CAPITAL MARKETS ECONOMICS

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Special Report: Temporary Ways Of Getting Around The US Debt Ceiling

- **While a number of policy options could be hypothetically invoked after Treasury's extra-ordinary measures are exhausted, none are sustainable and all carry significant risks.**

US Treasury Secretary Jack Lew has guided markets toward this Thursday, October 17th, as a hard deadline when Treasury will have exhausted its extraordinary measures and butts up against the debt ceiling. (See this link to Mary Webb's *Fiscal Pulse* report, October 4, 2013). The risk of default if no compromise emerges is likely not immediate for two main reasons.

For one thing, the remaining cash on hand (estimated by Treasury at US$30 billion as of October 17th) and how long it might last remain a source of conjecture, subject to daily events. However, significant payments due in late October and the first half of November likely limit the grace period before the debt ceiling becomes binding (see table). There are also minor savings associated with the partial government shutdown.

There are also several possible options at the disposal of the US Treasury and President Obama's administration for sidestepping the debt ceiling. Each carries strong caveats and is hardly ideal, but emergency powers may well be able to postpone default risk. Exploring these powers goes beyond assessing the likelihood that an agreement will be passed in both the House of Representatives and the Senate. The context of the negotiations is fluid and difficult to evaluate, but out point in this paper is to briefly review what we think are the options to avert default.

1. Payments prioritization.

This is an option that has been proposed by the Republicans but to date refused by the Administration, which could have many variations. For example, payments due to entities with ample liquidity could be replaced with paper "iou's" alongside the federal government's commitment to reimburse with interest after the ceiling is raised. For example, in a "debt issuance suspension period," the US Treasury defers the interest payments owing on government securities held in the Civil Service Retirement and Disability Fund and the Postal Service Retiree Health Benefits Fund, with a promise to make these Funds "whole" after the crisis. While interest on the federal debt is paid out through a separate computer system, other federal payments also are computerized and the automated system of disbursements was never designed to accommodate prioritizing outflows. Thus, this is but the first of several untested options that would place the US Treasury into uncharted waters.

Difficult Budget Calendar

Interest Payments:		USD, Bns
Oct. 31	Interest	6
Nov. 15	Interest	30
	Total	***36***
Other Major Outlays		
Oct. 16	Social Security	12
Oct. 23	Social Security	12
Nov. 1	Social Security, Medicare, Military, Various Other Benefits	67
Nov. 13	Social Security	12
	Total	***103***
Total Receipts Oct. 2012		*184*
Total Non-Interest Outlays, Oct. 2012		*280*
Total Receipts Nov. 2012		*162*
Total Non-Interest Outlays Nov. 2012		*310*

Source: CBO, Treasury, Scotiabank Economics

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2. The President could invoke Section 4 of the 14th Amendment.

This was adopted in 1868 and says: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellions, shall not be questioned." The original intent of the 14th Amendment was to avoid a scenario whereby the South could hold Congress to ransom by jeopardizing the federal debt position in order to obtain concessions. While some believe it may be subject to a legal challenge, others believe it already has and that the option remains a viable one. The Supreme Court ruled in 1935 that "While this provision was undoubtedly inspired by the desire to put beyond question the obligations of the government issued during the Civil War, its language indicates a broader connotation."

3. The President can choose the least damaging violation of the Constitution.

An article that was authored by two law professors and published in October 2012 in The Columbia Law Review (available here) argued that since by failing to raise the debt ceiling, Congress is essentially saying the government cannot issue debt but must spend and cannot raise additional tax revenues through further means, and therefore the President "has to decide which of Congress's orders to follow" and must "choose the least unconstitutional option." The authors believed that issuing debt was the least unconstitutional.

4. Issue 'premium' bonds.

The thinking here is that because the debt ceiling applies to the face value of bonds issued and not the total funds raised, new bonds can be sold at a premium interest rate and thus raise greater funding than the par value of the bonds. Such issues could be used to roll over other previously existing debt without violating the debt ceiling while simultaneously raising more funds. This would be a potentially very costly option that would carry a higher interest burden that would further crowd out other government spending, but it may help to temporarily avert a default.

5. Issue a very large denomination platinum coin.

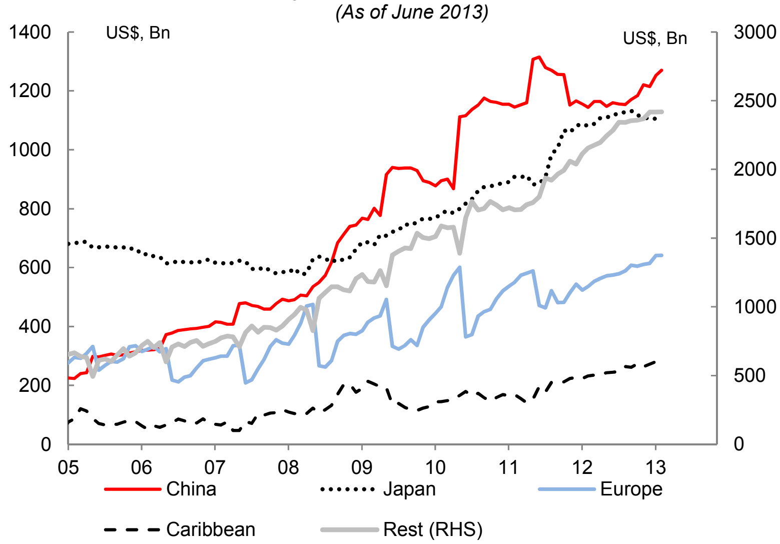
The US Treasury has the option of issuing platinum coins with no limit. Jack Balkin, a Professor of Constitutional Law at Yale, was the first to suggest this option. It would amount to exploiting a loophole that was designed to allow the issuance of commemorative coins and turn it into a funding instrument.

6. Tap the Federal Reserve.

The Federal Reserve is not a direct option for funding the US government because the *Federal Reserve Act* prohibits buying bonds at issue as opposed to the secondary market. Some speculate, however, that in desperate times the US government could write an option to the Federal Reserve to purchase government property for a specified amount and the Fed would then credit the government's account. The option could then expire worthless if not needed. This option clearly assumes that the Federal Reserve would play along. Some have noted that a variant of this option is similar to that which has been pursued by other governments at other times, including Greece's use of derivatives to mask its deficits.

All of these options would risk legal challenges, possibly risk impeachment proceedings and a full-blown constitutional crisis, set a potentially dangerous precedent, and risk raising inflation expectations on an abuse of monetary policy by government policymakers on the view that if it's done once, it may be repeated in future. The choices are not easy, and the market ramifications for some of these options could be substantial—not least for major and vocal foreign holders of US Treasury securities (see chart). There is also the shadow of additional ratings downgrades. In fact, any of the options would intensify, severely, the market's negative reaction to the debt ceiling issue, compounding the adverse consequences for both the public and private sectors of a borrowing authority impasse.

Major Holders of US Treasuries
(As of June 2013)



Source: US Treasury, Scotiabank Economics