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US public debt – how big a threat?

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Key points

- America's public debt situation is a major issue for investment markets going forward. Currently it is in worse shape than Spain and Portugal and long-term projections suggest it is on an unsustainable path.
- Inflating its way out of the problem is not an option, so sooner or later significant fiscal austerity is likely in the US. This will probably start next year, though real action is unlikely until 2013. This is all likely to result in a constrained medium-term growth outlook for the US.
- For investors it likely means longer-term downwards pressure on the US dollar (US$), ongoing interest in hedges against a falling US$ such as gold and the Australian dollar (A$), an ongoing source of volatility for investment markets and constrained longer-term returns for US shares compared to shares in emerging countries.

Introduction

The huge US budget deficit and its ballooning public debt is arguably the elephant in the room of global investment markets. Wrangling between Republicans and Democrats about how to cut it is intensifying, the International Monetary Fund (IMF) has been singling out the US for a lack of action and ratings agency Standard and Poor's has put the US' AAA sovereign rating on negative credit watch. Many fear it will be the source of the next crisis or America will inflate its way out of debt or fiscal cutbacks will plunge the US back into recession.

The basic problem

But first let's look at the scale of the problem.

- The budget deficit of the US (covering all levels of government) at around 10.8% of gross domestic product (GDP) this year is well above that for comparable countries, namely the UK (8.6%), Europe (4.4%) and Australia (2.5%). See the table opposite.
- Thanks to the stimulus package late last year, the US will be the only advanced country along with Japan to see its budget deficit worsen this year. However, 2012 will see significant fiscal austerity as global financial crisis stimulus measures expire – amounting to a fiscal cutback of around 2.5% of GDP.
- While not as bad as Greece and Ireland, America's budget deficit and public debt to GDP ratios are worse than Portugal and Spain.
- Its level of net public debt and interest expense is more comparable to AA-rated countries (such as Belgium, Spain, Israel and Japan) than to AAA-rated countries (such as Germany and Australia).
- Based on current policies, America's budget deficit will remain well above comparable countries in five years time and its level of gross public debt to GDP will have risen above the Organisation for Economic Cooperation and Development (OECD) average. Projections by the US Congressional Budget Office on the assumption the Bush-era tax cuts are extended and allowing for ballooning age-related spending see federal gross public debt rising from 62% of GDP in 2010 to 200% of GDP by 2040. This is clearly not sustainable.
- The IMF projects that for the US to reduce its gross public debt to pre-crisis levels of around 60% of GDP by 2030, tax hikes or spending cuts of around 11% of GDP would be required. Factoring in increased spending on social security and health pushes this to 17.5% of GDP. This is well above that required for other OECD countries.
- While some US states (notably California and Illinois) and local governments suffer from excessive debt, the bulk of the deficit and debt is at the federal level. State and local government budget deficits will account for just 1.1% of GDP this year and their gross public debt was around 30% of GDP in 2010 compared to about 62% of GDP at a federal level.
- Roughly 47% of US federal debt is held by foreigners, up from 36% eight years ago, with half of this held by China, Hong Kong and Japan. This contrasts with Japan where less than 5% of debt is held by foreigners. America's status as a net debtor country with a huge budget deficit and a current account deficit imparts a vulnerability not faced by net creditor countries such as Germany and Japan. Japan has been able to sustain its high public debt as it largely borrows from itself.

US compared - budget deficit and debt projections

% GDP	Budget balance				Gross public debt	
	2010	2011	2012	2016	2011	2016
US	**-10.6**	**-10.8**	**-7.5**	**-6.0**	**99.5**	**111.9**
France	-7.0	-5.8	-4.9	-1.5	85.0	84.1
Germany	-3.3	-2.3	-1.5	0.0	80.1	71.9
Greece	-10.5	-7.4	-6.2	-2.1	152.3	145.5
Ireland	-32.4	-10.8	-8.9	-3.8	114.1	121.5
Italy	-4.6	-4.3	-3.5	-2.9	120.3	118.0
Portugal	-9.1	-5.6	-5.5	-5.9	90.6	106.5
Spain	-9.2	-6.2	-5.6	-5.0	63.9	75.9
Euro-zone	-6.0	-4.4	-3.6	-1.8	90.4	89.0
UK	-10.4	-8.6	-6.9	-1.3	83.0	81.3
Canada	-5.5	-4.6	-2.8	0.0	84.2	72.6
Japan	-9.5	-10.0	-8.4	-7.4	229.1	250.5
Australia	-4.6	-2.5	-0.6	0.7	24.1	20.6
OECD	-7.7	-7.1	-5.2	-3.5	101.6	107.3
Emerging countries	-3.8	-2.6	-2.2	-1.2	35.3	30.2

Source: IMF projections, AMP Capital Investors

Ways out for the US

There are potentially three paths the US can take to get its budget deficit and public debt down:

- Print money and inflate out of it by reducing the real value of debt. This is feared by many and partly explains the surge in gold and silver prices as investors look for a hedge against a fall in the real value of the US$. However, it's unlikely to occur. Firstly, much US public spending is linked to inflation

so boosting inflation won't cut the budget deficit. Secondly, it's hard to see the US Federal Reserve (Fed) allowing a sustained rise in inflation and the US Congress is unlikely to agree to the Fed becoming less tolerant of inflation. Finally, if bond investors got wind of sustained higher US inflation, the subsequent rush for the exits would likely result in some sort of crisis. Knowing this, it's hard to see US authorities risking it.

