Total debt in the United States is significantly higher—in both absolute terms and relative to GDP—than it was a few decades ago. While there are few signs of financial stress at present, how sustainable is the build-up of debt that has occurred in the American economy over the past few decades?

In the series of reports that follow, we endeavor to answer this question by drilling down to debt sustainability issues in individual sectors of the U.S. economy. In short, we believe the excessive angst about American debt today is not really warranted because the economy is less levered now than it was a decade ago. Moreover, the low level of borrowing costs has enhanced the ability of borrowers to service their debts. 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.
Should We Worry About American Debt?: Part I

Total debt in the United States is significantly higher than it was a few decades ago, but there are few signs of financial stress at present. Is this debt build-up sustainable?

Debt Higher, But Few Signs of Financial Stress

The U.S. economy is on the cusp of entering its longest expansion in the post-World War II era, but longevity often raises questions about sustainability. Moreover, the scarring experience of the financial crisis, which was triggered by an unsustainable build-up in mortgage debt, is still fresh in the minds of many market participants, and the rising level of U.S. debt in recent years is a source of concern among some observers. As shown in the top chart, the combined debt of the household, business, government and financial sectors in the United States totaled $4.3 trillion in 1980. Total American debt grew non-stop until early 2009, when it took a temporary breather. But it has resumed its upward trend and currently stands near $70 trillion. Indeed, every sector, with the exception of the financial sector, has more debt today than it did in Q1-2009 (middle chart). Notably, the outstanding debt of the federal government is more than $10 trillion higher today than it was ten years ago.

The upward trajectory of total debt over the past four decades may be disconcerting to some readers. But recall that the size of the U.S. economy was less than $3 trillion in 1980. Nominal GDP today exceeds $21 trillion. Just as a company can service more debt as it grows larger, everything else equal, so too can an economy handle more debt as it grows larger, everything else equal. So the correct way to think about outstanding debt in an economy is to measure it as a percent of GDP, which is shown in the bottom chart. The good news is that the overall debt-to-GDP ratio of the U.S. economy has receded to less than 330% at present from 370% ten years ago. The bad news, however, is that the ratio today is more than twice as high as it was four decades ago. The debt-to-GDP ratio of the federal government has mushroomed to nearly 87% today from 27% in 1980, but every other sector has also experienced an increase in its respective ratio over this period.

Although debt in the U.S. economy today is higher—in both absolute terms and relative to GDP—than it was a few decades ago, there are few signs of financial stress at present. The yield on the 10-year Treasury security is hovering around only 2%, corporate bond spreads are generally tight and the stock market stands near an all-time high. But how long can these generally benign financial conditions last? How sustainable is the build-up of debt that has occurred in the American economy over the past few decades?

We will endeavor to answer these questions in a series of reports in coming weeks. Using some previously published analysis and some new research we will drill down to look at debt sustainability issues in individual sectors of the U.S. economy. As noted previously, household debt, specifically mortgage debt, was the catalyst of the last recession. Therefore, we will start by analyzing the financial health of the U.S. household sector in the next report of our series.
June 20, 2019

Economics Group

Special Commentary

Should We Worry About American Debt?: Part II
Household Debt Poses Few Macro Risks at This Time

Executive Summary
In the second part of our series on debt in the U.S. economy, we focus on the debt of the household sector. Because the financial health of consumers has generally improved meaningfully in recent years, a downturn in the U.S. economy that is caused by financial stress in the household sector does not seem likely, at least not in the foreseeable future. But the rise in auto and student debt could have adverse effects, at least at the margin, on certain individuals and specific areas of consumer spending in coming years.

Household Financial Health Has Generally Improved
In a recently released report, we highlighted the rising amount of debt that the United States has accumulated over the past few decades. Indeed, the combined debt of the American household, business and government sectors is about $15 trillion higher today than it was ten years ago. Yet there are few signs of financial stress in the U.S. economy at present. That is, long-term interest rates are extraordinarily low, the stock market is nearing all-time highs, and credit spreads generally remain tight. But many reasonable observers can rightly wonder if different sectors in the U.S. economy can continue to accumulate debt without eventually suffering adverse consequences.

In this second installment in our series on American debt, we focus on the U.S. household sector.

Figure 1
U.S. Household Debt
Trillions of Dollars

Figure 2
Household Balance Sheets
Trillions of Dollars

Overall debt has increased by $15 trillion over the past ten years, but there are few signs of financial stress today.

Source: Federal Reserve System and Wells Fargo Securities

In this report, we draw heavily on analysis we published earlier this year and we refer interested readers to that report for more details. As shown in Figure 1, the amount of household debt outstanding totaled $13.7 trillion in Q1-2019, which represented an all-time high. Mortgage debt accounted for the vast majority (68%) of the total with student loans and auto loans the next largest categories. But it would be mistaken to focus on the absolute amount of consumer debt in isolation.

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.
Rather, one should look at both sides of the household balance sheet. Although household liabilities have risen by $1.6 trillion on balance since 2008, the value of household assets have mushroomed by about $48 trillion over that period (Figure 2). Households have $10.4 trillion of net worth at present, an increase of roughly 80% relative to 2008.

Not only are consumer balance sheets generally stronger today than they were ten years ago, but the ability of the household sector to service monthly debt is much improved as well. [As shown in Figure 3, the financial obligations ratio, which measures the ability of households to service monthly financial obligations, such as mortgages, auto loans, etc., - fell sharply in the immediate aftermath of the Great Recession as interest rates nosedived]. At only 15.3% of disposable income, the financial obligations ratio currently stands near a 40-year low. Even if the Federal Reserve were to raise interest rates significantly, which does not seem likely anytime soon, the debt profile of the household sector implies that the financial obligation ratio would not shoot higher, at least not for the foreseeable future. As noted previously, mortgages account for two-thirds of overall household debt, and the vast majority of mortgages have fixed-rate structures. Subdued debt growth over the past ten years in conjunction with solid income growth over that period has resulted in a marked decline in the household debt-to-income-ratio, which is measure of household leverage-over that period (Figure 4).

