Rapid Federal Spending Underpinning GDP

The transmission of tighter monetary policy to the real economy may have been delayed because of near unprecedented government spending. For example, the year-to-date (YTD) increase in federal outlays is nearly 10%. Normally, such large spending increases occur either during or shortly after recession, as illustrated in chart below. This is intentional as the government tries to stimulate aggregate demand and push down the unemployment rate. This happened in the late 1970s, but this policy only fed double-digit gains in inflation.

Today’s unemployment rate is just 3.8%, which is close to a five-decade low. Hence, excessive government spending is competing with the private sector for scarce resources keeping inflation higher than it otherwise would be. The Fed needs to tighten rates to overset the demand-side stimulus from rapidly rising federal outlays.

To place today’s fiscal largesse into context, the current fiscal YTD spending clip is the fastest since 2009 when federal expenditures were up 22%. But the economy was in deep recession then, and the unemployment rate was approaching 10%. The other instances when government spending was like today were around downturns, such as 1981-82, 1990 and 2002. In fact, there was only one other time when federal outlays were this strong, and the economy was not in recession.

At this point in 1985, government expenditures were up a large 12%. However, the unemployment rate was still high at 7.4%. And more importantly, the 1985 federal spending splurge was temporary, thanks to the Gramm-Rudman-Hollings Balance Budget Act. The growth in government outlays fell sharply over the next several years and did not turn up until the 1990 recession arrived.

There is little doubt that current fiscal dynamics are working at a cross purpose with monetary policy, keeping aggregate demand higher than it would otherwise be. Therefore, the Fed may have to keep short-term interest rates higher for longer to better align economy-wide supply and demand and to lower the inflation rate. To be sure, none of this should be confused with either a “no landing” or a “soft landing.” Severe restrictive monetary policy has always led to a recession. It just may take a bit longer this time. Stay tuned.
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