Danske Bank

29 September 2021

Research US

Government shutdowns are usually short-lived and no one is interested in a default by the end of the day

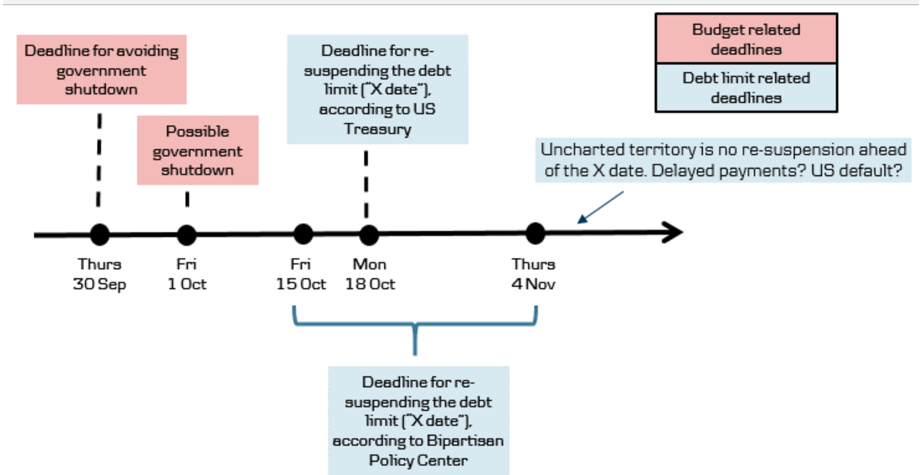
Key takeaways

- We expect Congress to pass a short-term funding bill (not a full budget) without a re-suspension of the debt limit ahead of the Thursday deadline, which will avoid a government shutdown. However, as learned by experience, we should definitely not be surprised if the government shut downs for some time. They are, however, usually very short and hence do not derail the economy.
- Congress has more time to re-suspend or increase the debt limit (and avoid a default), as extraordinary measures are not exhausted until mid-October at the earliest (the so-called X date). As no one is interested in a default, we expect a solution in one way or another ahead of the X date (either with Republican support or using reconciliation).
- The financial and economic impact from not re-suspending or increasing the debt limit in time is much more severe than a government shutdown.

The political situation: Disagreements both between and within parties

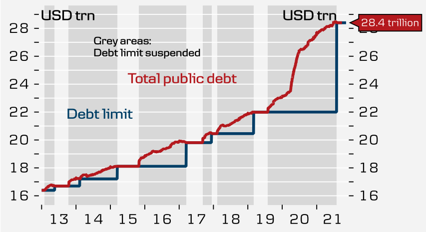
The debt limit suspension expired on 1 August and the government will shut down on Friday if Congress does not pass a new budget financing discretionary spending. The two things are not necessarily related (see box on page 5 for definitions and differences). On Tuesday, the Republican Party blocked a Democratic bill that would both fund the government and re-suspend the debt ceiling. **The Republican Party has said it would pass a short-term funding bill without a re-suspension of the debt limit, so it is still possible to avoid a government shutdown before Thursday**. What complicates things are that the Democrats cannot agree internally on the USD3,500bn welfare package.

Timeline



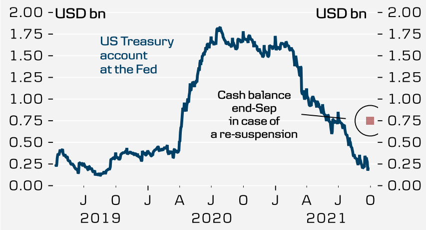
Sources: Bipartisan Policy Center, US Treasury, Danske Bank illustration

US debt limit is binding at USD28.4trn



Sources: US Treasury, Macrobond Financial

US Treasury will increase the cash balance as soon as the debt limit is re-suspended or lifted



Sources: US Treasury, Federal Reserve, Macrobond Financial

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The Democrats prefer a combined vote on short-term funding and re-suspended the debt limit but according to *Politico Huddle*, the Democratic Party may be willing to drop the re-suspension of the debt limit in order to avoid a government shutdown near-term. **One reason is that government shutdowns are very unpopular** and many may blame the Democrats, see e.g. poll from *MorningConsult and Politico (tweet)*, where 32% say they would blame the Democratic Party (versus 24% the Republicans and 36% both parties equally).The midterm elections next year are not far away.

