Ep54: The Government Deficit – What the Numbers Actually Mean!

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PATTI BRENNAN: Hi, everybody. Welcome back to the Patti Brennan show. Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives. Folks, here is the episode that you've been waiting for.

We're going to be talking about the government debt. Just what you wanted to hear about, right? My goal in this episode today and the one that's going to follow it, is going to be talking about the Federal Reserve. We'd like to take some very complicated concepts and a very complicated subject and break it down into terms that you can understand.

I'm hoping that by the end of all this, you come out of this with a better understanding of how the government works with the Federal Reserve because we certainly have seen that during this crisis with the coronavirus. I just want to boil it down and give you a little bit of perspective and understanding of why they might be doing some of the things that they're doing and what that might mean.

In yesterday's "Philadelphia Inquirer," the headline read, "Government deficit shatters the one-month record." In the article, goes on to report that about 10 years ago, the deficit for the month of June in 2019 was $1 billion. In June of 2020, it has skyrocketed to $864 billion in one month. The question is, are we robbing future generations in almost assuring bankruptcy for our children?

Joining me today is the Professor. It's who we call Eric Fuhrman. Eric is just a student of this stuff. He is so articulate. He's got such a good grasp and an understanding. Between the two of us, we're going to banter about and really boil this down in such a way, hopefully, that's going to make some sense.

Eric, let's tackle that first one. What do you think? Are we really being irresponsible with the deficit that we're adding on top of the debt that the federal government already owes? It's pretty crazy.

ERIC FUHRMAN: That's a deep question. I'd like to have a lighthearted moment with you first, which is, how is it that you and I keep getting topics like this over and over again? Income taxes, estate planning, social security. Now, the national debt. All the fun stuff.

PATTI: Hopefully not.

ERIC: We try and make it exciting, right?

PATTI: Exactly.

ERIC: That's the hope for the people there. To answer your question, yes. It's only human nature. Anything that seems large, big, unknown, what other feeling would you have other than to fear what you don't really understand or what you don't know

PATTI: Especially when you're comparing it to a deficit 10 years ago, that was a billion dollars versus over $700 million. We're talking one month, Isn't that scary? Should we be afraid?

ERIC: Yeah. What I think is important for people out there, regardless of how you get your information, maybe it's print, maybe it's TV and so forth, is to always remember you're getting data points but you're not getting all the data points. You're not getting the whole story.

To look at the deficit of last year versus the deficit of this year, I think the Bureau of the Fiscal Service publishes the monthly borrowing of the Treasury, borrowing or surplus. It's a very, very volatile number. You see these wide differences, but you really have to take it in context of a much broader picture.

I hope what we're able to communicate here to our listeners, is really to dispel some of the myths. More importantly, when you have education, when you have understanding of something, then I think it becomes less scary. Hopefully, we're successful in doing that today.

PATTI: I think it was Brian Wesbury. He had a blog. I love Brian Wesbury. He just writes so well. The headline was, "Coronavirus, it's scary but is it dangerous?" He goes on to really explore that concept. It is scary, but is what is going on actually that dangerous, as it relates to the economy, the markets, etc?

Is the response that the government has really had to embark upon, does it necessarily mean that income tax rates are going to have to skyrocket, inflation is going to get out of control? Are we in fact, robbing the future for our children?

ERIC: I think that's an important distinction. When we're talking about the government response here, we're talking about the fiscal and economic response that they're engaging in. I think what we have to explore first, is the predominant view. It's almost orthodoxy amongst politicians and the public, that the US government debt is this bad thing.

This looming thing that is a great burden, that eventually has to be paid back, that eventually by spending profitably today, we're essentially robbing future generations, and they're going to be stuck with a bill.

PATTI: I'm going to stop you right there, and what doesn't help are the headlines and the newsflashes that basically just give you our national debt. It just ticks up, and up, and up every single second, and it just makes people feel that much more uncomfortable.

I think that one of the things that we had talked about, and not to steal the thing, I think the newsflash that we're going to get from this, the bottom-line to this is, it might not be as bad as you might think, right?

ERIC: Yeah, absolutely. I think the first observation you have to make is that the government, just like businesses, are perpetual. They don't have an infinite life…I'm sorry, they don't have an end like we all do. Our life is finite. These institutions aren't, so I think that's first to keep in mind.

Also, when you talk about the size of the debt, people have to realize right context here. The economy is phenomenally bigger today than it was in 1990, 1970, 1940. We exist now in what's called basically a fiat or a credit-based system.

As credit expands, when economic activity expands, the debt is going to naturally expand as well. It's a first important distinction that people have to have.

PATTI: Let's talk about how the federal government manages its finances, and compare that to how we manage our own finances. If I were the financial planner for the US government, I'm not so sure that I would feel that great about the debt.

