Gulf One
Investment Bank

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US Debt Ceiling Debacle:
Implications for the GCC Countries

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Overview

In just less than two years the United States (US) has twice come to the brink of defaulting on its debt obligations due to political wrangling about raising the borrowing limit. The debt ceiling, set by Congress (US lawmakers), is a cap on the total amount the US government can borrow. Since March 1962, the lawmakers have altered the debt limit 77 times without a big fuss[1], but in the last two years, raising the borrowing limit became a big issue, largely due to political reasons rather than economic considerations. Since members of the Democratic Party (President Obama's party) lost control of the House of Representatives to the Republican Party in 2010, budget fighting between the two parties has become commonplace.

Republicans viewed their victory in the mid-term congressional elections of 2010 as a sign that Americans had rejected the Democratic agenda. At the heart of the Republican confrontation with the White House is the Patient Protection and Affordable Care Act (President Obama's landmark healthcare law), which the Republicans labelled it as "Obamacare". The so-called Obamacare will undoubtedly provide millions of Americans without health insurance to enjoy health care services, something which the Republicans are strongly opposed to. Needless to say, Republicans did everything in their power to force President Obama to delay implementation of the healthcare law without much success as substantial parts of the Obamacare became effective on 01 October 2013, the same day as the Federal government shutdown began.

On the other hand, Democrats accused the Republicans of being mischievous about the Obama healthcare law arguing that the law was overwhelmingly passed by the US Congress in 2010 and validated by the US Supreme Court (the highest court in the US) in June 2012. The Democrats also argued that the Obama healthcare law was a key issue in the November 2012 presidential election, which President Obama won decisively, thereby giving him the mandate to implement it.

The political posturing on the debt ceiling meant that between May 2013, when the debt limit of $16.7 trillion was reached, and 17 November 2013, when the US government was literally to run out of money, the US Treasury resorted to using extraordinary measures to keep servicing US government bills. Although a last minute deal was struck on 16 November 2013 to extend the debt ceiling to cover repayments until 07 February 2014, the political wrangling about America's fiscal and debt challenges only serves to undermine the economic and political clout of the US in the international arena, and a US debt default will set a precedence that will have serious implications for its credit worthiness, the greenback, interest rates, capital markets, and economic recovery. All this will have profound repercussions for the global economy.

As the largest economy in the world, the US has traditionally been able to borrow at low interest rates on the international markets, which has helped keep interest rates low for consumers. But a default could destroy confidence, raise the cost of borrowing for Americans, and create a chaotic situation on the international debt market as investors would be unwilling to accept US bonds that were no longer being honoured. Needless to say, US bonds have always been seen as a safe investment and trillions of dollars are invested in them, so a default would send a shock wave through the financial markets creating ripple effects across countries around the world. If a default were to persist for a long period of time, it could trigger a switch from US dollar bonds into other perceived haven instruments, such as German and Swiss bonds. It could also lead to a rush into gold, which is traditionally seen as a safe alternative investment.

