



June 25, 2026

From: Martin Eichenbaum
To: Canadian Deficit Watchers
Re: HOW CANADA SHOULD PREPARE FOR THE COMING US DEBT BOMB

Should Canadians worry about their governments' debts? Yes, of course they should.

Canada's own public debt is not trivial. Ottawa and the provinces face real fiscal pressures from healthcare, an aging population, defence obligations and weak productivity growth. But Canada's fiscal problem is manageable. So long as policy follows pre-COVID patterns, Canada has time to adjust. The situation is serious, but it is far less dangerous than the one unfolding in the United States.

The US government is running large, persistent "primary deficits" – tax revenues do not even cover regular government expenditures, let alone interest payments. Federal debt is already above 100 percent of GDP and is projected to keep rising.

Without serious fiscal reform, the debt-to-GDP ratio will not merely drift upward – under a variety of plausible assumptions about interest rates and growth, it will rise without bound.

Debt dynamics depend on three forces: The interest rate governments pay on their debt, the economy's growth rate, and the primary balance (taxes minus non-interest spending).

A country can live with high debt if growth is strong, interest rates are low and primary deficits are small. But persistent large primary deficits eventually dominate the equation. Low interest rates help, but they do not repeal the arithmetic.

There is no magic debt threshold at which crisis suddenly strikes. But the more debt a country carries relative to GDP, the greater the risk of a doom loop. At some point, investors worry about sustainability. Borrowing costs rise. Higher interest payments add to deficits. Larger deficits push borrowing costs even higher. Growth falters, revenues fall and fiscal stress intensifies.

This logic applies even to the United States. The world's great appetite for dollars and the depth of US financial markets do reduce the risk of a crisis and give the United States more room to manoeuvre than most countries have. But even the United States is subject to the dictates of fiscal arithmetic.

Could Washington fix its fiscal problem? Yes. But the federal budget is dominated by protected categories such as Social Security, health, defence, interest payments and other mandatory spending.

Stabilizing the debt would require large spending cuts or tax increases or both. Raising taxes to Canadian levels would help, but there is little evidence the US political system could make such changes on the required scale. A temporary tax hike might be possible in the face of an impending crisis but would only buy time to implement more difficult permanent reforms before another crisis.

Canadians may be tempted to treat all this as an American problem. That would be a mistake. Canada cannot be fiscally safe if its largest trading partner and the centre of the global financial system is not.

A US fiscal crisis would affect Canada through several channels.

A sharp recession would reduce Canadian exports. A flight from US dollar assets could raise the value of the loonie relative to the US dollar, hurting exporters. A global recession would depress oil and commodity prices. Sell-offs in US stocks and bonds would hit Canadian banks, pension funds, insurers, and households.

Most dangerous of all, a loss of confidence in US Treasuries could trigger a global liquidity crisis. The result would be a severe Canadian recession, a higher debt-to-GDP ratio and stress on a financial system built on the assumption that US sovereign debt is risk-free.

Canada obviously cannot control US fiscal policy. But it can prepare in several ways.

- As long as interest rates remain reasonable, governments should borrow at longer maturities, reducing rollover risk and buying time if global rates spike.
- Regulators should stop treating US Treasuries as risk-free, and banks, pension funds and insurers should be stress-tested against severe US sovereign stress scenarios.
- Canada should re-examine institutional exposure to the US, including direct holdings of US government debt and indirect exposure through funding markets, collateral, derivatives, subsidiaries, and asset prices.
- The Bank of Canada and other federal authorities should prepare contingency plans for a global liquidity crunch in which the usual safe asset is no longer unquestionably safe.
- Finally, Canada needs to get serious about productivity growth. Higher productivity raises GDP, improves tax capacity, lowers the debt-to-GDP ratio and creates more fiscal room in a crisis. Canada's productivity performance has been weak for too long. Artificial intelligence may help but will not solve the problem on its own.

The United States may yet put its fiscal house in order, and AI-boosted growth could ease the debt burden. It would not be wise to count on that, however.

Canada cannot fully insure itself against a US fiscal crisis. But it can become more resilient – and it should start work on that now.

Martin Eichenbaum is an international fellow of the C.D. Howe Institute and is Charles Moskos Professor of Economics at Northwestern University.

To send a comment or leave feedback, click [here](#).

The views expressed here are those of the author. The C.D. Howe Institute does not take corporate positions on policy matters.

A version of this Memo first appeared in the Financial Post.