Daunting debt limit dynamics

Goldman Sachs Exchanges

Stephen B. Kaplan, Associate Professor of Political Science and International Affairs,
George Washington University
Alec Phillips, Chief Political Economist,
Goldman Sachs Research
David Beers, Former Head of Sovereign Credit Ratings, Standard & Poor's,
Senior Fellow, Center for Financial Stability
Allison Nathan, Host, Goldman Sachs Research

Allison Nathan: Concerns about a failure to raise the US debt limit before the government runs out of money to pay its bills have subsided as the Biden administration and Congressional Republicans have struck a deal to raise it. But this chapter will still go down in history as just one in a growing line of contentious debt limit episodes in recent decades.

The debt limit was originally enacted to simplify the process of issuing debt to fund government spending. But what began as an attempt at efficiency has turned into a frequent game of political brinkmanship with the

opposition party using the debt limit to extract concessions from the president's party in exchange for agreeing to raise it.

I'm Allison Nathan and this is Goldman Sachs Exchanges.

[MUSIC INTRO]

On this special episode, we're breaking down the daunting debt limit dynamics that were the topic of our most recent Top of Mind report now available on GS.com. We dig into whether the repeated brinkmanship around raising the debt limit could ultimately undermine the value proposition of US assets. We speak with Stephen Kaplan, associate professor at George Washington University, Alec Phillips, our chief political economists, and David Beers, former head of sovereign credit ratings at S&P who oversaw the rating agency's US credit rating downgrade in 2011 after another disruptive debt limit episode.

Kaplan argues that the constant wrangling over the debt limit creates the tail risk, however small it may be, of a US sovereign debt default.

Stephen Kaplan: There's a tendency, I think, over time for the market to shrug this off as political theatre. And yeah, there's going to be political wrangling and brinkmanship, but ultimately, is any politician going to really want to risk a default? And if we think about that from a standpoint of risk, the balance of risk would suggest, yeah, political rationalism and prudence would pass and increase the debt ceiling. However, I think there is tail risk involved.

And I think that every time we come up to a deadline for the debt ceiling, there's a potential tail risk that there's not a resolution on time. So, I don't think there's a high probability. But I do think there's tail risk there.

Allison Nathan: Kaplan warns that this tail risk could eventually erode the willingness of countries and investors to hold US dollars.

Stephen Kaplan: A high demand for dollars as a secure, safe asset internationally is not really questioned. Competitors, such as the renminbi, Chinese authorities love to talk about dedollarization. But most of the increase in the renminbi we see tends to be associated with Chinese trade, not necessarily an intermediary between other

countries outside of Chinese trade. And as a share of reserves, Chinese renminbi accounts for about 2 percent of total reserves compared to the dollar which is about 50 percent or so.

So, I don't think there's much of a concern from a pure market standpoint, economic standpoint about the demand and need for US dollars. But if we think about it from a broad, long-term perspective, this outstanding political polarization, casts a cloud on the United States' ability to repay its debt. Not its economic capacity to do that, its institutional economic ability, but rather the political willingness. That can't be good for any US dollar asset.

Year after year, we come up to a debt ceiling where it creates this moment where the globe questions the political willingness to pay. And economic actors question the political willingness to pay. It starts to create an incentive for investors internationally to think about alternatives, to think about diversification. Enterprising countries, enterprising institutions have an incentive to try to find an alternative.

What we've seen China do is really try to, on some level,

strengthen the renminbi and use its big build up of dollar reserves in order to invest increasingly globally, including developing countries. So, they may be doing this via trade. But nonetheless, that presents a challenge, not necessarily again, for the dollar as an intermediary between countries, but from a trade and settlement standpoint, it does start to slowly create a challenge for the dollar in developing countries over the long run. This is a very slow-moving process.

But if we think of demand for dollars internationally, what has that done for the United States? And what it's done for the United States, essentially over the course of the last several decades, is provide a low interest rate facility. Even in an increasing interest rate environment as we've seen, relatively, the United States has a fairly cheap cost of capital. So, ultimately, that is an asset. That demand for dollars, the global demand for dollars and the dollar as the world's reserve currency I think is something that US politicians ultimately should do everything possible to support.

