The Costs of Debt Limit Brinksmanship*

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Vice-Chair Klobuchar, Chairman Brady, and Members of the Committee, thank you for inviting me to discuss the debt limit. It's a particular honor and pleasure to appear before this Committee, which gave me my start in public service more than a decade ago.

As you know, the federal government reached the debt limit in May. Since then, Treasury has used a variety of extraordinary measures, such as suspending investments in the Thrift Savings Plan's G-Fund, to stay within the limit. Those measures will be exhausted in mid-October, according to Treasury Secretary Jack Lew, leaving the government with just $50 billion of cash on hand.[1] The debt limit will become truly binding sometime soon thereafter. For example, the Bipartisan Policy Center projects that the "X Date" will fall between October 18 and November 5.[2] After that, Treasury won't be able to pay all of America's bills.

Congress should keep four things in mind as it works to raise the debt limit before that deadline.

1. Congress must increase the debt limit. Failure to do so will result in severe economic harm.

2. Debt limit brinksmanship is costly, even if Congress avoids breaching the limit at the last minute. The 2011 showdown scared investors and consumers, weakened the economy, and drove up Treasury borrowing costs.

* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its trustees, or its funders. Erin Behrman, Len Burman, William Gale, Benjamin Harris, Erika Poethig, Roberton Williams, and Eric Toder provided helpful comments, but all errors are my own.

[1] Lew (2013)

[2] Bell et al. (2013)

3. Our economy remains fragile. Unemployment has declined since the worst days of the Great Recession but remains far too high. Full employment appears to be years in the future. Now is not the time to hit the economy with unnecessary shocks.

4. The long-run budget outlook remains challenging. Deficits have fallen sharply in the past few years, due to the economic recovery, fading stimulus, deficit reduction efforts, and slower growth of health care costs. But current budget policies would still create an unsustainable trajectory of debt in coming decades. Congress should address that problem. But the near-term fiscal priorities are funding the government and increasing the debt limit.

Given the focus of today's hearing, I focus on the first and second points in the remainder of my testimony.

Failing to raise the debt limit would hurt our economy, perhaps catastrophically

If Congress fails to increase the debt limit, Treasury won't be able to pay all of America's bills. Someone—perhaps millions of someones—won't be paid on time. The resulting economic damage would grow with each passing day.

Delaying and prioritizing non-debt payments

After the "X date," Treasury would have to delay or stop transfer payments, employee salaries, and other non-debt payments. A key question is how it would do so.

One approach would be to delay payments day-by-day until sufficient resources are available. For example, if Treasury owed $15 billion on a particular day but had only $5 billion of free cash, it could wait—a day or a week or a month—until it had the full $15 billion in hand and then make all of those payments together. It could then repeat the process for the next day's set of payments. With each passing day, unpaid bills would pile up further, and payments would become more and more delayed. According to Treasury's Inspector General, officials concluded that this approach was "the least harmful option available to the country" during the 2011 debt limit impasse.[3]

Another approach would be for Treasury to pay some bills as they come due, while delaying others indefinitely. For example, Treasury might (hypothetically) prioritize

[3] Thorson (2012).

unemployment insurance and veterans' benefits, while delaying tax refunds and payments to contractors. In theory, such prioritization might allow Treasury to avoid some of the worst damage from a sudden stop in federal payments. In reality, however, it poses a host of logistical, legal, and political challenges. For example, Treasury's systems are not designed to allow picking and choosing among the more than 80 million payments it makes each month; payments are automatically made as they come due.[4]

Either approach would damage the economy. Federal employees, contractors, program beneficiaries, businesses, and state and local governments would find themselves suddenly short of expected cash, creating a ripple effect through the economy. Delays would be short at first, but would grow rapidly given current borrowing needs. The Bipartisan Policy Center estimates, for example, that if we hit the "X date" on October 18, Treasury will be more than $100 billion short in paying all its bills over the following month.[5]

Such delays could pose a significant challenge for any families or businesses that operate with tight budgets. Through no fault of their own, they could find themselves unable to pay their own bills.

