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GLOBAL ECONOMIC & MARKET OUTLOOK

Eurobank EFG

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Focus Notes

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Risks surrounding the US debt burden

- The US needs a very large fiscal consolidation program, focused on reinforcing medium-term debt sustainability and tailored accordingly so as not to impede the US economic recovery.
- A gradual tightening of fiscal policy resulting in a primary budget deficit of about -2.5% in 2015 and -1.0% by 2021 will lead to a general government debt increase from 100% of GDP in 2011 to about 115% by 2021.
- The political disagreement is fueling investors' uncertainty that the government will fail to reign over public finances. After the meeting between the president and congressional leaders on July 14, S&P concluded that there is an increasing risk of a substantial policy stalemate enduring beyond any near-term agreement to raise the debt ceiling.
- As a result, foreign bondholders could diversify away from investing in the US debt, threatening the US and the global recovery.
- A delay in raising the debt limit would force the Treasury to sharply reduce government spending, giving priority to Treasury interest payments. The implied sharp fiscal contraction would have negative direct economic consequences.
- We believe that this is a low-probability event and expect the Congress to reach agreement at the very last minute under the imminent risk of a government shutdown.

The US general government has been recording over the last couple of years budget deficits that are the largest as a percentage of GDP since 1945 (Figure 1). Consequently, general public debt as a percentage of GDP has surged from 62% in 2007 to 92% in 2010, and is expected to rise further to about 100% in 2011 (Figure 2). Should we take into account debt securities or mortgage-backed securities issued by Fannie Mae and Freddie Mac -the two government-sponsored enterprises (GSEs)-, the US gross general debt held by the public would skyrocket to about 130% of GDP in 2010. The growing debt reflects not only anti-cyclical policies, i.e. higher government spending and lower tax revenues related to the 2007-2009 US recession, but also a discrepancy between revenues and spending that predated the recent recession. Although some of the deficit is cyclical and an economic recovery provides some help for its reduction, most of it is structural[1] and needs to be dealt with fiscal tightening at the state and local level. Given the population aging and the rising cost of health care which will exert pressures to the budget in the long-term[2], the US needs a very large fiscal consolidation program, focused on reinforcing medium-term debt sustainability.

According to our estimates[3], in our baseline scenario, which assumes a gradual tightening of fiscal policy, resulting in a primary budget deficit of about -2.5% in 2015 and -1.0% by 2021, general government debt is projected to rise from an estimated 100% of GDP in 2011 to about 115% by 2021. This would put the US gross general government debt at the same debt level as Greece in 2008. However, if policymakers manage to agree on a more aggressive consolidation program than presumed in our baseline scenario, combining a significant revenue increase with the $1.5-2 trillion spending reduction over ten years that is currently discussed between Democratic and Republican officials (resulting in a primary deficit of about -1.5% in 2015 and a primary budget surplus of about 0.5% by 2021), then general government debt could be reduced by about 7% from current levels. In the worst-case scenario that fiscal consolidation fails (low-probability event), general public debt could soar to 150% of GDP by 2021 (Figure 3).

The divided US government and the lack of bipartisanship are fueling investors' uncertainty that the government will fail to reign over public finances. Negotiations continue between Democrats and Republicans over a debt ceiling increase and accompanying deficit reduction package, as President Barack Obama and congressional leaders did not agree on a resolution to the dispute at the meeting held on July 14. After the meeting, Standard & Poor's -who has already downgraded the outlook for its AAA rating of US debt from "stable" to "negative" on April 18- concluded that there is an increasing risk of a substantial policy stalemate enduring beyond any near-term agreement to raise the debt ceiling, indicating a substantial likelihood of a rating downgrade within the next 3 months. Two days before, Moody's placed the US government bond ratings on review for possible downgrade given the rising possibility that there will be no progress in negotiations to raise the statutory debt limit in the following days.

The US federal government reached its debt ceiling of US$14,294 bn on May 16, 2011. According to the Treasury Secretary Timothy Geithner, the usual measures[4] that have been employed in the past to maneuver around the borrowing limit could be employed by August 2. The debt ceiling applies to almost all federal debt, such as marketable issuance, nonmarketable securities (special State & Local Government Securitities-SLGS), debt that the government owes to itself (trust fund obligations for civil service retirement, social security, Medicare etc.), so manipulations of intragovernmental obligations can create additional room to borrow from the market. Although the Treasury continues to urge Congress to avoid the catastrophic economic and market consequences of a default crisis by raising the statutory debt limit, the key sticking point between Congress and the Administration is taxes: Republicans are demanding massive spending cuts for defense, domestic and entitlement programs, including Medicare and Medicaid, in exchange for their support for raising the debt ceiling, while Democrats push for a more balanced deficit reduction, with a mixture of spending cuts and tax increases. In particular, the White House is proposing to eliminate tax breaks for oil and natural gas companies, raise taxes on investment fund managers and limit deductions for high-income families and small businesses, totalling around $400bn. Shifting from a previous strong opposition to any new revenue in the deficit negotiations, key Republicans in the House of Representatives notified that reductions in certain tax breaks would have to be paired with offsetting tax cuts somewhere else in order to pass muster with the Republican party. The latter have demanded upfront spending cuts that match the requested increase in the debt ceiling, i.e. around $2 trillion increase in Treasury borrowing capacity in order to fund the federal government through the election. However, the Democratic agreement will probably be conditional on increased revenue measures, or else a much smaller amount than $2 trillion will gain actual bipartisan support.

