Too Much of a Good Thing? Examining the Risks of America's Growing National Debt

The debate over government borrowing has been a fixture of American politics since the earliest days of the republic. Thomas Jefferson took a hawkish perspective proclaiming, "I consider a permanent public debt as a canker inevitably fatal." His fellow Founding Father, and first Treasury Secretary, Alexander Hamilton viewed debt as a tool to build national credit and foster economic growth, famously stating that "a national debt, if it is not excessive, will be to us a national blessing."

The United Sates entered nationhood with debt from other countries used to fund the Revolutionary War. Since then, the federal government has been debt-free only once in its history, during the presidency of Andrew Jackson. In 1835, Jackson successfully paid off the entire national debt. This debt-free period was short-lived, lasting until 1837. Economic challenges following the Panic of 1837 forced the government to resume borrowing.

While a debt-free stance has its merits, Hamilton's perspective on federal borrowing was ultimately proven correct. The ability to spend more than the government received in revenue helped the nation develop and prosper. Favorable circumstances undoubtedly helped. A growing population and accelerating advancement in technology that led to robust productivity gains supported the US path to becoming a global superpower.

Moreover, debt issued by the U.S. Treasury has also been a critical facilitator for the advancement of capital markets. As the perceived risk-free asset, it serves as the foundation of global finance. However, the perception of being the world's most creditworthy borrower stands conditional on remaining fiscally responsible. Since ending the gold standard in 1971, the "full faith and credit" stands as the sole backing of America's currency and debt. If that faith in the United States to be a responsible borrower should waver, the implications would undoubtedly reverberate throughout the global economy and financial markets.

