The debate on the ceiling of the U.S. debt and its consequences

The legal ceiling of the U.S. federal debt was reached on May 16. From that point on, the outstanding total debt cannot rise any further. For the time being, the U.S. Treasury has some recourse enabling it to keep funding the government’s operations, but that recourse is quickly being exhausted. The Treasury Secretary has indicated that these temporary solutions will expire on August 2, 2011. Therefore, Congress must approve a higher ceiling for the U.S. debt. It is important to understand that the problem is not any financial inability on the part of the government to obtain financing, but its legal inability to do so. If a new ceiling is not adopted in time, the government will not be able to fulfill its commitments. However, the most likely scenario is that an agreement will be reached, probably at the last minute, between President Barack Obama’s Democratic administration and the Republicans in the Congress. Without such an agreement, which is highly unlikely, major impacts will ensue for the financial markets, in particular higher stresses in the liquidity market and greater risk aversion.

The supply of debt securities is therefore limited at present. Over the past few years, the market had become accustomed to a monthly increase of approximately US$100B in the outstanding debt. This low supply therefore helped, in part, to drive interest rates down, as we have observed since the beginning of the spring. Moreover, until the end of June, the demand for securities linked to the Federal Reserve’s (Fed) quantitative monetary policy measures also helped to keep rates low. Finally, the deterioration in many economic indicators from May onwards is another important factor underlying the low rates.

As at June 30, the debt held by the public amounted to US$9,742.2B. The intragovernmental debt holdings amounted to US$4,600.9B. Of the publicly held debt, the Fed held approximately 13.9% as at March 31. The proportion held by households was 10.0%, that of commercial banks was 3.1%, and that of mutual funds (including monetary funds) was 6.6%. Foreigners held 46.2% of the U.S. public debt. The Chinese, followed by the Japanese, the British and oil exporters, are the main foreign investors in U.S. Treasury securities.
THE LEGAL DEBT CEILING
The legal debt ceiling system has existed since 1917. It avoids the Treasury having to ask Congress’s permission for every funding request, but it also enables the Congress to sporadically monitor government finances to some extent. The ceiling has often been raised as needed (graph 2). The request to raise the ceiling sometimes generates acrimonious political debates. This was the case in 1985, in 1995-1996, in 2002 and in 2003. However, the U.S. government has never been unable to honour its financial commitments.

Since the debt ceiling was reached in May, the U.S. Treasury has been funding its operations using amounts earmarked for two funds: the Civil Service Retirement and Disability Fund and the Government Securities Investment Fund of the Federal Employees’ Retirement System Thrift Savings Plan. According to the Treasury, these measures should be exhausted by August 2, 2011.

It cannot be ruled out that the Treasury may find other, temporary solutions after that date in the absence of an agreement.

THE POLITICAL DEBATE SURROUNDING THE CEILING
The debate surrounding the debt ceiling is primarily the continuation of a political debate that has been going on for years, but which has intensified since the mid-term elections of the fall of 2010. The White House and the Democrats in the Congress, on one side, and the Republican members of Congress, on the other, simply do not agree on budget issues.

The Republican members of Congress have already refused (with support from some Democrats) to raise the ceiling without introducing measures to reduce future deficits. The Congress wishes to take advantage of the ceiling debate to put forward solutions to the problem of the federal government’s indebtedness. On one hand, the Democrats want to reduce some discretionary spending, both civilian and military, and to increase certain taxes, particularly for the wealthy. This is consistent with the campaign promises that were made during the 2008 elections. On the other hand, the Republicans want to cut non-military discretionary spending. No tax increase (whether real or effective, by reducing certain credits) is acceptable at this time, according to the Republicans.

As happened in April during the debate on the continuing resolution on spending (which nearly led to a shutdown of the federal government), the most likely scenario is a last-minute agreement in which both sides will make compromises. Spending cuts, not too drastic in the short term, should be a part of the program, without affecting social programs too much and without raising taxes too much. The real debate about the long-term situation of the U.S. government debt might not take place until after the presidential election of 2012. However, should a broader agreement be reached in the short term offering sensible solutions for reducing the expected deficits, this would certainly be welcomed by investors and by the credit rating agencies.

Although the clock is ticking, we expect that an agreement will emerge by the deadline. The stakes are too high, and no one in Washington would benefit by tarnishing the U.S. government’s reputation as a good creditor. There is little political capital to be gained by provoking a disaster. However, some skepticism remains regarding a quick agreement: in a market of political and financial predictions, the probability of an agreement before the end of July is around just 40% (graph 3). However, that same market shows a 80% probability of an agreement before the end of August. We can only hope that the difference between the two will consist of just the first two days of next month. We also note that fears of sovereign debt default are perceived as greater in the United States than in Germany (graph 4 on page 3). Despite all the uncertainty surrounding debt in the euro zone, the difference between the cost of insurance against default in the United States and that in Germany widened since mid-

Graph 2 – The legal debt ceiling has frequently had to be raised

Sources: U.S. Treasury and Desjardins, Economic Studies

Graph 3 – The probability of a resolution before the end of August is high, but not that of a resolution before the end of July

Sources: Intrade, Datastream and Desjardins, Economic Studies
May, which certainly reflects fears that no debt ceiling agreement will be reached.

