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The story of the US debt ceiling! Will it be breached or not?

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When the world's largest economy hit the debt ceiling then surely people are going to talk and write about it. The US hit the debt ceiling limit of $31.4 trillion on 19 January 2023 and the US treasury Secretary Janet Yellen reaffirmed that the US could default on its debt obligation in early June 2023. Debt ceiling refers to the maximum amount of money that the government can borrow to meet its legal obligations which include paying interest on its debt and paying military salaries, tax refunds, and social security, etc. It is something similar to the Fiscal Responsibility Balanced Budget Management Act 2003 in India, that suggest that ideally fiscal deficit for India should be contained within 3% of the GDP. But unlike India, where the largest ruling party at the Lok Sabha can take a decision, in the US any change in the debt

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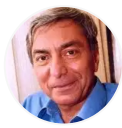
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ceiling requires majority approval by both chambers of Congress.

If the Democrats and the Republicans fail to reach to an agreement to suspend or increase the debt ceiling limit, it will imply that the US government will default on its debt obligation. According to the Congressional Budget Office, the US government is currently spending $1.4 trillion more than what is generating as revenue. For the years 2020 and 2021, US ran a deficit of $3.1381 trillion and $2.77 trillion, respectively. In fact, since the start of the US financial crisis in 2007, the US government on average was spending $1 trillion annually more than what it was earning as receipt. This meant the US government is constantly borrowing from international source to finance its deficit at home. Almost 30% of the US debt is of foreign origin.

But then why the US government always has to borrow so much? Let us step back some years into history.

The US dollar started its stature as a global currency initially after the Bretton Woods- conference in 1944 and then gained a foothold with the advent of the ‘petrodollar’ in the 1970s. In the early 1970s, during the Yom Kippur War, the Organisation of the Petroleum Exporting Countries (OPEC), of which Saudi Arabia is a member, implemented an oil embargo. The price of oil per barrel went up from $3 in 1973 to $12 in 1974, and the OPEC member countries started generating money. The then American President, Richard Nixon struck a deal with Saudi Arabia ensuring that all oil deals across the world would take place in US dollars. Other oil-producing nations in the OPEC joined Saudi Arabia, depositing a large portion of their money in the US banks, thus marking the beginning of the 'petrodollar'.

Then starting in the early 1980s and through the 1990s, most of the economies around the world, in particular the emerging and developing economies from Asia, including India, China, Korea, and other South East Asian nations, followed the path of liberalization and globalization. This led to more trade. Since international trade was primarily happening in the US dollar, demand for dollars continued.

The US economy was strong enough that countries across the world held on to the dollar as a reserve currency even though the parity with gold was discarded. The US was able to finance a big fiscal and current account deficit through the major part of the last century on account of the huge external demand for the US dollar, which was aided by the low-interest rate policy of the US Federal Reserve.

However, things started to change with the onset of the global financial crisis in 2007. There was a sharp increase in the US budget deficit. This was followed by a slower and stagnated economic growth rate in Europe. The US and the EU regions accounted for more than half of world trade volumes, and a slowdown in these regions impacted global trade. For the first time since the advent of the 'petrodollar' during the early 1970s, global trade as a percentage of the world Gross Domestic Product (GDP) started to fall.

The outcome of slower trade growth then got manifested in individual countries turning protectionist. Protectionism became evident in terms of an increase in applied tariffs (although, keeping them below the rates countries bound at WTO) and non-tariff barriers, mainly in the form of anti-dumping measures, sanitary and phytosanitary sanctions, and even through the provisions granting subsidies to domestic producers. A slower growth in trade and investment flow led to lower demand for dollars.

In 2021 the world witnessed Covid-19, and now the war in Europe dented the trade and investment flow, further. As of 31 December 2022, the US government spent $4.2 trillion in response to Covid-19. The generous social security meant that the US workers did not have to work and money kept on coming to their bank accounts. As most of the money was not spent on productive activities, it led to inflation and an increase in budget deficit, so much so that the US hit the debt ceiling limit.

The proponents led by the Democrats are arguing for an increase in the debt ceiling limit to continue with the social programs such as the food and cash aid that started at the time of Covid-19. Also, President Biden wants to put aside a chunk of money towards the US commitment for climate change and green energy; economic impact of which is not going to show up in the short-run. As the US heads for the presidential election next year, such commitments by the Democrats are understandable.

The opponents led by the Republicans are suggesting way to contain the budget deficit, failing which it will be difficult to control inflation. In fact, they are willing to increase the debt ceiling act, provided the Democrats slashed the commitment for Covid-19 fund and reduce the age limit of the workers. In some states in the US, the Republicans are proposing for hiring workers as young as 14 years to fight the labor shortage problem and wage inflation.

The exogenous shock in the form of Covid-19 and a concomitant quantitative easing, increased the inflation rate to 9.1% (a 40 year high in June 2022), but nevertheless the Fed is now able to bring down the inflation to 4.9% in April 2023. The US economy is looking strong, with strong job market data and better tax revenue collection.

In this regard, some of the unconventional monetary policy measures undertaken by the Fed are yielding results. For example, Fed is monetizing government debt by buying securities in the primary market bypassing the secondary market. As this portion of the debt is not traded in the market it will not lead to an increase in money supply, and therefore inflation. Additionally, the Fed can increase the mandatory reserve requirements and/or incentivise the commercial banks to park excess funds in return for higher interest rates than the federal fund rates. This will essentially suck in money from the economy making the system inflation neutral. Going forward it is unlikely that the Fed will increase interest rates, and quite likely that the Congress will agree for increasing the limit for debt ceiling.

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