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The Debt Limit Drama Heats Up

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BY MARK ZANDI AND BERNARD YAROS

The political drama over the Treasury debt limit is suddenly heating up. With April tax receipts coming in weaker than expected, at least so far, it appears that the X-date, when the Treasury will run out of the cash needed to pay the government's bills on time, may hit as soon as early June. House Speaker Kevin McCarthy's recent unveiling of proposed legislation to increase the limit is thus none too soon. In exchange for increasing the debt limit just enough so that it will not be a problem again until about this time next year, the Speaker wants to significantly cut discretionary spending over the next decade, impose stricter work requirements on healthcare, food and other assistance for low-income households, and roll back much of the Biden's administration's agenda on climate change and student lending. In this note, we assess the macroeconomic consequences of the Speaker's debt limit legislation.[1]

The X-date

The Treasury debt limit—the maximum amount of debt that the Treasury can issue to the public or to other federal agencies—was hit on January 19, and since then the Treasury has been using "extraordinary measures" to come up with the additional cash needed to pay the government's bills. Nailing down precisely when these extraordinary measures will be exhausted, and Treasury will run out of cash and thus be unable to pay everyone on time—the so-called X-date—is difficult. It depends on the timing of highly uncertain tax receipts and government expenditures.

Since Moody's Analytics began estimating the X-date early this year, we have thought it to be in mid-August. But April tax receipts are running 35% below last year's pace, which is meaningfully weaker than anticipated. And despite weaker tax refunds than anticipated, it appears that the X-date may come as soon as early June. If not, and Treasury is able to squeak by with enough cash, then the X-date looks more likely to be in late July. That is because Treasury will get a cash infusion from non-withheld tax payments around the June 15 estimated tax deadline, and then another tranche of extraordinary measures will become available, providing Treasury with a few more weeks of cash.

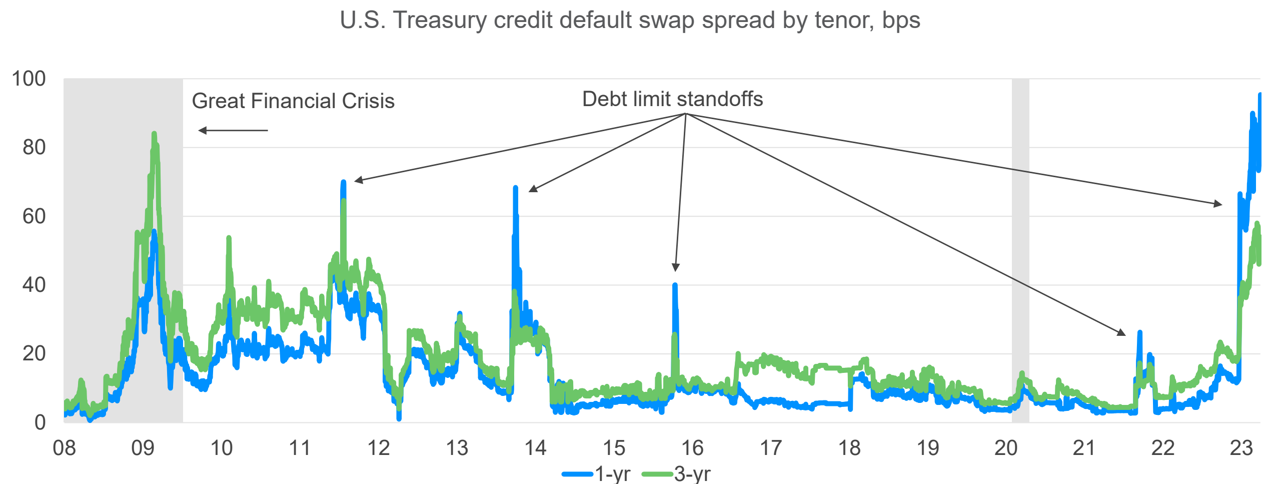
Investors take notice

Regardless, time is running out for lawmakers to act and increase or suspend the debt limit, and global investors are suddenly focusing on the risks posed if they do not act in time. Credit default swaps on Treasury securities—the cost of buying insurance in case Treasury fails to pay its debt on time—have jumped in recent weeks (see Chart 1). At close to 100 basis points, CDS spreads on six-month and one-year Treasury

