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Does the National Debt Really Matter?

By Trevor Tormoen

The national debt in the United States has been a contentious political issue floating in and out of the spotlight since the inception of our nation. Throughout recent decades, the topic has been widely debated, with it coming to a head recently due to increases in government spending. As a result, the current outstanding debt held by the US is just over $26 trillion. Since the early-1980s, public debt, the percentage of the national debt owned by the public sector, as a percent of Gross Domestic Product has continually increased, expanding from 30.6% in 1981 to its current level of just over 135%, according to the Federal Reserve Economic Data. Before 2008, the increase was steady but controlled, even decreasing for a number of years at the turn of the century. However, as a result of the Financial Crisis and the COVID-19 pandemic, the national debt continues to explode with no end in sight. As the current Presidential administration has shifted and another round possible stimulus is on the horizon, it is likely that the US will approach public debt levels consisting of 150% of GDP. On a micro scale, debt levels exceeding annual revenue by any margin, let alone by 135%, would be incredibly concerning. However, governments are not beholden to their debt in the same way businesses and individuals are, complicating the issue dramatically. In the near-term, increasing national debt figures does not outweigh the benefit to Americans of another round of stimulus. Eventually though, as interest on this debt continues to mount, there can be some considerable repercussions.

In order to fully understand the nature of the US's national debt, it is imperative to break it down into its component parts. According to the US Treasury Department, the overarching national debt figure can be separated into two major sections: intragovernmental holdings (23%) and debt held by the public (77%). Intragovernmental holdings are debt aspects that the Treasury owes to other US federal agencies. For example, some organizations, like the Social Security Trust Fund, receive more tax revenue than is necessary for its operations and choose to invest the remainder in US Treasury bonds. This segment of the national debt is by far its least pressing aspect as, if push comes to shove, there is little to no likelihood that the US would not be able to pay off the debt it owes itself. The area of possible concern lands with the public debt, outstanding US debt owned by members of the public, foreign and domestic. Of this figure, about one third is held by foreign entities, primarily concentrated in China and Japan as a result of maintaining their fixed currency exchange rates with the US Dollar. Over the past 13 years, foreign debt holdings as been the fastest growing segment of the national debt, expanding from 2.4 trillion in 2007 to 6.81 trillion in 2020. While the Japanese and Chinese holdings are a concern for some, the two nations only own $1.07 trillion and $1.26 trillion respectively of the total foreign holdings. Although a majority of the total, their amounts sum to slightly just under 9% of the overall national debt, a figure amounting to little international influence. Additionally, despite past threats, these nations are under no incentive to sell off their massive reserves; the act would undo much of their exchange rate manipulation, dramatically hurting their exports abroad. The remaining amount of public debt is held by domestic investors, the Federal Reserve, along with state and municipal governments. When accumulated between Social Security, retirement, and pension funds, over half of the US Treasury liability is held in preparation for American's retirement. As one of the United States' largest generations, the Baby Boomers, continue to reach retirement age, the national debt is only expected to continuously expand as the associated medical and living costs grow.

As the national debt grows in relation to GDP, the risk of a government default increases in turn, bringing about a slew of contractionary policies aimed to combat this outcome. According to The Economist, theoretically, the US Treasury would need to raise more capital to pay off the surmounting interest by increasing the yield on newly issued securities to compensate for the added risk. This reduces the amount of funds available for social services and other federal programs, decreasing the American standard of living. Additionally, as Treasury rates increase, private sector operations will also be perceived as riskier than their foreign counterparts, forcing interest rates on corporate debt to increase as well. As their cost of debt increases, the prices of American goods and services will also increase to offset it, yielding higher rates of inflation. To combat this new inflation and increasing Treasury security rates, the Federal Reserve will be forced to increase interest rates as well, increasing the cost of borrowing money and decreasing durable asset prices, suppressing the housing market. As a result, the perceived wealth of American homeowners decreases, reducing autonomous consumption and investment spending. Further, as interest rates increase, the value of the US dollar also increases. The currency appreciation makes American goods more expensive in foreign markets, decreasing net exports. This, compounded with the aforementioned decrease in consumer, investment, and government spending, would almost certainly incite a recession. More generally, as the risk of default increases for a nation, it loses social and economic power on the world stage.

Perhaps more comfortingly, these effects would only take place if there was a widespread perceived increase in the default risk of the US government relative to other nations, which, historically and presently speaking, is extremely unlikely to happen. The US Dollar is still the world reserve currency and, considering its possible alternatives, it is unlikely to be replaced. Moreover, the global flight to safety that has historically occurred during recessions still happened in April, cementing the world's faith in the United States' financial health. Additionally, even when the US credit rating was downgraded in 2011 as a result of the massive amounts of fiscal stimulus, purchasing habits of US debt was not adversely affected. However unlikely, it is still possible that its default risk increases; if government budget deficits continually go largely unchecked for long periods of time, the domestic debt could reach a breaking point, inciting economic turmoil and threating the stability of the US.

As concerning as the United States' national debt may seem on a surface level, the concerns of default are less impending than some would suggest. Therefore, the immediate benefit of another round of stimulus outweighs the effects on the government budget deficit. However, this should be the final mass government intervention in the economy for the time being to allow for some of the outstanding debt to be curtailed to help prevent irreparable economic damage over the long term.