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Chairman Heinrich, Vice Chairman Schweikert, and members of the Committee,

My name is Wendy Edelberg, and I am the director of The Hamilton Project and a senior fellow at the Brookings Institution. Thank you for this opportunity to discuss how a debt ceiling crisis could harm American families and businesses.

While greatly uncertain, the effects of allowing the debt limit to bind could be quite severe, even assuming that principal and interest payments continue to be made. If Treasury wanted to be certain that it always had sufficient cash on hand to cover all interest payments, it might need to cut non-interest spending by 35 percent or more. If instead Treasury fails to fully make all principal and interest payments—because of political or legal constraints, unexpected cash shortfalls, or a failed auction of new Treasury securities—the consequences would be even more dire.

The workarounds that have been proposed—the platinum coin, increasing borrowing despite the debt limit, prioritizing payments—either bring significant legal uncertainty or are not sustainable solutions. These unlikely workarounds do not avoid the chaos that is inherent to the debt ceiling binding.

The only effective solution is for Congress to increase the debt ceiling without delay or, better yet, abolish it.

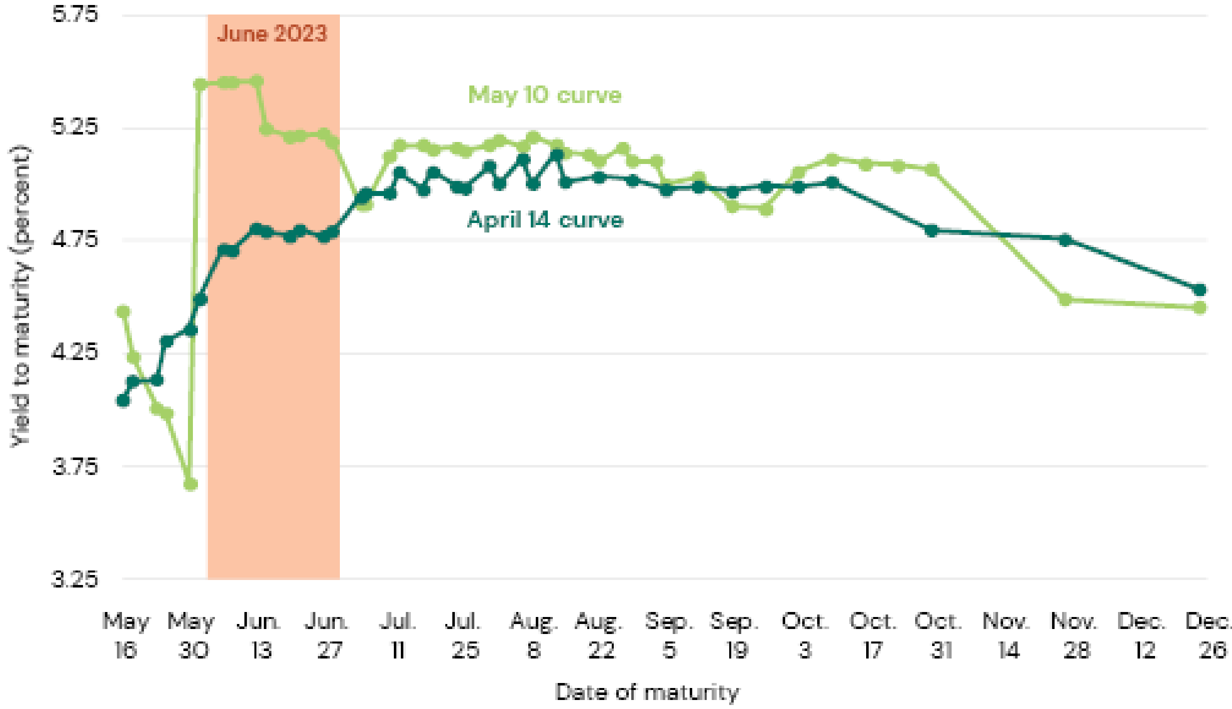
How would a binding debt limit affect the economy?

Should the debt ceiling bind, and the U.S. Treasury does not have the ability to pay its obligations, the negative economic effects would quickly mount and risk triggering a deep recession. There is enormous uncertainty regarding the damage the U.S. economy would incur, as it depends on how long the situation lasts, how it is managed, and the extent to which investors alter their views about the safety of Treasury securities. Would the stock market tumble precipitously the first day that a non-interest payment is delayed? Would the Treasury securities market, the world's most important, function smoothly? Would there be a run on money market funds that hold short-term Treasury securities? What actions would the Federal Reserve take to stabilize financial markets and the economy more broadly?