1 The Moody's Analytics white papers "Down the Debt Limit Rabbit Hole," and "Debt Limit Brinkmanship (Again)" provide additional relevant analysis on the Treasury debt limit.

securities are already substantially more than in 2011 when that debt limit drama was so unnerving it caused rating agency Standard & Poor's to strip the U.S. of its AAA rating.[2]

Chart 1: Debt Limit Breach Begins to Worry Investors...



Sources: ICE, Moody's Analytics

The CDS spread on U.S. Treasury securities measures the cost of purchasing insurance to protect against a default on that Treasury. For example, a 100-basis point spread means it costs $100 to insure $10,000 worth of Treasuries.

This may overstate investors' angst as the CDS market for buying insurance in the case of a Treasury default is not actively traded, and it does not take much trading to push up the cost of insurance. A few hedge funds speculating on the CDS could drive up the cost since they are purchasing something akin to a lottery ticket. Moreover, the current spread remains far from signaling that investors are attaching much of a probability on a default. For context, during the European debt crisis in 2011, the CDS spread on the sovereign debt of stressed countries in the periphery of the euro zone, including Greece, topped out at 1,400 basis points. Even the CDS for core euro zone countries such as Germany and France were more than 200 basis points at the time.

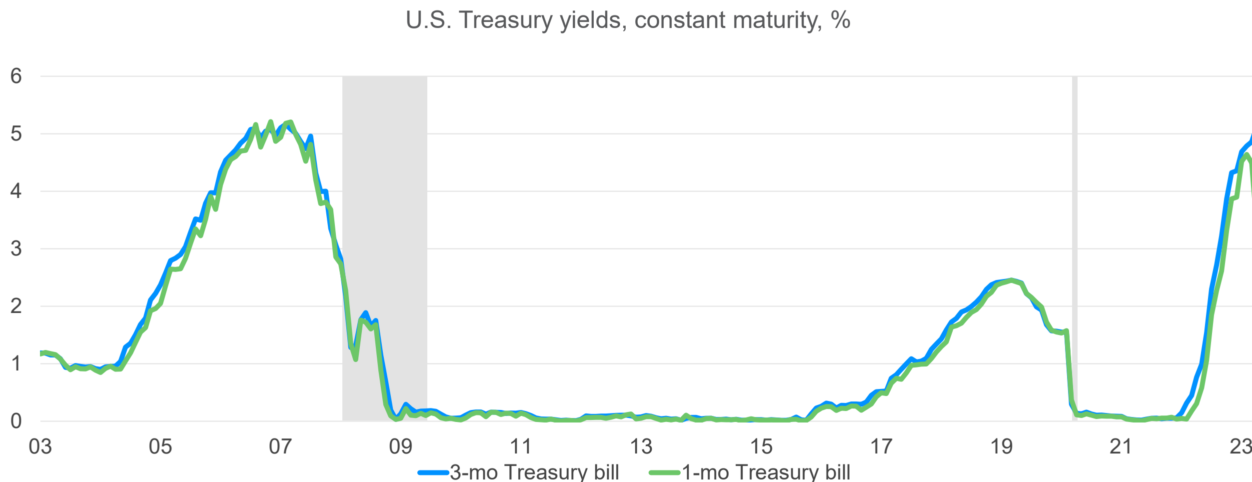
That said, the runup in Treasury CDS should not be dismissed out of hand. The recent sharp decline in one-month Treasury bill yields also signals mounting investor angst (see Chart 2). As it has become clear in recent days that April tax receipts were coming in weak and the X-date may be just a few weeks away, investors have piled into the safety of one-month Treasury securities. Yields have plummeted, from 4.75% at the start of April to less than 3.4% currently. At the same time, yields on three-month Treasury bills have continued to rise. The difference between one- and three-month Treasury bill yields has never been as wide. Global investors thus appear to be attaching non-zero odds that the debt limit drama will end with a default sometime in June or July.

