



MACRO STRATEGY

The Final Countdown?

Ballooning Treasury Issuance and The Rising U.S. Debt

November 30, 2023

Key Takeaways:

- U.S. publicly held debt is on an alarming path.
- In every scenario that we examine, publicly held debt rises – up to 139% of GDP by 2029.
- Annual net issuance is expected to remain four times as high as before the pandemic, raising questions about how easily markets can absorb the issuance.
- Debt metrics are poor and projected to worsen; U.S. debt-to-GDP is far worse than Fitch's AA-rated median and its interest-to-revenue ratio of over 10% is more akin to a BBB-rated country.
- The probability of further downgrades and outlook revisions will increase significantly if drastic fiscal action is not taken.

A Precarious Fiscal Situation

The United States faces a challenging fiscal outlook. A rising primary deficit (the deficit excluding interest payments) and rising interest rates are projected to push federal debt held by the public to the highest levels in the country's history, easily surpassing levels reached during World War II. Even if discretionary spending is reduced, fiscal pressure may remain high in the longer term as an aging population and rising healthcare costs increase spending in "mandatory" programs like Social Security and Medicare.

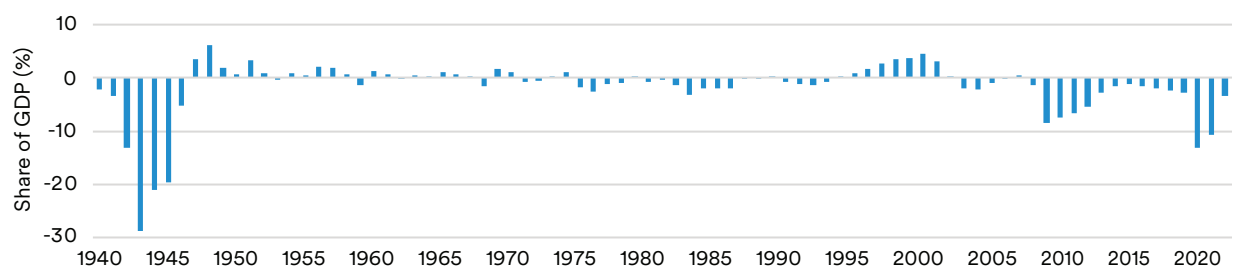
Between the years 1940 and 2007, Congressional Budget Office (CBO) data show the U.S. had an average primary deficit of 1.1% and an average total deficit of 2.9%. Since 2008, these have ballooned: the primary deficit has averaged 4.7% (3.6% if two pandemic years are excluded), and the total deficit averaged 6.2% (5.1% excluding pandemic). The country's total debt-to-GDP reached 113% in 2022. While Moody's still rates the U.S. as AAA, Fitch recently downgraded the U.S. to AA and even then, the median Fitch AA-rated country had a debt-to-GDP ratio of just 49% (Table 1).

While these trends are a risk for the U.S. economy, especially given increased scrutiny over the government's budgeting process, they also have an impact on the global financial system, given the international role of the U.S. dollar and, relatedly, the Treasury market. A loss of confidence in the U.S. creditworthiness could impact investor preferences for U.S. Treasuries, leading to higher borrowing costs for the U.S. government and the private sector, as well as for other countries that rely on the U.S. dollar for trade and financing. Moreover, further downgrades could accelerate the diversification of central bank reserves and undermine the status of the U.S. dollar as the world's reserve currency, reducing the demand for U.S. assets and increasing exchange rate and interest rate volatility. Ever rising debt issuance could also crowd out other investments, and investors may demand higher yields to absorb the growing supply of U.S. Treasuries. These effects could in turn exacerbate the economic and fiscal challenges facing the country, creating a spiral that may be hard to control.

Stable Revenue, Growing Outlays

The U.S.' primary deficit fluctuates significantly from year to year (Chart 1), but this variation obscures a core point that, over time, revenues as a share of nominal GDP have stayed relatively stable while outlays have fluctuated (i.e., increased).