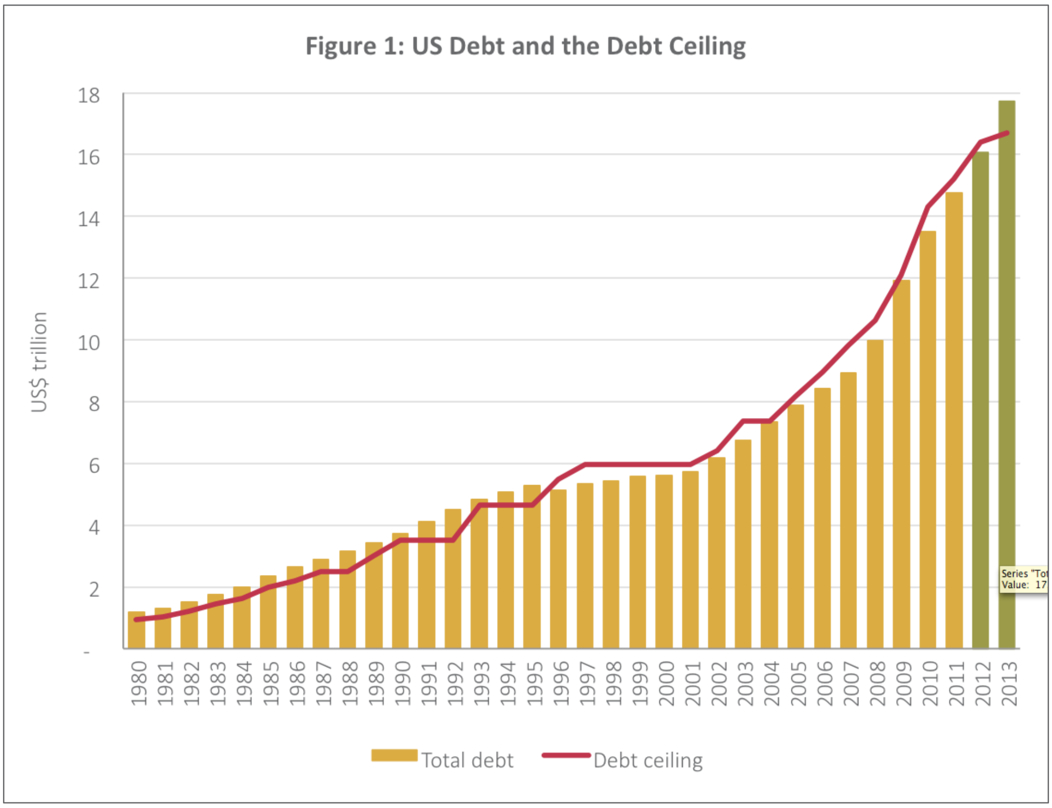
For now, the short-term deal to extend the debt limit until early February 2014 has averted disaster, but the tug-of-war is not over yet and a more acrimonious debate on raising the debt ceiling is in the offing, which could make America's international creditors wary of the credibility of the US not only as a creditworthy

[1] What is the US debt ceiling? Ben Morris, Business Reporter, British Broadcasting Corporation News, 03 October 2013.

economy but also as the custodian of the international reserve currency[2]. This will mark the beginning of the demise of the US as an economic powerhouse and of the dollar as a safe haven currency. These and other issues, including the implications of a US default on the GCC and other emerging economies, are analysed in this bulletin.

The US Debt Ceiling

The US is undoubtedly the world's most indebted country, with an estimated total debt of over $17 trillion (Figure 1). As can be implied from the figure, the US debt outstanding grew by over 1,400% during the past 33 years (1980-2013) or by 43% per annum, far outstripping the growth rate of nominal GDP. It is therefore not surprising that the US debt overhang has already caught up with the country's total national income, and the debt ceiling was raised on countless times to match the rapid growth in the US debt obligations. On current trends, the US debt level could reach a mind-boggling $23 trillion during the next five years, making it unsustainable in the future.



Source: IMF; Congressional Research Service; Gulf One Investment Bank

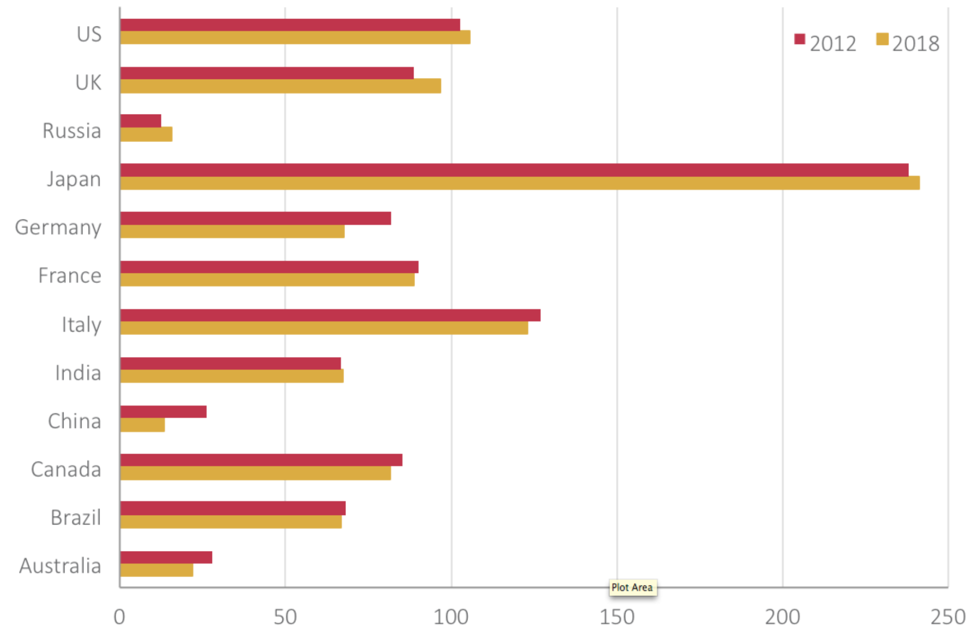
In spite of all this, it is noteworthy that the absolute size of a country's debt is not a big problem *per se* if the country has the income to cover the debt, as economists often use total debt as a percentage of either GDP or budget deficit to gauge the extent of a nation's indebtedness. In the case of the US, the debt-to-GDP ratio, at 102%, suggests that the total debt is roughly equivalent to its GDP (Figure 2). At this level of debt-to-GDP ratio, the US debt level can be said to be sustainable. What is worrying, however, is that since the

