Economics

IN FOCUS

May 17, 2023

The US debt ceiling debate: can anything good come of this?

by **Avery Shenfeld** avery.shenfeld@cibc.com

The tick, tick clock that's counting down to America's debt ceiling deadline is growing louder day by day, and markets just want a deal, any deal, that avoids a government shutdown or an outright default. Virtually every forecast has that outcome as the base case, but achieving it might be like a trip to the dentist that reveals no cavities. It still won't have been fun, and won't have accomplished much. That's what would happen if the White House got its way, and the debt ceiling increased is given a rubber stamp approval with no other policy changes in the works.

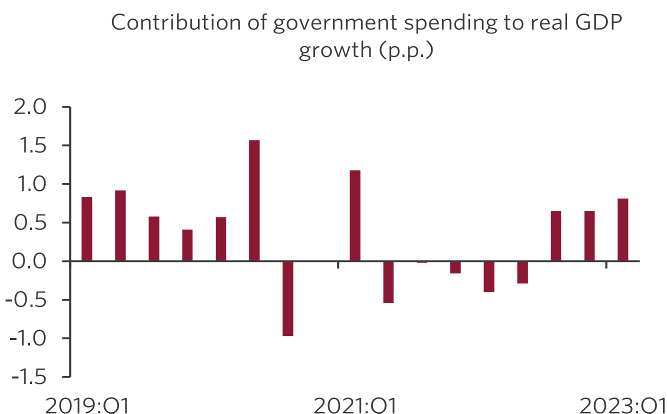
But there is some hope for an outcome that actually improves the outlook for the US economy. Not by spurring growth, which would be counterproductive while we're still battling inflation. Instead, if raising the debt ceiling includes some near-term fiscal restraint, that could allow for a more balanced overall stance of monetary and fiscal policy that would still bring inflation down, but perhaps carry fewer downside risks than leaving the job of restraint only in the hands of the Fed.

Fiscal policy in neutral, monetary policy braking hard

We earlier wrote about the risks to banking stability, and a related squeeze on office real estate, as potential fall outs from an unprecedented pace to Fed interest rate hikes in the past year. But one reason why monetary policy has had to brake so hard, with the associate risks of an overkill, is that the fiscal policy reins are loosening up, particularly on government spending. Collectively, federal, state and local government spending added an annualized 0.8% to Q1 GDP (Chart 1). That's not the blowout spending seen at the height of the pandemic, but it's a reversal from the restraint seen in the first half of last year.

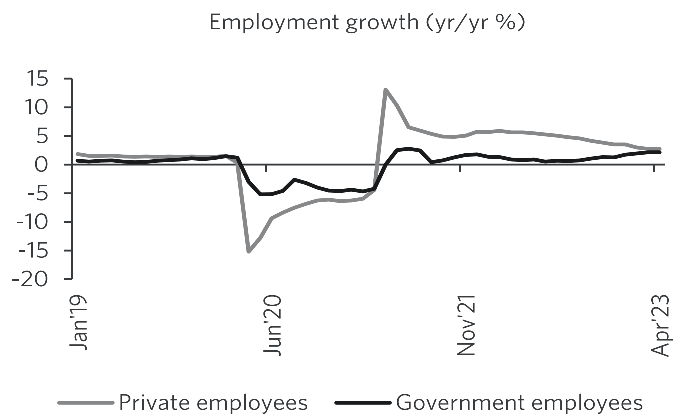
Moreover, amidst excessively tight labour markets, governments are now ramping their role in the competition for scarce workers. Government employment didn't plunge as deeply when the pandemic hit, and so it naturally trailed the private sector when businesses started rehiring. But of late, government employment has accelerated while private hiring is slowing (Chart 2). Similarly, median wages for public

