

## US Rates Strategy

Joseph Abate  
[joseph.abate@smbcnikko-si.com](mailto:joseph.abate@smbcnikko-si.com)  
1 212 893-1592

September 22, 2026

### The Treasury's debt service cost

Higher interest rates pushed the Treasury to increase the size of its buybacks. But the interest cost on the Treasury's outstanding debt is growing faster than GDP and the Congressional Budget Office (CBO) expects this to continue.

- **The Treasury's interest costs are projected to reach 4.6% of GDP in 2036 from 3.2% last year.** Interest costs are higher than their prior peak in 1991 when the debt/GDP was less than half as large.
- About half of this increase comes from higher rates caused by an increase in the debt/GDP ratio. Treasury's debt/GDP ratio is expected to increase to 120% in 2036 from 100% last year.
- **The Treasury's future debt costs reflect the size of its primary deficit, the level of its outstanding debt and the portion that rolls over each year.**
- The primary deficit may trough in 2030, but without changes in outlays or higher taxes it will remain above 2% of GDP through the next decade.
- Although the WAM of Treasury's debt has lengthened since 2014, about 36% of it matures within a year. **This increases the sensitivity of its debt servicing costs to changes in Fed policy.**
- Since the Treasury's maturity mix is already near the efficient frontier between the level and volatility of its debt service costs, it may not achieve much by cutting back term issuance in favor of more bills. **Instead, bending the debt service cost curve will depend more heavily on faster productivity growth (or trimming the primary deficit).**

### Debt loop

Budget math eventually becomes unsustainable when governments are adding to the stock of their debt faster than the economy is growing. As outstanding debt grows, the interest burden on it rises and the government needs to borrow more. This in turn crowds out private investment and pushes interest rates higher. The reduction in investment slows GDP growth while a larger share of aggregate income is sent offshore to pay bondholders. Eventually, the debt level becomes unsustainable when investors refuse to roll maturing debt.

Smetters and He argue that this point is reached when the debt/GDP ratio reaches 210%.<sup>1</sup> Of course, this exact level is unknowable; it depends on investor attitudes about an event that has never occurred. Based on their assumptions about healthcare expenses they estimate this solvency limit could be breached between 2047-51. That said, their debt/GDP ratio is quite a bit higher than CBO estimates (averaging 153% over the period) because they include “implicit debt” in their total. Implicit debt is the “pay-as-you-go” obligations like Social Security.

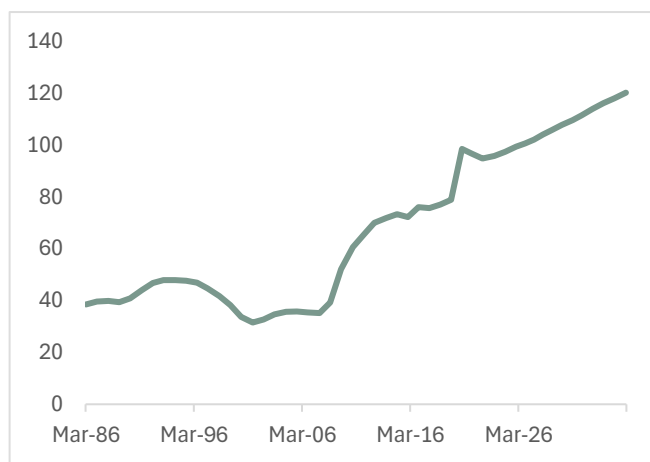
## Debt/GDP

**Regardless of the exact timing of the solvency limit, the US debt stock is growing faster than GDP.**

The debt/GDP ratio is currently 100% having tripled since the financial crisis (Figure 1). It is expected to grow 20% by 2036.

