Economic Insight
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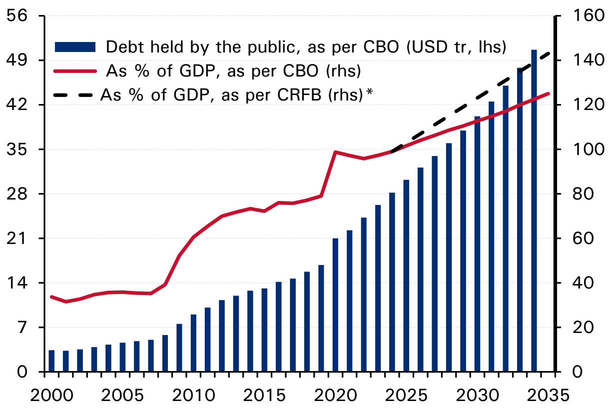
US: Fiscal discipline is required to put back debt on a sustainable trajectory

President-elect Trump will be inaugurated on 20 January, with an aggressive policy agenda that includes higher trade tariffs, tax cuts, and deregulation across some sectors. One aspect of the economic outlook that is receiving growing attention is rising US federal debt, which is on an unsustainable trajectory driven by ongoing fiscal deficits. No recent administration has shown a serious commitment to tackle the issue. If Trump goes ahead with his announced policy plans, the deficit is likely to widen further. This, along with slower progress on disinflation and solid economic growth, has in recent months shifted the interest rate outlook higher. If the fiscal trajectory continues to worsen, government bond yields could rise further, not only widening the deficit, but also hampering economic growth and job creation and weighing on the stock and housing markets. The government has limited leeway to materially cut its spending, adding to pressures to boost revenues, which does not seem a priority for the incoming administration, to tackle the deficit.

US debt on an unsustainable trajectory amid worsening fiscal dynamics

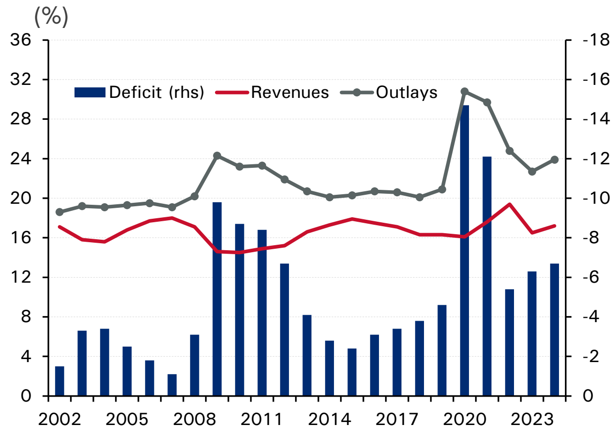
The US federal debt held by the public stood at $28.8 trillion at the end of 2024, having risen a whopping 8.5 times (+9.2% CAGR) since FY2000 (fiscal year ending in September), from 34% of GDP to more than 100% currently. The rate of increase in debt has been on the rise recently with, for example, a nearly 30% jump over the past three years only. This massive increase in debt has been driven by uninterrupted fiscal deficits since FY2002, which are, in fact, on a worsening and unsustainable path. For example, as per the non-partisan Congressional Budget Office (CBO), the deficit stood at 6.4% of GDP in FY2024, the highest since FY2012, outside the pandemic period.

Chart 1: Federal debt (held by the public)



Source: Haver, *The CRFB, unlike the CBO, accounts for the impact of Trump's pre-poll pledges on the debt

Chart 2: Fiscal metrics* (% of GDP)



Source: Haver, *of the Federal government

Since FY2000, fiscal revenues increased by a CAGR of 3.7% while outlays expanded by a faster 5.8%. Moreover, on the spending side, expenditures on non-discretionary "mandatory" items have increased

