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Economics Group

Special Commentary

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Should We Worry About American Debt?: Part VII

Generalized Debt Crisis Not Likely in Foreseeable Future

Executive Summary

In this our seventh and final report in a series on American debt, we summarize our findings. In short, we believe that excessive angst about American debt today is not really warranted because the economy is less levered today than it was a decade ago. A spike in interest rates, should one occur, would make it more onerous for some borrowers to service their debts. But there are a number of factors, cyclical as well as secular, that are exerting downward pressure on interest rates at present, and these factors are not likely to reverse anytime soon. Although there eventually will be another debt crisis in the U.S. economy, there appears to be little reason to believe that one will occur in the foreseeable future.

Total Debt at Record High, But Debt-to-GDP Ratio Has Receded

We have been writing about debt in different sectors in the U.S. economy over the past few weeks. Part I of the series provided a brief overview of the scope of the issue, and Part II focused on the household sector. We turned our attention to non-financial business sector debt in Part III. We then analyzed federal government debt in Part IV and the debt of state and local governments in Part V. Financial sector debt was the topic of Part VI. We summarize our findings in this, our seventh and final, report in the series.

Figure 1

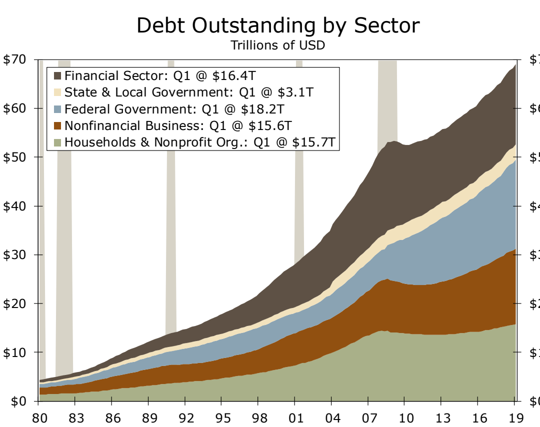
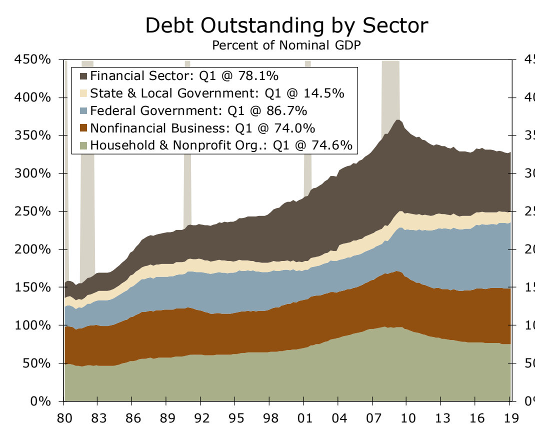


Figure 2



Source: Federal Reserve Board, US Department of Commerce and Wells Fargo Securities

As discussed in Part I, total debt in the American economy has swelled from about $4 trillion in 1980 to a staggering $69 trillion today (Figure 1). But the ability to service debt rises as the economy grows, everything else equal, and the size of the American economy has grown nearly eightfold over the past four decades. Measured as a percent of GDP, total debt grew to 370% in early

2009 from roughly 150% in 1980 (Figure 2). Although the total amount of debt in the economy is more than $15 trillion higher today than it was ten years ago, the overall debt-to-GDP ratio of the U.S. economy is lower today (328%) than it was at its peak. The title of this series asks whether we should worry about American debt. Should we?

Some Sectors Have Levered Up While Others Have De-levered

The federal government has the highest debt-to-GDP ratio among the five sectors we analyzed, so it would appear to be the most worrisome. Moreover, gaping budget deficits in the aftermath of the financial crisis has led to a rapid increase in the amount of outstanding federal government debt over the past decade. Although there clearly is uncertainty associated with long-range projections, the Congressional Budget Office (CBO) projects that the debt-to-GDP ratio of the federal government will rise significantly in coming years (Figure 3).

The borrowing costs of the federal government remain manageable at present.

