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Here We Go Again: The Debt Ceiling

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On the cusp of a climactic battle a long, long time ago in a galaxy far, far away, an exasperated droid, C3PO, tells his companion, R2D2, "Here we go again." Actually, it was in 1983 when there were only three installments of *Star Wars* in the can and proved prescient for the multitude of cliff-edged confrontations that followed in prequels, sequels, manga and novels. In all, the tempo picks up, the odds are uneven, and the matter is settled just as always. After so many tries, why don't they learn to get along? Aren't they an advanced civilization?

While the comparison may be disrespectful, the sequence, say, surrounding "The Battle for Endor" recurs with a frequency that would frustrate C3PO on US Capitol Hill with "The Fight over the Debt Ceiling".[1] Among the sorrier spectacles in our representative democracy are the dramatic standoffs in which the Congress refuses to increase this limit, constraining the Treasury's operations and ultimately risking default. It is a hollow exercise because no one actually wants to default and jeopardize the status of the dollar as the world's reserve currency. It is also a repeated performance, spread across the 78 times the Congress has raised the limit since 1960.

Among the similarities between *Star Wars* and the debt ceiling are:

- The contest is between good and evil (from each side's perspective);
- A clock counts down to a catastrophic event;
- The technology, terminology and tradition are baffling to the uninitiated;
- Galactic order is restored at the last minute; but,
- The resolution is incomplete, setting up the cycle to repeat.

After a while, the sequence gets boring to some and attention lapses.

Investors should not make that mistake, at least about the debt ceiling in current circumstances. We do not.

The current debt-ceiling standoff shares features with its predecessors, even beyond name-calling, assertions of high-but-differing principles, and an indifference to financial market angst. For now, Congressional consideration of raising the debt ceiling is joined at the hip with passing spending authority (to avoid a government shutdown). However, they have often been surgically separated somewhere along the process.

There are a few notable differences in the dynamics, including:

- Heightened partisanship makes both sides more convinced they have the moral (and media) high ground;
- Spending already authorized by the Congress includes many large and chunky pandemic-relief plans, adding uncertainty to the Treasury's cash needs; and
- Payment system improvements give the Treasury and its fiscal agent (the Federal Reserve, the Fed) the ability to prioritize payments, effectively foaming the runway in advance of a default event and stretching the crash out over time.

Next is a primer on the three laws in play when the Congress's failure to act binds the Treasury at the top of the public debt subject to limit. It also covers the untried new wrinkle on payment prioritization that allows the Treasury to honor coupon and principal (and principle) even when no cash is available for other governmental business. After that, we sketch a few potential legislative outcomes and speculate what the Treasury and Fed might do if pushed to the edge.

Q: What is the likelihood that a failure to raise the US debt ceiling will result in a technical default?

A: We view the likelihood of a technical default by the US for failure to raise the debt ceiling as highly unlikely as the US Government has never failed to raise or suspend the ceiling since introduced in 1917. At present, the exact date when extraordinary measures will be exhausted is uncertain. The Congressional Budget Office (CBO) estimated in July 2021 that if the debt limit is not raised that extraordinary measures would be exhausted by October or November 2021. The US Treasury has indicated that if the debt ceiling is not raised in a timely manner, they could prioritize debt payments over other non-debt payments in order to preserve the full faith and credit of the United States.

