Flash Economics

N° 31
March 25, 2025

If the quality of its sovereign debt is called into question, the position of the United States will become very tricky

The United States has a structural trade deficit, which is financed by long-term capital inflows, in particular through purchases of US Treasuries by the rest of the world.

A major risk for the United States would therefore be a decline in the quality of its public debt as perceived by non-resident investors. If this were to happen, the US would have to reduce its external deficit, which would require a recession and a rise in long-term interest rates.

Where could a decline in the perceived quality of US Treasury debt come from?

- From a further increase in the US budget deficit and public debt;
- From a stated intent to depreciate the dollar exchange rate;
- From the undermining of given tenets of the rule of law: separation of executive and judicial powers, independence of the central bank, etc.;
- From financial manipulation of the Treasuries market.

Patrick Artus
Senior Economic Advisor
patrick.artus-ext@ossiam.com
@PatrickArtus

Marketing communication: this document is a marketing presentation. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research; and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Structural deficit in the US current account

The US current account shows a permanent deficit (Chart 1), which is financed by long-term capital inflows from the rest of the world; in particular by purchases of US Treasuries by non-residents (Chart 2).

Chart 1
United States: Current account balance
(as % of nominal GDP)

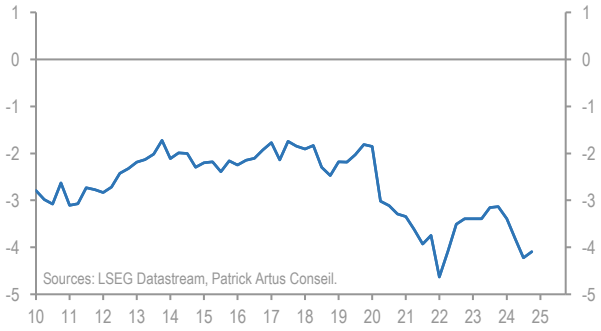
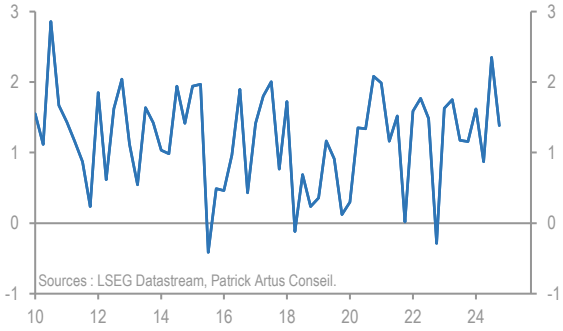


Chart 2
United States: Direct and portfolio investment inflows
(as % of nominal GDP)



(*) Direct and portfolio investment inflows are capital inflows leading to an increase in liabilities (in this case for the United States) and therefore have a positive sign.

A major risk for the United States

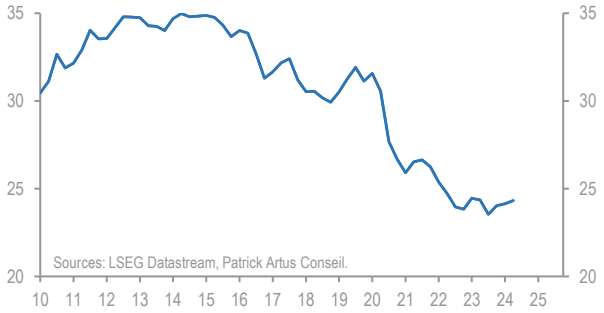
A major risk for the United States would therefore be **a decline in the perception of public debt** quality by non-resident investors. If this were to happen, the US would have **to reduce its external deficit** (Chart 1, above), which would lead to a recession and a rise in long-term interest rates (Chart 3).

Chart 3
United States: Interest rate on 10-year government bonds
(as %)



A decline in the perceived quality of US government debt could lead to **massive capital outflows**, since US Treasury debt is an asset that is very widely held by non-residents (Chart 4).

Chart 4
United States: Public debt held by non-residents
(as a % of public debt)



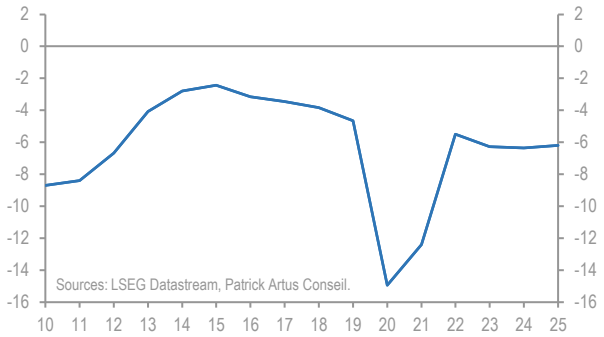
What factors could lead to a decline in the perceived quality of US Treasuries?

