Thoughts from the Frontline

Caught in a Debt Trap

By John Mauldin | August 15, 2026

We're caught in a trap
I can't walk out
Because I love you too much, baby
Why can't you see
What you're doing to me
When you don't believe a word I say?

- Suspicious Minds, Elvis Presley, 1969

Elvis Presley's rendition of Suspicious Minds topped the record charts in 1969. The lyrics portray a romance that couldn't work, but was also impossible to escape. That's also a good way to describe our relationship with government debt. We know it can't last, but we can't walk out. We love government spending and its benefits (like Medicare, Social Security, and unemployment insurance) too much.

In other words, we are in a debt trap. Our political process can't reduce spending and/or raise taxes enough to balance the budget, so the debt grows and grows. As it does, paying the interest plus the accumulated debt load pulls more capital away from more productive uses. This depresses economic growth, thereby generating even more spending and debt.

This has to end, and I think it will do so in the event I've called The Great Reset. When I first started talking about The Great Reset, we weren't in the debt trap. We were "merely" in a situation with only bad choices. I didn't think we would make them. Thus the underlying presumption was that we would end up in a debt trap.

The Great Reset will be our escape from the debt trap. It won't be fun for anyone, as taxes will go up and government spending of all types cut.

Diverted Capital

I have the great privilege of being able to talk to some of the finest economic minds in the country. I spend significant time on the phone with Dr. Lacy Hunt. Six years ago, he wrote a very important essay that we will revisit, as the principles are timeless. Lacy was in the "lower rates and going down" camp at the time. He now thinks long-term government bond rates are going up. That is a big change and is making waves throughout the economic world.

Six years on, it's worth noting how the framing has shifted. His [Q2 2026 letter] leans on what is called "Ferguson's Law": great powers historically decline once debt-service costs exceed military spending. By that measure the US crossed a meaningful line this decade, since net interest on the debt now rivals or exceeds the defense budget.

The conclusions of their 2020 analytical review (which are still on target today) are three-fold:

1) A very powerful secular downdraft has occurred in major measures of economic performance.

2) The US is caught in a debt trap, a term originated by the Bank for International Settlements: a condition where too much debt weakens growth, which elicits a policy response that creates more debt that results in even more disappointing business conditions.

3) The secular decline in economic conditions and the debt trap preclude the textbook conditions for powerful monetary policy measures to stimulate economic activity. Furthermore, debt-financed fiscal programs only boost the economy in the very short run, and ultimately reduce growth.

They go on to amplify point 2:

The concept of the debt trap is consistent with scholarly research, from the 19th century to present, which indicates that high debt levels undermine economic growth. This causality is supported by the law of diminishing returns, derived from the universally applicable production *function. Historical declines in economic growth rates have coincided with record levels of public and private debt. Total public and private debt jumped from 167.2% of GDP in 1980 to 364.0% in 2019, with an estimated record 405% at the end of this year [2020]. Gross government debt as a percent of GDP accelerated from 32.6% in 1980 to 106.9% in 2019 to an estimated 127% by the end of this calendar year.*

[2026 UPDATE] Both of those 2020 estimates can now be checked against actuals. Total public and private (all-sector) debt came in at roughly 356% of GDP in Q1 2026 — lower than the 405% projected for end-2020, mainly because the 2021–2023 inflation surge pushed nominal GDP up faster than debt grew, ***a kind of stealth partial default on existing obligations***. Gross federal debt was 122.6% of GDP in Q1 2026 — essentially right where the 2020 estimate placed it, even though the dollar amount of debt has nearly doubled since then.

As proof of this connection, each additional dollar of debt in 1980 generated a rise in GDP of 60 cents, up from 54 cents in 1940. The 1980s was the last decade for the productivity of debt to rise. Since then, this ratio has dropped sharply, from 42 cents in 1989 to 27 cents in 2019.

Let's unpack this. Debt, even government debt, isn't necessarily bad. It can actually be positive depending on how it is used. Borrowing to build a productive asset can make sense, if its output is sufficient to repay the debt and then produce even more.

