JOINT ECONOMIC COMMITTEE
RANKING DEMOCRAT SENATOR MARTIN HEINRICH
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Yet Again: Debt Ceiling Brinksmanship Forces Unnecessary Costs on All Americans

In 2015, Congress agreed to allow the Treasury to raise the money necessary to pay all the bills for our government's spending obligations. That agreement will expire on March 16th, 2017 and barring Congressional action, the United States will immediately breach the debt ceiling, forcing Treasury to resort to "extraordinary measures" to prevent a default. As indicated in his March 8th letter to Congress, Treasury Secretary Steven Mnuchin is already preparing for these measures.[1] Extraordinary measures are a stop-gap measure—that temporarily enable Republicans to shirk their responsibilities—and that impose real costs on taxpayers and families.

The last two episodes of debt ceiling brinkmanship—in 2011 and 2013—cost taxpayers through higher borrowing costs and suspensions of public services. But the experience also seemingly consolidated market expectations that Congress would eventually make good on their word, even if brinkmanship pushed America into a short-term technical default. (See Appendix for background on the debt ceiling.)

This time may be different, however. The unorthodox approach to governing from Trump administration officials and consolidation of Republican control of Congress add extra doses of uncertainty into the mix. President Trump suggested possibly renegotiating America's debt at one point in the campaign.[2] One of his key economic advisors, Office of Management and Budget (OMB) Director Mick Mulvaney, has questioned whether or not breaching the debt ceiling would be that big of a deal.[3] The longer Republicans push our nation toward default, the higher the costs will be for Americans, the federal government, and the economy.

The Costs of Debt Brinkmanship

For decades, U.S. government bonds were seen as a risk-free asset, earning U.S. Treasuries a privileged position as the backbone of the global financial system. Private financial institutions and foreign governments alike held U.S. Treasury assets in reserve against riskier investment decisions. This privileged position earned Americans on net an additional 0.3 to 0.5 percent of GDP annually, according to estimates by the McKinsey Global Institute—equivalent to \$56 to \$93 billion today.[4]

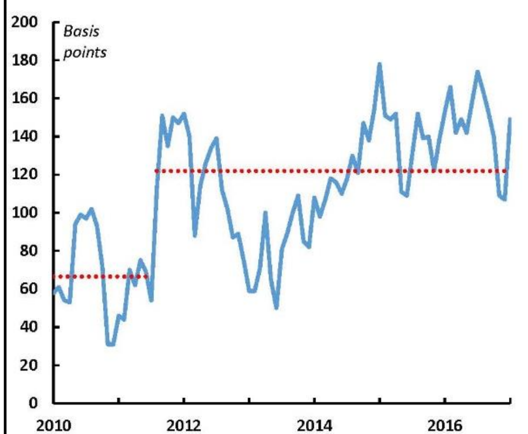
Permanent loss of faith. Over the past handful of years debt ceiling politics and threats to default on U.S. creditors did real damage to America's reputation. In 2011, the credit rating agency Standard and Poor's downgraded the U.S. credit rating to AA+, the first time in 70 years that the U.S. did not earn an AAA rating (the highest possible rating). S&P cited the "prolonged controversy over raising the statutory debt ceiling" as a primary factor.[5]

Less recent history is also instructive. A technical glitch prevented the Treasury from making interest payments on $122 million of bonds for three weeks in 1979. Some investors lost faith in U.S. debt, resulting in a permanent 60 basis point increase in interest rates on Treasuries and substantially increasing the cost of borrowing for the federal government.[6] In the current dilemma, a U.S. government default would not result from a technical glitch, but from Republicans' willful disregard for America's creditworthiness. The blow to America's reputation will not be easy to restore.

In 2013, when Congressional Republicans once again toyed with default, global investors registered the short-term risk, but seemed largely to shrug off the prospect of the government actually missing payments. In the future, Americans may not continue to be so lucky, particularly as perceptions of America's stability of governance have slipped around the world following the 2016 election. Ongoing willingness to risk defaulting on our debt will further erode America's creditworthiness reputation, and could jeopardize the dollar's status as the world's preferred reserve currency.

Increased borrowing costs for taxpayers. When bondholders lose faith in the United States' creditworthiness, they demand higher risk premiums for buying American debt. Debt brinkmanship in 2011 increased the federal government's borrowing costs by $1.3 billion in that year alone.[7]

Figure 1: Interest Rate Spread on 30-Year Fixed Mortgage



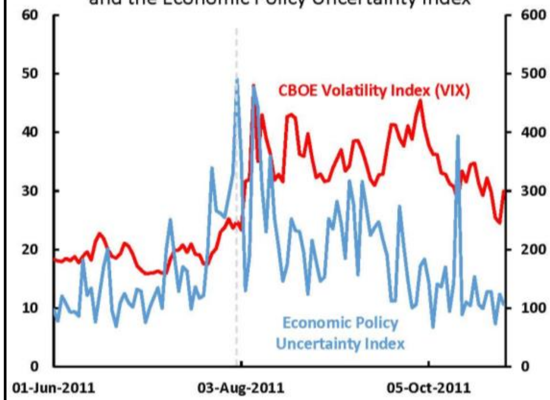
Source: Federal Housing Finance Authority and Federal Reserve
Notes: The red dotted lines show the average spread pre- and post-debt ceiling crisis; the pre-crisis period is defined as January 2010 to July 2011, the post-crisis period is defined as August 2011 to present (January 2017)

