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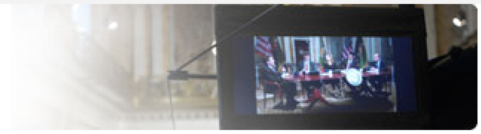

Report: The Potential Macroeconomic Effect of Debt Ceiling Brinksmanship

10/3/2013

Unprecedented default could result in recession comparable to or worse than 2008 financial crisis

WASHINGTON - The U.S. Department of the Treasury released a report today on the potential macroeconomic effects of debt ceiling brinksmanship. The report states that a default would be unprecedented and has the potential to be catastrophic: credit markets could freeze, the value of the dollar could plummet, and U.S. interest rates could skyrocket, potentially resulting in a financial crisis and recession that could echo the events of 2008 or worse. By looking at the disruptions to financial markets that ensued in 2011, the report examines a variety of economic indicators – including consumer and small business confidence, stock price volatility, credit risk spreads, and mortgage spreads – through which a similar episode might harm the economic expansion.

"As we saw two years ago, prolonged uncertainty over whether our nation will pay its bills in full and on time hurts our economy," Treasury Secretary Jacob J. Lew said. “Postponing a debt ceiling increase to the very last minute is exactly what our economy does not need – a self-inflicted wound harming families and businesses. Our nation has worked hard to recover from the 2008 financial crisis, and Congress must act now to lift the debt ceiling before that recovery is put in jeopardy."

The report notes that even the possibility of a default could roil financial markets and damage the economy, thereby harming American businesses and households. Sharp declines in household wealth, increases in the cost of financing for businesses and households, and a fall in private-sector confidence, all tend to undermine economic expansion. It also states that if the current government shutdown is protracted, it could make the U.S. economy even more susceptible to the adverse effects from a debt ceiling impasse than it was prior to the shutdown.

Key Findings of the Report Include:

- **The debt ceiling impasse in 2011 contributed to long-lasting scars on financial markets.** The financial markets stress that developed in August of 2011 persisted for many months. Then, as now, the economic expansion was vulnerable to adverse shocks.

- **Even the possibility of a default could lead to sharp declines in household wealth, increases in the cost of financing for businesses and households, and a fall in private-sector confidence.**

    - **Sharp declines in household wealth.** Wealth is an important determinant of household consumption spending, and consumption spending accounts for about 70 percent of GDP. From the second to the third quarter of 2011, household consumption fell $2.4 trillion.

    - **Increases in the cost of financing for businesses and households**. Increases in perceived risk and investor risk aversion mean that investors will demand a higher return on money lent. That higher return implies higher costs of borrowing for households and businesses, which results in lower consumption and investment spending and less hiring. The 30-year conventional fixed-rate mortgage spread over Treasury yields jumped by as much as 70 basis points late in the summer of 2011. In the summer of 2011, the BBB credit spread jumped 56 basis points.

    - **A fall in private-sector confidence.** Consumer and business confidence were falling in 2011, and as the debate about the debt limit progressed, business and household confidence fell to levels that are typically only seen during recessions. It took months before confidence recovered, even though, ultimately, there was no default.

- **In the event of a default, the U.S. economy could be plunged into a recession worse than any seen since the Great Depression.** The U.S. dollar and Treasury securities are at the center of the international finance system. In the catastrophic event that a debt limit impasse were to lead to a default on Treasury securities, financial markets could be shaken to their core as was seen in late 2008, which resulted in a recession worse than any seen since the Great Depression.

Additionally, there may be 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.

To review the report, click here: www.treasury.gov/initiatives/Documents/POTENTIAL%20MACROECONOMIC%20IMPACT%20OF%20DEBT%20CEILING%20BRINKMANSHIP.pdf

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