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InvestNews – Question & Answer

Debt Ceiling, Default or Deceit

The topic du jour hijacking the press, politics and the peace of mind of investors and regular citizens alike is the debate in Washington regarding the fate of the government's borrowing limit. If it is not increased above its current \$14.3 trillion limit by August 2, the government will not be able to pay all of its obligations on time. The rhetoric regarding what eventualities reaching that limit would cause has been pumped up to deafening levels. Predictions range from default on U.S. Treasuries, to a collapse of the dollar, to global "financial Armageddon."

Financial Armageddon? The rhetoric is implying is that the U.S. government could stop paying interest and principal on its debts, which, could directly cause the U.S. Treasury to default and immediately lead to all of the horrors described above. Really? Or is the government reaching its debt limit akin to you or me reaching the limit on our credit cards or home equity line? Would that really cause individual financial catastrophe? Would you or I immediately stop paying our most important bills, such as our home mortgage or electricity, so that we lose our homes or our health? Or would it be more logical that we would juggle our less critical payments while simultaneously cutting our expenses to the bare essentials?

The talking heads on both sides of the aisle in Washington are engaging in theatrical hyperbole purely for political jockeying. Fortunately the game of "chicken" they are playing is nowhere near as dire in the short term as their posturing is claiming. The net revenue the U.S. government will take in this year is \$2.5 trillion. The total interest on all of the U.S. debt is less than 1/10 that amount. Furthermore, government revenues have been \$220 billion higher over the past 12 months than over the prior 12 months. This increase in revenues will continue to rise as the economy continues to grow without raising taxes or cutting spending.

If the government does nothing at all, and the debt ceiling deadline passes without any compromise or agreement, the deficit will slowly shrink. But there will be a deficit. Therefore, the payment of some bills will get delayed. Delaying payment does not equal default. It means some government employees, retirees, military subcontractors and the like may not get paid on time. But the government will NOT default on its debt! Interest on Treasuries will get paid. So will principal – as Treasuries come due, the government will be able to issue new debt (T-bills, notes and bonds) and use the proceeds to pay back the principal on the maturing bonds on a dollar-for-dollar basis without taking on a penny of additional debt.

Keep in mind, this impasse is not unique. In 1995-1996, when Congress could not come to an agreement, parts of the government were shut down more than three months while Congress continued to work on fiscal policy. The economy survived. In fact it thrived. In the wake of the eventual agreements in Congress, over the following four years, real gross domestic product increased by more than 4% per year, and the stock market rose by more than 20% per year.

None of this is to say the economy does not currently face immense challenges. The contrary is quite true. The level of debt the government has taken on is indeed unprecedented. Even the \$2-2.5 trillion in cuts over the next ten years being discussed will not balance the budget. But that amount is a good start. And the debt limit is a completely valid and worthy device via which deficits can be reduced and ultimately balance the budget. If the deficits are not reversed, it is possible that some day in the very far distance, the Treasury could face the potential of a default. But that day is not coming in the near future despite the hot air emanating from Washington.

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COURAGE

By Paul Sutherland, CFP®

We don't worry when the price action goes against us. Not only do we not worry, but on the contrary, having done our research to give us deep conviction, we savor those opportunities to buy more of what has more value....

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