U.S. Debt Ceiling:
A Big Deal or Not?
October 5, 2023

In the spring of 2023, Republicans in the U.S. House of Representatives, having secured a narrow majority in the 2022 elections, refused to raise the U.S. debt ceiling unless certain categories of discretionary spending were capped. President Biden initially refused to negotiate. But as the date approached when the debt ceiling would prevent borrowing, discussions began among the President, congressional Democrats and House Republicans. These discussions were contentious, and it seemed a real possibility that the debt ceiling would not be raised in time and that the federal government would either default on its debt or be forced to shut down some operations, delaying payments to government employees, suppliers or recipients of transfer payments. Countless opinion pieces were written arguing for or against holding U.S. debt sacrosanct or prioritizing this or that category of government spending. At the last minute, a compromise was reached: the debt ceiling was suspended until January 2025 and a plan to cap discretionary spending was agreed upon.

During the debt ceiling fight, a relative in Canada asked me whether this was really such a big deal and what would happen if the United States defaulted on its debt. My immediate response was that it was, indeed, a big deal and it would be disastrous if the United States defaulted. I started this piece to explain my thinking. However, I was distracted for a couple of months and when I returned to the issue, the discretionary spending plan was not going well. A budget for FY2024, which started October 1, 2023, had still not been passed and a partial government shutdown seemed likely. At the last minute a shutdown was averted, with the House voting to fund government another 45 days, buying more time to resolve differences.

The second shutdown threat was not over the debt ceiling, as such. Rather, the focus was discretionary spending - the 25-30 percent of the budget that must be appropriated annually. Defense accounts for almost half of discretionary spending. Other areas subject to annual appropriations include the Departments of Labor, Health and Human Services and Education; Transportation and HUD; and Homeland Security. "Mandatory" spending, which includes Social Security and most other entitlement spending, and interest payments were not at risk. Thus, the fall fight, unlike the spring confrontation, did not directly affect the government's ability to borrow and meet its credit obligations, although it does not bode well for future debt ceiling talks.

I continue to think a default on U.S. debt would be very unfortunate for both the United States and the world, but disastrous may have been an overstatement.

Why Governments Borrow

Sovereign governments borrow when expenditure needs outstrip revenues from taxes and other sources. Wars commonly lead to massive borrowing. Countries may also borrow to

invest in major infrastructure projects or other development initiatives. Recessions lead to increased borrowing, as tax revenues fall and social welfare needs increase.

Sometimes the reason for borrowing is a simple matter of timing: government spending occurs at a steady rate while tax receipts are concentrated around certain dates. The government borrows – usually short term – in anticipation of these tax inflows to meet ongoing spending needs.

Government debt is issued in various lengths and designs. Interest rates must be competitive with rates in other countries and the return on investments in the private sector. Short-term securities normally have lower interest rates than longer term. However, borrowing short requires returning to the market to borrow again and again. If interest rates rise, a government that borrowed short finds itself refinancing at a higher interest rate, whereas borrowing long would have locked in the lower rates of the past.

Governments often roll over their debt – that is, pay off maturing debt by issuing new debt. The nominal amount of debt outstanding does not go down. However, if the country's economy is growing, servicing the debt – paying interest and refinancing maturing debt - becomes less burdensome. If the growth is due to real economic activity or unexpectedly higher inflation, debt and interest payments fall relative to GDP. However, if growth is due to expected inflation, the debt-to-GDP ratio is unlikely to fall, because expectations of inflation will be reflected in higher interest rates, which will raise interest payments, increase budget deficits and add to accumulated debt. The ratio of debt to GDP is a common and useful indicator of changes in a country's debt situation over time. It is also used to compare the debt burdens of different countries.

U.S. debt-to-GDP soared in WW II, fell steadily into the mid-1970s, rose in the 1980s and early 1990s, dipped in the late 1990s, rose sharply in response to the 2008 financial crisis and the sluggish recovery that followed, and then surged again in the pandemic.

Brief History

Most countries do not have debt ceilings. But most countries do not have political systems quite like that in the United States.

