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ISSUER IN-DEPTH
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Government of United States of America

Widening deficits will drive gradual decline in fiscal strength over medium term

The United States' (Aaa stable) fiscal strength is set to gradually decline from 2019 onward, driven by widening federal budget deficits, a rising debt burden and falling debt affordability. In this report, we assess the final outcomes of the fiscal year ending in September 2018 (fiscal 2018) and provide an updated fiscal outlook for 2019 and beyond. We conclude that absent any material changes in the direction of fiscal policy, a persistent widening of fiscal deficits will push the federal debt and interest burdens to historic levels, which will ultimately weigh on the sovereign credit profile. However, the US' exceptional economic strength and the preeminent role of the US dollar and Treasury bond market will continue to provide substantial support to the credit profile over the medium term.

» **Fiscal 2018 outcomes reaffirm our expectation of a gradual decline in fiscal strength.** In fiscal 2018, the US' federal budget deficit widened for the third consecutive year in a row to 3.8% of GDP, driven by weak revenue intake and a rising interest burden. We expect this trend to continue in 2019 and beyond.

» **Congressional midterm election results will not reverse the adverse trajectory of US fiscal policy.** Post-midterm changes in the makeup and control of the US Congress will not alter the trajectory of fiscal policymaking. We expect increased legislative gridlock with the Democrats regaining control of the House of Representatives and the Republicans retaining control of the Senate, which will limit any potential material changes in fiscal policymaking.

» **Fiscal deficits will widen further in 2019 and beyond, contributing to a deterioration in the US' fiscal position over the medium term.** Our updated projections continue to point to a significant widening of the federal deficit over the medium to long term. Under current policy settings, we expect the federal budget deficit to widen to around 8% of GDP by 2028 from about 4.8% of GDP in 2019, driven by rising federal interest payments and age-related entitlement spending. As a result, the debt burden will continue to rise and debt affordability will decline, detracting materially from fiscal strength.

» **Offsetting credit strengths will continue to support the Aaa sovereign credit profile.** As fiscal strength deteriorates, the US will increasingly rely on its exceptional economic strength and the unique roles of the US dollar and Treasury bond market in the global financial system to preserve its Aaa credit profile. Nonetheless, rating pressures could emerge in the coming years in the absence of a shift in fiscal policy to reduce the government's budgetary imbalances and stabilize its debt metrics.

Fiscal 2018 outcomes reaffirm our expectation of a gradual decline in fiscal strength

According to the Congressional Budget Office (CBO), in fiscal 2018 the US' federal budget deficit expanded for a third consecutive year to 3.8% of GDP ($779 billion), from 3.5% in 2017 and 3.2% in 2016. The widening of the deficit was driven by effectively flat revenue growth combined with expenditure pressures from rising debt service payments.

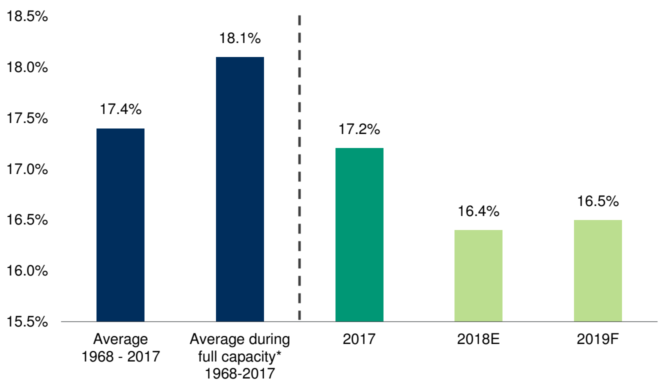
On the revenue front, robust GDP growth and expanding employment rolls were insufficient to offset total revenue losses from last year's landmark Tax Cuts and Jobs Act reform. Total federal receipts grew by only 0.4% in nominal terms to $3.329 trillion. Relative to the overall size of the economy, revenue intake declined to 16.4% of GDP from 17.2% in fiscal 2017, well below the 18.1% average in years when the economy was growing at or above potential (see Exhibit 1).

Overall, the weakness in federal revenue was driven mainly by a significant 31% decline in corporate income taxes, which accounted for about 6.2% of total revenue and 1.0% of GDP ($205 billion) in fiscal 2018, the lowest intake relative to GDP since the global financial crisis (see Exhibit 2). Personal income and payroll taxes, which account for more than 80% of federal revenue and have remained buoyant since 2015, were 8.3% and 5.8% of GDP last year, close to their 50-year averages of 8.0% and 5.9%, respectively. Other receipts fell to 1.3% of GDP last year, down from their post-recession high of 1.7% in 2016, driven primarily by lower remittances from the Federal Reserve.

