Credit Union National Association CUNA

Debt Ceiling Default Analysis

A Looming Debt Ceiling Debacle?

The recently updated CUNA Economic and Credit Union forecasts follow divergent paths this quarter: we are now less convinced that the most predicted recession in memory will occur this year, but we see 2023 as being more challenging for credit unions and other depository institutions. The remarkable strength of the labor market, with the unemployment rate at 3.4%, combined with strong household balance sheets suggest the economy, although likely to slow, will avoid a recession despite a year of Federal Reserve tightening and the substantial and long-lived inversion of the yield curve.

Our discussion of financial markets and overall economic performance included a good deal of conversation over the political climate and whether Congress would increase the federal debt ceiling. The Congressional debt ceiling, created during WWI, limits the Treasury's ability to borrow (and therefore pay) obligations already incurred. Congress increased the most recent debt limit on December 16, 2021, to $31.4 trillion. The U.S. reached this limit on January 19, 2023. Treasury Secretary Yellen has indicated that the "extraordinary measures" she has invoked since then to pay the government's bills (e.g., borrowing from federal pension plans) will run out in June.

CUNA's baseline forecast cautiously assumes that after much fuss Congress will raise the federal debt ceiling in time to avoid significant turmoil in financial markets, or even more concerning, an outright default by the U.S. government.

However, it is quite possible that a stalemate, worse than the last time Congress came close to not raising the ceiling, could occur. This would have severe economic consequences. It would:

- Seriously disrupt financial markets.
- Lead to a dramatic fall in confidence, with appreciably lower investment and spending.
- Balloon job losses and push the unemployment rate up dramatically.
- Almost certainly drive the U.S. economy into recession. Spillover effects internationally would likewise be very troublesome. At the very least, higher borrowing costs (wider credit spreads) could push many nations – especially in the developing world – into crisis.

Negative impacts would obviously differ in severity based on the duration of any disruption. In general, the impacts would include some - or all - of the following:

- **Increased Market Volatility**: Even a short-lived breach of the debt ceiling would increase financial market volatility and negatively impact investor confidence. Stock prices would likely decline. Looking back at similar dislocations historically suggests that equity market declines of about 10% to 15% would probably occur. Moreover, a recent comprehensive Moody's Analytics study found that if a government default were to last longer — well into the summer — the consequences would be far more consequential – wiping out roughly $10 trillion in equity market value (an amount equal to roughly 25% of the current U.S. equity market valuation).

- **Substantially Higher Borrowing Costs**: The U.S. government has various financial obligations, such as Social Security benefits payments, payment of military salaries, interest on existing debt, and others. Failure to increase the debt ceiling could result in a situation where the government cannot meet these obligations, leading to default. A default would damage the U.S. government's credit rating and increase borrowing costs in the future. But a less serious situation also can be problematic. Even if default does not occur, the mere perception that the U.S. is a higher-risk borrower could have investors ultimately demanding higher interest rates to compensate for a perceived increase in risk. As a point of reference, note that in late April 1979 the U.S. Treasury delayed payment on government bills due to a short run technical difficulty. That resulted in a 60-basis point increase in the T-bill rate (which translated to a $12 billion increase in federal interest expense). More recently – in the week before the 2013 debt ceiling crisis – the yield on T-bills rose by the same amount: 60-basis points. Regardless of the exact magnitude of the increases, borrowing costs would rise not only for the government but also for businesses and consumers, leading to broad-based reductions in investment and spending.

- **Plunging Confidence**: Elevated financial market volatility and higher borrowing costs would undermine investor, consumer, and business confidence – both domestically and abroad. U.S. consumer confidence plummeted by 15 points during the 2011 debt ceiling crisis – a larger fall than that seen in the wake of both the 9/11 terror attacks and the implosion of Lehman Brothers at the beginning of the financial crisis. More recently, during the 2013 debt ceiling and FY2014 budget crisis, consumer sentiment fell 12 points between July and October.

- **Big Employment Declines**: The previously mentioned Moody's Analytics study finds that a shorter-term breach could wipe out as many as 1.5 million U.S. jobs. Moody's projects a debt ceiling dislocation lasting well into summer would be far more impactful – with a loss of up to 7.8 million American jobs. (Each of these job loss estimates are *in addition to* the expected 1.5 million loss following the Federal Reserve's year-long inflation fight.) The 7.8 million decline in jobs would mean the unemployment rate would top out at 8.0% (well above the current 3.4% reading). Labor market declines of this magnitude are rare but uniformly associated with deep recessions.

- **Banking Crisis Part 2?** Financial institutions involved in the recent banking crisis had several common characteristics: 1) for-profit commercial bank charters; 2) material financial and/or operational weakness; 3) funding sources that were greatly tilted toward uninsured deposits; and 4) large potential impacts on the FDIC (the federal deposit insurance fund for banks) with several of the failed commercial banks reporting well over $200 *billion* in total assets. The Federal Reserve, FDIC and Treasury responded quickly and forcefully to recent bank failures – significantly stabilizing the industry. However, a spike in interest rates and an economy in steep decline would cause much more obvious financial weakness: Unrealized losses in bank investment portfolios would balloon and asset quality would sink dramatically (with much higher loan losses) – perhaps near levels close to those seen in during the Great Recession. Against this backdrop uninsured depositors would flee. Using the most recent call report data, we find 800 banks that survived the crisis reporting ***at least*** 40% of their deposits are uninsured by the federal government. These banks have $14 trillion in total assets and represent nearly 66% of commercial bank total assets. A prolonged debt ceiling fight would reignite profound concerns around the viability of some of these institutions – the result could be a crisis that makes the challenges in the past several months look like a small bump in the road. [Note: only 11 credit unions with less than one-half billion in assets have uninsured deposits comprising more than 40% of total deposits. These institutions hold 0.02% of credit union assets.]

That said, if there is a meltdown in the banking sector, it would create significant disruption that would likely impact credit unions as well.

CUNA's baseline economic forecast assumes that Congress will raise the federal debt ceiling in time to avoid significant shocks to the economy. If that assumption proves incorrect, economic and financial market disruptions are apt to result in recession – with the odds of deep recession increasing as time passes.