

The Sustainability of US Debt (Part One)

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A political deal may have been cobbled together to keep the US government operating until November, but on Monday treasuries kept selling off. As investors game out what the funding deal means for monetary policy, they are unlikely to find succor in the US's poor fiscal outlook.

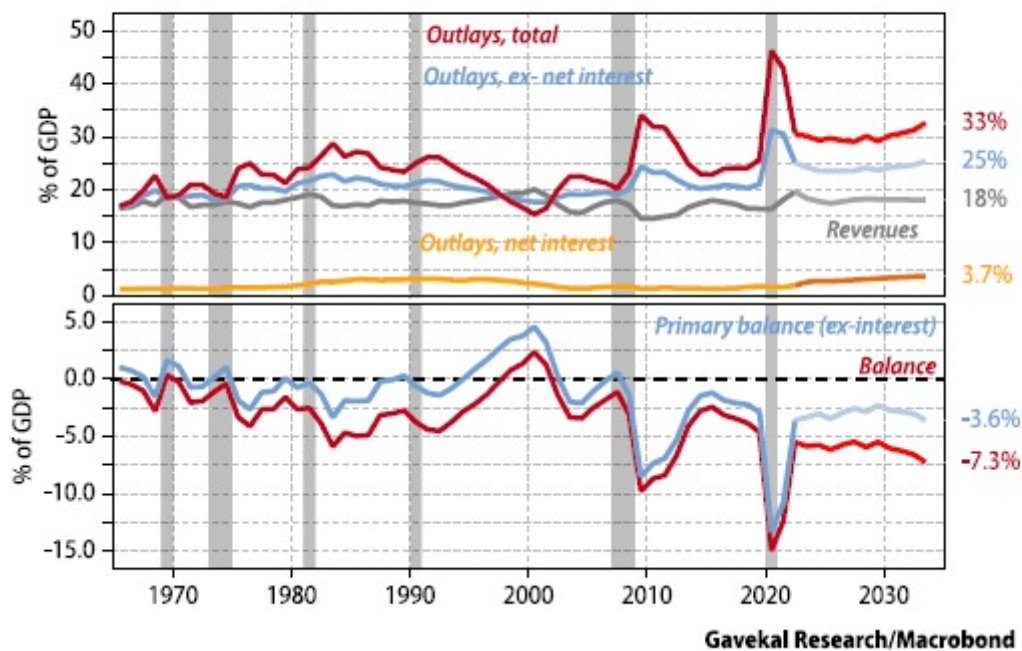
Some analysts blame this fiscal deterioration on past tax cuts, but government revenues have been stable at 15-20% of GDP since the 1960s. Today, revenues are at the high end of that range and not expected to vary much in the next decade. The real issue is rising government outlays, with two types standing out: (i) public pension and health care spending and (ii) interest expenses. With bond yields pushing higher, the second factor is worsening by the day.

As is well known by now, an aging population will increase outlays for Social Security and major health care programs, from 10.9% of GDP this year to 12.6% of GDP in 2033, according to the latest [projections](#) from the Congressional Budget Office. However, with other types of government spending projected (but not guaranteed) to be restrained, the primary balance (excluding interest costs) is expected to be stable at around -3% of GDP for the next decade, give or take 60bp in any given year. That is nothing to be proud of, especially at a time when unemployment is near record lows.

Add in rising interest costs, however, and the overall fiscal outlook becomes downright worrying. Louis has warned of this for a while (see [The Three Prices: An Update On US Treasury Yields](#)), but his concerns have not been a major worry for the broader market. Indeed, the US's total budget deficit (including interest) is projected to run at almost double the primary deficit for the coming years, or around -6% of GDP from today through 2030. It is then projected to blow out to more than -7% by 2033.

