

## HW #2: U.S. Debt Ceiling

The debt ceiling is a limit placed on government borrowing to fund its pre existing programs, such as social security and medicare. Congress has established a strong and consistent precedent of raising the debt ceiling when potential default looms on the horizon: the U.S. has raised the debt ceiling 78 times since 1960 alone<sup>1</sup>. Consequently, investors in both domestic and foreign markets have come to view U.S. government debt as virtually risk-free, since the U.S. has historically been able to stave off default. Rising political polarization and contention over government spending more broadly has created conservative opposition to raising the debt ceiling; congressional failure to agree on raising the debt ceiling before October 18th could have consequences far and wide in the global economy.

Despite a stable recovery, the U.S. economy still remains in a state of relative precarity as it emerges from the pandemic. As the housing market and corporate debt levels suggest, low interest rates have played a critical role in stimulating investment and bolstering the national economy. If congress were to fail in raising the debt ceiling and the U.S. treasury were to default, however, government bond yields would rise. Since the interest rate associated with government bonds often has a strong influence on interest rates from private lenders, a default would cause interest rates to rise nationally- a consequence that many corporations and even households may not yet be prepared to face. Another factor to consider is market reaction: a government default, given its lack of precedent, would likely cause investors to liquidate their assets in a panic selloff. Moreover, consumers- especially those that rely on government salaries, pensions, and benefits- would likely adopt more frugal spending practices, either out of necessity or prudence. Both investment and consumer spending were imperative economic stimulators in the post-covid

---

<sup>1</sup> "Debt Limit." U.S. Department of the Treasury, October 1, 2021.  
<https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit>.

economy<sup>2</sup>. A prolonged default could also cause serious downsizing among firms that are liquidity-constrained in the short term. Ultimately, a failure to raise the debt ceiling has the potential to wreak considerable damage on the post-covid economic progress seen domestically, as well as financial markets around the world.

The U.S. is one of the largest economies in the world; that size carries with it a significant amount of influence on global market performance. Among other prosperous nations with large-scale economies and production capacity, the U.S. maintains a key role in international trade and investment. In 2019, total U.S. trade was valued at 5.6 trillion, with 3.1 trillion coming from imports. A government default and the subsequent decline in consumer spending likely to follow would prove a major disruption in global trade given this presence; hardest hit are those economies which specialize in capital goods and most rely on their exports to the US (e.g. capital goods was the largest component of U.S. import expenditure in 2019, valued at 678 billion). Devaluation of the U.S. dollar, another consequence that would likely follow a default, would have direct effects on dollarized economies that rely on the stability and power of U.S. currency. Currently, seven independent nations have adopted full use of the U.S. dollar, and sixty five nations peg their currency with the U.S. dollar<sup>3</sup>. With this level of global presence, the potential devaluation of the U.S. dollar would directly carry over into the developing economies that rely on the U.S. dollar for its purported stability and power. A final factor worth noting is the redirection of capital away from the U.S. The strength and relative stability of the U.S. economy has made it a target for investors in times of both global prosperity and recession. In times of

---

<sup>2</sup> Long, Heather. "What's Happening in Congress Right Now Will Have a Big Impact on the Economy and American Families." The Washington Post. WP Company, September 30, 2021. <https://www.washingtonpost.com/business/2021/09/30/debt-ceiling-biden-agenda-impact/>.

<sup>3</sup> Garver, Rob. "5 Ways US Debt Default Would Echo through Global Economy." VOA. 5 Ways US Debt Default Would Echo Through Global Economy, September 30, 2021. <https://www.voanews.com/a/five-ways-us-debt-default-would-echo-through-global-economy/6250949.html>.

economic prosperity, U.S. firms attract foreign investors who are optimistic about their potential returns. U.S. treasury securities are perceived to be ultra-low risk assets and are, for that reason, a common purchase to limit risk exposure in times of economic recession. Therefore, a default could deter investors from investing in both U.S. firms as well as U.S. treasury securities.

A major economic disruption, as I see it, is one that will or has the capacity to negatively affect the basic measures of economic health and activity, such as GDP, interest rates, unemployment, or consumer spending figures. While the question of whether the debt ceiling could prove a disruption does rely partially on the factors explained above, it also is contingent on the chances that congress actually fails to raise or resuspend the debt ceiling; the former indicates yes, the latter indicates the opposite. There is no doubt that a U.S. government default would have far-reaching effects not only rippling throughout most facets of our own economy, but throughout others as well. Based on the considerations in the prior paragraphs, a scenario of prolonged default certainly has the potential to prove a major economic disruption for the U.S., since it could affect those aforementioned figures. Whether congress will actually allow for a default to happen points the likelihood of major disruption in an opposite direction; a brief glance at historical precedent would suggest that the true risk associated with a default is low, since congress has repeatedly been able to raise the debt ceiling under both republican and democratic control, even during times where treasury deadlines crept closer and the nation began to speculate of some crisis they are currently<sup>4</sup>. Ultimately, the question of whether a default would cause a major economic disruption is not easily answered. Yes, an unprecedented government default possesses the potential to cause serious economic damage, but for that

---

<sup>4</sup> Balkin, Jack M. "The Not-so-Happy Anniversary of the Debt-Ceiling Crisis." The Atlantic. Atlantic Media Company, July 31, 2012. <https://www.theatlantic.com/politics/archive/2012/07/the-not-so-happy-anniversary-of-the-debt-ceiling-crisis/260458/>.

potential to be realized would require unprecedented congressional failure, and would certainly rely on the duration of the default and how other government bodies would manage the crisis in the interim.

In speculating a potential course of action for the federal reserve, it is fruitful to look at their activity during the 2011 debt ceiling bind, which is practically identical to our current risk of default. When congress was delayed raising the debt ceiling in 2011, the nation speculated a crisis and the federal reserve discussed a course of action should the U.S. truly default.

Transcripts from conversations between federal reserve officials in 2011 and 2013 reveal multiple measures these officials agreed to implement in the event of a default. For example, officials agreed upon a bond-buying program wherein the federal reserve would purchase defaulted treasury securities at a lower price if they were certain that the default would be resolved in a timely manner.<sup>5</sup> Other, more indirect actions include providing emergency liquidity to mutual funds that are constrained in the short-term, as well as implementing reverse repurchase options, wherein the federal reserve would agree to purchase these treasury securities from third parties during the default period, and would sell those securities back to the third parties at a predetermined date

---

<sup>5</sup> Davidson, Kate. "Officials Planned to Prioritize Debt Payments as 2011 Debt-Ceiling Deadline Loomed." The Wall Street Journal. Dow Jones & Company, January 13, 2017. <https://www.wsj.com/articles/officials-planned-to-prioritize-debt-payments-as-2011-debt-ceiling-deadline-loomed-1484257028>.