December 2022

Fed Thoughts: The Fed & the Fisc

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Let's start with the easy part—monetary policy. The Federal Reserve (Fed) seemingly hates surprising markets that a half-point hike in the funds rate on December 14 seems pre-ordained based on comments by officials. Because shaping market expectations about future moves features early and prominently in their playbook, Fed officials lay down more markers than on a typical jet runway about the direction of the policy rate.

It's much harder to plot out the path of fiscal policy in 2023 in the aftermath of the midterm elections. When the government is divided, legislative initiatives historically grind to a halt, and partisans rely on already enacted deadlines to lever action to their advantage. The weapons handiest to the task are the authorization of the federal budget and the public debt ceiling. The likely net effect: the drag on income growth from fiscal policy will be substantial.

What to Know About Monetary Policy?

We believe the Fed's policy rate will be higher for longer than priced in markets.

- We expect the Fed to slow the pace of hikes at its December meeting, as inter-meeting comments by officials strongly signal a 50-basis-point rise in the fed funds rate. The lock on this outcome was the characterization of members' discussion about the next move in the Federal Open Market Committee (FOMC) minutes from the November meeting. This was the first draft of history in explaining that "a substantial majority of participants judged that a slowing in the pace of increase would likely soon be appropriate."[1]

- Stepping down the pace of hikes sets the precedent for even slower hiking in 2023, and the Fed likely won't stop until the fed funds rate is 5 to 5¼ percent in the spring.

Where to?

We anticipate the "dot plot" released in December will shift up to justify December's action and a bit more next year. The terminal rate probably drifts up a bit. We will be listening for Chair Powell's characterization of the next FOMC action at his press conference. If data permit, we think they'll raise the fed funds rate another 50 basis points in January then step lower for two more 25-basis-point hikes. Alternatively, there could be three 25-basis-point moves.

The rate will likely stay at a level they are confident is restrictive over the rest of 2023, despite pain to economic activity. They don't know the natural real rate, but they know that restraint, if allowed to persist, will cool inflation eventually.

Why?

Inflation is too high, too broad across categories, and has too much momentum.

- The pandemic and Russian aggression boosted goods price inflation from below to well above the Fed's goal. Although goods prices have mostly adjusted, the rise fed into costs, which still have further catch up, and service-price inflation, which is very sticky.

- Policy must restrict demand growth to below trend to create resource slack. Activity has momentum now. Fed restraint and the reversal of fiscal impetus will bite later.

- We believe recession is likely; this will test the Fed's resolve.

OUR VIEW

The Fed fails the test by easing too soon in 2024 given internal disagreement and external pressure. Inflation comes to rest somewhat above goal.

What to Know About Fiscal Policy?

With the government divided after the midterm elections, elected officials are not going to agree on a budget and the public debt ceiling easily and without drama. This implies fiscal policy will increasingly restrain growth.

- A stop-gap strategy on the federal budget boosts the odds of a government shutdown, possibly even this year and more likely in 2023.
- The debt ceiling binds in the spring, complicates Treasury issuance in the summer, and threatens default in the winter.
- Fiscal drag on aggregate spending, already written into the budget, will likely get more severe. This complicates the Fed's assessment of the appropriate policy rate because fiscal multipliers are uncertain.

Deficit Dysfunction

The unwieldy machinery of federal budgeting is easy to stop. Congress must pass twelve separate bills to appropriate discretionary spending. Some can be rolled together in omnibus legislation, but all are subject to extensive hearings, debate and amendment.

- In the best of times, Congress usually comes nowhere close to completing the job by its self-imposed deadline of April 15, 5½ months before the start of the fiscal year on October 1.
- In most years this century, there has been no comprehensive budget package. Congress can opt to work through the reconciliation process to authorize spending without legislative detail. A more robust Democratic majority in the Senate (by potentially one vote) helps there, but the budget has to pass in both chambers—a doubtful proposition with a Republican House.
- A stop-gap continuing resolution can get the government past October 1, but it is often a short-term solution and sets up drop-dead drama soon thereafter.

Here We Go Again

Without budget authority, government workers (of the nonessential sort) cannot work, and the government shuts down. This has played out often enough that federal officials are practiced in limiting the disruption and it is mostly ignored in financial markets. Headline writers, however, don't miss the opportunity, and when enough disgust is registered by constituents, politicians compromise until the next time.

A shutdown would be still more evidence of government dysfunction and a lack of appetite among elected officials to bend down the longer-term trajectory of government debt, which is dire. Investors and ratings agencies will take note.

OUR VIEW

Budget theatrics are a side show. The Fed, not included in the federal budget, keeps working, so the shutdown, by itself, has no significant consequence for monetary policy.