[2] In mid-December 2013, the US Congress reached a budget deal to fund the federal government for the next two years, thereby averting a repeat of the October partial government shutdown. However, many Republicans have vowed not to raise the debt ceiling in February 2014 until the Obama administration makes substantial concessions on the spending cuts and the landmark healthcare law, raising the probability of a default.

rate at which the US borrows outstrips the rate at which its nominal GDP expands, the US may be unable to pay its debt in the future unless drastic measures are taken to curtail the size and growth of the debt.

It is also worth noting that, although the US debt-to-GDP ratio is relatively high, it is still lower than the average figure of 108% for the developed countries as a whole. Within the group of industrialised countries, Japan and Italy tend to have some of the highest debt-to-GDP ratios. For instance, Japan's total debt outstanding stands at $11 trillion, but as a percentage of its own GDP, it stands at 238%. Similarly, Italy's debt stock is only $2.6 trillion but as a percentage of the country's GDP it is around 126%.

Figure 2: Debt of Selected Countries (% of GDP)



Source: IMF

Other advanced countries whose debt-to-GDP ratios approach that of the US include the France (90%), the UK (88%), and Canada (85%). Even Germany, traditionally seen as fiscally responsible, has a debt-to-GDP ratio of more than 80% (Figure 2).

US versus the Eurozone

Despite its relatively massive debt profile, the US historically has had a lower debt burden (debt as a percentage of GDP) than the Eurozone bloc. But since 2008, the US has overtaken the Eurozone in terms of both the absolute value of debt outstanding and as a percentage of GDP. Thus between 2008 and 2012, the debt burden of the US ballooned from 73% to 103% while that for the Eurozone rose from 70% to 93% during the same period (Table 1). The debt-to-GDP ratios for both sets of economies are, however, below the average for the developed world, but well above that of the emerging market economies.

It is noteworthy, however, that the aggregate debt burden ratios for the Eurozone and the emerging economies mask considerable variation across individual countries where the debt ratios for some countries are in triple digits. For instance, within the Eurozone countries, Greece had a debt-to-GDP ratio of over

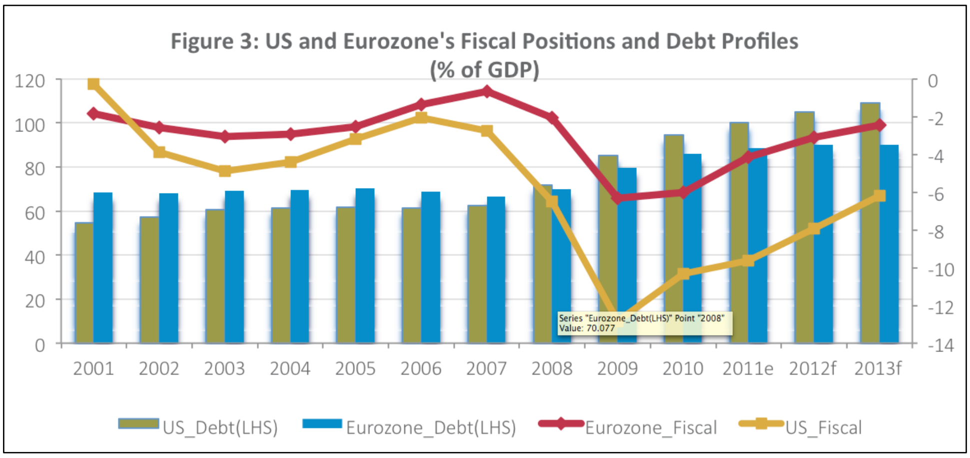
150% in 2012, while Portugal, Ireland and Belgium recorded debt-to-GDP ratios of 124%, 117% and 100% respectively[3].

