

Ceilings and Budgets and Shutdowns. Oh my!

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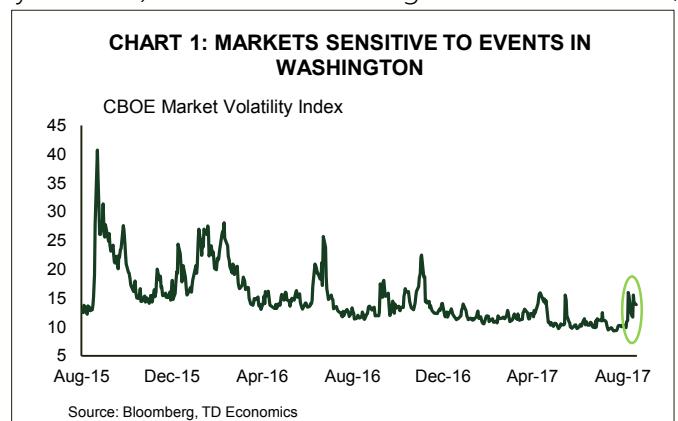
Highlights

- Congress has two critical to-dos in September: raise the debt ceiling and pass a resolution to fund the government beyond Sept. 30th. In recent years, these issues often are not settled until the 11th hour, resulting in market volatility.
- With Republicans dominating Washington, agreements on both items should seemingly be reached more easily. However, the need for Democratic cooperation in the Senate raises the probability of a government shutdown in particular. A brief government shutdown would dent, but not derail, economic growth in the fourth quarter.
- The risk is a standoff could damage market confidence in Washington Republicans enacting pro-growth policies they expect. We had a sneak preview of the volatility that could result from this last week. While not our base case, a worst case scenario of a bad standoff and severe market turmoil could lead to the Fed delaying the start of normalizing its balance sheet in September.

When Congress resumes sitting on September 5th it has two pressing matters to address: the debt ceiling and funding the government beyond the end of September. In theory, the stakes are high on both fronts. If the debt ceiling is not raised or suspended, the government can no longer borrow to fund its deficit. This would be equivalent to an individual who has maxed out their credit cards, used all the cash hidden in cookie jars, and whose next paycheck isn't going to cover their expenses – something has to give. This raises the risk the government would either default on its debt payments, or leave other bills unpaid. And, if legislation is not passed to fund government programs beyond September 30th, many government functions and services would shut down, as we saw most recently in 2013.

Both of these items have proved contentious in the past, as various factions in Congress use them as leverage to achieve other policy priorities. With Republicans (GOP) controlling the Senate, the House and the White House, it would seem that a standoff is less likely this time around. Financial markets' are currently making the same bet. On a trend basis, volatility (as measured by the VIX) had been hovering near all-time lows, or reacting to geopolitical events such as North Korea and rumors about turmoil in the White House's economic leadership (Chart 1). Last week's experience shows how sensitive markets are to perceived turmoil in Washington. Markets currently assume the lion waiting for them in September is cowardly, just like in Oz. But, they will likely be spooked if it turns out to be the Wicked Witch.

However, the diversity of views within the GOP, and a narrow majority in the Senate doesn't eliminate the risk of a standoff. If a game of fiscal chicken erupts on either front, as we have seen in the past, market sentiment is likely to



sour quickly.

The Debt Ceiling – the more you ignore me, the closer I get

For starters, the debt limit or “ceiling” caps the government’s authority to borrow money (issue Treasury securities) to pay for spending already authorized by Congress. The U.S. government hit this ceiling back in mid-March, and the Treasury has since been using “extraordinary” measures to fund the government. The Treasury estimates the money in cookie jar and under mattresses will run out by September 29th, and has formally requested Congress to raise or suspend the debt ceiling, which it did not do before going on its August recess.

So far, the GOP leadership has not conveyed an interest in engaging in a public, confidence-damaging fight on the decision to raise or suspend the debt ceiling. GOP leadership, including Freedom Caucus leader Mark Meadows, recently reassured markets that they will raise or suspend the debt ceiling with no strings attached. No doubt, the 2011 experience of a disastrous debt ceiling standoff remains fresh in the minds of Republicans. Historically, Congress routinely raised the debt ceiling without much fuss. But in 2011, Republicans, having recently taken control of the House, demanded the President negotiate over deficit reduction in exchange for an increase in the debt ceiling. Two days before Treasury’s stated deadline, Republicans agreed to raise the ceiling in exchange for future spending cuts embodied in the Budget Control Act of 2011. In reaction to the standoff, S&P downgraded the sovereign credit rating of the U.S. government for the first time ever. This resulted in the worst financial market volatility since the financial crisis, with the S&P 500 dropping about 12% over the course of the 2011 debt ceiling debacle.

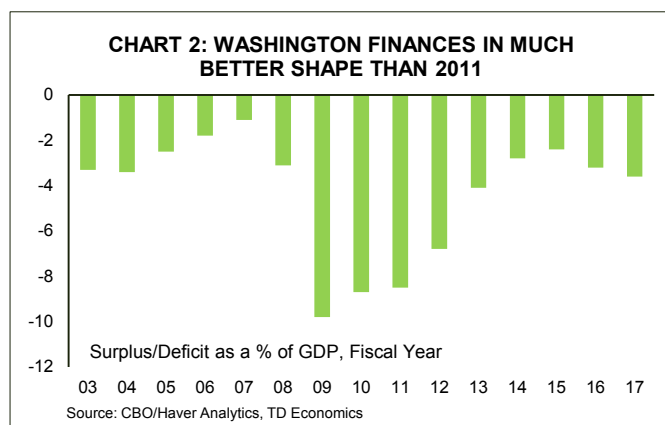
There’s some comfort today that the 2011 experience was under a Democratic President, and this time around, members are likely more confident that government spending restraint is more achievable with a Republican President. But it’s not totally free and clear, as legislation to raise the debt ceiling will need 60 votes to pass the Senate, and Demo-

crats could choose to be obstructive in getting a bill passed in a timely manner. It is unclear at this time what the Congressional leadership’s strategy will be.

