MARKET *view*

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US public debt: a potential "Liz Truss" scenario?

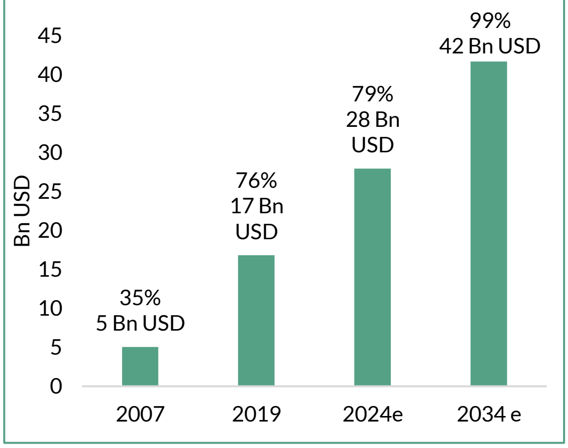
> *The circumstances in the US are certainly different from those of the UK in 2022. Yet, without corrective fiscal policy measures, it could be a matter of time before the US faces its own "Liz Truss" moment.*

If a frog is thrown in boiling water, it will leap out instantly. But if placed in cold water that is slowly heated, it will supposedly stay there. As the tale goes, the frog only perceives the slow change in temperature as a danger when it is beyond saving. In reality of course, frogs are not that foolish. Rather, the story serves as a parable for the following point: **people often seem to ignore slowly building risks until it is too late.**

This is particularly true of national debt. In the US specifically, government debt has surged in recent years. According to the Congressional Budget Office (CBO), by the end of 2024, US national debt, insofar as it is not held by the government agencies (so called debt "held by the public"), is likely to sit just below the 100% mark of gross domestic product (GDP). Gross debt, which aligns more closely with European definitions, is around 25 percentage points higher.

Rising interest payments make fiscal consolidation more difficult. Let's illustrate: the CBO projects that, between 2025 and 2034, the budget deficit will average 5.6% of GDP, exceeding 6% by 2034. During this period, estimated interest costs will rise to nearly 4% of GDP. This implies that debt held by the public in the US would expand to $42 trillion (or around 116% of GDP) by 2034 (see Figure 1).

FIGURE 1: US PUBLIC DEBT OVER TIME



Source: U.S. Congressional Budget Office, February 2024; percentages: debt as a percentage of gross domestic product; 2024 and 2034: CBO forecasts

However, this projection assumes that the US government will avoid any new financial policy excesses. The CBO's estimate is based on the current legal framework. **Yet, none of the leading presidential candidates have a history of fiscal restraint, and there's no indication of a shift in this approach**.

Donald Trump, in particular, appears to be pushing for more aggressive measures: his team is considering lowering the corporate tax rate from the current 21% to 15%. This would be the rate that Donald Trump had already considered in 2016/17. According to estimates by the Tax Foundation, such a tax cut over the next 10-year budget period could result in a revenue loss for the US government of between $400 billion and $600 billion *(source: Tax Foundation: A Lower Corporate Rate Is an Opportunity Worth Taking as Part of Broader Tax Reform, 18 October 2023).*

Under current law, many of the tax cuts in the Trump administration's 2017 *Tax Cuts and Jobs Act* will expire at the end of 2025, particularly those affecting personal income tax and inheritance tax. **President Joe Biden is considering making some of the relief measures for lower and middle-income groups permanent. Donald Trump is looking to extend all tax relief measures without any changes. According to the CBO, such a move would increase the debt by $3.8 trillion over the 10-year period leading up to 2034** *(source: CBO: Budgetary Outcomes under Alternative Assumptions About Spending and Revenue, May 2024).*

Returning to our frog analogy, **the key question is: at what point should government debt levels concern investors and the public?** There is no clear answer to that. Recently, the bond market experienced a brief shock at the end of May, after US government bond auctions were met with only tepid demand on two consecutive occasions. The yield on US Treasury notes (10-year maturity) shot up by 20 yield points at times, from just over 4.4% to over 4.6%. Although the situation normalised in the following days, this development serves as a warning sign: **it shall not necessarily remain self-evident that the US forever keep the ability to easily issue any amount of Treasury note. If high financing needs coincide with other disruptive factors—such as more restrictive monetary policy or large-scale selling by foreign investors—the situation could quickly become problematic.**

The British learned this lesson the hard way. In the fall of 2022, the UK's inflation rate and deficit ratio were approaching 10%. Against this backdrop, the newly elected Conservative Prime Minister Liz Truss and her then Chancellor of the Exchequer Kwasi Kwarteng drafted the ill-fated plan for a fiscal policy big bang reminiscent of the Thatcher era. **After Truss** had already committed to an energy price guarantee worth around £200 billion, her finance minister presented a supplementary budget ("mini budget") that included £45 billion in tax cuts. These tax cuts were primarily aimed at benefiting companies and high-income earners, following the principles of 1980s supply-side economics. The plan was to finance these cuts through additional debt.

This is when the markets rebelled. Long-term government bond yields shot up by 2.50 percentage points, followed by a sharp rise in mortgage rates, which are crucial to household finances and the stability of the housing market. Pension funds were caught off guard by the abrupt move and suffered massive losses, some of which threatened their very existence. The situation only began to stabilise after the Bank of England intervened and the government withdrew its plans. This series of events also marked the end of Liz Truss's term of office, which lasted just 44 days before she was forced to resign as Prime Minister.

Despite her record as the UK's shortest-serving Prime Minister, Liz Truss has left a lasting impression on bond market participants as an example of politicians who disregard market reactions. The term "moron risk premium" was coined to describe the added risk priced into British yields.

The circumstances in the US are certainly different from those of the UK in 2022. The debt situation is more favorable, the economy is stronger, and the US dollar remains the dominant investment and reserve currency, all of which suggest that the US does have substantial fiscal headroom. While the risks of an acute crisis are currently very low, the US seems to be heading in the wrong direction. Without corrective fiscal policy measures, it could be a matter of time before the US faces its own "Liz Truss" moment.

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