And why this issue is most concerning is that politicians using a dollar asset, the prospect of potentially, even if it's

a low probability event, potentially having a default as a way to negotiate, why do that to an asset that's so important to the US economy?

Allison Nathan: Because of that, Kaplan believes that the debt limit should be abolished.

Is the solution that we abolish the debt limit?

Stephen Kaplan: Yeah. Of all the political questions that are out there in today's environment, I think this is one of the most straightforward political questions. I don't really see a value in the debt ceiling. It creates an economic cost that isn't really rational. So, we should abolish it.

Allison Nathan: And if we look at the alternatives, how do other countries do it, is there a best practice? What would you recommend?

Stephen Kaplan: There are a few different options. For one, Denmark is another country that does have a debt ceiling. But their actual debt ceiling is much higher than the country's level spending. So, they're not bumping up against the debt ceiling in the same way that the United

States is. So, that's one option of having such a high debt ceiling that you're not immediately bumping up to it as has been the case in the United States.

Some other options. Poland and Brazil both have spending caps. Poland does a constitutional cap as a share of GDP. 60 percent of GDP. While Brazil limits constitutional spending in line with the previous year's inflation rate. So, those are countries that go about it a bit differently through a constitutional spending cap rather than a debt ceiling.

I would say in terms of the balance of risks, it's much better to eliminate any kind of economic uncertainty, abolish the debt ceiling. And instead, just have a natural budgetary process with a long with any increased spending would come increased financing along with that. And then if it's an automatic process, you remove all this layer of uncertainty.

Once Congress would pass the budget, essentially automatically along with that they would pass any new issuance of debt that would be necessary to cover any deficits.

Allison Nathan: But Goldman Sachs's chief political economists Alec Phillips doesn't believe that the dollar is particularly harmed by the brinkmanship around the debt limit.

Alec Phillips: The US is essentially the only country that has a debt limit. And I think all else equal, it probably does reduce confidence in treasuries and, ultimately, reduces confidence slightly in the dollar. With that said, this is less an issue about credit and solvency and it's much more ultimately a technical issue.

And so, while I think that there is certainly an argument to be made that having this thing happen every two years could gradually erode the dollar's status, there are other issues with other potential reserve currencies as well. And I think it is safe to say that we have seen, for example, in Europe, which would be the other contender for a reserve currency, I think it is safe to say that we have also seen some fiscal issues there over the years. And unlike the US, to some extent those actually involved more credit risk.

So, overall, I would say that while it certainly does not help

the status of the dollar, it's unclear that it really hurts it that much, particularly in absence of an obvious alternative.

Allison Nathan: Phillips also points out that the debt limit exists for a reason and that abolishing it would be easier said than done.

Alec Phillips: So, the reason we have the debt limit is because it would be very annoying for Congress to have to pass legislation every time the treasury wanted to issue treasury bills. Which happens two times a week. Under the original articles of the Constitution, Congress has the power to issue debt, not the president. Not the treasury. Likewise, Congress has the power to tax. And Congress has the power to spend.

And over the years, it became more cumbersome for Congress to approve every debt issuance. And in World War I, it became necessary to change the process. And that eventually became what we have now which is just a dollar limit on debt issuance.

Now, if you look back to, say, the 1950s or the 1960s, the

debt limit was in some ways thought of as an actual limit. There were periods where there was debate as to whether they should raise it. And it wasn't about default, it was essentially because at that point, deficits were small and there was a hope that they wouldn't have to raise it because the Treasury might not actually have to borrow.

Now it's taken on a much different meaning, in part because it's in nominal terms. So, in an inflationary environment where nominal interest rates are higher, you're going to end up having to raise the debt limit regardless. And beyond that, the fiscal situation is much worse than it was in some of those prior periods. And so, it's unavailable to issue debt.

