

ORIGINAL ARTICLE

## **U.S. Debt: The Next Financial Crisis?**

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Received 21-11-17   Revised 04-12-17   Approved 09-12-17   Online 25-04-18

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Cite as:

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Stuart, P. (2018). US Debt: The Next Financial Crisis?. *Journal of Economics, Finance and International Business*. 2(1), 72-83.  
Doi: <http://dx.doi.org/10.20511/jefib.2018.v2n1.221>

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## Abstract

As the U.S. economy has mainly recovered from the 2008 Financial Crisis, with unemployment below 5%, inflation below 2%, and the stock market near all-time highs, there is growing concern about the huge amount of U.S. government debt, which today stands at over \$20 Trillion dollars and 106% of Debt/GDP. Could this be the next thing to derail the U.S. economy, and in so doing, negatively affecting nearly every other country in the world?

This paper reviews the size and scope of the U.S. National Debt in it's historical context. There are three reasons to be alarmed about this, especially now. First, the annual budget deficit, which had been shrinking in the later years of the Obama administration, is once again on the rise. Second, the Republican tax reduction bill is estimated to add another trillion dollars to the overall level of government debt in the next 10 years, even with higher GDP growth rates factored in. Third, the Trump administration, while slashing other areas of government spending (State Department, Environmental Protection Agency, and more) is once again seeking major increases in military spending. This scenario is strikingly similar to the early 1980's, where deficits soared as a result.

The paper also offers some solutions as to what can be done to bring it down to a more manageable level (or at least reduce it's rate of growth). Like many things in economics, the "best" solution is to find ways to return to levels of historical GDP growth rates (3% and above).

**Keywords:** Debt, Deficit, Debt/GDP Ratio, GDP Growth, Taxes, Crisis

**JEL Code:** G18; G15

In the United States, there has been some sort of economic crisis about once per decade over the past 40 years. There was stagflation (a combination of high unemployment and high inflation) in the 1970's, due to the market manipulation of oil by OPEC. There was the Savings and Loan (S&L) crisis in the 1980's, as the oil bust and lax regulation led to weak financial institutions in the oil rich South. Then the "dot.com" boom of the 90's gave way to a bust, made worse by the attacks of September 11th. And the housing bubble burst in 2008, leading to the worst economic downturn since the great depression.

As we approach the 10 year mark since the end of the housing bubble, with our economy nearly recovered and our stock markets near all-time highs, economists are increasingly worried about the staggering amount of U.S. government debt.

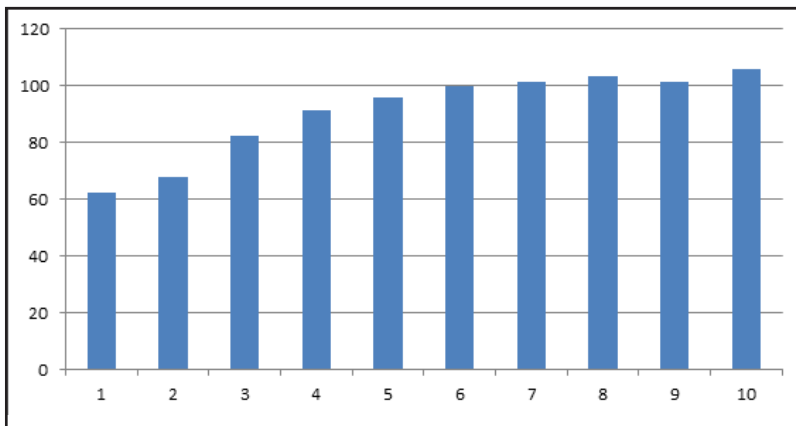
The current government debt stands at \$20.8 Trillion ([usdebtclock.org](http://usdebtclock.org)), an almost unfathomable number. To put it in perspective, that's larger than the size of the entire U.S. economy. It translates into \$208,000 per U.S. citizen! And this is in addition to the personal debt that many Americans have, a combination of student loans, mortgages, credit cards, personal loans, etc., which currently is another \$18.5 Trillion on top of the Government debt. The interest alone on the government debt was \$229 Billion in 2015, an increasing line item in each years budget.

