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How Did US Hit the Debt Ceiling and What Will Happen Now?

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The US hit the debt ceiling of $31.4 trillion on January 19 and as early as June 1, the US government may run out of money to pay its bills if Congress does not raise or suspend the debt ceiling. US treasury secretary Janet Yellen reaffirmed that defaulting on the US debt obligation would be a "catastrophe" and would put into question Washington's "global economic leadership". The debt ceiling refers to the maximum amount of money the government can borrow to meet its financial obligations.

According to the Congressional Budget Office, the US government is currently spending $1.4 trillion more than what it is generating as revenue. In fact, since the start of the US financial crisis in 2007, the US government, on average, has been spending $1 trillion annually more than what it has been earning as receipts. This means the US government is constantly borrowing from international sources to finance the deficit at home.

But then why does the US government always have 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. Richard Nixon, as the president of the US, struck a deal with OPEC ensuring all oil deals across the world take place in the US dollar, 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, South Korea and Southeast Asian countries – followed the path of liberalisation and globalisation. This led to more trade. Since international trade was primarily taking place in the US dollar, demand for the dollar continued. Alongside, the US played a major role in international financial institutions, like the International Monetary Fund and the World Bank, and settlement mechanisms, like the Society for Worldwide International Financial Telecommunications, or SWIFT, further promoting the use of dollars.

The US economy was strong and countries around 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 accounted for more than half of world trade volumes, and a slowdown in these regions affected global trade. For the first time since the advent of the "petrodollar", global trade as a percentage of the world's Gross Domestic Product started to fall.

The outcome of slower trade growth then manifested itself in individual countries turning protectionist. A slower growth in trade and investment flow led to lower demand for dollars.

In 2020, the COVID-19 pandemic arrived. The pandemic and, subsequently, the war in Europe dented the trade and investment flow further. As of December 31, 2022, the US government had spent $4.2 trillion in response to COVID-19. The generous social security meant that US workers did not have to work and money kept on coming into 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.

The Democrats are arguing for an increase in the debt ceiling to continue with social programmes like food and cash aid that started at the time of COVID-19. As the US heads for a presidential election next year, such commitments by the Democrats are understandable.

The Republicans insist that the budget deficit must be contained, failing which it will be difficult to control inflation. In fact, they are willing to raise the debt ceiling, if the Democrats slash the commitment for the COVID-19 fund and reduce the lower age limit of workers. In some states, the Republicans are proposing hiring workers as young as 14 to fight the labour shortage 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 the Fed was able to bring it down 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, the Fed is monetising 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. It is unlikely that the Fed will increase interest rates, and quite likely that Congress will agree to raise the debt ceiling. Since 1960 Congress has suspended or raised the debt ceiling 78 times, and I am sure this time will be no different.

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