The $16 Trillion Question: The U.S. Debt Ceiling

At the close of business on August 31, 2012, the United States broke a record that had nothing to do with the London 2012 Olympics: The country’s total outstanding public debt closed above $16 trillion.1,2 In addition, with 2012 U.S. gross domestic product estimated to be $15.7 trillion,3 the country’s debt-to-GDP ratio crossed the closely watched 100% frontier for the first time since the 1940s.4

The United States faces a key obstacle to continuing this level of borrowing to fund the government—the statutory debt ceiling. Congressional consent is required to increase federal debt beyond this designated limit, which is $16.4 trillion. Moreover, rating agencies have once again placed a bull’s-eye on the sovereign ratings of the United States given the inability of Congress and the Administration to address the fiscal situation. The high and growing level of debt continues to feed concerns related to the U.S. fiscal position.

As the debt level rises and the “fiscal cliff”5 continues to be a major focus point before and after the November elections, expect discussions regarding the debt ceiling to come once again to the forefront. Negative comments from rating agencies—and potential actions—could contribute to financial market turbulence similar to what transpired in August 2011, when the debt ceiling debate and subsequent ratings downgrade by Standard & Poor’s (S&P) led to volatility.

U.S. public debt ceiling nearing limit

Just over a year ago, U.S. public debt outstanding stood at $14.5 trillion. In order to continue to fund the government and prevent a default, the Budget Control Act of 2011 was signed on August 2, 2011. This legislation ended contentious tax and spending discussions, and increased the debt ceiling to $16.4 trillion. Since the beginning of 2012, U.S. public debt outstanding has risen by more than $800 billion, to $16 trillion (see Exhibit 1, below).

EXHIBIT 1: The debt ceiling has stayed just ahead of the federal debt level since 2010.

KEY TAKEAWAYS

• At more than 100% of GDP, U.S. public debt is approaching its statutory limit—the debt ceiling.
• Major rating agencies have the U.S. on negative outlook, and will be watching developments closely.
• The mercurial election season and resulting lame duck Congressional session are not likely to support productive debt ceiling negotiations.
• Investors could witness escalating market volatility as debt ceiling rhetoric builds.
The accelerated accumulation of debt was particularly pronounced during the past 12 months. During this period, lower-than-expected tax revenues and larger-than-expected expenditures contributed to a more rapid pace of borrowing.

The U.S. Treasury can issue approximately $300 billion in additional debt before the debt ceiling is reached. Based on average borrowing needs during past years and the current trajectory of the debt, the Treasury is projected to run out of borrowing room in November or December 2012.

Congress and debt ceiling legislation

Very little is likely to be done to address the debt ceiling in the weeks prior to the November 6 elections. Hence, the debate and uncertainty resulting from the looming debt ceiling could continue to cloud market sentiment.

Since a “grand bargain” between Democrats and Republicans appears highly unlikely for 2012, the next round of debt-ceiling discussions could once again come down to the last moment. In 2011, some policymakers were very adamant about the preconditions to raising the debt ceiling, and even hinted at default as an option.7 In the equity market, this resulted in volatility and negative reactions (see Exhibit 2, below). While Congress is likely to avoid such comments this year, the chance of another hard-line fiscal debate certainly exists.

Bundling the increase in the debt ceiling with a broader piece of legislation addressing the fiscal cliff would be an ideal way to move forward. However, if Congress reaches an impasse in addressing the fiscal cliff prior to the end of 2012, the potential for reaching an increase in the debt ceiling becomes even more remote. A delay in raising the debt ceiling could in turn lead to investor concerns about a repeat of last year’s acrimonious discussions. Given the financial volatility experienced last year, some investors may be anticipating the same environment in the fourth quarter of 2012. In many ways, even without the fiscal cliff approaching, the debt ceiling is the true line in the sand for the two political parties to resolve their differences of opinions. However, just like last year, the Treasury does have some options to defer the decision on the debt ceiling—and other fiscal issues—for a short period of time.

Options at the Treasury’s disposal

U.S. Treasury Secretary Timothy Geithner estimated earlier this year that the debt ceiling would be reached “before the end of the calendar year [2012].”8 Even though federal borrowing will likely lead to reaching the debt ceiling later in November or in December 2012, the U.S. Treasury has a number of tools that it can use to continue financing the government. This additional borrowing authority could provide the government with enough headroom until early in the new year.

Specifically, short-term measures that are permitted by statute would involve accessing intergovernmental sources of liquidity and asset dispositions.9 For example, the Treasury could choose to cease the issuance of short-term (i.e., daily maturity) Treasury securities provided to federal employees in a government fund (G Fund) as part of its retirement plan (Thrift Savings Plan), thereby freeing up roughly $150 billion in borrowing capacity. Similarly, the federal government has the ability to cease issuing debt of other nonmarketable, short-term securities in other funds, such as the Exchange Stabilization Fund and the Civil Service Retirement and Disability Fund, to boost its borrowing capacity (see Exhibit 3, page 3).

