Trump's empire of debt

This century the US has embarked on wars of choice and borrowed more to pay for them. With the conflict in Iran costing an estimated $2bn a day, the risk of overstretch suddenly looks very real.

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Is the US finally about to fall victim to imperial overstretch? Despite years of speculation, the country's position as global military, economic and financial hegemon has to date remained intact.

But Washington's status may be about to be hit by fast-changing geopolitics and geoeconomics — and the habit, picked up by the US this century, of borrowing from tomorrow to pay for wars today.

The conflict in Iran has been costing an estimated $2bn a day in short-term direct costs. The ratio of US public debt to GDP is set to breach its historic postsecond world war high. And President Donald Trump has submitted to Congress a national defence budget request for 2027 of an astonishing $1.5tn, double the figure for 2020.

That number includes nothing for Trump's latest war of choice. Suddenly the risk of overstretch looks very real — both to the US's friends and to its foes.

When Trump visited Xi Jinping last month, the Chinese president made a pointed reference to a concept of overstretch put forward over two millennia ago by the ancient historian and general Thucydides.

"Can China and the US overcome the Thucydides trap?" Xi asked in his very first comments on welcoming Trump to the Great Hall of the People in Beijing.

The nub of Thucydides' argument, initially used about the fall of Athens, is that dominant powers decline when the financial and military costs of maintaining external security commitments exceed the productive capacity of the domestic economy.

The challenge posed by rising powers is also instrumental in precipitating the incumbent's loss of primacy.

The concept has obvious explanatory force in relation, for example, to the end of the British empire, the fall of the Austro-Hungarian empire, the decline of the Ottomans and the collapse of the Soviet Union, to name just a handful of examples. But does it work in the American case today, as Xi seemed to imply?

For much of the 20th century, the US was less vulnerable than earlier hegemons such as Britain because it adopted a less territorially expansionist — and hence, in comparative terms, less expensive — form of imperialism.

Washington preferred to exercise political and economic influence and soft power, latterly within the rulesbased international order that it helped invent, with occasional aberrations such as the Vietnam war.

But since the 1990s, Democratic and Republican presidents have pursued more interventionist policies in the name of humanitarianism, the promotion of democracy and American values — although some saw the rhetoric as just a mask for foreign-policy realism.

The US is still the world's biggest economy and most potent military power. Its defence budget in 2025 was over $900bn, equivalent to 35 per cent of total global defence spending and more than three times the defence budget of China, the next most powerful military actor.

The American economy is notable for its high productivity and an impressive capacity for innovation, not least in AI. The question, then, is what could undermine the country's otherwise winning formula for protracted hegemony.

The most plausible answer is costly wars and unstoppable surges in deficits and debt — a combination aggravated by Trump's erratic foreign policymaking.

Consider, first, the issue of war finance. In 1951, with the US engaged in the Korean war, President Harry Truman said: "We could try to escape the financial cost of defence by borrowing — but that would only transfer the financial problem to our children and would increase the danger of inflation with its grossly unfair distribution of the burden."

Instead, he said: "The sensible and honest thing to do now is to tax ourselves enough, as we go along, to pay for the financial costs of defence out of our current income."

No such restraint has been apparent in recent decades. Linda Bilmes of the Harvard Kennedy School notes that since the September 11 2001 attacks the funding pattern of US military conflicts in Iraq, Afghanistan and the wider region has been unprecedented.

"For the first time since the American Revolutionary War," she wrote recently, "costs were paid for almost entirely by debt." She argues that the US also reduced oversight of military spending by using emergency appropriations to fund operations, concealing expenses through poor accounting and integrating the private sector into core military activities.

The Brown University Costs of War project has estimated that the total budgetary costs and future obligations of the post-9/11 wars, including $2.2tn in future costs for veterans' care, were about $8tn in 2021 dollars. The figure does not include any future interest costs on the debt.

Against total current US government debt held by the public and federal agencies of about $36tn, this guns-andbutter tally amounts to fiscal incontinence on a very grand scale.

This, along with the financial crisis of 2007-09 and the Covid pandemic, is an important reason for the return of public debt close to the level of 1946, in the immediate aftermath of the second world war. And there is no prospect of a fiscal peace dividend of the kind experienced at that time or after the end of the cold war.

The US Treasury's interest bill has ballooned from 1.5 per cent of GDP in 2021 to more than 3 per cent today. The US deficit is currently running at nearly 6 per cent of GDP. There is no likelihood that this will come down significantly under Trump, despite promises by Treasury secretary Scott Bessent to halve it by the end of the president's term. Nor is the deficit likely to fall much under Trump's successors because there is a structural deficit bias built into US politics.

The last time the US government ran a budget surplus was in 1998–2001 under Bill Clinton. This Democratic legacy was promptly thrown away by the Republican president George W Bush on the Iraq war.