Our base case is that Congress will pass a clean short-term funding bill ahead of the deadline, which will avoid a government shutdown by Friday. Supporting this is that the Senate is fast-tracking a vote on a clean short-term funding bill, which may happen as soon as today, see *tweet from John Bresnahan from Punchbowl News*.

We know that these political infights usually gets down to the wire before there is a solution and **there is definitely a risk of a government shutdown**. **A government shutdown would be negative for growth near-term but since they are usually very short** (the longest is 35 days in 2018/19), they are not derailing the economy. **What makes it different this time around is that it would happen in the middle of a pandemic**, where many states are still hard hit.

Not re-suspending the debt limit would be a much bigger problem both from a financial market and economic perspective, as it would mean the world's most important "risk-free" asset (US Treasuries) is not really risk-free. **There is still more time to solve the debt limit problem, although the so-called X date, when the extraordinary measures, are fast approaching**. **According to a *letter from US Treasury Secretary Janet Yellen*, the X date is 18 October. According to Bipartisan Policy Center, the X date is sometime between 15 October and 4 November, see *analysis***.

We are in uncharted territory, if we get beyond the X date (never happened before), as US Treasury then would need to prioritise payments (and delay some) and may eventually default on its obligations. This would have a significant negative impact on financial markets and the economy.

We expect the debt limit to be re-suspended or increased in one way or another: Either the Republicans cave in by supporting a re-suspension of the debt limit to avoid an US default (or by choosing not to filibuster it) or the Democrats include it in the social welfare package (based on a reconciliation bill). When analysing political discussions it is always good to look at the incentives: No one is interested in the US defaulting on its obligations. The Republicans are, however, arguing for the Democrats using the reconciliation procedure, see e.g. *Reuters*, and Senator Ted Cruz has said he will block an attempt to bypass the filibuster on the debt ceiling, see *The Hill*. **The problem is that the Democrats do not agree what to include in the USD3,500bn welfare package (which is set to be approved using reconciliation) and time is running if it is to be approved ahead of the X date**. House Speaker Nancy Pelosi has indicated that the price tag will be lowered (see *CNBC*), as moderate Democrats like Senator Joe Manchin is against it amid high inflation and high public debt, see *op-ed in WSJ*. Some Democrats have called using reconciliation a "nonstarter" but it may be necessary to speed up things. **Another issue is that the debt limit cannot be re-suspended using reconciliation but only increased by a specific dollar amount (the Democrats may choose to set the debt limit extremely high to avoid future discussions on the debt limit, just like it is the case in Denmark). In practice, it does not matter whether the debt limit is re-suspended or increased, as long as there is a solution.**

Another question is when the House will vote on the bipartisan infrastructure agreement (USD1,000bn), which has already passed the Senate, as liberal Democrats are concerned about what will happen with the bigger welfare package, see e.g. *Reuters*. The infrastructure package will pass the House sooner or later, in our view, and it could be as early as tomorrow Thursday 30 September.

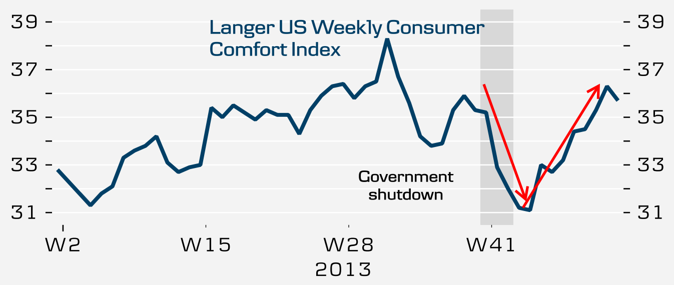
Economic impact of a government shutdown

Usually, the economic impact of government shutdowns is limited, as they do not last long. We know from the weekly consumer confidence index from Langer that consumer confidence usually takes a hit in shutdowns but recovers fairly quickly when it is over. Consumer confidence declined in both 1995/96, 2013 (see chart 1) and 2018/19 (see chart 2).

Also business confidence (as measured by the NFIB survey) declines during shutdowns and improves afterwards (see chart 3 and chart 4).

