Remarks by Assistant Secretary for Financial Markets Joshua Frost on the Historical and Current Perspectives on the Debt Limit at the Federal Reserve Bank of New York’s Annual Primary Dealers Meeting

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As Prepared for Delivery

Good afternoon and thank you to the New York Fed for inviting me to talk with you today. I’m delighted that circumstances permit our meeting in person again after these past few years of virtual interaction. In my role as Assistant Secretary for Financial Markets at Treasury, one of my main responsibilities is overseeing Treasury’s Office of Debt Management, which is the policy team responsible for developing the marketable debt issuance strategy for the federal government.

Between my current role at Treasury and my decades here at the New York Fed, I’ve developed a thorough appreciation for the role that the primary dealer community plays in ensuring that the Treasury market remains the deepest and most liquid market in the world. Your firms serve as critical conduits between Treasury and financial markets, as the only group of market participants with an obligation to bid in each of the more than 380 auctions that we conduct each year. Primary dealers also actively intermediate secondary market trading and provide us with insights into the health of the Treasury market and feedback on our issuance strategy.

One notable area where primary dealer feedback has historically been quite helpful is evaluating the adverse effects that debt limit impasses impose on the primary and secondary markets for Treasury securities. My remarks today are not going to include any speculation on when the debt limit might next become binding, or when Congress may act. Rather, my intention is to put the debt limit in context with a brief history, resolve some common misconceptions, and describe some of the many negative outcomes that these impasses produce. Unfortunately, debt limit episodes have become more frequent and consistently prove to be counterproductive in achieving our objective to fund the government at the
lowest cost to the taxpayer over time.

Given the history of debt limit impasses over the last 40 years, it might come as a surprise that the debt limit was originally intended to simplify the government’s borrowing process. Prior to World War I, Congress exerted tight control over federal debt management decisions as individual bond issues were subject to legislative approval. This began to change with the Second Liberty Bond Act of 1917 and then more so in 1939, when Congress consolidated restrictions on specific types of debt into the aggregate limit that we have today. According to the Congressional Research Service, the debt limit has been raised or suspended 61 times since 1978, which works out to roughly once every 9 months. It’s important to acknowledge and reiterate that raising or suspending the debt limit does not authorize new government spending. It simply permits Treasury to continue financing existing obligations that Congresses and Presidents of both parties have incurred.

Most recently, Congress twice raised the debt limit in 2021: by $480 billion in October and then by an additional $2.5 trillion in December. Increasing the debt limit by a specific dollar amount was a common practice during the late 1990s and throughout the early 2000s but fell out of favor after 2011. Instead, between 2013 and 2019, time-based suspensions of the limit were Congress’s preferred method for resolving a debt limit impasse. From a Treasury perspective, the mechanics of an increase in the debt limit compared to a temporary suspension of the limit differ in one crucial respect: certainty on timing.

With a debt limit suspension, it is immediately apparent when the next impasse would begin --- absent action from Congress prior to the end of the suspension --- because the end date of the debt limit suspension is specified in the legislation. Conversely, when the debt limit is instead increased by a fixed dollar amount, the date when the debt limit might again bind is less certain, as it is dependent on the evolving fiscal picture.

Regardless, once the amount of outstanding debt subject to limit approaches its statutory limit, there are certain extraordinary measures that the Treasury Secretary is authorized to use to temporarily prevent the U.S. government from defaulting on its obligations. I’ll address the harm that taking those steps can cause later in my remarks.

With that as a backdrop, I’d like to first turn to few common misconceptions related to the debt limit:

*Misconception #1: There is no cost to repeatedly running up against the debt limit*
As I’ll explain shortly, there are real costs borne by taxpayers, including damage to the U.S. economy and increases in funding costs.