Some people will say can we just get rid of it? I think the challenge there is to truly get rid of it, you would probably have to amend the Constitution. And that seems difficult. There's been a second option which is that ultimately the courts could always decide that the debt limit is just fundamentally incompatible with other laws that Congress has passed. And specifically, the question that at some point courts might face is whether the debt limit or the requirement that the president spend money that Congress

appropriates is more important. Because if the debt limit prevents spending from happening, and Congress has ordered that spending to happen, then Congress has ultimately given two conflicting instructions to the president. And somebody, eventually, has to choose which one of those he follows.

Allison Nathan: Phillips also argues that raising the debt limit to such a high level that it never gets hit probably isn't feasible either. Here he is talking about this.

Alec Phillips: There is a proposal to increase the debt limit to a gazillion dollars. Whatever that number turns out to be. Of course, the challenge in doing that is that neither party wants to take responsibility for raising the debt limit even a small amount. So, raising it a really large amount seems very difficult when that decision can always be left to somebody else in the future.

I think the clearest example of this was in 2021 where Democrats had the power to increase the debt limit to any amount they wanted without any Republican support. In 2021, we actually came reasonably close to the debt limit deadline, despite the fact that Democrats controlled the

House, Senate, and White House. And the reason is because they wanted Republicans to vote with them on a debt limit increase.

So, in the environment where one party actually has the ability to unilaterally raise the debt limit to whatever it wants and is unsure that it wants to raise the debt limit at all because it wants the other party to help, then I think the odds of raising it to a gazillion dollars are probably pretty low.

Allison Nathan: Given that much of the concern around the debt limit stems from the potential implications for the US credit rating, we then speak with former head of sovereign credit ratings at S&P, David Beers. He first explains what rating agencies look at when rating sovereigns. These ratings are a key metric investors us to determine what assets they can hold.

David Beers: When rating sovereigns, the large rating agencies look at a combination of political, economic, fiscal debt factors recalling what rating agencies do, which is provide opinion on the credit worthiness of the borrower. Obviously, the focus is in the case of governments, on

among other things, the trend in public debt, which is measured in a variety of different ways. And each rating agency also has a view of the political factors which they think may help explain trends in the government deficits.

Allison Nathan: If credit ratings are intended to measure credit risk as you just said and the risk of defaults on government debt in local currency for countries that print their own money is technically zero--

David Beers: Well, no, it's not. When I went to the Bank of Canada after I left S&P, one of the things that I decided to do because nobody had ever done it before was develop a comprehensive database of sovereign defaults from 1960. And one of the things that I used to talk about even when I was at S&P is it's simply not true that sovereigns from time to time don't default on their local currency debt. They do. And you can take a look at the database to see.

And there are some big restructurings happening now, Ghana is an example, where the government has had to restructure its local currency debt as well as it's in the process of restructuring its foreign currency debt. So, even if the frequency in default is less than for foreign currency

denominated obligations, it doesn't mean that it doesn't happen.

The other thing to say is that the US has something called a debt ceiling. That is peculiar to the United States. And as we have seen in the past, including 2011 and before that, it has to be raised by Congress. And the problem back in 2011 was that the lower house of Congress under the Obama administration was led by the Republicans and there's a similar issue today since the midterm elections, the Republicans now have a majority in the House of Representatives. So, this is not the first time nor, I suppose, will it be the last time where there may be some controversy about the debt ceiling and the trade-offs that might come when one party is in control of one part of Congress and the administration is another party.

And if the debt ceiling is not raised, given the underlying budget deficits in the United States, then at some point the government wouldn't have the resources to service its Treasury debt. And that, of course, would lead to a default.

Allison Nathan: But while the debt limit could lead to US default, Beers emphasizes that S&P's 2011 downgrade of

the US credit rating under his watch was not motivated by the contentious debt limit process. In fact, the downgrade came after the debt limit had been raised. Rather, the downgrade was driven by the concerning US fiscal and political trajectory that the debt limit process highlighted, both of which, Beers says, have deteriorated substantially in the 12 years since.