Chart 1: Government spending adding to US GDP growth



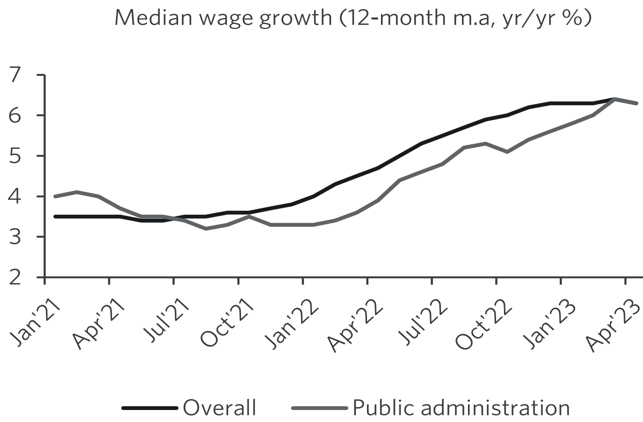
Source: BEA, CIBC

Chart 2: Government is competing for scarce workers



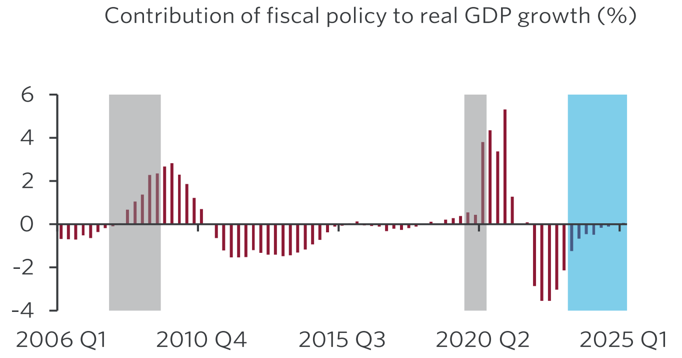
Source: BLS, CIBC

Chart 3: Public admin wage gains have caught up



Source: Federal Reserve Bank of Atlanta, Haver Analytics, CIBC

Chart 4: Fiscal policy no longer a meaningful drag



Source: Hutchins Center, CIBC

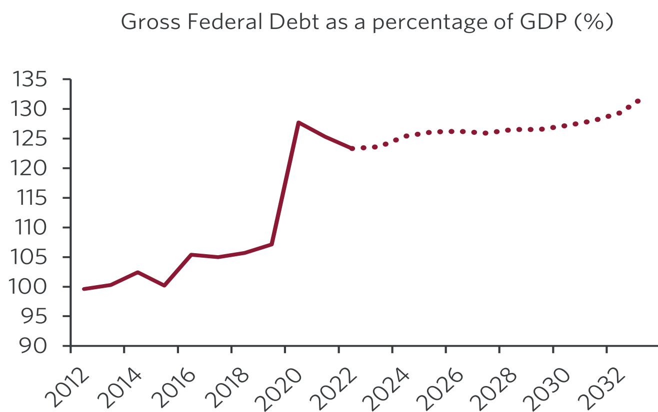
administration workers, having earlier lagged behind, have now caught up to trends in the overall economy, and thereby added to the impetus to inflation coming from worker purchasing power (Chart 3).

That's not the full story, however. Government "spending" in the GDP accounts includes only the impact of government purchases of goods, services (including the service delivered by government employees in such areas as public administration, education, policing etc,) and capital projects (public works, defense equipment and the like). But transfer payments can provide an additional boost by supporting consumer or business spending, while taxes in turn drain such spending power. Whether spending restraint or tax hikes should be the weapon of choice is largely a matter of political tastes over the appropriate role and size of government, and views on whether more private or publicly provided economic goods and services are in greater need.

The Hutchinson Center (a branch of the Brookings Institution) provides a comprehensive measure of the quarterly impact of fiscal policy, and a projection for what lies ahead. Fading transfer payments as pandemic period programs wind down meant that fiscal policy was, all told, a slight drag on Q1 growth (Chart 4). But in short order, that small drag is set to disappear, and fiscal policy will be essentially neutral, after having big a major drag in 2022 when we were in the steepest retreat from COVID-era relief.

Some might be surprised, after the passage of bills like the IRA and the CHIPS Act, that the outlook isn't for a return to major stimulus. Remember, however, that the big-ticket expenditures under the IRA will roll out over many years, and were offset by tax hikes included in that bill. But with inflation still running hot, this is still a missed opportunity to make greater progress on reducing deficits while the economy is in need of a cooling.

Chart 5: Federal debt burden set to climb



Source: CBO, CIBC

Rebalancing restraint

Right now, we're in a period in which fiscal restraint could actually be painless for the economy as a whole. Not because it doesn't slow growth; virtually any mix of spending cuts or tax hikes will do just that. Instead, it's because the Fed is already looking to stall growth for a few quarters to bring inflation back to 2% next year. Tightening fiscal policy would enable the Fed to take a less aggressive path on interest rates, helping it to either eschew further hikes that are still a risk for this year, or perhaps bring forward the timetable for the first rate cuts.

Such a rebalancing of restraint would actually be a less risky path, reducing the odds that strains associated with a record pace to rate hikes end up being an excessively severe hit to the economy due to unanticipated spillovers into the financial system. One reason why monetary policy was as gentle in the cycle after 2008, and therefore allowed for a healing of the financial system, was that fiscal policy under Obama shifted from a strong dose of stimulus in 2008-09 to four years of ongoing fiscal restraint beginning in 2010 (see Chart 4 again).

The long journey

We're not budget debt alarmists. There are countries with even higher debt/GDP burdens that are coping, and financing rates on government debt aren't likely to revisit the punitive levels of the 1980s. But the latest projections from the CBO don't say anything very promising about federal debt trends over the medium term (Chart 5). That poses a risk should we end up in an era of higher interest rates decades from now.

If we don't take opportunities to ease up on that path when they are available, it is surely going to be more difficult to lean against growing government debt when the economy has slack, and spending cuts or tax hikes would run counter to being at full employment. What we fear is that the debt ceiling stalemate will be solved by pledging medium term fiscal restraint, which for all we know could hit the economy when it's weak and in need of stimulus. The Chinese proverb notes that a journey of a thousand miles starts with a single step, and in the case of a fiscal journey to pare deficits, the right time for that step is now.

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2023 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license..