



Insight

What If the Federal Government Hits the Debt Limit?

GORDON GRAY, MADDISON ERBABIAN | JULY 15, 2019

Executive Summary

- The U.S. Treasury Secretary recently advised Congress that the federal government may hit the current debt limit in a little over a month.
- Failure to increase or suspend the debt limit would require the federal government to reduce financial activities to the amount of cash inflow and consequently prioritize which expenses the federal government pays.
- This scenario – *prioritization* of payments – is highly risky, and an actual default on Treasury securities would substantially harm economic growth and raise unemployment.
- While federal payment systems seemingly could ensure timely interest payments, that scenario is fraught with risks.

Introduction

According to the most recent projections from the Congressional Budget Office, the United States will run a federal budget deficit of \$898 billion this fiscal year. To finance that deficit, the Treasury Department regularly auctions debt to the public. That debt is subject to a statutory limit, also known as the debt limit. Periodically, Congress raises or suspends this provision in law to accommodate the additional borrowing needed to finance the nation's growing deficits.

Increasing the debt limit is generally unpopular, and elected officials of both parties often do so grudgingly after extended negotiations. Increasingly, these negotiations have been characterized by brinksmanship that puts at risk Treasury's ability to pay the nation's bills as they come due.

In the absence of congressional action, the Treasury and other federal payment processes would essentially have to reduce payments to the cash inflow of the federal government to ensure that bondholders are paid, and to thus avoid a default on federal securities. This "prioritization" would require deferring timely payment of other obligations, likely incurring penalties, and would nevertheless be perceived as a *de facto* technical default. Such an outcome would be highly disruptive to federal governance and financial markets and would impose enduring costs on the U.S. economy and federal finance.

What is the Debt Limit?

The debt limit, also known as the debt ceiling, is the legal limit on certain types of borrowing by the federal government. It was first enacted in 1917, when Congress agreed to give the executive branch more flexibility for borrowing as the nation entered World War I, rather than authorizing every debt issue the Treasury could borrow, as long as total borrowing was under the limit. Because the limit restricts the ability to borrow, it restricts the ability to pay obligations already incurred. It is important to note, however, that the debt limit has

no direct impact on running deficits or limiting future obligations.

Federal debt subject to the limit includes both debt held by the public and debt held by governmental accounts (i.e., debt the government “owes to itself”). With the exception of certain *de minimis* accounting measures and relatively small tranches of other obligations, the debt limit covers virtually all federal debt issuance. At present, the statutory debt limit stands at \$21,987,705,611,407.70.[1] This limit took effect March 2, 2019, and Treasury has been using a number of accounting measures known as “extraordinary authorities” to liquidate federal obligations while operating close to the constraints of the debt limit. These authorities reportedly could be exhausted just days after Congress returns from its August recess.[2]

Implications of a Failure to Increase the Debt Limit

The need to raise the debt limit has usually been couched as essential to avoid defaulting on the nation’s debts. A 2013 Treasury study on the macroeconomic implications of debt limit brinksmanship observes: “The United States has never defaulted on its obligations, and the U.S. dollar and Treasury securities are at the center of the international financial system. A default would be unprecedented and has the potential to be catastrophic: credit markets could freeze, the value of the dollar could plummet, U.S. interest rates could skyrocket, the negative spillovers could reverberate around the world, and there might be a financial crisis and recession that could echo the events of 2008 or worse. Political brinksmanship that engenders even the prospect of a default can be disruptive to financial markets and American businesses and families.”[3] In substance, this outlook is likely correct. The *mechanism* of these deleterious consequences, however, requires a more nuanced understanding.