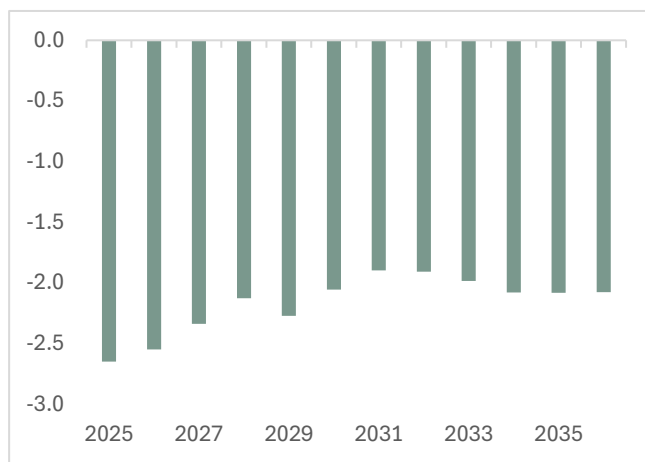
Two factors will determine the future path of the ratio. **First, how quickly is Federal spending adding to the stock of debt.** The CBO projects the primary deficit will improve in coming years – shrinking from 2.7% of GDP to 2.1% in 2036 (Figure 2). This assumes no changes in legislation and that recently enacted tax cuts expire as planned. While a useful baseline assumption, it is unclear how politically feasible this is. Moreover, primary deficits could expand with a recession or financial crisis. Not surprisingly, there is a significant degree of uncertainty around their estimates. Since 1985, the average absolute forecast error for the deficit (primary and interest costs) is 1.1% of GDP in the second year of the projection. By year six it is about 2%. Thus, while the CBO is forecasting a 2032 deficit of \$2.4trn (with a primary imbalance of \$770bn), it might reasonably be as large as \$3.2trn (or 8.1% of GDP).

**Figure 1: Debt/GDP (%)**



Source: US Treasury, CBO, SMBC Nikko

**Figure 2: Primary deficit (% GDP)**



Source: US Treasury, CBO, SMBC Nikko

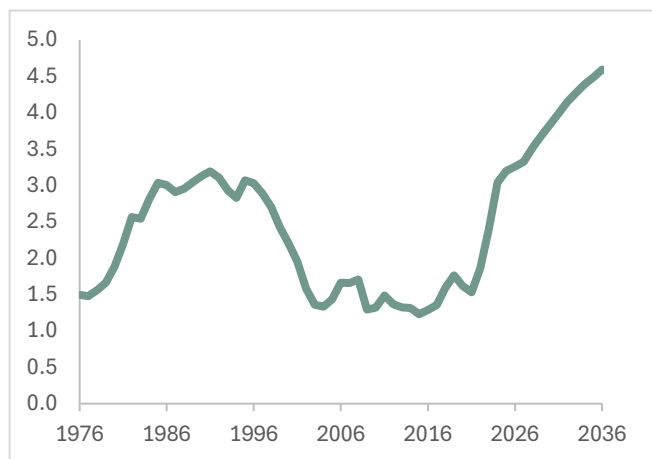
<sup>1</sup> See, “When Does Federal Debt Reach Unsustainable Levels?”, K. Smetters and H. He, Penn Wharton Budget Model, Spring 2026

## Debt service costs

**Second, the future debt path depends on Treasury's debt servicing costs.** Unlike the primary deficit, Congress has less influence over servicing costs which instead reflect past decisions about borrowing maturities, roll-over frequency and market rates. The Treasury's current interest costs are somewhat larger (3.2% of GDP) than its primary deficit (2.7%). But while the latter is expected to head lower, the Treasury's servicing costs are projected to steadily increase in the next decade – reaching 4.6% of GDP in 2036. **The Treasury's interest costs are already higher than their previous peak of 3.2% reached in 1991** (Figure 3). Back then, interest rates were higher with the 10y yield around 6.7% *but* the debt/GDP ratio was 44% compared to 100% today.