Interest costs are projected to add significantly to US budget deficits

US federal budget, % of GDP, including CBO's latest 10-year projections | Shaded grey: US recession

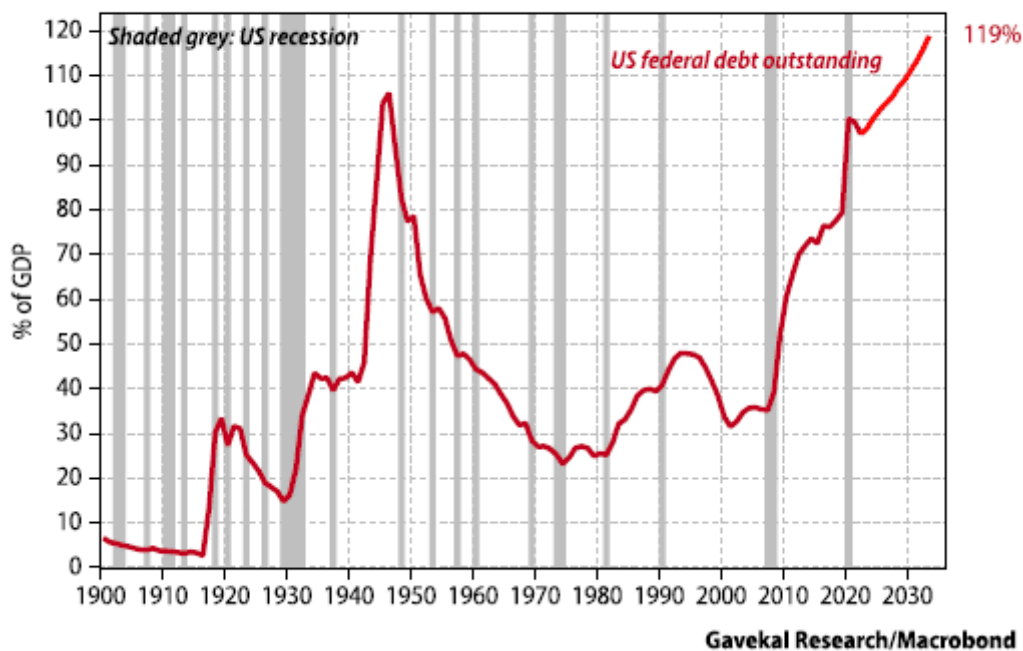


A decade from now, interest expenses are projected to total 3.7% of GDP, exceeding “discretionary” spending on defense (2.8%) and non-defense programs (3.2%). As an aside, it strikes me as odd to call public pension and healthcare programs “mandatory”, while dubbing defense a “discretionary” activity, when a core role of the government is to provide national defense. The real point is that interest costs are becoming one of the biggest components of government outlays, as shown in the chart on the prior page.

Such large and sustained deficits mean that debt will accumulate rapidly, with the CBO projecting a rise in the US's debt-to-GDP ratio from about 100% today to almost 120% in 10 years time. More worryingly, the CBO made these projections in May, when bond yields were some 100bp lower. If yields hold up, or rise further, the next set of projections will be even worse.

Debt will accumulate quickly with such large and persistent deficits

US federal public debt held by the public (including Fed), including CBO projections, % of GDP

