The Anatomy of US Public Debt

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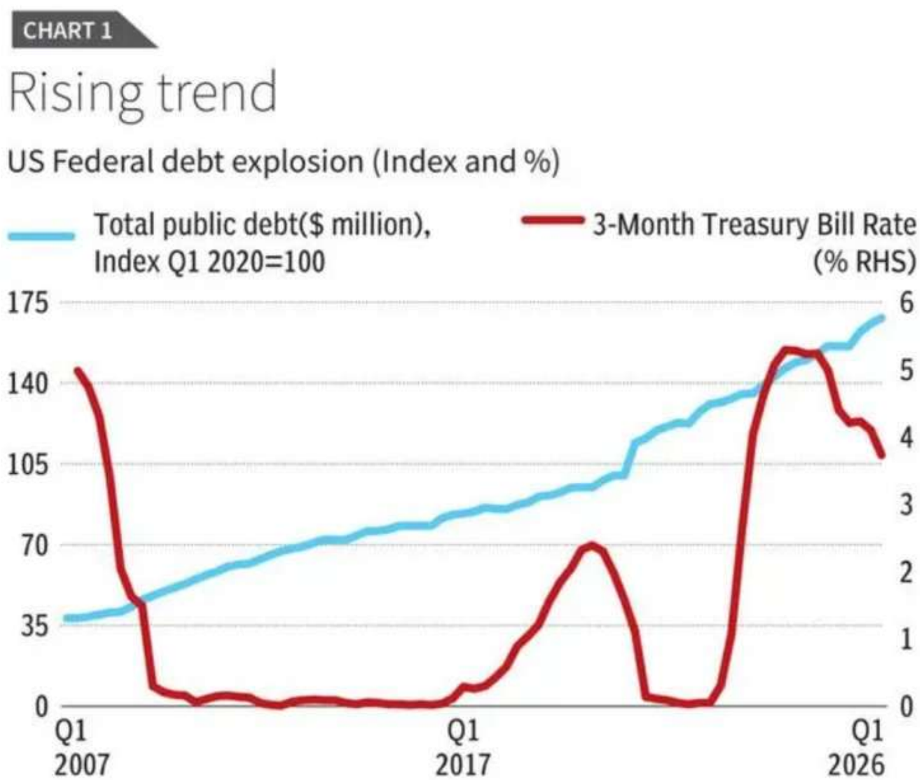
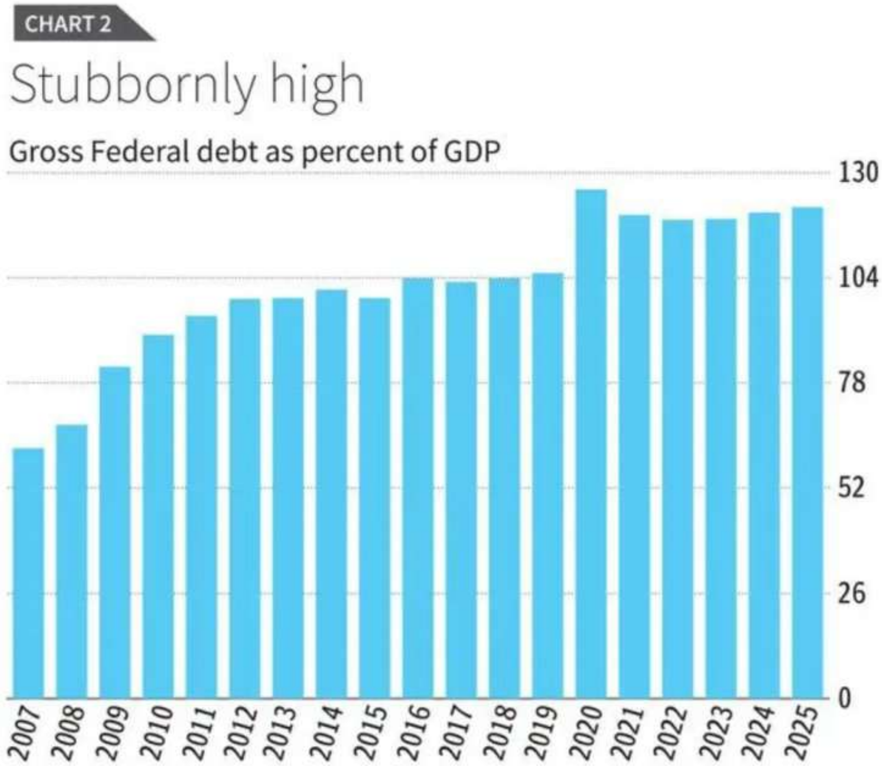
The US government, the world's media declares, is mired in debt with the volume of debt crossing a record $4 trillion level. But that absolute number is not what matters. As countries grow it is not abnormal for the debt of their governments to grow as well. What is of significance is that the absolute debt has not only been growing faster than GDP but has also recorded accelerated growth in the years since the Covid pandemic (see the trend in the index of debt volumes in Chart 1).



