Deficits, Debt, and Debt Ceilings

Background and Definitions

- During the 2020 recession and since, the USG has been incurring large budget deficits and increases in government (also referred to as national and public) debt.
- The Biden Administration’s budget, if approved (?), looks to continue large deficits.
- And, come December, the Debt Ceiling will return to scene.
- This topic examines these trends and issues.

Background and Definitions

- First some definitions.
- Budget deficit is the amount by which USG revenues fall short of USG expenses in a given fiscal year or other period.
- Government debt is the amount the USG owes all creditors at any point in time; it also is sum of all deficits ever run less any surpluses
- This debt appears in 2 ways. Gross debt is simply the total amount of the debt. Net debt, or more correctly debt in the hands of the public, is the debt that is not held by USG and USG-like agencies such as Social Security Administration, Fannie/Freddie/ Sallie Mae, and includes debt held by all domestic and foreign private creditors, the Federal Reserve, and foreign central bank and governments.
- The Debt Ceiling, at any point in time, is amount of Gross Debt that Congress has authorized the USG to have outstanding (see also next slide).

Debt Ceiling Details

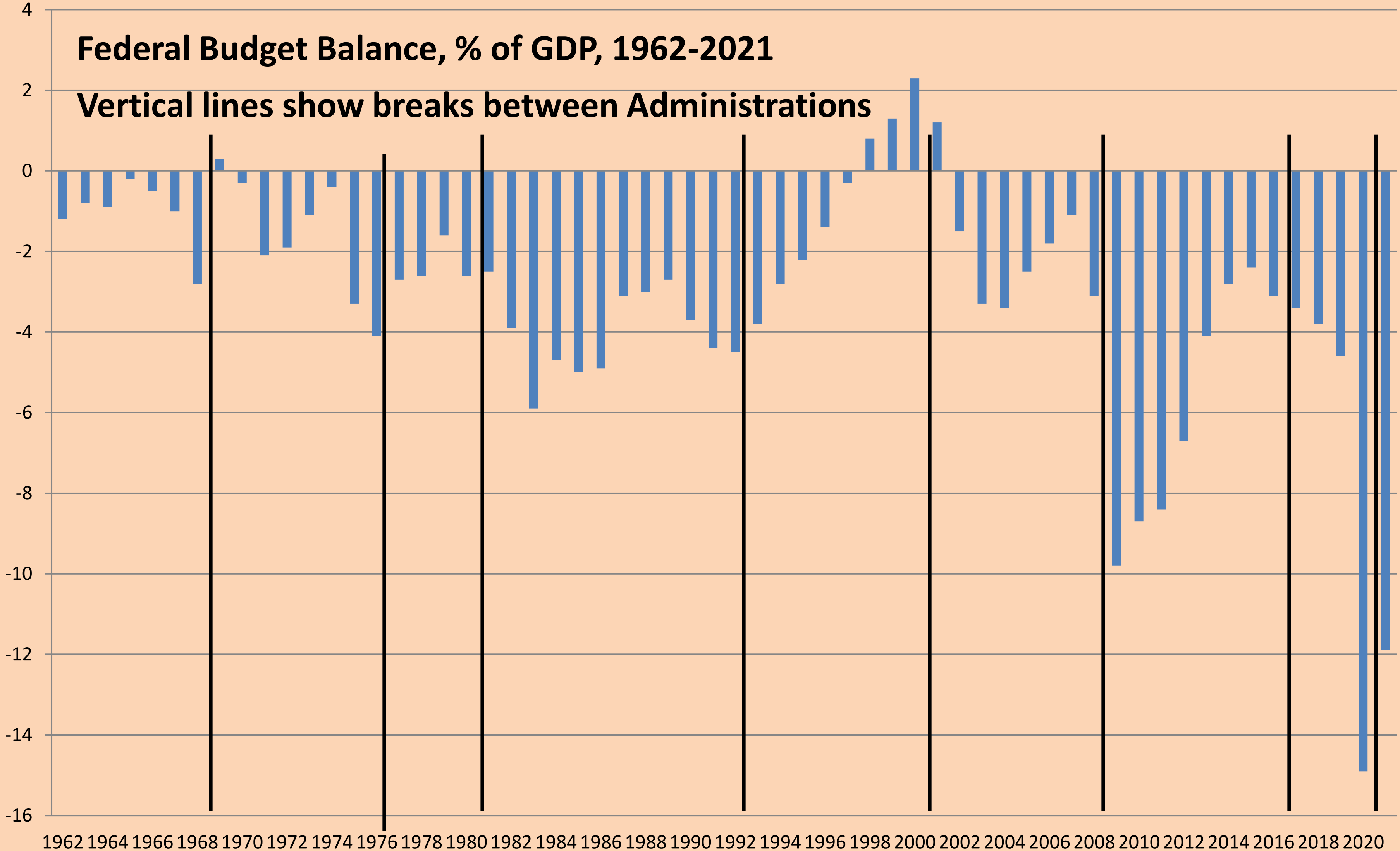
- The debt ceiling is the maximum amount that the U.S. government can borrow by issuing bonds. It was created under Second Liberty Bond Act of 1917
- When the debt ceiling is reached, the Treasury Department must find other ways to pay expenses. Otherwise, there is a risk the U.S. will default on its debt.
- The debt ceiling has been raised or suspended several times to avoid the risk of default.
- There have been a number of showdowns – 78 since 1960, 49 under Republican Presidents, and 29 under Democratic Presidents – over the debt ceiling, some of which have led to government shutdowns. The conflict is usually between the White House and Congress, and the debt ceiling is used as leverage to push budgetary agendas.