Now, let's talk a little bit about, does the government pay off the debt? Should we be paying it down? What is this thing that's referred to as this thing, this fallacy of composition, that the government should be managing its finances like you and I do? Why is that a fallacy?

ERIC: I think that's an interesting point. I think part of the public's bewilderment over the debt really stems from what you're describing, that there's this parallel that's drawn between government finances and that of an individual household.

We all recognize that we should…Judicious financial management is to save, to basically invest wisely and not engage in unprincipled behavior. We take that and say, "Well, the government should do the same thing."

That's a fallacy of composition to assume what is good for the individual is good for the nation as a whole, and I think that part of the misunderstanding is that that's not how it works. What's good for you and I is not good policy at the national level.

Part of this understanding that we're going to explore is, there's really two primary sectors in the economy. There's the private sector, which are basically households and businesses, and then there is the public sector, which is the government.

We're going to get into that a little bit more, but I think that's the biggest thing that people have to understand, those two distinct sectors in the economy.

PATTI: I think that the myths and the misperceptions of how all of this works is an important thing we want to clarify. Let's talk about the Fed and the government, and how the balance sheet works.

When you and I look at a balance sheet, we've got the liabilities, but when we're working with a client, we're not just looking at the liabilities. We're looking at the assets as well, so what is missing in all of those headlines?

ERIC: That's an interesting point. I think you put up the picture of the national debt clock, that everyone knows what that is, and it shows your family share of the national debt.

You make a great point. There is this myopic focus on the debt, but why would you not ask the question, "Well, what are the assets?"

Every liability has an asset somewhere in the financial system. We would never look at one of our clients and only look at the mortgage, and not consider the collateral, the home that secures that mortgage.

I think what's important for people is to understand what are the assets of the country. You really have to consider the other side of the balance sheet, which is far more important for that matter.

There's various ways you can calculate this, but the Federal Reserve puts out every quarter what's called the Z1 report. This is a reconciliation of the country's finances.

What you would find, and I believe this is at the end of 2019, is that the household sector of the United States has over $117 trillion of assets. These are physical things, buildings, structures, equity, $117 trillion. When you consider the national debt, there's about, I don't know, roughly five times more assets than there are debt.

PATTI: Yeah, I mean if that was a home or any other kind of debt, that's a pretty good debt to equity ratio. Let's kind of take a step back, and really think about an important principle that I think so many people kind of miss, and that is something that Abraham Lincoln said in his Gettysburg Address.

What he said was, "We are a government of the people, by the people, for the people." That's really important because, when you bring up the government debt and then you talk about the household assets, why are we adding in the household assets?

That's because we are the United States of America, we are owners, if you will, of that debt one way or the other. When you think about a treasury bond, and let's really simplify this for everybody listening, because it was the only way I could get it, Eric.

We're simplifying here for Patti Brennan, and then hopefully, it'll help everybody listening today. When the government has debt, what is that? Basically, it's treasury securities. What they do, very simply, is they issue a bond, bond represents debt.

If I, Patti Brennan, buys a $10,000 treasury bond or if I buy a mutual fund that's treasuries or government debt, I have lent the federal government $10,000 and they've got the cash, and I have the security, so literally I have an asset that is part of my net worth.

Over time, the federal government is going to pay me interest, every quarter, what have you, and at the end of the term, they're going to give me my money back. That's the way it works, so you know to a certain extent. The government really owes the money to us, the citizens.

ERIC: Right. Yes. Essentially, the interesting observation from what you just described is that we both owe the debt and we own the debt, right?

PATTI: There you go.

ERIC: That's an interesting concept to think about here, but really what you're kind of describing is, basically, the auction process of how does the government issue debt? When the government decides to run a deficit, which they pretty much have since the 1950s, there's been very few times where there's a surplus, they have to close the gap. What do they do?

The treasury then will sell securities to a network of dealers, and those dealers then sell the bonds to individuals, and so forth. Think about the transaction that's happening.

Basically, the government will sell a treasury bond, the owner of the bond will now have an asset. The government records a debt, one offsets the other. And the government receives payment.

They take cash from the person that bought the bond. Now the government spends the cash which goes right back into the financial system, just in different accounts. The recipients of whoever invoiced the government, employees, whoever it might be.

Essentially, there's an equal and corresponding asset and liability, one in the private sector, one in the public, and the cash in the system has not changed. There's been no printing of money that's occurred.

PATTI: That's really interesting. You've brought up a really important point, and it goes to this kind of idea of the spending, and how the government uses the money. Again, the government gets money different ways.

It gets money from taxes, part of what I think the reason why the deficit was so high in June is because, guess what, those of us who owe taxes didn't pay them April 15th. We got an extension. The April 15th is going to be in July. That's number one, but also, they issued that debt.

What happens is they pay that interest. It goes into our pockets. Then we have it to spend or to invest. Those are, basically, the only two things that can happen. When the government spends money, they are either using it, it's an expense, to hire people to work for the government.