Table 1: Debt of the US, Eurozone, Advanced Economies and Emerging Markets (% of GDP)

	US	Eurozone	Advanced Economies	Emerging Markets
2000	53.0	69.3	71.4	48.7
2001	53.0	68.2	71.3	48.9
2002	55.4	68.1	72.4	51.5
2003	58.5	69.3	74.5	49.7
2004	65.4	69.7	78.4	46.4
2005	64.9	70.3	77.9	41.2
2006	63.8	68.6	75.3	36.4
2007	64.4	66.5	72.9	34.6
2008	73.3	70.3	79.8	32.4
2009	86.3	80.1	93.0	35.4
2010	95.2	85.7	99.6	39.0
2011	99.4	88.2	103.6	36.7
2012	102.7	93.0	107.9	35.5

Source: IMF; Gulf One Investment Bank

Similarly, the fiscal deficit for the US since 2008 has outstripped that of the Eurozone by two-fold, seemingly suggesting that the Eurozone is in a much better financial health than the US, which nearly defaulted on its debt repayments in August 2011, prompting Standard and Poor's rating agency to downgrade America's "AAA" rating by one notch to "AA+", the first time in history. The US was also put on the credit watch list of the rating agencies following the recent government shutdown and debt ceiling raising debacle.



Source: IMF; Gulf One Investment Bank

Until now, the US has avoided the kinds of economic problems Eurozone faced during the last five years but the self-inflicted political dysfunction in the US is likely to lead to economic brinkmanship. It should be noted that policy paralysis contributed to the exacerbation of the Eurozone economic crisis as policy responses of

[3] According to the IMF World Economic Outlook Database for October 2013.

regional leaders were piecemeal in nature, muted, inadequate, and half-hearted. By resorting to half-conceived short-term policy measures, caused by political dysfunction, the US now risks repeating the kinds of policy mistakes Eurozone leaders made in tackling their fiscal and debt challenges.

Implications of a US debt default for the rest of the world

For now, the US economy is big enough to withstand its debt burden, but the rate at which the US debt is piling up is a great source of concern for the US and the rest of the world, as the inability of the US to pay its debt obligations will set a precedence that will have serious implications for its credit worthiness, the greenback, interest rates, capital markets, and economic growth. All of this will have devastating spillovers for the rest of the world, as the lessons from the 2008 US financial crisis have shown that if the US economy catches cold, the rest of the world get pneumonia.

These negative spillovers have been widely highlighted by informed economic and financial analysts in both developed and emerging economies. For instance, during the annual meeting of the IMF and the World Bank in October, Christine Lagarde, head of the IMF warned of the damage the US debt crisis could do to the world economy. This sentiment was echoed by Singapore Finance Minister, Tharman Shanmugaratnam, the chairman of the IMF policy committee, who said that a US default would be harmful to the entire world because it would be a blow to the confidence that is needed for businesses to make investment decisions. In his words: "If we don't clear resolution of the US debt issue, it is hard to see how that confidence will come back so it is a critical issue for all of us”[4].

Similarly, the Governor of the European Central Bank (ECB), Mario Draghi, told reporters at the IMF/World Bank meeting that if the US debt crisis were to last a long time, it would be very negative for the US economy and the world economy and could certainly harm the global recovery.

The Organization for Economic Co-operation and Development (OECD), a Paris-based club for the world’s 34 industrialised economies, also warned of US threat to global recovery. In its biannual report on global economic outlook, the OECD warned that while the OECD remains worried about the Eurozone’s frailties, the most immediate threats to the global recovery now appear to come from the US. It stressed the dangers arising from the US debt ceiling, arguing that if the debt ceiling became binding the US economy would be catapulted into a deep recession. Even if such a scenario were to be avoided, as was narrowly the case in October, the acrimonious negotiations were damaging, as “the continuous affair of discussing debt every few months is simply detrimental to confidence levels and therefore growth," according to Pier Carlo Padoan, OECD Chief Economist. The OECD report then went on to suggest that the US debt ceiling should be abolished and replaced by a “credible long-term budgetary consolidation plan with solid political support[5].”

