Special Update

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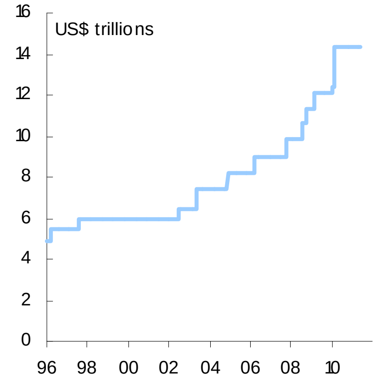
No Free Lunch In the U.S. Debt Ceiling Debate

- **Emerging markets and past U.S. experiences showcase that the impact of delaying a higher debt ceiling may not be apocalyptic but that the best case scenario is likely years of moribund growth.**

Whether or not a debt default solution arises in the next few days or weeks, there is no free lunch to be had in addressing America's fiscal problems. The fact that the immediate problem stems not from an actual inability to pay but rather from the use of the debt ceiling as a political bargaining tool has only served to underline the divisions within Washington on the tough trade-offs required. We worry that either default will be avoided through the pursuit of only modest fiscal retrenchment that further agitates rating agencies and financial markets, or that the cuts necessary to satisfy rating agencies will come at the cost of a sharp long-run fiscal drag on growth. In catch-22 fashion, cuts being debated may not be sufficient should long-run growth disappoint budgetary assumptions as a result of fiscal retrenchment. Should the champagne cork pop following the achievement of a deal to raise the debt ceiling, the reward is therefore likely to take the form of weak growth prospects for the U.S. economy for a long time to come.

Washington's Progressively Higher Debt Ceiling



Source: U.S. Treasury, Scotia Economics.

1. The Prospects and Impact of a Technical Default

That said, we start by considering the impact of a selective U.S. default. The costs to the global economy and financial markets of a messy U.S. default may be severe, but the consequences of a short-lived technical default on the path toward an agreement to raise the debt ceiling and achieve fiscal austerity may not be. Given the United States' elevated "safe haven" reputation and the vastly significant role of Treasuries in global financial markets, a messy default would place financial markets in uncharted waters, sparking a wave of deleveraging and pressure to enhance collateralization to the net detriment of the risk trade and the global economy. Treasuries set a base yield off of which other sovereign bonds are priced, are the cornerstone to many leveraged transactions including their role as collateral in repurchase agreements and other derivatives, and are held as 'risk-free' securities by financial institutions from banks through mutual funds, who count on these securities for their immediate liquidity.

We cannot be sure how large the impact of a short-term technical U.S. default would be, but we do know that *technical* (as apart from an ability to pay) defaults by sovereign countries are uncommon. While in the world of emerging markets investing, a country defaults about once a year on average, those defaults are usually accompanied by a major economic crisis that most observers agree precludes the government from fully honoring its obligations. In fact we are only aware of two recent technical defaults: a default by Venezuela in 2005 due to difficulties in calculating the correct coupon, and a default by Ecuador in 2009 based on their belief that foreign debt was immoral and illegitimate.

There are, however, at least three main reasons why the U.S. may be different from such emerging market experiences. For one, an important contrast with emerging markets — and even with other developed sovereign markets — is that investors in those markets are used to thinking about forward-looking credit risk, and market prices respond continually to new information on the government's ability and willingness to pay in the future. Investors in U.S. Treasuries are much less experienced in having to consider evolving credit risk. This may raise the risks.

For another, despite Treasury Secretary Tim Geithner's understandable attempts to inject a sense of urgency into the debate, we are not sure that August 2nd is a hard deadline. The possibility exists of short-term extensions to the August 2nd deadline, though entwining the deficit reduction policy debate into the debt ceiling process and the ensuing credit agencies' response, has probably limited Washington's flexibility. To allow U.S. Treasury auctions to continue from mid-May to early August, the U.S. Treasury has already undertaken a series of extraordinary measures to reduce inter-governmental and other federal obligations that fall under the debt ceiling definition. After early August, options for accessing cash and curtailing federal operating expenses could eke out some more time, though the extent of Washington's required funding from the public — currently exceeding US$100 billion a month — is challenging. The July 22nd cut-off for an agreement to allow sufficient time to draft legislation and gain Congressional approval stands out as a deadline that could be pushed if a substantive deal were shaping up, as the President has already signalled. If progress on a credible deficit reduction strategy is not apparent, markets' patience could dissipate on relatively minor disruptions of Washington's payments.