House Republican proposal

It is thus none too soon that House Speaker McCarthy unveiled the "Limit, Save, Grow Act of 2023" on April 19. House Republicans hope the legislation will put political pressure on President Biden to negotiate changes in fiscal policy in exchange for an increase in the debt limit. The president continues to reject these efforts, arguing for a so-called clean debt limit increase—an increase in the debt limit without substantive

2 A CDS spread of 100 basis points means that it costs $100 to insure $10,000 worth of Treasury securities against a default on those securities.

Chart 2: ...More Than a Little Bit

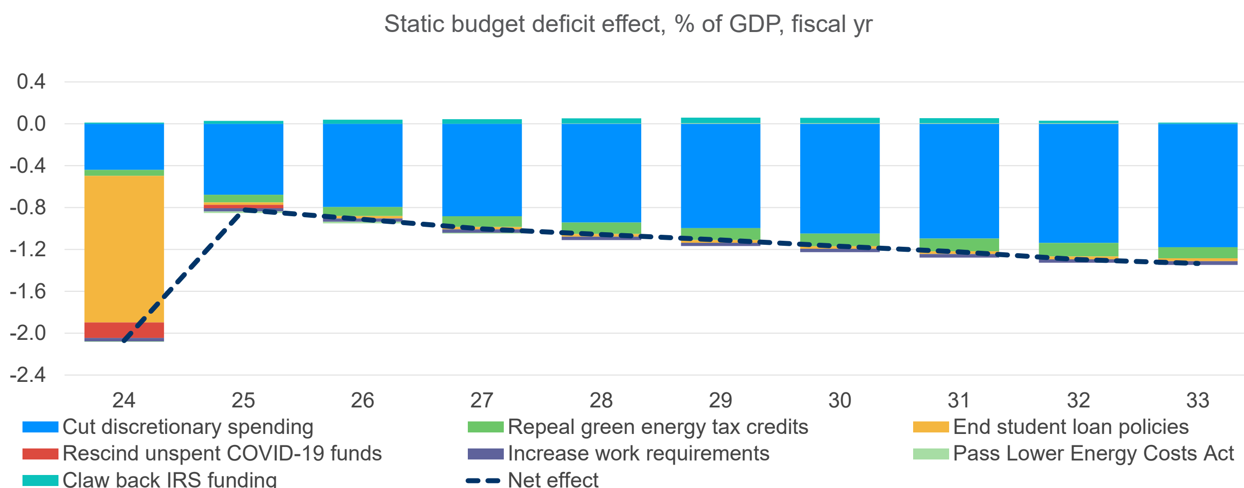


Sources: ICE, Moody's Analytics

changes to policy. His position is that increasing the debt limit is necessary to pay the government's bills resulting from past fiscal policy decisions, over which there can be no negotiation.[3]

Speaker McCarthy's proposed legislation would increase the debt limit by $1.5 trillion or until March 31, 2024, whichever comes first. In exchange, it would cut government spending by $4.5 trillion over the next decade and implement a number of consequential changes to fiscal policy (see Table 1 and Chart 3). The most significant spending cuts would come by setting fiscal 2024 discretionary spending equal to fiscal

Chart 3: Budgetary Consequences of the Limit, Save, Grow Act of 2023



Sources: CBO, CRFB, JCT, Moody's Analytics

3 Those past policy decisions resulting in budget deficits and more government debt are bipartisan. Both Republicans and Democrats supported the close to $3 trillion in deficit-financed fiscal aid provided to the economy through the COVID-19 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 in 2021, 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.