Like many temptations, debt can be good in moderation but destructive if abused. Some infrastructure spending doesn't have a direct payoff, but clearly helps the overall economy, like the US interstate highway system.

Let me offer a few illustrations. It seems that every congressional representative gives lip service to the concept of "infrastructure spending." And they never really get around to doing it in any sufficient quantity. Airports are necessary infrastructure and are typically paid for by landing fees. That's productive debt.

I have read that much of the US loses up to 20% of the water our water systems produce due to leaky pipes. To rebuild the national water system would take hundreds of billions if not over $1 trillion. Congress can easily allow the formation of a public-private partnership and guarantee the bonds so the Federal Reserve could buy them. Cities could access those bonds and raise the cost of water by 1% or so to pay for the bonds. Consumer water bills should still drop since we would be saving 20% of the lost water.

Everyone knows this. Congress does nothing. The same could be done with electric power. A smart grid could pay for itself even with debt costs. And consumer power prices would likely go down. I could go on and on.

But the debt we are accumulating today is not productive in that way. We use it to finance current expenditures like Medicare and Social Security. Necessary? Absolutely. But not the economic definition of productive debt.

Problems arise when debt becomes excessive, relative to the output it will produce. The cost of repaying it diverts capital from other uses, leaving less capital available for productive investment. You start needing more debt to generate the same amount of production. Or, said another way, each additional dollar of debt produces less GDP.

Debt service comes from taxation and even more borrowing (which is the definition of a Ponzi scheme), which leaves businesses and families with less money to spend on other things. This results in lower economic growth, inflation, and interest rates.

Why is it a trap? Here's where I have to get political.

Fiscal Futility

To those on the conservative side, the problem is simple. We have excessively high taxes and debt because the government spends too much.

That's easy to say but gets a lot more difficult when you talk specifics—particularly if you are a member of Congress who must answer to voters. Exactly which government spending would you like to cut? What programs, departments, and agencies would you eliminate? Every dollar the government spends has a constituency—people who benefit from it and will fight to preserve it.

Large amounts of spending are essentially on autopilot: Social Security, Medicare, assorted social programs, interest on the debt. These "mandatory" expenditures happen automatically, no matter the amounts, without Congress acting at all. The simple fact is that this mandatory spending plus defense spending is now consuming all tax revenue before any other government services are paid for on the federal level.

The so-called "discretionary" budget that Congress votes on (defense and all the assorted departments and agencies) is relatively minor. You could cut it all in half and we would still have a serious problem.

When Trump first entered office the US deficit as percentage of GDP was less than 5%. That pandemic-year deficit peaked at 16% of GDP, or $3.1 trillion. Fast-forward to today: the FY2025 deficit came in at $1.8 trillion — 5.9% of GDP, well below the pandemic peak but still about 55% above the 50-year historical average of 3.8% of GDP. And it's headed the wrong way again. The CBO's latest FY2026 estimate is $2.1 trillion, up from $1.9 trillion projected back in February, after the Supreme Court struck down the IEEPA tariffs in February 2026 and blew a roughly $200 billion hole in expected tariff revenue that mandatory spending and interest costs are filling right back in. Whoever is in the White House, the deficit keeps landing in roughly the same trap.

Sad to say, government spending just keeps growing no matter which party is in power. We have crossed a form of political Rubicon where past performance is not indicative of future results. The few serious fiscal conservatives are now gone after finding the Republican Party under Trump spends differently than Democrats would, but has no desire to spend less.

And that's the real problem: Voters like all this spending. They differ on priorities, but no one really wants to balance the budget. There is no desire to make the sacrifices and endure the pain it would take to change the course we are on. So, it won't change, and debt will keep piling up.

Jaws of the Trap

Debt, as I have said many times, is future consumption pulled forward in time. It lets us consume more today by consuming less in the future. There is a school of thought which says this doesn't matter because we can always just keep pushing the due date further out. I disagree, and Lacy Hunt's research explains why.

