WHAT WOULD HAPPEN

IF THE

US WENT BROKE?

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Greece may have staved off default for another few months, but as protestors leave the streets of Athens, global attention has moved to the US and its enormous debt problem.

The US is the richest country in the world, so it follows that its credit limit is the largest. But Uncle Sam has run up incredibly large bills in recent years and it is now close to the top of its credit limit.

But the US has its own central bank and Treasury so it could just mint new coins and notes if it ever ran out of money, right?

Well, that is technically correct but US politicians in Congress are supposed to act as the US's bank manager and set its credit limit (they also spend the US's money, so one could argue that it's a fairly lax system).

In recent years, Congress has raised the debt ceiling because of some exceptional circumstances like the subprime crisis and the financial sector bailout in 2008/2009. But now that the recovery has taken hold, the Republicans in Congress want to start paying the debt away.

That's all fine except that the US is hitting its latest debt ceiling and needs to borrow more money. But Congress is in deadlock.

The scale of the problem

The US needs an extension on its $14.3 trillion credit limit urgently. As anyone who has racked up debt on multiple credit cards will know, the more you owe the more you need to borrow just to pay back your original debts. This is where the US now finds itself.

The biggest economy in the world needs Congress to give it the green light to tap the markets for more cash to pay debt redemptions and coupon payments that are due to be repaid in the coming months.

Since these tally up to more than $500 billion, the extension will have to be fairly hefty to ensure the US's finances are sustainable in the future.

If Congress says no then expect carnage in the financial markets. Already one of the major credit rating agencies has said it will immediately cut the US's credit rating to default; it is currently rated triple A and considered the safest security in the world to hold in your portfolio.

With no money, the US government would not be able to pay public sector workers, pensions, disability allowance; schools and hospitals may have to close their doors.

Congress has shut down before because the debt ceiling hasn't been extended, but this time is slightly different.

Debts have never been this big and credit rating agencies have never threatened to cut the US sovereign debt rating to a D - worse than Greece.

The fallout

A US debt crisis would also reverberate across the globe. Most of the US's debts are held overseas. Almost a quarter are held by China and 20% is held by Japan. The UK is the next biggest holder with 7% and oil exporters are the fourth largest with nearly 5%.

If the US stopped making payments on its obligations then its creditors would suffer. Not only would these countries not receive the money they were due, but this could disrupt their cash flows and impact their economies.

If the US's credit rating was slashed then it would most likely send yields sky high and since bond prices move inversely to yields the value of the debt they hold would also tumble.

So investors would be hit twice: firstly the value of their investment would fall through the floor and then they wouldn't get the money they expected to receive.

It's unlikely there would be many people willing to purchase US debt after this, so Congress needs to put ideological differences aside and look at the practicalities of what defaulting means.

If you have $14 trillion in debt, you shouldn't anger your creditors.

Even if Congress does raise the debt ceiling in the coming weeks, the wrangle up on Capitol Hill has already eroded the US's debt's status as a risk-free asset.

No country is entirely free from the risk of default, even one as rich as the US. From now on investors may start to price in a political premium to US debt, which could make it more expensive for the US to borrow in the future.

We are now in a period whereby excessive debt loads will not be tolerated by investors, so the US needs to toe the line and gets its fiscal house in order or else pay the consequences.

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