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Will a Unified Government Increase Government Debt and Inflation Risks?

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As markets process the sweeping Republican victory in the US 2024 election, some investors and pundits are anticipating more government spending and a larger budget deficit. One think tank, the Committee for a Responsible Federal Budget, has estimated that President Trump's policy proposals could add another $7.5 trillion dollars to the US deficit by 2035.[1] This would result from an extension of the corporate tax rate reduction passed when he was last in office as well as other new tax cuts.[2] With unified control of Capitol Hill and the Whitehouse, Republicans may well be able to implement a plan of more spending *and* more tax cuts.

With higher deficits and more spending on the minds of many investors, Modern Monetary Theory (MMT) has risen back to the top of conversations. MMT takes a unique view of how to accommodate sustained levels of deficit spending. MMT posits that a country's ability to issue debt in its own currency allows that country to always pay its debt by issuing currency. From the perspective of MMT, this means deficit spending should not be limited by "arbitrary" desires to have a balanced budget. Instead, MMT reframes deficit spending not as a burden but as a means to advance desired programs without a fear of defaulting on debt.

At the start of 2008, the Federal deficit was six trillion dollars, and that rose to nineteen trillion dollars at the start of 2020.[3] The Federal deficit then grew by nearly fifty percent in dollar terms to $28 trillion dollars between 2020 and 2024.[4] In fact, the deficit (as a percent of GDP) reached its largest level since World War II.

[1] Source: Financial Times, B. Koranyi, "Trump Victory to Reverberate Through the Global Economy," November 6, 2024.

[2] Source: Wall Street Journal, J. Sindreu, "Trump Victory Sparks Debt Worries, But the Dollar Says Its Fine," November 6, 2024.

[3] Source: FRED as of October 2023.

[4] Ibid.

Based on the prospect of higher future deficits, longer-dated Treasury yields have recently risen to levels not seen since 2007 (see Figure 1). Often, rising bond yields are associated with investor optimism where the coupon payment may be insufficient to attract investors who seek investment returns elsewhere.[5] However, there are concerns that the recent rise in Treasury yields could signal investor concerns regarding the sustainability of US debt levels.

[5] Source: St Louis Federal Reserve, P. Grittayaphong, "What Do Rising Bond Yields Signal About the Economy?" October 2022.

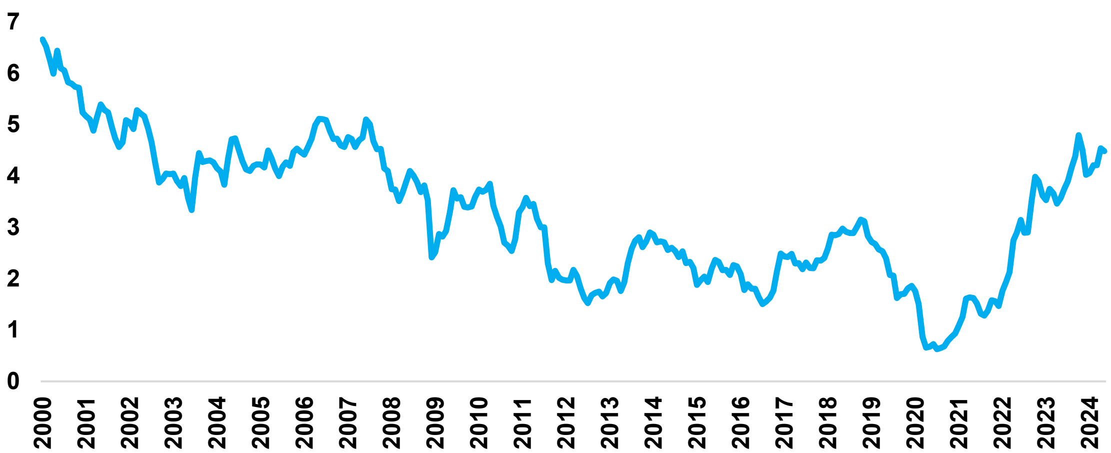

FIGURE 1

Ten-Year Nominal Interest Rate 2000-2024 (%)

Source: FRED as of May 2024. Ten Year Treasury yield shown as monthly percentage.

The higher levels of debt combined with higher interest rates are driving up the cost of servicing the national debt (i.e., paying interest). Debt servicing costs rose from \$200 billion in 2022 to \$659 billion in 2023.[6] The rapidly rising cost of servicing US debt is demanding a larger share of government resources. The interest expense is expected to rise from 2.4% of GDP in 2023 to 3.2% over the same period in 2024[7] As of late 2024, the interest expense on US debt is more than the entire defense budget for the fiscal year 2023.

MMT's proponent argue that resource capacity should serve as the primary (or only) constraint on government spending. The impact of spending beyond resource capacity – namely, that it can lead to inflation – has become more obvious in recent years. Resource constraints previously were not at the forefront of discussion because they were immaterial for more than a decade. As the labor force declined and supply chains faced constraints, their relevance has reemerged. The concept that productive capacity and resource availability should set an upper limit on spending may temper MMT's popularity.

[6] Source: New York Times J. Taukersley, "The Federal Deficit if Growing. This is Why," October 20, 2023. See also the Congressional Budget Office and the Center on Budget and Policy Priorities.

[7] Source: Congressional Budget Office, "The Budget Outlook," February 2024. The CBO estimates that interest payments could reach nearly a trillion dollars (\$951 B) in 2025.

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