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Client Considerations

Raising the U.S. Debt Ceiling

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Whether or not Congress should raise the U.S. debt ceiling is more than just a simple "yes or no" question. Wrapped in historical precedent and laden with future repercussions, the question evokes multiple considerations and potential scenarios.

Consideration #1: Debt ceiling votes are not new developments.

The Second Liberty Bond Act of 1917 gave rise to the concept of debt limits. Before the passage of this Act, Congress had approved each debt issuance separately. The Act gave the Department of the Treasury more authority to issue debt and relieved Congress from the responsibility/burden of making these specific individual financing decisions. What we view as the modern "debt limit" (defined as total federal debt not exceeding a stated ceiling) then developed over time.

According to the Congressional Research Service, the debt ceiling has now been raised by Congress 74 times since March 1962. Congress has often raised the debt ceiling in dramatic political fashion at the "eleventh hour," so it is not at all surprising to see the same sort of process now.

Consideration #2: Do we really need a debt ceiling?

Congress (specifically the House of Representatives) has authority over the budget. And according to Congressional Budget Office projections, this year's federal budget will show a deficit of close to $1.5 trillion, based on revenues of approximately $2.2 trillion and government outlays of $3.7 trillion. This considerable deficit will be financed through the issuance of additional debt (treasury bills, notes, bonds, etc.), which is why the extension of the debt ceiling is now necessary.

Some argue that the debt ceiling debate simply sets the stage for superfluous political grandstanding. After all, we have elected our representatives, and they have passed a budget, seemingly not too concerned about the wide budget deficit. In this context, arguing over the debt ceiling extension seems like arguing over whether or not to pay the bills that we have already agreed to pay. Some politicians grab onto the debt ceiling debate for political theatrics: to paint an opponent or an entire party as fiscally irresponsible. It also has been used as a tool by the minority party to force budgetary changes.

However, in a broader context, the debate surrounding the debt ceiling issue (and media coverage of the issue) has helped the average voter to become more informed about the challenges that we face as a nation. The record $1.5 trillion deficit requires more than the passing consideration that prior votes have. A politician's vote to extend the debt ceiling can also be viewed as an important accountability tool. An old adage states that "sunlight is the best disinfectant." It seems that the debt ceiling votes bring a little sunlight into the budget process. If a politician chooses to extend the ceiling, he is in a sense going on record, both for the budget decisions that helped create the need for the vote and for the debt vote itself. So, the debt ceiling issue really stands as an important political "check and balance" to Congressional power over the purse strings of the budget.

Consideration #3: How did we get here so quickly?

In the last fifteen years, the debt ceiling has nearly tripled. In the mid 1990s, the debt ceiling was less than $5 trillion. It now stands at $14.3 trillion. While roughly half of this increase in the debt ceiling has occurred in the last three years, the United States has been running annual federal deficits every year since 2002. We did not get into this problem overnight; despite all the political bickering over the issue, both Republicans and Democrats share the blame.

For its part, the George W. Bush administration ramped up military spending significantly to fund engagements in Iraq, Afghanistan, and the broader "war on terror." But the Bush administration was also often far too weak in arguing against (and vetoing) spending initiatives advanced by Congress, especially once the Democrats took control in 2006. Of course, one can argue that some of these decisions were externally imposed and some were driven by various policy goals from within. But the cold truth is that by the end of the Bush Administration, the surpluses that were generated by the "Republican Revolution" Congress and the Clinton Administration looked like distant fantasies.

Since the early days of the 2008 credit crisis, the country's deficit situation has deteriorated even more rapidly. In part, this has been due to decisions of the current Obama administration in its pursuit of (what we believe to be) a flawed Keynesian economic model: one that relies on increased government spending to spur aggregate demand and thereby increase economic growth. In following such a model, the Obama administration supported (and Congress passed) a massive federal stimulus program in the new president's first few months in office. Sadly, this stimulus program has only met with limited success. What we have seen instead is massive growth in the country's annual deficits and in the nation's debt burden. This proclivity for much higher spending levels in the midst of a "great recession" took place in the context of significantly declining tax revenues.

Consideration #4: But I've heard we've already hit the debt ceiling … what is happening now?

This is true. The math may not be exact, but most measures indicate that the U.S. Treasury hit the debt ceiling ($14.294 trillion) early in the week of May 16, 2011. There was little fanfare or market reaction to the news. Why?

Thankfully, the U.S. Treasury had been planning for this event for some time now. They began implementing "extraordinary measures" in the days leading up to the piercing of the debt ceiling. These measures included:

- ending a Supplementary Financing Program used by the Federal Reserve,
- cancelling a lending program used by state & local governments for the pre-refunding of municipal debt,
- deferring certain payments to government employee pension accounts.

According to Treasury Secretary Geithner, these measures will allow the Treasury to function somewhat normally until early August. But the Secretary has also stressed repeatedly that the sooner the Congress takes action on the debt ceiling extension, the better. Like it or not, the U.S. is the world's largest debtor nation, and there are clear economic implications for world markets if more and more investors become convinced that the U.S. may consider defaulting on its obligations.

Consideration #5: Some politicians are calling for no extension of the debt ceiling. Since we already seem to be drowning in debt, that appears to be a good idea. Is it? What are the practical implications of not raising the debt ceiling?

