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Debt Limit Brinkmanship (Again)

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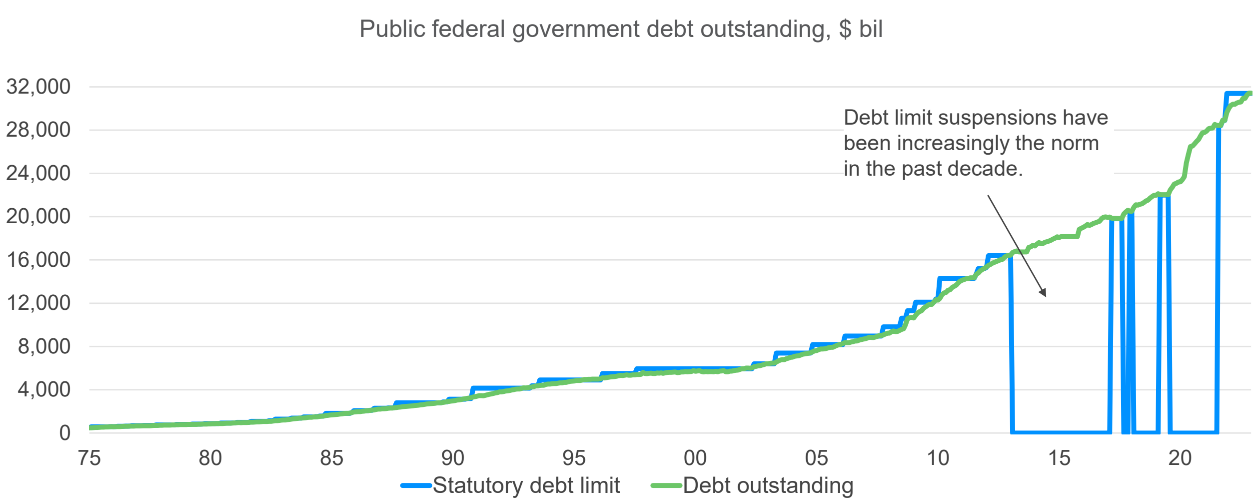
The Treasury debt limit, which puts a statutory cap on the amount of Treasury debt outstanding and the ability of the Treasury to issue securities to fund government obligations, was hit on January 19 (see Chart 1). Treasury must now use "extraordinary measures" to come up with the additional cash needed to pay its bills, but those measures will be exhausted by no later than early October. If not resolved by then, someone will not get paid in a timely way. The U.S. government would default on its obligations.[1]

At the Debt Limit



Sources: U.S. Treasury, Moody's Analytics

A default would be a catastrophic blow to the already-fragile economy. Global financial markets and the economy would be upended. Even if it is quickly resolved, Americans likely would pay for this default for generations, as global investors would rightly believe that the federal government's finances have been politicized and that a time may come when they would not be paid what they are owed when owed it. To compensate for this risk, investors will demand higher interest rates on the Treasury securities they purchase. That will exacerbate our daunting long-term fiscal challenges and be a lasting corrosive on the economy, significantly diminishing it.

Debt limit countdown

The Treasury debt limit, also known as the debt ceiling, is the maximum amount of debt that the Treasury can issue to the public or to other federal agencies. The amount is set by law and has been increased or suspended many times over the years to allow the Treasury to finance government operations. The original intent of the debt limit was to force lawmakers to remain fiscally disciplined. It has failed at this and instead has become highly disruptive to the fiscal process.

Brinkmanship over the debt limit has become increasingly common. The most recent battle occurred in late 2021 when the limit was increased to its current $31.4 trillion. Treasury Secretary Janet Yellen announced in a January 13 letter to House Speaker Kevin McCarthy that the nation's outstanding debt would hit its limit on January 19, and that Treasury would have to engage in extraordinary measures to prevent a default on the government's obligations. But these measures will work for only so long, and while it is not possible to know precisely when the Treasury will default given the uncertainty in the timing of the federal government's payments and receipts, Secretary Yellen has said this could be as early as June. Our best estimate is that the Treasury will run out of options in August but no later than early October.

Debt limit workarounds

There is considerable debate over whether the Treasury could prioritize to pay Treasury securities investors first and thus avoid defaulting on its debt obligation. While the Treasury may have the technical ability to pay bond investors before others—those payments are handled by the Fedwire payment system, while a different computer system handles other government obligations—it is unclear that Treasury is legally able to do so. The move would be challenged in the courts. Bond investors, unsure of how this legal uncertainty would be resolved, would demand a much higher interest rate in compensation. Moreover, politically it seems unimaginable that bond investors, including many foreign investors, would get their money ahead of American seniors, the military, or even the federal government's electric bill for long.[2] And there is the question of how all the other bills would be prioritized. It is not possible for the Treasury to sort through the blizzard of payments due each day. More likely, as outlined in a report by Treasury's inspector general, the Treasury would delay all payments until it received enough cash to pay a given day's bills.

