

Rising Interest Rates Will Crush the Federal Budget

The interest costs of Treasury debt are about to soar while revenue from capital-gains taxes will plunge.

The Federal Reserve's policies of increasing interest rates and quantitative tightening—reducing its \$8.9 trillion balance sheet—will increase the volume and cost of federal government borrowing, slamming the federal budget and exposing the consequences of decades of deficit spending.

The impact will be felt even without a recession, but if the economy does contract, the government will have limited capacity to spur a recovery with fiscal stimulus.

Exploding federal debt.

Since February 2020, publicly held U.S. Treasury debt has exploded, growing from about \$17 trillion to \$24 trillion. Almost half of the increase has wound up at the Fed, whose Treasury holdings have ballooned from \$2.5 trillion in February 2020 to \$5.8 trillion.

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Quantitative tightening is a big initiative. In May the Fed announced plans to reduce its Treasury holdings by \$330 billion by the end of the year, and by \$720 billion annually thereafter until its balance sheet shrinks to a yet-to-be-determined size. The Fed can reduce its balance sheet, but that doesn't mean the federal government can reduce its balance of outstanding debt.

Given the extraordinarily low interest rates on new federal debt issued during the recent economic shutdown, federal interest costs barely increased despite the \$7 trillion increase in Treasury debt. Over the last three federal fiscal years ending on Sept. 30, 2021, total gross interest cost was \$573 billion, \$523 billion and \$562 billion. (Net interest, after accounting for interest income primarily in government trust accounts, is \$150 to \$250 billion lower.)

Rising interest rates.

That is changing. Short-term rates have risen 2.25% following the Fed's 75-basis-point rate increases in June and July and smaller increases in March and May. By the end of 2022, additional rate increases will bring cumulative

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rate increases to 3%, according to the Fed's official guidance. The Fed projects short-term rates averaging 3.4% in December and rising thereafter.

As this additional 3% works its way into the refinancing of maturing Treasuries, federal interest costs will skyrocket. As of July 31st, there were about \$3.5 trillion outstanding Treasury bills, which mature in less than a year. In 12 months the 3% increase in rates will generate roughly \$105 billion in additional annual interest expense on these Treasury bills.

According to the Monthly Report of the Public Debt, on July 31st, there were outstanding \$13.6 trillion of Treasury notes, which are issued with maturities of one to 10 years. \$2.5 trillion had remaining maturities of less than one year.

The \$2.5 trillion had a weighted average original interest rate of 1.2% and a weighted average original maturity of 4.6 years. The current yield on five-year Treasury notes is about 2.95% — 0.6% points higher than the current fed-funds-rate. If the \$2.5 trillion of maturing Treasury notes roll over at the same spread over the projected year-end fed funds rate of 3.4%, they will bear interest at 4.0% and cost additional annual interest of \$70 billion.

Financing the debt.

Total federal gross interest cost over the 12 months ending on July 31 was \$684 billion (\$445 billion, net). If we include only the impending extra interest on Treasury bills and on the notes maturing in the next 12 months (and ignore Treasuries with longer remaining terms and of

other types and ignore possible further rate increases), that figure rises to \$859 billion. That is a staggering cost. National defense spending was \$741 billion over the 12 months through July 31; Medicare spending was \$669 billion.

With the federal government in perpetual deficit, where will the Treasury find money to make extra interest payments? New taxes? Lower spending? Fat chance. In all likelihood, it will have to borrow to pay interest.

Who will buy Treasuries? Under quantitative

tightening, the Fed isn't planning to reduce its holdings of Treasury bills, only of longer-term notes and bonds. Buyers—especially of long bonds—face an uncertain inflation outlook. The high pace of the Fed's reduction of its Treasury holdings will require a fast-paced refinancing

program. It will be challenging and costly to find buyers to replace the Fed.

The effect of falling markets.

The revenue side doesn't look much better. The sharp selloff in equity markets will severely depress capital-gains tax revenue, which averages more than 10% of federal individual income-tax revenue. Such revenue is [now reversing](#) from a historic peak in 2021. The shortfall in 2022 could be as much as \$250 billion. Almost inevitably, this revenue loss will have to be made up with more federal borrowing.

Investors are painfully aware of the plunge in stock and bond markets so far in 2022. Are federal and state officials aware of the damage plunging markets will do to public budgets and

The impending extra interest on Treasury bills and notes maturing in just the next 12 months will push federal interest costs far past national defense spending and Medicare spending over the last 12 months.



finances? Tax revenue from capital gains looks set to fall off a cliff.

The Monthly Treasury Statement for April indicated that capital-gains tax revenue reached record levels in 2021. The markets are telling us capital gains will shrink dramatically in 2022. If what the statement and the markets are signaling is correct, the reversal of fortune for federal tax revenue could be as large as \$250 billion. In New York, Connecticut and other states that are heavily reliant on individual income taxes for revenue, the reversal could be devastating.

The last time the markets crashed this severely was during the 2007-09 financial crisis, when the tax rate on long-term capital gains was 15%, well below today's 23.8% rate. Federal capital-gains tax revenue plummeted 75% in two years, from about \$140 billion in 2007 to \$35 billion in 2009.

Two factors could extend and exacerbate a market swoon and plunging capital-gains tax revenue. First, interest rates on bonds in 2008 were much higher than they are now. This allowed for a post-crash resumption of the decades-long bull market in bonds that continued right up to the pandemic. Substantial capital gains were available in bonds throughout this period. After the super low interest rates that prevailed during the pandemic, there is nowhere for interest rates to go but up and for bonds prices to go but down. Falling bond prices will leave little potential for capital gains on sales.

Second, in 2009, inflation wasn't a concern; in 2022 it's at a 40-year high. The Federal Reserve is expected to continue raising interest rates

and to keep them high until current high inflation is tamed. This isn't a promising economic and financial outlook for capital gains.

Federal and state officials be warned: If you haven't yet anticipated that a major source of tax revenue is drying up, you may have waited too long to begin to make necessary budget adjustments.

Federal budget officers face another revenue hit. In 2021 the Fed Reserve Bank generated nearly \$108 billion in profit. Big banks make big money. The Fed is required to remit most of its profits to the Treasury. As the Fed shrinks, it will remit less.

An unsustainable path.

Under current Fed policy, the federal government's annual gross interest expense could reach \$1 trillion. As rates rise and Uncle

Sam borrows ever more to pay the extra interest expense, a vicious cycle ensues as more interest expense necessitates ever more borrowing.

This dire outlook has been long coming. The current debate about inflation and whether the Fed's monetary

moves have been too late or are now too aggressive misses the point. The U.S. has been on an unsustainable fiscal and financial path for a long time. We are beginning to see the inevitable result.

Portions of this brief analysis appeared in the May 17 and June 30, 2022 print editions of The Wall Street Journal. Where available, updated data has been included in this edition.

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