



## THE ECONOMIC COSTS OF DEBT-CEILING BRINKSMANSHIP

The federal government effectively reached its borrowing limit on May 19, 2013.<sup>1</sup> Since then, the Treasury Department has undertaken so-called “extraordinary measures” that increase the federal government’s borrowing capacity, allowing the government to postpone default until mid-October.<sup>2</sup>

With that deadline approaching, there is broad agreement among the nation’s economic leaders that action must be taken to raise the debt ceiling and avoid default. Failure to do so would have serious economic consequences – potentially disrupting financial markets, limiting access to credit and raising financing costs for consumers and businesses. Foreign investors, who hold nearly half of U.S. debt, could reduce their purchases of U.S. Treasuries for an extended period of time, or sell some of their holdings of U.S. debt. A default could also trigger a run on money market funds, sparking a severe and disruptive crisis.<sup>3</sup>

Because the economic stakes of a potential government default are so high, debt-ceiling brinksmanship increases economic uncertainty, which has economic costs. The prolonged uncertainty during the debt-ceiling debate in 2011 resulted in a downgrade of the U.S. credit rating by Standard and Poor’s. Delays in lifting the debt ceiling have been shown to increase costs for the federal government and impair the operation of the market for Treasury debt, affecting those who benefit from the liquidity provided by that debt market.

### Background

The debt ceiling, or debt limit, is the maximum amount of outstanding federal debt the government can incur under statute. Raising the debt ceiling allows the United States to pay for mandatory and discretionary spending Congress has already obligated, honoring commitments made to households, businesses and governments, both here and abroad. Normally, the U.S. government sells Treasury securities to finance budget deficits. Once the debt limit has been reached, Congress must approve an increase to the debt ceiling before the Treasury can issue new bonds. Increasing the debt limit authorizes the Treasury to sell bonds to finance spending.

Because the debt limit is defined in terms of a particular dollar amount, normal growth in the U.S. economy means that the debt limit will be reached inevitably after some time. Congress has raised the debt ceiling more than 70 times since 1962 and has voted on the debt limit 12 times since 2002.<sup>4</sup> The last Congressional vote to increase the debt limit was part of the Budget Control Act of 2011, signed into law by President Obama in August 2011, which increased the Treasury’s borrowing capacity by between \$2.1 and \$2.4 trillion in three increments.<sup>5</sup> More recently, Congress voted to suspend the debt limit through May 18, 2013.<sup>6</sup> Once the debt-limit suspension lapsed, the Treasury reset the debt limit at \$16.699 trillion (\$305 billion above the previous statutory limit) to go into effect on the next business day, May 20.<sup>7</sup> The Treasury Department also began

extraordinary measures to allow the government to continue to operate.

### **How a Default Might Affect Markets, Consumers and Businesses**

If Congress does not increase the debt ceiling to pay for spending already committed by Congress and, as a result, the Treasury fails to make the debt-related payments for which it is responsible, default would occur, resulting in significant harm to the economy.

In 2011 testimony before the Senate Banking Committee, Chairman of the Federal Reserve Ben Bernanke said that a default would be a "calamitous outcome" and "create a very severe financial shock."<sup>8</sup> The global financial system relies on Treasuries, which have long been considered one of the safest investments. Bernanke explained that a "default on those securities would throw the financial system into chaos."<sup>9</sup> He likewise observed that not raising the debt ceiling is "like a family saying, 'Well, we're spending too much – let's stop paying our credit card bill.'"<sup>10</sup>

It is difficult to provide a precise estimate of the economic costs resulting from an actual default, but it is not hard to illustrate the significance of those potential costs to consumers and businesses.<sup>11</sup>

Chaos in the financial system, such as Chairman Bernanke described, would undermine credit and equity markets and impair the economy's capacity to grow. Limitations on access to credit, for example, would raise investment costs. For consumers, the increased cost of credit could translate into less borrowing for purchases of homes, autos or other durable goods and education. Businesses could encounter difficulties in acquiring the short-term debt they need to finance their payrolls or accumulate inventories, and higher financing costs would lead them to invest less in equipment and construction. In addition to the costs to consumers and businesses, cash-strapped municipalities would also face higher financing

costs and could be forced to make cuts to essential services such as education and public health.

