14 March 2017

Research US

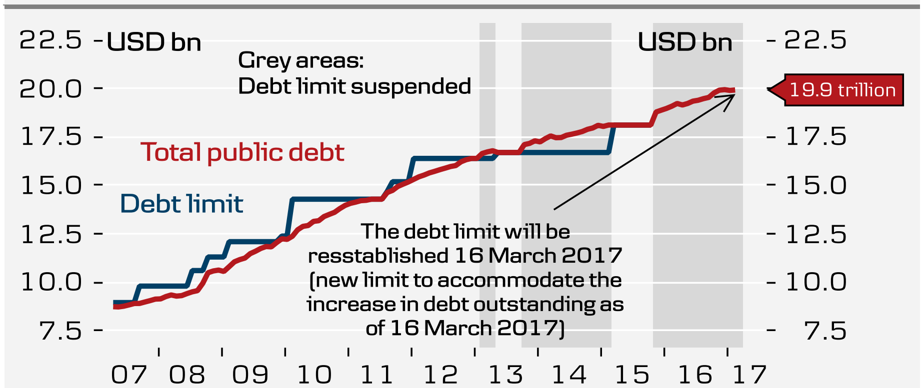
Debt limit suspension expires tomorrow

- **Suspension of the US debt limit expires tomorrow and we may enter a period with renewed fiscal uncertainty in the US. Estimates suggest the Treasury will run out of money in the autumn. We do not expect a solution before tomorrow and we could see infighting for some months.**
- **We do not expect a major impact on the US growth outlook in the short run from higher fiscal uncertainty but risks increase the longer it takes to reach a deal.**
- **The Fed is set to hike tomorrow but the next hike could be postponed if no deal is reached in coming months.**
- **The US Treasury's cash buffer at the Fed has declined but is set to be rebuilt when a solution is found leading to a tightening of USD liquidity.**

Debt limit to be set at the level of total debt as of 16 March

The suspension of the US debt limit expires tomorrow (on the same day as the Fed is set to hike again – see *FOMC Preview: Fed to maintain signal of three hikes this year*, 13 March) and we may enter a period with renewed fiscal uncertainty in the US, as the Republicans do not have a super majority in the Senate. This means the Democrats (perhaps supported by fiscal hawks within the Republican Party) can filibuster any legislation on the debt limit. We have not heard much about how the Democrats will tackle this but one scenario is that the Democrats will use it as a negotiating tool in order to get some concessions on, for example, Obamacare. We have not heard much about the debt limit and thus it seems unlikely the US politicians will reach a deal and potentially we could see infighting for some months. However, we think a solution will be found eventually, as no one has an interest in the US defaulting on its obligations. Another important date is 28 April. In December, the US Congress passed legislation to fund government at fiscal year 2016 levels until 28 April, thereby avoiding a government shutdown. Congress needs to pass new legislation before 28 April to keep the federal government running. Donald Trump's budget proposal for the fiscal year 2018 (running from Q4 17 to Q3 18) is expected to be published on Thursday.

Debt limit to be set at the level of total debt as of 16 March



Source: Macrobond Financial, US Treasury forecast from 31 October 2016

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- *FOMC Preview: Fed to maintain signal of three hikes this year,* 13 March.
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- *Why EUR/USD should fall near term and rally medium term*, 17 February.
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- *FX Edge: US Treasury Q1 cash deluge to ease USD support near term*, 19 January.
- *FX Edge: Mind the New Year's USD supply gap,* 20 December 2016.
- *US monetary policy normalisation tool box stocked and ready for second rate hike*, 12 December 2016.

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The debt limit is the total amount of money that the US government is authorised to borrow to meet its existing legal obligations and applies to the total federal debt, which is the sum of debt held by the public and debt held by government accounts (federal trust funds such as Social Security and Medicare). The US Treasury's cash management gets more complicated when the debt limit is reached, as it means it can no longer borrow in the market and the Treasury has to take so-called 'extraordinary measures' (including things such as postponing contributions to retirement funds for federal employees).

In a recent update from the Congressional Budget Office (CBO), it estimates the Treasury would have sufficient cash by using extraordinary measures to meet its usual payments without lifting the debt limit *'until sometime in the fall of this year'* (see *pdf file here*). This may be sufficient for the Trump administration to include a solution in the reconciliation bill for fiscal year 2018. If so, this may not be an issue for Trump's intention to cut taxes for persons and companies and increase infrastructure spending, although it remains a risk that he will have to compromise on his election promises. However, the problem is that some Republicans are not keen on making fiscal policy more expansionary, as it would be likely to raise government deficit (and hence debt), which they oppose. Based on the repealing and replacing of Obamacare, it may be difficult to get even the Republicans to agree.

The debt limit has been criticised by many, as it is a mechanical rule, which has no impact on actual government expenditure/revenue. Raising the debt limit just means that the government is able to finance what Congress has already decided; it is not an instrument to reduce government deficits. President Trump and his administration are working on a tax reform and infrastructure investment package, which we believe will be likely to lead to higher government deficits and debt in coming years. Even if Trump's economic policy has positive dynamic effects, it will take time before these affect the economy. Thus, in our view, Trump is likely to deal with the debt limit several times throughout his presidency. In comparison, President Ronald Reagan raised the debt limit 18 times during his presidency.

The Trump administration has three options, which are subject to approval in Congress: (1) agree to suspend the debt limit again, (2) raise the limit (significantly) or (3) change the debt limit rules. Given the problematic nature of the debt limit, as there is no direct link between the government budget and the debt limit, the latter option is likely to be the best one from an economic perspective. Treasury Secretary Steven Mnuchin said during his confirmation hearing that he would like *'to raise the debt ceiling sooner rather than later'*.