The personal costs of delayed payments would grow, of course, as delays mounted. So would the macroeconomic damage. A short delay in non-debt payments might do relatively little harm to the overall economy, but a prolonged delay would be a powerful "anti-stimulus." In essence, the federal government would have to balance its budget immediately by cutting spending. That shock would grow with each passing month (except those occasional ones in which the government runs a surplus). It would also undermine confidence and increase economic uncertainty, further discouraging economic activity. During January's debt limit debate, Macroeconomic Advisers (2013) estimated that such spending cuts could drive the economy into a deep recession. Deficits have since come down, so the effect would be smaller today, but the basic result still applies. If the government has to suddenly move to a balanced budget for an extended period, the U.S. economy would likely plunge into recession.

Debt default

An even more severe possibility is that Treasury might default on the federal debt. To prevent that from happening, I expect that Treasury will attempt to prioritize interest and principal payments, but there is a risk that it won't succeed.[6]

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[4] Thorson (2012).
[5] Bell et al. (2013).
[6] The Bipartisan Policy Center (Bell et al. 2013) and Macroeconomic Advisers LLC (2013) also anticipate this approach. As far as I know, no administration representative has publicly endorsed

Prioritizing debt payments over other obligations is technically feasible because they go through Fedwire, a computer system separate from the one that handles other payments. It is also appropriate because it would maintain the full faith and credit of the United States in financial markets. Less clear is whether prioritizing debt payments would be financially feasible. Interest payments average only 8 percent of federal revenues at the moment,[7] but cash management isn't about averages. Interest payments are lumpy, and tax receipts are lumpy and uncertain, so Treasury would have to take care in matching them. In addition, there's a risk that a debt limit crisis may cause problems rolling over maturing debt issues. For both reasons, debt prioritization is harder than sometimes claimed, and Treasury might unintentionally find itself short of cash when an interest payment comes due or maturing debt needs to be rolled over.

In considering this risk, Congress should keep in mind that accidents can happen. In 1979, for example, Treasury accidentally defaulted on a portion of the debt in the wake of a debt limit showdown:

> Investors in T-bills maturing April 26, 1979 were told that the U.S. Treasury could not make its payments on maturing securities to individual investors. The Treasury was also late in redeeming T-bills which became due on May 3 and May 10, 1979. The Treasury blamed this delay on an unprecedented volume of participation by small investors, on failure of Congress to act in a timely fashion on the debt ceiling legislation in April, and on an unanticipated failure of word processing equipment used to prepare check schedules. (Zivney and Marcus 1989)

That default was narrow, applying only to T-bills owned by individual investors, and was rectified in a few weeks. Nonetheless, financial markets reacted badly. Zivney and Marcus (1989) estimate that T-bill interest rates increased by about 60 basis points after the first default and remained elevated several months thereafter. The default thus significantly boosted the government's borrowing costs.

If a debt limit impasse forced Treasury to default on the debt today, the results would be at least as severe. Faced with new risks, investors would demand a premium to invest in U.S. Treasuries. Debt service costs would rise, crowding out funding for government programs, forcing higher taxes, or boosting deficits.

But higher interest rates are only the beginning of the costs. Default would also threaten our financial system and, thereby, the real economy. Treasury securities play a unique and

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debt prioritization, but in the final days of the 2011 impasse, one anonymous official reportedly said that Treasury would do it if necessary (Cook and Hopkins 2011).

[7] Congressional Budget Office (2013).

vital role in financial markets. Large swaths of America's financial infrastructure have been built on the assumption that U.S. Treasuries pay on time. Treasury securities serve as collateral in the short-term lending markets that provide trillions of dollars of liquidity to the financial system. In addition, money market funds hold Treasury securities to make sure they can repay savers' investments.

Those financing arrangements all presume that Treasuries are money-good. If the federal government defaulted, those markets would begin to unravel. Credit would tighten, financial institutions would scramble for cash, and savers might desert money market funds. The magnitude of the resulting economic harm is difficult to judge and would depend on the scope and duration of the default. But anyone who remembers the financial crisis of five years ago should shudder at the thought of disrupting these markets again.[8]

"Super-extraordinary" measures won't save us

Given the severe economic harm of delaying payments or defaulting on the debt, many observers have wondered whether Treasury might find another way out—a "super-extraordinary" measure—that would allow it to keep paying America's bills even if the debt limit isn't raised. Ideas include ignoring the debt limit on the grounds that it violates the 14th Amendment to the Constitution,[9] using a loophole in coinage laws to mint platinum coins of extremely large denominations,[10] or selling gold or other assets owned by the government.