Treasury bond investors also know that other often-proposed workarounds to the debt limit, like minting a $1 trillion platinum coin, would be unworkable. Federal law does give Treasury the authority to mint platinum coins, and the thinking is that Treasury would mint a $1 trillion coin, deposit it at the Federal Reserve, and draw it down to pay the government's bills. But the law authorizing platinum coins envisaged commemorative coins—not circumventing Congress' power of the purse. This would also put the Fed in the middle of the battle, badly politicizing it, and thus significantly jeopardizing Fed independence, which is critical to a well-functioning economy.

Another idea is to have Treasury issue premium bonds rather than par bonds as Treasury debt comes due, lowering the face amount of debt outstanding and subject to the debt limit. A simple example illustrates.

The seven-year Treasury bond is trading at 3.5%, and there is an upcoming auction for $35 billion in these securities. Suppose Treasury offers $35 billion face value of seven-year bonds at 5% instead. The bond market should price them at around 109% of par. This would bring in $38 billion in proceeds, which would retire $38 billion in Treasury debt, but only increase the debt subject to the limit by $35 billion for a net reduction in debt subject to the limit of $3 billion. This could be scaled up by issuing even higher coupons, for example the Treasury might bring in $14 billion with $35 billion of face value and a 10% coupon. Of course, the present value of the Treasury's debt obligation has not changed, so this is just a budget gimmick, but so too is the debt limit. While this is creative financial engineering, it is not something Treasury could roll out quickly, and it would be very costly to commit Treasury to higher and higher interest payments. It also threatens the well-functioning of the Treasury bond market, the world's largest and most liquid market. Besides, interest rates would likely still spike as investors view this chicanery as putting the nation's fiscal discipline at risk.[3]

Yet another proposed workaround to the debt limit is to have the president invoke Section 4 of the 14th Amendment to order the Treasury to keep issuing bonds and paying the government's bills. The 14th Amendment states that the "validity of the public debt of the United States…shall not be questioned." If push comes to shove, and lawmakers are about to breach the limit, a 14th Amendment declaration seems the most viable option since it highlights the sanctity of the nation's debt. But Section 4 of the 14th Amendment was passed in the wake of the Civil War to ensure the federal government was not on the hook for the war debt of the Confederate states. Investors would rightly wonder if using the amendment to abrogate the debt limit law would stand up in the courts, and even if it did, what that would mean for our political system's checks and balances. Given the constitutional crisis this would set off, financial markets would still be roiled, and a recession ensue.

Despite these looming dark scenarios, financial markets have yet to react to the possibility of a government default. Of course, it is still months away and it has become standard practice for Congress to run down the clock but, in the end, figure out a way to raise the debt limit when absolutely necessary. It is still widely expected that this Congress will do so, although investors are much more wary after witnessing the chaotic process for choosing Kevin McCarthy as Speaker of the House and the rule changes for managing the legislative body that he acquiesced to in order to win the post. Passing legislation as politically charged as the debt limit requires especially deft policymaking to corral the necessary votes. That seems a heavy lift for this Congress.

Economic costs

As the deadline gets closer, global investors will rightly begin to worry that lawmakers will err and fail to act in time. Uncertainty will push interest rates higher and stock prices will fall, slowly at first but then more quickly. And if policymakers actually do fail to increase or suspend the limit before the Treasury runs out of cash and defaults on its obligations, interest rates will spike, and stock prices will crater with enormous costs to taxpayers and the economy.

The magnitude of the potential economic costs is evident in the substantial costs associated with previous debt limit episodes, even though lawmakers acted just in time. In 1979, the Treasury inadvertently missed payments on Treasury bills maturing that spring. The mishap was caused in part by fallout from a delay in raising the debt limit, but also by problems with payment processing equipment the Treasury used at the time. Even though investors received their payments with only a small delay, Treasury bill yields jumped 60 basis points and remained elevated for several months. The cost to taxpayers was ultimately estimated in the tens of billions of dollars.

The Treasury came closest to a default in summer 2011, when that debt limit battle was part of the budget wars between the Obama administration and Republican-controlled Congress that raged in the wake of the global financial crisis. The brinkmanship around raising the debt limit was especially heated and Treasury debt lost its AAA rating from credit rating agency Standard & Poor's due to governance concerns raised by the political dysfunction. Credit default swaps on Treasury securities—the cost of insuring against a default by the Treasury—spiked as high as 80 basis points on one-year Treasuries and 65 basis points on five-year Treasuries.[4] In typical times, the cost of insuring against a Treasury bond default is less than 5 basis points for one-year securities and 30 basis points for five-year securities.