Apart from the costs that stem directly from the financial market impacts, a default would require the federal government to limit, delay or even suspend payments to creditors, program beneficiaries and others. The federal government makes about 80 million payments each month.<sup>12</sup>

Delays in Social Security, Medicare, Medicaid, veterans' benefits, unemployment insurance and other essential government programs would have a direct impact on millions of Americans and, in turn, would negatively affect the economy by pushing down consumer spending. For example:

- If Social Security benefits were delayed or disrupted, 57.5 million Americans would not receive their monthly Social Security payments in a timely manner.<sup>13</sup> About 70 percent of Social Security beneficiaries are retirees and 30 percent of beneficiaries receive survivors insurance or disability insurance payments. The average monthly Social Security benefit is \$1,159.<sup>14</sup> Without these payments, retirees, widow(er)s and disabled workers would struggle to make ends meet. In addition, more than \$66.6 billion in monthly benefits would not enter the economy when expected – damaging the economic recovery.
- If veterans' benefits were delayed, 3.4 million veterans would not receive service-connected disability benefits on time. While those payments vary greatly based on the degree of the veteran's disability and the number of dependents, the average annual payment is \$11,500. In FY 2011, those annual payments totaled nearly \$39.4 billion.<sup>15</sup>

## Uncertainty and the Costs of Delaying an Increase in the Debt Ceiling

Even if a default is ultimately avoided, the increased uncertainty in the days leading up to a debt-ceiling deadline would also have negative effects on the economy. That is because the costs of default are so significant that even a small chance of such an outcome must be factored into the decisions made by consumers, businesses and investors. In the face of the uncertainty, a consumer or business may choose to delay purchases or decrease investment. The way in which the debt-ceiling impasse is resolved can also affect uncertainty and economic behavior.

There is precedent for this uncertainty to harm the economy: In 2011, the Dow Jones Industrial Average dropped more than 2,000 points in late July and early August as Congress struggled to reach an agreement on lifting the debt ceiling, and Standard and Poor's downgraded its quality rating of U.S. sovereign debt (**Figure 1**).<sup>16</sup> Although the stock market eventually recovered, the lower Standard and Poor's rating remains. The volatility affected the portfolios of consumers and businesses and may have led many to change their

consumption and investment plans, even if only for a short period.

Standard and Poor's downgraded the U.S. government's credit rating from AAA based on the protracted delay in increasing the debt limit and on its assessment of how the impasse was resolved. In announcing the first-ever downgrade of U.S. sovereign debt, Standard and Poor's noted:

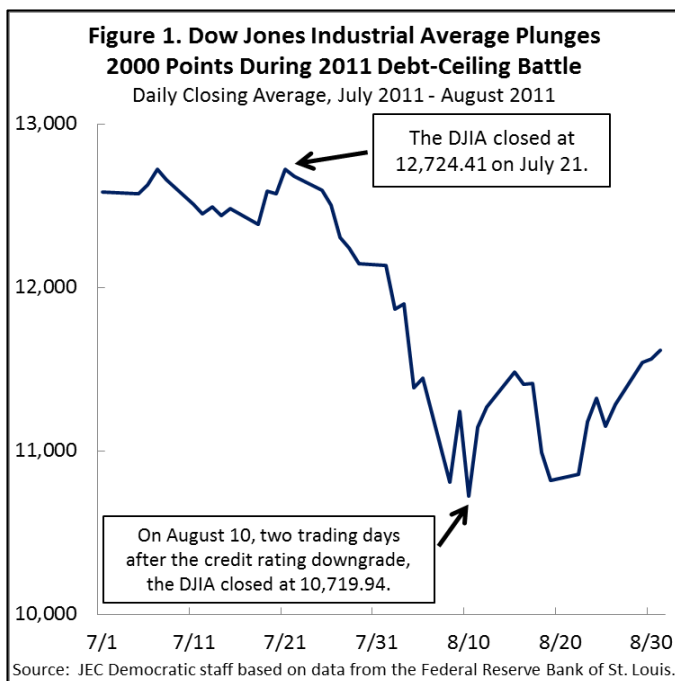
*"We lowered our long-term rating on the U.S. because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process."*<sup>17</sup>