Chart 1 | Primary Deficits Vary Over Time



Source: CBO, MIM

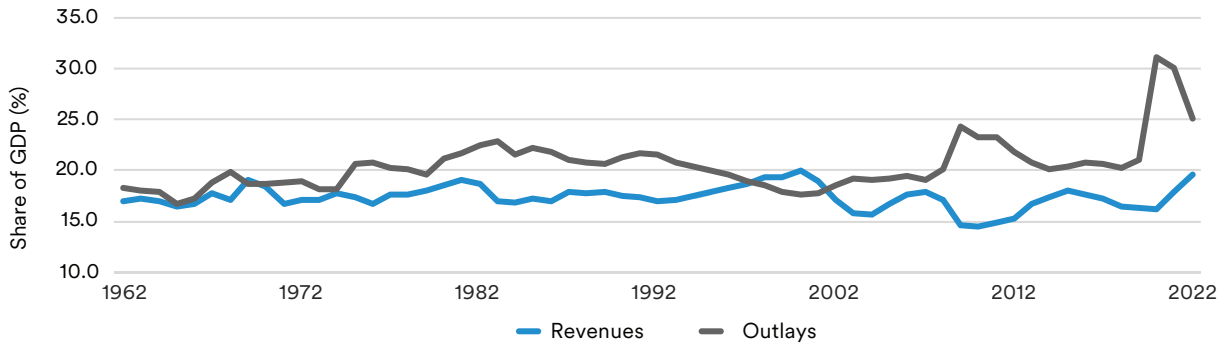
Figure 1 | Top Fitch AA-Rated Countries by Gross D/GDP in 2022

Country	Debt to GDP
United States	112.5%
France	111.8%
Belgium	105.1%
United Kingdom	101.0%
Canada	100.2%
Austria	78.5%
Finland	72.9%
Hong Kong	53.0%
Korea	49.4%
Fitch AA Median	49.4%

Source: Fitch Ratings

CBO data show that from 1963 to 2022, government revenue averaged 17.4% of nominal GDP, with a standard deviation of just 1.1%. Revenue does decline in a recession; it fell to 14.6% in 2009. It also increases in good times, reaching a peak of 20% of GDP in the late 1990s (Chart 2). But the range of revenue outcomes is narrow, and the variance is low. Meanwhile, total government outlays increased from just over 18% of GDP in 1962 to just over 25% at the end of 2022 (Chart 2).

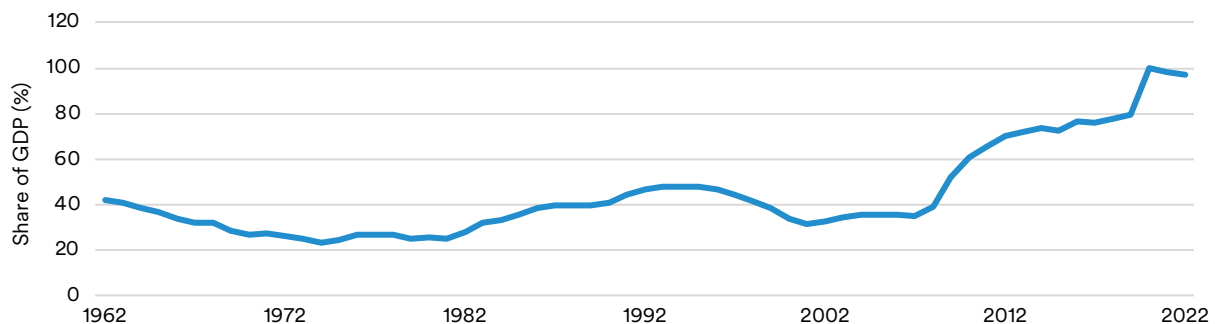
Chart 2 | Stable Revenues, Growing Outlays



Source: CBO, MIM

The result? A long-term structural trend of rising publicly held debt-to-GDP (Chart 3).