The Debt Ceiling is the Real Deal

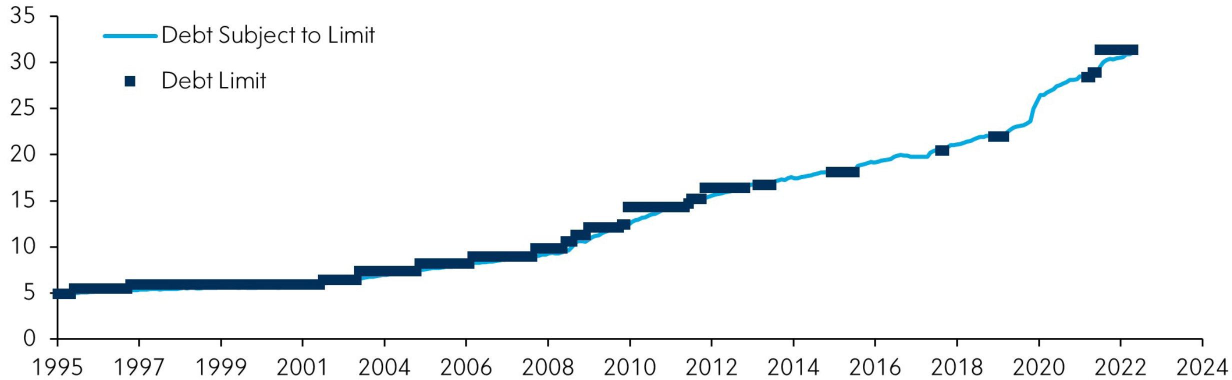
Politicians huff and puff about budget deadlines, and often miss them, but not much happens in markets and the economy. Debt ceiling drama is the reverse. For all the threats not to budge and send the nation into default, politicians always step back from the brink. The reason is that going over that cliff would be calamitous, but that won't stop threats in 2023.

Where Are We?

The debt ceiling stands at $31.4 trillion (as of November 2022), about $180 billion above the public debt subject to limit (as shown in the chart; the following page explains the debt limit in more detail). Debt subject to limit is a legislated construct substantially above marketable debt in the hands of the public because it includes intra-governmental holdings, such as those in the Social Security Trust Fund.

Public Debt Subject to Limit and Its Ceiling's Ceiling

Trillions of Dollar



Source: Bloomberg, accessed 11/16/2022. Firm analysis.

- The federal budget deficit, however, is large, and the US Department of the Treasury (the Treasury) is expected to bump up against the ceiling in spring 2023. Considerable uncertainty surrounds that judgment. Since tax flows are seasonally large and volatile, the odds favor that date being pushed back in time with tax receipts running on the high side of expectations lately.

- At the point the debt ceiling comes close to binding, the Treasury may declare a "debt ceiling emergency" that permits the use of extraordinary measures to find breathing space, such as temporarily disinvesting trust funds to substitute interest-bearing securities with obligations that do not count to the limit. This allows the Treasury about six months of issuance before it no longer has sufficient funds in its account at its fiscal agent, the Federal Reserve, known as the "x-date" inside the Beltway. This is the crunch because the Federal Reserve Act forbids the Fed from lending directly to the Treasury.

The Public Debt Subject to Limit

The Constitution enumerates the powers of Congress, including its ability to authorize spending, levy taxes, coin money and issue debt. Since the Second Liberty Bond Act of 1917, Congress has delegated debt issuance to the Treasury subject to an overall cap on the amount outstanding. The cap has been raised and its form revised over the years, transforming that $15 billion limit in 1917 to the $31.4 trillion ceiling that was signed into law by President Biden in December 2021. On occasion, legislation suspended the limit, so the ceiling does not plot a solid line to the sky over the past 105 years.

The logical problem is that Congress also takes spending and revenue actions. If the outflows from spending exceed the inflows from revenue, debt must be issued as a matter of arithmetic. Imposing a restriction on top of this is either redundant or overdetermined when the cumulated flows do not add up to the mandated stock. Our elected officials cling to this redundancy because it is baked into the Constitution's separate authorizations of spending, taxing and issuing. The charitable interpretation is that the debt ceiling is a level check on the Constitutional authority of Congress and debt issuance delegated to the Treasury. Don't ever expect Congress to surrender it.

The concept of debt subject to limit includes both debt held by the public and intragovernmental holdings, mostly trust funds. Thus, the ceiling is not a measure of net exposure to the private sector (and the public here includes the Federal Reserve, an agency of the US government). To some extent, the debt the government owes to itself embodies some of its contingent liabilities. However, the trust funds do not come close to the total contingent liabilities of the government.

