ECONOMIC VIEWPOINT

A Year Out from the Presidential Election, America's Fiscal House Is Not in Order

By Francis Généreux, Principal Economist

Investors are increasingly alarmed by the state of America's finances, which deteriorated further in the fiscal year that just ended. Given the political divide in the US, however, it's hard to imagine the fiscal situation improving any time soon—especially as a year out from the next presidential election, Americans don't consider it a major priority. But barring a dramatic turn of events, the sorry state of public finances could keep interest rates elevated, with the destabilizing effects that this entails.

US bond yields have surged recently, and there are a number of reasons why. Investors are looking to offset their inflation-induced losses, and soaring key interest rates and rate expectations have affected the future path of monetary policy. But these two factors alone don't explain the spike in bond yields over the past few months. The answer lies in the rising term premium—the compensation for the risk of future interest rate fluctuations. We discussed this in a recent Weekly Commentary.

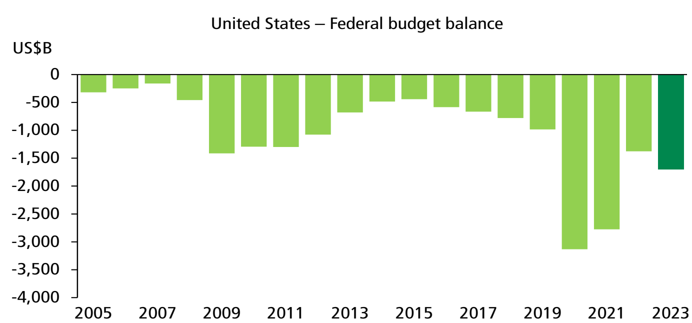
One of the risk factors a higher term premium offsets is the supply of public debt on the market. While part of this supply is from the Federal Reserve's quantitative tightening, some is the result of public finances. The size of the federal debt and deficit has been under increased scrutiny of late. For a long time, it seemed as though deficits didn't matter anymore. But times have changed, and bond investors are now being more cautious. This caution is warranted, as federal government finances have deteriorated further in the past year. And we don't have the pandemic to blame anymore.

Finances Are Moving in the Wrong Direction

The US ended fiscal year 2023 (FY2023) on September 30 with a deficit of US$1.695 trillion. That's an improvement over the pandemic deficits of US$3.132 trillion in FY2020 and US$2.776 trillion in FY2021, but it's higher than the FY2022 deficit of US$1.375 trillion (graph 1).

And it could have been much worse, as the Biden administration's student loan forgiveness program was blocked by the Supreme Court before it took effect. The US Treasury added US$379B to the deficit in FY2022 for the program before having to reverse most of the accounting and reduce the FY2023 shortfall by US$333B. Without student loan forgiveness, the deficit would have topped US$2 trillion in FY2023, twice the nearly US$1 trillion deficit that would have been recorded in FY2022.

GRAPH 1
The Federal Deficit Increased in FY2023

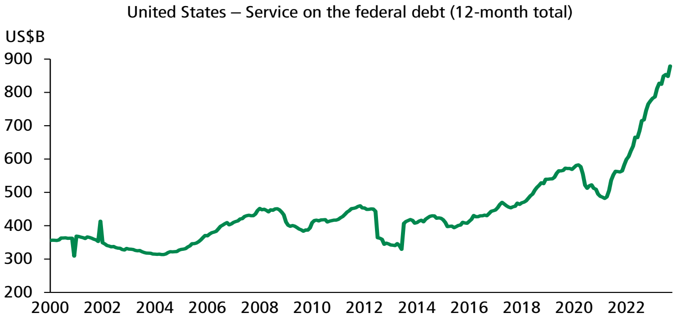


Sources: U.S. Treasury and Desjardins Economic Studies

Why the Slide?

