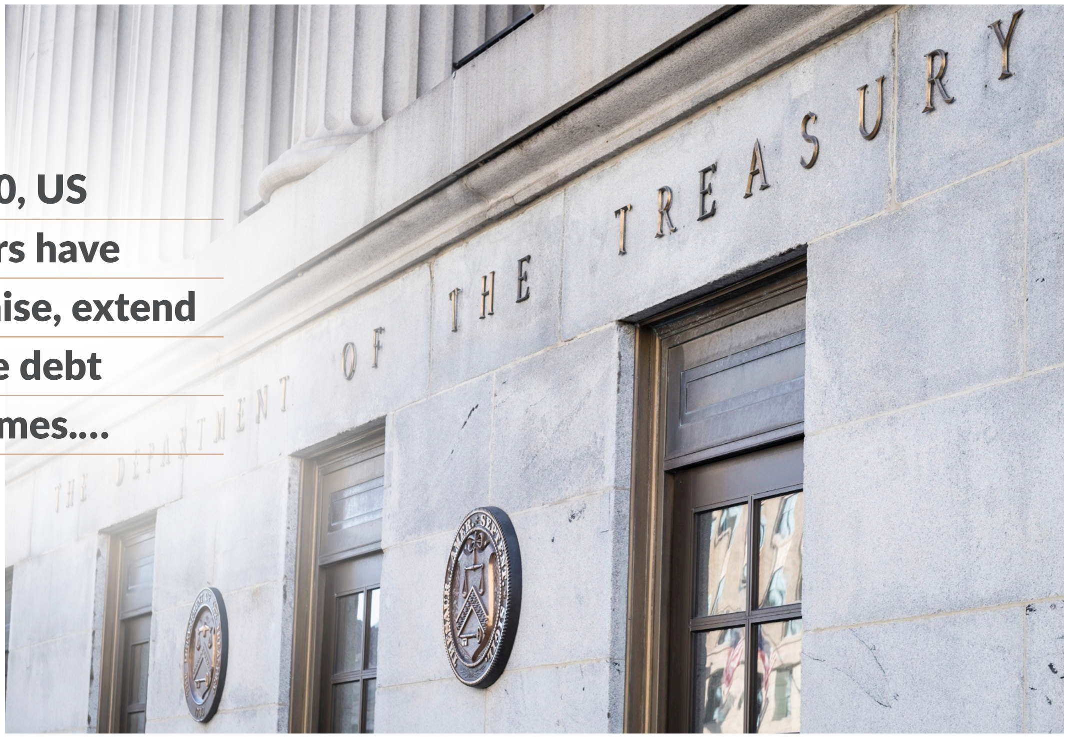
Wednesday 17 May 2023

# focus

# Debt Wars: A game of political chicken

The United States Government debt ceiling debate has reared its ugly head again. Markets are watching closely. While we think a last minute agreement between the rival US political parties will very likely be reached, there is an outside chance (like in any game of chicken) neither side blinks and we see a political and economic pile-up.

FORSYTH BARR



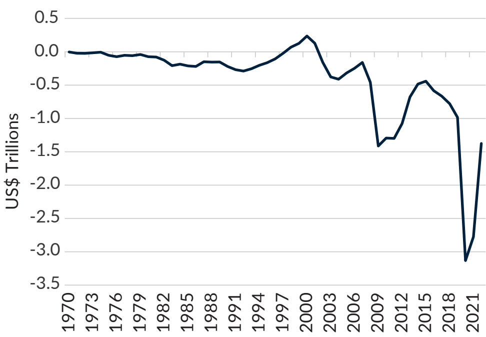

**...Since 1960, US policymakers have agreed to raise, extend or revise the debt ceiling 78 times....**

### What is a debt ceiling?

The US debt ceiling is essentially an artificial construct, but one that has a long and storied history. Legislation enacted in 1917 puts a cap on the amount of debt the US Treasury can borrow and every time it is hit, Congress needs to either agree to raise the ceiling or cut back spending. It was implemented during World War I to increase fiscal responsibility on Congress.

Since 1960, US policymakers have agreed to raise, extend or revise the debt ceiling 78 times in order to accommodate higher levels of government spending and debt payments. Cutting spending isn't a realistic option — the US Government has rarely run a surplus, the last time was 2001 (see chart below).

**THE US GOVERNMENT HAS RUN PROGRESSIVELY LARGER BUDGET DEFICITS IN RECENT DECADES**




Source: Federal Reserve Bank of St Louis

Debt ceiling negotiations often involve high levels of political brinkmanship, especially when the political environment is tense and then the ceiling debate can be used as a bargaining chip. Currently a drawn-out negotiation and yawning gap in views between the two parties is taking things down to the wire.

### 'X' marks the spot

US Treasury Secretary Janet Yellen confirmed that the US officially hit the debt ceiling on 19 January 2023, reaching the current limit of US$31.4 trillion. From this date, the US Treasury has been using 'extraordinary measures' to help ensure that payments keep flowing. But those extra measures (things like running down cash reserves) can only last for so long.

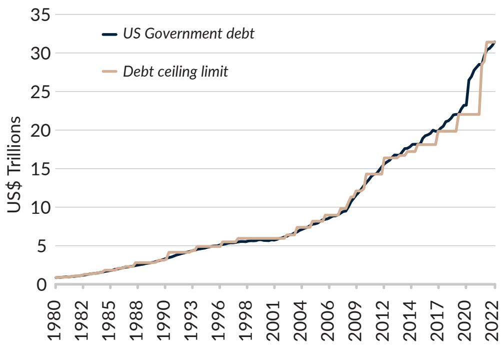
Forecasting the exact date when the Treasury will actually run out of money, termed the 'X date', is part art, part science. That's because there are numerous inflows coming in all the time in the form of tax revenues and out-goings in the form of government workers' salaries, social welfare payments etc. Earlier estimates suggested the X date would occur between July-September this year, but lower tax revenues have seen Treasury Secretary Yellen suggest the X date could occur at the start of June — just a few weeks away.

