



US Debt Ceiling

Frequently Asked Questions

Negotiations related to the U.S. debt ceiling continue to take centre stage in the financial news. This situation is likely to evolve rapidly in the coming days, and the points below are intended to provide background and context of the situation. The bottom line is that we are in an environment of extreme uncertainty. The next several months will be hugely informative and, hopefully, give the market confidence that the recovery is continuing, and sustainable. We are cautiously optimistic, but recognize that the forecasting environment remains unusually murky. We continue to monitor the situation and its related implications closely.

What is the Debt Ceiling?

The debt ceiling is a limit on how high US debt levels can get. The limit is currently set at \$14.295 trillion, a level that was set by Congress and has been raised a number of times in the past. The deadline to raise the limit is slated for August 2nd; however, there is some uncertainty over the exact date as payments are required at different times.

How Serious Is this Situation?

On a number of occasions Congress has seemed close to a resolution only to drift apart. Despite all this, the markets have remained fairly calm. The markets understand that the US fiscal situation is serious, but not critical, and not like the situation in Greece. There is enough economic horsepower in the US to deal with the level of debt, ultimately because the country's debt burden is significantly lower, interest rates are lower and growth is more dynamic, meaning that the country can grow its way to a sustainable debt burden more quickly than Greece can. Congress agrees that the US budget deficit needs to be smaller, and as stimulus expires the deficit is on track to be reduced; however, the budget is not yet anywhere close in a balanced position, and there is considerable disagreement on how to get there.

Why Is It Suddenly So Serious?

The level of debt in the US has been growing very quickly, so the limit has been hit more regularly. Normally, policymakers would be able to raise the limits and continue servicing debt; however, there has been some difficulty coming to an agreement because Congress is split and the Tea Party movement has extreme views on controlling debt and bringing down taxes. Ratings agencies have put US AAA rating on negative watch, and while there is a need to deal with broader fiscal issues, the debt situation in the US is not nearly as serious as the European sovereign debt issues.

What Would Happen If the Deadline Was Passed Without a Deal?

If the debt ceiling is not raised by August 2nd it would not constitute a default. Instead, the US would first scramble to find other sources of funds – possibly borrowing from government agencies or lending its gold stock, and then resort to selectively not paying certain bills for a few days, until political pressure mounted. Treasury makes approximately 80 million physical payments a month, and they would be short around \$130 billion for August. If an agreement is not reached, the U.S. Treasury will have to make some tough decisions on which bills will be paid. Debt and interest payments would still be made (avoid a default), but there could be some fancy footwork, including selective non-payment of some other obligations. This will put significant pressure on politicians and will likely lead to a deal in fairly short order. The chance of an outright default is very low, and would be very damaging.

What Would a Default Situation Look Like?

If the US were to default on its debt, the country's sovereign rating would be downgraded to junk. Yields would increase and some of this would be passed along to household and business borrowers. Moreover it would

severely hurt the US reputation. Given that many institutional investors can not hold junk debt, there would likely be a massive outflow, which would be very costly to global economy and markets. The U.S. dollar would continue to fall. The money market would be damaged, and so would the repo market. That said, a default situation would be temporary as Congress would be pressured to make a deal so the US could start paying its debt and borrowing again shortly thereafter.

How is Congress Split on the Decision?

Policymakers are having difficulty agreeing on how big of an austerity package is needed. Both parties agree that \$1.5-2 trillion in cuts are needed over 10 years, but the question is whether they can get that number up to \$4 trillion, and include some modest tax increases. The Tea Party and Republicans want the entire amount through spending cuts (and would like to introduce a balanced budget amendment), while the Democrats and some moderate Republicans are willing to increase taxes as well. Some members want spending cuts that are at least equal to the increase in the debt ceiling. Ultimately, it is highly probable that they will increase debt ceiling either by August 2nd or shortly thereafter. It is becoming less clear whether significant fiscal reform will accompany this. There is a risk the debt ceiling is merely punted down the road. Preferable would be an increase of at least \$1.7-2.4 trillion, which would get the Treasury past the November 2012 Presidential election.

Implications

Ultimately, this doesn't have to become an emergency. The issue should and most likely will be resolved in early to mid-August and market may breathe a sigh of relief thereafter. The impact on GDP really depends on how serious the measures are. In the event that the U.S. debt ceiling is lifted but the broader U.S. fiscal challenges are not addressed, the U.S. debt rating could suffer a slight downgrade which could bring with it modestly higher borrowing costs (likely no more than about 25 basis points). The good news is that the U.S. fiscal position can be fixed. So far, the market has shown some concern, but has not priced a significant risk of default into Treasuries. Reaching a deal, and putting this issue behind, could provide a much-needed boost to confidence – for markets, businesses and households.

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