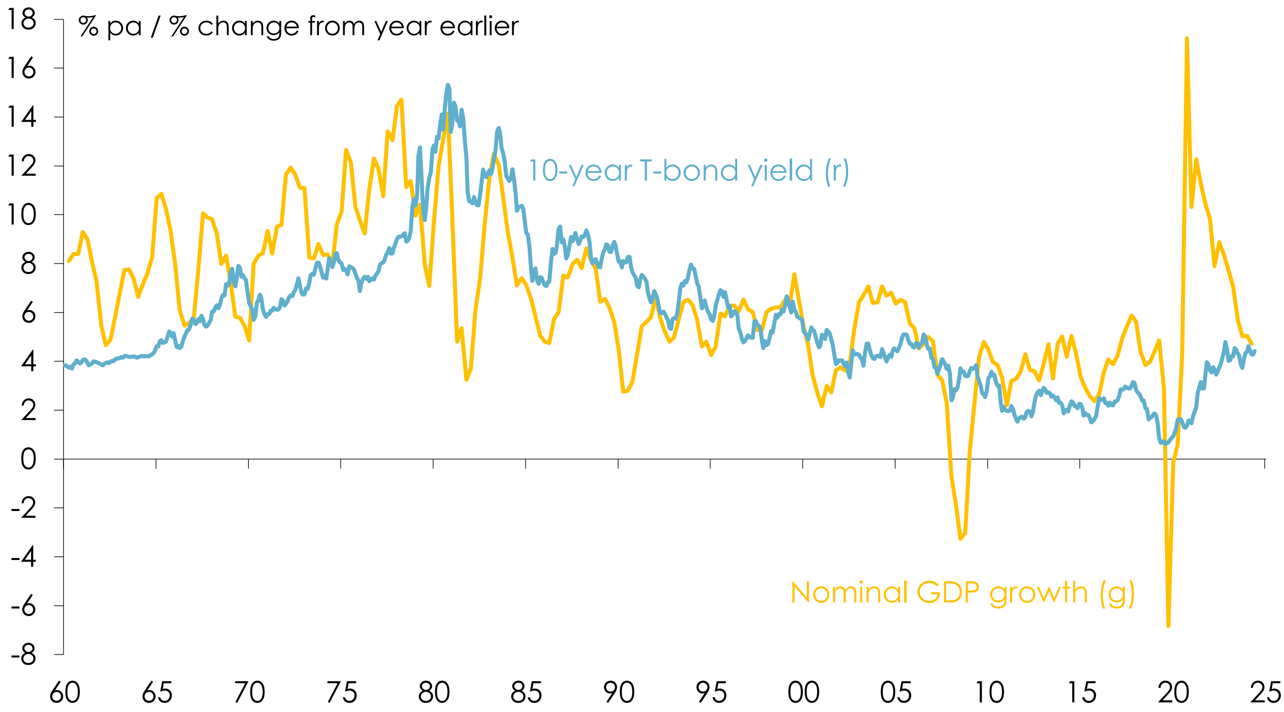
Is the United States about to step over a very dangerous financial precipice?

In the aftermath of the global financial crisis of 2007-09, and especially during Covid-19, mainstream economists came to take a more benign view of budget deficits and public debt than they had typically done during the previous two or three decades.

A particularly influential contribution to this shift in the conventional economic wisdom was the 2019 Presidential Address to the American Economic Association by former IMF Chief Economist Olivier Blanchard, in which he argued that where interest rates on government debt ('r') were lower than the growth rate of nominal GDP ('g') - which he observed "is more the historical norm than the exception" - then "public debt may have no fiscal cost." Blanchard was at pains to emphasize that this didn't constitute carte blanche for wasteful debt-funded public spending. But nonetheless, it did make both economists and (more importantly) polcy-makers feel less concerned than they might otherwise have been about the large deficits which most governments around the world incurred during the pandemic, and about the ensuing rapid build-up in public debt.

However, the US is now approaching a point where "Blanchard's inequality" no longer holds - ie where r > g , rather than the other way around (as Blanchard rightly observes, as illustrated in the Chart 1, it has been for most of the past sixty-five years, except for the 1980s).

Chart 1: US 10-year T-note yield vs nominal GDP growth



Sources: US Bureau of Economic Analysis; US Federal Reserve.

Since mid-September last year, when financial markets started coming to the conclusion that Donald Trump was likely to win the November US Presidential election, the yield on US 10-year Treasury notes (bonds) has risen from 3.65% to (as of Friday) 4.50%. The 30-year bond yield (which serves as the benchmark for pricing 30-year fixed rate mortgages in the US) has risen by even more, from just below 4.00% in mid-September last year to 5.04% on Friday, its highest level since July 2007 (just before the onset of the GFC).

Meanwhile the annual growth rate of nominal GDP has slowed to 4.7% over the year to the first quarter of 2025.

