Perspectives

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What Are the Ramifications of a Debt Ceiling Breach?

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With an agreement finally showing promise to resolve the U.S. government's potential and impending debt ceiling breach, investors are assessing how this development might affect underlying portfolios. The debt ceiling is the maximum level that the U.S. government is permitted to borrow. This threshold was set by Congress over 100 years ago to make sure government borrowing does not reach excessive levels. Historically, every time the ceiling has been close to being breached, Congress has legislated a higher debt limit. However, the current situation is especially concerning given how close to the deadline we are and how contentious this issue is in Congress right now. This newsletter will examine the key issues of the debt ceiling, important dates both past and present, and the potential impact of a breach.

WHAT ARE THE KEY ISSUES RIGHT NOW?

There are several issues at play that make the current situation particularly complex:

- A key challenge is that the debt ceiling is close to being breached just as Congress is holding heated debates on President Joe Biden's $3.5 trillion infrastructure and social stimulus package. The ceiling is one of four large spending items being debated by Congress, with one of those being the bipartisan infrastructure bill. The contentiousness from debates over the infrastructure bill — with Democrats angered by the Republicans' lack of support for the bill and House Progressive Democrats seething over Senate Moderates' lack of buy-in — is adding fuel to the fire in debates over the debt limit.
- Congress historically raises the ceiling, with the key rationale being that the money has already been spent; raising the ceiling simply allows the federal government to continue to pay creditors. So, the mechanics of raising the ceiling are not difficult. This time around, the standoff is a result of politics.

- Certain market pundits, including Jamie Dimon, CEO of JPMorgan, are advocating for getting rid of the debt ceiling altogether. However, this potential solution — although swift — is currently not being considered by Congress.

KEY DATES: PAST & PRESENT

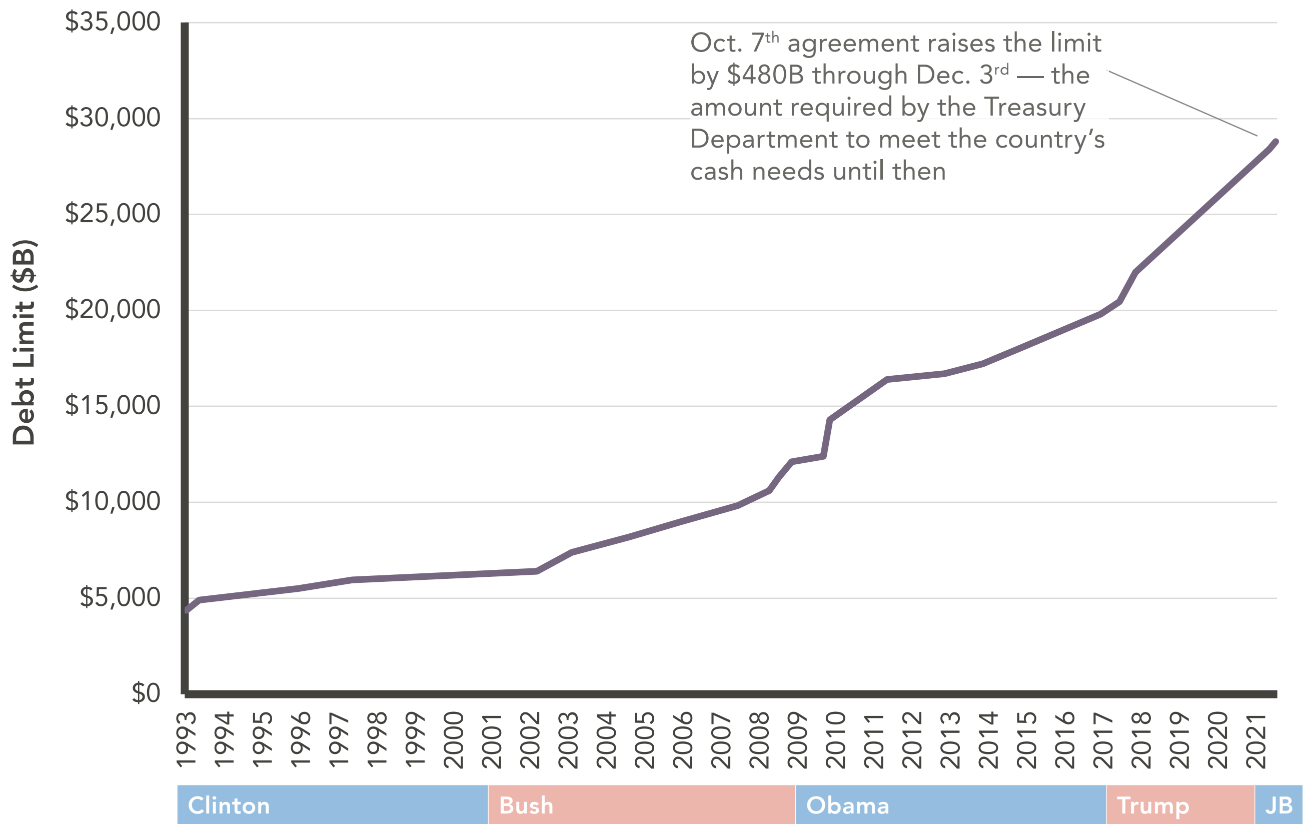
The following are important dates to consider at the center of the debt ceiling debate:

