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MACRO PICTURE:

America's Fiscal Dominance Problem

By

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14 October 2025

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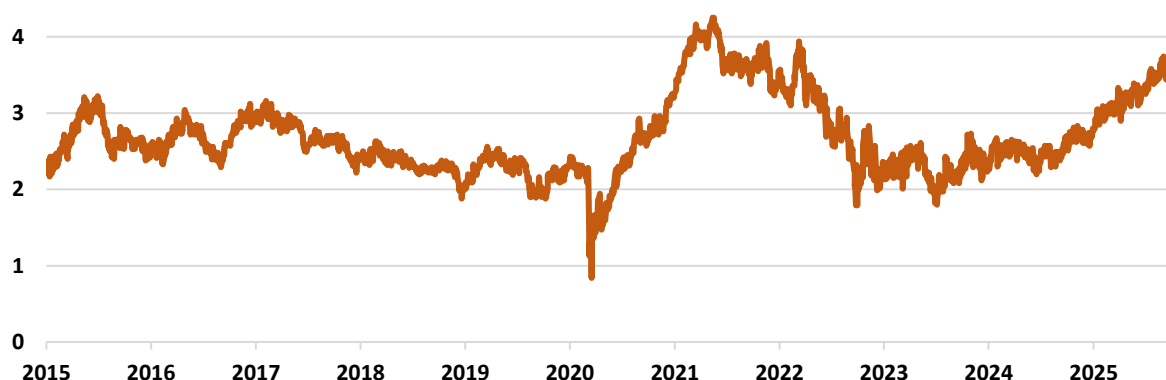
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Executive Summary

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- ✦ Trump's attacks on Chair Powell and moves to replace Governor Lisa Cook with loyalists like Stephen Miran threaten the Fed's institutional independence, eroding confidence in its inflation-fighting role and prompting investors to demand higher yields to compensate for policy risk.
- ✦ Markets are already pricing in fiscal dominance. The widening spread between 30-year nominal and 5-year real Treasury yields (above 3.7%) reflects investors' demand for higher risk premia amid concerns over rising deficits, a politicized Fed, and weakening institutional guardrails—ironically raising borrowing costs instead of lowering them.
- ✦ The White House claims the One Big Beautiful Bill will cut debt to 94% of GDP by 2034, CBO projects it will add \$4–5 trillion to deficits, pushing debt to 127–129% of GDP.
- ✦ Tariff gains are fleeting. Expected \$4 trillion in tariff revenue may fade as slower growth erodes receipts. Powell warned that the true danger lies in the trajectory, not the level, of U.S. debt.
- ✦ Recently, the 10-year Treasury yield dipped below 4% on weak data but rebounded to 4.16% as fiscal and political pressures resurfaced. Inflation expectations remain near 2.3–2.4%, suggesting rising yields are driven less by inflation fears than by higher real rates and term premia amid mounting uncertainty over U.S. fiscal and institutional stability.
- ✦ For the first time since 1996, foreign central banks hold more gold than Treasuries as a share of reserves, signaling waning confidence in U.S. assets amid rising yields, fiscal strain, and geopolitical risk. The shift reflects structural diversification toward assets insulated from U.S. policy and sanction risk.
- ✦ Bond market stress triggered a global equity correction. Rising long-term yields and fiscal uncertainty sparked a late-August sell-off, with the S&P 500 down 0.7% and the Nasdaq 0.8%, as investors repriced valuation multiples and risk premia.
- ✦ AI-related costs and stretched valuations weighed on tech stocks—Nvidia's 8% S&P 500 weight amplified losses—as 30-year U.S. yields neared 5% and European yields hit decade highs, triggering a global "bond-market spillover."
- ✦ Political pressure on central banks has eroded confidence in monetary independence and Treasury credibility. Efforts to suppress yields and cheapen debt risk backfiring by lifting term premia and weakening U.S. monetary power—a paradox of control.

Key Picture: US Fiscal Dominance Proxy (30Y Nominal Yields minus 5Y Real Yields)



Source: Fred

Fiscal Dominance and Political Risk

Political turmoil makes it harder for the U.S. to manage its debt. [In early 2025, the country's political risk rating calculated by Bruegel fell sharply, from 83 to 76](#), an unusually large drop. Such a fall can slow economic growth and push up government borrowing costs.

President Trump has openly called for bringing the policy rate down from 4.25–4.50% to around 1%, arguing that such a move would save the Treasury roughly \$1 trillion in interest payments. This makes fiscal relief, not price stability, the implicit target of monetary policy, a textbook case of *fiscal dominance*. Such statements make debt affordability, not price stability, the de facto policy goal, exemplifying fiscal dominance in action. The resulting loss of credibility risks stoking inflation expectations and weakening the U.S. dollar, especially amid stagflationary headwinds from tariffs.