Looking back over the last 100 years, we see that as a % of GDP the annual deficit (as opposed to the overall level of debt) was highest during the two world wars. A budget deficit or surplus is the one year gap between spending and revenues. The highest deficits were 17% in 1919 (towards the end of world war I) and 24% in 1945 as world war II was drawing to a

close. Note that these levels were higher than even during the Great Depression in the 1930's, and much higher than today. However, those budget deficits quickly turned into budget surpluses after the two wars ended, and the level of debt was then paid down throughout the following decades, leaving our annual debt to GDP ratio at a more manageable level by the start of the 1980's. In fact, in comparison to today the debt levels assumed during the world wars barely register.

What is striking is how quickly our debt to GDP ratio has grown over just the last 10 years. Although the U.S. economy has mostly recovered from the 2008 Financial Crisis, overall debt has continued to grow to historically high and dangerous levels (see figure 1).

*Figure 1: US Gross federal debt to GDP 2007-2016 (Source: Trading Economics US Bureau of Public Debt)*



When comparing debt to GDP ratios for different countries, the only two major economic powers in the top 12 are the U.S. and Japan. And with the exception of Jamaica, the U.S. has the highest Debt to GDP level of in the Western Hemisphere.

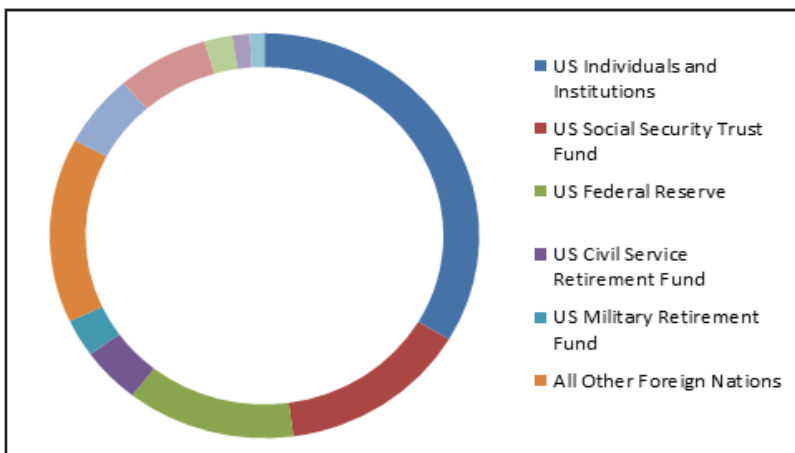
In comparison, Peru has a very manageable level of debt of just 25% to GDP (Source: Trading Economics, 2017).

The majority of the U.S. debt is owned by the government itself, and also by its own citizens – investors who purchased government securities that earn interest. However, some of this debt is owned by foreign governments, the largest being China who owns about 7%, which has led many in Washington to express concern (CNNMoney, May 2016).

U.S. debt is perceived by investors around the world as one of the safest investments there is, but as the debt load grows that perception could begin to change. This would ultimately lead to higher interest rates in order to attract future investors, more expensive debt service payments, and an even deeper hole to climb out of. This is what happened to Greece.

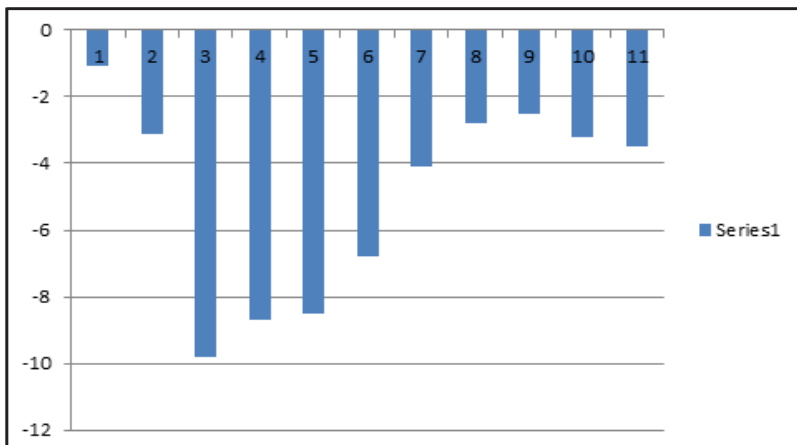
So how did this happen in the United States? Put simply, through run-away government spending and year after year of budget deficits. It started in the 1980's with Ronald Reagan

