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National Economic Trends

Die Another Day? Budget Deficits and Interest Rates

In January 2002, the Congressional Budget Office (CBO) projected that the federal government, operating under current fiscal policies, would run a cumulative budget surplus of about $2.25 trillion for fiscal years 2003-12. By August, this projected surplus had been cut in half, and the CBO now projects modest deficits (averaging less than 1 percent of GDP) through fiscal year 2005. (In fiscal year 2002, the unified budget deficit totaled $157 billion, with a deficit of $145 billion projected for 2003.)

The swing from projected budget surpluses to actual budget deficits has led some economists to warn of the economic consequences of a return to deficit financing. Indeed, Federal Reserve Chairman Greenspan has argued that larger budget deficits may lead to higher interest rates and, as a consequence, slower growth of investment and labor productivity.[1] These warnings are particularly relevant given proposed new legislation for a Medicare drug prescription plan and extension of the expiring tax provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001.

The classic argument is that large deficits raise interest rates because government borrowing "crowds out" private borrowing. As the government competes with private borrowers to take a larger share of a fixed pool of saving, the *real* interest rate rises. Conversely, rising surpluses should be expected to lower interest rates.

Empirically, the linkage between budget deficits/surpluses and interest rates is weak, as a series of papers published in the 1980s showed.[2] However, most large macroeconometric forecasting models presume that larger deficits lead to higher interest rates. The past five years provide a natural experiment to test this hypothesis. After all, sharply larger surpluses were projected until 2001, with much smaller projected surpluses thereafter (and even modest-sized deficits over the near term).

The figure provides some countervailing evidence against the view that real interest rates move inversely to large changes in the federal government's projected budget balance. The figure plots the CBO's biannual 10-year cumulative surplus projections against the yield on 10-year (on-the-run) Treasury Inflation-Indexed Securities (TIIS), which the Treasury began issuing in 1997. As the figure shows, projections of ever larger budget surpluses from 1997:Q3 to 2001:Q1 were essentially associated with rising real interest rates, not falling rates. From 1997:Q1 to 2000:Q1, the yield on the 10-year TIIS rose from 3.36 percent to 4.23 percent. Since then, 10-year TIIS yields have fallen to just under 2.5 percent, as has the size of the projected cumulative budget surpluses.

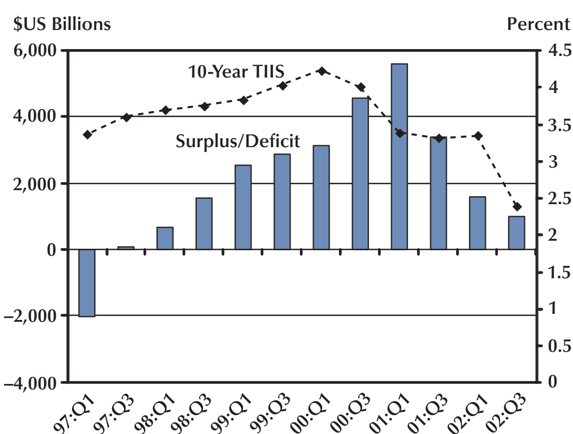
The evidence presented here suggests that changes in the economy's *expected* growth rate greatly affect both projected surpluses and real interest rates. When economic growth is expected to be strong, particularly labor productivity and investment, the return to capital (the real rate of interest) is thus high, as is the growth of taxable incomes (and hence tax receipts). When growth slows, the opposite tends to occur. Large budget deficits or surpluses may affect interest rates, but other factors appear to be more important.

—Kevin L. Kliesen

[1] Greenspan, Alan. "Current Fiscal Issues." Testimony before the Committee on the Budget, U.S. House of Representatives, 12 September 2002.

[2] Evans, Paul. "Do Large Deficits Produce High Interest Rates?" *American Economic Review*, March 1985, *75*(1), pp. 68-87.

Cumulative 10-Year Surplus/Deficit Projections and Yield on 10-Year TIIS



NOTE: TIIS yields are daily averages for the quarter indicated.

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