One person's expense is another person's income. Very important. One person's expense is another person's income. Yes, they're spending it, but if they spend it to judiciously, I can't say that word, Eric. You say it much better.

ERIC: Judiciously.

PATTI: If they're smart with it, let's say that.

ERIC: That's good. I like that. We'll go with that.

PATTI: If they're smart with it, what they're doing is they're keeping people employed, or they're using it to purchase things to support the military, or to provide services for its citizens, because again we are a government of by and for the people. The government is there to provide relief, service, protection to the citizens. They do that by spending money, employing people, etc.

ERIC: Right. Yep. Absolutely. I mean they do all kinds of things in terms of the research that they provide, employment in all kinds of various industries. They're doing, in a lot of cases, there's plenty of criticism that there is fraud and waste that occurs. There's no doubt about that.

PATTI: I was going to say that too. When we talk about spending, and this is where the politicians get involved, and this is really an important topic as we get into the election. It's not to say that there's an endless amount of spending that the government can do, and there is responsible spending that really helps the economy. It juices things up, creates demand where it doesn't exist, and it supports people who really need the support.

ERIC: Absolutely. I think the government does things, big things, that would be difficult for any individual or single private company to do on their own.

PATTI: Yeah. Let's talk about that, Eric, because I really like that point that we were talking about before, because there's two things you can do with money. You either spend it or you invest it.

ERIC: Right.

PATTI: Let's talk about the investment that any government makes. It can invest in transports, roads, bridges, trains. It can invest in the electric grid. The goal there, always, the goal for a government is to increase output. That's their bogey. They want to increase GDP, that's it. That's how they get measured.

We need to have growth in the nation to keep those assets building, because as long as we can have growth, the assets will grow in value, and the value of the debt, especially given today's interest rate environment, becomes less of an issue.

If they're frivolous, if they are wasteful, and we're not investing it to propel innovation and ease of use, ease of business, etc., then it's a waste, and it doesn't help GDP.

ERIC: Right, so that's an interesting concept. If the government is running up debts, and they're using that money on unproductive things, on subsidies or special interest, things like that, that are not going to provide a productive return to society, that's wasteful.

That's not good spending that invests in our future. As you point out, what's interesting is that we record the revenues, the spending, and the result in deficits, but the government makes very large investments. Think about the international highway system.

This is a significant investment that lowered transportation costs, made the entire economy far more productive because of the ease of moving goods and services, from coast to coast, and into the interior of the country. That's how many of these cities blossomed.

PATTI: It's really interesting. When we were comparing, I love the comment that you made Eric. It said something like, imagine at what life would be like if we were still on horseback.

ERIC: We wouldn't be nearly as productive as we are today.

PATTI: Exactly.

ERIC: We wouldn't have the standard of living that we have today.

PATTI: That's the goal, is to increase standard of living. It was also interesting, the way we look at it. Spending improves our standard of living today. Investment improves our standard of living tomorrow.

ERIC: Yes.

PATTI: That's how the government hopefully is and should be looking at this. The spending that's happening now, again, bring it back to today with COVID, they're spending a lot of money to improve or support standards of living today.

Right now, again, incomes went down, unemployment was huge. How are we going to keep these people afloat? The government steps in unemployment benefits, plus $600, etc. Right?

ERIC: Right. I think you make an important point too. Just on the last one about the investment, the interesting thing is that we see what the government spends, but we never calculate into that the return on the investment, the highways, the airports, the bridges, and those things.

Ultimately that gets expressed in basically the private sector, the increase in wealth that we all enjoy because now we can be more productive, live better lives, and so forth.

PATTI: Which is why GDP is the measurement.

ERIC: Exactly. I think there's an interesting segue here into times of crisis. How can government debt be helpful? I think that leads into another one of this wonderful fallacy of compositions, what John Maynard Keynes, the famous British economist called the paradox of thrift.

When you enter periods like COVID for example, it's enormous, unforeseen, enormous shock to the system. We have to think we're all human beings. We all have the innate response for self-preservation. Economically, what does that mean? That means that basically, we're going to save.

We're scared. We don't know what the future holds. We're going to save as much as we can. We're going to try and pay down debts.

PATTI: We're not going to spend it. We're not going to do what we would normally do. We see that on a micro level right here. People change their plans and say, "We're not going to do this renovation." We're not going to do these things that we were thinking about doing because we're worried. We don't know what's going to happen.

ERIC: Yeah. I think about how many clients that we've talked to, where they've received maybe a stimulus check, or they just said, “We’re just not spending money because we’re not going out and doing the things that we do.” Think about this on an aggregate level.

The idea behind the paradox of thrift, is that individual savings is good, but when everybody does it, it’s bad. Right back to your point, that one person’s expense is another person’s income. When people stop spending, what happens is all of that savings, that money, essentially becomes trapped in the banking system, in the financial sector.