**Figure 3**

Household Financial Obligations Ratio

As a Percent of Disposable Personal Income

Source: Federal Reserve Board and Wells Fargo Securities

**Are Auto and Student Loans a Problem?**

In sum, the financial health of the U.S. household sector has improved meaningfully, at least relative to its status ten years ago. That said, there have been some changes in the profile of household debt that could have some financial and economic implications down the line. Although the level of household mortgage debt today is more or less unchanged on balance relative to 2008, the amount of auto loans has risen by nearly $500 billion over that period. Moreover, auto loans to individuals with low credit scores (i.e., FICO scores less than 660) have increased markedly over the past ten years (Figure 5). Origination of auto loans to individuals with FICO scores less than 660 totaled only $84 billion in 2009, but origination ramped up to nearly $200 billion per annum between 2015 and 2018.

But the risk profile of new auto loans has not changed much over the past ten years. Roughly one-third of new auto loans in 2009 were made to individuals with FICO scores less than 660, and that percentage has remained more or less constant subsequently. Furthermore, the amount of outstanding auto loans simply is not in the same ballpark as mortgage loans. There are nearly $1.3 trillion worth of outstanding auto loans today, but the amount of residential mortgages at the height of the housing bubble a decade ago exceeded $9 trillion. A wave of defaults on auto loans, should one occur, would not have the same crippling effect on the economy as mortgage defaults did a decade ago.

The financial health of the household sector has improved meaningfully.

The outstanding amount of car loans has risen by $500 billion over the past ten years.
The amount of student loans has also increased sharply in recent years. Specifically, there was $600 billion worth of student loans outstanding in 2008, but that amount has mushroomed to $1.5 trillion today. Should we be worried? On the one hand, the threat to the U.S. economy from student loans is, in our view, not as dire as the popular perception seems to be. As in the case of auto loans discussed previously, the amount of student loans today pales in comparison to the outstanding amount of mortgages at the height of the housing bubble. Student loan debt is not likely to bring the U.S. economy suddenly to its knees as mortgage debt did a decade ago.

On the other hand, however, student loan debt could have adverse implications for certain individuals and some segments of the economy. Student loans account for 35% of the total outstanding debt among individuals aged 18 to 29 years old (Figure 6). High debt loads make it more difficult, everything else equal, for those individuals to qualify for mortgages or auto loans, which could exert headwinds on the housing and auto markets. Indeed, researchers at the Federal Reserve Bank of New York (FRBNY) estimate that the increase in student loan debt can explain between 11% and 35% of the 8 percentage point decline in the homeownership rate of individuals in their late 20s.1 In addition, delinquencies could negatively affect individuals’ credit scores for a long time, which could also impede their ability to finance other types of spending in the future. In that regard, roughly 9% of student loans are seriously delinquent (i.e., 90 days or more past due), which is significantly higher than comparable rates on other types of household debt such as mortgages, auto loans and credit cards.

Conclusion
The financial health of the household sector has improved markedly over the past ten years. Households have de-levered, net worth has risen significantly and the amount of income that consumers need to service their monthly financial obligations has declined meaningfully. In our view, a downturn in the U.S. economy that is caused by financial stress in the household sector does not seem likely, at least not in the foreseeable future.

There could be adverse consequences for certain individuals and sectors of the economy, at least at the margin. Individuals with excessive auto and/or student loan debt could find qualifying for mortgages or additional auto loans to be more difficult, which could exert some headwinds on the housing and auto markets in the future. But the increase in auto and student loans that has occurred over the past decade probably will not have significantly negative effects on the macro-economy in the near term. We will analyze debt in the non-financial corporate sector in our next report in this series.

Should We Worry About American Debt?: Part III
Financial Health of Business Sector is OK, At Least for Now

Executive Summary
In the third part of our series on debt in the U.S. economy, we focus on the debt of the business sector. Business debt has risen by roughly $5 trillion over the past decade, and the debt-to-GDP ratio in the sector currently stands at its highest in at least 40 years. But balance sheets generally remain sound, and strong cash flow gives most businesses the wherewithal to service their debts without much difficulty, at least at this time.

That said, the financial health of the business sector is not as strong as it was a few years ago. The increase in debt in the business sector in recent years probably will not be the catalyst for recession, at least not in the near term. But the increase in corporate debt over the past decade means that some businesses may not be able to weather a downturn, should one occur, as well as they would have a few years ago.

Business Sector Debt Has Risen Significantly in Recent Years
In Part I of this series we showed that the total amount of debt in the overall U.S. economy has risen by more than $15 trillion (nearly 30%) over the past ten years. But the debt of the household sector, which we addressed in Part II, is up by less than $2 trillion over that period. Indeed, we argued in that report that the financial health of the consumer sector has generally improved over the past decade, and that the risk of an economic downturn stemming from excessive household debt seems to be rather low at this time. In this, our third report in the series, we focus on debt in the non-financial business sector.

Figure 1
Nonfinancial Business Debt

Figure 2
Debt in the United States

Source: Federal Reserve Board, Bank of International Settlements and Wells Fargo Securities
Debt in the non-financial business sector has risen from nearly $11 trillion about ten years ago to roughly $16 trillion today (Figure 1). Non-financial corporations, which tend to be the largest business organizations in the economy, account for the majority of this debt (about $10 trillion). Drilling down further shows that there are $6.4 trillion worth of corporate bonds outstanding and $3.5 trillion worth of bank loans that have been extended to the corporate sector. Loans to non-financial non-corporate businesses currently total $5.7 trillion.

