Daiwa Securities

Daiwa's View

What will come following debt ceiling deal

- Tightening effects caused by issuance of a large number of Treasury Bills
- It could cause a shift from path of fiscal expansion

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What will come following debt ceiling deal

Outcome will not be limited to risk-on factors

On the night of 27 May, it was reported that the White House and House Speaker Kevin McCarthy had reached a tentative deal on the debt ceiling issue. While we cannot know whether the objections of hardliners can be restrained, a hard default of US Treasuries was never part of the main scenario. Now is the time to start considering what is going to happen after this agreement.

I am focusing on two things in the future following the agreement: (1) the effects of a reduction in easing that could be caused by the issuance of a large number of Treasury Bills (TBs) in the near term (next one to two months) and (2) a shift from the path of fiscal expansion in developed nations that could be triggered by concerns about a downgrading of US ratings over the next several years. These are not limited to risk-on factors.

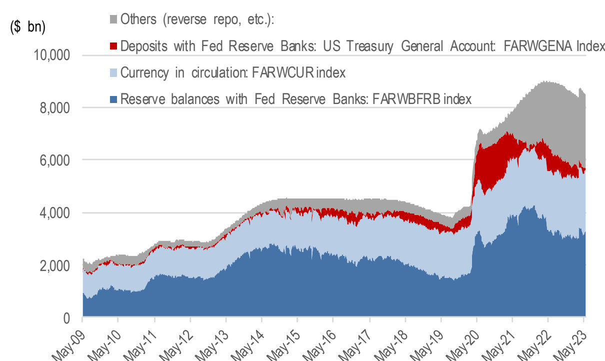
Tightening effects caused by issuance of a large number of TBs

◆ Tightening effects caused by issuance of a large number of TBs

As soon as the debt ceiling is raised, a large number of TBs are expected to be issued in order to restore the TGA balance, which has shrunk to an excessive degree. This may cause stress on the market in the near term (next one to two months).

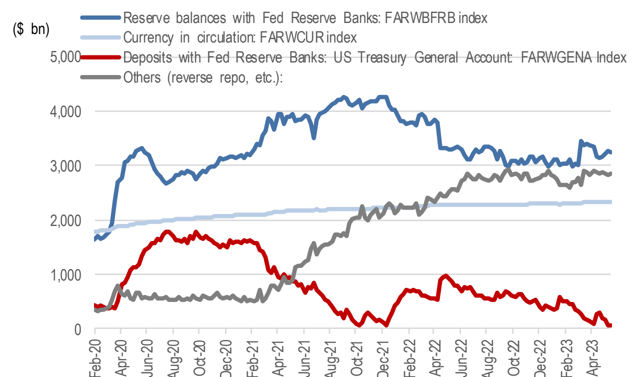
While it may seem surprising, it would appear that the debt ceiling issue had the effect of working in the risk-on direction by blocking QT by the Fed. While assets held by the Fed have been steadily shrinking on the asset side of its balance sheet due to QT, a stable reduction in reverse repo (RRP) and bank reserves is expected on the liability side (the reverse side of QT). However, since the beginning of 2023, TGA has decreased significantly due to the impact of the debt ceiling issue, which prevented RRP and bank reserves from decreasing at the Fed's intended pace.

Balance Sheet at Fed (liability side, stacked chart)



Source: US Department of Commerce; compiled by Daiwa Securities.

Balance Sheet at Fed (liability side)



Source: Bloomberg; compiled by Daiwa Securities.

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If the reduction in the TGA balance has been blocking the tightening effects of the Fed's QT, and if the TGA balance recovers due to the issuance of a large number of TBs from now on, the effects of QT that have been kept dammed up thus far may spread throughout the market. Caution is warranted with regard to discontinuous effects that could be caused by absorption of large-scale liquidity by the market.

This may cause significant stress. If we assume that the RRP balance will remain high[1], the flip side of a sharp recovery in the TGA balance would be that it would lead to a plunge in reserve deposits in macro terms. Given the fact that the Fed's reserve deposit balance consists disproportionally of deposits from major banks, we will likely see developments in which small and medium-sized banks will be directly hit by the impact of a plunge in reserve deposits. If small and medium-sized banks were to be forced to secure deposits at a high interest rate via the IORB rate (which has risen to 5.15% due to substantial rate hikes), stress on the banking system may recur in the process of restoring the TGA balance.

Of course, if the Fed implements additional rate hikes, the IORB rate and the reverse repo rate would rise to 5.4% or more and 5.3% or more, respectively. This should further increase the burden on the banking system. The burden on the banking system tends to increase in this way in the process of restoring the TGA balance. Therefore, the Fed has a reason to make more cautious policy decisions than usual during this process. If the Fed chooses to skip a rate hike at the June FOMC meeting, we suspect this may be one of the factors it takes into consideration when doing so.

◆ Shift from path of fiscal expansion

It could cause a shift from path of fiscal expansion

Fitch Ratings of the UK placed the US' AAA long-term foreign-currency issuer default rating on Rating Watch Negative. While it seems that this is often reported about in relation to the X-date, reading the release shows that what Fitch is really concerned about is not just the X-date, but fiscal soundness, as well. In fact, the downgrade by S&P in 2011 was implemented in light of the fiscal outlook after the US had reached agreement on the debt ceiling issue.

In the release, Fitch estimated that the fiscal deficit would worsen to 6.5% of GDP in 2023 and 6.9% of GDP in 2024, and that deficits over the coming decade would exceed 7% of GDP on average (5.5% in 2022). The agency also estimated that the ratio of federal debt held by the public to GDP would worsen to 117% in 2024 and approach 119% within a decade (112.5% in 2022). If the agency were to decide that measures for achieving fiscal soundness were insufficient after the current tentative deal passes Congress, it may issue a downgrade.

The key point here is that the rating agency is viewing developments from the standpoint of how much the latest debt ceiling issue restores fiscal discipline, which has become lax since the outbreak of the pandemic. During a crisis, like the pandemic, implementation of temporary urgent expenditures is not a reason for a downgrade. However, if expenditures of that degree become ordinary, medium/long-term projections for fiscal indicators change. Therefore, this could easily lead to a downgrade. It is about time for an examination of post-pandemic fiscal conditions.

Looking back on the past, since the path of fiscal expansion was affirmed at the G7 Ise-Shima Summit in 2016, the trend towards adopting fiscal expansion (in order to ease concerns about deflation) has intensified among developed nations. However, amid awareness of concerns about downgrades in light of high inflation and looser fiscal discipline since the pandemic, a shift away from the path of fiscal expansion may become a global trend going forward. This may lead to a solution for inflation that is more appropriate for the current situation—i.e., reduced spending would serve as a substitute for rate hikes, rather than tighter credit conditions. If we were to see a change in the fiscal direction since the Ise-Shima Summit, it would be an important turning point for the global economy.

[1] Use of reverse repo by MMF may decrease due to MMF purchasing a large number of the TBs that are to be issued.

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