So the US is on the cusp of having $r > g$ - rather than the other way round as (to repeat Olivier Blanchard's observation cited above) it has been for most of the past 65 years. Indeed if you take the 30-year (or, for that matter, 20-year) bond yield for 'r', then r is *already* greater than g.

This matters more than it might otherwise because the US is also on the cusp of embarking on substantial, deliberate, increase in its budget deficit and debt - in circumstances very different from those in which Blanchard and others deemed such a step might be 'ok'.

In March this year, the US Congressional Budget Office published its annual long-run (30-year) projections for the US Federal budget which showed that, on then current policy settings, the US Federal Government's budget deficit would widen from US$1.8 trillion (6.4% of GDP) in FY2024 to US$2.6 trillion (6.1% of GDP) by FY2034, and thereafter to US$9.6 trillion (13.3% of GDP) by FY2055 (see Chart 2 on following page)

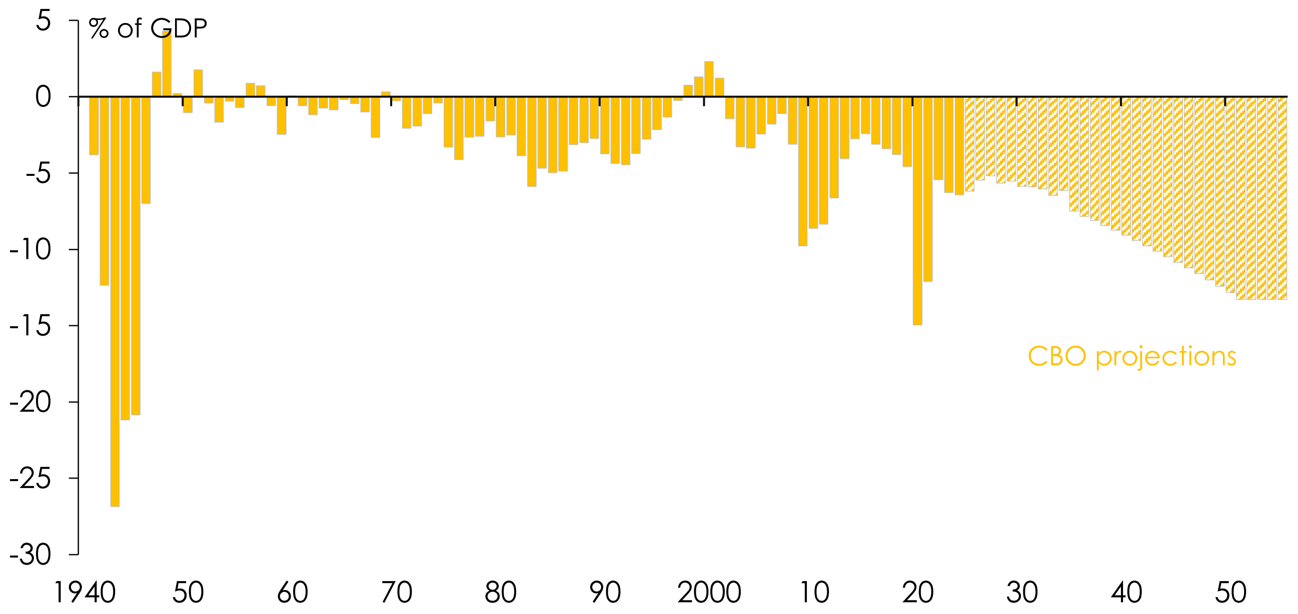
As a result, the CBO forecast, "Federal debt held by the public" (the most widely-used measure of US public debt, which excludes debt held by the Social Security and other US Government Trust Funds) was projected to increase from US$28.2 trillion (97.8% of GDP) at the end of FY2024 to $50.7 trillion (117% of GDP) by the end of FY2034, and to $114.1 trillion (156% of GDP) by FY2055 (see Chart 3 on following page). For context, the previous peak debt-to-GDP ratio was 106.1% in 1946, immediately after the end of World War II.

And one consequence of that build-up in debt, according to CBO forecasts, is that net interest payments will rise from 10.8% of total US Federal Government revenues in FY2024 to 19.8% of Federal revenues by FY2034, and thereafter to 26.2% of Federal revenues by FY2055. And this was on the assumption that 10-year Treasury note yields stayed at 3.7-3.8% (ie, about 75 basis points lower than they are now) over this entire period.

It's therefore especially troubling that Donald Trump's "One Big Beautiful Bill Act" - yes, it really *is* called that! - which passed the US House of Representatives by one vote this week (two Republicans actually voted against it, for which they will presumably be targeted at their primaries ahead of next year's mid-term elections) will, according to the CBO, add a further US$3.8 trillion to the deficits in prospect over the next decade (taking them from US$21.1 trillion to $24.9 trillion).

