GlobalData. TS Lombard

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US Watch

IS INTEREST ON THE DEBT A PROBLEM? (YES)

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- Federal budget has a 3% GDP structural imbalance with debt compounding 3.5%/year at today's rates.
- Trump's plan to reshore CAPEX is stymied by this budget math.
- R<G benchmark for whether interest on the debt is problematic is more complex than advertised.

Real interest rates rising because, in part, interest payments on the public debt have doubled relative to GDP, will get in the way of Trump's plan to reshore production. The historic, neo-Keynesian notion is that interest payments are a transfer payment among bondholders and payments are not a problem especially if the rate paid is lower than real growth (r<g). This is true in some cases, not in all, and US has moved into the "not true" category. Trump plans to do something about it, through a mix of tax cuts, tariff hikes, and slashed spending. Success or failure TBD, and it worth waiting to see what is proposed and looks to be enacted. All of it is the name of lifting real growth through reshoring. MMT has had its moment.

The issue, to be clear, is not fiscal sustainability, the current twitter-trend, but the impact of large and growing interest payments on the Federal debt relative to GDP on saving, consumption and, in the end, capital investment. Fiscal sustainability can become an issue if tariffs successfully break the global trading system in place since the Louvre-accords and global capital flows become equally disjointed in response. A quick way of seeing the impact of the debt burden, unless the Fed steps in again, is high real rates punishing domestic capital investment and rewarding global sourcing through the conduit of a strong dollar. The opposite of what Trump wants to achieve. Add to this the turmoil Trump promises more broadly and it is hard to assume anything but a rising risk premium on term yields which, in turn, should impact the equity risk premium as well.

Background math on the budget

The budget is gaining more attention because of Trump's announced plans to shift revenue sources, keep the 2018 TCJA, toss in some more tax breaks, increase defence spending, and then set out to cut spending elsewhere including entitlements. As a starting point, in fiscal year 2024, the budget deficit is 6.4% of GDP, of which 3.6% of GDP is the primary deficit (excludes interest payments). In 2019, the total deficit was 4.6% of GDP, with net interest a negligible 1.8% of GDP (primary deficit was 2.8%, expanded by the TCJA, as it was 1.8% in Obama's last year). Public debt outstanding is 99% of GDP vs 79% in 2019 and was 76% when Trump took office. Thanks to compounding, debt held by the public increased $1.9 trillion in fiscal 2024 even though the primary deficit was $1 trillion, about the same as fiscal 2023.

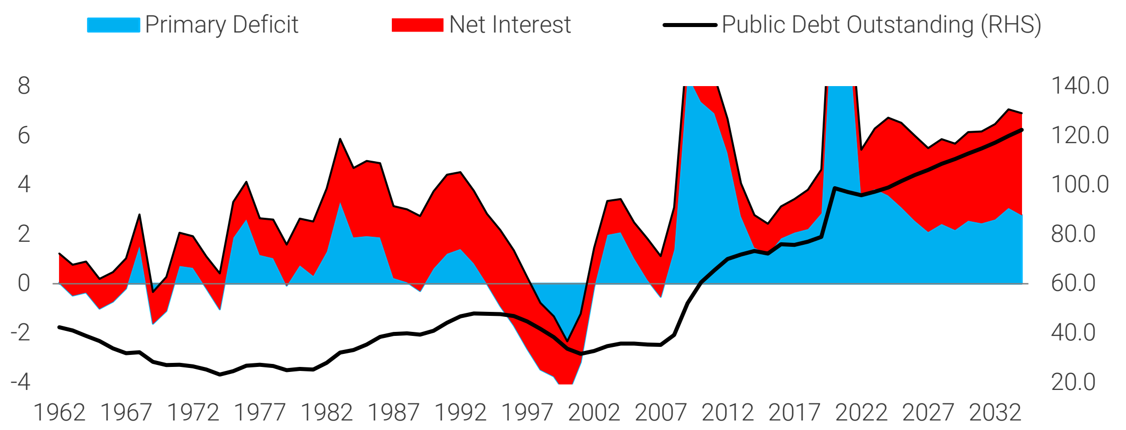
Looking forward, the CBO has 2025FY deficit the same as this year relative to GDP, with debt held by the public rising to 102% of GDP from 99%. In 2026FY, CBO has the primary deficit dropping to 2.6% of GDP but debt outstanding rising to 104% because the total deficit sits at 6% of GDP (interest payments). CBO calculations are based on current law – namely they assume TCJA taxes are sunset.

