Beneath the Surface

October 2024

SIGNET

Deficits, Deficits, Deficits

- The US economy grew slower than expected during the third quarter of 2024, with GDP rising by an annualised 2.8% (the 'Advance' estimate), against the second quarter's 3% increase. This growth has been driven largely by consumer and federal government spending, specifically defence spending. For comparison, the Euro area GDP growth rate is closer to 0.6% and Japan's GDP growth rate is closer to -0.8%. While it may appear that the US economy is no longer sensitive to higher interest rates, the impact has been delayed by extraordinary monetary and fiscal stimulus. Corporate and consumer balance sheets were first fortified during the era of ultra-low interest rates and elevated liquidity. The Covid episode only improved on that: US federal debt climbed from $23.22 trillion in Q1 2020 to $34.59 trillion in Q1 2024 (+49%). The US government is still running a pro-cyclical fiscal policy: the federal deficit just hit a staggering $1.83 trillion (6.2% of GDP) for the 2024 fiscal year. This is the third largest budget deficit in history, exceeded only in 2020 and 2021 (chart below, left). As of September 2024, the government interest expense on its debt came to $1.13 trillion, which represents 17% of total federal spending in the 2024 fiscal year. Other developed economies, which have not utilised as much stimulus, have slowed down considerably in the last two years and have fallen below their pre-Covid trend rates as well.

- The International Investment Position accounts represent a statistical balance sheet between the US and the rest of the world. The accounts show the accumulated value of US owned financial assets in other countries and foreign owned financial assets in the US (US 'liabilities'). The difference between assets and liabilities is the net position. The US Net International Investment Position (NIIP) is currently negative, at -$22.52 trillion (chart, below right), and comprises mostly portfolio investment and direct investment – these are US assets owned by foreigners. The evolution of the NIIP in recent decades has been driven by the US Treasury Bill 'standard' and the neo-mercantilist policies of China, amongst others to a lesser extent. China's geopolitical strategy since the 1990s has resulted in a savings glut, where China sacrifices domestic consumption and natural economic adjustments for exports to the US and beyond. China is the world's factory and creditor of the first resort. The US is the chief consumer and debtor of the first resort, producing the reserve currency that the transactional proceeds are held in, and without recourse since 1971 of course. US dollars are accumulated in the hands of foreign entities and are recycled to finance the US budget deficit and fund dollar investments, at the expense of investment elsewhere. This is the US exorbitant privilege.

- This dynamic has become more sensitive in recent years, however, as evidenced by the ongoing shift into gold as an escape valve. The US current account deficit widened markedly in Q2 2024 to $267 billion (3.7% of GDP), up from $241 billion in Q1. This was the second largest current account deficit in the history of the series. US equities now represent over 72% of the MSCI World equity index, up from 50% ten years ago – this reflects not just American entrepreneurialism and valuations, but also the geopolitical strategies underpinning this international flow of dollar funds. While the flow continues, so will the results.