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ECONOMIC RESEARCH DEPARTMENT

US: Chronicle of the last minutes

- Once again, the debt ceiling had become a threat. The Treasury estimated that by Monday 2 November it would have exhausted the exceptional cash management measures which, since March, had allowed it to meet the obligations of the federal government without issuing debt.
- Months of fruitless negotiations finally gave way to an agreement, coming, yet again, at the eleventh hour.
- The agreement – reached between members of Congress and President Obama – was approved by the House and will soon be reaching the Senate floor. It would allow a new suspension of the debt ceiling until March 2017.
- The agreement would also allow a relaxation, over the short term, of spending limits, without any substantial change on the medium-term fiscal outlook.

From one crisis to the next

Although it received less media coverage than the FOMC meeting or the release of advance estimates of third quarter GDP, the budget agreement reached between President Obama and Congress this week was particularly welcome. Once again, the debt ceiling had become a real threat. In August 2011, the difficulty in reaching an agreement, which was finally resolved at the last minute, led the ratings agency Standard & Poor's to downgrade the sovereign rating by one notch (from AAA to A+). As everyone now knows, the US federal debt is subject to a limit[1]. Previously, this ceiling had generally been raised as needed without further debate. In 2011, the raising of the debt ceiling hit a snag, particularly in the House of Representatives. Some members of the US lower house made their approval of a higher debt ceiling conditional on a reduction in the future deficits. This incident was not the first of its kind[2] but was more worrying than its predecessors, as this time it was the very ability of the federal government to meet its obligations (maturing debt, pensions, civil servants' pay, etc.) that was held to ransom.

[1]Only part of federal debt: that held in the form of negotiable securities by the public, and that held, in the form of non-negotiable securities, by government agencies such as the Social Security trust fund, Medicare and so on.

[2]Earlier in 2011, no fewer than four resolutions were required to ensure the financing of the federal government and thus avoid a shut-down, which would have closed non-essential government services.

The cost of discord

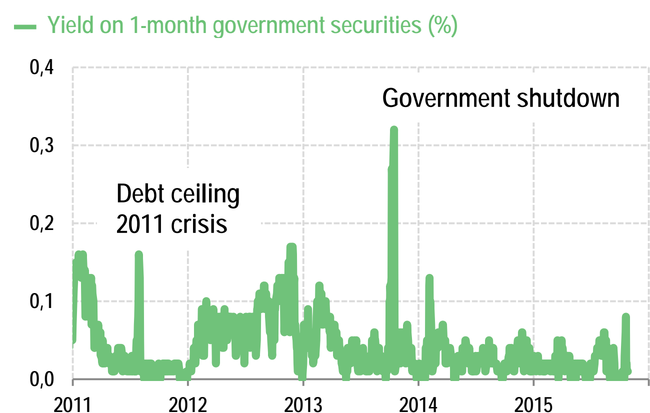

Figure 1 Source: Federal Reserve

The crisis resulted in an agreement which, just, avoided a default by the federal government. Working out whether or not this was a happy ending is a bit more complicated. Uncertainty over the outcome of this episode caused a violent increase in yields on short-term government debt (Figure 1) and the Treasury was forced to modify its issuance calendar. According to the Government Accountability Office (GAO) the cost to the public purse was USD 1.3 billion. In addition, the 2011 Budget Control Act, which enabled the raising of the debt ceiling, was also the piece of law that eventually resulted in the introduction of the Sequester[3]. In the absence of a fresh agreement with Congress, this measure required automatic and widespread reductions in federal government spending from March 2013. These spending reductions are to run until the 2021 fiscal year, and have the effect of limiting economic growth. The Congressional Budget Office (CBO) estimated in last August that the removal of these spending caps would add 0.4% to GDP in 2016 and 0.2% in 2017, allowing the creation of respectively 500,000 and 300,000 additional jobs, without having negative long-term effects on the public finances.

[3]See in particular "How many As for America?", Alexandra Estiot, Conjoncture, BNP Paribas, February 2012.

However, the introduction of these spending caps was not the most serious of the decisions 2013 events, the year that began with an agreement that avoided only part of the Fiscal Cliff'[4] (and resulted in a fall of nearly 4% in households' disposable income in the first quarter of 2013) and saw the government shut down over the first sixteen days of October. This shutdown was, yet again, the result of the failure of Congress and the White House to find agreement. This time, as well as a further increase in the debt ceiling, the disagreement related to approval of the appropriation laws allowing the federal government to function[5], something that some Congressmen wanted to make conditional on a delay in the introduction of Obamacare and a review of the Dodd-Frank Act. The cost for the US economy was substantial, at around USD 6 billion (or USD 24 billion, 0.6% of GDP, in annualised terms) with the resulting loss of jobs estimated at 120,000.

