November 05, 2024

Rising US National Debt – Key Risks and Impact on Global Economy!

What's the Point?

The National Debt of United States (US) now stands at US$36 trillion (122.8% of GDP) as on October 31, 2024, with one of the main drivers of its rise in recent times being the increased funding of programs and services during the COVID-19 pandemic. While this continues to be true, a more noteworthy reason fuelling this rise in the recent times has been that the national debt interest payments have increased by over 2x – from US$368 billion in September 2020 to US$882 billion in September 2024. Elevated debt levels and persistently high inflation could suppress demand for US national debt, as investors seek higher yields for bearing such risks. Rising US national debt risk higher interest rates globally, volatility in currency and financial markets, and general economic slowdown which could have a negative impact Indian economy and investors as well.

Numbers in Perspective

Chart 1: US Debt as a percentage of GDP stand at elevated levels

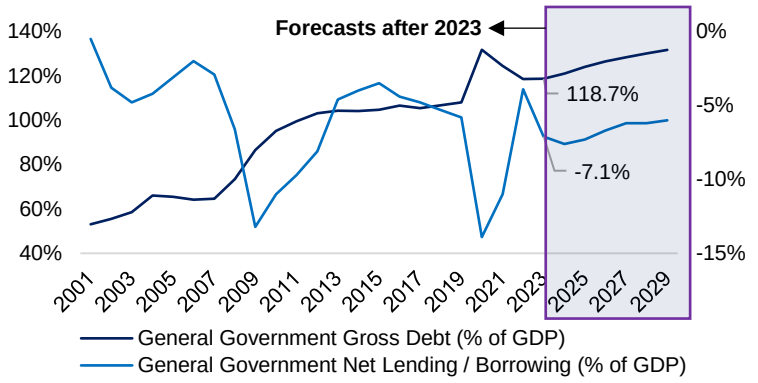
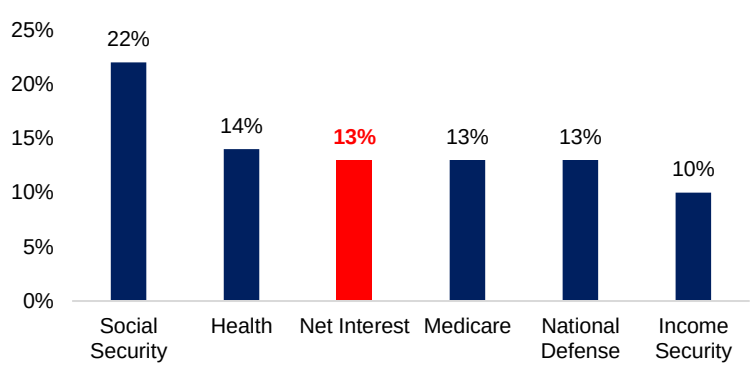


Chart 2: Interest Payments have become larger than the spending of National Defense and Medicare



Source: International Monetary Fund, Fiscal Data (Official US Government Data)

