

Student Loan Debt - Is Another Financial Crisis Looming?

August 8, 2012 - Student loan debt is at historic levels; now exceeding \$1 Trillion. But according to FED Chairman Ben Bernanke it is nothing to be concerned about. But the FED's record of predicting financial trouble based on consumer borrowing patterns is actually abysmal over the last decade. When Allan Greenspan was FED Chairman (Bernanke's immediate predecessor) he went before congress to complement lenders on their ingenuity for finding ways to lend to people that would have previously been considered unqualified. He did that just a few months before the market collapsed. We disagreed with him at the time, and we'll have to disagree with Bernanke now. From what we can see, the writing is already on the wall when it comes to student loan debt.

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Yesterday, Bernanke told a group of teachers that he didn't think federal student loans don't pose a "financial stability issue to the same extent that, say, mortgage debt was in the last crisis because most of it is held not by financial institutions but by the federal government." But this statement is completely shortsighted on two counts. First, student loans are currently being given to people without any regard to what they are majoring in. That means that the government simply isn't looking at their future income potential or their ability to repay their loans.

Second, it ignores the fact that the US economy is driven by consumer spending. When debt becomes so great that consumers can't spend money in other areas, it is bound to have an impact on the overall economy. That will be true even if banks don't have financial issues as a result of student debts.

These are both significant issues and they are both coming home to roost already.

Student loans are no great bargain. Unsubsidized student loans currently have an interest rate of 7.9%. Given that current bank interest rates on savings are well below 1%, that sounds like highway robbery. But student loans also have the highest default rate of any category of consumer debt. If the loans were being offered by private institutions rather than the government, and without any government guarantees, market forces would correct these issues in relatively short order. But government involvement in the lending process means that students going into high demand professions are actually subsidizing other students that have a significantly higher chance of defaulting on their loans. This will only change when the student's major plays a central role in determining how much money they can borrow, and what interest rate they must pay.

That aside, many student loans simply go unpaid. But Congress has made it clear that it expects these loans to be repaid at nearly any cost. The loans can't be dispatched in bankruptcy proceedings and the government has the right to garnish tax returns, social security benefits, and other forms of payment if the money can't be repaid in any other way.

A colleague of mine sent me an article this morning that detailed how this issue is already impacting elderly Americans. There are now over 110,000 Social Security recipients who are having their benefits garnished to repay old student loans. These loans are not necessarily their own. If they co-signed with their children or grand children, and the actual borrower defaulted, then grandpa could be on the hook for the debt.

Given that the US population is aging rapidly, nobody really knows how many people will eventually find themselves in the same position as those who are already having SS benefits withheld. But one thing is sure. That number is only going to get larger, and that will certainly have an impact on the economy. By garnishing SS benefits, the government may actually be robbing from Peter to pay Paul. Reduced benefits will mean that many people have to turn to other publicly paid assistance programs to meet basic needs. It will also mean that many people have less in the way of disposable income.

Student loan forgiveness is not the answer. That is just another way to make taxpayers responsible for college education costs. Instead, the current system needs to go through fundamental reform. And because such reform is likely to mean that many colleges and universities would have to significantly reduce tuition for a majority of their majors, any effort to change the current system is going to face very, very stiff resistance.

by Jim Malmberg

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