Continuing Resolutions and Debt Ceilings: an observer's guide to US fiscal policy

There is a growing risk of a federal government shutdown and debt ceiling dispute in the United States. As we have seen in the past, these events can be disruptive to markets and have real consequences.

Following a lengthy period of political squabbling over the debt ceiling in 2011, the rating agency S&P delivered its first ever downgrade to US sovereign debt stating:

> *"…the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned…"*

Unfortunately, nothing much has changed since then.

In late 2018/early 2019 a one-month federal government shutdown is estimated to have subtracted 0.3% from GDP over the period, according to the Congressional Budget Office.

Right now, there are two key deadlines fast approaching. Firstly, US federal government funding is scheduled to run out on September 30th if Congress can't agree a Budget for the next fiscal year. If a Budget isn't agreed, Congress needs to pass a Continuing Resolution (CR) before then to avoid a federal government shutdown.

Secondly, some time in late October or early November (its hard to be precise), the US Treasury will no longer have sufficient cash to meet the financial obligations of the federal government.

Since the expiration of a 2019 two-year deal to suspend the debt ceiling at the end of July, the Treasury has been using extraordinary measures and cash on hand to remain compliant with the debt ceiling, but they are fast running out of options. The risk here is default.

The Budget background

At the heart of the budget issue is the passing of President Biden's American Jobs Plan and American Families Plan.

The bulk of the infrastructure portion of the Jobs Plan has been carved out as US$1 trillion bi-partisan deal that was passed by the Senate in August and is expected to be passed by the House of Representatives.

The Democrats have opted for the budget reconciliation process for the more politically challenging US$3.5 trillion social spending and tax credits aspects of their agenda. Budget reconciliation means a Bill doesn't require the usual 60-40 vote majority in the Senate but can pass with a simple 51 vote majority.

The problem for Biden is that while the Democrats hold majorities in both the Senate and the House, those majorities are slim, and some moderate Democratic members have signaled that they are uncomfortable with the proposed $3.5 trillion of new spending/tax credits and a similarly sized amount of offsetting tax increases. Other members of the Democratic caucus have argued the opposite and appear vigorously opposed to scaling back the current proposal.

Late on Tuesday (US time) the House of Representatives

passed a bill to avert an October shutdown and extend the debt ceiling until December 2022. Voting took place on strict party lines, with 220 Democrats in favour and 211 Republicans opposing the bill, indicating potential Democrat hold-outs conceded to the greater interest. However, whether Republicans and even some Democrats at the Senate approval stage will be pragmatic remains to be seen. Expect late-night wrangling full of trade-offs and "pork-barrel" bribes as the Administration pushes for a resolution and the clock ticks louder in coming days.

The politics

The starting point assumption is that neither party wants to be blamed for the chaos of a full government shutdown.

For their part, the Republicans would prefer a CR that is free of amendments or commitments to Democrat partisan policies. But they don't want to help the Democrats raise or suspend the more important debt ceiling.

Republicans would prefer there to be a direct link to the US$3.5 trillion social policy bill that is now being drafted under reconciliation rules to avoid the prospect of a Republican filibuster. That way the Republicans avoid accusations of agreeing to "wasteful" spending in upcoming mid-term elections in a little over 12-months' time.

The Democrats would prefer a link between a debt ceiling increase and the government funding bill to blame the Republicans for all ensuing chaos if they opt to filibuster.

We've seen it before, and it will be fraught

This sort of political brinksmanship never paints the American democratic process in a particularly favourable light. It just looks childish and irresponsible.

Previous episodes have resulted in considerable market volatility, lower business and consumer confidence and, as mentioned above, even a credit rating downgrade.

Such market volatility and economic uncertainty are a potential source of economic policy uncertainty and would come on top of all the recent Covid challenges. This would be difficult for the Federal Reserve as it contemplates tapering decisions over the next few months.

Janet Yellen, Former Fed Chair and now President Biden's Treasury Secretary, has warned in strong terms of the need for an enduring solution to the debt ceiling squabble cycle, and stressed the critical need for an urgent agreement. This raises the unorthodox possibility that the administration may be able to engineer a new model for its borrowing and cash flow requirements, given time. However, for the present occasion, time is almost up.