Exhibit 1

Revenue intake will likely remain well below historical averages...

Federal government revenue, % of GDP



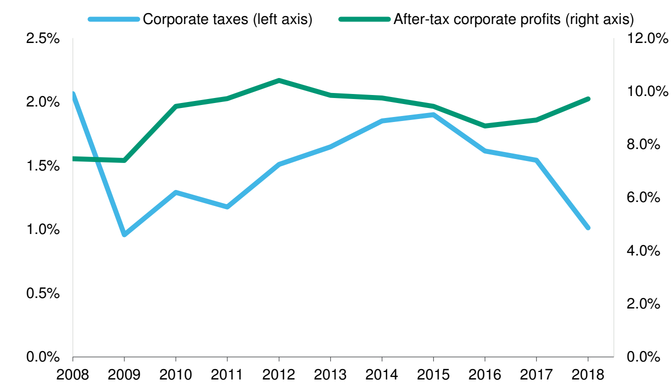
*Average in years when GDP was at or above CBO's estimate of potential GDP

Sources: CBO and Moody's Investors Service

Exhibit 2

...in part due to lower corporate tax receipts following tax reform

Corporate tax receipts and after-tax corporate profits*, % of GDP



*Corporate profits adjusted for inventory and depreciation.

Sources: CBO, BEA, Haver and Moody's Investors Service

Meanwhile, total nominal federal outlays increased by 3.2% to $4.108 trillion in fiscal 2018, equivalent to 20.3% of GDP compared to 20.7% of GDP in 2017. Expenditure pressures were mainly driven by a 20% increase in net interest payments on public debt, resulting in a total debt service cost of $371 billion. This increase reflects both higher interest rates and a growing debt burden. Higher defense spending (up 5.6%) also contributed to the deficit, along with a small nominal increase in combined major entitlement program spending (up 2.5%). However, on a relative basis, entitlement spending fell by 0.2 percentage points relative to GDP (see Exhibit 3).

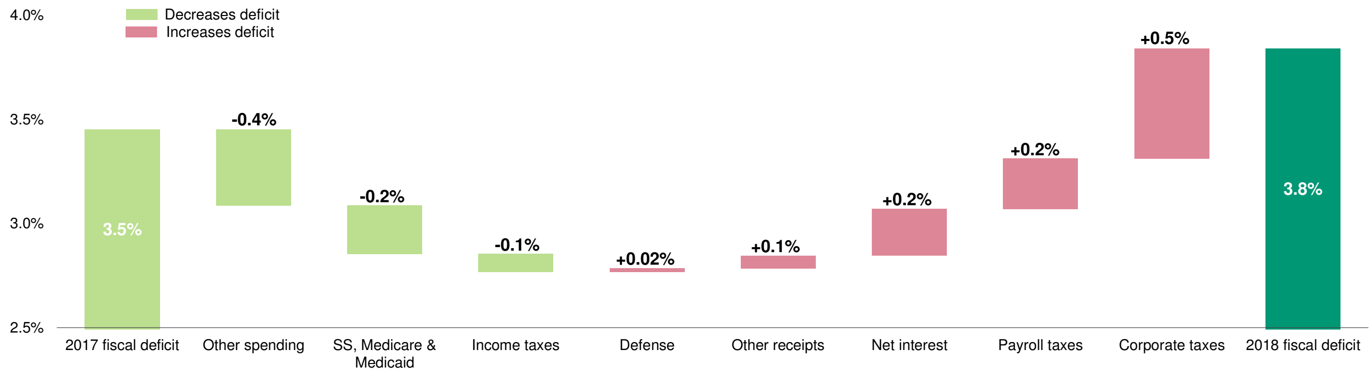
Although CBO's preliminary estimates indicate that 2018's budget deficit came in 0.3% of GDP below our April 2018 projections (3.8% result compared to our 4.1% forecast), the lower deficit was primarily due to the timing of certain payments rather than improvements in fiscal dynamics.[1]

Moving forward, we expect the trend of relatively weak revenue growth and rising debt service payments, along with entitlement spending, to persist, contributing to an ongoing widening of federal fiscal deficits (see more detail below). This trend will be reinforced by slowing global growth momentum in 2019-20 and ongoing tightening of financial conditions.

Exhibit 3

Reduced revenue intake and higher interest payments drove most of the increase in the 2018 deficit

Contributions to the fiscal deficit by budget item, percentage points of GDP



Note: Defense spending excludes outlays by Department of Defense on civil programs.

Sources: CBO, Haver and Moody's Investors Service

Congressional midterm election results will not reverse the adverse trajectory of US fiscal policy

Post-midterm changes in the makeup and control of the US Congress will not alter the trajectory of fiscal policy given the Democratic policy agenda and our expectations of increased legislative gridlock.