All of a sudden demand starts to contract, financial assets go down in value. Eventually, you’ll have a domino effect of bankruptcies that emerge until the system just completely clears itself out, which is bad. That’s the stuff that happened in the Great Depression.

Where government debt can be very useful is that in these times, the government is the spender of last resorts. What they’ll do is run humongous deficits that will require them to sell treasury bonds. If you’re an environment of great fear, what do people want? They want a safe haven, a risk-free safe asset.

What do you know? What’s the best performing asset class this year? Long term government bonds. They’re up phenomenally. Essentially, what the government is able to do by running deficits and selling those treasuries, is that they are able to extract that savings that is trapped in the banking system, and then spend it in the economy.

They’re essentially trying to make up for the lack of demand because consumers are not spending. Ultimately, that will hopefully soften the landing, arrest, the decline in asset prices, and hopefully reinvigorate the economic engine again to get people spending and borrowing.

PATTI: It’s so interesting. I think it’s fascinating how the government basically can monitor that, and basically come in where the consumer has left. The consumer to your point leaves two ways. They stop spending, they pull in, maybe stop paying their mortgages and things of that nature, making the banking system more fragile, etc.

Although sidebar, I think it’s very interesting to see how well the banking system has performed, passing the stress test. The legislation that was passed after 2009 really was effective. The banks know that they’re going to be monitored, and that whole thing has to continue. They’ve got to remain solvent.

The bank’s role really is to lend the money out. The whole idea of the banking system is to put money, literally cash into the hands of individuals and businesses in the forms of loans for them, to give people a bridge to get through this crisis. Right?

ERIC: Yeah.

PATTI: I think it's also important to point out to everybody listening because I know that this is a heavy subject. It's one filled with lots of fear. When we think about that huge rise of the debt, we have to understand that the debt really never gets paid off. To use a quote that you had shared with me, a rolling stone gathers no moss, so that it just continues to get rolled over.

The real expense for the federal government is the interest on the debt. When you compare the amount of interest that the federal government is paying on that debt, it's actually lower than it was in the '80s and the '90s because interest rates were much higher.

ERIC: Actually, to go back on that comment, I think in central banker speak they would say, "A rolling loan grows no loss."

PATTI: Ooh.

ERIC: That's how they would modify it probably.

PATTI: That's interesting.

ERIC: As long as you can rollover your debt, then you never have an issue.

PATTI: Let's talk about that part. We can say, yeah, the federal government can spend and spend, and support and support, and do all of that wonderful stuff. What could happen, Eric, in terms of, what's the downside to this? Ultimately, for example, could the debt be called?

Could people stop buying it? Ultimately, we're only as good as the confidence that people have in our ability to pay it back. Right?

ERIC: Absolutely. I think the United States when it comes to the debt, would never have a problem of insolvency. We think about ourselves, an individual can certainly become insolvent. You could run out of money to keep supporting and paying your debts. That's how you become bankrupt.

The United States is unique. It doesn't have that problem. We have an independent monetary authority called the central bank, and they have a monopoly power over printing money. In our case, the Federal Reserve can create an infinite amount of money. There would never be an issue of never having enough dollars.

Really the problem that you would have would be one of confidence. You see this and other governments, Zimbabwe, Argentina, there's other serial defaulters in the world that are a great examples. It would ultimately be one of confidence where there would just be such mismanagement by the monetary authorities or our elected officials.

That would be the thing that would be problematic, in terms of the debt. It would never be an issue that there wouldn't be enough money to pay it.

PATTI: It's interesting. I guess it's hard to go bankrupt when you owe the money to yourself, right?

ERIC: Yes. That's an interesting concept. It's a little bit hard to wrap your mind around, but yes. Essentially, we are the ones that own the debt and we owe the debt.

PATTI: We're going to get into that in a little bit of detail in a minute. I know you guys who are listening to this, or watching this or thinking, "Well, wait a minute. We don't own all of the treasuries out there." You're absolutely right.

The United States, the citizens of the United States, via either mutual funds or individual bonds, or through especially institutions and especially pension plans, own 64 percent of the debt. Who owns the rest? It is other nations. All right. Since I brought that up, I'll bring Abe Lincoln in a little bit later. Actually, can I just tell you about this Abe Lincoln? I love this quote.

ERIC: Yeah. Sure.

PATTI: Let's just do this.

ERIC: He had many great speeches in history that are just timeless.

PATTI: It's just crazy that he was so smart. It's just crazy, way back when he really understood something, that we really didn't get our arms around until after the depression, and the mistakes that were made during the Depression. What he said was, "The great advantage of citizens being creditors as well as debtors, with relation to the public debt is obvious."