According to the Constitution, Congress is responsible for passing laws, including approving a budget and raising the necessary revenues. Increasing taxes and authorizing borrowing are congressional responsibilities. The President is head of the executive branch, which carries out the laws passed by Congress, including administering the budget, collecting taxes and managing borrowing.

Until 1917 , Congress approved each individual debt issue, usually specifying purpose, type of instrument, and terms. With the U.S. entry into WWI and the need to borrow heavily, congressional approval of individual borrowings was too cumbersome. A ceiling was

established under which the Treasury could issue bonds without congressional approval to finance the war effort.[1]

Additional legislation in 1939 gave the Treasury more flexibility in issuing and managing the government's debt, subject to an overall limit on debt outstanding. This limit was raised substantially in 1941 and several times thereafter. In 1946 the debt limit was cut back.

In the 1950s, 60s and 70s, the debt limit was frequently increased. Sometimes debates were prolonged, forcing the Treasury to engage in various accounting and other maneuvers to avoid running out of money before the limit was increased.[2] These maneuvers were termed "extraordinary measures." Despite increases in government debt, the ratio of debt to GDP declined through most of the period.[3]

In the 1970s debate shifted from the debt ceiling more to the budget itself; and in 1979, the House adopted the Gephardt Rule, under which passage of a budget by the House was considered to have suspended the debt limit and a separate vote on the debt ceiling was not required. This allowed House members to take credit for spending without having to explicitly approve more borrowing.

In the 1980s, during President Reagan's term, the debt limit was frequently increased and the debt limit and debt itself began to increase relative to GDP. The Treasury's use of extraordinary measures became relatively commonplace.

The debt limit and outstanding government debt continued to rise relative to GDP into the 1990s. Gross debt surpassed 65 percent of GDP in mid-decade compared to under 35 percent at the end of the 1970s. However, in the 1994 election, Republicans gained control of the House of Representatives, and the following year they passed a budget including spending cuts strongly opposed by President Clinton and fellow Democrats. Clinton vetoed the budget. Subsequent Republican budget proposals were also rebuffed. Republicans countered by refusing to increase the debt ceiling. The result was a partial shutdown of the government and the furlough of many government workers over the 1995-96 holiday season. Republicans were blamed for the shutdown and eventually conceded to Clinton's priorities. But they have claimed credit for the fiscal restraint exercised during the rest of Clinton's presidency. The government ran budget surpluses for several years and the debt-to-GDP ratio fell below 60 percent.

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[1] Interestingly, a few scholars argue that the United States defaulted on some of these bonds in the 1930s by paying bondholders in paper currency rather than in gold coin as stated on the bonds. There do not appear to have been adverse repercussions for financial markets.

[2] The debt ceiling applies to the gross debt issued by the federal government. Some of this debt is held by government trust funds controlled by the government. Extraordinary measures usually involve delaying reinvesting the securities held by these funds. In FY2022, this intragovernmental debt was over 20 percent of total gross debt. The remaining debt is called debt owed the public, although it includes the debt held by the Federal Reserve.

[3] Real growth was strong in the 1950s and 1960s; inflation picked up in the late 1960s and accelerated in the 1970s.

In the 2000s the federal government again began to incur budget deficits, requiring increases in the debt ceiling. Deficits and the need for a higher debt ceiling increased sharply in the global financial crisis of 2007-9 and in the sluggish recovery that followed.

Debate over raising the debt level was particularly heated in 2011. The rating agency, Standard & Poor's, lowered its credit rating for U.S. federal government debt from AAA to AA+, citing "brinksmanship" among other reasons. In 2013, disagreement over the budget led to a partial government shutdown. The Republican-controlled House would not pass a budget including funding for the Affordable Care Act (ACA), while President Obama and the Democrat-led Senate insisted on a budget with ACA funding. The shutdown ended with Congress providing the necessary funds for government operations including ACA and suspending the debt limit for a year, but also imposing caps on discretionary spending. Gross debt-to-GDP in FY2014 was 102 percent.[4]

By FY2022, debt-to-GDP had risen to 120 percent, reflecting the impact of the pandemic, President Trump's tax cuts, and President Biden's infrastructure and other spending initiatives. Under the agreement in spring 2023, the debt ceiling was suspended until January 2025.[5]

Why So Contentious?

