

The U.S. Debt Ceiling: Does This Mean Foreclosure?

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“Every problem has in it the seeds of its own solution. If you don’t have any problems, you don’t get any seeds.” -Norman Vincent Peale

We have all experienced debt in our lives - home loans, car loans, student loans, etc. We also know that we cannot survive for very long if we spend more than we make. That is happening in the USA right now and there is a fierce debate over our country’s debt ceiling. This article will define the term 'debt ceiling' and examine reasons why our politicians are so up in arms over it.

The debt ceiling is a cap set by congress on how much money the U.S. federal government can owe. The cap applies to debt owed to the public (i.e., anyone who buys U.S. bonds), in addition to debt owed to federal government trust funds, such as Social Security and Medicare (termed intra-governmental holdings).

Article I, Section 8, of the United States Constitution gives Congress the power to borrow money on the credit of the United States. Under this act, Congress established an aggregate limit, or 'ceiling', on the total amount of bonds that could be issued. The first limit was set in 1917 and was set at \$11.5 billion. The ceiling has raised 74 times since March of 1962 and 10 times since 2001. The current limit is set at \$14.294 trillion, and the country’s accrued debt hit that mark on May 16, 2011. The United States was effectively at the limit of Congressionally authorized debt. A 'toolkit of emergency measures' was instituted on that date to provide the government with eight weeks of additional funding. The eight weeks will end on August 2nd, 2011.

So, what happens if Congress does not raise the debt ceiling before August 2, 2011? There is no exact answer to that question, other than the fact that the Treasury would not have authority to borrow any more money. That is a problem, because the government borrows to make up the difference between what it spends and what it takes in. In recent years we have been running huge deficits, and this is generating a fast-growing national debt. In April 2011, rating agency Standard & Poor’s issued a 'negative' outlook on the U.S. AAA (highest quality) debt rating for the first time since the rating agency began in 1860. This indicates that there is a one in three chance of an outright reduction in the rating over the next two years. According to S&P, meaningful progress towards balancing the budget would be required to move the U.S. back to a 'stable' outlook. Losing the AAA rating would likely mean higher interest rates. Moody’s followed suit in June and warned that if Congress did not quickly raise the debt ceiling, the agency might reduce the debt rating.

Additionally, without raising the debt ceiling, the Treasury would be put in the situation where they would selectively decide which debts to pay and which to ignore. Institutional investors would be a first priority, so that a formal default would not occur. The Treasury would be forced to postpone millions of payments at home. This would include Social Security recipients, federal employees, contractors, and the military. Postponement of federal payments would have a dramatic impact on cash flow, consumer spending, consumer credit, and even interest rates.

On December 6, 2010, the President announced that he had come to a deal with Congressional Republicans. The deal was to extend the Bush Tax cuts for 2011 and 2012, along with tax breaks on payroll taxes and business equipment spending, and a further extension of unemployment benefits. While those

measures likely helped bolster the economy in the short run, they also put off the inevitable day when the federal government would engage in actual budget restraints.

On April 8, 2011, the Administration came to a last minute agreement with Republican lawmakers to avoid a government shutdown. This agreement included \$78.5 billion in cuts to discretionary spending for the 2011 budget, but it did not address longer-term budget issues. Also in April, Representative Paul Ryan, the Chairman of the House Budget Committee, laid out a proposal to cut \$4.4 trillion over 10 years. This plan attempts to do most of the heavy lifting on the budget from the spending side. Eight days after the Ryan proposal, the President announced one of his own. He proposed to cut \$4 trillion from cumulative deficits over the next 12 years. Approximately \$1 trillion of this would derive from tax increases and \$1 trillion from lower interest rates. The remaining \$2 trillion would derive from spending cuts in defense, non-defense discretionary programs, and medical programs.

Current drama involving the debate on deficits and debt stems from a threat by some lawmakers that they will refuse to raise the federal debt ceiling in the absence of progress on the long-term issue. Republicans propose that any deal to raise the debt limit must also include an agreement on spending cuts that exceed the debt limit increase. The White House and congressional Democrats say they are open to a deal. However, they state that it must include tax increases, or the elimination of tax breaks, and loopholes for major corporations and high-earning Americans. Republicans respond that some of these moves would be “job-killing tax hikes”. Negotiations have been aiming to increase the limit by over \$2 trillion with the same amount in deficit reduction.

Despite the dire consequences of failing to agree to an increase in the debt ceiling, a recent CBS poll found that 63 percent of Americans think raising the limit is a bad idea. Most economists would agree that the debt problem is a critical one that is best dealt with by means of a disciplined plan implemented over a number of years. We do not need to reduce the deficit from 9 percent of GDP to zero percent in one year. All issues need to be on the table. Tax reform would be critical to reducing the sting of higher taxes on the economy.

Are there any investment implications if a compromise (as expected) is achieved? TPI believes that it is unlikely that there would be a financial crisis in the U.S. If the President is re-elected, we believe there would be higher taxes to individuals and higher taxes on dividends and capital gains. We also expect to see budget cuts, especially in the areas of Medicare and Social Security. The bottom line is that the federal budget is not in mortal danger, and that this should not be perceived as a time not to invest. The appropriate response should be to ensure that portfolios are large enough, and protected as much as possible, from both higher taxes and potentially higher interest rates. TPI is equipped to analyze the changing economy and to take the necessary steps to maintain well diversified portfolios.