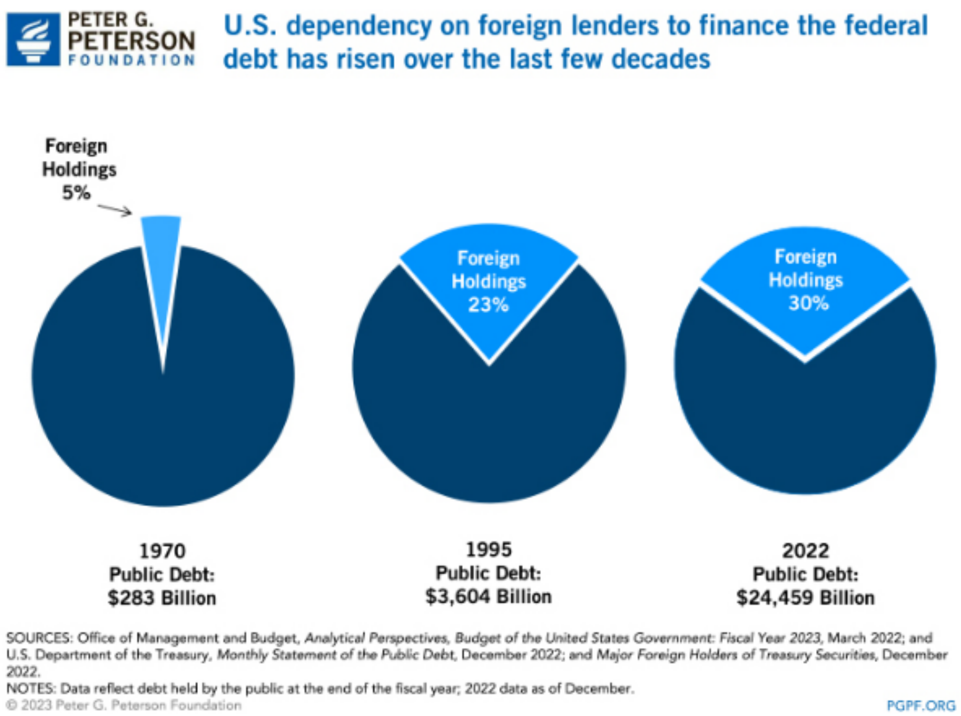
Not really all that much better.

Who "owns" all this?

The vast majority of the debt is owned by themselves – "domestically held". It's shared around something like the following:



But over the last few decades, an increasing amount of the debt is being held by foreigners:



Notice the title given to the chart above – "U.S. dependency on foreign lenders to finance the federal debt has risen over the last few decades". We're going to try and understand this a bit more in a moment.

Why is the debt rising?

A lot of people are concerned about the relentless rise in U.S. debt, especially the acceleration experienced since the 2008 global financial crisis. People are right to be concerned – it's not "good".

Explaining why the debt is rising would seem simple – the U.S. government keeps spending more than it earns! It follows that the solution is also simple – they need to spend less or tax more!

As individuals, this is the reality we know to be true about the world. We're all "financially-restrained" and we know that if we continue to spend more than we earn, bad things are guaranteed to happen. But as I've described when tackling these sorts of topics before, nations are not individuals or businesses! We cannot apply the same logic to a nation.

Whilst there's no "one reason" for the debt build-up, a key reason is global trade patterns.

Global trade? What's that got to do with profligate politicians? Well, as I'm going to attempt to explain, a lot…

Globalisation

Selling goods and/or services is a great way to earn money – as individuals, we know that to be true. Well, it is the same for a nation. If a nation can increase the amount of goods and services it sells, it will be better off.

