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MARKET SIGHT LINES

Looking Beyond Inflation and Federal Reserve Policy: Answering Client Questions About the Federal Budget, Deficit, and Debt

Recently, we've had the labor market, inflation, and Federal Reserve (Fed) policy in focus to assess the risk of recession and related market implications. Clients are also asking appropriate questions about the federal budget, deficit, debt, and debt ceiling, as well as a new payment system being launched by the Fed, FedNow.

In this week's Sight|Lines, we take the opportunity to answer recent these client questions briefly.

THE TAKEAWAY: THE U.S. FEDERAL BUDGET RUNS A DEFICIT, ADDING TO DEBT. CONGRESS MUST RAISE THE DEBT CEILING.

The Biden administration's proposed 2024 budget includes a $1.8 trillion deficit, which must be funded by debt. And already in 2023, the government has hit the debt ceiling, which must be raised soon. Clients have been asking questions about these and related topics. Here are some answers, in summary:

- The U.S. government has run a deficit every year starting in 2002, after running a budget surplus each year from 1998 to 2001.
- The budget deficits hit historic levels in 2020 and 2021 to fund significant fiscal spending to aid in the recovery from the pandemic.
- The U.S. national debt has reached $31.5 trillion.
- Analysts assess the deficit, debt level, and cost of debt service (interest payments) in relation to U.S. gross domestic product, or GDP. While these figures can appear more reasonable, they are increasing, with some reaching historic limits.
- Debate on these issues will continue, and we believe our government leaders will eventually work to rein in the deficit spending and debt via an expanding economy and budget discipline.

Clients have also been asking about FedNow, a new Federal Reserve payment service expected to launch later this year. The Fed says this service will allow banks and credit unions to transfer funds and is not a digital currency nor a step toward one.

IN-DEPTH: THE U.S. FEDERAL BUDGET HAS RUN A DEFICIT SINCE 2002, ADDING TO THE NATIONAL DEBT. CONGRESS MUST NOW RAISE THE DEBT CEILING AND PASS THE 2024 BUDGET, AND BOTH WILL BE HOTLY DEBATED. FEDNOW IS A NEW PAYMENT SYSTEM.

The U.S. government has begun the process of trying to pass a 2024 budget, and, as is most often the case, the budget will likely run a deficit (currently proposed at $1.8 trillion), which must be funded by debt. This funding adds to the U.S. debt, which is limited by a debt ceiling set by Congress. In fact, the current debt ceiling has been reached in 2023, so Congress is debating a stopgap bill for this year and potentially next year. Clients have been asking questions about these topics, and here we intentionally focus on high-level figures rather than the budget details to understand how the budget, deficit, debt, and debt ceiling are interrelated. Going deeper:

- The U.S. government has run on a deficit every year starting in 2002, with big increases in 2020 and 2021 to fund significant fiscal spending to aid in the recovery from the pandemic:
  - From 1998 to 2001, the budget surplus averaged $140 billion. From 2002 to 2009, the budget deficit averaged $0.4 trillion. For the 10 years ended 2019, the deficit averaged $0.8 trillion.
  - The budget deficit hit $3.1 trillion in 2020 and $2.8 trillion in 2021, falling back to $1.4 trillion in 2022. It is expected to be $1.4 trillion in 2023 and $1.8 trillion in 2024.
- The U.S. national debt has increased materially:
  - The national debt has reached $31.5 trillion, up $11 trillion over the last 10 years.
- Analysts often seek to assess the deficit, debt level, and cost of debt service in relation to U.S. GDP:
  - In 2022, the debt-to-GDP ratio sat at 121%, off the 2020 peak of 128%, and above the previous historic peak of 119% in 1945, after growing during World War II.
  - The 20 years ended 2022 includes fiscal support for the Great Recession and the pandemic, with the deficit-to-GDP ratio averaging 10.5%, a level last seen in the wake of World War II.
  - Low interest rates in the wake of the Great Recession kept the cost of debt service, as measured by net interest payments as a percent of the federal revenues, contained. But higher rates and higher debt mean this debt service cost is rising, expected to be 13.3% in 2023, up from 9.7% in 2022, and projected to be 20.1% in 2033, according to the Congressional Budget Office.

While both parties will continue to debate these issues, in our view, the growth of the debt is unsustainable, so we will eventually have to rein in the deficit spending and debt, likely through a combination of an expanding economy, budget discipline, and perhaps even austerity.

As mentioned, clients have been asking questions about these topics, as well as FedNow and the potential for a central bank digital currency (CBDC). In short, FedNow is a Fed service being made available later this year for banks and credit unions to transfer funds, similar to current services like Fedwire and FedACH. The Fed has said, "The FedNow Service is neither a form of currency nor a step toward eliminating any form of payment, including cash…The Federal Reserve has made no decision on issuing a CBDC and would only proceed with the issuance of a CBDC with an authorizing law."

CONCLUSION

While our focus recently has been on the labor market, inflation, and Fed policy, we've been answering client questions about the federal budget, deficit, debt, and debt ceiling, all of which have become increasingly important areas of focus as evaluate the U.S. markets and economy over the medium to long term.

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