Chart 3 | Public D/GDP has been Rising since the 2000s



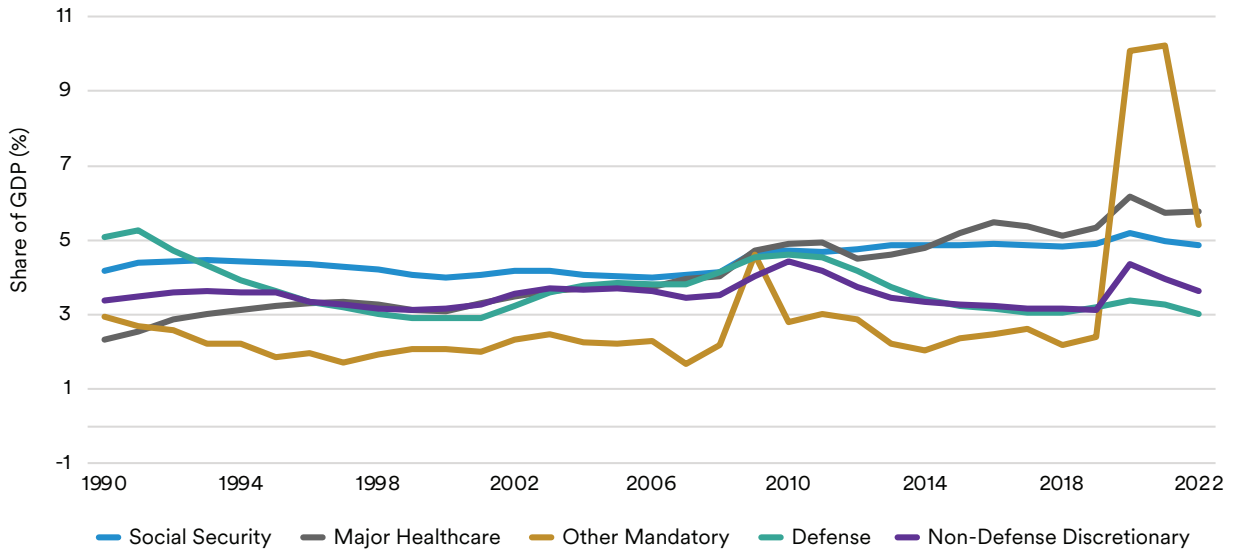
Source: CBO, MIM

What About the Future?

The future path of the public debt (“debt”) should depend on two main drivers: real GDP growth, via productivity increases, and the deficit, via government spending decisions. Using annual data from 1963 to 2019, our model finds that that assuming no growth and no deficit, debt would decrease by 1.4pp every year (Source: BEA, CBO, MIM). Each percentage point of real GDP growth would decrease the debt a further 0.3pp. Government policy is a bigger driver, with each point of surplus decreasing the debt an additional 1.1pp each year.

The relative stability of government spending as a share of GDP over time (Chart 4) extends to the components of revenues and outlays (e.g., non-defense discretionary spending and healthcare spending) and allows us to construct reasonable assumptions of the deficit over time, barring extraordinary circumstances. Combining these assumptions with MIM’s GDP and inflation forecasts allows us to construct scenarios depicting the potential trajectories of U.S. debt over the next few years.

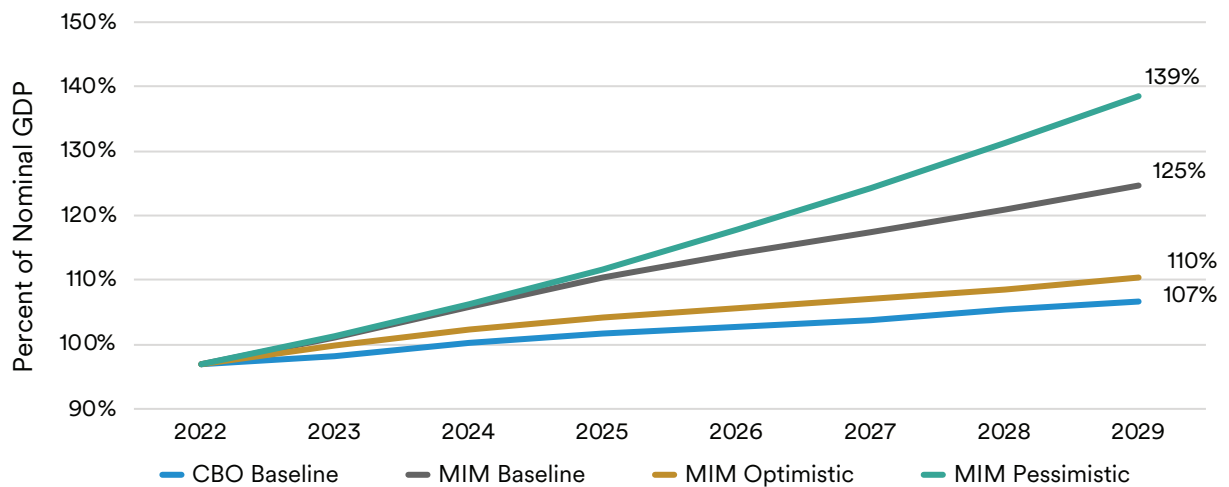
Chart 4 | Spending Categories Move Mostly Predictably