The potentially catastrophic crisis precipitated by negotiations over the US debt ceiling and the US Federal Reserve’s planned tapering of its asset-purchase programme, coupled with heightened risks from a fragile Eurozone banking sector, Japan’s fiscal situation, and slowdown in some large developing economies, led the OECD to trim its forecast for global economic growth for 2014 and 2015.

Governments around the world have also aired their concerns about the US debt obligations. China, the largest holder of the US government debt, has told the US not to imperil the value of its holdings of US

[4] “US Debt Ceiling Crisis – World Finance Focus on Global Risks”, www.huffingtonpost.com, 12 October 2013.
[5] “OECD Warns of US Threat to Global Recovery”, *Wall Street Journal*, 19 November 2013.

Treasury bills. It urged Washington to take decisive steps to avoid a debt crisis and ensure the safety of Chinese investments. Referring to the August 2011 deadlock that led Standard & Poor's to downgrade the US credit rating from "AAA" to "AA+", China's deputy Finance Minister, Zhu Guangyao, averred: "We hope the United States fully understands the lessons of history"[6]. Both the 2011 and the 2013 confrontations over the debt ceiling ended with an eleventh-hour agreement under pressure from shaken markets and warnings of an economic catastrophe if a default were allowed to happen.

Implications for the GCC Countries

As discussed earlier, a US debt default would affect its economy through a variety of ways, including the impact on the value of the dollar, interest rate, and capital markets, all of which could combine to undermine economic growth. Each of these transmission channels could also affect the rest of the world. In the case of the GCC countries, they will be mostly impacted directly by the fall in the value of the US dollar and indirectly by adverse developments in global capital markets and a slowdown in global growth.

The dollar effect

All GCC countries, except Kuwait, operate a dollar pegged exchange rate regime, thus a fall in the value of the US dollar will not alter their nominal exchange rates against the dollar but will weaken the real purchasing power of the GCC currencies. In effect, even Kuwait, which had abandoned the dollar peg since mid-2007 and is currently using a system that links the Kuwaiti dinar to a basket of major global currencies, could be impacted because the dollar still accounts for a large proportion of its currency basket[7].

One of the transmission channels through which a fall in the value of the dollar could impact the economies of the GCC countries is loss in competitiveness via appreciation of the real exchange rate, defined as the nominal exchange rate adjusted for inflation rates between GCC trading partners. Such a loss in competitiveness would then lead to deterioration in the income terms of trade, which would erode the purchasing power of local currencies.

In one of our previous bulletins, we provided a detailed case study of the consequences of a fall in the US dollar for Saudi Arabia. In it, we demonstrated that depreciation in the value of the US dollar against other major international currencies could alter the bilateral real exchange rate (BRER) between the two currencies, and also the trade-weighted real exchange rate (REER) between riyal and the currencies of major trading partners of Saudi Arabia.[8] For instance, during the past decade, the real exchange rates (BRER and REER) and the official exchange rate of the riyal against the US dollar diverged considerably.

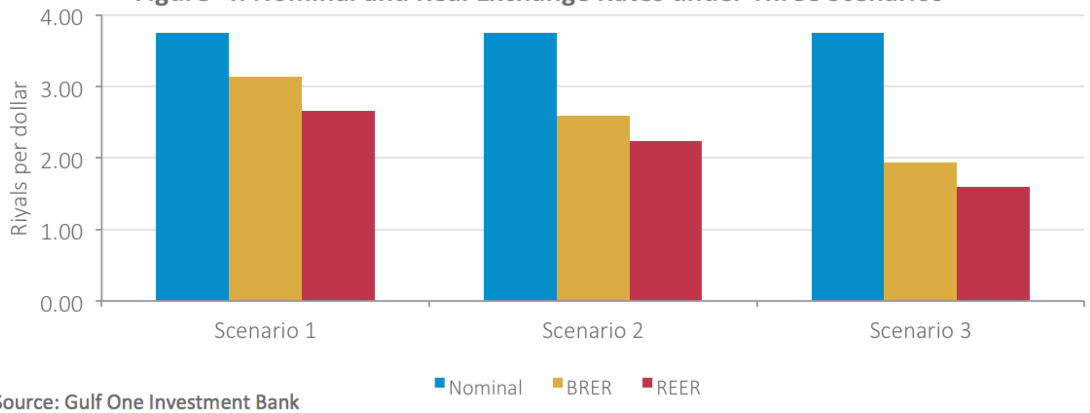
An appreciation of the real (riyal) exchange rate would lead to a loss of competitiveness of the kingdom in a number of ways. First, it would discourage exports and encourage imports, thereby leading to the worsening of the external trade position of the country[9]. Second, since the bulk of Saudi Arabia's imports

