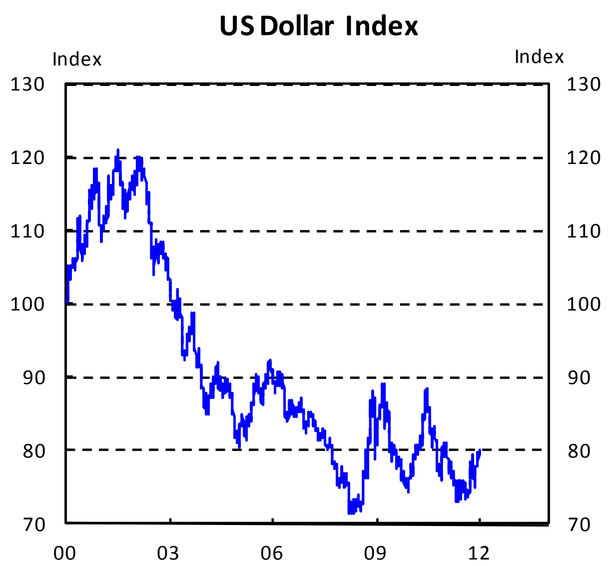
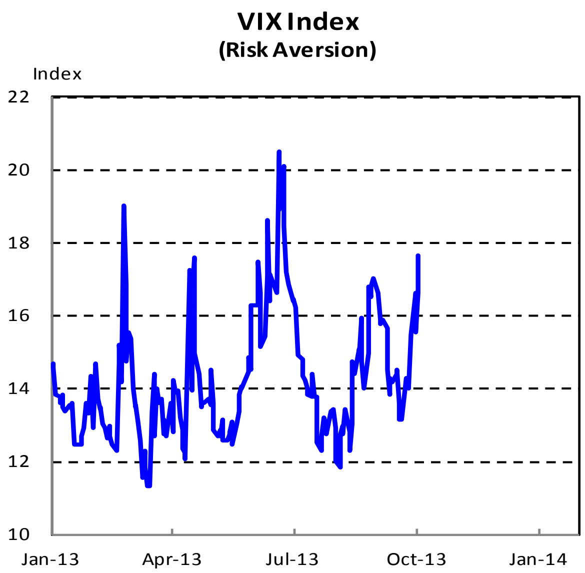
Friday, 4 October 2013

Government Shutdown & Debt Ceiling

Déjà Vu

- **The disagreements within US Congress have reached a point that could significantly destabilise the US economy and disrupt financial markets. It has resulted in a partial government shutdown and raises the prospect of technical government default by the United States if Congress fails to raise the debt ceiling in a timely manner.**
- **The US has typically been in similar situations before in the past, and Congress has usually avoided a catastrophic event at the eleventh hour. However, the extreme deadlock between opposing parties is worrisome and at present the parties appear no closer to compromise.**
- **The current Government shutdown could potentially detract a sizeable chunk from growth in Q4, depending on how long the standoff lasts. However, the consequences failing to raise the debt ceiling in time would be more damaging and the negative impact could be longer-lasting. Even the prospect of default would be disruptive for financial markets and poses a downside risk to economic growth.**





Government Shutdown

Every year, US Congress is required to pass legislation which authorises spending for government departments and agencies (appropriations bills), or at least adopt stop-gap measures (continuing resolutions) to allow funding for the government's every day operations. Congress has a deadline of 1 October, the start of each US budget year to pass this legislation, and this time around, they have failed to do so resulting in a partial government shutdown. Approximately 800,000 federal employees are on leave without pay, national parks and monuments have closed and other services deemed non-essential have also ceased.

The Debt Ceiling

The debt ceiling or debt limit is a different matter altogether. While the Government shutdown prevents the government from spending on every day services, the debt ceiling determines how much the government is legally allowed to borrow. Increases to the debt ceiling are authorised by Congress and is a separate piece of legislation from authorising any new spending by the Government.

The debt ceiling currently stands at US$16.7 trillion, which was reached in May. However, the Treasury Department has taken some “extraordinary measures” to postpone the need to increase the statutory debt limit. Treasury has said that the “extraordinary measures will be exhausted no later than October 17, 2013.”

Why Can’t Congress Agree?

Republicans and Democrats have had immense difficulty in coming to an agreement in anything regarding public finances over the past few years. This is in part because of the polarised nature of US politics, although it also reflects the difficult task of putting US finances on a more sustainable path over the long-term.

Currently, the battle focuses on Obama’s Affordable Care Act or “Obamacare”. The law was passed in 2010, and aims to make health insurance more accessible for Americans across the board. However, the law has been controversial among Americans and has received mixed support. Some opponents of Obamacare are worried it would cost too much and harm the quality of doctor’s care. At the same time, news polls are indicating that the majority of Americans do not fully understand the new law and how it will affect them.