Note that Trump plans to publish his budget proposal for fiscal year 2018 (running from Q4 17 to Q3 18) on Thursday.

Fed set to hike tomorrow but may postpone the following hike if the debt limit conflict drags on

The debt ceiling has been an issue several times in recent years and the FOMC members have repeated that not raising the debt limit pose a risk to financial stability and the broader economy and should be avoided, as the damages could potentially be *'catastrophic'*. We do not expect a major impact on the US growth outlook in the short run from higher fiscal uncertainty but believe the risks will increase the longer it takes to reach a deal. The same goes for the impact on financial markets. Although we still expect the Fed to hike on Wednesday (see *FOMC Preview: Fed to maintain signal of three hikes this year*, 13 March), the next hike could be postponed if the fiscal uncertainty is prolonged, as the Fed takes financial market developments into account.

In connection with the latest debt limit situation in October 2015, the FOMC minutes from the October meeting stated that *'it remained appropriate to follow the strategy…that was discussed at the Committee's video conference meeting of 16 October 2013'*. The participants at the video conference agreed that the Fed *'would continue to employ prevailing market values of securities in all its transactions and operations, under the usual terms'* and that there is a *'need to maintain the traditional separation of the Federal Reserve's actions from the Treasury's debt management decisions'*.

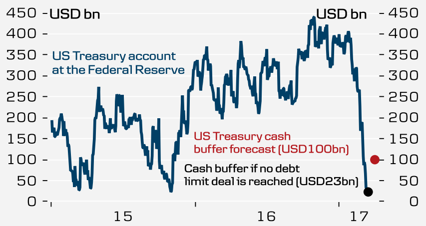
The debt limit should not affect the Fed's reinvestment of its System Open Market Account (SOMA) portfolio, at least not in the short-term, as the Treasury pays back the Fed, which uses the money to buy new debt, i.e. a zero-sum game. In the long term, it may be a problem if the Treasury runs out of money but we expect a deal to be reached before that.

Treasury's cash deluge set to stay until debt-ceiling solution is found

As we wrote in *FX Edge: US Treasury Q1 cash deluge to ease USD support near-term*, 19 January, the US Treasury's cash balance has become an important autonomous factor in the US. The cash balance has been reduced from USD399bn at the end of 2016 to USD34bn now. In the latest forecast, the Treasury expects to hold a cash balance of USD100bn by the end of Q1 and USD200bn at the end of Q2. However, in our view, it is likely it assumes that the debt ceiling does not pose a constraint at this point in time. In 2015, during the previous 'debt-ceiling episode', the cash balance declined to USD23bn. This explains why the cash buffer is now below USD100bn.

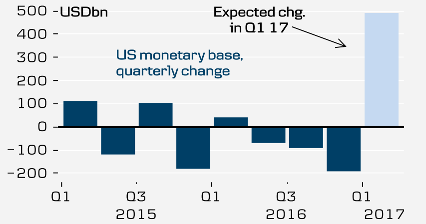
The US Treasury Q1 cash deluge has significantly eased USD liquidity in the USD money market. It has contributed to an around USD500bn increase in the US monetary base, which is a significant rise in USD liquidity. It is more than double the amount of USD the Federal Reserve added to the market on a quarterly basis during its recent stint of quantitative easing. One area where this is likely to have made an impact is on the EUR/USD XCCY basis swap. It has narrowed significantly since the start of the year, as USD has become cheaper due to increased supply of USD. This effect has mitigated the increase in interest rates on the back of the Federal Reserve preparing the market for a rate hike tomorrow. Consequently, carry in EUR/USD FX forwards is about unchanged. Hence, while the Federal Reserve has tightened monetary conditions in Q1, the US Treasury has eased monetary conditions.

US Treasury's cash buffer set to fall further



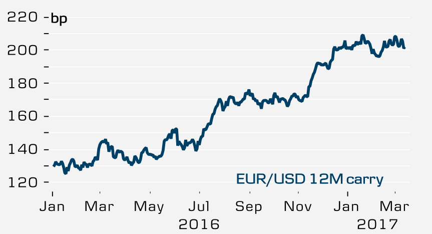
Source: US Treasury

USD cash deluge in Q1



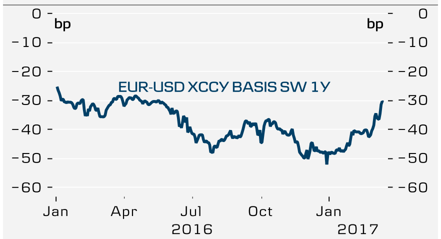
Source: Macrobond Financial, Danske Bank

Carry on EUR/USD about unchanged



Source: Macrobond Financial

USD has less expensive in XCCY basis swap



Source: Macrobond Financial

The US Treasury prefers a cash balance in the area of USD150-500bn. Once a solution to the debt-ceiling problem is found (as noted above it may take months), we will look for the US Treasury to rebuild its cash balance up to this range. This would lead to a corresponding tightening of USD liquidity and thus make USD more expensive in, for example, the EUR/USD XCCY basis swap. The risk then is that the market will end up in a situation in H2 17 where the Federal Reserve resumes hiking and USD liquidity tightens due to a rebuilding of the US cash balance, consequently making USD more expensive in terms of both interest rates and the XCCY basis swap.

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This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S (‘Danske Bank’). The authors of the research report are Mikael Olai Milhøj, Senior Analyst, and Jens Nærvig Pedersen, Senior Analyst.

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Expected updates

None.

Date of first publication

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