

# The world begins to worry about the US fiscal deficit



## IMF Fall 2023 Meetings Takeaways

By David Austerweil, and the Active Emerging Market Debt Team

### Summary

Higher for longer US rates and the size of the US fiscal deficit were concerns shared in every meeting.

- Rapidly rising long-term US real yields are sucking up global capital and raising global borrowing costs raising the risk of financial accidents as credit is scarcer to lower rated borrowers.
- Global growth outlook is mediocre, with only the US and China characterised by exceptionalism.
- Global inflation is falling but too high, with US inflation still far from converging to target.
- Pessimism on the outlook for China's growth was pervasive, excessively to our eye, but China has policy options.
- Against this concerning backdrop, the resilience of emerging market economies shone through; EM's low debt levels and independent central banks praised.
- Turkey, Brazil, Indonesia, South Africa, Hungary, and Czech Republic were among the major EMs that showed continued policy credibility.

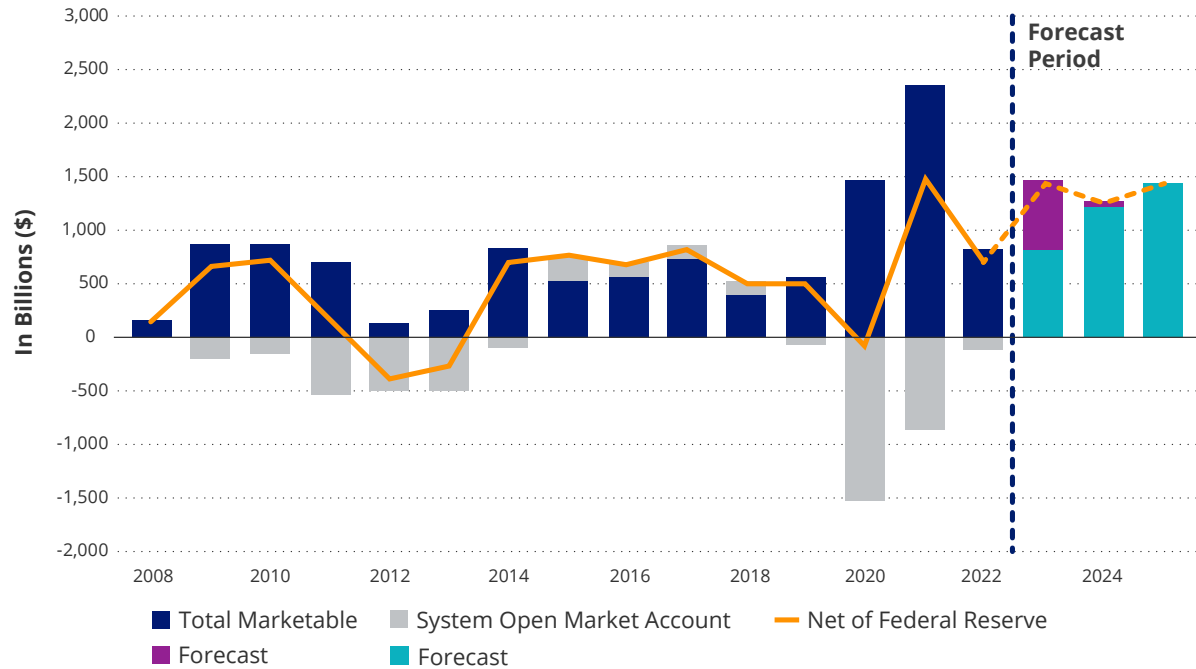
**Global growth outlook is mediocre, with only the US and China characterised by exceptionalism.** When excluding US growth, developed market growth is forecast to be just 1% for 2023. The US growth outlook was revised upwards by 0.3% to 2.1% from the spring meetings when most expected the US to enter a recession this year. In contrast, the remainder of developed economies saw their growth forecasts revised downwards. Similarly, in emerging markets, growth excluding China is forecast at just 3% in 2023. China is still forecast to achieve a 5% growth rate which makes it the second fastest growing economy in the world after India.