Table 1: Budgetary Consequences of the Limit, Save, Grow Act of 2023

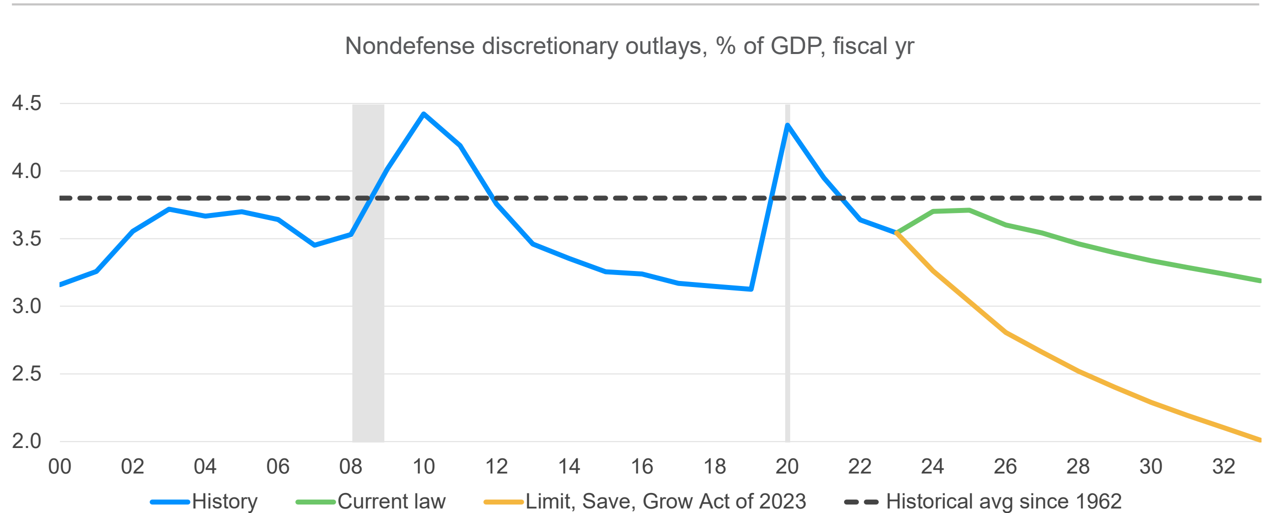
Effect on cumulative budget deficits from fiscal 2024 to 2033, $ bil

Reduce discretionary budget authority to fiscal 2022 level and limit growth to 1% per annum over the next decade	-3,165
Block student loan forgiveness of up to $20,000 per borrower and revamped Income-Driven Repayment plan	-465
Repeal clean energy tax breaks under the Inflation Reduction Act	-350
Increase work requirements in TANF, SNAP and Medicaid	-120
Rescind unexpired unobligated balances under COVID-19 relief funding	-60
Enact H.R. 1, the Lower Energy Costs Act	0
Claw back IRS funding for enforcement, taxpayer services and operations	114
Interest savings	-510
Total	**-4,556**

Sources: CBO, CRFB, House Speaker Kevin McCarthy, JCT, Moody's Analytics

2022 spending levels. Annual spending growth would then be capped at 1% for the next decade. While not stipulated in the legislation, Republicans would likely work to exclude discretionary spending on defense and veterans' benefits from the cuts, putting the burden of the cuts on nondefense, non-VA discretionary programs.[4] If nondefense discretionary outlays were to bear the full brunt of the proposed budget cuts, they would fall to 2% of GDP by fiscal 2033, the lowest since at least the early 1960s (see Chart 4).

Chart 4: What if the Nondefense Discretionary Budget Bears the Full Brunt?



Sources: BEA, CBO, CRFB, Moody's Analytics

The Speaker's debt limit legislation also works to roll back a number of President Biden's policy initiatives. On energy policy, the legislation would focus on increasing fossil fuel supplies through the enactment of House Republicans' energy package, which aims to boost oil and gas production and mining by cutting down on the time it takes to greenlight energy projects. It would also end tax breaks for clean-energy projects and qualifying electric vehicles included in the Inflation Reduction Act.

4 Discretionary spending comprises outlays that lawmakers control through annual appropriation acts. Nondefense, non-VA discretionary spending includes a wide range of government programs, ranging from spending on affordable housing assistance and air traffic control to NASA and job training, to name a few.

