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What if the Debt Ceiling is Breached?

Treasury will likely no longer be able to satisfy all of the government's obligations if Congress has not acted to raise or suspend the debt limit by early June.

– Janet Yellen, Treasury Secretary May 15

The risk that Congress fails to raise the debt limit by the X-date, which could be as early as June 1st, is higher than at any point since 2011. We expect the same sort of brinksmanship that occurred twelve years ago when an agreement was reached just two days prior to the Treasury running out of cash.

As we approach the X-date, we believe there are four possible outcomes:

1. A compromise deal is reached before the deadline: It pushes the next X-date into 2025 in return for moderate reductions in discretionary spending. [40% probability]

2. Short-term extension: It puts a bit more time on the clock and aligns the next X-date with the federal government's fiscal year (starts Oct. 1st). [30% likely]

3. An agreement isn't reached in time, forcing the Treasury to default on its obligations: We believe the resulting market reaction would be so fast and furious that the technical default would only last 3-4 days (similar to the first TARP vote on 9/29/2008). [20%]

4. President Biden invokes the Public Debt Clause of the 14th th amendment: It states, "The validity of the public debt of the United States, authorized by law ... shall not be questioned." Some pundits believe this could allow the president to ignore the debt limit and keep issuing bonds. [10%]

The market has a lot of experience with the first two scenarios (the debt limit has been raised 78 times since 1960), so we'll now briefly discuss the latter two potential outcomes.

Waiting until the last minute to suspend or increase the debt limit can cause serious harm to business and consumer confidence, raise short-t borrowing costs for taxpayers, and negatively impact the credit rating of United States.

– Janet Yellen, Treasury Secretary
May 15

An agreement isn't reached in time, resulting in a technical default

While default remains an unlikely outcome, it is no longer unthinkable. The economic damage would be both sudden and severe as it could mean eliminating payments worth around $200 bn per month (equivalent to 8-12% of personal consumption). This would include Social Security benefits, Medicare, Medicaid, Federal employees pay and veterans' benefits, as well as various income support programs. To help American's understand the potential impact, the White House recently published their estimates, which depend greatly on the length of default **(Figure 1)**.

Further, downgrades by ratings agencies would likely be forthcoming. To illustrate, the 2011 debt ceiling crisis resulted in S&P downgrading U.S. sovereign rating one notch (AAA to AA+). This is important because a 25 bps increase in the borrowing rate would increase annual interest expense by $60 bn and result in less stable funding. It could also jeopardize the reserve currency status of USD.

Additionally, the 2011 experience suggests significant downside for risk assets (particularly

"Last July and August, the federal government's monthly budget deficit was more than $200 bn. Cutting that amount would represent a fiscal tightening of about 10 ppts of GDP."

– Bill Dudley, former NY Fed president
May 2

Figure 1: The Potential Economic Impacts of Various Debt Ceiling Scenarios

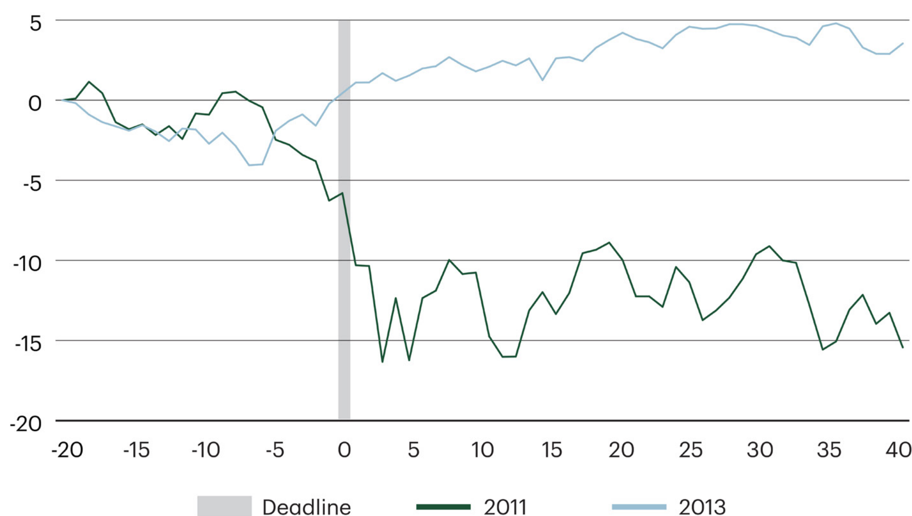
	Brinkmanship	Short default	Protracted default
Jobs (mn)	-0.2	-0.5	-8.3
Unemployment (ppts)	0.1	0.3	5.0
GDP (%)	-0.3	-0.6	-6.1

