Major US think tank probes debt crisis

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The Economics Studies program of the Brookings Institution has published a study on how mounting US federal debt, now at $36 trillion, could spark a devastating financial crisis in the US and globally.

While it concluded that the chances of such a crisis are low, the fact that such an analysis has been carried out by a major US think tank indicates this issue is causing greater concern. As the report acknowledged, "That the US is on an unsustainable fiscal trajectory is well-established and has long been evident in debt projections."

Their paper, they wrote, sought to "examine the various channels through which debt can affect the economy to assess the risk that elevated debt will lead to a crisis."

They defined a fiscal crisis as a "sudden, large and persistent downturn in demand for Treasury securities relative to supply that triggers a sharp and persistent spike in interest rates."

One of the transmission mechanisms through which such a crisis could pass into the broader financial system is the so-called repurchase or repo market. This is the market in which financial institutions obtain short-turn funds, sometimes just overnight, using Treasuries as collateral.

The use of Treasuries in this way is relied on "heavily" in the financial system, the report noted, and a "sudden loss of confidence would impair liquidity, potentially leading to widespread bank failures, as banks and financial institutions use Treasuries to meet capital requirements."

Such an event is not "off the charts" but has already happened. In September 2019 there was a crisis in the repo market when interest rates on ultra short loans shot up to as high as 10 percent from their normal level of a fraction of a percentage point and the Federal Reserve was forced to intervene.

The report warned that a crisis in the Treasury market would "most likely" be accompanied by a "dramatic fall" in both the US dollar and equity markets. Given the critical role of the US Treasury market in the global financial system, it "would likely lead to a financial crisis involving widespread bank losses, a collapse in credit availability, and very likely a global recession."

Such a scenario is well within the bounds of possibility. In fact, the conditions for it emerged in the freeze in the US Treasury market at the start of the COVID-19 pandemic in March 2020. For several days there were no buyers for US Treasury bonds, supposedly the safest financial asset in the world.

A full-scale global meltdown was only prevented by the Fed which intervened to the tune of several trillion dollars to back virtually every financial asset.

As Darrel Duffie of the Graduate School of Business at Stanford University wrote shortly after the immediate crisis had passed, while the Fed accomplished what it needed to do, it was not acceptable that the market was based on "the notion that the Fed is available as the lender of last resort."

Duffie remarked that the turmoil revealed that the structure of the Treasury market was "overdue for an upgrade." In the five years that have since passed, nothing resembling that has taken place. In fact, the various financial regulatory authorities are still trying to figure out what exactly took place in March 2020 and what might be done to prevent a recurrence.

The report posed the question as to whether future disruptions could be so large that even the Fed could not respond effectively. It said given the Fed's capacity to purchase an unlimited amount of Treasuries this was "unlikely."

"Still," the report continued, "as the Treasury market continues to grow, episodes of dysfunction might become more frequent, potentially undermining confidence in US Treasuries as the world's safest asset."

The report's authors recognised they were very much in uncharted waters—there has never been a time, except in World War II, when the US debt to GDP ratio has been as high.

That was in very different conditions. The US was then an industrial powerhouse which formed the economic basis for the post-war boom through which it was able to pay down the debt. Today the US economy is shot through with debt and financial parasitism, dominated by the financial oligarchy whose source of wealth is not the expansion of industrial power but market speculation.

These issues are not touched on in the report, but the authors are aware that their claim that the chance of a crisis appears to be "quite low" rests on somewhat shaky ground.

"We recognise," they wrote, "there is great uncertainty about the repercussions of debt as a share of GDP rising to levels far exceeding historical precedents, and an analysis benchmarked to historical relationships in the macroeconomy may understate the risks of a fiscal crisis."

After analysing projections by the Congressional Budget Office on the increase in debt, the report noted that "the required adjustments to fiscal policy to stabilise the debt are sizable." Moreover, those projections may well be an underestimate because they are based on present conditions and not the measures which the Trump administration has planned such as major tax cuts for corporations and the effect of tariffs.

Where is the axe going to fall? There were no explicit policy prescriptions, but the answer was contained in the analysis of the reasons for debt escalation.

"In 2024, Social Security and health programs accounted for 3 percent more of GDP than they did in 2006 while revenues and non-interest spending were about the same. Thus, primary deficits as a share of GDP increased from 2006 to 2024 because spending on Social Security and health programs rose." 2006 was chosen as the baseline because it was prior to the global financial crisis of 2008 and might be considered as being "normal."

As with all such institutions providing advice on the running of the capitalist economy, the Brookings analysis essentially rules out as "off limits" for its calculations any consideration of the massive increases in US military spending, or the trillions of dollars handed to corporations and banks in the form of bailouts and subsidies. Also ruled out are the effects on the economy of the provision of virtually free money to companies and banks by the Fed, and, more recently, the payment of interest to Treasury bond holders, now approaching $1 trillion a year.

The focus of policy prescriptions, either explicit or implied, is on expenditure measures that most directly impact the working class.

Among possible triggers for a crisis it listed problems that the Fed is unable to mitigate. These included a depression or war, and political brinkmanship, which regularly takes place over lifting the debt ceiling leading to the loss of credibility. Also listed were the fear of default, a loss of inflation control and concerns that the Fed had abandoned its mandate and was allowing hyperinflation, and a "strategic default" at least on some debt. On the last possibility, Republican Senator Lindsey Graham suggested in 2020 that China should not be paid the $1 trillion it holds in US Treasuries.

The overriding fear pointed to was that investors came to believe that "the US was never going to address its long-term fiscal challenges." This raised the "serious possibility" of a strategic default on its debt and "the result could be a cataclysmic event."

It said the fiscal challenges had to be addressed and a "perceived unwillingness" to ever take these steps "would likely lead to a fiscal crisis, even with a Federal Reserve willing to act as a lender of last resort."

The report did note that there was great uncertainty about "debt as a share of GDP rising to levels far exceeding historical precedents." But it concluded that analysis suggested "so long as the US maintains its strong institutions and a fiscal trajectory that isn't vastly worse than the ones currently projected the chance of a fiscal crisis over the next decades appears quite low."

During an online event to discuss the report, however, David Wessel, a senior fellow at Brookings, drew attention to these lines which he said had been "haunting him."

Clearly referencing the upending by the Trump administration of what had been economic, political and legal norms and the weakening of US institutions and a worsening fiscal trajectory, he said: "These are things I used to assign a zero probability to that are now somewhat higher."

Louise Steiner, one of the authors of the report, said she was worried about the chance of a crisis not sparked by the amount of debt, and "not following the law as we used to understand it."