In total, these “extraordinary” tools could provide the Treasury with more than $200 billion in additional borrowing capacity. This additional cushion, barring any very large or unforeseen expenditure, could minimize the risk of a government default. However, the fact that these tools were used would likely be an object of significant focus by the media and Congress.

Potential for U.S. credit downgrades

In addition to the debt ceiling discussions, the potential for U.S. sovereign debt downgrades could also capture the attention of the media and investors in the coming months. Once again, given the timing of the elections and the need to address the spending cuts and tax increases set to take place on January 1, 2013, the ability of Congress or the president to come to meaningful agreement is unlikely. While backchannel discussions between government
officials continue to take place in Washington, the chance of a major legislative effort is very low. As a result, Congress is likely to propose a postponement of the fiscal consolidation measures that will rear their head at the start of next year.

While postponing the arrival of the “fiscal cliff” may initially be viewed positively by investors, it could present considerable downside. The implications of not imposing the $4 trillion of deficit reduction measures over the coming decade as proposed by the Joint Select Committee on Deficit Reduction will likely lead to significant rating agency concerns.

S&P's downgrade of the United States credit rating from AAA to AA+ on August 5, 2011, was unanticipated. However, since then other rating agencies have clearly signaled their intent to address the rating if fiscal measures are not carried out as prescribed in the fiscal debates last summer (see Exhibit 4, above). For example, Fitch Ratings has focused on the U.S. credit rating more closely. In June 2012, Ed Parker, sovereign ratings analyst at Fitch, noted in a speech that the “United States is the only country [of four major AAA-rated countries] which does not have a credible fiscal consolidation plan.” This recent statement follows Fitch’s decision in November 2011 to lower its rating outlook for the United States from stable to negative after the Joint Select Committee on Deficit Reduction failed to agree on at least $1.2 trillion in deficit-reduction measures.

Like the other credit rating agencies, Moody's placed the U.S. credit rating on negative watch in 2011. In September 2012, Moody’s specifically warned that the U.S. credit rating could be downgraded to Aa1 from Aaa or be under review if:

- Congress fails to “produce specific policies” that stabilize the negative federal debt-to-GDP trend over the medium term;
- The stabilization efforts lead to a large fiscal shock, that limits the ability of the economy to rebound;
- The process for the increase in the statutory debt limit is disorderly, which leads to market volatility; and, importantly,
- If an agreement on increasing the debt ceiling is not reached before the Treasury begins using its extraordinary tools, which is likely to occur at the end of this year.

All told, evidence suggests that the actual mechanics surrounding the debt ceiling increase—less of a factor in prior years—is now a focal point for the major rating agencies.

Hence, significant hurdles have been put in place by Moody’s to maintain the current U.S. credit rating and outlook. Without near-term action, the potential for a negative outcome is quite high.

**Investment implications**

The debt ceiling will likely be a line in the sand on a number of fronts early next year, including potential Congressional action to resolve the fiscal cliff issue, and sovereign debt ratings actions by Fitch, Moody’s, and possibly S&P. While the Treasury has tools for raising the debt ceiling temporarily, it may be too little too late in terms of negative attention. Combined, these developments have the potential to unsettle investors, which could create negative market sentiment and financial market volatility as the end of the year approaches.
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Endnotes

1 In this document, U.S. public debt refers to debt held by the public. Under this definition, debt held by the public includes all federal debt held by individuals, corporations, states or local governments, foreign governments, Government Account Series Deposit Funds, and other entities outside the U.S. government less Federal Financing Bank securities. Types of securities held by the public include, but are not limited to, Treasury bills, notes, bonds, TIPS, U.S. Savings Bonds, state and local government series securities, and government account series securities held by deposit funds. Monthly Statement of the Public Debt of The United States, August 31, 2012, page 16. http://www.treasurydirect.gov/govt/reports/pd/mspd/2012/opdm082012.pdf.


4 The debt-to-GDP level used in this paper is the sum of intragovernmental debt and marketable debt, which results in a debt-to-GDP ratio of more than 100%. Investors can also express debt to GDP using only marketable debt, which results in a debt-to-GDP ratio of nearly 70%.

5 The “fiscal cliff” refers to the expiry of the Bush-era tax cuts (i.e., Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003) as well as spending cuts enacted resulting from the Budget Control Act of 2011. The total impact on the public debt is estimated to be $4 trillion over 10 years.

6 The debt subject to the limit is the amount of federal debt that is counted against the debt ceiling. This amount is lower than the public debt outstanding, because certain federal intragovernmental debt is not included.


8 Written testimony of Secretary Geithner before the Senate Finance Committee on the President’s FY2013 Budget, February 14, 2012.


11 On August 2, 2011, the Budget Control Act of 2011 was signed into law, thus increasing the debt ceiling. The Act created the Joint Select Committee on Deficit Reduction to address spending cuts. No resolution was reached.


13 Update of the outlook for the U.S. government’s debt rating, Moody’s, September 11, 2012.

Other important information

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