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Research Briefing | US

Debt ceiling time bomb

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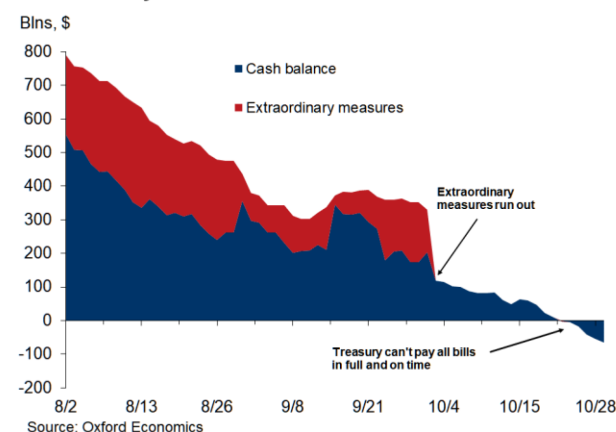
- **Congress must raise the debt limit by October 18 to prevent a possible Treasury default, financial market turmoil, and a self-inflicted recession. We believe the worst-case scenario will be avoided, but with Republicans and Democrats digging in, the debt-ceiling time bomb has yet to be defused.**
- **Republicans have refused to vote for a debt-limit increase, forcing Democrats to use the reconciliation process (requiring a simple 50-vote majority in the Senate). Democrats, however, are short on time to use this partisan procedure, and want to hold Republicans accountable for the potential crisis.**
- **Barring an agreement to raise the debt ceiling, the government can no longer issue new debt and must balance the budget by cutting government spending in half to equal revenue. Such a cut would equal at least 7% of GDP, pushing the US economy into a self-inflicted recession, if prolonged. The economy would lose over 5 million jobs, with the unemployment rate surging up to 8%.**
- **The 2011 debt-ceiling episode led to a spike in the VIX volatility index and to a massive 10% plunge in stock prices. While quickly reversed once the debt ceiling was raised, we shouldn't discount the risk from rapidly tightening financial conditions and the knock-on effects on private sector activity.**
- **If Congress fails to act in time, we expect Treasury to prioritize payments to bondholders and delay paying other obligations. While such an approach would avoid a pure debt default, it wouldn't prevent sharp plunges in consumer and business confidence and financial market turbulence, exacerbating the downturn in economic activity.**
- **The Federal Reserve will consider a range of escalating, emergency options aimed at promoting market functioning and stability in the banking system.**

Figure 1: US Treasury is running out of time and money



Treasury is likely to exhaust all its options to pay its bills on time and in full in mid-October. Treasury's special measures have been used up and available cash will fall short of what's needed soon after.

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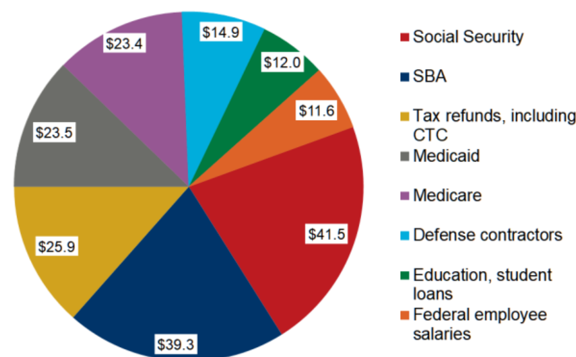
Democrats will have to pass a debt-limit hike without GOP votes

The latest suspension of the debt limit expired on July 31. Since then, Treasury has relied on its cash balance, incoming revenues, and "extraordinary measures" to pay its bills. Without action on the debt limit, the Treasury is expected to run out of the cash it needs to pay all its obligations in full and on time on October 18 **(Figure 1)**.

Currently, the most likely – although by no means certain – scenario is that Democrats enact a debt-limit increase as part of a reconciliation bill that is separate from the budget reconciliation bill.

Figure 2: Major Treasury payments due in the second half of October



Source : Oxford Economics/Haver Analytics

Key Treasury payments starting in mid-October include Social Security benefits and child tax credits (CTC). These payments will be a large drain on Treasury's cash balance.

Treasury has an (unofficial) backup plan

Treasury doesn't say so publicly, but there is a plan to manage a debt-ceiling crisis

If Congress doesn't act in time, Treasury would not be authorized to issue new debt and would have to fund the government with the cash on hand on any given day. Transcripts from FOMC meetings in both 2011 and 2013 show that Treasury and Fed officials had developed a plan to manage Treasury payments during those debt-limit crises:

- Payments on debt obligations would be prioritized.
- Principal on maturing debt would be paid by rolling over maturing debt at auctions, assuming investors continued to participate fully in those auctions.
- Interest on debt would be paid on time by conserving cash normally used to pay all other obligations, ranging from Social Security and Medicare benefits, to payments to defense contractors **(Figure 2).**
- Those other bills would be paid when Treasury accumulated sufficient cash through incoming revenues, after setting aside enough to meet upcoming interest payments.

Since interest payments on the debt are made through a separate payment system (Fedwire), we believe the Treasury could prioritize these payments, but creating a delayed system of payments for the remaining millions of other transactions executed each day could be extremely difficult. Even if successful, we expect significant fallout in financial markets if Treasury and Fed officials had to put such a policy in place.

The last two debt-ceiling crises (2011 and 2013) led to heightened uncertainty, and in the case of the 2011 crisis it sparked Standard & Poor's to downgrade the long-term credit rating of the US from AAA to AA+ for the first time ever. We can't rule out another debt downgrade even if Treasury avoids a debt default but doesn't honor other obligations.

