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The Debt Ceiling: The Other Nuclear Threat

Vincent Reinhart | Chief Economist & Macro Strategist

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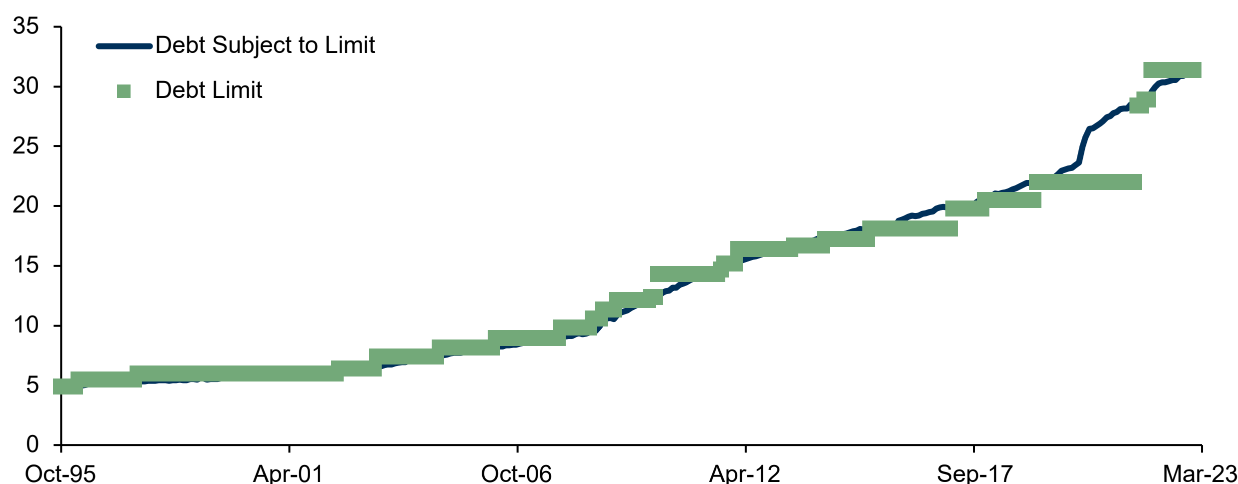
On January 13, US Secretary of the Treasury Janet Yellen informed the Congress that there was no headroom under the ceiling on the public debt subject to limit beginning January 19. This marks the start of a debt suspension period that allows the Treasury to take extraordinary measures in fiscal management. This includes the now-familiar disinvestment of a few retirement trust funds and swapping nonmarketable interest-bearing debt that counts toward the limit for obligations that do not. The Treasury gains almost six months of issuance before it no longer has sufficient funds in its account at its fiscal agent, the Federal Reserve (Fed). This is the crunch because the Federal Reserve Act forbids the Fed from lending directly to the Treasury. Meanwhile, officials and investors dust off contingency plans for the possibility that failure to raise the debt ceiling forces the Treasury to default on debt, something threatened often but that has never happened.[1]

Public Debt Subject to Limit and its Ceiling
Trillions of dollars



Source: Bloomberg, accessed 1/27/2023.

Why Threaten It If It Never Happens?

In a divided Congress, politicians have few opportunities to advance their legislated agendas. Some essential bills have to be passed, including funding the government and providing the Treasury borrowing authority. Threatening to impede such legislation is a lever to force passage of other policy initiatives, explaining the recurring threats about not providing budget authority or raising the debt ceiling.

