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US Policy Pulse

Debt Ceiling FAQs

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In this report, we address our clients' frequently asked questions about the debt ceiling.

Key Insights:

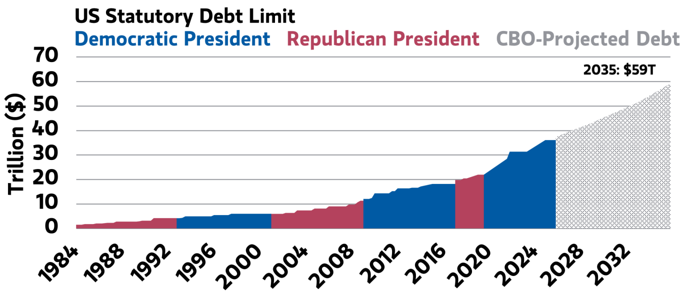
- What is the role of the debt ceiling, and why is it important?
- How do government spending and monetary policy affect the debt ceiling?
- What can the Treasury General Account tell us about the X-date?
- Could periods of tension concerning the debt ceiling pressure the US Treasury market?
- How have equity markets responded to prior debt ceiling standoffs?
- What options are available to Congress to resolve the debt ceiling problem?

What is the role of the debt ceiling, and why is it so important?

When the US federal government spends more than it receives in revenues, it is said to be running a deficit, and it borrows funds by issuing Treasuries to finance the difference. The debt limit is the legal limit, set by Congress, that the government can borrow to pay bills and fund programs. The debt limit was established in 1917 to facilitate and streamline government borrowing. The convention was based on both an aggregate limit on federal debt and discrete limits for different types of issuance. The structure and function of the federal debt ceiling weren't formally addressed again until 1939 when a general maximum limit became law, establishing the playbook for present-day negotiations.

According to the Congressional Research Service, roughly 99% of the federal debt is subject to the $36.1 trillion debt limit (approximately 123% of US GDP), which the government reached on Jan. 21. The Congressional Budget Office (CBO) projects that by the end of 2035, $59.3 trillion (approximately 203% of 2024 GDP) will be subject to the limit. While the debt ceiling has not led to default, it has fostered significant tension when the government has moved dangerously close to the limit, and it has pressured the Treasury's ability to pay for basic government operations and conduct necessary borrowing. Since 2002, the statutory debt limit has been lifted or suspended over 20 times, with efforts to raise the limit supported by both Democratic and Republican parties (see Exhibit 1).

Exhibit 1: Both Parties Have Supported Debt Limit Increases

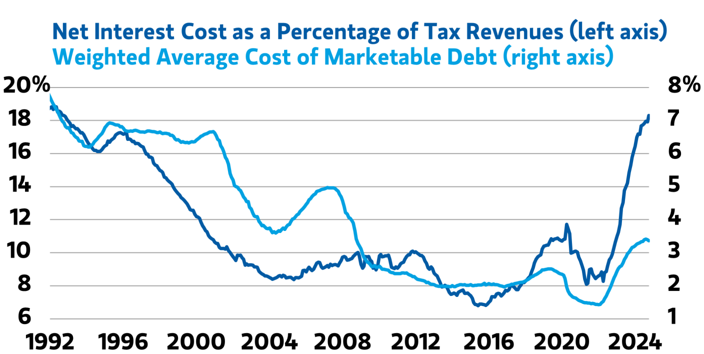


Source: Bloomberg, Congressional Budget Office (CBO), Morgan Stanley Wealth Management Global Investment Office as of Jan. 17, 2025

How do government spending and monetary policy affect the debt ceiling?

Debt accrual approaches its limit as a result of government spending outpacing revenues, causing persistent deficits year after year. The relationship between debt and government spending becomes especially important in a high interest rate environment, when a high fed funds rate increases the amount of interest owed on government debt, known as net interest costs. This is particularly relevant now, as the fed funds rate has increased from 0% in March 2022 to as high as 5.25%, and to 4.25% today. Rising interest rates and mounting debt from major fiscal stimulus initiatives have pressured net interest spending. Net interest outlays, at over $1 trillion in 2024, grow as deficit spending increases and new debt is issued at higher rates. Annual net interest costs currently amount to 18% of tax revenue, the highest since the early 1990s, and budget growth is likely to keep federal deficits higher for longer (see Exhibit 2). On the current trajectory, the CBO estimates that by 2035, net interest outlays could rise from 3.2% to 4.1% of GDP, comprising 66% of the federal deficit—the highest since the Great Financial Crisis.

