UNITED STATES

BUDGET BATTLES AND MONETARY TIGHTENING

On the whole, the US economy has recovered very quickly, albeit unequally, from the loss of business caused by the Covid-19 pandemic. Exceptional Federal transfers have fuelled a spectacular rebound in private consumption, so much so that it is nearly overheating. Faced with a global parts shortage and hiring troubles, companies are having a hard time meeting demand. Prices have come under pressure. For the US Federal Reserve, the time has come to begin withdrawing monetary support. The debt ceiling has just been hit, and major budget bills remain in suspense until an agreement to raise the limit can be reached with the Republicans.

Known for its plasticity, and heated red hot by USD 5,000 bn in fiscal transfers, the US economy did not take long to erase the loss of business engendered by the Covid-19 crisis (chart 1). By spring 2021, numerous sectors had returned to or exceeded the pre-pandemic levels of 2019. The big exceptions were the leisure and transport sectors. With the partial or total lifting of travel restrictions, these sectors have also begun to recover, and are now struggling with capacity problems. Prices are currently rising at an annual rate of 5%, the fastest pace since 2008. Very early on, the US stock markets were betting on a recovery and holding to a vertical curve, but now they have shifted their focus to supply shortages and surging inflation, and its consequences for monetary policy. The business climate was euphoric through mid-summer, but has since eased somewhat, as illustrated by the decline in growth expectations, from an average of 7% to 6% in 2021. The latest subject of concern is the political battle over the debt ceiling: unless it is suspended or raised, the debt ceiling controversy could seriously compromise the recovery.

GROWTH AND INFLATION (%)

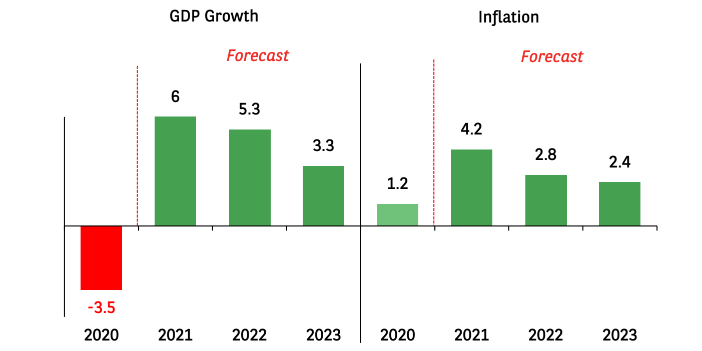

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

PRE-PANDEMIC GAP (FROM Q4 2019))

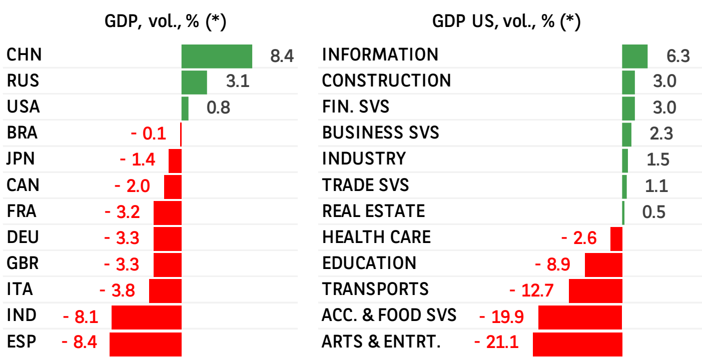

CHART 2

SOURCE : NATIONAL ACCOUNTS, OECD, BNP PARIBAS. COUNTRY ISO CODES

BUDGET BATTLES

With the Covid-19 crisis, the US Federal debt has ballooned dramatically, swelling by a record 25% in barely two years (chart 2). Estimated at USD 28,780 bn (USD 22,500 bn or 103% of GDP excluding intra-government holdings), the debt has already exceeded the authorised ceiling of USD 28,500 bn. As a result, Congress will have to raise or suspend the debt ceiling. Long considered to be a simple formality, the debt ceiling has been transformed into a political battleground between the Democrats and Republicans, ever since the Tea Party weaponised it in 2011 to counter President Barack Obama. An agreement was reached at the last minute in exchange for fiscal concessions, but the impasse nonetheless led Standard & Poor's to downgrade the US sovereign rating from AAA to AA+.

In her letter to Congress dated 19 September, US Treasury Secretary Janet Yellen expressed her alarm at the repeat of such a damaging saga, arguing that without a decision on the debt ceiling, the Federal government would find itself short of liquidity *"sometime during the month of October."* In addition to the probable shutdown of government services, the Treasury would no longer be able to issue debt, triggering a *de facto* payment default that would cause *"irreparable harm"* to the economy, to use Ms Yellen's words. For the moment, the standoff is coming from the Senate and the Republican Party, whose votes are normally needed to raise or suspend the debt ceiling. Such a decision requires a qualified majority of 60 votes, but the Democrats have only 50 seats. Borrowing authorisations are only supposed to cover spending that has already been approved, but the Republicans are trying to tie it to the Build Back Better plan, the budget package that encompasses the entire Biden agenda. The Republicans are hoping to influence a bill that has not yet come up for a vote.

