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The U.S. debt ceiling conundrum

Contact:

Madan Sabnavis
Chief Economist
mailto: Madan.sabnavis@careratings.com
91-22-67543489

Aditi Khutal
Research Analyst
Aditi.khutal@careratings.com
91-022-6754 3568

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-022-6754 3515

History

The Congress created the debt ceiling in the Second Liberty Bond Act of 1917. It allowed the Treasury Department to issue Liberty bonds so the U.S. could finance its World War I military expenses. These longer-term bonds had lower interest payments. This condition has been in operation since this time period.

Recent enough, in November 2015, Congress and the then President Obama, agreed to suspend the debt limit through March 15, 2017. It was raised to $ 18.1 tn. During this period, the Treasury has been able to borrow to pay for the government's obligations under standard operating procedures.

Subsequently the debt ceiling has increased by $1.7 trillion to $ 19.8 tn. However there have not been any significant reforms initiated to stabilize the debt which is very important for a sound Fiscal Policy.

This debt ceiling got reinstated in September 2017 and hence the lawmakers in the U.S. had to reach a deal before Congress moves on to approve the government funding for 2018. If Congress failed to complete these tasks, the U.S. could default on its debt.

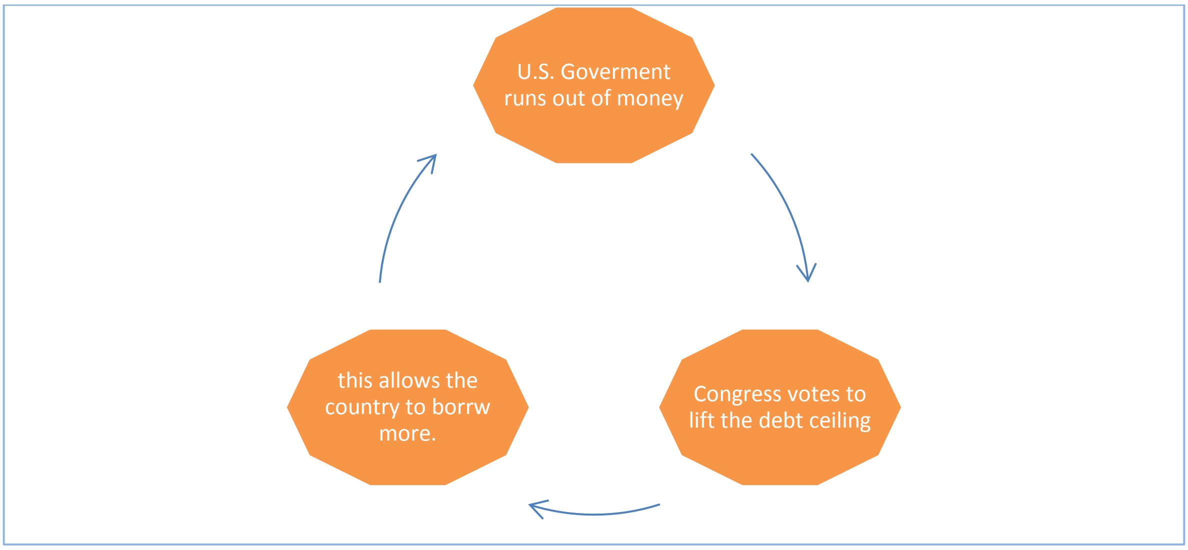
Now comes the question of what do we mean by a debt ceiling and its implications.

A 'debt limit' is how much the Treasury can borrow, whereas the 'debt ceiling' is a limit on how much debt the federal government can carry at a given time in order to pay for its operations. This ceiling limit is imposed by the Congress; and through a procedure of voting can be increased.

Once the ceiling is reached, the U.S. Treasury Department cannot issue any more Treasury bills, bonds or notes. Only the payment of bills can be initiated from the tax revenues which it receives. And if the revenue isn't enough, the Treasury Secretary will have to choose between paying federal employee salaries, social security benefits or the interest on the national debt.

What does it mean by 'raising the debt ceiling'?

It simply means that the country will be able to pay the bills for things that they have already spent. Raising the limit does not give the government power to spend beyond the level Congress has approved, but allows the government to meet its existing obligations to citizens, to vendors and to investors. Therefore, Congress had to raise the debt ceiling so the United States doesn't default on its debt.



