PERSPECTIVES ON THE U.S. DEBT CEILING DEBATE

The debate over the U.S. statutory debt limit has come down to the wire. The U.S. Treasury has stated (and restated) that if an increase in the debt ceiling is not in place by August 2nd, they will run out of funds to pay all of their bills. Yet, with just days left before the deadline, political brinkmanship in Washington shows no sign of letting up.

There are so many ways in which this political crisis can play out. Each one is further complicated by the fact that there is no way of knowing precisely how financial markets will react if the deadline is breached. There is a tendency for market pundits to look at the sovereign debt downgrade experiences of other countries, like Japan (1998) or Canada (1994). However, even these two experiences provide diametrically opposite outcomes. It’s difficult to tease out the exact market reaction given other considerations, but 10-year Japanese bond yields fell by roughly 0.7 percentage points from the time the negative watch was first announced until the downgrade was put in place. In contrast, the Canadian experience saw yields shoot up 0.8 percentage points from the negative watch to the downgrade. Neither of these really offers a good basis for comparison when it comes to the United States, because it represents the deepest and most liquid financial market in the world and the U.S. dollar effectively acts as a global reserve currency.

So, how would financial markets react in the event of a ratings downgrade on sovereign debt versus a selective default? There’s no simple answer, but investors already appear to be looking for protection. Around the world, equity markets have taken losses over the last week, even as earnings in many cases have outperformed estimates. Moreover, diversification away from U.S. bonds towards other AAA rated countries such as Canada, Sweden, and Germany is also taking shape. Thirty-year bond yields in all those countries have widened against their U.S. counterpart over the last several days. In fact, this is even true for the U.K. where debt woes have also been in the spotlight.
Thinking through potential economic ramifications can make your head spin. In an attempt to simplify the discussion, we’ve boiled the analysis down to what we deem are the four most likely outcomes and present each one below.

**Scenario 1 - to dream, the impossible dream**

The first scenario considers that a grand bargain of $3-4 trillion in fiscal austerity over the next decade is struck before the August 2nd deadline. This scenario is certainly the most optimistic of them all and would be a tall order to achieve under the tight remaining time frame and the seeming intransigence of the political parties. Nevertheless, it would yield the most positive financial market reaction, as investors breathe a sigh of relief. Not only would the U.S. have put the debt ceiling issue to bed, but a rough path would have been carved out for a more sustainable U.S. budget picture.

End of story? Yes and No. Financial market uncertainty would certainly dissipate with the U.S. no longer in danger of a sovereign debt downgrade or an unthinkable ‘default’. In fact, given that some nervousness is starting to bleed into markets, this outcome would likely lead to an upside rally in equities and the greenback. However, the amount of fiscal consolidation necessary to put U.S. debt levels on a sustainable path will still come with an economic price tag. And, because the Federal Reserve is operating monetary policy at the effective lower bound, it has limited ability to use monetary policy to offset contractionary fiscal policy.

Without an offset of lower interest rates, we would expect fiscal consolidation of this magnitude to trim real GDP growth by roughly 0.5 percentage points per year for the next three to five years. After that period, the impact from the initial dislocation of resources starts to fade, as lower debt levels translate into lower interest rates, reduced risk of a financial crisis and greater private sector investment - key drivers of long-run economic growth.

Although the grand deal seems like a heroic feat at this point, it is the ultimate end game for the U.S. in order to place debt on a sustainable path. Getting there, however, is what we’re all waiting on with intense fascination.

**Scenario 2 - no harm, no foul**

The second scenario is similar to the first one, in that a last minute deal is struck by Congress and government operations are not interrupted. However, this deal involves only an incremental increase in the debt ceiling in exchange for ongoing discussions on larger consolidation efforts. Standard & Poor’s has repeatedly stated that they would still consider downgrading the AAA status of the U.S. if they believe a credible longer term solution to the rising debt burden has not been found. However, even if this were to occur, we believe this scenario would likely have a relatively benign impact on the U.S. economy. Other ratings agencies do not appear inclined to follow-through with a downgrade under this scenario. With the risk of a shut down in government operations and a debt default having been averted, we suspect markets would take a downgrade by a single agency in stride. Nonetheless, worries about the long-term prospects to deal with the fiscal imbalances would persist. This scenario would augur for continued weakness in the U.S. dollar, but not a sharp decline from current levels. Bond yields would be largely unaffected, as markets would go back to fretting about the sub-par pace of economic growth.
Scenario 3 - a flesh wound

The third scenario reflects a political impasse that results in a breach of the August 2nd deadline. In all probability, this would eventually be followed by a ratings downgrade by Standard & Poor’s, and there would certainly be heightened risk of action by other rating agencies depending on how the government addresses their funding shortfall. In this scenario, we end up with a double hit on the economy. The first hit comes from the direct impact of withdrawing government funds from the economy equal to their financing shortfall - estimated to be $135 billion for the month of August. The second hit comes from the indirect impact of a potential rise in Treasury yields and flight out of equities due to deteriorating market sentiment. There is no way in knowing how long the political impasse would last if it were to occur at all, but we’ll need a set up assumptions in order to provide context to the potential economic impact.

