



August 3, 2022

Honorable Jason Smith
Ranking Member
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Re: Budgetary Costs of Higher Interest Rates and Inflation

Dear Congressman:

This letter responds to three questions you asked about the budgetary costs of higher interest rates and inflation.

How Have the Congressional Budget Office's Projections of Interest Payments Changed?

Higher interest rates and inflation have increased CBO's baseline projections of the government's interest payments.¹ Between February 2021 and July 2021, CBO raised its projections of interest rates and inflation, boosting projected net interest outlays from 2022 to 2031 by \$835 billion. Between July 2021 and May 2022, CBO raised its projections of interest rates and inflation further, boosting net interest outlays from 2022 to 2031 by an additional \$1.7 trillion.² All told, projected net interest outlays over the 2022–2031 period rose by \$2.5 trillion because of changes in projected interest rates and inflation. (Those changes are distinct from

¹ Inflation rates affect net outlays for interest, mostly for Treasury inflation-protected securities, which differ from other securities in that their principal amounts are adjusted to account for inflation. For more details on federal net interest costs, see Congressional Budget Office, *Federal Net Interest Costs: A Primer* (December 2020), www.cbo.gov/publication/56780.

² See Congressional Budget Office, *The Budget and Economic Outlook: 2021 to 2031* (February 2021), www.cbo.gov/publication/56970, *An Update to the Budget and Economic Outlook: 2021 to 2031* (July 2021), www.cbo.gov/publication/57218, and *The Budget and Economic Outlook: 2022 to 2032* (May 2022), Appendix A, www.cbo.gov/publication/57950. The amounts shown here include interest on the added debt resulting from higher interest payments.

the effects on deficits and thus interest payments of other changes in the baseline projections.)

How Does Increased Debt Affect Federal Borrowing Costs?

On average over the long term, each increase in federal debt of 1 percent of gross domestic product (GDP) boosts interest rates by 2 to 3 basis points, CBO estimates.³ Thus, an increase in federal debt of 10 percent of GDP would boost interest rates by about one-quarter of a percentage point—raising the government’s net interest costs. CBO takes such changes into account in developing its economic projections.

The amount by which interest rates respond to additional debt depends on the prevailing economic and financial conditions. Over time, additional debt could lead to increased concerns by market participants that the U.S. government would allow high inflation to erode the real value of the debt. Because the United States borrows in dollars, market participants could be concerned about the risk of future inflation rather than about the government’s ability to repay the debt. Such concerns could lead to higher interest rates.

Ultimately, such concerns could lead to a fiscal crisis in which interest rates rose markedly as market participants required higher compensation to lend to the Treasury. The risk of such a fiscal crisis increases as the burden of federal debt increases, but in CBO’s assessment, there is no specific point at which a crisis becomes likely or imminent. The risk of a fiscal crisis in the near term appears to be low despite the larger deficits and higher debt stemming from the coronavirus pandemic.

How Would Holding a Greater Portion of Federal Debt in Short-Term Securities Affect the Budget?

Holding a greater portion of federal debt in short-term securities would reduce interest costs when the yield curve was upward sloping (that is, when short-term interest rates are lower than longer-term interest rates). Although interest rates on both short-term and longer-term securities fluctuate, short-term securities historically have lower interest rates than longer-term securities. Any shift in the composition of the Treasury’s borrowing toward short-term securities would tend to increase interest rates on those securities relative to rates on long-term securities. That change

³ See Edward Gamber and John Seliski, *The Effect of Government Debt on Interest Rates*, Working Paper 2019-01 (Congressional Budget Office, March 2019), www.cbo.gov/publication/55018. A basis point is one one-hundredth of a percentage point.

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would affect the slope of the yield curve; the magnitude of that effect would depend on the amount of debt issued and on market conditions when that change in the composition of the debt occurred.

Holding a larger proportion of short-term debt would also make interest costs more sensitive to changes in interest rates. That increased sensitivity would occur because short-term securities mature more frequently, and, as they matured, they would be replaced by newly issued securities at prevailing rates. Currently, about half of all outstanding federal debt will mature in the next two years. The average maturity is about 74 months, the longest average in the past 40 years.

In addition, an increase in the supply of short-term securities would tend to increase interest rates on those securities and could affect the relationship between short-term and long-term interest rates.

I hope this information is useful to you. Please contact me directly if you have further questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Phillip L. Swagel", with a long, sweeping flourish extending to the right.

Phillip L. Swagel
Director

cc: Honorable John Yarmuth
Chairman