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SKBA Economic Update

The False Default Dilemma - Aftermath

Remember that great Beach Boys song “Fun, Fun, Fun”? Well it is apropos—now that the default dilemma is over for now—to give it a twist to express Treasury Secretary Janet Yellen’s *delight* in having the bill passed by Congress and signed by the President.

And she’ll have fun, fun, fun now that Congress gave her T-bills to plaaaay!

Indeed, elimination of the borrowing limit between now and January 1, 2025 will result, by some estimates, in the issuance of $1 trillion in new T-bills between now and yearend to fund continued out-of-control government spending.

Although this seemed like a crisis, the debt ceiling drama was a false default dilemma for three reasons:

1. Precedent did suggest that as in the past debt ceiling battles, such as 2011, even if agreement had not been reached by the “till is empty” date established by the Treasury Secretary, non-debt-service government expenses would be temporarily cut to enable continued interest and principal payments on Treasury obligations. Painful as this might be, that would not have constituted a crisis or a default. Agreements by necessity are shortly (in terms of weeks) reached, and markets return to normal. Note, however, the government wouldn’t have officially defaulted.

2. Monthly Treasury debt service payments are small compared to the monthly receipt of federal tax revenue. So it would have been extraordinary for the Treasury Secretary to announce that the U.S. government plans to default on the nation’s debt obligations. Was Janet Yellen willing to be the first? Such an announcement ***would have been*** catastrophic for financial and credit markets. Yet, an agreement between the House and the President was reached at the “eleventh” hour, in time to gain passage by the House and Senate, obviating the supposed need to default.

3. Yet this is still one false narrative that should be debunked. Section 4 of the 14th Amendment contains the “full faith and credit” promise U.S. Treasury markets have relied upon since 1868 for U.S. bond holders to believe payment of federal government debt is inviolable. Constitutional scholars debate the precise meaning of this section, and at the same time, the plain reading of the text appears to state the public debt, “authorized by law, …. shall not be questioned.” The debate seemed to have the issue backwards. Full faith and credit for Treasuries, just as stated for general obligation bonds of states and municipalities, means that interest and principal payments have first priority over the use of government tax revenue. If there are insufficient receipts to cover all other government expenses, either expenses are cut or income/property taxes are raised to pay such guaranteed debt service. The argument to “use” the 14th Amendment to issue new debt above the Congressional approved debt ceiling because the debt ceiling legislation is unconstitutional seems dubious. According to statements (prior to the deal) by Secretary Yellen and the President, its constitutionality wasn’t going to be tested.

What facts were accurately portrayed in this debate? The deficit crisis has been created by:

1. the federal debt load explosion to $31 trillion since the beginning of the COVID pandemic,
2. two successive presidential administrations pursuing unbridled and massive deficit spending to create this rise, and
3. the Federal Reserve Board's belated hikes in the Fed Funds rate from 0% to above 5% in such a short period that have added massively to the government interest expense load. With money no longer being "free", high deficits create even more debt growth to fund the payment of interest expense.

We have not held that all deficits are bad, and if nominal Treasury debt levels had risen at roughly the same pace as nominal GDP, debt levels would not by themselves create a financial crisis. Of course, this has not been true for a few decades. Federal debt has risen much faster than tax revenues and U.S. economic growth, and we now appear to be at the point at which FEDERAL DEFICITS FINALLY MATTER!

The COVID pandemic was unique in U.S. history. It's not that pandemics haven't occurred before. Some estimates suggest 675,000 people died in the U.S. from the Spanish Flu epidemic during World War I. What made COVID 19 unique from an economic perspective, however, was the decision to shut down the U.S. economy and much of the world economy in an effort to slow its spread. Such extraordinary economic and financial challenges that occurred surely required extraordinary help for the millions of people and businesses that required government financial support. It is also appropriate to recognize that all sorts of economic distortions and consequent problems occurred from goosing government spending while constraining the supply of goods and services. And now, with the pandemic officially declared to be over, it does not appear unreasonable to bring federal spending back down toward pre-COVID levels.

The far right and left wings of both the Republican and Democrat parties hated the compromise deal. As a result, 117 House members and 36 Senators voted against the bill. This is probably a good sign that the compromises were just "about right." The fear that Republicans couldn't get a majority together to pass it was misplaced, as it was a reasonable expectation that with the President's and Speaker of the House's support for the bill it would get bipartisan support. Indeed, it did as roughly two-thirds of Republican House members and three-quarters of Democrat House members voted in favor the Fiscal Responsibility Act of 2023.

The agreement cut some expenses, recaptured some unspent COVID funds, and control future appropriations appeared to offer reasonable trade-offs for suspending the debt ceiling for 19 months. Don't expect it to solve our federal deficit problem, however. A trillion of spending here and a trillion there, and pretty soon we're talkin' about real money!

But she'll have fun, fun, fun now with all those new T-bills to play…

Hope you weren't fooled by this false default dilemma.

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