Gimmicks abound around these debt-ceiling events. If the Secretary of the Treasury declares a "debt issuance suspension period," the Treasury can replace obligations from some trust funds with IOUs that do not count toward the limit, opening headroom for marketable borrowing. These unconventional devices are administratively costly and make the government accounts more opaque, as outlined by the US Government Accountability Office.

Lawbreaking is not typically a legislated instruction, but it is in debt-ceiling events. Fundamentally, there are three governing instructions:

- The Second Liberty Bond Act of 1917 (and its successors) set an overall limit on the public debt
- The Federal Reserve Act of 1913 forbids the central bank to lend directly to the US Treasury
- The 14th Amendment to the US Constitution directs that "...the validity of the public debt of the United States, authorized by law...shall not be questioned."

The Fed, as the fiscal agent of the Treasury, processes all payments, including coupon and principal payments; it also offers the Treasury a deposit account for its cash. The drop-dead date for a debt-ceiling crisis occurs on the day when the Treasury does not have enough funds in its Fed account to make its payments. The Fed cannot let the Treasury overdraft its account, so it pends payments until sufficient funds flow in. If those scheduled but suspended payments are for coupon or principal remittances, the result is default. On that day, officials have a choice:

- The Secretary of the Treasury could sell marketable debt above the limit, violating the Second Liberty Bond Act
- The Chair of the Federal Reserve could allow the Treasury to overdraft, violating the Federal Reserve Act
- The Secretary of the Treasury could allow default, violating the 14th Amendment by calling into question the validity of the debt

None of these are good choices, any are grounds for removal with cause, and all would probably, in our view, lead the rating agencies to opine about the creditworthiness of the US government.

Must it Always be like This?

This game of chicken has played out about a half dozen times in the past three decades and always ends in compromise when one side determines it is getting more of the blame from the voting public.

- The political backlash from potentially not making salary, pension and vendor payments, as well as the unknown but calamitous effects on financial markets by defaulting on debt, have previously stopped politicians from going over the brink.

- The precedent is reassuring, but past performance is not always predictive of the future, especially as partisan divisions have ratcheted higher.

Is this Time Different?

Political brinkmanship has not kept pace with the progress of the payments system, potentially providing the Treasury a cushion before the event inimical to financial market stability (a default) and completely running out of working funds.

- In earlier episodes, the Fed was unable to prioritize payments, implying the possibility that a Treasury overdraft would require stopping all payments, including coupon and principal payments.

- Now with most payments electronic at the Treasury's behest, the Fed can pend some payments and continue others, such as on debt, to keep its account out of the red. If so willing, the Treasury could ignite the political firestorm of criticism from missed payments on Social Security and other entitlements while continuing to meet debt obligations.

- The ethics and optics of not paying, say, military or Social Security recipients to conserve cash for debt holders is, to be understated, problematic. Of course, this also involves violating the laws in which Congress authorized the pended payments to be made.

- Many other governments resort to "below the line" financing to keep the show running by letting arrears mount with vendors, employees and retirees. By relying on arrears to the private sector, the US will move up in the league table of late-payers to join the company of Greece and Italy.

Who Pays for This?

The US taxpayer because the standoff is costly. The Treasury incurs administrative expenses to put extraordinary measures in place and to tailor new issuance to the room under the ceiling (including cash-management bills that are more expensive).

- More broadly, these episodes tarnish the US reputation as a safe haven. The downgrade of the US debt rating by Standard and Poor's (S&P) in 2011 was explicitly attributed to debt-ceiling drama.

- Concern over the debt ceiling is proportional to the distance from the New-York-to-Washington-DC corridor. Having seen it often before, market participants are mostly inured to the drama, only pricing in premiums in advance associated with the interruptions to typical Treasury issuance and, perhaps, the possibility of a technical hiccup around the "x-date," in our view. Foreign investors are usually more troubled by the headlines describing a byzantine, opaque process that risks significant capital losses.

OUR VIEW

Despite the likely coming histrionics, the nation has never hit the drop-dead date when the debt ceiling binds, presumably because the stakes associated with failure are so high. Expect the same, but this episode may be closely run and uncomfortable.