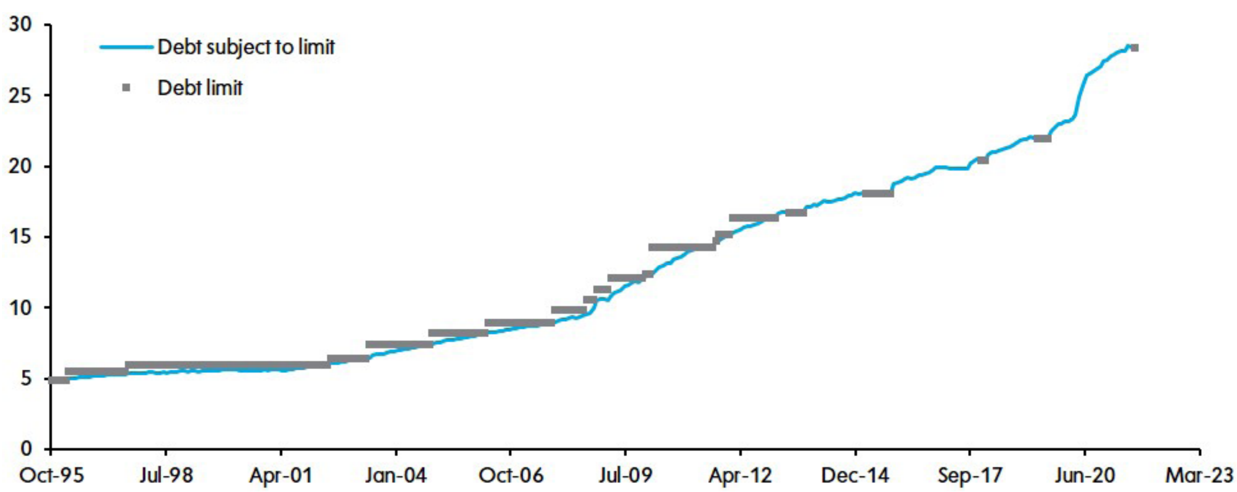
The Public Debt Subject to Limit[2]

In our view, the debt ceiling as written into law: (1) confounds stocks and flows; (2) is pinned to an unsatisfying concept of the public debt; (3) invites gimmicks; (4) requires government officials to violate the law if it were to bite; but, (5) may have little market bite thanks to processing improvements at the Federal Reserve, the fiscal agent of the Treasury. We take these issues in turn.

Stocks and flows of the same variable (such as the level and issuance of debt) are related arithmetically over time, but you would not know it from the *Federal Register*. The Constitution enumerates powers of the Congress, including the ability to authorize spending, levy taxes, coin money, and issue debt in the name of the US. Since the Second Liberty Bond Act of 1917, the Congress has delegated debt issuance to the Treasury subject to an overall cap on the amount outstanding. The amount of that cap has been raised and its form revised over the years, transforming that $15 billion limit of 1917 to the one binding today that has fourteen digits to the left of the decimal point. The chart plots its recent course, along with public debt subject to limit. Note that the line depicting the ceiling is broken in parts because, on occasion, legislation suspended the limit. The last observation on the debt limit is the pesky one. The debt ceiling suspension has lapsed, snapping it up to current debt as of August, at $28.4 trillion, which is now binding on Treasury operations.

Public Debt Subject to Limit & Its Ceiling

Trillions of dollars



Source: Bloomberg, accessed 9/17/2021.

The logical problem is that the Congress also takes spending and revenue actions. If the outflows from the former exceed the inflows from the latter, debt must be issued as a matter of arithmetic. Imposing a restriction on top of this is either redundant or overdetermined (as right now) when the cumulated flows do not add up to the mandated stock.[3]

The concept of debt subject to limit includes, as in the table, both debt held by the public and intragovernmental holdings[4], mostly trust funds. Thus, the ceiling is not a measure of net exposure to the private sector. (And the public here includes the Federal Reserve, an agency of the US government owning about $5-1/8 trillion of US government obligations.) To some extent, the debt the government owes to itself embodies some of its contingent liabilities. But the trust funds do not come close to the total contingent liabilities of the government.

Debt Subject to Limit
Millions of dollars

Thursday, September 16, 2021	Closing Balance
Debt Held by the Public	**22,284,197**
Intragovernmental Holdings	**6,143,038**
Total Public Debt	
Outstanding	28,427,235
Less: Debt Not	
Subject to Limit:	
Other Debt	478
Unamortized Discount[5]	19,266
Federal Financing Bank	6,053
Plus: Other Debt Subject to Limit	
Guaranteed Debt of	
Government Agencies	0
Total Public Debt	
Subject to Limit	28,401,438
Statutory Debt Limit	**28,401,463**

Source: US Department of the Treasury, Daily Treasury Statement, 9/16/2021.

