



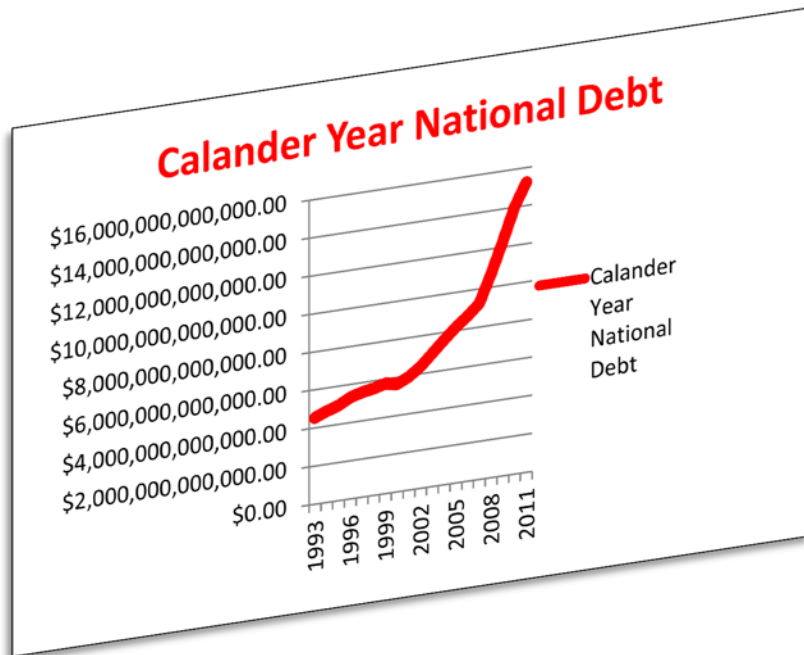
L. R. Levin Consulting, L.L.C.

Newsletter

January 2012

Drowning In Debt, Can The United States Learn To Swim?

In commenting on the growing federal spending projected over the next 10 years, including the growing cost of entitlements,



the Congressional Budget Office (the “CBO”) has said “If revenues remained at their historical average share of gross domestic product (GDP), such spending growth would cause federal debt to grow to unsustainable levels. If policymakers are to put the federal government on a sustainable budgetary path, they will

need to increase revenues substantially as a percentage of GDP, decrease spending significantly from projected levels, or adopt some combination of those two ap-

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proaches.” The most striking thing about 2011 was that, in spite of the 2010 election message, the government, including the Fed, took no meaningful steps toward reducing the deficit and putting the U.S. on a sustainable course!

What are the alternatives to avoid our debt becoming “unsustainable?”

One is to adopt policies that promote economic growth as measured by GDP. The U.S. was known as the “land of opportunity” because our free market system efficiently allocated resources based on a consumer oriented demand based model. Our liberty and free market economy has repeatedly fueled substantial periods of high GDP growth.

As we have pointed out in numerous columns over the past 3 years, the current government’s policies have not contributed to a return to meaningful economic growth. ([Click Here, for example, to see our January 2010 Newsletter and article “Will The U.S. National Debt Level Affect Our Recovery?”](#)) By failing to return to a sustained strong growth in GDP and control spending, federal revenues have not grown at a rate necessary to sustain our current spending levels.

Secondly, the CBO suggests increasing revenues as a percentage of GDP. Fundamental economics teaches that if we merely increase taxes under current circumstances, thus taking a higher percentage of annual GDP for the government, economic activity will decrease and GDP will fall. In short, taxes will become an increasing percentage of the falling GDP, but tax revenues will also fall making the problem worse.

The third course suggested by the CBO is to decrease government spending. This has both positive and negative effects. The positive effects come from reducing both taxes and borrowing. By reducing borrowing, the government stabilizes interest rates and capital allocation by not competing with the private sector. This increases growth by more effectively allocating resources to activities that consumers will continue to demand, sustaining growth both in GDP and government revenues.

