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FOCAL POINT

US fiscal profligacy:
How much to worry?

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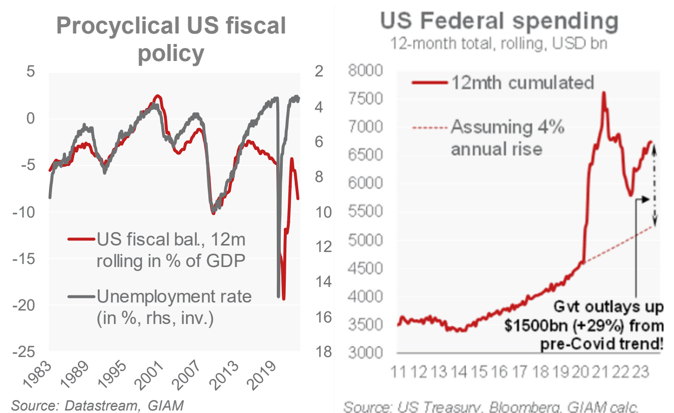
Our Focal Point series explores topical issues on macro, markets and investment

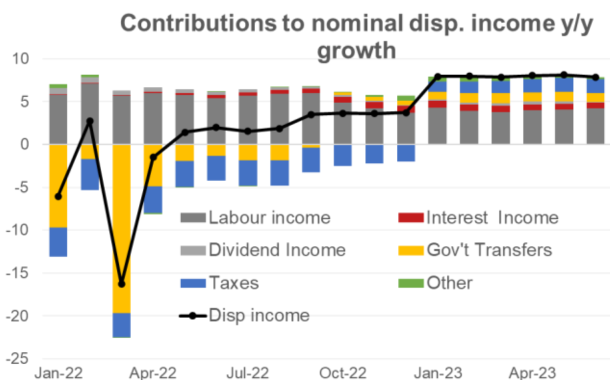
- **After the last-minute deal on the US debt ceiling in May, the recent downgrade by Fitch and a larger-than-expected bond issuance have brought US fiscal concerns back into the spotlight.**
- **The US fiscal deficit has soared to 8.6% of GDP, adding to US growth resilience but undermining the Fed's inflation fight. A polarised Congress and the 2024 elections will prevent a meaningful policy shift. We expect federal debt to rise from just below 100% to 113% of GDP by 2033, only slightly below CBO estimates.**
- **The "exorbitant privilege" of issuing debt in a reserve currency will ensure a high US rating for longer despite worrying fiscal metrics, with a poor handling of future debt ceiling extensions the most prominent risk.**
- **High Treasury net supply will decline only slowly, raising the term premium somewhat further. Yet the yield impact will be largely outweighed by economic and key rate developments.**

The unexpected decision by Fitch to cut the US government top rating to AA+ brought the US' challenging fiscal outlook top of mind. Fiscal policy is highly procyclical Despite unemployment close to record lows, the fiscal deficit soared to 8.6% in Q2 (12 mth. rolling basis), doubling from the same period last year and reaching levels only seen during the Great Financial Crisis over the past decades. Worryingly, fiscal spending has strongly picked up again, remaining US$1.5tr above the pre-pandemic trend (see charts). This has added to pressures on US Treasuries in August, just as the Fed is running off its UST holdings via Quantitative Tightening (QT). Meanwhile, fiscal profligacy threatens to undermine the Fed's inflation fight.

Fiscal expansion bolstered US resilience in H1 as substantially raised social security compensated beneficiaries for inflation. Yet nearly 40% of the budget deterioration is due to low income tax receipts owing to the 2022 drop in asset prices. This affects largely high-income individuals, with a lower propensity to spend. Reduced Fed remittances (as higher rates boost payments to banks' reserves) also boosted the deficit, while a large chunk of



higher interest rate expenses on bonds only partially benefit consumers (with banks and foreigners absorbing a big chunk). Since the beginning of 2023, government transfers



contributed around 1.5% to the 7.5%yoy growth in disposable income, with a slower tax burden helping by another 1%.