**…. So far, months of negotiations have failed to reach agreement….**

### Taking it down to the wire

Raising the debt ceiling requires a majority of 60 votes in Congress and would require some Republicans to support the Democrat bill. So far, months of negotiations have failed to reach agreement. Republicans are keen to get the Democrats to cut spending, some of which would curtail President Biden's ability to implement key climate and healthcare reforms. To date, President Biden has asserted that he will not give in to Republican demands. Lifting the ceiling isn't the only option, there have been seven occasions when the debt ceiling was suspended entirely for a period of time — most recently in 2021. However, this also requires a majority agreement in Congress and just delays the process of a formal lift in the ceiling.

US GOVERNMENT DEBT HIT THE DEBT CEILING IN MID-JANUARY




Source: Federal Reserve Bank of St Louis, US Government Publishing Office

The last time we saw such a serious squabble over raising the debt ceiling was back in 2011. At that time the US economy was still recovering from the Global Financial Crisis and the federal government's spending had quickly expanded to provide support for the ailing economy. As things stabilised, Congress commenced a heated debate over further debt increases. After much brinkmanship a deal was cut at the eleventh hour, just a couple of days before the US would have defaulted on its debt obligations. Despite the last minute agreement, rating agency Standard & Poor's (S&P) downgraded the US's country credit rating one notch from AAA to AA+ on concerns over fiscal stability and on-going debt levels.

In a recent letter to Congress, Treasury Secretary Yellen has warned that leaving an agreement to the last minute could, "cause serious harm to business and consumer confidence, raise short-term borrowing costs for taxpayers, and negatively impact the credit rating of the United States".

Despite these warnings, history suggests that a last minute agreement is the most likely outcome. There's also the possibility of an interim measure — a short-term debt increase to give the US enough to fund itself for a few months. But this would probably just kick the can down the road with the same process to repeat later in the year — usually it requires the sense of urgency of a looming deadline to finally reach a resolution.

DEBT CEILING BRINKMANSHIP AND POLITICAL LEADERSHIP

| Date | President | Senate Majority | House majority | Time to deadline when agreement reached |
|---|---|---|---|---|
| Aug 2011 | Democrat | Democrat | Republican | Hours |
| Feb 2013 | Democrat | Democrat | Republican | Debt ceiling suspended |
| Oct 2013 | Democrat | Democrat | Republican | 1 day |
| Feb 2014 | Democrat | Democrat | Republican | Debt ceiling suspended |
| Nov 2015 | Democrat | Republican | Republican | Weeks, compromise deal |
| Sep 2017 | Republican | Republican | Republican | Debt ceiling suspended |
| Feb 2018 | Republican | Republican | Republican | 1 month, compromise deal |
| Aug 2019 | Republican | Republican | Democrat | 1 month, compromise deal |
| Oct 2021 | Democrat | Democrat | Democrat | Debt ceiling suspended |
| Dec 2021 | Democrat | Democrat | Democrat | Days, Democrats get ‘clean’ increase, no compromise |
| 2023 | Democrat | Democrat | Republican | To be decided |

### What it means for markets

The on-going debt ceiling headlines are adding to a general environment of volatility. Markets have had a lot to digest this year — banking sector woes, significantly higher interest rates, and recession fears.

While we expect there is a very high chance that this all gets resolved at the last minute — as it has been for decades — markets are certainly considering the risk that an orderly solution isn’t forthcoming. Commentators have placed a 5–10% probability on an agreement not being reached in time, which could result in a technical default on US debt obligations. Traders are taking out insurance against a US debt default through credit default swaps (CDS). A CDS is a financial derivative instrument that acts as a form of insurance that pays out if (in this case) the US defaults on its debt. Investors pay a regular premium to the seller of the CDS in exchange for the default protection. The more likely a default is to happen, the more expensive the premium to ensure against that event occurring — hence why the cost of CDSs are rising rapidly at the moment.

In the extreme scenario where an agreement can’t be reached and the debt level isn’t raised the federal government will have no choice but to stop paying salaries to government and military employees, cease benefits and welfare payments, and halt many government services. Another impact is that the US Treasury wouldn’t be able to repay its debt obligations as they come due and would miss coupon payments on outstanding bonds. Put plainly, a technical default would be a nasty shock, even if the default is only temporary.

THE COST OF INSURING AGAINST DEFAULT ON US GOVERNMENT BONDS IS RISING AS SEEN IN CREDIT DEFAULT SWAP (CDS) SPREADS


Source: Refinitiv, Forsyth Barr analysis

**...Neither the Democrats nor Republicans really want to cause economic turmoil....**

It would likely create instability in the US, wider global economies and financial markets. Beyond the initial reaction, it would depend on how long a resolution takes as to whether there is a lasting flow-on effect to the real economy.

While this scenario sounds disconcerting it's important to put it in perspective. Neither the Democrats nor Republicans really want to cause economic turmoil. Politicians and the media like to create and promote the drama around negotiating debt ceilings, but through history they have been a normal course of business for the US Government. Our central expectation is that the negotiating process will keep markets on edge for another couple of weeks, but ultimately the political jockeying will end and Congress will agree to lift the debt ceiling once again. Even if the worst case scenario emerges and we do see a temporary pause in US Government payments, it wouldn't be the first (and certainly not the last) crisis that companies and markets have navigated through. As always, it's important to separate the noise from your long-term plan. Stay calm and carry on.

**Zoe Wallis , CFA**
Investment Strategist

**If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.**

**0800 367 227**

**forsythbarr.co.nz**