As discussed in our previous report and as shown in Figure 2, the debt-to-GDP ratio of the household sector has receded markedly over the past decade. In contrast, the comparable ratio for the non-financial business sector has trended higher in recent years and is now about 9 percentage points higher than it was relative to its recent nadir in 2012. Moreover, the debt-to-GDP ratio of the business sector presently is the highest it has been in at least 40 years. Is the business sector overindebted?

How Financially Healthy is the Business Sector?

In this section, we update the analysis we did last year on the financial health of the non-financial corporate (NFC) sector and the non-financial non-corporate (NFNC) sector. As shown above, the debt-to-GDP ratio of the overall business sector currently stands at 74% with the NFC sector accounting for 47 percentage points of this overall ratio and the NFNC sector representing a 27 percentage point share (Figure 3). Because it comprises the lion’s share of business sector debt, we will focus on the NFC sector in the remainder of this report.

Figure 3

Debt in the non-financial business sector has risen from nearly $11 trillion about ten years ago to roughly $16 trillion today.

The NFC sector probably has adequate cash flow to service its debts, at least at present.

As discussed in more detail in our report last year, we have constructed an index, which is based on eight metrics that the academic literature has identified as important determinants of the financial health of the corporate sector. The downward movement in our index over the past few years indicates that the financial health of the NFC sector has deteriorated over that period (Figure 4). Part of this deterioration reflects the 225 bps of monetary tightening that the Federal Reserve has undertaken since late 2015 that has lifted corporate borrowing costs. As shown in Figure 5, the interest coverage ratio, which measures the amount of cash flow that the NFC sector has to service its debt, has receded over the past few years. That said, the ratio, which is not abnormally low in a historical context, suggests that the NFC sector probably has adequate cash flow to service its debts, at least at the present time.

* We plot our “adjusted” Corporate Financial Health Index, which excludes the value of corporate equities in Figure 4. The stock market was in a bubble in the late 1990s, which collapsed in 2000. Including the value of equities that companies held on the asset side of their balance sheets gives an overly sanguine assessment of corporate health during the late 1990s, in our view. See our previously referenced report for more details.
The index has also been pulled down by the trend decline in the return on assets in recent years (Figure 6). Although after-tax profits jumped when corporate tax rates were cut at the start of 2018, net income still remains below the levels reached in H2-2014.2 In the meantime, corporate assets have risen, implying that the return on those assets has declined. That said, the return on assets in the NFC sector generally remains at a fairly high level.

The rise in debt that was noted previously has also started to push down the debt-to-assets ratio in the NFC sector over the past few quarters (Figure 7). But this ratio also remains at a high level in a historical context. The market-to-book ratio (i.e., the market value of firms relative to their book value) edged down in Q4-2018 as the stock market tumbled at the end of last year, but the ratio recovered some lost ground in the first quarter (Figure 8). With the stock market rising to all-time highs again, it appears that investors generally remain fairly optimistic about the future stream of corporate earnings.

So where does this leave us? Debt on business balance sheets has risen by roughly $5 trillion over the past decade, but there are few signs of financial stress at present. Credit spreads generally remain tight, and the stock market has risen to an all-time high. This general lack of financial stress

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2 The collapse in oil prices that started in the second half of 2014 weighed on profits in the energy sector. Additionally, the downturn in investment spending in the energy sector hurt profitability among producers of capital goods.
is probably warranted because, in our view, the underlying fundamentals of the business sector are fairly sound at present. Assets have more or less kept pace with the rise in debt, so corporate balance sheets remain generally solid. The rise in interest rates over the past few years has pushed up borrowing costs, but strong cash flow generally gives businesses the wherewithal to service their debts without much difficulty at this time.

The operative phrase in the previous sentence is “at this time.” The modest decline in the interest coverage ratio over the past few years shows that rising interest rates would make it more difficult for businesses to service their increased debt load, everything else equal. The good news is that the Federal Reserve probably will not be raising rates anytime soon. Indeed, the Fed is more likely to cut rates than to hike them, at least in the near term. So businesses probably do not need to fret about higher borrowing in the foreseeable future.

But a recession, should one occur for any reason, would slow revenue growth and make it more challenging for the business sector to service its debt. Excessive debt in the business sector probably will not be the catalyst for recession, at least not at this time. But unforeseen shocks can sometimes trigger a recession, and some businesses today may have more difficulty surviving a downturn than they would have had a few years ago when they were less levered.

**Conclusion**

In Part II of this series, we concluded that the financial health of the household sector has generally improved over the past decade. The picture in the business sector is more mixed. Business debt in the United States has risen by roughly $5 trillion over the past decade, and the debt-to-GDP ratio in the sector currently stands at its highest ratio in at least 40 years. But balance sheets are generally in solid shape and most businesses are able to service their debts without much difficulty. In short, the financial health of the business sector is not as strong as it was a few years ago, but it is not so weak at present to make us unduly alarmed either. We would be more concerned about the business sector if the Fed were aggressively hiking rates. But further monetary tightening does not appear to be on the radar screen anytime soon.

Excessive debt in the household sector a decade ago triggered the last recession. The increase in debt in the business sector in recent years probably will not be the catalyst for recession, at least not in the near term. But the increase in corporate debt over the past decade means that some businesses may not be able to weather a downturn, should one occur, as well as they would have a few years ago.

In upcoming installments of this series, we will analyze debt in the federal government, the state and local government and the financial sectors. We will then conclude with a grand assessment of debt in the U.S. economy.
Economics Group

Special Commentary

July 02, 2019

Should We Worry About American Debt?: Part IV
Federal Debt Is Exploding but It Is Manageable, For Now

Executive Summary
Federal government debt is much higher than it was before the Great Recession, and the outlook is for sizable budget deficits for the foreseeable future. However, yields on U.S. Treasury securities remain persistently low, helping to keep debt service costs for the federal government manageable. The factors that have helped keep Treasury yields low, such as dovish monetary policy, fiscal consolidation abroad, the global savings glut and U.S. structural advantages, seem unlikely to change anytime soon. This should help prevent federal government debt from becoming a “problem” in the near term. Were some of these factors to change over time, however, the federal government’s current fiscal path could prove far less tenable.