According to the independent Congressional Budget Office (CBO), the largely climate related Inflation Reduction Act (IRA) and the CHIPs Act aimed at reshoring IT production will add to deficit by respectively US$ 200 and US$ 80bn over the course of the next ten years. It is some 2.3% of 2022 GDP mostly due to tax credit and other incentives to corporations. This has spurred construction investment by manufacturers, with the contribution to year-on-year GDP growth nearly doubling from H1 2022 to H1 2023 to 0.15%.

Changes in Federal Budget (US$ Bn, Fiscal year to date)

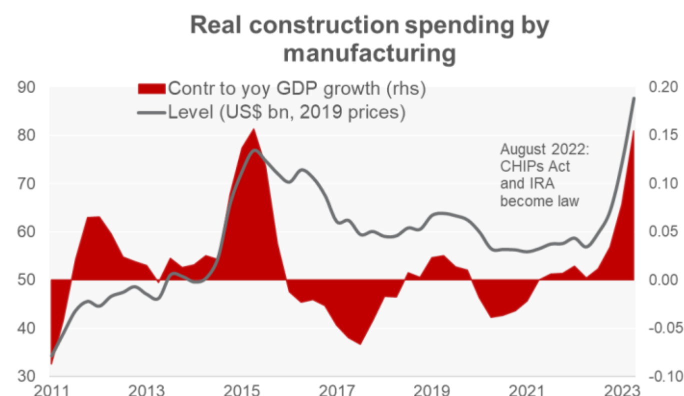
Receipts		Outlays	
Income tax	-326	Interest on debt	133
Fed Remittances	-93	Cost of living adj	101
Other	-85	Medicare/Aid	113
		FDIC (aid to banks)	52
		Other	-25
Total	**-504**	**Total**	**374**

Source: Congressional Budget Office

Overall, this means that the effective impact on growth has been smaller than the high headline numbers suggest. But the procyclical deficit has still be one factor supporting US growth resilience in H1, while jeopardizing the Fed's efforts to tame inflation.

Political impasse boding ill for consolidation needs

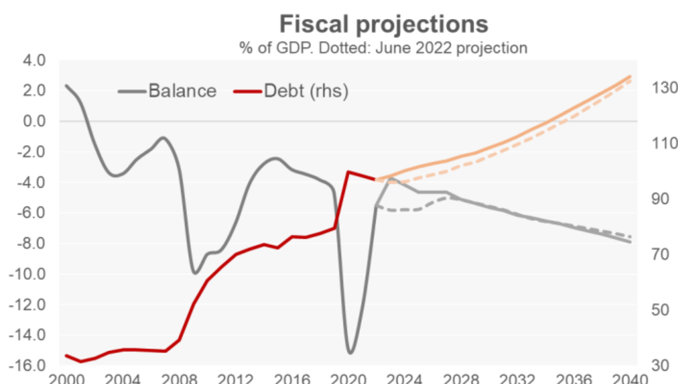
Going forward, the political impasse prevailing in Congress is set to prevent any meaningful change in the fiscal stance. Without the control of the Lower House, the administration cannot implement any significant fiscal measures ahead of the November 2024 election. Meanwhile, Republicans' push



Source:BEA, GIAM

for fiscal discipline is hampered by the same split Congress. Back in May, the compromise on the debt ceiling was reached also as the Republicans asked to spending caps on discretionary spending (around 15% of federal outlays) leaving Biden's flagship projects like the IRA largely unscathed. Yet the Fiscal Responsibility Act agreed in May imposes automatic cuts by 1% in discretionary non-defence spending (vs current fiscal year) if by 1/1/2024 the Congress has not passed spending bills covering the whole year. This would result in cuts to government expenditure worth around 0.2% of GDP. But automatic spending caps are not a guarantee that a government shutdown after the end of the fiscal year (Sep. 30) will be avoided. Lawmakers would at least need to agree on a continuing resolution (a stopgap funding bill that maintains spending levels with past year's).

The system remains fragile given the high uncertainty about the level of spending and the very thin majority the Republicans have in the House. This makes an agreement hinging on some Republican hardliners who are likely to call for deeper spending cuts which the Democrats will strongly oppose. This keeps the risk of a temporary government shutdown into autumn elevated. In the past, such incidences had a relatively small impact on economic activity (only 2% of federal outlays are affected) and a limited and short lasting one on financial market, but remain a source of uncertainty.