Even in a best-case scenario in which the impasse is short-lived, the economy is likely to suffer sustained—and completely avoidable—damage. An extended impasse would needlessly cause significant damage to the U.S. economy. Much depends on whether investors would be confident that Treasury would continue paying interest on time even as other payments are delayed and on how long they think the impasse will persist. Already, for Treasury bills that are scheduled to mature in June, investors are demanding a significant premium to shoulder the risk of not being paid on time. Between mid-April and May 10, interest rates on some of those securities rose nearly 1 percentage point (see figure 1).

FIGURE 1

April 14, 2023 and May 10, 2023 Yield Curves



Source: US Department of the Treasury, Bloomberg LP.

Note: The figure shows, at an annualized rate, the yield to maturity on Treasury bills scheduled to mature between May 16, 2023 and December 31, 2023. For Treasury bills scheduled to mature in June 2023 (shaded in orange), investors are demanding a significant premium to shoulder the risk of not being paid on time. For example, between mid-April (dark green line) and May 10 (light green line), interest rates on Treasury bills maturing in the first half of June rose nearly 1 percentage point.

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If failure to raise the debt ceiling affects payments by the U.S. Treasury, and people expect a short-lived impasse with full and timely payments on Treasury securities, it is possible that the initial response could be muted. However, the certainty around those expectations would in part depend on whether there are swift legal challenges to Treasury prioritizing interest payments and the outcome of subsequent rulings.

Regardless, even if the debt limit were raised quickly so that it only was binding for a few days, there could be lasting damage. At the very least, financial markets would likely anticipate such disruptions each time the debt limit nears in the future. In addition, the shock to financial markets and loss of business and household confidence could take time to abate.

The U.S. government pays a lower interest rate on Treasury securities because of the unparalleled safety and liquidity of the Treasury securities market. Some estimates suggest that this advantage lowers the interest rate the government pays on Treasury securities (relative to interest rates on the debt of other sovereign nations) on the order of 0.25 percentage points on average.[1] Given the current level of the debt, this translates into interest savings for the federal government of roughly $50 billion next year and

[1] Jiang, Krishnamurthy, and Lustig 2018.

more than $750 billion over the next decade. If a portion of this advantage were lost by allowing the debt limit to bind, the cost to the taxpayer could be significant.

If the impasse were to drag on, market conditions would likely worsen with each passing day. Concerns about a default would grow with mounting legal and political pressures as Treasury security holders were prioritized above others to whom the federal government had obligations. Concerns would grow regarding the direct negative economic effects of a protracted sharp cut in federal spending.

Worsening expectations regarding a possible default would make significant disruptions in financial markets increasingly probable. That could result in an increase in interest rates on newly issued Treasury securities. If financial markets started to pull back from Treasury securities altogether, the Treasury could have a difficult time finding buyers when it sought to roll over maturing debt, perhaps putting pressure on the Federal Reserve to purchase additional Treasury securities in the secondary market. Such financial market disruptions would very likely be coupled with declines in the price of equities, a loss of consumer and business confidence, and a contraction in access to private credit markets.

Financial markets, businesses, and households could become more pessimistic about a quick resolution and increasingly worried that a recession was inevitable. More and more people would feel economic pain because of delayed payments. Take just a few examples: Supplementary Security Income beneficiaries seeing delays in their payments could face trouble with expenses such as rent and utilities; federal, state, and local agencies might see delays in payments that interrupt their work; federal contractors and employees would face uncertainty about how long their payments would be delayed. Those and other disruptions would have enormous economic and health consequences over time.

Given that those disruptions would likely occur when the economy is growing slowly and perhaps contracting, the risk that the crisis would quickly trigger a deep recession is heightened. Moreover, tax revenues, the only resource the Treasury would have to pay interest on the debt, would be dampened, and the federal government would have to cut back on non-interest outlays with increasing severity.

In a worst-case scenario, at some point Treasury would be forced to delay a payment of interest or principal on Treasury securities. Such an outright default on Treasury securities would very likely result in severe disruption to the Treasury securities market, with acute spillovers to other financial markets, and to the cost and availability of credit to households and businesses. Those developments could undermine the reputation of the Treasury securities market as the safest and most liquid in the world.

Estimates of the quantitative effects of a binding debt limit on the U.S. economy

It is difficult to quantify the effects of a binding debt limit on the macroeconomy. However, history and illustrative scenarios provide some guidance.