**Global inflation is falling, with US inflation far from its target.** US inflation is not forecast to return to target until 2025. Forecasts for core inflation were revised upwards. Labour markets remain tight not just in the United States but across Europe and many emerging markets. The lack of a more convincing global disinflation process makes it very difficult for credible central banks to ease policy and those that believe policy rates are sufficiently restrictive are likely to hold them there for longer than markets are pricing. Even in a country where inflation has converged to target, such as Brazil, cutting interest rates too quickly would lead to currency depreciation and imported inflation. The "higher for longer" narrative was pervasive throughout all meetings. For as long as the Federal Reserve maintains that stance, the rest of the world will remain under its spell.

**Rapidly rising long-term US real yields are sucking up global capital and raising global borrowing costs.** There was tremendous focus and criticism of US fiscal policy and the resulting borrowing needs. The 2023 US budget deficit of \$1.7 trillion is inconsistent with the current economic expansion in the US and is mostly the result of structural factors stemming from large tax cut packages, increased entitlement spending and growing interest expenditures. Additionally, the Fed's quantitative tightening (QT) of \$900 billion means \$2.7 trillion of annual borrowing needs. These large borrowing requirements are putting upward pressure on US long term real yields. When the US finally enters a recession, these borrowing needs will only increase. The Fed will cut interest rates to help the economy and this will relieve some pressure on government interest expenditure, but the Fed will still not stop QT as it seeks to bring its balance sheet back to a size that no longer stimulates the economy.

### Net U.S. Treasury Duration Supply

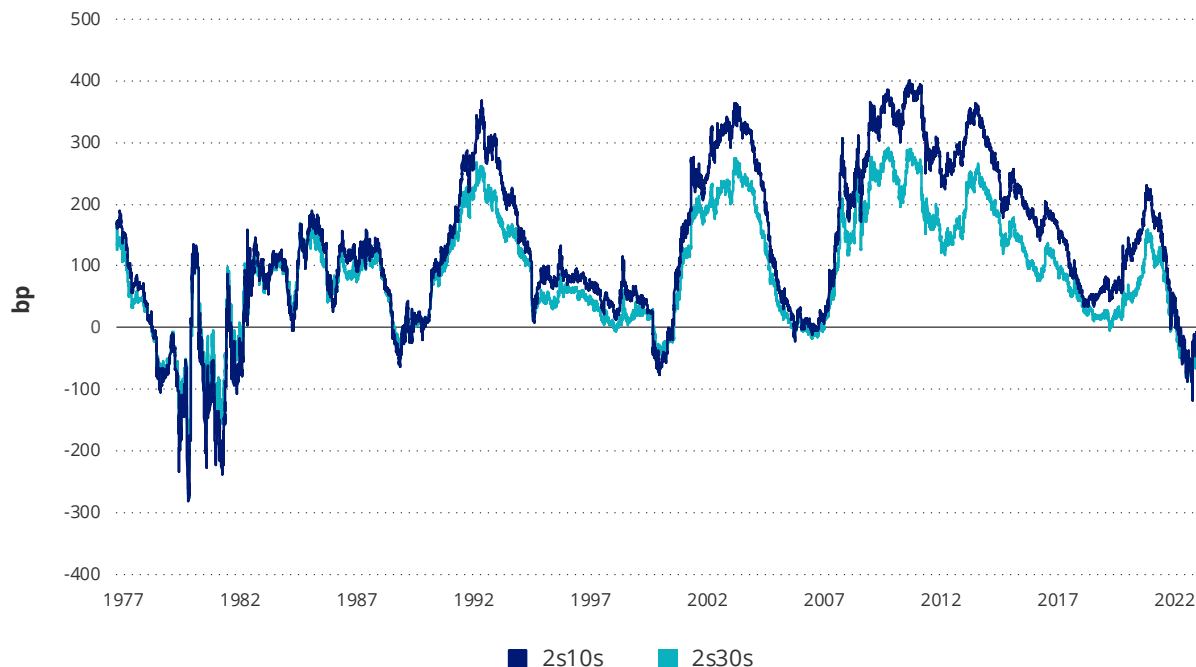
(10-year equivalent in U.S. Billion Dollars)



Source: International Monetary Fund; October 2023. Not intended as a prediction of future results. For illustrative purposes only.