Source:CBO, GIAM

Barring any nasty surprise, we expect the deficit to climb from 5.5% of GDP in FY 2022 to 6.5% this year. Afterwards, the decision by the Supreme Court to strike down loans forgiveness and the spending caps will dent discretionary spending a bit. The primary deficit is set to shrink from 3.5% of GDP in 2022 to around 2.5% by 2027 but slowing trend growth and the weight of sticky Medicare and social security expenditure will widen it again thereafter. On top of that, borrowing costs will climb from the 2% of GDP seen in 2022 to around 3.5% by 2033, owing to higher interest rates.

Therefore, the decrease in the federal debt held by the public as a share of GDP (from 102% at the end of 2020 to 96% by YE 2022 thanks to fast nominal growth) will reverse. By 2033 we project the federal debt held by the public to reach 113% of GDP. This is only slightly lower than the latest projection by the independent Congressional Budget Office (CBO) of 115%, due to our mildly higher growth forecast for the medium run. In June, the IMF published its latest assessment on the US economy, in which debt is projected to reach 115.5% of GDP already in 2032. The IMF also warned that in order to "put debt on a downward path by the end of the decade" a primary surplus of 1% of GDP would be required, i.e. an adjustment of near 5 percentage points of GDP. Moreover, the IMF deems this impossible without an increase in income taxes extended to those earning less than US$ 400k or reforming Medicare. But both options look at present politically unfeasible.

Rising debt is complicated by a decreasing Fed's footprint in the market for Treasuries. The Fed started to run off its balance sheet in June 2022, with the reduction currently running at a pace of US$90bn per month. The FOMC refrains from providing a firm guidance but stressed that holdings will be reduced at a "predictable speed" and will be phased out once the Fed balance sheet somewhat exceeds levels deemed "consistent with ample reserves." This could be the case at levels of Treasury and MBS holdings of just below 25% of GDP, i.e. some 3-4 pp higher than the 2014-2019 average, consistent with a more cautious approach on excess liquidity. This means that QT is likely to be phased out toward year-end. The Fed is unlikely to convert into a net buyer of securities again before end-2025, then with the intention to help excess reserves growing in line with nominal GDP. In a companion *Focal Point*, we will provide more details regarding the broader Fed's policy framework and outlook.

The prospect of a steady rise in debt was one of the reasons behind Fitch's recent downgrade of US debt, but the acute trigger was likely what the agency called "erosion of governance": *"The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process."*

US versus high rating developed countries (group medians)

2022 values	AAA	AA+	Germany	US
Curr. Acc % GDP	4.9	-4.2	4.2	-3.6
Gross Debt % GDP*	44.1	34.1	66.5	121.1
projected for 2028	41.6	42.4	59.6	136.2
Prim. bal % GDP	-0.2	-2.7	-2.1	-3.4
Int. Exp.% revenue	0.4	1.3	1.2	6.3

Source: IMF, Fiscal Monitor, April 2023

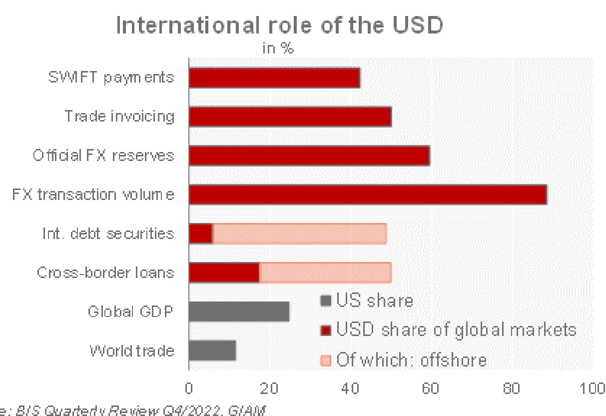
** This measure includes federal and state liabilties and federal obligations to other public entities (e.g. social security)*

Despite being stripped of its AAA rating by two of the top three agencies, the US government debt enjoys a much more favourable standing than the fundamental outlook would suggest. While in 2000 the US budget deficit (both overall and primary) was broadly in line with that of other developed AAA countries, by 2022 it exceeded its peers by almost 3 pp. Moreover, the 2028 gross public debt-to-GDP ratio projected by the IMF is roughly three times the median of other advanced economies with the same S&P rating (AA+). Note that this measure differs from that used by the CBO (federal debt held by the public).