Split Congress points to increased political wrangling over policy priorities...

In the November 2018 US Congressional midterm elections, the Democratic Party won control of the House of Representatives (House) for the first time since 2010 and the Republican Party maintained control of the Senate. Although the split Congress could lead to increased political wrangling over budgetary issues and public finances, we expect overall fiscal policy to be a secondary concern for US policymakers, as they will instead likely continue to focus on issues related to trade, healthcare and immigration through 2020.

Early indications of the Democratic leadership's planned legislative package for the coming year point to a focus on establishing ethics and lobbying reforms, lowering the costs of health insurance premiums and prescription drugs, and a $1 trillion infrastructure investment program, with fiscal policy initiatives limited to financing arrangements for spending programs. Meanwhile, any Republican efforts to advance further tax reforms will be severely limited because of their loss of the House.

...limiting any potential material changes to adverse fiscal dynamics

Democrats regaining control of the House and Republicans' consolidation of power in the Senate increase the probability of legislative gridlock, further limiting any potential material policy changes over the next two years to address the US' adverse federal fiscal dynamics.

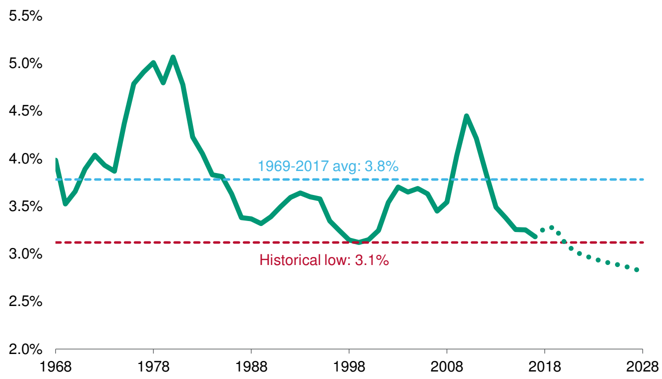
On the revenue front, we do not expect the newly-empowered Democrats to move to include a repeal or revision of the Tax Cuts and Jobs Act 2017. If they did, Republicans have marginally improved their majority in the Senate following the midterms, which increases the difficulty of passing any Democratic House legislation through a Republican-controlled Senate. If such a revised bill were to pass both chambers of Congress, it would likely be vetoed by President Trump.

Meanwhile, bipartisan support for meaningful expenditure reforms, including entitlement reform, appears unlikely. Neither party is currently proposing any viable policy options to address the US' fiscal challenges. We expect some changes to expenditure to take place at the margins, primarily focusing on non-defense-related discretionary spending, which is already nearing its lowest point in 50 years. While such spending has declined consistently over the last decade, largely as a result of budgetary caps imposed in 2011 via the Budget Control Act, it comprises only about 15% of total expenditure, which is less than one third of total spending on social security and major health care programs. Therefore, its impact on deficit reduction would be relatively small (see Exhibits 4 and 5).

Exhibit 4

Non-defense discretionary spending will continue its declining trend...

Non-defense discretionary outlays, % of GDP

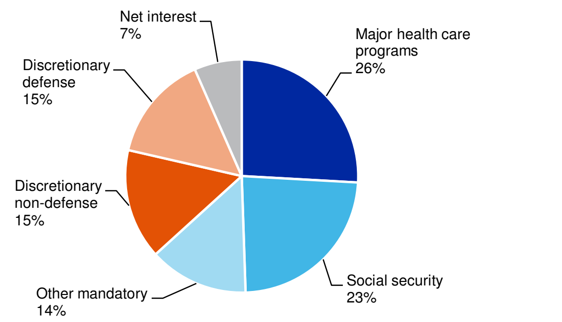


Note: Projections are from CBO's 10-year Budget & Economic Outlook (April 2018)
Sources: CBO and Moody's Investors Service

Exhibit 5

...but is only a relatively small contributor to total federal expenditure

Federal expenditure by category, % of total, 2017



Note: Major health care programs include Medicare, Medicaid, and the Children's Health Insurance Program and ACA subsidies.
Sources: CBO and Moody's Investors Service

Political risk surrounding budget appropriations and debt limit will return in late 2018 and early 2019

Delays to funding of key federal agencies for 2019 could lead to government shutdown…

Congress faces a 21 December 2018 deadline to fund key federal government agencies, risking a partial government shutdown in the event that it is unable to resolve disagreements on partisan issues, primarily related to funding of the southern border wall.

A shutdown would halt federal discretionary spending, which funds most day-to-day government operations. However, spending on mandatory programs, such as Social Security, Medicare, Medicaid and other social programs, would continue, as would principal and interest payments on US government debt. As we have noted in the past, although a shutdown would be credit negative for the sovereign to the extent that it disrupts the US economy, it would not have any immediate implications for the US government's credit rating.

