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ISSUER COMMENT

US Government to Reach Debt Limit Soon

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The United States statutory debt limit will be reached again soon if Congress does not act to raise the limit. We view the debt ceiling as a permanent feature of the US government risk profile (Aaa / negative outlook), as captured in our view on susceptibility to event risk. We expect protracted negotiations on the budget, and the debt ceiling may not be addressed until a budget agreement is reached or the government comes close to exhausting all other temporary measures. Nonetheless we expect the government will act to raise the limit, as it has done on many occasions in the past. Our view is that the probability of a missed interest payment on Treasury bonds is extremely low, although we will monitor political developments in the coming months for evidence the probability has shifted.

The US Treasury has said that it expects the statutory debt limit of $16.394 trillion to be reached by the end of this month. Debt subject to the limit, which includes both debt held by the public and intragovernmental holdings, stood $96 billion below the limit as of December 21 and had grown at a monthly pace of $152 billion during October and November. When the limit is reached, the Treasury is no longer authorized to increase the amount of outstanding debt, although it continues to issue debt to refinance outstanding bonds and notes as they mature. After the limit is reached, the Treasury can use its cash balances ($52 billion as of December 21) and a number of extraordinary measures so that government operations can continue at normal levels. However, all of these measures, which also include the suspension of the issuance of bonds to various government accounts and funds and accessing the balance in the Exchange Stabilization Fund ($23 billion as of October), will only be sufficient for a limited period of approximately two months.

If the extraordinary measures are exhausted, the federal government will only be authorized to spend an amount equal to incoming revenues. During the last fiscal year, revenues were equivalent to 69% of expenditures. If this ratio were the same in the current fiscal year, government spending would have to be reduced by 31%. Which expenditures, including interest payments, would be cut would be decided by the administration, which has not said in the past how it would prioritize its obligations.

Moody's believes it is likely that interest payments on bonds and notes held by the public, which accounted for about 6% of total federal expenditures in the last fiscal year, would receive high priority under such a scenario. While this is by no means certain, action to increase the statutory debt limit is highly likely. Even if Congress does not raise the limit before January 1, we would expect them to act before the Treasury exhausts the variety of measures as they have done many times in the past. A history of the statutory debt limit is discussed at length in our February 2011 special comment.

Eventual action to increase the debt limit is highly likely. Our baseline assumption is that Congress will raise the limit prior to severe expenditure cuts being necessary. This expectation is based on the long history of debt limit increases, the vast majority of which have occurred before the limit is actually reached. Some increases in the limit have been contentious and this is particularly likely to occur when one political party has a majority in the House of Representatives and the other occupies the White House, as is currently the case. While we may consider a review for downgrade, such a rating action may not become necessary, even if action to raise the debt limit is delayed for a period of time because the risk of default will likely remain extremely low. As a general practice, we place ratings under review when the probability of a rating change is substantial, such as 25% or more. Considering the history of the debt limit and the speed with which compromises can be reached, we believe it is still unlikely that this condition will be reached during the political negotiating process. We see a high probability that there will be a political compromise, even if it has a last minute nature.

As we said in October, the direction of the US government bond rating will most likely be determined by the outcome of budget negotiations that are ongoing and may well extend into 2013. In particular, if budget negotiations lead to specific policies that produce a stabilization and then downward trend in the ratio of federal debt to GDP over the medium term, the rating will likely be affirmed and the outlook returned to stable. If those negotiations fail to produce a plan that includes such policies, we would expect to lower the rating, probably to Aa1. The maintenance of the Aaa with a negative outlook into 2014 is highly unlikely unless the method adopted to achieve debt stabilization involved a large, immediate fiscal shock with a resulting unstable economic situation. Such a shock could come from the so-called "fiscal cliff". In such circumstances, we would await evidence that the economy could rebound from the shock before considering a return to a stable outlook.

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