



## Washington debt ceiling circus is back in town

- **US lawmakers are locking horns over raising US\$31.4 trillion debt ceiling**
- **A US debt default would be a colossal shock to global financial system**
- **Longer term questions remain around the extent to which the US can continue to borrow and print money at gargantuan levels**

**Fears that the government of the world' largest economy is going to run out of money are once again haunting global financial markets, although optimism is rising that the potential calamity can be averted.**

US lawmakers are locking horns over whether to raise or suspend the limit placed on the national debt, or the amount that the Federal government has borrowed by issuing treasury bonds to pay for the public sector and service its existing debt. Emergency talks are taking place at the White House and President Joe Biden has cut short a foreign trip in an effort to secure a deal, possibly this week.

It is enshrined in the US Constitution that only Congress can authorise the Federal government's borrowing of money. The president can set the budget but Congress must approve the debt limit, or 'ceiling'.

The ceiling is unusual among liberal democracies. It was created in 1917 to ensure fiscal responsibility on the federal government. While it does cause political showdowns and even government shutdowns periodically, it means the US Treasury does not have to secure Congress approval every time it needs to raise money. The current debt ceiling was set at US\$31.4 trillion in December 2021, which represented a US\$2.5 trillion increase. The US government reached this limit in January, however, and to borrow more will require Congress approval.

When the debt ceiling is reached then the Treasury can find other ways temporarily to pay expenses until it can be raised. But failure to increase the debt ceiling would risk the US government defaulting on its legal financial obligations. The US constitution demands that the 'validity of the public debt of the United States ... shall not be questioned', arguably making it unconstitutional for the US to default on its debt, or even have a ceiling. However, Janet Yellen, the US Treasury secretary, has warned that the US could face a historic and damaging default on its bonds by 1 June if the ceiling is not raised.

President Joe Biden is currently meeting congressional leaders. As a Democrat, the main opposition to Biden's spending plans is the Republican Party. While the Democrats argue that the debt limit should be raised unconditionally, the Republicans insist the limit should only be raised alongside legislation that slashes government expenditure.

If the US were to default on its debt, it would be a colossal shock to the global financial system. A loss of confidence in the biggest economy and issuer of the world's reserve currency would have disastrous consequences for financial markets. The value of the US dollar and treasury bonds would plummet, and the disruption would spark a major US recession. The resulting crash in US equities would be followed around the world and foreign investment would flow out of the US. Moody's Analytics, the credit rating agency, estimates that a four-month default would cause a 4% fall in US GDP and the stock market to crash by a third.

What is particularly unnerving for markets is that credit default swaps on US treasuries, which gauge the cost of insuring exposure to US government debt, have reached all-time highs. The chances of a

default are still quite low, but even a delay in payments by the Treasury on its bonds could have substantial consequences.

Growing polarisation in US politics has been an issue for many years. Despite the political brinkmanship in Washington though, it is highly unlikely that the ceiling will not be raised. There are many precedents to what is happening now and Congress has always raised the limit eventually.

Aside from the circus that is US politics, there will be serious discussions taking place behind the scenes. Ultimately, it is accepted on Capitol Hill that the debt ceiling must be lifted and the US cannot default on its debts. The Republicans would not wish to be held responsible for driving the US into a default that would be disastrous for the economy so a compromise will highly likely be reached.

But longer term, there are major questions to be addressed around the extent to which the US can continue to borrow and print money at gargantuan levels.

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