FLASH: 30 SEPTEMBER 2021

US debt ceiling: a dangerous game

Summary

- The issue of raising the US debt ceiling is back in the spotlight, as it was reached.
- A vote must be taken in Congress to increase or suspend the ceiling. Democrats have the majority in Congress, but they will have to rely on the support of Republicans who have a blocking minority.
- Negotiations appear to be at an impasse on the eve of a first deadline. Republicans say they will not be part of any effort to fix the debt ceiling. Democrats, on the other hand, believe that the Republicans will eventually give in.
- The first risk (15% probability according to us) is that non-essential federal administrations will have to remain closed as of 1 October (government shutdown).
- The second risk (5% probability in our view) is a technical default by the US.

Debt ceiling: the return

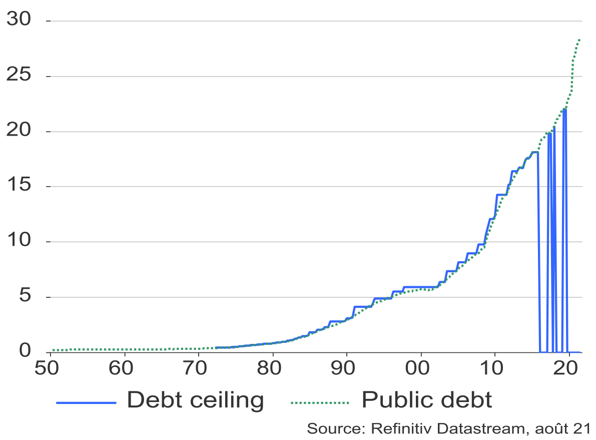
The issue of raising the US debt ceiling is once again back in the spotlight.

This concept, created in 1917, was intended to allow the US Treasury to raise debt without prior authorisation from Congress as long as the total debt remained below a certain ceiling. Since then, the ceiling has been raised 92 times through political negotiations, often at the very last minute.

Since 1 August, the current USD28.4 trillion debt limit has been reached. Congress must then approve an increase or suspension of the ceiling, without which the political and economic consequences could be severe.

Democrats have the majority in Congress, but must reach an agreement with Republicans who have a blocking minority.

US PUBLIC DEBT AND CEILING (USD TRILLION)



Source: BNP Paribas Wealth Management

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30 September, midnight: First deadline and three scenarios

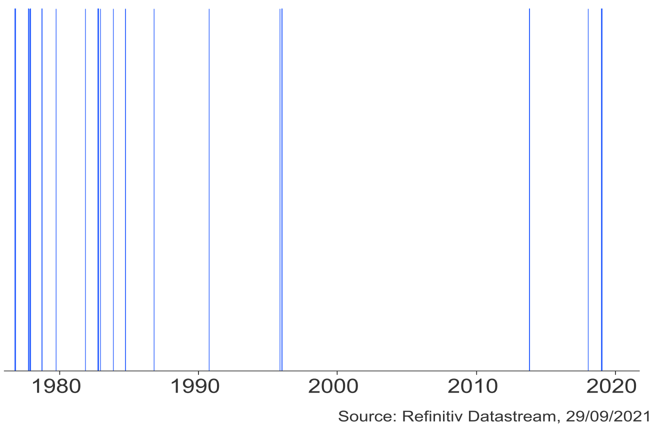
Negotiations appear to be at an impasse as the end of the fiscal year on 30 September means that a 2022 budget proposal must be passed imminently in order for the federal government to continue operating.

Scenario 1 (10% probability): Democrats and Republicans agree on the budget and on raising the debt ceiling. Democrats did not include any debt ceiling instructions in their 2022 budget proposal in the belief that Republicans would eventually cave in, since past debt ceiling increases have been bipartisan. The chances of this bill passing are quite slim. Senate Minority Leader McConnell has been repeating the same message since July, that Republicans will not be part of any effort to fix the debt ceiling. In August, 47 Republican senators signed a letter pledging not to vote to increase the debt ceiling, "whether that increase comes through a stand-alone bill, a continuing resolution, or any other vehicle". Their aim is to prevent President Biden from making what they consider to be "irresponsible" expenditures.

Second scenario (75% probability) : Democrats set the debt ceiling aside and submit only the 2022 budget proposal. In this case, the debt ceiling issue is postponed and must be resolved by mid-October/Novembre.

Third scenario (15% probability): government partial/temporary shutdown. If the budget proposal does not pass, then Federal administrations will have to shut down on 1 October. In concrete terms, non-essential administrations such as federal parks and museums would not be able to open and civil servants would not be paid (in the past, they have received their salaries after the budget was passed). The US Congressional Budget Office estimated that the five-week partial shutdown at the end of 2018 reduced GDP growth (not annualised) by about 0.06% per week. The same is expected to happen with a partial shutdown this time.

A HISTORY OF GOVERNMENT SHUTDOWNS



Source: BNP Paribas Wealth Management

The latest news is that scenario 2 seems to be on track and scenario 3 of a federal government shutdown should be avoided. The Senate is reportedly set to vote this Thursday 30 September morning to extend government funding until 3 December.

Mid-October to mid-November: Second deadline and many scenarios

If the political impasse is expected to continue, Treasury Secretary Janet Yellen believes that the country can probably hold out until 18 October. It is possible that the Treasury could survive another month given the likely slower pace of spending with the elimination of the federal unemployment insurance supplement.

After that date, if Congress has not raised or suspended the ceiling, the Treasury will most likely run out of cash and the US will no longer be able to borrow on the markets to finance itself. This would cause a potentially deep crisis. The government will not be able to pay its bills, millions of Americans will no longer receive their salaries, nearly 50 million seniors will no longer receive their retirement Social Security checks and soldiers will no longer be paid, according to Yellen.

Furthermore, confidence in the US signature and the dollar would be damaged. We can then fear a chain reaction with the downgrading of the country's credit rating, a sharp rise in yields and a fall in the equity markets. Such a scenario is quite extreme and we attach only a low probability to it, in the order of 5%. Past experience has shown that political parties, once their backs are against the wall, have been able to make the right decisions at the last minute.

The most likely scenario (55% probability) remains that of a bipartisan agreement to suspend the debt ceiling before the mid-October or November deadline. That said, the risk of Democrats using the reconciliation process (which allows for a 50+1 vote out of 100) has increased (now 40% probability), which would likely impact the final size of President Biden's infrastructure programme.

Market Impact

Investors are a little more nervous as the first deadline approaches that could lead to a federal government shutdown. Equity volatility has increased recently and US equity markets have been trending lower. On the interest rate front, 1-month T-bills now pay more than 2-month T-bills, with rates of 0.0507 % and 0.0380 %, respectively as of September 29, suggesting a very short-term risk premium, but also that the market is confident that the problem will be solved later. Indeed, in the currency market, the dollar has even strengthened, which does not indicate nervousness about a future default risk.

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