On a dynamic basis, in the 2026FY, extending the TCJA alone adds $316bn to the deficit in 2026FY against current scoring not in fact. The primary deficit rises from 2.6% of GDP to 3.6% of GDP, and pushes the total deficit, which matters, from 6% of GDP to 7% of GDP – basically where it is today. Here is where tariff magic comes in. According to the Tax Foundation, projected first year revenue (20% universal tariff plus an additional 50% on imports from China) is guesstimated to be $330bn and then there is $81bn revenue gain from repealing the IRA Green Energy Tax Credits – thereby offsetting the extension of the TCJA and then some. This gives Trump the bandwidth to deliver more than just extended cuts. He has promised another $300bn or so of additional cuts – and this is before projected increases in defence spending. Also not being counted in all this are the Child Tax Credits and the ACA tax credits that expire at the end of 2025.

most of these revenue items are 1-time additions

In the end, campaign promises, the intractable growth of entitlements and defence spending, and compounding growth of the public debt will keep the budget deficit too high for a non-recessionary period (Chart 1) – and the deficit grows faster if nominal interest rates end up higher than the CBO forecast.

Chart 1: Compounding interest on the debt to drive deficit higher, no spending relief.
Data expressed as a percent of GDP. Data 2025 forward is CBO current-law estimate

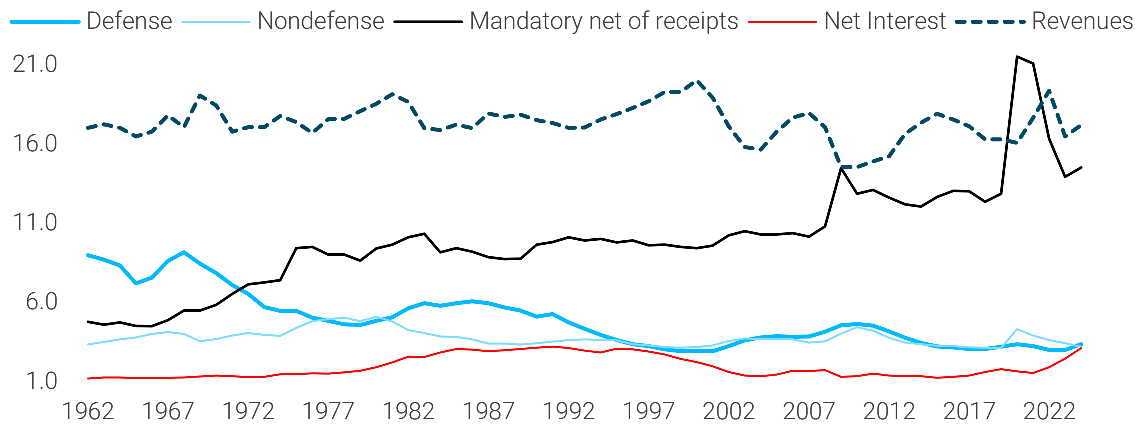


Source: BEA, CBO, Treasury, GlobalData. TS Lombard

Congress got discipline during the later Reagan years by enacting spending caps (Gramm-Rudman-Hollings), and the caps plus the strong economy of the 1990s turned the deficit into a surplus by the end of the 1990s. This, in turn, lowered public debt relative to GDP. George W Bush and a Republican Congress decided not to renew the caps and it has been off to the races ever since (VP Cheney's comment that deficits do not matter) – save for Obama's second term when the debt ceiling compromise limited spending. The budget, post-Covid, is at a similar point, where GDP growth and spending discipline are needed to reverse the budget's current course.

