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MACRO MORNING BRIEFING

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Fiscal Dominance And iFlow

The ability to know when markets have reached a tipping point for financial stability has become the third rail of central bank policymaking since the Global Financial Crisis. The US's current debt burden is to the point that it's often discussed as a medium-term risk for another crisis. Most politicians and policymakers see it as fixable, but requiring attention within a few years, rather than decades.

History has examples of when debt burdens over 120% of GDP lasting for over a decade spelled trouble for an economy – cyclical downturns can become structural disasters. However, growth and inflation are key parameters in any debt barometer. Determining when debt dynamics are unsustainable is an ages-old exercise and all failures are outcasts. The US numbers speak for themselves: $35trn in government debt funded by $8trn in foreign buying and the rest internally, with debt held by the public at 100%, just shy of the 106% in 1944. The Congressional Budget Office projects this to rise to 106% in 2028 and to 160% by 2050 unless policy changes.

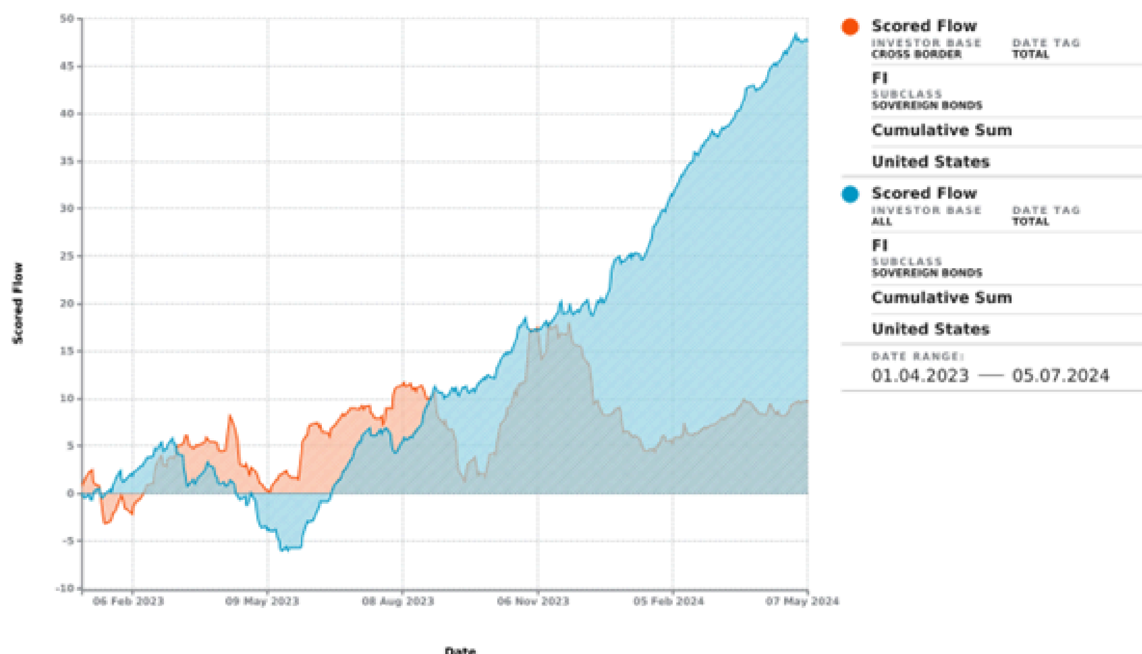
Ascertaining just when the medium-term risk becomes more immediate derives from the intersection of politics to economics. The ability to see when cross-border flows stall is one variable to use in forecasting when trouble might arise. Enter iFlow data.

- What could send US bond yields higher? A growth slowdown leading to lower tax intake; inflation preventing the Federal Reserve from delivering expected easing; more fiscal expansion; and less foreign appetite to own US paper.
- Views on the ability of the US to support ongoing deficit spending cross both main parties. Republicans blame Democrats for spending, Democrats blame Republicans for tax cuts. The ability of the US to pay down its debt is substantial given the health of both corporate and household balance sheets.

- Two options to lower debt without a default – pay it off over time with inflation doing its part, or so-called financial repression helping to defray the compounding problem. In the post-WW II debt dynamic, US investors were subject to repression, which eventually led to slower growth and, ultimately, broke down with deficit spending for the Vietnam War. The tie-in for FX to this came from President Nixon scrapping the gold standard in 1971.
- When central bankers support a government's fiscal expansion they could be seen as putting their credibility with respect to fighting inflation at risk while providing for the "greater good" of the nation at times such as during a pandemic or a war. Much has been written about fiscal dominance. Several historical examples illustrate the dangers of it. During emergencies, central banks may temporarily accommodate expansionary fiscal policy, such as during WW II or the COVID-19 pandemic. As Cato's James Dorn points out, "Fiscal authorities normally dominate central banks during wartime."