Some policymakers and observers have noted that annual tax revenues more than cover interest payments on the federal debt, which suggests a failure to increase the debt limit would not risk a default on Treasury securities. But this assumption belies the fact that under such a scenario, Treasury would have to ensure timely interest payments on a *daily* basis. While it is true that over the course of a year, revenue exceeds interest payments, the daily cash position of the Treasury can have significant deficits – as much as *tens of billions* in a single day.[4]

Recently released minutes from the Federal Reserve, as well as correspondence from the Treasury Department’s Inspector General provide insight into the practical reality, and the associated risks, of a failure to increase or suspend the debt limit in a timely fashion.[5] The Treasury and the Federal Reserve have developed contingency plans to prioritize interest payments on debt securities. The plans assume that principal payments could be made by rolling over maturing securities. This is a significant assumption, however. If investors were unwilling to accept rollovers – realized in an undersubscribed Treasury auction – the Treasury would require substantially higher cash balances to redeem maturing Treasury securities. Indeed, during the debt limit impasse of 2011, if Congress had not increased the debt limit on August 2nd and if Treasury had not been able to roll over maturing debt, Treasury would have needed \$87 billion in cash to redeem maturing securities. At the time, Treasury projected that it would only have \$20 billion in cash on hand on August 4th – resulting in a default on some portion of those maturing securities. The economic implications of this unprecedented event are difficult to gauge, but an internal 2013 Federal Reserve study estimated that U.S. GDP growth would be nearly halved for two consecutive years, and unemployment would remain significantly above baseline estimates for at least 5 years.[6]

Assuming investors would be willing to accept rollovers, Treasury would have to defer other due payments to ensure it had sufficient cash to pay interest. Such a scenario would require reliance on uncertain cash projections. Indeed, Treasury has disclosed that the margin of error for its cash projections, even with 98 percent confidence, is plus or minus \$18 billion over a one-week period and \$30 billion over a two-week horizon. Delayed payments to non-interest recipients would likely be perceived as a *de facto* default, and in the context

of other related adverse market conditions, would further damage the credibility of Treasury securities as a riskless asset in the global financial system.

While past debt-limit impasses have been resolved without reaching these extraordinary scenarios, financial markets have still reacted harshly to these events. In 2011, concerns about fiscal calamity led to a “heightened demand for liquidity [that] put upward pressure on short-term interest rates...Some notable distortions also emerged in the Treasury bill curve, reflecting concerns about whether debt payments will be made in a timely manner. Bills maturing in the first half of August cheapened notably, with their yields reaching about 25 basis points by the end of the week.”^[7] The Government Accountability Office estimated that uncertainty surrounding the 2011 debt limit negotiations raised federal borrowing costs by \$1.3 billion in the following year.^[8] This sum represents a lasting cost from a brief stalemate, and it would likely be dwarfed by the adverse consequence of a potential default or a perceived *de facto* default due to delays in payments on other federal obligations.

Conclusion

Historical experience and federal contingency planning reveal the fundamental impracticality of not raising or suspending the debt limit. While the federal government could reduce the risk of defaulting on Treasury securities under such circumstances, significant risks attend that scenario. Financial markets would likely perceive deferral of other due payments as a *de facto* default, raising borrowing costs and damaging the credibility of Treasury securities, while an actual default, which can’t be entirely ruled out, would substantially harm economic growth and raise unemployment.

[1] <https://fsapps.fiscal.treasury.gov/dts/files/19071000.pdf>

[2] <https://twitter.com/burgessev/status/1149323754855645186>

[3] <https://www.treasury.gov/initiatives/Documents/POTENTIAL%20MACROECONOMIC%20IMPACT%20OF%20DEBT%20LIMIT%20ON%20THE%20ECONOMY>

[4] Daily Treasury Statement: Cash and debt operations of the United States Treasury: Wednesday, December 3, 2012,” United States Treasury Financial Management Service, December 3, 2013, <https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=w&fname=12120300.pdf>.

[5] <https://www.federalreserve.gov/monetarypolicy/files/FOMC20110801confcall.pdf>;
<https://www.federalreserve.gov/monetarypolicy/files/FOMC20131016confcall.pdf>;
[https://www.treasury.gov/about/organizational-structure/ig/Audit%20Reports%20and%20Testimonies/Debt%20Limit%20Response%20\(Final%20with%20Signature\).pdf](https://www.treasury.gov/about/organizational-structure/ig/Audit%20Reports%20and%20Testimonies/Debt%20Limit%20Response%20(Final%20with%20Signature).pdf).

[6] <https://www.federalreserve.gov/monetarypolicy/files/FOMC20131004memo02.pdf>

[7] <https://www.federalreserve.gov/monetarypolicy/files/FOMC20110801confcall.pdf>

[8] <https://www.gao.gov/products/GAO-12-701>