



- “You played it for her, you can play it for me! If she can stand it, I can! Play it!”
Casablanca (1942)
- “Well, here’s another nice mess you’ve gotten me into!” *Sons of the Desert (1933)*
- “Gentlemen, Chicolini here may talk like an idiot and look like an idiot, but don’t let that fool you. He really is an idiot.”
Duck Soup (1933)
- “All of life’s riddles are answered in the movies.” *Grand Canyon (1991)*

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Groundhog Day or Apocalypse Now? The periodic ruckus over funding the federal government and increasing the debt limit is starting to seem a lot like *Groundhog Day* where Bill Murray’s character is condemned to repeat February 2 over and over again until he “repents.” More seriously, we narrowly avoided a global financial apocalypse that would certainly have occurred had the U.S. defaulted on its debt obligations.

Our fearless folks in Washington managed to shut the government down for more than two weeks and then bring us to the edge of the debt default cliff. And after all this totally unnecessary anxiety, they only managed to cut a deal that funds activities until January 15 and allows additional borrowing through February 7. Hopefully, they’ll reach an agreement long before going to the brink of disaster again.

I won’t go into who is at fault, even though I have a pretty good idea. Some of the key Washington characters remind me of the whacko Colonel Kilgore superbly played by Robert Duvall in *Apocalypse Now* who uttered the unforgettable line, “I love the smell of napalm in the morning.” Suffice it to say that NOBODY has the right to hold me and my family – and you and yours – as economic hostages while they bicker over political and ideological issues. They have done real harm to the economy and our national (and international) credibility.

It is also very distressing that a sizable number of legislators and many citizens thought that default would do little or no harm. Misinformation seems to have a way of becoming the truth. Close to 40-percent of Americans said a government default would do little or no harm. I guess it’s a little like most Americans of a certain age would swear that Humphrey Bogart said, “Play it again, Sam,” in *Casablanca*. He never did.

A debt default by the U.S. Treasury would cause a financial tsunami. The default would cause the hitherto “risk free” U.S. securities to plunge in value. Holders of the debt would sell before they fell even more and – in the process – make them drop further. The malaise would quickly spread to mortgage-backed securities. As a result, financial institutions would find their capital base shrinking and possibly even facing insolvency.

Although getting rid of Obamacare was probably the chief motivation, an oft-cited goal was to come to grips with those federal deficits that are supposedly spinning out of control. To paraphrase another great movie line from *Cool Hand Luke*, “What we have here is a failure to communicate.” In Washington, it’s more like, “What we have here is a failure to distinguish between near-term and longer-term budget issues.” The main immediate problem is sluggish economic growth as evidenced by high unemployment and modest jobs gains. The situation has actually been made worse by attempts to shrink those deficits through, e.g., the spending sequester. The Europeans have spent that past few years proving beyond any reasonable doubt that fiscal austerity further weakens economies that are stumbling, making it even harder to repay their debts.

Longer term, there really is a deficit problem as baby boomers retire and swell the outlays on Social Security and Medicare. There is also growing concern that future U.S. economic growth will continue to disappoint as a result of slow labor force growth and lackluster productivity gains.

An offer they might not refuse. How about taking a page from *The Godfather*. But instead of an offer they “can’t” refuse, at least one they “might not” turn down. Big, bold actions to reduce the deficit seem doomed to failure, especially by those opposed to raising taxes or reducing entitlements. Suppose we look for a more incremental approach that has some advantages of “equality of sacrifice.”



What I have in mind is reducing the rate of growth of various spending programs by a fixed percentage, e.g., one-percent annually. The simplest example I can think of to start with is the annual Social Security COLA which raises benefits by the amount of the CPI rise in the previous year. Suppose the CPI rises two-percent, then benefit checks would go up by one-percent under my proposal rather than two. Same thing the following year: deduct one percentage point from the actual CPI rise in calculating the annual COLA. In FY 2013, Social Security outlays totaled close to \$670 billion, so my idea would reduce the COLA from \$7 billion to about \$3.5 billion. If we kept this up for 10 years, total benefits would be at least 10 percent lower and savings would be in excess of \$70 billion annually – just from Social Security. This could be applied to practically all other spending – with the exception of interest payments. Net of interest payments, Federal spending was \$2.6 trillion in 2013 so that a 10 percent reduction would amount to more than \$270 billion by the tenth year.

The same approach could be used on the revenue side with an across-the-board surcharge. In FY 2013, receipts came to \$2.8 trillion so that applying my annual “surcharge” that would eventually hit 10 percent and raise more than \$280 billion.

OK, I didn’t quite make it because the total deficit reduction only totals \$550 billion in the tenth year. Actually, it will exceed this because as the economy grows and population increases total expenditures and revenues will rise from FY 2013 levels. But you get the idea and the experts in Washington can do the math more precisely.

My proposal doesn’t require the Congress to do any heavy lifting. And phasing-in the program does not wreck the recovery as some other approaches might. The impact builds over time. If, *as time goes by*, (get it?) the public does not like some of the implications, then legislation should allow different spending and revenue measures – as long as they reduced the deficit as much as my proposal.

Perhaps lower income entitlement recipients would get a break. Closing loopholes might be fairer and more efficient than the surcharge. I almost forgot, we should also get rid of the debt ceiling legislation which would be totally unnecessary with a credible deficit reduction plan in place.

Back to the Future. Lots of attention is being paid to when the Fed will start “tapering.” This is Wall Street jargon for winding down the Quantitative Easing program whereby the Fed has been purchasing \$85 billion per month in

Treasury and mortgage-backed securities in order to keep long-term interest rates low. The “smart money” bet that it would begin in September. They lost, that didn’t happen. The Fed was worried then about slow economic growth and the deepening concerns over the possible government shutdown and default. The Fed is still concerned enough that the first move towards tapering may have to wait until 2014.

I think that an equally important question is what interest rates will look like when the economy is back to “normal” – whenever and whatever that is. Buried in the forecasts, the Fed makes public is their projection for the “longer term” fed funds rate. Although no year is given, this is what will most likely prevail when the unemployment rate is back down to five to six-percent and inflation is around two percent. The answer: four-percent.

If the Fed funds rate is four-percent then the 10-year Treasury note is likely to be at least 5 to 5.5 percent and probably even more. This, in turn, implies a 30-year fixed rate mortgage rate of around 6.5-7 percent. My guess as to when this will take place is somewhere around 2016 or 2017. As long as the U.S. and global economies grow, there will be upward pressure on bond yields. For one thing, the Chinese will no longer be “exporters” of capital as they redirect their funds to finance the transition from an investment-driven to a consumer-driven economy. The easy availability of Chinese capital helped hold long-term rates down prior to the financial crisis.

If I’m right, then bond and equity markets have a lot of adjusting to do. The good news is that banks will be paying their depositors a lot more than at present. The bad news is that those investors who recently purchased bonds at low yields will find them worth much less as they have to compete with new issues that have those higher coupons. The hit could be especially hard to long maturities. I guess this might be viewed as a case of *The Good, The Bad and the Ugly*.

Just in case you were wondering, my all time favorite movie is *The Godfather* and my favorite line is “Leave the gun. Take the cannoli.”