On student lending, the legislation would prevent a couple of key executive orders by the Biden administration, including the White House's plan to provide up to $20,000 in student loan forgiveness for some borrowers. That hit a roadblock last year when it was met with several legal challenges, and the Supreme Court is expected to decide its fate later this year. An income-driven repayment plan rolled out by the Education Department earlier this year is also in the crosshairs.

The Speaker's legislation also imposes restrictions on income support programs, including work requirements on Medicaid recipients who do not have children, an increase in the age limit for work rules under Supplemental Nutrition Assistance Program (food assistance), and a requirement that states report on work outcomes under the Temporary Assistance for Needy Families program. It eliminates much of the additional funding provided to the IRS last year to help increase tax enforcement efforts and improve taxpayer services, and it rescinds unspent COVID-19 relief funds. And the legislation would also require congressional approval before major regulations could take effect.

Macroeconomic impacts

The Limit, Save, Grow Act of 2023 would cut into near-term economic growth if passed into law. Compared with a scenario that includes a clean debt limit increase and no other significant changes to fiscal policy under current law, real GDP in the year ending in the fourth quarter of 2024 would be 0.65 percentage point lower (see Table 2).[5] That is, in the Clean Debt Limit scenario, real GDP is expected to grow 2.25% in the year compared with 1.6% if Speaker McCarthy's legislation becomes law.

While the economy skirts recession in both scenarios, recession risks are uncomfortably high, with a consensus of economists and many investors and business executives expecting a downturn beginning late this year or early next. The timing of the government spending cuts in the Limit, Save, Grow Act is thus especially inopportune as it would meaningfully increase the likelihood of such a downturn. Indeed, under the legislation, GDP growth is so weak that employment declines in the first three quarter of 2024, and the unemployment rate rises by more than a percentage point to 4.6% by the fourth quarter of 2024. Compared with the Clean Debt Limit scenario, by year-end 2024, employment is 780,000 jobs lower, and the unemployment rate is 0.36 percentage point higher.

The significant government spending cuts in the Limit, Save, Grow Act are substantial headwinds to near-term economic growth. The cuts reduce nondefense outlays by $120 billion in fiscal 2024 compared with the Clean Debt Limit scenario, equal to about half a percentage point of GDP. The multipliers on this spending—the change in GDP a year after a change in spending—are estimated to be just over 1, as the programs suffering budget cuts are essential government services and tend to benefit lower-income households that quickly spend any support they receive from the government. Adding to the economic headwinds created by the legislation is the considerable uncertainty created by having to address the debt limit again a year from now. Given that 2024 is a presidential election year, that future debt limit drama may well be even more heated than the current one. This is sure to weigh on investor, business and consumer confidence and thus economic activity.

5 The Clean Debt Limit scenario assumes that the moratorium on student loan payments ends this summer, but that President Biden's student debt forgiveness and income-driven repayment plans remain in place. This scenario also assumes lawmakers agree to increase the debt limit just enough to ensure that it will not get caught up in the 2024 presidential election.