How Did We Get Here?
In Part I of this series, we showed that the total amount of debt in the U.S. economy has risen more than $15 trillion (nearly 30%) over the past ten years. We found in Part II that the household sector has de-levered over the past decade, while the financial health of the business sector, which we analyzed in Part III, has deteriorated somewhat. In this report, our fourth in the series, we focus on debt of the federal government.

On the eve of the Great Recession, the federal government of the United States had a relatively small budget deficit of about 1%. The federal debt-to-GDP ratio was also a relatively low 35% (Figure 1). Since then, however, the federal government’s debt burden has more than doubled as a share of the economy, because the budget deficit ballooned and currently stands at more than 4% of GDP (Figure 2). How did the U.S. government accumulate so much debt in just a decade?

Figure 1
U.S. Federal Debt Held by the Public
Share of GDP

Figure 2
Federal Budget: Deteriorating in an Expansion
4-Quarter Moving Sum, Percent of GDP, Wells Fargo Forecast in Blue

Source: U.S. Department of the Treasury and Wells Fargo Securities

The Great Recession played a major role because budget deficits usually widen during a recession. First, slower economic activity leads to lower tax revenues. Second, government spending usually

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.
increases as ‘automatic stabilizers’ (e.g., unemployment benefits) kick in and as governments often undertake proactive fiscal stimulus. The severity of the Great Recession and the robust stimulus response by policymakers helped drive the sharp widening in the deficit in 2008-2009. After the deficit bottomed out in 2009, it narrowed as a percent of GDP every year through fiscal year (FY) 2015, leading to a much slower pace of debt accumulation as the expansion progressed.

Starting in FY 2016, however, the deficit began to widen again, an unusual development given the economy’s continued expansion (see Figure 2, front page). The culprits of this widening have been varied. For starters, the Federal Reserve first began hiking the fed funds rate in December 2015, and higher rates have brought federal expenditures on interest payments up from historically low levels (Figure 3). Second, structural pressures from the aging of the population and rising health care costs have spurred continued steady growth in the major entitlement programs, such as Social Security and Medicare. Policymakers have also agreed to a series of two-year spending deals in recent years that have boosted discretionary spending above the limits set by the Budget Control Act of 2011. The budget agreement reached in February 2018 was particularly notable for its sizable two-year, $300 billion boost to discretionary spending (Figure 4). Finally, the tax cuts passed at the end of 2017 have also been a factor. Federal revenues grew only 0.4% in FY 2018, and revenues are up just 2.3% thus far in FY 2019. This sluggish pace of tax collections has come even though nominal GDP has grown at a fairly steady 4-5% annual pace since the tax cuts were enacted.

**Figure 3**

Federal Spending: Net Interest Payments

![Federal Spending: Net Interest Payments](chart)

**Figure 4**

Increase in BCA Budget Caps

![Increase in BCA Budget Caps](chart)

**Source:** U.S. Department of the Treasury, Congressional Budget Office and Wells Fargo Securities

**Will Federal Debt Continue to Grow?**

In the near-term, we expect the federal budget deficit to be about 4-5% of GDP. Our forecast assumes that the expansion remains intact and policymakers keep inflation-adjusted discretionary spending fairly steady in FY 2020 and FY 2021. What about the longer-term outlook? In its last update, the Congressional Budget Office (CBO) projected that, under current law, the debt-to-GDP ratio would continue to rise over the next decade, climbing to 92% in 2029 (Figure 5). CBO projections that go even farther into the future show debt on a perpetual upward ascent, eventually rising above the record levels reached shortly after World War II (Figure 6).

Long-range projections are obviously uncertain, but there are good reasons to believe the balance of risks is fairly even. For optimists, one potential driver of lower deficits/debt over the next decade may be low interest rates. CBO’s projections assume that, over the long term, the yield on the 10-year Treasury security will reach a steady state of 3.7%, with short-term interest rates a bit above 3%. Given the structural downshift in yields that has occurred during this expansion, CBO has been revising this forecast down for years. As recently as 2015, its steady state 10-year Treasury yield forecast was 4.6%. If interest rates over the next decade are much closer to where they are today, then growth in federal government debt would be much slower than CBO currently projects, all else equal. On the other hand, however, pessimists note that CBO’s projections are based on current law. Thus, when much of the Tax Cuts and Jobs Act expires in 2025, CBO assumes large tax hikes...
will take place as scheduled. But there are valid reasons to be skeptical that Congress will allow these tax hikes to take place. Much (though not all) of the Bush tax cuts of the last decade were extended temporarily and eventually adopted permanently after a similar sunset provision came due in 2010.

**Figure 5**

*U.S. Debt Held By The Public*

CBO Baseline Projections Begin in 2019, Percent of GDP

*Baseline Debt: 2029 @ 91.8%*

**Figure 6**

*U.S. Debt Held by the Public*

CBO Extended Baseline Projections, Percent of GDP

*Federal Debt Held by the Public: 2049 @ 144.0%*

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**Source:** Congressional Budget Office and Wells Fargo Securities

**Why Are Bond Yields So Low and Will They Remain Depressed?**

Despite historically high debt levels and widening federal budget deficits, U.S. Treasury yields have remained persistently low. Can the federal government really run large budget deficits indefinitely with minimal consequences? In this section, we draw heavily on analysis we published earlier this year, and we refer interested readers to that report for more details.

Persistently low yields on Treasury securities have helped the U.S. government easily finance a large and growing debt burden. Although the stock of debt is historically high, net interest payments as a share of GDP remain quite low by historical standards (Figure 7). But why have yields been so low in the face of so much issuance and such an ominous long-run outlook? In our view, yields on Treasury securities have remained low in the face of bigger deficits for both cyclical and structural reasons. On the cyclical side, a dovish turn by many of the world’s major central banks, including the Federal Reserve, has offset, at least to some degree, the upward pressure on yields generated by robust U.S. government debt issuance.