Whether Trump can deliver the discipline is a reasonable question, considering the politically charged shifts he is proposing. There is no CBO scoring of his proposal yet because CBO waits until actual legislation is available to score. Nevertheless, looking at the breakdown of receipts and outlays (Chart 2), receipts are at 17% of GDP, where they have averaged beginning 1962. Total expenditures (including interest) are 24% of GDP. From 1962 to 2019 the average has been 20%, although the composition has changed from discretionary spending to mandatory entitlements. Expenditures ex interest payments are 21% of GDP and averaged 18% from 1962 to 2019.

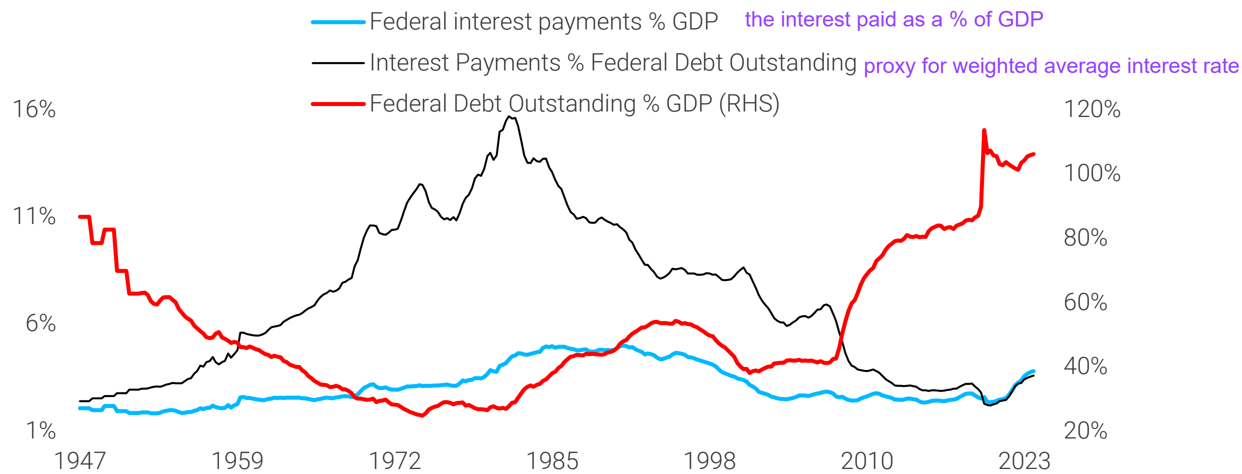
Chart 2: Entitlements driving out mandatory spending, unless tax take shifts up
Data are a percent of GDP



Source: BEA, Treasury, GlobalData. TS Lombard

Looking at the Chart 2, it is easy to see why many budget hawks, Republicans notably, see no other way to budget discipline other than through cuts in entitlements. What is not being said is that stronger real growth and a younger, growing population would lower entitlements relative to GDP. Trump's ultimate plan with trade and tariffs is to do just that, but again the potential for success rounds back to the size of the debt and interest payments. At present, **government is getting lucky because interest rates are so much lower than they were during the 1980s (Chart 3)**. Then, Reagan raised debt from 27% of GDP in 1980 to 44% at the end of his term, compounding continued, and this ratio peaked at 54% in 1995. Interest payments were 5% of GDP in 1991, up from 4% when Reagan took office. Today, with debt at 99% of GDP but interest rates halved, interest is 3.8% of GDP, up from 2.4% when Trump took office the first time.