While debt can be a problem, private debt is also critical to economic growth. It finances innovation and adds to the economy's productive capacity. Excessive government debt diverts resources away from investment, without which growth slows to a crawl. Lacy proves this mathematically but really, all you have to do is look at GDP growth around the world since 2008. Europe, Japan, and the US have all struggled to maintain positive growth. It was only a matter of time until something pushed us all underwater. The pandemic did it. By 2026 it's a different pressure doing the pushing — elevated-for-longer interest costs and a wall of AI-driven capital spending are testing the same limit from the other direction.

All that being said, this can continue far longer than most people think. Japan is now at 248.7% (2025) of debt to GDP. Eurozone debt is about 87.8% (2025), but that understates the true situation in most countries. The US, on the same gross-debt basis, was at 122.6% in early 2026 — closer to Japan and the Eurozone than most Americans realize. Europe and Japan both have low or nonexistent GDP growth. The explosion of US debt means the US will soon join them. The answer from almost every economist of any stripe about how to fix the debt problem is to "grow our way out of it." The problem is we have passed the point of no return.

We can't stop growing debt. That would bring down the system in a true greater-than-the-Great Depression crash. What do you cut? Social Security? Medicare? Military pensions? Education? Interest payments on the debt? The State Department? The only way to maintain that spending is to keep adding debt, which sends us further into the debt trap.

Anomalies in Paradise

At some point, this will simply stop working. That moment is when the world will face what I first called The Great Reset over a decade ago. I am often asked exactly when it will happen. I typically demur as taking a date is tricky. But I think we can narrow it down.

Right now, the Social Security Administration says that Social Security will have to be cut by roughly 22% at some point in 2033. 10 years ago they said 2034. Without some major changes in the economy, that they will probably slip into 2032. It will be an election year and that will become ***the*** major topic.

We are now at $39.9 trillion of US debt. Interest on the debt is $1.1 trillion, at an interest rate of a little under 3%. That rate is obviously rising. Deficits are climbing over $2 trillion per year. By 2031, the deficit will be over $50 trillion. Interest costs will run anywhere from an optimistically estimated low of $1.5 trillion to over $2 trillion. That's assuming no recession.

We are not going to cut Social Security for the vast majority of recipients. The compromise will likely be some combination of raising the age of benefits, means testing and increasing Social Security taxes. But that doesn't solve the rest of the deficit problem. Somewhere around that time the bond markets will finally say, "Enough, already!" Congress will be forced by markets to act.

Spoiler alert: We will need to completely revamp our tax code, with a greater percentage of GDP going to taxes than any of us want. But we'll have to collect it differently and not destroy incentives as Europe and Japan have done. Sadly, I don't expect a willingness to do that, at least political willingness, until we are already in the middle of a deep crisis. The bad news is we will get one and maybe change some things.

We built our dreams on excessive debt. Now we can't go on together. We're caught in a trap. We can't walk out.

RIP Grace Watson

Cleveland, NYC, Washington DC, and Austin

Longtime readers know that Patrick Watson and I have worked together for over 38 years. I hired him out of Rice University based on his writing talent. He has been a good friend and compatriot whether he was working directly with me or in another company. He is the driver behind Over My Shoulder and writes in his own voice at Connecting the Dots. Patrick is somewhat introverted, so all of our friends were happily surprised when Grace walked into his life and basically transformed him. They were married in 2001. It was a deeply personal relationship and all of us who knew them were just delighted for both of them. It was one of those marriages that was deep and profound and infected people they were around.

Sadly, in April Grace was diagnosed with stage IV lung cancer and after a long and painful struggle, she passed this week. She will be missed. Patrick wrote this moving note on his Facebook page.

I will be in Cleveland next Friday with my daughter Abbi. After she passed out in the gym a few years ago, they did a brain scan and found a small tumor in the middle of her brain, but said it was benign. Then she had open heart surgery. Last month, they did another scan. The tumor has grown and the Tulsa neurosurgeon said, “we can’t deal with that here in Tulsa.” Mike Roizen arranged for us to see one of the top neurosurgeons at the Cleveland Clinic, so we will be there next Friday. We are hoping the tumor is still benign. Not quite sure how the letter will work out.

I picked up Covid last weekend and have been more than a little under the weather. Thank you, Tony Fauci. And with that I will hit the send button. You have a great week.

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