Global savings are needed to finance increased US borrowing, but price sensitive private sector savings are not being properly compensated to increase their holdings. Large current account surplus countries such as China, Russia and Saudi Arabia are no longer interested in financing US borrowing. By sanctioning Russian holdings of US reserve assets, it sent the message that US treasuries were no longer a safe investment for central banks that were not in the US friend zone. China realised the mistake it made in hoarding US dollar reserves to protect for a financial crisis and instead is switching to holding strategic resources such as commodities as reserves instead for national security interests. Without price insensitive central bank buyers, more of the burden falls on private sector lenders, both domestic and foreign, who are highly price sensitive buyers.

### History of U.S. Treasury curve shape for 10y - 2y (2s10s) and 30y - 2y (2s30s)



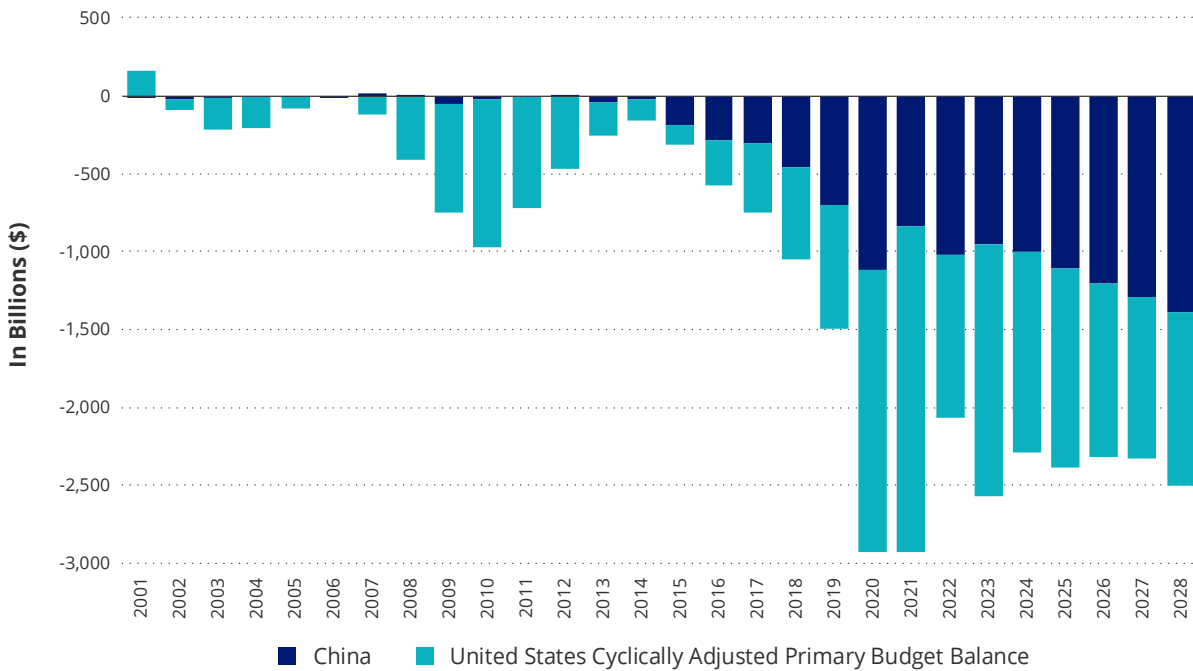
Source: VanEck Research, Bloomberg LP; October 2023. Past performance is no guarantee of future results.

US government duration risk is still not adequately priced to compensate for the risk of ownership. The yield to both 10-year and 30-year US treasuries are still below the yield on 2-year US treasuries, meaning investors get paid less to take more risk! Historically, there was an average of 50 basis points (bps) of compensation paid for taking this additional duration risk. This repricing of duration risk necessary to restore value has been a violent and painful adjustment recently: most investors are long duration already and expected yields to be lower due to a US recession that never materialised, treasury market liquidity is not functioning well as dealers cannot warehouse risk from large treasury auctions and the banking sector already owns too much interest rate risk. Additionally, there are discussions of a capital charge for banks in the US for interest rate risk that would consequently lead to higher yields.

