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Summary

The Congressional Budget Office's January estimates of baseline federal budget deficits have grabbed the attention of members of Congress and the public. The cumulative effects of persistently large deficits show up in the stock of debt held by the public and the net interest costs of servicing that debt. This brief will provide historical data on those items and CBO's current projections. It also will discuss some of the risks to CBO's estimates.

Debt Held by the Public

Federal debt held by the public represents the total amount of borrowing from non-governmental sources needed to finance the cost of current and past government operations. It does not include borrowing from federal trust funds (such as Social Security), which are included in the broader measure of government indebtedness, the gross federal debt. Economists focus on the debt held by the public because it represents the amount of capital that the government has diverted from the private sector. CBO's report notes that "increases in federal debt over time would probably constrain long-term economic growth by reducing national savings and investment."[1]

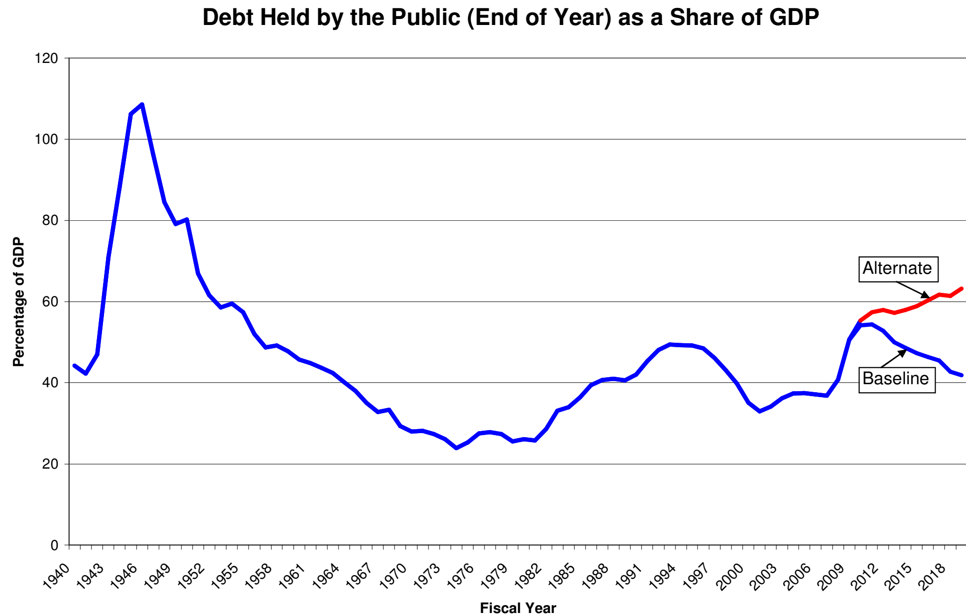
Debt held by the public generally increases by the amount of the unified budget deficit. The debt has been on an upward path since 1969 except for a brief decline during the period between1998 – 2001 when the government ran unified budget surpluses. As a share of the economy, the debt has varied, but has averaged 35.8 percent over the last 40 years.

As a result of the crisis in the financial sector and economy, CBO projects for fiscal year 2009 the single largest jump in debt held by the public as a percentage of GDP in the post-WWII period: from 40.8 percent of GDP in 2008 to 50.5 percent of GDP in 2009, for an increase of 9.7 percentage points. This is even before additional actions are taken to provide economic stimulus, or appropriations to cover the costs of military operations in Iraq and Afghanistan (see chart below). The baseline estimates also indicate that debt held by the public as a share of the economy will peak at 54.4 percent of GDP in 2011, and will decline thereafter by 12.5 percentage points, to 41.9 percent of GDP in 2019.

However, CBO's baseline may well underestimate the fiscal deterioration ahead. Many likely policies that would have sizable fiscal impacts are not included in the CBO baseline since they are not part of current law. The

[1] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 2009, p. 31.

alternate baseline in the chart assumes 1) gradual drawdown of troops deployed in the war on terrorism to 75,000 by 2013 (from 190,000 in 2009); 2) continuation of the 2001 and 2003 tax cuts; and 3) indexing the AMT. Under this scenario, the debt held by the public continues to grow.[2] Under this scenario, debt would reach 57.3 percent of GDP in 2011 and grow to 63.2 percent of GDP by 2019.



Net Interest Costs

Debt levels are highly dependent on the level of interest rates as well as policy choices. When interest rates are higher than forecast, the deficit increases relative to the past projections, and in turn the debt held by the public increases. Further, the costs of higher interest rates compound over time, leading to an even higher level of debt.

The federal government has been fortunate so far in the financial crisis in that U.S. government debt has been in great demand as investors look for safe havens for their capital. As a result, the interest rates demanded by bond holders have declined to unprecedented levels. (In fact, the U.S. sold $30 billion of four-week bills at a zero percent interest rate on December 10, 2008.[3]) The CBO baseline expects some increase in interest rates over the next several years, but by and large portends a favorable environment for federal debt issuance.

