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A NEW "LEHMAN MOMENT," OR SOMETHING WORSE? A SCENARIO OF HITTING THE DEBT CEILING

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The United States entered the second week of a government shutdown on Monday, October 7, with no end to the deadlock in sight. The cost to the government of a similar shutdown in 1995–96 amounted to $2.1 billion in today's dollars (CRS 2013). However, the cost and broader consequences of today's shutdown are not yet clear, especially since the US economy is in the midst of an anemic recovery from the biggest economic crisis of the last eight decades.

The situation becomes more serious when one considers that the US Congress needs to raise the debt ceiling before October 17—the date, according to Treasury estimates, on which the US government will exhaust its borrowing capacity. At that point, the Treasury's cash balance would be $30 billion—an amount that is expected to be depleted by the end of the month (Hoffine 2013).

If Congress does not agree to raise the debt ceiling, the consequences are even more uncertain and perplexing than those of the ongoing shutdown, because there is no precedent for a US government default, and there is a series of legal and technical questions that are very difficult to answer.

Examination of these consequences usually starts with the effects on the creditworthiness of Treasury bonds and the repercussions for financial markets and the real economy. If the debt ceiling is not raised, the US government will default, the rating of Treasury bonds will be downgraded to "selective default" status, and payouts on US sovereign CDSs will be triggered. This could

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act as a new “Lehman moment,” pushing the US and global economies back into recession.

Technical and legal complexities aside, this scenario could be averted. The Treasury could prioritize the interest and principal payments of the government debt securities, so that none of the above happens.[1] Nevertheless, if the debt ceiling were not raised for a significant period of time, the government would have to balance its budget immediately. Such an outcome could be more dangerous than the collapse of Lehman Brothers in 2008.

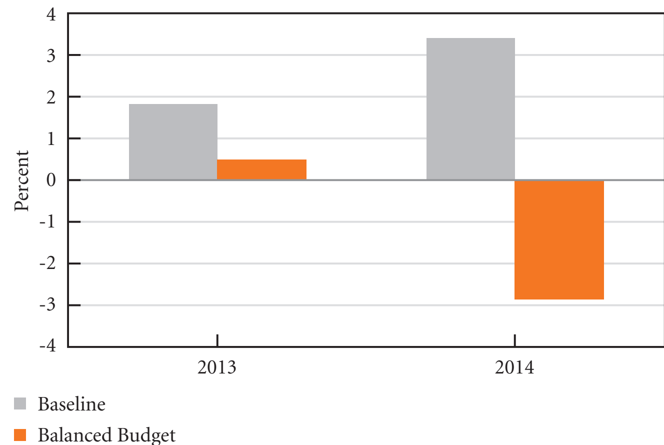
This policy note explores this hypothetical “balanced budget” scenario. What would happen if the US government had to balance its budget for the 2014 fiscal year (from the fourth quarter of 2013 until the third quarter of 2014)? This scenario is unlikely.[2] Nevertheless, it is interesting because bargaining about raising the debt ceiling (or not) has been taking place every few months. Even if Congress were to agree to raise the ceiling in the coming week (which is the most likely scenario), the farce would be repeated sooner rather than later. It is thus useful to know what is at stake every time.

Our analysis utilizes the Levy Institute’s macroeconomic model of the United States. It builds on a baseline scenario that simulates the projections of the Congressional Budget Office (CBO 2013a, 2013b) for the growth rate of the US economy and the fiscal stance of the US government. It also assumes that the growth and inflation rates of US trading partners will follow those projected by the International Monetary Fund (IMF 2013) in its April *World Economic Outlook* report. In turn, these assumptions about the government and foreign sectors of the economy imply a certain behavior for the private sector.[3]

The only difference in the “balanced budget” scenario vis-à-vis the baseline is that there is rapid fiscal consolidation beginning in the last quarter of 2013 and the government balances its budget for the remainder of fiscal year 2014.

