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The Fed just ended Washington's cheap-money era

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The Federal Reserve's decision Wednesday to raise its benchmark interest rate by a quarter percentage point to 4% surprised almost no one. Inflation is considerably above the Fed's 2% target. Economic activity is expanding at a solid pace. Capital investment is robust, job gains have kept pace with the workforce, and unemployment has changed little. The vote was unanimous.

Those are the conventional reasons for the hike. But the White House and Congress should pay attention to another message the Fed is sending: the government cannot count on cheap borrowing anymore.

Fed Chairman Kevin Warsh has spent years arguing that the central bank's balance sheet became too big after the 2008 financial crisis. Before taking the chair, he called the balance sheet, which is weighed down by \$7 trillion of government IOUs, "trillions larger than it needs to be" and advocated a big withdrawal of the Fed's presence in financial markets. *Note*

That matters to Congress because the Fed's post-2008 purchase of Treasury

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paper pushed down long-term interest rates. The central bank bought trillions of dollars in Treasury securities and mortgage-backed securities to achieve what is called quantitative easing, deliberately removing longterm bonds from private markets. *Note* The Fed's own research found that those purchases substantially reduced longterm Treasury yields. Lower Treasury yields meant cheaper borrowing not just for homeowners and businesses, but also for the federal government.

Congress took advantage of this to ramp up spending. At the end of fiscal 2008, gross federal debt stood at roughly \$10 trillion. Last month, it crossed \$40 trillion. *Note* Debt held by the public is now roughly equal to the nation's annual economic output.

For years, lawmakers could run enormous deficits while interest rates were kept artificially low. This masked some of the cost of borrowing; the principal accumulated, but servicing it remained relatively manageable.

That is no longer true. Through August, the federal government had already spent \$1 trillion on interest this fiscal year, compared with about \$833 billion on defense and \$979 billion on Medicare. *Note* Debt servicing has therefore passed defense and Medicare and is now second only to Social Security among major categories of federal spending.

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The Fed does not dictate fiscal policy, and Warsh has been careful not to seem to do so. But the fiscal implications of higher rates and a smaller Fed balance sheet are unavoidable. Treasury must refinance

maturing debt, and when old debt issued at low rates is replaced with new debt at higher rates, the government's interest bill rises.

That changes the arithmetic facing Congress. Washington does not have a revenue problem but a spending problem. Federal revenue this year is expected to be slightly above its historical average as a share of the economy. Spending, however, is running well above its historical average. In a high-interest-rate world, deficits become more expensive. More spending means more borrowing, more borrowing means higher interest costs, and higher interest costs mean still more borrowing. Congress cannot count on cheap debt to hide the cost of overspending any longer.

That debate is now unavoidable. Social Security trustees forecast that the trust fund will exhaust its reserves in 2032. That is not bankruptcy — payroll taxes would continue coming in — but without legislative changes, incoming revenue would cover only 78% of scheduled Social Security benefits. Congress will have to address Social Security sooner or later. Waiting until 2032 would mean fewer options and sharper changes. Acting earlier would allow reforms to be phased in more gradually and give workers more time to plan.

The Fed's rate hike was primarily about inflation. But for Congress, it underscores a broader fiscal reality: the era in which Washington could borrow trillions of dollars at unusually low cost should be assumed to be over, perhaps never to return.