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Fiscal Dominance: Another Fine Mess

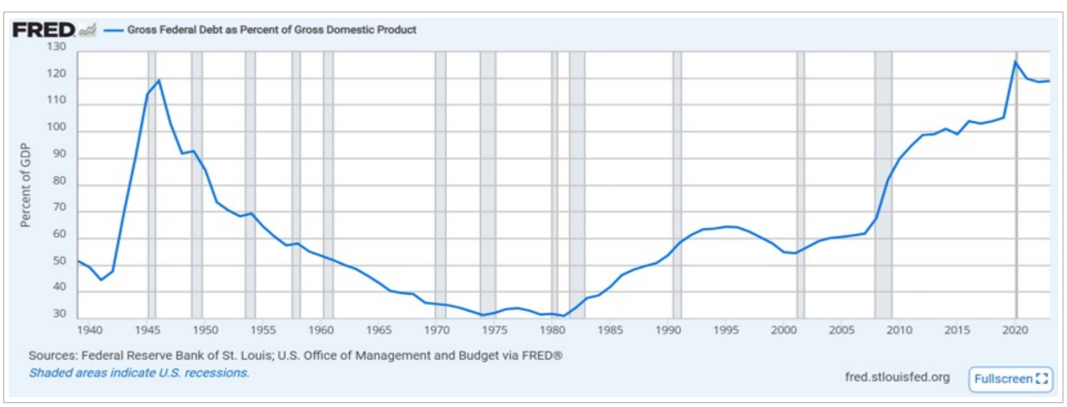
A recurring theme in the Stan Laurel and Oliver Hardy slapstick movies of the 1930s revolved around the catchphrase "Another fine mess you've gotten me into…". Sadly, it doesn't take a lot of imagination to level the same allegation toward US fiscal and monetary policymakers. Since the Great Financial Crisis of 2007- 2009 (GFC), referring to the actions of these policymakers as "unconventional" is an understatement. A consequence of this adventure into unconventional territory has been the emergence of an economic condition not seen in the US since the end of World War II: Fiscal Dominance. Fiscal Dominance is when, in order to pay our bills, the Federal Reserve (the Fed) gives up the fight against inflation. The following factors contribute to Fiscal Dominance:

1. Debt levels exceed GDP
2. True Interest Expense exceeds tax receipts
3. Treasury borrowing dominates new borrowing across economic sectors
4. Foreign lenders dry-up
5. The Fed and Treasury print money to keep the system afloat

Debt crises emanate from high debt loads. Currently, federal debt exceeds 120% of gross domestic product (GDP). As mentioned, debt levels have not been this high since the 1940s. However, the driving force behind those debt loads ended with the Allied Forces victory in World War II. The chart below shows how the Debt/GDP ratio began to fall rapidly after that point[1].

The same does not hold true today. We have returned to the same high debt load, but our budget deficits have become a structural component of ongoing annual government spending rather than a temporary emergency response to a global military crisis. These high and growing debt loads lead to another defining factor of fiscal dominance.

The US does not bring in enough annual tax receipts to cover its true interest expense. Interest is the annual cost of servicing outstanding debt. Every outstanding Treasury bill, note, or bond was issued with a specific interest rate. Determining the total annual amount of these interest payments is a straight-forward calculation. In fiscal year 2024 that number exceeded $1 trillion for the first time ever. However, there is more to the true interest expense. In addition to the outstanding amount of Treasury obligations, there is an unknown dollar amount of future entitlement obligations (Social Security and Medicare). These are lifetime benefits to recipients and, therefore, will last for several decades. We can't know the total future cost of these obligations, but we do know the annual cost of servicing them – it is the total of the annual benefits paid. When added to the interest on Treasury debt, the sum is the true annual interest expense. For the fiscal year ending in September 2024 the true interest expense for the US government consumed 92% of tax receipts[2]. With projections of ongoing annual fiscal deficits exceeding $2 Trillion[3], it will not take long for that number to exceed 100%. Not only causing the government to borrow money to pay its annual true interest expense, but it is causing it to borrow



every dollar needed to run all the other departments of the government.