In Figures 1 and 2 we present the results of our simulations for real GDP growth and unemployment in 2013 and 2014. In Figure 1 we can see that an abrupt decrease in fiscal expenditures in the fourth quarter of 2013 will lower the growth rate to around 0.5 percent from almost 2 percent, which is the projection of the CBO. Given US economic performance so far this year, this translates into an annualized growth rate of -2.5 percent for 2013Q4. In 2014, the discrepancy between the baseline and “balanced budget” scenarios will be even larger, and the US economy will shrink by almost 3 percent.

Figure 1 **GDP Growth Rate**



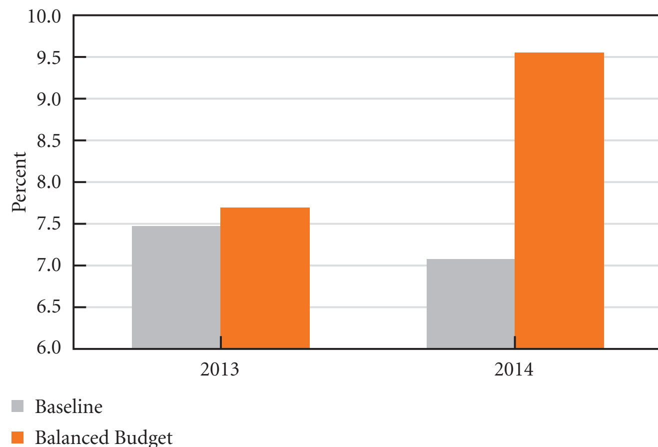
Sources: Bureau of Economic Analysis; author's calculations

Figure 2 shows the effects of such fiscal consolidation on the unemployment rate. In 2013, unemployment’s slow decline over the last two quarters would be interrupted, and the unemployment rate would rise to 7.8 percent. In 2014, the unemployment rate would increase to more than 9.5 percent, close to its peak in the last quarter of 2009. Given the smaller labor force participation rate compared to four years ago, an unemployment rate of 9.5 percent in 2014 would mean a significantly bigger stress on the labor market than in 2009Q4.[4]

It is worth noting that these forecasts are probably on the optimistic side of what would really follow a rapid fiscal consolidation of the US government. The IMF projections for US trading partners are based on the assumption of relatively robust US growth. A recession in the United States would certainly exert a negative influence on growth in the rest of the world, which would in turn feed back to the States.

Moreover, the private sector in the United States (and the rest of the world) has been deleveraging since the crisis of 2008. In recent quarters, this deleveraging has slowed down and the recovery has picked up, but various data sources show that the health of the private sector’s balance sheet is still fragile. Since we do not live in a Ricardian world, a plunge in the growth rate would damage the balance sheet of the private sector and induce a new round of rapid deleveraging, which would further push down the growth rate. It is not hard to imagine that this situation would also have negative spillover effects for the financial sector.

Figure 2 Unemployment Rate



Sources: Bureau of Labor Statistics; author's calculations

The failure of Congress to raise the debt ceiling will also reveal the inability of Washington to effectively handle the US economy. This will have further negative consequences for the economy in the United States and internationally.

Finally, in the recent Great Recession, automatic and discretionary fiscal spending halted the downturn. In the case of a new crisis originating from rapid fiscal consolidation, it is not clear who would play the role of system stabilizer.

In conclusion, our simulations show that even if a (hypothetical) congressional failure to raise the debt ceiling does not lead to government default, the fiscal consolidation that will ensue will be enough to push the US economy back into a deep recession.

Notes

1. A discussion of these technical complexities and legal uncertainties is provided in the recent issue of Goldman Sachs's *US Economics Analyst* (see Phillips and Dawsey 2013).
2. At this writing, there are reports in the press that Speaker John Boehner will ask House Republicans for a short-term debt ceiling increase.
3. Details about the logic of our macro-model simulations can be found in the Levy Institute's Strategic Analysis report series; see, for example, Papadimitriou, Hannsgen, and Nikiforos (2013).
4. The inadequacy of the unemployment rate as a measure of the health of the labor market is discussed more extensively in Nikiforos (2013).

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