# US fiscal policy Q&A

## Dancing on the ceiling

**9 October 2013**

### Update from the Economic and Market Research team at Colonial First State Global Asset Management.

### 1. What is the US Government shutdown?

The US Government began a partial shutdown for the first time in 17 years at midnight, on 1 October 2013. This happened after the US Congress failed to approve the US Budget before the fiscal year ended on 30 September 2013. As a result, parts of the US Federal Government have closed down due to a lack of funding.

Since 1976, there have been 17 US Federal Government shutdowns, the last and longest of which occurred in 1995/96 over a 21 day period.


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### 2. How did it come to this?

Each year, the US House of Representatives and Senate are expected to agree on 12 appropriations bills to fund US Federal Government agencies and set spending priorities.

Since the Republican Party gained control of the US House of Representatives in 2010, fighting between the Republican majority in the House and Democratic Party majority in the Senate have become commonplace. Despite Democrat President Barack Obama’s decisive re-election in November 2012, Republicans have taken their 2010 mid-term victory as a sign that Americans have concerns over the President’s healthcare agenda – known as the Patient Protection and Affordable Care Act, or ‘Obamacare’.

The Republicans see ‘Obamacare as increased government centralisation, as it represents the largest change in US social policy since Medicare was introduced in 1965.

In recent years, the US Congress has resorted to stop-gap US Budgets to keep the Government funded (known as ‘continuing resolutions’). The last stop-gap passed on 28 March 2013 ended on 30 September 2013 – hence the current partial shutdown.

### 3. Who is affected?

The laws and regulations governing government shutdowns separate US federal workers into ’essential’ and ’non-essential’.

The Office of Management and Budget issued orders for these 'non-essential' staff to shutdown at midnight on 1 October 2013. It is estimated that this affects around 800,000 of the total 2.1 million-strong US federal public service. Therefore, national parks, museums, federal buildings and services have been closed. 'Essential' non-civilian workers such as air-traffic controllers, active military personnel and border security guards have all continued to report for work and be paid.

The partial government shutdown has impacted a long list of federal agencies ranging from health, transport and tourism to immigration. Importantly, the US Social Security Administration will retain enough staff to make sure that welfare-related cheques continue to be posted to beneficiaries (at this stage). However the agency won't have enough employees to do things like help recipients replace their benefit cards or schedule new hearings for disability cases.

## 4. When will the Government shutdown end?

There has been little progress in the shutdown negotiations between Republicans and Democrats to date.

Before the shutdown, the Democrat Party-laden US Senate rejected a bill from the Republican Party majority in the US House of Representatives that would have funded the Government, but which included a one-year delay to President Obama's healthcare reforms – 'Obamacare'.

One potentially constructive step thus far is that the Republicans appear to be shifting their focus from delaying 'Obamacare' to entitlement reform and tax reform, which is considered more fertile ground for negotiations.

Last weekend, the House of Representatives guaranteed back-pay for federal workers and the US Department of Defence recalled around 400,000 furloughed (unpaid leave) employees.

Overall, US Congress needs to pass a bill (or bills) to fund the Government, and the White House has to sign them. They can do this at any time. Otherwise the US Government remains partially closed. Nothing requires them to do anything, though a prolonged shutdown will likely have negative political and economic consequences for the US and possibly the global economy.

## 5. What are the likely economic costs of a shutdown?

While it is difficult to quantify the exact impact of the shutdown on the US economy, the previous shutdown reduced real GDP growth by 0.3% in the December quarter of 1995. It is expected that a two week shutdown, which looks like being the base-case scenario, would have a similar impact. Some US-based economists estimate that a three week shutdown would detract an estimated 0.9% from GDP growth in the December quarter of 2013.

While the extent of the impact on the US economy will depend largely on the length of time that it takes the US Congress to reach a budget agreement, most concerns revolve around the spill over effects from the fiscal impasse.

While the likely delay is expected to have a fairly limited effect on the US economic recovery, concerns over the adverse consequences on consumer spending and confidence from a reduced paid workforce will increase as the stand-off continues. Therefore, the longer the political brinkmanship, the longer the delay in the pick-up in the US economic recovery, where some momentum has been gathering this year.

