February 6, 2023

Should we be worried about the debt ceiling?

By Angelo Katsoras

In almost every country, when spending plans are approved, the government can simply borrow what it requires. This is not so in the United States. Congress sets a limit on how much money the government can borrow, and when the limit is reached, lawmakers must raise or suspend the limit before the Treasury Department can issue more debt. Because the United States consistently runs large annual deficits, the debt limit is a recurring issue. The United States hit its statutory borrowing limit of $31.4 trillion on January 19 of this year.

"The US hit the debt ceiling. What happens next," Financial Times, January 19, 2023

House Republicans are saying that they will agree to raise the debt limit only in combination with spending cuts, whereas the White House wants the debt ceiling lifted with no strings attached.

While the borrowing limit has been officially reached, it does not mean that default is imminent. The Treasury Department has enacted certain accounting manoeuvres, such as suspending investments in the pension funds of certain government workers, to push back the date when the nation will no longer be able to honour all its financial obligations.

The Treasury estimates that this will allow the government to operate fully until June. Most analysts in the private sector believe that this date can be pushed back even further to between August and October. Determining the exact date is difficult because it depends on the amount of tax revenues collected and the state of the economy.

What happens if the debt ceiling is not raised in time?

If the Treasury no longer had sufficient cash to meet all of its payments, the government would have to prioritize certain payments over others. Most experts believe that the Treasury would place interest payments on the debt at the top of the list to avoid a default. However, telling voters that you are going to favour foreign bondholders over, say, veteran's health care, government employee salaries, and/or school programs, would not play out well politically.

Moreover, being forced to cut expenditures 20% to balance the budget—even for just a short period of time—would likely send the United States into recession.[1] The economic pain would be even greater still were the United States to miss a debt payment. Given that Treasury debt is held widely throughout the world and that the dollar is the world's primary reserve currency, a default would have global ramifications. This in turn could strengthen the position of other major currencies, such as the euro and the yuan, and increase demand for gold.

Some analysts have suggested unorthodox moves to stave off this risk. These include minting a $1-trillion coin or invoking the 14th Amendment, which asserts that the validity of the public debt shall not be questioned, to raise the debt ceiling without congressional approval. However, not only would these actions in all likelihood be challenged in the courts, they would also probably come across as gimmicky and further undermine confidence in the U.S. economy.

How the debt ceiling has been handled in the past

The debt ceiling has been raised or adjusted 78 times since 1960.[2] For the most part, this was routinely approved by Congress. Below are a few recent examples.

In 2021, the debt ceiling debate was resolved by a deal between Senate Democrats and Republicans to let Democrats raise the debt ceiling with a simple majority vote, rather than the 60 votes typically required to pass legislation in the Senate. The Democrats controlled the White House and both chambers of Congress.

Before that, Congress voted to suspend the debt ceiling several times since 2013 and three times under President Donald Trump. Republicans are accused of conveniently not worrying about debt levels when a GOP president is in office.

Negotiating an agreement to raise the debt ceiling has proven much more problematic when a Democrat is president and the Republicans control at least one chamber of Congress. The debt ceiling sagas of 2011 and 2013 are cases in point.

Today, the United States is in a similar position: Democrats control the White House and the Senate, while Republicans hold a majority in the House of Representatives. Complicating matters this time around is that Kevin McCarthy obtained the position of Speaker of the House for the Republicans by vowing to secure significant spending cuts in exchange for raising the debt limit. His grip on power is particularly tenuous on account of the narrow 222-212 majority Republicans hold in the House, compared with the 242-193 majority they enjoyed during the debt ceiling crisis of 2011.[3]