At present, the investment community does not appear to be pricing in any adverse borrowing limit scenarios. This is reflected in the fact that Treasury bond yields are currently at very low levels. But nonetheless, potential risks lie ahead as the debate over raising the debt ceiling continues well three weeks before the Treasury exhausts measures to maneuver around the debt limit. Hence, we should not

[1] See Chairman Ben S. Bernanke's testimony concerning the Economic Outlook and Monetary and Fiscal Policy, Board of directors of the Federal Reserve System, January 7, 2011.
http://www.federalreserve.gov/newsevents/testimony/bernanke20110107a.htm

[2] According to Congressional Budget Office's (CBO) projections (CBO's 2011 Long-Term Budget Outlook, June 2011), if current law remained in place, the aging of population and the rising cost of health care would cause spending on the major mandatory health care programs and Social Security to grow from 10% of GDP today to about 15% of GDP 25 years from now.

[3] For more details, see Appendix below.

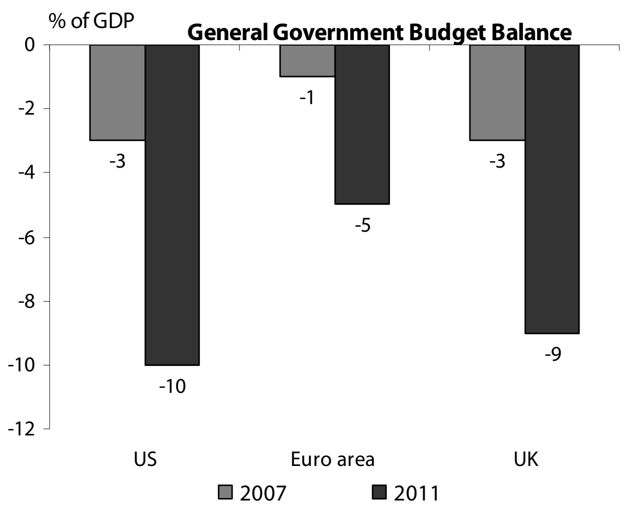
[4] E.g. suspend State & Local Government Securitities (SLGS) issuance, wind down Treasury Supplementary Financing Program (SFP), disinvest all of the G-fund (a money market fund offered to federal government workers), or part of the Civil Service Retirement Fund etc.

ignore the risk that foreign bondholders, concerned about US public finances and political uncertainty, could diversify away from investing in the US debt. In other words, Treasury securities could be seen as riskier and could, therefore, become less attractive. This is very important as foreign investors own more than 50% of the privately held Treasury coupon debt outstanding. As a result, interest rates would rise in the US, not only making it harder for the government to finance budget deficits and sustain debt, but also raising borrowing costs across the US economy, slowing investment spending and private consumption. The US dollar would weaken further, undermining the value of currency reserves around the world. Given that global growth remains highly dependent on US economic activity, slower growth in the US economy could affect global demand, which in turn could offset the positive contribution from the dollar weakness to US exports, creating a vicious cycle of negative implications for the US and the global economy.

Apart from the possibility that investors become nervous, a prolonged delay in raising the debt limit would force the Treasury to sharply reduce government spending, resulting in a rapid deceleration in short-term economic activity. Past experience suggests that, in such a case, government would give priority to Treasury interest payments (and Social Security and Medicare payments) over other spending in order to provide relief to US bondholders, causing a sharp fiscal contraction with negative direct economic consequences. However, we believe that this is a low-probability event and expect the Congress to extend the ceiling before the Treasury runs out of measures to create additional room. Nevertheless, the path to a compromise is very foggy at this point, so Congress may reach agreement at the very last minute under the imminent risk of a government shutdown.

