Q&A June 2025

National Debt and the Implications for the U.S. Economy and Capital Markets

Our nation's debt has grown markedly over the last several decades, which creates potential burdens down the road on both the economy and capital markets. To discuss the implications of our national debt, we conducted the following Q&A session with Jim Palmer, CFA, Chief Investment Officer of U.S. Bancorp Asset Management and Ken Schiebel, CFA, Managing Director and Chief Investment Officer of PFM Asset Management, a division of U.S. Bancorp Asset Management.

What does the national debt entail, and how has the United States has managed to accrue ~$36 trillion in debt?

Schiebel: The federal government collects revenue in the form of individual and corporate taxes, social security and Medicare taxes, customs duties, leasing of government owned buildings and land, the sale of natural resources and more.[1] For fiscal year 2024, total receipts were $4.92 trillion.

This revenue is used to pay for government activities, as well as goods and services provided to U.S. citizens and businesses. This includes outlays for social security benefits, Medicare and Medicaid, the military, various other federal government departments, and interest on outstanding public debt. For fiscal year 2024, outlays totaled $6.75 trillion, resulting in a budget deficit of over $1.8 trillion. That deficit had to be financed through the issuance of Treasury debt, which added to the already large total national debt burden.

Of course, the deficit wasn't always that massive. Prior to 1975, the largest annual deficit was during World War II and totaled about $50 billion. In the 50 years since, the government has run deficits in 46 of those 50 years, with the only exceptions being fiscal years 1998 through 2001. The U.S. ran trillion-dollar plus deficits in the post global financial crisis (GFC) period, and again over the last five years, including the costs of COVID relief. We've added more than $13 trillion to the national debt in just the last eight years.[2]

But how did we get here? Very simply, administrations from both parties have spent way more than the government took in, in both good times and bad.

1 U.S. Department of Treasury - https://fiscaldata.treasury.gov/americas-finance-guide/government-revenue/.
2 STLFRB FRED, Federal Surplus or Deficit [-] (FYFSD) | FRED | St. Louis Fed.

What are the implications for the U.S. economy?

Schiebel: A significant burden is the cost of paying interest on all that accumulated debt. When rates were near zero, borrowing costs were cheap. With a return to more historically normalized rates, the gross interest cost last year exceeded $1 trillion for the first time ever.[3] That money is not going toward productive services. It is simply to cover the cost of all the past deficit spending and is now one of the largest portions of government spending.

As we look forward, a big challenge is how to cover the interest costs while maintaining all the other mandatory and discretionary spending programs that Americans have come to rely on. Spending cuts to lower the deficit could directly reduce the services provided to American families, veterans and retirees. And lower income households would be hurt the worst.

One historically ineffective method to try to keep debt in check is the national debt limit. The debt limit is the total amount of debt that Congress has authorized for the Treasury to borrow. Of course, Congress also approved all the deficit spending. Since Congress has also raised, temporarily extended, or revised the definition of the debt ceiling 78 times since 1960, the debt limit is just an artificial barrier.[4]

What are the long-term potential implications for the equity and credit markets?

Schiebel: One recent example of a sovereign debt crisis was seen in the United Kingdom in 2022. Fears were sparked by then Prime Minister Liz Truss's announcement of $116 billion of spending increases and tax cuts with limited details on funding plans. That led to financial instability and sent markets searching for answers as to how the government would pay its bills. The immediate result was 10% depreciation in the pound and a surge in long-term UK bond yields from 1.80% to 4.50% in less than two months. Truss ultimately resigned and the tax cuts and borrowing plans were scrapped. So, the market itself provided some discipline which forced a policy reversal.

A similar scenario in the U.S. is less likely given the credibility of the Federal Reserve (Fed) and the global reserve status of the dollar, but the recent episode with longer-term Treasury yields is a shot across the bow that the market can directly signal its displeasure to policies inconsistent with financial and fiscal stability through market pricing. If faith in U.S. Treasuries wanes, that would be a seismic event in the marketplace for global bond and equities.

Should the U.S. continue on its current path, we may see investors want to further diversify muti-asset portfolios into more non-U.S. dollar denominated assets or into real assets such as gold, which has seen a recent surge to new record highs. As they used to say, "never bet against the U.S. economy," but the recent market volatility amid economic and policy uncertainty has refocused attention on the U.S. ability to borrow and service its national debt.

Why should we care that our nation's debt continues to grow each year?

Schiebel: Since the Bretton Woods Agreement in 1944,[5] the U.S. dollar has been the dominant global currency, and U.S. Treasuries have been viewed as the safest, most liquid debt in the marketplace, and the base on which most fixed income securities are priced off. While the strong and growing U.S. economy has supported our ability to service all that debt in the past, the question remains: how much is too much? Naturally, the overall debt burden on the U.S. is important as it could lead to higher interest costs, higher inflation, reduced discretionary spending, and volatility across financial markets.