If an agreement does prove difficult when Congress returns in September, financial market reaction is likely to be more muted than the 2011 experience. At that time, S&P already had the U.S. rating on a negative watch. That is not the case this time around. S&P recently reaffirmed (Aug. 2, 2017) the US AA+ rating as stable. With the U.S. government’s fiscal situation markedly improved since then (Chart 2), a downgrade is not in the offing.

Absent the credit rating experience, more recent debt ceiling showdowns in 2013 and 2015 were less damaging to markets. In 2013, the S&P 500 dipped slightly as the clock ticked down to the deadline, but rebounded quickly afterwards, and in 2015 equity markets rose steadily. These more muted responses may reflect the fact that they expect an 11th hour deal, as was the case in 2011. Moreover, markets have greater confidence that default is not really on the table. According to transcripts (made public in 2016) of a Conference call with then Fed Chair Ben Bernanke in 2011, the Federal Reserve and Treasury had developed procedures that would have insured principal and interest on Treasury securities would continue to be made on time. “Other” payments may be delayed. We don’t know specifics, but these payments could include salaries, payments on contracts or even delay Social Security or Medicare payments.

Even if the debt ceiling isn’t raised and the U.S.



avoids a technical default, there would still be a price to pay for the standoff apart from losses on equity markets. Reduced market confidence in the U.S. government's ability to keep its fiscal house in order has a real cost. The U.S. Government Accountability Office estimated that delays in raising the debt ceiling in 2011 led to an increase in government borrowing costs of \$1.3 billion in 2011. 2011 likely represents a worst-case scenario, but the short-term measures Secretary Mnuchin has had to take since the debt limit was reached in March have cost at least \$2.5 billion, not including any increased borrowing costs. (Ultimately, this is a drop in the bucket for a \$4 trillion budget.)

Government shutdown more likely, but less damaging

The second pressing issue facing the GOP relates to funding government services for the next fiscal year, which starts on October 1st. On this front, consensus is less clear. In the tangled web of U.S. budgeting process, the appropriations process for the 2018 fiscal year is underway without a Budget resolution. The House has passed four of 12 appropriation bills, but these would likely need Democratic support in the Senate. So funding decisions for FY2018 are far from assured, and Congressional leadership has not outlined their plan publically for September.

Congress must either pass a budget resolution or a continuing resolution stop gap to fund the government beyond September 30th. To pass tax reform through reconciliation, Congress ultimately needs to pass a budget resolution with reconciliation instructions. But, in the interim, a continuing resolution to fund government for a given period of time may be more achievable given the House is only sitting for 12 days in September. However, a continuing resolution could be filibustered in the Senate, and therefore would need Democratic support to pass. Add to this the fact that Trump had threatened a government shutdown in the fall earlier this year, and the risks that an agreement will not be reached cannot be ignored.

This is not uncharted territory. The U.S. government has gone through 18 government shutdowns in the

modern budgeting era (since 1976), and the economic impact would be small provided the shutdown is not prolonged. The Bureau of Economic Analysis (BEA) estimated that the 16-day shutdown in 2013 lowered real GDP in Q4 2013 by 0.3 percentage points (annualized), but growth was still very strong in that quarter as a whole. If the shutdown were to drag on, for example, for four weeks, it is estimated it would lower real GDP growth by 1.5 percentage points (annualized) in the fourth quarter.

On average, government shutdowns have lasted seven days. However, the two most recent shutdowns were far longer. During the 2013 shutdown, about 40% of government workers were furloughed, equivalent to 850 000 people. However, one of the reasons that the impact isn't greater on economic activity is because essential roles remain in place, like air-traffic controllers, armed forces, and food safety inspectors. The Federal Reserve is not funded by Congress, so it too would remain open for business. But, tax refunds and economic data releases would be delayed, among other things, causing significant disruption in the lives of many Americans.

Worst case scenarios could stay the Fed's hand

Facing midterm elections next year the GOP likely wants to demonstrate their ability to govern, and a damaging game of fiscal chicken is not in their interest. That said, raising the debt ceiling and passing a continuing resolution to fund government beyond Sept. 30th will require cooperation with Democrats in the Senate. That is a wide ideological expanse to bridge with right-wing factions in the GOP. Therefore, a down-to-the wire debate on either matter cannot be ruled out. If market volatility spikes significantly, the Fed could delay normalizing its balance sheet, which is expected to be detailed at the September 20th meeting. Back in May, Fed Governor Brainard had flagged the debt limit as a possible pitfall for her outlook.

This scenario is not our base case, but financial markets have until recently been complacent about domestic risks. There is a tendency for agreements to

not be reached until the 11th hour, and it would not take much in this environment to see volatility return in September. This was born out in last week's experience where mere rumors that moderate White House economic advisor Gary Cohn might resign, sent volatility back as nearly as high as it was during heightened worries about North Korea. As such, investors would do well to brace themselves for a potential twister of volatility in September.

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