COMMENT ON RAISING THE DEBT CEILING

Peter Martin and Heath Aston," Treasurer Joe Hockey Seeks Deal with Greens to Scrap the Debt Ceiling," *The Sydney Morning Herald,* 2 December 2013. Available at: https://www.google.com/search?q=define+semantics&oq=define+semantics&sourceid=chrome&espv=210&es_sm=93&ie=UTF-8.

Are you confused with the recent attention that has been given to the debt ceiling in Australia? Did you believe that it applied only to the US government? Unless you have an unusually good knowledge of public finance, you would probably answer each of these questions in the affirmative. In fact Australia had a limit imposed on the face value of Commonwealth Government Securities, which includes Treasury Bonds, Treasury Indexed Bonds, Treasury Notes and Aussie Infrastructure Bonds, since the enactment of the Commonwealth Inscribed Stock Act 1911.[1]

Why impose the limit on the *face value* of the securities rather than the *market value*? The latter can be influenced through government policy (as, for example, through Reserve Bank actions that tend to raise or lower the rate of interest), but it cannot be controlled. That is, a limit set in terms of the market value could easily, and rather quickly, be exceeded through larger-than-expected fluctuations within the market, and this possibility partly accounts for the perceived need for a statutory limit.

It is important for governments to maintain liquidity in the market for their debt. Most people understand financial liquidity as the relative ease (or difficulty) of converting household assets into cash, with cash being the most liquid and the family dwelling being the least liquid. The ability to shift from one liquidity level to another is relevant to households when they experience a shortage of one type of asset, say cash, and they then determine how much they will be required to sacrifice to obtain additional cash. The amount of the sacrifice depends on a number of things, all of which can a put together under the term *liquidity of the market* for household assets. Market liquidity would be satisfactory if a given household can convert durable goods or other assets into cash with a minimum delay and at a relatively small cost.

The same applies to governments that seek cash to pay government debt or for other purposes. Governments prefer to utilise financial markets for which financial institutions as well as individuals can easily buy and sell Commonwealth Government Securities (invest in them or convert them into cash) since otherwise the government's ability to increase or decrease the amount of those securities could become difficult and perhaps more costly. Governments nevertheless differ from households in a number of ways, but the one that is most critical to this analysis of a ceiling on government debt is that the quantity of Commonwealth Government Securities that are bought and sold is often so large that the

[1] Richard Webb, "Government Debt", in Parliament of Australia, Budget Review 2012-2013. Available at: http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/BudgetReview201213/GovDebt.

required transactions may change the liquidity of the market, and this is likely to affect the assessment of risk. In order for financial institutions to be willing to buy the securities, it is important that they know the face value of all that is expected to be sold by the government within the current period, and how much this might change the government's level of indebtedness. An indication of the maximum amount indebtedness that the government anticipates for the next several years acts as a benchmark for the market to assign a risk factor to the transactions. The ease of assessing risk is an indication of market liquidity, so contributing to this ease is the first and most important reason for having a debt limit.[2]

There is an additional justification for a ceiling on government debt, and this is the one that was recently brought to the our attention by the current US Congress. It stems from the need to finance government deficits and this raises a number of questions about why government deficits occur. The obvious reason is that a deficit means that governments spend more than they take in and for many people, that is associated with a gross irresponsibility on the part of any government that "brings in a deficit." Irresponsibility is sometimes apparent, but "bringing in a deficit" does not properly characterise the situation since in many cases the deficits are unplanned and cannot be easily avoided.