I see four reasons why raising the debt ceiling is a political flashpoint, and also a legitimate issue.

a) Fights over the debt ceiling highlight major policy differences within government and the country.
b) Failure to raise the debt ceiling would force the federal government to choose between defaulting on its debt and severely cutting spending.
c) A high ratio of debt to GDP is undesirable in itself.
d) The U.S. dollar is the world's dominant currency. This dominance would be threatened if the United States defaulted on its debt.

Sign of Policy Differences

Prolonged and recurring fights over the debt ceiling are a sign of a deeply divided government in which the opposing sides are fairly evenly balanced.

Congressional law-makers dislike raising the debt ceiling. Even when relations between the two parties are cordial and the President and Congress are aligned, Congress looks for procedures, such as the Gephardt Rule, that avoid a vote on the debt ceiling. Congress also

[4] Gross debt-to GDP figures are from *The Economic Report of the President 2023,* Table 46.

[5] Suspending the debt limit for a specified time period, rather than raising the limit, has become more common. When the end of the period is reached, the debt limit is reinstated, but with the increase in debt that occurred during the suspension added. The limit can be suspended again.

tends to procrastinate on the debt ceiling, forcing the Treasury to regularly resort to extraordinary measures. However, the confrontations of the mid 1990s and since the global financial crisis were grounded in serious policy differences.

Most government policies have budget implications. Control over the budget affords significant control over policy. New policy initiatives often require more spending. Without a budget, the program cannot go forward. And not just new policies are vulnerable. If enough lawmakers are unhappy with an agency's policy direction, they may try to force change by cutting its budget. While the appropriations process is usually where policy/budget disagreements are addressed, a binding debt ceiling – that must be increased for the government to borrow - provides a second chance for those who lost in the budget debates to try again.

The most intense fights have occurred when Republicans recently gained control of the House of Representatives and the President was a Democrat. Since the President is elected every four years and members of the House every two years, a Democrat can be elected as President with a House controlled by Democrats and two years later the House is run by Republicans. Democrats tend to favor larger and more active government; Republicans favor smaller, less intrusive government. When the Democrats have both the President and the House, they often launch new spending programs, which the Republicans oppose. If the Republicans gain control of the House in the next election, they may use the debt ceiling to rein back initiatives they dislike, as well as control general spending. Although the Senate must also approve budgets and increases in the debt limit, it has been less active in these debates than the House.

As noted above, in 2011 Standard and Poor's downgraded the U.S. federal government credit rating at least partly because of the polarization between the parties. Fitch did the same in the spring of 2023.[6] The ratings agencies feared that disagreements over the budget and raising the debt ceiling would not be resolved before the government ran out of money and that the U.S. Treasury might fail to meet its interest and repayment obligations to holders of its securities.

Disruptive

Since World War II, the U.S. federal government has almost always run a budget deficit. The notable exception was the late 1990s, when there were surpluses for four consecutive years.

With outlays normally surpassing revenues by 15-20 percent - and by a much wider margin recently, the government fills the gap by borrowing. If the government cannot borrow because of the debt ceiling, it cannot pay all it owes or has promised. The Treasury can push out the date when it runs out of money, but eventually the government must choose which obligations to meet on time and which will be postponed.

[6] As of September 25, 2023, the third major rating agency, Moody's, still gave U.S. government debt its highest rating (Aaa.)

The choice is usually framed as a choice between meeting credit obligations, that is making interest payments and paying off maturing debt,[7] on the one hand, and cutting government programs and services, and potentially transfer payments, on the other. Most lawmakers and senior government officials seem to view meeting credit obligations as the top priority.[8]

The government is then faced with deciding which programs and services to cut. Someone expecting funds from the federal government will not get paid on time. Those at risk include contractors or vendors that provide goods and services to the government, state and local governments expecting grants or other federal funding, and government employees who could be furloughed or required to work and paid later. Possibly, some entitlement programs would be affected. These delays will be painful for those directly affected and a source of anxiety to others who fear they might be.

Government services to the public will be curtailed. National parks might be closed; people might be unable to get passports; research programs could be interrupted; military preparedness could suffer. Longer term effects include impacts on employee morale and public confidence in government.

