Debt-ceiling crisis a core risk to credit ratings of US government

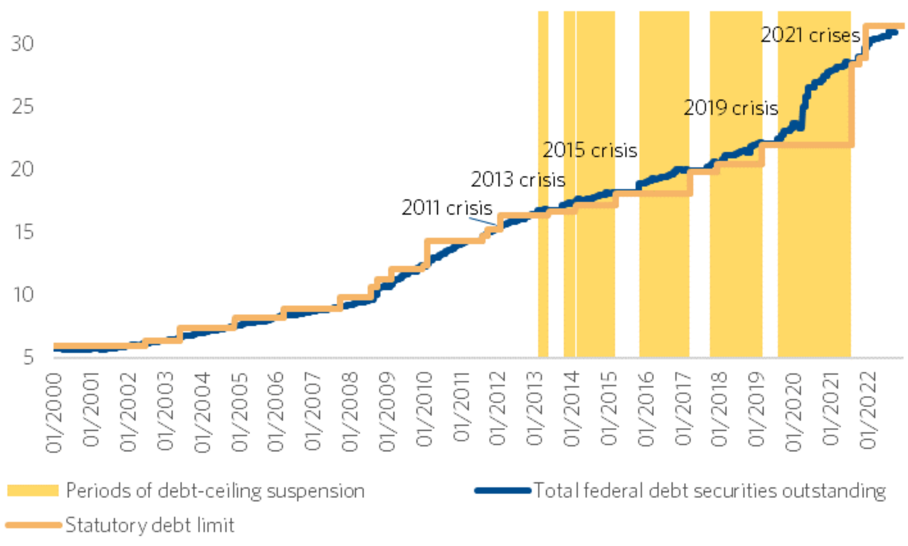
Debt-ceiling crises are a challenge to the AA sovereign credit ratings of the US government. Risks are more pronounced than at any stage since 2011 given heightened political polarisation alongside outstanding fiscal imbalances. Even a last-minute avoidance of technical default could have meaningful consequences for the creditworthiness of the US.

The US Treasury reached its debt limit of USD 31.4trn (**Figure 1**) on 19 January, prompting the Treasury to adopt a set of extraordinary measures, such as deferring federal pension investments.

Scope Ratings has expressed the view that the debt ceiling represents the most meaningful near- to medium-term downside risk for the AA credit ratings of the US government. Since we first published sovereign ratings on the United States in 2017, we have never rated the United States as a AAA, risk-free borrower.

Risk to the ratings from the debt ceiling are more pronounced than ever before in an age of heightened political polarisation alongside more elevated deficits after recent economic crises. Substantive spending obligations cut the time and space the government has to resolve debt-ceiling crises. We estimate the US general government deficit at a meaningful 5.4% of GDP during this year.

Figure 1: Federal debt
USD trn



Source: Congressional Budget Office, US Department of Treasury, Congressional Research Service, Scope Ratings

Our baseline scenario is for the federal government to raise the debt ceiling at the 11th hour after agreement around some form of spending-curtailment programme. Congressional Republicans may not have enough to gain from allowing specific drop-dead deadlines to pass as the political leverage the debt limit provides may evaporate the moment Social Security payments are delayed.

Unlike what most coverage of the debt-ceiling crisis consistently appears to argue, the United States *has* missed payments on federal debt before. The most recent example (and only example of the post-war era) of technical default was in 1979 due partially to partisan misuse of the debt limit. So, markets should not automatically assume that debt-limit stand-offs are *inevitably* resolved in the nick of time.

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Debt-ceiling crises are most perilous when a Democrat President faces a divided Congress

In 2021, Scope postulated that a significant debt-ceiling crisis might occur after 2022 congressional elections after which a fraught bipartisan solution becomes compulsory to resolve the ceiling, unlike party-line congressional votes concluding 2021 crises. Our view concluded debt-ceiling crises as being most perilous when a Democrat President faces a divided Congress such as we have today. Political brinkmanship for securing political advantage heightens during such phases of divided government ahead of imminent elections.

