A COSTLY RECESSION
The recession and the rescue of financial institutions have cost the U.S. federal government dearly, particularly since its budget situation was very fragile to begin with. In the space of eight years, public finances have deteriorated under the strain of the wars in Iraq and Afghanistan, the tax cuts in 2001 and 2003, and the rising cost of social programs. Ten years ago, the federal government recorded a budget surplus of US$236B, and its outstanding debt was equivalent to 35.1% of GDP. The 2009 tax year wound up with a deficit of US$1,413B and a debt reaching US$7,544B, or 53% of GDP. The 2009 tax year wound up with a deficit of US$1,413B and a debt reaching US$7,544B, or 53% of GDP1.

This deterioration is far from over, and it will grow during the current budget year which, according to the Obama administration’s proposal, should show a deficit of US$1,556B (10.6% of GDP) and a debt of US$9,298B (63.6% of GDP). Once again, the impact of the economic and financial crisis and the government’s response to limit the economic consequences continues to make itself felt. The Congressional Budget Office, a non-partisan body of Congress, estimates the cost of the recovery plan that Obama brought in one year ago at US$200B for the 2009 fiscal year and at US$404B for the current year. The Troubled Asset Relief Program (TARP), adopted to rescue the financial institutions, cost US$150B last year, although this is offset by the inflow of US$95B this year (refunded by some of the banks, including costs plus interest). Finally, the Obama administration’s new proposals to foster job creation, if they are adopted, would cost US$98B in 2010 and US$147B in 2011.

A DEBT THAT IS FINDING TAKERS
So far, the outpouring of government securities onto the financial markets has gone fairly smoothly. Since 2000, a good portion of the public debt has been finding takers among international investors, in particular in emerging countries (especially China and the oil-exporting countries) which were experiencing an abundance of savings during this period. During the crisis, the swelling public debt found rising demand for safe-haven securities from both local and foreign investors. According to the capital flow data calculated by the Federal Reserve (Fed), the US$1,743B increase in Treasuries over the past year (that is, from the third quarter of 2008 to the third quarter of 2009, to be precise) was financed nearly 55% by domestic demand and 45% by the rest of the world (table 1 on page 2).

As long as demand meets the supply of government debt, the U.S. federal government’s financial situation will remain manageable and the cost of financing that debt will stay low.

1 The U.S. debt referred to in this Economic Viewpoint is the debt held by the public, that is, a sort of net debt which excludes the debt owned by federal government accounts. In comparison, the gross debt amounted to US$11,876B in 2009, or 83% of GDP. Data used for comparison with other countries, such as those of the OECD, use the gross debt.

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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It should be noted that competition in the debt market is currently anemic. While economic activity remains fairly weak, private sector financing requirements are timid (graph 1). Actually, this is what usually happens after a banking crisis or a recession: private-sector deleveraging is replaced with public-sector indebtedness (graph 2). Indeed, this cyclical indebtedness is necessary if we want governments to participate vigorously in recovery efforts. The recent actions of the Bush and Obama administrations, including the recovery plans and rescue efforts for the financial sector, prevented an even more drastic deterioration of economic activity and of financial markets. Attempting to keep public finances balanced in such circumstances (including a reversal of the cost of natural economic stabilizers such as unemployment insurance and declining tax revenues) would have pushed the economy into a deeper recession, even a depression, as occurred in the 1930s.

In the short term, Treasuries will still have no trouble finding buyers locally. Households, suffering from a high unemployment rate and precarious personal finances, will remain cautious over the next few quarters. Given the pace at which consumer credit is contracting, consumers have clearly resolved to get their balance sheets into shape, and this process should continue for several years. Judging by the experience of past crises, this should result in a reallocation of household portfolios towards quality securities (graph 3 on page 3).

It should also be noted that, as far as foreign investors are concerned, the overall American debt (public and private sectors combined) is not growing by leaps and bounds (graph 4 on page 3). Thus, despite the sharp deterioration in public finances, the need for foreign financing for the American economy as a whole has changed very little, and the current account deficit, in relation to GDP, stands at a lower level than it did the first decade of the new century (graph 5 on page 3). This situation goes a long way towards eliminating any downward pressure that might be put on the U.S. dollar, despite all the debate about public indebtedness.

### Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Total liabilities</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Level</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>5,099.2</td>
<td>5,299.1</td>
<td>5,250.6</td>
<td>5,777.5</td>
<td>6,338.2</td>
<td>7,143.1</td>
<td>7,520.8</td>
<td>1,743.3</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>5,177.5</td>
<td>5,374.1</td>
<td>5,326.9</td>
<td>5,853.7</td>
<td>6,418.2</td>
<td>7,234.1</td>
<td>7,610.8</td>
<td>1,800.7</td>
<td>101.3</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>5,250.6</td>
<td>5,447.1</td>
<td>5,399.7</td>
<td>5,926.9</td>
<td>6,491.8</td>
<td>7,307.1</td>
<td>7,683.9</td>
<td>1,858.3</td>
<td>102.7</td>
<td></td>
</tr>
</tbody>
</table>

* Including money market mutual funds, mutual funds, close-end funds, exchange-traded funds, government-sponsored enterprises, ABS issuers, brokers and dealers.

Sources: Federal Reserve Board and Desjardins, Economic Studies

### Graph 1

- It is still difficult to find quality securities other than those issued by the Treasury in the United States

### Graph 2

- Public indebtedness is offset by a surplus in the private sector (savings less investment)

* Statistical error is included in the inflow of foreign capital.

Sources: Federal Reserve Board and Desjardins, Economic Studies
A RISK IN THE MEDIUM AND LONG TERMS

Thus the cyclical increase in public debt in periods of economic and financial crisis is normal and, to a certain point, desirable. The absence of upward pressure on interest rates in the bond market is evidence of this. However, there is more to be worried about if there is no foreseeable correction of the fiscal situation within the medium or long term. In this respect, the American position raises far greater concern. The Obama administration’s proposed budget anticipates that the country’s public debt will increase by US$8,532B between now and 2020. In other words, the debt issued on the markets should double. In proportion to GDP, the expected increase is a bit less; the debt would rise from 53% to 77% of GDP (graph 6).

Naturally, the bulk of this deterioration should happen in the very short term. The expected deficits from 2011 onwards, especially after 2013, are far more modest than those of 2009 and 2010 (graph 7 on page 5). However, we note that the United States will not manage to restore balance to its public finances, despite fairly optimistic forecasts about economic growth (see box on page 4).

TIMID EFFORTS TO PUT THINGS BACK ON COURSE

The Obama administration seems to be aware of the problem that the budget situation and indebtedness could cause in the medium and long terms. In his recent state-of-the-union address, the President declared:

“If we don’t take meaningful steps to rein in our debt, it could damage our markets, increase the cost of borrowing, and jeopardize our recovery – all of which would have an even worse effect on our job growth and family incomes”.

Unfortunately, it seems that the administration’s intentions are not always manifested in concrete solutions. The announced freeze on discretionary spending not linked to security is a step in the right direction, as is the recommendation that Congress adopt fiscally neutral (pay-as-you-go) legislation. But these measures are not enough to eliminate a deficit that is way beyond US$1,000B. For one thing, discretionary spending is relatively modest compared to the weight of social and defense programs (graph 10 on page 5). For another, the proposed cuts to 126 programs will save a mere US$23B in 2011—a drop of water in the ocean. Some tax increases, in particular the expiry of cuts introduced in 2001 and 2003 for more affluent households, and the new tax imposed on the big banks to refund the TARP, are encouraging. However, the extra revenues to be generated seem to be quickly swallowed up by new initiatives.

Among other things, we must not count on households to carry the ball. Given the small rise in income (apart from transfer payments from government programs), the negative wealth effect associated with dwindling house prices and the banks’ reluctance to grant credit, consumer spending will probably be below the average of the past few years (graph 9).

Secondly, we must keep in mind that the budgets that the White House presents are hardly ever adopted “as is”. The President proposes, but it is Congress that decides. For example, the budget that was presented just recently includes expenses associated with health care reform. At present, Congress has not agreed to this reform, and the President’s budget items pertaining to it are likely to be quickly set aside. The same holds true for certain other items in the proposed budget, such as new job creation initiatives and the partial expiry (for households earning more than $250,000) of the tax breaks introduced by the Bush administration in 2001 and 2003. Given that 2010 is an election year (in which all the representatives and one third of the senators must stand for election), common ground will be hard to find.

Graph 8 – Relatively strong economic growth expected

Graph 9 – Continuing clean-up of lending practices will lead to a decrease in consumer spending

Box
Very uncertain forecasts

The Obama administration’s forecasts are based on certain assumptions that might not be realized, with the result that the financial situation could turn out to be even worse... or better.