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**Source:** U.S. Department of the Treasury, International Monetary Fund and Wells Fargo Securities
Fiscal consolidation has occurred in many foreign economies.

The global savings glut has helped to hold down yields on sovereign bonds.

On the structural side, the amount of foreign government bonds that the private sector has needed to absorb in recent years has also been quite low (Figure 8). For starters, fiscal consolidation has been underway in many foreign economies. The combined budget deficit in the euro area narrowed to 0.6% of Eurozone GDP in 2018 from 3.7% in 2012, while Japan’s budget deficit reeled to 3.2% of Japanese GDP from 8.6% over the same period. The United Kingdom saw an even sharper fiscal consolidation, as the country’s budget deficit narrowed to 1.4% in 2018 from 7.5% in 2012. At the same time, the European Central Bank, the Bank of Japan and the Bank of England ramped up their purchases of government bonds (as well as other securities) at various points over this period, which has effectively reduced the amount of sovereign bonds that the private sector has needed to absorb. The resulting decline in sovereign bond yields in most foreign economies has helped to pull yields on U.S. Treasury securities lower.

Yields on sovereign bonds would arguably be higher today if investors had more attractive investment opportunities from which to choose. But the excess of global saving relative to global investment, the so-called “savings glut,” has caused savers to park excess funds in sovereign bonds.¹ The global savings glut was caused largely by developing economies, especially China, a decade ago (Figure 9), and this excess savings helped to hold down sovereign bond yields at that time. More recently, the savings glut has moved to the advanced economies due to weakness in investment spending in those economies (Figure 10).

The United States enjoys many built-in advantages that make financing large deficits easier.

Furthermore, the United States enjoys many built-in advantages that make financing large deficits easier. The United States clearly has some economic and fiscal challenges, but these challenges are arguably more daunting in many other economies. Government debt-to-GDP ratios in Italy and Japan are even higher than the U.S. ratio, and rates of economic growth in Japan and most European countries are anemic. Although large developing economies such as China and India could one day take the economic mantle from the United States, the reforms and economic/financial market maturation that are still needed in those countries remain significant. Germany is a relatively large economy with fairly sound fiscal policy, and one could point to its sovereign bond market as a plausible alternative to the U.S. Treasury market. But the market for German government bonds is a bit less than $1.5 trillion, significantly smaller than the $16 trillion market for U.S. Treasury securities.

Simply put, the U.S. Treasury market is the deepest, most liquid bond market in the world, backed by the world’s reserve currency and the largest and most diversified economy among all others. These factors help the United States finance its deficits more easily than otherwise would be the case. In that regard, the foreign “official” sector, which is largely comprised of foreign central banks

and government entities that own foreign exchange reserves, holds about $4 trillion in U.S. Treasury securities, or roughly one-quarter of the entire marketable Treasury market.²

**Conclusion**

The debt of the federal government has exploded over the past decade, not only in absolute terms but as measured as a percent of U.S. GDP as well. Yet yields on U.S. Treasury securities remain extraordinarily low due to both cyclical and structural reasons. The dovish turn by the Federal Reserve has helped to pull yields down in the United States. Furthermore, fiscal consolidation in other developed economies, a continued glut of global savings and the depth and liquidity of the U.S. government bond market have boosted the demand for Treasury securities.

In our view, many of these factors that have depressed yields on Treasury securities are not likely to change anytime soon. The Fed seems poised to keep its policy rates low for a significant amount of time. A sustained acceleration in investment spending in many economies does not seem likely in the foreseeable future, which will likely help perpetuate the global savings glut. No other economy is set the rival the United States in terms of the depth and liquidity of its government bond market. Although the United States faces some formidable fiscal challenges that will eventually need to be addressed, a significant increase in the borrowing costs that the federal government faces does not appear to be in the cards, at least not anytime soon. That said, the federal government’s current fiscal path could prove far less tenable were some of these aforementioned factors to change.

This report has focused on the debt of the federal government, but state and local governments collectively have about $3 trillion of outstanding debt. We will turn our attention to state and local government debt in an upcoming report in this series.

² In addition, foreign private sector investors currently own more than $2 trillion worth of U.S. Treasury securities.
July 12, 2019

**Economics Group**

**Special Commentary**

**Should We Worry About American Debt?: Part V**

*Debt of State & Local Governments is Low, But...*

**Executive Summary**

The outstanding debt of state and local governments (SLGs) has been flat in recent years, and the sector has a very low debt-to-GDP ratio. However, unfunded pension liabilities, which are currently being accrued, are not included in conventional measures of SLG debt. The pensions of some, but not all, SLGs are seriously unfunded.

We are generally not worried about a full-blown nationwide municipal debt crisis. But, some SLGs have coped with their rising pension liabilities by cutting back on spending in other areas, especially in capital investment. Failure to invest adequately (e.g., replace aging infrastructure) could act as yet another hurdle to faster potential GDP growth in the United States in the years ahead.

**Debt-to-GDP Ratio of SLGs Is Only 15% Presently**

In Part I of this series, we showed that the total amount of debt in the overall U.S. economy has risen more than $15 trillion (nearly 30%) over the past ten years. We focused on consumer debt in Part II and determined that the financial health of the consumer sector has generally improved over the past decade. In Part III, we analyzed the increase in debt in the business sector in recent years. We concluded that 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. In Part IV, we discussed the sizable growth in federal government debt and the factors that have held down Treasury yields, which have made this debt burden easier to finance. In this, our fifth report in the series, we focus on debt of SLGs.

