Why the Debt Ceiling Matters

Since the 118th Congress convened, the federal debt ceiling has taken center stage among the many issues facing lawmakers. But what exactly is the debt ceiling, and how could a failure to increase it affect markets and the economy?

The X-date, when the government runs out of cash, will happen later this year unless Congress increases the debt ceiling.

On January 19, the United States hit its statutory debt limit. This limit -- or ceiling -- is a cap on the total amount of money the Treasury can borrow to meet its existing obligations. It applies to nearly all federal debt, including that held by the public, as well as intragovernmental debt for programs such as Social Security. Once the ceiling is reached, the government is technically unable to issue any new debt and is in danger of defaulting on existing obligations.

Extraordinary Measures

Fortunately, there are ways to stave off an actual default, temporarily at least. On January 13, Treasury Secretary Janet Yellen announced that the Treasury would begin taking "extraordinary measures" to avoid a default. These consist of selling certain assets early, delaying new investments, and moving money between government agencies and departments to enable payments as they come due. Together, these measures temporarily allow the Treasury to continue financing government operations.

There are still other ways to prevent actual default, but such measures can postpone the "X-date" for just so long. The Treasury has not provided an estimate of how long, but Secretary Yellen has indicated that cash and extraordinary measures may not be sufficient to keep the government running past June.[1]

Financial Armageddon

A failure to increase the ceiling would have "catastrophic consequences," according to Secretary Yellen. Incoming tax receipts would be insufficient to pay millions of daily obligations such as Social Security payments, salaries for federal employees and the military, or interest on Treasury bonds. An actual default would create chaos in domestic and global financial markets. Interest rates would rise, and demand for Treasuries would plummet. The stock market would take a nosedive as the economy buckles under the pressure of rising rates and restricted credit.

Deja Vu

If this doomsday scenario sounds familiar, it's because the debt ceiling impasse has happened before -- most recently in 2011. Then, like today, it was used by Congress as a bargaining chip to reduce current deficits and to shift spending priorities.

Although an agreement was eventually reached and the debt ceiling increased, the whole incident left a bad taste with investors and voters. The standoff rattled markets, with the S&P 500 dropping more than 10% over the period, and for the first time, the rating on U.S. government debt was downgraded. What's more, the use of extraordinary measures came with a cost, as the Treasury was forced to sell certain investments earlier than it otherwise would have.

What Lies Ahead

Although the statutory ceiling has already been reached, lawmakers have several months to agree on a compromise and avoid an actual government shutdown or default. Here's what to expect:

A noisy political battle. Unlike in 2021, the last time the debt ceiling was extended, this time it's likely to be more contentious -- more along the lines of the 2011 standoff. Republican leadership in the House has made it clear that it intends to use the ceiling to negotiate spending cuts. Meanwhile, President Biden has indicated that he will not negotiate the debt limit. Such brinkmanship will likely intensify as the X-date draws nearer.

Market volatility. As if inflation, rate hikes, and the possibility of recession weren't enough, the uncertainty surrounding a debt ceiling standoff is certain to stoke even greater market volatility.

Economic repercussions. Should the standoff reach the point where the X-date is in sight, interest rates would likely rise. This is what happened in the 2011 standoff, making it more expensive for companies and homebuyers to borrow, and dampening economic growth.

In the end, both Democrats and Republicans would be shooting themselves in the foot if they continued their brinkmanship for too long. An actual default would be a disaster for the U.S. economy and its standing in global markets. So, no matter what noise may come from Washington about the debt ceiling in the coming months, remember the past, and keep your sights set on your long-term goals.

[1] New York Times, *How 'Extraordinary Measures' Can Postpone a Debt Limit Disaster*, January 18, 2023.