2021: On October 18th, the federal government will likely run out of funds to make payments on the goods and services that it procures as well as on the Treasury bonds that it has outstanding, which could lead to a default (as warned by Treasury Secretary Janet Yellen). Such a default could be a major market event, delaying government spending on a wide range of services and social interests, as well as interest and principal payments on Treasury bonds to investors — both institutional and individual — across the globe. It would likely exert tremendous downward pressure on the markets and the economy. The only way to prevent this systemic event is for Congress to raise the debt ceiling.

2019: When the debt ceiling was raised in 2019, most of the votes against the move were from Republicans in both the Senate and the House. So, the challenge is for the Democrats to push a vote through the GOP. Technically, the ceiling was not actually raised in 2019: instead, a law was passed that stipulated that the ceiling "shall not apply" for a short term of two years.

2011: A decade ago, Congress refused to authorize an increase to the debt ceiling — a backdoor plan masterminded by Republican Senator Mitch McConnell — and passed the buck to President Obama to lift the ceiling as a way to force spending cuts.

Exhibit 1: Debt Ceiling Increases



Sources: Congressional Research Service, Congressional Budget Office

POTENTIAL IMPACT

If the ceiling is not raised, the U.S. may come into default as a result of missing some of its interest and/or principal payments on Treasury bonds; this is a worst-case scenario and could trigger significant market volatility. In such an event, the U.S. Treasury would have to prioritize which bonds and social projects on which to make payments and which ones on which to miss payments. This may also mean missing payments on Social Security for the millions depending on these benefits. It goes without saying that a U.S. default could have significant ramifications both domestically and abroad, impacting individual lives as well as global markets.

CONCLUSION & NEXT STEPS

Over the last week, Senate Democrats have been exploring a way to change Senate rules such that the ceiling could be raised by a simple majority vote. Such a modification known as a "budget reconciliation" filibuster rule change would have reduced the 60-vote threshold in the Senate to only 50 for passage. In this case, if the Senate were split 50-50, Vice President Kamala Harris may then break the tie and make way for the Democrats to get the vote through the Senate. Additionally, Democrats have also been exploring potentially passing the buck to the executive branch again, and letting Biden lift the threshold to circumvent default. These are among a number of other proposals that have been deliberated down the aisle on Capitol Hill, with both parties standing ready to point the finger on the other if default comes to fruition.

Biden has been warning of the dire consequences of default, and certain senators have been expressing optimism that a deal could be reached soon. Democrats and Republicans worked late into last night towards agreeing on an actual amount to increase the ceiling prior to October 18th, and as of mid-day today (October 7th), a deal has just been reached. Though not yet passed, the agreement extends the ceiling through early December with an additional $480 billion added to the limit — bringing the total to $28.8T and averting disaster at least for the next three months. However, the problem will rear its ugly head again come Thanksgiving, when the rodeo happens all over again. Marquette will continue to monitor the situation on Capitol Hill and provide updates and guidance as appropriate.

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