These ideas differ in their particulars, but share one common feature: administration officials have rejected all of them as impractical or illegal. The president's lawyers reportedly do not believe that the 14th Amendment gives him the authority to ignore the debt limit.[11] Treasury and the Federal Reserve announced that platinum coins won't work.[12] And Treasury officials have concluded that selling gold would be "destabilizing to the world financial system" and that selling student loans (the government's largest financial asset) would not be feasible.[13]

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[8] Matthew Zanes (2012) describes the financial market risks at greater length; at the time, he chaired the Treasury Borrowing Advisory Committee.
[9] Section 4 of the amendment reads: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."
[10] Marron (2013).
[11] See, e.g., Calmes and Hulse (2011): "'I have talked to my lawyers,' Mr. Obama said, and 'they are not persuaded that this is a winning argument.'"
[12] Klein (2013) quotes Treasury spokesman Anthony Coley: "Neither the Treasury Department nor the Federal Reserve believes that the law can or should be used to facilitate the production of platinum coins for the purpose of avoiding an increase in the debt limit."
[13] Thorson (2012).

Treasury thus has no good options when the debt limit clock runs out. Billions, then tens of billions, then hundreds of billions in federal obligations would go unpaid, and millions of Americans would suffer the consequences.

Brinksmanship also imposes large economic and fiscal costs

Going past the "X date" would harm our economy and our people. That's why it's vital for Congress to increase the debt limit.

But that isn't enough. To completely avoid harm, Congress must do more: it must raise the debt limit without the extreme brinksmanship we saw in 2011. Such brinksmanship does not come free; instead, it imposes costs in its own right.

First, and most important, is the risk of making a mistake. Cash flows are uncertain, and parties to heated negotiations sometimes misread their opponents' position and capabilities. As a result, there is always the risk that brinksmanship would result in the United States going over the brink by accident, delaying payments and raising the risk of debt default.

Second, interest rates would rise. Investors are forward-looking. If they believe there is a real risk that Treasury might default in the future, they will demand a premium for holding Treasury securities today. That's exactly what happened during the 2011 crisis. As documented by the Government Accountability Office (2012), the funding advantage that the United States enjoys over private businesses narrowed during that debate, suggesting that investors saw greater risk in holding Treasuries. GAO estimates that the federal government paid out an extra $1.3 billion in interest during fiscal 2011 as a direct result. Over the full maturity of the debt, that figure balloons to $18.9 billion according to the Bipartisan Policy Center. Brinksmanship can be expensive.[14]

Third, debt limit showdowns increase uncertainty and reduce confidence. As a result, families and businesses may cut back on their spending and investment while they wait to see what will happen. During the 2011 debt limit crisis, consumer confidence and the stock market both plummeted and concern about financial market risks skyrocketed.

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[14] The GAO (2011) notes that debt limit impasses disrupt the regular schedule of Treasury bill and bond auctions and thus weaken Treasury's ability to get the lowest interest rates. The GAO estimates that the debt limit debates in 2002, 2003, and 2010 "modestly" increased borrowing costs as a result.

Finally, brinksmanship weakens America's global image. The United States is the only major nation whose leaders talk openly about the possibility of self-inflicted default. At the risk of sounding like Vladimir Putin, such exceptionalism is not healthy. As every other nation understands, if you need to borrow, you can only hurt yourself by scaring your creditors. But the problem is deeper than that. Debating intentional default contributes to the perception that the United States does not know how to govern itself.

The debt limit is one failure of a broken budget process; we need a new one

The debt limit is a peculiar and flawed feature of America's fiscal policy. Borrowing decisions cannot be made in a vacuum, separate from other fiscal choices. America borrows today because this and previous Congresses chose to spend more than we collect in revenue, sometimes with good reason, sometimes not. If Congress is concerned about debt, it needs to act when it makes those spending and revenue decisions, not months or years later when financial commitments are already in place.

When the dust settles on our immediate fiscal challenges, Congress should re-examine the entire budget process, seeking ways to make it more effective and less susceptible to dangerous, after-the-fact brinksmanship.

Thank you again for inviting me to appear today. I look forward to your questions.

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