Gimmicks abound around these debt-ceiling events. If the Secretary declares a "debt issuance suspension period," the Treasury can replace obligations from some trust funds with IOUs that do not count toward the limit, opening headroom for marketable borrowing. These unconventional devices are administratively costly and make the government accounts more opaque.

Lawbreaking is not typically a legislated instruction, but it is in debt-ceiling events. Fundamentally, there are three governing instructions.

- The Second Liberty Bond Act of 1917 (and its successors) set an overall limit on the public debt;
- The Federal Reserve Act of 1913 forbids the central bank to lend directly to the US Treasury; and,
- The 14th Amendment to the US Constitution directs that "…the validity of the public debt of the United States, authorized by law…shall not be questioned."

The Fed, as the fiscal agent of the Treasury, processes all payments, both for goods and services and for interest and principal, and offers the Treasury a deposit account for its cash. The drop-dead date for a debt-ceiling crisis occurs on the day that the Treasury does not have enough funds in its Fed account to make all of its payments. The Fed cannot let the Treasury overdraft its account, so it pends payments until sufficient funds flow in. If those scheduled but suspended payments are of coupon or principal, the result is default. On that day, officials have a choice:

- The Secretary of the Treasury could sell marketable debt above the limit, violating the Second Liberty Bond Act;
- The Chair of the Federal Reserve could allow the Treasury to overdraft, violating the Federal Reserve Act; or,
- The Secretary of the Treasury could allow default, violating the 14th Amendment by calling into question the validity of the debt.

None of these are good choices, any are grounds for removal with cause, and all would probably lead the rating agencies to opine about the credit-worthiness of the US government.

Processing efficiencies may make it possible for the Federal Reserve to make some payments and not others at the Treasury's instruction. There was a special briefing to the Federal Open Market Committee in 2011 during still-another debt-ceiling crisis. The money paragraph from that discussion is:

> With respect to the first, the principal on Treasury securities that are maturing would be funded by having auctions that would roll over those maturing securities into new issues, so the new issues would be able to fund the redemption of the maturing securities. With respect to interest payments, the way the Treasury planned to ensure that it would be able to pay interest payments timely by holding back other government payments and accumulating sufficient cash balances in its Fed account to pay upcoming coupon payments. The implication of this approach would be that the Treasury would be delaying non-principal and interest (P&I) payments even on days when it may have ample balances in its Fed account to have been able to make those payments if it had so chosen. Instead, the Treasury would be conserving that cash to be able to ensure that it would be able to pay future-dated interest payments.

The ethics and optics of not paying, say, the military or Social Security recipients to conserve cash for debtholders is, to be understated, problematic. Of course, this also involves violating other laws—the ones in which the Congress authorized the pended payments to be made. But, if the Treasury Secretary agrees to prioritization, default can be avoided.

The mechanics are that, mindful of coming but uncertain inflows, the Treasury would start pending some payments while it still had cash on hand at the Fed so as to meet scheduled coupon and principal payments—effectively creating new IOUs not subject to the limit—thereby preserving funds and turning up the heat on politicians to act. (Imagine the load on Capitol Hill switchboards if the Treasury did not send out Social Security payments, for example.)

This is not so unusual in the wider world. Many governments resort to "below the line" financing to keep the show running by letting arrears mount with vendors, employees and retirees. As already mentioned, the US has relied on inter-government arrears during debt-ceiling emergencies since 1994. Twelve times, the Treasury has replaced nonmarketable government securities in the Thrift Saving Plan (more precisely in the "G-Fund" of the deferred-contribution retirement plan for federal employees) with non-interest-bearing IOUs. The former counts toward the public debt subject to limit (PDSTL) but the latter, as it does not bear interest, does not. (The Treasury always makes the G-Fund whole after the fact.) By relying on arrears to the private sector, the US will move up in the league table of late-payers to join the company of Greece and Italy. Calls for Secretary Yellen's impeachment will follow (as was the case when Robert Rubin first disinvested the G-Fund in 1994), even though she would be led to this as the lesser of multiple evils imposed by her political masters.

