Will Trump administration tax cuts, spending hikes blow up deficit and doom economy?

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Is President Trump blowing up the deficit and dooming the economy?

Trump's big tax cuts and spending increases have substantially widened the deficit – the annual gap between government income and expenses – to nearly $1 trillion, lending fresh urgency to a debate that seemed to have vanished from the halls of Congress in recent years.

Some economists and think tanks say the red ink could ultimately crimp the economy by pushing up borrowing costs for Americans and hampering the government's ability to spend in a crisis. That could mar Trump's economic legacy, much as a big debt run-up in the 1980s tainted President Reagan's.

Meanwhile, the sum of all annual deficits and surpluses, the national debt, is an eye-popping $21 trillion. The ratio of national debt held by the public – which excludes things like Social Security – to gross domestic product is at 78 percent, the highest level in 70 years, according to the Committee for a Responsible Federal Budget, a nonpartisan, nonprofit group.

The 35-day partial government shutdown, resolved at least temporarily on Jan. 25, raised questions about whether a divided Congress can pass a new spending deal this year that begins to tackle the budget gap. In early January, Fitch Ratings warned that a failure to grapple with the deficit could eventually prompt it to lower the nation's credit rating, a move that would roil markets and the economy.

"Given that the president and Congress can't agree on simply keeping the government open, there is little prospect they can agree on addressing the nation's fiscal problems," says Mark Zandi, chief economist of Moody's Analytics.

Also placing renewed focus on the deficit: The economic lift fueled by the Republican tax and spending measures is expected to fade this year. That's sparking questions about whether the lingering hangover – higher deficits – will ultimately slow or derail an economy already set to cool.

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"Even with a big deficit, the U.S. is still a pretty good bet" for bondholders, says economist Paul Ashworth of Capital Economics. "I'm not sure why ... people will start to panic in another month or two or in a year."

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During the Great Recession of 2007-09 and its aftermath, when President Obama spearheaded a $787 billion stimulus to resuscitate the economy, Republicans in Congress grumbled routinely about the mounting debt burden. But many of those deficit hawks have receded from the spotlight. The loudest, House Speaker Paul Ryan, R- Wis., retired last month after embracing the Trump tax and spending laws.

Some economists, however, says the calm may belie a coming storm.

"I think of (the deficit) like climate change," Zandi says. "We know if we don't do something, it's coming, but we don't know when. It's corrosive."

Deficit approaches $1 trillion

The budget deficit is expected to reach $900 billion in fiscal 2019 and hover at about $1 trillion or above for the next decade, up from $779 billion last year, according to Congressional Budget Office projections. At least 40 percent of the increase can be traced to the tax and spending measures. Trump vowed that the sweeping tax cut would pay for itself by generating more economic growth that swells government coffers.

But that hasn't happened. The tax cut, passed in late 2017, is expected to cost the government $1.84 trillion over the next decade, according to the Committee for a Responsible Federal Budget and the CBO. While faster economic growth is forecast to generate about $570 billion in additional revenue, that will be offset by higher interest payments on a bigger national debt, the committee says.

"Deficit projections over the next decade are unrivaled by any time in our nation's history save for World War II and the immediate aftermath of the Great Recession," House Budget Committee Chairman John Yarmuth, D-Ky., said at a hearing recently.

All told, the tax and spending laws are poised to add $2.1 trillion to $4.7 trillion to the debt over 10 years, depending on whether they're extended beyond their current terms. And so the U.S.

debt held by the public as a share of gross domestic product is expected to rise from 78 percent to 93 to 105 percent over the next decade. Without the legislation, debt to GDP would have climbed to 89 percent over that period, the committee for a responsible budget says.

To be sure, other expenses such as Social Security, Medicare and interest on the debt are also big drivers of the deficit.

"The (tax and spending) legislation just made things worse," says Michael Peterson, CEO of the Peter G. Peterson Foundation, which addresses U.S. fiscal challenges.

Like Trump, Reagan slashed taxes and sharply increased military spending, nearly tripling the debt to $2.8 trillion by the time he left office in 1989. Some economists say the initiatives helped dig the economy out of a double-dip recession in the early 1980s. Others say they helped stoke inflation fears and Federal Reserve interest rate increases that contributed to the 1990-91 recession.

