Torsten Slok

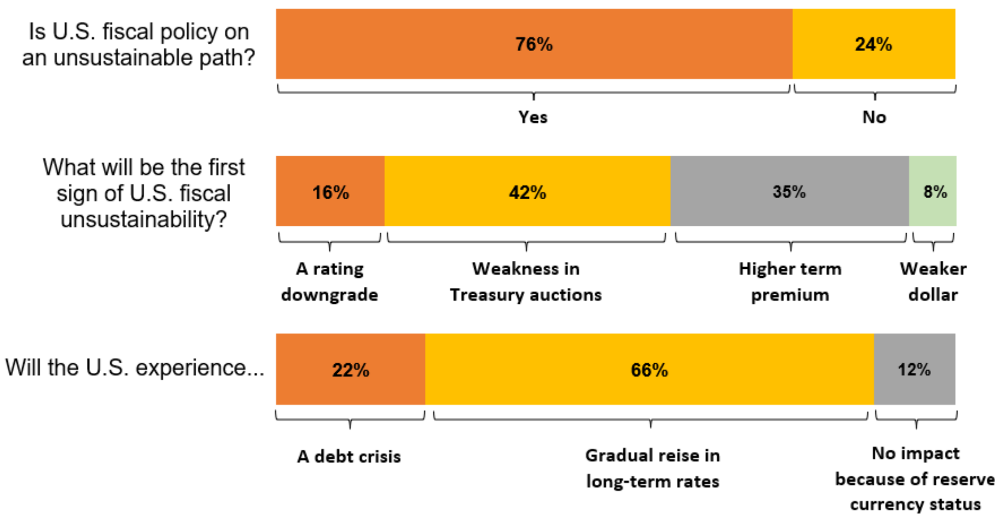
U.S. Fiscal Policy and Long-term Interest Rates

On Friday, November 15, Torsten Slok joined Markus' Academy for a conversation on Long-term Interest Rates, Fiscal Policy and the Term Premium. Torsten Slok is a Partner and the Chief Economist at Apollo.

A few highlights from the discussion.

- **A summary in three bullets**
  - U.S. fiscal policy is on an unsustainable path. How could this become an issue for financial markets? There are four areas to consider:
  - (1) Rating downgrades based on fundamentals, (2) weakness in treasury actions (of which there is no sign now), (3) the rise of the term premium, and (4) the dollar remaining the global reserve currency
  - The bottom line: a U.S. debt crisis is unlikely. More likely is that we see a gradual upward pressure on long term interest rates

- **[0:00] Markus' introduction and poll questions**
  - Government debt levels are at levels unseen since the world wars, with further rises expected. Historically, high debt has often been managed with financial repression or monetary financing (endangering central bank independence)
  - The safety of american debt is about relative safety with respect to the debt of other countries ("least ugly horse theory")
  - A safe asset is like a good friend: it appreciates and is liquid during bad times. By offering its safe asset as a global public good, the U.S. enjoys an exorbitant privilege in the form of lower interest rates
  - During uncertain times this privilege grows. The government, knowing this, may choose an erratic policy to increase uncertainty, but without creating too much uncertainty that the privilege is lost



- [6:38] **Overview**
  - It is not a controversial statement that the U.S. fiscal policy trajectory is unsustainable. There is no single model to determine what happens when fiscal policy becomes unsustainable, but there are 4 areas to consider:
  - (1) A rating agency downgrade. Which fundamental fiscal policy parameters drive them?
  - (2) Weakness in treasury auctions. For now there are no signs of it
  - (3) The term premium: the measure of investor's willingness to buy long duration government bonds. An increase in the term premium reflects a rise in long-term interest rates beyond the effects of Fed policy expectations, influenced by factors like fiscal sustainability
  - (4) The dollar as the global reserve currency, which could decline if the U.S. economy slows down or the Fed significantly cuts rates
  - There will be no problem selling treasuries in the foreseeable future, but as history shows things like ratings or auction distress can change very quickly
  - The more likely scenario is a gradual and orderly rise of long term interest rates

- [15:02] **The fundamentals of the U.S. budget**
  - The Congressional Budget Office estimates that the debt-to-GDP ratio will reach almost 200% by 2054, up from the current 100%. The CBO also projects further deficit growth from the current 5%
  - For these projections, the CBO assumes a constant 10-year Treasury rate of 4% (and a flat average interest rate of federal debt) in the coming decades. Changing this assumption can result in even more adverse projections
  - 13% of government spending goes to debt servicing costs, and it is expected to reach 23% by 2054
  - Many in the political debate argue that fiscal sustainability is achievable by cutting discretionary spending (e.g. defense or R&D). However, the size of discretionary spending has already declined significantly: from 70% in the 60s to 30% today
  - While today healthcare and social security (mandatory spending) account for 54% of total spending, in 2054 they are projected to reach 67%. Perhaps mandatory spending could be curbed through more gradual cost of living (inflation-based) adjustments
  - Although long-term rates typically decline following a Fed rate cut, the opposite occurred after the recent September cut. This puzzling rise in long-term rates can be partly explained by an increase in the term premium
  - Christensen and Rudebusch (2012, SF Fed) and Adrian et al. (2013, NY Fed) are prominent measures of the term premium, but we ultimately do not know what drives it
  - The recent rise may reflect growing concerns about fiscal sustainability, highlighted by studies from the Committee for a Responsible Federal Budget, the Penn Wharton Budget Model, and the Tax Foundation. Investors are waking up to this conversation
  - Italy has fiscal fundamentals similar to the U.S., yet it has a BBB rating while the U.S. has a AAA. This opens up debate about what makes a country

