Debt Ceiling update

June 06, 2023

A Game You Don't Want to Play

We all know what a game of chicken is. In the most extreme example, the drivers of two automobiles barrel down the highway at reckless speed directly toward each other, and usually (but not always) one of them swerves away at the last second, and the driver who didn't swerve is declared the 'winner.' It's not the smartest recreational activity we can engage in.

What's going on in Washington right now is a classic game of chicken, except instead of using automobiles, the 'drivers' are withholding their votes to raise America's debt ceiling. The U.S. House of Representatives is required to authorize, or not, the government to issue more government bonds (take on more debt) in order for the government to continue to pay its workers, Treasury bondholders, Social Security and other beneficiaries, members of the military and various other elements of the spending that was previously authorized and approved by (you guessed it) members of Congress.

When you play chicken with automobiles, the risk is that one fool or the other will be horrifically killed. Playing chicken with the national debt creates a lot of collateral damage, not least to the reputation of the United States as a country that can be reliably counted on to make good on its fiscal obligations.

Chances are, you know all this. You may not know that as the proverbial cars approach each other, the U.S. Treasury has been taking a number of extraordinary measures to use the cash coming in from tax revenues to keep the government ship afloat. That includes suspending making contributions to the retirement funds for federal employees, civil service retirees, and the Postal Service Retiree Health Benefits Fund and cutting back on the Exchange Stabilization Fund that is used to stabilize global exchange rates (and the dollar's value) on the foreign markets.

You also may not know that if the government has to suspend payments on government bonds, as early as June 7, it will be mostly stiffing American investors, American pension funds, American states, and our own Federal Reserve system. You can see from the chart that more than two-thirds of the public debt is funded here in the U.S.; the primary outside holders of government bonds are Japanese funds, the Japanese government, and the Chinese government.

There is no direct linkage between raising the debt ceiling and budget negotiations; that is, the debt ceiling is not in any way dependent on an agreement as to how next year's budget should be allocated. The current game of chicken in Washington is entirely voluntary on the part of the leadership in the U.S. House of Representatives, who were in agreement with the budget obligations they are now objecting to paying for.

That said, there is probably a good case to be made for more fiscal responsibility in Washington, and that will probably involve a combination of spending cuts and higher taxes. On the spending cuts side, there is one elephant in the room: the U.S. military budget, which has grown to $877 billion, and there have been consistent reports of waste and mismanagement. All parties in Washington seem to agree that a well-financed military is the best way to keep Americans safe from potentially aggressive enemies. But if you look at the chart, it's hard to see that the current spending level is absolutely necessary to deter an invasion from any other nation, simply based on their military budgets. If the U.S. were to cut back to, say, China's level of (not inconsiderable) military spending, we could reduce government expenditures by $600 billion a year, right off the bat.

The most dangerous aspect of all this for investors is the possibility that the markets will sink, and there will be panic selling, permanently locking in temporary losses. There is no reason why a pause in the U.S. government paying its employees and bondholders should have any long-term effect on the enterprise value of American corporations, whatever the markets do in the short term.

The game of chicken ends when one side or the other swerves at the last second, or in an awful, always-fatal collision. Investors are thankfully not sitting in the passenger seat of either car or so they can simply choose not to participate.

Source:

https://www.pgpf.org/

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