David Beers: In 2011, the debt ceiling, per se, was not the issue of the downgrade because it was resolved. If the US had deflated, then the rating wouldn't have dropped one notch to AA+, it would have dropped to D, which stands for default. What S&P drew attention to back then were two factors. We thought that the political dynamics, the increased political polarization itself was problematical for the US's credit worthiness. As well as the rising trajectory of the government debt.

If you look at the expectations that S&P had at that time and trying to exclude for the moment the exceptional impact of COVID in 2020/2021, S&P's expectations of the rising debt burden were remarkably prescient. We foresaw that the debt burden would continue to rise.

And in 2011, which was the year of the downgrade, the net general government debt was 76 percent of GDP. And then what you see is it continued rising. By 2019, it was 83 percent of GDP. So, that was actually a higher number that we were anticipating. So, the underlying fiscal dynamics in the US have actually deteriorated compared to what S&P was expecting.

Last year, according to the IMF, the US's net total government debt burden will reach just about 94 percent of GDP. It's fallen since 2020 and 2021, which was heavily affected by COVID. But that's close to the highest that it's been since World War II.

And coming back to the politics of all this, we commented back in 2011 that we thought that political polarization was worsening in the United States. And that was relevant to us because it made it harder to put together a consensus over fiscal policy priorities, things like taxes, spending, and the size of deficits. And we can't argue the political polarization has actually done anything other than continue to worsen since 2011. So, I think the S&P's decision to lower the rating was more than justified, not only by the events at the time, but has, if anything, been

confirmed by events more recently, which from a credit worthiness perspective have been worse than what we were anticipating back in 2011.

Allison Nathan: In Beers' view, high levels of debt in many countries, including the US, is the real problem that could ultimately aversely impact US credit worthiness. And abolishing the debt limit would do little to solve those fiscal concerns.

David Beers: Other countries get into debt difficulties that don't have debt ceilings. The underlying issue is public finances. You can't just keep borrowing and expect that your creditworthiness isn't going to suffer, whether you're in the private sector or the public sector.

Allison Nathan: So, you don't buy into [UNINTEL] that we've learned that we can live with higher debt without that bad of consequences?

David Beers: No. Because if that were true, we wouldn't still be having financial crises. We wouldn't be seeing sovereigns deflating. And the defaults are going up. They're still relatively low compared to what we saw in the 1980s.

But remember, lots of countries got debt relief 20 years ago. And what did they do with the debt relief? They started borrowing money again. And now you have many sovereigns that are as highly indebted as they've ever been.

And so, I expect to see more sovereign defaults over the next decade. And at some point, governments are going to have to rethink their fiscal priorities. So, it's a myth that governments can borrow at will. Because if that were true, then no sovereigns would be deflating on their debt anywhere at any time. And that's belied by the data and by history and experience. And that includes advanced economies. People thought that the Eurozone was going to be impervious to a debt crisis until it arrived. And then we saw a number of countries there have to restructure their debt.

So, the idea that we shouldn't care about the debt burdens of countries or of the private sector of countries, public and private and globally, is a dangerous notion that, as it has always done, will come back to bite us when we least expect it.

Allison Nathan: With questions about the implications of

repaired brinkmanship around raising the debt limit sure to remain in focus, we'll continue to keep a close eye on it. I'll leave it there for now.

If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode of Goldman Sachs Exchanges.

Make sure to like, share, and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

And if you'd like to learn more, visit GS.com and sign up for Briefings, a weekly newsletter for Goldman Sachs about trends shaping markets, industries, and the global economy.

This transcript should not be copied, distributed, published, or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or

completeness of the statements or any information contained in this transcript and any liability therefor (including in respect of direct, indirect, or consequential loss or damage) are expressly disclaimed. The views expressed in this transcript are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this transcript. In addition, the receipt of this transcript by any recipient is not to be taken as constituting the giving of investment advice by Goldman Sachs to that recipient, nor to constitute such person a client of any Goldman Sachs entity. This transcript is provided in conjunction with the associated video/audio content for convenience. The content of this transcript may differ from the associated video/audio, please consult the original content as the definitive source. Goldman Sachs is not responsible for any errors in the transcript.