Markets are already pricing in these concerns. The spread between 30-year nominal yields and 5-year real yields (TIPS)—a “fiscal-dominance proxy”—has surged above 3.7%, its highest level since 2021 (**Key Figure**). The widening gap signals that investors are demanding greater compensation to hold long-dated Treasuries, not because inflation expectations have become unanchored, but because fiscal expansion and political interference are eroding confidence in the Fed’s ability to lean against future inflation.

The dynamics align directly with the administration’s pressure campaign on the Fed, from attempts to remove Governor Lisa Cook to the nomination of Stephen Miran. If the Fed is seen as politicized and tilted toward financing deficits cheaply, the market builds in a higher term premium at the long end. This explains the rare pattern now emerging: five-year real yields softening while thirty-year nominal yields climb — a sign that investors anticipate large deficits, a dovish-biased Fed, and weaker institutional guardrails.

The paradox is clear. Trump’s aim is to engineer lower borrowing costs, but the assault on Fed independence achieves the opposite. By undermining the Fed’s credibility, fiscal dominance risks push long-term yields higher, weaken Treasuries’ safe-haven status, and ultimately raise the cost of servicing the very debt that the administration’s policies are expanding. Thus, this backdrop of fiscal expansion, institutional friction, and political interference has begun to reshape investor perceptions of U.S. debt sustainability.

Post-BBB Fiscal Position and Debt Outlook

US debt had already reached 120% of GDP in 2024. Additionally, the U.S. is running large and rising deficits, worsened by the Big Beautiful Bill, and financing them through ever-expanding borrowing. The White House touts the One Big Beautiful Bill as the cornerstone of Trump’s pro-growth agenda, claiming it will spur robust expansion and restore fiscal discipline. [The Council of Economic Advisers projects that under Trump’s plan, debt would fall to 94% of GDP by 2034](#), compared with 117% under current law. They argue that historic tax cuts, deregulation, and spending restraint would turn primary deficits into surpluses, halve the 2034 deficit, and reduce cumulative shortfalls by up to \$4.5 trillion. By contrast, rejecting the bill is framed [as endorsing a \\$4 trillion tax hike that would push debt higher](#). CBO and independent analysts disagree.

According to [the Congressional Budget Office \(CBO\)](#), the One Big Beautiful Bill will add \$4.1 trillion to deficits over FY2025–2034, lifting public debt to 127% of GDP by 2034. If temporary tax provisions are extended, the shortfall could widen to \$5 trillion, pushing debt to 129% of GDP. These estimates are benchmarked to [CBO’s January baseline](#) and exclude subsequent policy actions on tariffs, immigration, and shifting economic conditions, meaning the true fiscal impact could be even greater.

CBO’s January baseline saw deficits rising from \$1.9 trillion (6.2% of GDP) in FY2025 to \$2.6 trillion (6.1%) in FY2034, with debt climbing from 100% to 117% of GDP. The One Big Beautiful Bill adds another \$4.1 trillion in deficits—\$3.4 trillion in primary shortfalls plus \$0.7 trillion in interest costs—pushing the 2034 deficit to \$3.0 trillion (7.1% of GDP) and debt to 127% of GDP (\$53.7 trillion), a full 10 points higher than CBO’s baseline.

If temporary provisions in the One Big Beautiful Bill were made permanent, CBO estimates the cost would rise by \$858 billion, lifting the total deficit impact to \$5 trillion over FY2025–2034. That would mean \$4.2 trillion in primary shortfalls and \$0.8 trillion in added interest costs.

Under this scenario, the annual deficit would grow from \$1.8 trillion (6.1% of GDP) in FY2025 to \$3.2 trillion (7.5%) in FY2034, or \$589 billion more than CBO’s January baseline. Public debt would reach 129% of GDP (\$54.5 trillion) by 2034—12 points above baseline and 2 points above the bill as written.

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[CBO director Phillip Swagel said](#) new tariffs are projected to cut U.S. deficits by \$4 trillion over the next decade—up from a previous \$3 trillion estimate. That revenue would partly offset the \$4.1 trillion debt increase from Trump’s One Big Beautiful Bill. [Trump hailed the report as proof his strategy “was right,”](#) while Treasury Secretary Scott Bessent forecast tariff receipts of about \$200bn this year, far above the \$80bn annual average of recent years.

Credit rating agencies S&P and Fitch both cited tariff inflows in holding U.S. debt ratings steady, though Fitch warned deficits will remain large. Analysts, however, cautioned the boost may prove temporary, as tariffs weigh on growth and trade shifts erode revenues.

Fed Chair Jay Powell has echoed those concerns, noting that while the current debt level may be manageable, its trajectory is not: [“We need to address that sooner or later. Sooner is better than later”](#).

