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Why the Debt Ceiling Debate Matters

To justify and preserve their confidence; to promote the increasing respectability of the American name; to answer the calls of justice; to restore landed property to its due value; to furnish new resources, both to agriculture and commerce; to cement more closely the union of the States; to add to their security against foreign attack; to establish public order on the basis of an upright and liberal policy;—these are the great and invaluable ends to be secured by a proper and adequate provision, at the present period, for the support of public credit.

– Alexander Hamilton, First Report on the Public Credit, January 9, 1790[1]

Why the Debt Ceiling Matters

Our Federal Government has not run a surplus since Bill Clinton was President. To make up the shortfall between revenue and outlays, the Treasury issues bonds, notes, and bills, debt instruments representing government borrowings. Investors have long regarded these Treasury securities as among the safest in the world, subject to price fluctuations in response to changing interest rates, but highly reliable in terms of the timely payment of interest and return of principal. The notion that the Treasury might fail to makes its promised payments of principal and interest on its debts — that the Treasury might default — has historically seemed unthinkable.

The Treasury derives its legal authority to borrow and to service the debt from Congress. For many years, Congress has specified a limit to the amount of Treasury debt that may be outstanding at any time — the debt ceiling. In periods of chronic deficits, where no Government revenue is available to go toward retiring debt, the total amount of borrowings outstanding must continually increase. That's just simple arithmetic. Accordingly, every now and then Congress has to vote to pass a law raising the ceiling.

[1] For the full text of Hamilton's report, including block quotes later in this paper, see http://press-pubs.uchicago.edu/founders/documents/a1_8_2s5.html

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Treasury Secretary Jack Lew recently informed Congress that by November 3, 2015, the Treasury would essentially run out of cash unless it can borrow beyond the current limit. That date, then, is a kind of deadline for Congressional action.

Meanwhile, the announcement by House Speaker John Boehner (R-OH) that he plans to step down as Speaker and resign his House seat has created a leadership crisis in the majority party in Congress. Much to the consternation of traditional conservatives in the party, a few dozen right-wing hardliners appear to have seized on the turmoil as an opportunity to strengthen their influence in the Republican caucus. More worrisome, some hardliners have expressed a willingness to use the debt ceiling as a cudgel, and even conservative voices that ordinarily prefer less, rather than more, government spending have expressed alarm at the possible consequences. Those voices are right. Threatening to withhold action on the debt ceiling recklessly creates an entirely unnecessary risk to our economy, and even to our banking system.

Part of the political problem with the debt ceiling debate is that the ceiling itself is such an abstract notion that its implications may be difficult to see. Absent an increase in the debt ceiling, Treasury would become unable to meet its obligations, both from Congressional appropriations and from the necessity of servicing the Federal debt. Some hardliners have hinted that by threatening to cause enough havoc over the debt ceiling, they may be able to advance a more radical agenda than would otherwise be possible. But forcing the issue with such a blunt instrument as the debt ceiling could lead to economic shocks with profound, and possibly unintended, consequences. To see why, we need to look at how US Treasury debt operates in our economy and our banking system.

A sudden stop to government borrowing could have both fiscal and monetary consequences. Part of the problem is technical. Reaching the debt limit would prevent Treasury from making all of its payments, since only a portion of the required funds would be available. However, Secretary Lew has warned that, lacking both precedent and legal authority, the Treasury simply has no mechanism for prioritizing some payments over others. Thus, it remains far from clear which payments Treasury would make, and which it would withhold or defer. The practical uncertainty this would cause Federal employees (including members of the military), contractors, and creditors could disrupt economic activity in broad and unpredictable ways. But even supposing Treasury could clearly delineate a schedule on which anyone due payment from the Government could rely, the effects would likely still be profound. And unlike a short-term Government shutdown, a disruption to the Treasury's ability to borrow could have damaging, long-term consequences.

Contaminating the Money Supply

In one scenario, Treasury would fail to make timely payments of interest or principal on outstanding US Treasury debt. Such a failure would constitute a default. The potential consequences of such a default are difficult to overstate. The most obvious likely problem would be an increase in the interest rates the US Government would have to pay on future borrowings. But it's much worse than just that. US Treasury debt, properly serviced, underpins our very monetary and banking systems. This is no hocus-pocus financial innovation. Alexander Hamilton, Treasury Secretary under George Washington, set out the basic idea in his 1790 *First Report on the Public Credit:*

> It is a well-known fact, that, in countries in which the national debt is properly funded, and an object of established confidence, it answers most of the purposes of money. Transfers of stock or public debt are there equivalent to payments in specie; or, in other words, stock, in the principal transactions of business, passes current as specie.

Hamilton didn't just propose the idea; he implemented it. While his *Report* suggested that Government debt could circulate as currency, in practice banks would hold the Government debt. This provided a base against which they could extend credit, some of which borrowers would receive in the form of bank notes. These bank notes then circulated as currency, supplying money in an economy desperately short of so-called "hard" currency — gold and silver coins.