Crisis most similar to today's was 2011

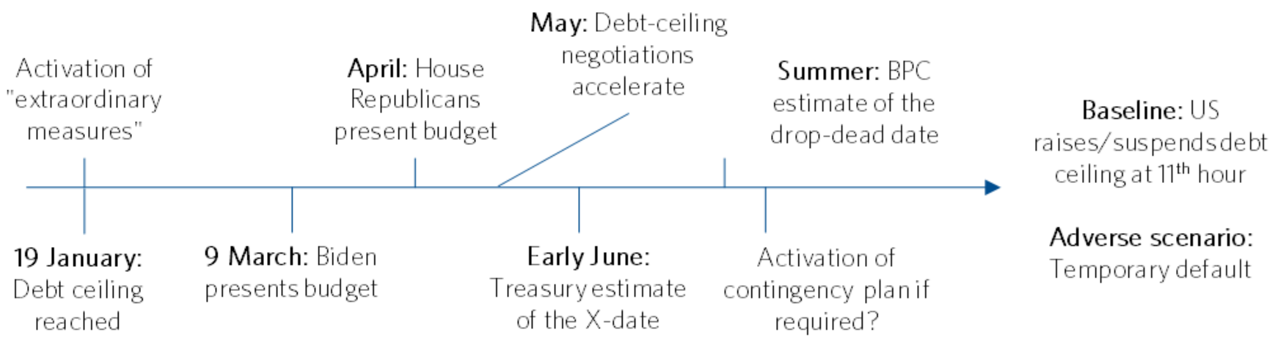
The current episode is similar to 2011, when Democrat President Barack Obama faced a Republican House of Representatives stipulating spending reductions. Extraordinary measures were depleted and debt default loomed within two days before the debt ceiling was hiked.

Contingency plans could temporarily prevent default even if a forthcoming "X-date" were exceeded

X-date by around the summer of this year

In the current episode, the government estimates an "X-date" – the date on which Treasury faces a decision of either delaying payments for its activities or defaulting on debt obligations – as early as June (although the Bipartisan Policy Center, BPC, estimates Q3 2023) – **Figure 2**. Regardless of the specific date, if Treasury, in unprecedented fashion, exceeds the X-date, technical default becomes more probable even if it were to remain not a baseline scenario.

Figure 2: Debt-ceiling crisis timetable (2023)



Source: Scope Ratings

A contingency plan is likely to be activated if the X-date were crossed

In 2011, the Treasury pulled together a contingency plan for stemming short-run default should an X-date be exceeded. This plan reflected, were it ever called upon, payment delays to agencies, contractors, Social Security beneficiaries, and Medicare providers to maintain continuing service to holders of treasury securities. We assume such a contingent strategy for a worst-case scenario, effectively shutting down part of government to service debt, is potentially on the table of the Joseph R. Biden administration should need arise.

Nevertheless, any such unprecedented delay of payments for non-debt federal obligations and a furlough of federal employees would provoke significant legal challenges questioning any such preferential treatment of securities holders. The Treasury will be exceptionally keen to avoid the high uncertainty involved in such scenarios.

Baseline scenario is for the debt ceiling to be raised or suspended at the last minute

Our baseline scenario is for the federal government to raise or suspend the debt ceiling at the 11th hour after agreement around some form of spending-curtailment programme. Nevertheless, risk around this debt-ceiling crisis is the highest it has been in a decade.

Debt-ceiling crises and non-negligible possibility of non-repayment weigh on ratings

The frequency of debt-ceiling stand-offs alongside a recurring, non-negligible possibility of temporary non-repayment during specific and severe episodes weigh on the credit ratings of the United States. Such non-repayment could come via a so-called 'accidental' credit event after a miscalculation of the consequences of brinkmanship and the duration of political processes.

No sovereign rated AA by Scope aside from the United States experiences such frequent crises during which default is a real scenario barring last-minute legislative action. And none in the AA category, aside from the United States, has experienced a credit event since the end of the Second World War. Under Scope's sovereign rating methodology, any technical default would be evaluated via a 'selective default' rating.

Mitigating factors of debt crises and even of a technical-default scenario

Cost of debt-ceiling crises manageable so long as default is side-stepped

Nevertheless, other factors mitigate the ultimate cost of debt-ceiling crises if default is side-stepped. A halt in Treasury issuance during debt-limit crises reduces treasury yields. Although debt-ceiling crises may raise borrowing costs long run, global safe-haven flows during peaks of debt-ceiling crises ironically drive inflows to treasuries in the short run, even if this undermines current Federal Reserve objectives of quantitative tightening.