A Moody's Analytics analysis of the 2013 debt limit battle showed that investor concerns over a Treasury bond default pushed 10-year Treasury yields up an estimated 6 to 12 basis points at the height of the angst.[5] Short-term interest rates also jumped. Even though the Treasury ultimately did not default, and interest rates quickly declined, the episode likely cost taxpayers nearly a half-billion dollars in added interest, not including the costs to households and businesses of higher interest rates on the funds they borrowed. While these costs were modest, they were unnecessarily incurred.

Default scenarios

If lawmakers are unable to resolve the debt limit in time and the Treasury begins paying its bills late and defaults, financial markets would be roiled. A TARP moment seems likely, hearkening back to that dark day in autumn 2008 when Congress initially failed to pass the Troubled Asset Relief Program bailout of the banking system, and the stock market and other financial markets cratered. A similar crisis, characterized by spiking interest rates and plunging equity prices, would be ignited. Short-term funding markets, which are essential to the flow of credit that helps finance the economy's day-to-day activities, likely would shut down as well.

It is unimaginable that lawmakers would allow things to get to this point, but as the TARP experience highlights, they have done the unimaginable before. Yet, if that experience is a guide, lawmakers would quickly reverse course and resolve the debt limit impasse to allow the Treasury to resume issuing debt again and pay its bills. Much damage will have already been done, and although markets would right themselves, it would be too late for the already-fragile economy, and a recession would ensue.

However, if lawmakers do not reverse course and the impasse drags on for even a few weeks, the hit to the economy would be cataclysmic. Most immediately, the federal government would have to slash its spending. Say the debt limit was breached on October 1 and dragged on all month. The Treasury would have no choice but to cut government spending by an estimated $125 billion. And if there is no agreement in November, another close to $200 billion in spending would need to be cut. The hit to the economy as these government spending cuts cascade through the economy would be overwhelming.

Adding to the economic turmoil would be the loss of consumer, business and investor confidence. Political brinkmanship over the operations of the federal government has been frightening for Americans to watch. In both the 2011 and 2013 debt limit episodes, households were closely attuned to the political hardball being played in Washington, and consumer sentiment slumped. The brinkmanship is also unnerving for businesses, which will pull back on investment and hiring, and for financial institutions, which will quickly turn more circumspect about extending credit to households and businesses.

The timing could not be worse for the economy; even before the specter of a debt limit breach, many CEOs and economists believe a recession is likely this year. With the Federal Reserve ramping up interest rates in an effort to quell wage and price pressures, avoiding a recession would be difficult even if nothing else went wrong. Most leading indicators of recession, including the prescient policy yield curve—the difference between 10-year Treasury yield and the federal funds rate—point to recession beginning later this year at about the time lawmakers will be doing battle over the limit.

It is difficult to envisage what steps policymakers would take to mitigate the economic damage. With lawmakers at loggerheads over the debt limit, it is unlikely they would agree on any fiscal support for the economy in response to the crisis created by the breach of the debt limit, at least not quickly. The Fed would immediately cut short-term rates back to the zero lower bound and ramp up its quantitative easing—purchases of Treasury bonds—but any benefit would likely be overwhelmed as global investors sold or stopped buying U.S. securities.

Based on simulations of the Moody's Analytics model of the U.S. and global economies, the economic downturn ensuing from a political impasse lasting even a few weeks would be comparable to that suffered during the global financial crisis.[6] That means real GDP would decline almost 4% peak to trough, nearly 6 million jobs would be lost, and the unemployment rate would surge to over 7%. Stock prices would be cut almost in one-third at the worst of the selloff, wiping out $12 trillion in household wealth. Treasury yields, mortgage rates, and other consumer and corporate borrowing rates would spike, at least until the debt limit is resolved and Treasury payments resume. Even then, rates would not fall back to where they were previously.[7] Since Treasury securities no longer would be perceived as risk-free by global investors, future generations of Americans would pay a steep economic price.[8]

What's next

It is unclear how lawmakers will resolve the current impasse over the debt limit. Given the severe economic and political costs of a debt limit breach, the most likely path is for lawmakers to come to terms just in time to avoid it. This might include an agreement on the debt limit in tandem with an agreement on the federal budget for fiscal 2024 that begins October 1. Coming to terms after much Sturm und Drang would be consistent with the long, arduous history of agreements on the debt limit—and fitting given the bipartisan nature of the financial obligations the debt would cover.[9] The 2024 budget could include enough government spending restraint and perhaps new budget process rules to satisfy enough Republicans to join most Democrats to pass the legislation. Getting the legislation across the finish line will surely be messy and painful, causing heightened volatility in financial markets, but lawmakers ultimately will get the job done before there is significant economic damage.