We believe that the debt ceiling should be – and ultimately will be – extended. As we said previously, we did not get into this fiscal situation overnight. We are not going to wave a magic wand and suddenly escape from its grasp, either.

Those who advocate not extending the debt ceiling seem to have the country's best interests at heart. As a country, there is no denying that we are spending too much relative to government tax revenues. From their perspective, going "cold turkey" is akin to quickly returning fiscal sanity to the federal government. The problem with this approach is that it is similar to a morbidly obese person deciding to stop eating between now and Christmas. While he will likely lose weight, it is also likely that he'll face other health problems, maybe even death, before the holiday arrives. Likewise, failure to raise the debt ceiling is a decision with widespread repercussions.

The consequences of a failure to raise the debt ceiling by early August are rather severe. The Treasury Department would no longer be authorized to issue new debt and the federal government would begin to operate on a cash flow basis. In effect, outflows paid (interest payment on outstanding debt, service payments, etc.) would be matched against inflows received (tax revenues and fees). This "prioritization of payments" system could lead to delays in payments for government services or other operations, since servicing existing interest and principal payments coming due on Treasury bonds (avoiding default) would likely take top priority of any cash flow. Federal government workers could see delays in receiving their salaries or other benefits as the fiscal strains became more pronounced. Eventually, as these strains become more severe, a default could occur as the likelihood of an inadvertently missed interest payment on an existing debt obligation grows over time.

If a default event involving U.S. government debt were to occur, the market and economic reaction to the event could be severe, even if the event was quickly resolved. The value of the U.S. dollar would likely decline rapidly as international confidence in its "reserve currency" status declined. The value of real assets (gold, alternative reserve currencies) would likely rise. The AAA rating of U.S. debt would likely be lowered, and one would expect a significant increase in interest rates as a credit risk premium is priced into the valuation of Treasury debt, currently considered the world's "risk-free asset." Economic growth would be negatively impacted by higher interest rates, coupled with lower confidence levels for consumers, businesses, and banks. Risk-based assets like stocks would suffer. The situation would be akin to the market reaction following the Congress' failure to pass TARP (the Troubled Asset Relief Program) in late September 2008. While TARP was eventually passed just a few days later, in the interim the U.S. stock markets lost about 10%.

Consideration #6: If refusing to extend the debt ceiling is not the best answer, what can be done to address our debt imbalances?

In the previous weight loss analogy, what the overweight man needs to do is reduce his calorie intake and start a physical training program that returns his body to health *gradually*. Similarly, we need to extend the debt ceiling, *but we need to do it in a responsible way.* This might come in the form of a federal spending cap tacked onto the debt ceiling vote. We might also see politicians acquiesce to significant spending cuts in order to secure passage of the extension.

In our opinion, long-term budget reform is a critical component of this process. The United States needs to target reforms in many areas where politicians (and voters) do not want to look: areas like Social Security and Medicare. The situation with Medicare is particularly troubling because it is one of the most popular government programs ***and*** its costs appear to be rising the fastest. Voter education in these areas also appears to be badly needed. A recent Washington Post-ABC News poll showed that most Americans are poorly informed about the budget, believing that small tweaks can fix the problem. In these polls, the only thing most Americans seem to agree on is that taxes "for the rich" need to increase. The reality is that small tweaks *cannot* fix the problem, but long-term structural changes can.

The solutions are not that difficult on paper. Washington politicians only have to look back to their home states and municipalities, where government expenses have been reduced to match declining revenues. Unfortunately, most Washington politicians don't want to cut anything that could result in less federal money flowing back into their districts.

Thus far, the president has largely promoted tax increases as a means of cutting the deficit. Republicans have pushed equally hard against tax increases and favored spending cuts. Bipartisan groups have been formed to discuss solutions to the deficit issue, and they have generally recommended a combination of spending cuts and tax increases. However, members of each political party within these groups are often far apart on what the proper mix should look like.

As it stands now, it appears that Congress is unlikely to consider significant Medicare reform until after the 2012 elections. That is unfortunate in our view, as it represents another decision by our political leadership to "kick the can" down the road.

What's Next? We have little doubt that a debt ceiling extension will be passed, as the potential consequences of inaction are too great. But there is still much uncertainty as to whether we will see:

- a longer-term extension (accompanied by significant budget reform progress) or
- a shorter-term (and smaller) debt ceiling raise (with little budget reform) that adds to market uncertainty and leaves us to debate these same issues again in a matter of months.

Pending developments (especially those involving a bipartisan committee of legislators currently working with Vice President Biden) must be carefully monitored and evaluated over the weeks ahead. Late this week, the key Republican leadership on the Committee walked out of negotiations due to an impasse on the issue of tax increases. This move highlights one of the biggest difficulties concerning forecasting the ultimate resolution to the debt ceiling debate (and to the debt situation in Europe, for that matter). Namely, that the decisions being made are about more than just economics. The decisions are being made by politicians, meaning that any decision they reach will reflect a compromise between economic realities and political opportunities.

Our political leadership may ultimately reach the right economic decision (and we hope they do), but the path taken will be influenced by considerations of short-term political gain, for themselves or for their party. This fact increases uncertainty levels for the market, and ultimately the implications for the market could be quite severe if political considerations continue to trump economic reality.