To simplify things the U.S. debt is of two types-

First, what the government owes to itself, like Social Security Trust Fund and federal employee retirement funds and the second is what it owes to everyone else, which is called the public debt. This public debt is almost 70% of the total debt. Hence, if the debt ceiling isn't raised, it will affect the ability to make payments of future obligations. Also, the Congress and the President might find themselves in a situation where they can no more make any new financial commitments in the future. Increasing the debt ceiling ensures that the Treasury has enough funds to pay for the services and benefits that have already been approved by Congress and are included in the Budget.

An analogy can be drawn with the credit card business. The debt limit is said to be similar to the limit of a credit card that a company places on the spending. The only significant difference is that in this case the Congress is in charge of both the spending as well as the debt limit. It already knows how much it will add to the debt when it will approve the coming year's budget deficit. If the Congress refuses to increase the debt limit, it's like saying that the credit card company is allowing spending above the card limit but is refusing to pay to the stores for all the purchases made.

What Are the Potential Consequences of Not Raising the Debt Limit?

If lawmakers do not raise or suspend the debt limit, the consequences would be severe for both the U.S. Federal government and the economy. All the discretionary spending which includes both defence and non-defence could be subject to significant cuts; which might, at the extreme, lead to government shut down. As the spending is limited to the amount of incoming tax revenue, the federal government will have to involuntarily delay-

- Payments to employees,
- Payments to beneficiaries of government programs (including Social Security and Medicare) could be delayed or reduced, and
- Also, contracts could be violated.

Even if the Treasury Department would continue making timely principal and interest payments on the public debt, it could tarnish the government's creditworthiness and cause the interest rates to increase leading to an increase in government's cost of borrowing.

A Federal default of this nature would have serious economic consequences. The Treasury will have to stop issuing new notes. Even a brief debt limit deadlock like this would push the economy into-

- Recession leading to a prolonged economic downturn
- Increase unemployment
- The yields of Treasury notes sold on the secondary market would rise. That would create higher interest rates. This would increase the cost of doing business and buying a home. This would lead further to an economic slowdown.
- Owners of U.S. treasuries might lower their holdings. That would cause the dollar to fall headlong. The dollar has already been falling against the euro since the beginning of the year and will get exacerbated. This decline in the dollar can question its status as the world's reserve currency.

Currently, in the U.S. Parliament

Government funding for 2018 is the main agenda on the table of the Donald Trump government. Despite GOP (Republican Party or - Grand Old Party) control of the White House and Congress, Democratic votes will be needed to advance a budget agreement, which would determine spending levels for an appropriations package. To pass this legislation 60 votes are required in the Senate in order to reach the final vote.

What is the Federal Budget?

One of the most important functions of the U.S. government is to lay down priorities and then figure out how the country is going to pay for them. Together this comprises the federal budget. After the World War II, the United States government has been spending much more money than it makes. To compensate for this difference, it has to borrow. The borrowing is done by selling bonds to investors which includes the likes of large corporations or foreign governments. Countries like Japan and China lend the U.S. government in exchange for a promise that payback will be made to them in full and with interest. RBI also invests its forex reserves partly in US Treasury bonds. This money is then used to pay for items in the budget, like highway construction and maintenance, and military salaries, etc.

What happened on September 8, 2017?

On Friday, Congress approved with bipartisan majorities a budget and hurricane relief deal brokered between Donald Trump and top Democrats. With a vote of 316 to 90, the House of Representatives approved a bill to raise the debt ceiling and fund the federal government **through till 8 December** and provide $15bn for relief from Hurricane Harvey, which hit Texas and Louisiana last month. All the 90 votes of against came from Republicans. Interestingly, October 3, 2017 was the deadline for Congress to raise the debt ceiling. Otherwise, the government would have defaulted on 25% of its bills for that month.

Implications for the global Economy

There is a need for the U.S. federal Government to decrease the debt through various fiscal measures else the inability to repay such huge debts would pull the world economy down. The U.S. Treasuries are pinned to the economic and financial systems of the world. Thus anything that has the tendency to disrupt it is most likely to put the banking sector off balance in the global economy. As the U.S. securities are considered the safe haven for all the investors, any default in them would severely impact the global capital markets.

For us in India, the impact of an impasse would have meant more volatility in the exchange rate. Investment flows could increase if supply of bonds declines in the USA while exports would have slowed down in case the American economy receded. But given the turmoil to be potentially caused in the USA, the world economy would have entered the zone of turbulence. This has now been avoided.

CORPORATE OFFICE:
CARE Ratings Limited (Formerly known as Credit Analysis & Research Ltd)
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022; CIN: L67190MH1993PLC071691
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com

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