US Macroeconomics

April 25, 2023

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The Debt Ceiling Debate: Much Ado About Nothing

The United States is not going to default on its debt. In addition, there will not be a technical default on the debt whereby the Treasury misses an interest payment. The US government will continue to pay its bills on time, at least this year. We have been through this debate dozens of times in the last 40 years. The outcome will be the same: no default.

A more realistic concern, although still unlikely, is whether another one of the three main rating agencies downgrades Treasury debt. In August 2011, the Standard and Poor's (S&P) rating agency downgraded US debt one-notch from AAA to AA+. Fitch and Moody's had maintained the Treasury's AAA status at the time but put the government on negative watch.

S&P had put the US government on watch in April 2011. So, the agency had laid the groundwork for a potential downgrade. In this regard, their decision to downgrade later that summer was not out of the blue. There was intense public debate between the Administration and the Congress. Each were playing a game of chicken with default. The environment is different today.

For starters, S&P has a stable rating on the US government but said just last month that if there was going to be another downgrade it would happen over the next two to three years if "unexpected negative political developments weigh on the resilience of American Institutions" or if the government "jeopardize(s) the dollar's status as the world's leading reserve currency." Another S&P downgrade is not forthcoming. Protocol is to put the US on negative watch first. This is standard practice for the other agencies, too.

Moody's and Fitch both have triple-A and stable ratings on US debt. Hence a 2011 repeat downgrade is not going to happen. But there is another more important factor to consider and that is the current makeup of the GOP-led House. **Republicans only have a nine seat majority** which means that Speaker McCarthy cannot lose more than four votes to hold his coalition together. His negotiating power is limited, which means the White House can continue to advocate for a clean debt ceiling bill.

Ultimately, if there is brinksmanship, we could easily see five (if not many more) moderate Republicans peel off to the Democrat side. **The current debt ceiling situation is entirely different from 2011 when Speaker Boehner had a massive 49 seat majority**. He had to contend with the Tea Party caucus which was in no mood to bargain with the President after their stunning 63 seat pickup the previous fall. Boehner had to deliver spending cuts which came through budget sequestration.

While Speaker McCarthy may feel like he needs to look tough by advocating for spending cuts and not supporting a clean debt ceiling increase, his options are limited given the GOP's narrow majority. Perhaps this explains why he proposed a debt ceiling suspension. Despite this, **bond investors continue to act as nervous nellies, evident from the 150 basis point gap in yield between four-week and three-month treasury bills**!

Unless the Administration agrees to a temporary suspension, which is possible if they believe it can be used to their advantage to highlight their spending priorities, we should expect a debt ceiling deal sometime in late July. Congress has an incentive to get it done then, ahead of their standard summer recess beginning in August. Stay tuned.

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