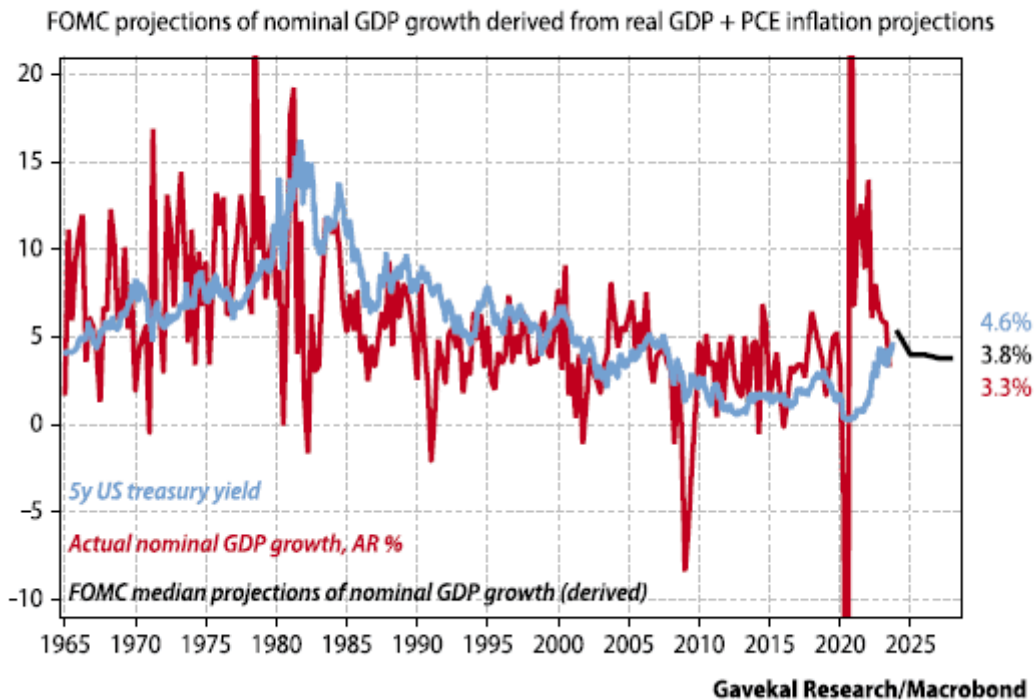


What happens when $r > g$?

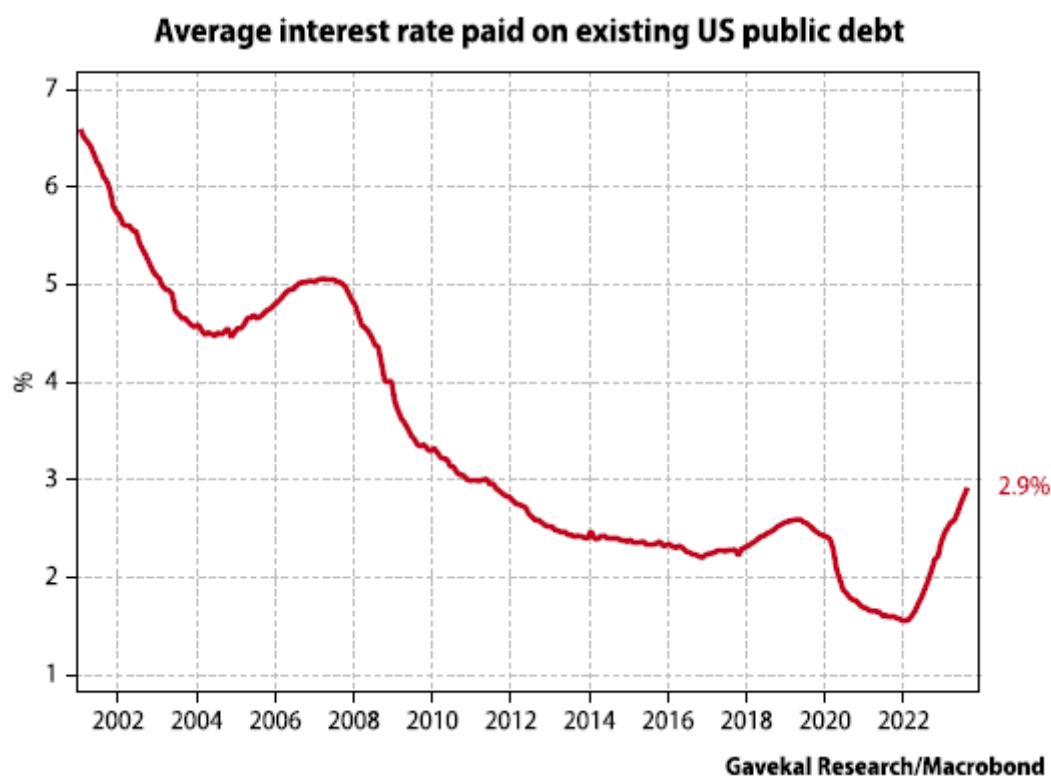
The rise in bond yields is concerning given that it has coincided with a decline in nominal growth rates. When interest rates (r) are above the nominal growth rate (g), interest costs rise relative to GDP. And if that interest is financed with additional debt, interest alone will increase the debt-to-GDP ratio, even if the primary budget is balanced. Add in a primary budget deficit, and the outlook gets worse still. Absent a change of policy, on current trends for interest rates and nominal growth such a “debt trap” dynamic seems set to play out.