If we assume a political resolution is not found for the entire month of August, a reduction of $135 billion from the economy would equate to an annualized 1.5-2 percentage point drag on real GDP growth in the third quarter. While missed payments will eventually be made once the ceiling is lifted, not everything lost during the shutdown will be recouped. In particular, services provided by federal workers that are furloughed (put on temporary leave) are unlikely to be recovered once the government begins normal operations. At least a portion of the shutdown would represent a permanent loss in GDP.

The secondary economic impact that feeds through the financial market channel results in adverse wealth effects. It is estimated that the financial impact could shave real economic growth by an additional annualized 1 percentage point in the third quarter, which also may not fully reverse in the following quarter since the risk profile of the U.S. economy may end up permanently altered, particularly in the eyes of foreign investors. It is impossible to know how badly financial markets would react to the prospect of lower economic growth, greater financial uncertainty and an unprecedented loss of America’s AAA status. At the very least we expect to see a flight out of risky assets, like equities. When Congress initially failed to pass the TARP legislation in late-2008, the S&P 500 suffered one of its largest single-day drops on record (-9%).

While we are no longer facing an economy gripped by a deep recession and seized-up financial markets, we still have an economy gripped by a fragile consumer and lending environment. So, the magnitude of equity flight would likely be less today, but some degree of retreat would occur. As for Treasury yields, there has already been some steepening in the yield curve in the past month, which may be reflecting, in part, the added political risk. Standard and Poor’s estimates that a downgrade of U.S. debt from AAA to AA would cause long-term interest rates to rise by 25 basis points. This is likely an optimistic assessment and given recent market reaction it could easily be double this. Indeed, as we discussed in the introduction, there is already evidence of a global rebalancing away from U.S. dollar assets due to heightened uncertainty and a potential downgrade. Any rise in yields would naturally increase private sector borrowing costs, while also increasing the debt burden of the government. In August alone, the Treasury will need to tap markets for almost $500 billion in maturing debt.

In this scenario, the assumption is that the financial market and public reaction would bring the parties back...
to the table and hammer out a deal to lift the debt ceiling in short order. Since it is assumed that much (but not all) of the negative economic and financial market drag would reverse course when the debt ceiling is eventually lifted, the net effect may be as little as a 0.5 percentage point drag on real GDP growth in the second half of the year. However, with the U.S. economy unable to even hit the 2% growth mark in the first half of this year, any added drag would be unwelcomed and could further undermine consumer and business confidence. Adding in the shock to confidence and the total impact could be a greater: perhaps up to a whole percentage point cut from growth in the second half of this year. Of course, the longer the fiscal crisis drags out, the more severe the consequences. In the final analysis, this scenario is one of short-term financial turmoil that leads to weaker economic conditions for an already fragile U.S. economy.

Scenario 4 - a mortal blow

The fourth scenario would reflect an actual default, where the U.S. government fails to make an interest payment when it is due. This seems like a real outside risk given that interest payments are only 5% of government expenditures and the Treasury would place them at the top of the priority list. However, a technical default could occur if either the impasse lasts so long that the government simply lacks the revenues to meet a payment as it comes due, or if the volatile nature of daily revenues results in a funding gap that happens to coincide with a scheduled interest payment. The difference between what the government collects in revenue and what they have committed to spending is not constant through the month. According to analysis by the Bipartisan Policy Center, on some days spending would have to be cut by as much as 65% in order to remain in line with revenues. A technical default would lead the rating on U.S. government debt to fall right past single-A to a rating of “SD,” which stands for selective default. This would definitely take us into unknown territory. A default, even if viewed as a mere technicality that is quickly cured, would magnify the financial market impacts described in scenario 3. U.S. interest rates would not just rise, but could spike dramatically. A steep move upwards in yields could lead short-term money market funds, which are mainly composed of U.S. Treasuries to lose value. Similarly, repo markets - a major source of short-term funding for financial institutions - use Treasuries as collateral. In short, a loss in value of an asset that is considered one of the safest around the world could trigger a rash of redemptions and collateral haircuts. The result could be a rapid rise in interbank funding costs and a total freeze in U.S. credit markets. An economic recession would surely follow.

Bottom Line

Depending on how long it takes Congress and the President to reach an agreement, the impact could range from mildly negative to disastrous. The result of effectively shutting down the federal government will be to lower economic activity for at least as long as this shutdown occurs. Provided this is only a few days, the economic impact will be limited. However, if it lasts a whole month it could start to really bite into economic growth.

Moreover, financial market impacts will likely worsen the longer a debt impasse remains in place. A short-term delay and credit rating downgrade could cause shockwaves to ripple through bond and equity markets. U.S. interest rates would rise and the U.S. dollar would weaken. But, the turmoil should pass provided a solution is put in place in relatively short order. However, if brinkmanship is maintained, the shock to wealth and the financial system becomes more permanent and the contagion to broader financial markets more significant.

Finally, it must be recognized that whether the debt ceiling is lifted by August 2nd or not, the end game is still the same. Fiscal austerity must happen to stabilize the debt-to-GDP ratio and avoid a future financial crisis. However, it does not have to happen tomorrow or even next year. Financial markets need to see a credible long-term strategy that reduces debt while not crippling economic growth. If we could have it our way, we would prefer to not to see any dramatic fiscal austerity measures until there was sufficient confidence that economic growth has firmed up. Otherwise, we could end up in a self-perpetuating cycle where a weak economy exacerbates the fiscal challenges. 

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