**Misconception #2: Treasury has absolute control over the issuance and redemption of its debt**

To begin to address this misconception, it is important to delineate the two broad categories of debt subject to limit: marketable securities (the bills, notes, bonds, TIPS, and FRNs that we auction) and nonmarketable securities. When our funding needs change, Treasury adjusts its issuance of marketable securities. The amount of cash that needs to be raised is broadly outside of Treasury’s control and is subject to considerable forecast uncertainties, because it depends on the revenues and expenditures of the entire federal government. But Treasury is responsible for determining how to meet those cash needs. We decide which securities to issue, on which days, and in what amounts. The goal is to maintain our “regular and predictable” issuance paradigm that lowers costs to the taxpayer over time.

However, the issuance and redemption of nonmarketable securities typically operate differently. Some are driven by statute, such as investments in the Social Security Trust Fund, with net issuance to trust funds increasing overall debt subject to limit. It is worth noting here that Treasury does not determine the timing and magnitude of this issuance. In other instances, issuance and redemption decisions are managed by federal agencies where Treasury does not know with advance certainty how much, when, or what type of nonmarketable debt an agency will choose to purchase or redeem. Shifts in the amount, timing, and type of this activity can meaningfully affect the contours of how the amount of outstanding debt subject to limit evolves.

Finally, there are instances where external stakeholders control the amount of securities that are issued, such as State and Local Government Series (SLGS) securities. In these specific cases, external parties generally drive issuance and redemptions, but as an extraordinary measure, Treasury can choose to close the window to new issuance, as we have done in the past with SLGS.

In short, the issuance and redemption of nonmarketable securities are far more rigid, and more driven by autonomous factors, than they are for marketable securities.

**Misconception #3: There is a specific date known well in advance, referred to as the ‘x-date,’ on which Treasury’s internal modal forecast says that the government will no longer be able...**
As professional forecasters are well aware, there is typically a probability distribution to projections. Given the unacceptable risks associated with even the possibility of default, I think that a useful definition for the ‘x-date’ is the date after which Treasury no longer possess a high degree of confidence that it can continue to meet all of its obligations while remaining under the debt limit. It is not the date when there is an equal likelihood that we will or won’t be able to meet our payment obligations, nor is it the last conceivable date when the government could run out of money. That said, as the level of all-in resources continues to be exhausted, these dates tend to converge.

To put the aforementioned probability distribution into context, the federal government’s gross daily cash flow (excluding financing) has averaged nearly $50 billion throughout FY2022, which equates to more than $12 trillion annually. This means that even a small forecast miss in percentage terms can materially move the date by which Treasury would exhaust its resources. If I were to evaluate the error bounds of our quarterly refunding borrowing estimates since 1998, and exclude periods affected by the Great Recession or the COVID pandemic, our current-quarter financing estimates (i.e., those looking out only the next two months) have a 95% confidence interval of roughly $90 billion in both directions when expressed in 2022 dollars. Thus, because of the very real possibility that fiscal flows could deteriorate with little notice, the only reasonable, responsible approach is for Congress to raise or suspend the debt limit before the date when we are no longer highly confident that we will be able to continue to meet all of our obligations.

Additionally, it is not only the forecasted aggregate level of cash and extraordinary measures that matters here, but also the distribution between these two components. For example, unexpected shifts in the fiscal forecast or net nonmarketable security issuance could require Treasury to take unusual steps that we generally seek to avoid, like issuing same-day cash management bills or conducting buybacks. These scenarios highlight that there are instances in which Treasury might have enough resources to meet its obligations while remaining under the debt limit, but would run an unacceptably high degree of execution risk.

Now, returning to the issue of the costs of repeatedly running up against the debt limit, first consider the damage that these impasses can impose on the U.S. economy. In 2013, Treasury published a report entitled “The Potential Macroeconomic Effect of Debt Ceiling
Brinkmanship,” which used the 2011 impasse as a case study.[2] During those particularly acrimonious debt limit negotiations, we witnessed a decline in household and business confidence, a fall in household wealth as equity prices fell amid a spike in market volatility, and wider credit and mortgage spreads. Each of these shocks contributed to a slowdown in economic activity.