This situation marks a change of circumstances, since most of the pandemic period saw low interest rates and high nominal GDP growth ($r < g$). Budget deficits blew out due to large-scale primary deficit spending, even as benign interest rate dynamics kept the debt sustainable. In recent months, however, nominal GDP growth has slowed while yields have risen, such that rates now exceed nominal growth ($r > g$). (Five-year treasury yields are used in the chart overleaf because the average maturity of outstanding treasuries has ranged from 4-6 years since the 1990s).

US bond yields are no longer below nominal GDP growth



Actual interest rates paid by the US government will rise gradually as it issues new debt to refinance maturing debt, pay interest on existing debt, and finance ongoing primary deficits. But it won't be *too* gradual given the scale of primary deficits ahead, the fact that the average maturity on existing debt is not that long, and given significant exposure to short-term rates (either directly, or via the Federal Reserve, which has kindly converted a bunch of US bonds into zero-duration, interest-bearing liabilities of the consolidated government—more on this in part two). The bottom line is that while there is a lag, rising market rates will eventually translate into higher interest rates paid on government debt—as is already starting to happen (see chart below). And that will raise more questions about the sustainability of US debt.



The US's fiscal outlook will vary if the recent trend of rising nominal interest rates and slowing nominal growth continues apace. Consider three scenarios:

1. **$r > g$** : interest rates continue to rise, while nominal growth continues to slow, widening the gap between r and g . In this scenario, interest costs per unit of GDP will rise sharply. In turn, this makes the already worrying outlook for deficits and debt, relative to GDP, much worse.
2. **$r = g$** : it is possible that what the chart on the prior page shows is both a normalization and convergence of interest rates and also nominal growth. Having normalized, both variables could now fluctuate around similar rates—as has been the case historically. This dynamic is not as favorable to public finances as that of the past few years (when $r < g$), but it is better than scenario #1. In such a case, the debt-to-GDP ratio will still rise—assuming primary deficit spending continues—but the link between r and g will not make it worse.
3. **$r < g$** : this amounts to a reversal in one or both of the recent trends, with interest rates rolling over and/or nominal growth rebounding. This would be a return to the dynamics of recent years and a welcome development for fans of government spending. While that does not include me, the former chief economist of the International Monetary Fund, Olivier Blanchard, is betting on this scenario. He thinks “secular stagnation” will soon return, characterized by low rates of nominal growth but even lower nominal interest rates (so $r < g$). If so, the fiscal outlook, in terms of debt-to-GDP, will at least marginally improve, even without any improvements to the primary balance (his January 2023 book, [Fiscal Policy Under Low Interest Rates](#), already seems dated, but remains an interesting read).

Whatever scenario unfolds, the fiscal outlook will be poor due to ongoing primary deficits. But interest rates will put more pressure on the government to act, should scenario #1—or even scenario #2—prevail.

What can the US government do?

With debt funding becoming increasingly costly, how will the US government respond, if at all? There are a few options:

1. Raise taxes? While the government may try to raise tax rates—e.g., on the wealthy or on corporations—this may not boost revenues. After all, despite US tax rates being adjusted many times over the years (with thousands of pages added to the code), US tax revenue has since the 1960s varied within a stable range of 15-20% of GDP (see the chart on page 1).
2. Cut spending? This could occur by reforming Social Security or health care programs. It could come from cost-saving technological breakthroughs (e.g., in health care). Or it could take the form of cuts to discretionary spending, in defense or non-defense categories. Quite likely, some combination of all such spending cuts will eventually be required. However, given the political obstacles to cutting spending aggressively, this is likely to be only part of the solution.
3. Force regulated entities to buy more Treasury debt? The government is already doing this. Indeed, after three of the largest bank failures in US history earlier this year, the government did not let a good crisis go to waste. It quickly got to work raising capital requirements, which amounts to forcing banks to hold more “risk-free” treasury securities. Justified or not, it is convenient. This is also likely to be part of the solution.
4. Rely on the Fed to monetize the debt? This is more limited in scope than is generally perceived—at least given current economic and financial conditions and the Fed’s existing monetary policy framework. However, conditions change and so can policy frameworks. As such, I’ll explore in depth the viability of this option in part-two of this series on US debt sustainability.

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