TD Bank Financial Group

TD Economics

Special Report

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BAILOUT ROCK – IS $4 TRILLION A MAGIC NUMBER?

Among the economic uncertainties weighing on markets is the question of exactly what the final price tag will be to U.S. taxpayers of all of the fiscal stimulus and financial aid provided by the U.S. Treasury. Here, we briefly run through the numbers and find the governm ent borrowing over the next three years is likely to breach $4 trillion. Some of these costs are likely to be recouped in the future, and there are a few assumptions that must be made. When it comes to the U.S. fiscal position these days, though, one need assume little to leave aghast both you and me.

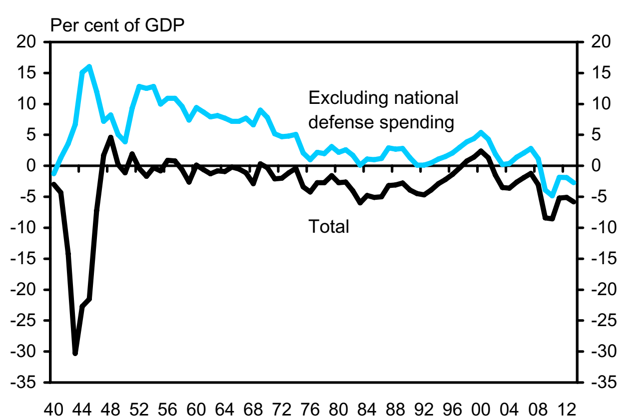
The $4 Trillion Pyramid

Given the fungibility of much of the spending, a three-year time horizon provides a good gauge of what may ultimately be spent. So how does one get to a $4 trillion borrowing requirement? While the full assumptions can be found in the appendix, the roadmap is as follows. The Office of Management and Budget's (OMB) assumptions as of July 2008 were for a cumulative U.S. deficit for FY2009-2011 of $763 billion. But the OMB assumes tax receipts will grow unabated through the current recession. This is doubtful – for example, instead of growing by 4% in 2009, receipts are likely to fall by 5% due to the decline in wages, capital gains, and corporate profits – and all told, this will likely subtract $1.0 trillion over three years. Moreover, the OMB must assume unchanged legislation, so no more Alternative Minimum Tax (AMT) exemptions by Congress (unlikely) and the Bush tax cuts fully expire in 2011 (very unlikely and contrary to Obama's campaign pledge). This adds another $470 billion to the deficit (and brings the total decline in revenues in FY2009 to 13%). Likewise, we must add about $100 billion in likely additional defense spending (the OMB forecast assumes the war abruptly ends this year), bringing us to $2.4 trillion before even talk-

HIGHLIGHTS

- **U.S. federal government borrowing is likely to exceed $4 trillion over the next three years and over $2 trillion in FY2009 alone.**
- **The current recession alone will cost $1 trillion in lost tax revenues over the next three years relative to earlier government forecasts.**
- **Excluding defense spending, FY2009 will see the first deficit since 1940, when the U.S. was still financing the New Deal.**
- **Interest costs alone are forecast to add over 4% of GDP per year to the deficit within a decade.**
- **But, interest rates on U.S. government debt are at generational lows, and they aren't done falling yet, meaning there is no better time for the Treasury to borrow.**

U.S. FEDERAL DEFICIT



*TD Economics forecasts for FY2009-2013;
Source: U.S. Department of the Treasury and CBO

ing about bailouts and stimulus packages.

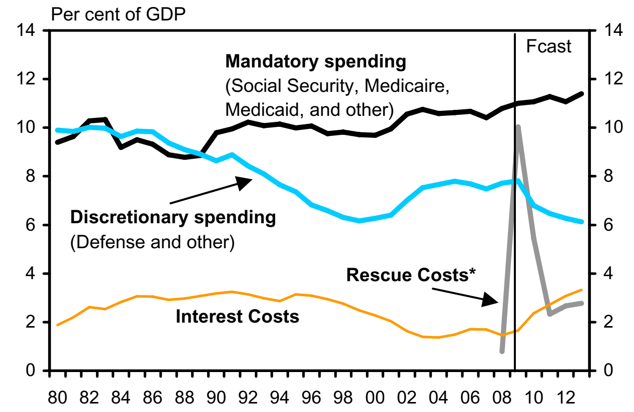
To this new baseline figure, we then add another $210 billion in government-sponsored enterprise (GSE) purchases of mortgage-backed securities (MBS), as well as operating income of Fannie Mae and Freddie Mac which are now on-balance sheet. We then have the current $700 billion TARP – $330bn of the first $350bn approved by Congress has been appropriated and we believe it's likely the remaining $350 billion will be approved by Congress shortly into President Obama's term. This brings the borrowing requirement to $3.4 trillion. Adding a second fiscal stimulus package of around $600 billion – $500-$750 billion is what is being debated on Capitol Hill – and an additional $400 billion in new debt service costs brings the total to slightly more than $4 trillion over the next three years.