**ALTERNATIVE SCENARIO: NO AGREEMENT REACHED IN TIME**

An agreement will probably be reached before the government finds itself unable to meet certain financial commitments. However, it is worth wondering what would happen if there were no agreement. Is there a risk of immediate default, the day after the August 2 deadline, on interest payments?

The Democratic administration considers that, indeed, the government will be unable to fulfill its commitments. Even if it pays some interest on its debt, the government cannot guarantee anything. According to the administration, the Treasury has no legal authority to prioritize its commitments; it has to issue payments when they are due. If interest payments come after other items, there is a risk of default.

Some Republican politicians believe that the government will be able to prioritize its payments. Current or program expenses could be reduced in the short term (as in the case of a shutdown), and interest payments on the debt will continue. This supposes that there is no default on the debt. An opinion issued by the government comptrollers (the General Accounting Office) in 1985 states that “Treasury is free to liquidate obligations in any order it finds will best serve the interests of the United States.”

In any event, there will be plenty of uncertainty. The credit rating agencies will have the power to judge the situation as a default or a potential default. If there is no agreement, the agencies are most likely to decide to issue a very unfavourable rating on the securities that have payments due in the following weeks, and to lower the overall rating of the United States. A substantial distinction will probably be made between the very short-term situation and the longer-term situation.

However, if overly large swings occur in the markets, the politicians will quickly rally. For one thing, after what happened in the fall of 2008, the Republicans will not want to shoulder the blame for another global financial crisis. The pressure will be particularly strong on the Republican presidential candidates. At the same time, the Obama administration has a duty to keep the government running; a default would be a serious blot on the President’s leadership qualities. The pressure on the White House will therefore be just as great, particularly since any budgetary uncertainty that lasts too long, or a default, could push the U.S. economy back into recession. Sudden and drastic cuts to public spending, a drop in confidence among economic agents, and a negative wealth effect generated by the deterioration of investment portfolios would trigger a marked downturn in economic activity.

In the absence of an agreement, there would inevitably be a major initial shock. In the event of a default or a significant downgrade, the following financial trends could ensue:

- Yields would rise on the entire yield curve, especially on securities on which payments were due in the following weeks.
- There would be a slump in the main stock markets, both in the United States and elsewhere.
- Credit spreads would be likely to widen.
- The U.S. dollar would depreciate against the other major currencies.
- The price of gold would rise.
- The values of credit risk instruments (Credit Default Swaps, etc.) would increase.
- The international liquidity market would suffer increased stress, since Treasuries are one of the main sources of collateral in financial transactions.
- Despite the decline in the U.S. dollar, fears of recession would likely push down the price of oil and other commodities, except for gold.
- The Canadian dollar would depreciate against the other main currencies, including the U.S. dollar.
- In the very short term, Canadian bond yields would be likely to rise.

After the initial shock, if the uncertainty were to persist, some of these effects could be reversed. The financial markets would adjust to a higher risk of recession. As a result, the safe haven effect could be beneficial for global bond markets as well as for Treasuries and the U.S. dollar. Meanwhile, Canadian interest rates would be likely to go down. The situation could give the Canadian bond market a boost until it were resolved, particularly thanks to a healthier economy and public finances.
It is difficult to imagine a disastrous scenario in which the crisis would not resolve itself. This very unlikely situation would inevitably lead to a marked increase in U.S. bond yields. All the sovereign debts would also feel the impact.

**THE PROBABLE RESOLUTION OF THE SITUATION**

We can be certain that the legal ceiling will be raised sooner or later. Regardless of who wins the political debate, the federal government will still show deficits in the years to come.

The Republicans, who hold a majority in the House of Representatives, support a budget plan that would reduce funding requirements by US$4,400B within ten years. This plan mainly calls for cuts in non-military spending and would restrict social programs such as Medicare and Medicaid, while reducing certain tax rates. A zero deficit would not be reached until 2040.

Last spring, the Obama administration released the broad outlines of a plan that would reduce the accumulated deficit by US$4,000B within 12 years or less. It consists of cuts in both civilian and military spending as well as tax increases. A unilateral spending cut mechanism would be implemented if certain interim targets were not met.

These financial requirement reductions are comparable to a basic scenario developed by the Congressional Budget Office which assumes additional debt of approximately US$8,500B within ten years (graph 5). Thus, despite the proposed stabilizing measures, the debt and its legal ceiling will have to increase by at least US$4,000B in ten years.

Even though the U.S. debt is approaching problematic levels, excessive cuts in the very short term would risk injuring an economy that is still fragile. There is a risk of falling back into recession if spending is cut too much or if taxes increase abruptly. We must be aware, though, in the long term, of the real problem of public sector financing. Expenses are too high compared with revenues. Even stronger economic growth will not solve the problem.

An agreement on the debt ceiling will surely materialize just before the early August deadline. However, a lasting solution to the problem of U.S. public finances is not likely to be adopted before the next presidential term of office, which will follow the elections of November 6, 2012.

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