Exhibit 2: Deepening Federal Deficits Driven by Net Interest Outlays

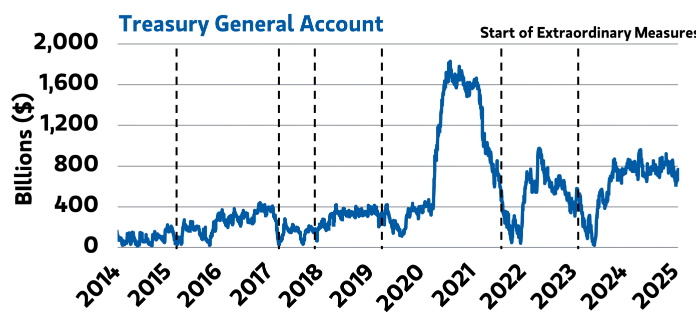


Source: Strategas, Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 6, 2025

What can the Treasury General Account tell us about the X-date?

The projected date of default, frequently referred to as the "X-date," varies because it is closely linked to the Treasury's daily needs. In 2023, the X-date occurred in May. In 2025, we expect the X-date to arrive in the third quarter. Reaching the debt ceiling triggers the use of extraordinary measures, which prohibits net new debt issuance as the Treasury draws on the Treasury General Account (TGA) balance, a cash account that sits outside of the Treasury and the banking system. Today, the TGA sits at $769 billion, its highest level at the beginning of extraordinary measures entering a debt ceiling episode and well above its $182 billion average during those time periods. This may suggest a later X-date, with significant cash cushion to spend down (see Exhibit 3).

Exhibit 3: The TGA Is at Its Highest Level Ever Entering a Debt Limit Episode



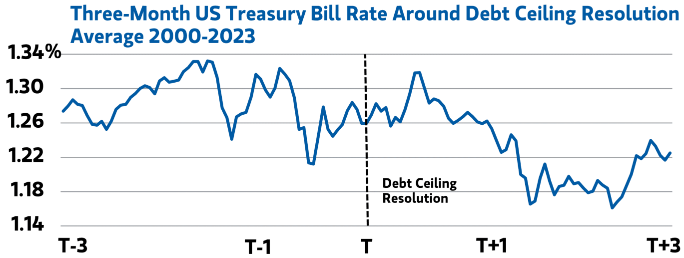
Source: Bloomberg, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of Jan. 24, 2025

However, while April tax revenues may provide a budget boost due to rising household wealth, the recent Los Angeles wildfires could potentially pull the X-date forward for two reasons. First, disaster aid for the LA fires passed by Congress could expedite a TGA drawdown. Second, the IRS is allowing individuals and businesses impacted by the fires to postpone filing tax returns until October, which is important since California is the fifth largest economy in the world, and Los Angeles County accounted for 4% of total US tax due at the time of filing in 2021.

Could periods of tension concerning the debt ceiling pressure the US Treasury market?

Performance of US Treasuries reflects market uncertainties related to the debt ceiling. We analyzed average three-month Treasury bill performance from 2000 to 2023, isolating for three-month periods before and after Congress voted to raise or suspend the debt limit. We found that, on average, in the three month period leading up to resolution, rate volatility increased, with notable jumps in yields up to two weeks before. Once the debt limit was addressed, however, volatility did not subside, as the government replenished its coffers and debt supply increased. The supply influx pushed rates higher during the subsequent week, followed by a period of falling rates, as default risk subsided and macroeconomic factors once again took hold (see Exhibit 4). While the same pattern of rate volatility may be repeated in coming months, monetary policy and macroeconomic conditions are likely to dominate, as debt limit episodes tend to be resolved more gracefully amid unified-government scenarios.