In recent years, the need for Congress to make regular authorisations to raise the debt ceiling has been a source of uncertainty that has had particularly deleterious effects on the economy. Several attempts have been have been made to eliminate this step, which is rendered superfluous by the fact that Congress already votes to approve the budget and appropriation credits, and thus controls both the income and spending of the government, and therefore its funding requirements. On several occasions the debt ceiling has been suspended[6]. However, proposals for a permanent suspension (whether total or partial) of the ceiling have all failed. The most recent (the Default Prevention Act) was approved by Republicans in Congress, but is unlikely to be passed by the Senate where the Democrats hold the majority: for the time being the Senate has no plans to consider the Act. On top of that, President Obama has already stated that he would veto it. The Act would authorise the Treasury to issue debt above the ceiling in order to cover payments of principal and interest to service the debt held by the public and certain government agencies[7]. Creditors would be protected but not pensioners, civil servants (including members of the armed forces) or companies working on government contracts. The plan was therefore described by the Treasury as the 'default that dare not speak its name'.

[4]Temporary cuts in income tax and social security contributions (amongst other things) were programmed to end on 1 January 2013. It was therefore the job of Congress to avoid the Fiscal Cliff, which the CBO estimated would have trimmed 4 percentage points off annual GDP. The agreement, reached at the customary eleventh hour, reduced the size of the cliff, without eliminating it completely. In particular the payroll tax rate was restored to its previous level, an increase of 2 percentage points. See "A new deal for a new dream", Alexandra Estiot, Conjoncture, BNP Paribas, December 2012.

[5]The budget process is particularly long and complex. See "The US federal budget: no more time for compromise", Alexandra Estiot, EcoWeek, BNP Paribas, 7 March 2014.

[6]On a first occasion between 4 February and 18 May 2013, a second between 17 October 2013 and 7 February 2014 and the most recent occasion between 12 February 2014 and 15 March 2015. It has been since this date, and the re-introduction of the debt ceiling, that the US Treasury has once again used extraordinary cash management measures to fund spending without increasing its debt issuance. With the ability to use these measures now reaching its end, the Treasury was obliged, this week, to postpone its auction of 2-year notes.

[7]The Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund are the two Social Security reserve funds.

The Temporary Debt Limit Extension Act of early 2014 suspended until 15 March 2015 the validity of the debt ceiling, which was then automatically raised by the amounts issued by the Treasury during the grace period. On 16 March 2015, the ceiling was therefore set at USD 18,113 billion. In the absence of any agreement, the limit remained the same, and in order not to exceed it, the Treasury has been managing its cash so as to honour its obligations without further borrowing. From 2 November the Treasury believed that these "extraordinary measures" would no longer be up to the task. Yet again, a number of republicans in the House did not want to consider a bill that would only increase the debt ceiling, seeking to add further spending cuts to the package.

The agreement

The Bipartisan Budget Act of 2015, passed yesterday by the House, includes a USD 80 billion relaxation in spending limits (of which USD 50 billion is allocated to the current fiscal year, running to 30 September 2016) and the release of additional funds (USD 16 billion for the current year, USD 15 billion for the following year). There is also a measure aimed at avoiding an increase in the premiums paid by beneficiaries of Part B of Medicare (which cumulative increase had been estimated at 50% over the next few years)[8]. This additional spending will be financed by a reform of Disability Insurance, an extension (from 2021 to 2025) in the cap on Medicare spending and by the sale of a part of the strategic oil reserve. Overall, the CBO estimates that the plan will only marginally increase the cumulative deficit over ten years (by less than USD 1 billion or 0.01% of current GDP). This small price should be compared to the expected benefits. On the basis of the CBO's work, the White House believes that the plan will add 0.3 point of percentage to GDP growth in 2016 and will allow the creation of 500,000 jobs over two years. Lastly, the debt ceiling will be once more suspended, this time until 15 March 2017, subject to the usual checks and balances (borrowing must relate to spending and not the creation of a cash reserve).

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[8]Part B (Medical Insurance) is an optional feature for which recipients pay a premium. It covers a share of costs which are not covered under Part A (Hospital Insurance) which covers all residents (of more than 5 years' standing) aged over 65. Medicare also has other two options: Part C (Medicare Advantage) and Part D (Prescription Drugs), both of which allow beneficiaries to pay additional premiums for more extensive health cover.

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