America's looming debt crisis

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***"How did you go bankrupt?
Two ways: Gradually, then suddenly."***

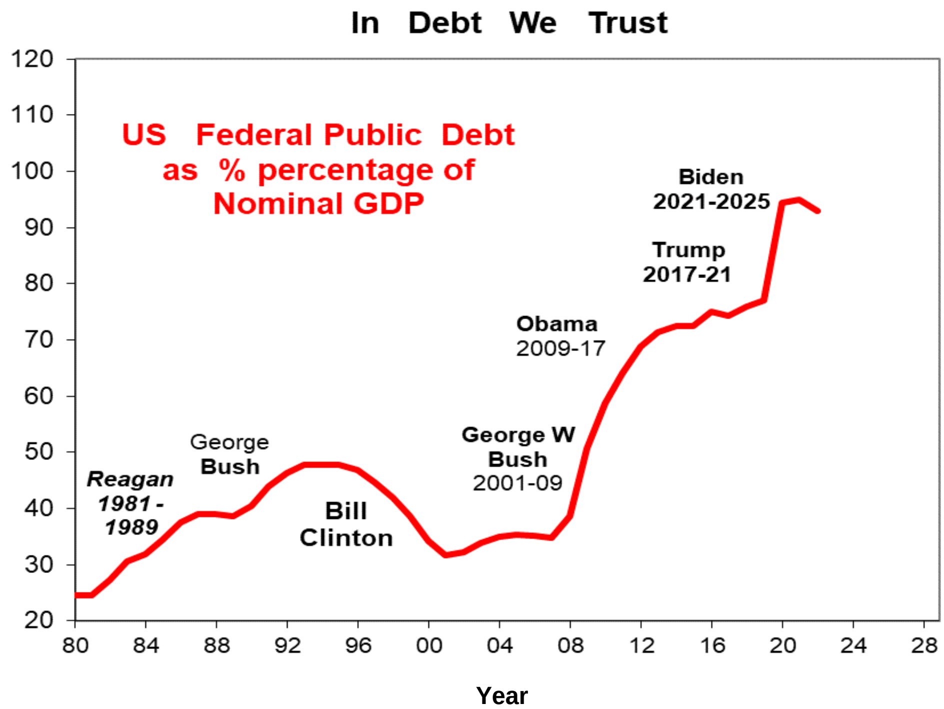
*Ernest Hemingway
'The Sun Also Rises'*

Is the United States heading towards a government debt crisis?

Recent events have cast a glaring spotlight on the US Federal Government's debt position. In May 2025, the credit ratings agency Moody's downgraded the US government's credit rating from AAA to Aa1.[1] Moody's were alarmed on whether the US government has sufficient budget discipline. According to Moody's, rising budget deficits given higher spending commitments and "*broadly flat*" revenue are "*likely*" to see the US debt performance "*deteriorate*".

History supports Moody's assessment that "*successive US administrations and Congress have failed to agree on measures to reverse the trend"* of large US budget deficits and rising debt obligations. Since January 1981 when Ronald Reagan began his first term in the White House, US government debt has been heading higher (Chart 1). In the past 54 years, there has only been one brief window with President Bill Clinton (1993-2001) where Federal Public Debt as a % percentage of US Nominal Gross Domestic Product (GDP) actually declined given the benefit of budget surpluses. The latest available data for 2024 suggest that US Public Debt now stands at 96% of GDP. Hence for every US$100 of national income as measured by GDP, America's government debt obligations amount to US$96.[2]

Chart 1: US government debt has generally been trending higher



Source: Moody's.[1]

What is a "debt crisis" for governments and what are the possible paths that get the US there?

Sixteen years ago, Europe experienced a dramatic debt crisis. Starting in Greece in 2009, this crisis spread across the continent to engulf Portugal, Ireland, Spain and Italy. This crisis was characterised by investors becoming alarmed about governments having large debt obligations that may cause a default. The result was a sharp rise in government bond yields for these countries, a selective default in the case of Greece and the European Central Bank being compelled into a "whatever it takes" approach of cutting interest rates and providing funding to banks. This 'European Debt Crisis' proved to be a prolonged period of pain that is still resonating across those countries that were involved.

A simple definition of a government 'debt crisis' or 'fiscal crisis' is provided by the Brookings Institution as:[3]

"***a sudden, large, and persistent downturn in demand for (Government) Treasury securities relative to supply that triggers a sharp and persistent spike in interest rates."***

Notably Brookings also provides a road map on the possible paths to a US government debt crisis. Four possible paths are suggested as involving inflation risks, political brinkmanship, the US central bank changing their inflation target and finally the deterioration in the "long term" Federal Budget outlook. This final path of a "deterioration" in US budget discipline is the key concern here given that Congressional Republicans and President Donald Trump are currently considering a dramatic shift in the US Federal Budget.