Table 2: Macroeconomic Impact of Speaker McCarthy's Debt Limit Plan

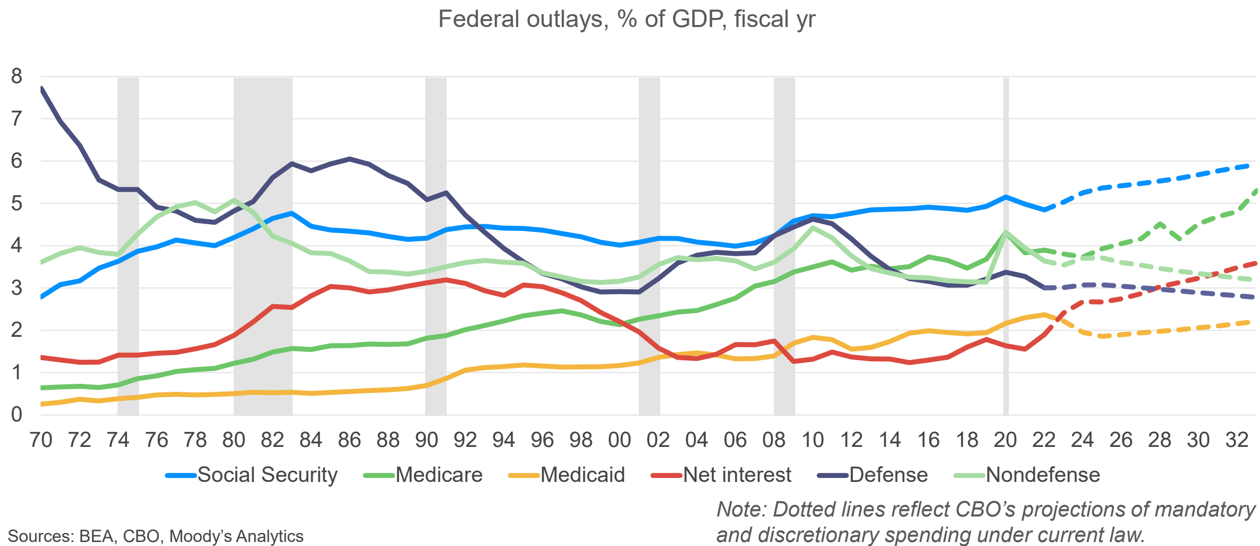
	2022Q4	2023Q1	2023Q2	2023Q3	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4	2033Q4	% change 22Q4 - 23Q4	% change 23Q4 - 24Q4	Avg. Ann. % change 23Q4 - 33Q4
Real GDP													
Clean Debt Limit, 2012$ bil	20,182	20,290	20,341	20,368	20,430	20,520	20,641	20,771	20,890	25,561	1.23	2.25	2.27
Annualized % change	2.57	2.15	1.01	0.54	1.23	1.76	2.38	2.55	2.32				
McCarthy Plan, 2012$ bil	20,182	20,290	20,341	20,368	20,416	20,479	20,559	20,643	20,744	25,372	1.16	1.60	2.20
Annualized % change	2.57	2.15	1.01	0.54	0.95	1.25	1.56	1.66	1.96				
Difference, %	0.00	0.00	0.00	0.00	-0.07	-0.20	-0.40	-0.61	-0.70	-0.74			
Nonfarm employment													
Clean Debt Limit, mil	154.3	155.3	155.5	155.6	155.7	155.7	155.9	156.1	156.4	162.3	0.89	0.46	0.42
Change, ths	948	1,024	235	64	55	87	149	222	250				
McCarthy Plan, mil	154.3	155.3	155.5	155.6	155.6	155.5	155.5	155.5	155.6	161.8	0.85	-0.00	0.39
Change, ths	948	1,024	235	64	(12)	(45)	(62)	(19)	118				
Difference, ths	0	0	0	0	-67	-199	-410	-652	-784	-569			
Unemployment rate													
Clean Debt Limit, %	3.60	3.50	3.59	3.66	3.87	4.01	4.10	4.18	4.21	4.14			
McCarthy Plan, %	3.60	3.50	3.59	3.66	3.91	4.11	4.31	4.50	4.57	4.25			
Difference, bps	0	0	0	0	4	10	21	32	36	11			
Consumer price index													
Clean Debt Limit, 82-84=100	298.5	301.5	303.5	305.5	307.8	309.5	311.2	312.8	314.3	378.9	3.10	2.12	2.10
Annualized % change	4.16	4.03	2.63	2.71	3.03	2.23	2.27	2.00	1.99				
McCarthy Plan, 82-84=100	298.5	301.5	303.5	305.5	307.8	309.5	311.2	312.7	314.2	378.2	3.10	2.08	2.08
Annualized % change	4.16	4.03	2.63	2.71	3.02	2.22	2.24	1.94	1.93				
Difference, %													
Federal publicly traded debt to GDP													
Clean Debt Limit (%)	96.3	95.3	94.2	96.2	96.5	96.9	97.4	97.7	98.3	116.5			
McCarthy Plan (%)	96.3	95.3	94.2	96.2	96.5	96.7	97.0	97.3	97.9	106.5			
Difference (basis points)	0	0	0	0	-8	-22	-30	-34	-37	-992			
10-yr Treasury Yield													
Clean Debt Limit, %	3.83	3.65	3.84	3.97	4.00	3.98	3.93	3.84	3.78	3.79			
McCarthy Plan, %	3.83	3.65	3.84	3.97	4.00	3.97	3.91	3.80	3.72	3.58			
Difference, bps	0	0	-0	-0	-0	-1	-2	-4	-6	-21			

