

Goldman Sachs Exchanges
What happens if the U.S. government
can't pay its bills?

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Allison Nathan: The debate over the U.S. debt ceiling is quickly heating up. If the debt limit is not lifted before the deadline what does this mean for markets and the economy?

Alec Phillips: I would expect to see a substantial increase in equity volatility. A delay of any more than a few days could be really damaging because you would just pull a lot of money out of the economy. This is something that could certainly tip the economy into recession if it lasted for any period of time.

Allison Nathan: I'm Allison Nathan and this is Goldman

Sachs Exchanges. The U.S. government's deadline to raise its debt ceiling could be here sooner than expected. That pulls forward the risk of a debt default that could ripple through global financial markets.

To explain how we got here, the potential impact on markets and the path forward. I'm here with my colleague in Goldman Sachs Research, Alec Phillips, our chief U.S. political economist.

Alec, welcome back to the program.

Alec Phillips: Thanks

Allison Nathan: So just to level set for our listeners, can you just explain to us what is the debt ceiling and why are concerns over it ramping up?

Alec Phillips: So the Treasury hit its borrowing limit of \$31.381 trillion in January. The borrowing that Treasury does is used to finance the budget deficit, which basically occurs because the Treasury and the federal government spends more money than it collects in taxes. Raising the

debt limit happens once every couple of years because Treasury debt rises over time.

The last time that we got into real serious trouble around the debt limit was in 2011 and then in 2013, where ultimately Congress raised the debt limit, only essentially a day before the deadline. This time around, the politics look similar and a lot of us are looking at the debt limit deadline this year as potentially almost as disruptive, or maybe even more disruptive, than those previous episodes.

Allison Nathan: And so just to clarify, the government has already hit its statutory debt limit of the \$31.4 trillion that you just mentioned in January. So the deadline we're facing now is when it will actually run out of money to pay its bills unless that debt limit is raised. Correct?

Alec Phillips: Right. So basically on January 19th they technically hit the limit, but there are two things that they can do to keep things flowing smoothly for a while after that. The first is what they call extraordinary measures. And basically, this just has to do with swapping out a few of those non-marketable treasuries in a couple of specific

funds with IOUs essentially and they can do about \$300 billion dollars of that. They did that in February and they've used up most but not all of it. The second thing they can do then is run down the cash they have on hand and it happens that they have a substantial amount of cash on hand. So they started the year with over \$500 billion dollars of cash in their accounts in the treasury's account at the fed and they have been running that down. Before we had the big tax deadline in mid April that had run down to under \$100 billion, but it has now come back, to around \$300 billion given those tax receipts that have been coming in. So the deadline now will basically be whenever they run out of those extraordinary measures plus when they've used up all of that cash on hand.

Allison Nathan; And so in terms of the timing of all this on Monday, Treasury Secretary Janet Yellen did come out and warn that the U. S. Could run out of money to pay its bills as early as June 1st if Congress doesn't raise or suspend the debt limit before that time. You've been thinking late July. So why are we now hearing early June?

Alec Phillips: Secretary Yellen came out with the early

June deadline even though we thought that they would probably be able to make it until, late July because I think she decided that it was a close enough call that it wasn't a risk worth taking. The issue here is that toward the beginning of June, they're likely to run to a pretty low cash level. We think probably something like \$25 or \$30 billion dollars. And while we think that they probably would not hit zero, in the past, the Treasury has set a minimum as far as how low it's willing to go on its cash balance, and that happens to be around \$30 billion. So we actually thought that there was a good chance that the Treasury would say an early June deadline, even though it seemed to us that they could probably make it little bit farther than that. Of course, this is the US Treasury. So probably is not good enough. They need to be really pretty certain that they can make it. And I think so from a sort of a risk management perspective they decided, that early June was the real cutoff in terms of Congress raising the debt limit.

Allison Nathan: Can we just take a quick step back, Alec? Why is there so much uncertainty around this deadline?

Alec Phillips: It did come as a little bit of a surprise to the

markets and the reason that all of this is happening right now is basically because of the non-withheld tax receipts, which are basically the checks and electronic payments that individuals make when they file their tax returns in April. And those are a big part of projecting the debt limit deadline because unlike most other things in the federal budget, which you can track on a week to week basis, and they reported daily, those non-withheld tax receipts don't show up really before tax day. They start coming in a few days before the deadline, but it's not something that you can look at in March and say, okay here's what we think is going to happen in April.