Is President Trump's and the Republicans "One Big Beautiful Bill" (OBBB) another step towards a debt crisis?

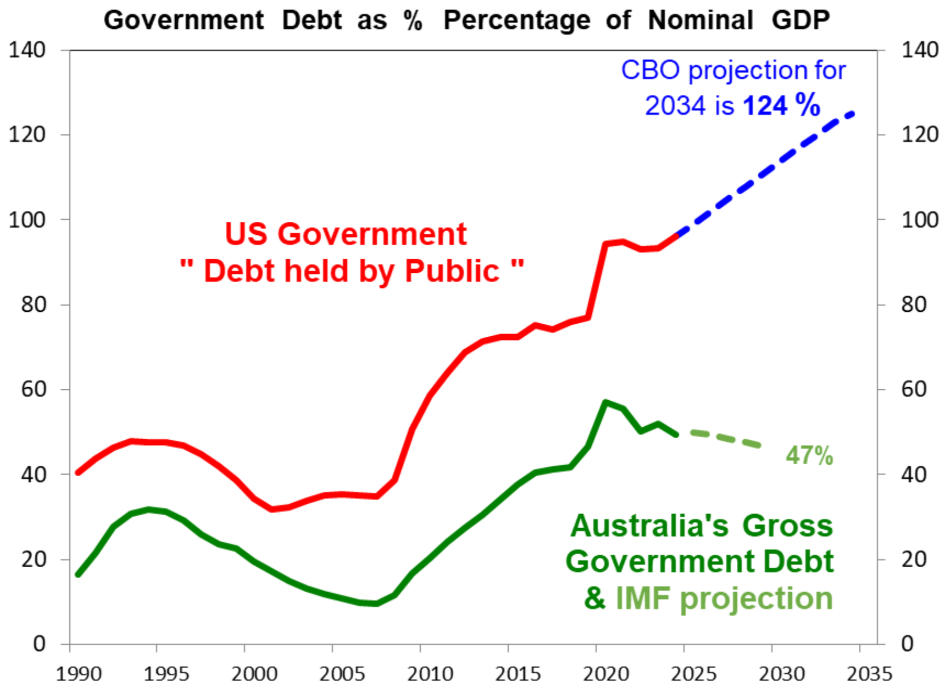
The OBBB aims to preserve the current low US personal income taxes, cut welfare support and increase spending on 'national security'. Some of the most dramatic OBBB proposals include[4]:

- Extend the 2017 Personal Income Tax Cuts that were due to expire at the end of 2025.
- No taxes on tips and overtime for service workers until 2028.
- Tax deductions on up to $10,000 in interest on car loans for cars made in the US.
- Reverse the clean energy tax credits and add annual federal registration fees for electric vehicles (EVs) and hybrid car owners: $250 for EVs and $100 for hybrids.
- $500 increase in the child tax credit to $2,500 until 2028.
- 3.5% tax on foreign cash payments sent by non-US citizens overseas.
- Medicaid work requirements and eligibility checks as well as restrictions on access to food stamp programs (eg The Supplemental Nutritional Assistance Program (SNAP) for low-income families is to be cut by $128 billion).
- Border security: $47 billion to build Mexico wall and $45 billion for "Adult Alien Detention Capacity".
- Extra defence spending of $150 billion including "Golden Dome" (layered missile defence shield).

Given that the OBBB has yet to be formally passed by both the House of Representatives and the Senate, there is the possibility of changes to the above proposals that may alter the final impact.

However, the alarm bells are already ringing in the sense that the independent guardian in the Congressional Budget Office (CBO) has warned that this Republican OBBB budget package will see a sharp increase in the US Government's Debt to GDP ratio. According to the CBO, the OBBB will result in a cumulative US$3 trillion increase in budget deficits over the next 10 years and the US Debt to GDP ratio climbing from 96% currently to 124% by the end of 2034 (Chart 2). This is greater than the CBO's previous projections of a 117% Debt to GDP ratio in 2034. Hence this is a clear "deterioration" in the US budget outlook that Brookings warned would be a path to a "Debt Crisis."

Chart 2: A sharp increase in US government debt is projected



Sources: International Monetary Fund for Australia, Federal Reserve Bank of St Louis for US.

