

# Can the US afford a rocketing public deficit?

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The US government budget deficit will rise sharply in 2009 and 2010. Recession will reduce tax revenue and raise social spending, the incoming Obama administration will implement (expansionary) fiscal measures and the financial sector support package will be costly.

Official borrowing forecasts of \$438 billion in 2009 and \$431 billion in 2010 are optimistic: \$1 trillion in 2009 is possible and 2010 borrowing could be yet higher.

The case for a targeted, temporary, fiscal injection is compelling as monetary policy struggles to gain traction. Fiscal support will help prevent job losses and support economic growth, and the financial system support package will reduce impairments on banks' balance sheets and support lending to the private sector.

An aggressive policy response is essential to short-circuit the negative feedback loop from credit markets to the real economy. The economy is going through a painful adjustment process - policy can help avoid unnecessary undershooting.

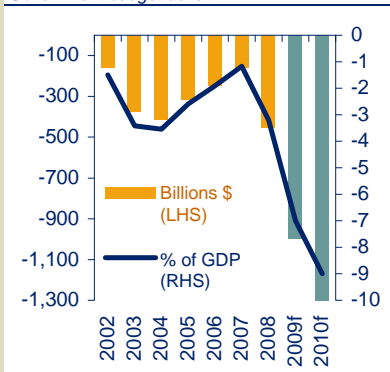
However, financing a larger deficit requires investors to hold much more US debt. Current low interest rates and lack of appetite for risky assets mean the government can issue debt cheaply. But interest rates will rise as the economy recovers meaning that debt-service costs will be a growing burden on public finances.

Moreover, in recession, investment will be weak. As the economy recovers a mammoth budget deficit is likely to drive up the cost of capital for the wider economy. This could potentially crowd out private sector investment and weigh on economic growth.

However, while serious, these are issues for late 2009 at the earliest. The true extent of US borrowing requirements, and the implications for public finances and the economy, will become clearer in coming quarters. In the meantime, the current focus on reflation of the economy is the correct one.

## 1: Budget deficit could explode

Source: Congressional Budget Office, US  
 Government budget deficit



## Concerns over the impact on US public finances

The US government budget deficit will expand substantially in 2009 and 2010. We believe it could reach \$1,000bn in 2009 (7% of GDP) and expand further in 2010 (the European Commission forecasts 9% of GDP in 2010, chart 1). Fiscal stabilisers will kick in as the economy enters recession, such that tax revenue will fall and social security payments will increase. The budget deficit for financial year 2008 (which ended in September) exceeded Congressional Budget Office (CBO) forecasts by \$48bn, or 12%, due to the weakening economy. CBO forecasts for 2009 appear wildly

optimistic. Latest releases assume GDP growth of 1.1% and forecast a budget shortfall of \$438bn, or 3% of GDP.

**We are less optimistic and expect at least a 0.7% contraction in US GDP.** As a rule of thumb, each percentage point decline in GDP leads to at least a \$40bn increase in the budget deficit. In addition, the increase in the Alternative Minimum Tax (AMT) threshold, recently announced and not yet incorporated into the CBO forecast, would add another \$80bn to the shortfall. Before the costs of various financial system bailout packages or additional fiscal stimulus measures are taken into account, we expect a minimum budget deficit in 2009 of \$600bn (4.2% of GDP).

**Additional fiscal stimulus is likely.** Congress can be expected to pass a second stimulus package following the defeat of an earlier package by the Senate in September, and President-elect Obama will follow up with his own policy measures. Mr Obama is expected to introduce a fiscal stimulus to the tune of \$200bn to inflate the economy out of recession, in addition to plans to cut the tax burden for working and middle class families and increase spending on affordable healthcare.

### Can the US afford the financial system bailout?

**The US cannot afford NOT to have the bailout.** Without it the financial crisis would be much deeper and longer and the impact on the real economy more devastating. Table 1 summarises recent measures to stabilise the financial system.

Institution	Amounts committed
Fiscal Stimulus May - July	\$150bn of tax breaks for US households and investment incentives for companies.
Bear Stearns 18 <sup>th</sup> March	\$29bn of central bank loans to JP Morgan Chase. The Treasury is exposed to all losses exceeding \$1bn.
Fannie & Freddie September 7 <sup>th</sup>	Up to \$100bn each in capital injections plus \$5bn for GSE backed bonds and an unlimited liquidity facility. CBO estimate \$25bn cost in 2008-09.
AIG September 16 <sup>th</sup>	\$85bn investment for 80% stake + \$37.8bn loan to increase liquidity in exchange for collateral.
TARP October 2 <sup>nd</sup>	Up to \$700bn to purchase mortgage related assets and equity in banks. \$250bn available for equity purchase in troubled institutions.
Commercial Paper Funding Facility (CPFF)	This programme will purchase commercial paper of 3 month maturity from high-quality issuers to increase access to funding for businesses. This will not enter the budget deficit.

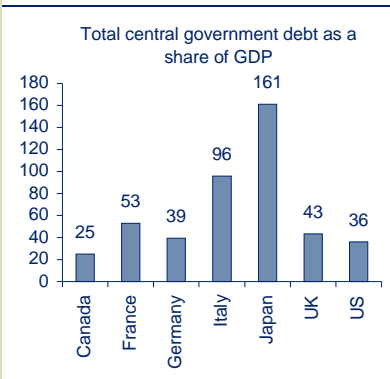
Source: US Congressional Budget Office, US Treasury

The Troubled Assets Rescue Plan (TARP) and the Fannie and Freddie rescue are officially off-budget expenditures and will not inflate the budget deficit *per se*. However, the Treasury will need to raise funds to cover its outlays and this will add to the official government debt. If TARP spending is completely disbursed in the next four quarters as is expected, it will add \$700bn to 2009 financing requirements. Excluding the rollover of existing borrowing, the budget deficit, TARP and GSE financing requirements could reach \$1½ trillion (10% of GDP).