*Figure 2: Owners of the U.S. Government Debt- Sources: US Treasury Department, US Federal Reserve*



and his combination of tax cuts coupled with increased government spending, especially on the military. And with the exception of a few years in the late 1990's under president Bill Clinton, the government has nearly always run a budget deficit. However, under president Barack Obama, the budget deficit grew significantly as his administration applied the trusted Keynesian recipe of massive government spending coupled with low interest rates to help the economy recover from the housing bubble bursting, and the subsequent "great recession" that it created. When Obama took office in January 2009, the total U.S. government debt was \$11.9 Trillion (Congressional Budget Office, Nov. 2009), still a huge number but \$7.7 Trillion less than it is now, after only 8 years. To be fair, as the economy has recovered the annual budget deficit has been shrinking. In 2016, the budget deficit was a much more normal 3.2% of GDP, a smaller number but still adding to the overall debt each year (see Figure 3 below). A fair analogy might be to say that at least the run-away train has slowed to only 80 miles per hour, but it is still out of control.

Figure 3: US Federal Government Budget 2007-2017, Source: *Tradingeconomics.com US Treasury*



Note that the budget deficit is again starting to grow as growth in GDP and tax revenues are not keeping pace with increased government spending. And the deficit will grow even more in 2018 and beyond thanks to President Trump's signature legislative accomplishment of major tax cuts.

In 2016, neither presidential candidate was talking about this, and President Trump has largely avoided the topic since taking office. Republicans in general were unconcerned that a major reduction in taxes would eventually have to be paid for. And it's because there is nothing to be gained politically by informing the American public that the next decade or two could be remembered for low growth and stagnant wages as we have to start paying down our debt. Certainly villifying free-trade deals and immigrants is not the solution, just like in the 1930's, when the Great Depression was made worse by the U.S. closing themselves off from their trading partners by enacting new and higher tariffs. In fact, the solution lies in the opposite response, welcoming immigrants who can increase our productive capacity, and exporting more goods and services to increase GDP, and thereby increasing tax revenues and beginning to pay down the debt. Many countries in Asia have followed this policy, with China and South Korea perhaps the best examples, and it's now generally known as the "Asian economic miracle".

The argument is sometimes made that the U.S. could simply print their way out of this mess, albeit with the side-effect of devaluing the dollar. And perhaps as long as the greenback continues to be demanded by the rest of the world, a crisis can be avoided. They point to the massive monetary stimulus of the last decade, and that the dollar has held up quite well against a basket of other currencies. But this argument fails to consider that many other countries have also engaged in

flooding their economies with money, in an attempt to foster a recovery of their own. Indeed, the ECB (European Central Bank), Japan, China, and many other countries have lowered interest rates and weakened their currencies, in some cases into negative territory, which is unprecedented in modern economic history. And like the U.S., they've also conducted major bond purchasing programs (known as Quantitative Easing, or QE) that have increased their countries money supply and devalued their currencies.

All this loose monetary policy has caused some to predict a second housing bubble in certain geographic parts of the world. If all countries turn on their printing presses at the same time, then nobody's currency loses value. But in the future, if the U.S. continues to generate massive amounts of monetary stimulus and other countries do not follow suit, then confidence in the dollar will erode and printing ever increasing amounts of money will just generate inflation and lead us back to stagflation (high inflation coupled with high unemployment, which characterized most of the 1970's).

The other major issue with an ever increasing debt load are the interest payments. We are in a period of unprecedented low interest rates, but as the U.S. economic recovery continues interest rates are rising. So interest on our debt was 1.3% of GDP in 2015, but is expected to be well over 2% of GDP by 2020. As we pay more and more interest on our debt it becomes more likely that we will continue to run budget deficits and add to our debt. Again, this is the case of Greece, and only through continued borrowing and major fiscal austerity have they been able to stabilize their situation, and only recently have begun to grow their economy again. The recovery process will not be quick for Greece. Bringing their debt load back to normal will most likely take decades of further



austerity and fiscal discipline (note that as a member of the E.U. they have almost no control over monetary policies, i.e., they can't "print" their way out of their debt crisis).

It seems that the U.S. government is setting itself up for many decades of low government spending as they are forced to finally balance their budget, and begin paying down the government debt. The resulting lack of fiscal stimulus will lead to many years of negative or low-growth GDP, high unemployment and shrinking wages.

