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WASHINGTON POLICY STRATEGY

Potomac Perspective

The House could vote on a Republican debt ceiling bill this week. Passing the bill could ease the way to negotiations by giving House Speaker Kevin McCarthy some leverage in talks with the White House. Investors should discount the bill's current proposals since it is merely a starting point. Failure to pass the bill could undercut McCarthy and further complicate negotiations. The X-date remains a moving target. The Treasury Department could update the public this week with its latest estimate on when the government will exhaust extraordinary measures for managing government payments and when certain payments might be delayed.

HOUSE DEBT CEILING VOTE

On Tuesday, the House Rules Committee is scheduled to markup Speaker Kevin McCarthy's debt ceiling bill which would set up a House floor vote later this week. **The outcome of the vote is in doubt, and its failure could complicate the already delicate debt ceiling discussions and could increase volatility in financial markets.**

When the House votes on the Republican leadership's debt ceiling bill later this week, it will face the difficult reality of passing, given that Democrats will be united in opposition, some Midwestern Republicans are reluctant to support the bill's repeal of ethanol subsidies, conservatives who think the additional work requirements for food stamp recipients are too weak, and some conservatives will be reluctant to vote for any bill that raises the debt ceiling. House Republicans can afford only four defections.

If the bill passes, it could be a starting point for serious negotiations on this legislation. **Although some investors might react negatively to the proposed repeal of the Inflation Reduction Act and its clean energy tax credits, the chances of that section of the bill being included in a final debt ceiling agreement are low, and the headlines related to these tax credits should be discounted accordingly.**

Although the Republican bill is merely a starting point in debt ceiling negotiations, some GOP lawmakers have concerns about parts of the bill. If House Republicans leaders fail to convince the rank and file to support the bill, it could set back negotiations as it would undercut Speaker McCarthy's leverage in future debt ceiling talks with President Joe Biden. **A failed vote would raise questions on whether he can keep Republicans unified – especially conservatives who he will have to assuage on future debt ceiling votes lest they act to remove him as Speaker.**

If the House passes the McCarthy debt ceiling bill, it opens a complicated but viable path towards an agreement on a final debt ceiling bill over the next six weeks. If the House blocks the bill, negotiations between House Republicans and the White House will probably become longer and more complicated, increasing the chances of reaching the X-date without a deal to raise the debt limit. Under this scenario, we expect a risk-off trade sentiment will start to take hold as investors become more sensitive to debt ceiling-related headlines.

ACTUAL X-DATE STILL FLOATING

Treasury could update its estimate this week on when the government will reach the X-date. This is when Treasury exhausts its extraordinary measures which it uses to manage the government's cash flows once the debt ceiling is reached (which occurred in January 2023). **As of now, it appears the X-date could fall anywhere between the first half of June and July. If Treasury can manage until June 15, corporate tax receipts due on that day could provide enough of a cushion into July.**

As a reminder, managing the debt ceiling and federal payments (debt payments, government benefit recipients, government employee payrolls, and payments to vendors and contractors) is a cash flow management issue rather than a date specific issue, since it involves changes to when government payments are typically scheduled to occur.

Federal revenues fund approximately 75% of federal outlays, so when the X-date is reached, it is possible that some government payments could be delayed. Federal Reserve and Treasury officials seem to be confident that maturing government debt can be rolled over and new issuance can be used to make payments so that bondholders are paid on time (which would avert a technical default). If this is true and government debt is prioritized, then the question is which other payments might be delayed. It is likely that Treasury would attempt to prioritize Social Security and government payrolls, which could mean that other government payments (such as payments to contractors and vendors) could be delayed which, in turn, raises questions about those recipients' ability to pay their workers or make timely payment on their debt obligations.

For the first week or two, the system might work as normal, but the cumulative economic effect of delayed payments or the political fallout from delayed payments to Social Security recipients or government employees will be intense. Paying a Wall Street or Chinese bondholder before Grandma or an American soldier will have big political implications, which could lead to a debt ceiling deal within a week or two of the X-date.

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