Third, in sharp contrast to other sovereign debt markets is the current market situation for U.S. Treasuries. A combination of mutually reinforcing factors, including credit quality, high liquidity, stable monetary policy and the sheer size of outstanding issues has made Treasuries relatively immune to recent U.S. fiscal developments. As shown in the table below, institutional investors do not have many choices when it comes to issuers of sovereign debt. The largest issuers, euro zone countries and Japan, certainly have as great if not greater problems than the U.S. does. But these countries, plus the U.S., constitute 79% of worldwide government debt. Excluding China, whose bonds are mostly not available to foreigners, the next largest issuer is the UK with only one-eighth as many bonds as the U.S.. Other issuers have even smaller amounts outstanding or have much higher credit risk.

Country	Total Amounts Outstanding (US$ billions)	% of Total	Financial Institutions (US$ billions)	% of Total	Corporate Issuers (US$ billions)	% of Total	Governments (US$ billions)	% of Total
U.S.	32,534.5	35.5	16,841.5	40.3	4,530.0	45.6	11,163.1	27.9
Euro Area*	24,626.6	26.8	13,819.5	33.1	2,163.7	21.8	8,643.8	21.6
Japan	14,153.5	15.4	1,563.1	3.7	954.9	9.6	11,635.5	29.1
U.K.	4,782.3	5.2	3,045.9	7.3	315.3	3.2	1,421.2	3.5
China	3,106.9	3.4	946.5	2.3	531.9	5.4	1,628.6	4.1
Canada	2,112.4	2.3	636.7	1.5	336.5	3.4	1,139.1	2.8
Australia	1,646.6	1.8	1,221.9	2.9	74.4	0.7	350.1	0.9
Brazil	1,512.8	1.6	593.3	1.4	38.1	0.4	881.3	2.2
South Korea	1,254.1	1.4	350.6	0.8	421.2	4.2	482.2	1.2
Sweden	821.5	0.9	583.4	1.4	67.3	0.7	170.8	0.4

* Includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain.
Source: BIS.

Once we recognize that the role of the U.S. in the global financial system does not just stem from some magical forces associated with the country's name and recent payment record, but rather depends on a forward-looking assessment of the same types of economic variables that are regularly used in the sovereign analysis of any other country, the situation becomes more difficult. Note, for example, that S&P foresees a one-in-two chance of lowering the U.S. credit rating, based not just on the threat of imminent default, but rather on its concern of a growing and unsustainable debt burden. For these reasons, we think considering the policy options available to lawmakers, as outlined in section 2, becomes critical.

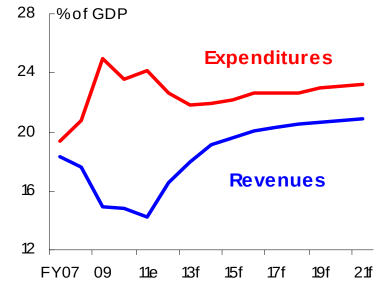
2. The Conditional Policy Options

There are various deficit reduction packages being floated to gain Congressional approval for a debt ceiling increase. The *Cut, Cap and Balance Act*, though passed by the House of Representatives earlier this week, is a purely symbolic effort by House Republicans. Senate approval is not expected (since Republicans control the House but Democrats control the Senate) and the President has indicated he would veto this legislation.

The fate of the remaining options? President Obama's 'Grand Bargain' is reportedly too focused on increasing tax revenue to garner sufficient Republican support. Senator Coburn's lengthy plan, *Back in Black*, that would trim the federal deficit by US$9 trillion over the next decade, including US$1 trillion from limiting tax expenditures, offers measures that might be incorporated in a collaborative effort. The current most likely base for collaboration is the *Bipartisan Plan*, sponsored initially by six Senators, which would shave US$3.7 trillion from the cumulative US$6.7 trillion deficit outlined in the March 2011 baseline projection of the Congressional Budget Office (CBO). The *Plan* is broadly aligned with the recommendations of the President's bi-partisan National Commission on Fiscal Responsibility and Reform, tweaked to garner broad support from Senate colleagues. Its proposals would trim Washington's budget deficit from Scotia Economics' forecast of a shortfall equal to 8.9% of GDP in fiscal 2011 (FY11) to 6.7% in FY12, 3.0% by FY14 and 2.0% for FY18 through FY21 and stabilize its publicly held debt at 70% of GDP by 2014.