Chart 3: Lower rates tamping down Federal interest expense -- for now

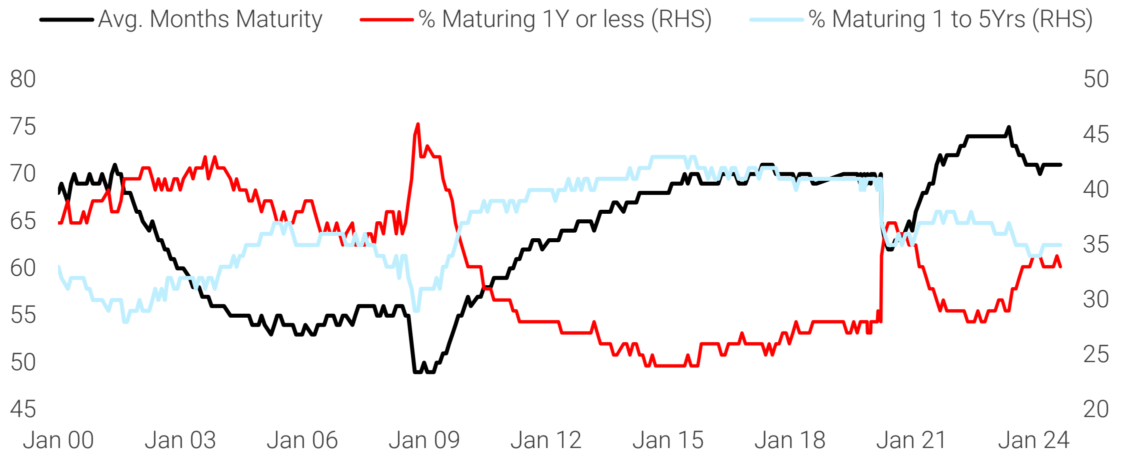


Source: BEA, Federal Reserve, Treasury, GlobalData. TS Lombard

Current sensitivity of the Treasury debt is increasing thanks to QT driving up the demand for T-bills and Treasury meeting the demand. Even when QT ends, sooner than later, the Fed will be buying more bills than coupons – looking to get its balance up to 20%-25% bills from 5%, so they look more like their depositors. This is one place where the Fed is open for criticism -- its balance sheet policy now dictates the structure of Treasury debt. It will be interesting to see whether Trump's Treasury will fight the Fed on this, only to see the conflict disrupt the yield curve's shape. In other words, expect a more subtle battle.

Today, average maturity of Treasury debt is 71 months (5.9 years), about three months shorter than it was before QT began in June 2022 (Chart 4), The percentage of debt maturing inside of one year his risen from 28% to 34%. At present, 68% of the debt matures inside of five years. In other words, if Trump's plans result in higher term yields, as I believe they will unless he creates a recession (always possible), the jump in interest payments will dominate the deficit.

Chart 4: Treasury debt is shortening thanks to QT -- interest rate sensitivity is rising



Source: Treasury, TBAC, GlobalData TS Lombard

Should we care about the debt?

positive view

This question has been debated among economists for a long time. On one side is a neo-Keynesian view that interest on the debt is money we owe to ourselves. Raising taxes to paydown the debt only transfers money from taxpayers to debtholders, often the same people. If the interest rate is below the nominal growth rate, then the government is in a net positive position to service the debt. In addition, one must ask what spending the deficit is funding and whether it is raising the domestic capital stock to produce higher income down the road. It is too soon to tell whether Biden's plans will do just that.

There are several arguments countering this sanguine perspective for the US. First and perhaps foremost, although interest on the debt is nominally below US growth, the size of the debt continues to increase faster than GDP because of the structural primary deficit that is about twice the pre-Covid average. Add to this the compounding the current debt by the average rate of interest and we see debt/GDP continuing to rise and with it the debt service as a percent of GDP. The Keynesian view is valid for past debt that is not being added to by current structural deficits.

negative view

Second, there is a behavioural difference between earning interest and being taxed instead. Raising taxes to paydown the debt might have a worse outcome for national income growth.

Third, not all the interest is paid to US residents. Some 30% of US debt is held by foreign owners, down from a high of 57% at the end of 2008, when Fed policy began its shift to a surplus of reserves system and consequently disintermediated foreign buyers of UST. Because of its role in monetizing some portion of the debt, the thumb of the Fed on the interest rate scales is evident in hiding the real cost of funding the Treasury.