Source: CBO, MIM

In all of our scenarios (see Appendix for key assumptions), and in the CBO’s baseline included for comparison, debt as a share of GDP increases over the next six years. In our most optimistic scenario, we assume increased government revenue, decreased net interest outlays, and decreased discretionary spending. In the pessimistic scenario, we assume the opposite in all three variables, along with a slight increase in other mandatory spending.¹ Increased defense spending, which is considered discretionary,² would be somewhat captured by this scenario. Every scenario makes similar assumptions about healthcare and Social Security, as these are less flexible. Healthcare expenses are predicted to increase 0.3pp to 5.9% of GDP by 2029, and Social Security expenses are projected to increase by 1pp to 5.7% of GDP by 2029.

Chart 5 | Debt to GDP Increasing in Every Scenario



Source: CBO, MIM

It is important to note that our baseline estimate and the CBO’s baseline estimate use different underlying macroeconomic assumptions as well as a different approach in estimating the change in debt. MIM’s explicit recession forecasted in the first half of 2024 sets the level of debt higher at the outset, but then our optimistic scenario grows at a similar pace to the CBO’s baseline. The CBO’s own scenario analysis around its baseline assumptions have debt reaching 103% to 118% by 2029.

While debt-to-GDP is the most conventional metric for measuring sovereign leverage, the interest-to-revenue ratio is also used by ratings agencies because it shows the impact debt is having from a cash flow perspective. World Bank data show that in 2021 the U.S. had an interest to revenue of 13.3%, far higher than the OECD average of 3.2% and more in line with a BBB-rated emerging market credit rather than that of an AA-rated developed market. Our model predicts this to further deteriorate to 17% by 2029 in the baseline scenario, exacerbated by higher percentages of short-term debt and more debt rolling over at prevailing higher rates.

Table 2 | Interest-to-Revenue Ratios

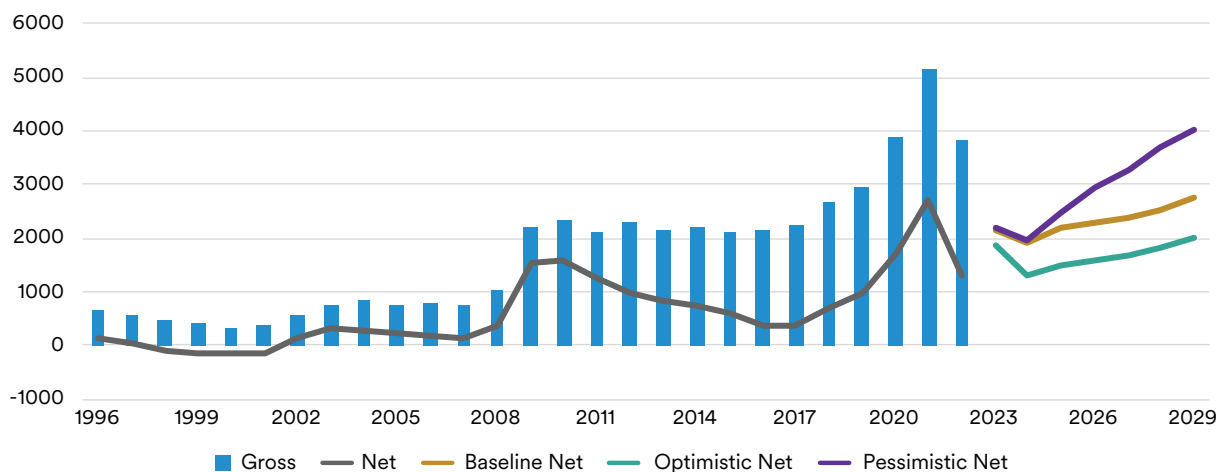
Geography	2021 Interest to Revenue
United States	13%
United Kingdom	8%
OECD members	3%
World	6%
France	3%
Germany	1%
China	3%
Canada	5%
Guatemala	14%

Source: World Bank

More Debt is Coming, but How Much?

Our focus is on debt held by the public (i.e., excluding intra-governmental debt like that owed to the Social Security Administration (SSA)), because this issuance is ultimately what must be absorbed at auctions, with more direct implications for the Treasury market.