To illustrate the extent to which government surpluses and deficits can change within a relatively short period of time, Chart 1 on the next page shows government net lending (arising from a budget surplus) and net borrowing (resulting from a budget deficit) beginning in the year 2000, with projections for 2013 to 2017 made by the International Monetary Fund for Australia and for the United States.[3] The data are expressed as a percent of gross domestic product so the larger population of the US is not a factor, nor are the exchange rates between the two national currencies a relevant factor.[4]

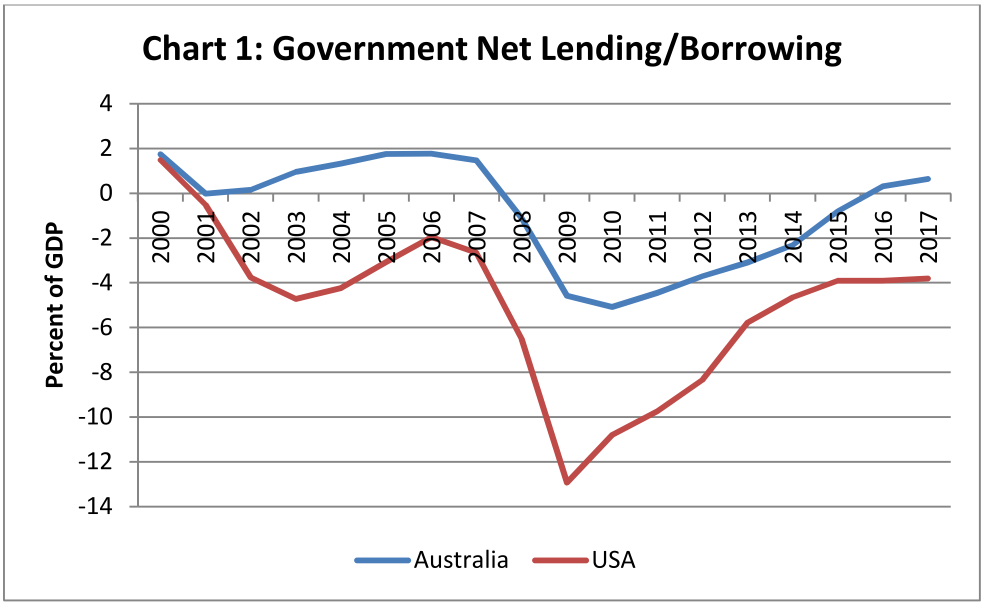
The chart indicates that both countries were net lenders in the year 2000, but the US became a net borrower in 2001 and especially in 2002 after defence expenditures were increased substantially following the terrorist attacks on 11 September 2002. Circumstances for both nations changed in 2007 with the global financial crisis. Australia became a net debtor early in 2008, while US failed to achieve a balance and dropped quickly to a net borrowing-to-GDP ratio of 13 per cent in 2009. Both governments improved their fiscal borrowing position during the past several years, with Australia projected to reach a balance in its borrowing position in 2016. The US is projected to remain a net borrower

[2] Further elaboration is available from the reference cited above and from Dan Denning, "Beware the Big Government Debt Switcheroo*," Daily Reckoning*, 19 April 2012 (available at: http://www.dailyreckoning.com.au/beware-the-big-government-debt-switcheroo/2012/04/10/), as well as Stephen Koukoulas, "Lift the Debt Ceiling or Lose Liquidity," *Australian Financial Review*, 14 May 2013 (available at: http://www.afr.com/p/opinion/lift_the_debt_ceiling_or_lose_liquidity_UpDb3FiVSzgXsKkuaRHpqO).

[3] The IMF defines net lending (+) and borrowing (-) as revenue minus total expenditure. This is a generally understood government fiscal balance that measures the extent to which the government is either putting financial resources at the disposal of other sectors of the economy and of non-residents (net lending), or making use of the financial resources generated by other sectors and non-residents (net borrowing).

[4] The date for the charts were taken from the International Monetary Fund's World Economic Outlook Database. Available at: http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx.

through the period to 2011, but the risks associated with that level of additional debt are much less than those experienced in 2009.



These major changes in government net/lending and borrowing were unexpected and therefore unplanned. The sharp decline in the two lines on the chart required adjustments to the debt ceilings of the respective nations and these adjustments gave financial markets an indication as to what they might expect as additional government borrowings for the subsequent year.