Fed Independence Under Political Pressure

Since returning to office, President Trump has waged an open campaign against the Federal Reserve. He has berated Chair Jerome Powell as a [“stubborn mule”](#) and moved to oust Governor Lisa Cook, while elevating loyalists such as Stephen Miran. These actions constitute more than personal clashes; they represent a direct challenge to the institutional independence that has long underpinned global confidence in U.S. Treasuries. Ironically, while Trump seeks lower interest rates to ease borrowing costs and fuel growth, the erosion of Fed autonomy may have the opposite effect, pushing long-term yields higher as investors demand compensation for greater policy and inflation risk.

Trump’s effort to reshape the Fed fits into his broader assault on the American administrative state. By threatening to fire Cook and nominating Miran, he aims to secure a compliant majority on the Board of Governors. Such moves politicize monetary policy, making rate decisions appear subordinate to White House priorities rather than data. The risk is not just institutional: confidence in the Fed’s inflation-fighting credibility underpins both the dollar and the Treasury market. Undermine that confidence, and investors will demand higher yields.

Market Dynamics: Yields, Inflation Expectations, and Term Premiums

Recent market behavior underscores this tension. The 10-year Treasury yield briefly fell below 4% amid weak labor data, but rebounded as concerns over deficits, tariffs, and Fed independence resurfaced. Inflation expectations remain anchored near 2.3–2.4%, suggesting that the rise in yields primarily reflects higher real rates and term premia rather than renewed inflation pressure.

Since then, Treasury yields rose amid the ongoing government shutdown and investor scrutiny of economic conditions. The 10-year yield climbed over 4 bps to 4.16%, the 30-year advanced to 4.76%, and the 2-year edged up 2 bps to 3.60%.

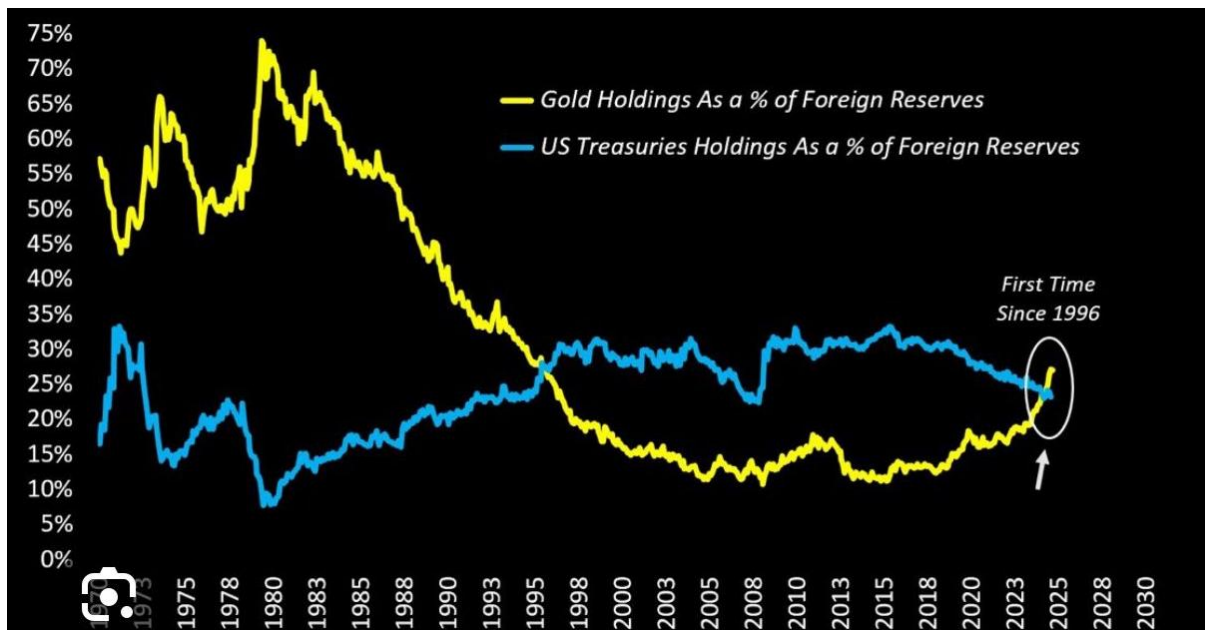
The tug-of-war in bond markets is clear: slowing growth exerts downward pressure on yields, while fiscal dominance and institutional uncertainty drive them higher. Across advanced economies, this tension is increasingly visible in relative rather than absolute yield levels, especially at the long end of the curve.

