OCTOBER 2013

THE POTENTIAL MACROECONOMIC EFFECT OF DEBT CEILING BRINKMANSHIP

Introduction

The United States has never defaulted on its obligations, and the U. S. dollar and Treasury securities are at the center of the international financial system. A default would be unprecedented and has the potential to be catastrophic: credit markets could freeze, the value of the dollar could plummet, U.S. interest rates could skyrocket, the negative spillovers could reverberate around the world, and there might be a financial crisis and recession that could echo the events of 2008 or worse.

Political brinksmanship that engendgers even the *prospect* of a default can be disruptive to financial markets and American businesses and families. The closest historical precedent is the debt ceiling impasse in 2011, around which time consumer and business confidence fell sharply, and financial markets went through stress and job growth slowed. In 2011, U.S. government debt was downgraded, the stock market fell, measures of volatility jumped, and credit risk spreads widened noticeably; these financial market effects persisted for months. To be sure, other forces also played a role, but the uncertainty surrounding whether or not the U.S. government would pay its bills took a toll on the economy. An additional consideration now is the government shutdown that started October 1. If the shutdown is protracted, the economy could be weakened, making the expansion even more susceptible to the adverse effects from a debt ceiling impasse than prior to the shutdown.

In 2011, U.S. debt was downgraded, the stock market fell, measures of volatility jumped, and credit risk spreads widened noticeably.

It is clear from economic theory and evidence that lower stock prices and wider risk spreads have adverse effects on private spending, all else equal. Because the debt ceiling impasse contributed to the financial market disruptions, reduced confidence and increased uncertainty, the economic expansion was no doubt weaker than it otherwise would have been. So far this year, Treasury yields have been rising on balance, which means that any adverse effects from financial market disruptions caused by a debt ceiling debate may not be offset as it was in 2011.

The Experience of 2011 and the Links to the Economy

The financial market stress that developed in August of 2011 persisted into 2012 even though Congress raised the debt ceiling prior to the exhaustion of extraordinary measures. In this report, we discuss in more detail some channels through which a similar episode might harm the economic expansion. In brief, reduced household and business confidence, lower equity prices, volatility in the stock market and increased corporate and household borrowing costs all tend to undermine the economic expansion.

Household and Business Confidence

From June to August 2011, consumer confidence fell 22 percent and business confidence fell 3 percent. Measures of both had already begun to fall earlier in 2011, in part because of developments abroad, but as the debate about the debt limit grew, these measures of confidence fell further. Moreover, it took months before confidence recovered fully, even though, in the end the debt limit stand-off was resolved. Although these measures of private-sector confidence are not measures of spending or the direct costs of doing business, they capture the mood of the private sector with regard to spending.

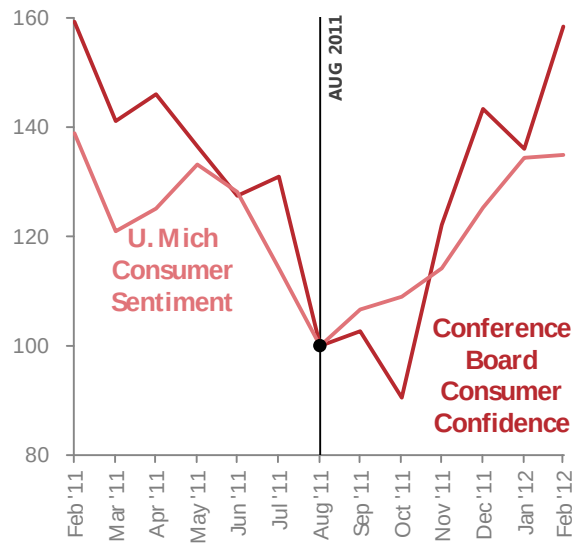
Financial Market Effects

Financial market conditions have a direct effect on economic activity. A good deal of household wealth is held in financial assets, and much of household and business spending is funded by borrowing. Thus, lower asset prices and higher borrowing costs tend to weigh on private spending, and greater uncertainty about asset prices, borrowing costs, and economic activity can make households and businesses reluctant to spend. Stock prices, stock price volatility, credit risk spreads, and mortgage spreads all deteriorated in August 2011 and recovered only after many months.