And so because of that, and because it's such a substantial amount last year in April and May, for example, it was around \$650 billion. There's a real potential for surprise coming out of that. So we thought tax receipts in April would be down pretty substantially versus last year mainly because of lower capital gains realizations. But it turns out that while that was right, receipts have been even lower than expected. And then there was also one twist, which is that the state of California, for various reasons having to do with weather disasters, has a later tax deadline. Most

California residents don't have to pay their taxes until October.

So the combination of these things has left the treasury collecting something like 30 to 40 percent less this year than last year. And that means that the risk of running out of cash earlier than we had expected has risen. So while a lot of people on Wall Street were projecting late July and some were actually projecting August, think it's a very credible projection that there's a good chance that they could run out of cash in June, even though that's not our base case.

The reason that I mentioned those two deadlines specifically is that there's yet another tax deadline June 15th. So basically if they can make it from here to June 15th, they'll take in additional receipts that will get them to the end of June. There's then another one-time accounting thing they can do to get into July. And then from there, however long, that cash lasts is where the deadline occurs.

Allison Nathan: So if the debt limit is not lifted before the deadline, does that mean the U S will default on its debt?

What happens at that point?

Alec Phillips: So there are basically three things I would point to and three milestones. So the first is just the deadline itself, whatever date the Treasury ultimately points to. Going to that date or past that date is technically not that directly impactful on the ability to make payments. But it represents the Treasury's best estimate of when it will run out of cash.

So it's certainly possible that they could go, that Congress could go. You know, one day past the deadline and that the Treasury might still be able to pay all of its bills on that first day past the deadline. But we also know that if they go a couple of weeks past the deadline, the Treasury is almost certain to run out of cash.

And where in that range the problem starts is hard to know. Of course, you know, the, the reality is that there's no reason to test it they should just raise the debt limit. So at some point soon after the deadline, the Treasury would not be able to pay all of its daily obligations with the amount of cash coming in from tax receipts.

And at that point, they would need to decide what to do with all of those payments that they make on a daily basis, a lot of which are automatic. The likely answer, and this was outlined in 2011 and 2013 FOMC transcripts where they discussed what the Treasury was planning on doing, the likely answer is that they would essentially delay payments until they built up enough cash from incoming taxes to make a full day's worth of payments and then essentially stop payments.

Let the cash build up, make another day's worth of payments, stop again. And so with every day that goes by, you would essentially be delaying more and more payments. And I assume that that would not last for very long.

The third potential milestone would be payments on debt service. So this would be coupon payments on treasury securities as well as just the redemption of maturing debt. There is no reason from a technical perspective that the Treasury and Fed cannot figure out how to pay those ahead of other claims, and it seems likely that they would have

enough cash on hand, assuming a little bit of planning, that they would be able to make those payments.

In 2011 and 2013, the guidelines that they discussed internally suggested that the Treasury and Fed were expecting to continue to make all debt service payments even if they had to stop making everything else. But obviously, that's uncertain and again there's no reason to test it.

Allison Nathan: And what does everything else include? Just give us a flavor of what payments would be disrupted.

Alec Phillips: The biggest payments that the treasury makes are Social Security, Medicare, Medicaid and then I'll sort of combine a bunch of things into one bucket, which are things like military and federal employee pay and retirement benefits, veterans benefits, things like that. A lot of these things go out on a set schedule that's set years ahead of time based on the calendar and would be difficult to turn off quickly.

The biggest single thing I would point to would be Social

Security payments, which go out four times a month and are around \$25 billion a piece. And so that means that no matter when the deadline is, you probably wouldn't be more than a few days away from a scheduled social security payment. And that's one reason why I think going past the deadline to the point where these payments are called into question would be a real sensitive political situation.

Allison Nathan: So House Republicans have a proposal to lift the debt ceiling in exchange for spending cuts and some policy changes. What does the latest proposal include and is it likely to have any legs?

Alec Phillips: The proposal that passed last week in the House had around \$4.8 trillion in deficit reduction and that's over 10 years. Of that, a little more than \$3 trillion, so the majority, came from one provision, which is to reduce spending in 2024 back to the level of around last year, nominal, and then to grow it at 1% in nominal terms for the next 10 years.

That would represent a reduction of around \$3.2 trillion

over 10 years, which happens to be about nine-tenths of a percent of GDP on average over that period. And that I think is going to be the basis for whatever deal is finally struck, at least conceptually, that sort of notion of a spending cap.

Beyond that, there were a whole bunch of other things that were less central to the fiscal outlook. And I think you could characterize as more sort of other things Republicans would like to get done this year and they see the debt limit as a sort of the best opportunity to get those things done.

Those things include, for example, blocking the Biden administration's student debt forgiveness proposal; repealing almost all of the energy provisions from the Inflation Reduction Act, and then a whole bunch of other things along those lines. But I think by far the most likely is some kind of deal on spending levels, albeit one that is not nearly as restrictive as what the House passed last week.