More Debt Ceiling Details

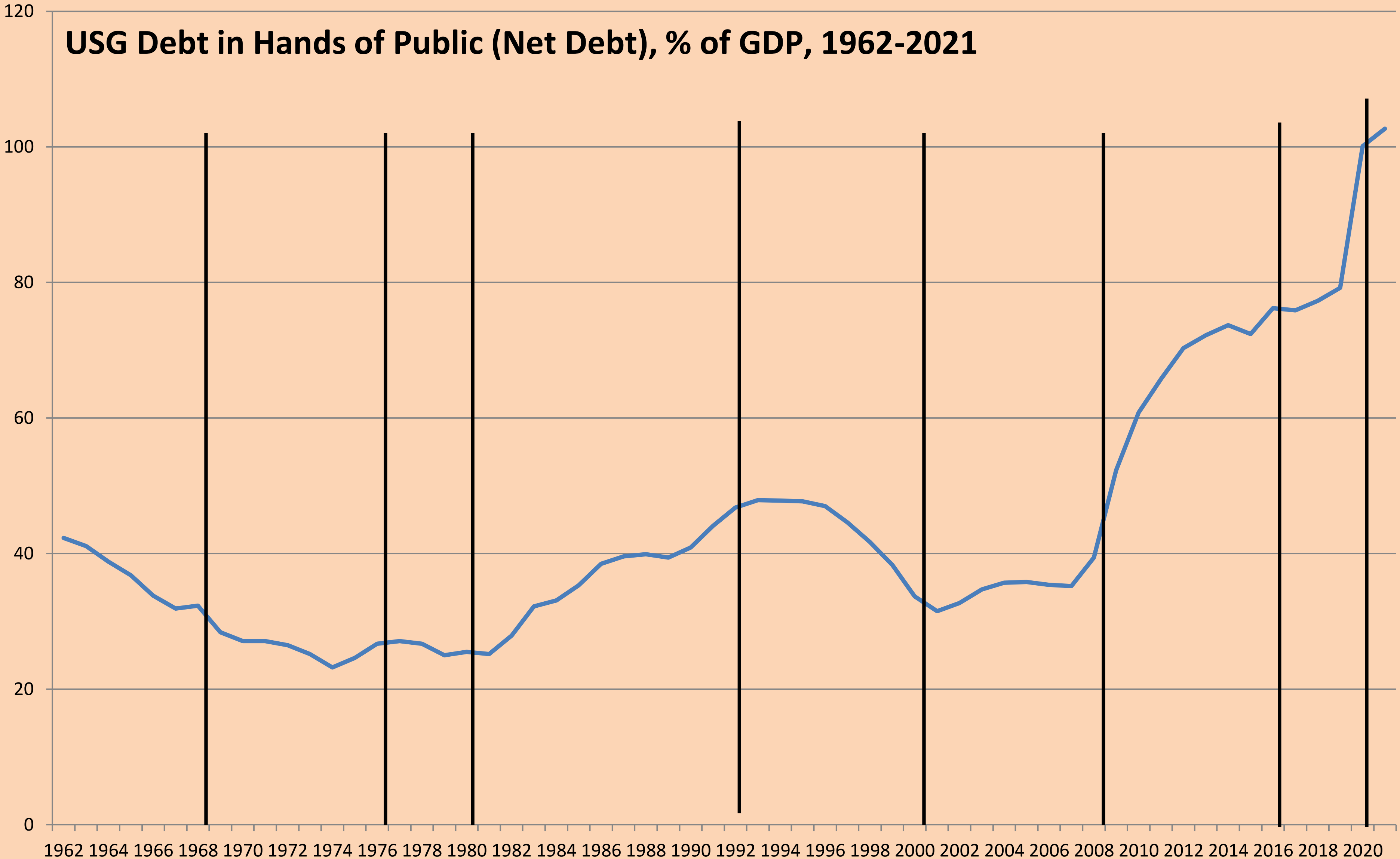
- Debt Ceiling FAQs
- What is the current debt ceiling?
- The current debt ceiling was suspended by former President Trump until July 2021.
- Who controls the debt ceiling?
- The debt ceiling is approved by Congress.
- What happens if the debt gets too high?
- Hitting the debt limit and failing to pay interest payments to bondholders would have grave economic consequences. The United States government would be in default, lowering its credit rating and increasing the cost of its debt. This would throw the U.S. economy into a tailspin.
- Is there a limit to the national debt?
- The debt ceiling is the limit set on the amount of debt the U.S. government is allowed to incur. As of April 8, 2021, the U.S. national debt was $28.1 trillion and rising.[6]

