If the US debt ceiling is not raised

- **Logically and sensibly, there will be an agreement to raise the US debt ceiling**
- **But this is politics; logic need not hold**
- **A prolonged impasse could have substantial impact on growth, short- and long-term**

On 2 October 2013, the Financial Times quoted the Republican former presidential candidate Jon Huntsman saying that "The debt ceiling is a thermonuclear explosion compared to the hand grenade [of the shutdown]." If the debt ceiling is not raised by 17 October, the Treasury will (probably) fail to pay interest on 12 trillion dollars of bonds, and the United States Government will technically be in default for the first time in its history. Thenceforth, unless and until the debt ceiling is raised, federal expenditures cannot exceed federal revenues.

This is certainly far worse than a shutdown. A shutdown, at least a short-lived one, will have only a marginal impact on growth. In the short-term, it even improves the US fiscal balance, since tax revenues continue to flow in, while expenditures are frozen or at least slowed. By contrast, hitting the debt ceiling means that the government continues to operate (unless in combination with a shutdown) but that its spending is restricted. This is exacerbated by the fact that the Treasury claims that it cannot prioritise between payments but has to pay as invoices are presented.

The logical and sensible assumption remains that the debt ceiling will be raised before the 17 October deadline (though "before" could mean very shortly before or even just past). Most likely, it will be as part of a broader agreement on government spending and it's financing; although "broader" may well turn out to be as temporary and fragile as the 2011 debt ceiling deal which eventually cause the fiscal cliff). It cannot be in anyone's interest for the US Government to default; and the closer we approach the deadline without a deal, the more extreme the market reaction and anticipation is likely to be, adding to the urgency of an agreement.

Here it could be instructive to look at the market reaction during previous fiscal debates. The most recent debt ceiling debate occurred in the summer of 2011 and was resolved on 31 July of that year. The S&P500 fell from 1353.2 on 7 July 2011 to 1292.3 on 29 July, a fall of 4.6%. In spite of the deal, it then fell by a further 13.4% to 119.5 on 8 August. The bond reaction was more muted, with markets essentially interrupting a fall in long-term bond yields in early May before resuming the fall in August. Moreover, the spread against Bunds (for 10-year bonds) narrowed sharply during the discussion, from close to 30 basis points in late June 2011 to nothing in early August after the agreement was reached. This relatively sanguine reaction may have been due to the firm belief that an agreement would eventually be reached.

By contrast, markets were far more nervous in late 2012, when it seemed that the much-feared, much-hyped fiscal cliff would be triggered on 1 January 2013. This included a 5.2% fall in the S&P500 on 27 November 2012 (although reversed in its entirety the next day); as well as a 25bp rise in the yield on the 10-year Treasury, from 1.59 on 6 December to 1.84 on 18 December. Similarly, the failure to pass the original TARP package in September 2008 was quickly reversed, partly because of market reaction and

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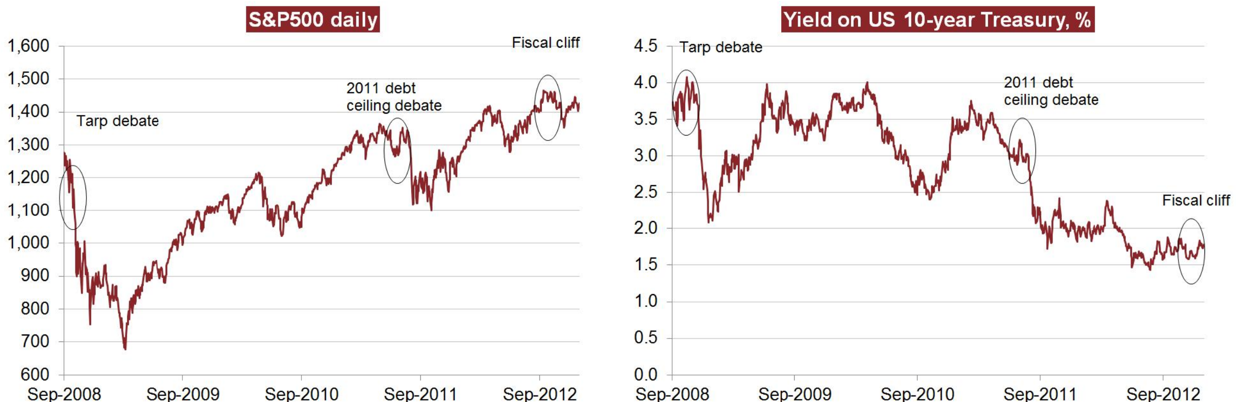
the impact of market developments on household wealth. So far this time, equity markets have weakened very slightly in the last week, while bond markets have held steady (although yields on T-Bills are rising). However, as the 17 October deadline approaches, this is likely to change.