Chart 6 | The Market Must Absorb More and More Treasuries



Source: Bureau of Public Debt, CBO, Haver, MIM

By the end of 2022, the CBO reported that this debt was around \$24.6 trillion. In our baseline scenario, we project a net average annual issuance (i.e., gross issuance excluding maturing securities and bills) of roughly \$2.5 trillion, resulting in a debt level of over \$42 trillion by 2029. In our optimistic scenario, average issuance of \$1.9 trillion would result in a debt level of \$38 trillion. The pessimistic scenario yields about \$3.2 trillion in average annual net issuance and a debt level of \$47 trillion by 2029.

Using previous work done by the Treasury Borrowing Advisory Committee (TBAC) on Treasury issuance patterns, we can use an estimate of the “steady state” maturity composition of debt to get an idea of how new net issuance will be distributed among the different types of government securities (Table 3).³

Table 3 | Est. Net Issuance - MIM Baseline (Billions USD)

Year	Total	Bills/FLOATERS	Notes	Bonds	TIPS
2023	2,374	237	1,116	950	71
2024	2,084	208	979	834	63
2025	2,429	243	1,141	971	73
2026	2,532	253	1,190	1,013	76
2027	2,605	261	1,225	1,042	78
2028	2,789	279	1,311	1,116	84
2029	3,031	303	1,424	1,212	91

Source: CBO, TBAC, MIM

An additional point is that debt held by the Federal Reserve is included in the public debt, but this debt is technically not available to the public. Therefore, the Fed’s balance sheet normalization will put further upwards pressure on the supply of debt available to investors. In this case, the Treasury will also end up paying more interest as the Fed will no longer be remitting its excess interest income back to the Treasury as it did in the past (the Treasury effectively paid a 0% interest rate on those holdings).

In short, the market must be prepared to absorb an increasing number of Treasury notes and bonds. By way of comparison, between 1996 and 2019, Federal Reserve data show the average annual net issuance was just \$478 billion. Moreover, in past years where net issuance was greater than \$1 trillion (2009-2011, 2020), the Fed was an active buyer of securities, leaving the true net amount of bonds absorbed by the market closer to the historical average.

What Can be Done?

In order to stabilize the debt trajectory, an aggressive and sustained fiscal adjustment is needed, to the tune of 3-4% of GDP, according to our model. While that number may appear small, it is drastic. 3% of GDP amounts to 50% of the government’s discretionary spending, or the entirety of defense spending in 2022. It is roughly half of the annual expense of all major healthcare programs combined, or equivalent to 60% of 2022’s social security expenditures. Some of the gap could also be made up by revenue increases, but 2022’s revenues of 19.6% of GDP were close to the highest seen since the 1960s. Whatever the combination, policymakers will have to negotiate a very delicate situation if they are to make a deliberate effort to change the U.S.’ debt trajectory.

If a spending cut of 3% of GDP coincides with a productivity boom (real GDP growth of 3%), very similar to the situation in the 1990s, then we predict a slight decline in debt-to-GDP to the tune of 0.1pp annually. But the spending reductions are crucial; we do not expect strong growth (within reason) alone to decrease debt-to-GDP.

Complex Challenges Ahead

We expect the U.S. debt burden to increase materially in all plausible scenarios. As time passes, the challenges become more complex. For example, in 2021 the Social Security Trust Fund began redeeming excess reserves to fill a funding gap. As the gap grows, the government will have to cut

spending elsewhere to fund Social Security’s redemptions, or issue even more bonds to the public. But the Trust Fund’s excess reserves are estimated to run out in the 2030s, and the Congressional Research Service projects annual contributions will only be able to fund 80% of Social Security obligations. Within the next decade, the U.S. government will have to cut benefits or find alternative solutions (potentially using more debt) to fund the 20% shortfall.

Regardless of the precise level of debt reached in the next decade, the one thing that can be said with relative certainty is that the markets will have to wrestle with an increased issuance of Treasury bonds as the government tries to finance its obligations. More issuance could put upward pressure on interest rates, dampening economic activity and raising inflation expectations. Meanwhile, the current political landscape does not seem amenable to the tough fiscal adjustment required to avoid this path.

