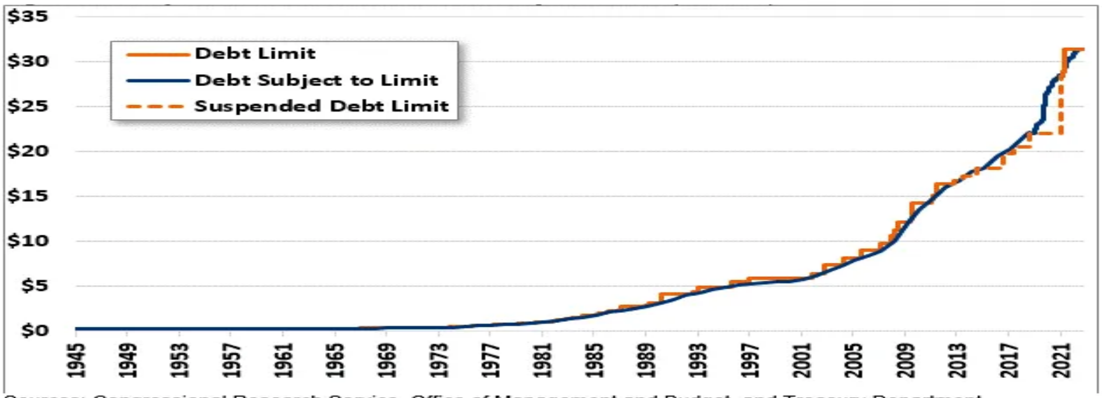
The US Debt Ceiling Conundrum

Overview

The US debt ceiling limit issue which originated as an internal US problem is expected to affect countries worldwide because of the significance that the US economy has on the global economy/ financial markets coupled with the fact that the USD is the world's reserve currency. The US national debt has hit the ceiling of $31.4 trillion, not counting off-balance sheet expenses and future expenses that ought to be paid in the coming years (refer to Figure 1 below). This consists roughly of $24.6 trillion of debt held by the public and $6.8 trillion the government owes itself as a result of borrowing from various government accounts like Social Security and Medicare trust funds. The X Date is the day the US will be unable to fulfil its financial obligations and this is expected as early as 1st June 2023.

Figure 1: Statutory Debt Limit and Federal Debt Limit ($ trillions)



Sources: Congressional Research Service, Office of Management and Budget, and Treasury Department.

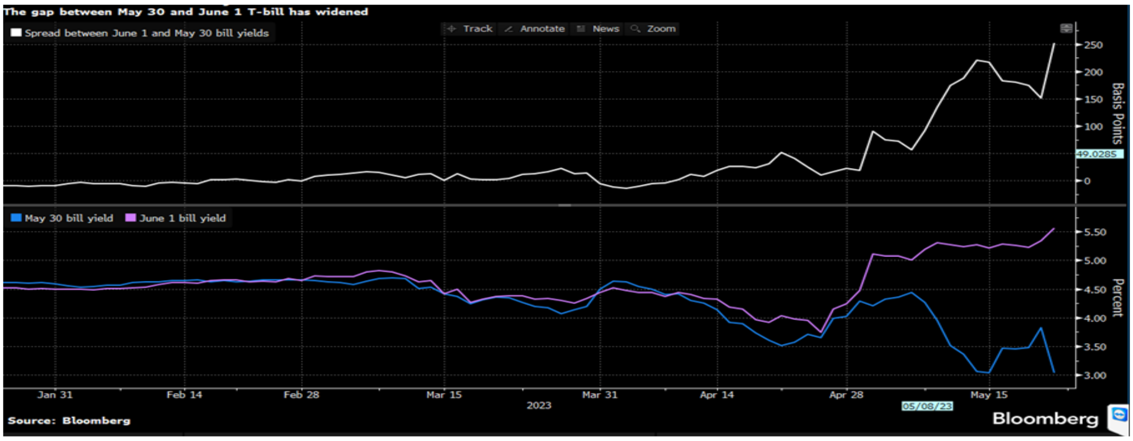
Implications of a default

- Interest rates would soar, leading to higher payments on mortgages, car loans and credit cards
- It would tip the US into a recession causing a substantial cessation of economic activity and high unemployment.
- Massive plunge in stock market wiping out billions in market capitalization.
- More than 50% of the world's reserve currency are in USD and a default would undermine the status of the greenback as investors lose confidence in the safety of USTs, considering that approximately $7.6 trillion or roughly 30% of these debts are held by foreign governments and investors.

What has happened to the debt market to-date?

- Yields on T-Bills with maturity dates around the X-date have increased considerably—directly increasing the cost of borrowing for the government and thus the cost to taxpayers. The chart below demonstrates this; since the early of April, yields on short-duration T-bills around the expected X-date and thereafter have increased by nearly 1.0 percentage-point, or roughly 20%, from 4.50% to 5.50%.

Figure 2: Gap between May and June T-bills



- The cost of insuring US debt has also risen substantially and is now at an all-time high, reflecting increased worries about a US default. In fact, credit default swap (CDS) spreads—the insurance premiums that must be paid to insure US debt has started to increase dramatically in April, as demonstrated in Figure 3.

Figure 3: One-year US government bond insurance premiums

Unconventional methods possible

The Fed and Treasury could mint $1 trillion worth of note currencies OR choose to invoke Section IV of the 14th Amendment (which simply states that the validity of public debt also applies to government bonds and shall not be questioned). Lifting the debt ceiling does not authorize new spending, but rather allows the US to spend on programs that had already been approved by previous administrations and sessions of Congress

Conclusion

The US government endured three disruptive shutdowns in October 2013, January 2018 and also December 2018-January 2019 because neither legislation appropriating funds for the coming fiscal year nor a continuing resolution bill for the prior year's appropriation was passed by the deadline. In each case, the shutdowns furloughed thousands of federal employees, closed institutions, national parks and were a source of short-term market volatility.

Nevertheless, since 1917, the US Congress has raised or adjusted the debt ceiling more than 100 times, which means that on average, there is one (1) debt ceiling increase every year. Especially after 1960, when the US dollar was decoupled from gold, the debt ceiling has been raised 78 times. Although one can argue that debts ultimately must be paid and that a large and growing national debt, such as we have today, requires increasingly greater interest payments to service and can exacerbate higher interest rates and lead to lower credit ratings; BUT deficits should be less of a concern. If the economy is growing at a rate faster than the level of real interest rates, growth should naturally shrink the ratio of debt to GDP over time. Hence, we expect all parties i.e., US government, Congress, and Treasury to achieve a compromise, largely involving the $4.5 trillion government spending cuts (as requested by the republicans) and removal of tax breaks for clean energy, thus allowing the government to continue its policy of borrowing new money to pay-off old debt.

It is expected that this standoff will end sooner or later with a deal in one form or another which will unquestionably ratify any debt issued over the debt ceiling. Hence, we opine that auctions will not fail and US Treasury may have to pay a higher coupon. **Each time they have come close to crossing this fiscal Rubicon, members of Congress have always found a way to pull back from the edge and, as a result, the US has never defaulted on its obligations. Our take - “Buy the value, sell the fear!” just like any other risk event.**

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