Center for American Progress

The Federal Debt Ceiling and Your Finances

What the Republican-led Effort to Cap the Government's Borrowing Limit Means for American Families

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Introduction

Think the pain of the recent run-up in gasoline prices was punishing to your wallets and pocketbooks? That will be nothing compared to the costs to families' savings and payments on their debts if Republicans in the House of Representatives succeed in blocking an increase in the federal debt ceiling.

The discussion over the federal debt limit is turning into a political showdown with America's financial stability and families' economic security at play. The U.S. government is expected to reach its debt limit—the maximum amount it can borrow without Congress raising the limit—in a few weeks. Republican leaders are forcefully stating they will not raise the debt ceiling or only raise it under conditions that are exceedingly damaging to the economy and therefore unacceptable to Democratic members of Congress.

Holding the line against Republican efforts to torpedo the nascent economic and labor market recovery over raising the debt limit will be critical to the well-being of American families. Failure to raise the debt limit would deliver a serious blow to U.S. financial markets. The stock market would plunge in a panic due to the uncertainty over the U.S. government's willingness to pay its bills and consequently what that would mean for the U.S. economy. The economy would take a serious hit.

Once government borrowing resumed—as surely it must as both parties will eventually come to an agreement to run the government—lenders to the U.S. government would demand higher interest rates on U.S. treasuries. These higher interest rates would trickle throughout the economy because treasury interest rates are the benchmark against which other interest rates, such as for mortgages and business loans, are set.

The upshot: Families would suffer immediately due to substantial losses in their retirement savings from lower stock market prices, and then would face higher debt payments on their outstanding debt due to higher interest rates once the debt limit debate is resolved. These immediate investment losses could total three to four times the amount of money an average family paid for gasoline in 2008, the last time gas prices soared as high as today, and higher interest rates would equal the extra amount of money the average family paid for gas since the beginning of 2011—with that extra cost locked into place for many families for years to come.

So let's look a little deeper at the consequences for families should Congress fail to reach a deal on the debt limit due to House Republicans' determination to jeopardize families' economic security over raising the federal debt limit. The cost of the recent run-up in gas prices is peanuts compared to what a failure to raise the debt limit will inflict on American families.

Lower retirement funds for households

A substantial stock market drop of between 20 percent and 30 percent[1] alongside an increase of 0.5 percent in interest rates[2] would have severe financial consequences for households.

Savings in 401(k) retirement savings plans specifically will drop sharply. The average 401(k) account balance amounted to $58,351 by the end of 2009, according to researchers at the Employee Benefit Research Institute and the Investment Company Institute, rising to an estimated $66,520 by the end of 2010.[3] Almost 60 percent of these funds are invested in the stock market,[4] which means a 20-percent drop would cost savers on average $7,911, and a 30-percent decrease would total almost $12,000.

This means families would lose three to four times what they spent on gasoline in 2008 (in 2010 dollars), the last time gasoline prices soared as high as they are today. The losses that families would see in their retirement savings could cover their basic gasoline spending needs for several years.

The average retirement savings account balance would fall to $58,608 or $54,653, respectively. Either decrease in retirement savings would set savers substantially back. They would lose all gains made in 2010 and much of their gains in 2009, moving them further below where they were at the end of 2007, when the total account balance amounted to $68,897 (in 2010 dollars).

The average saver will probably claw back some of this money as the stock market overcame the initial panic since eventually a deal will be struck and the debt limit will be raised, albeit possibly with a delay. But the market may stay a little lower than it otherwise would have for a long time since global investors—banks, mutual funds, and pension funds, among others—may become more leery about investing in the United States given the uncertainty in the financial markets that Congress created by not raising the debt limit.

The cost of this uncertainty—less accumulated wealth upon retirement—would fall on families, many of whom are still reeling from the unprecedented stock market, housing, and labor market losses delivered up during the Great Recession of 2007-2009. For those nearing retirement, the luxury of time would be lost. They would not be able to wait until the market recovers, unlike the average saver, and those near retirement have also a lot more money at stake.

The Employee Benefit Research Institute and the Investment Company Institute report that the average account balance for somebody who has had an account for 20 to 30 years and was in their 60s amounted to $155,662 at the end of 2009. A 10-percent gain due to better performing financial markets and continued contributions could have easily raised this amount to $171,228 by the end of 2010. In contrast, a 20-percent drop in the stock market (assuming that 45 percent of all savings are invested in stocks) would translate into a loss of $15,416. A 30-percent stock market decrease would result in losses of $23,116.

Those near retirement would have to delay retirement—if they could amid already high unemployment rates and given the anticipated downturn in the economy if the debt limit is not raised. Or these near-retirees would have to accept a lower standard of living in retirement, which would mean fewer medications, fewer repairs to their house, and fewer visits to grandchildren.