"special" in ratings. While politics, demographics, and growth differ, the key question is how these factors are weighted against the fiscal fundamentals

- [24:49] **The maturity structure of U.S. debt**
    - 98% of U.S. debt is marketable, and 89% of it has a fixed interest rate. 50% of it is in the “belly of the yield curve” (in notes with maturities of 2 to 10 years). However a growing share is in short maturity Treasury Bills (21%)
    - In next year the US will have to roll over $9tr in debt, amounting to 33% of all marketable debt outstanding, or 31% of GDP
    - Treasury auction sizes grew by 29% across the yield curve in the last year. Quarterly gross issuance as share of nominal GDP stands at 25% today, while before Covid it was at 15%
    - The growth issuance has been much larger in shorter maturities. The challenge of issuing at longer maturities is that demand is mostly from pension funds and insurers, whose size only grows slowly with GDP
    - In contrast, money market funds, which buy short maturities, grow when policy rates go up. They have grown by $2tr since the Fed began hiking rates
    - T-Bill issuances usually go up during recessions, when government financing needs grow and policy rates decline. The past year has been abnormal in that T-Bills have gone up despite the absence of a recession and of low policy rates. Now T-Bills amount to 85% of all issuances
    - Higher policy rates are driving up interest payments, with interest expenses reaching 3% of outstanding debt. Before Covid, the U.S. spent $1.5bn on interest daily; now it exceeds $3bn per day. The Fed's quantitative tightening is further increasing the supply of Treasuries

- [42:58] **The ownership structure of U.S. debt**
    - The Fed holds 17% of treasuries, while mutual funds + pension funds collectively account for 20%. Foreign investors however are the largest holders, with 33%
    - In the last decade we have seen a decline of 10 percentage points in the foreign share. In part this decline can be attributable to China, while increasing amounts of foreign purchases are coming from private investors
    - In the past China bought treasuries to manage its exchange rate, in an effort to sell renminbi, buy dollars, and depreciate the currency to make exports competitive. Now it is doing the opposite, and its holdings are in decline
    - Because China’s purchases were driven by the exchange rate they were insensitive to its yields. As a result, its decline entails a shift towards yield sensitive buyers, with growing ownerships by households (as discussed before through money market funds), pension funds, and private foreign investors
    - New tariffs on China will likely intensify this trend. As its exports to the U.S. would decline, it would receive fewer dollars to recycle into treasuries
    - At the same time, we could see an opposite effect: the Chinese government could try to neutralize the tariffs by returning to its strategy of depreciating the exchange rate, by buying treasuries again or by lowering rates

    - Japan's ownership has remained unchanged. Most interesting is the behavior of Japan's private investors. It is currently very expensive to buy Yen-hedged treasuries. Though there is no reliable data, this hints that more investors may be buying unhedged treasuries. While foreign fixed income investors typically hedge, this would be a sensible strategy if investors believe that the Bank of Japan will not raise rates, that the Yen will continue depreciating, and that rates will be higher for longer in the U.S.

- [52:59] **No signs of weakness in Treasury auctions**
    - The ratio of total bids over the amount of treasuries offered ("bid-to-cover") has been broadly stable
    - The percentage awarded to indirect bidders, those who bid through an intermediary and are usually foreign, is also stable
    - Despite a few episodes that drew attention, auction tails are also broadly stable. The auction tail is the difference between the settled auction yield and the "when-issued" yield –the yield quoted in the secondary market for the security before it is officially issued– moments before the auction concludes. A positive tail reflects slightly lower demand than expected
    - A treasury market liquidity index can be constructed by comparing observed yields to those implied by a cubic spline-fitted yield curve, where deviations may signal market disruptions. This index has also been broadly stable
    - Nevertheless, there has been a decline in the amount of market-making done by traditional dealers, with an associated rise in the amount done by high frequency traders. This could be problematic if in periods of high volatility these traders exit the market
    - Despite this robustness, experiences from other countries shows that seemingly stable conditions can shift suddenly

- [1:01:42] **The term premium, the reserve currency status, and the Fed**
    - Despite the recent rise, the term premium is still lower than it was 10 or 20 years ago. However it has been getting a lot of attention in the markets
    - The reserve currency status remains unquestioned, but sanctions have influenced the demand for U.S. dollars, prompting sanctioned countries to shift to alternatives like gold. Rising gold prices partly reflect this trend
    - If the Fed lowers rates, investors may move away from money market funds and into higher-yield credit, affecting T-Bill demand (as supply remains fixed). While the Fed's independence will not change, this complicates the link between Fed policy and fiscal policy
    - A "Truss moment" is unlikely for the U.S. because the debate isn't about the ability of the U.S. to pay its debt, but about the price at which it clears.
    - Markets are increasingly focused on U.S. fiscal policy, but the country remains the world's most dynamic economy, with the largest capital markets, and the leader in AI innovation
    - Foreign investment flows will continue, attracted by high returns and growth potential, so financing the deficit remains feasible. However high debt levels make the U.S. more vulnerable to shocks or slowdowns

    - Competing economies face significant challenges: China struggles with demographics, housing disinflation, and trade tensions, while Europe faces a slowdown, energy transition costs, and weaker political leadership

Timestamps:
[6:38] Overview
[15:02] The fundamentals of the U.S. budget
[24:49] The maturity structure of U.S. debt
[42:58] The ownership structure of U.S. debt
[52:59] No signs of weakness in Treasury auctions
[1:01:42] The term premium, the reserve currency status, and the Fed