Economic Research Department

BBVA

U.S.

Economic Observatory

September 22, 2008

U.S. Fiscal Outlook

- **Fiscal deficit is likely to increase in coming years**
- **Rescue measures that tackle financial turmoil could significantly widen the gap**
- **Pressures could extend to U.S. dollar and interest rates**

As fiscal year 2008 comes to an end on September 30th, the outlook for coming years has worsened and thus, the uncertainty on the U.S. dollar and interest rates has increased. The fiscal deterioration is evident when taking into account that 2008's deficit will be close to $410 billion, approximately 2.9% of GDP, compared to -$161 billion in 2007 (1.2% of GDP). Moreover, according to the Congressional Budget Office, the fiscal deficit in 2009 will be $438bn equivalent to 3% of GDP.

CBO estimate for 2009 relies on a downwardly revised real GDP growth of 1.1% -similar to BBVA forecast-, and includes different government actions to tackle the financial turmoil taken before September 9th.[1] The financial crisis can affect this forecast through three main channels: by unexpected outcomes in those programs already considered in the estimation; by the impact of recently approved measures but not included in the forecast; and by the effects of potential new legislation.

Of the measures already in place, the biggest risks stem from potential bankruptcy of institutions which currently owe debt to the Fed through one of its several facilities, further capital injections to Fannie Mae and Freddie Mac, and potential losses from the FHA and other programs. According to our estimates the increase in the fiscal deficit from these sources could be between $40 and $400 billion. Regarding the proposed Treasury authority to purchase up to $700 billion in troubled assets –currently under debate-, we estimate that losses could range between $50 and $500 billion, assuming that the monies used are less than the $700 billion requested.

This first approximation suggests that the fiscal deficit could increase by $100 billion to $1 trillion on top the baseline scenario. Assuming a symmetric distribution over the next couple of years, the fiscal deficit as a share of GDP could stand between 3.3% and 6.3% in 2009 and somewhat below in 2010. These estimates are preliminary given the elevated uncertainty surrounding the Treasury's proposal and thus, subject to significant changes. In addition, these calculations do not include the effects of changes to military spending, health care and social security, expiration of tax cuts, and others.

[1] These steps mainly consist of $29bn loan by the Federal Reserve (Fed) to JPMorgan Chase against a portfolio of $30bn of Bear Stearns's less liquid assets. Also, around $425 billion as part of the range of options opened by the Fed to address liquidity problems such as TAF, discount window, PDCF and TSLF, and $85 billion pledged to prop up insurer AIG. In addition, $300 billion available to the FHA to refinance loans under the Housing and Economic Recovery Act of 2008, which also authorizes the Treasury to temporarily purchase obligations and securities held by Fannie Mae and Freddie Mac and by the other housing GSE, the Federal Home Loan Banks. Also, the Ensuring Continued Access to Student Loans Act of 2008.

Main Government Actions in Response to Financial Turmoil

	US$ billions
In Place	1,269
Bear Stearns	29
AIG	85
TAF	150
Other loans	50
Repos	125
Other Fed assets	100
Swap lines	180
MM funds	50
GSEs	200
FHA	300
Potential	700
Total	**1,969**
Fiscal cost	**100-1,000**
As % of GDP	**1 - 7%**