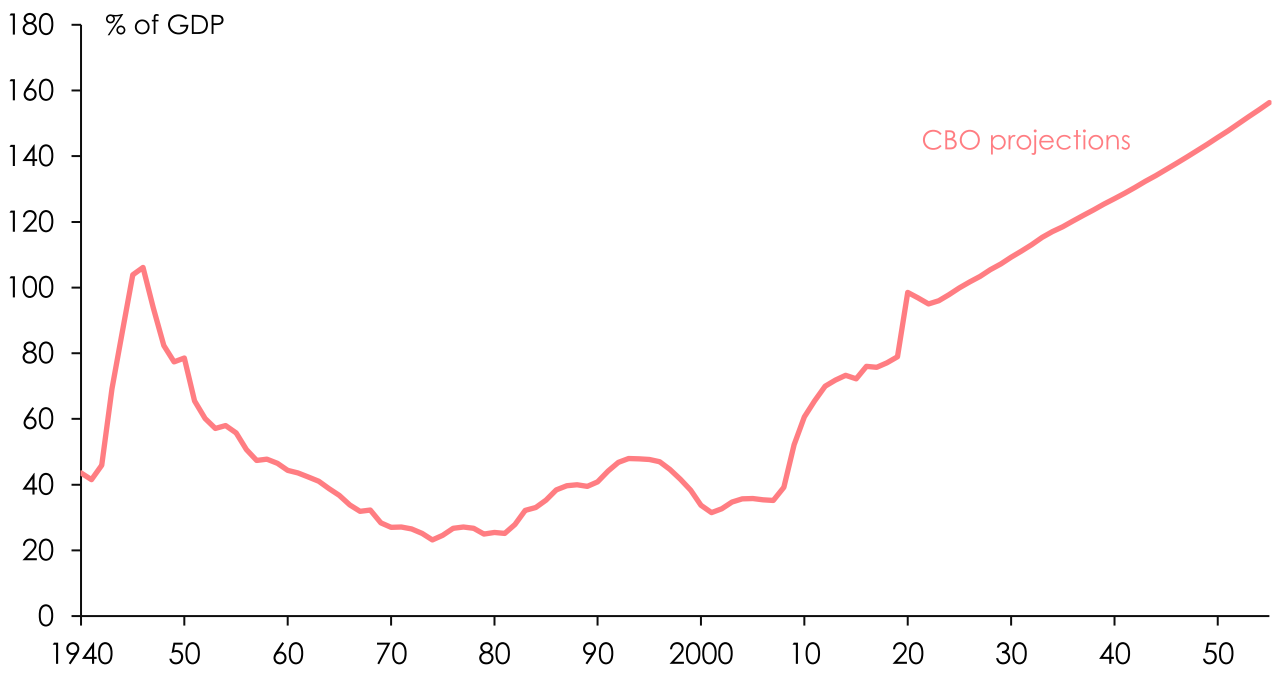
SAUL ESLAKE
CORINNA ECONOMIC ADVISORY

Chart 2: The US Federal Budget deficit



Source: US Congressional Budget Office.

Chart 3: US Federal Government debt held by the public



Source: US Congressional Budget Office.

The non-partisan Committee for a Responsible Federal Budget estimates the impact on the deficit will be even larger, at an additional US$3.1 trillion over the next decade, or as much as $5.1 trillion if "temporary provisions" in the OBBBA are extended without offsets.

The Yale Budget Lab has a similar estimate to the CRFB of the costs of OBBBA over the next 10 years, but goes further by estimating the cost over the three decades to 2055 at US$23.7 trillion), and predicting that if OBBBA's "temporary provisions" become permanent (as it says they usually do), the debt-to-GDP ratio would hit 200% in 2025. And it notes that "the only countries that currently have a higher debt-to-GDP ratio are Sudan and Japan.

OBBBA now goes to the Senate, where the Republicans have a 5-seat majority - and where reconciliation procedures mean that Senate Democrats are unable to 'filibuster' the Bill in order to prevent its passage with fewer than 60 votes (out of 100) in favour (the Bipartisan Policy Centre has a good explainer of 'reconciliation procedures' if you need one) .

One of the (many) consequences of the policies which the Trump regime has promulgated - and of the chaotic ways in which it has sought to implement them - is the trashing of America's "brand" - as reliable trading partner, as a dependable ally, as a desirable destination for tourists and students, as a 'beacon of democracy' and, most relevantly in this context, as a 'safe haven' (for investors) in a time of uncertainty (even if, as during the GFC, the US was itself the source of much of that uncertainty).

Since Donald Trump's return to the White House on 20th January this year, and especially since his self-proclaimed "Liberation Day" tariffs on 2nd April, the US dollar and US Treasury bonds have not been a 'safe haven'. Unlike stocks, they haven't recovered in the aftermath of Trump's back-downs, in particular to China, over tariffs.

If, as now seems increasingly likely, we have entered an extended period where r > g (ie, where interest rates on US government debt are higher than the growth rate of nominal GDP), then US debt-to-GDP ratios will rise exponentially.

The United States could be about to step - consciously and deliberately - over a financial precipice, with consequences that may extend well beyond the boundaries of the United States.

Saul Eslake
Corinna Economic Advisory