There was a lot of discussion about the US neutral real interest rate now being higher than post GFC levels with a return to either 2% (Dudley's estimate) or 2.5% (Summer's estimate). Using a 2.5% real yield and adding in a 2.5% annual inflation rate and a 50bp term premium, the fair value for real long-term US interest rate comes to 5.5%. For the structural reasons just listed, it seems reasonable to think that 5.5% nominal is closer to a market clearing level.

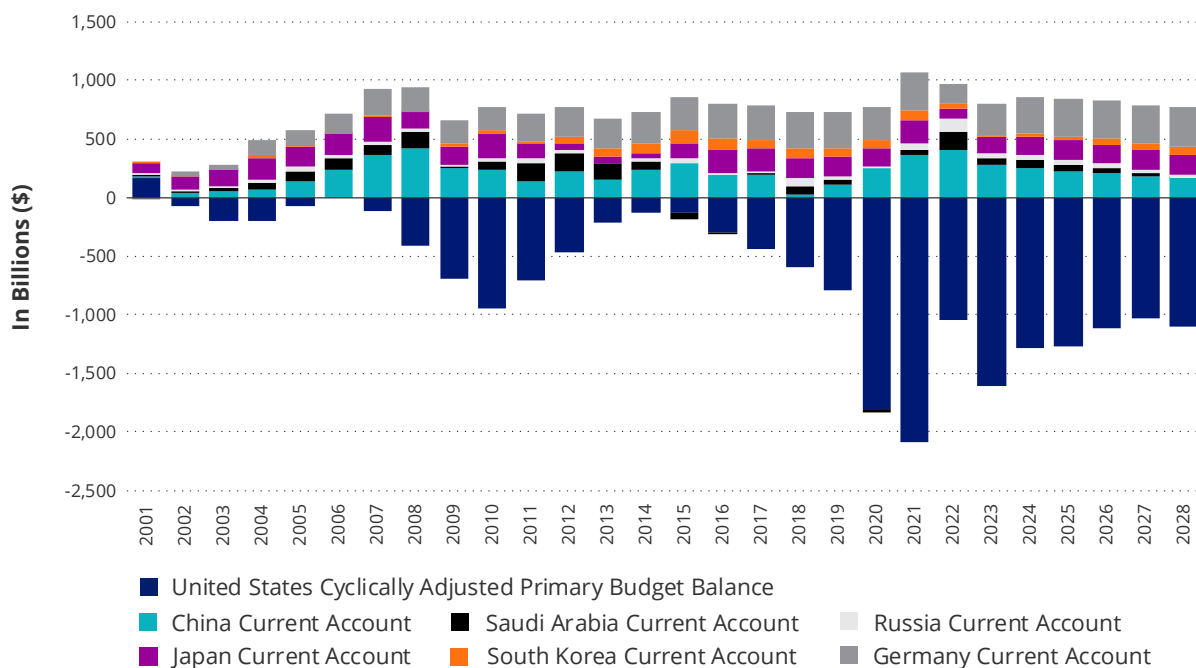
**As real yields rise to attract new price sensitive buyers, it reduces the pool of savings available to other borrowers and increases the risk of financial accidents.** The US and the IMF want to incentivise the private sector to finance an ambitious global transition to green energy. The call to action largely falls on deaf ears as the borrowing requirements of up to 50% of domestic GDP in financing costs over the life of investment is unrealistic when the concern is just financing the world's current borrowing needs. To put current borrowing needs in context, China and the US's deficits combine to 2.5% of world

**Cyclically-Adjusted Primary General Government Balances of China and U.S., % World GDP**



Source: VanEck Research; International Monetary Fund; Bloomberg LP; October 2023

### U.S. Cyclically-Adjusted Primary General Government Balance and Selected Current Account Surpluses, (bn USD)



Source: VanEck Research; International Monetary Fund; Bloomberg LP; October 2023

The US deficit dwarfs the world's largest current account surpluses; global investment will need to fall and savings grow to finance it. The structural need to attract more and more global savings is the main reason to expect interest rates to remain higher for longer and the main reason the risk of a financial accident rises as there will be less and less savings available to lend to less creditworthy borrowers. The IMF ran global bank stress tests that incorporate a stagflationary scenario of higher for longer interest rates, a scenario US stress tests overlooked, and the results were particularly troubling for the developed market banking sector plus China. CET1 ratios fall below 7% for 27% of developed market banks and 50% of Chinese banks. Emerging market banks, in contrast, fared well with just 10% falling below 7%.

