Points of View:  
US technical default - low chance, high impact

Key Points

• At this stage, investors deem the risk of the debt ceiling not being raised in time to be low, but the consequences of this low-probability event, should it materialize, could be very high.
• Even if the delay is temporary, a technical US Treasury default could cost up to 6-7% of GDP, according to former NY Fed President Bill Dudley, which would potentially plunge the US into a recession.
• In this scenario or should the risk of a shutdown increase even without one ultimately materializing, Treasury rates (outside of Treasury bills maturing around potential shutdown date) would be expected to decline on risk-off sentiment. This was the case in 2011, when the debt ceiling was finally raised only 2 days before a potential default.
• Consensus for the “hard” deadline to raise the debt ceiling, including exhausting extraordinary measures, is September 30, but given that tax receipts are running below last year’s, this could come as early as June.
• We believe there is a high probability of both the debt ceiling and federal funding bill negotiations running dangerously close to the final deadlines.
• If agreement is not reached in May, the Federal Reserve’s stance may turn more cautionary considering fiscal policy risks.
• More broadly, the US fiscal trajectory is unsustainable: debt service costs are projected to rise just as baby boomers retire and government expenditures therefore set to balloon.

Economic and financial implications of a debt ceiling debacle
At this stage, commentators deem the risk of a US Treasury default to be low, but the consequences of this event, should it materialize, could be very high. A temporary government shut down to prioritize debt payments could itself be detrimental but coupled with a US Treasury default could translate into a sizeable GDP contraction and hit investment sentiment for months if not longer. Former President of the New York Federal Reserve Bill Dudley recently estimated that the ultimate negative shock to the US GDP from such an event could reach 6-7%. Such a hit to growth could come both from lower consumption and investment and from financial shocks and investor confidence.

If the US Treasury defaults on some of its debt, the rating agencies would be likely to issue downgrades not only of the US Treasury, but also of entities that enjoy explicit or implicit backstops from the US federal government, such as large banking organizations or Government-Sponsored Enterprises (GSEs). Money markets, a substantial source of financing for financial and other private institutions, could seize as investors may flee government-only money market funds, and liquidity in repo markets (market for repurchase agreements) may deteriorate given that US Treasuries are their most widely used collateral. Longer-term, a reduction of foreign holdings of US Treasuries would weigh on the US dollar. In line with these risks, credit default swap contracts (CDS) on US government debt have widened significantly since late 2022.
However, note that the signal from the CDS widening is somewhat distorted by the difference between the dollar pricing of the Treasury bonds in 2011-13 vs. today. US Treasuries are much cheaper in the higher rate environment: the lowest dollar bond price that prevailed in 2011 was $90, while today it is only $57. This, in turn, implies a lower recovery rate, rendering the applicable CDS contract more valuable. The recovery rate can be even lower if the rest of the Treasury market rallies in the face of a default risk, as it did in 2011.

**Timeline: what to watch**

Attention on the debt ceiling issue will likely rise in the coming days as April tax receipt data continues to trickle in, and the House may put forward a bill to stake out the Republican position more clearly. As of April 23, analysts estimate that the US Treasury has received just under 60% of expected tax collections for the year, which are running about 35% (roughly $140bn) below last year’s levels. ¹Private sector estimates for the debt limit deadline of late July/ early August 2023 don’t appear to have moved (yet) on this data. Similarly, market consensus for July/ August debt ceiling deadline appears intact, judging by the cheapness of T-bills maturing between late-July and August versus the neighboring tenors. However, anecdotal evidence suggests that some investors are now skewing their expectations toward an earlier deadline, possibly as early as June 2023. If we avoid an early June debt ceiling fiasco, the probability of the US Treasury making do till at least July/ August would increase. This is because the Treasury should receive a smaller round of non-withheld tax payments in mid-June, and another ~$145 bn of “extraordinary measures” would become available around June 30. Note that consensus for the “hard” deadline to raise the debt ceiling, including exhausting extraordinary measures, is around September 30.

For context, the actual debt ceiling of $31.4 trillion was effectively reached in January. This event garnered little market reaction at the time, because the Treasury still has two temporary means of funding federal outlays: the cash in the Treasury General Account (TGA) that it holds with the Federal Reserve and what are known as “extraordinary measures”, mostly amounting to various accounting arrangements. However, these would be exhausted this year if the debt ceiling is not raised. The relatively low tax collections to date, as described above, increase the chances of the Treasury running out of funding from the “extraordinary measures” sooner rather than later.

Political context is especially challenging this year. The political configuration in Washington complicates the debt ceiling negotiations immensely. For historical background, the debt limit has been raised 78 times since 1960. Mostly, raising or suspending the limit was just the last step in finalizing the federal budget and spending process. However, this year, a Republican caucus is demanding commitments to cut federal spending as part of their negotiations with the White House. The Democrats dig in, retorting that they agreed to raise the debt ceiling with no issues under the previous administration that was extraordinarily unpopular among their won constituents. The House Speaker Kevin McCarthy is in a particularly challenging political position: he has already made concessions to a wing of his own party that would allow a single member of the House to call a no-confidence vote. He could then easily lose the simple majority vote if he moves toward a compromise with the White House/Democrats that the more conservative Rep party wings deems against their stance. On the other hand, a legacy of a debt ceiling fiasco would mean an undesirable political legacy for McCarthy.

The debt ceiling negotiations are also taking place against an increasingly unsustainable debt trajectory of the United States. The Congressional Budget Office (CBO) most recent estimate suggest that the federal debt held by the public sector will reach 118% of GDP by 2033, with the debt burden to reach $46tn by fiscal year 2033. Federal debt could grow to over 130% of gross domestic product (GDP) if policymakers extend various expiring policies. Moreover, these projections are based on an economic outlook without a future crisis with fiscal consequences, such as the ones experienced in 2008 or 2020. Of course, the US public debt has been growing faster than the US economy for over 50 years now. At the same time, interest rates have been falling more often than rising, making an argument that public sector borrowing is not crowding out private investment in the US. Many analysts have pointed to the US dollar’s premier status as the reserve currency, and, relatedly, the most utilized currency in international trade as the key reason for the lack of “crowding out” effect. However, it is important to note that investor debt concerns tend to emerge in a non-linear manner. Historically, they have been more likely to transpire when debt to GDP ratio has topped 100% and when real interest payments on public debt rise above 2% of GDP.
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