The US presumably might receive special treatment even under a default scenario

Even under a non-baseline scenario of technical default, the US would presumably receive significant special treatment. When sovereigns default, this is usually because of a severe lack of capacity to pay due to structural liquidity and/or solvency limitations. In the case of the United States, the capacity and the willingness to pay exist. The problem is a problematic political process and governance challenges.

The fact that any default event for the US would probably be temporary and would present minimal nominal losses for investors in the long run means the repercussions of default would likely prove much more benign than that experienced by other sovereigns concerning effects for market access, borrowing rates, and financial stability. The Federal Reserve would step in to prevent substantive financial panic in an event of a technical default, suspending or adjusting its collateral regulations. A 'real default' of the United States, under a traditional sense of the term – involving much more substantive credit losses, remains highly unlikely.

Resolution of this debt-ceiling crisis anything but easy

But resolving this current crisis will prove anything but easy. The House Rules Committee controls whether legislation around the debt ceiling goes to a vote and a single House Republican lawmaker can start a process for the House Speaker's removal due to an agreement he co-signed. This may delay resolution of the crisis even after a suspension or raising of the debt ceiling already holds a majority in the House.

Concepts such as Treasury minting a collectible trillion-dollar platinum coin and depositing this at the Federal Reserve for cash and/or a proposal to invoke the 14th Constitutional amendment are unlikely to be considered seriously except under worst-case scenarios. A rare parliamentary manoeuvre labelled a "discharge petition" to force a vote around raising the debt ceiling might be overly long and complicated for the narrow spaces of time available in severe crisis.

At this stage, debt and spending negotiations only starting

At this stage, negotiations are only beginning. The White House has said it would release a budget proposal on 9 March. House Republicans aim to produce their own draft by April.

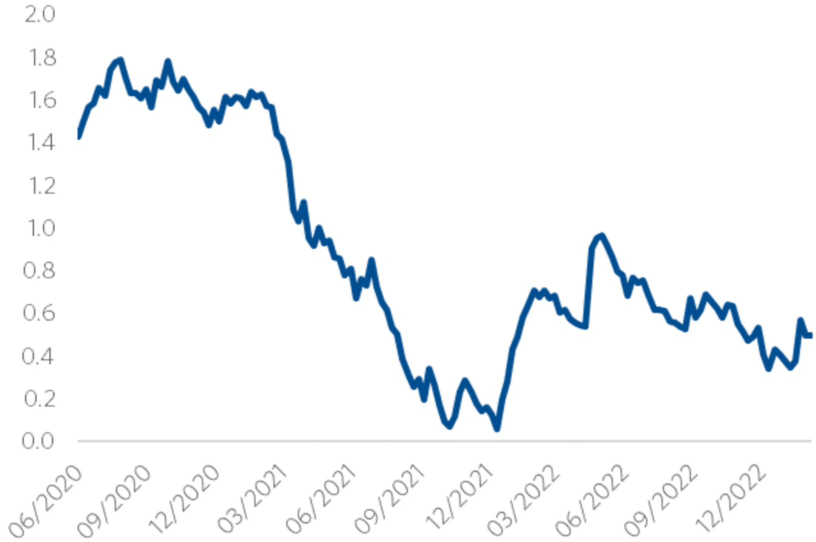
House Republicans indicated last week such a draft may propose hundreds of billions of dollars in spending reductions to Social Security and Medicare, ending fraud in food stamps, cancelling USD 100bn of unspent coronavirus funds, cutting green energy programmes and legal assistance for asylum seekers, capping Obamacare subsidies at lower income levels as well as recension of a student loan forgiveness programme. While there are some areas of possible common ground, many such proposals are likely to meet fierce Democratic opposition.

The cash balance to be drawn down over the coming months

The US Treasury holds around USD 496bn in cash at the Federal Reserve (**Figure 3**). This will be run down over the coming months, potentially re-approaching a low of USD 58bn last seen during peaks of the previous debt-ceiling episode of late 2021. This cash balance represents a core monitoring metric as Treasury acts to preserve the full faith and credit of the US in the coming period.

Figure 3: US Department of the Treasury deposits at the Federal Reserve, General Account

USD trn



Source: Federal Reserve, Scope Ratings

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