U.S. Economic Policy: Profligate Fiscal Prodding Tighter Monetary

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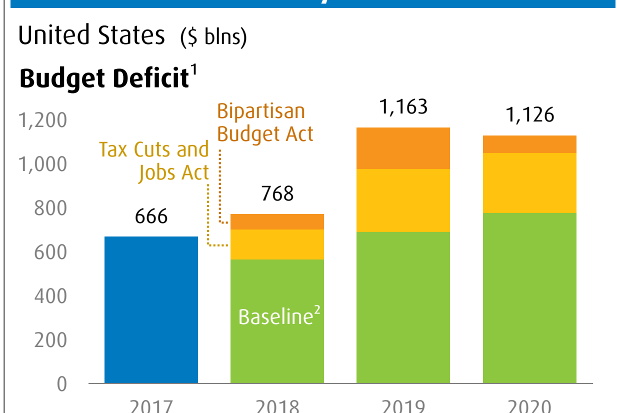
On February 9, President Trump signed the Bipartisan Budget Act (BBA) into law, with its near-$300 bln combined increase in discretionary spending caps for this fiscal year (ending September) and next. This is technically an increase in the budget authority or "room to spend" and actual outlays are spread over several more years (in this case, nearly 90% will be spent by fiscal 2020). The Act also includes $85 bln in multiyear disaster relief, along with other smaller measures. All told, federal government spending is set to increase almost $70 bln by September and another near-$185 bln in fiscal 2019 before ebbing to just over $70 bln in fiscal 2020. And, budget deficits will increase commensurately (*Chart 1*).[1]

Recast on a calendar-year basis, the U.S. economy will receive a near-$115 bln dose of fiscal stimulus (0.7% of GDP) in 2018, and this will rise to above $155 bln in 2019 (0.9% of GDP). With spending hikes sporting a multiplier of at least one, real GDP should get a boost of at least 0.7 ppts this year and another 0.2 ppts next year, other things equal. This powerful fiscal lift is on top of the economic boost already coming from the Tax Cuts and Jobs Act (TCJA), which President Trump signed into law in December.

Recall that the TCJA contained cumulative net tax cuts totaling $1.5 trillion over the next decade, starting at $136 bln in fiscal 2018, rising to $280 bln in fiscal 2019 and $259 bln in fiscal 2020, and, again, increasing budget deficits commensurately.[2] On a calendar-year basis, net tax cuts total more than $205 bln this year (1.2% of GDP) and $275 bln next year (1.6% of GDP). Unlike spending hikes, tax cuts sport a multiplier of less than one (0.4 is our working assumption)[3]. Net tax cuts should provide a 0.3 ppt boost to real GDP in 2018 and another 0.1 ppt lift in 2019, other things equal. **Taking the TCJA and BBA together, the U.S. economy will be getting a colossal dollop of fiscal stimulus that should boost real GDP growth by about 1 ppt this year and 0.3 ppts next year** (other things equal).

Chart 1
Deficit Double Whammy



[1] fiscal years ended September [2] CBO June 2017
Sources: BMO Economics, CBO

In providing this significant economic stimulus, the budget deficit is poised to explode above $1.1 trillion or 5% of GDP by next fiscal year.[4] Last year, the deficit came in at $666 bln or 3.5% of GDP. Such (two-year) 1.5%-plus increases in the relative size of the

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1 The budget shortfall will be augmented by incremental debt service, which we account for. However, the deficit will be diminished a bit by the additional tax revenue generated from the extra economic activity sparked by the spending hikes, which we do not account for.

2 Again, we account for incremental debt service but not the additional tax revenue generated from the extra economic activity sparked by the tax cuts. For example, the Joint Committee on Taxation (JCT) estimates the latter at a cumulative $385 bln over the decade, starting at $32 bln in fiscal 2018 and drifting up to $37 bln by fiscal 2020.

3 The tax multiplier is less than one because some households will use the incremental after-tax income to bolster savings or pay down debt, in addition to funding more consumer spending; some firms will use it to buy back their shares, raise dividends or pay employees, in addition to funding more investment spending.

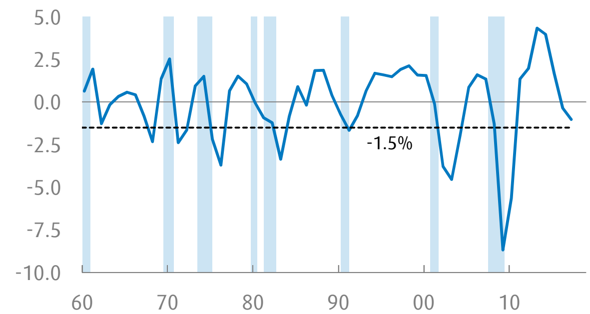
4 Incorporating the JCT's estimates of the positive economic/revenue effects of the TCJA and adding the BBA's fiscal 2019 spending amount to both the numerator and denominator results in a deficit-to-GDP ratio of 5.3%.

budget deficit have occurred before, but almost always around recessions (*Chart 2*). During these recession episodes, budget balances deteriorated because the economic downturn dampened tax revenues and/or the government conducted countercyclical policies (cutting taxes, hiking spending). Interestingly, there is only one other episode in which the deficit deteriorated similarly but in the absence of recession; it was the mid-1960s' combination of tax cuts (the Revenue Act of 1964, a.k.a. "the Kennedy tax cuts" although it was President Johnson who saw them through) and spending hikes (defense spending related to the Vietnam War).