In addition to the direct economic effects, debt limit impasses tend to cause the federal government’s perceived creditworthiness to deteriorate and increase the government’s borrowing costs. For example, the political brinkmanship in 2011 was cited by S&P when it downgraded the United States’ sovereign credit rating from AAA. The GAO found that “delays in raising the debt limit in 2011 led to an increase in Treasury’s borrowing costs of about $1.3 billion in fiscal year 2011.”[3]

Perhaps closer to home for this audience, debt limit impasses have also repeatedly disrupted implementation of Treasury’s cash management policy – with knock-on effects for money markets. As a reminder, Treasury’s policy is to maintain sufficient funds to cover at least our one-week-ahead cash need, which includes both net fiscal outflows and the gross volume of maturing marketable debt. This policy is a risk-management tool to protect against potential interruptions to market access. However, during a debt limit impasse, it isn’t always possible to comply with this policy. For context, while our cash balance varies over time and has a seasonal component, recently it has typically been between $600 billion and $700 billion when debt limit constraints have not been binding. But as a debt limit impasse goes on, it forces the cash balance closer and closer to zero. At the extreme, between early-October and mid-December 2021, an examination of realized flows reported on the Daily Treasury Statement indicates that there were several instances when we didn’t have sufficient cash on hand to meet even our next-day obligations. [4] During the course of that impasse, Secretary Yellen wrote eight separate letters to Congress regarding the importance of acting to address the debt limit.

Meanwhile, with respect to issuance, serving as a “regular and predictable” issuer has been a longstanding hallmark of our borrowing strategy and lowers costs to the taxpayer over time. In 2015, the Treasury Borrowing Advisory Committee (TBAC) estimated that applying this paradigm had reduced interest costs by $27 billion since 1998.[5] Unfortunately, as we maneuver to remain under the debt limit, the variability of our issuance increases and our predictability decreases. Our longstanding practice is to rely on Treasury bills as an issuance “shock absorber” because we believe that adjusting issuance in that sector (rather than in
coupons, TIPS, or FRNs) minimizes the broader effects on the market. However, that is not to say that heightened variability in bill issuance is costless.

During a debt limit impasse, Treasury typically reduces bill issuance – at times, precipitously – to remain under the debt limit. For example, during the final two months of the 2015 impasse, bill supply declined by $210 billion – a rapid and sizable drop that led to elevated volatility in the primary and secondary markets.

Regrettably, variability in issuance doesn’t immediately subside once the debt limit has been resolved. At that point, Treasury must rapidly replenish its cash balance for risk-management purposes. During those periods, we again see elevated volatility in the primary and secondary markets for bills.

Outside of these direct disruptions to supply, bouts of debt limit-induced volatility may also have a deleterious effect on the resilience of this globally important market. The resilience of the Treasury market is a top priority of the Financial Stability Oversight Council for good reason – a healthy Treasury market is essential for a strong U.S. economy, stable global financial system, and the dollar.

In summary, debt limit impasses inject additional uncertainty into financial markets: uncertainty about when the debt limit will be reached; uncertainty about how long extraordinary measures will permit Treasury to continue to satisfy the government’s obligations; and uncertainty about the timing and pace of changes in Treasury securities issuance. As market participants have repeatedly highlighted, markets do not like uncertainty and will demand a risk premium to hold Treasury debt as compensation. This undermines Treasury’s efforts to finance the government at the lowest cost to the taxpayer over time.

Finally, as Secretary Yellen noted last year: “A delay that calls into question the federal government’s ability to meet all its obligations would likely cause irreparable damage to the U.S. economy and global financial markets.”[6] Ultimately, the only solution is for Congress to address the debt limit.

Thank you, all, again for the invaluable feedback you provide as we face these periodic challenges.

Treasury was wholly reliant on being able to settle previously auctioned securities successfully.