Until the recent tariff announcements, risks related to growing Treasury debt always seemed somewhat "down the road." But, the recent combination of tariffs and the resulting trade wars, Department of Government Efficiency (DOGE) cuts to government employment, proposed tax cuts, threats against the independence of the Fed, and some perceived rotation out of U.S. dollar assets has pulled that concern forward. The recent up-tick in Treasury yields despite falling equity prices is highly unusual and concerning.

3 *Net interest costs in fiscal year 2024 totaled $882 billion according to the U.S. Department of Treasury.*
4 *U.S. Department of Treasury, Debt Limit | U.S. Department of the Treasury.*
5 *https://www.investopedia.com/terms/b/brettonwoodsagreement.asp.*

In addition, increased debt levels may limit the ability and effectiveness of the United States to react to economic stress such a recession or pandemic.

All that is counterbalanced by the strength and diversity of the U.S. economy – the largest in the history of the world. U.S. gross domestic product (GDP) per capita today is more than seven times what it was in 1980, despite large annual fiscal and trade deficits. The U.S. has been and continues to be an exceptional contributor to prosperity and innovation for the global economy.

Are there any potential solutions that could mitigate the impact of the growing debt?

Palmer: There are several things that come to mind that could limit the adverse impact.

Economic growth: Conceptually, the most straightforward way to lower the U.S. debt-to-GDP ratio would be to grow the economy faster than the rate of debt accumulation. Boosting GDP could include pro-growth policies such as business and tax incentives as well as net-positive investments into technology, infrastructure and energy, which could lead to higher productivity. While the concept may seem non-divisive along party affiliations, there is considerable political disagreement on the proper methods to incent a faster growth rate.

Fiscal consolidation: Lowering annual deficits through a combination of spending cuts, tax increases and entitlement reforms is consistently cited as the key to controlling debt. Given the political realities in the U.S. and the expected pain inflicted by these policies, significant fiscal reform is doubtful. If anything, the current environment leans toward extending 2017 tax cuts and expanding tax breaks such as exempting tips from income and reinstating deductions for taxpayers in high tax jurisdictions. While there seems to be momentum for identifying waste and inefficiencies in government spending and programs, the sentiment has yet to be realized in tangible reforms and would only yield a fraction of the fiscal restraint needed to reign in deficit and debt levels. Given evolving U.S. demographics, entitlement reform is perhaps the most crucial pillar in deficit control. But given entitlement's status as the "third rail" of politics, near-term reform is unlikely.

Debt management strategies: With the rise in U.S. debt levels and rising interest rates over the past few years, gross interest payments have grown to over $1.1 trillion annualized in Q3 2024 or over $600 billion higher than the annualized rate four years ago. For context, this level now represents 15.2% of total federal government expenditures. In the short run, the U.S. Treasury could alter the composition of issuance toward lower yielding debt. But given the number of cross currents beyond the Treasury's control (e.g.: Fed policy decisions, inflation, foreign demand, yield curve shifts, etc.), the impact of debt management tactics are difficult to determine and could even be negative.

Inflation: Reducing the real value of the U.S. debt burden through inflation would make servicing the debt easier as debt is repaid in "cheaper" dollars. The economy and tax receipts would grow at a faster nominal clip, further easing the debt burden. However, debt monetization comes with potentially severe drawbacks, including the erosion of Fed credibility, loss of confidence in the U.S. dollar and higher interest rates as inflation expectations rise.

Much of the concern regarding rising government debt has been focused on the increased issuance of Treasury securities, which are necessary to continue funding the deficit.

How do you view the impact of supply of U.S. Treasuries on fixed income markets?

Palmer: For the coming year, J.P. Morgan forecasts $4.4 trillion in gross Treasury coupon-bearing supply, with roughly $2 trillion in net Treasury supply mainly in coupon debt. From straight supply and demand economic theory, increased supply of U.S. Treasuries should result in higher interest rates, and inversely, lower bond prices. However, the number of additional factors influencing the yield curve – fiscal policy, Fed rate and balance sheet policies, investor sentiment, foreign investment, inflation and inflation expectations, system liquidity, etc. – makes it difficult to determine the precise impact of supply on yields. But it is safe to say on the margin, increased supply puts upward pressure on interest rates.

For now, solid 2024 U.S. GDP growth suggests limited economic fallout from rising debt levels. And with corporate credit spreads near historically tight levels, there appears to be little evidence Treasury issuance is crowding out the private sector's ability to secure debt capital. Perhaps the most onerous aspect to rising U.S. debt is the growing portion of the federal budget dedicated to interest payments on Treasuries. For example, the government made $82 billion in net interest payments in December 2024, or 15.1% of $541 billion in total outlays. Analysts view the growing debt service liability as unsustainable in the long run.

For questions about this report, please reach out to your relationship manager.

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