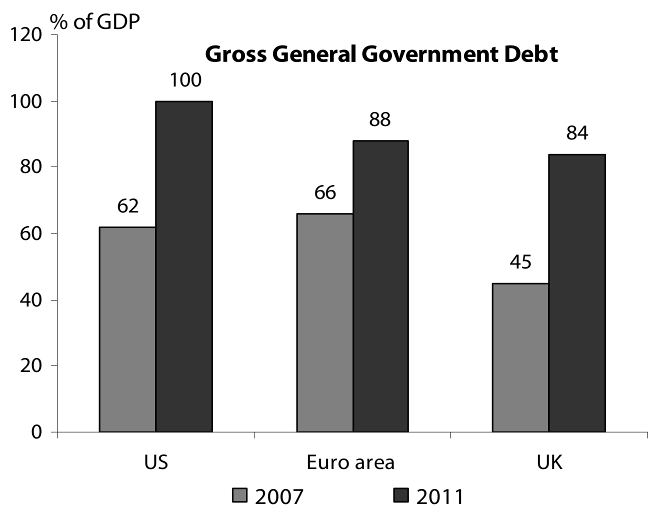
Looking ahead, the market should not overlook a longer-term risk surrounding an eventual fiscal consolidation package to accompany the debt limit, i.e. whether fiscal austerity measures will impede economic recovery. Implementing effective consolidation and reform plans in a fragile US economic recovery will probably prove a real challenge for the US authorities. Given the recent softness of US economic data, fiscal consolidation focused on reinforcing medium-term debt sustainability should be gradual, so as not to curb growth prospects. Should the recent deceleration in the US recovery prove to be more persistent than currently projected, the pace of fiscal consolidation should be tailored accordingly. Furthermore, on the monetary front, eventual Fed tightening over the coming year should be gradual, as an aggressive monetary tightening could result in a rise in bond yields, undermining economic growth and increasing the debt servicing burden.

Figure 1



Source: AMECO, Eurobank EFG estimates

Figure 2



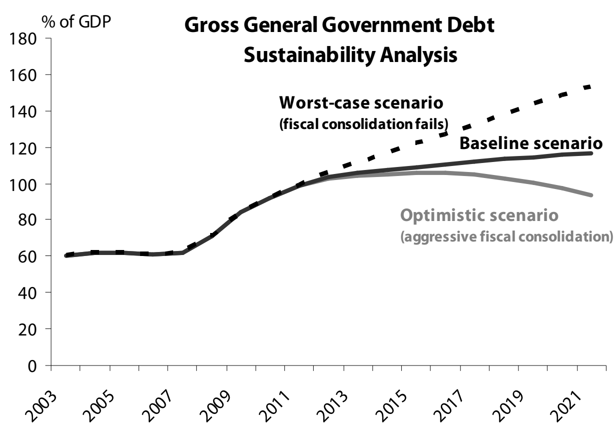
Source: AMECO, Eurobank EFG estimates

Appendix:

A scenario analysis of US general debt over the next ten years

We estimate gross general government debt for the next 10 years using the formula $b_{(t+1)} = b_t + b_t\,(r_{t+1}-g_{t+1}) + def_{(t+1)}$, where b is the debt-to-GDP ratio, r is the real interest rate, i.e. the inflation adjusted interest rate on 10y Treasury notes, g is the real GDP growth rate and def is the primary deficit, i.e. the general government budget deficit after deducting net interest payments (as shares of GDP). Our estimates are based on benchmark economic projections for real interest rates and real GDP growth to account for alternative fiscal adjustment policies, without taking into account the effect of the budgetary changes on the economy. In particular, real interest rates are projected at 0.55% for 2011 and 1.75% for 2012. For the long run, real interest rates are projected to increase gradually to 3% by 2017, and stay stable around 3% up to 2021, which is near the average of the past four decades. We expect a 2.5% real GDP growth rate for 2011 and about 3% for 2012. From 2013 to 2016, real GDP increases by an average of 3.3% per year, close to its long term average in the post war period. From 2017 to 2021, GDP is projected to grow by an average of 3% per year. In our baseline scenario, the primary deficit is projected to decline gradually from -9% of GDP in 2011 to about -2.5% in 2015 and -1% by 2021. In such a case, gross general government debt increases gradually from its already high level to around 115% over a 10-year horizon. However, should policymakers manage to agree on a more aggressive consolidation program than presumed in our baseline scenario, combining significant revenue increases with outlay reductions, resulting in a primary deficit of -1.5% in 2015 and a primary budget surplus of 0.5% by 2021, then general government debt could be reduced to about 93% of GDP. In the worst-case scenario that fiscal consolidation fails, with primary budget deficit still hovering around the high level of -4.5% in 2021, general public debt could surge to roughly 150% of GDP in the following ten years.

Figure 3



Source: Eurobank EFG estimates

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