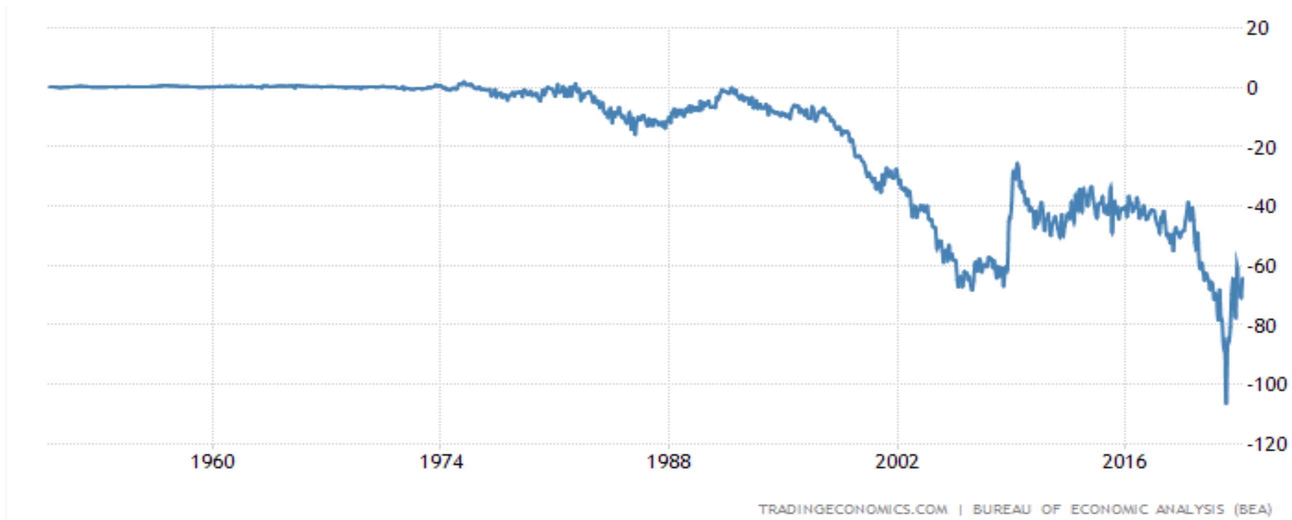
Trade between different countries and different parts of the world has obviously been a thing for many centuries. But something very significant has happened over the past 25 years. Global trade patterns have changed – and in a very significant way.

The most significant event during this period was China's entry into the World Trade Organisation in 2001. As I've described before, this heralded the "made in China" era that has persisted since then.

Think back over the past 10 to 15 years… How often do you remember saying to yourself "wow, stuff is so cheap these days". I know I sure have. $400 big screen TV's and computers… $99 pressure washers… $2 plastic things… And everything almost exclusively has a "Made in China" tag attached.

This era has seen a general dismantling of trade barriers. Goods have freely flowed around the world. Companies from all over the world have been driven to set up manufacturing and source goods from wherever is cheapest. China has played a pivotal role in this globalisation as it embarked on "mercantilist" economic policies specifically aimed at capturing a huge share of global demand for "stuff".

It seems like a win for everyone, right? We in the west get cheap "stuff" whilst Chinese people get jobs. Well, it does have benefits, but under the surface there's been some serious economic shifts. Western nations can now source goods from other countries far cheaper than we can produce them ourselves. In many countries such as the U.S. this has had a major impact on the "terms of trade". Below is a chart of the U.S. trade balance with the rest of the world:



Notice that a trade deficit has been a standard feature of their economy since the ‘80’s. But notice how it really sped up over this last 25-year period.

In dollar terms, the U.S. imports far more goods and services than it exports.

On the flipside, there’s nations like China that export far more goods and services than they import – they run massive trade surpluses.

Consider that, conceptually, a “cash adjustment” is needed to balance this. For example, say China sends the U.S. $500 worth of goods and the U.S. sends China $100 worth of goods. Conceptually, the U.S. has had to send $400 in cash to make up the difference.

If a nation is running a trade surplus with the rest of the world, they are essentially importing “money”. This might seem fine – as individuals, we’d sure be very happy with that arrangement! And to an extent it is fine on a national level. But when the numbers get as large as the current global trade imbalances, it gets a bit problematic.

Unlike an individual, consider that on a national level China doesn’t exactly benefit via making a profit selling goods. The money isn’t the reward - the real benefit to them is the ability to export the surplus capacity it has created – to make much more than they can consume themselves and then sell it. All the jobs created from being the world’s factory – that’s the national advantage.

But due to its massive trade surplus, China in essence has mountains of cash it received from the sale of those goods. What do they do with it?

This is where it’s important to really focus on the reality that a nation is not an individual or business.

If we’ve received US$5,000,000 from the sale of something to a U.S. company, we’re delighted! We can go to our friendly banker in Sydney and have them exchange it for Aussie dollars. We can then go on a wild spending spree!

Now, bearing in mind that the Chinese government catches huge amounts of the capital inflows at the border as a means of keeping its currency value under control, what do they collectively do with billions in capital inflows?

Convert it to Yuan and go on a spending spree? In aggregate, they can’t! The nation can’t absorb the inflows without undesired consequences such as a soaring currency, loss of competitiveness and inflationary pressures.

So they have to “park” it all somewhere. And where do you park billions – trillions – of money? Well, you need a deep, open, trustworthy market. Most of it needs to be “liquid” also – you need to be able to get it back quickly if you need to in order to aid in controlling those capital flows and currency stability.

How about dumping it in Russian or Saudi government bonds? You could a little bit, but the markets simply aren't big/deep enough to absorb much, not to mention perhaps somewhat "untrustworthy".

Australian government bonds? Stable and trustworthy, but again simply not big enough to absorb much.

How about resources? Stockpile it in minerals, farmland… Nope – that's not going to work on any meaningful scale for various reasons.