Foreign holdings of US debt is estimated at 30%, down from 43% in 2013. However, the difference is more about the rise in US issuance rather than a buyers' strike by the largest foreign holders, Japan and China. Holdings totaled $7.965 trillion, up from a revised $7.945 trillion in January. Treasuries owned by foreigners rose 8.7% from a year earlier. Our iFlow data on cumulative flows in the post-pandemic world is notable – and still comforting in that the foreign buying has not reversed.

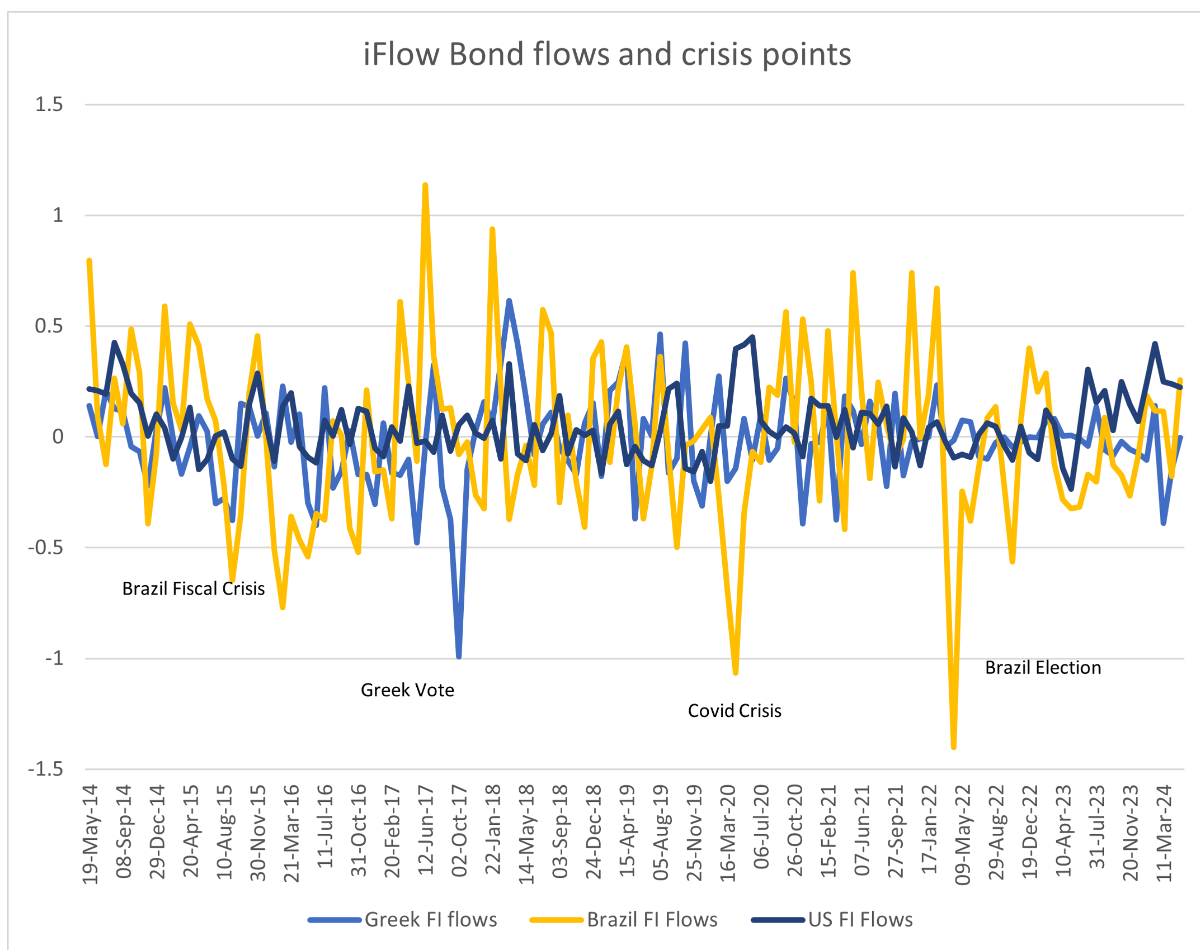
Exhibit #1: iFlow On US Cross-Border Demand



Source: BNY Mellon

Holdings of Treasuries grew the most in Belgium, +$27 billion to $320 billion. Japan, the largest non-US holder of Treasuries, increased its holdings to $1.167 trillion, the largest since August 2022, when the country's holdings were $1.196 trillion. The comparison of US TIC data to US Treasury iFlow data is close – and so this begs the question of whether there is information for investors in anticipating other potential trouble points. Looking at the history of Greece and Brazil in bonds and FX, there is some information that iFlow highlights amid financial instability.