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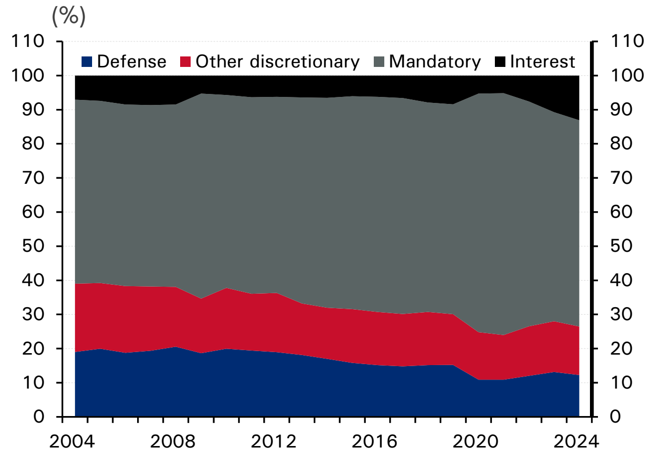
faster than on discretionary items, which include defense. The bulk of the non-discretionary items include Medicare (health insurance mainly for the elderly), Medicaid (health insurance mainly for low-income people), and Social Security. Total non-discretionary spending currently accounts for around 60% of total spending, and rises to an elevated 74% with interest payments. In addition, in terms of discretionary spending, defense accounts for nearly half of the total. Cutting defense spending is usually a sensitive and not-so-popular topic, with Trump actually pledging to increase spending on defense. Given all that, the government has limited leeway to cut spending going forward. Meanwhile, the creation of the Department of Government Efficiency (DOGE) and its original target to slash spending by around $2 trillion seems far-fetched given that this target exceeds total discretionary spending, which stood at around $1.8 trillion in FY2024. Elon Musk, who is co-leading DOGE, recently mentioned that the $2 trillion target will be difficult to achieve, stating that there is a "good shot" at cutting half that amount. Moreover, Trump's Treasury Security nominee, Scott Bessent, had mentioned previously his aim to reduce the fiscal deficit to 3% by 2028, without giving details, which seems an optimistic goal.

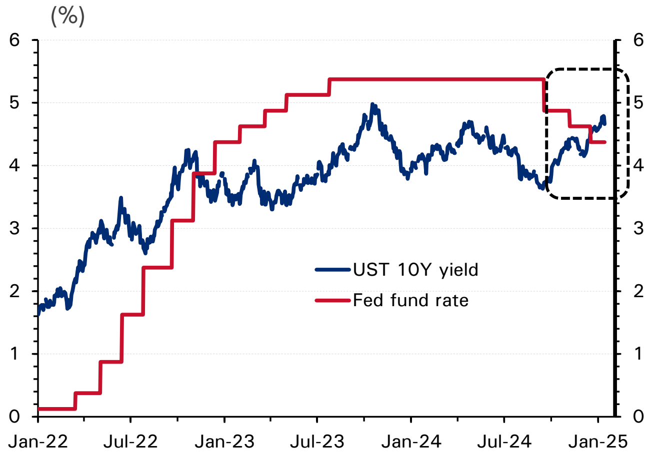
On the other hand, no respite can be expected to come from the revenue side given Trump's plans to enact additional tax cuts on top of the extension of previous tax cuts that are scheduled to expire at the end of this year. The plan to impose steep tariffs (10-20% on most goods and higher on Chinese goods) comes with considerable uncertainty regarding scope of implementation, timing, and efficacy. Even with that, preliminary estimates for how much these tariffs could raise, such as the $2.7 trillion over ten years as per the non-partisan Center for Responsible Federal Budget (CRFB), will be far from sufficient to plug the hole that will result from the expected tax cuts. So overall, it is likely that fiscal deficits will persist, and even widen, putting the debt of the US government on an increasingly unsustainable path. This outcome should not be surprising, and many economists have rung warning bells, including Federal Reserve Chairman Jerome Powell. Any possible boost to GDP growth from Trump's policies is not expected to outweigh the higher projected debt, indicating that the debt/GDP ratio will continue to trend higher. The CBO, in a pre-election projection, had forecast debt to GDP to rise to 125% by FY2035. However, accounting for the impact of Trump's pre-poll pledges on the debt (but keeping GDP forecasts unchanged), the CRFB projects the debt to GDP will rise to 143% by FY2035.