Trends

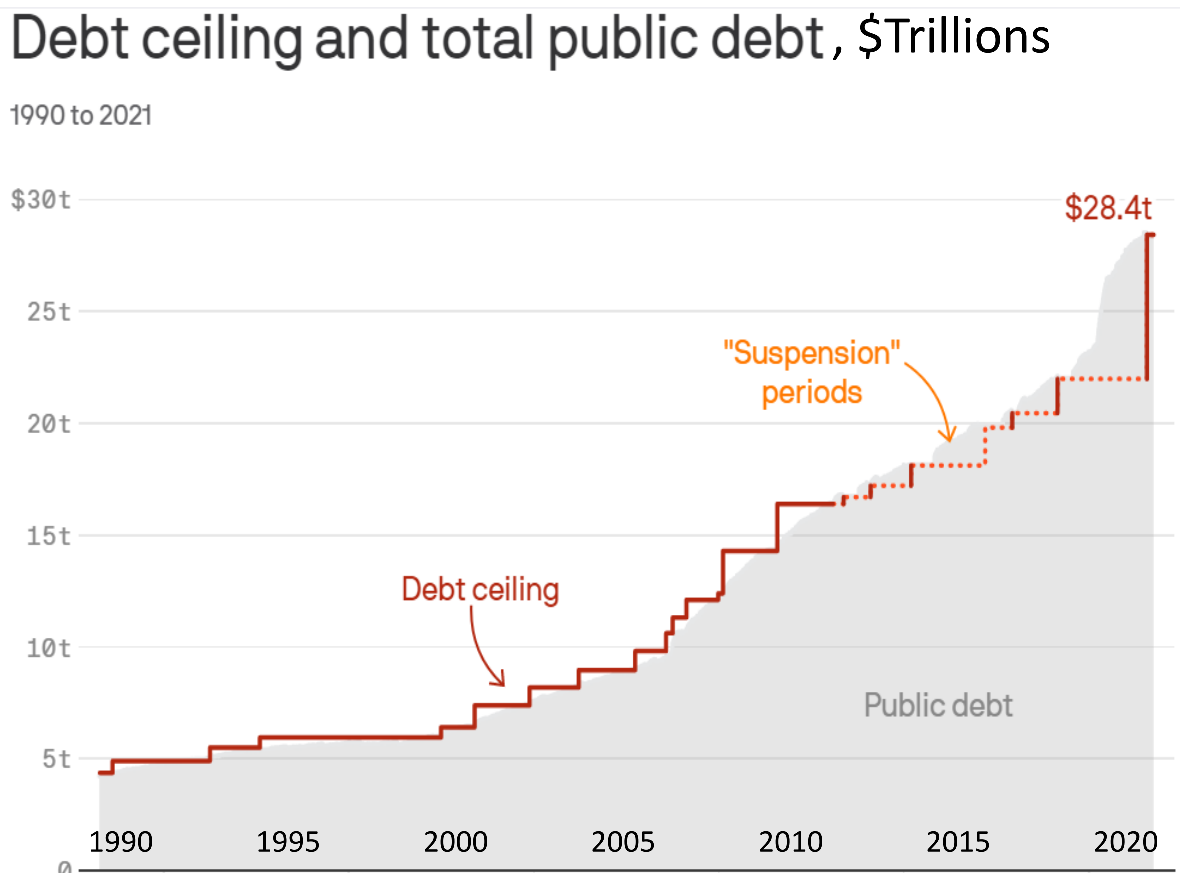
- This and following slides shows trends in deficits and debt.



Trends


USG Debt in Hands of Public (Net Debt), % of GDP, 1962-2021
0
20
40
60
80
100
120
1962 1964 1966 1968 1970 1972 1974 1976 1978 1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012 2014 2016 2018 2020