What all does this bill cover? It pools together all of the measures that were not covered by the bi-partisan agreement, or that are unlikely to muster bi-partisan support. Spread over 10 years, the USD 3.5 trillion budget reconciliation bill only requires a simple Senate majority to pass. Its key objectives are outlined below:

- Strengthen the public healthcare system by making permanent the adjustments to the Affordable Care Act (Obamacare) contained in the American Rescue Plan (increase the federal government's share of health insurance premiums) and by expanding Medicare's healthcare coverage (which currently covers those age 65 and older);

- Promote the green transition via subsidies for renovations for more energy efficient buildings, the conversion to renewable energy sources, and the switch to electric cars, among others. It incorporates practically all of the infrastructure measures initially incorporated in the American Jobs Plan, but that were rejected under the bipartisan agreement of 24 June;

- Support for families, especially low and middle income households, by making permanent the increase in child and worker tax credits included as part of the American Rescue Plan, by providing free access to kindergarten and 2-year community colleges, and by expanding access to the Electronic Benefit Transfer (EBT) programme that provides food stamps to students. Once again, virtually all of these measures can be found in the American Families Plan presented last April.

The Republicans oppose the reconciliation bill based on the argument that it would only add to the Federal debt, which is not exactly true. To offset the spending increases (which some call investment), the House of Representatives Ways and Means Commission (majority Democrat) intends to introduce an ambitious fiscal reform that would cover about two-thirds of the cost of the bill.

According to the estimates of the Committee for a Responsible Federal Budget, financing measures included in the last segment of the Build Back Better Plan would generate additional revenues of roughly USD 2.3 trillion over 10 years. For the most part, it would raise the corporate tax rate from 21% to 26.5%, raise the income tax rate for the upper tax bracket from 37% to 39.5%, eliminate the 20% Trump rebate on business income from pass-through entities, and raise the tax base and rate on foreign earnings (from 10.5% to 16.5%).

As we were going to press, the battle of nerves between the Republicans and the Democrats over budget issues was not affecting the economy or the markets as much as the shortage of parts and labour. The job market is recovering rapidly, with 4.7 million new jobs since the beginning of the year, and the Federal Reserve members esteem that it is far enough along to push ahead with the normalisation of monetary policy (see box).

Jean-Luc Proutat
jean-luc.proutat@bnpparibas.com

William de Vijlder
william.devijlder@bnpparibas.com

MONETARY TIGHTENING: THE AGENDA TAKES SHAPE

The Federal Reserve has successfully prepared financial markets for the gradual reduction in the pace of its asset purchases, thereby avoiding the market turbulence ('taper tantrum') that occurred in May 2013 following hints by Ben Bernanke that tapering was becoming increasingly likely. This time, things went smoothly because the Fed started communicating well in advance, and the pace of reduction should be gradual – so as to avoid market disruption in terms of demand versus supply – and, most importantly, it has been emphasized that tapering is not mechanically linked to the policy rate decision. We expect tapering to start in November, provided the labour market reports are reasonably good. Fed chairman Jerome Powell has stated that a *"gradual tapering process that concludes around the middle of next year is likely to be appropriate"*[1] . Our forecasts is in line with this message.

However, market attention will quickly shift to the timing of the first rate hike. Following last year's strategy review, the conditions for a lift-off in terms of the policy rate are more stringent than for tapering. It requires labour market conditions that are consistent with the FOMC's assessment of maximum employment – no numerical target has been set in this respect – and inflation that has risen to 2% and is on track to moderately exceed 2 percent for some time. The latest FOMC members' rate projections (the 'dots') show that an increasing number expects conditions will be met to justify a rate hike in 2022, but this really depends on the speed of decline of the unemployment rate and hence on growth in real GDP. We expect a first hike in the federal funds rate in the fourth quarter of 2022 followed by three more hikes in 2023. This prospect should push Treasury yields somewhat higher. This development is expected to have global spillovers, given that advanced economies' government bond yields are highly correlated due to capital flows. Research has shown that fluctuations in global risk appetite of investors crucially depend on the stance of US monetary policy. Emerging markets issuers and investors but also equity markets will scrutinise any change in guidance from the Fed on its policy rate. For the FOMC, it will be a balancing act.

1 Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 22 September 2021.

FEDERAL DEBT

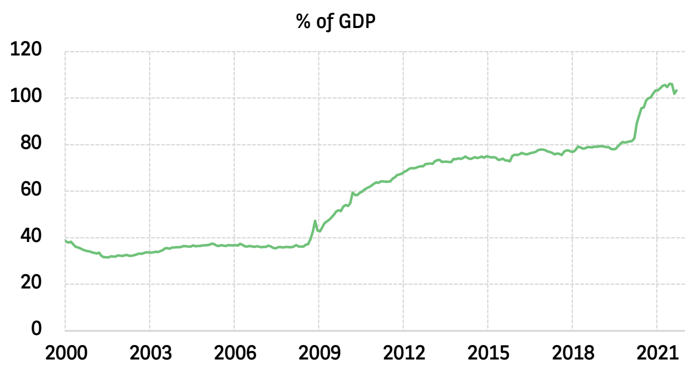

CHART 3 SOURCE: US DEPT. OF THE TREASURY