<u>Evidence from prior "near-misses":</u>

As discussed in a Hutchins Center Explains post, when Congress waited until the last minute to raise the debt ceiling in 2013, rates rose on Treasury securities scheduled to mature near the projected date the debt limit was projected to bind—by between 21 basis points and 46 basis points, according to an estimate from Federal Reserve economists—and liquidity in the Treasury securities market contracted.[2]

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[2] Belz et al. 2019, Cashin et al. 2017.

Yields across all maturities also increased a bit—by between 4 basis points and 8 basis points—reflecting investors' fears of broader financial contagion.[3] Similarly, after policymakers came close to the brink of the debt limit binding in 2011, the Government Accountability Office (GAO) estimated that the delays in raising the debt limit increased Treasury's borrowing costs by about $1.3 billion that year.[4] The fact that the estimated effects are small in comparison to the U.S. economy likely reflects that investors didn't think it very likely that the debt ceiling would actually bind and thought that if it did, the impasse would be very short-lived.

<u>Evidence from macroeconomic models</u>:

In October 2013, the Federal Reserve simulated the effects of a binding debt ceiling that lasted one month—from mid-October to mid-November 2013—during which time Treasury would continue to make all interest payments. The Fed economists estimated that such an impasse would lead to an 80 basis point increase in 10-year Treasury securities yields, a 30 percent decline in stock prices, a 10 percent drop in the value of the dollar, and a hit to household and business confidence, with these effects waning over a two-year period. According to their analysis, this deterioration in financial conditions would result in a mild two-quarter recession, leading to an increase in the unemployment rate of 1.25 percentage points in the first year after the crisis and 1.7 percentage points in the second.[5] Such an increase in the unemployment rate today would mean the loss of about 2 million jobs in 2023 and 2.8 million jobs in 2024.

Macroeconomic Advisers conducted a similar exercise in 2013. It assessed the economic costs of two scenarios—one in which the impasse lasted just a short time and another in which it persisted for two months. Even in the scenario in which the impasse was resolved quickly, the economic consequences were substantial—a mild recession and a loss of 2.5 million jobs that returned only very slowly. For the two-month impasse, which included a deep cut to federal spending in one quarter, offset by a surge in spending in the next quarter, the effects were larger and longer lasting. In the analysis, such a scenario would lead to the near-term loss of up to 3.1 million jobs. Even two years after the crisis, there would be 2.5 million fewer jobs than there otherwise would have been.[6]

In March 2023, Moody's Analytics concluded that the costs to the U.S. economy of allowing the debt limit to bind would be severe. In Moody's simulation, if the impasse were to last several months, after a year employment would be lower by over 8 million and real GDP would be lower by about 6.5 percent, with the economy remaining weaker for years to come.[7]

The economic consequences to prioritizing certain types of payments

If the debt limit binds, and Treasury were to make interest payments, then other outlays will have to be cut in an average month by about 25 percent. That would be necessary because CBO expects close to 25 cents of every dollar of non-interest outlays to be financed by borrowing in 2023. If Treasury were to prioritize interest payments as well as Social Security payments, as some commentators have suggested

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[3] Cashin et al. 2017.
[4] Government Accountability Office (GAO) 2012.
[5] Engen, Follette and Laforte 2013.
[6] Macroeconomic Advisers, LLC 2013.
[7] Zandi, deRitis, and Yaros 2023.

they could,[8] other payments to people, businesses, and agencies would see even more substantial cuts of roughly one third.

However, the size of the cuts would vary from month to month because infusions of cash to Treasury from tax revenues vary greatly by month. Tax revenues in July and August tend to be fairly low. Thus, the required cuts to federal spending when an increase in federal debt is precluded are particularly large during these months. If Treasury wanted to be certain that it always had sufficient cash on hand to cover all interest payments, it might need to cut non-interest spending by 35 percent or more.

How will the U.S. Treasury operate when the debt limit binds?

The debt limit caps the total amount of allowable outstanding U.S. federal debt. The U.S. hit that limit—$31.4 trillion—on January 19, 2023, but Treasury has been undertaking a set of "extraordinary measures" so that the debt limit does not yet bind. The Congressional Budget Office and Treasury estimate that those measures will be sufficient through at least early June.[9] Sometime after that, unless Congress raises or suspends the debt limit, the federal government will lack the cash to pay all its obligations. Those obligations are the result of laws previously enacted by Congress. As my colleagues Len Burman and Bill Gale wrote, "Raising the debt limit is not about new spending; it is about paying for previous choices policymakers legislated."[10]

The timing of when Treasury will not have enough cash to meet its obligations—the so-called "X-date"—is uncertain because it depends on the inflows of federal tax payments. Estimates of the X-date range from early June to August; the range is so wide because the delay in the tax filing deadline for those affected by storms in California, Alabama, and Georgia makes the pace and amounts of federal tax particularly uncertain this year.[11] That uncertainty underlines the urgency around this issue.

