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A drop in the U.S. Treasury securities market could trigger or deepen the next recession: A Brief Note

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The Fiscal Responsibility Act of 2023 (FRA) reduces the deficit by cutting discretionary spending gradually in tiny steps during the next 10 years by placing “caps” on selected budget items. However, the ceiling of some of these “discretionary” spending categories are flexible whenever Congress considers above-cap spending as “emergency” needs. In other words, it has a built-in moving target. Unfortunately, the budget process is very murky and perhaps only understood by longstanding congressional aides.

The recent history of fiscal responsibility in the U.S. began with the Gramm-Rudman-Hollings Balanced Budget and Emergency Budget Control Act of 1985 and has been followed by numerous other similar fiscal acrobatic acts which never reached even close to their targets. The often-used fiscal financing technique is to commit to balancing the budget within ten years, with most of the reduction occurring in the last three years.

According to the Congressional Budget Office (CBO) the FRA will reduce the budget deficit about $1.5 trillion during the next decade if exceptions to the caps are not utilized to raise the deficit. CBO’s calculations show that at the end of the ten years, the FRA will have reduced total U.S. Treasury debt by only 2.9%. If the U.S. were to be subjected to an International Monetary Fund stabilization program, as many countries have, a $1.5 trillion deficit cut would likely be expected to occur in under a year.

A very worrisome feature of FRA, and by far the main component, is that it has eliminated the debt ceiling for two years, this enforces the addiction to deficits. Technically, debt could go up by $2 trillion or by even $6 trillion, particularly if the U.S. enters a recession. By now the Federal Government has become addicted to printing money, and the Fed’s hands may be tied, as it is the lender of last resort.

Each time that the Federal debt ceiling expiration has approached, political disagreements and threats from all sides get closer to not meeting the deadline to avoid a default. The next time the deadline approaches, the political wrangling could go too far, past the deadline, thus triggering a default of U.S. Treasury debt with a consequent spike in interest rates, that could cause if not deepen the next recession.

The rating agencies have not yet sounded the alarm but have held back on a downgrade of U.S. Treasury debt, in our opinion, out of a concern that a downgrade would disrupt financial markets. Is not their job to apprise investors of credit risks? Undoubtedly, this is not going to end well.

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