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Debt Ceiling Update: No Near-Term Deal Maker

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- If partisan gridlock drives concern about resolving the so-called fiscal cliff, then it should similarly raise concern as U.S. borrowing closes in on the Federal debt ceiling, likely around the start of the new year.

- It is widely understood that the U.S. Treasury could delay the need for imminent action for a few months once the debt ceiling is hit. It could then avoid debt default even if the ceiling is *not* raised, but not without cuts of over 40% to Federal spending – a roughly 8% static drag on U.S. GDP – mitigated only by potential tax revenue increases from the "cliff."

- The catastrophe that an *unresolved* debt ceiling would represent drives the widespread assumption that a bipartisan deal to raise it will once again be made. So if this is the case, then other fiscal agreements would seem more plausible too. Amid continued if somewhat diminished concerns that the fiscal cliff will be *allowed* to occur, resolving the debt ceiling by late in 1Q 2013 would seem a reasonable deadline for reversing or mitigating "cliff" impact.

- The likelihood of a deal to avoid the fiscal cliff in late 2012 (to allow for wider agreements next year) remains unclear and depends on full Presidential and Congressional election results. We continue to expect such action, but also believe that a failure to address the cliff before year end would result in considerable financial market turmoil in all but some special circumstances.

- Like two cases within the past few years, policymakers who would prefer *not* to act could be swayed by markets and other public pressures.

Could Catalyze Action, But Only Post 2012

It is strongly believed by observers of Washington D.C. politics that in a number of election scenarios, political forces may favor going over the so-called fiscal cliff, at least temporarily.[1] In the view of some policymakers, the higher tax revenues under current law could finance existing spending programs for a longer period regardless of near-term economic impact. For others, a partisan sweep in November would allow the newly dominant party to reshape tax and spending policy without significant input from the other side. Amid historically large tax increases on January 1, this might even be a *tactical preference* among those wishing to see no tax increases at all.

As such, a powerful election sweep by either side, while unlikely, might raise the probability that either party eschews compromise in the post-election "lame duck" session. In the view of some, a preference for the victors to take control of the new Congress in January - after the cliff has been breached - might also come with *even more limited* cooperation from the opposition in the final two months of 2012.

Eventual bi-partisan compromise on fiscal policy is likely, but market pressure may be a pre-requisite to trigger action.

But exigencies can change the plans of U.S. policymakers. As a somewhat smaller fiscal cliff was hit two years ago, a deal was struck to extend current tax rates. A deal to increase the U.S. debt ceiling in mid 2011 was more difficult, but ultimately reached. Like the passage of legislation associated with the Troubled Asset Relief Program (TARP), financial market turmoil may be a *pre-requisite* to trigger action.

A very credible promise (such as one backed by sizeable majorities in Congress) to quickly erase "cliff impact" could leave expectations for U.S. economic recovery intact, even without immediate action in 2012. However, a clear gridlock or less credible promise of action could leave U.S. equity markets to suffer a plausible 10% correction as a "down payment" for more severe weakening that would come amid an actual U.S. economic contraction in 2013.[2] As we've discussed previously, expectations alone are unlikely to account for the weight of the immediate tax increases and spending cuts near 4% of GDP.[3]

While we have made no assumption that the entirety of the fiscal cliff will hit, uncertainty around the issue plays a role in the sequential growth slowing we expect in 4Q 2012. (We expect a real GDP gain of 1.9% versus 2.2% in 3Q). A further slowing to a 1.0% real GDP gain in 1Q 2013 is driven largely by a rise in the payroll tax assumed in our forecast. But policy uncertainty itself seems to be having at least a mild limiting affect on business expansion and hiring plans already.

Update: No Debt Ceiling Crisis Ahead of Cliff Deadline

As an update to our report "Daylight on the Debt Ceiling," March 26, 2012, we consider the possibility that hitting the statutory debt limit and exhausting resources to delay required action works as a catalyst for Congress to reach *other* fiscal agreements, including steps to mitigate the fiscal cliff. However, the most likely course remains one in which the statutory debt ceiling is reached around the turn of the year, and various delaying tactics would only force an increase by late in the first quarter 2013.