'Exorbitant privilege' to hold for longer

Does the challenging US debt outlook bear the risk of deeper cuts to its rating? This is unlikely as long as the dollar preserves its dominant international role. It is providing the US the "exorbitant privilege" (a term coined by former French finance minister Giscard d'Estaing) to issue cash and safe bonds quite freely thanks to strong international demand. Since a government never needs to default on papers issued in domestic currency, this privilege strongly expands the boundaries of US debt sustainability – and the capability to maintain a very high rating.

Some see this US privilege under threat as the risk of Western sanctions make some EMs scrambling for alternative ways to accumulate reserves and for settling their trade bills. Indeed,



Source: BIS Quarterly Review Q4/2022, GIAM

the USD share in global reserves has fallen over recent years from a peak of 66% in 2015 to 59% early this year.

While anecdotal efforts are discernible among several EMs (notably BRICS), international USD dominance is unlikely to falter any time soon. Most of the cited decline in USD reserves is due to valuation effects as USTs held at central banks cheapened amid the particularly steep rise of US yields (rivalling EUR and GBP holdings similarly suffered, but JPY and CNY did not). Some EMs also have tapped their USD holdings for FX interventions to cushion USD strength in 2022. Others (e.g. Singapore) simply transferred USD reserves into sovereign wealth funds. This means that the declining USD share in reported reserves may much overstate the extent of deliberate diversification out of the greenback.

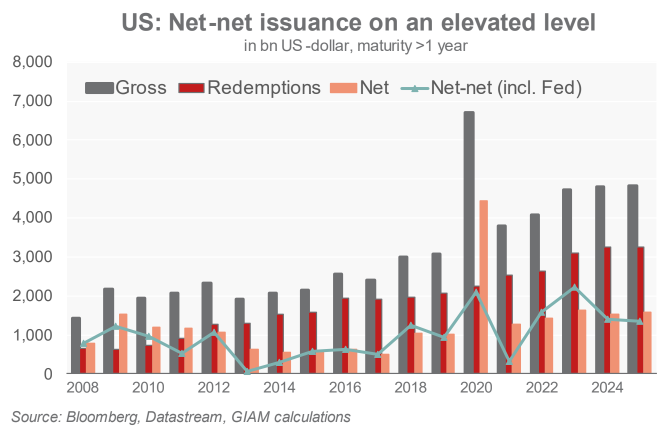
A recent Fed study neither found evidence that geopolitical rivalries have triggered a shunning of US assets. Furthermore, USD dominance goes far beyond FX reserves. It still accounts for the biggest single chunk of SWIFT transactions. About half of global trade is settled in USD. 88% of global daily U$7.5tr FX transactions involve the USD (see chart prev. page). The US remains a powerful and innovative economy, with the depth and liquidity of its capital market unrivalled. This creates powerful inertia via network effects.

Dysfunctional politics are a more direct threat. The next debt limit extension has been pushed into early 2025. But as detailed above, the risk of an accidental technical default – while still small – has risen. The consequences of just a few days of unpaid US bills and coupons would be tremendous for the global financial system, likely triggering a higher risk premium for USTs and intensified global efforts to diversify into alternatives.

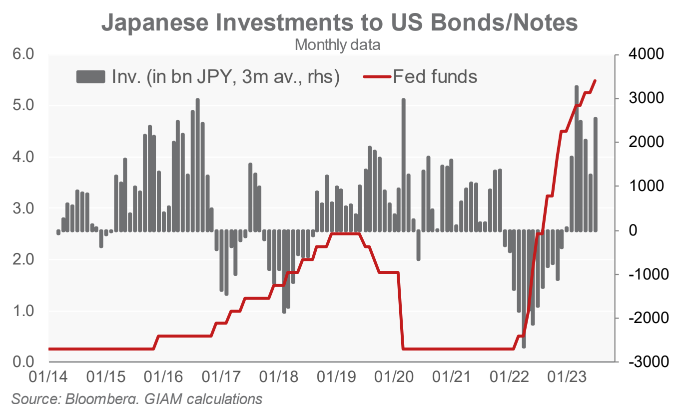
Unfavourable supply/demand mix lifts term premium