The year 2020 was extraordinary, as falling revenues and an unavoidable spike in expenditures induced by the pandemic widened the US Federal deficit and increased federal borrowing. But, as the pandemic waned, it was expected that this 'unnatural' spike would be reversed and debt levels would return to growing at or below the rate of growth of GDP.

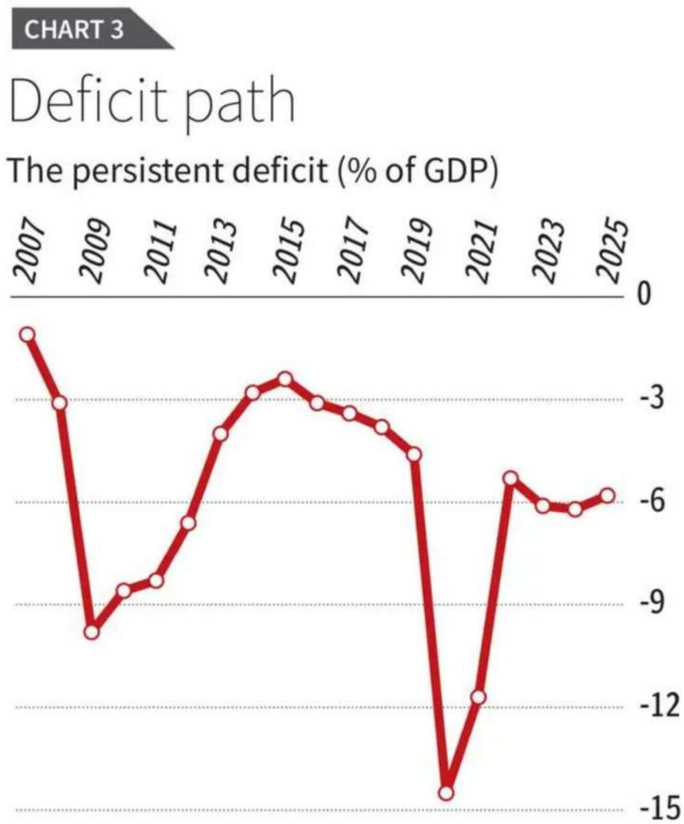
That indeed seemed to be the case in 2021 and 2022 when the ratio of federal debt to GDP fell from its high 2020 level of 125.9 per cent to 119.6 and 118.4 per cent respectively. But that was still way above the pre-Covid level of 105.2 per cent, so the decline had some way to go. However, what occurred was a return to a faster increase in debt levels with the ratio of the federal debt-to-GDP rising to 121.5 per cent in 2025 (Chart 2).



As Chart 1 makes clear, two factors contributed to the renewed growth in the debt-to-GDP ratio. The first was an accelerated rise in the volume of debt itself. And the second, which partly accounts for the first, was a rise in the interest rate to levels not seen since the years immediately preceding the 2008 US-centred financial crisis. That rise in interest costs was in turn driven by the Federal Reserve's policy response to the inflation that has persisted through the post-Covid years.

Rising Interest

As is to be expected, a large deficit in the federal government's budget necessitated the borrowing that drove the outstanding volume of federal debt. Even before the pandemic, the federal deficit had been rising from 2.4 per cent of GDP in 2015 to 4.6 per cent in 2019 (Chart 3). The explanation for that rise was an increase in borrowing costs from the near-zero level that prevailed between the last quarter of 2008 to the last quarter of 2015.