U.S. government bonds? Now you're talking! A massive, transparent, open market capable of (and willing) to absorb massive capital flows!

Understand that a "surplus" nation will have a problem of where to park capital inflows and the bigger the number, the lower the options available. As long as China wants to run a trade surplus, it will have this problem. It will in essence be forced to invest in U.S. government debt as this is the only market capable of absorbing the scale of fund flows.

Returning to the statement on that chart above – "U.S. dependency on foreign lenders to finance the federal debt has risen over the last few decades".

Well, that's a bit disingenuous to say the least. It's not that the U.S. has become more "dependent" on foreign lenders. It's the reality that major "surplus" nations have been required to park money in U.S. debt in order to help maintain their trade surplus.

It follows that as long as China wants to run a significant trade surplus with the U.S., an inevitable consequence will be China holding vast quantities of U.S. debt.

"Okay, I think I follow you on that Lindsey… but it doesn't really explain why U.S. debt is constantly rising…"

That's true. In terms of the global trade imbalances, we need to think about what impact these have on "trade deficit" nations like the U.S.

To try and explain this in a "plain English" way, let's turn our attention to Australia.

We too have had a habit of running a trade deficit (importing more than we export) in recent decades. However, it's been much more balanced than the U.S. – often even a surplus.

What's the main reason for that? Commodities – our vast commodity exports! Without them, we'd probably have persistent massive trade deficits just like the U.S.

Now, imagine for a moment that demand for our exports completely collapsed. What sort of effects would that have on the nation?

One immediate impact would be rising unemployment, right? All those mine workers out of a job. These workers would need to be absorbed into other sectors of the economy.

Say you're an electrician working in the mines on $190,000 p.a. You're qualified to get a job doing some domestic or industrial work, but these jobs only pay $100,000. And what's more, because there's plenty of displaced electricians seeking a new job, employers are finding they can secure skilled electricians at a lower wage than previously!

A decline in domestic production causes a rise in unemployment which has further flow-on effects such as suppressing wages across the entire economy.

In developed western nations, we're pretty good at looking after each other – we have pretty good government "safety nets" – unemployment benefits and the like.

Unemployed workers don't tend to pay much tax whilst they can often claim some government financial support.

So a decline in domestic production reduces government revenues whilst increasing government costs.

Now another example… Say you're a civil engineer that's previously been working in the mines. You're capable of working on some major infrastructure projects… if only there were some going ahead…

A decline in domestic production resulting in a rise in unemployment will likely mean the economy is performing pretty ordinary at that point. Western nation governments feel the heat when this happens. They feel pressure to do "something". And spending money investing in projects is a good way to create economic activity and employment.

What I've hopefully done in a crude but practical way is to demonstrate the economic forces exerted on nations by global trade. Whilst on an individual level, it's great to get loads of cheap "stuff" from China, as a nation, accepting a persistent trade imbalance comes with negative consequences.

The consequences are a drag on growth. It will pressure national debt to rise – either government or personal debt (or both).

In summary, as long as the U.S. runs a significant trade deficit and is accepting of the capital inflows resulting from "parking" the cash outflows required to balance the trade deficit (i.e. the "current account surplus"), it is likely there will be relentless pressure on debt to rise.

It follows that in order to help reduce this pressure on debt, the solutions are not necessarily about the government simply spending less - they need to focus on measures to reduce the trade deficit.

Separately (but very much related), in terms of the U.S. dollar being the dominant global currency for trade, little progress can be made as long as the U.S. continues to flood the world with dollars – a side-effect of those cash outflows that's an inescapable feature of the trade deficit.

Put differently, as long as China wants to run a significant trade surplus with the U.S. they will need to deal with accumulation of substantial reserves and all the dollars it causes.

Their "solution" is to balance the trade but of course that would be damaging to their economy as they would either need to absorb all their production internally (impossible, at least to begin with) or close factories and lay off workers.

But there's more…

Circling back to "cheap stuff", this period of global free trade has brought powerful **<u>de</u>**flationary forces. And to repeat, a decline in production in many western nations has pressured economic growth.

How have western central banks responded? Well, as we know well, the U.S. Federal Reserve in particular has been emboldened by the low inflation environment. After the early 2000's Tech Wreck and subsequent recession, central bankers have become increasingly "activist".

Zero interest rates. "Quantitative Easing". Come on economy – grow! Come on inflation – go up!

With inflation not an issue, rates were held too low for too long after the 2001 recession. One outcome was a worldwide "reach for yield" culminating in the mortgage bubble and subsequent Global Financial Crisis of 2008.

Then the Bernanke Fed doubled-down. With inflation still non-existent, they did even more to try and stimulate growth (and inflation).

By depriving investors of any risk-free yield for many years, the Fed encouraged a huge bubble in all kinds of assets – shares, bonds, crypto, NFT's, real estate, venture capital… you name it.