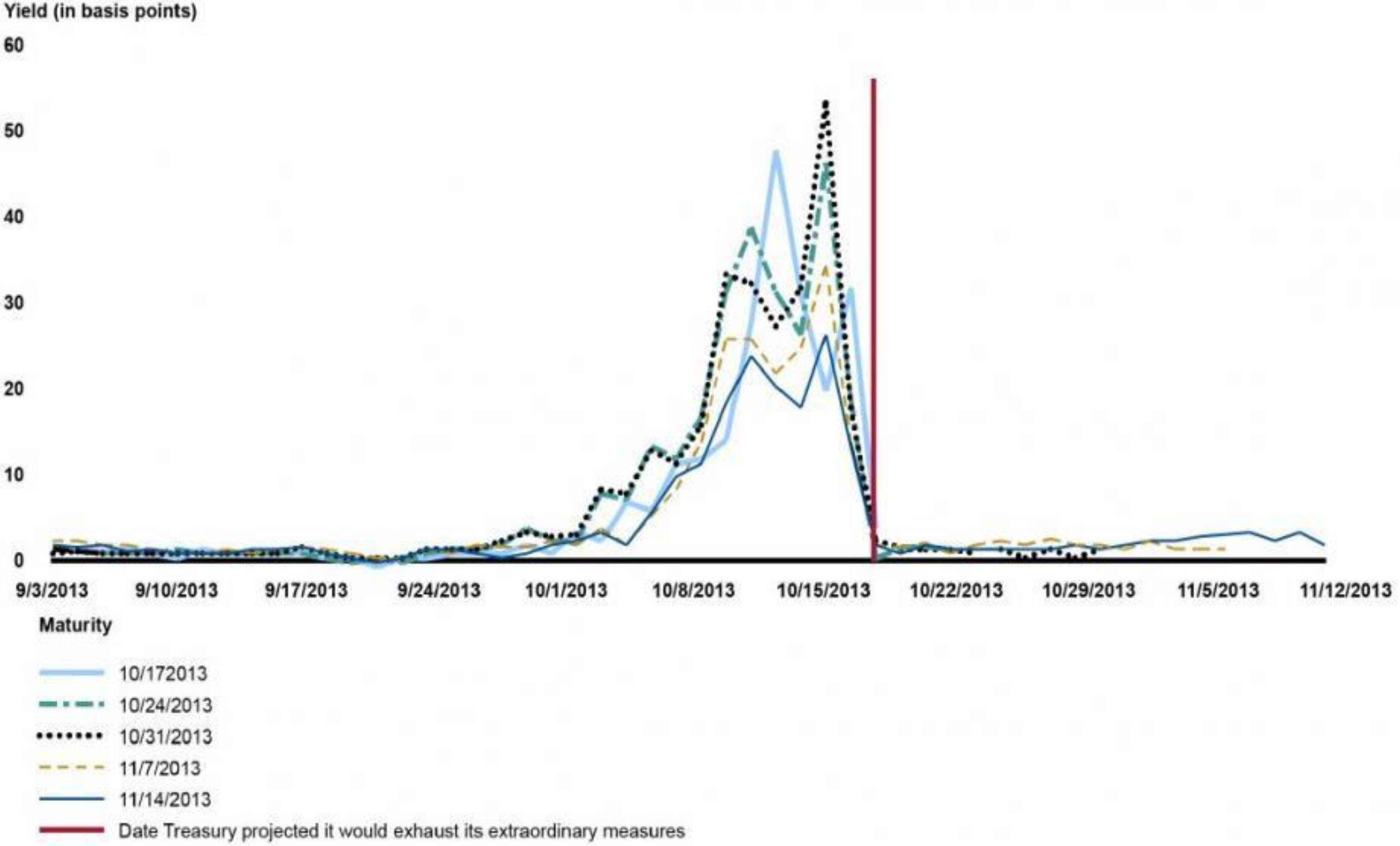
Trends


Debt ceiling and total public debt, $Trillions
1990 to 2021
$30t
25t
20t
15t
10t
5t
0
$28.4t
"Suspension"
periods
Debt ceiling
Public debt
1990
1995
2000
2005
2010
2015
2020

The Short Term Issue

- In late September, the Treasury Department confirmed that in mid October or so, it would reach the debt ceiling / be unable to continue to finance the government.
- This is a major issue, because at an annual deficit level of around 10% of GDP, or over $2 trillion, the Treasury must borrow about $50 billion a week to be able to cover all expenses coming due, including "rolling over" maturing debt. Without that borrowing authority, USG financial obligations would go unpaid.
- Importantly from a financial standpoint, this could include interest payments, which if unpaid would put USG in default, and would have severe financial market effects.
- In 2013, this brink was approached close enough that USG debt was downgraded by credit rating agencies and USG and other interest rates spiked (see next slide).