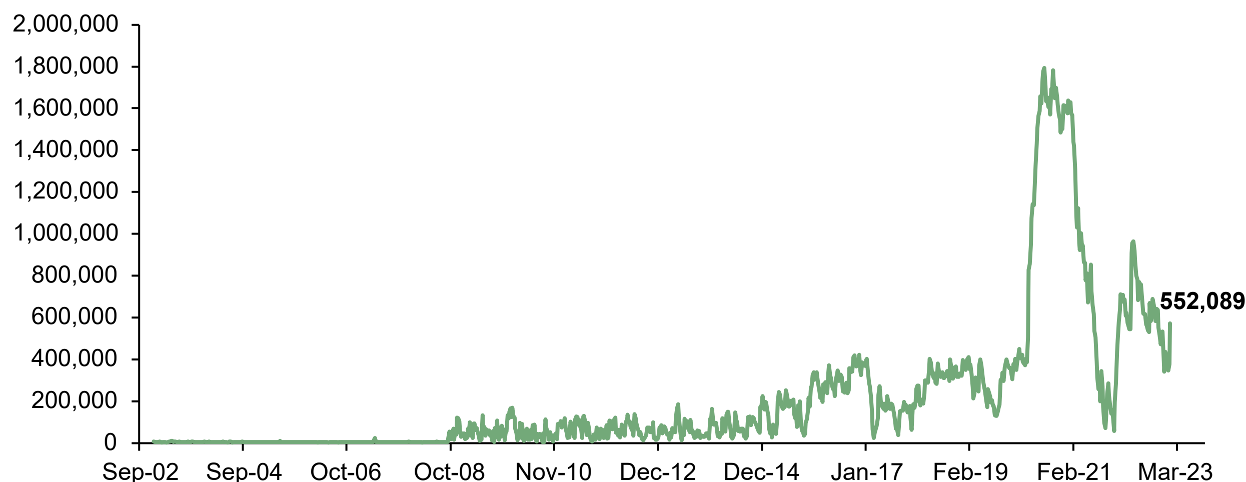
- **Budget Authority:** Failure to provide budget authority shuts down the government, which has happened several times over the past two decades, and it effects only a portion of government operations.

- **Raising the Debt Ceiling:** Delaying an increase to the debt ceiling to the point that the Treasury runs out of cash and cannot meet interest and principal payments has not happened before because the cost may be materially higher depending on the context. On the one hand, if investors doubted whether they would ever be repaid, the credit rating of the US would be marked decidedly lower, potentially knocking US dollar debt off its pedestal as a safe-haven asset. Borrowing costs for the government, when it could borrow again, would rise, lifting the rates on private sector debt priced to it. On the other hand, if investors were confident that payments were only briefly paused and they would quickly be made whole, market disruptions would be contained, but the reputational stain would linger.

These uncertain but certainly calamitous effects on financial markets from a US default have previously stopped politicians from going over the brink. The threat of going over the brink, however, gets them attention and may get them some of what they want legislatively. One side backs down when it concludes it is getting the lion's share of public criticism during the debt-ceiling dysfunction, and that can either be the politicians who threaten not raising the debt ceiling or the politicians supporting the policies that the opposition want to stop.

We suspect that the timing of the debt-ceiling emergency reflects this political calculus. The Treasury added almost $200 billion to its cash account at the Fed to bring it to more than $500 billion during the week of Secretary Yellen's announcement. That is, the Administration rushed to hit the limit, probably to bring up the standoff while the reputation of Republicans was still reeling from its disorderly choice of Speaker of the House.

Treasury Deposit at the Federal Reserve | Treasury General Account (TGA)
Millions of dollars



Source: Federal Reserve H4.1, accessed via Federal Reserve Economic Data (FRED) on 1/27/2023.

Is This Time Different?

The precedent that politicians have always stopped short of the cliff's edge is reassuring, but past performance is not always predictive of the future, especially as partisan divisions have ratcheted higher. Moreover, political brinksmanship may shift given progress of the payments system.

- In earlier episodes, the Fed was unable to prioritize payments, implying that the possibility of a Treasury overdraft of its account would require stopping all payments, including those on coupon and principal of debt.

- Now with most payments electronic, at the Treasury's behest, the Fed can pend some payments and continue others to keep the Treasury account out of the red. Practically, by pending vendor payments, workers' salaries and even retirees' pension payments, the Treasury could hoard cash to continue to meet debt payments for a long time. Some politicians may be reassured that the Treasury would opt to do so, avoiding default and turning failure to raise the debt ceiling into a more minor inconvenience on par with shutting down the government. If so, they would be much more willing to leap over the cliff.

- However, there are two sides to that coin. Prioritization would ignite a firestorm of criticism about missed payments on Social Security and other entitlements. The ethics and optics of not paying, say, the military or Social Security recipients to conserve cash for debtholders is, to be understated, problematic. Of course, this also involves violating the laws in which Congress authorized the pended payments to be made.

Welcome to the Club

This may be new to the US, but it is common around the world. Many other governments resort to "below the line" financing to keep the show running by letting arrears mount with vendors, employees and retirees. By relying on arrears to the private sector, the US will move up in the league table of late-payers to join the company of Greece and Italy.

Who Pays for This?

The US taxpayer pays for this because the standoff is costly. The Treasury incurs administrative expenses to put extraordinary measures in place and to tailor new issuance to the room under the ceiling (including with cash-management bills that are more expensive).

