



Washington's Deficits: A Looming Threat to American Interest Rates

Key Takeaways:

- **Deficits Raise Rates, Stifling Growth:** Large federal deficits drive up interest rates, making it more expensive for businesses to invest and families to borrow, which ultimately slows economic growth.
- **Federal Cuts Burden States:** When the federal government cuts funding due to deficits, states with balanced budget laws are forced to raise taxes or reduce vital services like healthcare and education.
- **Less Crisis Flexibility:** Mounting deficits limit the U.S. Treasury's and Federal Reserve's ability to respond effectively to recessions, leaving fewer tools to stimulate the economy when a crisis hits.

For years, the sheer size of our national debt and persistent government deficits have been topics of concern in Washington and across the country. While deficit spending can be a necessary tool during economic downturns or national emergencies, a consistent pattern of spending more than we take in risks pushing up interest rates for everyday Americans and ultimately stifling our economic growth.

We've seen our national debt soar, particularly after events like the 2008 financial crisis and the recent pandemic. Currently, the U.S. national debt is well over \$36 trillion, and it continues to climb. This isn't just a number; it represents a fundamental imbalance between what the government spends and what it collects in taxes. And when Uncle Sam spends more than he earns, he has to borrow the difference.

THE MECHANISM: HOW WASHINGTON'S BORROWING PUTS PRESSURE ON YOUR WALLET

Think of it like this: the U.S. government borrows by issuing Treasury bonds, which are essentially IOUs sold to investors, both here and abroad. When the government needs to borrow a lot – as it does with large and persistent deficits – it increases the demand for these funds in the financial markets. This increased demand, all else being equal, drives up the "price" of borrowing, which is the interest rate.

It's a classic supply and demand scenario. There's a finite pool of savings available in the economy. If the U.S. Treasury steps in as a massive borrower, it competes directly with



American businesses looking for capital to expand, entrepreneurs seeking loans to start new ventures, and families needing mortgages for homes or financing for cars. This competition inevitably pushes up interest rates across the board.

Furthermore, if investors perceive that our nation's debt trajectory is unsustainable (and the recent credit downgrade of US debt by Moody's as well as bond selling indicate an emerging concern) they might demand an even higher return to compensate for the perceived risk. This creates a dangerous feedback loop: higher deficits lead to more borrowing, which pushes interest rates higher, making it even more expensive for the government to service its existing debt, thereby exacerbating the deficit. In fact, net interest payments on the national debt are now one of the fastest-growing categories of federal expenditure, even surpassing defense spending in fiscal year 2024.

THE "CROWDING OUT" EFFECT: WHEN GOVERNMENT SPENDING SQUEEZES AMERICAN ENTERPRISE

One of the most concerning ramifications of rising interest rates driven by government deficits is what economists call "crowding out." Simply put, crowding out is when increased government borrowing, by raising interest rates, makes it more expensive for the private sector to borrow and invest. This effectively "crowds out" private economic activity.

Here's how this plays out and why it can lead to a less dynamic American economy:

- **Higher Costs for Businesses:** When interest rates climb, businesses face higher borrowing costs for everything from building new factories to investing in research and development. Projects that were once profitable at lower rates

may no longer make economic sense. This discourages private investment, which is a vital engine for job creation, innovation, and long-term economic growth. Fewer new businesses means fewer jobs and less economic dynamism.

- **Impact on the American Household:** The effects aren't limited to businesses. American families feel the pinch too. Higher interest rates translate directly into more expensive mortgages, making homeownership less attainable for many. Auto loan and credit card interest rates also rise, increasing the cost of borrowing for everyday purchases. This reduces the purchasing power of American households and can lead to a slowdown in consumer spending, a crucial component of our GDP.
- **Stifled Productivity and Innovation:** Less private investment means a slower accumulation of capital stock – the tools, machinery, and technology that make our workforce more productive. When businesses invest less in these areas, our overall productivity growth can stagnate. This limits our ability to produce goods and services more efficiently, ultimately constraining wage growth and a rising standard of living for future generations.
- **Reduced Fiscal Flexibility:** As a larger chunk of our federal budget goes towards simply paying interest on our debt (which is projected to total \$13.8 trillion over the next decade, according to the Congressional Budget Office), less money is available for other critical public investments. Think about infrastructure improvements, education, or scientific research – areas that are essential for our long-term competitiveness and prosperity. A high debt burden also limits our government's ability to



respond effectively to future economic shocks or unforeseen national needs.

THE RIPPLE EFFECT: FEDERAL CUTS AND STATE BALANCED BUDGETS

The federal government's budget decisions don't just impact Washington; they have a profound and direct effect on every state across the nation, particularly due to laws mandating balanced budgets. Unlike the federal government, nearly all states are required by their constitutions or statutes to balance their operating budgets annually. This means states cannot spend more than they collect in revenue.

When the federal government, driven by its own deficit pressures or a desire to reduce spending, cuts funding for programs like Medicaid, education, or social services, it doesn't eliminate the need for those services. Instead, it effectively shifts the burden onto the states.

REDUCED FLEXIBILITY FOR THE TREASURY AND THE FED IN A CRISIS

The growing national debt and persistent deficits also tie the hands of the very institutions responsible for steering the U.S. economy through rough waters: the U.S. Treasury and the Federal Reserve. Their ability to respond effectively to recessions or economic shocks is significantly diminished by a high-debt burden.

- **The Treasury's Fiscal Policy Dilemma:** With already elevated deficits and a massive national debt, the Treasury has less "fiscal space" to implement such measures. Further borrowing to fund stimulus packages would add to an already strained debt load, potentially spooking investors, driving interest rates

even higher, and worsening the long-term fiscal outlook. This limits the size and scope of necessary government interventions, making economic recoveries slower and more painful.

- **The Federal Reserve's Monetary Policy Constraints:** The Federal Reserve, as the nation's central bank, primarily uses monetary policy to influence the economy. During a recession, the Fed typically lowers interest rates to encourage borrowing and investment, and may engage in "quantitative easing" (buying government bonds and other assets) to inject liquidity into the financial system.

CONCLUSION

In essence, a nation burdened by high deficits and debt is like a patient with a chronic illness; their body has less resilience to fight off a sudden infection. The U.S. Treasury and the Federal Reserve, the doctors of our economy, find their tools blunted and their options constrained when our fiscal house is not in order.

The current fiscal path, with debt-to-GDP ratios projected to climb even higher, is unsustainable. While the U.S. dollar's status as the world's reserve currency provides some buffer, it doesn't eliminate the risks. We need a serious conversation in Washington about how to address our structural deficits.

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