When one compares the CBO's US debt projection to Australia's Gross Government Debt profile made by the International Monetary Fund (IMF), America appears to be on a dangerous path. Australia has a stable and steady Debt to GDP ratio of around 47% of GDP for the next five years to 2030.[5]

Even more disturbing is that the Trump Administration's budget calculations are completely the opposite to the CBO's and Moody's warnings. The White House has stated the "*One Big Beautiful Bill Improves the Fiscal Trajectory"* by reducing budget deficits. By some creative accounting methods that includes assuming President Trump's tariffs will raise government revenue of US$2.8 trillion, the White House claims that they can deliver a reduction in the 10-year Budget deficit profile of nearly US$7 trillion.

President Trump is bold enough to contend that the US Government's 'budget discipline' has been maintained (well that's a major surprise!). But if President Trump is wrong and the CBO and Moody's projections become reality, then the consequences could be devastating.

The potential consequences of an American 'debt crisis'

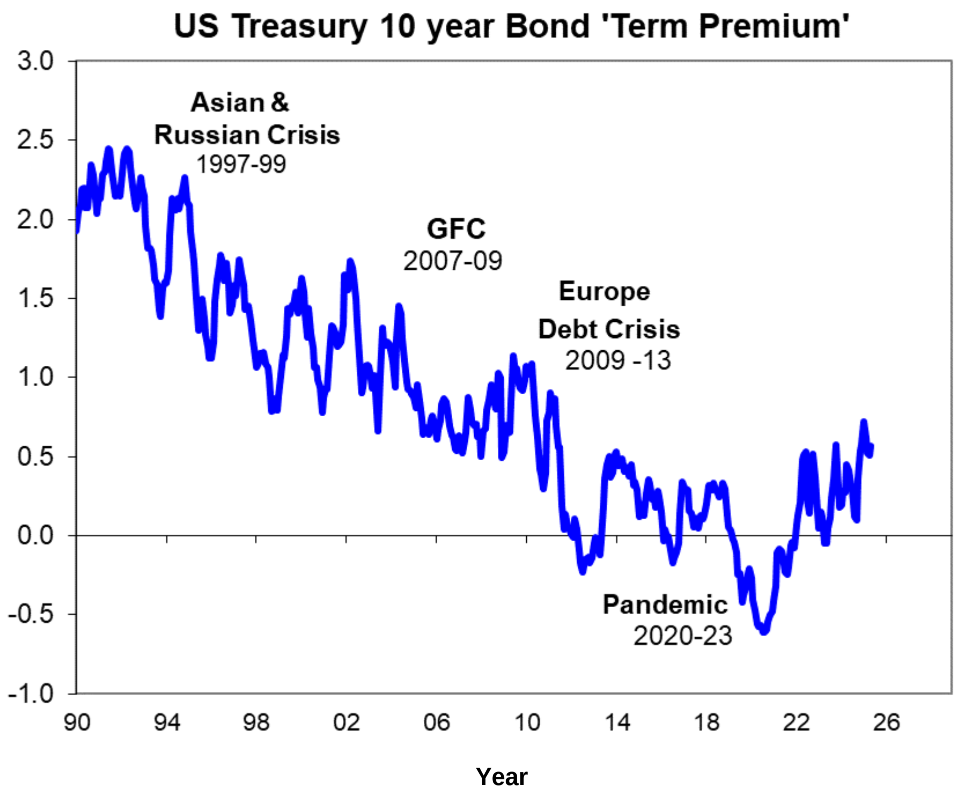
The Brookings Institution provides a troubling scenario of the impact of a 'US debt crisis'. Under this scenario, rising US government interest rates generate sharp falls in American share prices and US dollar that then leads to a "*financial crisis*" and "*global recession*".

"*Such a rise in (US interest) rates would most likely be accompanied by a dramatic fall in both the value of the US dollar and equity markets. Given the critical importance of Treasuries in global financial markets, the fiscal crisis would likely lead to a financial crisis involving widespread bank losses, a collapse in credit availability, and very likely a global recession*."

Clearly this scenario involves a dramatic ‘domino effect’ across global financial markets. The rationale is that US Government Debt in the form of Treasury bills and bonds are a key pricing measure and ‘safe haven’ for the global financial system. A loss of confidence in the credibility of US government debt would see investors question the capital position of private banks across the world and their ability to provide credit to businesses and consumers. Higher global borrowing costs and lower credit availability would then see businesses cut employment and investment while consumers would wind back their spending, thereby resulting in a “global recession”.

There are worrying signs that investors are already asking for higher risk premiums for US government debt (Chart 3). The “term premium” on the US Government 10-year Treasury Bond now stands at 0.55% which is a 12 year high for this term premium. This “term premium” is a statistical measure of both the credit risk and duration risk on US government borrowings that is calculated by adjusting for expected US interest rates over the next decade. Hence this is a broad analytical measure of a “risk premium”.

