US Viewpoint

# Debt limit: Diminished tail risk

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United States

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FY = Fiscal Year

## Deal in principle

Following an intense round of negotiations, President Biden and Speaker Kevin McCarthy reached a deal in principle to lift the debt-ceiling on Saturday. The agreement would suspend the debt ceiling for two years—through the next presidential election—removing a key source of uncertainty for households, businesses, and financial markets.

In exchange, the bill freezes nondefense discretionary spending at its FY 2023 level ($936bn) for FY 2024 and capped the FY 2025 increase at 1%. After FY 2025, the deal also includes provisions to limit increases in nondefense discretionary spending to the rate of inflation. Though, these provisions were reportedly unenforceable. Meanwhile, the agreement allows discretionary spending on defense to grow by 3.5% to $842bn, the same rate outlined in the President's March budget proposal. Relative to the President's March budget proposal, the agreement would reduce budget authorization for FY 2024 and 2025 by roughly $50bn and $ 75bn respectively (Exhibit 1).[i]

In addition to the provisions around spending, the deal reduces the $80bn increase in Internal Revenue Service (IRS) funding included in the Inflation Reduction Act (IRA) by a total of $21.4bn through FY 2025. It also claws back some of the unspent COVID funds, which the Congressional Budget Office (CBO) estimates would save $30bn in spending over a ten-year period.[ii] Other provisions include slight changes to help streamline energy permitting and work requirements for SNAP benefits and some other programs.

## Next steps

The final legislation will be voted on in the House first. Speaker McCarthy is currently rallying support as is Minority leader Jeffries. Like the Budget Control Act of 2011, the bill is likely to pass with bipartisan support. The vote could occur on Wednesday given the House rule to allow 72 hours between a bill being made public and a vote on the bill. There remain risks that more conservative members of the House could call a vote of no confidence for Speaker McCarthy, which would gum up the process when timing is running short given Treasury Secretary Yellen's estimate of a June 5 X-date. However, we think the risk of a no confidence vote on the Speaker is low.

If the bill passes the House, it will then be sent to the Senate for a vote. Unlike the House, the bill will need a 60-vote majority to be sent to the President's desk, which is also likely to be reached through a Bipartisan vote given the narrow split in the Senate.

## Economic implications

The most significant economic implication, in our view, is that the deal removes a key source of uncertainty for financial markets, households, and businesses. The debt-ceiling impasse along with concerns over bank stress have been two key sources of downside risk for the economic outlook. The deal in principle, effectively takes one of these risks off the table. Therefore, we expect to see a positive sentiment reaction over the coming weeks. *(Continued on next page)*



Timestamp: 30 May 2023 04:30AM EDT

**Exhibit 1: The President's FY 2024 Budget proposal**

The deal maintains increases to Defense and Veterans Affairs Medical Care Program proposed by the administration in March

| | Enacted FY 2023 | President's March Proposal FY2024 | Change from FY 2023 $bn | % |
|---|---|---|---|---|
| Total base discretionary funding | 1,618.3 | 1,695.5 | 77.2 | 4.8% |
| Defense | 858.3 | 886.4 | 28.1 | 3.3% |
| Non-defense | 641.2 | 688.1 | 46.9 | 7.3% |
| Veterans Affairs Medical Care Program | 118.7 | 121.0 | 2.3 | 1.9% |

**Source:** Office of Management and Budget

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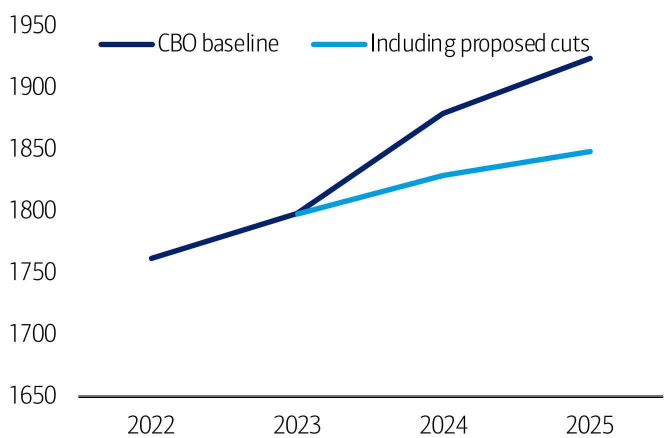
The deal also removes the risk of a government shutdown at the end of September. In exchange for lifting the debt ceiling, the Republicans extracted a detailed outline of the FY 2024 and FY 2025 budget that will shape discussions around appropriations for the next two fiscal years. We saw a real risk of a government shutdown later this year given a divided Congress, which were it to occur, would have sliced GDP growth by about 0.1ppt per week by our estimate (See A most dangerous game: the economics of a debt limit battle Feb 14, 2023 for further discussion).