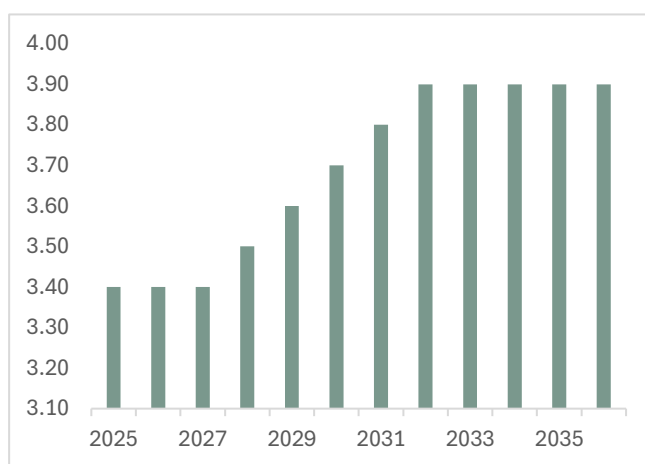
The Treasury's borrowing costs increase with the growth of its debt stock. **But how much do interest rates increase with rising debt?** Bhatt et al used the natural experiment of the 2021 Georgia senate rate run-offs to estimate the effect of a debt financed expansion in fiscal stimulus.<sup>2</sup> They estimate that each 1% increase in the debt/GDP ratio increases the term premium by about 3bp. This matches estimates from Gust and Skaperdas as well as earlier studies.<sup>3</sup> And it is consistent with CBO's baseline forecast which assumes a 20% increase in the debt/GDP ratio and a 50bp increase in average interest rates (Figure 4).

**Figure 3: Net interest cost (% GDP)**



Source: US Treasury, CBO, SMBC Nikko

**Figure 4: CBO average interest rate forecast (%)**



Source: CBO, SMBC Nikko

We examined the CBO's simplified budget model to estimate the interest rate sensitivity of the deficit. First, we increased the average borrowing rate by 50bp in 2026 with no change in future interest rates. The projected cumulative deficit over the 10y window increases by \$185bn (or 6%). Next, we permanently

<sup>2</sup> See, "The Causal Effect of Debt on Interest Rates", A. Bhatt, A. Diercks, B. Eyal, and A. Skaperdas, Federal Reserve Board, May 26, 2026

<sup>3</sup> See, "Government Debt, Limited Foresight, and Longer-term Interest Rates, C. Gust and A. Skaperdas, Federal Reserve Board, April 23, 2024

increased the average borrowing rate by 10bp over the entire decade. This increases the cumulative deficit by \$380bn (or 12%).

**The Treasury's debt costs are also affected by the maturity distribution of its outstanding debt and the portion that rolls over each year.** As short-term rates are (normally) lower than term rates, the Treasury might be able to reduce its servicing costs by shifting more of its borrowing to shorter maturities. But this increases the sensitivity of these costs to changes in the fed funds rate. As a result, the Treasury faces a tradeoff; it can lock in term rates by paying the term premium, or it can lower its servicing costs while increasing their volatility.

**Since 2014, the Treasury has shifted the distribution of its maturities while lengthening the overall WAM of its debt by nearly a year (to 65m).** The Treasury's <1y maturities have grown to 36% of outstanding debt. This reflects the barbellung of issuance. As the Treasury increased bill issuance, it simultaneously increased the supply of debt longer than 10y. It reduced the issuance of debt in the 1-5y and 5-10y sectors, by 7.8% and 3.9%, respectively. [Optimal issuance](#) calculations suggest that the Treasury's current mix of maturities is near the efficient frontier of this tradeoff.

Last year, the Treasury Borrowing Advisory Committee (TBAC) examined the Treasury's debt service costs under different simulations for growth, inflation, and interest rates ( $r^*$ ).<sup>4</sup> While the focus was on the optimal maturity structure of the Treasury's debt, the simulations reveal other features of its servicing costs. First, the **Treasury's debt costs increase with higher inflation**. Higher inflation forces the Fed to keep interest rates higher than otherwise. **A productivity boom, however, lowers debt servicing costs** because GDP increases faster without creating inflation or forcing the Fed to raise rates. The productivity boom was assumed to push the economy's potential growth rate to 3.5% (from about 1.8% currently). Simultaneously, higher tax revenues reduce the primary deficit. As a result, over the 20y forecast period, the debt/GDP ratio remains below 100% and debt service costs hold near their current level of 3%.

Since the Treasury's maturity mix is already near the efficient frontier between the level and volatility of its debt service costs, it may not achieve much by cutting back term issuance in favor of more bills. Instead, bending the debt service cost curve will depend more heavily on faster productivity growth (or trimming the primary deficit).

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<sup>4</sup> See, US Treasury Refunding Charge, November 2025

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