Chart 2
Deficit Deterioration Like It's a Recession

United States (% of GDP : 2-yr chng)

Deficit-to-GDP Ratio



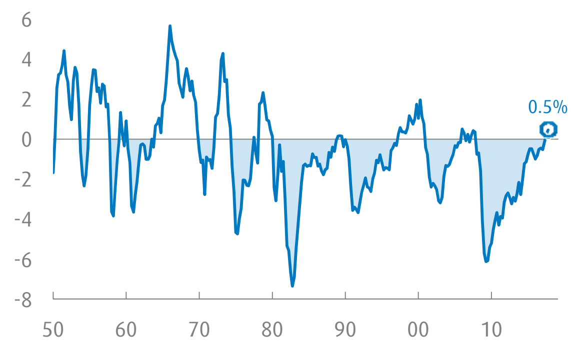
Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

Also interestingly, the **current economic expansion will soon become the second longest in history**, surpassing the 1960s come this May. It was the mid-1960s' tax cuts and spending hikes that helped engineer the longest business cycle in history, at the time. And, it appears that coming tax cuts and spending hikes could do the same again, if the economy can continue expanding until July 2019 (thus surpassing the 1990s expansion). This emphasizes that the current business cycle is becoming long in the tooth, a context which, with stimulus about to be unleashed, is increasing America's medium-term fiscal and inflation risks. While the credit rating agencies might eventually weigh in on the former, we judge the Fed will probably feel compelled to mollify the latter.

Chart 3
Becoming More Positive

United States (percent)

Output Gap[1]



Sources: BMO Economics, Haver Analytics, [1] CBO

With respect to **fiscal risks**, the late stages of business cycles have almost always been associated with improving budget balances, creating fiscal capacity to cope with the next economic downturn (to absorb revenue falloffs and provide scope for countercyclical policy). For example, before the Great Recession, the deficit-to-GDP ratio averaged around 1%, and the Treasury Department boasted a budget surplus of about 2.5% of GDP before the 2001 recession. However, in the current situation, with the budget deficit soon to top 5% of GDP, we're afforded much less fiscal capacity to deal with the next downturn. And, even if the downturn doesn't materialize for a while, with longer-run nominal GDP growth around 4%, such large-sized deficits put the debt-to-GDP ratio on an unsustainable increasing trajectory.

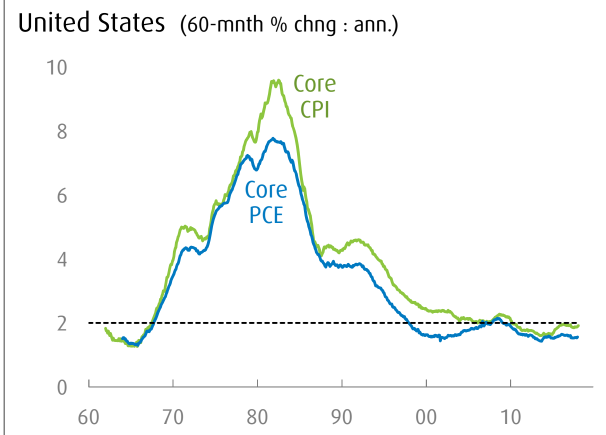
With respect to **inflation risks**, the economy is now operating at full capacity or with a positive output gap (*Chart 3*).[5] While estimates of the output gap are fraught with uncertainty, the current positive reading (which, at 0.5%, is the highest in 17 years) is a signal that the economy should not be growing too much longer above its potential pace (which is slightly under 2% according to the Fed), in order to minimize the risk of overheating. Last year, real GDP growth averaged 2.3% (it was 2.5% on a Q4-over-Q4 basis), but the pace is going to pick up this year and possibly next year owing to fiscal stimulus. The current positive output gap is going to get larger (think

[5] The output gap is the broadest economic slack metric, measuring the discrepancy between the levels of GDP and potential GDP. The latter is the output level generated when the economy has grown at its potential pace, which, in turn, is the maximum long-run growth rate that can be achieved while maintaining stable inflation and having all factors of production fully employed. In effect, it's the economy's long-run speed limit.

aggregate demand growing even faster than aggregate supply with no slack left in the economy), raising the risk of rising inflation.[6]

In the 1960s, core PCE inflation rose from an average of 1.3% in the first half of the decade to 3.4% in the second, as tax cuts and spending hikes worked their way through an economy already at full capacity (*Chart 4*). This doesn't mean that this is going to happen again (for the record, core PCE inflation has averaged 1.6% over the past five years). The mid-1960s fiscal stimulus occurred amid much larger positive output gaps; the economy was more inflation prone to begin with. Moreover, secular disinflationary forces such as an aging population, globalization and technology-enabled disruption weren't around then as they are now.

Chart 4
That '60s Show



Sources: BMO Economics, Haver Analytics

Inflation is not likely to get out of hand as it did back then, but the risks that it could are definitely escalating. And, in response to these escalating risks, we now judge the FOMC will likely move a little more ardently along the policy rate normalization path, sticking to a quarterly rate-hike cadence until they are satisfied these risks have been adequately mitigated. Whether this will require rates to rise above the FOMC's perceived long-run neutral level (2.75%) we'll have to wait and see. But, for now, **it's looking like four rate hikes this year instead of three**.

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[6] Part of the risk will be mitigated by increased capital spending already incented by late-cycle capacity constraints and now going to be incented further by tax cuts.