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Economic Watch

US

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Economic Analysis

US
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Debt Ceiling Resolution Calms Markets

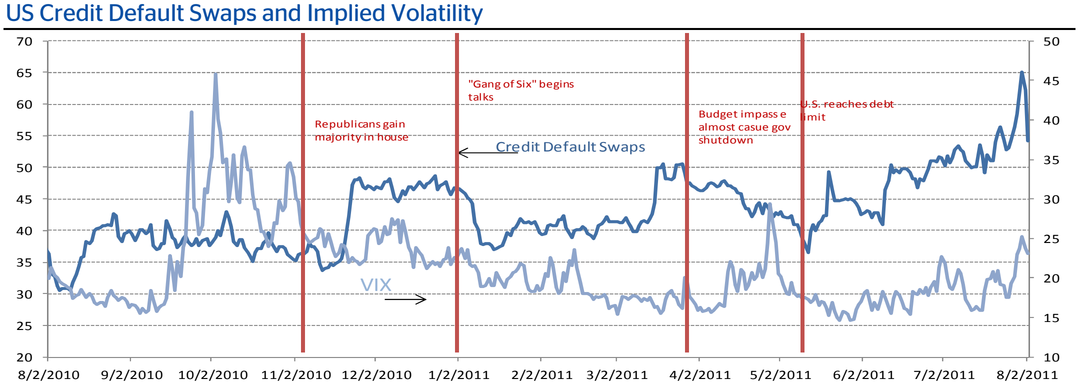
Today's increase is only the first step towards austerity

- **U.S. raises debt ceiling and cuts $917bn with the possibility of $1.5tr more**
- **Low risk of a credit downgrade after today's deal**
- **Another round of debate will increase the probability and market jitters**

Congress today passed the Budget Control Act, which increases the United States' borrowing authority after months of political histrionics. After passage yesterday of 269-161 in the House, the bill headed to the Senate where it was ultimately passed The overall trajectory of negotiations over the past few months started with a strong bipartisan Senate committee and then moved to a near implosion after the partisan Boehner "Cut, Cap, & Balance" plan. This trajectory significantly increased volatility in financial markets and raised doubts about US commitment to resolve long-term fiscal sustainability issues. Despite weeks of difficult negotiations, the main text of the legislation remained constant, with the result being that cuts were pushed back to 2013 and the President received the desired amount of borrowing authority. Though backed by the White House, the plan appears to favor the conservative caucus's demands for no tax increases, a vote on a balanced budget amendment, and a dollar-for-dollar decrease in deficit per debt ceiling increase. In other words, rank-and-file Democrats lost out, while Republicans and the Obama administration achieved their goals.

As customarily mandated by Congress, the Congressional Budget Office (CBO), released an analysis of the proposed legislation which revealed $917bn in deficit reduction over the 2012-2021 period, while also including a committee plan for additional $1.2tr in scheduled cuts if no deficit consensus is reached before 2013. The Democrats can claim victory on two specific issues. One is the timing of the cuts, which do not take full effect until after 2013, allowing the already-stalling recovery to maintain momentum. The second victory for the Democrats was the heavy cuts to defense spending beginning in fiscal year 2013. The bill also gives the President operational authority between now and the election to increase the debt ceiling if there is no agreement on cuts necessary to meet the requested $2.1tr threshold.

Chart 1
US Credit Default Swaps and Implied Volatility

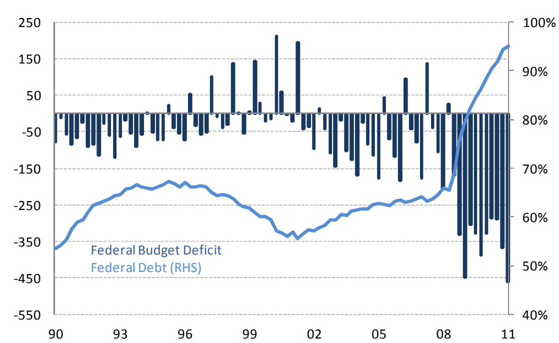


Source: Bloomberg

This was a significant point of contention for both the President and markets. The threat of another political standoff would force the rating agencies to revisit downgrades as a result of a lack of borrowing authority. This agreement removes this particular source of downgrade threat for now. The cuts are accelerating in nature and should allow for recovery prior to bulk of the austerity measures. The first substantial cuts will occur in 2013, and will involve $350bn reduction in defense spending. This would be the first defense spending cuts in 20 years. Furthermore, the acceleration scheduled for nondefense related spending are back-loaded, which could give Democrats the time needed to address the current tax code inefficiencies, which presumably could offset cuts to entitlements and health care. In addition, a hard $1.2tr discretionary cap and a mandated $1.5tr in deficit reduction over the next ten years will force committee negotiations to entertain compromises.

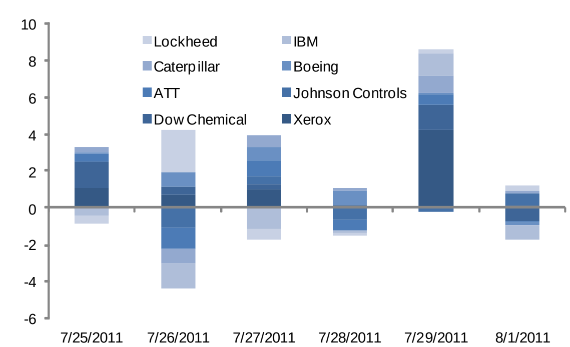
The rigidity of the mandated cuts and oversight powers now enjoyed by the White House should allow for more transparency for markets in regards to fiscal sustainability; however, the proposed deal is not the ultimate compromise that eradicates debt concerns. One important point to mention is that this bill is focused on spending cuts with debt reduction as a byproduct. The effect of a debt ceiling outcome is traditionally asymmetric: while a failed raised ceiling creates chaos, a successfully raised ceiling merely returns us to the status quo. The real tackling of fiscal sustainability has yet to occur. Market reactions suggest that the measure appeased domestic markets. However, this deal will not soften China's stance on U.S. austerity measures. International pressures should subside in the short-term. However, the Chinese are not likely to relent if there is no further attempt to decrease the US debt, mostly by continued subtle public statements at international events urging reforms in the US.

Chart 2
Federal Budget Deficit and Debt to GDP Ratio ($bn & %)



Source: CBO & Treasury Department

Chart 3
Daily Contribution to Investment Grade CDS, in bp change



Source: Markit

Bottom line: a step in the right direction, but not the final resolution

It appears after yesterday's passage that domestic and international markets still hold U.S. in high regard. The declining yields and drop in credit default swaps (CDS) is an indication that market are less fearful than by last week end. However, to achieve fully realize the proposed plan further fiscal reform is required. Estimates suggest that if all the measures reported in the plan are implemented, the average annual impact on GDP could be 0.1%. If the second round of cuts, currently projected at $1.5Tr, are blocked or stalled there could be an average annual effect of 0.7% on GDP. For the next few months, markets will probably reflect more strongly Friday's GDP release than today's Budget Control Act passage. Compared to the case of no agreement on any fiscal issues, today's agreement reduces the chance of a US ratings downgrade. However, given that we believe more consolidation is needed, the threat of downgrade is not altogether removed. Although we may suffer another contentious round of political histrionics, we believe necessary measures will pass.