Fiscal Policy is a Drag

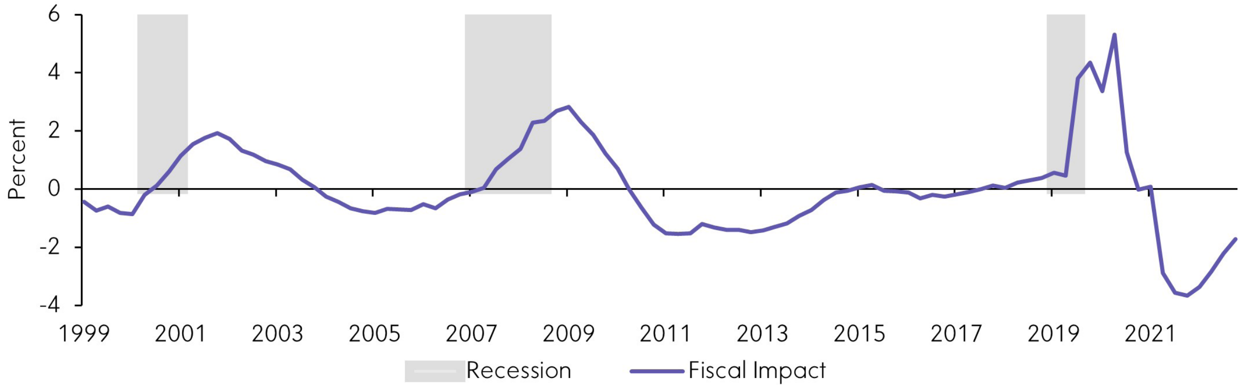
Washington, DC, kicked into overdrive providing economic relief from pandemic disruptions, some of which it created by other policies. As that recedes in the rearview mirror, so too does the boost to demand growth from fiscal policy embodied in legislation.

- In retrospect, stopping sooner with fiscal largesse would have offered a smoother landing for the economy and the Fed.

- The Hutchins Center at Brookings provides a measure of fiscal impetus, which as charted swings from robustly positive to deeply negative.

Fiscal Impact

Contribution of Four-Quarter Real GDP Growth



Source: The Hutchins Center on Fiscal and Monetary Policy, accessed 11/18/22. Firm analysis.

Why does this Matter?

The Fed needs a deceleration in aggregate demand to lessen pressure on resources and bring inflation back down to its 2 percent goal. It is helpful in this task that monetary and fiscal policy are pulling in the same direction.

- Europe offers the contrast of poorer policy coordination, where the European Central Bank is tightening policy even as fiscal authorities are providing stimulus via energy subsidies.

- Even more telling, the adverse reaction to the short-lived budget proposal of the previous, equally short-lived, UK government was important because discretionary policies were at cross purposes.

OUR VIEW

This should be manageable for the Fed, as it always embeds its best guess on the path of fiscal policy into its forecast and, therefore, its policy rate decisions.

Considerable uncertainty always attends that judgment and this time more than most.

- The net fiscal swing is large and its multiplier effect on spending difficult to gauge. Households, states and municipalities will presumably dip into their considerable cumulated savings from earlier governmental payments. Their willingness to do so, however, depends uncertainly on their expectations about future swings in entitlements and changes in taxes that ultimately have to pay for them.

- Caution in forecasting should incline the Fed to view future budget arithmetic as shaded mostly to the restrictive side given the likely play of politics. If, however, it counts on too much restraint from its fiscal counterparts, the Fed may find itself like a trapeze artist caught midair without a partner.

A Cautionary Conclusion

Right now, the Fed's job of returning inflation to the Volcker-Greenspan zone of price stability is hard. It is harder still because fiscal policy will not be providing a stable backdrop for its decisions. The political fight over the budget, threatening or triggering a shutdown of the government, is mostly play acting. The debt ceiling is the more considerable threat. Because of the harm associated with default, politicians will blink, as they always have. Still, there are risks. The drama may incline the Fed to count too much on fiscal restraint, raising the likelihood that monetary restraint ends too soon to return to price stability.

As for our particular concern about the debt ceiling, its political economy poses a sharp-edged threat that the two parties can use as a lever to get movement elsewhere. The device is especially attractive, we suspect, because deep-down most politicians believe that the event is only seemingly sharp-edged. The Secretary of Treasury and Chair of the Fed will, in extremis, dull the edge with still another gimmick to save them from themselves. In that faith, politicians may extend the standoff until one of the parties concludes that they will be blamed for any untoward consequences.

In the event, Congress will act because it must, but it may be close to the wire and raise not yet evident angst in financial markets. Sadly, this is a repeated game of chicken. It is a costly contest both in terms of administrative expenses and borrowing costs. It is a risky one, too, because of the low level of trust among the parties involved. Remember that the prototypical game of chicken was among teenage drag racers in *Rebel Without a Cause*. Late in the movie, Sal Mineo goes over a cliff, his coat sleeve caught in the car door. Mistakes happen even when the stakes are high.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

1. Board of Governors of the Federal Reserve System, Minutes of the Federal Open Market Committee held on November 1-2, 2022. Accessed at: https://www.federalreserve.gov/monetarypolicy/fomcminutes20221102.htm.

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