The Short Term Issue



Source: GAO analysis of Bloomberg data. | GAO-15-476

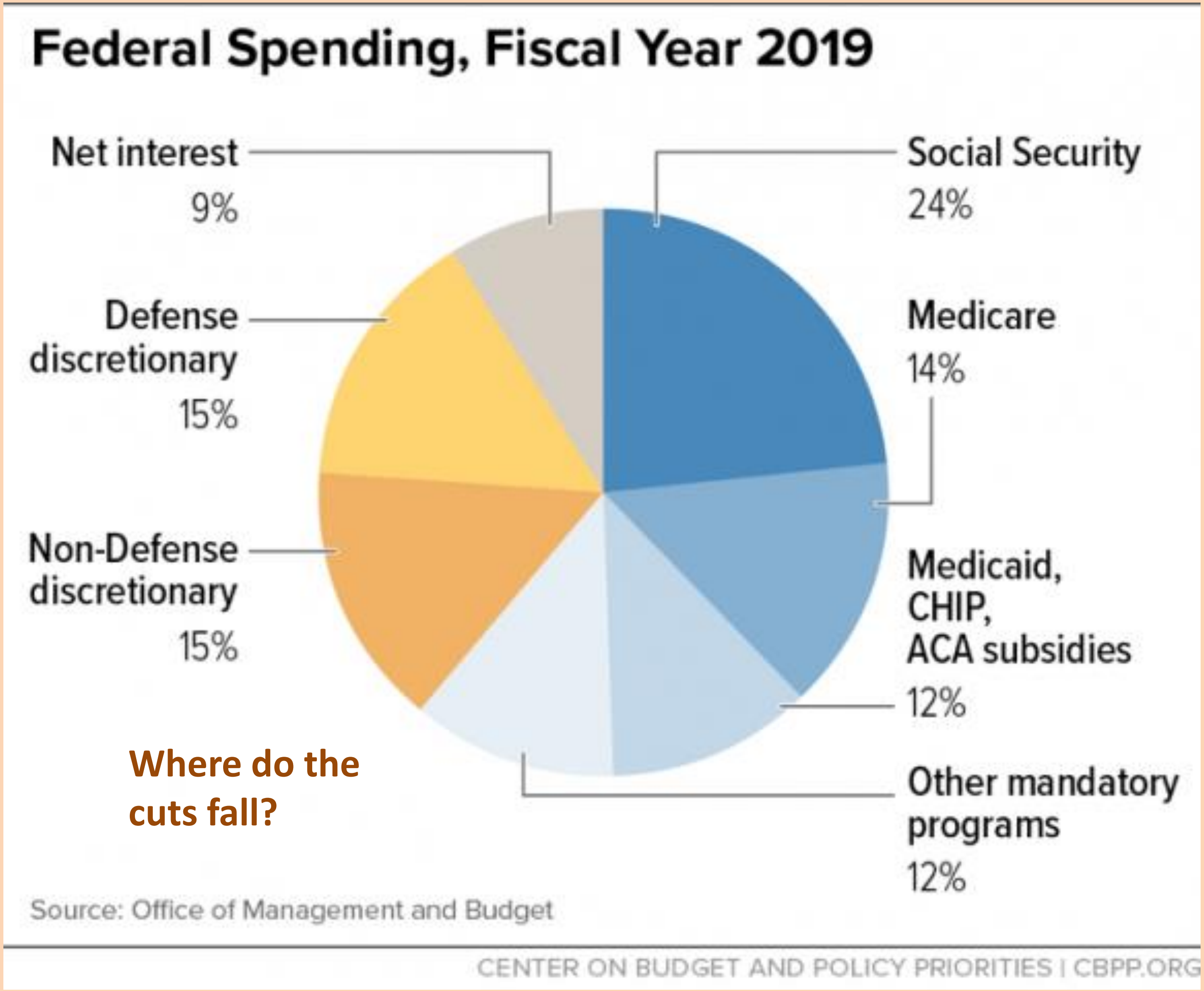
The Short Term Issue

- On October 8, the Senate voted 50-48 to extend nation's debt limit to early December after Democrats and Republicans reached a deal to avert economic disaster following weeks of partisan deadlock over the issue, followed by House approval and Presidential signature.
- An aide familiar with negotiations told CNN that the deal is to increase the ceiling by $480 billion, which is how much the Treasury Department told Congress it would need to get to December 3.
- The announcement came a day after Senate Minority Leader Mitch McConnell publicly floated a debt ceiling proposal, which sparked negotiations between the two parties to reach an agreement.

The Short Term Issue

- Unfortunately, we could be back in the same "soup" in December.
- If the debt ceiling is reached and not raised, the Treasury is unable to issue or auction any more Treasury bills, bonds or notes. Routine and ongoing government expenses can only be paid as incoming tax revenues are received, *which would reduce USG spending ability by between one third and one half.*
- Without ability to expand beyond tax revenues, the Treasury would have to decide which debts to pay and postpone. This creates a ripple effect because if there isn't enough cash to go around:
- Federal employees can be furloughed.
- Federal pension payments aren't sent.
- Foreign lenders don't get paid.
- Interest on the national debt cannot be paid.
- Contracts are cancelled or not paid.
- The next slide shows the division of USG spending on which these cuts would have to be distributed.
- Essentially, a government shutdown occurs. If various segments of the national debt cannot be paid, the government must make some choices. Since law prevents any borrowing from Social Security and Medicare, it turns to retirement funds.
- Or, the government can withdraw money it keeps on hand, up to $800 billion, from the Federal Reserve Bank, but that would be quickly exhausted.