At first glance, there does not appear to be much of a problem regarding SLG debt. Most SLGs have balanced budget requirements, or statutory debt limitations. Unlike the debt of the federal government, SLG debt is utilized in a more project-oriented, capital investment way rather than simply as a means to plug a structural gap between general revenues and outlays. The result is that SLGs generally do not run large budget deficits that lead to persistently rising debt. As shown in Figure 1, the outstanding amount of SLG debt, the vast majority of which is financed via municipal bonds, stood at $2.5 trillion in 2005. It subsequently trended up to more than $3 trillion as SLGs, which reined in investment spending in the early 2000s, started to spend again on investment. But the absolute amount of SLG debt has been flat in recent years because SLGs have reined in investment spending again, a subject to which we will subsequently return. Indeed, inflation-adjusted capital spending by SLGs has contracted at an average annual rate of 1% since 2010. Moreover, the economy has been expanding for ten years, so the debt-to-GDP ratio of the SLG sector has receded to less than 15% today from 21% in 2010. When compared to the federal government sector, where the debt-to-GDP ratio is 78%, and the business sector (74%), this ratio for the SLG sector appears to be miniscule.

However, this low amount of SLG debt does not fully capture the overall financial picture of the sector. That is, the $3 trillion of outstanding debt has been largely used to finance capital spending...
At present, the unfunded liabilities of SLGs are equivalent to 20% of U.S. GDP, up from 12% a decade ago.

In the aggregate, pension funding ratios have clearly deteriorated, though there are significant differences on a state-by-state basis.

But Unfunded Pension Liabilities Could Be a Problem for Some SLGs

In a sense, the pension challenge facing state and local governments is a bit different than the traditional leverage challenges we have addressed in previous reports. Traditional debt instruments, such as Treasury securities or corporate bonds, are more straightforward than future pension obligations because there is some uncertainty around pension liabilities and the extent to which they are (or are not) funded. One common way to assess the solvency of a pension plan is to, at a given point in time, compare the level of a plan’s assets to its accrued liabilities. While this is a useful measure of a plan’s solvency at a fixed point in time, it is also inherently backward-looking. On a forward-looking basis, the outlook can be a bit murkier: what is the assumed rate of return on those pension plan assets? What assumptions are made about life expectancy or retirement rates? Have policies been put in place to increase future contributions to make up past shortfalls?

In the aggregate, pension funding ratios have clearly deteriorated, though there are significant differences on a state-by-state basis. According to analysis by the Pew Charitable Trusts, 69% of the nationwide pension liabilities were funded in 2017, down from 86% before the recession. However, as the map below illustrates, this average masks significant differences among the states. Some states, such as North Carolina, New York and Wisconsin, have funding ratios close to or at 100%, while others, such as Connecticut, Illinois and Kentucky, have funding ratios below 50%.

Against this backdrop, policymakers have a few choices given their balanced budget requirements. In order to meet their future pension obligations, they could raises taxes, reduce non-pension spending, make retirement benefits less robust or go with some combination of the three. Making retirement benefits less generous may seem to be the most obvious of the three, but not only can this be a politically thorny issue it can also be a legally challenging one, particularly as it relates to those in or nearing retirement. The Illinois Constitution, for instance, states that “membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” This makes retroactive benefit changes especially...

\[ \text{Source: Federal Reserve Board, US Department of Commerce and Wells Fargo Securities} \]

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difficult, and likely means that states like Illinois will need to make up the bulk of past pension funding shortfalls with higher taxes and/or lower non-pension spending.

**Figure 3: State Pension Funding in 2017**

There are signs that a grim pension outlook (as well as other structural state budget pressures, such as rising health care costs) have weighed on non-pension spending in some states. As discussed previously, the level of state and local government investment spending has been stagnant during this expansion. And as a share of GDP, it has trended lower over the past ten years (Figure 4). State and local government employment growth has also lagged in this cycle, and as a share of total employment is at its lowest point in decades (Figure 5).

**State and local government employment as a share of total employment is at its lowest point in decades.**

**Figure 4**

**State & Local Gross Investment Expenditures As a Percent of Nominal GDP**

**Figure 5**

**State & Local Government Employment As a Percent of Total Nonfarm Employment**
While Others May Be Missing Opportunities for Capital Investment

In our view, the crowding-out effect that pension obligations can potentially have on public investment spending, especially on public infrastructure, should not be idly dismissed. SLGs are responsible for two-thirds of infrastructure investment. Not only can public infrastructure spending serve as a useful macroeconomic stabilization tool during economic downturns, but it could also boost productivity growth, which has generally been anemic during the current expansion. In our view, the relative fiscal austerity by SLGs, illustrated in Figure 6, represents a missed opportunity to address needed capital investment in U.S. infrastructure, especially in an environment of historically low borrowing costs for SLGs that, taken in aggregate, generally have a low debt-to-GDP ratio.

Should we worry about the pension outlook of the SLGs? On one hand, the unfunded pension situation of the SLGs is not very worrisome because it is not universal. Although some SLGs face significant challenges, others are in good shape. In the aggregate, the combination of traditional municipal debt and unfunded pension liabilities totals about 35% of GDP, which is rather low when compared to some other sectors we have examined in this series. State tax revenue as a share of GDP has been fairly steady over the past couple decades, while federal government revenue relative to the economy is currently about one percentage point below its long-run average. This suggests there could be some scope to raise taxes at the SLG level without “overtaxing” households and businesses.

On the other hand, however, the aggregate numbers mask the fact that some of the states with especially large pension problems are already relatively high tax states. Should we worry about the pension outlook of the SLGs? On one hand, the unfunded pension situation of the SLGs is not very worrisome because it is not universal. Although some SLGs face significant challenges, others are in good shape. In the aggregate, the combination of traditional municipal debt and unfunded pension liabilities totals about 35% of GDP, which is rather low when compared to some other sectors we have examined in this series. State tax revenue as a share of GDP has been fairly steady over the past couple decades, while federal government revenue relative to the economy is currently about one percentage point below its long-run average. This suggests there could be some scope to raise taxes at the SLG level without “overtaxing” households and businesses.