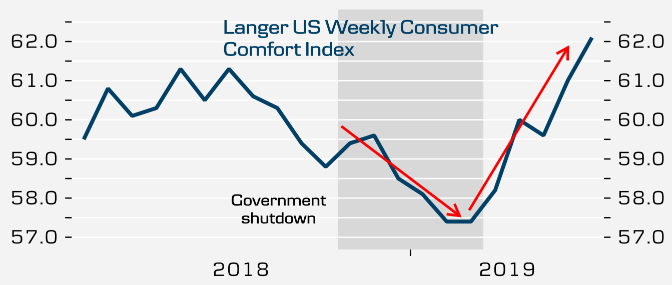
If the government is shut down, we expect something similar to happen.

Chart 1: Consumer confidence declined in 2013...



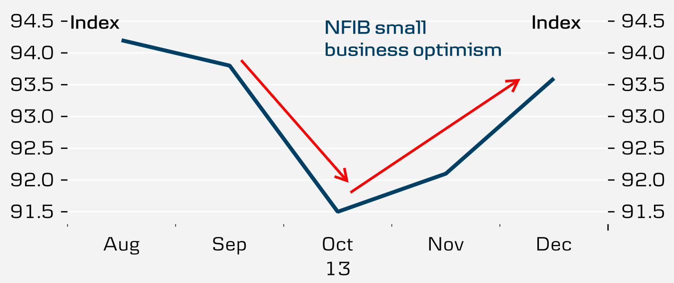
Sources: Langer, Bloomberg, Macrobond Financial

Chart 2: ... and in 2018/19 but recovered quickly



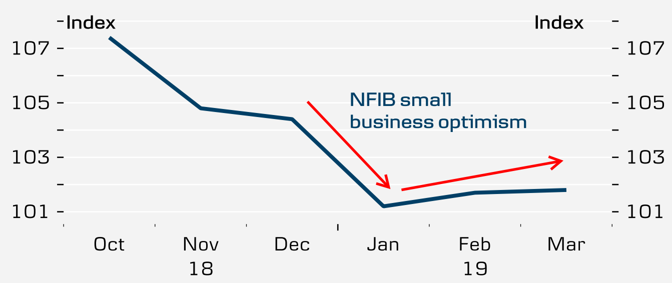
Sources: Langer, Bloomberg, Macrobond Financial

Chart 3: Also business confidence declines



Sources: NFIB, Macrobond Financial

Chart 4: ... and increases afterwards



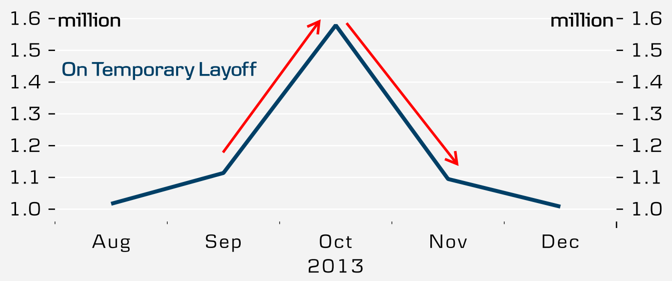
Sources: NFIB, Macrobond Financial

Federal employees are sent home without pay during shutdowns (or will not get paid). All are paid when the government re-opens. Looking at employment, federal employees on furlough is considered employed because they work or receive pay (or will receive pay) in the establishment survey (which includes the headline nonfarm payrolls). The household survey (which the unemployment rate is based on) is affected, however, as the number on temporary layoff increases sharply, i.e. they are counted as unemployed (see chart 5 and chart 6). **This means the unemployment rate may tick up despite no impact on employment growth as measured by nonfarm payrolls**. Also note that some furloughed workers may be misclassified as “employed but absent from work”, which distorts the picture.

Unfortunately, it is difficult to estimate the impact on private employment but we usually see an increase in the number of people employed part time for economic reasons (involuntary part-time workers). This may be related to 1) people need to find another job to pay the bills or 2) not enough business to work full-time. Also the number of people working part-time for economic reasons falls quickly when the shutdown ends (see chart 7 and chart 8).

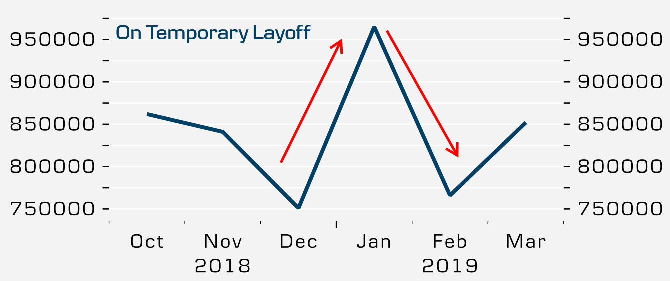
BLS wrote a more thorough piece in February 2019 in connection with the latest shutdown.