Exhibit #2: iFlow Bond Flows - US, Brazil & Greece

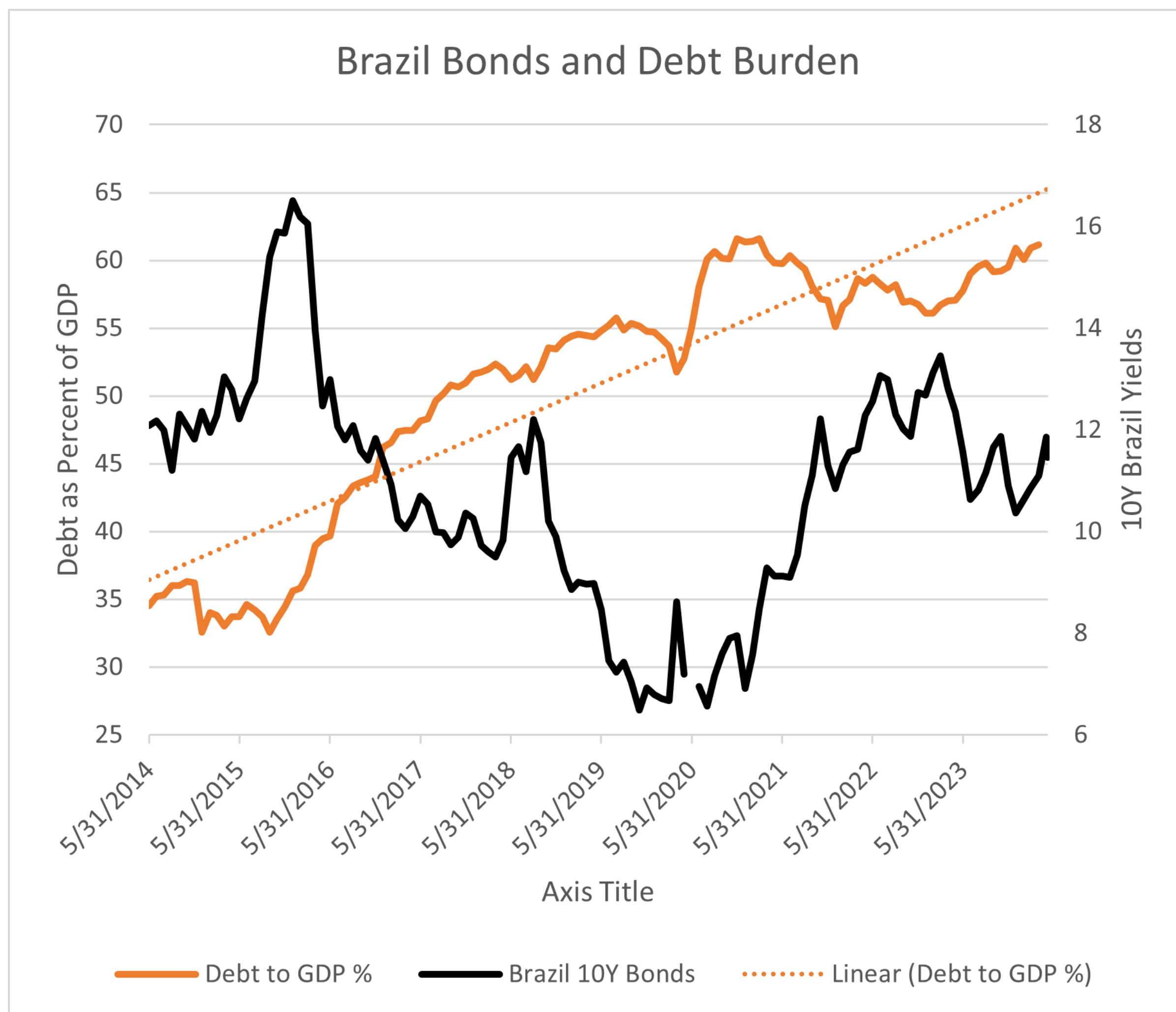


Source: BNY Mellon

The recent history of fiscal dominance starts with the Greece debt crisis in November 2009. Rough timeline: peaking in 2012, political fallout in 2015 and a missed payment to the IMF, all which lasted until 2017. (Only last year was Greece debt raised back to Investment Grade status). The Greece example has one distinct difference: the European Central Bank represents all Eurozone nations, not just Greece. The crisis in Greece began to matter to the ECB when the EUR moved

lower and when the bond spreads of other highly indebted Eurozone member nations blew out. The crisis culminated in the referendum in 2017, into which iFlow recorded significant outflows. A recovery then followed – the election of a new government with a different fiscal plan clearly shifted flows back to mostly positive.