But as we concluded in Part IV, we do not worry about federal government debt, at least not at the present time, because borrowing costs largely remain manageable due to a number of cyclical and secular factors. For starters, the Federal Reserve does not seem likely to raise interest rates significantly anytime soon. Secondly, a global savings glut seems to have developed during the past decade, and it persists today. Due to the relative paucity of attractive investment opportunities, investors continue to channel excess savings to sovereign bonds. Furthermore, no other economy can rival the United States in terms of the depth and liquidity of its government bond market, which help to support the attractiveness of U.S. Treasury securities *vis-à-vis* other sovereign bonds. A crisis that develops from a spike in borrowing costs for the federal government simply does not look likely in the foreseeable future. That said, the current size of the federal deficit—roughly $1 trillion or 4% of GDP—could constrain the ability of authorities to respond to an economic downturn with countercyclical fiscal policy.

Figure 3

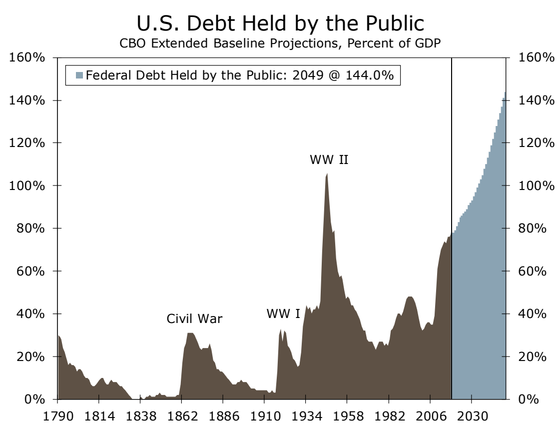
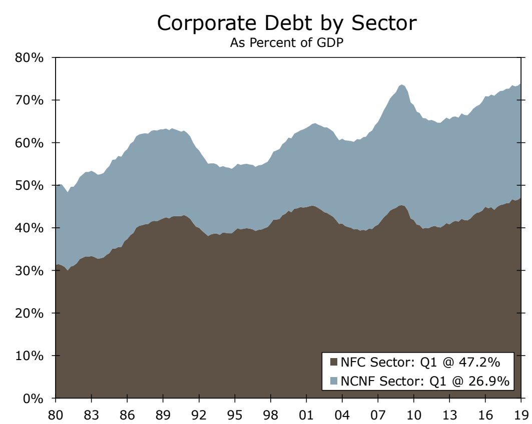


Figure 4



Source: Congressional Budget Office, Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities

The financial health of the business sector is not so weak at present to make us unduly alarmed.

Turning to the non-financial business sector, the combined debt-to-GDP ratio of the non-financial corporate (NFC) sector and the non-financial non-corporate (NFNC) sector has risen to its highest level in at least 40 years (Figure 4). In other words, the broad non-financial business sector has levered up, at least modestly, in recent years. But businesses generally have ample cash flow to service their interest expenses. Although the financial health of the business sector is not as strong as it was a few years ago, it is not so weak at present to make us unduly alarmed either.

At first glance, the debt of state and local governments (SLG) is not very concerning at all because there has been no net growth in this sector's debt since the end of the Great Recession. However, the unfunded pension liabilities of the SLGs, which are not captured in conventional measures of debt, have trended significantly higher in recent years (Figure 5). Some SLGs have attempted to cope with their rising pension liabilities by cutting back other types of spending. For example, capital investment (*e.g.*, infrastructure spending) by the SLGs has been stagnant during the current expansion. But in our view the biggest economic challenge faced by the SLG sector is not a full-blown nationwide municipal debt crisis. Rather, some states may endure an ongoing squeeze on their budgets as they try to close the pension funding gap. Although this outcome would likely not lead to a debt crisis in the traditional sense, continued stagnation of investment spending at the SLG level could act as yet another hurdle to faster potential GDP growth in the United States in the years ahead.