Allison Nathan: And so how will Secretary Yellen's June 1st deadline affect negotiations?

Alec Phillips: They have a real time issue here. Congress is out of session right now, or the House is out of session right now. The Senate and House together over the course of the next month until that June deadline will actually only be in session at the same time for, I think, eight legislative days. So there's not a lot of time to put a deal together. With that said, theoretically, the deal doesn't have to be all that complicated. Obviously, they're going to have to raise the debt limit. And then beyond that, there's probably going to have to be some kind of spending concession depending on what they come up with that could actually be something pretty simple. It could just be a lower level of spending, and they can write that pretty quickly. In theory, there's no reason that they can't get this done fairly quickly. And ultimately, we know that every time we get to one of these debt limit situations, they end up doing the deal at the last minute anyway.

So the fact that the last minute is happening maybe four weeks from now, instead of two months from now or three months from now doesn't really necessarily change the amount of time they have if they're only going to spend the

final few days actually working out the deal. With that said I think that there was a hope that they would have a little bit more time to sort something out.

And so I do think that this is going to raise the odds of a short-term extension from, say, early June to either late July or maybe more realistically, even to the end of the fiscal year, which ends September 30th, so that they can align the next spending deadline, which they have to extend spending authority for the new fiscal years.

They have to decide on some spending level and the debt limit deadline and, and tie those two things together. So while it's not clear that they will actually do a temporary extension, I think the odds are. higher now than they would have been if we had a July deadline.

Allison Nathan: And so you mentioned 2011 as well as 2013. 2011 was a debt ceiling episode that was quite disruptive. We came close to a default and the U.S. was actually downgraded by Standard and Poor's. So are we in a comparable situation? How likely is it that we come to a resolution or how likely is it that there is a similar type of disruption?

Alec Phillips: I think the odds of a similar type of disruption to 2011, where Congress finally did the deal one day before Treasury's projected deadline, I think the odds of that are really pretty high. At this point, it's hard for me to see the scenario where we don't come to within a day off the deadline before getting a deal.

And frankly, I can certainly see the scenario where they don't do, uh, the final deal until the day off the deadline or possibly even, you know, one day after the deadline. I'm a little more skeptical that they would go much past that simply because I don't think either side really has the incentive to do that.

As I mentioned before, Social Security payments and a whole bunch of other things would become a major focus in the days leading up to the deadline. And I don't think that Congressional Republicans who might have concerns about voting for a debt limit increase until they get what they're looking for, I don't think that they're going to believe that they're going to get a whole lot more by going a day past the deadline when then Social Security checks and other

things start to come into question. So I think, maximum leverage for both sides is basically on the deadline. And that's why I think the deal probably gets done at that point.

There are a lot of similarities to 2011. Basically in 2011, you had Republicans taking the house in the prior midterm. You had still a Democratic Senate. and you had a democratic president in his first year. You also had a big run up in public debt. So a lot of things that we see now.

The differences I think are number one, the midterm win in 2010 going into the 2011 episode was huge. They won 63 seats. This time around, the midterm win was small. They won nine seats. And the consequence of that is that the majority is very slim, and that makes getting a deal among Republicans more difficult.

And it has put Speaker McCarthy in maybe a slightly more sort of fragile situation than his predecessor Speaker Boehner was in. The other difference. I would say, I'm sure there are plenty of them, but the other big difference I would point to is that fiscal issues are not actually front and center this year the way they were back then. If you

look at what was happening in 2010 and 2011, you basically had a substantial portion of the public very focused on the rising budget deficit and the rise in public debt following the financial crisis. You had the president trying to organize a fiscal commission at the same time that Republicans were also focused on deficit reduction. This time around there, despite a comparable rise in public debt there just hasn't been that kind of focus. And so, while I think that, you know, you have a lot of members of Congress who view a vote to raise the debt limit as one of the most politically toxic things they can do. I'm actually not sure that the politics of voting for an increase in the debt limit are any worse than they were in 2011 and they might actually not be quite as bad.

Allison Nathan: And if the deadline passes and we do have to stop payments, what could the market impact be?

Alec Phillips: Well, we probably will see some of the market impact even before any stoppage of payments, but the things I would expect to see would be a substantial increase in equity volatility. We saw that in 2011 as well, even though they were able to make all payments on time.

We would probably see a lot of disruption in the Treasury curve but that kind of cuts both ways, because right now if you look at Treasury bills that are maturing right around the various deadlines I mentioned, those bills are essentially cheaper, meaning that the yields are higher and some typical buyers seem to be avoiding them.

