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CIO Viewpoint

Brace, brace! The US crashes through its debt ceiling, again

Investment Solutions

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It is easy to dismiss a dispute over the US's debt ceiling as a political fight that will be resolved before any damage to the country's financial credibility. Nevertheless, the argument matters because the same issue triggered America's only credit rating cut in 2011. As the economy slows, and the US dollar shows signs of weakening, we look at the stakes.

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Key takeaways

- The US has breached its debt ceiling, setting up a dispute that has historically triggered government spending compromises. In 2011, the same issue led to the country's only credit downgrade
- The US Treasury is taking 'extraordinary measures' to finance the debt, expected to run out 'before early June'
- Congressional tensions over the ceiling should prove no more than a political distraction, and we expect a compromise, as in the past
- The USD is weakening as the Fed nears the end of its monetary tightening cycle and the outlook for global growth improves with China reopening. By the end of 2023, we see the EURUSD at 1.12 and USDJPY at around 120.

The debt ceiling sets a cap on how much new debt the US Treasury can issue through its sovereign bonds, which is how the government pays for spending once approved by Congress. US Treasury bills underpin the global financial system as a benchmark for a risk-free rate, a worldwide reference price, or act as collateral for other assets. The ceiling does not authorise new payments; it is a limit on US government borrowing to finance its legal commitments, including medical benefits, salaries in the armed forces, debt interest payments and tax refunds. Breaching the nation's debt ceiling also has potential consequences for the global economy, because it forces the Treasury to make savings, or refinance its maturing debt.

On 13 January 2023, US Treasury Secretary Janet Yellen said that the nation would breach its debt ceiling on 19 January. Without a deal, the Treasury cannot issue new bills, and Congress would effectively be letting the government default. Despite often-repeated assurances that the US government has never defaulted, a recent article pointed to four occasions - in 1862, 1933, 1968 and 1971 - when it failed to honour its debts. Even without going that far, debt-ceiling disputes have historically taken a toll by weakening the dollar in favour of gold, raising volatility in money market flows, or widening credit default swaps, which measure investor confidence that a government will make its repayments.

"In the past," Ms. Yellen wrote to the House of Representatives' speaker last week, "even threats that the US government might fail to meet its obligations have caused real harm," including the country's only credit downgrade in 2011. Then, a standoff over the debt ceiling resulted in Standard & Poor's, a debt rating agency, downgrading the US's credit rating for the first and so far only time, from AAA to AA+, where it has stayed since.

The US debt ceiling has more than doubled over the last decade. It was last raised by USD 2.5 trillion, to USD 31.4 trillion on 16 December 2021 (see chart).

June's x-date

The latest breach now demands accounting measures to prevent the government from defaulting, but has its own limits. It is "unlikely that cash and extraordinary measures will be exhausted before early June" 2023, Ms. Yellen wrote. These measures include halting contributions to a federal employees' pension fund. There is another short-term solution: lawmakers may decide to borrow a tactic from 2021 and agree to suspend the deadline through December of this year.

The dispute comes as the Federal Reserve's inflation fight slows economic growth, possibly into recession in 2023, before averaging, we estimate, gross domestic product growth of 0.7% over the full year. The central bank has pushed its benchmark interest rate to its highest level since 2008, and we see Fed Funds rates peaking around 5%, and then on hold for most of 2023.

The US Congress has limited federal debt for more than a century. In April 1917, during the First World War, lawmakers set a limit on the country's federal spending so that it did not have to approve the objective of each new issuance by the Treasury. Until the mid-1990's, the House of Representatives increased the debt limit in line with its annual budget approvals, avoiding a political dispute over the ceiling, before passing it to the Senate for their backing.