High Debt-to-GDP

While a debt ceiling is inconvenient, persistently large deficits and a high and rising debt-to-GDP ratio are problems. Government debt may crowd out private investment. Rising interest expenses may crowd out other federal spending or require tax increases. Investors may become reluctant to buy additional public debt, raising interest rates and possibly leading to excessive money creation and inflation. Even if debt-to-GDP is manageable today, aging populations and their needs for financial and medical support will increase the debt burden facing tomorrow's workers.

Crowding Out Private Investment

Sovereign government debt is lower risk than the country's private debt and tends to set a floor on interest rates. Increased government borrowing raises interest rates generally, making it more costly for households and businesses to borrow and potentially squeezing out productive private investment that would contribute to future economic growth. Of

[7] Rolling over maturing debt would not run afoul of the debt ceiling if there were no net increase in outstanding debt.

[8] In the 2023 debate, some congressional Democrats and legal scholars argued that Section 4 of the 14th Amendment gives the President the authority to issue debt even if it does violate the debt ceiling – and does not, therefore, require cutting spending. Others view this as a very strange interpretation of the statement in Section 4 that "The validity of the public debt of the United States, authorized by law,… shall not be questioned." Such an interpretation would certainly be challenged in court; until its legality was resolved, investors would almost certainly be hesitant to acquire new U.S. debt.
In the 2011 debate, a contingency plan seems to have been developed prioritizing payments of principal and interest, according to contemporary Federal Reserve FOMC records.

course, debt-financed public investment can also be very productive. The 1803 Louisiana Purchase, which opened up vast expansion possibilities, was financed by borrowing. Today, however, much government borrowing supports routine services and transfer payments.

Crowding Out Public Spending

The interest payments that the federal government makes on its debt are an expense. If these increase, other spending must be cut or taxes raised to prevent an increase in the deficit. If neither step is taken, the deficit will grow and further borrowing will be required with the attendant increase in interest payments. Discretionary spending, that is spending requiring annual appropriations, is particularly vulnerable to being squeezed. The major entitlement programs, especially Social Security, are considered mandatory and are largely untouchable.

Of course, interest rates also determine what happens to interest payments. After the global financial crisis, the Federal Reserve kept interest rates very low; the federal funds rate was close to zero until 2016. As a result, the government's net interest payments were 6 percent of outlays from FY2009 to FY 2016 – a much lower share than before the crisis. Rates and payments rose modestly at the end of the decade. But then came the pandemic. The federal funds rate was cut to zero again; and even though government debt ballooned, interest payments were 5 percent of outlays in FY2020 and FY2021. However, in March 2022, responding to higher inflation, the Fed began raising rates. Interest payments accounted for 8 percent of outlays in FY2022 and 10-11 percent in FY 2023. [9]

Over the long run, the relationship between the interest rate and the growth rate of GDP is critical to a government's ability to service its debt and fulfill its other functions. If the interest rate is less than the growth rate, the ratio of debt to GDP will fall, provided the deficit does not expand. But if the interest rate is above the growth rate, debt-to-GDP will increase even if the budget, excluding interest payments, is balanced. If the latter situation persists, doubts about the government's ability to meet its obligations can create a self-fulfilling prophesy, with investors demanding ever higher rates.

For the United States, government interest rates have usually been less than the rate of growth in GDP, but some countries have had extended periods when growth rates fell short of interest rates. The European Sovereign Debt Crisis of 2011 arose largely because of investors' concerns that Greece and several other Eurozone members faced that challenge. The European Central Bank alleviated the crisis.

Market Resistance

Countries with high ratios of debt to GDP are generally borrowing in financial markets all the time. They cannot easily postpone borrowing because ongoing expenditures exceed

[9] Net interest relative to outlays from *The Economic Report of the President 2023,* Table B-47; supplemented by the "Monthly Treasury Statement" August 2023.

revenues by a sizable margin. Also, much of their debt is usually short term to take advantage of low short-term interest rates.

