Institutional
Asset Management

US debt ceiling debate

Monday 7 October 2013

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Partial shutdown

- No deal on the budget and no deal on continuing resolution (CR) by Sept 30: partial shutdown of US government
    - 18th shutdown since 1976: on average 6.5 days (longest was 21 days in 1995-96)
    - Limited direct impact + partial payback after reopening
    - Varying estimates, also depending of duration of shutdown: 0.05% to 0.2% of GDP
    - More important risk in impact on confidence: limited with earlier shutdowns
    - Total impact of earlier shutdowns on the economy was limited
- Compromise is possible at any moment, but currently not in sight:
    - Republicans have linked any deal to concessions on Obamacare, on which Obama is unlikely to concede (Obamacare already approved by Congress and Supreme Court)
    - The debt ceiling is far more important: CR deal will probably be linked to this

Debt ceiling

Debt ceiling:

- There is a hard limit on US Federal debt, above which the Treasury is not allowed to issue additional debt
- As debt issuance is a direct result of earlier decisions on expenditure and revenue this is an illogical rule
- Since 1960, the debt limit has been raised 78 times
- In the past it was usually raised without debate, although on occasions it has been used as a political bargaining chip (most recently during the Summer of 2011)

Failure to raise the debt limit would have serious consequences:

- Treasury could still issue debt to rollover maturing securities, but would not be allowed to increase the total amount of outstanding debt
- Failure to raise the limit would not imply immediate default of the US government
- Beyond the limit funding needs to happen out of current revenue
- Treasury is likely to (be able to) prioritise debt-related payments so an outright default should be avoided
- Treasury will be forced to balance the budget, which means closing the current 4% of GDP deficit. By itself, this kind of fiscal tightening would push the economy into recession
- Confidence issues are likely to exacerbate the situation

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Debt ceiling

Timing:

- Since the government reached the limit in May, the Treasury has been using extraordinary measures to keep funding on track
- October 17: extraordinary measures run out (but Treasury will probably still have 30 bn in cash)
- October 22: CBO estimates Treasury will run out of cash
- Uncertain when Treasury starts missing payments, but large payments scheduled for November 1 (about 70 bn) will not be met

Alternatives:

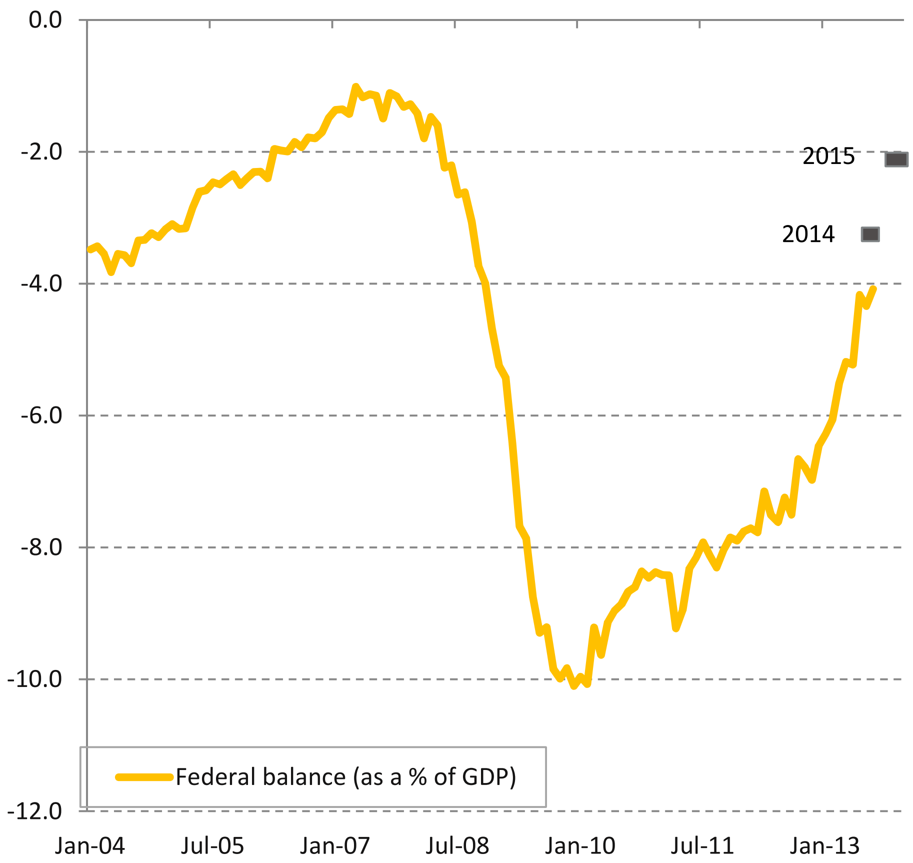
- 14th amendment of the Constitution ('the validity of US debt shall not be questioned') could be used by the President to ignore the debt ceiling: unlikely, as the legal interpretation is not clear, this would increase uncertainty linked to US debt paper
- The platinum coin: Treasury is still allowed to mint commemorative coins, it could mint a trillion dollar coin and deposit at the Fed to secure funding: unlikely as this would not be in the strategic interest of the Democrats
- Treasury could go into arrears and pay as money comes in: possible, but in practical terms it would not really imporve the situation