- Grow out of it as occurred after World War II. This would be nice but looks unlikely given slowing labour force growth and increasing age-related expenses.
- Increase taxes and cut spending, just as Europe and the UK started to last year. This is the only way to go. Either the US starts to move over the next two years or investors and ratings agencies will force it on them.

A bit of breathing space

While the statistics above paint the US as being on the way to another Greece, and worse than Spain and Portugal, it probably has a bit more leeway than many fear. Firstly, the US borrows in US dollars and doesn't face the risk of a falling US$ causing a foreign exchange crisis, unlike other countries that borrow in foreign currencies. Secondly, there is a natural demand for US Treasury bonds from investors (to manage their portfolios) and, more importantly, from foreign central banks in the emerging world who are selling their own currencies and buying US dollars as part of an ongoing effort to stop their currencies rising. However, the obvious risk is that if the US doesn't move fast enough to put its fiscal house on to a more sustainable path the patience of foreign investors may wear thin. Pressure for change could also come if central banks in emerging countries stop intervening in their currencies or as the world gradually shifts towards using other currencies than the US$ for trade and finance. It will also come as US economic growth recovers, resulting in more competition for funds pushing up bond yields – this is a more immediate risk given that there are signs credit demand in the US is on the rise. So while the US has a bit of breathing space, aided by a likely fall in the budget deficit next year, this is likely to be limited with pressure to do something likely to rise going forward. Standard and Poor's has effectively given the US two years to act, before undertaking a rating downgrade.

The path to sustainability

Right now the pressure for change in the US political system appears to be stepping up. President Obama recognises the budget deficit needs to be cut substantially and the Republicans who control the House of Representatives in Congress are pressuring him for action as highlighted by the last minute deal to pass the 2011 Budget which resulted in additional (albeit minor) spending cuts. The problem is there is a major difference between Republicans who want to focus on spending cuts and Democrats who want a combination of both spending cuts and tax increases. This pressure is likely to intensify over the next two months with Congress needed to pass an increase in the US Government's debt ceiling. This is due by 16 May, but it appears the US Government can survive until 8 July. No doubt another last minute deal is likely. The most likely outcome is more cuts and constraints on discretionary spending (which amounts to about 18% of spending) in return for defence cuts (which amount to 19% of spending). Given the presidential election next year, it's hard to see any action on entitlements (which cover 57% of spending and mainly cover Medicare, Medicaid and social security). As a result, short of a market panic, action on entitlements is unlikely until after the November 2012 presidential election. This all suggests that 2013 is the likely time for aggressive fiscal austerity in the US.

What are the implications for the US economy?

Fiscal austerity will be a major constraint on US growth over the next few years. The experience of other countries such as Sweden, Finland and the UK over the last few decades, which have undertaken large fiscal cutbacks, provides some confidence the US economy need not be derailed. However, much will depend on whether US households seek to further raise their savings rate and whether net exports provide an offsetting boost to growth. The latter may be difficult given the size of the US economy but may be helped by US$ weakness. The most likely outcome is another year of constrained US growth in 2012 as currently scheduled fiscal austerity partly offsets stronger private sector spending growth. However, there is a risk of a cyclical slowdown in 2013 as fiscal austerity becomes more aggressive. US budget cutbacks are also likely to take pressure off the Fed and may ensure the Fed keeps US interest rates low for much longer than would normally be the case.

Implications for investors

So what does all this mean for investment markets? Firstly, significant fiscal austerity and the associated continuation of low US interest rates on the one hand and the risk of a market panic if the US doesn't act on the other are all long-term negatives for the US$. Secondly, this is all likely to ensure investor demand for US$ hedges, such as gold and commodity currencies like the A$ will remain strong. Thirdly, providing the US doesn't blow up but faces constrained growth – as we think is most likely - then this adds to the relatively favourable medium-term outlook for emerging equity markets (where public debt is generally not an issue) over traditional developed equity markets, once the current inflation scare in the emerging world is brought under control. Finally, while the cyclical recovery in global shares likely has further to run, US public finances are a likely source of periodic scares in financial markets over the next few years – this could flow from brinkmanship in the run-up to the debt ceiling deadline, worries about the size of the cutbacks and/or worries if the budget is not soon put on to a sustainable path. If some sort of crisis ensues forcing a more rapid austerity program in the US, then the economic impact will be greater and this could have an impact on Australia as slower US growth dampens global growth.

Concluding comments

The US budget deficit and public debt problem is probably the most worrying item on the 'worry list' for investors right now. I don't see it as causing an immediate blow-up sufficient to derail the cyclical recovery in global shares and if the impact is limited to constraining US economic growth then the world will muddle through. But it's certainly an issue worth keeping an eye on.

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