At the end of FY 2022, about a third of the U.S. government's marketable debt outstanding was vulnerable to higher interest rates the following year. Eight percent was, in effect, variable rate debt; 15 percent was fixed rate debt in bills with a maturity of a year or less and another 12 percent was in longer term notes and bonds maturing in 2023.[10]

For some countries, the need to roll over short term or maturing debt poses risks beyond the prospect of higher interest rates increasing interest payments' share of the budget. If the government's need to refinance coincides with a severe financial crisis, the government might find itself facing rates that are unsustainably high or even the possibility of no private sector buyers at all. If the government's debt is denominated in its own currency, the central bank can purchase the debt itself. Such purchases may lead to excessive growth in the money supply and inflation, but default would be avoided. If, however, the country has borrowed abroad and the debt is denominated in a foreign currency, this option is not available. To meet obligations in a foreign currency, the government must draw down its foreign reserves and if these run out, it defaults.

The United States borrows abroad but in its own currency. U.S. dollars and U.S. government debt are in demand around the world. It is hard to imagine circumstances in which the U.S. government could not sell debt at an acceptable rate. This is a great advantage – part of the privilege of having the world's dominant currency[11] - a privilege no other country enjoys and one that the United States should ensure it retains.

Global Currency

The U.S. dollar is the world's dominant currency. Its role in international transactions is much larger than the U.S. share of global output or trade. Governments, businesses and households in other countries keep sizeable wealth in dollars and in dollar-denominated assets. They buy U.S. government securities and acquire private assets, such as U.S. bank accounts, corporate debt and stocks. About 60 percent of the foreign exchange reserves of the world's central banks are held in dollars. It is thought that about half of U.S. cash outstanding is held by foreigners.[12]

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[10] Variable rate (TIPS and FRNs) and bill shares are from the *Economic Report of the President 2023,* Table B-51 and the notes and bonds share is estimated from Figure 1 in Kozlowski, Julian and Samuel Jordan-Wood. 2023. "Assessing the Cost of Rolling Over Government Debt." *Economic Synopses,* Federal Reserve Bank of St. Louis, 2023 No. 13. Posted 2023-06-02.

[11] In the 1960s, Valery Giscard d'Estaing, then Minister of Economy & Finance in France, described the dominance of the U.S. currency as an "exorbitant privilege."

[12] Numbers in this paragraph are from Bertaut, Carol, Bastian von Beschwitz, and Stephanie Curcuru. 2023. "The Fed-The International Role of the U.S. Dollar" Post Covid Edition. *FEDS Notes.* June 23, 2023. https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-us-dollar-post-covid-edition-20230623.html

Oil and many other globally traded commodities are priced in dollars. Trade often takes place in dollars without U.S. involvement. International financial transactions are disproportionately in dollars. A borrower in country X may get a dollar-denominated loan from a lender in country Y, because it can be easier to convert country Y's currency into dollars and dollars into country's X's currency than to exchange Y and X's currencies directly.

Why is the dollar used so much for international transactions and as a store of wealth? Although its share of global output has declined, the United States has been the world's largest economy for a long time,[13] and over the years U.S. entities were on one side or the other of many transactions. The United States also has had a well-developed financial sector for a long time. No other country has such large and liquid financial markets. Critically, the U.S. government's track record of timely payment of interest and principal on its own debt is good – much better than most countries'. And unlike many countries, the United States does not have capital controls restricting international transactions.[14] Additionally, U.S. banks and other financial services firms have become expert in assisting global investors in deploying their funds.

The bottom line is that U.S. dollar assets are prized and short term U.S. Treasury securities are the safest, most liquid asset available to global investors.

Pros and Cons

What are the pros and cons of the dollar being a global currency? Because dollar-denominated assets are in demand around the world, the value of the dollar is higher relative to other currencies. This is a disadvantage for U.S. exporters and producers of import-competing goods, as their products are more costly relative to their foreign competitors'. The manufacturing sector is adversely affected. The other side of a strong dollar is that U.S. households and businesses can purchase foreign goods and services more cheaply.

The global demand for U.S. assets also means that interest rates are lower than otherwise. This favors interest sensitive activities, such as construction and real estate. The federal government can readily borrow from abroad in its own currency.[15] Private U.S. companies also benefit from global investors' strong demand for dollar assets. In financial crises, even ones of U.S. making, the United States is seen as a safe haven and attracts funds from other countries.

