BLOG POST

Interest and the Budget

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There is a growing concern among economists that we are on an unsustainable path with respect to the debt and the associated interest costs. The narrative has been told countless times since the financial crisis of 2008. When the COVID-19 pandemic hit, the yield on the 10-year Treasury bond more-or-less hit the zero bound. Since then, interest rates have gone one direction – up. Now, higher inflation expectations are part of the reopening narrative. In particular, how high would yields have to rise to attract investment in the bond market under an inflationary scenario? The chart to the left illustrates the current "base" scenario for interest expense using today's rates and debt levels.

- As the chart illustrates, a 3% jump in yields would send the debt service from $303 billion to $975 billion. We would spend more on debt service than defense and would approach the cost of funding social security. The Federal Reserve knows how tenuous the situation can become if yields were to surge higher.

- Consequently, they are prepared to provide as much liquidity as possible through direct purchases of Treasuries to keep yields in check (i.e., the Fed will print money). Of course, we do not fully understand how this would end, or if it would end. If there comes a time where the dollar is no longer the world's reserve currency, there could be dire ramifications.