The *Bipartisan Plan* has several advantages. It is a two-stage process, beginning with near-term deficit reduction totalling US$500 billion over a decade that relies upon a number of broadly accepted measures such as adopting statutory discretionary spending caps, freezing Congressional pay, and shifting indexation to a chained-CPI (a lower, reportedly more accurate inflation measure). The more controversial measures, such as closing tax breaks and scaling back future health care costs, would be deferred to the second stage, with existing Congressional committees fast-tracking these reforms. Contingency provisions are outlined if any of the Committees do not succeed, leaving the *Plan's* mid-term details comfortably vague. The importance of supporting economic growth is recognized and sensitive areas are skirted, such as stipulating that tax expenditures relating to homeownership and retirement could be reformed, not eliminated. Strengthening Social Security, to be considered after Senate approval of comprehensive deficit reduction legislation, would target 75-year solvency, with savings during the reform reinvested in the program, not in narrowing the deficit.

The February 2011 Budget: Revenues and Expenditures



Source: Office of Management and Budget (FY11 estimates updated with monthly data), Scotia Economics.

The sticking point is that essentially one-quarter of the *Plan's* fiscal repair depends upon tax reforms providing US$1 trillion in additional revenues by 2021, plus US$133 billion to raise the solvency of the Highway Trust Fund without hiking the federal gas tax. Though marginal income tax rates would be scaled back and the Alternative Minimum Tax repealed as personal and corporate income tax expenditures are curtailed, the more conservative Republicans are unlikely to be convinced by the claim that a CBO evaluation of the *Plan* would find US$1½ trillion of tax relief. A further compromise on raising less revenue may be required. Nevertheless, details of the projected end result are appealing with a new single corporate income tax rate falling somewhere between 23% and 29% and the personal income tax simplified, with target rates of 8%-12%, 14%-22% and 23%-29% for three brackets.

If compromise on a substantive deficit reduction plan fails, an alternative being refined 'in the wings' is the McConnell plan. It would increase the debt ceiling in three steps, with the President, in three tranches, submitting budget cuts totalling more than the requested debt ceiling increase, avoiding a two-thirds Congressional vote against any tranche. Mirroring this plan's fall-back status is its convoluted procedure, and the likelihood that the requested ceiling increase would be roughly US$2½ trillion. The game changer is S&P's stipulation that a downgrade will only be avoided if the measures represent a serious effort, on the order of US$4 trillion, that can be sustained throughout the decade.

A last ditch option that has never been explored is for the President to call upon emergency powers backed by the 14th Amendment's dictum that "…the validity of the public debt of the United States….shall not be questioned." That may work in the short-term, but of course would in no way alleviate S&P's concerns; indeed, it could exacerbate concerns among the rating agencies and expedite downgrade risk.

3. Impact on U.S. Economic Growth

Even if a default scenario is averted, an austerity package that meets S&P's requirement of budgetary savings in the US$4 trillion range over the next ten years would significantly dampen growth. The substantive near-term complication is the very lacklustre U.S. labour market recovery and the real possibility of some stimulus, such as hiring incentives and reduced payroll taxes, being extended. Assuming a fiscal multiplier of 1.0, admittedly a "high-end" assumption, the impact upon nominal GDP growth could approach 2.0% per annum on average over the next decade, not that far off the long-run real (inflation-adjusted) historical growth rate. Assuming a multiplier half this size trims the average impact to less than 1% per annum, though this is still a substantial bite when applied for a number of consecutive years. The calculation is assuredly imprecise given the substantial number of unknowns, including the distribution of austerity measures over time and the differential lag in their impact.

In order to absorb such a degree of fiscal retrenchment, private demand will have to be exceptionally strong in the years ahead. For instance, even just 1% average annual fiscal drag effects on GDP growth would require about 4% sustained growth in GDP excluding this effect and thus net out to actual nominal GDP growth of about 3% per annum. That would be exceptional strength in private demand on a sustained basis following a historical period of deleveraging and weak overall GDP growth, and the pick-up in worker retirements after 2015. Since these are nominal figures, they point to much softer real GDP growth figures.