The Fine Print

But longer term, there are revenues to be had by the Treasury of around 2-3% of GDP each year from FY2014-2018 to offset some of the increased debt interest costs. The GSE's profitability will ultimately return based on their MBS purchase and guarantee business. Moreover, we believe some part of the spending on asset purchases will ultimately be recouped. Past government asset purchases around the world have seen recovery rates between 75-100%. While we assume the midpoint of this range, we are somewhat optimistic on potential recovery rates – based on the large equity stakes taken by the government, the stipulations built into the TARP funds, and the ability of the government to wait until asset values return before selling. There is also another $500 billion in potential revenues over the next decade from the planned scaleback of the balance sheets of Fannie and Freddie (10% per year until their assets reach $250 billion), though it it unclear whether these revenues would accrue to the federal government. In addition, it is uncertain how reflationary the recovery from the current crisis will be, and our conservative assumption on tax receipts may prove overly pessimistic.

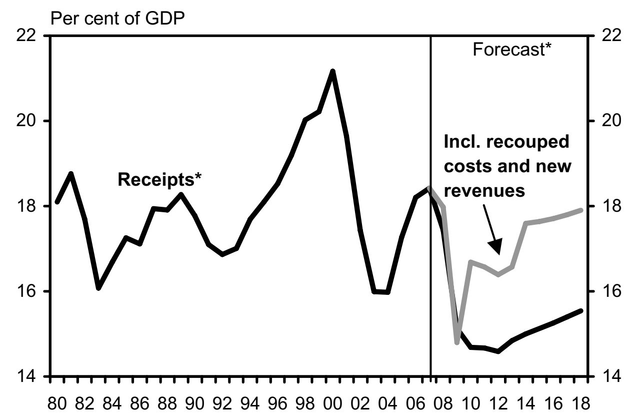
All told, borrowing in FY09 may hit 16% of GDP. With uncertainty over the accounting rules, up to half of this may be off-balance sheet. As a result, the U.S. fiscal deficit may be reported at something closer to 8%. But that would not negate the need to issue debt. The total borrowing would see publicly-held U.S. debt increase by almost 50% of GDP over the next decade, bringing the total to 83% of GDP. Would the U.S. sit idly by and let that happen? Probably not, but while some share of this

U.S. FEDERAL SPENDING



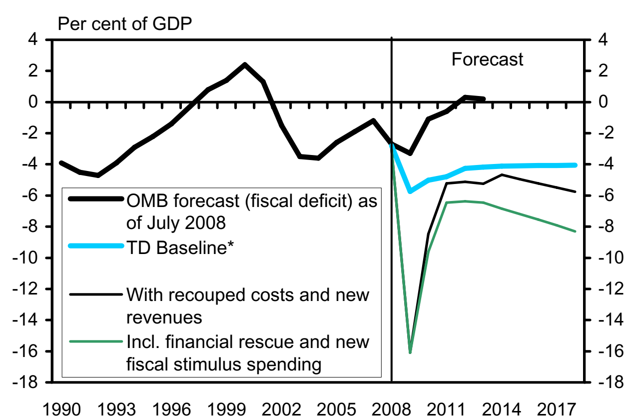
*Includes costs of financial aid packages and expected new fiscal stimulus; Source: OMB

U.S. FEDERAL TAX RECEIPTS



*Including TD forecasts on the impact of the recession and expected tax code changes; Source: OMB

U.S. BORROWING REQUIREMENTS



*Including tax revenue lost due to recession and expected Obama changes to the tax code in 2011; Source: OMB and TD Economics debt may be avoided, it is premature to speculate on the combination of increased taxes and reduced mandatory spending (faster GDP growth and/or inflation would do the trick, too), that would be used. It is also a remote possibility that some of this debt will be bought directly by the Federal Reserve, again limiting the amount of publicly-held debt.