Figure 5

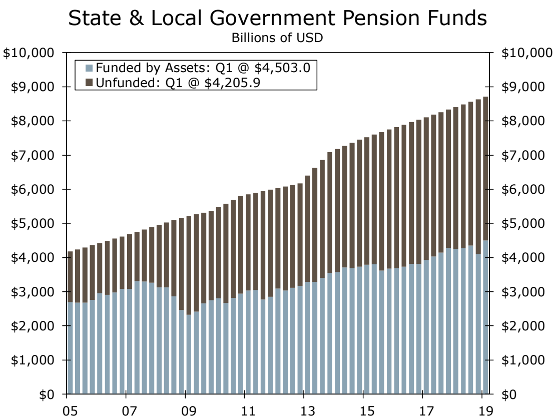
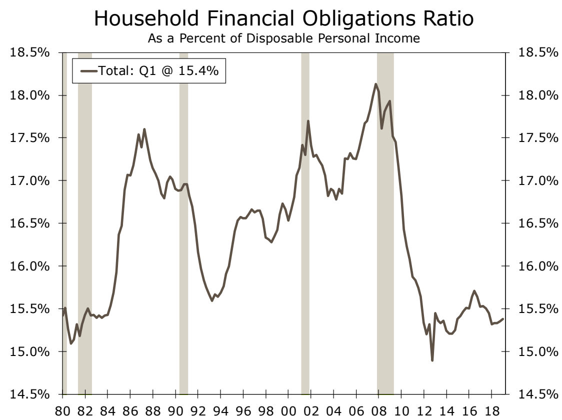


Figure 6



Source: Federal Reserve Board and Wells Fargo Securities

The household and financial sectors have both de-levered over the past decade.

As shown in Figure 1 and Figure 2, the household sector has de-levered over the past decade. Furthermore, the swoon in the financial obligations ratio, which measures the proportion of disposable income that households need to service their financial obligations (*e.g.*, monthly mortgage payments, monthly auto loan payments, etc.) is not much higher today than the four-decade low to which it plunged a few years ago (Figure 6). Consequently, another debt crisis that is centered on the household sector does not look likely in the foreseeable future. The U.S. financial sector has also de-levered markedly in recent years.

So where does this leave us? The debt-to-GDP ratio of the federal government has risen significantly since the onset of the financial crisis, and CBO projections of the ratio in coming years is disquieting. The debt-to-GDP ratio of the non-financial business sector has not risen as quickly as the comparable ratio for the federal government, but it currently stands at its highest level in at least forty years. The SLG sector does not have a debt problem in a conventional sense, but the unfunded pension liabilities of some state and local governments could lead to further cutbacks in non-pension spending, especially in much needed infrastructure spending.

We do not lie awake at night worrying about a debt crisis in the U.S. economy.

But we do not lie awake at night worrying about a debt crisis in the U.S. economy, at least not in the foreseeable future. As we noted in a previous report, there are a number of cyclical and structural factors that are keeping borrowing costs for the federal government extraordinarily low at present. A spike in borrowing costs, should one occur, could put fiscal policymakers in a challenging spot. But the factors that are keeping borrowing costs low do not seem likely to reverse anytime soon.

Similarly, the financial health of the non-financial business sector is not as strong as it was a few years ago, but most businesses appear able to adequately service their debt at present. Unless borrowing costs spike, which probably will not happen in the near term, a debt crisis centered on the business sector does not seem likely. Further cutbacks in infrastructure spending by SLGs to make room for higher pension expenditures could exert headwinds on productivity growth in coming years, which could weigh on potential GDP growth, everything else equal. But a full-blown nationwide municipal debt crisis does not seem likely, in our view.

Conclusion

So should we worry about the amount of American debt that has swelled to $69 trillion? We don't mean to sound overly complacent, but we believe that excessive angst about American debt today is not really warranted. For starters, the overall debt-to-GDP ratio of the U.S. economy has receded since its peak ten years ago. In short, the economy is not as levered today as it was a decade ago. Moreover, the low level of borrowing costs has enhanced the ability of borrowers to service their debts. Clearly, a spike in borrowing costs, should one occur, would make it more onerous for some borrowers to service their debts. But there are a number of factors, cyclical as well as secular, that are exerting downward pressure on interest rates at present, and these factors are not likely to reverse anytime soon. Although there eventually will be another debt crisis in the U.S. economy, there appears to be little reason to believe that one will occur in the foreseeable future.

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