Research Working Papers

Fiscal Implications of Interest Rate Normalization in the United States

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Interest rate normalization is unlikely to pose an immediate threat to U.S. government debt sustainability at the current level of 90 to 100 percent of GDP.

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This paper studies the fiscal implications of interest rate normalization from the zero lower bound (ZLB) in the United States. At the ZLB, the decline in tax revenues and the real bond price drives up government debt. During normalization, interest payments continue to rise higher than they would have had rates not reached the ZLB, potentially increasing government debt even as output and tax revenues recover. We find that against the yardstick of ability to pay, interest rate normalization is unlikely to pose an immediate threat to debt sustainability at the current net federal debt level of 90 to 100 percent of GDP. If the net federal debt reaches 150 percent of GDP, however, sovereign default risk can rise more quickly. We also find that a more active monetary policy better anchors inflation expectations and generates a faster recovery than a less active one, helping slow debt accumulation during normalization.

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Related Research

- Battistini, Niccolò, Giovanni Callegari, and Luca Zavalloni. 2019. "Dynamic Fiscal Limits and Monetary-Fiscal Policy Interactions." European Central Bank Working Paper no. 2268, April.

- Bi, Huixin. 2012. “Sovereign Default Risk Premia, Fiscal Limits, and Fiscal Policy.” European Economic Review, vol. 56, no. 3, pp. 389–410. Available at https://doi.org/10.1016/j.euroecorev.2011.11.001

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