[1] Please see Global Political Insights, September 12, 2012, Tina Fordham and Matt Dabrowski.

[2] 10% was the average decline in the S&P 500 over the one month period ahead of passage of the Emergency Economic Stabilization Act of 2008 (TARP legislation) and the passage of the Budget Control Act of 2011, which authorized an increase in the debt ceiling, among other measures. In both of these recent cases, the threat of inaction loomed, and despite passage, some lingering negative impact was felt in the period that followed.

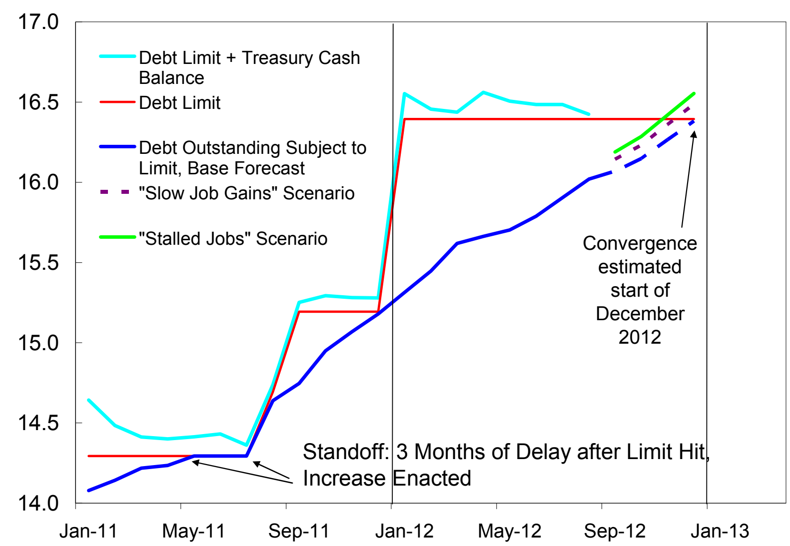
[3] Please see our June 11 report "Taking the Toll: Policy Uncertainty vs. Actual Shocks."

Increases in U.S. debt this year subject to the debt ceiling have been slightly smaller than we estimated in March. In August, debt subject to the statutory maximum was $11 billion below our March projection, an insignificant difference, but one that continued to suggests no pre-election timetable for hitting the debt ceiling (see figure 1).

The most timely data suggest the debt ceiling won't be hit until early January, with delaying maneuvers in place through 1Q.

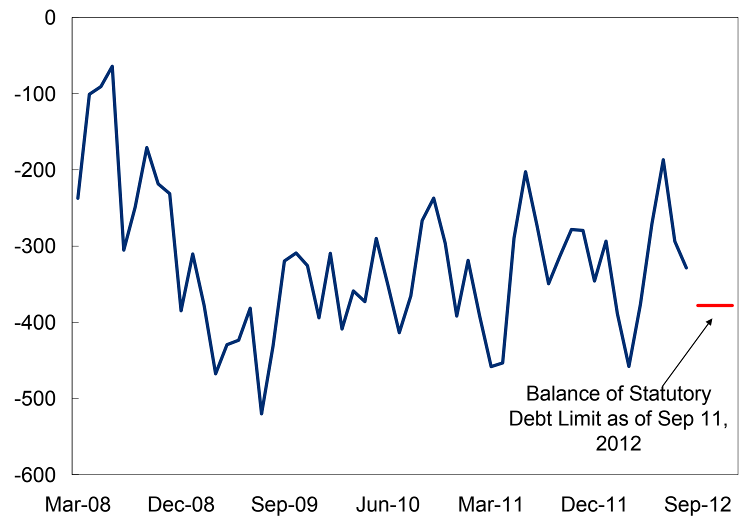
More timely data than available in March suggest a sub-$300 billion federal deficit in 4Q. With debt $378 billion below the ceiling as of mid September, the data now suggests the limit will not be hit until January (see figure 2). Special delaying tactics such as running down the Treasury cash balance and suspending the issuance of special purpose securities to state and local governments (among other unusual steps) would likely force Congressional action late into the first quarter 2013 or very early in 2Q.

