# Debt ceiling stresses heighten US recession risk

The US is running out of time to agree a deal on raising the debt ceiling. Failure would mean the government is unable to fund its obligations within a matter of weeks. Unfortunately, political positions are entrenched and the threat of a government shutdown and a hugely damaging default is very real. Here we look at what might happen


House Majority leader Steve Scalise (left) and Senate Democrats holding a news conference with Sheldon Whitehouse (right)

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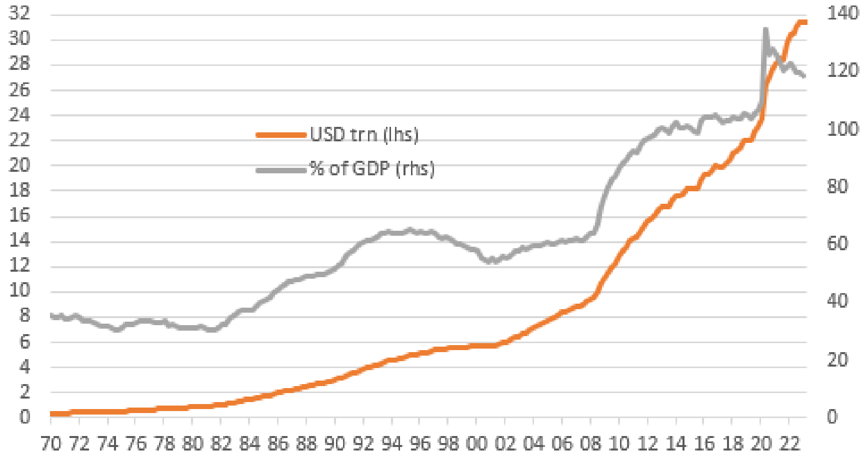
## A debt ceiling deal needs to be agreed quickly

The US debt ceiling – the cap on US government borrowing set by Congress – was hit in January and ever since then the Treasury has been running down its cash balances and using accounting wizardry to prevent a default. Treasury Secretary Janet Yellen has since warned that these "extraordinary measures" may be exhausted by 1 June. This means a deal must soon be struck between the Democrats and Republicans, otherwise the US government will not be able to fund its obligations. These include paying its workers and making Social Security, Medicare and Medicaid payments. It would also result in debt interest payments and redemptions ceasing and America defaulting intentionally for the first time in history.

## US government debt




Source: Macrobond, ING

What makes striking a deal to raise the ceiling so challenging is that we have a split Congress with the House controlled by the Republicans and the Senate controlled by the Democrats, and both need to approve the deal. House Republicans have already approved a package to raise the ceiling, but this involves significant government spending cuts that Senate Democrats refuse to even consider. They and the White House want the ceiling raised with no conditions attached, which the Republicans won't accept.

The best-case scenario is that politicians see sense and recognise the economic and financial damage default would cause. Government workers and creditors may get a little nervous about whether they would be paid, but we remain hopeful that concessions will be made by both sides and the debt ceiling is raised in time.

## Economic stress may be required to trigger action

The problem is that the personalities involved and their entrenched positions mean it is almost impossible to believe that a deal will happen smoothly and quickly. We fear that it will take significant economic and financial market stress to trigger a climbdown from the key players; perhaps a realisation that individuals responsible for any pain will be punished at the ballot box.

If a government shutdown and default look likely, the impact on financial markets, consumers and businesses would be huge at a time when sentiment is already fragile in the wake of recent banking failures. Lending conditions, which are already tightening rapidly, could become even more restrictive and a crisis of confidence could quickly envelop the US economy with contagion for the rest of the world. Recession risks would be heightened which would push unemployment higher and lead to a more rapid fall in inflation, opening the door to even more aggressive interest rate cuts from the Federal Reserve than we are currently forecasting.

The one crumb of comfort is that we don't need all Democrats and all Republicans to agree on a deal. It's safe to say the hardliners will never be happy.  We merely need enough movement within the centre ground to create a package that allows enough members of each party to save some face and claim they have been able to win concessions. This needs to happen fast though to minimise the disruption to markets and the economy. Failure would undoubtedly heighten the chances of a US recession.