The Short Term Issue



The Short Term Issue

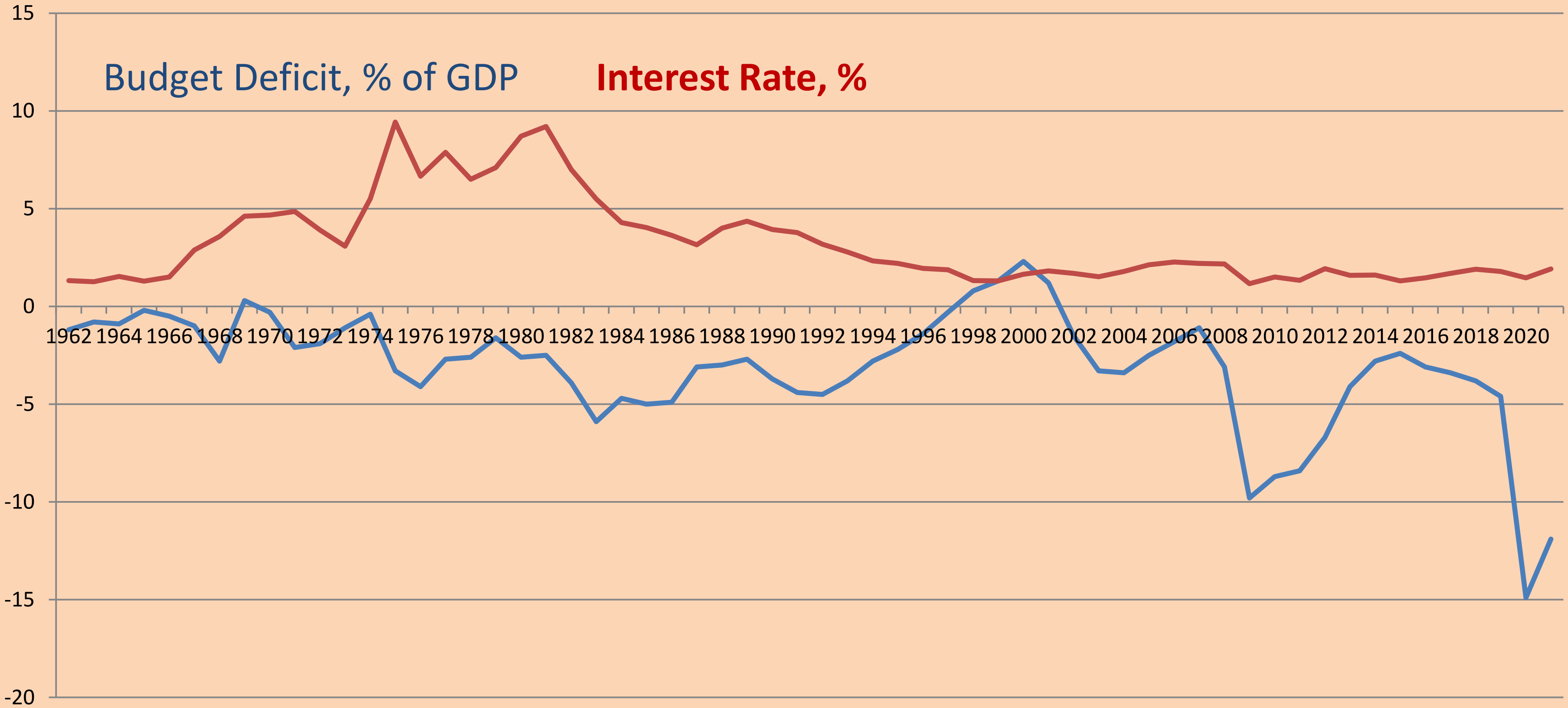
- Economically the effects would be just as serious.
- A US default would undermine the bedrock of the modern global financial system.
- "We pay our debt. That's what distinguishes the United States from almost every other country on the planet," Zandi of Moody's said.
- Because of America's long track record of paying its debt, it's very cheap for Washington to borrow. But a default would force ratings companies to downgrade US debt and shatter that borrowing advantage. Markets plunged in 2011 when that debt ceiling standoff caused Standard & Poor's to downgrade America's credit rating.
- Higher borrowing costs would make it much harder for Washington to borrow to pay for infrastructure, the climate crisis or to fight future recessions. And refinancing America's nearly $29 trillion mountain of existing debt would become that much more expensive. Interest expenses, which totaled $345 billion in fiscal 2020, would quickly rival what Washington spends on defense.
- Soaring Treasury rates would set off a chain reaction in financial markets. That's because Treasuries, viewed as risk-free investments backed by the full faith and credit of the federal government, serve as the benchmark by which virtually all other securities are measured.
- Everything from stocks and bonds to exotic securities take their cues from Treasuries. A spike in Treasury rates sparked by a default would cause booming stock markets to become unglued.
- "Stock prices would crater," Zandi said. "We'd all be less wealthy, instantaneously."
- Not only would millions of Americans lose money in the stock market, but it would suddenly become more expensive for families and companies to borrow. That's because Treasuries serve as the benchmark for mortgages, car loans, credit cards and corporate debt. A spike in borrowing costs is a huge problem for an economy that relies on access to credit.

The Long Term Issue

- Moreover, even if a December Debt Ceiling Crisis is avoided, the large and increasing size of the debt could cause problems if not a crisis in out years.
- Economists identify several ways that excessive government deficits and debt can be damaging.
- Large deficits cause high levels of government borrowing which competes with private borrowing; this is known in economics as crowding out effect.
- High, and rising, levels of government debt create concerns that at some point the government will either raise taxes or inflate the debt away, which could inhibit long term investments
- Very high levels of debt can cause creditors to refuse to purchase new debt, and lead to a default, ala Greece in 2010
- Debt that comes to be held internationally puts a drag on income and spending by taxing domestic entities to pay foreign entities.
- To date, however, the US seems not to be much affected by these factors, as illustrated on following slides.