Hamilton's same concept underlies the basic architecture of the Federal Reserve System, which governs our banks and regulates the issuance of our currency. When a local bank wants Federal Reserve Notes (to stock an ATM, for example), it orders them from the Federal Reserve Bank in its district. The Federal Reserve Bank delivers the notes, charging the amount against the reserves the local bank holds at the Federal Reserve Bank. The Federal Reserve Bank, in turn, orders the Notes from the central Federal Reserve. Under the Federal Reserve Act, the Federal Reserve Banks have to post collateral against the Notes they issue, or hold to issue, to banks. According to the Federal Reserve Bank of New York, "The bulk of the collateral pledged is in the form of U.S. Government securities and gold certificates owned by the Federal Reserve Banks."[2]

In other words, the currency in your pocket is not, as many imagine, a fiction created by Government fiat. It's a liability of the banking system. The Federal Reserve Act protects its soundness by requiring the posting of a countervailing asset — US Treasury

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[2] For more detail, see Federal Reserve Bank of New York, "How Currency Gets into Circulation," at http://www.newyorkfed.org/aboutthefed/fedpoint/fed01.html

securities — as collateral against the issuance of the currency. If Congress impairs the soundness of the collateral by precipitating a default on Treasury debt, the damage would likely extend beyond Treasury borrowings and into the basic functioning of our monetary system, threatening the value of the currency we use every day.

Effects on the Broad Economy

One of the objectives some Congressional hardliners seem to express in threatening to block a debt ceiling increase is to rein in what they regard as runaway spending. Now, determining the level and nature of Government spending is absolutely one of the primary responsibilities of Congress, and Members that believe Government spends too much have a duty to advocate for that position. But on balance, the mischief that would result from undermining Treasury's ability to borrow is much greater than any extending the borrowing limit would permit. Hamilton, again in the *First Report*, argued that a sound public credit acts as a basis for sound public policy, while unfunded credit would destabilize markets, making the creation of sound public policy more difficult, and acting as a drag on economic activity:

> And from the combination of these effects, additional aids will be furnished to labor, to industry, and to arts of every kind. But these good effects of a public debt are only to be looked for, when, by being well funded, it has acquired an adequate and stable value; till then, it has rather a contrary tendency. The fluctuation and insecurity incident to it, in an unfunded state, render it a mere commodity, and a precarious one. As such, being only an object of occasional and particular speculation, all the money applied to it is so much diverted from the more useful channels of circulation, for which the thing itself affords no substitute; so that, in fact, one serious inconvenience of an unfunded debt is, that it contributes to the scarcity of money.

What if there's no Default?

Hamilton's arguments were rather abstract, but we can also estimate more concrete, direct effects of a sudden brake on Government borrowing. The Office of Management and Budget publishes tables of historical and projected Government receipts and outlays.[3] To estimate the effect of a debt-ceiling freeze, let's look at the estimates for Fiscal 2015, and assume that Treasury is somehow able to pay all interest owing on Treasury debt,

[3] These are Excel spreadsheets available for download from the White House website: https://www.whitehouse.gov/omb/budget/Historicals/

and *pro-rate* everything else. OMB estimates total outlays of $3.759 trillion, against total revenues of $3.176 trillion, a deficit of $583 billion, about 15% of the budget. Of the outlays, about $229 billion are net interest payments. That would mean that, on an annualized basis at least, Treasury would have $2.947 trillion in net revenue (that's the $3.176 trillion, less $229 billion allocated to debt service) to cover $3.530 trillion in net outlays (the $3.759 trillion, less the same $229 billion). That shortfall is almost 20%. But more important, the gap of $583 billion would come directly out of Government spending, one of the main components of Gross Domestic Product. OMB helpfully estimates 2015 GDP at $17.985 trillion, so the gap would represent the sudden disappearance of about 3.2% of GDP. Even imagining no knock-on effects from the sudden change in household and corporate earnings that such a hard stop would entail (and completely neglecting the effect on tax receipts or things like unemployment benefits), cutting nearly $600 billion per year from economic activity would more than offset current levels of economic growth, dropping the US economy into a recession overnight.

Conclusion — Toward an Honest Debate

Setting fiscal policy — the level and nature of our taxes and Government spending — is one of the essential functions of our Congress. It's a messy process, full of reasoned debate, inane bluster, back-room dealings, and, in the end, compromise. The results are never fully satisfactory to anyone, because competing interests must battle over finite resources. But the results of the process become our law and policy. Hardliners in Congress are now threatening to upend the process by refusing to permit an increase in the Treasury borrowing necessary to support the appropriations Congress has already approved. This is irresponsible. For reasons as old as our Constitution and as current as next quarter's GDP growth estimate, a Congressional failure to authorize an increase in the debt ceiling could have profoundly damaging and disruptive effects for the entire US economy, echoing far into the future. So let the hardliners make their case for a smaller Federal budget, if they feel it's what their constituents elected them to do. But not by threatening self-inflicted injury to the economy, the banking system, and the US dollar itself.

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Menlo Park, California
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