## A default would go hand in hand with rating downgrades

A default (or the material threat thereof) on just one bond would cause the rating agencies to downgrade US Treasuries. They would have to. The AAA rating is related to the certainty to receive redemptions and coupon flows. It is tough to argue a product class is AAA rated if there is a missed payment on one of its bonds, even if subsequently made good. It should not be a multi-notch downgrade to junk though. More likely a notch or two. But that would become more if there was to be one missed payment followed by no action taken.

All product that is beholden to the US in any way would be at material risk for downgrade too. Any product with an explicit or implied government guarantee would have to be downgraded. This would include the housing agencies (Freddie and Fannie), and other semi-government agencies. Regional and State debt too would be impacted. Corporates that have a strong US underpinning would be impacted as well, as AAA-rated Treasuries are typically seen as the reference against which corporates are measured.

There is the possibility that the Fed could step in and take the defaulted line out of circulation by swapping it with an alternative non-defaulted bond or bill. It has not said it would do this of course, but it is an option. The other could be for the Fed to buy the defaulted bond off holders at par, so that the investors are made whole and the body of free-floating Treasuries in the market are non-defaulted bonds and bills. It would not be a good look for the Fed. But such damage limitation would be necessary.

If this did happen there could be a danger that both Congress and the president see this as a way to hold out longer. This would be extremely dangerous, as the market would quickly jump on the notion that all Treasures are extremely tainted and subject to default as coupon payments come due over time. Any Treasuries used as collateral in repo or margin guarantees, or anything really, would be subject to a huge margin call or a hard call for replacement of collateral. That would bring down the entire system.

## What happens if the US Treasury misses just one payment

Any failure to pay one US Treasury bond interest payment risks contaminating the entire US Treasury product. That risks taking down the system. It's highly unlikely to happen. But mistakes can be made. The CDS levels we are seeing (75bp for 5yr USD) are at the highest since the Great Financial Crisis, and identify market apprehension/worry as at elevated levels.

For CDS, the key element is the ISDA committee agreement that a credit event has occurred. A credit event in the case of US Treasuries would most likely be a default. A default would be where the US Treasury fails to make either an interest rate or redemption payment. There is no grace period. Any missed payment on any bond would constitute a default. CDS cannot be triggered unless you have a hard default. A bond trading at a super deep discount, for example, would not constitute a credit event. Other forms of credit events could be a bond restructuring or bankruptcy. These are not in play here, so we're left with the fact that CDS will get triggered should the US Treasury miss a payment – any payment.

Importantly, there is no cross-default in US Treasuries. So, if one bond is in a state of default, that does not accelerate the rest of the Treasury market into a state of default. This would be the case for many corporates for example. But it's not the case for US Treasuries. However, this is a bit of a legal grey area, as if one bond is defaulted on, it can tarnish other Treasury bonds by association. For example, can they still be employed as eligible collateral? Open to interpretation. So while there is technical agreement that there is no cross-default, it can still be there by implication, or by inference (even if not there in fact). In all probability, just one missed payment has the potential to unravel into something quite sinister for the function of the system.

For CDS, the trigger is a missed payment (subject to ISDA approval), then default, and then the opportunity to swap a cheapest-to-deliver bond versus par. In actuality, though, the US Treasury will make any defaulted bondholders whole by ultimately paying the coupon or redemption in question. But contractually there would have to be a payout. Either way, a missed payment would significantly damage the quality of US Treasuries and dollar products generally, and certainly during the default period itself. This should be quite short as Congress rushes to correct things by suspending or raising the debt limit. If not, the longer the stand-off continues, the greater the risk that the entire system is taken down. Highly unlikely. But not impossible.

## Authors

**James Knightley**
Chief International Economist, US
james.knightley@ing.com

**Padhraic Garvey, CFA**
Regional Head of Research, Americas
padhraic.garvey@ing.com

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