[6] Thomson Reuters, "China tells US to take steps to avoid debt crisis", Monday, 7 October 2013.
[7] Although the precise weights of currencies in Kuwait's exchange rate basket are not disclosed, many analysts believe that the dollar accounts for more than 70 percent of the currency basket.
[8] Real exchange rate is defined as the official exchange rate weighted by trade shares of a country's trading partners, adjusted for relative inflation. So BRER is calculated by adjusting the nominal riyal-dollar exchange rate of 3.75 by the relative inflation rates between the Saudi Arabia and the US. In the case of REER, the official exchange rates between riyal and other countries' currencies are multiplied by the shares of those countries in Saudi Arabia's trade and then adjusted by the relative inflation between the Kingdom and the trading partners. Here, we used import shares rather than total trade to abstract from the influence of oil exports which are largely determined by developments in the international oil markets rather than those in the foreign exchange market.
[9] This is likely to jeopardise current and future efforts at diversification away from oil exports to non-oil (manufacturing-based) exports.

come from the European Union and Asia, the devaluation of the dollar could make imports from such non-dollar currency areas more expensive, and can fuel domestic inflation in the kingdom, as witnessed in 2007 and 2008 when inflation reached a peak of 11.5 percent in July 2008. Third, real appreciation of the riyal could lead to a deterioration in the income terms of trade by eroding the domestic value of foreign exchange earnings since the same incomes earned abroad could purchase less when adjusted for domestic inflation.

estimated that a fall in the value of the US dollar against a basket of international currencies could lead to a real exchange rate appreciation in value of Saudi Arabia's riyal in the range of SAR 1.50-2.50 per dollar, based on three dollar depreciation scenarios (Figure 4).

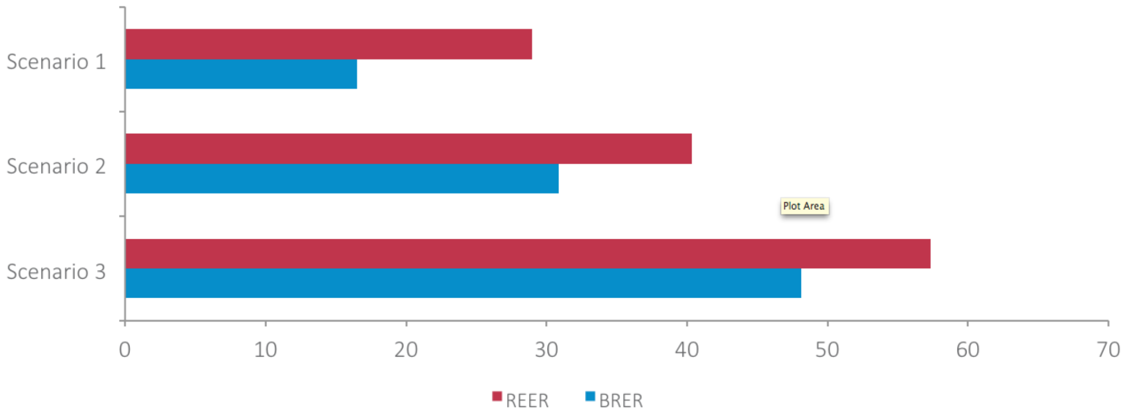
Figure 4: Nominal and Real Exchange Rates under Three Scenarios



Source: Gulf One Investment Bank

Figure 5 shows the potential loss in competitiveness under the three scenarios using both bilateral and trade-weighted real exchange rates. The latter (REER) is the more widely used indicator for gauging the loss in competitiveness of nations. Thus, on the basis of the REER, Saudi Arabia could lose nearly 60% of its foreign exchange earnings as the value of the US dollar is severely weakened by a US debt default scenario. This could also have a debilitating effect on the kingdom's fiscal position and its ability to fund key infrastructure and economic development projects.

Figure 5: Saudi Arabia's Potential Loss of Competitiveness (%)



Source: Gulf One Investment Bank

Capital markets effect

The globalisation of trade and finance means that capital markets in the GCC region are not isolated from their global counterparts. This is illustrated by the strong positive correlation between global capital markets and the GCC capital markets (Table 2). In so far as a US debt default could unsettle stock exchanges in the advanced economies, it will also adversely impact the GCC markets, as demonstrated by the 2008 global financial crisis.