The other notable impact of the shutdown is on the release of US economic data, which is critical for the US Federal Reserve's determination of its monetary policy settings. Last week, the US Department of Labor failed to release its all-important September US employment report which is critical to the Federal Open Market Committee's (FOMC) decision making around its QE3 policy at its meeting on 29-30 October 2013. With insufficient data, the US Federal Reserve will most likely delay its decision regarding the 'tapering' of its asset purchase program further.

## 6. Is the Government shutdown the same as the debt ceiling?

No. They are two separate issues. However, the more significant concern for global financial markets is if the US Government shutdown spills over into the US debt ceiling debate in mid-October.

Critically, the US Congress will need to agree a deal to raise the US Government's $US16.7trn debt ceiling by 17 October 2013.

The debt ceiling is defined as the limit at which the US Government can borrow money to pay for its financial obligations (bills). More specifically, if the US Government 'hits' the debt ceiling then the US Treasury Department won't be able to borrow money to pay for spending that US Congress has already approved.

## 7. How is the debt ceiling / shutdown debate progressing so far?

At this point, Republicans in the House of Representatives are working on a proposal that would tie raising the debt ceiling and government funding to other party priorities. This 'wish-list' of Budget concessions includes tax reform, entitlement savings and potentially the repeal of the medical device tax which forms part of the funding for 'Obamacare'.

Clearly, conservative Republicans (known as the 'Tea Party') will need to extract some concessions given their posturing with Republican House Speaker Mr John Boehner's tenure likely to be dependent on this outcome. Also at stake politically are the US mid-term elections due on 4 November 2014.

At this stage, President Obama is unwilling to give the Republicans any concessions on his legacy-leaving healthcare reform. Therefore, the shutdown and debt ceiling brinkmanship is likely to continue all the way up to the debt ceiling deadline next week.

## 8. Could the US default?

While this is not the base-case scenario at this stage, if the US Congress does not raise the debt ceiling by 17 October 2013, the US Federal Government will have to delay payment on some of its obligations, possibly including payments to bond holders or social security pay-outs.

The US Treasury would be unable to increase net debt outstanding. As a consequence of restricted borrowing, US Treasury would run out of funds shortly after the 17 October 2013.

In the event of a technical inability to repay its obligations, the first key date would be 31 October 2013, when the Treasury would be unable to make its first interest (coupon) payment of $US6bn on US Treasury securities – providing that it doesn't prioritise payments for bondholders.

This outcome would trigger a likely US sovereign one-notch downgrade by credit ratings agencies immediately: Moody's to Aa1 or Aa2; S&P to selective default then AA; and Fitch to AA+.

A further $US30bn coupon payment is then due on 15 November 2013. There is also $US67bn of social security payments which could be delayed on 1 November 2013.

## 9. How would financial markets likely react?

Market speculation that a technical default by the US Government could lead to a bigger financial and economic crisis than the collapse of Lehman Brothers seems a little overdone in our view.

The crucial difference is that the US Government would still be a going concern, with all the tax and spending powers of a sovereign state. Once the US politicians reach a deal, it is more than likely that the US can return to servicing its debts as usual. Moreover, unlike the Lehman crisis, global policy makers and market participants still have some time to prepare for a potential US default.

Notwithstanding this, a technical US default would likely trigger big disruptions and heightened volatility in the financial markets — or a long-term rise in borrowing costs and risks around the treatment of US Treasuries as collateral held against derivative exposures.

Possible financial market outcomes:

| Asset class | Market direction | Outcome |
|---|---|---|
| **Equities** | Shares decline | Volatility increases and flight from risk |
| **Bonds** | Yields decline | If US Treasury prioritises bond holders – assuming interest paid – 'flight to safety' |
| | Yields increase | If US Treasury does not prioritise bond holders |
| **US dollar** | Initial decline | Declines immediately but could soon increase in a 'flight to safety' |
| **Gold** | Increase | Benefits from its 'safe haven' status |

Source: CFSGAM

Overall, while we continue to think that default will most likely be avoided, a prolonged period of US political uncertainty would clearly be negative for the global economy and for the prices of risk assets.

## Want more information?

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