With the expiration of the continuing resolution, the U.S. federal government has been forced into a temporary shutdown. Critical functions will continue – defense will still be operational, border guards will still be present, postal service will continue, social security checks will still get mailed. However, close to 800k government employees in non-critical functions are subject to unpaid furlough.

The economic impact from this shutdown is notable, but not devastating so long as it doesn’t last too long. If the shutdown persists for two weeks, the estimated impact is to lower real GDP growth in the current quarter by about 0.3 percentage points (at an annualized rate). The economic impact assessment intensifies if the shutdown extends to a month or more. This is because some of the non-critical government activities are still very important. The lengthy shutdown would also have a greater impact on consumer and business confidence. So while a temporary shutdown is a disruption, a longer shutdown could significantly impede the economic recovery.

Last week, the financial market reaction to the looming shutdown was a selloff in equities – which is a logical reaction given that a temporary shutdown would modestly lower economic growth – and a rally in bonds – again, rational since the shutdown delays when the Fed might scale back its stimulus. Then, financial markets took the actual announcement in stride, with stocks rising slightly – an example of the old adage of ‘sell on rumor and buy on fact’. Moreover, the reaction is indicative that financial markets are counting on a temporary shutdown, not a protracted one.

But, financial market complacency may not last long, as the government shutdown is only a preamble to the main issue of substance, which is the debt ceiling negotiation. The U.S. government has already hit the debt ceiling, but the U.S. Treasury has been taking extraordinary measures in order to avoid adding to the debt. The government’s flexibility to keep making payments will run out in mid-October, with October 17th being the date that Treasury Secretary Jack Lew gave as the drop-dead date at which point cash available to the Treasury will fall short of daily expenditures.

The inability of Democrats and Republicans to reach a deal on extending the continuing resolution once again shows that the parties cannot easily reach a compromise. This is a problem for the debt ceiling deliberations. The Republican efforts to link government funding and the debt ceiling to changes to the Affordable Care Act is simply a non starter for the Democrats and the Administration. President Obama staked out an initial position that he will not negotiate on the debt ceiling, which might be an effort to depoliticize this issue that will continue to come up in the future. Nevertheless, the optics are that both sides have dug in their heels and are playing a game of political chicken.

So far, financial markets view this as simply political posturing. The financial market reaction at the moment is also tame because we have seen this story before and we think we know how it ends. It is simply unacceptable for the U.S. government, the holder of the world reserve currency,
to default on its financial obligations. Therefore, the rational outcome will be to raise the debt ceiling and to put in place a new continuing resolution.

There are, however, two risks. The first is to be reminded of the end of the movie “Rebel without a Cause”, where two kids are playing chicken in cars that are driving towards a cliff. You know the drivers will turn away, but then due to an accident one goes over the edge. An accident could happen. If it does, and America has to start prioritizing its bills, I suspect the financial market reaction will be so severe that it will force a resolution very quickly, just like when the TARP bill failed to pass on the first reading in 2008 and Congress scrambled to get a revised bill through 48 hours later. The second risk is that a continuing resolution is put in place and the debt ceiling is increased, but only for a short time. If so, we will continue to be trapped in this heightened political risk environment.

Beyond the financial market risks and their economic consequences, we should also highlight that the political wrangling in Washington is taking a toll on confidence that is hard to measure. It is evident that while profit growth has been strong in recent years, businesses have been cautious in their commitment to invest and hire. Regrettably, recent events will not help to improve business confidence. The recovery in housing and the prospects for stronger consumer spending are key to the economic outlook, but they too could be dampened if confidence is damaged.

Finally, the political challenges and economic implications have forced the Fed to pursue more stimulus for longer, which could ultimately bring greater challenges and economic risks when monetary policy is rebalanced. The politicians likely know that they will not be held to account if the Fed has a problem with its exit strategy.

So long as the shutdown doesn’t last long and the debt ceiling is ultimately lifted, the economic and financial effects should prove limited. And, history still supports the rational outcome. Despite the polarized political environment, the TARP bill was passed, the debt ceiling was raised in 2011, and the fiscal cliff was largely avoided. So, here’s hoping that political rationality wins out once again, which only time will tell.

Craig Alexander
SVP & Chief Economist, TD Bank Group
416-982-8064

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