Source: White House, Council of Economic Advisors, May 3

equities, but also high yield credit and EM FX), and markedly higher volatility for equities, fixed income, and FX (Figure 2). Contrary to the commonly expressed view that treasury yields would move markedly higher, we expect a short-term flight to safety that drives yields significantly lower (as occurred in 2011). Over the longer term though a default could raise questions about the U.S. political process and reduce trust in our institutions. This could add to the USD's challenges and accelerate the loss of its hegemonic status.[1]

> **No one should assume the Fed can protect the economy and the financial system and our reputation globally from the damage that [a US default] might inflict.**
>
> **– Jerome Powell**
> **May 3**

Figure 2: SPX (% chg. from day -20): Trading days around the debt ceiling deadlines in 2011 and 2013



Source: Bloomberg

Note: The 2013 debt ceiling process was relatively benign and is presented here to provide contrast with the highly contentious 2011 crisis.

Invoking the Public Debt Clause: "The validity of the public debt of the United States, authorized by law … shall not be questioned."

> **I've not gotten there yet**
>
> **– President Biden (on the possibility of invoking the 14th amendment)**
> **May 5**

We now turn to Section 4 of the 14th Amendment which was ratified in 1868 to ensure that federal debts incurred during the Civil War couldn't be reneged on by a future Congress that included members from the former Confederate states. However, the Public Debt Clause isn't limited to just Civil War debts, it is believed to cover all federal debt authorized by Congress.

However, for three reasons we put a low probability on Biden invoking the 14th. First, Article 1 of the Constitution lists the powers of Congress, with the second clause of Section 8 providing Congress with the power "to borrow money on the credit of the United States." Together with the responsibilities over taxes and spending, these powers of the purse

[1] See "Who wins from US debt default? China," by M. Noland, Peterson Institute, May 17

belong entirely to the legislative branch. Given that context, it is clear the debt limit is an authorization from Congress to borrow up to a certain amount and the executive branch cannot borrow additional funds on its own authority.

Further, many constitutional experts argue that missing a payment does not question the validity of federal debt any more than missing a payment to your bank questions the validity of your mortgage. Finally, if the president were to issue new bonds without congressional authorization (that is, not "authorized by law"), the text of Section 4 makes it clear that these bonds would not be constitutionally binding, and the bond market would know those bonds were not backed by the full faith and credit of the U.S. Bottom-line: If President Biden issued an Executive Order requiring the Treasury to ignore the debt ceiling, it would immediately face legal challenges, likely end up before an unsympathetic Supreme Court and cause an extended period of financial uncertainty.