In terms of the cuts to spending and their effects on economic activity, it depends largely on the counterfactual or prior outlook. One comparison that can be made is against the Presidents proposed FY 2024 budget published in early March. Since the deal maintains the proposed 3.5% increase in Defense spending and the 1.9% increase in Veterans medical care, it caps spending on less than half of total discretionary spending. By our estimate, it reduces total spending authorization by $50bn. Should the entirety of that reduction occur in FY 2024, it would translate into a drag of about 0.2% GDP.

We can also compare the provisions of the deal to the latest projections from the Congressional Budget Office (CBO). Like the comparison against the President's budget we find that the cuts would reduce the budget authority by roughly $50bn in FY 2024. For FY 2025, we estimate the cuts would lower budget authority by $75bn or a 0.3ppt drag on growth relative to the CBO's baseline. Notably, total budget authority would still increase modestly in FY 2024 owing largely to the increases in Defense and Veterans medical care (Exhibit 2).

**Exhibit 2: Total Discretionary Spending Budget Authority ($bn)**

Compared to CBO's may baseline, the debt-limit deal would reduce budget authority by roughly $50bn in FY 2024 and $75bn in FY 2025




**Source:** Congressional Budget Office, BofA Global Research

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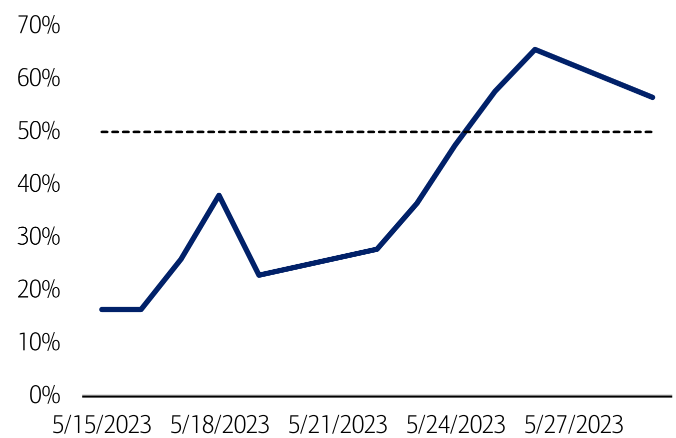
**Exhibit 3: Market pricing of a 25bp hike at the June FOMC meeting**

The market is pricing in a greater than 50% chance of a 25bp hike at the June meeting.




**Source:** Tullet Prebon, Bloomberg

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Finally, we can compare the deal to our baseline outlook. Since the midterm results, we had assumed that a divided congress would likely yield little in the way of fiscal expansion. Indeed, we expected real Federal government spending would grow by 0.9% Q4/Q4 in FY 2024, or roughly 3% in nominal terms given our inflation forecast. As our forecast stands, Federal Government spending adds roughly 5bp to growth in each quarter in FY 2024. The details of the deal, meanwhile, suggest discretionary spending growth is likely to be closer to 2% in nominal terms from 4Q 2023 through 3Q 2024, which would translate into 0% in real terms by our estimate.

Therefore, we think the direct effects of the deal pose a slight downside risk to our forecast, but after rounding, it does not change our GDP outlook. As a result, we maintain our economic forecast and our FY 2024 deficit projection of $1.450tn.

In short, we see the deal in principle as being largely positive for the outlook. The debt ceiling was a key source of uncertainty and downside risks for the economic outlook. Given that the deal is expected to be signed into law, the risk has been removed from the table. That should reduce uncertainty and boost to sentiment, which could very well offset any drag from the direct cut to spending.

## Fed: a closer call for June

It also removes a key source of uncertainty for Fed policy. As we have written previously (See: US Economic Weekly: Lying in wait), we see three conditions for the Fed to hike in June or July. First, strong inflation and employment data. The latest reports confirm that inflation is only slowing modestly, and employment growth remains robust. Second, subdued regional bank stress. We feel the weekly Fed and commercial bank balance sheet data suggest stress is diminishing in the banking sector. Third, a deal to raise the debt ceiling. Arguably, we have checked all these conditions with the debt limit deal.

Therefore, we continue to see a strong likelihood that the Fed's next move will be a hike. Currently, we maintain our expectation for the Fed to leave rates unchanged at its June meeting, as we felt Chair Powell's comments on May 19 tilted towards skipping a move in June. However, it is a very close call. Markets are currently pricing in a greater than 50% chance of the Fed hiking rates at its June meeting and a full hike is priced in by the July meeting. We think the data is the last hurdle to clear. Should the May employment report on Friday and the May Consumer Price index report on June 13 signal robust hiring, wage growth, and price inflation, it could easily tip the scales in favor of a June hike.

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