Chart 3: Fiscal outlays components* (% of total)



Source: Haver, *of the Federal government

Chart 4: UST 10-year yield and Fed fund rate*



Source: Haver *middle of range

Partisan brinkmanship with respect to the debt ceiling compounds the risks

The existence of a "debt ceiling", which has been reinstated this month (at the current debt level) after being suspended in 2023, should, in theory, be a factor supporting fiscal restraint. However, in reality, it effectively increases the government's default risk, with the clock now ticking until the Treasury department runs out of special maneuvers to prevent the new limit being breached (potentially in a few months). One common point of view is that the US government, irrespective of the direness of the fiscal situation, will never default given that the debt is denominated in US dollars, a currency which the US Treasury can print, in addition to an adjacent argument that the dollar is the world's reserve currency. However, while the US Treasury has indeed the privilege of printing US dollars, in practice, the existence of a debt ceiling would effectively prohibit such printing if it were to lead to a breach of that ceiling. So given the assumption of ever-increasing debt levels, and the fact that outstanding debt is nearly at that ceiling currently, the possibility of defaulting or not will rest at the mercy of partisan brinkmanship in Congress. This is déjà vu, but the fact that the post-election Republican majority in Congress (especially the House of Representatives) is razor thin is not helpful in that regard, particularly given that some Republicans are staunchly opposed to any increase in the debt limit. This was at play few weeks ago, when a government funding bill that included a suspension of the debt ceiling for two years (which is a matter that Trump pushed for) was voted down in the Republican-led House. Given all that, the fact that default was avoided at the very last minute several times before is not in itself a strong guarantee that this will continue to be the case going forward.

Concerns about Trump's policies, solid growth and slower progress on inflation shifted rate outlook higher

This backdrop, along with slower progress on bringing inflation down, ongoing solid economic growth, and concerns that Trump's policies (especially on tariffs, immigration, and tax cuts) might reignite inflation and widen the deficit, have recently led to a major shift in the interest rate outlook. For example, UST 10-year yield has soared by more than 100 bps (to around 4.7%) since September, and more importantly, despite the Fed cutting policy rates by 100 bps since, a divergence that is unprecedented in recent times. This puts the 10-year yield at close to the highest level since 2007. This can create a vicious cycle such that the market's concern about the fiscal trajectory leads to higher yields, which would worsen that trajectory even more. In fact, this is already at play, with higher interest payments, driven by both higher interest rates and a rising outstanding debt, putting extra burden on the fiscal situation. For example, the cost of servicing the debt soared to 14% of total spending in FY2024, up from 5% three years before. In terms of revenues, interest expense ate up more than 19% of the total in FY2024, nearly doubling in just two years.

Similarly, the outlook for policy moves by the Fed has sharply changed with the market now expecting only one more 25 bps cut by end-2025, taking the upper limit to 4.25% compared with 3% when the Fed started its easing cycle in September.

If fiscal trajectory is not addressed, yields may trend even higher, jeopardizing growth

If the fiscal trajectory continues to worsen, which is likely if the incoming administration goes ahead with all of its announced policy plans, the risk is that the so called "bond vigilantes" will continue pushing yields higher. This will not only put further pressure on the fiscal trajectory, but also hamper economic growth and job creation as well as weigh on the stock and housing markets.

To conclude, addressing the fiscal trajectory should be one of the priorities of any US administration. Given the limited leeway to cut government spending as mentioned above, pressure will be on to tackle the deficit through revenue raising measures. The current strength of the US economy potentially provides leeway for the enactment of new measures – though such steps will become more difficult if the economy weakens in 2025 or enters recession. In fact, among the G7 countries, the fiscal revenue/GDP ratio is by far the lowest in the US, implying scope for revenues to go up without breaching major economy norms.

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