…and impending reimposition of debt limit could increase political rancor…

In February 2018, Congress suspended the debt limit through 1 March 2019, which allowed the government to borrow as much as it needed to finance its operations. After that, the debt limit will be reimposed, preventing the government from borrowing to finance already approved operations. To lift borrowing restrictions, the government will need to pass legislation approving a new debt limit.

We expect negotiations over the fiscal 2020 budget to take center stage as the March 2019 deadline approaches, a dynamic that would be reminiscent of previous debt ceiling negotiations in late 2017 and early 2018 that were tied to funding measures for fiscal 2018. Given the newly divided Congress following midterm elections, we now see heightened risk of political brinkmanship around the debt limit deadline, which could lead to it being missed. If this were to happen, the Treasury would resort to using “extraordinary measures”[2] to meet its daily financing needs until an agreement was negotiated to lift or suspend the ceiling once again.

...but a missed debt payment remains highly unlikely

In the event that the debt limit is not raised, we believe that the Treasury would prioritize interest payments over other expenses to preserve the full faith and credit of the government, and to avoid disruptions in financial markets. A prolonged delay in raising the debt ceiling could exhaust the Treasury's use of its extraordinary measures, which independent observers estimate could cover between three and six months of operations[3], which could result in a missed interest payment and government shutdown.

However, if the inability to raise the debt ceiling were to result in a missed interest payment by the US government – an outcome we consider to be highly unlikely – there would be negative implications for the creditworthiness of the sovereign and various other issuers. In the unlikely event of an interest payment not being made as a consequence of the debt ceiling, we would expect the default to be short lived and to be cured with a recovery rate of 100%.

The limited operational relevance of the debt limit in the US' fiscal framework and its propensity to add to political discord and weaken the budget-making process was an important consideration in our decision to adjust the US' institutional strength score to "Very High," a notch below its indicative score of "Very High (+)," earlier in 2018. The US and Australia (Aaa stable) are currently the only Aaa-rated sovereigns with institutional strength scores below "Very High (+)."

Fiscal deficits will widen further in 2019 and beyond, contributing to a deterioration in the US' fiscal position over the medium term

Our projections continue to point to a slow but persistent deterioration in the US' fiscal strength over the next 10 years, absent any material changes to fiscal policy, as the debt burden grows and debt affordability declines. This adverse fiscal dynamic will be driven by widening federal budget deficits due to significant expenditure growth, led by interest payments and age-related entitlement spending, and below-average revenue intake.

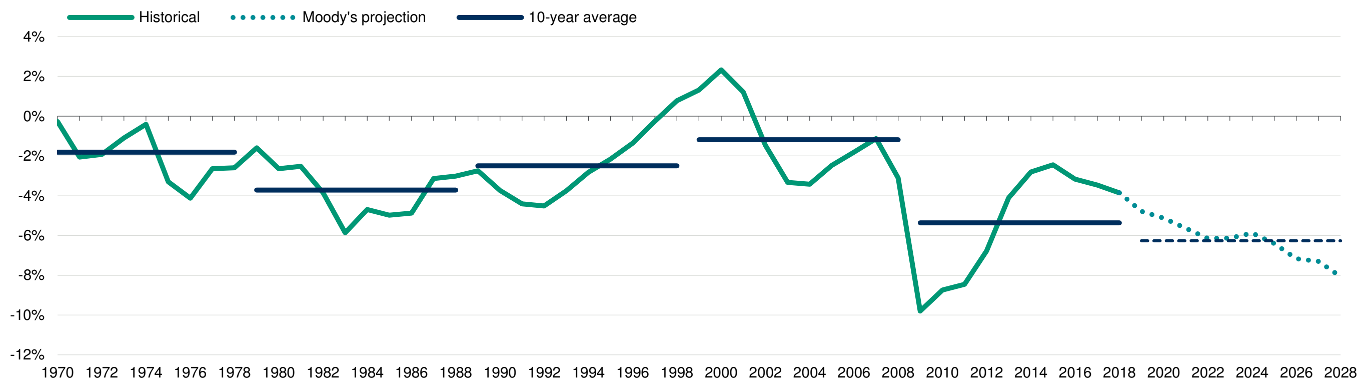
Despite a slightly lower-than-expected federal budget deficit in 2018, we have maintained our 4.8% of GDP fiscal deficit forecast for fiscal 2019, uninterrupted in its steady rise from a post-recession low of 2.4% in 2015. The Federal Reserve's ongoing normalization of interest rates will drive debt service costs higher, while entitlement and defense spending will also rise, bringing total expenditure up to about 21.3% of GDP, from 20.3% of GDP this year. We expect revenue growth to be contained at around 16.5% of GDP, up only slightly from 16.4% in 2018, due to slowing US GDP growth as last year's fiscal stimulus fades and financial conditions continue to tighten. We estimate that US real GDP growth will decelerate from about 2.9% in 2018, to 2.3% in 2019 and 1.5% in 2020.