1- A further increase in the US budget deficit and outstanding debt

If we look at the projections made in January 2025 by the Congressional Budget Office (CBO), we see an increase in the budget deficit relative to GDP since 2019 (Chart 5); the budget deficit could amount to 6.2% of GDP in 2025, falling to 5.2% of GDP in 2027 and rising again to 6.1% of GDP in 2034. According to the CBO, the public debt ratio would rise from 99.9% of GDP in 2025 to 118.5% of GDP by 2035.

This failure to control the fiscal deficit could lead to a decline in the quality of US public debt.

Chart 5
United States: Budget deficit (as % of nominal GDP)

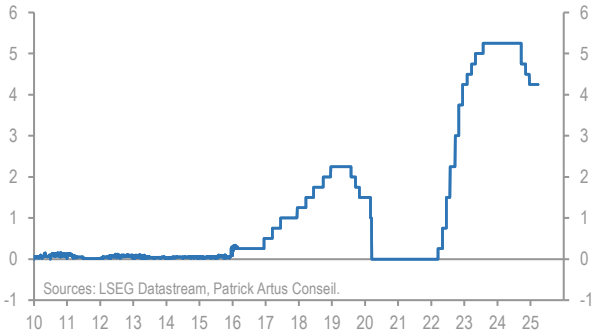


2- A stated intent to depreciate the dollar

The intent to depreciate the dollar could mean **a much more expansionary monetary policy** when a Federal Reserve Chairman appointed by Donald Trump replaces Jerome Powell in May 2026. Donald Trump has expressed his preference for a weak dollar in order to reduce the US external deficit. **If the dollar were to become abnormally weak, the quality of the US currency and that of US public debt would be reduced**.

This weakness in the dollar would be the result of a significant drop in US interest rates (Chart 6).

Chart 6
United States: Federal Funds target rate (low rate, as %)



3- The undermining of given tenets of the rule of law

The US public debt markets would react negatively to, for example:

- a challenge to the separation of executive and judicial powers;
- a challenge to the independence of the Central Bank.

4- Financial manipulation

It has sometimes been suggested (for example by Stephen Miran, who is to head the Council of Economic Advisors) that the US would force holders of US Treasury debt to sell this debt in exchange for very long-term (100-year) Treasury securities. The feasibility of this manipulation is doubtful, but the very fact that it is sometimes mooted diminishes the quality of US debt.

Summary: a decline in the quality of US public debt would have catastrophic effects

A perceived decline in the quality of US public debt would result in capital outflows from the US and a rise in long-term interest rates.

This decline in the perceived quality of US public debt could result from maintaining an excessive budget deficit and a continuous rise in the public debt ratio, from a stated intent to depreciate the dollar (which will be possible, by pursuing a very expansionary monetary policy, after the end of Jerome Powell's term of office in May 2026), or from undermining the rule of law (challenging the separation of powers) or the independence of the Central Bank.

Disclaimer

Ossiam, a subsidiary of Natixis Investment Managers, is a French asset manager authorized by the Autorité des Marchés Financiers (Agreement No. GP-10000016). Although information contained herein is from sources believed to be reliable, Ossiam makes no representation or warranty regarding the accuracy of any information of which it is not the source. The information presented in this document is based on market data at a given moment and may change from time to time. This material has been prepared solely for informational purposes only and it is not intended to be and should not be considered as an offer, or a solicitation of an offer, or an invitation or a personal recommendation to buy or sell participating shares in any Ossiam Fund, or any security or financial instrument, or to participate in any investment strategy, directly or indirectly. It is intended for use only by those recipients to whom it is made directly available by Ossiam. Ossiam will not treat recipients of this material as its clients by virtue of their receiving this material. All performance information set forth herein is based on historical data and, in some cases, hypothetical data, and may reflect certain assumptions with respect to fees, expenses, taxes, capital charges, allocations and other factors that affect the computation of the returns. Past performance does not predict future returns. Any opinions expressed herein are statements of our judgment on this date and are subject to change without notice. Ossiam assume no fiduciary responsibility or liability for any consequences, financial or otherwise, arising from, an investment in any security or financial instrument described herein or in any other security, or from the implementation of any investment strategy. This information contained herein is not intended for distribution to, or use by, any person or entity in any country or jurisdiction where to do so would be contrary to law or regulation or which would subject Ossiam to any registration requirements in these jurisdictions. This material may not be distributed, published, or reproduced, in whole or in part.