



What Should We Expect if the United States Defaults?

By Michael Madowitz October 10, 2013

The effects of a U.S. government debt default will largely depend on how soon the House of Representatives ends its fiscal brinksmanship. As the 2011 debt-ceiling stand-off showed, the effects of a potential default will not wait until the Treasury deadline of October 17, and the 2008 financial crisis proved it is extremely difficult to predict what will break in the financial system until it has broken.¹

With that in mind, this issue brief examines two basic scenarios of a U.S. default: one in which the debt ceiling results in a default for only a short time—say, less than one business day—and one in which the United States is unable to borrow for a longer period.

In either case, a failure to lift the debt ceiling in a timely manner will result in:

- Significantly increased interest costs on the national debt
- Long-term negative impacts for the U.S. economy
- Real, tangible, and costly consequences for everyday Americans
- Severe, unpredictable consequences for the U.S. and the world financial system
- Macroeconomic consequences that increase with each day the debt ceiling restrains activity
- An immense amount of unpredictable downside risk to the U.S. economy

It is difficult to overstate the amount of risk involved in failing to raise the debt ceiling—not because it is challenging to estimate the cost of each individual consequence, but because it is so difficult to conceive all of the relevant consequences. Due to the vast uncertainty about possible outcomes, this issue brief likely understates the nature of the risks involved.

The known risks to the economy

There is no ambiguity about whether failing to raise the debt ceiling will harm the U.S. economy. What is ambiguous is how much harm will be done. The 2011 debt-ceiling standoff offers some insight. At that time, Federal Reserve Chairman Ben Bernanke testified before Congress about the consequences of failing to raise the debt ceiling, saying, “It would be extremely dangerous and likely [a] recovery-ending event.”²

The simplest cost to the economy to pin down is how much long-term interest-rate increases will cost taxpayers directly. Like all bonds, U.S. Treasury-issued debt, or Treasuries, have interest rates that reflect a risk premium. The risk premium on Treasuries is currently very close to zero, which means the interest costs of our national debt are quite low, despite the fact that publicly held debt is just under \$12 trillion.³ Although mocked for the lack of market response at the time, the Standard and Poor’s downgrade of the U.S. credit rating in August 2011 appears prescient now. S&P stated that “the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened.”⁴ An increase in the interest premium paid on the federal debt currently held by the public would cost taxpayers a lot—an increase between 0.1 percentage points and 0.5 percentage points would cost taxpayers between \$120 billion and \$600 billion over the next 10 years.⁵

As a recent Treasury report noted, there are some direct parallels to the 2011 debt-ceiling standoff that serve as a baseline of comparison for some of the costs of simply approaching the precipice.⁶ If we assume that the current standoff is resolved in a similar manner as the last one—specifically, at the last minute, but before any defaults occur—the U.S. economy would still incur a host of negative consequences. The Treasury report notes that the S&P 500 Index declined roughly 17 percent in the period surrounding the 2011 episode, and in the same financial quarter, household wealth fell by \$2.4 trillion and retirement assets fell by \$800 billion; it took six months to return to pre-crisis levels after not quite hitting the debt ceiling.⁷ Unsurprisingly, the effects on consumer and business confidence were also strongly negative and took months to return to their pre-crisis levels.

If the current deadline is not met, similar, presumably larger effects can be expected. However, a number of complications make pinning down an exact cost difficult.⁸ While wealthier Americans will primarily be affected by changes in asset prices, all Americans will be affected by the ripple effects in credit markets. Virtually every kind of credit used by middle-class Americans—from credit cards to student, auto, and home loans—is connected to interest rates on Treasuries. Typically, the issuers of these credit products make their profits by charging an additional interest spread on top of Treasury rates, so an increase in the interest rate on Treasuries alone will drive up borrowing costs.

During the last episode, the spread on home loans significantly increased after the stand-off, with 30-year fixed rates jumping by almost 0.75 percent—about \$100 per month—for a typical mortgage on a median-priced home.⁹ Not only would a similar event slow the pace of refinances and purchases, but if the risk premium on U.S. bonds increases, Americans with adjustable-rate mortgages would also see the payments rise on their existing mortgages.

