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“The Federal Debt Limit and its Economic and Financial Consequences”

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The [Treasury debt limit](#) is an immediate threat to any optimism the economy can skirt recession in the coming year and poses a long-term threat to the nation's finances and economic growth. Unless lawmakers increase, suspend, or eliminate the limit, Treasury won't have the cash to pay all its bills on time later this summer. Financial markets and the economy would be hit hard. There is a temptation to brush off the developing debt limit drama thinking it will end the same way as the others over the years with lawmakers coming to terms and signing legislation just in time. That seems a mistake given the heightened dysfunction in Congress and the large political differences gripping the nation.

The [Treasury debt limit](#), which puts a statutory cap on the amount of Treasury debt outstanding and thus the ability of the Treasury to issue securities to fund the government's obligations, was [reached on January 19 of this year](#). Treasury must now use “[extraordinary measures](#)” to come up with the additional cash needed to pay its bills, but those measures are likely to be exhausted by mid-August. Someone will not get paid in a timely way. The U.S. government would default on its obligations. A default is defined to occur if the Treasury fails to make any payment obligation on time, regardless of whether it is Treasury debt or any other payment that is due.

A default would be a catastrophic blow to the already fragile economy. Global financial markets and the economy would be upended, and even if resolved quickly, Americans would likely 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, they 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 workarounds**

There is considerable debate over whether the Treasury could prioritize its payments and pay investors in Treasury securities first and thus avoid defaulting on its debt obligation. While the Treasury may have the technical ability to pay bond investors before others, as those payments are handled by the [Fedwire payment system](#) and a different computer system handles other government obligations, it is unclear whether Treasury is legally able to do so. It 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, that includes many

[foreign investors](#), would get their money ahead of American seniors, the military, or even the federal government's electric bill for long. And then there is the question of how all the other bills would be prioritized. It's 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](#) Treasury would mint a \$1 trillion coin, deposit it at the Fed, and draw it down to pay the government's bills. But the law authorizing platinum coins envisaged commemorative coins, and 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 its 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. Of course, the present value of the Treasury's debt obligation hasn't changed, so this is just a budget gimmick, but so too is the debt limit. While creative financial engineering, this isn't something Treasury could roll out quickly and it would be very costly committing Treasury to making 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.

Yet another proposed workaround to the debt limit is to have the President invoke [Section 4 of the 14<sup>th</sup> Amendment](#) to order the Treasury to keep issuing bonds and paying the government's bills. The 14<sup>th</sup> 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 14<sup>th</sup> amendment declaration seems the most viable option as it highlights the sanctity of the nation's debt. But Section 4 of the 14<sup>th</sup> Amendment was passed in the wake of the Civil War to ensure the federal government wasn't on the hook for the war debt of the Confederate states. Investors would rightly wonder if using the 14<sup>th</sup> Amendment to abrogate the debt limit law would stand up in the courts, and even if so, what it means 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 a few 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.

### **Economic costs**

However, as the deadline gets closer, global investors will rightly begin to worry that lawmakers will err and fail to act in time. The 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.

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 reverse course within a few days 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 quickly 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 if 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, who will pullback on investment and hiring, and financial institutions, who will quickly turn more circumspect about extending credit to households and businesses.

The timing couldn't be worse for the economy as 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 yields and the federal fund rate – point to recession beginning later this year at about the time lawmakers will be doing battle over the limit.

Based on simulations of the Moody's Analytics model of the U.S. and global economies, the economic downturn that would ensue would be comparable to that suffered during the global financial crisis. That means real GDP would decline beginning late this year and through much of 2024, falling over 4% peak to trough, costing the economy more than 7 million jobs, and pushing the unemployment rate to over 8%. Stock prices would fall by almost a fifth at the worst of the selloff, wiping out \$10 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. And the economy's long-term growth prospects will be materially diminished. A decade from now, real GDP is almost one percentage point lower than if there had been a clean debt limit increase, there are 900,000 fewer jobs, and the full-employment unemployment rate is 0.1 percentage points higher.

### **House Republican plan**

House Republicans have also sketched out a [plan](#) that requires big cuts to future government spending in order to balance the government's budget at the end of the 10-year budget horizon as a quid pro quo for their votes to increase the debt limit. Since Republicans have stated there will be no tax increases, and Social Security and Medicare benefits will remain untouched, to achieve a balanced budget would likely mean all but the elimination of nondefense discretionary spending and the Medicaid program.

Given the dramatic reduction in government spending in this scenario and the already fragile economy, the economy suffers a recession in 2024, costing the economy 2.6 million jobs at the worst of the downturn, pushing unemployment to a peak of near 6%. The economy's long-term growth prospects are also meaningfully diminished given the severe fiscal restraint. A decade from now, real GDP is 2.7% lower than if there had been a clean debt limit increase, equal to more than one year's worth of typical GDP growth, there are almost one million fewer jobs, and the full-employment unemployment rate is 0.2 percentage points higher.

### **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 year 2024 that begins on October 1.

Coming to terms after much drama would be consistent with the long arduous history of agreements on the debt limit, and it is fitting given the bipartisan nature of the financial obligations the debt would cover. 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.

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 doesn't 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 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 articulate in this analysis, but they are badly misguided.

That the U.S. government pays what it owes in a timely way is a bedrock of the U.S. economy and global financial system. It has paved the way for the U.S. dollar ultimately to become the global economy's reserve currency. The economic benefits of this over the generations are incalculable. Lawmakers should put an end to the wrangling over the debt limit and increase it with no strings attached so future generations can enjoy the same benefits.