The positive correlations between the global and GCC capital markets suggest that developments in the GCC capital markets are affected by developments in global capital markets. Therefore, any turbulence in the stock exchanges in the US, as a result of the inability of the US government to pay its debt, would also create turbulence in the capital markets of GCC countries. It is therefore not surprising that the OECD, in its latest global economic outlook report, estimated that a prolonged US debt default could lead to a 25% drop in equity prices in all countries[10].

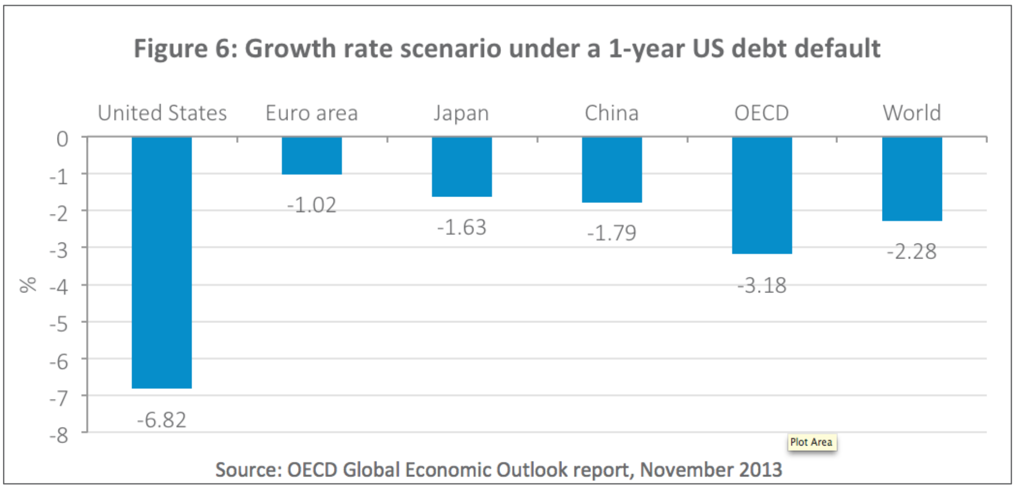
[10] OECD, *Global Economic Outlook: stronger growth ahead but more risks*, November 2013.

Table 2: Correlation Matrix for Global and GCC Capital Markets						
	Dow Jones	**S&P 500**	**FTSE 100**	**CAC 40**	**NASDAQ**	**NIKKEI 225**
Dow Jones	1.00					
S&P 500	0.97***	1.00				
	(0.00)					
FTSE 100	0.89***	0.91***	1.00			
	(0.00)	(0.00)				
CAC 40	0.57*	0.70**	0.73**	1.00		
	(0.06)	(0.01)	(0.01)			
NASDAQ	0.94***	0.90***	0.86***	0.38	1.00	
	(0.00)	(0.00)	(0.00)	(0.23)		
NIKKEI 225	0.46	0.62**	0.61**	0.95***	0.28	1.00
	(0.15)	(0.03)	(0.04)	(0.00)	(0.38)	
Bahrain	0.13	0.30	0.38	0.85***	-0.14	0.81***
	(0.70)	(0.38)	(0.27)	(0.00)	(0.68)	(0.00)
Kuwait	0.22	0.26	0.47	0.54*	0.15	0.46
	(0.49)	(0.43)	(0.14)	(0.08)	(0.65)	(0.14)
Oman	0.65**	0.61**	0.83***	0.55*	0.65**	0.34
	(0.02)	(0.04)	(0.00)	(0.07)	(0.02)	(0.30)
Qatar	0.63**	0.66**	0.78***	0.48	0.68**	0.46
	(0.03)	(0.02)	(0.00)	(0.13)	(0.01)	(0.14)
Saudi Arabia	0.39	0.54*	0.56*	0.65**	0.36	0.75***
	(0.22)	(0.080	(0.07)	(0.02)	(0.26)	(0.00)
Abu Dhabi	0.42	0.55*	0.62**	0.73***	0.37	0.76***
	(0.19)	(0.07)	(0.03)	(0.00)	(0.25)	(0.00)
Dubai	0.23	0.43	0.49	0.79***	0.05	0.86***
	(0.51)	(0.21)	(0.14)	(0.00)	(0.87)	(0.00)