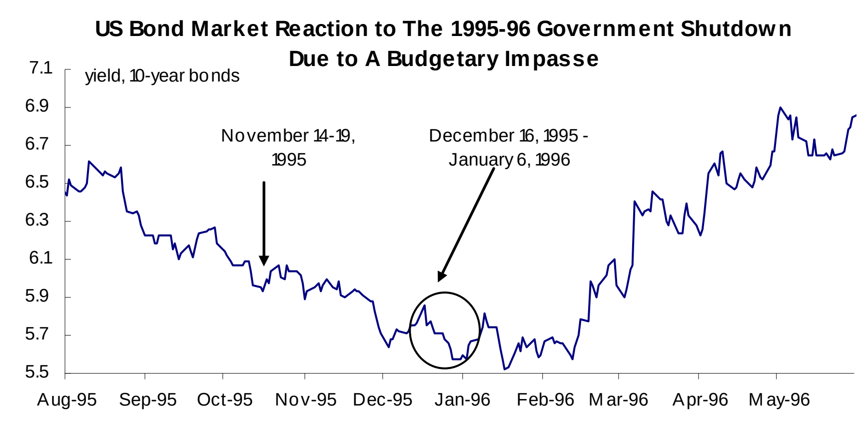
What is clear, however, is that some of the current assumptions among market players may have to be adjusted. The new reality is that the U.S. likely faces a downgrade or commits to embarking on tighter fiscal restraint sooner, with implementation beginning before the November 2012 elections despite a weak economy. The translation to softer real growth is assumed, but underlying inflation prospects also remain subdued under this scenario. The positive offset in terms of stepped-up consumer and business confidence as more sustainable federal and State fiscal prospects are regained and the benefits of personal and corporate tax reform gain traction is difficult to quantify in terms of extent and timing. Such a positive response, however, occurs over time, front-end loading the tough medicine and reinforcing our view that the Federal Reserve will stay on the sidelines until at least the second half of 2012. Given that other countries like Canada often assume average annual U.S. GDP growth in the over 3% range over coming years, including the Bank of Canada and the Federal Government's budgetary projections, they too may have to reassess and adjust for the spillover effects of U.S. fiscal austerity into their own economies in the years ahead.

4. Conclusion

How will bond markets react to these short-term and longer-term concerns? The prospect of a technical default or near-term downgrade presents a significant challenge to the traditional working of financial markets. Usually investors respond to uncertainty by buying Treasuries — assets with low risk and high liquidity — but what happens when it is uncertainty about Treasuries themselves that investors are most anxious about? We think, on net, Treasuries should sell off, though the effect would be mitigated by some of the other attractive features of Treasuries that we have mentioned besides credit quality. Our trading desk reports, for example, that there are many hedge funds ready to buy on any weakness in the event that certain institutional investors are forced to lower their exposures.

Aside from the experiences of emerging markets, the Clinton era showdown in the mid-1990s offers some useful insights today because it reinforces our notion that the impact of delaying an increase in the debt ceiling may not be apocalyptic to the U.S. Treasury market due to safe haven, supply shortage and order of payments arguments. U.S. Treasuries may not be reflecting much concern over today's debt ceiling impasse as yet, partly because bond holders know they'll be the first to be paid in the event of a short-term disruption. Indeed, that's what happened during the last game of debt ceiling brinksmanship. When failure to lift the debt ceiling led to the Clinton-era government shut-down over the period of November 14-19, 1995 and then again on December 16, 1995 to January 6, 1996, all non-essential government services were shut but debt service payments continued and US 10s did not sell off. Indeed, 10s had rallied from just over 6½% in August of 1995 to just over 5½% by late that year and into early the next. Thus, today's recent rally isn't at odds with past debt ceiling negotiations. It wasn't until the debt ceiling impasse was over that US 10s sharply sold off by pushing toward 7% in the summer of 1996. A shortage of supply as issuance hits the debt ceiling limitations is one reason to expect a rally, followed by a sell-off when supply eventually catches up. Today's environment is much more complex than back then, however, with Europe's crisis distorting flows into U.S. government debt and the dollar. Also, U.S. federal debt is obviously larger now than it was back then, the growth backdrop is weaker, demographic pressures are just around the corner, and rating agencies are playing a much more aggressive role this time around. That said, the pressure to achieve agreement on a higher debt ceiling in 1996 was only motivated by political pressure that was brought upon Washington when the effects of the government shut-down became acutely felt by Main Street.

In this way, we see some validity to the opposing positions of both Democrats and Republicans. While turning debt payment into a political negotiating tool is reckless, risking an increase in 10-year issuance rates required by the market to compensate for an unsustainable debt path is even more costly in the long-run. It is this delicate calculus in drawing up tolerable trade-offs between short-run market dislocation effects versus a prolonged period of soft growth that makes for a plot that not even Hollywood could have envisioned years ago.



Source: Bloomberg, Scotia Capital Economics

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