U.S. Municipal Bond Market

What Could "Irreparable Harm" Look Like if Lawmakers Fail to Extend or Suspend the Debt Ceiling Limit?

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- When lawmakers took the U.S. to the brink during the 2011 fiscal policymaking process, there were real negative financial consequences. There could be similar consequences if lawmakers follow a similar pattern in 2021. Unfortunately, this could be the best-case scenario based on where negotiations are today.
- More severe financial consequences could occur if lawmakers allow a brief default, even if it is quickly cured.
- There could be even more severe negative financial consequences–lasting a generation or more–if lawmakers allow an extended stalemate. We include details related to different scenarios below.

Treasury Secretary Warns of "Irreparable Harm"

The potential negative impacts from lawmakers leaving this important fiscal policy procedure to the last minute could be real, even in an 11th hour agreement, and should not be considered "politics as usual" by investors. An August 1 U.S. debt ceiling deadline was punted to at least October of this year, according to a Congressional Budget Office report and as we indicated in our July 22 commentary, Lawmakers May Exploit the Debt Ceiling Limit Again. But on Monday, Treasury Secretary Janet Yellen reminded the financial markets in a statement that, "Failure to meet those obligations would cause irreparable harm to the U.S. economy and the livelihoods of all Americans."

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What type of "irreparable harm" should the financial markets possibly be considering? Let's outline where things are right now before we get to a scenario analysis that will help answer the "irreparable harm" question. Before October or November 2021, lawmakers need to vote to either extend the debt ceiling or suspend the need for a debt ceiling limit, which is what they last did in 2019. The U.S. Treasury Department recently announced it is operating under extraordinary measures. Treasury suspended the issuance of State and Local Government Series Securities (SLGS), for example, and these extraordinary measures should allow the country to last at least until October 1.

After the extraordinary measures are exhausted, the Treasury Department will be forced to use only revenues to pay for ongoing expenses. This would be a significant test of the nation's liquidity situation since the U.S. is running at a deficit. The U.S. would not be able to borrow, and its ability to pay its debt obligations could come into question. There could be an untold toll taken throughout the financial markets and municipal bond market if the creditworthiness of the U.S. comes into question.

What Happened During the Debt Ceiling Crisis of 2011?

Even a scenario that brings the U.S. to the brink of default, like we experienced in the summer of 2011, could have negative financial consequences. The 2011 fallout, when awmakers took their debt ceiling debate close to the final hour, was more severe than what many seem to remember.

The U.S. debt ceiling crisis of 2011 negatively impacted the financial system in several ways, which ultimately slowed the U.S. recovery from the 2008 World Financial Crisis. We are drawing these examples from the U.S. Treasury Department's October 2013 report, The Potential Macroeconomic Effect of Debt Ceiling Brinkmanship.

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- S&P 500 fell about 17% and did not recover until 2012.
- VIX market volatility index roughly doubled and remained elevated for months.
- Consumer confidence fell by about 22% between June and August 2011.
- Corporate credit risk spreads (BBB-rated) jumped 56 basis points and remained elevated until 2012.
- Spread between mortgages and Treasuries rose by as much as 70 basis points

These results took a toll on asset prices and both consumer and business activities, including spending. Overall, U.S. household wealth fell by $2.4 trillion between the 2nd and 3rd quarters in 2011, and much of this had to do with the U.S. debt ceiling crisis of 2011. Unfortunately, 2011's results are close to the best-case scenario in 2021 if lawmakers even flirt with the debt ceiling deadline.

What Happens if Lawmakers Fail to Act Before the Debt Ceiling Deadline?

Much of what happens in Washington, D.C. is strictly for political effect, and it is often difficult for outsiders to navigate what may have real world consequences. Not following through with a debt ceiling extension would have severe negative financial consequences. This could have a lasting impact on the credit worthiness of the U.S., even if it only alters the perception of the U.S. credit quality. This, at best, could significantly raise the cost of U.S. debt going forward, and have other knock-on effects as well. At worst, the negative impact could last a generation or more.

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Our initial reaction is that a ripple-effect could roll through the world financial system and make the World Financial Crisis of 2008 look like a three-minute, G-rated movie trailer. The current Treasury Secretary described the potential impact from a default as unleashing "irreparable harm." In September 2013 testimony before Congress, Moody's Analytics' Mark Zandi said, "There will be a violent reaction in financial markets if policymakers fail to act in time." In 2013, the U.S. Treasury described the impact as profound and warned the effects could last for more than a generation in this summary, "Considering the experience of countries around that world that have defaulted on their debt, not only might the economic consequences of default be profound, those consequences, including high interest rates, reduced investment, higher debt payments, and slow economic growth, could last for more than a generation."

Treasury Secretary Yellen described the potential impact from a default as unleashing "irreparable harm."

Many are wondering what may happen in the financial system. This is difficult to nail down, especially considering that we have not yet exited the COVID-19 crisis era. An October 2013 report, The Cost of Crisis-Driven Fiscal Policy, by Macroeconomic Advisers, prepared for the Peter G. Peterson Foundation, considers two scenarios. Keep in mind that the unemployment rate in July 2021 is already 5.4%, according to the Dept. of Labor when reviewing the below summaries.

- Severe economic consequences could follow even a brief, technical default that is quickly corrected by lawmakers. Macroeconomic Advisers write, "In scenario one, risk aversion rises, financing costs rise, prices of risk assets fall, and the economy enters a recession. Exacerbated by the Fed's inability to lower shortterm interest rates, growth only begins to rebound at end of 2014 [report was published in October 2013] and the unemployment rate rises to a peak of 8.5% before starting to decline. At its peak, 2.5 million jobs would be lost."

- In an alternative case an extended, two-month stalemate is considered. To summarize this second potential outcome Macroeconomic Advisers write, "scenario two implies a longer and deeper recession than in the first scenario, but one characterized by extreme volatility. Annualized GDP growth fluctuates rapidly between plus and minus 8% until the oscillations diminish in 2015 [remember, the report was published in October 2013]. Unemployment rises to a peak of 8.9%–equivalent to 3.1 million lost jobs–before trending down."

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Near-Term Conclusion

The near-term political backdrop complicates the steps required by lawmakers to again raise or suspend the need to raise the debt ceiling. The current situation remains fluid, to say the least. We will assess the political dynamic as it evolves.

Even though October or November seems an eternity away, the point at which the debt ceiling will need to be addressed could surprise some (observers and lawmakers) if they are not paying attention. Also, there is the potential for a real negative impact to occur almost no matter what happens, especially because it seems the best case could be an agreement that is reached close to the 59th minute of the 11th hour.

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Observers should take away that there were real negative financial consequences from lawmakers taking the U.S. to the brink during the fiscal policymaking process in 2011, and this could happen again in 2021.

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