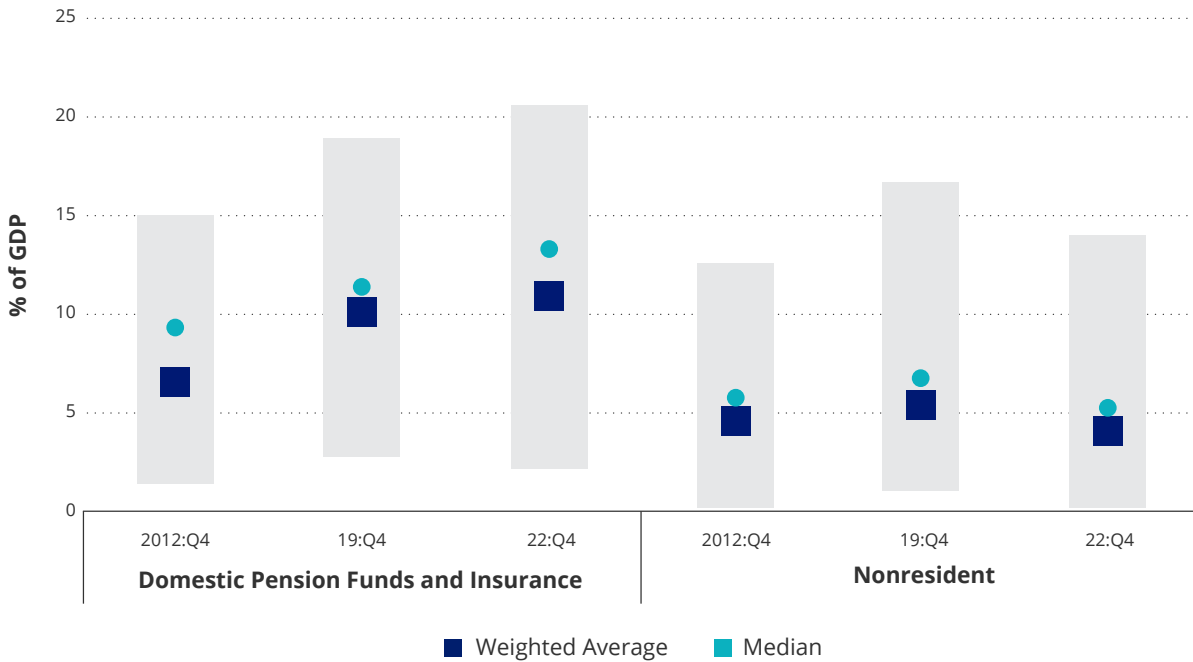
**Pessimism on the outlook for China's growth was pervasive but China has policy options.** Only 4% of investors were willing to add risk to Chinese assets! It is hard to imagine a more pessimistic survey. The collapse in the property market and the subsequent risk of local government financing vehicle (LGFV) defaults that could cascade into banking sector insolvencies was a major concern. There is reason to be worried. Over 50% of LGFV are unable to service debt when interest costs rise above 3%. But there is also domestic awareness of the issue and the government has the tools and fiscal space needed to avoid a debt crisis. The main issue is that so far there has not been a policy bazooka to resolutely solve the problem. The government is keen to avoid moral hazard issues but also given the centralisation of decision making under President Xi, there may be some policy paralysis at lower levels of government. The other main investor concern is what China's growth model will be going forward as investors would like to see a rebalancing of the economy away from investment and toward consumption. One key event to watch for is setting a date for the 3rd plenum where the economic policy strategy would normally be set. It typically takes place in November but so far, no date has been announced. If the government were to move more resolutely on tackling debt issues and addressing the country's future growth model, there could be a more sustained recovery in asset prices that are currently trading at very depressed valuations.