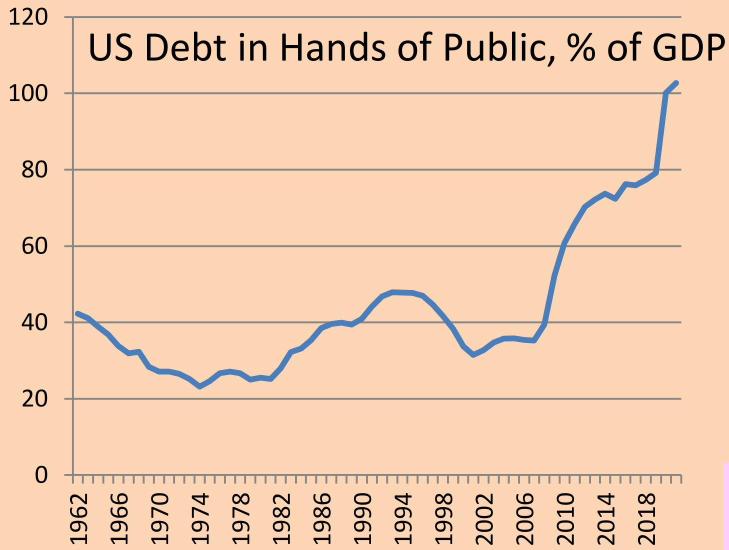
The Long Term Issue

- As shown by below chart, the crowding out effect, which would show up in higher interest rates at times of deficits, mostly has not occurred; interest rates have been higher mostly when there has been high inflation (late 1970s) or tight monetary policy (early 1980s) and do not appear that connected to deficits.

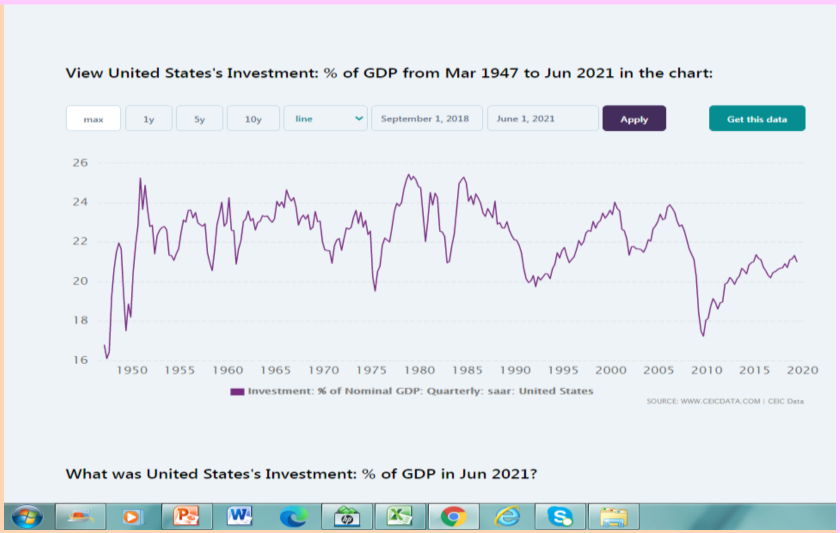


The Long Term Issue

- With regard to impacts of higher debt on investment, cursory examination of historical connections suggest they do exist but at not all that large a level.