Men can...and sorry, men and women. He said, "Men can readily perceive that they cannot be much oppressed by a debt, which they owe to themselves." I thought that was really fascinating even back then, as they were fighting the Civil War, and financing all of that, and we got into World War II.

Again, we go through all of these crises. If you listen to the last podcast with Brad, we talked about this. It was, every time we go through one of these things, we learn. We learn what worked, we learn what didn't work, what was OK, or how we could have gotten out of a crisis.

We're going to go through a crisis. It's just the human element and the human nature. What tends to get us out of it faster without as much moral hazard as other situations... again, moral hazard. People are out there talking about this unemployment benefit, where two-thirds of people were receiving unemployment in America today.

Two-thirds of those people are making more than they would have when they were working, because of the extra $600. I

ERIC: It's interesting. I thought it would it would be 50 percent.

PATTI: Nope. It's two thirds. What's happening is the moral hazard of that is, as we get into this crisis a little further, these companies are saying, "OK. Time to come on back. Time to come on back." These people are thinking, "Well, I don't know. I like this whole thing. I'm making more money. I don't have to go into work. I don't have to worry about my kids. This is a pretty good deal."

Again, it's temporary. Does it create a moral hazard, etc.? Again, I just think it's fascinating in terms of how all of these sloshes around the system, what it leads to in terms of behavior, whether it be on an individual level or a company level, what they did with the PPP loan. Hopefully, that is forgivable for many.

For a lot of businesses, that PPP kept them in business. That's important because we need businesses to provide goods and services. When demand comes back, if so many companies go out of business, we don't have the people when the businesses to create the goods and services.

We have all of this cash chasing even fewer goods, and guess what happens? Inflation goes nuts. That's what happened with all those governments. We need businesses. We need to keep people afloat. Those businesses are keeping people employed.

Those people who are employed then get the money. They get to pay their mortgages, they get to pay their bills, etc., and commerce continues to go on. It's not going to recover overnight. We talk about Vs. We talk about Ws.

We don't know. We don't know whether we're still in this recession or not, but the stock market, and we're not going to talk about the market, seems to think that we're going to get out of this thing pretty quickly. Who knows?

That's not what we're going to be talking about today, but it does make me think that the government may not be as clueless as a lot of people might think, right?

ERIC: Right. It easy to bash them, though.

PATTI: Oh, absolutely.

ERIC: It's a little bit fun too sometimes.

PATTI: Yeah, yeah, yeah. This patsy driving is the best. They are nothing like…

ERIC: I mean, come on.

PATTI: Yeah. Why not?

ERIC: It's like a pastime, right?

PATTI: Right, absolutely. Absolutely. Let's go back to this paradox of thrift.

ERIC: Yeah.

Patti: It just doesn't sound right. I thought it's good to save money, Eric. Why isn't it good for a nation to save money? What is the economic outcome if everybody just pulls back, puts money into the bank, and doesn't invest it, just let's it sit there? You mentioned it's trapped in the banking system. Why is that so bad?

ERIC: I would say it this way. We can't save our way to prosperity. You just can't. We're in a system that is based on the expansion of credit. You always have to keep expanding credit, and keep issuing loans.

PATTI: I'm going to play devil's advocate, Eric, because that sounds bad. Why are we expanding credit, because that means more debt? More debt is bad. Why does it work that way? I know the answer, but I want you say it.

ERIC: Gosh, I don't know. I would say that the reality is right. Ultimately, what's a loan? It's a financial asset for the bank, a liability for something else. Essentially, what we need, what banks do, they utilize the pool of savings, people out there that want to save and want a rate of return on their money, and then they essentially take that and make loans to good risks, to good ideas.

Ultimately, what does this do? It brings together all what we call the factors of production. Land, and capital, and all these things, and essentially, all that leads to greater output. We measure our standard of living by the size of our output. The more output is growing, that means the pie is growing, the economic pie is growing and everybody is better off for it.

If you look back from the 1950s, the '70s, and so forth, standard of living continues to rise, because people are being more productive. There's more output now, and it's more efficiently produced than it ever was at any point in the past.

Credit is really that way to access the savings that people are taking today and make those investments in the future that will lead to greater prosperity.

PATTI: I think it's also interesting, when you look at that, the interest on the debt, whether it be the government debt or what have you. Even though we have a lot more debt and the government is paying the interest on that, when you look back at the '80s and the '90s, and they were paying a lot more on an annual basis than we are currently, the '80s and '90s were one of the greatest periods of expansion in our nation's history.

It's not the debt, it is the servicing of the debt and how it's being used. If we expand credit, the goal there doesn't always happen, because you can loan money to a business for an idea that they have, and the idea may not work out. Over time, some ideas work out great.

Look at Tesla, for example, and look at what Tesla is doing with the space program. You might wonder why in the world do we care about a space program? It's not landing somebody on Mars, it's the technology that's developed to create the opportunity to land somebody on Mars, and then the application of that technology in life here on Earth.

