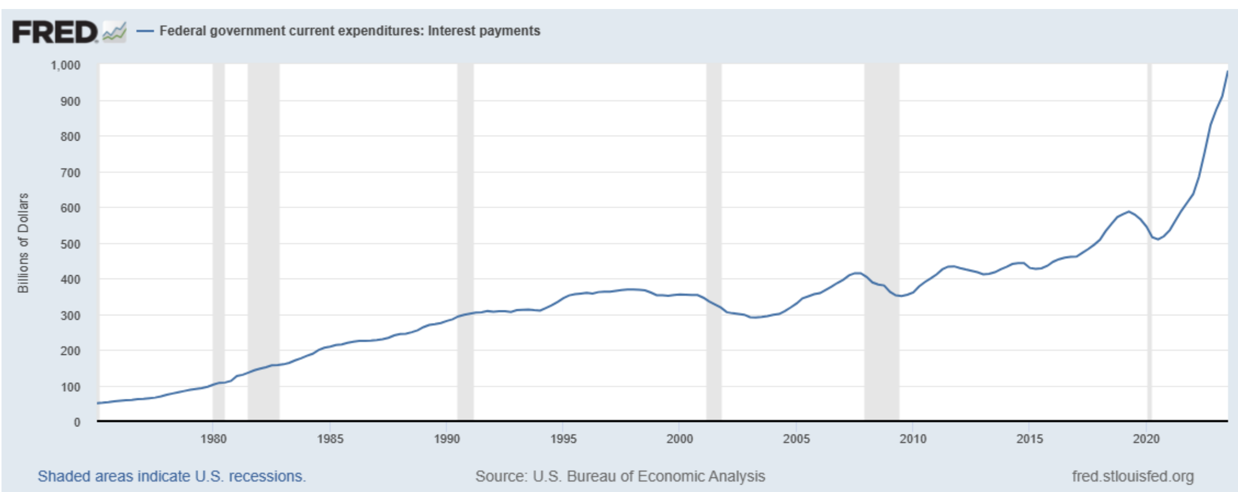
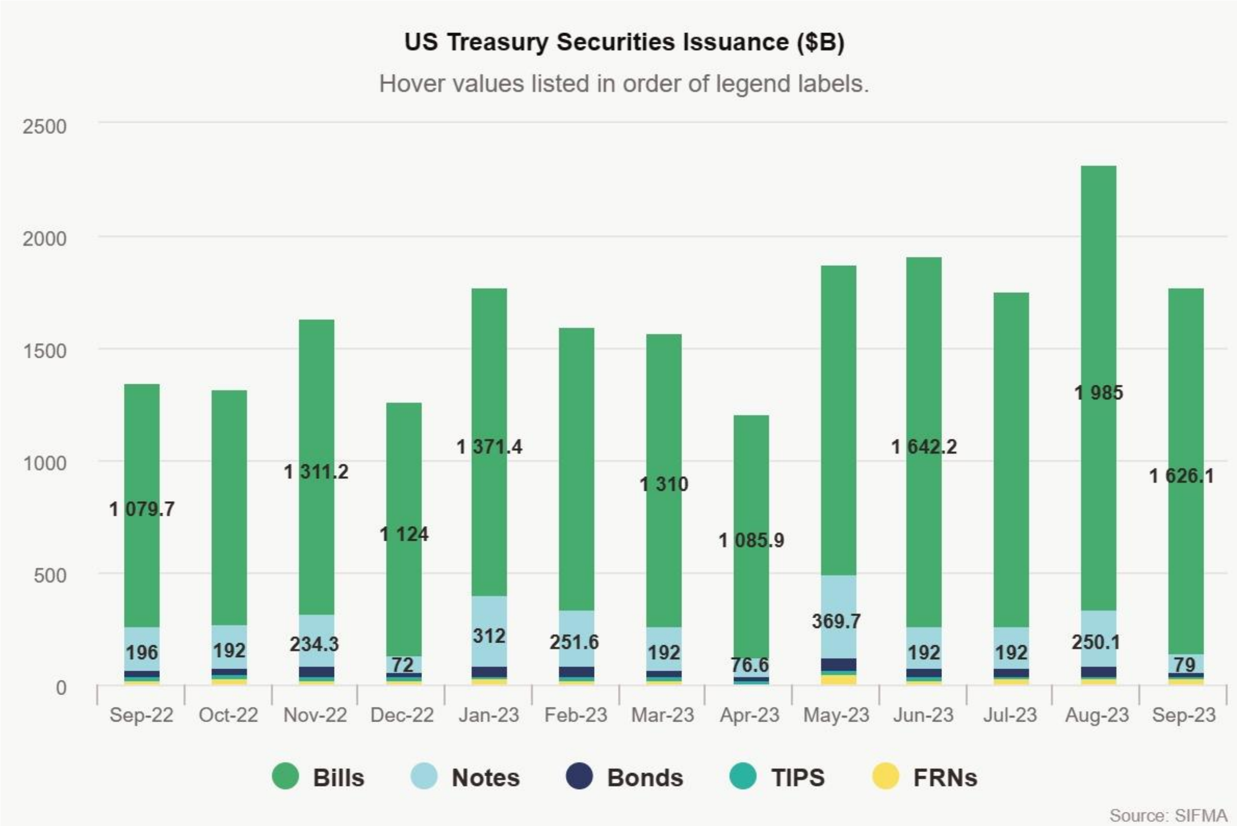
The Outer Limits of Fiscal and Monetary Policy