Looking beyond 2019, our updated federal budget deficit projections continue to point to a significant widening over the next 10 years, at a slightly faster pace than the CBO's forecasts. In the absence of at least partially offsetting measures, relatively static revenue and increasing expenditure would drive the federal deficit beyond 8.0% of GDP by fiscal 2028 (see Exhibit 6), a level only previously reached following the 2008-09 global financial crisis.

Exhibit 6

US fiscal deficits will widen in the absence of policies to offset rising funding costs and entitlement spending

Historical and projected federal budget deficit, % of GDP



Sources: CBO and Moody's Investors Service

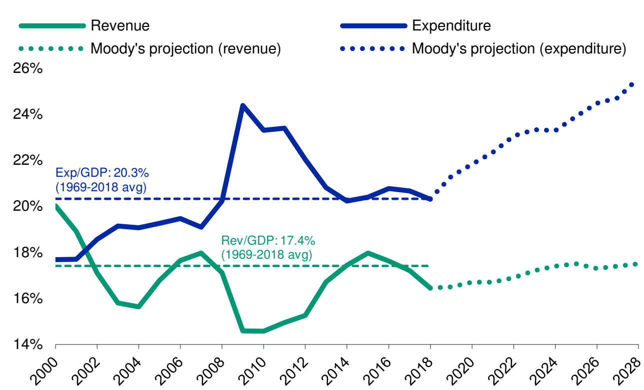
From a revenue perspective, last year's tax changes materially reduced the government's policy space. We expect federal revenue intake to remain constrained relative to its long-term average over the next decade, reaching 16.5% of GDP in fiscal 2019, compared to the 17.4% average over the last 50 years and 18.1% when the economy was running at or near full employment. Over the longer term, we project revenue intake to remain below 17.6% through fiscal 2028, with modest growth in receipts stemming primarily from rising real incomes that push some earners into higher tax brackets. Unlike the CBO, our projections assume that personal income tax provisions from the Tax Cuts and Jobs Act 2017 will be extended beyond their scheduled expiration date in 2025, resulting in about 0.7% of GDP worth of lost revenue.

Meanwhile, we expect federal government expenditure to steadily rise from its long-term average of 20.3% of GDP (average from 1969-2018) to around 26% in 2028 (see Exhibit 7). Rising interest payments will account for close to half of the deterioration in the fiscal deficit by fiscal 2028, due to a faster accumulation of debt and an accelerated increase in market interest rates, with the terminal 10-year rate converging to around 4.1% by 2022 and averaging 4.0% between 2019-28 (the CBO assumes an average rate of 3.8% over the same time period) (see Exhibit 8). The remainder of the increase will primarily be driven by increases in age-related entitlement spending, which will grow substantially as a result of the US' aging population and rising healthcare costs. While we also expect higher steady-state military spending to contribute to higher overall expenditure, a divided US Congress in 2019 could lead to some moderation in defense spending over the medium term. As a share of overall spending, we estimate that net interest will rise to about 16% in 2028 from 9% in 2018, while entitlement spending (social security and major healthcare programs) will remain around 50%.

Exhibit 7

Expenditures will outstrip revenue intake and economic growth...

Historical and projected revenue and expenditure, % of GDP

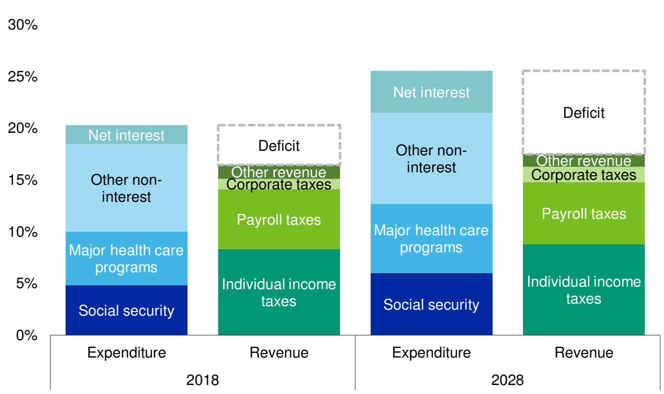


Sources: CBO and Moody's Investors Service

Exhibit 8

...as funding costs and entitlement spending drive deficits higher

Revenue and expenditure categories 2018 and 2028, % of GDP



Sources: CBO and Moody's Investors Service

Overall, our updated projections indicate a slight improvement over our April 2018 estimates, driven by changes to our 10-year Treasury rate forecast, which we now expect to average around 4.0% between 2019-28, down slightly from 4.1%. Based on these changes, we now estimate that the federal budget deficit will reach 8.1% of GDP by 2028, down only marginally from our previous estimate of 8.3%.