The Internet was spending through the Pentagon. That was government spending that created the Internet, that gives us access to information that we never would be able to access, to put together a podcast like we are today. How about that?

The whole idea of credit, I can't build a company overnight unless I have money. I can't hire people. I can't provide good benefits. I can't attract them. I can't build a factory unless I have capital. A bank lends me the money with the idea that I will create a company that's profitable enough so that I not only can pay the bank back, I will also pay employees who will then use the money that they're earning to pay taxes, works it way back into the government.

We can talk about a lot of things today, but how all of that works. Then it circulates back in other ways. There are so many things that are going on, and it's not all bad.

It does take money to create money. That's the whole concept of allowing credit to expand, because it's been shown over a hundred years of our nation's history that expanding credit increases the net worth of our nation.

Does it do it evenly? No, and we're seeing that. There's a separation, the rich versus the poor, and more is going to the wealthy. Truly, that's probably... We can get into philosophical, and the tax system, and moving the wealth from the very, very wealthy to people who are struggling, etc. That's another concept.

We are a nation of, by, and for. That's just to keep that principle in mind as we go forward. We might be idealistic when we talk about this, Eric. I think that it's OK to do that. I think that today, I want to just drive home the point as we go into this election, that the government is there to support all of us, the people.

Some of us have been blessed and we are so grateful, and yes, we pay a lot of taxes, and that tax money isn't always used the way we would love it to be used. There are judgments sometimes we may or may not agree with. Eventually, it circulates through the system. It keeps the economy going. Right now, it's more relief, and eventually, it will help it to grow again.

What have I missed?

ERIC: I think that about covers it for Podcast 1, and then the Podcast 2. [laughs]

PATTI: Oh, you know what, Eric? Timeout.

ERIC: Yup.

PATTI: We got to do one more thing. Sorry guys who are listening. I promised you we would get into the government debt and the fact that the foreign ownership is up. Let's nail that one, Eric, because that's important.

People always talk about China owns so much of our debt, and Japan. Actually, Japan owns more of it. Japan owns seven percent. China owns six percent. Other nations own our debt. Can you, for our listeners, explain how do they get our debt? First of all, why would they get it? How does all of that work?

Talk a little bit about the trade deficit and how that works, and how they get the dollars in the first place. You and I can chime back and forth in terms of what the different ways that they can use that dollar.

ERIC: Maybe the best way to frame it is why wouldn't you want to own it. Let's talk about…As an investor, we want to find safe, high-quality assets that we can buy that will provide an expected return. Treasuries do that in a great way.

What are the mechanics of how foreigners accumulate so much debt like China and Japan? Let's form the linkage here with what you might be hearing in the public discourse, which is trade deficits. We hear all about trade deficits.

If Walmart says to a Chinese manufacturer, "I'm going to place an order for $10 million of stuff, junk,"

PATTI: Widgets.

ERIC: Or whatever. I shouldn't say junk. If they are going to buy $10 million, they receive the goods. The Chinese exported it. What do they receive? They receive payment in US dollars. That leaves them with a limited set of choices. What are they going to do?

Now they hold US dollars. They really only have a couple of choices. The can just leave it in an American bank…

PATTI: Wait, timeout. Very important, and this is one that…Keep it simple. They hold US dollars. Remember, it's China. They can't use US dollars in their economy. It is not their currency.

ERIC: Yeah. A great example would be this week when you do your grocery shopping, bring a stack of Japanese Yen with you and see if they take it as payment for groceries.

PATTI: Perfect example, exactly.

ERIC: They're going to look at you funny and be like, what is this.

PATTI: Exactly.

ERIC: Yes, you make an excellent point. Those dollars can only be spent in the US financial system. They don't go abroad and things like that. Maybe in the black market, people with suitcases of money, that might be true.

In any event, on an international scale, when you run a trade surplus with another country, you accumulate their local currency, their domestic currency.

PATTI: By the way, let's stop here. The trade deficit has run between what, two and five percent since the '70s. Something like that.

ERIC: Yeah, I think so. It was really big back prior to the financial crisis. Now it's come back in line with the historical two, three percent.

PATTI: Yeah.

ERIC: Basically, if you are a foreign exporter now holding US dollars, what are you going to do? You can leave it in cash, which is not productive. We would never leave anybody's money just sitting in cash.

PATTI: It's dead money.

ERIC: Or you can invest in US financial assets. You can buy stocks. You can buy bonds. You can buy real estate. What do most people do? The buy US government Treasury securities.

PATTI: OK, let's talk about that. They buy stocks, that's not bad, because it makes our stock market go up.

ERIC: Demand for our assets, right.

PATTI: They buy bonds, I guess that's not bad either, because as they buy the bonds, interest rates go down, so that's a way of keeping our interest rates low.