If You Issue It, They Will Come

The scary part is that this does not even include all of the likely Treasury issuance. To help finance the Fed's growing balance sheet, the Treasury issued about $600 billion in bonds and left this cash deposited with the Federal Reserve. This could potentially be repeated with much more issuance in the future. While the Treasury is obligated to pay the interest cost on these bonds to bondholders, this is offset by the higher fees the Fed receives through the loans it extends with the proceeds and so is generally net neutral on the budget. As an extension, the above deficits do not include anything financed on the Fed's balance sheet (AIG, MBS purchases, TAF, etc). Also, the 83% of GDP in outstanding debt held by the public in ten years time excludes the 35% of GDP in Fannie and Freddie debt currently outstanding. Combined, this would put the U.S. in the 110-120% of GDP threshold that saw the debt ratings of Japan and Canada lowered in the 1990s. While that is a concern, we believe a combination of discounting the GSE debt given this is debt secured by mortgage assets, as well as a likely fiscal tightening response well down the line for the U.S., still limits the likelihood U.S. government debt would be downgraded.

No doubt, though, this is a lot of debt. If this issuance is too much for the market to accept, the value of the U.S. dollar will fall and U.S. yields will rise. While this is the more likely medium-term expectation, we haven't seen this yet. In fact, across the yield curve, it is now cheaper for the US government to borrow than at any time since the 1950s. Moreover, the Fed has already signaled that with short-term rates close to zero, they may begin trying to lower interest rates at longer maturities. Even more, the Chinese desire to see the yuan depreciate would likely entail increased demand for U.S. debt. The balancing act will begin once the accounting becomes a bit more concrete.

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APPENDIX

U.S. BORROWING REQUIREMENTS* (Billions of U.S. dollars unless otherwise stated)	Actual		Forecast			
	FY2007	FY2008	FY2009	FY2010	FY2011	FY2009-2011
OMB Baseline Fiscal Deficit	**162**	**425**	**482**	**178**	**103**	**763**
Treasury Invesment Spending			**1077**	**-10**	**-157**	**910**
TARP			700	0	0	700
MBS purchases			120	60	0	180
Net GSE Spending			257	-70	-157	30
Other Costs			**372**	**443**	**193**	**1008**
New debt interest costs			72	143	193	408
Second fiscal stimulus			300	300	0	600
OMB Assumptions Adjustment			**321**	**627**	**660**	**1,608**
Tax receipt loss due to recession			221	447	368	1,035
Tax code changes			100	110	263	473
Defense spending			0	70	30	100
U.S. BORROWING REQUIREMENTS	**162**	**425**	**2,252**	**1,237**	**800**	**4,288**
Per cent of GDP	**1.2**	**3.0**	**16.1**	**9.6**	**6.5**	**29.3**

*TD Economics forecasts as of December 2009. Positive figures denote deficit.
Source: TD Economics and Congressional Budget Office

U.S. FISCAL POSITION	Billions of U.S. dollars						Per cent of GDP					
FY (Oct-Sept)	Receipts	Outlays	o/w: Interest	Borrowing Requirement	Deficit	Debt*	Receipts	Outlays	o/w: Interest	Borrowing Requirement	Deficit	Debt*
2008	2,628	3,053	203	-425	-425	4,962	18.8	21.9	1.5	-3.0	-3.0	35.5
2009	2,284	4,536	231	-2,252	-1,175	7,214	16.3	32.4	1.7	-16.1	-8.4	51.6
2010	2,651	3,888	346	-1,237	-1,247	8,451	18.1	26.6	2.4	-8.5	-8.5	57.8
2011	2,745	3,544	416	-800	-800	9,250	17.9	23.1	2.7	-5.2	-5.2	60.4
2012	2,835	3,658	494	-822	-822	10,073	17.7	22.8	3.1	-5.1	-5.1	62.8
2013-2017 (avg)	3,443	4,391	695	-949	-1,079	12,787	18.6	23.7	3.8	-5.1	-5.8	69.1
2018	3,994	5,220	882	-1,226	-1,389	16,042	20.6	26.9	4.5	-6.3	-7.2	82.7

TD Economics Forecasts as of December 2008; *Publicly-held marketable debt; Source: TD Economics and OMB