FIGURE 2

Consumer Confidence

Index, August 2011 = 100

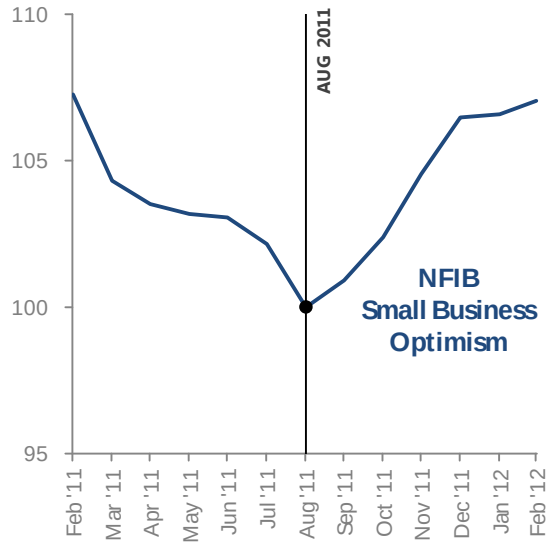


SOURCE: REUTERS/UNIVERSITY OF MICHIGAN, CONFERENCE BOARD.

FIGURE 3

Small Business Optimism

Index, August 2011 = 100



SOURCE: NFIB.

Equity Market Prices

The S&P 500 index of equity prices fell about 17 percent in the period surrounding the 2011 debt limit debate and did not recover to its average over the first half of the year until into 2012. Roughly half of US households own stocks either directly or indirectly through mutual funds or 401(k) accounts, so this fall in equity prices reduced household wealth across a wide swath of the economy. Between the second and third quarter of 2011, household wealth fell $2.4 trillion. A decline in household wealth tends, all else equal, to lead to a decline in consumption spending, and consumer spending accounts for roughly 70 percent of GDP. Moreover, because a good deal of retirement savings is invested in stocks, lower stock prices reduce retirement security – from the second to the third quarter of 2011, retirement assets fell $800 billion.

Between the second and third quarter of 2011, household wealth fell $2.4 trillion.

In the summer of 2011, corporate risk spreads on BBB-rated corporate debt jumped 56 basis points.

Businesses are also affected by stock prices because they rely on both debt and equity financing. When stock prices fall, investment or other spending to expand a business is more costly. The effects on households and businesses, moreover, are reinforcing. Less capacity and willingness of households to spend, when businesses have less incentive to invest, hire, and expand production, all lead to weaker economic activity.

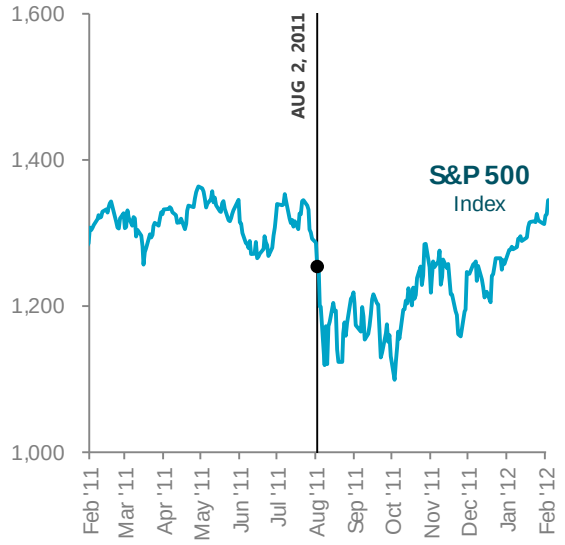
Stock Market Volatility

One common measure of volatility or uncertainty in financial markets is the "implied volatility" of stock prices, measured by the VIX. The VIX jumped around the