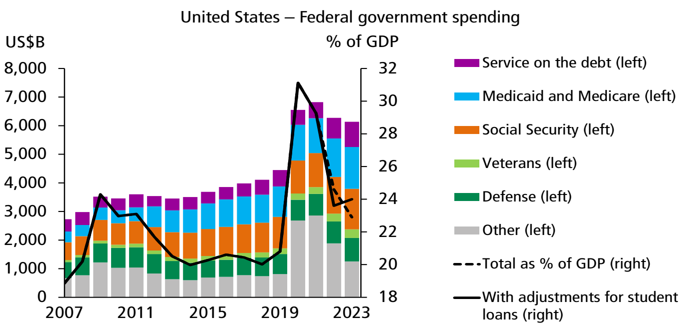
The United States has both a spending problem and a revenue problem. At first blush, spending appears to be down 2.2%. But take away the impact of the reversal of student loan forgiveness, and spending is up 4.1%, or US$242B, year-over-year. That's a big jump, though it's not surprising given today's high inflation—which also drives up government spending—and higher debt servicing costs, which were up 23%, or US$162B (graph 2). That said, in 2023 there was virtually none of the pandemic-related spending we saw in 2022. In other words, spending is still high. It accounted for 24.0% of GDP in 2023 versus 20.4% on average between 2014 and 2019 (graph 3).

GRAPH 2
The Cost of Servicing the National Debt Has Gone Up Considerably



Sources: U.S. Treasury and Desjardins Economic Studies

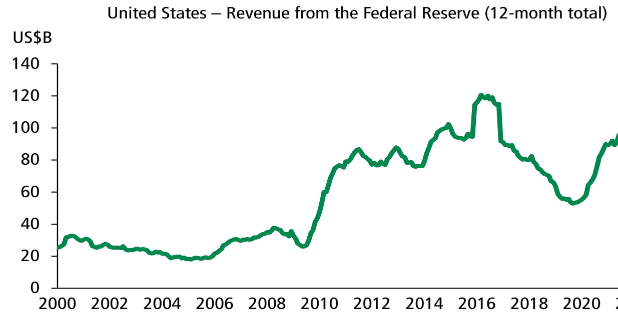
GRAPH 3
Federal Spending Remains High



Sources: U.S. Treasury, Congressional Budget Office and Desjardins Economic Studies

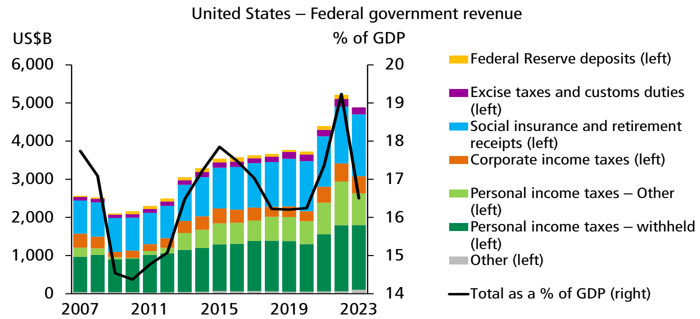
Looking at revenue, the change over the last fiscal year was even more stark. Revenue fell 9.3%, or US$457B, in FY2023. Personal income tax receipts excluding payroll deductions were down sharply. There was also a US$106B drop in revenue from the Federal Reserve compared to FY2022 (graph 4). As a percentage of GDP, revenue fell from 19.3% in 2022 to just 16.5% in 2023. That's in line with the 16.2% rate seen in 2018 and 2019 after the Trump tax cuts. The average over the four years prior to the cuts was 17.4% (graph 5).

GRAPH 4
Funding from the Federal Reserve Has Completely Dried Up



Sources: U.S. Treasury and Desjardins Economic Studies

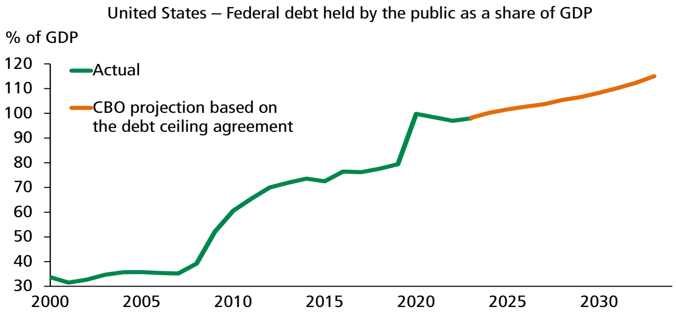
GRAPH 5
Revenue Is Down



Sources: U.S. Treasury, Congressional Budget Office and Desjardins Economic Studies