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[2] Those assumptions are similar to those used by CRFB in the Alternate Baseline published in February, 2008. Discretionary spending is assumed to grow at the rate of inflation rather than nominal GDP (which was assumed last year) because it is expected that some reductions in discretionary spending will be forthcoming. No assumption is made regarding economic stimulus because of the uncertainty of the magnitude and timing of a stimulus package.

[3] Matthew Benjamin and Liz Capo McCormick, “Treasury Benefits From ‘Paranoia’ as Rates Decline (Update2),” Bloomberg.com, December 15, 2008. http://federalreserve.gov/releases/h15/20081215/

[4] Data provided in the historical tables included in the administration’s 2009 budget submission do not allow for this computation for fiscal years before 1962.

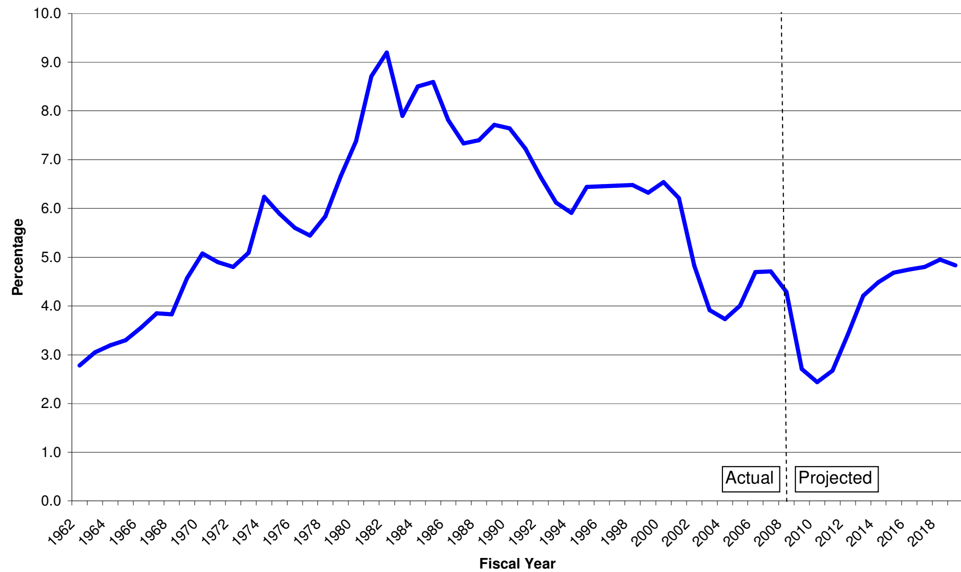
[5] Richard Berner and David Greenlaw, “A New Rate Outlook: QE and the Yield Curve,” Morgan Stanley Global Economic Forum, January 6, 2009.

The chart below shows historical levels of net interest costs as a percentage of debt held by the public along with the CBO baseline projections for that ratio. As can be seen from the chart, CBO expects that interest costs for the budget year (fiscal year 2010) will be the lowest as a share of the debt outstanding than in any year since 1962.[4] Net interest costs are expected to be 2.4 percent of debt outstanding for fiscal year 2010, 30 basis points below the expected 2009 level of 2.7 percent. The implied interest rate rises for years after 2010 — reaching 5 percent in 2018 — consistent with the rise in interest rates found in CBO's economic projections for those years.

There are several reasons why there is a reasonable risk that the observed net interest costs will be above the levels suggested by the CBO baseline:

- Monetary policy is as loose as it has ever been, with the target for the federal funds rate cut to between zero and 0.25 percent in December 2008. In addition, "quantitative easing" is being used to allow financial institutions to obtain credit on assets that are currently unmarketable. Unwinding these policies as the economic environment improves may boost interest rates by more than the modest expectations in the CBO baseline; though it is by no means a consensus view, some observers suggest that bond yields may increase by 2 percentage points over the course of 2010 if the economy improves and inflation shows signs of returning.[5]
- There is only so much capital available to invest, and that amount has shrunk significantly in the past several quarters. As the crisis in the financial markets eases and demand for investments starts picking up, U.S. government debt will have to compete for a larger share of a smaller pool of capital, and higher interest payments may result.

- Foreign lenders may not be as able or willing to purchase large amounts of U.S. debt. In the absence of exchange rate adjustments, slowing exports to the U.S. suggest that foreigners will have fewer dollars available to purchase U.S. government securities, and the need to provide fiscal stimulus in their domestic economies suggest that foreign governments may eventually need to trim rather than expand their current holdings of U.S. Treasury debt. CBO's report also suggests that this may cause "foreign lenders, who have recently been willing to lend to the U.S. government on very advantageous terms" to be "less willing to go so in the future, which would tend to raise interest rates in this country and dampen economic activity (p. 5)."



Conclusion

It is clear that actions taken in recent months to stabilize the financial system will have a huge impact on the budget outlook in future years. Actions under consideration to spur recovery from the current recession could be equally impactful. Accordingly, it is important that actions taken to facilitate economic recovery be temporary and cost-effective – and not simply additional borrowing to facilitate ongoing expansions of government spending. Failure to show resolve to get the deficit under control after the recession passes will make it even more likely that the debt will grow to unsustainable levels as the population ages and health care costs climb.