The debt burden goes up again

Families' debt service obligations include paying down their principal and paying interest on their outstanding debt. The Federal Reserve calculates the debt service burden ratio—the share of after-tax income spent on principal and interest each quarter—fell from a high of 14 percent in the third quarter of 2007 to 11.7 percent in the fourth quarter of 2010,[5] a decrease about equal to three-quarters of families' gasoline expenditures in the first quarter of 2011.[6] The drop in the debt service clearly eased some of the many financial pressures that families faced in recent years.

Two factors determine a drop in families' debt service burden. Families pay down debt, including loan write downs due to defaults and foreclosures, and interest rates fall. Data for the past few years suggest that a 1 percentage point drop in the long-term treasury interest rate went roughly along with at least a 1 percentage point decrease in the debt service burden.

A higher interest rate, following a failure to raise the debt limit, could thus quickly raise the debt service burden for families. Let's say that treasury rates immediately go up by 0.5 percentage points. The debt service burden rate would also increase by at least 0.5 percentage points, from 11.7 percent at the end of 2010, for instance, to 12.2 percent, assuming that families do not pay down debt more quickly or, more importantly, do not increase their borrowing again.

This can mean substantial pain for many families. An increase in debt service equal to 0.5 percent of after-tax income is larger than the gasoline spending increase for the average family to the first quarter of 2011 from the fourth quarter of 2010.[7] And many lower-income families will see much larger and quicker changes in the interest they pay than higher-income families since lower-income families are more likely to owe adjustable interest rate debt, such as credit cards, installment loans, and adjustable rate mortgages.

Finally, the effect of higher interest rates could very well linger much longer than the stock market drop following Congress's failure to raise the debt limit. Higher interest rates will reflect the new risk associated with lending to the U.S. government—and that estimated risk will not disappear because the government will eventually make its payments. The U.S. government will have to raise interest rates for some time to attract the same amount of interest as before from investors seeking to buy treasuries. Higher treasury interest rates will raise interest rates on everything else since treasuries serve as benchmark for other interest rates. Everybody in the end may have to live with higher interest rates and their associated economic pain.

Conclusion

The political impasse over raising the debt limit would have serious consequences for families if Republicans take the negotiations past the first debt-limit deadline in the coming weeks, and especially if they stretch debate out until August, when the Obama administration would no longer be able juggle accounts to stay current on the nation's debt obligations. Families' retirement savings could see major decreases, which many savers near retirement cannot hope to recover in time for retirement. And families, particularly lower-income ones, could quickly see their debt payments go up in the wake of higher interest rates.

What may seem like an esoteric debate far removed from people's lives on Capitol Hill, could in the end become a major setback for families' economic security at a time when millions of families still feel tremendous economic pressures from low housing values, high unemployment, and rising costs of living. This is no way to run U.S. government finances, playing with America's financial stability and families' economic security.

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Endnotes

1 There are no real estimates of how much the stock market will dive, but a drop of 20 percent to 30 percent seems easily in the cards. The S&P 500 dropped by 20.5 percent alone on October 19, 1987 in an ultimately irrational reaction to a series of smaller events, for a total of 30.6 percent in a span of three weeks in October 1987. The market also dropped by 15 percent in the three weeks surrounding September 11, 2011, from August 31 to September 21, including one week of market closure. And, the market dropped by 27.5 percent from September 19, 2008 to October 9, 2008, following the collapse of Lehman brothers. Substantial short-term stock market losses following unexpected events are clearly possible.

2 And, interest rates for everything from mortgages to refrigerators and credit cards will go up if the debt ceiling is not raised. The interest charged on U.S. government debt serves as a benchmark for the interest charged on all other interest. U.S. government debt is seen as risk free, hence other debt has to cost more to compensate lenders for the higher risk. William H. Gross, founder and managing director of PIMCO, one of the largest bond investment companies in the world, estimated that failure to raise the debt ceiling would increase interest rates by 50 basis points, or 0.5 percentage point.

3 Average 401(k) account balances in the crisis pretty closely followed the movement of total savings in 401(k)-type plans, which grew by 14.8 percent in 2010, according to the Federal Reserve's Flow of Funds Accounts. An increase of 14 percent brings the total account balance to $66,520 at the end of 2010.

4 This includes direct and indirect stock holdings through mutual funds. The total share amounts to 59.5 percent, according to the Federal Reserve's Flow of Funds, assuming that the share of stocks in mutual funds reflects the share of stocks in mutual fund investments in 401(k) plans.

5 Data taken from Federal Reserve System, Board of Governors, "Household Debt Service and Financial Obligation Ratios" (2011).

6 This is the ratio of gasoline expenditures to disposable income for the first quarter of 2011. Calculation based on data from Bureau of Economic Analysis, "National Income and Product Accounts" (2011).

7 This is the change in the ratio of gasoline expenditures to disposable income for the first quarter of 2011 relative to the last quarter of 2010. Calculation based on data from Bureau of Economic Analysis, "National Income and Product Accounts."