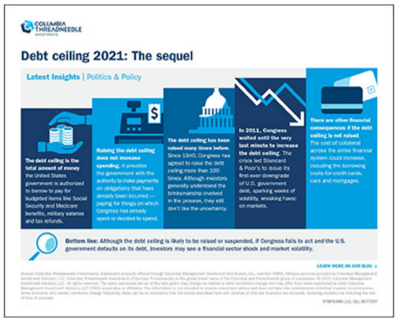
Debt ceiling 2021: The sequel

November 2, 2021

Congress temporarily avoided a debt ceiling showdown in October. But without meaningful action by year end, investors may see financial sector shock and market volatility.

For the larger part of a century, the debt ceiling — which was first introduced in 1917 — was mostly an uneventful congressional vote that raised the limit on the total amount of money the U.S. government is authorized to borrow to pay for budgeted items like Social Security and Medicare benefits, military salaries and tax refunds.

Raising the debt ceiling has been routine. In fact, since 1940 — when the national debt was consolidated under the Treasury Department — Congress has agreed to raise the debt ceiling more than 100 times. Doing so does not increase spending; it provides the government with the authority to make payments on obligations that have already been incurred.



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The debt ceiling is the total amount of money the United States government is authorized to borrow to pay for budgeted items like Social Security and Medicare benefits, military salaries and tax refunds.

Raising the debt ceiling does not increase spending. It provides the government with the authority to make payments on obligations that have already been incurred — paying for things on which Congress has already spent or decided to spend.

The debt ceiling has been raised many times before. Since 1940, Congress has agreed to raise the debt ceiling more than 100 times. Although investors generally understand the brinksmanship involved in the process, they still don't like the uncertainty.

In 2011, Congress waited until the very last minute to increase the debt ceiling. The crisis led Standard & Poor's to issue its first-ever downgrade of U.S. government debt, sparking weeks of volatility, wreaking havoc on markets.

There are other financial consequences if the debt ceiling is not raised. The cost of collateral across the entire financial system could increase, including the borrowing costs for credit cards, cars and mortgages.

Bottom line: Although the debt ceiling is likely to be raised or suspended, if Congress fails to act and the U.S. government defaults on its debt, investors may see a financial sector shock and market volatility.

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More recently, in early October, senators agreed on a short-stop measure to raise the debt ceiling temporarily. The legislation raises the amount the U.S. government can borrow to cover its expenses by $480 billion, which the Treasury Department estimates will last through early December. What then? While staving off a potential default, this compromise might have left things worse off than they were, as congressional Republicans and Democrats are now more at odds and more deeply entrenched in their positions.

Although investors generally understand the brinksmanship involved in the process, they still don't like the uncertainty. In 2011, Congress waited until the very last minute to increase the debt ceiling. The crisis led Standard & Poor's to issue its first-ever downgrade of U.S. government debt, sparking weeks of market volatility and wreaking havoc on markets. In 2013 and 2017, debt limit impasses resulted in Treasury bill yields spiking around the date markets expected the Treasury to run out of cash, which raises the government's financing costs.

If a similarly volatile market response were to unfold at year end, we could see credit spreads widening in a disorderly way. As it continues to meet payments coming due while trying to push off hitting the cap, Treasury will have to draw down its cash balance at the Federal Reserve, instead of financing by issuing Treasury bills. This reduces the amount of bills outstanding in an environment in which demand for these instruments is already high. This could also complicate the Fed's plans to taper asset purchases, which is anticipated as soon as this month. The Fed may even increase its purchases of Treasuries and reopen the 13(3) facilities as a backstop to the corporate credit market if things get really unruly. A prolonged stalemate introduces the prospect of recession.

The most likely outcome at present is that — as it has in the past — Congress will act before the Treasury runs out of cash. While there is no firm date, Treasury Secretary Janet Yellen has indicated that this could be in early December, which with extraordinary measures could be extended into early 2022. Congressional action would involve either raising or suspending the debt ceiling, with the difference likely to be driven by the legislation used to effect this outcome: If congressional Democrats resolve this through budget reconciliation, the debt limit will be raised by a specific dollar amount. If there is a bipartisan solution — which is now less likely — the ceiling may be suspended.

Bottom line

There is no way to position portfolios for a U.S. default. Active fixed-income strategies may outperform their passive peers in an environment where policy is changing rapidly, though, since they can position duration and credit risk to react to dislocations going into a debt limit crisis and then can invest around the resulting monetary/fiscal policy response.

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