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Economics Group

Interest Rate Weekly

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Potential Fiscal Policy Challenges to Monetary Policy: Part II

With a September fed funds rate hike on the table and several fiscal policy deadlines looming on the horizon, there could be more than just changes to monetary policy that could affect interest rates this fall.

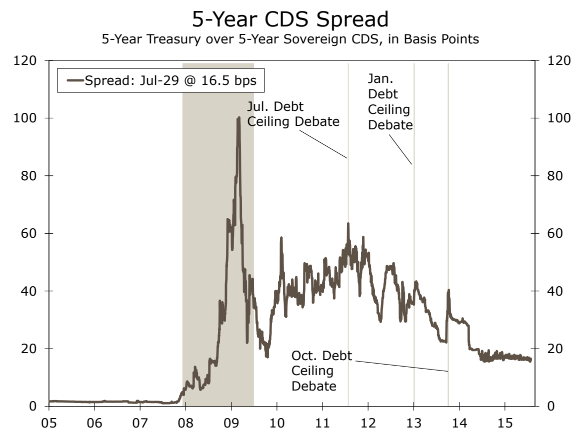
Yet Another Debt Ceiling Debacle?

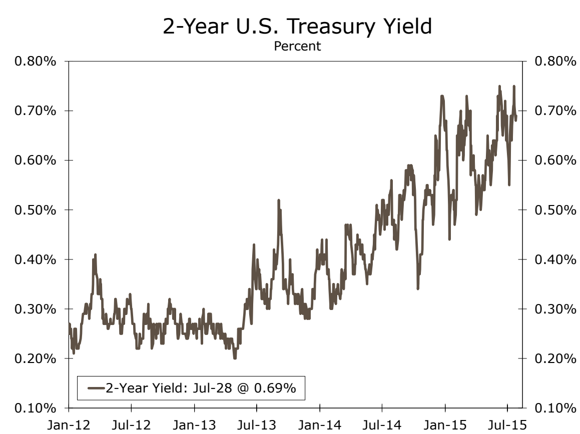
Last week in Part I of our two-part series on the potential fiscal policy challenges to monetary policy, we discussed the potential for higher deficit spending and the resulting net Treasury issuance that could have an effect in the Treasury repo market at the same time the Federal Reserve is trying to upwardly adjust interest rates. In Part II, we explore the effects of the impending debt ceiling deadline that has the potential to increase the risk premiums for Treasuries and could create a flight to safety into the Fed's new overnight reverse repo facility (ON RRP).

We estimate that Congress and the administration will need to act to increase the nation's borrowing limit (debt ceiling) sometime in October or November, just after the first expected fed funds rate hike in September. The exact timing of when the debt ceiling will be reached will depend on the growth in spending and revenues over the next several months. Currently, the U.S. Department of the Treasury is using extraordinary measures to remain under the borrowing limit (top graph). If Congress acts well in advance of reaching the borrowing limit, then we do not expect much of a reaction in rates markets. However, if Congress fails to act in a timely manner, then the result could be disruptions within interest rate markets. A look back at the last debt ceiling debacle provides a good case in point. When the debate over raising the debt ceiling in Congress went down to the wire in October of 2013, we saw a spike in the five-year credit default swap (CDS) spreads as markets priced in the increased risk of a government default (middle graph). In addition, the yield on the two-year Treasury note also shot higher during this time period. The Government Accountability Office (GAO) found that the debt ceiling impasse cost taxpayers an additional $38 million-$70 million in borrowing costs related to increased rates. In addition the report found that should a similar event occur in the future, then investors would systematically avoid Treasury securities.*

The Potential Problem: A Flight to Safety

So why is this a potential problem to the Fed during the upcoming tightening cycle? If a similar "down-to-the-wire" debate ensues this fall and global investors become nervous again, as they did in 2013, the result could be a flight to safety away from U.S. Treasuries to the Fed's new overnight reverse repo facility. In this event, the Fed risks losing control over short-term rates as investors pile into the safe haven ON RRPs offered by the Fed. As we mentioned before, if the size of the Fed's ON RRP is too small, then investors may flock to similar money market instruments, making ineffective the floor the Fed is trying to establish. Thus, the actions, or lack of action, of Congress and the administration this fall have the potential to create even bigger challenges for the Federal Reserve as it moves to raise rates.





Source: U.S. Dept. of the Treasury, Bloomberg LP and Wells Fargo Securities, LLC

***United States Government Accountability Office. (Jul. 2015). "Market Response to Recent Impasses Underscores Need to Consider Alternative Approaches." GAO-15-476.**

Wells Fargo U.S. Interest Rate Forecast

	Actual						Forecast					
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	2.00
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.28	0.70	0.95	1.20	1.45	1.70	2.20
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.50	5.00
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	3.98	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.01	0.13	0.55	0.86	1.15	1.33	1.72
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.11	0.27	0.63	0.91	1.22	1.42	1.75
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.28	0.69	0.99	1.24	1.57	1.79	2.17
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.64	0.86	1.08	1.27	1.72	1.94	2.38
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.63	1.78	1.89	2.01	2.20	2.32	2.61
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.35	2.41	2.49	2.55	2.66	2.80	2.91
30 Year Bond	3.56	3.34	3.21	2.75	2.54	3.11	3.18	3.22	3.27	3.34	3.55	3.72

Forecast as of: July 24, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.0	2.9	N/A
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
PCE Inflation			
Wells Fargo	1.0	2.0	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: July 24, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 17, 2015

Sources: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities LLC

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