Borrowers in many countries, including governments, cannot borrow abroad in their own currencies. Many do borrow abroad to take advantage of lower interest rates, but the loans

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[13] The United States is still the largest economy at official exchange rates but has been surpassed by China in purchasing power parity terms.
[14]Some analysts are concerned that the U.S. use of financial sanctions to combat terrorism and other international threats over the past 20 or so years undermines the dollar's attraction/
[15] Foreign holdings of U.S. dollars as cash are a source of seigniorage.

are typically in dollars. However, this puts them at risk if their currency depreciates relative to the dollar. Depreciation increases their debt obligations as measured in their own currency. If they are dependent on domestic activity for most of their revenues, paying interest and principal in higher cost dollars will be a strain.[16] Some borrowers default.[17]

With its own overseas debt in dollars, the U.S. government does not need to worry about a depreciation making debt service obligations more burdensome. The Federal Reserve can always create dollars. It does not need to stockpile foreign exchange reserves.

That the U.S. dollar is used in so many international transactions is also convenient and efficient for U.S. participants in these transactions. The U.S. importer does not need to acquire foreign exchange to make a purchase. The exporter does not need to convert sale receipts from another currency into dollars. Plans for the future can be made without much consideration of exchange rate fluctuations.

And there is undoubtedly an element of status in a strong dollar. While some may view status as unimportant, China has been actively trying to increase use of the RMB in international transactions. So far, success has been modest, but their efforts indicate that others see value in a strong, internationally recognized currency.

Implications for Debt Ceiling

If Congress failed to raise the debt ceiling on time and the Treasury was forced to delay payments of interest or principal on maturing securities, it would jeopardize the dollar's position as the world's dominant currency. Borrowing would be more costly. The value of the dollar would likely fall. The value of outstanding Treasury securities would certainly fall. How much would depend upon expectations about the length of the delay and the likelihood of recurrence. The impact on financial markets is impossible to predict. U.S. treasuries are the "safe asset" in a host of transactions, many of which are probably not well understood. Holders of dollar assets around the world would suffer losses.

That said, the financial system survived President Roosevelt's confiscation of the public's monetary gold in 1933 (in exchange for dollars) and the dollar's subsequent devaluation relative to gold. It also weathered President Nixon's termination of the remaining ties between dollars and gold in the early 1970s.[18] The latter event coincided with an extended decline in the value of the dollar relative to other currencies and a rise in inflation in the

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[16] A borrower that produces a global commodity priced in dollars would be much less affected by a depreciation than one that depends on locally generated revenues. This applies to private borrowers and governments.

[17] A perfect storm is a financial crisis that drives up interest rates in many countries, combined with a global financial flight to quality. Quality often means U.S. Treasury securities. Such capital flights put downward pressure on other countries' currency values relative to the dollar.

[18] Although the convertibility between dollars and gold for the public ended in 1933, foreign governments could exchange dollars for gold at the official rate of $35 per oz. Nixon ended this convertibility in August 1971. He expected to restore convertibility at a later date, but this did not happen,

United States and many other countries. But chaos did not ensue and the dollar remained dominant.

Given the uncertainties, however, this is not an experiment we want to undertake.

<u>Conclusion</u>

The United States is unusual among countries in having a debt ceiling. The debt ceiling was originally intended to facilitate management of the debt, allowing Treasury flexibility in choosing timing, instruments, terms and quantities of debt, provided the ceiling was not exceeded. Previously, Congress designed and approved individual debt issues.

Since the mid-1990s, the debt ceiling has been a political bargaining chip as Republicans, when they have gained control of the House of Representatives, have tried to rein back what they perceive as excessive spending approved by Democrats. Meanwhile, Democrat presidents and members of Congress have delayed negotiations and stonewalled. The resulting standoffs have gone to the last minute, occasionally leading to government shutdowns and raising the prospect of a default on government debt.

There are good reasons to be concerned about high and rising government debt. However, a government shutdown would be disruptive for many and a default on U.S. debt raises unknowns that we do not wish to contemplate.