



INTERNATIONAL

Who will buy U.S. debt if it shoots up?

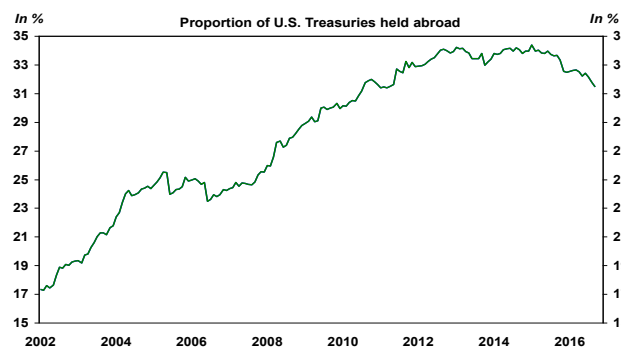
If Donald Trump keeps his promises and cuts taxes as well as increase military and infrastructure spending, U.S. public debt could increase rapidly in the next few years. Failing a concomitant increase in demand for new bonds, yields would have to go up further to attract buyers. This would add to other factors driving rates up, such as higher inflation expectations and an increased risk of insolvency.

The U.S. government has usually had an easy time selling its debt. Since the start of the 2000s, foreign demand has been especially strong. The proportion of debt held by foreigners went from around 17% in 2002 to nearly 35% in 2012. However, this share has crested and even started to decline recently. One of the explanations for the shift is that China is now cutting back on its foreign asset reserves; previously, it was growing them quickly. U.S. securities make up a large proportion of these reserves. The drop in oil prices has also been blamed, as many countries now have to dig into their foreign asset reserves to offset the decline in their oil income or support their respective currencies.

Other foreign buyers could take up the slack, but the potential still seems limited without major players like China and the big oil exporting nations. We also have to consider that Donald Trump plans to apply protectionist measures to improve the U.S. trade balance. However, capital flows and trade flows are intertwined. If the new U.S. administration manages to reduce the country's trade deficit, this will mean it has also reduced the influx of foreign capital.

The context could therefore require much stronger national demand for U.S. Treasuries. During the years it was expanding its balance sheet, the Federal Reserve was a major buyer, but those days are over given the onset of monetary firming. To compensate for an increase in public debt, U.S. businesses and households will have to respond by reducing the pace of investment and increasing savings. In economics, this phenomenon is called a crowding-out effect.

U.S. debt is not selling as much abroad



Sources: Datastream and Desjardins, Economic Studies



Implications: There is no real reason to worry about buyers being there if U.S. bond issuances increase sharply. However, there is reason to worry about the increase in yields that would be needed to draw these buyers, and the impacts that will have on investment and consumption. Without protectionist measures, we could think that foreign demand would absorb some of the U.S.'s additional financial needs, but that might not be the case. In the end, the beneficial impact of the measures promised by Trump could be curbed by more subdued investment growth. Consumption could benefit from tax cuts, but the increase in savings would wipe out some of that impact.

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