Chart 5: The number of people on temporary layoff increases...



Sources: BLS, Macrobond Financial

Chart 6: ... but falls back to pre-shutdown levels immediately after

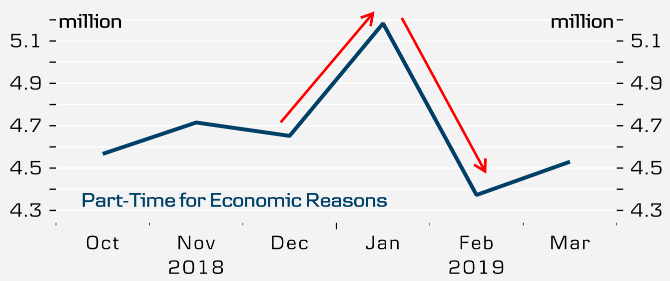


Sources: BLS, Macrobond Financial

Chart 7: The number of people working part-time for economic reasons....

Sources: BLS, Macrobond Financial

Chart 8: ... increased during shutdowns but declines immediately after



Sources: BLS, Macrobond Financial

Economic impact of not re-suspending the debt limit

It is much more complicated to say what will happen in case the debt limit is not re-suspended or increased ahead of the X date, as we are in uncharted territory. We expect a much more severe negative impact on risk sentiment and the economy if this scenario plays out, especially if the US defaults on its debt obligations. Fed Chair Jerome Powell said at the September FOMC meeting that "No one should assume the Fed or anyone else can fully protect the markets or the economy in the event of a failure", see *Reuters*.

Tighter USD liquidity in Q4

We expect USD liquidity conditions to tighten if the Fed starts tapering soon and we get a re-suspension/increase of the debt limit. The former means less QE buying and the latter means US Treasury will start rebuilding the cash balance again.

Definition of terms – debt limit and government shutdown are not related

Debt limit: The debt limit suspension expired on 1 August 2021. The debt limit means that US Treasury cannot increase US public debt above USD28.4trn and has to rely on so-called extraordinary measures (including a suspension of certain investments in the Civil Service Retirement and Disability Fund, the Postal Service Retiree Health Benefits Fund and the Government Securities Investment Fund of the Federal Employee's Retirement System Thrift Savings Plan) to finance the deficit (basically swapping non-marketable debt (held by the government itself) to marketable debt (held by the public).

It is difficult to estimate when the extraordinary measures run dry (the so-called X date). According to the US Treasury they will be exhausted "during the month of October", see *letter*. According to Bipartisan Policy Center, they are exhausted sometime between 15 October and 4 November, see *analysis*. There have been several occasions where the debt limit has been binding but the debt limit has always been re-suspended ahead of the X date, so we are in uncharted territory if the extraordinary measures are exhausted. After this day, US Treasury has no cash left to ensure obligations are paid on time. Most likely, US Treasury would have to prioritise, which obligations to meet and which to delay. The biggest risk is an US default.

The debt limit can be re-suspended if approved by both the House (simple majority) and the Senate (60 votes to avoid filibuster). The debt limit cannot be re-suspended using reconciliation but only increased to a specific amount. In practice it does not matter how the debt limit issue is solved, as long as it is solved ahead of the X date.

Government shutdown: Federal agencies and programs rely on annual funding appropriations passed by Congress. The fiscal year runs from 1 October to 30 September, so the current funding expires on Thursday and a new budget needs to be approved before the current funding bill expires. In case of a government shutdown, federal agencies must discontinue all non-essential discretionary functions until new funding is approved. Federal workers are furloughed and not paid during the shutdown (the same goes for private sector workers employed at government contractors). Essential services and mandatory spending programmes continue. *The Committee for a Responsible Federal Budget* has a great overview of which services are impacted by a government shutdown.

Since the financial crisis, there have been three government shutdowns. One lasting 16 days in October 2013, one lasting three days in January 2018 and one lasting 35 days in December 2018 and January 2019 (the longest in history).

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