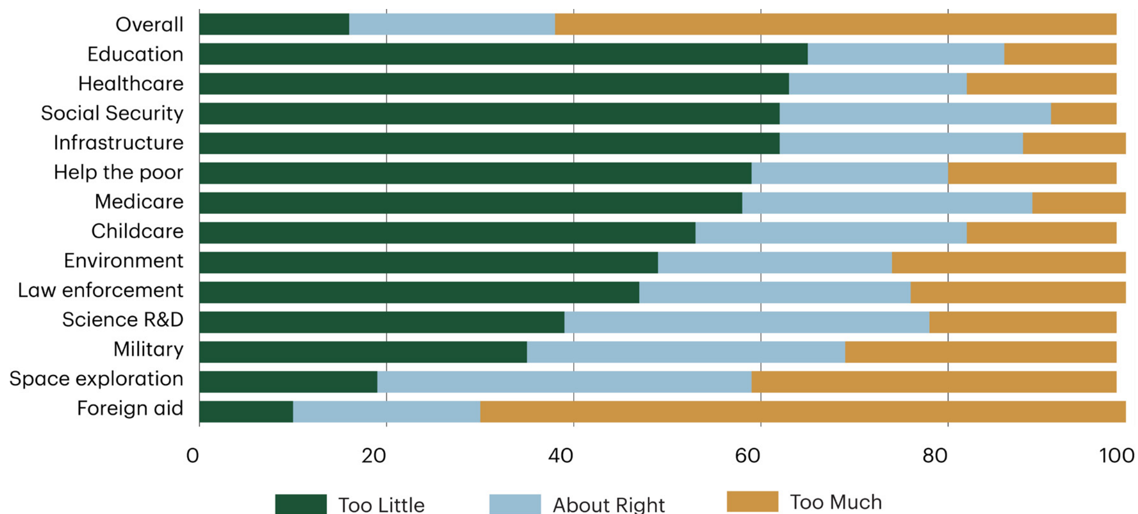
Living in a fiscal fantasyland: Not all of the blame lies with Congress

While many pundits are highly critical of the debt ceiling process, it is worth emphasizing that the eight largest debt reduction bills passed since 1980 were all adopted through the debt ceiling negotiations. Because the U.S. budget process is effectively broken, it's one of the very few opportunities that both sides have to seriously negotiate matters of the debt. These bipartisan negotiations are critical because it is the only way to negotiate the lasting reforms required to put the debt on a sustainable path.

Regardless, the May 4th Economist included a scathing article about debt ceiling wrangling, emphasizing how Congress is missing the bigger and more enduring problem. In particular, challenging demographics mean America's budget deficit is set to balloon, reaching 7% of GDP by the end of this decade.[2] Not only does Congress lack a sensible plan to shrink deficits, it hasn't even started credible discussions, and the proposals from most politicians look wildly unrealistic. All told, the picture is foreboding.[3]

Although everyone loves to hate Congress, we probably need to spend a bit more time looking in the mirror. A March poll found that 60% of Americans believe the federal government is spending too much overall **(Figure 3)**. However, in the same breath, people claim we're spending too little on education, health care, social security, and other major programs. The only budget item where a majority of Americans believe we're spending too much is foreign aid, which comprises less than 1% of the budget.[4]

Figure 3: The public believes the government is overspending but don't want to cut anything except space exploration and foreign aid



Source: National Opinion Research Center at U Chicago and Associated Press, March 2023

[2] The CBO estimates that over the next decade big ticket items such as Medicare and social security spending will increase by 129% and 100%, respectively.

[3] And it's not just a problem for America, the picture is even more worrisome in Europe, Japan, and China.

[4] To illustrate the extent of confusion, polls consistently report that Americans believe foreign aid is about 25% of the federal budget. When asked how much it should be, they say around 10%.

The contours of a deal are emerging

Republican priorities can best be gleaned from "The Limit, Save, Grow Act of 2023" which was passed in the house last month by a vote of 217 to 215. The Congressional Budget Office estimates it would reduce federal budget deficits over the next decade by an impressive $4.8 tn. The bulk of these savings would come from spending limits, specifically by reducing discretionary spending in FY 2024 to FY 2022 levels, and then capping growth at 1% per year.[5] Critically though, the Republican plan doesn't specify where they would like to reduce spending growth, which means postponing the hard and unpopular decisions to later.

Other areas where there is room for compromise include returning unspent COVID funds, ending student loan forgiveness programs, permitting reform for energy projects, reducing green energy subsidies (from last year's partisan Inflation Reduction Act), and establishing new work requirements for certain assistance programs. Negotiations are now underway in earnest, and we believe it is highly likely that a compromise deal is reached before the X-date. However, the risk that an agreement isn't reached in time, forcing the Treasury to default, is the highest it's been since at least 2011.

We have to make it clear to the American people that I am prepared to negotiate in detail with their budget. How much are you going to spend? How much are you going to tax? Where can we cut?

– President Biden
May 5

[5] Discretionary spending ex-defense represents 14% of total federal government spending, with the largest categories including health, education, transportation, and veterans' benefits.

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