FIGURE 4

S&P 500

Index

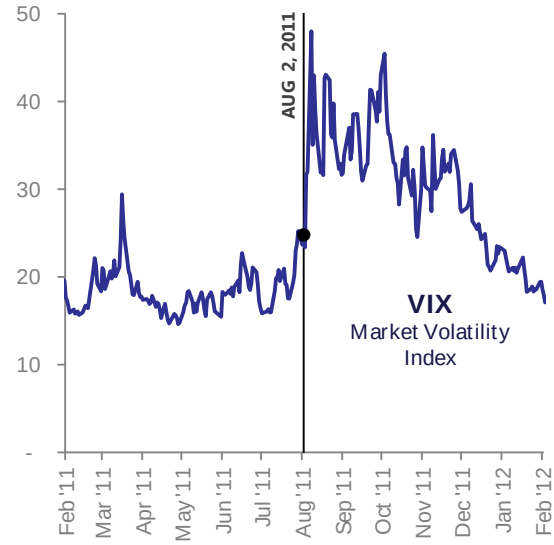


SOURCE: S&P.

FIGURE 5

VIX Market Volatility

Index



SOURCE: CBOE.

time of the 2011 debt ceiling impasse, roughly doubling, and remained elevated for months. Greater volatility can lead investors to pull back from any investment they perceive as risky, a development that tends to raise the cost of borrowing for households and businesses. Moreover, volatility can cause households and firms to pare back spending to accumulate larger reserves of cash to buffer possible future adverse developments.

Corporate Credit Risk Spread

Investors' willingness to lend to nonfinancial corporations is often summarized by credit risk spreads—that is, how much higher yields on private securities are than yields on comparable maturity Treasury securities. If investors are less willing to invest, they demand a higher return for that investment. From the borrowers' perspectives, wider credit spreads imply a higher cost of funding for a given level of Treasury rates. Higher funding costs lead to less spending on investment or other outlays that are financed. In 2011, corporate risk spreads on BBB-rated corporate debt jumped 56 basis points, and the wider spreads persistedb into 2012. A portion of the widening in this risk spread likely reflects the sovereign debt crisis in Europe among other factors, which both increased corporate risks and pushed down Treasury yields. The adverse effect on business was muted somewhat because the total cost of borrowing for businesses did not rise in line with the wider spreads. With Treasury yields rising this year, a widening in spreads would lead to an increase in yields on corporate debt. While corporate debt spreads are most applicable to borrowing costs for large institutions, in times of stress, banks tighten terms and standards on loans to small businesses, as well.

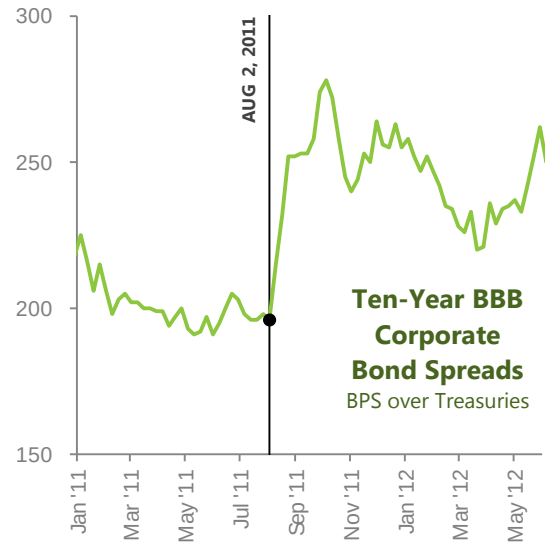
Mortgage Spread

Similar to corporate credit risk spreads, the spread of mortgage rates over yields on Treasury securities reflects investors' willingness to lend to finance housing. Mortgages involve some risk, and so an increase in risk aversion on the part of investors leads to a widening of mortgage spreads, and for a given level of Treasury