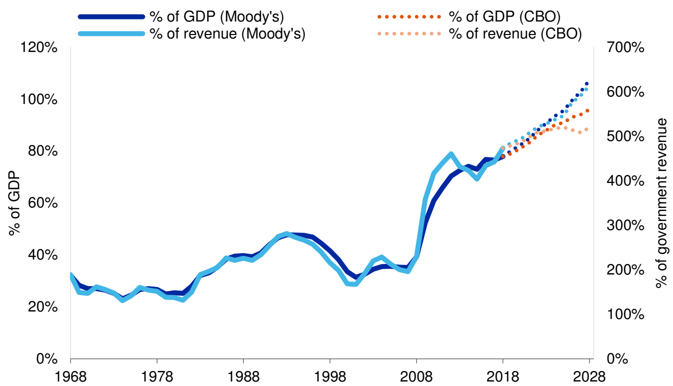
Notwithstanding marginal improvements in expenditure patterns, the challenging fiscal dynamics outlined above have already manifested themselves in a weakening of the US's fiscal strength. We estimate that the US' federal debt burden reached around 78% of GDP in 2018, nearly double its 2008 level of 39% and its highest since 1948 (following World War II). At the same time, the government's interest burden consumed 11% of revenue this year, up from 8% in 2017. This is the US' highest interest burden ratio since 1999 and the highest ratio among all Aaa-rated sovereigns.

On the basis of current policy settings, we estimate that widening budget deficits will drive the federal debt trajectory to increase by around 30 percentage points by fiscal 2028, to surpass 100% of GDP. Meanwhile, we estimate that interest payments to revenue will rise by about 12 percentage points, from 11% in 2018, slightly above the CBO's forecasts (see Exhibits 9 and 10).

Exhibit 9

Federal government will face a deteriorating debt burden...

Federal debt held by the public, % of GDP and % of revenue



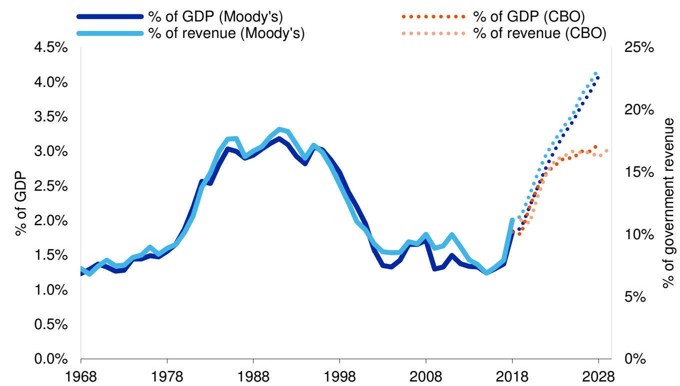
June 2018 CBO projections for 2019-2028

Sources: CBO and Moody's Investors Service

Exhibit 10

...as well as diminishing debt affordability

Federal interest outlays, % of GDP and % of revenue



June 2018 CBO projections for 2019-2028

Sources: CBO and Moody's Investors Service

The policy measures required to reverse these adverse fiscal dynamics would be substantial, particularly if macroeconomic conditions were to deteriorate.

If we take the CBO's June 2018 baseline as a starting point[4], which is more favorable than our current forecast, the federal deficit as a share of GDP would need to be reduced by around 2.0 percentage points and maintained at that level relative to the CBO's baseline forecast to stabilize the federal debt stock at below 80% over the next 10 years.

We consider the prospects of such a material shift toward fiscal consolidation over the next two years to be very low. First, as the US' late stage business cycle expansion begins to turn and growth slows, fiscal consolidation will become even more politically challenging. Meanwhile, it appears unlikely that the US political climate will be conducive to any material fiscal policy changes in the run-up to the US presidential election in 2020, particularly with a now divided Congress.