**Against this concerning backdrop, the resilience of emerging market economies shone though.** There was an abundance of praise for emerging market policy making across all geographies. Most EM central banks hiked interest rates early to levels high enough to begin the disinflation process before inflation expectations could deteriorate. For the most part they have been consolidated fiscal policy after the COVID era extraordinary spending. Since EM economies have not been able to rely consistently on portfolio flows post 2013's taper tantrum, domestic institutions have filled the space to channel domestic savings to fund government borrowings. By doing so, it has greatly reduced the volatility and sensitivity of government bond yields to US bond yields.

For large emerging markets, long-term domestic investment institutions have stepped in.

**Local Currency Government Bond Ownership for the Eight Largest Emerging Market Economies, by Institutions**

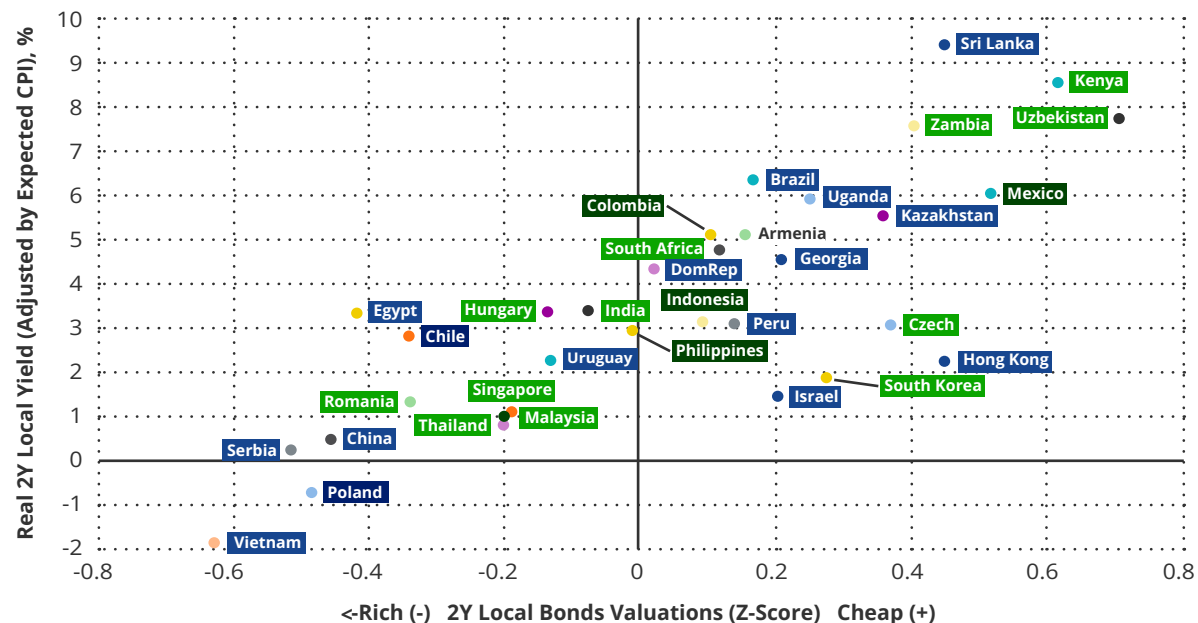
(Percent of GDP)



Source: International Monetary Fund; October 2023

The “higher for longer” message has been digested by most EM central banks who have adjusted expectations around the terminal policy rate and future rate cutting cycles to include it. Colombia will cut less, Brazil will not increase the pace of rate cuts, and countries like Philippines and Thailand are considering additional rate hikes. Indonesia just unexpectedly hiked interest rates to protect the exchange rate from higher US interest rates. The EM debt team finds it useful to consider which EM central bank policy paths are closely aligned to the US policy path as a step 2 overlay in screening local currency markets. The chart below illustrates our valuation model for 2-year real yields on the x-axis plotted again real 2-year interest rate on the y-axis. The upper right corner of the graph shows the countries with the most attractive short-term interest rates. Each country has a color code indicating the policy stance of the central bank: the darker red the more aligned to US policy and the lighter blue the more aligned to domestic policy needs.