FIGURE 6

Ten-Year BBB Corporate Bond Spreads

Basis Points over Treasuries

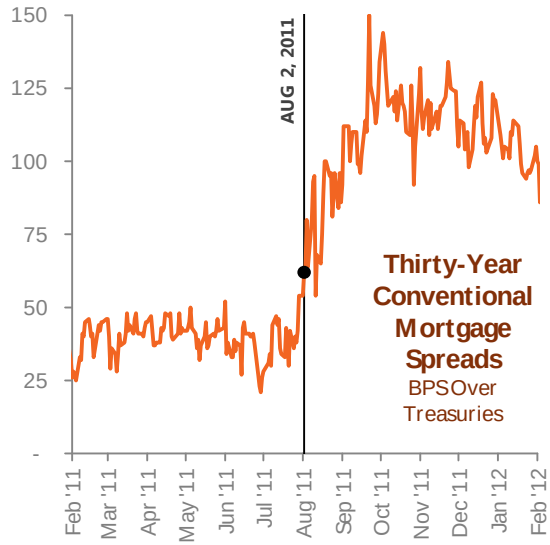


SOURCE: S&P, FEDERAL RESERVE.

FIGURE 7

30-Year Conventional Mortgage Spreads

Basis Points over Treasuries



SOURCE: WALL STREET JOURNAL, FEDERAL RESERVE.

yields, wider mortgage spreads increase mortgage rates, raising the cost of buying a home. Higher rates also mean that refinancing does not improve cash flow as much, which in turn restrains consumption spending. In the late summer of 2011, the 30-year conventional fixed-rate mortgage spread jumped by as much as 70 basis points and the wider spreads lasted into 2012. For an average mortgage of $235,000 at that time, 70 basis points more on a mortgage rate would increase monthly payments by about $100 per month. As noted above, sovereign debt concerns in Europe were affecting domestic financial markets, and part of the mortgage spread widening likely reflects those developments. Those same concerns pushed down Treasury yields, so on balance, mortgage rates actually declined even as the spreads widened. If the widening of mortgage spreads that resulted from the debt ceiling debate were to take place now, when yields on Treasury securities have been rising, the result would be higher mortgage rates that would restrain the housing market and household spending.

How does this information relate to the current situation?

Real GDP expanded at a 1.8 percent annual rate in the first half of 2013, and last month, a consensus of private-sector economists forecast real GDP to accelerate to a 2.4 percent annual rate in the second half and then to expand 2.8 percent in 2014. As economic activity strengthens, labor market conditions should improve further, creating new jobs and maintaining the downward trajectory of the unemployment rate. The government shutdown that began October 1 puts that outlook at risk. Private-sector economists have estimated that a weeklong shutdown could slow GDP growth in the fourth quarter by over a quarter percentage point, while a longer shutdown could have a substantially greater effect, perhaps even causing a recession.[1] If such projections prove accurate, the weaker-than-expected economic expansion would be even more susceptible to the adverse effects from a debt ceiling impasse than prior to the shutdown. A protracted debate about the debt ceiling could spark renewed financial market stress, and a fall in stock prices and wider credit spreads would depress spending from the private sector. In addition, increased uncertainty or reduced confidence could lead consumers to postpone purchases and businesses to postpone hiring and investments. A precise estimate of the effects is impossible, and the current situation is different than that of late 2011, yet economic theory and empirical evidence is clear about the direction of the effect: a large, adverse, and persistent financial shock like the one that began in late 2011 would result in a slower economy with less hiring and a higher unemployment rate than would otherwise be the case.

In the late summer of 2011, the 30-year conventional fixed-rate mortgage spread jumped by as much as 70 basis points.

[1] See, for example, Mark Zandi, written testimony before the Senate Budget Committee, September 24, 2013.

We may be starting to see some tentative signs that the current debate is affecting financial markets. Although the price moves are small and could easily reverse quickly, the fact that yields on Treasury bills that mature at the end of October are higher than bills that mature immediately before or after, might suggest nascent concerns about possible delays in payments on those bills. If market participants were to lose confidence in the United States' willingness to repay its debts, the adverse effects seen in 2011 could reappear, and even push up yields on Treasury securities. Such a rise in Treasury yields would also raise the cost of financing the government's debt and worsen the fiscal position of the government.

In the event that a debt limit impasse were to lead to a default, it could have a catastrophic effect on not just financial markets but also on job creation, consumer spending and economic growth—with many private-sector analysts believing that it would lead to events of the magnitude of late 2008 or worse, and the result then was a recession more severe than any seen since the Great Depression. 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. ■

not only might the economic consequences of default be profound, those consequences … could last for more than a generation.