Robert G. Kahl, CFA, CPA, MBA
https://SabinoIM.com

During the next recession, the federal government will be more limited in their ability to respond with additional spending financed by debt issuance. A combination of more debt and higher interest rates has pushed annualized interest expense of the federal government to nearly $1 trillion. As US Treasury bonds mature and are refinanced at higher rates along with new debt issuance, the annualized interest expense is bound to go higher during the next two years.

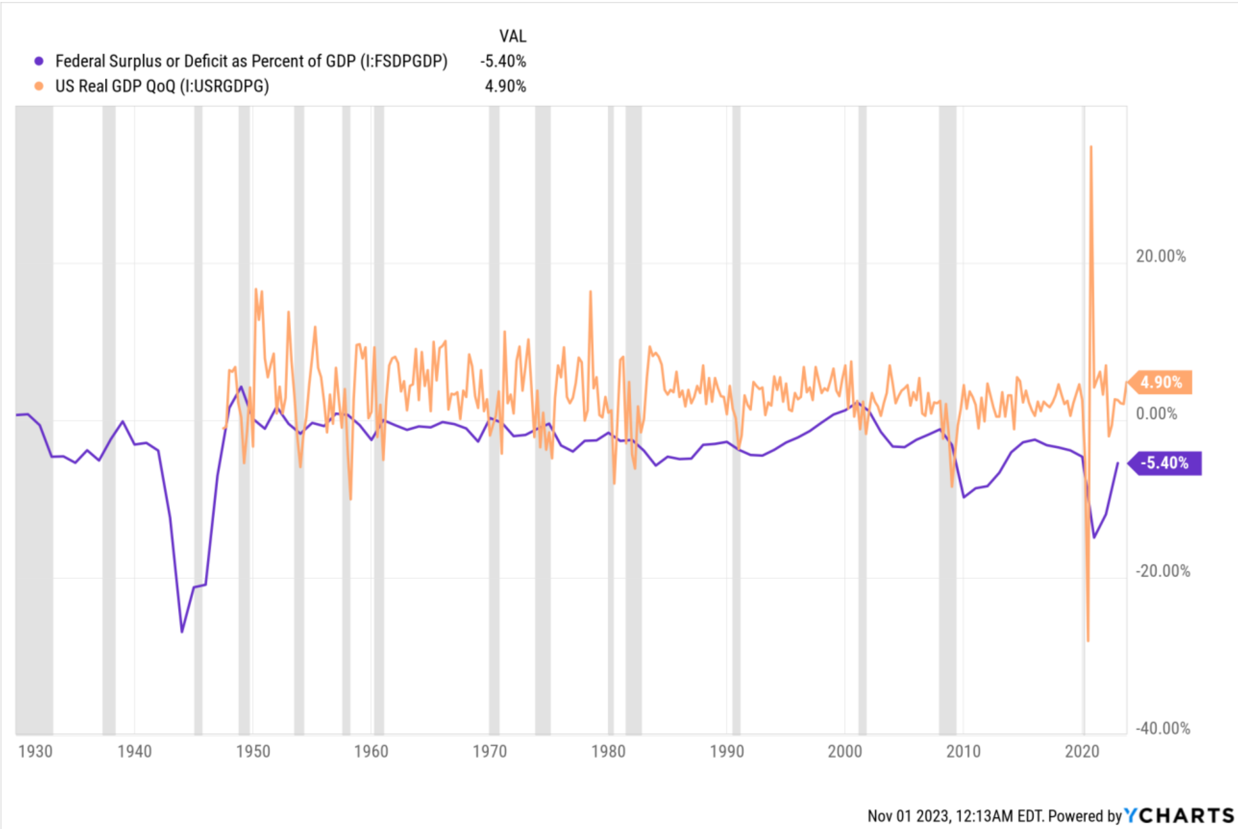


According to the Securities Industry and Financial Markets Association (SIFMA), for the 9 months ending September 2023, the US Treasury has issued $15.7 trillion in debt, 25.6% higher than one year ago. The bar graph below illustrates that the vast majority of new debt issuance is in the form of Treasury bills with a maturity of less than one year. As Treasury debt matures, it is being financed at higher rates. Thus, the parabolic rise in federal government interest expense.



As the US economy posted a preliminary estimate of 4.9% quarterly growth for the third calendar quarter, it has benefited from a federal budget deficit that was at 5.4% of GDP for calendar year 2022. The budget deficit for the federal government's fiscal year ending September 30, 2023 was $1.7 trillion, $320 billion higher than the fiscal year 2022. The US government raised $4.44 trillion in taxes in fiscal year 2023 and spent $6.13 trillion. As the chart below illustrates, large budget deficits have become commonplace regardless of the state of the economy.

David Rosenberg, Founder and Chief Economist at Rosenberg Research & Associates, emphasized that a decline in the budget deficit will have a negative impact on GDP growth. For example, if the budget deficit is reduced from 5% of GDP to 3% of GDP, there would be a negative impact on GDP growth of 2%. Budget deficits of the current magnitude will be difficult to sustain in the future regardless of the wishful thinking of politicians in Washington, DC.



