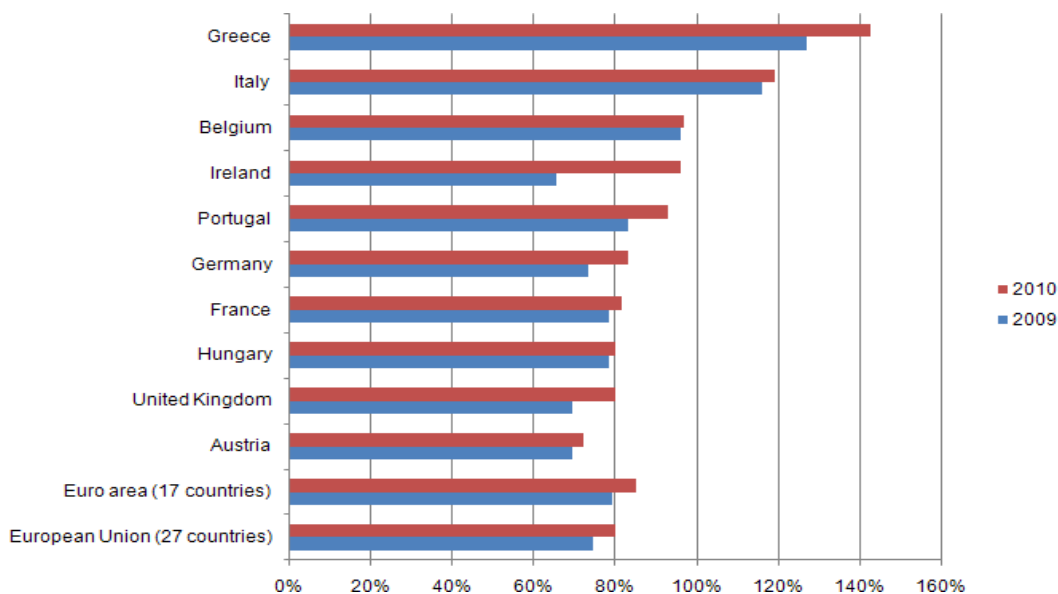




The ongoing debate in Congress about the federal deficit should be viewed in the context of whether and how deficits and debt affect economic activity. The financial crisis in Greece is attributable at least partly to large deficits the country has been running and the government's inability to service the debt. In January 2010, Carmen Reinhart and Ken Rogoff presented research on the relationship between central government debt and GDP across 44 countries. They concluded that when the ratio of gross federal debt to GDP exceeded 90%, a country was at risk that its GDP growth would slow significantly. There was not a significant relationship at lower ratios. The following chart presents the debt to GDP ratios for European Union (EU) countries for the past two years. Note that Greece's ratio exceeds 140% followed by Italy. The average for EU countries was 80%.

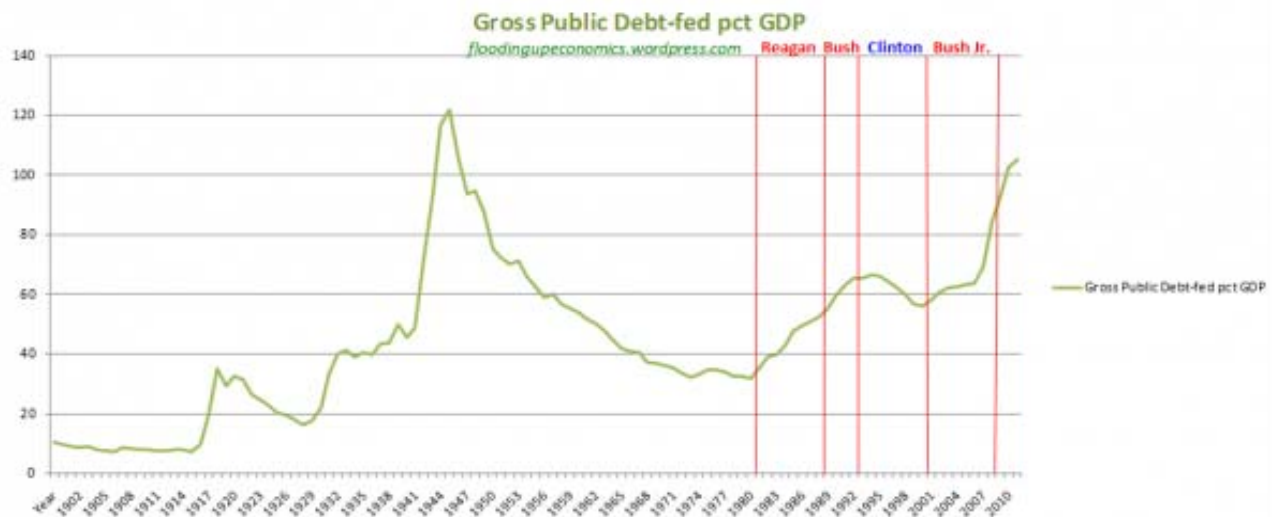
Gross Debt to Nominal GDP at EU Countries: 2009 - 2010



Source: Real World Economics Review blog; <http://rwer.wordpress.com>

The comparable ratio in the U.S. has exceeded 90% since early 2010 as demonstrated on the next page. We are thus in the danger zone with large deficits adding to high levels of outstanding debt. The ratio started its recent rise during the Reagan administration, leveled off during the Clinton administration and has accelerated during the past and current administrations. High debt burdens are doubly troubling because the level of interest rates is currently low. In 2010, interest expense on the federal debt amounted to 1.6% of GDP. The Treasury Department forecasts that at projected deficit levels, interest expense will almost double to 3.1% of GDP by 2016. What happens when rates rise? You cannot quickly pay down federal debt without running large surpluses, so interest on the debt will increase even more as a share of federal spending. Compounding this is the fact

that data for U.S. government debt do not include the debt of Fannie Mae and Freddie Mac, entities under conservatorship. What is the true debt to GDP ratio?



Breaking News

- Existing home sales declined in June for the 3rd straight month with 16% of prospective buyers with signed agreements canceling their contracts. The norm is 10%. The inventory of previously-owned homes listed for sale represents almost a 10 month supply at current sales levels.
- Effective today, banks are allowed to pay interest on demand deposits.
- Today is also the anniversary of the signing of the Dodd-Frank Act. Consider the following dissenting views with regard to the Act and its implementation.

“Many of those who fought reform during the legislative process are now trying to slow down and weaken rules, starve regulatory agencies of resources, and block nominations so that they can ultimately kill reform.” Timothy Geithner, WSJ, July 20, 2011

“The financial system has become far less competitive and far more volatile with the onset of systemically important institutions. Though large firms remain a critical part of our economic system in the United States, they should not become so dominant that they become unaccountable to our capitalistic system.” Thomas Hoenig, Dodd-Frank One Year On, June 27, 2011

Economic News

Large employers are laying off workers at a high rate. Consider the recent announcements of job cuts at Cisco, Lockheed Martin, Goldman Sachs and Bank of America. Other large, publicly-traded firms will likely follow in their pursuit of higher stock prices. How do we grow the economy in this environment?

Upcoming Events

- A Euro-zone summit meeting is being held today to try and reach agreement on additional aid to Greece combined with modifications to a bailout fund for members that might need assistance in the future. Leaders are discussing whether they should reduce Greece’s debt service requirements and if they do so, how much is appropriate.

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