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America is In a Debt Trap Death Spiral

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The US economy and its financial structures have never recovered from the great financial meltdown of 2008 despite the passage of ten years. Little discussion has been given to the fact that the Republican Congress last year abandoned the process of mandatory budget cuts or automatic sequestration that had been voted in a feeble attempt to rein in the dramatic rise in US government debt. That was merely an added factor in what soon will be recognized as a classic debt trap. What is now looming over not just the US economy but also the global financial system is a crisis that could spell the end of the post-1944 dollar system.

First some basic background. When President Nixon, on advice of Paul Volcker, then at US Treasury, announced on August 15, 1971 the unilateral end of the Bretton Woods gold-dollar system, to replace it with a floating dollar, Washington economists and Wall Street bankers realized that the unique role of the US dollar as leading reserve currency held by all central banks and the currency for world commodity and other trade, especially oil, gave them something that appeared to be a gift from monetary heaven.

So long as the world needed US dollars, Washington could run government deficits without end. Foreign central banks, especially the Bank of Japan in the 1980's and since the turn of the century, the Peoples' Bank of China, would have little choice but to reinvest their surplus trade dollar earnings in interest-bearing AAA-rated US Treasury securities. This perverse dollar system allowed Washington to finance its wars in faraway places like Afghanistan or Iraq with other peoples' money. During the Administration of George W. Bush, when Washington's annual budget deficit exceeded annually one trillion dollars, Vice President Dick Cheney cynically quipped, "debt doesn't matter; Reagan proved that." Up to a point that appeared so. Now we are getting dangerously near to that "point" where debt does matter.

Federal Debt Rise

There are generally speaking three major divisions of debt measured in the US economy: Federal debt of Washington, corporate debt and private household debt. Today, owing in large part to ten years of historic low interest rates following the largest financial crisis in history–the 2007-2008 sub-prime crisis that became a global systemic crisis after September 2008–all three sectors have borrowed as if there was no tomorrow because of the near-zero Federal Reserve interest rates and their various Quantitative Easings. Nothing so radical can last forever.

Since the financial crisis erupted in 2008 US Federal debt has more than doubled from $10 trillion to over $21 trillion today. Yet conditions were made manageable by a Federal Reserve emergency policy that dealt with the financial and banking crisis by buying almost $500 billion annually of that debt. Much of the remainder was bought by China, Japan and even Russia and Saudi Arabia. Further debt levels were restrained by the bipartisan spending caps established in the Budget Control Act of 2011 that had kept recent deficits partially in check.

Now conditions of future US Federal debt and deficit growth are pre-programmed for systemic crisis over the next several years.

‘Trumponomics’ Disaster

The economics of the Trump Tax Cuts Act of 2017, signed in December, dramatically cut certain taxes on business corporations from 35% to 21%, but did not offset that with revenue increases elsewhere. The promise is that cheaper taxes will spur economic growth. This is a myth under present economic conditions and overall public and private debt burdens. Instead, the new tax law, assuming ideal economic conditions, will decrease expected revenues by a total of $1 trillion over the next 10 years. If the economy goes into severe recession, highly likely, tax revenues will plunge and the deficits will explode even more.

What the new Trump tax cut act will do is dramatically increase the size of the US annual budget deficit. The Congressional Budget Office estimates that as early as Fiscal Year 2019 the annual deficit that must be financed by debt will reach $1 trillion. Then the Treasury Borrowing Advisory Committee expects government debt issues of $ 955 billion for FY2018, compared with $ 519 billion in FY 2017. Then for FY 2019 and 2020 the deficit will exceed $1 trillion. By 2028, ten years from now, under mild economic assumptions, the size of the USA Federal debt will rise to an untenable $34 trillion from roughly $21 trillion today, and the deficit in 2028 will exceed $1.5 trillion. And this year 2018 alone, with historically low interest rates the cost of interest only on the total Federal debt will reach $500 billion.

Zombie borrowers…time bombs

Now after almost a decade of unprecedented low interest rates to bail out Wall Street and create new asset inflation in stocks, bonds and housing, the Fed is in the early stages of what some call QT or Quantitative Tightening. Interest rates are rising and have been for the past year, so far very gradually as the Fed is being cautious. The Fed however is continuing to raise rates, and now the Fed Funds stands at 1.75% after nearly ten years at effectively zero. Were they to stop now it would signal a market panic that the Fed knew something far worse than they say.

Because never in its history has the Federal Reserve indulged in such a monetary experiment with so low rates so long, the effects of reversing are going to be as well unprecedented. At the onset of the 2008 financial crisis the Fed rates were around 5%. That is what the Fed is aiming at to return to “normal.” However, with rising interest rates, the lowest credit sector, so-called non-investment grade or “junk bonds” face domino style defaults.

Moody’s Credit Rating has just issued a warning that, barring some sort of miracle, as US interest rates rise, and they are, as much as 22% of US corporations that are being kept alive borrowing at historically low interest, not only in shale oil but in construction and utilities, so-called “zombie” corporations, will face an avalanche of mass defaults on their debt. Moody’s writes that, “low interest rates and investor appetite for yield has pushed companies into issuing mounds of debt that offer comparatively low levels of protection for investors." The Moody's report goes on to state some alarming numbers: since 2009, the level of global non-financial junk-rated companies has soared by 58%, representing $3.7 trillion in outstanding debt, the highest ever. Some 40%, or $2 trillion, are rated B1 or lower. Since 2009, US corporate debt has increased by 49%, hitting a record total of $8.8 trillion. Much of that debt has been used to fund stock repurchases by the companies to boost their stock price, the main reason for the unprecedented Wall Street stock market bubble.

Fully 75% of federal spending is economically non-productive including military, debt service, social security. Unlike during the 1930s Great Depression when levels of Federal debt were almost nil, today the debt is 105% of GDP and rising. Spending on national economic infrastructure including the Tennessee Valley Authority and a network of federally-build dams and other infrastructure resulted in the great economic boom of the 1950s. Spending $1.5 trillion on a dysfunctional F-35 all-purpose fighter jet program won't do it.

Into this precarious situation Washington is doing its very best to antagonize the very countries that it needs to finance these deficits and buy the US debt—China, Russia and even Japan. As financial investors demand more interest to invest in US debt, the higher rates will trigger the default avalanche Moody's warns. This is the real backdrop to the dangerous US foreign policy actions of the recent period. No one in Washington seems to care and that's the alarming fact.

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