WINTHROP WEALTH

NOVEMBER 2021 CLIENT QUESTION: THE DEBT CEILING

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What is the Federal Debt?
The federal debt is simply the amount of money that the United States federal government has previously borrowed and subsequently owes. When spending exceeds revenue, the government is running a deficit. When the government incurs a budget deficit, the Treasury sells securities and uses the proceeds to fill the gap between revenue and expenses. Essentially the federal debt is the total accumulation of historical deficits. Please see our **Client Question on The Federal Debt**.

When the government borrows money, the Treasury Department sells securities to investors in the form of bills, notes, and bonds. Treasury securities ("Treasuries") are backed by the full faith and credit of the United States, which means their principal and interest payments are effectively assured by the government. Treasuries are offered in a wide range of maturities, are exempt from state and local taxes, and are usually very liquid.

What is the debt ceiling?
The debt ceiling is the limit that the federal government is authorized to borrow to fulfil its obligations through the issuance of US Treasury securities. Once the debt ceiling is reached, the Treasury cannot issue new debt until Congress votes to raise or suspend the limit. This creates an obvious problem when the government is running a deficit and the Treasury cannot sell securities to close the gap between revenue and expenses.

According to the Constitution, Congress must authorize borrowing. The debt ceiling was created in 1917, to make it easier for the United States to finance World War I. Congress provided the Treasury with an aggregate debt limit so that each bond did not have to be approved separately.

Since 1960, Congress has raised, extended, or revised the debt limit 78 times. Congressional action to alter the debt ceiling has occurred 49 times under Republican presidents and 29 times under Democratic presidents.

The most well-known debt ceiling fight came in 2011, when Standard & Poor's (S&P) downgraded the United States debt rating from AAA (outstanding) to AA+ (excellent) on August 5th. The downgrade took place soon after Congress signed the Budget Control Act of 2011 that ended the preceding debt ceiling battle. According to the Government Accountability Office, the downgrade increased the Treasury's borrowing costs by about $1.3 billion in that fiscal year.

Where does the debt ceiling stand now?
In July 2019, Congress agreed to suspend the debt ceiling until July 31, 2021. This meant that any new borrowing during the intervening two years would not count against the debt limit. During that two-year window Congress passed three major fiscal stimulus bills to combat the impact of the pandemic. As a result, the national debt increased from $22.0 trillion to $28.4 trillion. As of August 1, 2021, the debt limit was reset to the current level of about $28.4 trillion.

On October 14, 2021, President Biden signed a short-term bill that raised the debt ceiling by about $480 billion, which the Treasury Department estimates will provide adequate funding until December 3, 2021. The short-term agreement was reached after bitter infighting between Republican and Democratic Senators about how to raise the debt ceiling before the previous October 18th deadline. Note that 12/3/21 is also the date that government funding expires, meaning that Congress will need to pass a new budget and raise or extend the debt ceiling by that date.

What are the options to raise the debt ceiling?
Congress is still deadlocked over the debt ceiling with Democrats and Republicans disagreeing over how it should be raised. Democrats are pushing for a bipartisan solution by arguing that raising the debt ceiling allows the Treasury to pay for expenses the government has already authorized, including, under the Trump administration. Republicans counter that Democrats should raise the debt ceiling on their own, through the budget reconciliation process, given that President Biden's Build Back Better agenda may cost up to $3.5 trillion.

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As it stands now, here are four possible solutions to raise the debt ceiling:

Legislative Method	Legislative Vehicle	House Votes Needed	Senate Votes Needed	Form of Debt Lmit Provision
Reconciliation	As part of the Build Back Better plan	217 (simple majority)	51 (simple majority)	Increase to a specific dollar amount
Regular Order (current rules)	Stand-alone debt limit bill	217 (simple majority)	60 (super majority)	Suspend until a specific date
Regular Order (if Democrats change the filibuster rules)	Stand-alone debt limit bill	217 (simple majority)	51 (simple majority)	Suspend until a specific date

The most likely scenario is that Democrats raise the debt ceiling through the reconciliation process as a stand-alone bill. In the last few weeks, the Senate Parliamentarian said the debt ceiling could be raised through reconciliation. After agreeing to raise the debt ceiling until December 3rd, Senate Minority Leader Mitch McConnell stated that he will not vote to increase the limit again. Of course, a lot can change in Washington in two months.