Exhibit #3: Brazil Bonds And Debt Burden



Source: Bloomberg, BNY Mellon

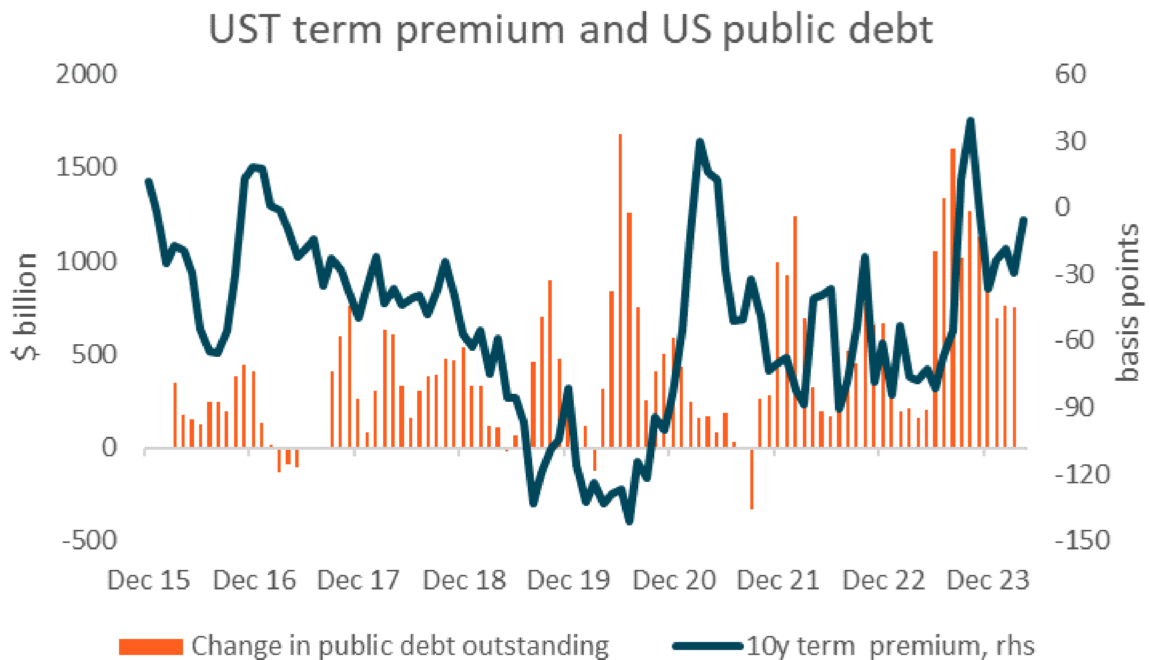
The other crisis to consider for fiscal dominance comes from Brazil post the 2008 crisis along with China's demand for commodities playing out against a high fiscal deficit. From the late 1990s until 2012, prices for Brazil's commodity exports rose significantly (partly because of increasing demand from China), resulting in about two decades of growth. During Luiz Inácio Lula da Silva's left-wing presidency from 2003 to 2010, the government redistributed wealth through welfare programs and raised the minimum wage in order to increase consumption. In response to critics of Lula's socialist economic stance, his successor, Dilma Rousseff (president during the crisis), introduced macroeconomic tax exemptions and subsidies. These policies are widely acknowledged as a major factor in the 2014–16 economic crisis. What is notable is that the fiscal issues were most severe when COVID broke out – the 2020

experience clearly hit flows into Brazil significantly. The trend for ever-higher debt in Brazil is slowing, and this is what investors are watching.

The lessons for the US from Greece and Brazil are not straightforward, of course. The crises in Greece and Brazil were decades in the making. The role of central bank policy in adding to the risk is different and not clear. The common ground for all nations, however, is that depending on foreign bond investment to cover fiscal deficits usually leads to fragility. The cost of such should show up in bond premiums.

The warning signal for the US isn't just in 10y bond yields moving higher – there are many drivers for that, from Fed policy expectations to breakeven inflation views to the risk of fiscal deficits, and more. We think the best indicators for US bonds besides the strength of the USD is in the term-premium correlation. So far, the US's deficits have been well managed by the US Treasury Dept. The ability for this to continue will be watched by investors closely. The correlation of US debt to term-premium is beginning to show linkage, making clear that future deficits matter.

Exhibit #4: US Debt And Term Premium



Source: Bloomberg, BNY Mellon

Bottom Line: iFlow bond data are helpful in observing the appetite of investors in periods running up to fiscal dominance. The risk for US markets ahead is likely years in the making, but the level of US debt requires some future actions on spending and

taxes. The US election later this year is not seen as opening a path to resolving this issue. Instead, many see 2028 and the next presidential election then as a more likely turning point for US fiscal policy and any related crisis risk.

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