Increased credit costs would have a significant direct effect on the recovery, even in the case of a very short-term default. As investors demand a larger risk premium on Treasuries, this cost will be passed through to financing costs in the housing and auto sectors. After struggling over the past few years, these sectors have recently regained steam and have begun to lead the recovery. Due in part to favorable lending conditions and pent-up demand, auto sales are on pace for their best year since 2007.¹⁰

The housing market—which often leads economic recoveries—has been extremely slow to respond to this downturn, in large part because it led the downturn. Fortunately, the market has markedly improved over the last year, but the housing recovery is very fragile. If there is a delay in lifting the debt ceiling, the best-case scenario for the housing market is not pretty. The additional risk premium generated by a default on Treasury bonds would be passed onto consumers in the form of higher interest rates, and the experience from the last standoff suggests fixed rates would increase by an even larger amount. Higher rates slow the pace of homebuying and, coupled with recent increases in interest rates, would have a chilling effect on the refinances that have been one of the major channels of monetary stimulus throughout the recovery.¹¹

None of these costs are trivial, especially at this fragile moment in the economic recovery. Default will carry long-lived increases in the risk premium paid on Treasury bonds, which filter through to every type of borrowing and banking done by Main Street America. Increased volatility in asset prices and decreases in consumer and business confidence as well as household wealth are harmful to an economy at any point; given the current state of the recovery, even these consequences—which are the least severe and most easily understood ones of a temporary default—will impose real, significant costs on average Americans.

'Good' news

While a default should result in substantial short- and medium-term declines in U.S. asset values and long-term increases in interest cost of the national debt, it is unlikely the United States would experience permanent capital flight on the scale that other nations have suffered. Many close substitutes for Treasuries are other U.S.-based assets, such as high-grade corporate debt and consumer debt.

Bonds from other countries will become more favorable to investors, but uncertainty around growth prospects in Japan, the United Kingdom, and the greater euro area suggests that investors will not flock to any particular asset. In many ways, the euro is giving the United States a buffer right now. If investors could still buy deutschemark-denominated German bonds, it is likely that even the political brinksmanship in the United States would have driven investors out of U.S. Treasuries and into German government debt. In some ways, the United States is experiencing a dividend from instability in the euro zone.

Other potential risks to the economy

If the American economy were a typical one, a default would go something like this: Investors would get spooked, pull capital out of U.S. stocks and bonds, take losses, and move their money to safer assets in other countries. Back in the United States, interest rates would rise and asset prices and the U.S. dollar would fall. Imports would become more expensive and inflation would rise. Gross domestic product, or GDP, and employment would fall. A default would be catastrophic, but in an utterly predictable way. Over time, the fall in the value of the dollar would make U.S. manufacturing and exports more competitive, leading the economy out of a deep recession and bringing the country back to reasonable conditions after a mere lost decade or two.

The U.S. economy, however, is anything but typical. In the scenario described above, bondholders are typical investors who hold bonds they perceive to be of relatively high risk and return, so they are judicious in the transactions they structure based on these bonds. A default causes investors to take a hit and sell at a loss, and the defaulting country is left paying higher interest rates with less foreign investment. The response is often deemed a “flight to quality,” and investors end up buying up traditionally safe assets—typically, Treasuries.

Since the inflation-adjusted return to holding Treasuries is close to zero, U.S. debt functions less like an investment than a source of liquidity. By far, the largest concern with the House’s brinksmanship is that the U.S. economy, specifically Treasury debt, is the lynchpin of the domestic and international financial system exactly because the U.S. government has a 200-year history of never behaving this irresponsibly.

This system’s effect on every American should not be understated. Large corporations often make payroll and other transactions by using facilities that require nondefaulted Treasury-issued debt as their foundation. Many Americans have assets in money-market funds, either directly or through pensions, many of which rely on the safety and liquidity of Treasuries. Every second the United States is in default introduces unwelcome uncertainty into a very liquid financial system that relies on a high degree of trust and certainty.

Today's fast-paced, highly electronic markets rely—to a surprising degree—on simple trust. Once any uncertainty is introduced into the system, the millions of transactions that happen seamlessly every day suddenly require considerably more due diligence than the system is built to handle, and make them less liquid.