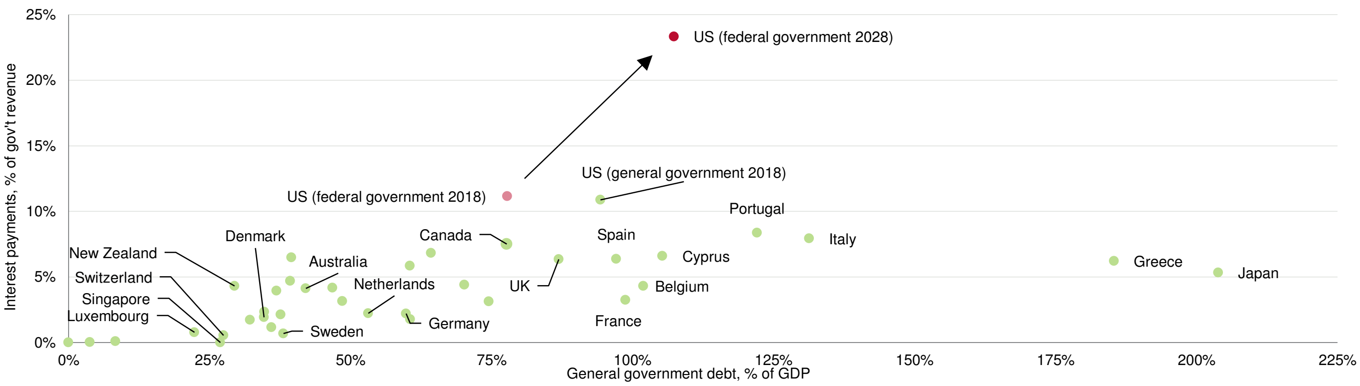
Over time, these adverse fiscal dynamics will weigh on our assessment of the US' fiscal strength, which could eventually impact the Aaa-rated sovereign credit profile.

In particular, the greatest challenge to the US' fiscal strength will be the sharp decline in debt affordability metrics relative to peers (see Exhibit 11). Over the next decade, in the absence of corrective fiscal policy adjustments, weaker fiscal indicators will bring the US' indicative fiscal strength score down from today's assessment of "High" to "Low." This will place ever-greater weight on the US' exceptional economic strength and preeminent reserve currency status to support the Aaa sovereign credit profile.

Exhibit 11

US debt and interest burdens are set to deteriorate materially over the next decade

General government debt (% of GDP) and interest payments (% of general government revenue)



Note: for illustrative purposes sovereigns included are Aaa-rated, advanced and/or highly leveraged

Source: Moody's Investors Service

Offsetting credit strengths will continue to support the Aaa sovereign credit profile

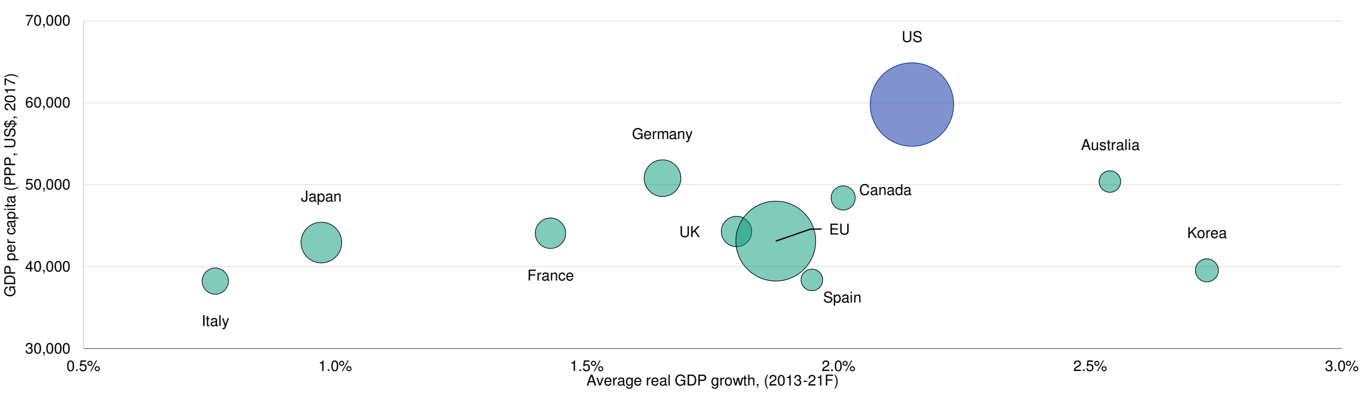
As the US' fiscal strength slowly deteriorates, the Aaa sovereign credit profile will increasingly rely on its exceptional economic strength and the unique roles of the dollar and Treasury market in the global financial system. Together, these key pillars of strength will help offset much of the gradual decline in the US' fiscal strength.

With an estimated nominal GDP of about $20 trillion in 2018, the US is by far the world's largest economy in nominal terms, implying a high degree of diversification and significant shock-absorption capacity (see Exhibit 12).