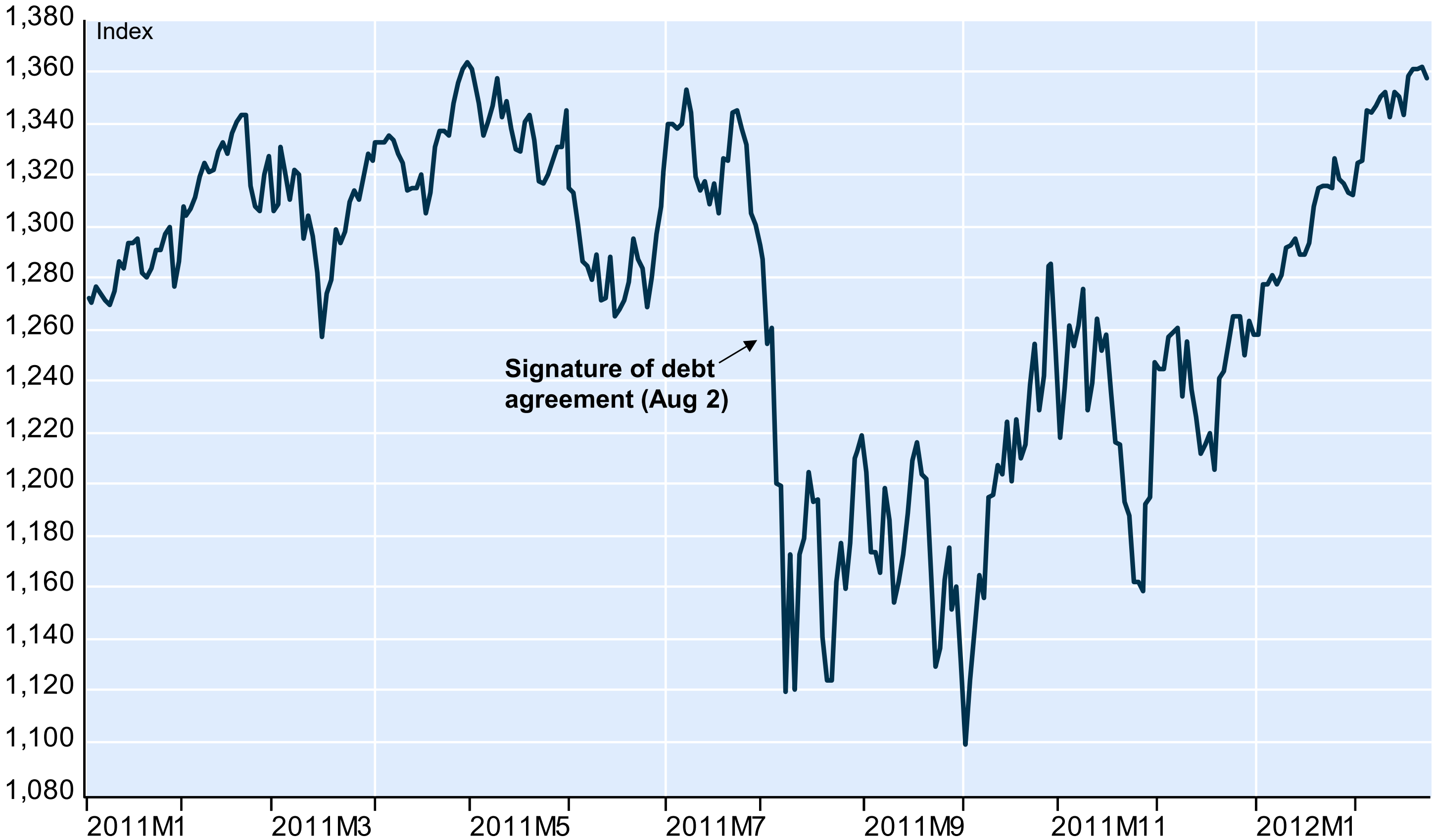
The close call of 2011

The closest the United States has ever come to defaulting on some of its financial obligations was in the summer of 2011. A Republican-controlled house wanted deficit reduction as a condition for backing an increase in the debt ceiling. An agreement was not reached until two days before the United States was slated to run out of cash to fully meet its obligations.

This close call shook the markets. The S&P500 equity index fell 17% from July 22 to August 8 and did not recover until six months later. Sectors most exposed to the U.S. federal government, such as health care and defence, dropped about 25% over this period.[4] This act of brinkmanship led Standard & Poor's to strip the United States of its triple-A credit rating.

[1] "There is no easy escape from America's debt-ceiling mess," The Economist, January 23, 2023
[2] U.S. Department of Treasury, 2023
[3] "Debt ceiling fight: This time it's different. Here's how," Reuters, January 5, 2023
[4] "How investors are preparing for a debt ceiling standoff," CNN. January 19. 2023

The S&P 500 market reaction before and after the debt ceiling saga
Daily index



NBF Economics and Strategy (data via Refinitiv)

It is important to note also that while short-term government bond yields moved up sharply, the 10-year Treasury yield headed in the opposite direction because it nevertheless continued to be perceived by investors then as a safe haven in turbulent times.[5]