ERIC: Right.

PATTI: They invest it in land, or BMW buys a factory and builds a factory down in South Carolina. Not a bad idea either, right?

ERIC: Yeah. I think there is a...Prior to China, remember, there was a time when people thought Japan was going to take over the world, and there was these big stories about Japanese investors buying landmark properties in New York City. They even bought Pebble Beach, and I think they paid over $800 million.

Ultimately, they overpaid for all these assets, because Japan was going through a tremendous bubble at the time. Ultimately, foreigners have US dollars, they have to spend it in the United States. They can buy our goods and services. They can buy our assets, physical or financial, but if they don't like any of those choices...

PATTI: Let's go buy goods for services. Let's say they buy something from Walmart. That puts the dollars right back into our economy, and Walmart gets the money to pay the employees, yadi-yadi-yada. I'm just trying to bring home the point that the foreign ownership of our dollars isn't necessarily a bad thing, because eventually, we benefit from it, right?

ERIC: Right. They can buy our goods and services. Think about a German car manufacturer. BMW builds a plant in North Carolina. What does that do? That provides employment. I think there are something like over seven and a half million jobs that are created by foreign direct investment, where foreign investors invest here in our country and so forth.

Keep in mind, the dollars that they accumulate because of trade surpluses have to be spent here in the United States. They could always say, "I don't like the dollars. I'm going to go to the euro," but guess what, they have the same set of choices in the European currency. Or if they go to Japanese yen, they have the same set of choices within Japan.

If they decide, "I don't like any of those, I'm going to bring the currency back," what does that do? That means they're selling dollars, which depresses the exchange rate and makes US foreign goods more competitive on the world market.

PATTI: They don't want that either.

ERIC: Yeah. They haven't done that, right? So, yeah. No.

PATTI: Right. That's interesting.

ERIC: Remember the Big Mac Index that we looked at?

PATTI: Yeah.

ERIC: When you look at that, "The Economist" publishes this to give you an idea of how undervalued or overvalued currencies are relative to the dollar, because a Big Mac is a homogeneous thing, unless you're getting one in India, because they don't use meat there.

Otherwise, the Big Mac is the same, same ingredients no matter where you go, so it should cost the same once you convert your currencies, but the reality is the interesting part about the Big Mac Index is that they don't.

This is playing on a concept called purchasing power parity, which says the same thing should cost the same amount in the foreign currency once you convert it. They don't. You see places like the UK, China, their currencies are massively undervalued, based on this Big Mac Index. It's an interesting little way to look at it.

PATTI: Fantastic. This is really feeling good. I'm getting it. Let's pull all this together. To summarize, when you hear about the rising debt, we've always got to remember that there are assets to offset that liability. $117 trillion to offset $26 trillion, that's a pretty good ratio.

We also have to keep in mind that the interest is really what the government has to be concerned about. Can they maintain the interest payments on that debt? In fact, it's lower than it was in the '80s and '90s because of interest rates.

ERIC: What I would say to that point too is keep in mind the interest is not really an expense. There's all this talk that the interest rates will go up and interest will become this unsustainable burden and crowd out other spending in the government budget, and so forth.

Interest is not a government expense. They are simply taxing us, you, and me, and everybody else, but what do they do? They return that money right back to US citizens that hold Treasury securities, and those citizens determine what goods and services that they will spend that income on.

The government, it's not like other expenses where they determine what they're going to buy or invest in. The interest just comes into the Treasury and goes right back out to the holders' pension funds, which pay pensions to millions of Americans.

The interest isn't really necessarily the kind of expense that you would normally think. It comes in from all of us and goes right back out to those of us that have bonds, or pensions, or rely on some kind of fixed income.

PATTI: That's a really good point. That's a really important point. We got that. Assets and liabilities, interest on the debt is the most important thing to look at. Deficits of between two and five percent of GDP have occurred since the '70s.

ERIC: When you think about that, the question I always ask in my mind is why? Why do we always have these persistent deficits all the time? I don't know if this is the answer. I just anecdotally thinking about it is there's a large swathe of the electorate that wants fiscal discipline and tax cuts.

There's also a large swathe of the electorate that derives benefits from social programs and government spending. The reality is if you're going to have a balanced budget, those two things are mutually exclusive. You can't cut taxes and spend more.

As much as politicians might loathe the idea of running government debt, the reality is the government debt is a convenient way to have both at the same time, where you can cut taxes, you can spend, and what do you do? You finance it by borrowing from American citizens who a large proportion of them want a safe, secure financial asset that they can use to build their household savings.

PATTI: I think you had said another conversation, when you compare the US Treasury market to any other market, first of all, it's huge. It is much bigger than the stock market. It trades very easily, and it's transparent, and it's backed up with one of the strongest, most resilient economies in the whole wide world, so it's trustworthy. That's why people want it.