Some fear that a repeat of 2011 could lead other ratings agencies to also downgrade the U.S. credit rating. Fitch Ratings warned on January 15<sup>th</sup> of this year that "failure to raise the debt ceiling in a timely manner will prompt a formal review of the U.S. sovereign ratings."<sup>18</sup>

Standard and Poor's, which on June 10, 2013 changed its long-term rating on U.S. sovereign debt from "negative" to "stable" due to the improved U.S. fiscal outlook, noted that:

*"Although we expect some political posturing to coincide with raising the government's debt ceiling, which now appears likely to occur near the Sept. 30 fiscal year-end, we assume with our outlook revision that the debate will not result in a sudden unplanned contraction in current spending – which could be disruptive – let alone debt service."*<sup>19</sup>

Thus, another bout of debt-ceiling brinksmanship, or forcing indiscriminate spending cuts as a condition for raising the debt ceiling, would be a step in the wrong direction. It could endanger U.S.



creditworthiness and reduce market confidence in the U.S. economy.

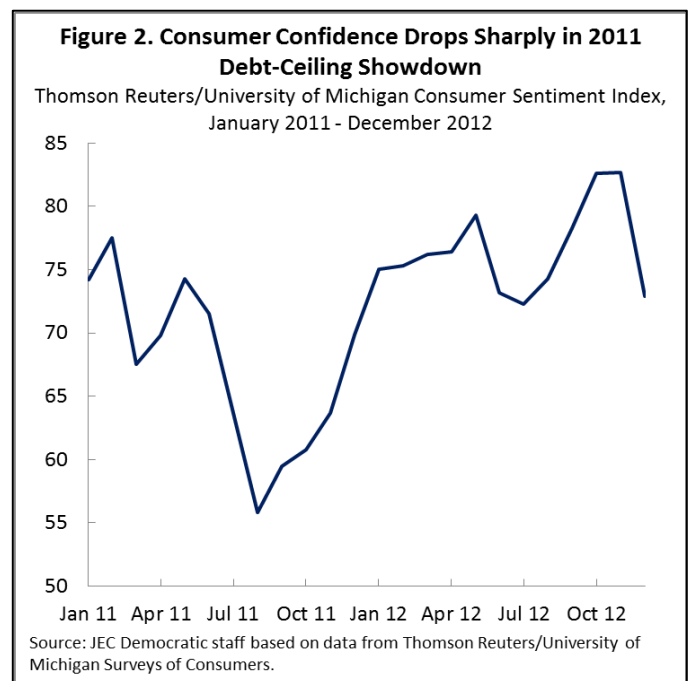
Consumer surveys in 2011 also illustrated the potential for a debt-ceiling impasse to increase uncertainty. Consumer confidence, as measured by the Thomson Reuters/University of Michigan Index of Consumer Sentiment, fell sharply in July and August of 2011, dropping from 71.5 in June to 63.7 in July and 55.8 in August (**Figure 2**). In releasing the August data, Thomson Reuters/University of Michigan noted:

*“Never before in the history of the surveys have so many consumers spontaneously mentioned negative aspects of the government’s role, and never before have consumers rated economic policies so unfavorably.”<sup>20</sup>*

It took until January 2012 for confidence to return to the June 2011 level (**Figure 2**). This decline may have signaled a drop in consumers’ willingness to make purchases, relative to what they would have done had the debt ceiling been resolved in a timely manner.

Delays in lifting the debt ceiling also complicate the already complex task of managing the federal debt. By forcing the Treasury to take “extraordinary measures” to temporarily increase the government’s borrowing capacity, brinksmanship forces the Treasury into decisions it would not have otherwise deemed consistent with prudent debt management. Such measures could affect market outcomes. For example, in the past the Treasury has been forced to cancel auctions for short-term debt as a debt-ceiling deadline approached without a resolution in sight. These cancellations can be extremely disruptive to the operation of global money markets especially as the global financial system continues to recover from the crisis of recent years.<sup>21</sup>

Impasses over raising the debt ceiling, and the extraordinary measures the Treasury must take in the interim, can erode confidence in the relative risks that markets associate with holding Treasury securities. That decline in confidence has translated



into higher borrowing costs for the federal government. The United States has long benefited from the widespread belief that U.S. debt is among the safest forms of debt in the world; indeed, Treasury rates are widely used as benchmarks for “risk-free” rates that determine other market rates. If investors believe that U.S. debt has become riskier, they will demand a higher yield when purchasing it, which would increase the costs of borrowing for the U.S. government.