Global Implications: Eroding Confidence in Treasuries and the Weaponization of the Dollar

The credibility challenge facing U.S. Treasuries extends beyond domestic fiscal and monetary dynamics. For the first time since 1996, foreign central banks now hold more gold than Treasuries as a share of their reserves — a clear signal of waning confidence in U.S. debt as the world's primary safe asset. While not a wholesale liquidation, this shift reflects a structural reallocation toward assets perceived as insulated from U.S. fiscal and political risk. Rising yields and a softer dollar have eroded Treasury valuations, while gold demand has surged as a hedge against inflation, geopolitical uncertainty, and potential financial sanctions.

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Figure 1: Foreign Central Banks Hold More Gold Than Treasuries (Central Banks' Gold vs UST Holdings as a % of International Reserves)



Source: Bloomberg; Tavi Costa

Against this backdrop, [Stephen Miran's "Bretton Woods III" proposal or Mar-a-Lago Accord](#) represents an escalation of fiscal dominance into the geopolitical sphere. The plan envisions compelling U.S. allies under the American defense umbrella to exchange their short-term Treasuries for ultra-long, 100-year bonds, with access to Federal Reserve swap lines as an incentive. Its stated goal is to suppress long-term yields, weaken the dollar, and reduce the trade deficit — effectively turning the global dollar system into a tool of U.S. industrial and strategic policy.

Such an approach, however, would weaponize the Treasury market, blur the line between fiscal and monetary authority, and risk accelerating diversification away from U.S. assets. If foreign reserve managers perceive coercion or political manipulation, they are likely to further shift toward gold and non-dollar alternatives. Rather than reinforcing American monetary hegemony, the proposal could undermine it.

More broadly, the administration's emphasis on Treasury-Fed coordination to finance reindustrialization and defense reshoring embodies a return to yield suppression policies reminiscent of the postwar era. While such coordination may reduce funding costs temporarily, investors tend to demand higher term premia when they perceive the central bank as captive to fiscal needs. In this sense, efforts to control yields can paradoxically push them higher, reinforcing the self-defeating dynamics of fiscal dominance.

These shifts are already visible in relative global spreads. Borrowing costs for highly rated emerging markets have converged toward those of developed markets, as Treasuries lose their traditional yield advantage. Meanwhile, safe-haven diversification into gold — and even digital assets such as bitcoin — has intensified. For

many central banks and sovereign funds, reducing exposure to U.S. debt now appears a prudent hedging strategy, not a political statement. This marks a gradual but meaningful erosion of Treasuries' unique status at the core of the global financial system.

Equity Market Spillovers

At the end of August, global equities came under renewed pressure amid a sharp sell-off in government bonds. The S&P 500 fell 0.7%, the Nasdaq Composite 0.8%, and European indices followed suit. This correction reflected a broad bond-equity spillover, as rising long-term yields forced investors to reassess valuation multiples and risk premia.

[Technology shares, which have driven U.S. indices to record highs this year](#), became the focal point for repricing. Concerns about AI-related capital expenditure and elevated valuations weighed on sentiment. Nvidia, [now accounting for 8% of the S&P 500](#), extended recent losses after cautious revenue guidance, dragging down the semiconductor sector and the Philadelphia Semiconductor Index by 1.1%, its worst weekly run since April.

The equity pullback was reinforced by higher sovereign yields: the 30-year Treasury yield approached 5% as deficits and tariff uncertainties raised fiscal concerns. Similar pressures appeared in Europe, where German Bund yields hit their highest levels since 2011 and UK Gilts reached 1998 highs. [As Barclays' Emmanuel Cau observed](#), markets are experiencing a "bond market spillover", where fiscal and inflation worries lift yields, compress equity valuations, and amplify risk-off sentiment.

Conclusion: The Paradox of Control

Fiscal dominance—the subordination of monetary policy to government borrowing needs—is re-emerging as a global risk, extending beyond fragile economies such as Argentina or Türkiye to advanced economies like the United States, the euro area, and Japan. In the U.S., President Trump's attempts to remove Federal Reserve officials, including Chair Jerome Powell and Governor Lisa Cook, represent direct political encroachment. Although Powell has signaled caution, persistent political pressure—combined with Trump's One Big Beautiful Bill and its \$5 trillion debt expansion—has heightened investor concern about the long-term credibility of U.S. Treasury issuance.

Trump's drive for lower rates and faster growth has produced an assault on Fed independence that may ultimately deliver the opposite result. Politicizing the central bank, coercing foreign creditors, and institutionalizing fiscal dominance risk raising term premia, weakening Treasuries' safe-haven appeal, and accelerating diversification into gold.

Yield suppression may temporarily support industrial policy, but it comes at the expense of eroding institutional credibility, destabilizing debt markets, and undermining the long-run foundations of U.S. monetary power. In seeking to dominate the Fed and the bond market, Washington risks losing control of both.