US

Of Debts, Deficits, and Recession Threat

Image courtesy: Houston Marriott Marquis

The Joe Biden Administration is hoping against hope that the Republicans, who now control the House of Representatives, will finally agree to increase the "debt ceiling"—the legal limit on the total amount of federal debt Uncle Sam can accrue. However, with the government and the opposition unable to come to an agreement, it is giving some anxious moments to Biden & Co amidst growing fears of a default.

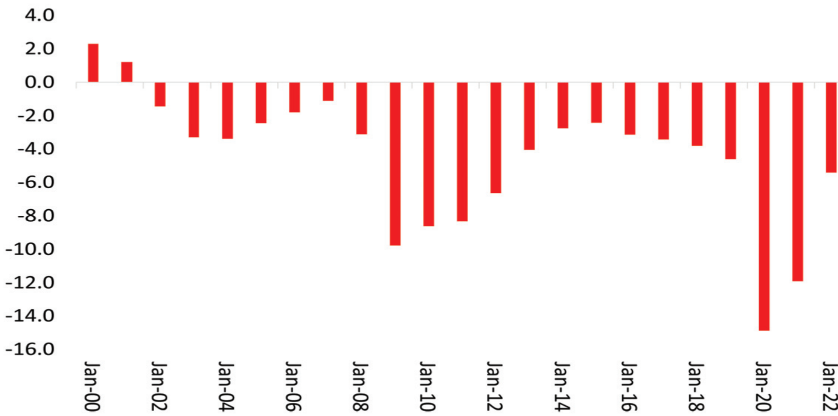
– By **Michael Roberts,** Economist, London

In his recent annual State of the Union speech to Congress, US President Joe Biden called for a range of policies that would "boost opportunity and reduce poverty, improve health and well-being, and advance widely shared prosperity." He also criticized oil companies for making high profits and other firms for benefiting at the expense of consumers, and he challenged the opposition Republicans, who now control the lower House of Representatives, to lift what is called the "debt ceiling", to allow the administration to borrow more to finance its budget plans. Biden said that the administration would "fully pay" for his expansive policies and so reduce the federal government deficit by $1 tn by requiring well-off households and profitable corporations to pay a "fairer amount of taxes." This promise was to be achieved over the next decade. In the immediate period, the government deficit and the public sector debt are set to rise.

Rising debts and fears of a default

The Congressional Budget Office (CBO) reported that the US federal government deficit had already reached $459 bn in the first four months of the budget year that started in October 2022 and that the whole year is likely to show a $2

US Federal Budget Balance % of GDP



tn deficit, excluding "off-budget" spending of possibly $200 bn or more. After the mammoth deficit (15% of GDP) recorded in financing Covid fiscal support to Americans in 2020, the deficit narrowed a little in 2021 to 12.5% of GDP. Even though the deficit fell to 5.5% last year, it is still higher than any pre-pandemic year since the Great Recession.

These cumulative deficits have driven the US gross public sector debt level to record highs, equivalent to nearly 130% of GDP.

And here's the rub. US operates what is called a 'debt ceiling', which is the legal limit on the total amount of federal debt the government can accrue. The limit applies to almost all federal debt, including the roughly $24.5 tn of debt held by the public and the roughly $6.9 tn the government owes itself as a result of borrowing from various government accounts, like the Social Security and Medicare trust funds.

Since the end of World War II, Congress and the President have modified the debt ceiling more than 100 times. During the 1980s, the debt ceiling was increased from less than $1 tn to nearly $3 tn. Throughout the 1990s, it was doubled to nearly $6 tn, and in the 2000s, it was again doubled to over $12 tn. Lawmakers have suspended the debt limit, rather than raising it by a specific dollar amount, seven times since February 2013. But this time the Republican majority in the House of Representatives is refusing to raise the limit (now at $31 tn). The federal government hit that limit on January 19, and has been forced to take "extraordinary measures" ever since to ensure it can keep spending. When the debt limit is reached, the treasury department can