Worse, if investors lose confidence in the U.S. fiscal position, markets may begin to treat Treasuries less as an exceptional asset and more as one of many high quality, low risk assets. Ratings pressure may increase as well, as a loss of confidence is likely to undermine the U.S.’ last remaining AAA rating (Moody’s), or even push the country’s debt towards a single A rating, similar to Japan.

Appendix – Key Scenario Assumptions

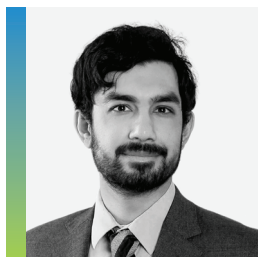
All revenues, outlays, and deficits expressed as a percentage of nominal GDP.

MIM Baseline			Revenue	Outlays				Surplus/Deficit	
Year	Real GDP Growth	Inflation	Total	Mandatory	Net Interest	Discretionary	Total	Total	Primary
2023	2.11%	3.0%	18.4%	15.1%	2.5%	6.5%	24.1%	-5.7%	-3.2%
2024	0.04%	2.8%	17.8%	14.3%	2.7%	6.6%	23.5%	-5.7%	-3.0%
2025	1.13%	2.8%	17.4%	14.1%	2.7%	6.4%	23.2%	-5.8%	-3.1%
2026	2.00%	2.5%	17.8%	14.0%	2.8%	6.2%	23.1%	-5.3%	-2.5%
2027	2.00%	2.5%	18.1%	14.1%	2.9%	6.1%	23.1%	-5.0%	-2.1%
2028	2.00%	2.5%	18.2%	14.2%	3.0%	6.0%	23.3%	-5.1%	-2.1%
2029	2.00%	2.5%	18.2%	14.4%	3.1%	6.0%	23.5%	-5.3%	-2.2%
MIM Optimistic			Revenue	Outlays				Surplus/Deficit	
Year	Real GDP Growth	Inflation	Total	Mandatory	Net Interest	Discretionary	Total	Total	Primary
2023	2.11%	3.0%	19.0%	15.1%	2.3%	6.3%	23.6%	-4.6%	-2.4%
2024	0.04%	2.8%	19.0%	14.3%	2.3%	6.0%	22.5%	-3.5%	-1.3%
2025	1.13%	2.8%	19.0%	14.1%	2.3%	6.0%	22.3%	-3.3%	-1.1%
2026	2.50%	2.0%	19.0%	14.0%	2.3%	6.0%	22.3%	-3.3%	-1.0%
2027	2.50%	2.0%	19.0%	14.1%	2.3%	6.0%	22.3%	-3.3%	-1.1%
2028	2.50%	2.0%	19.0%	14.2%	2.3%	6.0%	22.5%	-3.5%	-1.2%
2029	2.50%	2.0%	19.0%	14.4%	2.3%	6.0%	22.7%	-3.6%	-1.4%
MIM Pessimistic			Revenue	Outlays				Surplus/Deficit	
Year	Real GDP Growth	Inflation	Total	Mandatory	Net Interest	Discretionary	Total	Total	Primary
2023	2.11%	3.0%	18.4%	15.3%	2.5%	6.5%	24.3%	-5.9%	-3.4%
2024	0.04%	2.8%	17.8%	14.5%	2.7%	6.6%	23.7%	-5.9%	-3.2%
2025	1.13%	2.8%	17.4%	14.3%	3.0%	6.8%	24.1%	-6.7%	-3.7%
2026	1.50%	3.0%	17.0%	14.3%	3.1%	7.0%	24.4%	-7.4%	-4.3%
2027	1.50%	3.0%	17.0%	14.3%	3.2%	7.2%	24.7%	-7.7%	-4.5%
2028	1.50%	3.0%	17.0%	14.4%	3.3%	7.5%	25.2%	-8.2%	-4.9%
2029	1.50%	3.0%	17.0%	14.6%	3.3%	7.5%	25.4%	-8.4%	-5.1%

Endnotes

- ¹ “Other” mandatory spending includes tax credits and programs such as the Supplemental Nutrition Assistance Program, unemployment insurance, the earned income tax credit, and the child tax credit.
 - ² Non-defense discretionary spending includes areas such as education, transportation, veterans’ healthcare, and homeland security.
 - ³ This assumes the current funding strategy remains in place. While it is reasonable to expect a change in the funding strategy in the medium- or long-term, the exercise gives insight into the breakdown of issuances in the near term.
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