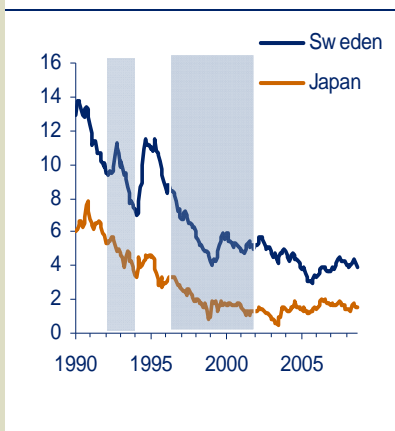
This exaggerates the potential increase. The proceeds from the eventual sale of mortgage assets and equity in financial institutions would be offset against the initial expenditure. It is perfectly feasible for the Treasury to make a profit out of TARP if asset values rebound. The increase in government debt due to TARP would therefore be a lot lower than \$700bn and the overall financing requirement would stay below \$1½ trillion.

### 2: US debt starting from a low base and lower than other G7

Source: OECD, 2007



### 3: 10-year Government Bond Yields (%)



Shaded areas represent period of banking crisis and government intervention. Sweden: Sept 92-94, Japan: 1997-2002

## Lessons from Sweden and Japan

The experience of Sweden and Japan when they faced similar financial crises is instructive. In 1992 large losses in the banking system following the bursting of a property bubble gave rise to a systemic problem in Sweden. This led the Swedish government to guarantee all bank deposits and creditors of the nation's 114 banks in September 1992. The authorities then took equity stakes in various banks in order to recapitalise them.

Sweden spent around four percent of its GDP to rescue ailing banks. But the final cost to Sweden ended up being less than two percent of GDP. Depending on how certain rates of return are calculated, some estimates suggest it was closer to zero. In particular, financial market confidence in Sweden returned after the government's intervention. The Swedish currency depreciated, but there was no run on the Swedish Krona, and the interest the government needed to pay on its debt (i.e. long-term interest rates) fell (chart 3).

Similarly, the Japanese bailout of its financial system between 1997 and 2002, while ultimately more costly to the Japanese taxpayer than the Swedish experience, did not lead to a significant increase in long-term interest rates. Japan spent nearly \$440 billion, mostly from 1998 to 2002, to protect depositors, nationalise the most troubled banks and beef up the capital of other financial institutions. Despite the extra strain on public finances, long-term interest rates remained low.

## The increasing deficit is not without costs or risks

To fund the budget deficit the US government issues debt. The level of issuance is therefore about to explode. A concern is that there may not be sufficient demand for the debt issuance to be completed in full unless the yield on government debt rises significantly.

Foreign central banks have been willing to fund US treasury acquisition from foreign currency reserves as the US has run a growing current account deficit. This has changed. An appreciating dollar and falling US current account deficit (see our paper on [US exports](#)) mean central banks will not accumulate dollar reserves nearly as quickly as they did earlier this decade. The size of the new issuance and reduced level of demand could mean the government will have to offer a higher coupon (interest rate) to entice investors. This has two consequences:

- The government's cost of borrowing increases due to the higher interest rate payable on the new debt. Redeemed existing borrowing will need to be rolled over at higher interest rates, further increasing the cost of debt.
- Companies wishing to raise capital are forced to offer a higher yield than the government as their debt is riskier. The increased cost may make investments unprofitable. Private sector investment could therefore be crowded out by higher public sector borrowing, lowering economic growth in the medium term.

**However, it is more likely that in the current environment the government will have no problem finding buyers for its debt.** Low interest rates, a poor economic outlook and low risk appetite (reflected in the recent flight to the security of government assets), mean investors are happy to purchase government debt without being compensated with higher yields. The recessionary outlook will be sufficient to dissuade corporations from issuing debt for investment anyway, and low interest rates would make the risk premium over government debt manageable if they did. Consequently private sector investment is unlikely to be crowded out and debt servicing costs may not rise substantially in the short term

**In the medium term the picture is bleaker. Problems are likely to emerge in late 2009 to early 2010.** When the economy recovers, the Federal Reserve's benchmark interest rate will rise and risk appetite will return to the market. The interest on the

stock of government debt will increase and this will place a large burden on public finances. Private investment could be crowded out at this time. An increasing share of income will be devoted to debt repayment, fewer funds will be available for investment, which will harm economic growth.

### The benefits outweigh the costs

It is easy to focus on the negatives, but the economy is facing a deep and protracted recession and things would be a lot worse if these measures were not implemented.

- Monetary policy is struggling to gain traction as financial markets remain clogged up and financial institutions unwilling to lend to one another. The economy risks grinding to a halt as liquidity problems turn into insolvency problems. The financial system bailout will put a floor under financial markets, restore regulatory capital to the banking system and allow it to lend again, supporting liquidity in the economy.
- Fiscal stabilisers prevent a recession becoming a depression. Social security benefits support spending in the economy, and can help prevent redundancies from leading to repossessions/foreclosures.
- A fiscal stimulus package does exactly what is says on the tin. An expansionary fiscal policy can support 'malfunctioning' monetary policy and stimulate demand through higher government spending and/or lower taxes.

While serious, the problems of financing increasingly expensive public debt and crowding out private investment are issues for late 2009 at the earliest. The true extent of increased borrowing and the implications for public finances will become clearer in coming quarters. In the meantime, the current focus on reflation of the economy is the correct one.