Note: Annual data for 2002-2012. Numbers in parentheses refer to p-values; *,**.*** correspond to 10%, 5% and 1% levels of significance.
Data sources: Thomson Reuters; Zawya; Computations: Gulf One Investment Bank

The growth effect

The US plays an important role in the global economic growth process through trade and investment in both developed and developing countries. The OECD has estimated that a prolonged US debt default could plunge the US economy into a deep recession, with real GDP shrinking by nearly 7%, thereby throwing other major economies, such as the Eurozone, Japan, and China into recession (Figure 6). The spill over effect could curtail global growth by over 2%. Thus, the direct and indirect effects of recession in the US and the rest of world could pose serious growth challenges for the GCC countries. As is already known, the 2009 economic recession in major advanced countries, occasioned by the US financial crisis in the preceding year, seriously weakened internal and external demand in those countries, which consequently depressed hydrocarbon prices, which in turn undermined economic growth in GCC countries. During the 2009 US recession, the country's real GDP shrank by 2.8% leading to slowdown in the growth rates of all GCC countries, with Kuwait and the UAE experiencing negative growth of 7.1% and 4.8% respectively[11]. Clearly, if the OECD predictions of a deeper recession in the US and other major economies were to materialise, then a prolonged US debt default will plunge the economies of all GCC countries into recession.



Source: OECD Global Economic Outlook report, November 2013

Conclusions

The political backlash between the US Congress and the White House over fiscal and debt issues has intensified in recent years, resulting in an unprecedented downgrade of America's triple rated sovereign credit rating to AA+ by Standard & Poor's in August 2011. In October this year, polarised politics on raising the debt ceiling also prompted other credit rating agencies to put the US on a credit watch alert before American lawmakers reached an eleventh hour deal to extend the debt ceiling to avert default. Of course, such a backlash had already led to a partial federal government shutdown, which knocked off around $24 billion from the US gross domestic product. A US debt default could plunge the US economy into a deep recession, with adverse spillover effects on growth in the rest of the world, including the GCC countries.

As the world's largest economy and the world's most indebted nation by monetary value, the US cannot ignore the consequences of its actions on the rest of the world, and must therefore take long-term policy

[11] The rest of the GCC countries experienced positive growth but at a much reduced magnitude. For instance, Bahrain's real GDP growth rate nearly halved to 3.2% in 2009, from 6.3% in the preceding year; Oman's growth rate decelerated from 13% to 3.3%; Qatar's growth rate slowed from 17.7% to 11.9%; and Saudi Arabia's real GDP growth rate decelerated from 8.4% to 1.8% between 2008 and 2009.

actions to tackle its massively growing debt overhang. Continuously raising the debt ceiling without addressing the root causes of the debt poses significant risks for the US as well as the global economy. Rather than raising the ceiling to accommodate the debt, the US should open additional windows or channels to drain the debt overhang. US politicians and policy makers should abolish the debt ceiling and introduce a longer-term debt-reduction strategy to replace the current arbitrary short-term consolidation measures. The sooner this is done the better for the US and the global economy otherwise the US runs the risk of undermining its own global economic clout, thereby expediting its own demise and facilitating the rise of its own successor.

The lessons of the 2008 US financial crisis are still fresh in the minds of investors. If the US politicians fail to get their acts together, investors will have to start pricing in a non-zero probability of a disaster scenario. This would provide strong incentives to international investors to further diversify their portfolios, reducing the overweight of dollar-denominated assets in favour of real assets such as gold or financial assets denominated in other currencies such as the euro and Chinese yen. In addition, the current low interest rate regime in the US provides strong incentive to rebalance investors' portfolios by moving capital outside the US in search of higher returns elsewhere. In other words, the increased tail risk on US government bonds and the likely reaction of US monetary policy should increase demand for non-US assets. These phenomena would be exacerbated by prospects of a US debt default, which could plunge the US economy into recession, thereby producing restrictive spillover effects in the rest of the world, including the GCC region, similar to those created by the Eurozone crisis. The impact of such a scenario on the GCC countries may be limited in the short-run as they would be able to cope with the negative spillover effects by drawing down their vast amounts of foreign reserves and sovereign wealth funds. In the long-run, however, given the limited diversification of the GCC economies, a prolonged US debt default will throw the economies of the region into various degrees of recession.

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