

What is the debt ceiling in the US and why does it matter?

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Over the past weeks there has been an issue holding back investment markets which is a US phenomenon: the debt ceiling. This is an issue peculiar to the US but it affects us all.

The debt ceiling, also known as the debt limit, is the maximum amount of money that the US government can borrow to finance its operations and pay its obligations. It is a legislative restriction that sets a cap on the total amount of debt the government can accumulate.

In the United States, the debt ceiling is a limit set by Congress on the amount of money the U.S. Treasury can borrow to fulfil its financial obligations. It is a value in US\$, so there is no latitude for interpretation. When the government reaches the debt ceiling, it cannot borrow any more money unless the ceiling is raised by an act of Congress.

The debt ceiling matters because it directly affects the US government's ability to fund its activities and pay its bills. It serves as a check on government spending by placing a limit on the amount of debt that can be incurred. When the debt ceiling is reached, the government faces the risk of defaulting on its obligations, such as paying salaries to government employees, making Social Security payments, or paying interest on existing debts.

Failing to raise the debt ceiling and defaulting on financial obligations could have severe consequences for the US, and in turn the global economy. It could lead to a loss of confidence in the US government's ability to manage its finances, increase its borrowing costs, and potentially trigger a financial crisis.

Simply put, the US debt ceiling is a check and balance on its government. This domestic US arrangement has direct bearing for UK investors as the price of most global assets is set by reference to US government bonds as the risk-free benchmark. If this benchmark should come to be discounted by the risk of default, all asset prices would fall until the benchmark price settled at a new equilibrium.

The UK fiscal budget is managed differently. For example, the UK government can borrow as much money as it feels it needs to at any time. There is no debt ceiling here. The difference, however, is that UK government bond market prices are set in relation to the debt of UK government and the ability of the economy to service that debt, so if investors become nervous that the UK is borrowing too much (as in late 2022) they will demand a higher yield from their investment to compensate for the perceived risk and the price of UK government bonds will fall until the government reigns in its spending or increases its revenues through taxes.

We have written many times that the US economy, the US\$ and US government debt are central to a functioning global economy. The past few weeks are another example of how ultimately all our destinies are tied to the politics of Washington.

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