Today, with increasingly polarised politics there is no prospect of a bipartisan attempt to solve the fiscal problem.

Despite such imbalances, the markets for US Treasury bonds and the dollar itself have remained stable because of what was termed in the 1960s as America's "exorbitant privilege" by Valéry Giscard d'Estaing, then the French finance minister who went on to be his country's president.

The dollar's status as the world's preeminent reserve currency and the Treasury market's role as the world's safest haven in crises have ensured that the US government has constant ready access to international capital along with low borrowing costs.

Conventional wisdom holds that there is no realistic alternative to the dollar. The Eurozone, China and Japan do not have deep, liquid government bond markets capable of providing safe assets to the world on the requisite scale.

But foreign investors are now moving out of Treasuries because of the debt problem, threats to the independence of the US Federal Reserve, the weaponisation of the dollar through financial sanctions and the erosion of political checks and balances under Trump.

In other words the markets are finally buying into the overstretch story. For their part the leading credit rating agencies have downgraded the US: S&P as early as 2011, Fitch in 2023 and Moody’s in 2025.

Until relatively recently, the largesse of monetary authorities was crucial in funding big increases in borrowing by the US and other rich countries.

Between 2008 and 2021, the managers in charge of central banks’ reserves bought up 63 per cent of the extra debt issued by G7 governments, according to a study this year for the Group of Thirty financial think-tank by Agustín Carstens, Klaas Knot and Stijn Claessens — respectively, the ex-heads of the central banks of Mexico and the Netherlands and a former senior IMF official.

But central banks have recently been unwinding their balance sheets, running down the dollar component of their reserves and looking for alternatives including gold, commodities and the more liquid currencies of smaller advanced countries.

Indeed, a report by the European Central Bank showed this week that gold had now replaced US Treasuries as the world’s top reserve asset.

This leaves a gap that has been substantially filled by hedge funds, mainly American owned but often counted as foreign investors because of their bases in tax havens such as the Cayman Islands. Many own Treasuries as part of highly leveraged “relative value trades”, financed by short-term borrowing that has to be constantly rolled over.

William White, former chief economist of the Bank for International Settlements, points out that this works well — until it does not.

Recent shocks from hedge fund margin and collateral calls have made the Treasury market more fragile and a potential source of systemic risk.

Although the benchmark 10-year Treasury yield remains roughly where it was at the beginning of Trump’s second term, the odds are rising that his administration could find itself confronting debt market turmoil of the kind that toppled former UK prime minister Liz Truss after her unfunded tax-cutting “mini” Budget in 2022. The Federal Reserve could then be obliged to buy Treasuries to prop up the market, perpetuating a morally hazardous boom and bust cycle in which investors assume the central bank will always come to the rescue when markets slump.

Each bust risks an ever-greater bill for taxpayers.

White also worries about fiscal dominance — a phenomenon in which the central bank cannot raise interest rates to meet its inflation target because of the punishing servicing cost of high, short-term public debt. This in turn undermines price stability. For the longer term, he foresees a stagflationary world marked by the formation of two blocs, one dollar-based, the other renminbi-based with the Chinese currency backed increasingly by gold.

In their report to the Group of Thirty, Carstens, Knot and Claessens warn of growing threats to global financial stability and have elsewhere highlighted three ingredients of this "witches' brew". They list the breakneck growth of non-bank financial actors such as private credit funds and hedge funds, the reversal of regulatory reforms put in place after the financial crisis, and the "relentless rise in public debt across major economies, compounded by geopolitical fragmentation and rising tensions that leave little room for policy error".

All these factors apply with particular force tothe US — as does the diagnosis.

Carstens, Knot and Claessens add: "While we do not predict an imminent crisis — the timing of such events is impossible to call — we do find that warning signs are multiplying and the window for preventive action is narrowing." The wisdom of the late Rudiger Dornbusch of MIT is relevant here. He famously remarked that "in economics, things take longer to happen than you think they will, and they happen faster than you thought they could".

Barry Eichengreen, a professor at the University of California, Berkeley, draws a telling parallel in his latest book between the currency of Trump's America and that of Nero's Rome.

The denarius served as an international currency across the Roman empire. Nero resorted to debasement, reducing the silver content of the denarius, in a desperate effort to finance his ambitious programme of canal building, the reconstruction of Rome following the great fire of 64AD and the building of his extravagant 300-room Domus Aurea palace — all this while prosecuting costly wars on multiple fronts. It was a classic case of imperial overstretch and marked the beginning of the protracted erosion of Rome's economic and military primacy.

Louis XIV, the warmongering, profligate Sun King of France, apologised on his deathbed for having "loved war too much . . . and spent too much". While the world well knows there is zero likelihood of any recantation from the unapologetic 47th president, such an admission would make a fitting envoi for Trump. But perhaps Trump's real legacy will be the debt he, like his predecessors, has accumulated — and how it has undermined American power.