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Will Our Debt Cause A Crash?

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Whew! I just got off the phone with another client, petrified that the current level of American debt would cause a financial crash. Let's take a more in-depth look at this issue.

As you no doubt know, if you read or watch the financial press, there is a constant drumbeat that a complete meltdown in our economic system lies ahead—the reason: our $34 trillion in national debt. Look at usdebtclock.org to get a feel for how fast we add to our country's obligations.

Undoubtedly, this is a staggering amount of debt, something that no one should argue is in any way desirable. I'm not here to tell you that we're in a good place financially. I wish that this country would bring its spending under control. However, the question that we're looking at today is whether complete financial collapse, as some are saying, is in our immediate future. I don't think so, but there are some specific examples that we can look at that point to a more harmonious future.

Case Study: Japan

Economists consider Japan an analogous case study of the evolving American Financial Condition. Like the United States, Japan has an aging population, with those citizens of retirement age representing an out-size portion of the economy.

Like the "Baby Boom," the Japanese have a substantial portion of their population who are retired and no longer pursuing a productive career. Yet they require significant social, health, and other services. It causes governments to spend money on these services, for which there is little or no tax revenue.

Look at the US's top two expenditures: Medicare/Medicaid and Social Security. These funds should have been accumulated earlier when the Boomers earned good salaries. But as you know, we didn't do that. Instead, we must borrow the money now to pay the Boomers' benefits, and our national debt rises.

Just how dangerous are these higher debt levels? The US Debt level currently exceeds our economy by 12% (112% of GDP). While that's certainly not a good thing, if Japan were our example, that level of debt to the economy would be manageable.

Japan surpassed the 12% debt over the economy 21 years ago. And no one is talking about a significant meltdown for Japan. Today, Japan's debt stands at a whopping 146% above its economy (264% of GDP). In other words, Japan's debt has more than doubled in the past 21 years.

I'm not suggesting we follow Japan's example and continue adding to our debt pile — far from it! My only point is that using Japan as our model, there is no absolute magic level of debt at which economies collapse.

Bringing our discussion closer to home, using several measures, the United States Debt Level is currently about the same as it was during the last days of World War II. Like in World War II, an outside enemy drove the country to these high debt levels. This time, that enemy was the COVID-19 pandemic.

In 2020, the first year of the Pandemic, Federal Spending skyrocketed; strategies like the Stimulus Programs, combined with the reduced Government Revenue from the "Lock-Down" caused the government deficit to balloon to the highest level ever in one year, over $3 Trillion.

Today, the United States maintains a credit rating of AA+ by Moody's and Aaa — by Standard and Poors, with an overall credit score of 97. It is not tremendous and indeed not a good comparison when, for years, the United

States had a credit rating of AAA and a score of 100. But no rating agencies see anything like a default or crash in our immediate future.

What Would Cause a Financial Crash?

So, if no magic debt level causes financial meltdowns, what does cause an economic crisis? The answer for the nation is the same as for any business or individual: Do you have spending under control, and do you have a plan for paying off and reducing debt?

Wall Street is very good at assessing whether someone is creditworthy. It's what we do. When evaluating any investment, the very first thing we look at is their financial reports.

Does management have firm control over their expenditures? Do they only spend what they need and purchase goods and services at a reasonable price? Or are they spending like the proverbial "drunken sailor," throwing money around on personal luxuries or other unneeded items?

In my prior life, I was responsible for developing a credit report for certain brokerage firms we wanted to deal with. Many of these were small firms just getting started. I remember walking into one new firm's office, which was the very height of luxury, with plush carpets, wing-backed chairs, and original artwork on the walls. Anyone would be impressed just walking into the reception room.

I voted against doing business with that firm. Why? Because I knew they had little income (their financial reports are public). Yet they had spent extravagantly, far beyond normal, on office decoration. To me, they appeared to be poor financial managers. Indeed, within two years of my visit, they filed for bankruptcy.

The United States is like any company or individual in financial difficulty today. The caution flags are out. However, there is nothing to date to indicate that the US is in immediate danger, and thus, any fear of a financial crash is not currently warranted. On the other hand, there can be no doubt that we are headed in the wrong direction.

The reality is that we are the number one debtor in the world. It's no time to arrogantly demand that the rest of the world support our spending. Instead, it's time for us to work within the global community and seek their financial support. Like any borrower, we are dependent upon our lenders.

More than anywhere else, the current Administration has failed here. Cutting Russia from the SWIFT International Settlement System was significant in fracturing the global world when we needed international support. China and Saudi Arabia, in particular, reacted negatively to this move. China opened up its Trading System, and Saudi Arabia abandoned the PetroDollar.

There is a persistent rumor that the Administration is behind a scheme to seize $300 Billion (US) in Russian deposits held by European and US Banks. This would drive yet another nail in the Global Financial System, a System we need to support our burgeoning debt. Although Russia holds only a tiny amount of US Debt (Treasury Bonds and Notes), it is clear that America's policies against Russia affect China, and China has over a trillion dollars of US Debt.

As CNBC and others are reporting, the Administration, which is far from controlling spending, continues to use its free-spending methods, building our deficit by $1 trillion every 100 days. It's not sustainable. And the Global Markets have noticed.

When the bond markets see something they don't like, they raise the rates they're willing to pay. With the United States over-spending by about $3 ½ Trillion annually, we have seen the yield on our bonds rise. Currently, the US 10-year Treasury yield is over 4%, a rate higher than England, Germany, France, and Spain, 177 basis points higher than China, and almost triple the rate of Japan.

And remember, this is not exclusively the result of the Federal Reserve Interest Rate Policy, although that's undoubtedly involved. These higher US rates are also the result of the Global Financial Markets' reaction to our profligate spending.

Summary

So, that's a long answer: Are we headed toward an eminent Financial Crash? No. But I wanted to make a couple of points.

The United States is not in danger of a financial crash, so panic is unnecessary. Panic is the last thing we want to do, but it can create just the sort of behavior that creates a crisis.

The two major financial rating agencies, S&P and Moody's, still rank the US number 13 in the world, ahead of over 180 other countries.

Annual Government Receipts (taxes and levies) for the US Government are nearly $5 Trillion. We can still pay our bills.

If we control our spending (are you listening, Biden Administration?), we could turn this around rather quickly.

The final point is this: the World Community is watching. We must pay one of the highest rates on our long-term obligations (US Bonds and Notes of 10-year maturity and more) because our spending is reckless. Bond investors cannot predict how much new debt we will add over the next several years. More supply of US Debt (bonds and notes) equates to lower prices. Something that investors want to avoid.

We can afford all the necessities: defense, social security, Medicare, and high-interest rates. But we need to put all that crazy new spending on hold. Several times, it has been suggested that the **US Government freeze** its spending at current levels. Now would be an excellent time to implement a freeze.