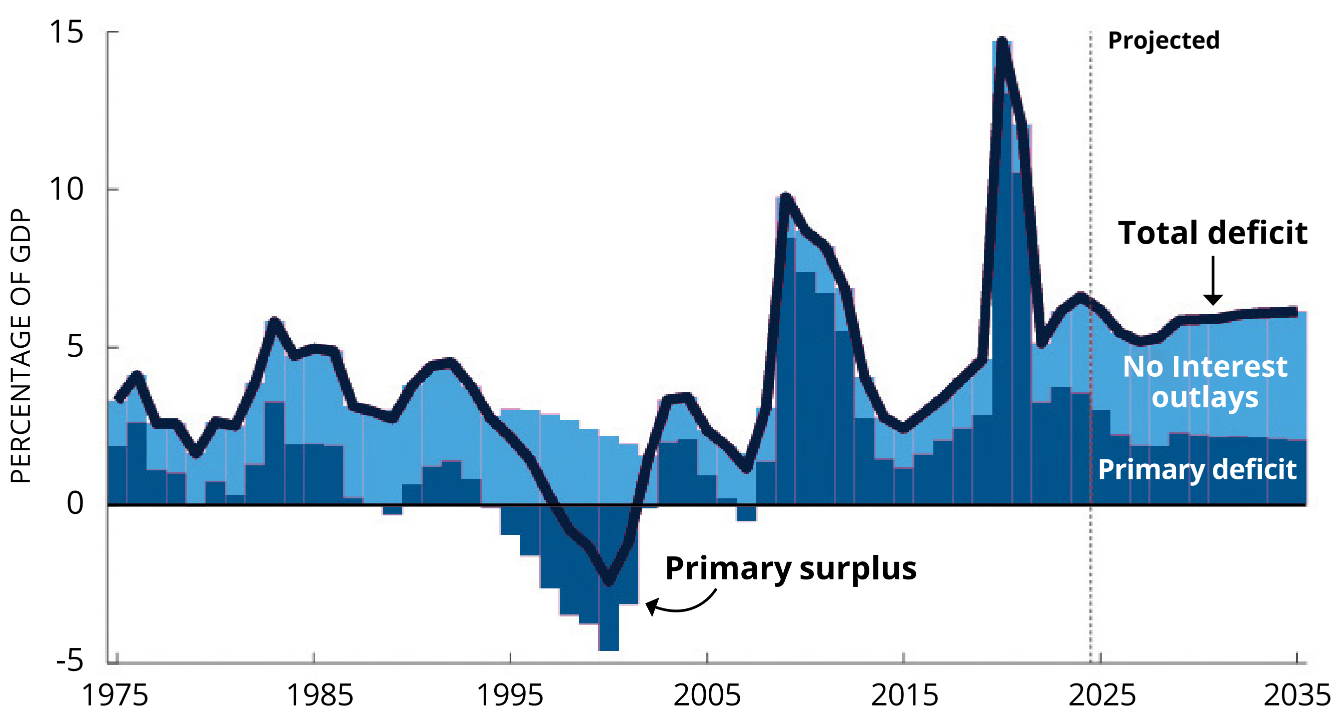
How It Happened

Dating back to the global financial crisis, the United States has played loose with the purse, running up a tab of over $36 trillion and opening the door for many to wonder how strong the full faith and credit really is. In other words, the US may be on its way to excessive territory with potentially fatal implications.

At the end of 2007, federal outstanding debt held by the public as a percentage of GDP totaled just 35%. In the aftermath of the global financial crisis, the figure more than doubled to 73% by the end of 2014 as the Great Recession increased spending and reduced revenue. The government response to the Covid pandemic pushed the level of national debt held by the public to nearly 100% of GDP. This level is just shy of the record 106% level reached in 1946 following World War II.

National debt relative to the size of the economy increases when fiscal deficits exceed nominal GDP growth. Historically, U.S. fiscal deficits have fluctuated based on economic conditions, wars, and policy decisions. For instance, during World War II, the deficit peaked at over 20% of GDP. In the aftermath of the 2008 financial crisis, the deficit surged to nearly 10% of GDP. The COVID-19 pandemic saw the deficit spike in excess of 15% of GDP in 2020. Last year, deficits remained at high levels (6.6% of GDP) despite low unemployment, driven by increased spending on entitlement programs and rising interest costs. By comparison, in the 20 years prior to 2007, the federal deficit averaged just 1.8%, including four years of surpluses from 1998-2001.