The Way Forward

Despite the histrionics, we have never as a nation hit the drop dead date of running out of cash while the debt ceiling binds, presumably because the stakes associated with failure are so high. On the surface, the political economy is that the debt ceiling poses a sharp-edged threat that the two parties can use as a lever to get movement elsewhere. The device is especially attractive, we suspect because, deep down, most politicians believe that the event is only seemingly sharp-edged. The Secretary of Treasury and Fed Chair will, in extremis, dull the edge with still another gimmick to save them from themselves. In that faith, they extend the standoff until one of the parties conclude that they will be blamed for any untoward consequences.

The cause for worry is that this time, the political camps believe that they each have higher moral ground. Democrats argue that the debt represents the accumulation of prior deficit legislation (including from the Trump years) and that the limit should be raised in regular order (i.e., with at least 60 votes in the Senate). Republicans argue that the recent deficit surge owes to a bill (or bills to be) passed through reconciliation with only Democratic support. If Democrats can spend on their own, then they can also raise the debt ceiling on their own.

Further complicating matters, there seems some desire to pair action on the authority on the stock of debt with the authority to spend, which is about *flows*, in a continuing resolution. If spending authority is not passed by the start of the new fiscal year, which begins next month, then the government shuts down. The 'X-date'-the date in which the US Treasury will be unable to meet its obligations-follows shortly thereafter. Both, obviously, are must-do, whether paired or put on separate tracks. The former is probably a coin toss to be enacted this month. The latter would avoid a shutdown but most likely leave the debt ceiling for a later day.

However, there aren't many later days left as the bandwidth of a normally shambolic Capitol Hill is already crowded with consideration of two massive spending and taxing proposals (the American Jobs Plan and the American Family Plan) to be routed through two different legislative procedures (respectively, regular order and reconciliation). This could push debt-ceiling action close to the edge of the cliff, recognizing that the cliff edge is indistinct given uncertainties about Treasury cash flows.

One Last Movie Reference

The Congress will act because it must, but it may be close to the wire and raise angst in financial markets not yet evident. The Treasury will likely speed the process along by instructing the Fed to pend other payments to protect coupon and principal payments. We believe this would unleash howls of protests from those counting on those receipts and waves of indignation from the Progressive wing on the Hill about protecting capitalists. Treasury and Fed officials may be pressed further if the Congress cannot consider actions conventionally deemed unthinkable. For instance, Secretary Yellen might resort to even more doubtful accounting gimmicks such as revaluing gold holdings or issuing a platinum coin. Chair Powell (who was a debt issuer in the first Bush Treasury) might look the other way on overdrafts, especially if they could be dismissed as short-term and technical on the cusp of Congressional action.

The sad conclusion is that this is a repeated game of chicken. It is a costly contest, though, both in terms of administrative expenses and borrowing costs. It is a risky one, too, because of the low level of trust among the parties involved. Remember that the prototypical game of chicken among teenage drag racers appeared in *Rebel Without a Cause*. Late in that movie, Sal Mineo goes over a cliff, his coat sleeve caught in the car door. Mistakes happen even when the stakes are high.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

[1] Apologies to all Ewoks, everywhere, for the comparison to US politicians.

[2] This is the formal name for the debt ceiling, abbreviated as PDSTL, an acronym sometimes as frightening as HWMNBN in another cinematic universe (as in "He Who Must Not Be Named" in Harry Potter).

[3] The "Gephardt Rule" from 1979 made the redundancy explicit for a time: this parliamentary rule automatically raised the debt ceiling when a budget was passed.

[4] Intragovernmental Holdings: Primarily, Government Account Series (GAS) held by government trust funds, revolving funds, and special funds. Debt Held by the Public includes all federal debt held by individuals, corporations, state and local governments, foreign governments, and GAS deposit funds, such as the Thrift Savings Plan.

[5] Unamortized Discount: The difference between the par value of a bond and the proceeds from the sale of the bond by the issuing company, less the portion that has already been amortized.

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