Politics

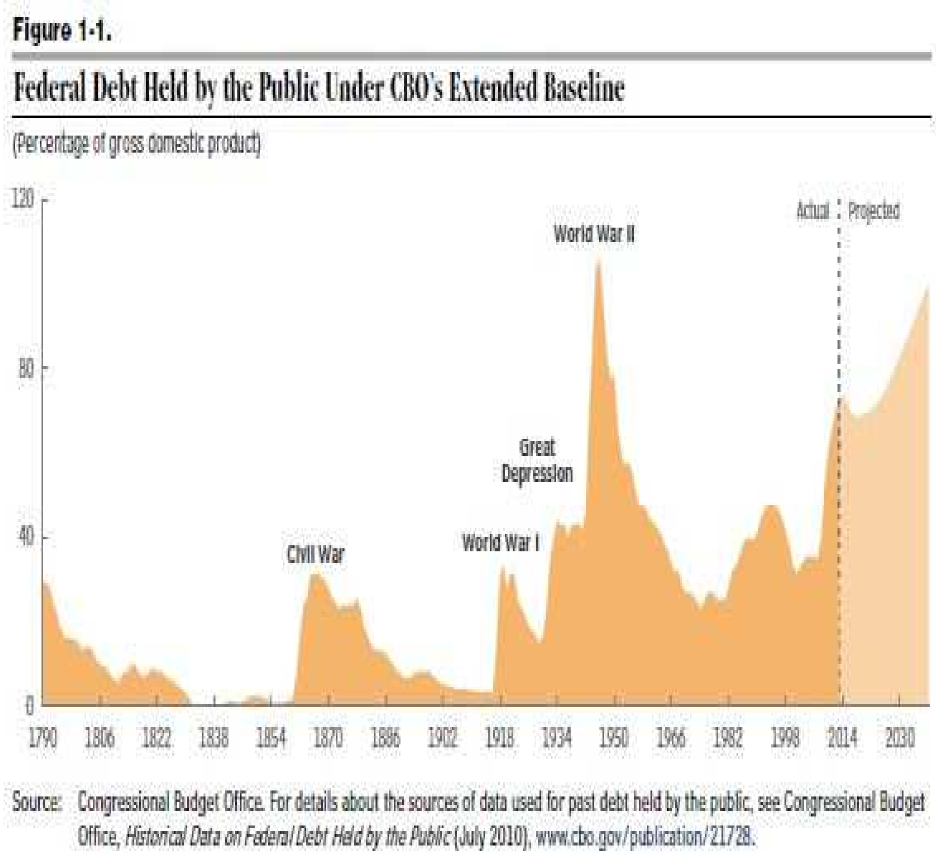
- This issue is all about political posturing
  - This is not about the state of US public finances: the deficit is falling rapidly (expected to hit 2% of GDP in 2015), while public debt is expected to decline in the next ten years
  - There real issue for US public finances is the combination of ageing population and uncontrollable health care cost, which will push up debt from 2022 onwards. At the moment, neither party has a plan to deal with this
  - This is all about the Republicans' attempts to delay/dilute Obamacare
  - The President will almost certainly not yield on Obamacare
- Compromise is currently not in sight:
  - Republicans continue to take a firm stance on this
  - Market reactions up to now have not increased pressure to come to a solution
  - Polls suggest the blame is being put on the Republicans, but up to now the latter have not given a lot of indications that they are worried
- Given the probably disastrous implications of not solving this, it remains unlikely that no deal will be done

No short term risks in US public finances

Rapidly improving deficit



US debt: LT-ageing risk, no near term risk



Possible ways out of this mess

- Republicans give in: Republicans are getting most of the blame + Tea Party-hardliners have a strong position within the party, but are still a minority, there are more than enough moderate Republicans who can vote with the Democrats to resolve this crisis => possible (if pressure increases)

- President Obama takes unilateral initiative to circumvent the debt ceiling => highly unlikely

- Grand Bargain: Democrats and Republicans work out an overall deal on the future of public finances (including the budget, the debt ceiling and the sequestration) => unlikely as this strategy has failed several times in recent years and it would take more time than the current deadlines

- Muddle through: limited increase of the debt ceiling, keeping sequestration in place => most likely, although it would probably be in the interest of both parties to put the debate beyond next year's midterm election

Scenarios

Compromise at the October 17 deadline

- Recovery remains on track
- Uncertainty increases as the deadline approaches, reflected in increased market volatility
- Relief after the deal as focus shifts back to economic recovery
- Modest correction in equity market, but uptrend resumes after deal
- Bonds come under pressure again after the deal as focus shifts back to recovery and Fed tapering

Compromise between October 18 and November 1:

- Recovery remains on track
- Uncertainty increases as the deadline approaches
- Significant increase in risk aversion as deadline passes
- Relief after the deal as focus shifts back to economic recovery
- Significant correction in equity markets, but full recovery following deal

Failure to raise debt limit lasts well into November

- Confidence shock hits recovery
- Severe hit to financial markets
- Relief after deal, but no near term return to recent levels as economic recovery is more muted
- Significant correction in equity markets, followed by incomplete recovery
- Bonds benefit from risk-off trade and Treasury efforts to avoid default

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Outlook

- Another ten days of uncertainty and increasing volatility as a near term solution seems unlikely

- A last-minute deal still seems by far the most likely scenario
  - Recovery remains on track
  - Equity markets bounce back after the deal

- Financial catastrophe is possible, but remains highly unlikely
  - It remains unlikely that a major political party would be willing to push its country into economic disaster (even if a faction within the party is clearly willing to do so)
  - In the end, common sense within the Republican party should prevail