With spending up and revenue down, the shortfall widened in 2023 despite fairly strong economic growth. As of September 30, 2023, the national debt stood at US$33.167 trillion, up US$2.238 trillion year-over-year. Looking just at the debt held by the public (including what is held by the Federal Reserve), the debt totalled US$26.330 trillion (98.0% of GDP) at the end of FY2023 compared to US$24.299 trillion at the end of FY2022 (96.9% of GDP). Unfortunately, there's no easy way—or even the political will—to balance the budget and get the debt under control. And therein lies the risk for investors: the debt is rising and appears to be going nowhere but up. According to the Congressional Budget Office's June outlook, the public debt will increase to 100.2% of GDP in 2024 and an astounding 115.0% by 2033 (graph 6 on page 3).

GRAPH 6
The Public Debt Continues to Go Up



Sources: Congressional Budget Office, U.S. Treasury and Desjardins Economic Studies

Political Gridlock a Year Out from Election Day

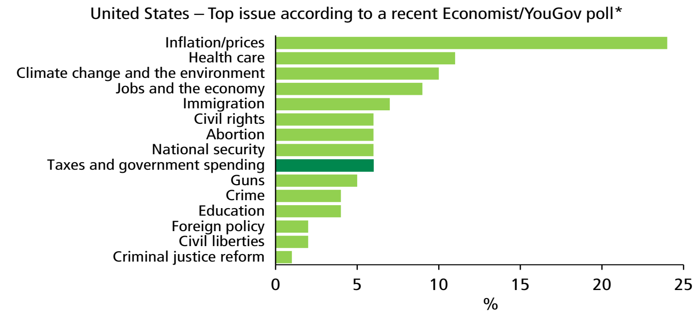
The political divide in Washington and across the US makes it hard to find a long-term solution. The Republican speaker of the House paid dearly for cutting bipartisan deals to end the debt ceiling standoff in May and avert a government shutdown in September. That left the House speakerless for three weeks, giving it precious little time to pass a new funding bill by mid-November. This underscores not just the Republican–Democrat divide, but also the rifts within the Republican party itself. There are differences between the centrists and the left flank of the Democratic party as well.

Gridlock always results in some pullback in spending, and we might well see that. But that's not a long-term fix, and it could short-change some near-term priorities. What's more, the White House recently requested US$105B in funding for the wars in Ukraine and Israel. That's on top of requests for things like border security and humanitarian aid that went unanswered during the House speaker fight. We'll have to see what the new House speaker, Republican Mike Johnson, can get done.

If Congress remains divided or gridlocked, a solution could be hard to come by. Republicans will likely never agree to raise taxes, which would boost revenues. And Democrats are opposed to cutting spending, especially on social programs—a major driver of long-term spending growth. There's talk of a bipartisan commission on public finances, but getting one off the ground wouldn't be easy. And the leaders of both parties would need to formally commit to implementing the commission's recommendations, which would be challenging in today's political climate.

But while investors are increasingly alarmed by the state of the nation's finances, it doesn't seem to be a major concern for voters. In a recent Economist/YouGov poll, just 6% of respondents said taxes and government spending was the most important issue for them. It came in 6th, well behind inflation and prices at 24% (graph 7).

GRAPH 7
Federal Government Finances Aren't a Major Priority for Voters



*Conducted between October 21 and 24, 2023
Sources: The Economist/YouGov and Desjardins Economic Studies

A lot can happen in a year. But right now, it's hard to see public finances becoming a major issue in the next presidential election. As in 2020, the election may well be a referendum on Donald Trump—if he clinches the Republican nomination. Geopolitics, national security, the environment, energy prices and President Biden's fitness could also be on voters' minds as they head to the polls on November 5. And the economy, which can be the deciding factor in presidential elections, continues to be an issue as well. Our latest forecast calls for a soft landing that brings down inflation without crushing the labour market. That would help Biden's re-election chances. The investments made in some communities through the Inflation Reduction Act and infrastructure spending may also help him. If the lagged effects of interest rate hikes hit the economy harder, however, it could help the Republican nominee. It remains to be seen whether public finances re-emerge as a leading issue not just for investors, but also for politicians and the public. But barring a dramatic turn of events, interest rates could remain elevated, with the destabilizing effects that this entails.