ERIC: We may talk about this in the next podcast, but there's always this notion that we have the world reserve currency. I think people have it a little bit backwards. We have the world's reserve asset. We have the premier financial asset that the globe wants, which is basically US Treasury securities, one of the largest, deepest markets in the world, as you said, backed by the highest quality revenue stream.

People across the globe don't accumulate dollars because they want US dollars. They accumulate dollars because they want the Reserve asset. Their holding of dollars is just a byproduct of that desire. As money moves fluidly throughout the economy, people are making transactions, there is a huge portion of that money that always seeks a safe haven, somewhere at the end of every day.

The system, it's beautiful. Every day, it balances, and there is always demand for that safe asset, which is the deepest liquid market in the world, US Treasury securities.

PATTI: I think also, to drive that point home, larger deficits coincide with slower economic growth, not spending. When you look at the charts, the graphs, all that kind of stuff, the bigger, larger deficits like right now, we just talked about that headline, it's because the economy has been shut down and growth has slowed. It's contracted. We're negative now. Negative

GDP. It tends not to coincide with greater spending. I think that's really interesting.

We've got that. We nailed that one. I think the most important, and I think the other thing is, and I keep on talking about Abraham Lincoln, just because I love him. We are a nation of the people, by the people, for the people. It is hard to go bankrupt when we owe most of the money to ourselves. That's the purpose.

We're getting back through the debt. I think we have to be smart about the way it's being spent and/or invested. That's really where you hear the bantering. We are a very wealthy nation. We are so wealthy. I think that that's something that we should all be happy about, proud of.

It's difficult a period of time, we're going to get back to growing one way or the other. It's going to come down to the virus, getting a vaccine. Here is that public-private partnership working very, very well. The government is funding these pharmaceutical companies, giving them money to do the research to get this vaccine faster than anybody dreamed possible.

Our government has made the decision to use some of our money, through debt, to give it to these pharmaceutical companies, to give them the incentive to say, "Work on this vaccine. We've got your back, and keep your employees working, and we got to find a solution."

Again, it's like the war bonds all over again when they issued war bonds to get us through war, too. This is not necessarily a discussion on public policy, although it just turned out that way. [laughs]

ERIC: Did we just fall into that? Oopsie.

PATTI: Yeah. We did. We did. It is not intended to be political commentary. I think it was just really important for you and I to lay it out, hopefully, in simple terms that people can understand, that there really is a lot of thought that's being put into this stimulus program that the government has approved.

Again, we got to understand that when you think about any kind of program, the fact that Congress and the Senate, collectively, every single individual approved the Cares Act, except for one person, that's crazy. To put that in perspective, these people understand that, that kind of...what was it? Two, four, whatever trillion dollars that they have committed over and above.

Back in the financial crisis, it was $800 billion. This is a big deal, right?

ERIC: Right.

PATTI: They did it like that within a week. Again, time will tell how it was spent, what it was being used for, lots of complaining, etc. I understand that. Yes, I wish everybody could get tested. These long lines are ridiculous. Was it perfect? No. Again, over time, they're going to get it right, or at least we can hope.

ERIC: I would say, if you look at the history, history provides a litany of examples of policy mistakes and times when the government didn't step in, in a big way. Bank panics were far more frequent in the 1800s and early part of the 19th century than they are today.

A big part of why they aren't there is because, you're right, of the regulations and the improvements in the central banking, the way it's done today versus the way it was done so many years ago in the infancy of our nation.

PATTI: Excellent. You've mentioned central banking, that's going to be the subject of our next podcast. Eric, thank you so much for joining all of us today. You are so eloquent.

You know so much about this stuff. I really appreciate all of the research and everything that you did to boil this down for this podcast for everybody listening.

ERIC: You bet. Are we going to wait for the next one and not reveal it till next season so everyone has to wait?

PATTI: Exactly. [crosstalk]

ERIC: They got to wait six months.

PATTI: This is the finale.

ERIC: That's right.

PATTI: This is the season finale.

ERIC: We're going to try and stretch it out.

PATTI: Exactly.

ERIC: The anticipation, central banking, lookout.

PATTI: Oh, my goodness.

ERIC: People will be hanging on the edge of their chair. [laughs]

PATTI: Actually, this is what they refer to as evergreen content. We could launch this now. For those of you who are listening, you could be listening to this now and every once in a while. When you got to want to get a primer on the federal debt, you can always listen again. Grab a glass of wine, having trouble sleeping, we're there for you no matter what.

Thank you again. Thanks to all of you for joining us. I look forward to the next time we get to meet again. I hope you have a great day. I hope your families are healthy, safe, and staying somewhat sane during a really difficult time in our nation.

Any questions, go to our website, www.keyfinancialinc.com. Give us your feedback. Ask us your questions. We're here for you. That's why we do all of this. Thanks again for taking the time today. Take care.