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Fitch Rtgs: U.S. Fiscal Weakening Could Hit Public Finance, Financial Credits

Link to Fitch Ratings' Report(s): The Coming Storm: Effects of U.S. Fiscal Deterioration on Key Sectors

Fitch Ratings-New York-18 September 2019: Low borrowing costs have helped to temper political concerns over rising federal budget deficits and debt in recent years. However, Fitch Ratings believes that public finances could emerge as a greater issue for U.S. policymakers in the event that borrowing costs rise or if the deficit increases sharply during a future downturn. In that scenario, elected officials could feel pressure to cut spending, which could pose a challenge to segments of the U.S. economy that rely on federal outlays. This in turn could broadly influence credit quality in a number of sectors, including U.S. public finance, financial institutions, and industrials.

Long-term U.S. federal debt projections have increased in recent years, despite the economy benefiting from a record long economic expansion. U.S. general government debt is already the highest among 'AAA'-rated sovereigns, and Fitch's debt sustainability analysis indicates that it could exceed 120% of GDP by 2028. This estimate is based on gradual increases in borrowing costs, widening primary deficits, and average growth just below the U.S.'s 2% potential growth rate. Federal spending will be challenged by these worsening fiscal dynamics.

Transfers to states and local governments represented 18% of total federal expenditures in 2018. These transfers stand out as being among the largest potential casualties of reduced federal spending and uncertainty related to federal policy decisions remains a key risk for state credit profiles.

Healthcare – primarily for the Medicaid program – comprises the largest portion of federal transfers to state and local government. It also is a major factor contributing to the variation in states' dependence on federal transfers as a source of revenue. Even though Medicaid is a mandatory congressional appropriation, meaningful changes to its funding structure cannot be ruled out over the long term, which could reduce overall federal Medicaid funding and raise fiscal burdens on states that choose to offset federal declines.

State operating budgets are structured to fund services provided by lower levels of government rather than the state government offering those services directly. This acts as a key source of financial flexibility for states but also a key risk for local governments and related public enterprises. Higher education has typically been targeted by states experiencing fiscal challenges, as cuts to state support for public universities through the Great Recession and its aftermath underscore. School districts also stand out in this area, given their high reliance on state funding, which usually accounts for more than 50% of total state-to-local transfers.

The effect of longer term federal deficit reduction on state and local government ratings would depend on the extent of the cuts, the types of functions targeted and the flexibility Fitch expects specific governments to have to counteract federal action. To maintain ratings, state and local

governments would need to demonstrate their ability to manage through a federal deficit reduction in a manner that retains an appropriate level of financial flexibility.

Federal budget decisions are expected to be less of a direct risk for government-sponsored enterprises, such as Fannie Mae and Freddie Mac and those belonging to the Federal Home Loan Bank System and the Farm Credit System. Federal loan programs channelled via private-sector U.S. financial institutions would be at risk to the extent that a downturn increases net subsidy costs to the government. While income from this activity is negligible for large and diversified lenders, it may be more significant for smaller institutions.

For analysis of how U.S. federal fiscal deterioration could affect credits across a range of sectors in U.S. public finance, financial institutions and corporates, see Fitch Ratings' report: "The Coming Storm: Effects of U.S. Fiscal Deterioration on Key Sectors".

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