Figure 1. U.S. Debt Limit and Federal Debt Outstanding Subject to Debt Limit, Forecasts, $Tln



Source: U.S. Treasury, Citi Research

Figure 2. U.S. On-Budget Deficit, 3-Month Sum through Aug. 2012 ($Bln) vs. Unused Debt Ceiling Capacity*



Source: U.S. Treasury Citi Research *shown with a negative sign for comparison to 3-month deficit

As noted, there remains no immediate threat of hitting the debt ceiling, which will most likely require some level of bi-partisan cooperation to overcome. It should be remembered and understood though, that lasting *inaction* on the debt ceiling could generate even larger negative effects than inaction on the "sunset" of marginal tax rates and the imposition of new spending controls in 2013 (the so-called fiscal cliff).

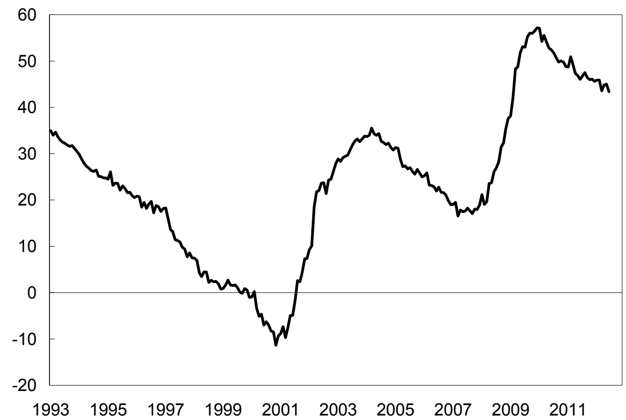
As figure 3 shows, 43.4% of current federal *non-interest* spending was still deficit financed as of July, despite a 7.1% rise in "on-budget revenues and slower 2.7% rise in spending over the past 12-months. Under highly unusual circumstances in which the Treasury would avoid a catastrophic default on U.S. debt by prioritizing interest payments - but balancing the federal budget immediately - the fiscal drag would approach 8% of GDP, and like the cliff, would occur very quickly.

At mid 2012, more than 40% of U.S. Treasury outlays (ex-interest payments) were still deficit financed, a huge and painful gap to hypothetically close quickly.

Such a debt prioritization would conceivably pit cuts in military pay, social security, and Medicare payments against most other federal outlays, some of which cannot be cut to zero without breaking other legal contracts. Such a course in isolation would significantly outstrip the restraint of the fiscal cliff shown in figure 4[4]

[4] If the existing debt ceiling is a binding spending constraint, it would interact with the fiscal cliff in some ways. It would not in anyway prevent the tax increases of the fiscal cliff, but the tax increases would limit the severity of the spending restraint to the extent that it effectively raises revenues.

Figure 3. U.S. Share (%) of Primary (Non-Interest) Federal Spending Deficit Financed



Source: U.S. Treasury, Citi Research

Figure 4. Select Expiring Fiscal Stimulus Measures and other Fiscal Changes, Jan 2013

	Billions of Dollars	**Percent of** GDP
Bush Tax Cuts — Top Two Tax Brackets	$55	0.4%
Bush Tax Cuts — Other Measures	195	1.3
2% Payroll Tax Cut	110	0.7
3.8% Medicare Tax on Investment Income	20	0.1
BCA Sequester	95	0.6
Total Fiscal Contraction	$475	3.1%
Impact w/o AMT relief	$580	3.8%

Source: Citi Research

The size of the debt ceiling is linked to any fiscal agreements. If tardy, fiscal agreement could come amid the pressure to act on the debt ceiling.

As debt increases, so must the debt ceiling. If such action is required near the end of 1Q 2013, then it suggests other deliberate actions on the fiscal front can be made as well. It may seem an inconvenience that the debt ceiling will most likely *not* serve as a catalyst to spur a decision on the fiscal cliff in 2012, ahead of any lasting damage that even a temporary (if severe) fiscal tightening might cause. But the likelihood of a debt ceiling agreement near the start of 2Q 2013 reduces the probability that gridlock keeps the entirety of the fiscal cliff in place through all of next year.

Appendix A-1

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