Republicans have attempted many times to repeal Obamacare and have recently attached conditions to change the healthcare reforms or defund the healthcare law in exchange for passing bills on spending measures. However, the Obama and the Democrats have refused to budge on his healthcare reforms, resulting in the current Government shutdown.

Even with the shutdown in place, the Obama’s healthcare law took effect from 1 October, and once more and more Americans qualify for insurance, the law will become harder to repeal.

At present, the opposing parties appear no closer to an agreement, which increases the downside risk to the US economy. The ensuing battle also increases the uncertainty that US Congress will fail to raise the debt ceiling in time.

Potential Economic Impact

The direct impact of the Government shutdown on the economy will be due to lost spending and employment as government workers will not be paid and lost tourism through the closure of monuments and museums.

The impact on the US economy will depend highly on the length of the shutdown. Analysts estimate that the shutdown would detract from growth in the December quarter by over 0.25 (annualised) percentage points every week the government is shutdown. However, given that this estimate is based on the shutdown that occurred in 1995-96, the impact could be more severe given that the economy is much weaker now that it was in the mid-1990s.

Government services which have been put on hold also include some key economic data releases. This could add more uncertainty to the Fed's decision that an economic recovery is making progress and so push out the start of tapering.

However, the more worrying consequences come about from a failure to raise the debt ceiling.

The US has never defaulted on its debt obligations. A default, therefore, would be unprecedented in the history of the US government. Predicting sovereign defaults is notoriously difficult, even when things appear to be bleak for a country.

The USD is the world's reserve currency and with the US debt denominated in USD, therefore, technically the US can never default if it wishes to avoid it. Specifically, the US can always print more money to pay its creditors. While this is technically true, it doesn't withstand the fact that there will be economic consequences of failing to raise the debt ceiling.

The unprecedented nature of such an event means that an exact estimate of the effects is impossible to predict with accuracy. However, economic theory and evidence can give us a guide as to the direction of the effect. The US Department of the Treasury in a recent report described the potential effects of a debt default as "a large, adverse, and persistent financial shock".

It is close to certain that a default would have negative effects on the US economy and this would be reverberated through financial markets and the global economy.

A default would almost certainly be accompanied by a downgrade in the sovereign credit rating of the United States by the ratings agencies, which means debt will be more expensive for any future borrowing.

The US dollar would be sold off heavily. It is already under downward pressure from the ongoing impasse.

US bond yields across the curve, particularly at the longer end, would rise sharply as demand for US bonds fell (ie pushing bond prices lower). These sharp moves would impact other interest rates and currencies around the world, including the Australian dollar and Australian bond yields.

Risk aversion would also rise sharply as investors would fear the implications for global growth. A measure of risk aversion, the VIX volatility index, is rising on the back of the impasse and stands at its highest level in three months.

The risk in risk aversion would induce wider spreads for risk. In times of stress, investors are less willing to invest. So they demand a higher return for that investment. From the borrowers' perspectives, wider credit spreads mean a higher cost of funding for a given level of Treasury rates. In times of stress, banks also tend to tighten covenants on loans.

Heightened risk aversion would also encourage flows away from any investments deemed risky and towards safer-haven assets, the most notable being gold. Government bonds are also typically considered among safe-haven assets but in this situation, US government bonds would not attract safe-haven flows.

Financial market conditions impact directly on the economy. Lower asset prices and higher interest rates (ie higher borrowing costs) would weigh on spending by consumers and businesses. Greater uncertainty about the economic outlook, including for asset prices, would also encourage consumers and businesses to be cautious and shy away from spending. Lower spending by consumers and businesses would add to the dampening impact on US economic activity.

The effects on consumers and businesses feed on each other. Reluctance by consumers to spend weakens business activity and spending, which also discourages hiring intentions and investment decisions.

As US financial markets are inter-linked with financial markets in other advanced economics, there would also likely be a dampening impact on economic activity in these markets. It includes the Australian market and economy.

The US is already recovering from the 2008 crisis and cannot afford a default now or in the near future. There's no doubt that the US and other countries around the world would be financially hurt by such a default.

Besa Deda, Chief Economist
Ph: 02-8254-0898

Janu Chan, Economist
Ph: 02-8253-0898

Contact Listing

Chief Economist

Besa Deda
dedab@stgeorge.com.au
(02) 8254 3251

Senior Economist

Hans Kunnen
kunnenh@stgeorge.com.au
(02) 8254 8322

Senior Economist

Josephine Horton
hortonj@stgeorge.com.au
(02) 8253 6696

Economist

Janu Chan
chanj@stgeorge.com.au
(02) 8253 0898