But this is politics, it is emotional with perceived high stakes on both sides; and, as Helmuth von Moltke the Elder said, “No war plan survives contact with the enemy.” In brinksmanship there is plenty of scope for mistakes and miscalculation.

A failure to agree on the debt ceiling for a day or two beyond 17 October will probably have little direct economic impact, although the market reaction could be considerably more violent than what we have so far seen, potentially with moves of up to 3-5% in one day. The long-term reputational impact is likely to be more severe, not least if it gives rise to the perception that ‘we did this, the world went on and we can do it again’. It would certainly lead to a Treasury sell-off and probably to an upward shift along the entire yield curve. This can potentially be off-set by the Fed increasing its pace of bond purchases to bring rates down; but that, in turn, further postpones any end to QE.

But what is the potential economic impact of a somewhat longer failure to lift the debt ceiling? The US federal government spends approximately 19% of GDP. The deficit so far this fiscal year (October 2012 – August 2013, September data not yet published) is approximately 23% of total spending, or the equivalent of 4.4% of Q2 GDP. However, this does not necessarily mean that the first-round impact on GDP would be a drag of 4.4%. It would indeed be the case if no agreement on the debt ceiling was reached for an entire year; but by then there would already be substantial second-round impacts from reduced household and corporate spending. But not raising the debt ceiling means that expenditures are governed by revenues; and the revenue pattern is uneven.

Assume that there is no agreement and that this deadlock is extended to the end of November; and potentially to the end of December. One immediate problem for the US Treasury is that October, November and December tend to be deficit months. January is the first traditional surplus month – but even then, the cumulative balance is too deep into deficit to provide any relief.

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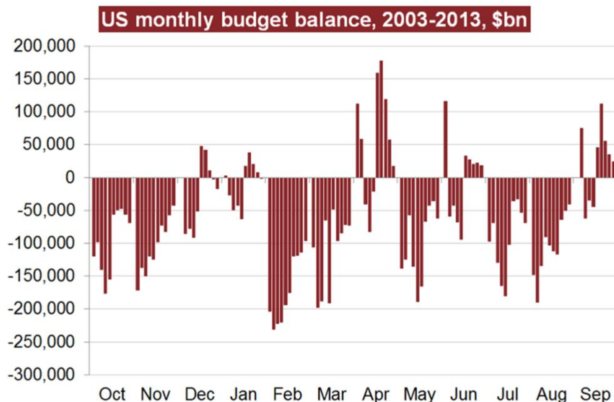

Over the past three years, the Treasury balance for November has shown an average deficit of just over 150 billion dollars. This is equivalent to 0.9% of GDP. But we also have to add in two weeks of October (18-31), which tends to be a substantial deficit month. That adds another 50 billion or so, taking us to just over 200 billion dollars, or 1.2% of GDP. So, assuming a debt ceiling freeze until end-November, federal government spending would be 1.2% less than otherwise. However, this is a hit of 1.2% of GDP in one quarter alone. On a quarterly annualised basis, it is equivalent to 4.8%. Fir 2013 as a whole, the impact would be in the 1/4-1/2% region.

For November and December both, the cumulative deficit over the past three years has averaged 208 billion. Again adding about 50 billion dollars for the second half of October gives us about 260 billion or 1.6% of GDP – or 6.4% annualised.

The full effect would almost certainly be less. The government has some cash in hand (about 135 billion dollars at the end of Q2, rather less now according to reports) and there are possibly other ways of alleviating the pressure (However, ideas like the minting of a trillion-dollar platinum coin or using the 14th Amendment to skirt around the issue are too gimmicky and likely to be met by immediate legal challenges.) Nevertheless, even the first-round the impact is severe enough to justify Mr Huntsman's characterisation of the debt ceiling.

A short-term absence of agreement on lifting the debt ceiling would be bad enough. A long-term failure would, as outlined here, be considerably worse. It would certainly throw monetary policy completely off track, with the Fed not only likely to postpone the QE taper, but also likely to increase its asset purchases. The economy would be thrown back into recession and stock markets would most likely not only fall but also become much more volatile. What is perhaps more uncertain is what the reaction in other bond markets would be. If the issue is considered specifically US-centric, Bunds, Gilts and other similar bonds should benefit, not least if there is a feeling that this will set back the global economic recovery. By contrast, if it is felt that this is a further nail in the coffin of government bonds being seen as 'safe', they

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could also suffer. It would also take the world back to risk-off – but with the dollar at the centre of risk, the most likely beneficiary would be gold.

To repeat, the basic assumption is that the debt ceiling will be raised, because the consequences of not doing so would be substantial. This also implies some form of short-term or (perhaps less likely) long-term fiscal policy agreement. But, it would be foolhardy to assume that this logic is enough to dissuade everyone concerned.

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