Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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SHUTDOWN, DEBT, DEFICIT, DEFAULT AND THE ECONOMIC IMPACT: WHAT YOU NEED TO KNOW AND WHAT IT MEANS FOR THE FED

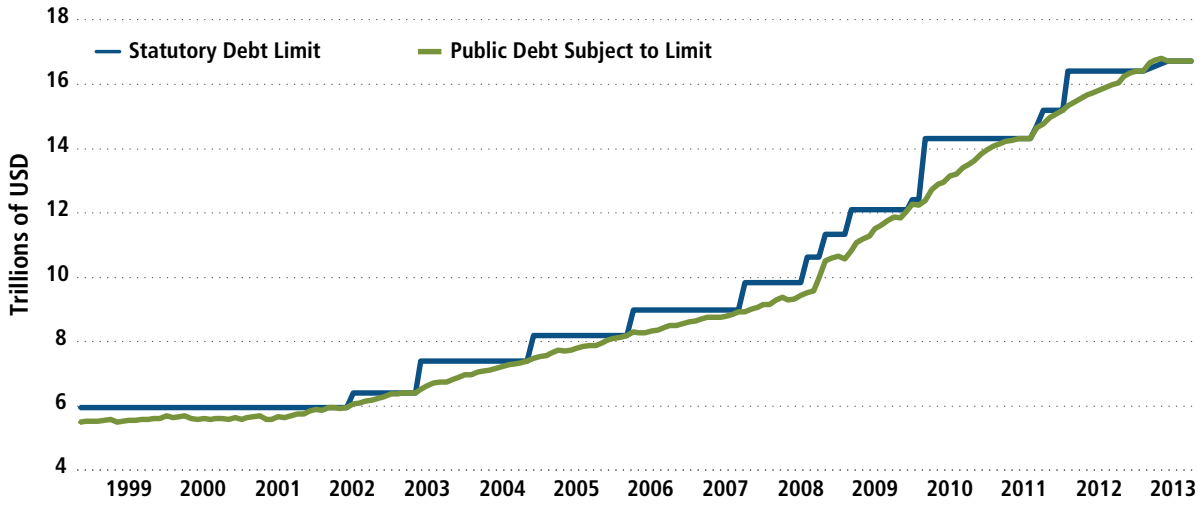
Uncertainty clouds most discussions of the US debt limit (the so-called "debt ceiling"). With the US Congress gridlocked and market jitteriness increasing, answers and solutions appear in short supply. That said, some clarification is possible. Below, we provide a rough road map of what could happen—along with the implications for the US economy and the Fed.

#1 The partial shutdown of the US federal government is not the same as the debt ceiling. In the case of the former, Congress was unable to reach agreement on appropriations as the fiscal year ended (on Sept. 30). The result: furloughs for between 500,000 to 1 million federal government employees. The debt ceiling is yet another issue, referring to the total amount of money Treasury can borrow to meet *existing obligations*. Increasing the debt ceiling simply allows the government to make the payments it owes.

#2 On the *shutdown* which began in early October: the direct macroeconomic impact of the partial *shutdown* is likely to be minimal. Though the final numbers are uncertain, a two-week shutdown would cut about 0.5% off quarterly annualized GDP growth. That said, some of the lost ground might be made up after the fact. Following the shutdown in 1995, Congress later voted to retroactively pay employees. Were this scenario to obtain in 2013, Q1 2014 GDP would likely see a commensurate boost.

#3 The US hit the debt ceiling in May 2013 (see Chart 1). Since then, Treasury has enacted extraordinary accounting measures (moving money between intra-governmental funds, withholding payments to others) to avoid colliding with the debt ceiling. Treasury Secretary Jack Lew informed the world that as of October 17th, Treasury would be unable to enact further extraordinary measures, and would, on that date, exhaust its borrowing authority. With borrowing and accounting tricks unavailable, incoming revenues and existing cash on hand are the only source of funds for expenditures.

THE DEBT LIMIT (IS IT REALLY A LIMIT?)



Source: US Department of Treasury

#4 In the event that the US Treasury lacks sufficient funds to make payments, a "technical default" could occur. Private sector estimates put the total payment capacity available to Treasury on October 17th at around $70 billion, though it could be much less. Treasury would likely be able to cover payments from cash on hand, revenues, and other technical maneuvers until about November 1. In addition to Treasury bills maturing in late October and early November, Treasury has coupon securities maturing in late October and mid-November as well as 2, 5 and 7-year Treasuries with coupon payments at the end of the month. In the event of a default, securities such as these could be victims of a temporary missed payment. Even in the worst case default scenario, nonpayment of coupon and interest is likely to be temporary.

