Deficits As Far as The Eye Can See

The Fed increased the funds rate 500 basis points over the last 15 months. This has been the fastest and largest rate hiking cycle since the early 1980s and is the direct result of excessively high inflation.

Monetary policymakers’ intentions are to weaken aggregate demand enough to bring it in line with long-term supply and bring the inflation rate back to 2% from nearly 5% at present. This is reflected in the FOMC’s central tendency forecasts of weak real GDP, rising unemployment and slowing inflation.

Unfortunately, the Fed’s job has been made more difficult by excessive fiscal stimulus. As we can see in the chart below, the budget deficit to GDP ratio is extremely high, especially for an economy that is at full employment. Normally, when the unemployment rate is under 4%, the budget deficit to GDP ratio is only around 1%, but not this time.

Last year, the budget deficit to GDP ratio was 5.5%. This year, the Congressional Budget Office (CBO) is projecting a budget deficit of 5.9% of GDP, where it is essentially expected to remain for most of the next decade. The recent debt ceiling agreement does little to meaningfully alter these projections.

However, the budget outlook is likely to be even worse than what the CBO is projecting if the economy enters a recession either this year or next. The CBO’s long-term forecasts do not account for a recession — they never do. Consequently, the government’s finances are set to get a lot worse under current law. What are the implications of this? Two thoughts come to mind.

One, since interest costs on the debt have exploded to the upside, there is likely to be intense political pressure on the Fed to cut rates and keep them low to reduce budget deficits. This may lead the Treasury to reduce the average maturity of the debt which is currently around five years.

Two, to the extent that short rates are kept artificially low, and the yield curve steepens to reflect increased inflation risk, the Fed also may be pressured to reinitiate either operation twist or quantitative easing. In such a world, Fed-related distortions may grow in ways investors have yet to contemplate.
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