Chart 3: Investors are asking for higher risk premiums for US government debt



Source: Federal Reserve Bank of St Louis.[6]

Notably there had been an extended downward shift in this US government term premium from 1992 at 2.5% (when Bill Clinton was elected US President) to a low of -0.65% during the Pandemic in 2020 with President Trump in the Oval Office. Since 2020 through a combination of aggressive government stimulus measures under President Biden and the inflation crisis in 2022-23, the US term premium has steadily risen to 0.55% currently. Should this US government ‘term premium’ suddenly head back to 1992 levels of 2.5% given a ‘US debt crisis’, then this could set in train a global financial crisis and recession.

Clearly there are worrying signs that President Trump and the Congressional Republicans are taking dramatic risks to achieve their “Make America Great Again” (MAGA) ambitions. The current rising “term premium” on US government bonds is a warning sign that they may be playing with dynamite. The sharp swings in perceptions of US government credit and duration risks are also a reminder of the critical need for active management of bond portfolios. Bonds are not a “set and forget” asset class but require constant vigilance by skilled investment managers.

However, as investors we also need to be conscious that a US debt crisis is not inevitable. Firstly, a sharp “temper tantrum” in the US bond market with rising interest rates could see Congress and President Trump reverse course on their Federal Budget plans. There is the recent precedent for a sudden political “U turn” which occurred in the United Kingdom in October 2022 when the bond market reacted sharply to the stimulus plans of Prime Minister Liz Truss. Secondly, the US central bank in the Federal Reserve could step in to mitigate bond market turmoil by buying government bonds. Lastly, US bond markets could draw some comfort that President Trump’s term in office comes to an end in January 2029 and may even be prepared to endure his impulsive decision-making.

References:

1. ‘Moody's Ratings downgrades United States ratings to Aa1 from Aaa; changes outlook to stable’, ratings.moodys.com/ratings-news/443154, 16 May 2025.

2. ‘What is the national debt?’, US Treasury Fiscal Data, fiscaldata.treasury.gov/americas-finance-guide/national-debt/.

   Chart 1 measures the US Federal Government’s “Debt held by the Public” which excludes “intra government holdings”. This exclusion removes the debt is held by “Social Security, Medicare, and other federal programs” that “purchase Treasury debt for their trust funds” according to the US Treasury. Hence “Debt Held by the Public” is only 96% compared to estimates of 121% of GDP for total US Federal Government debt. The 25% difference (121% - 96%) is the Social Security et al “intra government holdings”.

3. ‘Assessing the risks and costs of the rising US federal debt’, Brookings Institution, brookings.edu/articles/assessing-the-risks-and-costs-of-the-rising-us-federal-debt, 12 February 2025.

   Brookings noted that a “fiscal crisis” could occur under four paths involving:

   1) Demand or supply of Treasuries could abruptly shift for reasons unrelated to inflation or default risk such that interest rates spike, causing financial market disruptions that the Federal Reserve is unable or unwilling to mitigate.

   2) Investors could come to believe that the US Treasury might default on interest or principal payments because of political brinkmanship, and policymakers would be unable or unwilling to regain credibility.

   3) The Federal Reserve could be perceived as abandoning its mandate to preserve price stability and instead allowing for hyperinflation.

   4) The long-term fiscal outlook could deteriorate so significantly and so sharply that investors abruptly worry about some form of default, leading them to abandon Treasuries until policymakers take actions to rein in deficits.

4. ‘What's in Trump's House-passed "one big, beautiful bill"’, CBS News, cbsnews.com/news/whats-in-trumps-one-big-beautiful-bill-medicaid-taxes/, 23 May 2025.

5. ‘Australia: 2024 Article IV Consultation-Press Release; and Staff Report’, International Monetary Fund, imf.org/en/Publications/CR/Issues/2024/12/20/Australia-2024-Article-IV-Consultation-Press-Release-and-Staff-Report-559811, 23 December 2024.

6. US 10-year Bond Term Premium is sourced from the Federal Reserve Bank of St Louis fred.stlouisfed.org/series/THREEFYTP10#, June 2025.

   The Term premium is the “*compensation that investors require for bearing the risk that interest rates may change over the life of the bond. Since the term premium is not directly observable, it must be estimated, most often from financial and macroeconomic variables*.”

   See Federal Reserve Bank of New York: newyorkfed.org/research/data_indicators/term-premia-tabs#/overview

Important information