Just look at Japan, who started down this path in the 1990's and is most likely a decade or so away from full recovery and a manageable debt load. As mentioned, the U.S. was able to bring it's debt to GDP levels back under control after world war II, and with some fiscal restraint and enough time we can do it again.

The first step, obviously, is to balance the budget and end the practice of always running a budget deficit. That was the thinking behind the Balanced Budget Amendment of 1995, but it was never passed. Today, the Republican controlled congress is turning back to what worked in the 1980's..... applying Supply-Side Economics, which seeks GDP growth by increasing Aggregate Supply. They claim lower taxes could help lower the budget deficit (and eventually the overall government debt) by spurring GDP growth from the anemic growth of the last decade to estimates of 3.5% - 4.0%.

This idea is a major tenent of Supply-Side Economics, which was first proposed by Arthur Laffer (1974).

Yet even they admit that this alone won't close the budget defiicit. According to Kevin Brady, the Chairman of the House Ways and Means Committee, "We know tax reform done

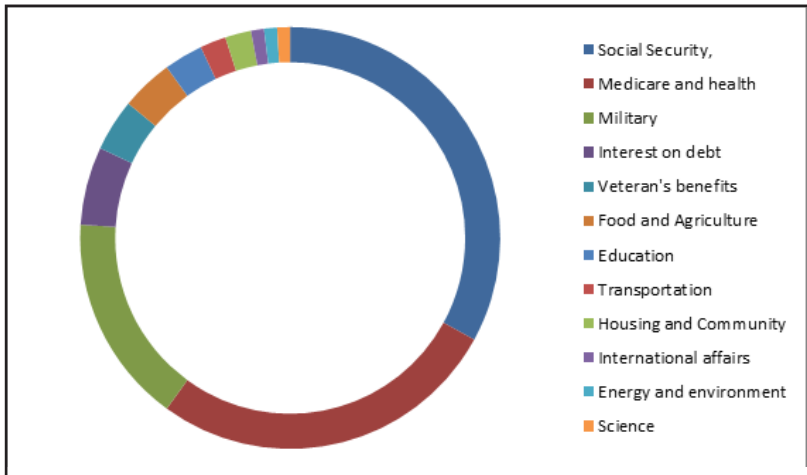
right can grow the economy in a big way. But that alone won't get us back to a balanced budget," said the Texas Republican. "You have to eliminate dozens, if not hundreds of provisions out of the code to lower those rates and move us back to a balanced budget." *CNBC interview on November 6th 2017.* Looking again at the Laffer Curve above, the Republicans are assuming that current corporate tax rates are in the region of declining revenue, and therefore cutting them will increase revenues as businesses will invest those tax cuts back into their companies and grow the economy.

Will tax cuts and increased GDP growth ultimately fix the problem and avoid a major economic crisis? I believe that it can, but only if congress can find the political will to slow the growth rate of spending in addition to the passing meaningful tax reform that stimulates GDP growth. That is, growing our way out of a debt crisis, whether you buy into the concept of the Laffer Curve or not, is tough without corresponding spending cuts (or at least cutting the growth rate of spending). But as the expression goes, "the devil is in the details". Deciding what departments or programs to cut is always difficult and politically dangerous.

So what are the biggest items in the budget? The biggest items are Social Security, unemployment benefits, Healthcare and Medicare services (see figure 4 below). All of these are critical government outlays that would be extremely difficult to reduce, especially because workers have paid into these programs throughout their careers and expect the benefits to be there for them (similar to the AFP system in Peru). The next biggest item is spending on the military, which was being reduced each year by the Obama Administration, and will most likely start to grow again under the Trump Administration, as a Republican Congress and White House

historically have sought to increase funding for the military. And notice that the next largest budget item is interest on the existing national debt (6% of the total budget, nearly \$230 billion in 2015). Again, this will only grow (and has grown) as the overall debt level continues to balloon.

Figure 4: Total federal spending 2015, Source: *nationalpriorities.org*



If there is a bright spot in all of this, it's that Republicans (versus Democrats) are usually more focused on limiting the amount of government spending. With a Republican president and congress, and the 2008 financial crisis almost 10 years old, this is the right time for the President to start working with the congress to reduce spending before this speeding debt train derails the entire economy and leads us to yet another financial crisis.

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