Dire Consequences from Failing to Raise the Debt Limit

Michael Mussa says that credit rating agencies would downgrade US debt if any scheduled federal payments are missed, not simply interest payments on the debt.

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Steve Weisman: In mid July Washington is still in turmoil over the debate on whether to raise the debt limit, with questions about the consequences. Michael Mussa, senior fellow at the Peterson Institute, is here to walk us through what some of these might be. This is Steve Weisman. Are predictions of a global calamity over a default by the United States exaggerated?

Michael Mussa: In part it depends on what we mean. If there is an extended period where we don't have an increase in the debt limit, yes, we are looking at a major disaster economically and financially for the United States and for other countries.

The more limited question is: suppose there were a few days in which the government wasn't able to pay all of its bills. That would be bad and I think it would incur a downgrading in our credit rating. How catastrophic it would be is difficult to know.

Steve Weisman: The credit rating is now triple A. What would it be downgraded to initially?

Michael Mussa: I think it depends on what happens. If the government fails to pay interest that is due on the debt it could be downgraded quite significantly, especially if that was over any extended period. There was once in 1979 an incident where there was a technical foul up and they didn't get the checks out. But this presumably would be more than that.

If they delay other types of payments, then presumably the downgrade would be less severe. But the rating agencies have indicated that failing to make payments, to which the government has committed, is not the act of a triple A credit.

Steve Weisman: That means that if the administration decides to make the interest payments, but to not pay veterans or Social Security recipients or hospitals, that would also be seen by credit agencies as a kind of default.

Michael Mussa: Not as a default, but as a reason for a downgrade.

Steve Weisman: There are some who say though that the United States has enough cash, for instance, in the Social Security trust fund to make payments to Social Security recipients no matter what. Explain the logic of that.

Michael Mussa: The trust fund has several hundred billion dollars in non-negotiable Treasury securities. Those are its assets. The trust fund cannot sell those Treasury securities on the open market. It would have to redeem them with the Treasury and that doesn't solve the problem where the Treasury ultimately gets the cash to make the Social Security payments.

The problem is not with Social Security specifically, but the federal government is making payments of about three hundred billion dollars a month, including Social Security, interest, defense, everything. It's taking in revenues of about a hundred and eighty billion dollars a month and there's a hundred and twenty billion dollars a month that it fills in by increased borrowing.

You can't increase the amount you're borrowing. Somehow you need to cut current expenditures, current outgo to the level of current receipts. So you need a hundred billion dollars or more per month reduction, things you don't pay, or delay paying, in order to make up for the fact that you're not able to issue more debt.

That would be a major shock to the economy and to the financial system if it went on for any meaningful period of time. And just having it go on a day or two is going to create concerns that the government cannot fulfill its basic commitments.

Steve Weismann: The government says that the hard and fast date for this moment of truth is what -- August 2?

Michael Mussa: They're saying August 2. Social Security payments are generally made at the beginning of the month, the second business day or something like that. So there's a large electronic transfer of funds from the government to Social Security recipients that occurs on that date.

Then on August 15, half of the federal debts outstanding, its coupons come due on August 15. The debt is issued with a maturity date of either February or May or August or November and the February and August ones all pay their coupons on the 15th of August. So that's another big source of outflow. And there's no big inflow. September will get the quarterly tax payments around the 15th but August is a month where typically speaking there is a larger than average shortfall of revenues relative to outgo.

Steve Weisman: What adverse consequences occur if there's even a modest downgrade? Higher interest rates, a run on the dollar?

Michael Mussa: I think there will be some increase in interest rates, even for a brief interruption of non-interest payments. An interruption of interest payments I think is going to probably stimulate a substantially larger increase. And a prolonged delay in making a substantial amount of payments is going to wreak havoc on the economy, independent of anything that happens to our credit rating. If the government is not paying out a hundred billion dollars a month, there are always people in there relying on getting it in order to conduct their lives and businesses. That's a disaster.

Steve Weisman: And the consequences of higher interest rates -- could that tip the United States back into a recession?

Michael Mussa: It might. As I say, any prolonged failure to raise the debt limit, which is going to cut back enormously on the amount the government is paying out, is going to impact the economy even more dramatically.

Steve Weismann: By itself.

Michael Mussa: Just by itself…

Steve Weisman: Right.

Michael Mussa: Independent of the credit cost. So that's not going to happen. Let us say that. The outcry is going to be so enormous that every politician in Washington is going to say we're going to have to stop this. But even stopping it after its stared is still going to have a cost.

Steve Weisman: Mike, thanks very much.