The 2011 episode also led to a spike in the VIX volatility index, a massive 10% plunge in stock prices, and a flight-to-safety drop in the 10-year yield from 3.00% all the way to 2.11%. Though these shocks were swiftly reversed once the debt ceiling was raised, one

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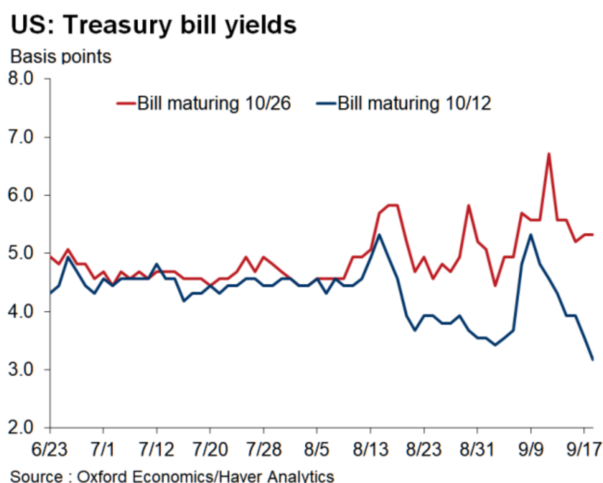
cannot discount the risk from rapidly tightening financial conditions and the ramifications for private sector activity.

Indeed, while financial markets have so far been mostly sanguine about the prospects of a debt-limit crisis, concerns about the debt cap have pushed up yields on bills maturing in the second half of October **(Figure 3)**. A similar market reaction to 2011 would knock the S&P 500 Index down to test the 4057 low from May 12 ahead of 4000. The ensuing flight to safety bid for Treasuries could push the 10-year yield back to test the 1.38% level that had been the key top to the narrow range that held throughout this past summer**.**

Figure 3: US Treasury-bill yields



Investors are demanding higher yields for T-bills that mature in late October and have been willing to accept less for bills maturing earlier in the month.

The Fed has developed a contingency plan

The Fed also has an (unofficial) plan

The transcript from the FOMC's unscheduled conference call on October 16, 2013, shows the Fed had developed a contingency plan to attempt to mitigate the economic and financial conditions impact from a technical default. If needed in the coming week, we believe the Fed would follow a similar plan.

At the time, while policymakers did not want to get "*entangled in fiscal policy decisions*" and worried about the "*the impression that the Federal Reserve was effectively financing government spending*," they understood the need for a contingency plan, with the acting as a backstop for financial markets and as the lender of last resort. In their discussion, they outlined a range of escalating, extraordinary measures aimed at promoting market functioning and stability in the banking system.

In the likely event that Treasury prioritizes its bond interest and principal payments, the impact on the financial markets and the banking system could be less severe, lessening the need for the Fed to take extreme actions. Still, financial markets stress would rapidly build until a permanent debt ceiling increase or suspension was voted. This would increase the drag from tighter financial conditions on the economy, and likely lead the Fed to delay its QE tapering plans (and possibly increase its asset purchases).

If the Treasury did not prioritize its payments and defaulted on Treasury interest or principal payments, the Fed would likely be forced to take on escalating measures to stabilize the financial system.

- **Traditional operations** could include continuing QE asset purchases, security lending, repo operations, and increasing bid limits for reverse-repo operations aimed at keeping the federal funds rate within its target range. Officials could also change the schedule or terms of currency swap arrangements if there is a surge

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in demand for US dollars. The regular operations could accept defaulted securities with applied market-determined price discounts if it was judged that delayed interest and principal payments would be made in full in a relatively short period of time.

- **Intermediate steps** would involve reducing the discount window rate to help promote broader liquidity and increasing the size of the recently instituted standing repo facility.

- **More extreme actions** would involve the Fed buying outright large volumes of Treasury securities including defaulted Treasuries or swapping non-defaulted Treasuries on its balance sheet for defaulted Treasuries in the secondary market. These actions could temporarily dampen market stress, but they would only address the symptoms, not the root cause of the crisis.

To avoid exacerbating market volatility and banking stress, the Fed would likely notify banks that risk-based capital treatment on US Treasury and GSE agency debt would remain unchanged despite a payment being missed. It would also temporarily relax its regulatory capital ratios for banks that experience large increases in their balance sheets stemming from large deposit inflows or draws on existing lines of credit. Lastly, it would encourage financial institutions to offer flexibility in working with their customers who might experience temporary financial hardship.

Still, there is a limit to how much the Fed could do. It wouldn’t manage to reverse the near-term hit to economic activity, nor the potential increased risk premium on Treasury bonds.

Failure to raise the debt limit would lead to a recession, if prolonged

Barring an agreement to raise the debt ceiling, the macroeconomic arithmetic is straightforward. Since the government can no longer borrow, it must balance the budget, or in other words government spending must equal revenues. With government outlays running much higher than revenues, we would expect to see a 50% cut to total federal spending. Using the Oxford Economics Global Economic Model (which factors second-round impacts), we consider a scenario in which Treasury abides by the statutory debt limit while prioritizing interest payments on the debt.

Since the US government is currently running a fiscal deficit of around 7% of GDP, we assume a cut to spending worth about $1.5tn. The spending cuts, *if prolonged*, would push the US economy into recession, and the downturn would be exacerbated by severe financial market turbulence and sharp plunges in consumer and business confidence.

The economy would lose over 5 million jobs with the unemployment rate surging up to 8%. Given the severity of such a self-inflicted economic shock, we wouldn’t expect politicians to stand idle for long. Indeed, as soon as Treasury fails to make full timely payments, voter pressure on Congress would likely force a deal.

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