Insight

Debt Limit Turmoil Has Real Costs

GORDON GRAY | FEBRUARY 11, 2014

According to the Treasury Department, the United States will run out of borrowing room after February 27th, at which point it will have to rely on cash reserves, and then ultimately prioritization to pay its bills. While the Treasury would almost certainly put creditors at the top of its list of priorities, global investors would likely take a dim view of the government of the largest economy essentially living hand-to-mouth. What the exact interest premium that capital markets would demand in the midst of this disruption is unknown – but it would not be zero. The United States would end up paying more interest than it otherwise would, which is certainly at odds with any understanding of sound fiscal policy. Higher interest payments mean less revenue and ultimately more interest payments down the road to both foreign and domestic creditors. This effect is further compounded by having to borrow at higher rates to finance the higher deficit. The CBO recently updated its budget baselines and provided an estimate for how a persistent one percentage point increase in interest rates could affect the budget.

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Such a persistent increase would result in a deficit increase of $1.5 trillion. Recent examples in disturbances surrounding the debt limit suggest this is an entirely plausible magnitude for what the U.S. might bear in costs if it risks default.

When the Treasury is forced to engage in “extraordinary measures” and otherwise alter Treasury auctions, those disruptions are not viewed favorably by investors. When close to the debt limit, Treasury can issue cash management (CM) bills to raise cash to liquidate obligations over the near-term. Because this strategy involves altering regularly scheduled securities auctions and borrowing less money over a shorter time, the Government Accountability Office (GAO) has said that it likely increases the long-term cost of borrowing money. Overall, GAO’s analysis indicated that CM bills had higher yield premiums, on average, of 4-48 basis points.[1]

Costs grow higher if the United States drew the ire of capital markets during a perceived default. Interest payments would certainly increase, but it’s not clear by how much. In the 1970s, the United States technically defaulted on an interest payment because of a confluence of equipment failure and unusually high investor demand – the price paid was a 60 basis point premium on interest payments. While transient, it does reflect how markets penalize even inadvertent and arguably excusable disruptions in timely credit payment. If the Treasury Department were to have to prioritize payments, it would likely do its utmost to assure investors they would be paid on a timely basis. The 1970s experience may then provide insight into what the interest rate penalty might be just for the *perception* of having defaulted. Unlike the 1970s experience, however, risking default over a failure of governance, as opposed to a technical issue, endangers the notion of Treasury securities as riskless. The penalty may thus be permanent rather than transient, and it would come with very significant costs.

More recent examples demonstrate that debt limit concerns exact pecuniary costs. Recent examples have been minor and transient, but do provide important context for how markets might react. Last October, during the last debt-limit standoff, the Treasury Department auctioned $30 billion worth of 4-week bills maturing Nov. 7 at a rate of 0.355 percent, nearly triple the 0.122 percent rate seen in the auction a week prior.[2] This phenomenon was again observed at a 4-week Treasury bill auction held on February 4th for $8 billion in Treasury securities coming due on March 6th, when the United States, absent a change in the debt limit, will likely have exhausted its borrowing authority. Yields jumped nearly three-fold to .132 percent over .051 percent from the prior auction.[3]

These are just illustrations of how transient disruptions can increase federal borrowing costs, and ultimately increase spending. Simple debt management disruptions have seen borrowing costs increase by 4-48 bp, an accidental default saw a premium of 60 bp, and recent anxiety in 4-week bills have seen far more modest declines in terms of absolute basis points, but several multiples of growth from prior yields. These experiences suggest that a 100 basis point premium penalty resulting from a technical default is possibly an understatement. However, assuming that such a penalty persists over a decade, even after an eventual and almost certainly inevitable debt limit increase, balances this conservative tendency. Accordingly, assuming a $1.5 trillion penalty for a debt limit breach is a reasonable estimate for the price of a failure to raise federal borrowing authority.

[1] "Debt Management: Treasury Has Refined Its Use of Cash Management Bills but Should Explore Options That May Reduce Cost Further," GAO-06-269, March 30, 2006.