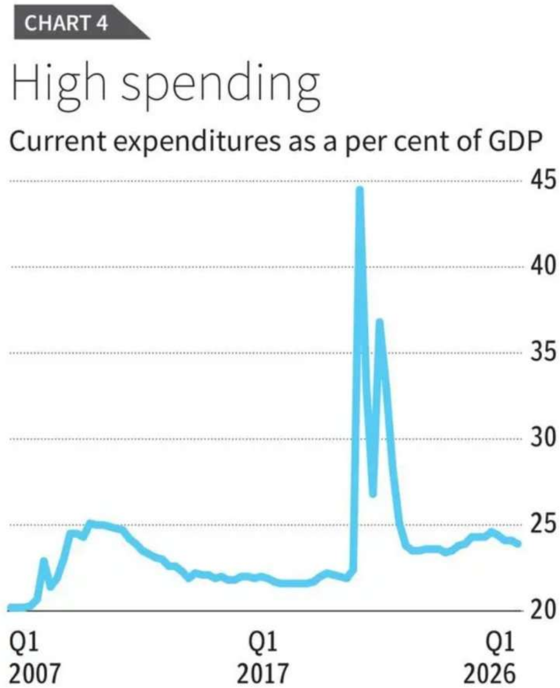
A steep reduction in interest rates to near zero was an important element in the toolkit used by the Federal Reserve to combat the Great Recession that followed the financial crisis. But by 2015 there were fears that this "unconventional" policy, as well as the policy of "quantitative easing" or bond purchases to inject liquidity into the system, could not continue.

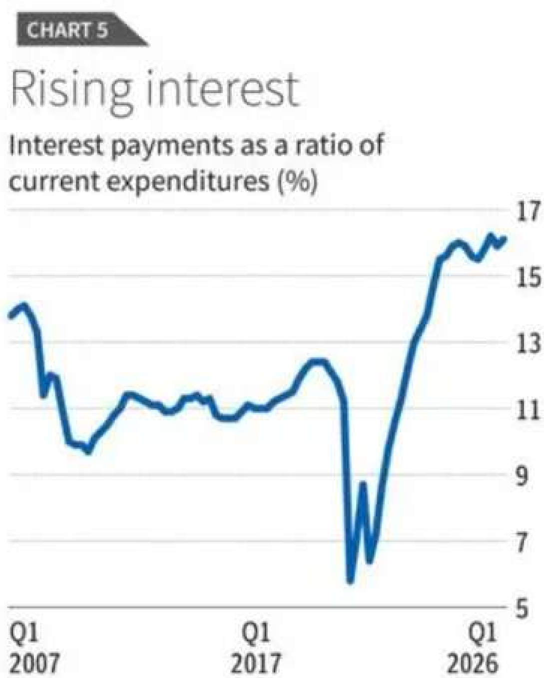
That view was influenced by the evidence that the abundance of 'cheap money' had unleashed speculation in asset markets. Fears that the asset price bubble driven by that speculation could unravel with damaging consequences had convinced policy makers that it was time to unwind the regime of near-zero interest rates. Policy raised the 30-day Treasury rate from near zero to close to 2.5 per cent by late-2019, before Covid-impact fears and the actual pandemic took them back down to near zero for two years starting in the third quarter of 2020.

From early 2022, inflation reared its head and persisted, prodding the Fed to raise rates once again, stabilising the government's borrowing costs at around 5 per cent. When Trump returned in 2025, he announced an ambitious agenda to reduce expenditures (through the exertions of the newly created Department of Government Efficiency headed initially by Elon Musk), and promised that he would reduce the deficit even while he offered business cronies significant direct tax benefits.

Limited Spending Cuts

The promise of expenditure reduction through efficiency improvement yielded nothing however expenditures actually increased (Chart 4). This was partly because 'austerity' notwithstanding, rising interest payments accounted for a growing share of current expenditures, neutralising the benefit of the limited expenditure cuts (Chart 5).





Secondly, this occurs at a time when the costs of the war against Iran are exhausting its defence stockpiles necessitating massive spending increases. The administration had put in a supplemental appropriations request of $67.1 billion for the Department of Defence in June, which awaits Congress approval. But in July it managed to push through by a narrow 216-214 vote a $95 billion budget reconciliation package which reportedly includes $60 billion for defence. That too awaits final approval. So as opposed to $972 billion of funding for defence in financial year 2026 ending September, the request for national defence in FY2027 is placed at $1,154 billion. That would raise expenditures and widen the deficit, intensifying the debt-interest payment spiral.

Finally, with the Iran war and closure of the Strait of Hormuz keeping oil prices high, inflation in the US at around 3 per cent is above target and could rise further. Contrary to expectations, the signal from the new Federal Reserve Governor Kevin Warsh delivered at the Jackson Hole symposium in late August is that he is committed to the Fed's 2 per cent inflation target and will rely on the interest rate as the main tool for inflation management. That possibly signals a policy rate hike, and definitely suggests that there are no plans for a rate cut given inflation. That would further widen the deficit and expand already bloated debt volumes.

The only way out for the administration to raise taxes and enhance tax revenues if it wants to reduce the deficit. But that is out of question for Trump, who is intent on appeasing big business and is already faced with an affordability crisis that precludes indirect tax increases. That leaves the US government mired in a debt trap of its own making.

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