Michael Roberts

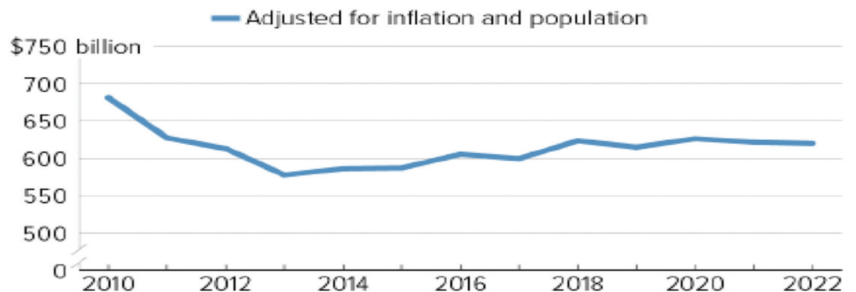
use a variety of accounting maneuvers to avoid defaulting on the government's obligations. The treasury has prematurely redeemed bonds held in federal employee retirement savings accounts (and replaced them later with interest), halted contributions to certain government pension funds, suspended state and local government securities, and borrowed from money set aside to manage exchange rate fluctuations.

But these tricks will be exhausted by June or soon after. At that point, either Congress has to raise the debt ceiling or US will default on its obligations. The debt ceiling battle usually leads to a last-minute deal. But this time there could be a default. It's politics. First, the new Republican majority leader, Kevin McCarthy, is rumored to have made a pact with rank-and-file Republicans not to agree to raise the ceiling, in return for his election as House speaker. The Republicans are looking to make significant cuts in federal spending and drop Biden's taxes on high-income earners. There is a real problem here because if defense spending (already hitting $800 bn) is not touched and social security and welfare spending is automatically raised (as it legally must), then that leaves only non-defense, 'discretionary' spending to reduce, and that has already been at the bare bones for the last decade. Moreover, it is precisely in this area that the Biden administration wants to increase spending.

So a political battle is likely to heat up over the next few months similar to the brinkmanship debt ceiling fight between a Democrat president and a Republican Congress back in 2011. But, does it matter? Well, yes. First,

Non-Defense Funding Outside Veteran's Health Care Still Below 2010 Level

(in billions 2022 dollars)



Note: Amounts include base appropriations plus Overseas Contingency Operations, Program Integrity, Wildfire Suppression, and Cures Act and Harbor Maintenance Trust Fund funding; exclude veterans' medical care; exclude the Census Bureau (because of its big funding shifts between decennial census years and other years); and do not reflect offsets from Changes in Mandatory Programs ("CHIMPs") or mortgage insurance fees.

Source: CBPP analysis of data from the Office of Management and Budget, and Congressional Budget Office

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it matters for the US economy and for plans to improve infrastructure spending and productivity growth through fiscal support. Second, it matters if US falls into a fiscal paralysis that could trigger the world economy into recession.

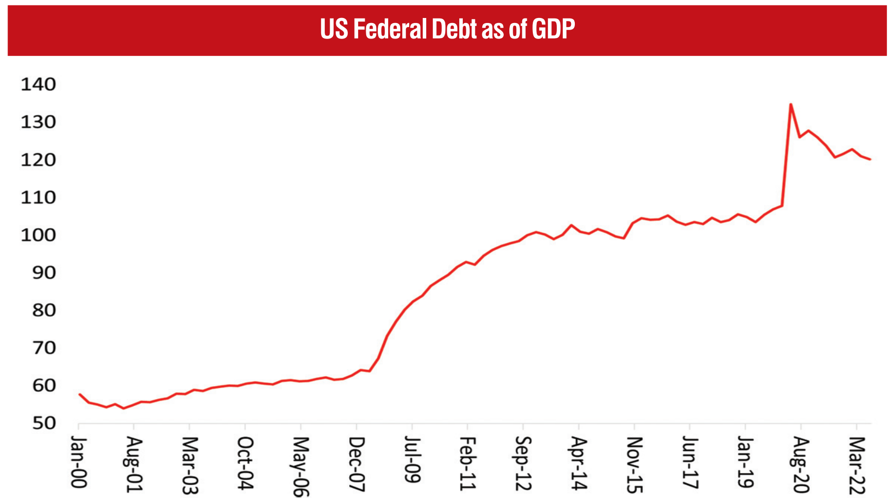
Fear of recession – For real?