In addition to dominating over monetary policy, the massive amount of borrowing required by the federal government dominates total borrowing across the economy[4]. In 1980 the federal government accounted for 12% of all new borrowing in the economy . Today that share has risen to 74%[5]. Further, the federal government is a price insensitive borrower. The price of money has no effect on the government's willingness to borrow. As such, federal borrowing at this level crowds out borrowing in the private sector and dampens potential economic growth.

A result of this irresponsible fiscal policy has been the departure of foreign lenders. The chart below shows outstanding federal debt (red line) growing more than 8% per year since the GFC. Not surprisingly, net foreign central bank holdings of Treasuries (blue line) have flatlined over that same period. Foreigners concluded that holding Treasuries which are being debased at 8% per year, in amounts that exceed what they need to accommodate foreign trade, makes no sense when they only pay 3 to 5%. They would be losing purchasing power of their savings. Their sentiment was further bolstered by the US freezing, and then confiscating, Russia's foreign exchange reserves in response to the Ukrainian invasion. It was reasonable for the rest of the world to ask, "Why wouldn't the US do the same thing to us for any reason?"

In the absence of willing foreign buyers for US Treasuries, who will lend that much money to an over-indebted borrower? There is only one balance sheet on the planet capable of absorbing that much borrowing, the Fed's. Fiscal Dominance forces the Fed to abandon its price stability (inflation fighting) mandate and instead focus their efforts on keeping the Treasury Bond market functioning by, effectively, printing money. The emergence of fiscal dominance sets the economic stage for a secular trend of accelerating inflation. As Oliver Hardy would say to Stan Laurel, "Well, another fine mess you've gotten me into!" Investors would be wise to align their portfolios with this emerging reality.

If you would like to discuss any of these ideas in more detail, I would welcome the conversation. Please feel free to reach out.

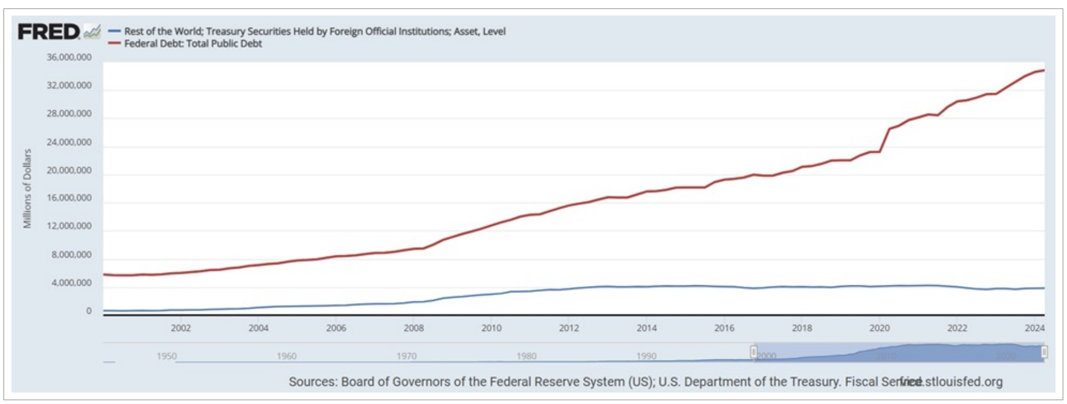
[1] https://fredblog.stlouisfed.org/2023/08/explaining-the-feds-recent-conventional-and-unconventional-monetary-policy/

[2] https://www.fiscal.treasury.gov/files/reports-statements/mts/budget-summary-with-adjusted-differences-report-september-2024.pdf

[3] https://www.cbo.gov/publication/59710#section0

[4] https://www.federalreserve.gov/releases/z1/dataviz/z1/nonfinancial_debt/table/

Ibid



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