Treasuries are directly used in many of these transactions precisely because of their liquidity and trivial risk. For example, they play a large role in the repurchase agreement, or repo, market, which banks use to meet short-term funding requirements. In repo transactions, safe assets are sold on a short-term basis with an agreement to repurchase the assets back at an agreed-upon date—often the next day—and price. This is a very large market. For example, outstanding repo borrowing by primary dealers using Treasury collateral is currently more than \$1 trillion.¹² Uncertainty about the future value of these assets may disrupt some of these transactions.¹³

In the 2008 financial crisis, the repo market for some assets—such as mortgage-backed securities not backed by Fannie Mae or Freddie Mac—shut down and caused significant stress for several important financial institutions. Repo of Treasury securities was largely unaffected.¹⁴ It is possible, however, that the Treasury repo market will not be so impervious to a federal default. Lenders may no longer perceive Treasuries as riskless collateral. Moreover, transactions may be affected because many repo agreements do not permit the use of defaulted securities as collateral. Although the consequences are hard to predict, there is a risk of negative shocks to firms or Treasury market liquidity.

Threats to output and employment

If the U.S. government defaults on its payment obligations, our economy will automatically be pushed into a new round of fiscal contraction. The size of the required expenditure reduction could be very large, even relative to the size of the economy. The Congressional Budget Office estimates that the United States is currently running an annual budget deficit of about 4 percent of GDP, which is around \$600 billion annually.¹⁵

Cutting expenditures at this rate would directly reduce aggregate demand. That would have a negative impact on output and employment, which would increase for the duration of the default.

Moreover, there is good reason to believe that the direct effects of forced expenditure reduction would be magnified by macroeconomic “multiplier” effects. Recent academic research on the effects of fiscal contractions in economies that are operating below potential have suggested that each 1 percent of GDP in fiscal contraction can reduce GDP by as much as 3 percent.¹⁶ The U.S. economy is certainly below potential, so it is reasonable to expect that a federal expenditure cut of 4 percent of GDP would reduce GDP by more than 4 percent annually.

Currently, the U.S. economy is growing by a little more than 2 percent per year. Therefore, a sustained fiscal contraction of this magnitude could push the economy into recession. It is easy to see why Federal Reserve Chairman Bernanke was so alarmed by the possibility of default in 2011.

Some commentators have suggested that the U.S. Treasury could “reprioritize” payments in the event of a protracted crisis to ensure that the government would not default on Treasury security payments.¹⁷ The Treasury Department has made clear that this is not possible.¹⁸ But even if it were possible, this would only privilege payments on Treasuries over other obligations of the government, such as Social Security benefits, payments to Medicare health insurers, military pay, military benefits, and veterans’ benefits. It would not reduce the size of the fiscal contraction or its negative effects on output and employment.

Moreover, once it is clear that payment of some U.S. financial obligations are contingent on political circumstance, it is possible that a new default premium would be added to the cost of Treasury borrowing for an indefinite period of time. Hence, reprioritization could fail to prevent this damaging financial market consequence of default.

Conclusion

It is extremely difficult to construct a credible scenario in which the United States hits the debt ceiling on October 17 without inflicting major damage to the U.S. and world economies. At best, a default that lasts only hours and increases the risk premium on U.S. debt by even a small amount would still cost taxpayers hundreds of billions of dollars over the next decade. More likely, any larger amount of time the United States spends in arrears may well harm the real economy and disrupt financial markets.

The United States has already been through one financial crisis, which taught us valuable lessons about the financial system. Legislators would be wise to consider those lessons now. The day-to-day U.S. economy is more reliant on a well-functioning financial system than previously thought, and there is a much clearer picture of how destabilizing financial market turmoil is to the real economy. The system is also less stable and less well understood than previously assumed—an especially important lesson for legislators who are proceeding as if they can use the U.S. economy as a bargaining chip in an unrelated, entirely political disagreement.

Political considerations aside, it is all but inconceivable that Congress would be irresponsible enough to not lift the debt ceiling. This belief is likely responsible for the lack of market movement against U.S. Treasuries so far, but the lack of movement underscores how destabilizing it could be if Congress fails to lift the debt ceiling before it affects the global financial system and American families.

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Endnotes

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