

Debt Limit: Last week, the House voted down a debt limit increase without any conditions by a vote of 97-318. Not a single Republican voted for it. Then, last Tuesday, the President invited the entire Republican caucus to the White House for a discussion on the debt limit. Frankly, all the President succeeded in doing was angering us. His arrogance, haughty nature and his unwillingness to say anything other than his campaign talking points left us all quite discouraged about any potential agreement. Still, the debt limit looms. Treasury Secretary Geithner says that we have already technically hit the ceiling, but that he is raising cash using "extraordinary measures" until August 2nd, at which he point he predicts we will be at the end of our financial rope and run out of cash. Conveniently, that day is just a couple of days before the House and the Senate are scheduled to go on summer recess. The potential to have to cancel that recess will focus negotiators in Washington.

So, what happens if we breeze past August 2nd without increasing the debt limit? Virtually every media outlet would have you believe that we will default on our debt. Even the business press, like the *Wall Street Journal* and CNBC, say that we will default without a debt limit increase. That means we would stiff bondholders, which would cause the bond market to run away from U.S. treasuries for a long time to come and would have a likely catastrophic effect on interest rates and the U.S. economy. Greece is experiencing this now as they dabble with defaulting on their debt.

But, it's not true. ***A failure to increase the debt limit will not trigger a default.*** Here's why:

- Reaching the debt limit means that the government is forbidden from borrowing an amount of money which would, in combination with all money already borrowed, exceed that limit. It does not mean that we stop paying interest or principal on the debt we already have. As proof of this, the Treasury Secretary says we have already reached the debt limit. But, there was an auction of Treasury bills this morning. How could we sell new bills when we have already reached the limit? Some older Treasury Bonds and short-term Treasury Bills are always coming due. And, we pay them off by selling new debt of the same amount. That's not exceeding the debt limit. That's keeping total debt at the limit. So, if \$100 billion in debt matures, we pay it off with \$100 billion in new debt and the total remains the same. As I said, we are doing this right now even though we are supposedly at the debt limit. We are not defaulting.

- The Treasury Secretary has well-established and enumerated powers to allocate payments of funds. The Secretary could in theory *choose* to default on the debt and prioritize other payments. But, this would be a hugely irresponsible move with negative long-term implications, which no sensible administration would do. Furthermore, such action might be challenged in court as the bondholders would claim their right to the "full faith and credit" of the United States and they could likely prevail.

- Once the debt limit is reached, the Treasury has a lot of "ordinary" and "extraordinary" measures it can take to find cash to fund the budgeted and appropriated costs of government for a while without additional borrowing. Whether those measures run out at, before, or after August 2nd, I do not have the information to know.

- But, if there is no debt limit increase, at some point that cash will run out. At that point, for the reasons enumerated above, we will not default. What we will have to do is only spend that which we have cash to fund. We are currently borrowing about 40 cents of every dollar we spend. So, subject to the monthly fluctuations in actual revenue receipts, we would have to spend 40% less almost immediately. As attractive as that may sound, the effects would not be

benign. We either stop paying for most of the government as we know it, potentially including the courts and the military, or we reduce Social Security and Medicare payments for all enrolled dramatically. That would be a substantial economic shock in itself. We would be truly in a "pay-as-you-go" mode, which the Democrats, at least in theory, love. The Treasury Secretary would have the power to decide what gets paid, what doesn't and when.

So, no default, but still a bad result. However, the reality is that we are headed towards a crisis right now if we don't get the deficit under control. We will have a worse collapse if we just increase the debt limit and continue deficit spending. This collapse will occur when the markets decide they won't loan us any more money because the U.S. becomes a bad credit risk and they are afraid we may not pay them back. In effect, we have 2 debt limits. One is the statutory limit on borrowing. The other is the maximum amount that the markets are willing to lend us. If we do not control the first limit, the second one will unquestionably cause a crisis soon. And, if that crisis comes, we will not be able to control its timing or its end.

I have become somewhat despondent lately at how little progress we are making in Washington on the deficit front. The 2011 spending reductions were miniscule. The responsible Medicare reforms put forth in the Paul Ryan budget are being demagogued heavily by Democrats who now believe they have found their 2012 campaign issue. Their "Mediscare" demagoguery is based on complete falsehoods. But, the point is that they are painting themselves into a corner where they cannot politically accept reforms that they have attacked so bitterly. Most Republicans won't reduce defense spending because it is defense, and most Democrats won't reduce any spending at all, including defense. So, the 2012 budget foresees a sizable increase in defense and homeland security spending. Because of this, the Ryan budget only reduces non-entitlement spending by \$31 billion below actual spending for this year. Remember the deficit is \$1.2 *trillion*. Democrats would like to raise taxes, an idea with which I obviously disagree. But, they only propose raising taxes on corporations and incomes over \$250,000. Even if you do all the tax increases they are proposing, you don't come close to balancing the budget. This is why Democrats in the House and Senate have thus far failed to even propose a budget for the last 2 years. The only budget they will vote for makes deficits worse instead of better. I had hope for the Senate "Gang of Six", but that broke up. The President is showing absolutely **zero** leadership as he seems to only be giving campaign speeches of late. We can improve revenue with job creation and growth (which I will write about in a future laptop), but there is no bipartisan agreement on that either. And, part of the current

economic malaise is caused by the overhang of the federal debt.

Part of the problem is that both parties believe that if they wait until after the 2012 election, they may control the House, Senate and the White House, and then they can solve the problem on their terms. But, markets won't wait for our election. And, it is certainly possible that neither party controls all the levers of government after the election either and, by that point, we will be 2 years closer to collapse and have lost 2 years of potential mending.

Taking all this into account, we must use this controllable debt limit of our own making to get good enough reforms to curtail future federal spending so that we avoid the inevitable crash that will occur when we hit the market-imposed debt limit. And, if that means going over the brink, so be it. I'm not sure we have 18 months to wait past the next election, and I obviously don't have much confidence in an agreement under normal conditions before then. This would bring on a crisis, but we will control it and we can end it. Hopefully it will bring on a longer-term solution. Sir Winston Churchill famously remarked that, "Americans can be counted upon to do the right thing, after they have exhausted all other possibilities." We need to do the right thing. Let's get there sooner rather than after it's too late.