Firstly, the underlying economic forecasts inject a fair amount of uncertainty into any budget exercise. The annual increases in real GDP anticipated for the years 2011 through 2014 are around 4% (graph 8). While not entirely in left field, those forecasts strike us as quite optimistic for an economy that is emerging from such a drastic crisis and that should experience a potential rate of GDP growth somewhat weaker than what was prevailing before the crisis.

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Unfortunately, it seems that the administration’s intentions are not always manifested in concrete solutions. The announced freeze on discretionary spending not linked to security is a step in the right direction, as is the recommendation that Congress adopt fiscally neutral (pay-as-you-go) legislation. But these measures are not enough to eliminate a deficit that is way beyond US$1,000B. For one thing, discretionary spending is relatively modest compared...
To make a real effort to rebalance public finances, it will be necessary to look farther down the road and, more important, to show political courage. To help him in this endeavour, President Obama hopes to set up a bipartisan tax commission. Its terms of reference would be to introduce measures designed to balance the budget (excluding debt servicing) by 2015. Congress has already refused to support such a commission, but the President seems to want to go ahead with it nevertheless. Time will tell whether this effort will bear fruit.

Fortunately, the United States is and will remain in a favourable position with respect to the available tax base (the potential for raising income and other taxes), both from a historical point of view (graph 11) and compared to the other industrialized countries (graph 12).2 In addition, productivity and population growth are still favourable for the American economy and, contrary to other countries, will contribute to potential GDP growth. These factors will make it easier to finance public spending, including debt servicing.

THE DEBT: A SOURCE OF UNCERTAINTY FOR THE MARKETS

The reason why it has been easy to finance the American debt in recent years—that is to say, at low interest rates—is that the demand has always managed to meet the growing debt in recent years—that is to say, at low interest rates. Unfortunately, we cannot predict that this demand will always be able to keep up with the expanding outstanding debt when matured securities are renewed. Accordingly, given the anticipated requirements, we cannot be sure of low financing costs. Our estimates, based on forecasts of economic growth and inflation and on trends in government indebtedness, show that interest rates for the medium and long terms will inevitably be subjected to upward pressure linked to increased indebtedness in an environment of economic recovery (graph 13 on page 6). This could prove

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2 For example, if the United States managed to increase its revenues in proportion to GDP to the same level that prevails in the Euro zone, it would (all other things being equal) have more than US$1,500B per year extra to play with. This would enable it to quickly balance the budget and start paying down the debt. However, this does not take into account the harmful effects of a sharp increase in taxes on economic activity.

Another solution that is sometimes put forward is the introduction of a federal sales tax on goods and services. A quick calculation shows (all other things being equal) that the adoption of a 5% tax on approximately three quarters of spending on goods and services would generate approximately US$375B per year.
quite costly for debt servicing, which until now has been quite inexpensive (graph 14).

Moreover, we cannot be certain that foreigners will be willing to finance the United States indefinitely. Already, we observe a tendency towards increased diversification of international reserves on the part of central banks, moving away from U.S. dollar assets. In addition, it is far from certain that in the long term, investors will want to keep accumulating federal securities when other investment opportunities start presenting themselves as the economic recovery gathers steam.

We should mention, however, that the risk of default on the U.S. sovereign debt appears to us to be practically nil. Some credit rating agencies are threatening to lower their rating for the U.S. if its budget situation is not improved, sooner or later. However, these seem to be idle threats, since American federal bonds continue to stand as the benchmark of the global bond market. Thanks to the high liquidity of the American debt, its safe-haven quality and the standing of the U.S. dollar in world trade and finance, the preferred status of U.S. bonds has yet to be called into question. Keep in mind that when the epicentre of the financial crisis was in the United States, U.S. federal bonds remained the preferred asset for all risk-averse investors. Until some other type of asset steps in to fill this role, a credit rating reduction strikes us as inappropriate. Moreover, since the American debt is entirely in U.S. dollars, and the United States controls its own monetary policy, attacks by foreign investors on the value of the currency or of the debt are highly unlikely. Finally, as a last resort and in extreme circumstances, the debt could always be financed by means of monetization on the part of the Federal Reserve; this would certainly generate inflation, but it would prevent a default on payment.

Nevertheless, the government debt is likely to haunt the American economy. While a major crisis may be avoided, the financial markets could be in for a bumpy ride. This burden could also undermine the major influence that the United States wields in the world economic order. Europe and its common currency could become alternative solutions to U.S. hegemony... although that region is also facing numerous problems.