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Economics Group

Interest Rate Weekly

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Interest Rates and Federal Revenues and Outlays

The current low interest rate environment has been very favorable to the federal budget; however, with rate increases on the horizon, the story is about to change. Federal revenues and outlays would both be affected.

Higher Rates Adversely Affect Federal Revenues

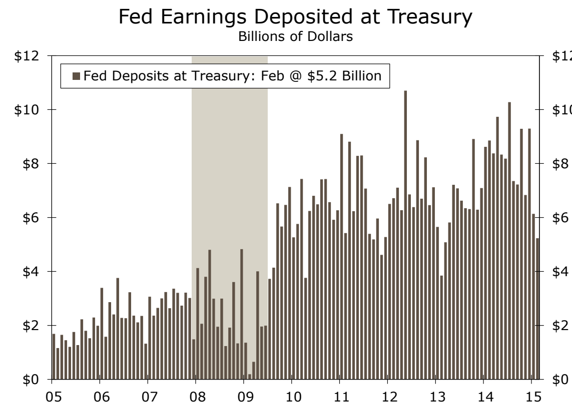
This week marks the annual due date for federal tax return fillings, so we felt it was appropriate to take a look at the role of interest rates on federal revenues. There are a number of ways in which interest rates interact with federal revenues. First is the overall effect of higher interest rates on economic growth. Typically, as interest rates rise, the higher rates begin to slow the pace of GDP growth, with some lagged effect. However, as we have explored in other reports, given that interest rates today are so low relative to historical norms and the utilization of credit has downshifted, the slowing effect on GDP growth of higher interest rates may not be as dramatic this time around. Thus, there is not likely to be a significant adverse effect of slower GDP growth on federal revenues from higher rates.

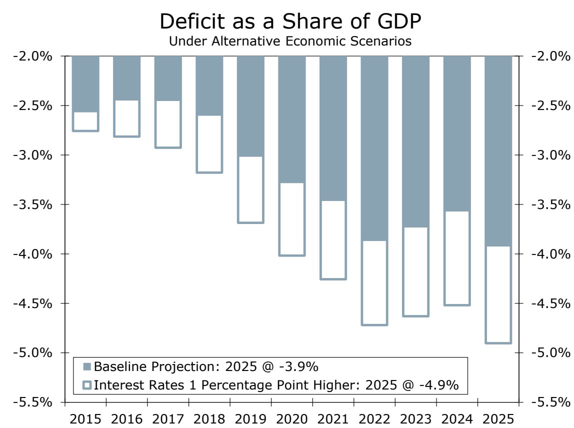
Another perhaps less-discussed effect on federal revenues from higher interest rates is the effect of remittances from the Federal Reserve to the U.S. Treasury. In 2014, the Federal Reserve sent $98.7 billion in profits to the Treasury, a record amount. These remittances have reached unprecedented levels given the bond holdings of the Federal Reserve (top chart). The Congressional Budget Office (CBO) estimates that if interest rates were one percentage point higher each year over the next 10 years than what they currently project, remittances from the Fed would be lower initially. However, as the Fed's holdings are gradually replaced with higher-yielding investments, the Fed's remittances would actually be higher by 2023.

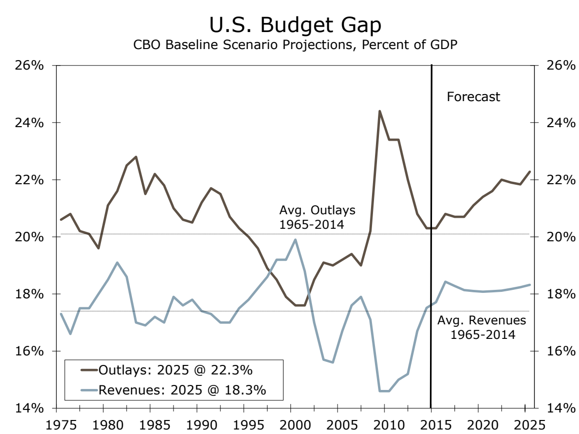
What Could Higher Interest Rates Mean for Budget Outlays?

While it is true that there would be adverse effects on federal revenues from higher interest rates, the real concern comes from the outlay side, namely interest expense. The CBO baseline projections call for the 10-year U.S. Treasury bond to yield 4.2 percent on average over the next decade. However, as the middle graph highlights, should interest rates rise one percentage point higher each year above current CBO projections, higher interest expenses would result in much larger federal deficits. In fact, by 2025, the CBO estimates that a one percentage point increase in interest rates would result in a $198 billion increase in outlays. In addition, higher interest expenses would result in increased borrowing by the Treasury compared to the CBO's baseline, as revenues are expected to be below outlays over the next 10 years (bottom graph).

Combining the effects of both revenues and outlays over the next decade of higher interest rates, on net, there would be adverse impacts on the federal budget which could, in turn, crowd out other investment on the part of the federal government. Should this situation transpire, we would expect federal fiscal policy to become contractionary to GDP growth again.







Source: U.S. Department of the Treasury, Congressional Budget Office and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual						Forecast					
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.71	3.95	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.13	0.55	0.86	1.15	1.43	1.81	2.28
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.27	0.63	0.91	1.22	1.52	1.85	2.35
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.30	0.69	0.99	1.24	1.57	1.89	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.70	0.87	1.07	1.26	1.71	2.00	2.46
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.68	1.78	1.89	2.01	2.19	2.31	2.59
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.19	2.35	2.41	2.46	2.53	2.77	2.89
30 Year Bond	3.56	3.34	3.21	2.75	2.54	2.77	2.89	2.99	3.09	3.18	3.39	3.58

Forecast as of: April 8, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.4	2.9	N/A
FOMC	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1
PCE Inflation			
Wells Fargo	0.9	2.1	N/A
FOMC	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: April 8, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: March 18, 2015

Source: Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

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