Rising interest rates

What does the bigger deficit mean? Higher costs for Americans. When the government has to borrow to pay its bills, it issues Treasury notes. As the supply of those bonds increases, their prices fall and yields rise to attract more buyers, assuming demand is steady. As a rule of thumb, each percentage point increase in the debt-to-GDP ratio boosts Treasury yields by about .04 percent point, Zandi says.

A jump in debt-to-GDP from 89 percent to 105 percent could increase Treasury rates by 0.64 percentage point. And since 10-year Treasury yields, now 2.73 percent, directly affect loans such as 30-year fixed mortgages, a monthly payment on a $200,000 mortgage could rise by up to $77. That could hurt the housing market and the broader economy.

Another reason Treasury rates could increase is that Uncle Sam has borrowed so much money that bondholders begin to doubt whether the government can pay it back. As a result, they demand a higher interest rate to offset the bigger risk.

Here’s the good news: The part of 10-year Treasury rates known as the term premium – which reflects the risk of default, the risk bondholders take by locking in the rate for a decade and the fluctuating supply and demand of Treasurys – has been roughly stable at about negative 0.5 percent since mid-2017. (The rest of the 2.73 percent 10-year rate reflects expectations for short-term rates, based mostly on Federal Reserve moves).

Treasurys offer 'safe haven'

In other words, Treasury bonds are so coveted by domestic and foreign investors that they’re willing to pay a premium to own them rather than demand a premium, as is typically the case. That negative 0.5 percent term premium has been little changed even after Congress passed the tax and spending bills, Ashworth says.

“The deficit has gone up but investors aren’t asking for more,” he says. “They’re asking for less.”

Why? In an increasingly uncertain global economy in which countries like Italy, Turkey and Argentina face financial crises, the U.S. economy is a beacon and Treasurys remain a rock-solid

investment. Also, the dollar serves as the world's reserve currency for international transactions, and many countries store their dollars in Treasury bonds.

“Treasurys have been a safe haven,” says Charlie Ripley, senior investment strategist and bond analyst for Allianz Investment Management. “It doesn’t really appear to us that the increase in the deficit has had a material effect” on Treasury yields.

But a closer look reveals that passage of the tax and spending bills in late 2017 and early 2018 did nudge Treasury rates higher in the following weeks by about 0.2 percentage point, Zandi says. Although rates retreated during the stock market turbulence late last year as investors bought more stable assets, including Treasurys, Treasury rates are slightly higher than they would be without the legislation, Zandi says. In other words, the monthly payment on that $200,000 mortgage costs about $25 more.

That’s still a modest impact. But experts say investors may not always have the same appetite, or risk tolerance, for Treasurys, especially if Congress doesn’t begin to tame the deficit or continues to let it balloon.

“There’s no credible argument for why we should be able (to run deficits) at unsustainable levels indefinitely,” says Maya MacGuineas, president of the committee for a responsible budget.

And Fitch Ratings Senior Director Charles Seville says, “It’s a bit early to say that interest rates won’t rise" as the budget deficit widens.

Will Congress's hands be tied in next recession?

The other way the deficit can hurt the economy is by making it harder for Congress to fund a new stimulus package in case of a recession, which many economists predict will occur in 2020.

Typically, deficits fall during strong economies as tax revenue rises, and they increase in downturns as tax income falls and the government spends more on unemployment insurance and stimulus programs. It’s virtually unprecedented for deficits to be this high while the nation is enjoying a strong economy and no major war, as it is today, according to the the committee for a responsible budget. . In fact, the committee says, the White House and Congress should be taking advantage of the healthy economy to whittle down the deficit.

“You have so little room to respond during the next crisis,” MacGuineas says.

In reality, though, it’s unlikely bond investors will hesitate to finance additional U.S. spending to combat another downturn, Ashworth says. After all, he says, even if U.S. debt-to-GDP approaches 100 percent, that’s still well below 130-percent-plus ratios in countries such as Italy and Japan.

Chris Edwards, senior fellow at the libertarian Cato Institute, notes that while the U.S. debt-to-GDP ratio is lower, its economy, and debt level, are much larger. He calls the deficit buildup "disastrous."

Capital Economics’ Neil Shearing is more worried about political resistance in Congress to a massive stimulus if the nation’s debt burden hits nosebleed levels.

Zandi isn’t concerned. “If we get into a mess, policymakers will ignore the deficit and do what they need to do,” he says.

Yet MacGuineas says the patience of bondholders and lawmakers eventually will run thin.

"We don't know when that is, and we don't want to try to find out."