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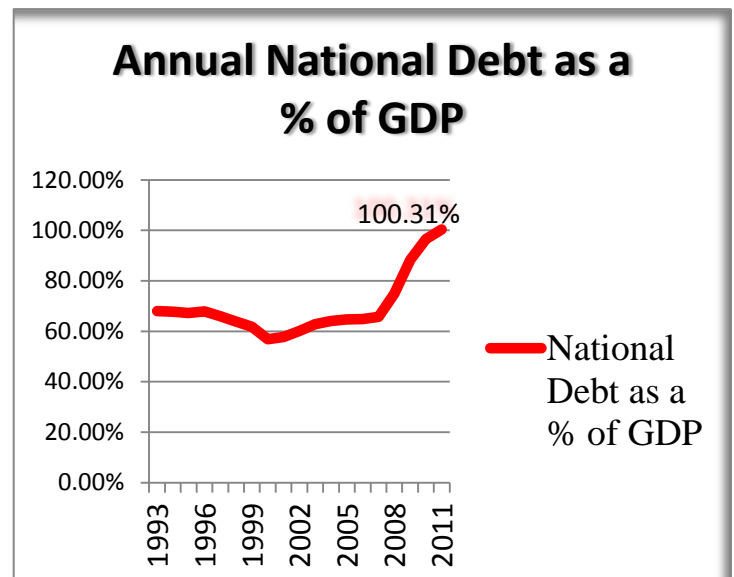


Lowering taxes similarly promotes sustainable growth by increasing purchasing power in the private sector. This creates jobs, increases tax revenues and reduces the government's cost of social programs associated with a stagnant economy.

The negative effects are that reducing government spending withdraws support from the areas of the economy that the government has been supporting. If the economic activity supported by the government is not replaced by private sector activity, it could hurt growth. That is why, just as with taxes or other aspects of policy, how and what the government cuts or increases matters.

Over the past 3 years the government has increased taxes and spending materially. The result is dramatically growing debt. There is scant evidence that the economy has benefited. The evidence is that government policy has impeded what a normal private sector driven recovery would have otherwise produced. *So as 2012 arrives, are we adjusting and learning to swim or pressing forward to exhaustion and drowning in debt?*

The national debt has now surpassed \$15,195,387,000,000. Our GDP for calendar 2011 is estimated at \$15,176,100,000,000 and our deficit for 2011 was \$1,304,152,000,000. In spite of a slight improvement in the size of the deficit, our 2011 deficit was 8.58% of our GDP and the total national debt as of year-end was 100.31% of our GDP. Between 2007 and 2010 the percentage of GDP represented by our annual increased debt went from 3.9% to 11.8%.



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The U.S. has largely escaped the sovereign debt problems of Europe for the past 3 years, because world economic conditions made U.S. debt the safe investment haven of choice. This, coupled with the Fed's low interest policy and disproportionate short term borrowing, has kept the average interest rate of our national debt artificially low. The current average interest rate on our debt is 2.835%.

If by a miracle, our deficit is zero in 2012 and our debt doesn't grow by even a dollar that would mean the government would pay \$430 billion in interest in 2012 alone. If the average cost of our debt returned to the 3.32% the U.S. paid in 2009 we would pay \$504 billion in interest. *But will these low interest rates last?*

By contrast to our 2011 budget deficit of 8.58% of GDP, Italy's deficit was only 3.3% of GDP in 2011. If the financial markets read the CBO's predictions more carefully, they might *not* find us more credit worthy than Italy!

Recently, Italy's interest rate on 2 year bonds hit 7.89%. If the U.S. had to pay the 2 year Italian rate, it would cost us \$1.198 **trillion** a year in interest on the current debt. That would be \$678 billion more than we currently pay. Should you think this unlikely to happen, in December of 2000 the average interest rate on our national debt was 6.64%. Even at that rate the interest cost on our current national debt would be over a **trillion** dollars a year.

If our deficit continued to grow by the same amount each year as currently, our total national debt would be over \$28 trillion dollars in ten years. At an average low interest rate of 2.835% that would mean more than \$800 billion in interest annually. Applying the December 2000 average interest rate to a \$28 trillion national debt would cost over \$1.8 trillion a year! Such debt figures are totally unsustainable. That is \$500 billion more than the entire 2011 discretionary budget for everything but key entitlements.