- More broadly, these episodes tarnish the US reputation as a safe haven. The downgrade of the US debt rating by Standard & Poor's® (S&P®)[2] in 2011 was explicitly attributed to debt-ceiling drama.

- Concern over the debt ceiling is proportional to the distance from the New-York-to-Washington-DC corridor. Having seen it often before, market participants are mostly inured to the drama, only pricing in premiums in advance associated with the interruptions to typical Treasury issuance and, perhaps, the possibility of a technical hiccup around the "x-date." Foreign investors are usually more troubled by the headlines describing a byzantine and opaque process that risks significant capital losses.

OUR VIEW

Despite the coming histrionics, the nation has never hit the drop-dead date of running out of cash while the debt ceiling binds, presumably because the stakes associated with failure are so high. Expect the same, but this episode may be closely run and uncomfortable. The unfortunate analogy is the threat of a nuclear weapon. Mutual assured destruction implies that rubble results from the first use, which presumably has stayed the hand of leaders since World War II. Even so, we are still right to worry, sometimes more so than at other times.

The Constitution enumerates the powers of Congress, including its ability to authorize spending, levy taxes, coin money and issue debt. Since the Second Liberty Bond Act of 1917, Congress has delegated debt issuance to the Treasury subject to an overall cap on the amount outstanding. The cap has been raised and its form revised over the years, transforming that $15 billion limit in 1917 to the $31.4 trillion ceiling that was signed into law by President Biden in December 2021. On occasion, legislation suspended the limit, so the ceiling does not plot a solid line to the sky over the past 105 years.

The logical problem is that Congress also takes spending and revenue actions. If the outflows from spending exceed the inflows from revenue, debt must be issued as a matter of arithmetic. Imposing a restriction on top of this is either redundant or overdetermined when the cumulated flows do not add up to the mandated stock. Our elected officials cling to this redundancy because it is baked into the Constitution's separate authorizations of spending, taxing and issuing. The charitable interpretation is that the debt ceiling is a level check on the Constitutional authority of Congress and debt issuance delegated to the Treasury. Don't ever expect Congress to surrender it.

The concept of debt subject to limit includes both debt held by the public and intragovernmental holdings, mostly trust funds. Thus, the ceiling is not a measure of net exposure to the private sector (and the public here includes the Federal Reserve, an agency of the US government). To some extent, the debt the government owes to itself embodies some of its contingent liabilities. However, the trust funds do not come close to the total contingent liabilities of the government.

Gimmicks abound around these debt-ceiling events. If the Secretary of the Treasury declares a "debt issuance suspension period," the Treasury can replace obligations from some trust funds with IOUs that do not count toward the limit, opening headroom for marketable borrowing. These unconventional devices are administratively costly and make the government accounts more opaque, as outlined by the US Government Accountability Office.

Lawbreaking is not typically a legislated instruction, but it is in debt-ceiling events. Fundamentally, there are three governing instructions:

- The Second Liberty Bond Act of 1917 (and its successors) set an overall limit on the public debt
- The Federal Reserve Act of 1913 forbids the central bank to lend directly to the US Treasury
- The 14th Amendment to the US Constitution directs that "...the validity of the public debt of the United States, authorized by law...shall not be questioned."

The Fed, as the fiscal agent of the Treasury, processes all payments, including coupon and principal payments; it also offers the Treasury a deposit account for its cash. The drop-dead date for a debt-ceiling crisis occurs on the day when the Treasury does not have enough funds in its Fed account to make its payments. The Fed cannot let the Treasury overdraft its account, so it pends payments until sufficient funds flow in. If those scheduled but suspended payments are for coupon or principal remittances, the result is default. On that day, officials have a choice:

- The Secretary of the Treasury could sell marketable debt above the limit, violating the Second Liberty Bond Act
- The Chair of the Federal Reserve could allow the Treasury to overdraft, violating the Federal Reserve Act
- The Secretary of the Treasury could allow default, violating the 14th Amendment by calling into question the validity of the debt

None of these are good choices, any are grounds for removal with cause, and all would probably, in our view, lead the rating agencies to opine about the creditworthiness of the US government.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Vincent Reinhart
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

[1] The US has never defaulted because of Congress' failure to raise the debt ceiling. However, the British invasion of Washington during the War of 1812, the revocation of the gold clause by Franklin Roosevelt, and a technical glitch in the early 1970s triggered defaults.

[2] Standard & Poor's (S&P) is a leading index provider and data source of independent credit ratings.

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