Note: 2022Q4 is history

Sources: BEA, BLS, Federal Reserve, U.S. Treasury, S&P, Moody's Analytics

Cushioning the negative near-term economic consequences of the legislation are lower interest rates. The Federal Reserve begins to lower interest rates late this year soon after the passage of the legislation given the weaker economic growth and heightened recession risks. Long-term Treasury yields are also lower in part because of the weaker economy but also because of prospects for smaller long-term budget deficits and a lower government debt load. A decade from now, the nation's debt-to-GDP ratio is expected to be 106%. This is up from 97% in fiscal 2022, but below the 116% debt-to-GDP ratio expected in the Clean Debt Limit scenario for the end of the 10-year budget horizon. GDP and jobs are lower, and unemployment a bit higher a decade from now under the Limit, Save, Grow Act than in the Clean Debt Limit scenario. Though the nation's fiscal situation is better, Speaker McCarthy's legislation does not propose reforms to old-age entitlement programs, which, if left unaddressed, will keep the federal budget on an unsustainable trajectory in the long run (see Chart 5).

Chart 5: Deficit Reduction Should Not Solely Target Discretionary Outlays



What's next

The Treasury debt limit drama is heating up and is sure to get much hotter in coming weeks as we get a better fix on April tax receipts and the actual X-date. If the X-date is as soon as early June, it seems a stretch for lawmakers to come to terms fast enough, and they instead will likely decide to pass legislation suspending the limit long enough to line the X-date up with the end of fiscal 2023 at the end of September. This will buy some time and combine the debt limit decision with the federal government's fiscal 2024 budget, which is also must-do legislation for lawmakers to ensure the government is funded and avoids a shutdown.[6]

Getting legislation that funds the government in fiscal 2024 and increases the debt limit across the finish line into law will surely be messy and painful to watch, generating significant volatility in financial markets. Indeed, a stock market selloff, much wider credit spreads in the corporate bond market, and a falling value of the U.S. dollar may be what is required to generate the political will necessary for lawmakers to avoid a government shutdown and breach of the debt limit. Lawmakers will not be sufficiently motivated to find a political path forward and act until they recognize the severe economic and political costs of not doing so.

But when all is said and done, the legislation that lawmakers ultimately pass will likely be anticlimactic, allowing both House Republicans and President Biden to declare political victory. For House Republicans, the legislation may include some restraint on the future growth in discretionary spending, a clawback of unused COVID-19 relief funds, and a streamlining of permits for energy development to allow House Republicans to declare victory. For the president, he can argue that these concessions were modest and simply part of the typical budget process and not a quid pro quo for a debt limit increase: a happy enough outcome to ensure the government is funded and the economy avoids financial calamity and recession. Of course, the nation's daunting long-term fiscal challenges remain.

6 To assure maximum political pressure to get this all done by the start of October, the legislation that suspends the limit could require the Treasury to have the same cash balance at the end of fiscal 2023 as it had at the start of the suspension when the cash balance was virtually exhausted. The legislation could also prevent the Treasury from targeting the G Fund of Federal Employees' Retirement System Thrift Savings Plan, which normally provides the Treasury significant headroom under the debt limit.

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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.

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He is a trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public. Dr. Zandi frequently testifies before Congress and conducts regular briefings on the economy for corporate boards, trade associations, and policymakers at all levels.

Dr. Zandi is the author of Paying the Price: Ending the Great Recession and Beginning a New American Century, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis, is described by The New York Times as the "clearest guide" to the financial crisis. Dr. Zandi is host of the Inside Economics podcast.

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Bernard holds an MSc in international trade, finance and development from the Barcelona Graduate School of Economics and a BA in political economy from Williams College.

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