On the other hand, however, the aggregate numbers mask the fact that some of the states with especially large pension problems are already relatively high tax states (e.g. Illinois or New Jersey). States with large unfunded pension liabilities could hope that asset prices continue to rise. But the stock market has trended higher for ten consecutive years, and bond prices are high already. How much higher can asset prices realistically rise? A recession, should one occur in the near term, would likely weigh on asset prices and, thereby, pension funding levels. Pension liabilities are long term, which still gives states time to address very real fiscal and political realities. But ultimately, many states will likely face some difficult decisions in order to meet pension funding requirements.

**Figure 6**

<table>
<thead>
<tr>
<th>Year</th>
<th>Median State Net Direct Debt % Change</th>
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<tr>
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**Figure 7**

<table>
<thead>
<tr>
<th>Year</th>
<th>Median State Rainy-Day Fund % of General Fund Revenue</th>
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<tr>
<td>08</td>
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<tr>
<td>09</td>
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<td>4.0%</td>
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<tr>
<td>18</td>
<td>4.0%</td>
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Source: Merritt Research Services/CreditScope and Wells Fargo Securities

State and local governments already have and likely will continue to look for new revenues sources (e.g., marijuana and gaming). We also believe that states will try to shift some cost burdens to local governments, but local governments in higher tax states will probably have the least amount of revenue-raising flexibility to meet obligations. That said, most states have utilized the expansion to rebuild rainy-day funds (Figure 7) to pre-recession levels in preparation for an economic downturn.

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2 See "Public Spending on Transportation and Water Infrastructure", Congressional Budget Office, October 15, 2018.
These reserves will probably give SLGs the ability to manage operations and debt service during the downturn, but at the expense of pension funding and capital investment.

**Conclusion**

The outstanding amount of traditional municipal debt has been relatively flat in recent years, and as a share of GDP it is less than 15% at present. However, the gap between pension plan assets and accrued pension liabilities has grown significantly since the pre-recession period, creating a future obligation that to some extent mimics a more traditional debt burden. With pensions eating up more SLGs resources, states have not, in the aggregate, ramped up traditional debt issuance to maintain current tax and spending levels due, at least in part, to balanced-budget requirements. Rather, pension challenges have been felt more through crowding-out channels as SLG hiring and investment have grown at a tepid pace over the past decade.

The pension outlook varies considerably at the state level, with some states in quite healthy shape and others facing a grim outlook. These facts suggest to us that the biggest economic challenge may not be a full-blown nationwide municipal debt crisis along the lines of the housing bubble. Instead, some states may endure an ongoing squeeze on their budgets as they try to close the pension funding gap. Although this outcome would not likely 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.
July 22, 2019

Economics Group

Special Commentary

Should We Worry About American Debt?: Part VI
Financial Sector Debt Not Overly Concerning at Present

Executive Summary
Leverage in the financial sector increased significantly in the years leading up to the financial crisis, and the rise in debt was especially marked among the government-sponsored enterprises, their associated mortgage pools and issuers of asset-backed securities. However, debt in the financial sector currently stands nearly $2 trillion lower than at its peak ten years ago, and the debt-to-GDP ratio of the sector has receded to a 20-year low. Deleveraging has been especially pronounced in the asset securitization part of the sector. Any concerns that readers may have about American debt at this time should probably not be focused on the financial sector.

The Overall Financial Sector Has De-Levered
In a series of reports that we have published recently, we have been analyzing debt in a number of sectors in the U.S. economy. As we showed in Part I, the aggregate amount of debt in the U.S. economy has trended higher over the past few decades and totals nearly $70 trillion today. We addressed debt in the household sector in Part II, and the debt of the non-financial business sector was the topic of Part III. We next turned our attention to public sector debt by delving deeper into federal government debt in Part IV and the debt of state and local governments in Part V. In this, our sixth report in the series, we analyze the debt of the U.S. financial sector.

Let’s start with a brief overview of the private financial sector in the United States. For starters, the size of the sector mushroomed to $70 trillion on the eve of the financial crisis from $15 trillion in 1990. The sector subsequently contracted by about 5% by early 2009 before growing anew. Today, the financial assets of the private financial sector are just shy of $100 trillion.

Figure 1 shows the composition of the private financial sector on the eve of the financial crisis in Q3-2008. The assets of depository institutions (largely commercial banks) totaled $13.8 trillion, which represented about 20% of total sector assets at that time. Insurance companies (both property & casualty and life) had $6.7 trillion worth of financial assets, pension funds (private and public) accounted for $13.9 trillion, and mutual fund assets stood at $11.5 trillion. The assets of the government-sponsored enterprises (GSEs) and their associated mortgage pools together totaled $8.3 trillion, and issuers of asset-backed securities (ABS) had $4.4 trillion worth of assets.1 The combined assets of other types of financial institutions, which include securities brokers & dealers, REITs, finance companies, funding corporations and holding companies, totaled $10 trillion in Q3-2008. In sum, financial sector assets were fairly well distributed across different types of institutions ten years ago.

The distribution of financial sector assets today is largely similar, although there have been some subtle changes over the past decade. The relative shares of depository institutions and insurance companies are little changed today relative to ten years ago (Figure 2). The relative sizes of mutual

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1 The GSEs include Fannie Mac and Freddie Mac as well as some smaller institutions. ABS issuers buy assets such as non-conforming mortgages, credit card receivables, etc. and package these cash flows into securities that are then sold to investors.
funds and pension funds are a bit larger today than they were in Q3-2008 due to the significant rise in asset prices over the past ten years. But the most notable change in financial sector assets relative to 2008 is the shrinkage in the relative shares of the GSEs and their associated mortgage pools and the issuers of ABS. Together, those institutions accounted for more than 18% of financial sector assets in 2008. Their combined share today is less than 11%. We will discuss the relative shrinkage of these sub-sectors in more detail subsequently.