Whilst not relevant to today's missive, it's our view that there's a lot more downside to occur in many risk assets as this unwinds – particularly shares.

What these bubbles have done is driven a massive transfer of wealth – asset owners have benefitted enormously from the economic forces of the past two decades. Ordinary workers in a deficit nation like the U.S.? Well, they've been squeezed by a sluggish economy and low wage growth. Now, they are further squeezed by a significant spike in inflation!

Relating this back to the U.S. government debt, many people fret over the nation's ability to service it. There's a few more comments below on this, but for now let's just focus on what servicing the debt means.

Servicing the debt means paying interest. Interest is paid to the bondholders. And (generally speaking) who owns government bonds?

Wealthy people.

The increasing government debt effectively acts as another driver of income inequality - debt servicing effectively transfers resources to already wealthy people from economic sectors that would be more likely to use these resources for consumption or investment. In such cases, the intra-country transfer of resources represented by debt-servicing will reduce aggregate demand in the economy and consequently slow economic activity.

Where to from here – is U.S. debt sustainable?

Accepting the above arguments, there's every reason to believe that U.S. government debt will continue to rise. And it's important to understand that this, to a reasonable degree, is the by-product of global economic forces, not profligate politicians.

Surely it has to end, right – it can't keep growing in perpetuity for ever, can it?

It's hard to say: It's important to acknowledge that a national government such as the U.S. cannot "go bankrupt" with respect to debt denominated in its own currency. It will always be able to pay the interest bill.

But as the numbers get larger, paying the interest bill along with all other government expenditures will mean debt increases at an even faster rate. It also means it exacerbates inequality as the interest goes to the rich whilst benefits and services to the poorer segment are reduced in a futile attempt to "balance the budget".

Economic history demonstrates that unsustainable debt-build-ups have resulted in one of two outcomes:

- Either there's a debt crisis, or
- The outcome is lower economic growth

We can use Greece as a fairly widely understood example of the debt crisis scenario. In the years leading up to the European debt crisis that followed the Global Financial Crisis, Greece was subjected to powerful trade imbalances within the European Union. For the same reasons as described above with regards to the U.S., these forced Greek government debt up.

Greece famously defaulted on their debt and needed rolling bailouts from the rest of Europe to avoid a complete implosion.

But the critical thing to understand is that case was that *Greece didn't have control over its own currency!* It was part of the Euro. This was a critical part of their outcome.

The U.S. government has a mountain of debt denominated in its own currency. It therefore has a lot of control.

In the interests of time I won't try and elaborate on the mechanics of all this. Suffice to say I believe it's very unlikely the U.S. has a government debt crisis. A private sector debt crisis similar to the Global Financial Crisis? Yes – I'd posit that's almost an inevitability at some point! But it's unlikely the U.S. faces a government debt crisis similar to Greece or Argentina or Venezuela.

The "lower economic growth" scenario seems a real possibility. The relevant example here is Japan.

Japan famously suffered what's often called its "lost decade" after their boom period. Since the '90's, government debt has been piled on – currently standing at around 226% of GDP. That's close to double the U.S.

It's quite well known that Japan's growth and inflation has been incredibly subdued. Indeed, a lot of the debt has been the result of their government trying to stimulate economic activity – to little avail.

In summary…

I appreciate this has been rather a long blog – hopefully you've stayed with me and I've stimulated some thought.

Perhaps the key point I'm trying to convey is that there's a lot of interconnected pieces in the global economy. And what's good for one nation can have damaging ramifications for others.

Based on the balance of payments accounting identities, trade surpluses need to be matched by trade deficits. Trade deficits need to be somehow "financed". This "financing" process necessarily means deficit nations transferring financial assets to trade surplus nations.

As long as the U.S. is “willing” to run a significant trade deficit and thus be “the consumer of last resort” for all the surplus goods produced by nations like China, the world will be flooded with U.S.$ assets. These can’t magically “transform” into something else.

All the while, by playing that role of “consumer of last resort”, the U.S. basically relies on continued increases in its debt burden (either public or private or both) to help balance things.

The U.S. would surely benefit from a world much less reliant on the U.S. dollar. Instead of implying doom and gloom, less reliance necessarily means global trade has equalised to some extent – the U.S. trade deficit will have declined, which is a great positive.

In terms of where the debt-road leads for the U.S., I really don’t know. Nobody does. Veteran U.S. finance commentator John Mauldin talks about “the great reset” – an idea that things are headed towards a point where it all somehow just stops. I’m sympathetic to these views – I’m a big believer in the idea that “what can’t go on forever won’t go on forever”.

But given the precedents like Japan, I sense that the re-set button isn’t in view at the moment.

There’s plenty of things to be concerned about in finance-land. But a U.S. debt crisis isn’t one of them.