As the national debt grows, more of the budget goes to pay interest on the debt. If the deficit continues to grow at the current rate, in 10 years there will be no dollars left to pay for anything other than interest! There were only 3 other

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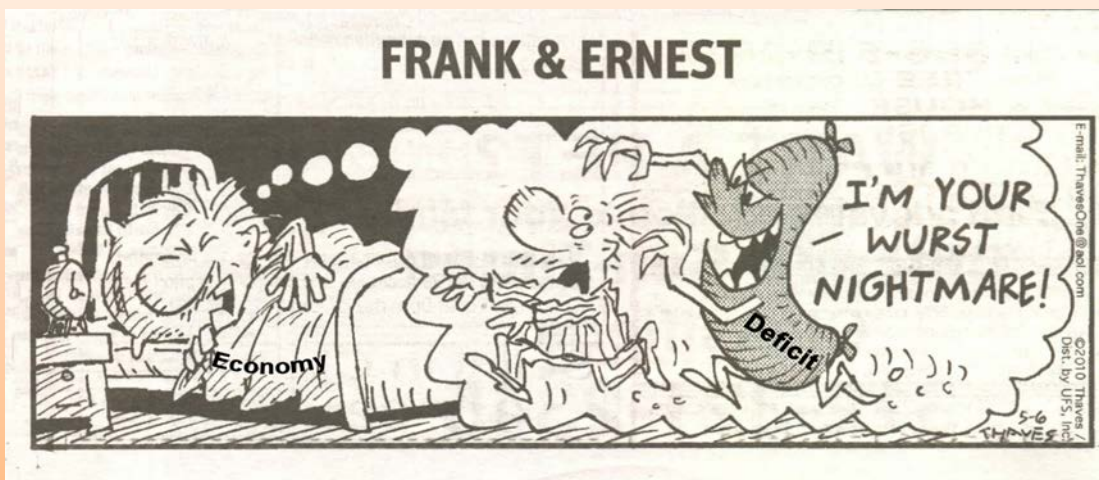
times in U.S. history where our annual deficit rate exceeded that of the last 3 years: the civil war, World War I and World War II. Because we have such a strong economy, we have not crossed the point of no return yet.

December was the 29th consecutive month of growth in the manufacturing sector and the 31st consecutive month of growth in the overall economy. Given all the stimulus of an election year, 2012 continues to look like another year of growth. Running one more year of trillion dollar deficits won't determine how the long term economy will turn out.

But if we go into 2013 continuing the current economic policy, we will, as John Maynard Keynes would say, drown in deficits "in the long run." By 2013 the government must concentrate on private sector jobs and growth through spending and tax cuts. Otherwise, our growing debt will, like Europe, drown our defense capabilities, our entitlement initiatives, and our standard of living.

In February 2011, we warned that if we didn't act to control the national debt it could lead to a new recession by 2014. ([Click Here to see our February 2011 Newsletter](#) and the article "[Will The Rising National Debt Cause A Recession In 2013 or 2014?](#)") Having failed to act in 2011, the consequences of not acting are becoming far worse.

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THE WISE OLD OWL

2012 in many respects will be a very unusual business year which can be confusing to many CEOs. A modestly rising business climate lies ahead for most sectors. Our **8 economic indicators** look like: retail sales should continue to improve, employment should rise throughout the year with unemployment gradually declining (although skilled labor will remain in short supply), GDP and industrial production should rise throughout the year, exports should improve, natural gas prices should continue low while petroleum should rise, the dollar should remain stable, the money supply should rise, and raw material costs should rise. As part of this, housing and nonresidential construction should see a modest improvement and banks will loosen lending.



Economists expect that the U.S. and China will have sufficient growth in 2012 to prevent Europe from pushing the world economy into a downturn. But economists do not expect the U.S. or Europe to have the will to face their problems during 2012.

It is 2013-2014 that will see the impact of failing to confront these problem. Underlying inflation, long term unemployment, uncontrolled spending and deficits, higher taxes, increasing entitlements all will have long term consequences.

As a business, that means the correct actions to take advantage of the growth opportunities in 2012, may well be the very actions that could cause dire consequences in 2013. How you plan for sales, marketing, financing, personnel, receivables and similar initiatives to take advantage of growth opportunities, while avoiding the pitfalls of a changing economic cycle, will make all the difference. The data strongly suggests that we will enter a new economic cycle in 2013.

What it does not suggest is what the ramifications of that cycle will be. The ramifications can take the form of any one of 5 different scenarios, depending on what actions the government takes or prepares to take in 2012. Each of those scenarios would have a very different impact on your business. We can help you prepare for what is ahead. [Call us.](#)

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