The debt-to-GDP ratio of the financial sector has receded to less than 80% today from nearly 125% in 2008.
If the amount of financial sector debt is lower today than it was in 2008, then how have the assets of the sector grown by $30 trillion over that period? Part of the answer is that commercial banks and other depository institutions are relying more heavily today on checking and savings deposits, which are non-debt liabilities, to finance their assets than they were a decade ago. Because deposits tend to be a more stable form of financing than short-term debt instruments, the banking sector is not as vulnerable today as it was prior to the financial crisis. In addition, the value of pension assets and mutual fund shares, neither of which is financed via debt issuance, have increased markedly over the past ten years.2

De-Leveraging Has Been Paced by GSEs and ABS Issuers

Figures 1 and 2 showed assets held by type of financial institution. Figure 4 shows the breakdown of financial sector debt on the eve of the financial crisis. Whereas assets of the financial sector were (and still remain) broadly distributed, financial sector debt in 2008 was more concentrated. GSEs and their associated mortgage pools held 44% of the financial sector’s debt at that time. ABS issuers, which securitized hundreds of billions of dollars of non-conforming mortgages, accounted for another 24% of the debt of the financial sector. All other types of financial firms (i.e., finance companies, REITs, securities brokers & dealers, holding companies, and funding corporations) held one quarter of the sector’s debt in aggregate.

Source: Federal Reserve Board and Wells Fargo Securities

In absolute terms, the GSEs, their associated mortgage pools and issuers of ABS together accounted for more than $12 trillion of the financial sector’s debt of $18 trillion in Q3-2008. This relatively high level of debt reflects the business models of these institutions. Specifically, these institutions would issue debt to finance their purchases of mortgages, which they would then package into mortgage-backed securities (MBS) that they sold to investors. There was a seemingly insatiable demand for MBS as the housing bubble inflated, and the GSEs and ABS issuers had little trouble issuing debt securities to finance their purchases of mortgages during the early years of the past decade.

The implosion of the housing bubble caused the demand for MBS that were securitized by non-conforming mortgages to nosedive. The amount of debt among ABS issuers plunged from nearly $4.7 trillion in mid-2007 to less than $1.2 trillion today (Figure 5). Consequently, the share of financial sector debt that is held on the books of ABS issuers has dropped to only 7% today (Figure 6) from 24% in Q3-2008 (reference Figure 4). As a percent of GDP, ABS debt swooned from more than 30% in 2007 to roughly 6% in Q1-2019.

* The bulk of the pension assets of the private sector are held today in defined contribution plans such as 401k plans. The shares that investors own are liabilities of the mutual fund companies and pension plans. We discussed the pension obligations of the state and local governments in Part V of this series.
Figure 6

**Financial Sector Debt by Institution Type**

- **GSE & Pools**: 56% (Q1-2019)
- **ABS**: 7%
- **Dep Inst**: 9%
- **Insurance**: 1%
- **Other**: 31%

Source: Federal Reserve Board and Wells Fargo Securities

**Debt is not an important means through which to finance asset acquisition for many types of financial institutions.**

Whereas GSEs and their associated mortgage pools accounted for 44% of financial sector debt ten years ago, their share has risen to 56% today. Part of this increase in share reflects a smaller pie. As noted previously, the aggregate amount of financial sector debt is $1.8 trillion lower today than it was a decade ago. But part of the increase in share reflects the modest net increase in GSE and mortgage pool debt over the past decade. As shown in Figure 7, the debt of these institutions totaled more than $8 trillion in early 2009. After a modest decline, debt started to grow again and currently exceeds $9 trillion. As a percent of GDP, however, the debt of the GSEs and their associated mortgage pools has receded from 57% ten years ago to 43% today.

Aside from the GSEs and ABS issuers, debt is not an important means through which to finance asset acquisition (depository institutions, insurance companies and mutual funds) or it represents a relatively small portion of the overall financial sector (finance companies, REITs, broker/dealers, holding companies and funding corporations).

**Conclusion**

The debt of the U.S. financial sector rose significantly in the first decade of the 21st century as the American housing bubble inflated. The leveraging of the household sector, which we addressed in Part II of this series, and the build-up in debt in the financial sector occurred in tandem. Consumers were eager to take on mortgage debt to finance house purchases, and these mortgages were subsequently purchased by the GSEs and ABS issuers, via debt issuance of their own, and then sold to investors in the form of MBS. However, the bursting of the housing bubble led to a de-leveraging of both the household and the financial sector. In that regard, the debt-to-GDP ratio of the financial sector has receded to a 20-year low.

More than one-half of the financial sector’s debt is held on the balance sheets of the GSEs and their associated mortgage pools today. Indeed, the combined debt of those institutions is higher today than it was a decade ago. But a replay of the events that brought the GSEs to their knees in 2008 does not seem likely in the foreseeable future. As we discussed in more detail in Part II, the financial health of the household sector has improved markedly over the past ten years. The household debt-to-income ratio has receded by more than 30 percentage points since its peak in 2008, and the financial obligations ratio of the household sector currently stands near a four decade low. Widespread defaults by households on their mortgage debt does not seem to be in the cards.

More broadly, we do not view the debt of the financial sector to be overly concerning at present. The amount of sector debt today is nearly $2 trillion lower than it was a decade ago, and the debt-to-GDP ratio of the financial sector is down by nearly 50 percentage points. Any concerns that readers may have about American debt at this time should probably not be focused on the financial sector.
July 25, 2019

Economics Group

Special Commentary

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
Debt Outstanding by Sector

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

Figure 2
Debt Outstanding by Sector

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 (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).

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**

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

**Figure 4**

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

Source: Federal Reserve Board and Wells Fargo Securities

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.

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.
Wells Fargo Securities Economics Group

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<th>Name</th>
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