#5 The federal government collected a record-setting $230 billion per month on average over the summer in tax receipts. Meanwhile, total federal outlays for debt service, Social Security payments, Medicare payments and Veterans Affairs averaged around $200 billion per month over that period (see Chart 2). In short, the Treasury should have no problem paying debt service and essential bills for a few weeks. The

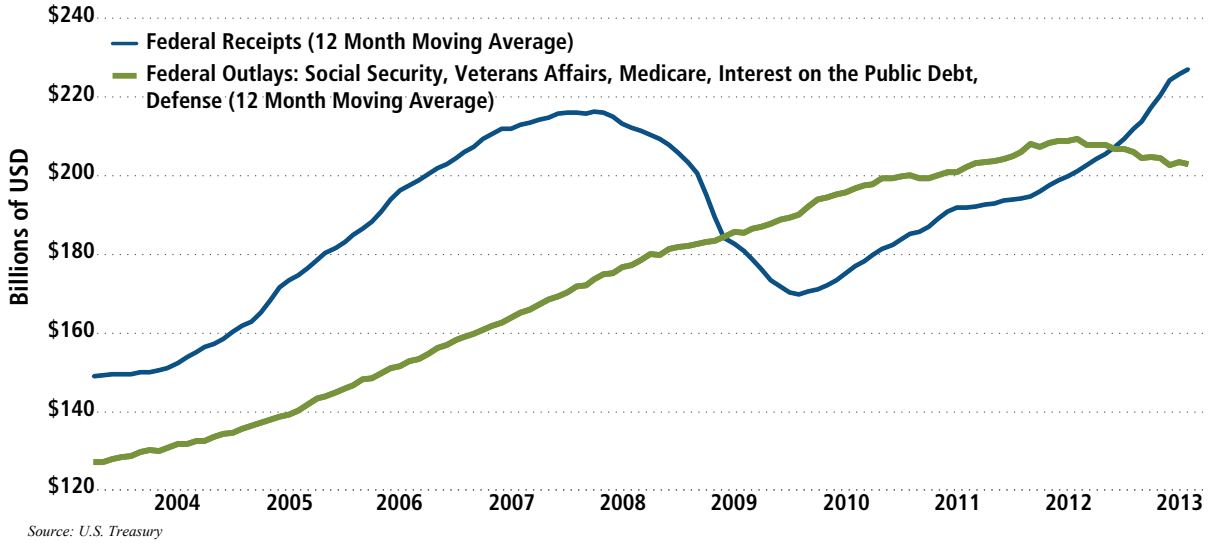
key problem is that on any given day outgoing checks may exceed revenues. Ultimately, even under the low probability default scenario, this is more of a cash management problem than a solvency crisis.

#6 If Congress does not raise the debt limit and the cash constraint hits Treasury, some conceivable options remain. Other possible options for Treasury financing include:

- Prioritizing payments: though theoretically possible, the technical implementation of such a plan remains difficult. Treasury makes 4 million payments per day, and, as these payments are automated, changing the order in which they are sent may or may not be possible. Additionally, some legal uncertainty exists as to Treasury's authority to selectively allocate funds. However, because principal and interest payment on debts run through Fedwire (payment system), they may be more easily separated.
- Make payments in arrears: Treasury could delay payments, waiting to accumulate sufficient cash to pay off daily balances.
- Treasury could issue very high coupon securities to be auctioned at a premium to face value. Such a strategy would win Treasury a large initial cash inflow, but large future coupon payments would remain. The debt ceiling applies to face value of public debt outstanding.
- Other: asset sales, minting platinum coins and depositing them in the Treasury's checking account at the Fed, etc., though popular on the internet are only very remote possibilities and will hence not be directly addressed here.

#7 The indirect economic effects of both the shutdown and the debt ceiling uncertainty loom larger than the direct effects (covered in #2 above)—though, for now, the market is complacent. As political uncertainty disrupts financial markets, the spillover to the real economy may grow. History is not a perfect guide but the 2011 debt ceiling and US credit downgrade provides some comparison. Equity prices dove 17%, which reduced household net worth by more than $2 trillion. This, in turn, reduced growth in consumer spending. It became more expensive for nonfinancial corporations to borrow, as the spread between BBB corporate bond yields and Treasuries rose by more than 50 basis points. Households, too, saw higher borrowing rates, as the spread between a 30-year conventional mortgage and Treasuries widened by more than 50 basis points during the summer of 2011. Importantly, even though an agreement was reached, spreads remained wide well into 2012 and therefore depressed business investment, household spending and overall economic activity beyond the crisis episode.

THE US TREASURY COLLECTS MORE THAN ENOUGH REVENUE OVER THE COURSE OF A MONTH TO PAY DEBT SERVICE--AND MORE



The conclusion: The October 17th date is not a hard debt ceiling deadline. Fiscal wrangling could last until late October. But even a relatively short period of shutdown and debt ceiling debate may have significant spillover effects on financial markets which will impede the real economy. We will keep our eyes on financial market indicators to gauge the severity this time around. For now, equities are off only about 2%, the VIX is still below 20 and credit spreads have pushed only marginally wider. Of note in terms of market impacts, it is now cheaper for the Treasury to borrow for 1-year (14 basis points) than 4 weeks (28 basis points) due to liquidity-focused T-bill investors shunning issues that mature in the month ahead.

Our longstanding macroeconomic view sees sluggish real GDP growth and a later taper than the market expected. The federal fiscal fiasco only adds downside risk to US economic growth and postpones a move toward Fed tapering—perhaps even until we see evidence of the knock-on effects in Q4 GDP. Minutes released on Wednesday revealed discussions at the September FOMC meeting centered around possible fiscal fallout harming the pace of economic activity. If anything those concerns have increased in the three weeks since policymakers met. Newly-nominated Fed Chair candidate Janet Yellen also remarked Wednesday afternoon that "more needs to be done" to bolster growth: such a clarion call for support further argues against a taper in the pace of asset purchases in the near-term and suggests that further steps from the central bank, likely in the form of enhanced forward rate guidance, may be in the works.