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Economic Views Brief

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Another debt ceiling fight looms as a potential source of volatility.

The federal government is once again at its self-imposed debt limit. On Friday, January 13th, Treasury Secretary Janet Yellen sent a letter to Congress stating that the federal government's statutory debt limit would likely be reached on Thursday, January 19th. After that time, the Treasury Department would once again employ "extraordinary measures" to keep the government's bills paid until new legislation is enacted to raise the limit.

Currently, the limit as to how much government debt can be issued by the Treasury Department to finance government operations and programs is $31.4 trillion (as set by Congress in December 2021). As of Friday, Jan. 13th, government debt subject to the limit had reached $31.3 trillion, according to Treasury. In her letter to House Speaker McCarthy, the Treasury Secretary estimated that the use of extraordinary measures would enable the Treasury Department to manage the government's obligations through at least early June.

Unfortunately, we could see yet another anxiety-inducing political battle over this issue, thus driving it down to the wire. The Biden Administration has said that the limit should be raised as soon as possible and without condition. However, according to CNBC, Speaker McCarthy *"has made little secret of the fact that Republicans intend to demand massive spending cuts to the federal budget in exchange for approving an increase in the debt ceiling."*

Key Takeaways

- The federal government has once again reached its debt limit. Over the next several months, Congress and the President will need to come to an agreement on raising the limit as to avoid a devastating default.
- The debt ceiling is a self-imposed legal limit on the amount of debt that can be issued by the federal government.
- Since 1990, the debt ceiling has been raised or suspended a total of 21 times, according to the Treasury Department.
- Given its importance, financial markets could experience a growing sense of concern (i.e., incremental volatility) until this issue is resolved.

Two key points:

- A potential source of added volatility financial markets do not need. Passing legislation to raise the debt ceiling appears as though it could once again become a political struggle over the next several months. However, we believe the odds of a default are very remote as a lack of timely action would carry significant, and lasting, economic consequences, in our opinion.
- Low odds /very high risk. A default, even a very short-lived one, would very likely carry severe economic and financial market consequences. As such, any political party that could be blamed for such a self-inflicted economic injury would likely face serious long-term negative repercussions. A default would likely result in materially higher borrowing costs for the federal government, thus also raising the borrowing costs of consumers and businesses as well. Further, it would likely lead to a decline in the value of the dollar and have a very disruptive influence on global financial market functioning. Importantly, this is a completely and easily, avoidable path.

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Secretary Yellen's letter additionally stated:

> *"Failure to meet the government's obligations would cause irreparable harm to the U.S. economy, the livelihoods of all Americans, and global financial stability. Indeed, in the past, even threats that the U.S. government might fail to meet its obligations have caused real harms, including the only credit rating downgrade in the history of our nation in 2011. Increasing or suspending the debt limit does not authorize new spending commitments or cost taxpayers money. It simply allows the government to finance existing legal obligations that Congresses and Presidents of both parties have made in the past."*

Unfortunately, we've been here several times over the last two decades. Reaching the debt limit does not mean a dead stop for government spending or immediate limitations on government debt refinancing (so long as the total value outstanding does not rise). When the limit is reached, the Treasury Department employs what it calls "extraordinary measures" to keep from exceeding the limit, usually for several months. Extraordinary measures essentially mean moving moneys around from different accounts or delaying some payments.

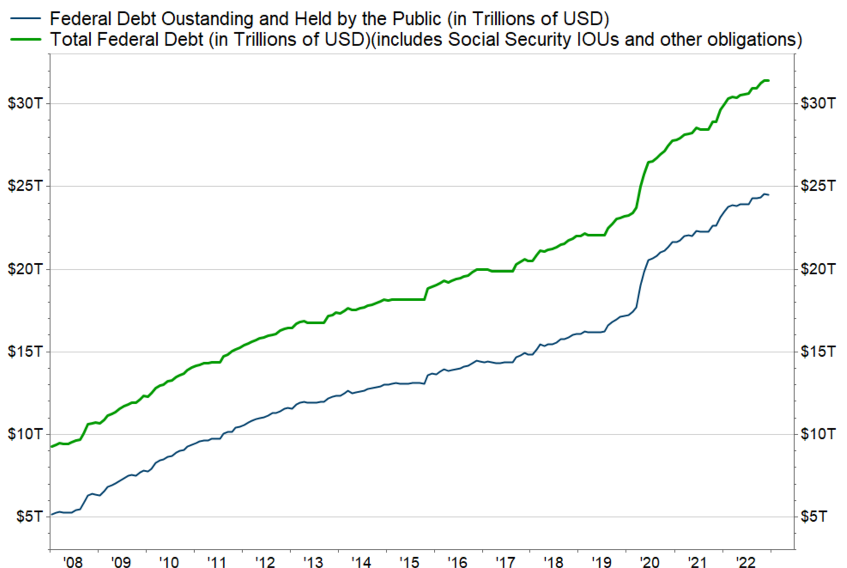
As was the case in past instances, we feel strongly that no principle or interest payments on U.S. government debt will be missed, this time either. The consequences of such a decision would be, as the Federal Reserve has described it, "severe," and solely self-inflicted. However, that doesn't mean that financial markets will not worry about such an outcome as time passes without an agreement. We note that the protracted debt ceiling fight of 2011 led Standard & Poor's to downgrade its U.S. government credit rating to AA+ from AAA.

U.S. Treasury operations are a key function of the global financial system, and financial computer networks are built on its systematic principal and interest payments. As many are aware, U.S. Treasury operations are SO entrenched in financial literature that financial formulas and theory have long referred to Treasury rates as the "risk free rate" (textbooks would have a lot of re-writing to do).

Few things are certain in Washington, but we believe no political party would want their name attached to such an avoidable disruption and the serious long-term consequences that a default would bring. We believe the debt ceiling will be raised, but it will remain an over-hanging concern for financial markets, the media, and all of us as citizens, until it is.

The chart at right shows two measures of U.S. government debt. The blue line shows the total value of U.S. government debt securities issued and outstanding. The green line (which is subject to the debt ceiling) includes other government obligations for which debt securities have not been issued and publicly outstanding. This latter category includes things such as certain government pension fund obligations and Social Security Trust Fund "IOUs".

The chart at right is sourced from FactSet and represents data through December 30, 2022.



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As of December 31, 2022

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