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DEFCON: An Examination of the Debt Ceiling "Crisis"

Presented by Mike Ovshak

Politicians and the media have a lot to say about the current debt situation. While the Democrats say "left" and the Republicans say "right," the media commentators warn of impending doom if an agreement to raise the debt ceiling is not reached by August 2. The fact is, the debt ceiling debate that's currently under way could indeed turn into a real crisis, with major consequences, but we aren't there yet. And there is reason to believe that we will never get to that point.

What does "default" mean?
A tremendous amount of ink has been spilled over the consequences of default, but most authors haven't defined what "default" actually means. There are several levels of default—and each could have dramatically different consequences. Let's call these scenarios DEFCON (default conditions) 1, 2, and 3.

DEFCON 1 explains where we are right now. The government actually hit its borrowing limit in mid-May; since then, the Treasury has been paying bills using cash on hand and tax receipts, as well as by dipping into federal employee pension funds. What that means is, we are already a couple of months into emergency mode—and we are spending down our cushion.

What changes if the government fails to reach an agreement by the August 2 deadline?

DEFCON 2 is the next step. So far, even though we have reached the debt limit, we have been able to pay all outstanding obligations as they come due through the methods described above. On August 3, we will no longer be able to pay these obligations in full, so something will have to give.

One possible scenario in this case would be to prioritize the following payments:

- Debt interest (a relatively small part of total obligations)
- Social security benefits
- National defense

After that, we could expect a shutdown of various parts of the government, again based on priority. (We can look to the 1995/1996 federal government shutdown, when President Clinton and Congress were unable to agree on a budget, as a guide.)

If this occurs, the government would begin defaulting on its obligations in some sense, but as long as bondholders continue to receive interest payments and existing debt can be rolled over, there is no *effective* default on debt.

How long this scenario could continue is something of an open question, as it would depend on the timing of cash flows and obligations. If the cash flows could not support payment of debt obligations, we would move on to the next step.

DEFCON 3 is a full-blown default, where the government makes a political decision to not pay interest or principal to debt holders. This is the big one—and it is the apocalyptic consequences of this definition of default that most commentators have focused on. Should we reach this stage, the global consequences could be dramatic. But because of the potential repercussions, and the latitude granted by DEFCON 2, the chances of us reaching this last stage are relatively slim. In fact, while some media commentators assume that "default" means that we'll immediately arrive at DEFCON 3, many other commentators refuse to consider the possibility, believing that no "sane" politician would be willing to risk such far-reaching consequences.

So what happens now?

We are currently at DEFCON 1. We may well proceed up the ladder to DEFCON 2. But if we do, we'll have some breathing room for a couple of reasons—first, because of those mentioned above, and, second, because we'll have some additional time, until the next round of interest payments is due, to figure out the next steps.

The consequences of reaching DEFCON 2 should not be as dire as DEFCON 3, but there's no telling how the markets will react. There is one indication that the markets may be ignoring the chatter, however: Treasury rates have not spiked, which is a sign that the market does not anticipate anything like DEFCON 3, or even DEFCON 2.

While we certainly don't intend to minimize the potential impact of a full-blown government default, it's important to separate the political theatre from the actual economic situation. There are enormous incentives to reach a deal. There are also enormous incentives to hang tough until there's no choice but to sign an agreement—which means we probably shouldn't expect a deal until the 11th hour. Given the August 2 deadline, and the pending Congressional recess starting August 5, it seems quite possible that the final stretch of this ride will be scary. At the same time, like any thrill ride, we should all make it back to solid ground intact.

If you have questions about this article, please use the contact information listed below and I will be happy to discuss them with you.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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