Recently, there has been a bit of optimism that the US economy will avoid a slump this year despite sharp rises in interest rates, high inflation, and low productivity growth. Unemployment remains near a record low, consumer spending is still buoyant, and inflation is falling gradually. The talk is now of a 'soft landing' for the US economy or even no landing at all. If so, then any debt dilemma may not be an issue.

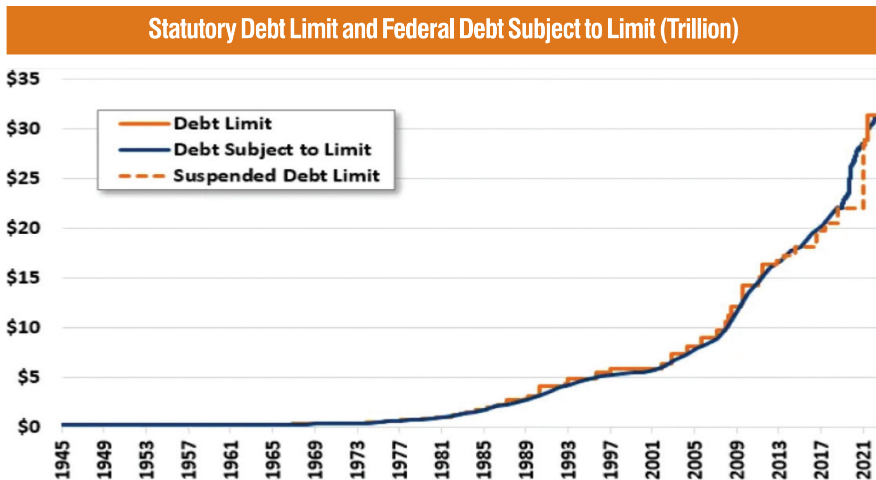
But that may well be too optimistic. America's industrial production is already contracting, and overall economic activity remains very weak. Most importantly, corporate profit margins and earnings are turning south as the cost of borrowing rises, increased wage costs begin to squeeze profits, and sales are flat lining. Also, a key sector of the US economy, home sales, has slumped. House building permits are down 46.6%, and housing starts are down 20.8%. Exports are also falling, by 11.2% y-o-y; while real retail sales (after inflation) are falling at a 6% rate.

The room for maneuvering has thus narrowed sharply. The US real GDP growth has slowed to just 1% a year; while inflation is still well above 5%; and the US Treasury yield has risen to 4%. And the Fed is still planning to hike its policy rate to the point that the real interest rate will be positive for the first time in two decades. That will raise the Treasury's borrowing costs, adding to annual deficits and the debt level. A default, or even the perceived threat of one, could have serious negative economic implications. An actual default would roil global financial markets and create chaos since both domestic and international markets depend on the relative economic and political stability of US debt instruments and the economy. The demand for the US treasuries would drop as investors stop or scale back investments if they are no longer considered perfectly safe, thereby increasing the risk of default. Even the threat of default during a standoff increases borrowing costs.

US Federal Debt as of GDP



Statutory Debt Limit and Federal Debt Subject to Limit (Trillion)



Source: Congressional Research Service, Office of Management and Budget, and Treasury Department

What a US default would mean?

Only recently, a Moody's Analytics report estimated that a default could have similar macroeconomic consequences to the Great Recession: a 4% decline in GDP, a loss of nearly 6 million jobs, and an unemployment rate of 9%. In addition, Moody's predicted a $15 tn loss in household wealth, with stocks dropping by as much as one-third at the depths of any sell-off. The White House Council of Economic Advisers (CEA) has warned that the macroeconomic effects stemming from default—or even getting too close to one—can last months or even years.

A CEA report found that following the debt limit cliffhanger in 2011, mortgage rates rose 0.7-0.8 percentage points for two months following the crisis, and rates for auto and other consumer loans also remained elevated for months. It is not that the US, the most powerful economy in the world, is unable to repay both domestic and foreign purchasers of its sovereign debt. It will be a political choice to suspend payment, made by the administration and Congress in a battle over fiscal policy.

To conclude, Uncle Sam may not come to an outright default this summer, but the uncertainty (over the 'debt-ceiling') is bound to add to its borrowing costs and weaken its investment plans. But in case it does enter into a recession, it would be hard for the rest of the world to stay unhurt. ■

Reference # 20M-2023-03-07-01