# US Deficit & debt update – May 2025

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The US debt and deficit position is once again in focus, and it is the bond market that will set the terms of any budget deal. Moody's cut its rating on US Treasuries from the coveted AAA to Aa1, the last of the big three credit ratings agencies to do so.  A recent auction of 20-year Treasurys just priced at a yield of 5.08% on lacklustre demand.

At the same time, Republicans are negotiating with the Administration over the budget bill, officially named The One Big Beautiful Bill Act which aims to make permanent the Tax Cuts and Jobs Act introduced in Trump's first term.  These tax cuts, because of their legal expiry this year, are not included in the Congressional Budget Office projections.  An extension will increase the deficit by $4 trillion over the next 10 years.

**How did this affect this year's Budget?**

The Budget Reconciliation process happens every year, but this time, the 'business as usual' outcome – with no material changes to revenue or spending, and an agreement to increase the debt ceiling – is not an option.  The bond market is watching, and it's anxious.

The current annual budget projection is approximately $5 trillion in tax revenue. Spending is expected to be $5.7 trillion, leaving a borrowing requirement of around $700 billion.  Furthermore, an incremental $900 billion is required to pay the interest on the existing debt pile.  Of that $5.7 trillion spending, around $4 trillion is mandatory (by law, covering Health, Social Security and Welfare programs) and $1.7 trillion is discretionary (half taken up by Defense).

**What's happening with US Debt?**

The stock of debt is rising, as is the interest rate.  The government's refinancing requirement for the coming year is just over $9 trillion and the incremental borrowing requirement is around $2 trillion.  Extending the Tax Cuts and Jobs Act while avoiding what would be, as Republicans describe it, the biggest tax rise in history, is estimated to cost $4 trillion over the next 10 years above what has been forecast.  It is not yet obvious what the government will do to balance income and spending.

So far, the Republicans have agreed to increase the permitted deduction of local taxes (from $10,000 to $40,000) from income subject to federal taxes – making the revenue situation worse.  Conservatives are looking for a reduction in Medicaid that accounts for $710 billion of Mandatory spending on the poorest; this would be political dynamite. Trump, with an eye on the mid-term elections, has told the Republican caucus in a private session "Do not [mess] around with Medicaid".  Medicare is the other big health program, available to everyone over 65 years old and accounting for $950 billion in Mandatory spending, but no one is proposing to touch that.

## Did these issues start with the last election?

All of this was apparent well before the election last year.  The rise in the stock of debt going into COVID and the inflation/interest rate shock coming out have utterly changed fiscal and political calculations.  It cannot be business as usual any longer.  The annual lifting of the debt ceiling without spending discipline is no longer tenable; the bond market now constrains every move of the Administration.  The fiasco around tariffs on China was unwound, not because of protests from business or because of the sharp drop in equities, but because 10-year bond yields began to tick higher toward 4.5%. They are now at 4.58%.

## What does this mean for the US economy?

The weaker dollar and higher bond yields now reveal the underlying weakness of the US political position and the bond market looks likely to be the arbiter.  It now seems highly likely that fiscal rebalancing will be accompanied by economic contraction.