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Analysis of today
Assessment of tomorrow

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Has the dollar become hostage to US government debt?

The US Federal Reserve faced a new form of monetary powerlessness at the end of June. At first glance, the inflation rate appears to be under control.

The official annualised Consumer Price Index stood at 2.7 per cent in May, well below the crisis high of 2022. But the price of this stability has entered a zone that economists no longer describe as a technical challenge but as a systemic burden.

Public debt in the USA has exceeded $37 trillion. The state spends $1.24 trillion annually on interest alone. This means that the cost of servicing the debt is higher than the total federal funding for national defence, which is projected to be about $886 billion for fiscal 2025.

Despite the official classification of these data as technical aspects of the budget balance, their political influence is increasing.

The Federal Reserve is trapped in its own instrument. Interest rates are still high, with a target rate of 5.25 to 5.50 per cent that has been in place for more than a year.

The planned rate cut cycle, announced back in March, is now in doubt due to stubborn inflation in the services and property sectors.

At the same time, keeping interest rates at existing levels will further deepen the budget gap and threaten to put financial pressure on the state itself, whose budget is dependent on borrowing at ever higher prices.

When monetary policy loses its neutrality

This situation raises a new question: whether monetary policy and fiscal stability can function at all in the same environment.

Until now, it was assumed that the central bank controls inflation independently of the political context and that fiscal policy depends on the decisions of Congress. But with rising interest rates, monetary policy is losing its neutrality. High interest rates not only affect the labour market or spending. They also have a direct impact on state coffers.

An unusual phenomenon occurred in the first half of 2025. Despite signs of an economic slowdown, the dollar did not weaken. On the contrary, it strengthened against the euro and the yen, partly due to the different interest rate policies but also partly due to the market expectation that the US will have to continue to achieve high yields in order to contain the structural budget risk.

The dollar therefore no longer reflects the strength of the US economy but the pressure under which it is borrowing. Investors are buying the dollar not because of growth but because of interest rates.

> The USA is borrowing at historically high real interest rates in an environment that no longer favours easing monetary policy

In such a situation, the American currency loses its status as the guardian of stability and enters the zone of self-preservation. The larger the debt, the more interest is needed to service it. The higher the interest rates, the more inflation is under control.

But the higher the interest rates, the higher the state's tax expenditure on interest. This closes a circle that is reminiscent of the fiscal model of developing countries, where the cost of debt becomes a political problem and not just an accounting item.

In the second quarter of 2025, the US Treasury Department announced a plan to issue $3.4 trillion worth of new bonds by the end of the fiscal year.

Most of these bonds will be placed with domestic and foreign market participants at interest rates of between 4.5 and 5.3 per cent, depending on the term. This means that the USA is borrowing at historically high real interest rates in an environment that no longer favours easing monetary policy.

A new kind of monetary reality

The markets remain confident. Foreign central banks still hold more than USD 7 trillion in US government bonds, and the dollar remains the world's most dominant reserve currency.

However, the ownership structure of US debt is quietly changing. China's share has fallen below 800 billion dollars, the lowest level in two decades. The share of Japanese institutions is also declining, while the portfolios of private hedge funds and funds that aim for high returns but tend to withdraw quickly in times of crisis are growing.

This creates a new kind of volatility. Debt is no longer held for political reasons but for profit. If the dollar is ever perceived as an unsafe currency due to internal fiscal pressures, there can be sudden capital outflows.

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And in this case, the Federal Reserve faces a dilemma for which there is no real solution. On the one hand, it would have to raise interest rates to stem the outflow and protect the dollar. On the other hand, high interest rates further destabilise the budget balance.

In its last statement in June, the Fed clearly emphasised its commitment to fighting inflation, albeit with more cautious forecasts for the pace of interest rate cuts.

Analysts, who had expected three cuts of 25 basis points each at the beginning of the year, now expect only one. The reason for this is not only inflation but also the ever-increasing pressure from Congress, particularly from the Democrats, to bring monetary policy into line with fiscal reality.

In this political context, the dollar becomes a hostage. Not because it is not in demand, but because it no longer reflects the independent balance of the market. Its value depends on the Federal Reserve's willingness to strike a balance between stability and fiscal endurance.

This implies that the US monetary policy no longer operates in a vacuum but rather within a system that is weighed down by its own structural contradictions.

If interest rates fall too quickly, inflation may accelerate again, particularly in areas like rents, credit and services. If they remain high, the cost of debt will enter the political discourse of the 2026 election and trigger a new wave of fiscal populism.

In this case, the Federal Reserve itself could become a political actor, which has so far been taboo in the American institutional framework.

In the medium term, there are only two options. The first is to consolidate public spending, including painful cuts and a possible reform of the tax system. The second is to accept higher inflation as an inevitable part of fiscal easing.

Both paths are politically expensive and financially unpredictable. Neither of them guarantees the preservation of confidence in the dollar as an instrument of global stability.

In this context, the Federal Reserve's current policy is no longer just a technical response to market movements. It is becoming a form of financial management, with monetary instruments that no longer only serve inflation but also government debt. It is a complete reversal of the paradigm on which the system has been based since the Volcker era.

The dollar is still the strongest currency in the world. But for the first time in more than fifty years, its preservation depends not only on the confidence of the markets but also on the ability of the state to manage its own debt. And this is a new kind of monetary reality — one in which nominal strength no longer means sovereignty over the instruments that maintain it.