Higher borrowing costs for individuals. Interest rates on U.S. Treasuries set the baseline for interest rates charged on a wide variety of financial instruments. When interest rates rise on Treasuries they also rise for individuals looking to borrow money. For example, interest rates on 30-year fixed mortgages jumped following the 2011 debt-ceiling brinkmanship, and remained 55 basis points higher, on average, than the period preceding the event (see Figure 1).[8] If upcoming debt brinkmanship has a similar impact, the average homebuyer could end up paying nearly $35,000 extra on their home mortgage.[9]

Increased economic uncertainty. Rising borrowing costs and the risk of default create uncertainty in the broader market, as well. During the 2011 crisis, major indicators of consumer and business confidence fell steadily as the standoff persisted, while both measures of market volatility and measures of policy uncertainty spiked (see Figure 2).[10] Economists have long understood that increased uncertainty can deter investments—which are key to economic and employment growth.[11] In this case, increased fiscal policy uncertainty has played a role in corporations accumulating large stockpiles of cash holdings rather than making investments that generate job and overall economic growth.[12]

Figure 2: Market Volatility

As measured by the CBOE Volatility Index (VIX) and the Economic Policy Uncertainty Index



Source: Chicago Board Options Exchange and Policyuncertainty.com

Notes: VIX measures market expectations for the expected range of change of the S&P 500 in the near-term, a reading of 20 would indicate that the market expects the S&P 500 to move less than 20 percent up or down in the near-term; the Economic Policy Uncertainty Index is based on newspaper coverage of economic policy; the dotted line is at August 2011, the height of the 2011 debt ceiling crisis.

If Extraordinary Measures Run Out

If the debt ceiling is not raised by the time extraordinary measures run out, Treasury will no longer be able to pay all of its bills. While receipts and payments fluctuate widely throughout the year, on average Treasury will need to issue $47 billion in new debt each month in FY 2017 to meet spending obligations. On average, the Treasury will owe $22.5 billion a month in interest payments to holders of already-issued debt in FY 2017.[13] This leaves just $24.5 billion a month for Treasury to meet all other obligations, meaning that Treasury would default on some of the checks that it is obligated to write each month, such as payments to:

- 60 million individuals receiving their earned Social Security benefits, one-third of whom count on Social Security for 90 percent of their income.[14]
- More than 4 million veterans with disability benefits and 9 million veterans who receive health care from the Veterans Administration.[15]
- 44 million low-income people that rely on the Supplemental Nutrition Assistance Program to put food on the table could see disruptions in benefits.[16]
- More than 4 million federal government employees, including nearly 1.5 million uniformed military personnel.[17]

While imposing undue hardships on millions of people, the effect of delay or defaulting on non-interest Treasury payments would cascade throughout the rest of the economy as affected individuals would cut back on their own spending in response. Even a two-week delay in payments may be enough to trigger a recession, economic models show.[18] On the other hand, prioritizing payments instead to individuals over principal and interest payments to Treasury bondholders risks sparking another financial crisis as investors around the world adjust to a world in which Congress throws the "full faith and credit" of the U.S. government out the window.[19]

Conclusion

Previous debt ceiling episodes may have numbed investors to the possibility of America defaulting on federal debt. But, given the unorthodox governing approach of the Trump administration and concerning past statements made by Trump's top budget advisor, markets are unlikely to remain calm for long. As extraordinary measures continue and the U.S. gets closer to default, markets could start panicking, which will have real costs for Americans, the federal government, and the overall economy.

Appendix: What is the Debt Ceiling?

All federal debt falls into two categories: publically held debt and intragovernmental debt. Publically held debt is the total amount of debt issued to the public in the form of bonds and treasury notes to help cover the federal government's accumulated budget deficits. Typically, a wide range of entities purchase these notes, from foreign investors to state and local governments to the Federal Reserve. Intragovernmental debt is comprised of notes the federal government issues to its own agencies that invest their surplus trust fund cash into securities. A mutually beneficial pact, the trust funds temporarily transfer their excess funds to the federal government that needs financial assistance to cover deficits. The debts are then paid back in full along with interest when they mature or when the trust funds need cash flow to deliver benefits.[20]

Nearly 100 years ago, Congress passed the Second Liberty Bond Act of 1917, establishing a statutorily binding debt ceiling. Initially, the law was designed to streamline debt issuance by granting the executive branch authority to issue debt without being required to seek Congressional case-by-case approval so long as the limit has not been reached. [21]

Lifting the debt ceiling is not a mechanism by which Congress increases its spending obligations for the future. In order to fulfill spending obligations while running a deficit, the federal government must issue debt to a range of entities.

Since 1962, lawmakers have come together 81 times to ensure the federal government never breaches the debt ceiling.[22] However, over the past six years, Republican-led brinkmanship repeatedly brought the country to the precipice of default, and tarnished the nation's stellar AAA credit rating in the process, rattling domestic and international financial markets.

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