negative view

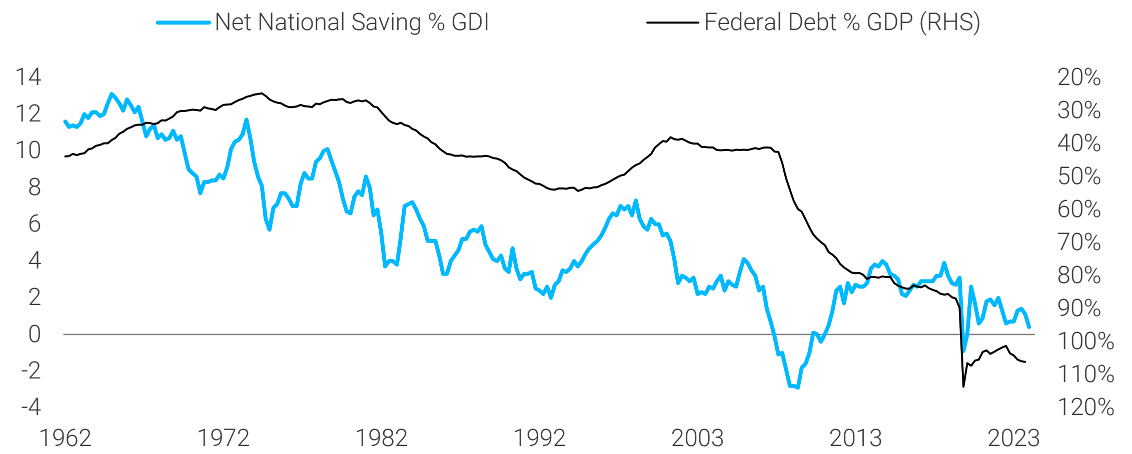
Therefore, while the argument of r<g has some validity, one must also account for r being suppressed by the Fed. The interest we owe, we owe to Fed, and this introduces distortions that are not necessarily all welfare-positive for the economy. In the current period, while Federal interest costs have jumped from 2.5% of GDP when QT began in 2022 to the current 3.8%, Fed holdings of UST outstanding dropped from 25% to 15%. The 10Y TIPS yield has risen from -0.64% to 2%. Real nonresidential fixed investment has slowed from an 8% Y/Y pace to 4%.

45% of the interest paid would be to non-Americans

higher debt led to lower investment = lower capital formation

This latest turn begins to look a lot like the crowding-out argument that is the basis of the neo-classical argument against large-scale government borrowing. The public buys Federal debt instead of spending or buying public equities and a wedge between wealth and capital investment is created. For the US, this story gets complicated by the role of the Fed in monetizing the debt through QE/QT and that US firms can supply domestic demand by sourcing labor and capital globally with real rates high enough to keep the economy going and the dollar bid. What we can see as confirmation of the neo-classic argument against persistent budget deficits is that the net national saving rate has dropped in sync with rising Federal debt as a percent of GDP (Chart 5). In other words, the bigger debt load has not created a surplus of income to be saved.

Chart 5: Rising Federal debt lowers net national saving



Source: BEA, Treasury, GlobalData. TS Lombard

The bottom line

The cost of servicing the debt and the structural deficit of 2.5%-3.0% of GDP is becoming problematic, as it will put increased pressure on the Fed to monetize more of it to keep the real interest cost from weighing on growth and curtailing Trump's aims. The Fed's position has been manageable, even before the QE period, though we have seen the impact of its policies through the years in the out-sourcing that is now the political issue on which Trump got himself elected and re-elected. Higher debt has indeed reduced the growth of domestic capital formation. For the Fed, going forward, with the debt burden growing faster than GDP, and inflation basing at a higher level than pre-Covid, their balancing act is about to get more difficult.

If there is a moral in this story, it is that a persistent deficit growing the debt/GDP ratio, whether created by tax cuts or entitlements, is going to work in opposition to the expectation of creating real growth that eventually raises GDP faster than the debt burden. The key word here is persistent – not periods of budgetary expansion followed by some deficit discipline (90s vs 80s).

As for Trump's plans to boost growth through increased domestic production using the budget, including tariffs to help finance tax cuts, none of it has a chance of working unless the structural budget deficit begins to narrow. He recognizes it, DOGE has been formed to attack it, Republicans in Congress are looking to cut entitlements, but this will not be an easy lift politically nor is it necessarily the right direction to better the economy. More on that in another US Watch.

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