Having said this, odds that lawmakers are unable to get it together and avoid a breach of the debt limit appear to be meaningfully greater than zero. The difficulty House Republicans had electing Kevin McCarthy as Speaker and the terms Speaker McCarthy had to agree to win election, including having a battle over the debt limit with Democrats, do not augur well. Getting any legislation through the legislative process is tough under typical circumstances, but getting highly contentious debt limit legislation signed into law through this Congress before a breach is highly problematic. Adding to the concern is the growing number of mostly Republican lawmakers openly contemplating whether Treasury could navigate a breach of the debt limit by prioritizing payments to bond holders. They may be earnest in their questioning of whether a breach would lead to turmoil in financial markets and the economy along the lines articulated in this analysis, but they are badly misguided.

There is also reason to be worried that Wall Street is too sanguine about the political and procedural headwinds to addressing the debt limit. Nonplussed investors believe they have seen this movie before many times and know how it ends. That is, after a bitter political back and forth, lawmakers will find a way to come to terms before a breach. Therefore, interest rates would not rise and stock prices would not fall as the debt limit deadline approaches, sending the wrong signals to lawmakers who are taking their cues from investors. Ironically, because investors seem so sanguine about how this drama will play out, policymakers may believe they have nothing to worry about and fail to resolve the debt limit in time. This would be an egregious error.

Conclusions

A bedrock of the U.S. economy and global financial system is that the U.S. government pays what it owes in a timely way.[10] Political brinkmanship over the debt limit is thus painful to watch. If lawmakers are unable to increase, suspend or eliminate the debt limit before the Treasury fails to make a payment to bondholders or anyone else, the resulting chaos in global financial markets will be unbearable. The U.S. and global economies will quickly descend into recession. In the more than century since the debt limit became law, lawmakers have taken strident warnings like these to heart and acted. Let us hope they do so again. Soon.

Endnotes

1 In this analysis, a default is defined to occur if the Treasury does not make any payment obligation on time, regardless of whether it is Treasury debt or any other payment that is due. A Treasury bond default is a missed payment on a Treasury security. If the Treasury default is short-lived and cured with full recovery, then according to the credit rating agency Moody's Investors Service, the ratings impact "would likely be limited, with the sovereign rating likely remaining close to Aaa, consistent with the U.S.' very high capacity to repay debt and supported by a number of key considerations, including very strong economic and institutional credit features."

2 There have been legislative attempts to prioritize Treasury's payments in the case of breach of the default limit. Social Security payments, payments to the military, and interest and principal payments to Treasury bond investors receive priority. But the legislation has never become law and would likely not mitigate a serious reaction by overseas investors, who would appropriately conclude that this prioritization would be politically untenable and not stand for long.

3 There are likely many unintended consequences as well given how engrained Treasury bonds are in a wide variety of contracts. The tax consequences of large premiums are also unknown and could be complicated.

4 On August 5, 2011, S&P announced the company's decision to give its first-ever downgrade to U.S. sovereign debt, lowering the rating one notch to "AA+" with a negative outlook.

5 The referenced Moody's Analytics study is available upon request.

6 The Moody's Analytics macroeconomic model of the U.S. and global economies is similar in theory and empirics to those used by the Federal Reserve Board and Congressional Budget Office for forecasting, budgeting and policy analysis. The model has been used to evaluate the plethora of fiscal and monetary policies implemented during the COVID-19 pandemic.

7 Economists at the Federal Reserve have conducted similar simulations with similar results. See "Possible Macroeconomic Effects of a Temporary Federal Debt Default," Engen, et al., October 2013.

8 The broad trade-weighted value of the U.S. dollar declines only modestly in this scenario, at least in the near term, as global investors are unsure of alternative global safe havens to the dollar. The Swiss franc, euro and British pound are the most significant beneficiaries. However, the value of the U.S. dollar steadily weakens in the longer run since its status as the global reserve currency is diminished.

9 Both Republicans and Democrats supported the close to $3 trillion in deficit-financed fiscal aid provided to the economy to manage through the pandemic under President Trump in 2020. And while only Democrats supported the almost $2 trillion deficit-financed American Rescue Plan passed early in the Biden administration to help with the fallout from the pandemic, only Republicans supported the nearly $2 trillion deficit-financed Tax Cut and Jobs Act passed early in the Trump administration that cut corporate and personal income taxes.

10 Alexander Hamilton, the nation's first Treasury secretary, established this principal at the founding of the nation when he agreed to pay Revolutionary War bond investors 100 cents on the dollar. This despite that the bonds were trading at pennies on the dollar because few believed the new American government would make good on its debts. When the government did make good, it established the sound credit of the U.S. and paved the way for the U.S. dollar to ultimately become the global economy's reserve currency. The economic benefits of this over the generations are incalculable.

About the Author

Mark Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

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Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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