Exhibit 4: US Treasury Rates Experience Volatility in the Weeks Prior to a Debt Ceiling Resolution

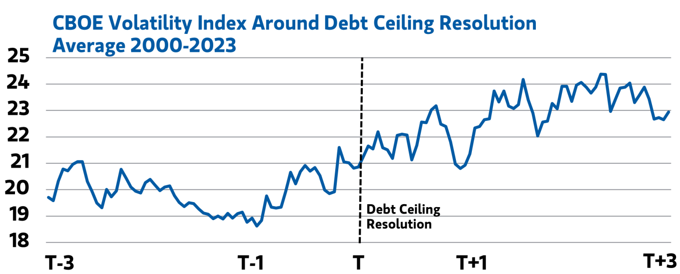


Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 27, 2025

How have equity markets responded to prior debt ceiling standoffs?

When the debt limit is approached, it isn't always accompanied by political standoff. However, we have found that uncertainty related to the debt limit, no matter how modest, is reflected in equity market volatility. In examining the CBOE Volatility Index (VIX) in the three-month period before and after votes to raise or suspend the debt ceiling between 2000 and 2023, we note a steady increase in average market volatility beginning about a month in advance. Volatility, on average, peaked about two months after congressional action, and as risk dissipated, macroeconomic factors began to drive performance (see Exhibit 5).

Exhibit 5: Market Volatility Increases Around Debt Ceiling Final Votes



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 27, 2025

What options are available to Congress to resolve the debt ceiling problem?

Investors should be aware that there is broad political willingness from both sides of the aisle to resolve the debt ceiling, yet unified partisan control does not guarantee swift resolution. Intraparty disagreements are also at play, with some GOP House members potentially conditioning votes on tax- and/or budget-related concessions. That said, while we do not expect a default, we highlight that upcoming debt negotiations are apt to be entangled with fiscal policy concerns over growing debt and deficits.

The debt ceiling is just one of many budget-related items and goals that the new Congress must address, including a looming March government funding deadline, the Tax Cuts and Jobs Act, which expires at the end of this year, and other policy priorities of the new administration, including border security and potentially disaster aid. Given these important agenda items and the risks associated with default, we expect a unified Republican White House and Congress to aim for a quick resolution that limits obstacles that could slow the pace of Trump's agenda in 2025.

Republicans hold slim majorities in both legislative chambers and are seeking creative solutions to passing the debt limit. For example, one proposal includes pairing it with California disaster aid or other policy priorities. While President Trump has floated the idea of eliminating the debt ceiling in order to accommodate his policies, we view this as unlikely. Republicans are also considering attaching it to a party-line reconciliation package that would require a simple majority and avoid the need for Democratic votes (see Exhibit 6). Regardless, timely resolution is expected, and the government is highly unlikely to depart from precedent and default on its debt.

Exhibit 6: Congress Has Several Imperfect Options

Congressional Options	Our View
Bipartisan bill that attaches debt limit increase/suspension to one or all of the following: disaster aid, border security, government funding	Somewhat likely outcome, but requires Republican majority to make concessions to gain Democratic votes
Republican **reconciliation** bill that attaches GOP priorities and avoids the need for Democratic votes	Somewhat unlikely outcome, as internal GOP factions may demand deep spending cuts
Discharge Petition: an absolute majority of legislators in the House could bypass committee approval and bring a bill to the House floor for consideration	Highly unlikely outcome, as discharge petitions are rarely successful and override the speaker of the House's authority
President may issue a proposal to raise the debt ceiling, subject to a Congressional motion of disapproval, which the president then vetoes to pass it	Highly unlikely outcome, but could be a last resort measure. This method was used during the Obama administration

Source: Congressional Research Service, Morgan Stanley Wealth Management Global Investment Office as of Jan. 27, 2025

While unlikely, if partisan divisions prevent legislators from raising or suspending the debt ceiling before the X-date, a major catalyst, such as a credit rating agency downgrade or a significant negative bond market reaction could spur bipartisan support for a joint measure. The potential for a catalyst could result in increased market volatility related to a debt ceiling vote.

Should the X-date come and go without resolution, we remind investors that Congress may invoke a government sequester until the debt limit is addressed, with few consequences for economic performance. In the event of sequestration, we encourage investors to be cognizant of the relationship between sector-level stock market performance and sequestration. Defense contractors, select health care companies and companies heavily reliant on government contracts could be pressured as a sequester could reduce or temporarily cease contract payments.

Disclosure Section

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

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