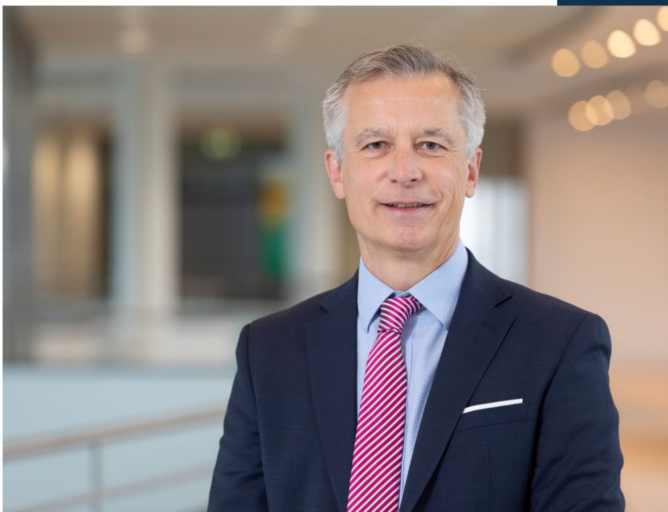

LBBW Bereit für Neues

To the point!

Cross-Asset- and Strategy-Research

The U.S. debt ceiling must be raised

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Failure to do so could cause a severe financial crisis. Don’t risk it!

It's that time again. There is an escalating dispute in Washington over whether the federal government should be allowed to issue new debt. By way of background, in the U.S., Congress passes a budget that the government is then allowed to spend. However, it does not at the same time provide approval for the resulting funding requirements. Instead, Congress decides in a separate piece of legislation on the debt ceiling. This separation is of course nonsensical and unique in the world. But that's the way it is.

In January, the government reached the $31.4 trillion debt ceiling authorized by Congress. Since then, Washington has been able to maintain its solvency only by letting the government melt down its reserves. However, according to Treasury Secretary Yellen, these are likely to be exhausted by early June. Then the game is over. The proud United States of America, the largest debtor in the world, would be in default. The debts would no longer be able to be serviced, nor could any other payments still be made.

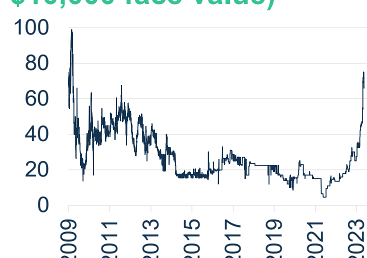
Why an agreement is so difficult this time

Of course, the government is not economically insolvent and could easily continue to service its debt. But it would no longer be authorized to do so if the House of Representatives, controlled since January by a razor-thin Republican majority, won't raise the debt ceiling. Adjusting the debt limit is actually a well-rehearsed routine. Since 1960, it has been raised 78 times. Usually this is done without any fuss.

But not this time. The political constellations make an accident more likely than ever. That's because the new majority leader in the House, Kevin McCarthy, has only a five-vote majority. That's

The probability of a U.S. default is higher than ever before

Cost of credit default insurance for U.S. government bonds ($ per $10,000 face value)



Source: Refinitiv, LBBW Research

probably less than the number of radical Republicans who would reject any compromise with the despised Democrats. The massive spending cuts demanded by McCarthy in return for raising the debt ceiling would be tantamount to cashing in on President Biden's government program – and then some. This is out of the question for the White House. Presumably McCarthy knows that, too. But breathing down his neck, as with all other Republicans, is the miraculously resurgent Donald Trump, who will lambast any Republican who takes even a step toward Biden.

Republicans are digging in

The situation reminds me of the James Dean classic "Rebel Without A Cause" (eerily apt movie title): Two young men race toward a cliff in stolen cars. Whoever jumps out first is the loser, the coward. In the movie, this game of chicken doesn't end well. The risk is increasing that it will also end badly with the debt ceiling. Except that it is the nation that might go over the cliff. This is also the view of the capital market (see figure).

What is at stake economically

A banking crisis looms large

U.S. banks are already struggling to keep depositors' trust. If the federal government were now to become insolvent, there would likely be a sell-off of U.S. bonds. This will lead to further significant write-downs on bank balance sheets and new bank runs. The government, however, would no longer be able to guarantee the deposits with its full faith and credit. After all, its credit would have been gambled away. A financial crisis is looming. The Fed would have to cut interest rates aggressively, the dollar and stocks would plummet. Only the Bitcoin disciples would have a good laugh. Above all, the risk of recession and social radicalization would swell.

And here in Europe? Better not find out. That's why today I join the chorus of those appealing to Kevin McCarthy: Do us all a favor, please raise the debt ceiling now!