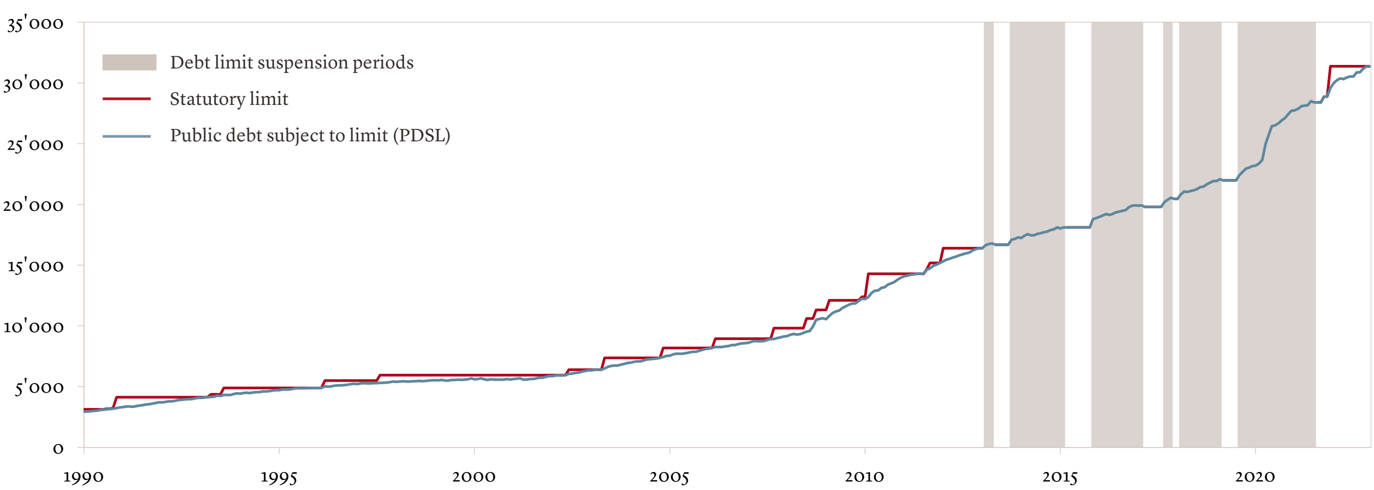
Compromise, Denmark, Taiwan

The mixture of a polarised political legislature and a fiscal safety valve designed more than a century ago have produced an almost annual dispute. Many Republicans have said they will not support lifting the ceiling without cuts to US spending from the Biden administration. The White House says that Congress has already approved its spending commitments, which presuppose an increase in federal spending. A split Congress complicates this. Since 3 January 2023, the Senate remains under Democrat control, whereas the Republicans gained a slim majority of seats in the House of Representatives. Still, there are also divisions even within the Republican Party, which slowed the appointment of the new speaker, Kevin McCarthy, to the chamber this month.

The US is not quite the only economy that sets a monetary threshold on spending, but is the only one that regularly unboxes it over political differences. Since 1993, Denmark sets a limit to government borrowing on behalf of the state, without asking for parliamentary permission. However, its limit, published by the country's central bank, is regularly so much higher than its national debt that it operates as a constitutional protocol. Taiwan has a different mechanism, limiting public debt to 50% of GDP since 1996. That ceiling enjoys cross-party support and the territory has never crossed its threshold. Even post-Covid, Taiwan's public debt ratio stands at 24%. Germany and Switzerland both operate 'debt brakes' which require their federal governments to balance budgets.

Divided Congress points to possible risks around debt ceiling in 2023

Statutory debt limit versus total US public debt outstanding (in USD trillions)



Sources: Bloomberg, Federal Reserve

Haven alternatives

Any threat to disruptions in US government spending adds to the growing indications that the US dollar's strength is starting to slip. Until November 2022, Europe's energy crisis and prospects for slower economic growth outside the US saw investors flock to the dollar, undermining demand for the euro and yen. That trend is reversing as the outlook for global growth improves for 2023 thanks to the reopening of China's economy. In addition, energy prices in Europe and Japan have collapsed in response to a warm northern-hemisphere winter, adequate stocks of natural gas and government efforts to source alternatives to Russian supplies. All of these factors are undermining support for the dollar just as the Fed slowed its rate hikes and the European Central Bank and Bank of Japan (BoJ) turned more hawkish.

We see the EURUSD reaching 1.12 by the end of 2023, and the Japanese yen becoming an attractive alternative haven to the dollar. Our expectation is that the USDJPY will trade around 120 by year-end, as Japan's terms of trade improve and the BoJ slowly drops its yield curve control policy.

As inflation eases and global growth forecasts receive a boost from China's reopening, we have raised equity risk exposure from underweight to neutral. We prefer Chinese and emerging market equities to their US counterparts, which are more at risk of negative surprises, and remain among the most expensive regions. Within fixed income, we seek quality assets, including US Treasuries and investment grade credit.

"At the end of the day we will meet our obligations and not cause substantial disruption," economist Larry Summers, a former US Treasury Secretary, told Bloomberg at the World Economic Forum's Davos summit last week. "It would be catastrophic for the United States and our sense as a serious country if we were to default."

The expectation is that the debt-ceiling's breach should prove little more than a distraction, since we expect Congress to reach a compromise, as in previous years. Yet while the likelihood of political failure is small, the risk will remain right up until the last moment, and would potentially trigger a shock to global markets. We remain vigilant.

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