Exhibit 12

The US economy's size and wealth exceeds that of

Average real GDP growth and GDP per capita; size of bubble = 2018E nominal GDP ($US)

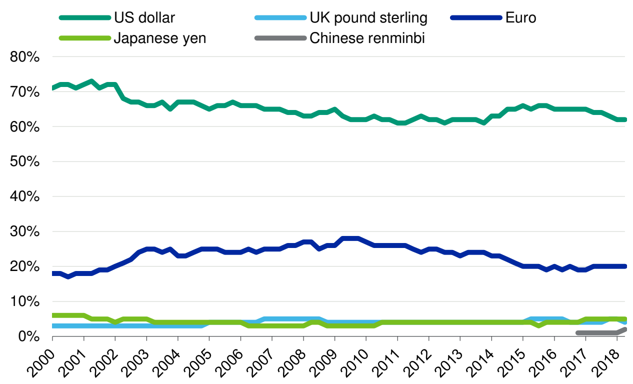


Bubbles represent the ten largest, advanced industrialized economies plus the EU.

Sources: IMF, Haver and Moody's Investors Service

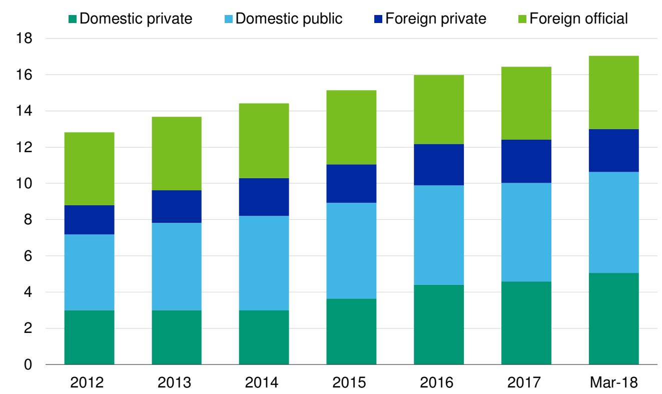
Additionally, as the world's preeminent reserve currency, the central role of the US dollar and Treasury market greatly reduce funding risks and financing constraints for the sovereign, despite a deteriorating fiscal position. US dollar-denominated assets comprise more than 60% of global foreign exchange reserves and overall demand for US Treasury securities remains diverse and robust (see Exhibits 13 and 14). The dollar's safe-haven status, underpinned by its role as the world's primary invoicing, settlement and reserve currency, suggests that most global economic shocks would likely be accompanied by increased demand for US dollar-denominated assets, as occurred during the global financial crisis, despite the shock having originated in the US. Meanwhile, the US Treasury market is the deepest and most liquid bond market in the world. These unique features insulate the US Treasury market, and therefore the funding of US budget deficits, from all but the most extreme liquidity risks.

Exhibit 13
US dollar remains the world's dominant reserve currency...
Select reserve currencies, % of global allocated official reserve holdings



Sources: IMF, Haver and Moody's Investors Service

Exhibit 14
...while the Treasury market remains the deepest and most liquid bond market
US Treasury securities by holder, USD trillions



Note: SIFMA statistics include all public debt except savings bonds and state and local series
Sources: SIFMA, US Treasury, Federal Reserve Board and Moody's Investors Service

Nonetheless, prolonged policy inaction entails increased downward pressure on the US' credit profile over the long term.

We would consider revisiting the US credit profile if we were to conclude over the coming years that US policymakers do not have the capacity to respond decisively to mitigate the country's adverse fiscal dynamics. Absence of effective policy action would gradually erode both fiscal and institutional strength and weaken the sovereign's credit profile, particularly if we were to conclude that it undermined the key pillars of economic strength and the role of the US dollar and Treasury bond market in the global financial system.

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Endnotes

1 Outlays in fiscal 2018 were reduced by a shift in the timing of certain payments: those payments were instead made in fiscal 2017 because October 1, 2017 (the first day of fiscal 2018), fell on a weekend. If not for that shift, the deficit in 2018 would have been $823 billion, or 4.1% of GDP, in line with our April 2018 forecast.

2 Existing statutes allow the US Department of the Treasury to change the normal operations of certain government accounts that can then be used in extraordinary circumstances to add borrowing capacity to generate cash to pay for daily operations. Treasury only resorts to these measures to avoid missing payments when the debt limit is reached.

3 How long extraordinary measures last depends on general trends in revenue and disbursement of outlays, the way that federal debt is managed, and the timing of when certain cash resources become available. Given the unpredictability of these factors the estimate is subject to a high level of uncertainty. However, when the debt limit was reinstated in March 2017, the April 2017 collection of tax receipts helped to push the Treasury's estimate for the expiration date of extraordinary measures to September of that year, providing approximately six months of operational cover. We view a similar outcome to be possible next year given the March 2019 deadline's proximity to April tax collections.

4 Consistent with its statute, in constructing its June 2018 baseline 30-year projections the CBO assumes that current US laws remain "generally unchanged."

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