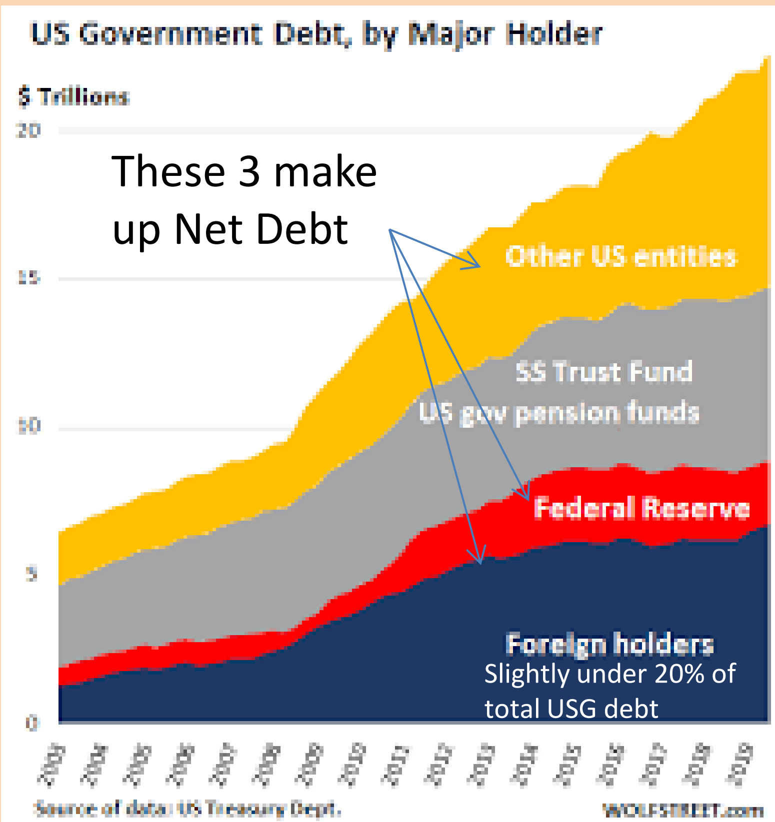


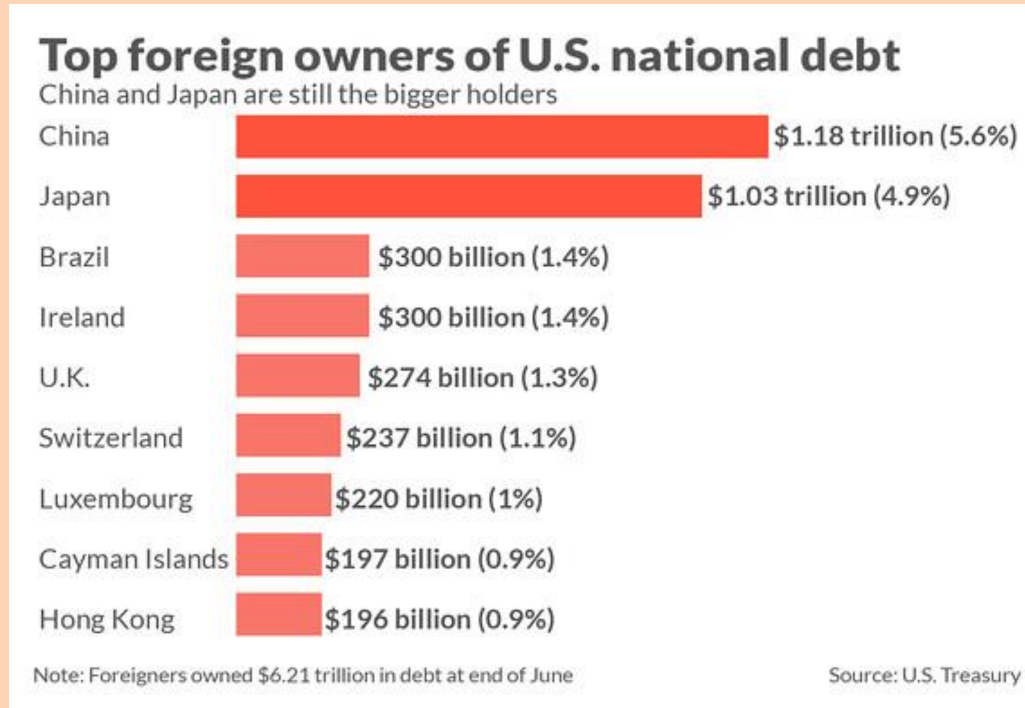
US Gross Fixed Capital Formation Rate, % of GDP



The Long Term Issue

- With regard to impact of foreign held US debt, again evidence would suggest that this has negatively impacted US income and spending, but again at not an overwhelming level.





The Long Term Issue

- Finally is long term issue of could USG debt get so big a default would occur, independent of debt ceiling issue. The "stock" answer is no. At no time in recent, and even not so recent past, has such an event been approached, and there is no market evidence that such concerns are imminent, in that the USG bi-weekly security auctions are heavily oversubscribed at some of lowest interest rates in the world.

10 year Government Bond Rates, %

Germany	**-0.0870**	**0.032**
Switzerland	-0.0400	0.0136
Netherlands	0.0360	0.2040
Japan	0.0960	0.0060
France	0.2420	0.0280
Portugal	0.4080	0.0130
Spain	0.5370	0.0186
Italy	0.9201	0.0063
Greece	0.9350	0.0080
United Kingdom	1.1340	-0.0560
United States	1.5803	0.0315
Canada	1.6340	0.006
Australia	1.6940	0.044
New Zealand	2.1300	0.0120
India	6.3260	-0.0140
Mexico	7.5090	0.0250
Brazil	10.9050	-0.1950

The Long Term

- That said, there clearly is some level out there somewhere that would cause creditors and potential creditors to pull back from purchasing new debt and precipitate a default crisis (Below are 2 possible scenarios below for Debt Held by Public 2020-2031).

2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
100.1	102.7	100.3	99.2	99.1	99.6	100.1	100.3	101.8	102.6	104.5	106.4 (CBO Baseline)
100.1	102.7	101.3	101,2	102.6	103.6	105.1	106.3	108.8	110.6	113.5	116.4(+$2T Spending)

- No one knows where that tipping point is, but USG does have a number of advantages that may make it higher rather than lower.
- 1. The fact that USG has never defaulted.
- 2. The fact that the US economy is regarded as the most stable in the world, certainly among large economies; in fact in many cases a US-based crisis has actually caused foreign money to come into US.
- 3. The fact that USG securities are the most desired in the world due to both their security but also their liquidity, that is, they are easy to get rid of if necessary.
- 4. The fact that there are no other similar foreign securities that can come anywhere close to accomodating a desire to move funds out of USG securities.

- In my view if this type of crisis occurs, it will be a US political event, not an economic event, that triggers it.

Internet Readings

- https://www.pgpf.org/the-current-federal-budget-deficit
- https://www.cbo.gov/publication/57493
- https://www.cbo.gov/publication/57218
- https://www.nytimes.com/2021/03/04/business/cbo-deficit-projection.html (behind NYT paywall)