The Fitch downgrade and an increase in Treasury auction sizes have weighted on Treasury markets recently. Yet other fundamental factors (including resilient economic data and residual Fed hike risks) were likely the main drivers for the yield increase in August. Comparisons with the 2011 downgrade of the US by S&P are distorted by different monetary policy stances and the smouldering euro area debt crisis at the time which kept safe-haven demand high. Given the absence of liquid alternatives and investment mandates (usually) including no reference to a specific rating level, there has been no forced UST selling.

This is unlikely to change in the foreseeable future. However, the lastingly high fiscal deficit and the increasing debt ratio will keep bond issuance high, raising the term premium. After an extremely high net-net supply (i.e., after subtracting redemptions and Fed's QT) in 2023, there will nevertheless be a slight decline in net-net bond issuance activity in the future, with the Fed's expiring QT programme the main driver. Second, it can be assumed that the Treasury will initially increase the share of bills in outstanding debt (currently 17%) to ease the burden further out the yield curve. Given the high volume of reverse repurchase agreements and the liquid US money market, bills will likely meet sufficient demand. In the wake of the GFC, the share was up to 35% (and during Covid-19 it was up to 25%). Overall, we expect that the net-net government bond supply will fall by more than US$ 800bn to around US$ 1400bn in 2024 due to the two effects and will continue to decline slightly to US$ 1350bn in 2025. Third, not only the absolute bond volume is relevant, but also the duration to be absorbed by the market. Given the rather high current weighted average maturity, the Treasury can take some pressure off the market by issuing short-dated bonds if necessary.



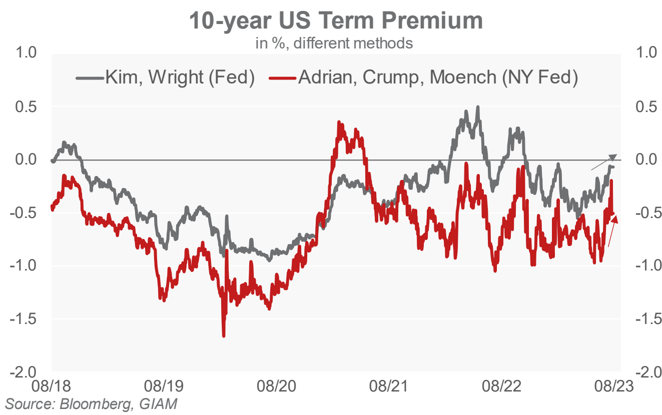
Source: Bloomberg, Datastream, GIAM calculations



Source: Bloomberg, GIAM calculations

Yet weaker demand may also add to the pressure. The tweaking of the YCC by the BoJ dents the appeal of Treasuries for Japanese investors, with portfolio investments representing an important component of demand (see chart below).

Overall, the less favourable supply/demand mix needs to be compensated by a higher term premium. which has already risen by more than 30 bps since mid-July (chart below). However, it is still in negative territory, leaving some further



Source: Bloomberg, GIAM

upside of up to 20 bps by year-end and even further beyond as the period of high bond supply will last for some time.

Notwithstanding this, the dominant drivers of yields remain the economic and monetary policy. Amid the mild US recession, we have in our books for winter and the first key rate cuts by the Fed in Q2 2024, we expect a rather friendly bond market environment going forward. Combined with a higher term premium, we anticipate a bull steepening of the yield curve. On a 12-month horizon, the inversion of the 2-yr/10-yr curve (currently almost 80 bps) is likely to dissipate completely.

Conclusions

The US faces substantial unaddressed fiscal challenges. Yet thanks to the outstanding international role of the USD, poor debt metrics alone are unlikely to erode the US rating further. More worrying, dysfunctional politics and the risk of an accidental default may trigger further rating revisions. Heavy UST pipeline supply points to more upside for the term premium. Yet this more challenging supply/demand balance is dwarfed by a still looming US recession towards year-end and a Fed pivot in 2024 which keeps the medium-term outlook for UST yields still tilted to the downside.

Imprint

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