Studies have concluded that in recent decades some debt-ceiling events have raised short-term Treasury yields relative to comparable private market debt.<sup>22</sup> During such periods, the Treasury has to pay higher yields than would otherwise be necessary, as happened in 2011. A recent study of daily market data collected during the debt-ceiling impasse of 2011 found higher borrowing costs to the Treasury, and American taxpayers, which amounted to \$1.3 billion in fiscal year 2011 alone.<sup>23</sup>

Debate over raising the debt ceiling should not be tied to negotiations on further reducing the deficit. While more must be done to move the nation toward fiscal responsibility, Congress has already taken steps to reduce deficits by at least \$2.4 trillion. However, the vast majority of the savings to



date come from spending cuts and, if sequestration continues, the ratio of spending cuts to revenue increases will be four-to-one.<sup>24</sup> Both the National Commission on Fiscal Responsibility and Reform and the Senate-passed budget call for a roughly even split between spending cuts and revenue increases. Future deficit reduction needs to be more evenly balanced between revenue and spending cuts, and the debate on the budget should not be tied to raising the debt ceiling.

## Conclusion

A delay in lifting the debt ceiling – even if default is ultimately avoided – increases uncertainty and has real economic costs. Delays in raising the debt ceiling increase costs for the federal government and affect the market for U.S. debt. Individuals and businesses may also face higher borrowing costs. As was seen in 2011, consumer confidence and the financial markets may be negatively affected. There is broad agreement that another bout of debt-ceiling brinksmanship would increase uncertainty, creating a new headwind for the ongoing economic recovery.

## Sources:

<sup>1</sup> Congressional Budget Office, “Federal Debt and the Statutory Limit, June 2013,” June 11, 2013. <http://www.cbo.gov/publication/44324>.

<sup>2</sup> Letter from Secretary of the Treasury Lew to Speaker of the House of Representatives Boehner, August, 26, 2013, <http://www.treasury.gov/initiatives/documents/082613%20debt%20limit%20letter%20to%20congress.pdf>, estimating that extraordinary measures will be exhausted by mid-October; see also Letter from Secretary of the Treasury Lew to Speaker of the House of Representatives Boehner, May 17, 2013. <http://www.treasury.gov/initiatives/Documents/Debt%20Limit%205-17-13%20Boehner.pdf>, explaining in detail the extraordinary measures being undertaken by the U.S. Treasury, which Treasury estimated will not be exhausted until after Labor Day. More recently, the CBO announced that it expected the extraordinary measures taken by the Treasury Department would run out sometime in October or November

of this year. See Congressional Budget Office, “Federal Debt and the Statutory Limit, June 2013,” June 11, 2013.

<sup>3</sup> Letter from Chairman of Treasury Borrowing Advisory Committee to Secretary of the Treasury Geithner, April 25, 2011.

<sup>4</sup> Austin, D. Andrew, and Mindy R. Levit, “The Debt Limit: History and Recent Increases,” Congressional Research Service, May 22, 2013; and Masters, Jonathan, “U.S. Debt Ceiling: Costs and Consequences,” Council on Foreign Relations, January 2, 2013.

<sup>5</sup> Budget Control Act of 2011, P.L. 112-25, August 2, 2011. <http://www.gpo.gov/fdsys/pkg/PLAW-112publ25/pdf/PLAW-112publ25.pdf>.

<sup>6</sup> On January 23, 2013, the House passed H.R. 325, which suspended the debt limit through May 18, 2013; the Senate passed the measure on January 31, and it was signed into law by President Obama on February 4.

<sup>7</sup> Austin, D. Andrew, and Mindy R. Levit, “The Debt Limit: History and Recent Increases,” Congressional Research Service, May 22, 2013.

<sup>8</sup> Federal Reserve Chairman Bernanke, The Semiannual Monetary Policy Report to Congress, Hearing before the Senate Committee on Banking, Housing and Urban Affairs, July 14, 2011. <http://www.gpo.gov/fdsys/pkg/CHRG-112shrg72339/pdf/CHRG-112shrg72339.pdf>.