The Federal Reserve System (Fed) has its own limitations, although many think it can expand its balance sheet at will without consequences. The latest report from the Federal Reserve (October 25, 2023), shows total assets of $7.9 trillion and total capital of $42.7 billion. The Fed's capital to assets ratio is 0.5%. The Fed has one liability that differs from most banks. Its balance sheet has $2.27 trillion of Federal Reserve notes as a liability that represents paper currency that cannot be redeemed and does not require any interest payments.

The Fed increased its assets from $4.17 trillion at the end of 2019 to the current level of $7.91 trillion, largely in response to the COVID recession. However, a good portion of their holdings (US Treasury securities and mortgage-backed securities) were purchased when interest rates were much lower and many of its holdings have long maturities. The Fed records most of its securities at amortized cost assuming they will be held to maturity, so the carrying cost does not reflect current market prices. As of October 25, the Fed had US Treasury and mortgage-backed securities (MBS) of $3.9 trillion with maturities over 10 years and $856 billion with maturities between 5-10 years. Some analysts estimate that an adjustment to market values for the Fed's securities holdings would be about $1 trillion.

11/1/2023

According to the Congressional Research Service (CRS), at the end of 2021, over 70% of the Fed's MBS holdings were issued in 2020 or 2021, and 70% had coupon rates of 2.5% or lower. The Fed does pay interest on the $4.3 trillion of deposits held at the Fed by commercial banks and the US Treasury. Projections by CRS suggest that the Fed may have negative interest income for several years. Given the Fed's current situation, it will be difficult to expand the balance sheet in response to any economic emergencies as they have in the past.

If you have any questions or comments, please contact me.

Sincerely,
Robert G. Kahl
CFA, CPA, MBA