MF il quotidiano dei mercati finanziari

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BANKING REGULATIONS AND THE DEBT CEILING

The US puts on the brakes

Financial issues are set to take central stage in US parliamentary debates over the coming months. Unfortunately, support for the economy is at risk of taking a back seat as priority is given to political considerations and tactics for the 2024 elections. The primary topic regards regulatory restrictions on the financial sector. In fact, the US government and the Federal Reserve have been taken by surprise by the sudden collapse of three different financial institutions. Admittedly, the banks in question all had some kind of involvement in cryptocurrency and tech start-ups, but it's also true that in two out of the three cases, the bankruptcy stemmed from an exodus of customers and losses on government bonds. It was an inglorious end: these banks boasted an innovative model but ultimately stumbled on simple mistakes that could be found in any banking textbook written in the last century. The majority Republican Congress has criticised the President, the Administration and the Federal Reserve for failing to both prevent and manage the crisis, only intervening when regulatory capital was all but exhausted. On the other hand, the government maintains that the situation of US medium-sized banks is the legacy of looser regulations during the Trump era. The idea of bailing out the sector with an extra guarantee on deposits would likely be welcomed by the markets but has been bounced from one aisle of the Congress to the other. Republicans are calling for state intervention. The US Secretary of the Treasury Janet Yellen has responded that an agreement could be possible but would need to be approved by the majority Republican Congress. Like in 2008, state intervention would be in everyone's interest but no-one is willing to put their name to it. However desirable the outcome, guaranteeing the financial sector is politically unpalatable. Everyone remembers the terrible management of the Lehman collapse, which opened the door for the Democrats led by Barack Obama. This time, the political calculations are aimed at exploiting the debacle under the Democrats to stymie the re-election of Joe Biden. Reaching a consensus on stricter legislation would be easy. Finding enough votes to support a public guarantee would be more difficult. While a repeat of 2008 is not on the cards, once again there is a risk that politics is delaying critical decisions for petty political motives. The same goes for the next hottest topic, the “debt ceiling”. In the US the amount of national debt has to remain within a ceiling established by law and approved by Congress. It is a bizarre law, because the absolute number in itself has no economic value (especially in a context of high inflation when the nominal level of debt naturally continues to rise despite the debt-to-GDP ratio remaining constant). Nonetheless, this limit cannot be exceeded. Once reached, the government is required to cease all spending and may find itself incapable of repaying public debt securities, thus falling into a technical default. Consequently, according to the law, Congress has to periodically approve an increase to this limit so that the government can get by for a few more years (as everyone knows that another increase will have to be requested anyway). This context, where the presidency and the parliamentary majority are misaligned, leads to the classic situation where the government of the day is held hostage by the parliamentary majority, which will demand huge concessions before approving any such rise. Meanwhile, the parliamentary majority is anything but united. In this situation, a small group of dissents would be able to hold up parliamentary proceedings for months. It seems unlikely that the US government will default on its debt. However, it seems fairly safe to assume that public spending is likely to be squeezed. In any case, similar events in the past (where a technical default was ultimately avoided in the end) point towards a possible weakening of the dollar, a drop in government securities and an increase in credit spreads.

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