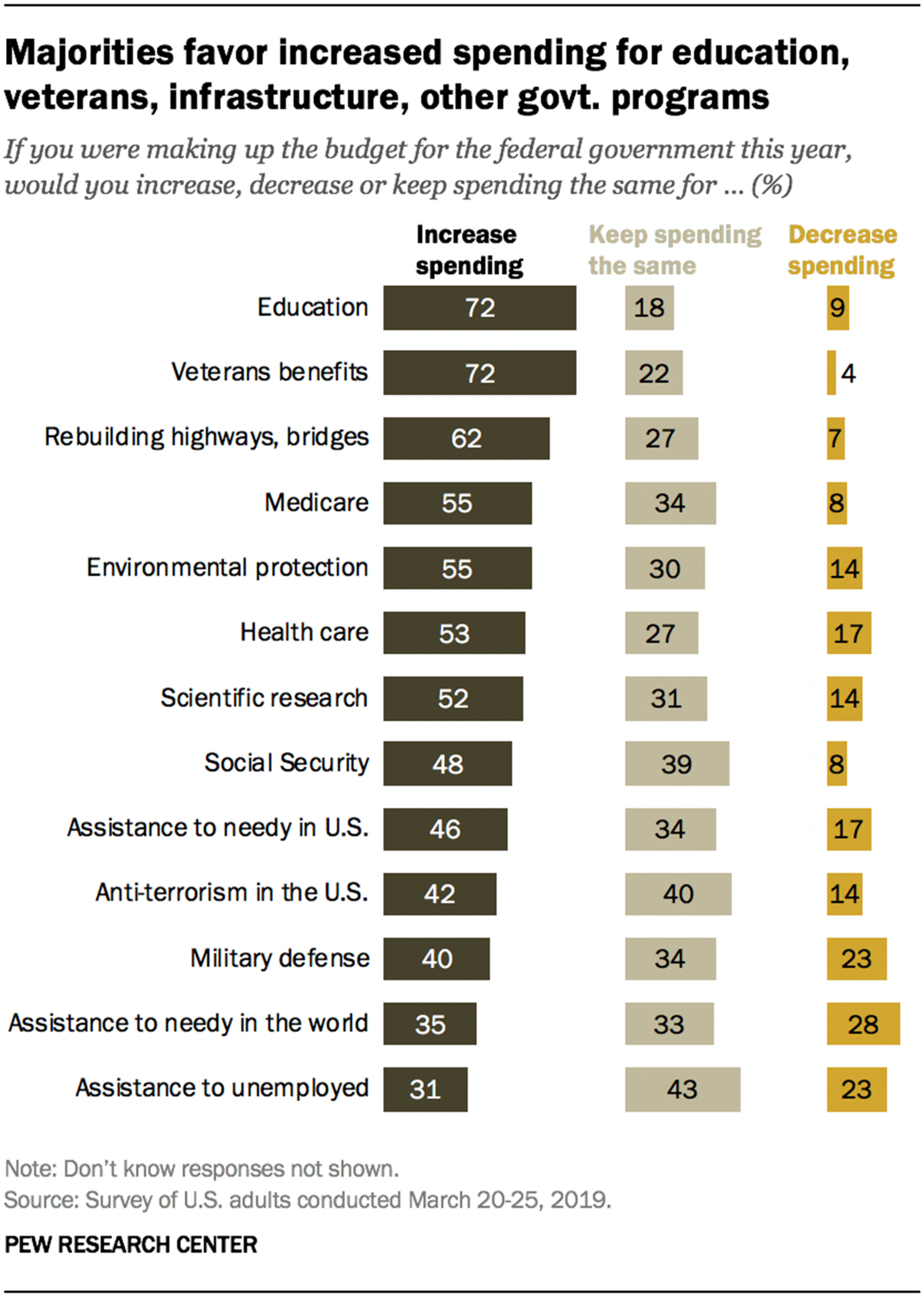
The most likely scenario

Though the U.S. debt ceiling is presently a hot issue in the news, the stock market has not reacted to the risk. Historically, the market has tended to take heed only once the deadline draws much closer. As in the past, the impasse this time will most likely be resolved again before certain payments are missed. This will be due to pressure brought to bear upon both parties by the public, political forces and the financial market to avert this catastrophic scenario.

Two factors in particular will motivate both parties to avoid this risk.

1. Neither one will want to be blamed for the economic consequences, particularly so close to the upcoming presidential elections.
2. There is very little support among Americans to cut major social programs (see chart below). This is all the more true among the Republican base, which is increasingly made up of working class and older voters.

[5] "As Debt Limit Threat Looms, Wall Street and Washington Have Only Rough Plans," New York Times, January 17, 2023



Source: "Little Public Support for Reductions in Federal Spending," Pew Research Center, April 11, 2019

Bottom line: The debt ceiling saga of 2011 teaches us that the closer to the deadline both sides wait to be before negotiating a deal, the greater the financial consequences. This risk is amplified by the fact that the economy is already grappling with slower growth, higher interest rates, quantitative tightening, higher debt levels, China-U.S. tensions and the fallout from the war in Ukraine.

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King, CFA
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.Schleich@nbc.ca

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. (“NBCFI”) which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited (“NBCFMA”)which is licensed by the Securities and Futures Commission (“SFC”) to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong (“SFO”)). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates’ businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.