"Unprecedented" growth of US debt could bring market shock

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26 March 2024

The US could be on course for a crisis in its bond market, replicating that which hit the UK in September 2022 when financial markets went into turmoil after the short-lived Liz Truss Tory government proposed major tax cuts funded by an increase in government debt.

The UK crisis, which required intervention by the Bank of England, had its own peculiarities bound up with the operations of pension funds. But it may well have been a foretaste for a much bigger crisis that could engulf the US financial system.

This scenario was outlined by Phillip Swagel, the director of the Congressional Budget Office (CBO), in an interview with the *Financial Times* (FT) yesterday. He said growing US government debt was on an "unprecedented" trajectory risking the kind of crisis which led to the collapse of the Truss government.

"The danger, of course, is what the UK faced with former prime minister Truss, where policymakers tried to take an action, and then there's a market reaction to that action," he told the FT.

He said the US was "not there yet" but warned it could be, with the increase in interest rates raising the cost of payments to $1 trillion in 2026 creating conditions for bond markets to "snap back."

Swagel did not go into details of its form, but a "snap back" could result in a sell-off of government debt, leading to a rise in market interest rates [as bond prices fall, interest rates rise] and liquidity problems.

The CBO has said federal government debt was $26.2 trillion at the end of last year, equivalent to 97 percent of gross domestic product. It has forecast significant increases in coming years, not least because of rising interest rates.

Back in February it said the US budget deficit was set to rise by almost two thirds over the next decade from $1.6 trillion to $2.6 trillion with much of the increase due to higher interest costs.

The CBO said that interest payments would account for around three quarters of the rise in the deficits between today and 2034. The deficit as a proportion of GDP would rise from 5.6 percent in 2024 to 6.1 percent in a decade's time, well above the average of 3.7 percent over the past 50 years.

The total government debt as a proportion of GDP would rise above 100 percent next year and would reach 116 percent by 2034. The CBO estimates that while interest costs on government debt are at present roughly equal to military spending, they could rise to one and half times larger in a decade's time.

Swagel noted that the expected rise in debt as a proportion of GDP would take it over the levels reached in World War II, and warned that even what seemed to be small changes in government spending could have major effects.

"We have the potential for some changes that seem modest—or maybe start off modest and then get more serious—to have outsized effects on interest rates, and therefore on the fiscal trajectory," he said.

The rise and rise and rise of government debt had seen a rapid expansion of the US Treasury market where it is bought and sold. This market, the foundation of the US and global financial system, has expanded to around $27 trillion, a 60 percent increase over the past five years. It is now six times larger than it was before the global financial crisis of 2008.

There has been a significant shift in operations of the market. In the past banks were major participants, but their activity has been cut back, partly because of regulations introduced after the financial crisis—an example of how attempts to stabilise the system in one area can create problems in another.

Hedge funds have assumed a greater role. But their activity, particularly in the so-called basis trade in which they seek to make profit on the very small difference between the price of bonds and the price of their futures using large amounts of borrowed money, is creating concerns among regulators.

The growth of US debt, coupled with the instability in the financial system, is starting to raise questions about the role of the dollar as the global currency, the maintenance of which is an existential question for US hegemony.

The credit rating agency Fitch last year removed the triple A rating from the US citing concerns over a “high and growing general government debt burden.” Moody’s has maintained the triple A rating but has changed its outlook for the US from stable to negative.

The gold market is pointing in the same direction with the price of the metal, which, unlike fiat currencies, does embody real value in and of itself, has been steadily rising for the past 16 months and has been touching record highs. One of the reasons is increased buying by central banks after the freezing of Russian central bank assets at the start of the Ukraine war raised concerns that dollar assets held by any country could not be considered sacrosanct.

Swagel touched on the international role of the dollar in his FT interview, warning that its role as the global reserve currency, enabling the US government to run up large deficits, would not always insulate the US from market pressures if interest payments increased.

“We need to borrow from foreigners, because foreign capital helps keep interest rates low in the US,” he said. “But there’s two sides to it, in that cash flowing overseas [interest payments on debt] means us losing national income. On the other hand, not having the capital coming in for us to borrow—boy, that would be even worse.”

In a generally upbeat recent speech on trust and confidence in central banks, Agustin Carstens, the head of the Bank for International Settlements, the umbrella organisation of central banks, pointed to how fast a situation can change.

Periods of apparent tranquillity, he said, are often when the seeds of future crises are sown, and when financial markets smell weakness, they can move very fast. Carstens recalled the words of the late German economist Rudiger Dornbusch: “Financial crises take much, much longer to come than you think and then they happen much faster than you would have thought.”

He did not reference the US but under conditions where the growth of government debt is “unprecedented” and inherently unsustainable it may well have been a veiled warning.

No one can predict exactly how financial developments will unfold. But one thing can be said with certainty. As the experience of 2008?2009 revealed, a crisis in the financial system will see an escalation in the assault on the working class to make it pay. And the intensity of that assault will be proportional to the size of the debt mountain.