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U.S. Debt Ceiling Problem Shakes U.S. Economy, International Energy Situation

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Various destabilizing factors always exist in the international energy market. But at this moment, the most important destabilizing factor is fears over the future course of the world economy. In this context, there are many destabilizing factors regarding the future course of the world economy, including the Greek debt problem's possible spillover to major European countries and China's inflation and asset bubble problems. Among them, the most serious problem at present is the U.S. debt limit hike and fears over the future U.S. economy.

In the United States, any change in the federal debt ceiling is subjected to Congressional approval. The present ceiling stands at $14,294 billion as approved by Congress in February 2010. As federal debt reached the ceiling May 16, the administration sent Congress a debt ceiling hike proposal. Since then, a debt ceiling debate or battle between the Democratic and Republican Parties has continued in Congress. Unless the debt ceiling is raised by August 2, the U.S. government is expected to face the risk of default on its debt obligations. As no breakthrough has been made, even up until just before the deadline, not only U.S. financial markets but also global markets have been greatly shaken.

The U.S. government issues bonds to raise funds for servicing earlier-issued bonds. Unless the debt ceiling is raised, it may remain unable to issue new bonds and may default on its debt obligations. In such event, U.S. Treasury bonds, which are the world’s most liquid and safe assets, with the top rating of Triple-A, may lose their creditworthiness and become subject to a rating downgrade, exerting grave impacts on the world economy and global financial markets.

The ruling Democratic Party and opposition Republican Party have failed to reach a compromise on conditions for accepting the debt ceiling hike (at the moment this paper was written). Specifically, their negotiations are deadlocked over how to structurally improve the federal government’s debt-ridden budget over a medium to long term in exchange for the debt limit hike. No breakthrough has come into sight at this moment. Structural budget improvement measures are divided into revenue-boosting tax hikes and substantial spending cuts. Earlier, the Democratic Party proposed tax hikes, facing harsh opposition from the Republican Party. Democrats later made some concessions, coming closer to compromise with Republicans.

But the two parties have remained wide apart over spending cuts. While Democrats proposed $2.7 trillion in budget deficit reductions over years and a debt ceiling hike of a similar size, Republican House Speaker John Boehner came up with a two-stage debt ceiling hike – a first-stage hike of $900 billion in exchange for $1 trillion in spending cuts and another hike contingent on full-fledged, substantial spending cuts subject to negotiations next year. He has urged Democrats to compromise with Republicans on the proposal. Complicating the problem is a group of conservative Republican congressmen who have a strong aversion to big government and stick to large-scale spending cuts. It may be difficult for Republican leaders to unite their party opinion. Prior to next year's presidential and Congressional elections, the two parties have had realistic and strategic political disputes over the size and timing of spending cuts and ideological differences over government roles, making it difficult for them to reach any compromise.

Fears of their failure to reach a compromise by the deadline, which could lead to the U.S. government's default and a Treasury rating downgrade, have greatly shaken the U.S. economy and financial markets. The Dow Jones industrial average on the New York Stock Exchange extended its losing streak to the fifth day, hitting a one-month low of 12,240. As the default is expected to affect global confidence in the U.S. economy, the dollar has dropped below 78 yen/dollar. Fears over the U.S. economy have spilled over to the entire world, leading to a global chain of stock market tumbles. While the battle over the U.S. debt ceiling hike attracts global attention, there are expectations that a final compromise could be reached by August 2 to avoid any crisis. But no optimism can be warranted.

Fears over the future course of the U.S. economy as the world's largest and over the falling creditworthiness of U.S. Treasury bonds as the world's most liquid and safe assets have shaken the international energy market as well. Economic trends symbolized by a stock market tumble are expected to greatly affect U.S. and world energy demand. If the U.S. economic and financial market turmoil deepens and expands, oil and other energy demand may slacken to shake the supply/demand environment for the international energy market. Perceptions about future energy demand can affect pricing on the energy futures market. Therefore, stock market tumbles and fears about economic trends can work to lower crude oil futures prices.

Interestingly, however, stock market drops have not necessarily led to a fall in the benchmark West Texas Intermediate crude oil futures price in the last few days. On July 28, for example, the WTI futures price gained $0.04/barrel to $97.44/barrel even amid the stock market decline. Behind such development were the dollar's depreciation and its impacts. As dollars have been sold on falling confidence in U.S. government securities and the U.S. economy amid the debt ceiling hike battle, money might have flowed into markets for commodities as real assets. In this respect, prices of gold viewed as a safe asset have rewritten records. The benchmark crude oil futures price basically followed a downward trend amid the stock market tumble over the past five days. But it closed higher in three of the five days. In this sense, the crude oil futures price's fluctuations amid the shaken financial markets have been very complex.

In this context, we can expect crude oil prices to remain excitable with regard to financial market developments. If the U.S. debt ceiling problem deepens further to add fuel to fears over the future course of the U.S. economy and the world economy, crude oil prices may basically come under great downward pressures. We may not be able to keep our eyes off U.S. financial markets for the immediate future.

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