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Does the Debt Ceiling Really Matter?

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Concerns about the debt ceiling tend to focus on the most unlikely outcome—a true default by the U.S. government. Even in a scenario where the government misses an interest payment, the most likely scenario is a delay in the payment rather than a true loss of principal. The increase in market volatility that is likely to result from a debt "default" would likely be more troublesome than any direct economic impact from reduced cash flows or transfers to beneficiaries or vendors.

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The Federal Reserve (the Fed) has detailed a "playbook" for containing the effects of a debt-ceiling-led default as we approached similar crises in the past—in 2011 and 2013. Minutes from a conference call in 2013 suggested that the Fed would first look to address market strains by using traditional tools—outright purchases of Treasury securities, securities lending, rollovers of existing debt, repurchase agreements (for monetary policy purposes) and the discount window. These facilities would accept Treasury securities currently in default at "their potentially reduced market prices."[1]

Other potential issues could be addressed by being a source of "unblemished (i.e., not in default) Treasury collateral" and by providing additional funding to dealers through repurchase agreements (not for monetary policy purposes). More aggressive actions could be taken as needed, including quantitative easing or the swapping of good CUSIPS for those in default.[1]

Some operational issues would potentially be created under a default scenario, which would be dealt with by the Treasury authorizing the Federal Reserve Bank of New York to "extend on Fedwire the maturity date of any security maturing the next day".[1]

If a default results in a significant issue that cannot be contained, the Fed has also estimated the impact on the economic outlook and markets—growth would be expected to be sharply lower as direct government spending and government-supported consumer spending would be curtailed. The Fed model would expect Treasury yields to rise and spreads in other debt assets to widen significantly.[2] History also suggests that the equity market could decline on a sustained basis.

We believe that the impacts noted above are highly sensitive to the exact timing of the event. A default that occurs at a time of the month that does not impact Social Security payments, for example, is likely to have a much less significant impact than one that results in a delay in those cash transfers to recipients. Further, when the last debt ceiling crisis occurred—one that resulted in a downgrade to U.S. government debt rather than a default—U.S. Treasury yields moved lower—the opposite move from what would be expected for a security class that was just downgraded by a rating agency. As such, what we can be reasonably sure of is that a default would result in a volatility-boosting event and a likely negative impact on liquid assets.

This focus on default ignores the most likely near-term risk—the debt ceiling is raised, and the Treasury Department is able to issue debt normally and return the Treasury General Account, the checking account of the U.S. government held at the Fed, to more normal levels.

The Fed's securities portfolio (System Open Market Account, or SOMA) peaked in May 2022 at $8,504 billion. At the May 2022 FOMC meeting, the Committee announced that the balance sheet would be allowed to shrink. The Fed would commence Quantitative Tightening (QT), beginning June 1, 2022. As the Fed's securities portfolio is the core asset held by the Fed to back the U.S. money supply, this action can be seen as an effort to reduce the amount of money outstanding and/or the liquidity in the economy. Since the start of QT, the Fed's securities portfolio has shrunk by more than $700 billion.[3]

This shrinkage has been offset by two factors. First, the recent banking turmoil has resulted in an increase in other assets such as loans on the Fed's balance sheet. These other assets are almost $250 billion higher than they were at the peak of the Fed's securities portfolio.[3] As a result, since the Fed announced QT, the Fed's overall balance sheet (the portfolio plus other assets) has only contracted by $458 billion.[3]

The second factor is more troubling as it has the potential to reverse itself quickly if the debt ceiling is raised—the Treasury General Account (TGA) balance. The TGA had a balance of $867 billion during the period when the Fed's securities portfolio peaked.[3] Now, because of efforts by the Treasury to avoid breaching the debt ceiling, it has a balance below $100 billion.[3] This reduction in the TGA balance has boosted the amount of liquidity in the economy (money held at the Fed is outside of the banking system) and has more than offset the impact of the Fed's QT efforts. In fact, between the Fed's actions to support the banking sector and the TGA flows, there has been a net increase in liquidity in the economy since the Fed began QT.

Should the debt ceiling be lifted, and the Treasury is able to return the TGA to a more normal size, it could result in a significant increase in the TGA within a relatively short time frame. That could be the equivalent of several months of QT. So, while the consensus is that market participants should be worried about default risk, there is also the risk of a liquidity shock once the debt ceiling issue is resolved, as the Treasury moves to rebuild the balance of the TGA, creating a liquidity drain.

Endnotes

[1] Federal Reserve, FOMC Conference Call, October 16, 2013
[2] Federal Reserve, Possible Macroeconomic Effects of a Temporary Federal Debt Default, October 4, 2013
[3] Federal Reserve, H4.1 report

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