The use of the debt ceiling to clarify the indebtedness position for the US was initiated by the US Congress by the Second Liberty Bond Act of 1917 to finance its World War I military expenses.[5] Prior to that year, congressional practice was to link authorisation of discretionary projects that would almost certainly result in an overall budget deficit with the means from raising the necessary funding via the bond market. Congress therefore had control of individual authorisations for government expenditure but could not exert direct control over the total.

Many members of the US Congress liked the idea of direct control, but something was added in the process of acquiring the capacity to have it. The amount of additional expenditure was already approved on an item-by-item basis so therefore the additional increment to the accumulated debt was already approved. In refusing to raise the debt ceiling, payment of the incremental debt was effectively reneged. US Congress was therefore placed in an awkward position of saying, “yes, we will pay our bills”, then “no, we won’t pay our bills since we failed to add them up in a timely manner.” It was, of course, the threat of such actions that was criticised as political blackmail, and that is what made the headlines.

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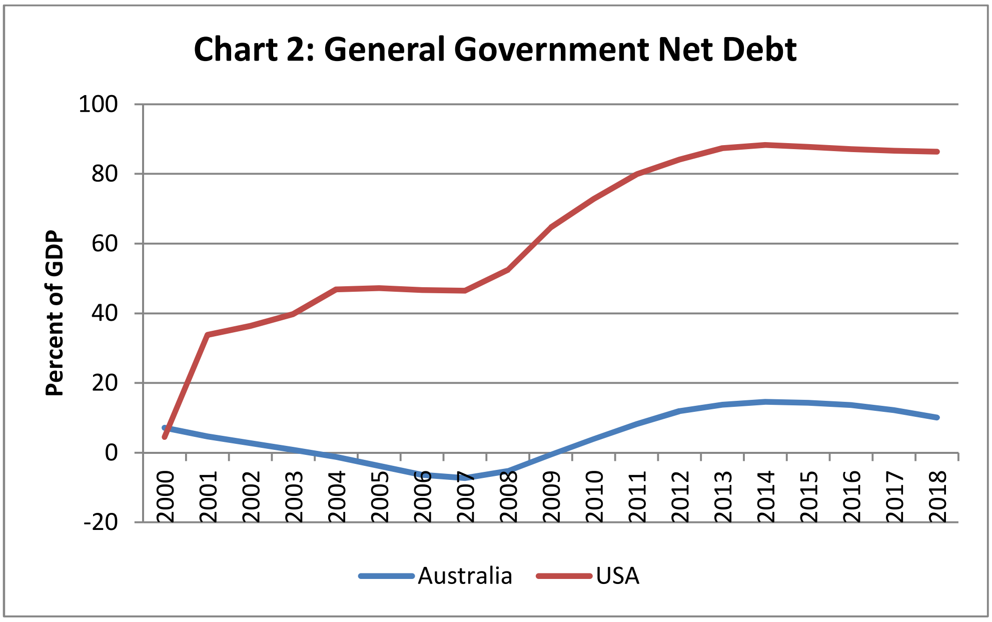
[5] Kimberly Amadeo, “US Debt Ceiling: What It Is and What Happens If It’s Not Raised,” About.com, 4 November 2013. Available at: http://useconomy.about.com/od/glossary/g/National-Debt-Ceiling.htm.

To illustrate the value of having separate estimates of government lending/borrowing on an annual basis and the accumulation of these annual amounts, Chart 2 on the following page can be compared with Chart 1. The main point to be illustrated here is that viewing Chart 1 suggests that the accumulated debt[6] for both Australia and the US was certain to increase substantially beginning in the year 2007, but it would remain difficult to visualise the amount of the rise in Chart 2 or to assess the difference between the two national debt levels. A comparison between two or more nations also helps to provide both scale and context to the data sets.