One cannot predict how Treasury will operate when the debt limit binds, given that this would be unprecedented. Treasury did have a contingency plan in place in 2011 when the country faced a similar situation,[12] and it seems likely that Treasury would follow the contours of that plan if the debt limit were to bind this year. Under the 2011 plan, there would be no default on Treasury securities. Treasury would continue to pay interest on those Treasury securities as it comes due. And, as securities mature, Treasury would pay that principal by auctioning new securities for the same amount (and thus not increasing the overall stock of debt held by the public). Treasury would delay payments for all other obligations until it had at least enough cash to pay a full day's obligations. In other words, it will delay payments to agencies, contractors, Social Security beneficiaries, and Medicare providers rather than attempting to pick and choose which payments to make that are due on a given day.[13]

Federal employees would likely continue working during a debt-limit impasse in contrast to the government shutdowns that occur when Congress hasn't enacted appropriations bills. That's because federal agencies would still have legal authority, provided by Congress, to obligate funds. Thus, government agencies such as the Centers for Disease Control and Prevention and the Department of

[8] The Wall Street Journal Editorial Board 2023.
[9] Swagel 2023; Yellen 2021.
[10] Burman and Gale 2023.
[11] Meade 2023; Internal Revenue Service (IRS) 2023.
[12] Board of Governors of the Federal Reserve System 2011.
[13] Board of Governors of the Federal Reserve System 2011.

Homeland Security would likely remain fully operational, but federal workers' paychecks would be delayed.

Uncertainty regarding legal challenges to Treasury's actions

Timely payments of interest and principal of Treasury securities alongside delays in other federal obligations would likely result in swift legal challenges by those who suffer delays.[14] It is not clear how such litigation would turn out, as the law imposes contradictory requirements on the government. Treasury is required to make payments, honor the debt, and not go above the debt limit: three things that cannot all happen at once.

While the motivation to pay principal and interest on time to avoid a default on Treasury securities is clear, there may be lawsuits that argue that Treasury has no authority to unilaterally decide which obligations put in place by Congress to honor. (Imagine the legal challenges if the executive branch were to indefinitely postpone payments related to a particular program enacted by Congress.) Courts would have to determine whether Treasury could prioritize interest payments while the legal challenges were being resolved—adding another layer of uncertainty. Indeed, a lawsuit on behalf of the National Association of Government Employees, a union of government workers, has been filed that argues the debt limit is unconstitutional in absence of explicit instructions of how payments should be prioritized when the debt ceiling binds.[15]

Several ideas have been floated for actions Treasury could take to forestall delaying payments on obligations instead of allowing the debt ceiling to bind. I am confident that if Treasury were to employ one of these workarounds, a negative reaction in financial markets and loss of confidence across the economy would be swift. **No action other than raising the debt ceiling is an effective solution to a debt ceiling crisis.**

Some argue that the 14th Amendment to the Constitution—which says that "the validity of the public debt of the United States … shall not be questioned"—would allow Treasury to ignore the debt limit and indeed requires it to meet all obligations.[16] In addition, Treasury may have the legal authority to mint and issue a "collectible" trillion-dollar platinum coin and deposit it at the Federal Reserve in exchange for cash to pay the government's bills. However, Treasury Secretary Janet Yellen has noted that the Fed, reluctant to intervene in a partisan political dispute, might not accept the deposit. In addition, Treasury may also have the legal authority to issue a certain kind of bond that pays interest to its holder but never matures and thus, in a sense, wouldn't add to the stock of outstanding debt.

However, these actions by Treasury would certainly be viewed as circumventing the law that establishes the debt ceiling, and they would likely not prevent havoc in the debt market. Would Treasury's actions and the issuance of related bonds be deemed illegal? Would this mean that Congress would *never* raise the debt ceiling? The reaction across the economy would likely be similar to the reaction if Treasury delayed non-interest payments. To reiterate, a crisis is only prevented by raising the debt ceiling.

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[14] Levit et al. 2015.
[15] Rugaber and Hussein 2023.
[16] Geoghegan 2023.

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