US Fiscal Deficit as a Percentage of GDP



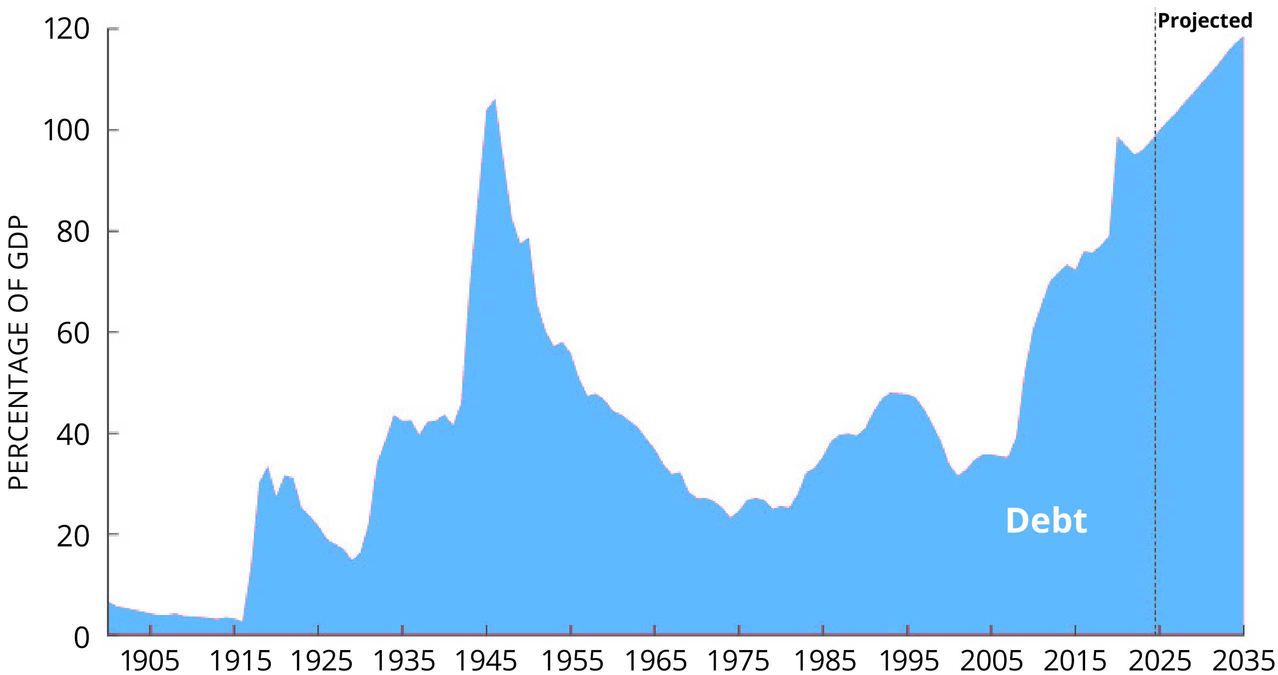
Source: CBO 2/27/2025

Wrong Way

In January, the Congressional Budget Office (CBO) published its projections for the US debt and deficit for the next 10 years. Its estimates are based on an economic forecast and current legislation at the time of publication. Unfortunately, there was little reason for optimism that the fiscal situation would improve.

The CBO's report estimated that debt to GDP would reach 118% by 2035 due to persistently high deficits increasingly driven by interest expense on debt. In 2019, the deficit was on the rise, but net interest costs accounted for 40% of the deficit. By 2024, interest costs made up 47% of the deficit. The CBO projects that will increase to two-thirds of the 6.1% deficit in 2035.

US Net Debt as a Percentage of GDP



Source: CBO 2/27/2025

Of course, these estimates cannot account for potential changes to fiscal policy. Dramatic changes to taxation and spending policies are expected under the Trump administration. What the net impact of these new policies will be is anyone's guess until the details are finalized. Undoubtedly, market participants both domestically and abroad will be closely following the changes.

Rating Downgrades

A deterioration of fiscal health has not gone unnoticed by credit rating agencies. The U.S. government has experienced two major credit rating downgrades in its history, both of which had significant, albeit short-term, impacts on financial markets.

In 2011, Standard & Poor's (S&P) downgraded the U.S. credit rating from AAA to AA+ for the first time in history. This decision was driven by concerns over political gridlock during the debt ceiling crisis, insufficient fiscal consolidation, and rising government debt levels. Paradoxically, U.S. Treasury yields declined as investors flocked to Treasuries as a safe haven despite the downgrade. The S&P 500 Index fell 6.7% on the first trading day after the downgrade.

Twelve years later, in 2023, Fitch downgraded the U.S. credit rating from AAA to AA+, citing concerns about rising fiscal deficits, growing debt burdens, and political dysfunction. Unlike in 2011, yields on U.S. Treasuries rose sharply following this downgrade, with the benchmark 10-year yield nearing cycle highs of around 4.25%.

Risks of a Reckoning

Despite initial shocks, neither downgrade had a lasting impact on U.S. financial markets or borrowing costs as investor confidence in American fiscal soundness persevered. But where will the good will end? Throughout history, many powerful civilizations have fallen due to unsustainable debt and financial mismanagement. The burden of excessive debt has repeatedly proven to be a decisive factor in nation decline, creating a pattern that has persisted across different eras and continents.

From the Roman Empire to Imperial Spain, history has proven the limitations of borrowing to fund spending beyond means. Even Alexander Hamilton knew there was too much of a good thing when he qualified the "blessing" of national debt with "if not excessive."

The faith afforded to the United States by investors is not a given. In the 1980s, market strategist Ed Yardeni coined the phrase "bond vigilantes" to describe investors who had sold off scores of Treasury bonds to protest Federal Reserve policies they deemed too inflationary. As Yardeni explained: "Bond investors are the economy's bond vigilantes. So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit markets." This notion embodies the idea that markets can impose discipline when government institutions fail to do so themselves.

If investor faith in America's fiscal responsibility continues to erode, the economic fallout could be severe. A resurgence of the "bond vigilantes" could send shockwaves through the financial system. Such an outcome may be described as a "grey swan," which is a low probability but high impact event - one which simple diversification can protect against, and few investors are prepared for. Policymakers will need to chart a careful course in the years ahead to maintain investor confidence and avert a potential fiscal reckoning. The stakes could hardly be higher.

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