Some observers, looking at Australia alone in Chart 2 would be tempted to highlight the "mountain of debt" left by Kevin Rudd,[7] (forecast to peak in 2014) but it is nowhere near the accumulated debt level of the US. Note especially the fact that both are expressed as a per cent of GDP and both were at the same level in the year 2000. This suggests that what is a mountain to one person might be a molehill to another.



The use of these charts was mainly for illustrative purposes and does not supply a direct answer the question as to whether in it necessary to have a debt limit. A limit imposed by statue is ineffective in controlling the total amount of government debt for reasons that formed part of the illustration with the use of the charts. That is, a debt limit did not prevent the two sharp falls in the red line in Chart 1 for US government net

[6] The accumulated debt is a specifically defined sum that includes all liabilities that require payment of interest and/or principal by the government to creditors at designated times in the future. It includes currency and deposits, debt securities, loans, insurance, pensions and standardised guarantee schemes and any other debt instruments that enter into the governments accounts payable. This specific series recorded by the IMF is net of any counterpart liabilities held by the government for which interest and payments of principle are received.

[7] See for example Peter Sheehan, "Tony Abbott Must Fight the Baby Boomers' Debt Explosion," *The Sydney Morning Herald*, 2 December 2013. Available at: http://www.smh.com.au/comment/tony-abbott-must-fight-the-baby-boomers-debt-explosion-20131201-2yjlm.html.

lending/borrowing nor for the decline in Australia's net lending after the global financial crisis.

Is it necessary then to maintain liquidity in the market for government debt? No, it is not necessary because capital markets, with the help of credit rating agencies, are much more capable now of assessing a nation's capacity to meet its debts than they were at the beginning of the 20th century. It is nevertheless useful for capital markets to have a benchmark of the total amount of accumulated national debt that is expected for the current year, and perhaps also for the following year. Financial institutions can of course calculate the total using the level of government debt this year and the forecast surplus or deficit for next year. But with a increasing amount of personal wealth held in superannuation funds that allow each member to choose between investments in shares, bonds, property and cash, knowledge of the way in which these markets are normally assessed needs to be more diffused.

So, should Joe Hockey negotiate with the Greens Party to scrap the debt ceiling? There is a good case for removing it as a statuary ceiling since it does not and cannot possibly function well as a fixed, legal ceiling. But there is a case for retaining the concept of a limit in the form of a requirement to report with each budget the net effect of the budgeted surplus or deficit on the level of net government debt. This could be called the "budgeted debt level" (as opposed to a legal limit), or something similar, and could be expressed on a per capita basis as well as a per cent of GDP.

Moreover, it should include all items in the budget and any foreseeable off-budget items, so as to stop, or slow down, the trend in "creative accounting" that postpones some approved expenditure until the next financial year with a view to avoiding an otherwise undesirable budget outcome for the current year. Joe Hockey wants to avoid the possibility of the political blackmail described above with respect of the US Congress, and may be re-observed in the US early next year. That is a reasonable request, but it should not be used merely to make the outcome appear to be politically correct.

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ADDENDUM

Agreement between the coalition government and the Greens Party to scrap the debt ceiling was announced in the early evening of 4 December.[8] In exchange for the support of the Greens to approve a bill calling for the repeal of the debt limit, the government agreed to inform Parliament whenever the government passes a threshold of a $50 billion increase

[8] Mark Kenny and Peter Martin, "Joe Hockey Gets Help from Greens Over Debt," *The Sydney Morning Herald*, 5 December 2013. Available at: http://www.smh.com.au/federal-politics/political-news/joe-hockey-gets-help-from-greens-over-debt-20131204-2yr3u.html.

in debt, and to accompany the announcement with a justification for any such increases. If the bill is passed, as seems likely, Parliament will be unable to veto the increase in the incremental increase in the debt, but it will be able debate the circumstances leading up to the increase. The Greens also secured an agreement that the government will report on the impact of climate change policy on the Australian economy.