What is the difference between a government shutdown and default?
While both a government shutdown and default both affect the ability of the government to function, they are two separate issues.

- **Government Shutdown:** Many federal government agencies rely on annual funding appropriations passed each year by Congress. A shutdown occurs when Congress does not pass the appropriations bills, typically leading to the temporary closure of non-essential agencies and furloughs for some government employees. Past shutdowns have temporarily halted Social Security and Medicare benefit verification, Environmental Protection Agency (EPA) site inspections, tourism at national parks, air traffic controller responsibilities, and Internal Revenue Service (IRS) functions. According to the Committee for a Responsible Budget, there have been four government shutdowns where operations were affected for more than one day (1995, 1996, 2013, and 2018).

- **Default**: A default would occur if the government has exceeded the debt limit and does not have enough money to pay its obligations, including, Social Security and Medicare benefits, military salaries, and payments to bondholders. In past government shutdowns, the government continued to make regular payments to retirees and bondholders. A default has far greater consequences than a shutdown.

What happens if the debt ceiling is breached and the government defaults?
Simply put, a United States government default would be a self-inflicted disaster. Treasury Secretary Janet Yellen recently stated that a default "would have catastrophic economic consequences. The full faith and credit of the United States would be impaired, and our country would likely face a financial crisis and economic recession." Here are just a few nightmarish things that may happen if the US defaults:

- **End of the risk-free rate:** United States Treasury securities are viewed as "risk-free" because their principal and interest payments are effectively assured by the government. The concept of the risk-free rate serves as a foundational component for all of finance; it is the basis to value all other assets. For example, most securities are valued as the risk-free rate plus an amount to compensate for the danger of potentially losing money on the investment. As the investment gets riskier, the investor will demand a greater spread over the risk-free rate. If the risk-free rate suddenly faces default risk, all of finance will be turned upside down.

- **Another US Debt Downgrade:** Standard & Poor's (S&P) warned that a default on a single US Treasury security would drop the United States credit rating from AA+ to D, the lowest level. S&P stated that, "it would be unprecedented in modern times for an advanced G-7 country, like the United States, to default on its sovereign debt."

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- **Higher borrowing costs:** Borrowing costs will likely increase for corporations, individuals, and homebuyers if people sell their Treasury holdings and thereby push up interest rates. The interest rate will rise for any debt instrument that uses Treasuries as a reference.

- **End of the dollar as the world's reserve currency:** In 1944 the US dollar became the world's reserve currency when 44 nations agreed to create the International Monetary Fund (IMF) and the World Bank. The arrangement became known as the Bretton Woods Agreement and decided that the world's currencies would be pegged to the US dollar instead of gold. According to the IMF, 59% of the central banks held their reserves in US dollars by the fourth quarter of 2020. If the US were to default, other countries would probably not feel comfortable holding their reserves in dollars.

While this list is frightening, it is not comprehensive. A US default would likely have many other negative consequences and knock-on effects.

Is the debt ceiling really going to be breached? Or is this just political theatre?

The debt ceiling is mostly political theatre. Since a default would be disastrous, most expect Congress to ultimately reach an agreement. In our view, it is very unlikely the United States will ever breach the debt limit and default. Politicians know that neither Democrats nor Republicans would "win" the event and that both sides would rightfully receive blame. The worst-case scenario we can imagine is that the debt ceiling is breached for a short-time period before the public outrage forces Congress to quickly reach an agreement (this would be national embarrassment but might not cause great economic damage). The unlikely event of a default is why the markets do not react much to the debt ceiling deadline anymore. Unfortunately, we all still have to watch the bad theatre and political grandstanding for the next few months before Congress likely addresses the issue at the last minute.

No matter what the two sides say between now and December, the odds strongly favor a resolution before the deadline. Of course, we will monitor the situation closely and we will continue to apply our time-tested investment process based on risk management, asset allocation, and security selection to utilize any volatility as an opportunity to reposition portfolios.

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