Key Reasons for the rise in US National Debt in the recent times

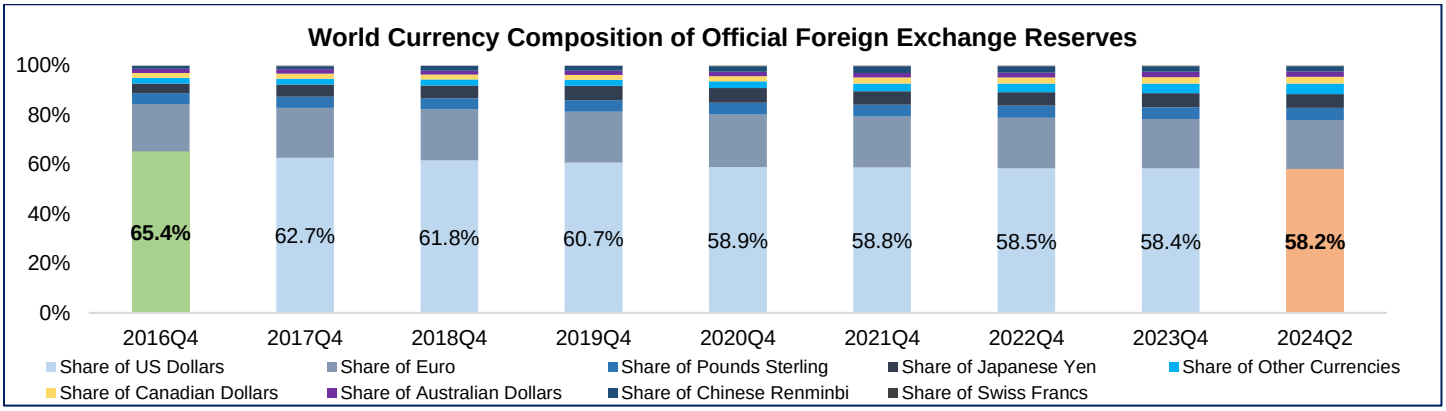
- **Social Security** has been the biggest component of US Federal Budget spending for 2024 – 22% of Government spending for 2024YTD. While the Social Security program currently has sufficient assets to operate, the long-term would require an intervention by Congress to ensure that the program has the resources to fully fund the program in the upcoming decades. The population of retirees in US is currently growing faster than its population of working-age individuals. As a result, the ratio of retirees receiving Social Security benefits to workers contributing payroll taxes has grown, creating a demographic challenge to the program and increasing its cost.
- **Rising Interest Cost of the National Debt**: Fiscal Data has highlighted that the Government has already spent US$882 billion (as on September 29, 2024) – more than the amount spent on the military and nearly as much as on Medicare – to pay interest on its national debt. Aside from the impact of a rise in debt levels, increases in US Federal Funds Rate in the recent years to respond to inflation have resulted in an increase in interest expense.
- **National Defense**, which accounts for 13% of Government spending for 2024YTD, has seen a step-up in spending. This increase in spending has taken place because the leaders of a bipartisan commission examining the National Defense Strategy believe that there is a need to respond to threats of China, Russia, Iran and North Korea (as per US Department of Defense).

Credibility of the US Dollar – Is its status as the Primary Global Reserve Currency softening?

As per an October 2024 report by JP Morgan Global Research, the narrative that *the US Dollar's status as the primary reserve currency is "being eroded"*, has gained momentum due to the division of the world into trading blocs in the

aftermath of Russia's invasion of Ukraine and heightened US-China strategic competition. Such an event could lead to **de-dollarization**, whereby economies would diversify away from US Dollar as the primary currency in world trade and financial transactions, decreasing national, institutional and corporate demand for this currency.

Another potential factor that could lead to de-dollarization, apart from geopolitical conflicts, could be US's **elevated borrowing levels**. If markets start questioning the credibility of US sovereign debt, the US Dollar could depreciate, and inflation could accelerate. Although historical data suggests this risk is low in the medium term, it cannot be entirely ruled out. As a matter of fact, the share of US Dollars in total Foreign Exchange Reserves has reduced by over 7% between Q42016 and Q22024 (Refer to Chart below). While this does not conclusively decrease the US Dollar's status as the primary global reserve currency, it does indicate that an unsustainable growth in debt could lead to an erosion in the US Dollar's purchasing power and increase import prices, contributing to inflation.



Source: Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics (IFS). Q4: Fourth Quarter-ending

Conclusion

With the imminent elections (Election Date: November 05, 2024), challenges like increasing debt levels have become a part of the narrative of political campaigns. With the behaviour of US capital markets becoming uncertain, the 2 talking points – increased questions around the credibility of US sovereign debt, and diversification away from the US Dollar, various global central banks have been diversifying away from the US Dollar for the last few years. However, with US Dollar being the backbone of global flow of trade and capital, medium term risks appear to be low.

From an Indian standpoint, the Government has been responding well to this evolving situation. The Reserve Bank of India has been holding higher amounts of Gold in local vaults, and safeguarding its interests. India's public debt to GDP is also under control, and has seen lower interest rates than the past, leading to reducing interest payments burden for the exchequer. Such a macroeconomic resilience has been a key tenet of the investment case for India.

Sources: IMF, COFER, IFS, Fiscal Data, Congressional Budget Office, and other publicly available information

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