Economic Analysis

CBO: Downward Revisions in Long-Term Interest Rates

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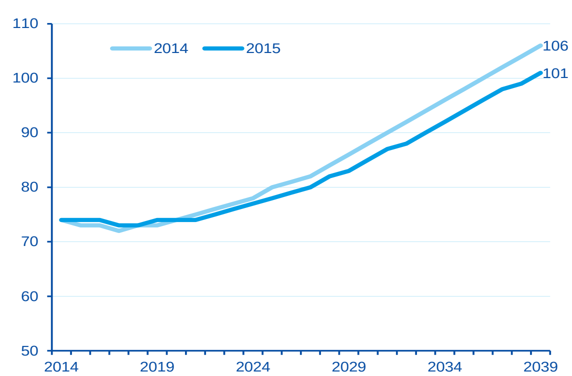
- **Projections for long-term 10-year interest rates revised down to 2.3%**
- **Government debt estimated to be 101% of GDP in 2039, down from last year**
- **No major revisions in federal spending and revenues**

The Congressional Budget Office (CBO) released its 2015 Long-Term Budget Outlook this week, presenting its forecast for the trajectory of the economy and government spending and revenues for the next 25 years. Notably, the CBO dropped its forecast for long-term rates for the second consecutive year, revising its projection for average real inflation-adjusted interest rates on Treasury loans from 2.5% to 2.3% in the long-term. Likewise, average interest rates for government debt were projected to be 2.0%, down from 2.2% in last year's outlook. The main impetus behind the downward revision for long-term rates was the expectation of a prolonged low interest rate environment by participants in financial markets.

Although the CBO's projections for interest rates were only slightly adjusted, the decrease could have a significant impact on the cost of financing the government's borrowing. Lower interest payments could free up federal spending, allowing more funds to be allocated to domestic and military programs. Taking into account its downward revisions for interest rates, the CBO projected that government debt would be 101% of GDP in 2039, down 5pp from last year's projections, but much greater than the current level of 74% of GDP.

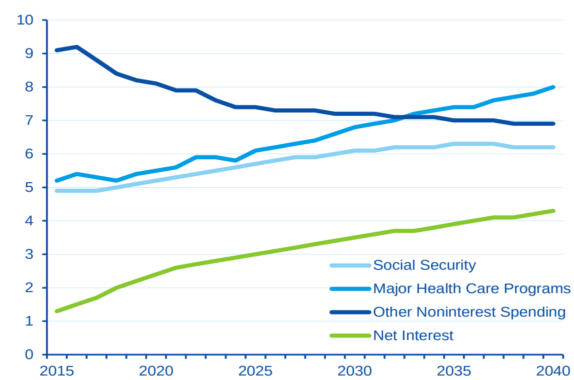
Although no drastic revisions were made from last year's forecasts, the CBO has consistently lowered its estimates for long-term interest rates and output. The agency projected that nominal GDP in 2039 would be about 3% smaller than last's year's estimate. This revision in output was driven mostly by an expected slowdown in productivity, or the efficiency with which labor and capital are used to produce goods and services. The CBO cited that the aging population and its adverse effects on the growth of the labor force as the major cause for the slowdown in productivity.

Chart 1
Projections of Federal Debt Held by the Public
% of GDP



Source: Congressional Budget Office

Chart 2
Selected Components of Federal Spending
% of GDP



Source: Congressional Budget Office

Projections of federal revenue and noninterest spending were very slightly revised downward, representing 19.3% and 21% of GDP in 2039, respectively. Federal revenues as a percentage of total GDP are projected to rise from the current average of 17.4% of GDP to 19.4% in 2040, largely driven by a boost in receipts from individual income taxes. On the spending side, federal healthcare spending was projected to be about the same as last year, while Social Security spending was lower due to projections that a smaller portion of earnings would be subject to Social Security tax. When compared to current levels, the CBO expects that federal spending will rise noticeably because of growth in federal healthcare programs, Social Security, and net interest costs. The CBO warns that unless substantial changes are made to healthcare programs and Social Security, spending for those programs will be a much larger percentage of GDP in the future, rising from the current average of 20.1% of GDP to 25.3% in 2040. All else equal, growth in revenues would fail to keep pace with growth in spending, resulting in larger budget deficits.

Bottom Line

The CBO issued a stern call for lawmakers to accelerate decision-making on policy changes that would shrink the federal deficit in order to hold down long-term interest rates and reduce uncertainty, raising business and consumer confidence. The timing for implementation would entail trade-offs however, as implementing policies too soon could weaken current expansion and give little time for planning and adjusting, while holding off implementation would entail the accumulation of debt and the necessity for larger changes. While Congress appears unlikely to compromise on any significant policy changes anytime soon, the Fed appears to be doing the budget a favor by delaying the announcement of a rate hike, thus trimming projections of interest costs on debt.