DO BUDGET DEFICITS RAISE INTEREST RATES?

January 13, 2003

> "I do not accept the assumption that it is somehow 'risky' to let taxpayers keep more of their own money."
>
> President George W. Bush

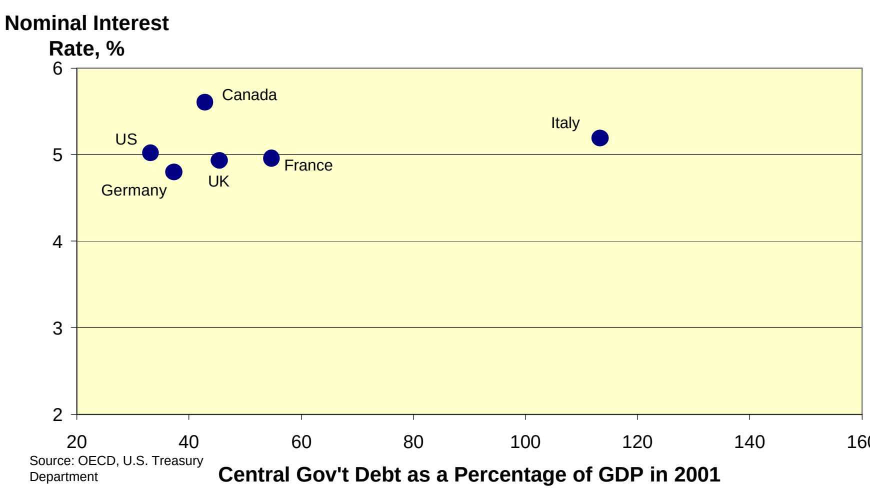
Policymakers are currently engaged in a heated debate over whether Federal borrowing has a large effect on long-term U.S. interest rates. This is nothing new. Two years ago, President Bush's critics feared that the tax relief he sought for the American people would detract from national saving, significantly boost interest rates and undermine the economy. Those fears were unfounded for several reasons:

- **Although the Federal budget moved from surplus into deficit in FY 2002, the 2001 tax cut accounted for less than ten percent of the shift.** By comparison, the weak economy and the sudden drop in taxable capital gains realizations (due to the bursting of the stock market bubble) accounted for roughly two-thirds of the swing. The remainder of the shift was due to increased spending for national priorities such as national defense and homeland security.

- **Long-term interest rates are determined in a *global* capital market for government bonds.** The outstanding supply of government debt issued by the world's seven largest countries is roughly $12 trillion, of which less than a third is debt issued by the U.S. government. Foreign investors hold more than thirty percent of U.S. government debt.

- In the current world economy, with an integrated market in government bonds (at least among the G7-G10 countries) and roughly similar inflation rates among countries (with the exception of Japan), it is a relatively straightforward matter to compare the real cost of borrowing across countries. **International evidence shows no relationship between government debt and interest rates.**

Nominal Long-term Government Bond Yields and Gross Central Government Debt as a Share of GDP, 2001



Source: OECD, U.S. Treasury Department