<sup>9</sup> *Ibid.*

<sup>10</sup> Federal Reserve Chairman Bernanke, quoted in Taibbi, Matt, “The Mad Science of the National Debt,” *Rolling Stone*, May 22, 2013. <http://www.rollingstone.com/politics/news/the-mad-science-of-the-national-debt-20130522>.

<sup>11</sup> Austin, D. Andrew and Rena Miller, “Treasury Securities and the U.S. Sovereign Credit Default Swap Market,” Congressional Research Service, August 15, 2011. Part of the difficulty in quantifying the impact of a default is that defaults are not common occurrences. The U.S. Treasury has only once missed a payment on Treasury bills. In 1979, the Treasury failed to make payments on \$122 million in Treasury bills on time. According to one analysis, that incident increased rates by 60 basis points for several years.

<sup>12</sup> Letter from Secretary of the Treasury Geithner to Speaker of the House of Representatives Boehner, January 14, 2013. <http://www.treasury.gov/connect/blog/Pages/Secretary-Geithner-Sends-Debt-Limit-Letter-to-Congress-1-14-13.aspx>.

<sup>13</sup> Social Security Administration, Monthly Statistical Snapshot, Table 2, June 2013.  
[http://www.ssa.gov/policy/docs/quickfacts/stat\\_snapshot/](http://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/).

<sup>14</sup> *Ibid.*

<sup>15</sup> U.S. Department of Veterans Affairs, Veterans Benefits Administration, “Annual Benefits Report: Fiscal Year 2011,” pp. 8-9. [http://www.vba.va.gov/REPORTS/abr/2011\\_abr.pdf](http://www.vba.va.gov/REPORTS/abr/2011_abr.pdf).

<sup>16</sup> The federal debt reached its statutory limit on May 16, 2011. Extraordinary measures were used to enable the federal government to meet its obligations before an agreement on the debt ceiling was finalized on August 2, 2011. The Dow Jones Industrial Average declined by more than 600 points on August 8, 2011, the first trading day after Standard and Poor’s downgraded the United States’ credit rating.

<sup>17</sup> “United States of America Long-Term Rating Lowered to ‘AA+’ Due to Political Risks, Rising Debt Burden; Outlook Negative,” Standard and Poor’s, August 5, 2011. <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563>.

<sup>18</sup> Fitch Ratings, “Fitch: Debt Ceiling Delay Would Prompt Formal US Rating Review,” January 15, 2013. [http://www.fitchratings.com/creditrisk/press\\_releases/detail.cfm?pr\\_id=779570&cm\\_sp=homepage--FeaturedContentLink--Learn%20More](http://www.fitchratings.com/creditrisk/press_releases/detail.cfm?pr_id=779570&cm_sp=homepage--FeaturedContentLink--Learn%20More).

<sup>19</sup> Standard & Poor’s, “United States of America ‘AA+/A-1+’ Ratings Affirmed; Outlook Revised To Stable On Receding Fiscal Risks,” June 10, 2013.

<sup>20</sup> Surveys of Consumers Thomson Reuters/University of Michigan, “Economic Downturn Expected by Consumers,” August 26, 2011. <http://www.sca.isr.umich.edu/fetchdoc.php?docid=42908>

<sup>21</sup> U.S. Government Accountability Office, “Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market,” GAO-11-203, February 22, 2011. <http://www.gao.gov/products/GAO-11-203>.

<sup>22</sup> S. Nippani, et. al., “Are Treasury Securities Free of Default?” *The Journal of Financial and Quantitative Analysis*, Vol. 36, No. 2, Special Issue on Corporate Governance, June 2001. pp. 251-265; and, P. Liu, et. al., “Did the repeated debt ceiling controversies embed default risk in US Treasury securities?” *Journal of Banking and Finance*, Vol. 33, 2009. pp. 1464-1471.

<sup>23</sup> U.S. Government Accountability Office, “Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs,” GAO-12-701, July 23, 2012. <http://www.gao.gov/products/GAO-12-701>.

<sup>24</sup> Memo from Senator Patty Murray and Senate Budget Committee majority staff to members of the United States Senate, January 24, 2013. <https://www.aamc.org/download/327164/data/senatebudgetcommitteechairmemo.pdf>.