**2Y Real Local Yields vs. Valuation (Rich (-)/Cheap (+))**



Source: VanEck Research; Moody’s; World Bank; International Monetary Fund; Bloomberg LP; October 2023. Past performance is no guarantee of future results.

EM countries that stand out are Mexico, Colombia, South Africa, Hungary, the Philippines and Thailand. Outside of Mexico where the EM debt teams has concerns over the valuation of the exchange rate and fiscal policy around the election, the EM debt team has allocations to these local markets.

**The government of Turkey deserves a special mention for the impressive showing given by both Economy Minister Simsek and Central Bank Governor Erkan.** Minister Simsek is well known by foreign investors and he made a compelling case that Turkey has credibly changed policy course by reducing the fiscal deficit, reducing the quantity of subsidised credit and tightening standards, allowing an exchange rate depreciation to restore competitiveness, begin rebuilding reserves and hike interest rates to levels restrictive enough bring inflation lower. Governor Erkan, however, was not known to investors and she made a very good first impression. It was clear she had a mandate to hike interest rates to levels where monetary policy would be restrictive. The meeting with them was the most packed one of the conferences and some major investment banks are recommending an overweight in Turkish Lira for the first time in recent memory.

**In addition to Turkey, there were many memorable country specific meetings:**

**Hungary's** inflation is finally heading for single digits, which can become the most important growth driver in 2024, boosting both consumption and investments. Higher growth should be associated with better fiscal outcomes, reducing the country's borrowing needs. A major uncertainty is the disbursement of the EU funds – both the timing and the size. But in the meantime, the country is benefitting from sizable FDI inflows, especially in EV battery manufacturing.

The **Czech Republic's** overall policy framework is probably the strongest in EM, but it is often trades “in sympathy” with the rest of the region. The latest fiscal consolidation proposal was a gutsy move and will help offset somewhat lower real interest rates than regional peers Hungary and Romania.

**Poland's** general election results were well received by the market, but the government formation, the policy agenda, the fiscal outcomes (both parties promised a lot before the elections), and geopolitical considerations would be just as important going forward.

**Brazil** is one of EM's poster kids for successful policy tightening, which did not kill growth (past reforms might be to “blame”) and opened room for gradual rate cuts. The focus now increasingly shifts to Brazil's ability to maintain fiscal discipline – a credible fiscal plan will keep inflation expectations and real interest rates under control and avoid “twin de-anchoring” (high inflation and uncertain fiscal results).

**Chile's** disinflation progress shows that the monetary policy transmission mechanism and the flexible exchange rate are working as intended. The central bank is now transitioning towards the policy rate's “normality” and continues to accumulate reserves, which can weigh on the Chilean peso, especially if there is more political noise associated with the new constitutional referendum.

**Colombia** is moving in the right direction... slowly. Inflation has finally peaked, but the tight labour market, rising wages, and the El Nino phenomenon pose additional upside risks, keeping the central bank on the defensive.

The market's key concern in the **Philippines** is the government's ability to reduce its fiscal gap. Plans look good, but the adjustment is expected to spread over many years. The central bank might need to tighten more to cool domestic demand, but the government is determined to maintain its pro-growth fiscal stance.

**Indonesia** remains a bright spot in EM Asia. Domestic activity, fiscal discipline, and the inflation outlook argue against additional policy tightening, while elevated trade surplus (buoyed by strong exports) provides fundamental support for the currency.

**South Africa's** inflation was more persistent than expected, with fiscal policy posing additional inflation risks. Multiple domestic and especially global risks make it difficult to simply look through them, keeping the central bank on the cautious side. South Africa's private energy generation is a potential positive for the country's assets, but it might take longer to play out.

**Morocco** remains a structural and economic success story in Northern Africa. The improving equilibrium current account balance is a major new positive that can help reducing Morocco's external financing needs from now on.

**Angola** continues to benefit from past reforms, and it continues to target greater diversification and the reduction of its debt burden. However, the economy remains too dependent on the price of oil – against the backdrop of stalling oil production and the end of the debt suspension agreement.

**Kenya's** growth story is still strong, and the IMF program remains a good policy anchor, but the market is frustrated about a lack of clarity about the maturing 2024 Eurobond, fearing that they will end up tapping into international reserves to make the payment.

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