They're cheaper right around the deadline then in sort of neighboring times, either before or after. With that said, if we were to actually see missed payments, I think what would happen is, That while people might still be avoiding those treasuries maturing right around the deadline Actually the sort of the broader effect would be risk off and you could actually see people moving into longer dated Longer maturity treasuries just as sort of the typical risk off move that you see in markets so it gets a little bit complicated

Allison Nathan: And are markets reflecting this risk at all at this point? I mean, there's obviously been an increased focus on this. So to what extent is that being reflected in markets already?

Alec Phillips: So the short answer is that you can see it in the short end of the treasury market. Where, as I mentioned, the bills, that are maturing around the possible deadlines, you seem to have some potential buyers, some normal buyers avoiding those bills. And then the other place where you can really see it is in sovereign credit default swaps, CDS. And so there you're seeing buyers paying a much higher price for protection against a default on treasury securities, than they normally have. And that actually they have even in 2011 or 2013 when things were also pretty dicey. There are some technical reasons why that comparison might not be entirely accurate, but nevertheless, it's clear that it's expressing some concern.

Allison Nathan: And so is that the best or only way that investors can hedge or position around this risk?

Alec Phillips: Well, CDS is tricky because it only pays out if the Treasury actually fails to make a payment on, interest or principle on treasury securities. And as we were talking before, I think that's really pretty unlikely. On the other side, though, you have, for example, the fact that equity volatility going into the 2011 debt limit episode rose

and it rose even further actually right after the deadline, particularly around the time that S&P downgraded U.S. debt. And so I think that equity volatility is probably the thing that you can count on more than some of these other tail risks, because even if they end up actually raising the debt limit by the deadline, it's hard to see how the equity market will be, you know, fully relaxed about that. So I think betting on equity volatility is probably the safest way to go.

Allison Nathan: And what about economic impacts?

Alec Phillips: On the economic side it's not complicated. It would just be bad. So there, a very brief payment delay is, possibly from a direct economic perspective would be worth around \$10 billion a day. So to put that in perspective, the spending cut that Republicans are seeking in the first year after enactment, the Congressional Budget Office estimates that it would save around \$130 billion. So 13 days of payment delays would equal a whole year of spending cuts in that bill. So that's the pretty substantial hit to impose over a very short period of time. And that's really the issue is that the federal government during July and August will

be running a budget deficit that's around 10% of GDP annualized, meaning if you take the deficit in a month and divide it by GDP in a month, that's what you get.

A delay of any more than a few days could be really damaging because you would just pull a lot of money out of the economy. I would say realistically, the bigger effect, even than the direct hit, could just be the fact that financial markets would react strongly and negatively.

Consumer confidence would be hit. And so given the already fragile state of the economy, this is something that could certainly tip, uh, tip the economy into recession if it lasted for any period of time.

Allison Nathan: So what are you watching in the days ahead in terms of how this unfolds?

Alec Phillips: So I think there are going to be three things. The first is going to be the Republican reaction to the new debt limit deadline. And for that matter, any update from the Treasury on the deadline. While Yellen was fairly clear and transparent in what they thought about Treasury cash flows and about the risks around that, they were also

pretty clear. That it could still change. And so I don't think that this is necessarily the last word on what the deadline actually is. There's also the question of how seriously Congressional Republicans take this deadline. The June timing is ultimately pretty tricky because there's just a short period where they might run out of cash.

And then June 15th tax deadline will bring them back. And so because of that my sense is that some congressional Republicans are a little bit skeptical of this early June deadline. So that reaction will probably also be important to watch. The second thing will be negotiations on the debt limit or, on spending changes. And that looks like it's now going to be getting underway on May 9th, when congressional leaders meet with President Biden. So that, will be the start of a process. That May 9th meeting certainly will not be the end of the process, but it's good that they're, at least kicking things off.

And then the third will be further votes on debt limit legislation. And so it looks like Senator Schumer is scheduling at least two votes on debt limit legislation coming up. One will be on the House passed bill, which is

likely to fail because it won't have enough Democratic support. And then the other will be on a clean debt limit increase, which will also fail because it doesn't have enough Republican support.

And so that will put everybody on the record in the House and the Senate. But of course, without those negotiations won't get them any closer to a final compromise.

Allison Nathan: Alec, thanks so much for joining us.

Alec Phillips: You're welcome

Allison Nathan: And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called the markets each week in just 10 minutes or less. We'll be breaking down the key issues, moving markets that week, giving you the information you need to stay ahead, search for Exchanges: The Markets on all podcasting platforms.

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