Raising the Ceiling

The deal that reopened the federal government in mid-October did not resolve the debt ceiling. That discussion continues to percolate.

Despite many past battles over the debt ceiling, some agreement has always been reached to preclude a default, which would have global consequences.

How concerned should investors be about the approaching debt ceiling?

As if the fiscal cliff, the budget impasse, and the government shutdown weren't enough, the latest looming crisis in Washington is the debt ceiling. Under the agreement reached on October 16 to reopen the government, the $16.7 trillion debt ceiling was temporarily suspended, but will kick back in on February 7, 2014. At that point, the Treasury estimates that the government coffers will be insufficient to pay its bills unless it can issue more debt to fund them.

The debt ceiling represents the maximum amount of bonds that the Treasury may issue, proceeds of which are used to not only fund government programs and operations, but to service existing debt. Note that the debt ceiling does not specify how much the U.S. government may spend; that is determined by the budget and spending bills.

For investors, who watched markets swoon, then quickly recover during the most recent Congressional clash, there is a temptation to dismiss the debt limit as mere political posturing. It certainly is not the first time Congress has attempted to use the debt limit to steer fiscal policy, nor will it be the last. But the battles have elevated and the consequences of not extending the debt limit are potentially huge, suggesting that investors keep a cautious eye on events as they unfold.

Setting limits

The debt limit was originally conceived in 1917. Before then, Congress had to give its approval every time the Treasury issued a bond. Since then, there have been many threats to not raise the limit, but the rhetoric was elevated in 1995 when the debt ceiling battle dragged on for months. Most recently, the debt ceiling has evolved into an annual combat between the Administration and Congress -- one that has become increasingly heated as Congress has polarized. During all these battles, Congress has eventually raised the limit. But if they were *not* to raise it, even for a short period of time, the consequences could be potentially devastating. The concern is not that the government would not pay its bills -- even the rating agencies seem to agree that the U.S. would eventually honor its commitments, as evidenced in their top or near-top ratings of U.S. Treasury bonds. But such a disruption could have huge repercussions in world financial markets. Many economists believe it would be disastrous if the government ever missed an interest payment on its debt. The global financial markets are structured around the notion that U.S. Treasuries are the safest asset in the world. If that assumption were ever called into question, havoc could ensue. Credit markets could freeze, the value of the dollar could plummet, U.S. interest rates could skyrocket, the negative spillovers could reverberate around the world, and there might be a financial crisis and recession that could echo the events of 2008 or worse.[1]

Should investors worry?

This doomsday scenario, however, is not likely to happen. If history is any guide, the most likely outcome of the current debt ceiling debate will be another eleventh-hour deal. Under the terms of the October 16, 2013, agreement, the government is funded through January 15. To avoid another shutdown, Congress will need to pass some spending resolution before that date, which would most likely be combined with an increase in the debt ceiling. In the event that another shutdown does occur and no agreement is reached by February 7, the Treasury also may be able to buy more time through accounting maneuvers, staying within the existing borrowing cap until tax season when tax dollars begin rolling in.[2]

But investors should nonetheless remain cautious and expect increased volatility as the deadlines draw near. Keep your long-term investing goals in sight and try not to lock in losses by selling into short-term volatility. Above all, remember recent experience and put the current round of Congressional battles in perspective.

[1]Source: The Washington Post, "Absolutely everything you need to know about the debt ceiling," October 14, 2013.

[2]Source: Bloomberg, "Treasury Has Tools to Push 2014 Debt-Limit Deadline Past Feb. 7," Oct 17, 2013.

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