US debt ceiling: What's happening and what are the risks?

As lawmakers return from summer recess, the first issue on the agenda will be to raise the debt ceiling and if they fail, it will hit markets hard

Source: iStockphoto

Deal, shutdown or default

President Trump is surely getting used to bad headlines following his Administration's failure to repeal and replace Obamacare together with the impasse over tax reforms. However, his situation and the media coverage may soon get even worse.

Lawmakers return to Washington on September 5 and could have as little as 12 working days to pass legislation to raise the debt ceiling. Otherwise, the US faces the prospect of a government shutdown of non-essential services and potentially even a debt default.

What is the US debt ceiling?

The US Constitution states that only Congress can authorise government borrowing. Until 1917, Congress separately approved individual debt issuance. However, the cost of World War 1 saw borrowing levels increase rapidly and lawmakers spending more and more time voting on bond issues. To provide flexibility Congress approved the Second Liberty Bond Act. This allowed the government to borrow up to a limit through each category of debt, such as bills and bonds.

The Public Debt Act of 1939 aggregated all these debts to facilitate one 'debt ceiling'. These spending and debt ceiling plans were initially voted on separately, but from 1979 the legislation was simplified so the debt ceiling was raised when a budget was passed. However, this was repealed in 1995 and since then it has become more contentious and led to a number of so called "debt ceiling crises".

How did we get to the current situation

The current debt ceiling level is $19.8 trillion, and this was hit in March. Since then the government has been using "extraordinary measures" to shuffle money around and give itself time to reach an agreement. The Treasury Department says this must happen by September 29, leaving just twelve working days to get the legislation passed. However, the Congressional Budget Office suggests a little longer, estimating that these measures will be exhausted and the government will run out of cash at some point between October 3 and October 11.

If the Treasury exhausts all the "extraordinary measures" before an agreement is reached then the US government will be unable to borrow money and will instead have to default, either to workers or supplies or on its debt payments.

Description of Extraordinary Measures

19.8 Current level of the US debt ceiling

(trillions of dollars)

Will it be eventually raised?

For a debt ceiling bill to pass in the Senate it needs 60 votes. The Republicans hold 52 seats, the Democrats have 46 and there are two independents. Therefore a bi-partisan deal is required. However, it isn't as simple as just 8 Democrats/independents backing a Republican proposal as the Republicans are not united. Many Republican lawmakers that are strict fiscal hawks that want any increase in the debt ceiling tied to either outright government spending cuts or at least a slower rate of spending.

This means proposals from the Republican leadership regarding a 'clean' increase in the debt ceiling -either a time limited suspension of the ceiling or a straight increase in the ceiling height - would likely be opposed by those on the right of the Republican Party. However, this course of action seems to have a better chance of success than agreeing to the fiscal hawks demands for austerity, which would fail to get support from Democrats.

History tells us these events don't last long with politicians quickly realising the need to get a bill passed.

However, the problem is it also has to pass in the House and conservative lawmakers there may not be as willing to acquiesce to spending cut demands. The House Freedom Caucus, of which there are 31 members out of 240 Republican representatives, have already stated that "a simple, clean raising is not something our members are going to be able to get behind".

Nonetheless, the consensus amongst lawmakers seems to be a bill will pass with some modest spending reforms with Democrats getting something in return, possibly further watering down of potential healthcare reforms. Given the tensions in Washington, this may not pass first time however we believe. The implications for markets and the economy will quickly lead to lawmakers agreeing to cut a deal.

While a temporary government shutdown is not inconceivable, mid-term elections in November 2018 may also help politicians to focus given inaction would not go down well with the electorate.

2004 Number of points the Dow Jones Index fell during the 2011 debt ceiling crisis

What happens if it isn't

If the ceiling is not raised, the government's first choice may well be to suspend non-essential services and put some government workers on furlough. The 1995 debt ceiling crisis saw 800,000 government workers furloughed for five days after a Republican controlled House refused to back Democrat President Clinton's budget and he subsequently vetoed the Republican spending bill. A temporary spending bill was passed, but this didn't prevent another shutdown in December which saw 280,000 workers furloughed for another 22 days before an agreement was finally reached.

10Y Treasury yields fell by around 40bp during this period, but equities were left relatively unscathed given the minimal impact on GDP growth and only a minor, temporary hit to consumer confidence. However, the next crisis in 2011 led to much greater market volatility. Once again, a Republican controlled House wanted deficit reduction as a condition to back an increase in the debt ceiling.

A deal was eventually made, but the fall out led to the US losing its AAA rating with S&P and the S&P500 equity index falling 17% between 22nd July and 8 August. While workers weren't furloughed, the economy saw just 0.8% annualised growth in 3Q11, before rebounding to 4.6% in 4Q11. The 2013 crisis saw the return of the furloughing of workers, this time 800,000 following a partial government shutdown before a bill was signed in February 2014.

In a worst case, 'perfect storm' a new debt ceiling crisis could lead to a spike in Treasury yields as fears worry over a potential debt default, a plunge in equity markets, furloughing of workers and a hit to economic confidence and activity.

History tells us these events don't last long with politicians quickly realising the need to get a bill passed. Nonetheless, such a risk makes it likely that the Federal Reserve will tread carefully so a government shutdown would make a further rate rise this year look less likely. If the uncertainty builds in coming weeks, it could also mean that the Fed chooses to delay its balance sheet reduction strategy, although for now we still expect an announcement in September with an October start date.

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