Testimony on:

The Federal Debt Limit and its Economic and Financial Consequences

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Chairwoman Warren, Ranking Member Kennedy, and members of the subcommittee, thank you for the privilege of appearing today to discuss issues surrounding the limit on federal debt. I hope to make the following main points:

- Congress should pass, and the president should sign, legislation to raise or suspend the debt limit as soon as possible.

- Failure to do so will inevitably lead to default on Treasury securities, generating global financial fallout, recession risks, and higher U.S. borrowing costs.

- The federal budget is on an unsustainable trajectory, driven in large part by entitlement spending. Congress and the president should also address this looming economic risk.

Let me discuss these in turn.

On January 19, 2023, the Treasury Department exhausted its typical borrowing authority as it confronted the $31.4 trillion debt limit. Since that time, it has used emergency borrowing authority known as "extraordinary measures" to continue funding the federal government. At some point in the near future, these measures will also be exhausted – a point that has come to be known as the "X date." It is imperative that Congress pass, and the president sign, a bill raising or suspending the debt limit prior to the X date.

<u>Failure to address the debt limit will lead to a default on U.S. Treasuries</u>. It has been asserted by some that the Treasury could avoid default by prioritizing payments of interest and principal, while deferring payment on other obligations. I will leave it to the legal community to adjudicate whether the Treasury has legal authority to simply ignore signed contracts and legislated benefits and simply note that I have no faith that it has the operational capability to execute this notion over any substantial time period. Failure to act in a timely fashion <u>is</u> default.

<u>Default would be a cataclysm for the global financial system</u>. Treasuries are the foundation of the global financial system because they are perceived to have zero credit risk. Impairing this perception would raise the specter of not getting repaid which, in turn, would be an incentive to dump Treasuries. The massive dumping of Treasuries would engender a global financial meltdown.

I hasten to add that the duration of the default episode would matter. If Congress acted hastily to suspend the debt limit, payments could resume, and the impairment would be limited. But it would not be zero, and it would take a substantial amount of time to be repaired.

Because the X date is uncertain, markets and rating agencies could perceive impairment even without a default. As the clock winds down approaching a putative X date, it is likely that rating agencies will increasingly question the ability of the U.S. government to manage its financial future, or markets will increasingly attach a risk premium to Treasuries, or both.

Regardless of the source, impairment will raise interest rates and impose costs. The exact interest premium that capital markets would demand 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 sound fiscal policy.

In the 1970s, the United States technically defaulted on an interest payment because of a confluence of equipment failure and unusually high investor demand, and the price paid was a 60-basis-point premium on interest payments. While the impairment was transient, the incident does reflect how markets penalize even inadvertent and arguably excusable disruptions in timely credit payment.

More recent examples demonstrate that debt limit concerns exact pecuniary costs. During the last debt-limit standoff, the Treasury Department auctioned $30 billion worth of four-week bills maturing 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 four-week Treasury bill auction held in February.

The federal budget is on an unsustainable trajectory, driven in large part by entitlement spending. Failing to address the debt limit will not improve the fiscal outlook. The Treasury is in the position of having to borrow because past decisions to spend have outstripped past decisions to tax. Some make the argument that being inflexible with the debt limit will limit future spending but, of course, Congress could accomplish that goal without involving the debt limit. If one wants to control future spending, one should stop spending so much.

Similarly, the evidence is that, in the past, the debt ceiling has gone up or has been suspended without accompanying fiscal legislation ("clean" debt limit increases) and has gone up along with fiscal restrictions (caps on discretionary spending, etc.). Regardless, in the 21st century, the debt has only gone up, even relative to the size of the economy. Any argument that there is a "right" way to raise the debt limit is at odds with history.

Thank you and I look forward to your questions.