

Debacle, Yes. Default, No.

Even the appearance that the government will default on its debts would roil the financial markets and cause severe economic problems, urged Congress on Tuesday to act now to extend the debt limit. (Los Angeles Times)

Failure to raise the government's debt ceiling...could lead to a default that "could cause profound damage to our country." (Washington Post)

These quotes were the leading stories of the day...back in 1995.

So, with history as a guide, let's take a step back and review what happened in 1995.

At that time President Clinton and Democrats were fighting off attempts by Republicans to link cutting the deficit to the increase in the debt ceiling. Then as now, there was a widespread misperception that failure to increase the debt ceiling would produce a default: "congressional Republicans are threatening to provoke the nation's first-ever default" (Washington Times). The Los Angeles Times reported: "the first real risk of a government default could occur November 15 [1995]." Even the then Chairman of the Federal Reserve, Alan Greenspan, warned that congressional Republicans should drop their efforts, declaring: "To default for the first time in the history of this nation is not something anyone should take in any tranquil manner."

Other ills predicted during that contentious debate were rising unemployment, reduced GDP growth, and soaring interest rates. Sound familiar?

After shutting down the government for five days in late November 1995, a temporary extension to the debt ceiling was passed, but the government was shut down again from December 16th, 1995 to January 6th, 1996 before the White House and Congress finally agreed to fiscal cuts and a long term increase in the ceiling was enacted.

Yet, no default ever occurred.

In retrospect, it is not surprising. Default only occurs if the government stops paying interest on the money that it owes or fails to pay back principal. Not increasing the debt ceiling only means that the government is forbidden from borrowing more money and that spending is limited to the revenue the government brings in.

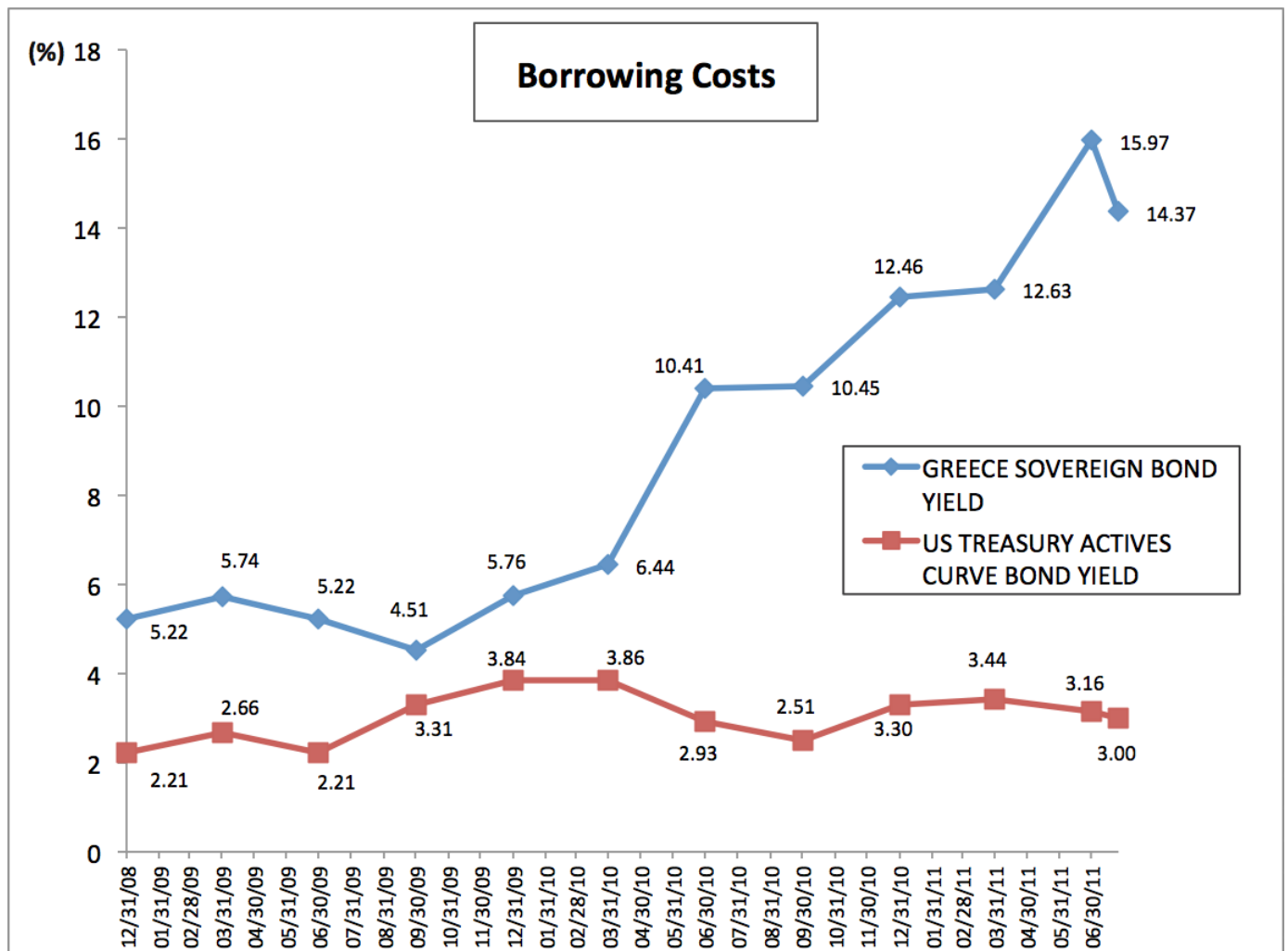
And, with interest payments on the debt making up only a small fraction of revenue, the interest itself was relatively easy to pay. (Today 4.6% of Federal spending (\$240 billion) goes towards interest payments on the \$14 trillion national debt. (Source: OMB, Table S-3))

These two shutdowns did not damage the economy. Unemployment remained constant during December 1995 and January 1996 and fell slightly in February 1996. The economy kept chugging along, growing as fast or faster during the fourth quarter of 1995 and the first quarter of 1996 than it had over the preceding four quarters. Stock prices also continued to rise throughout the whole drama, with the Dow Jones Industrial Average rising by over 6 percent, from 4,873 on November 13th to 5,181

on January 5th.

As for interest rates, US Treasury bond rates did not go up – to the contrary, they fell almost continually during 1995 and the beginning of 1996. This indicates that, despite the warnings by politicians and the media, investors were not at all worried about a default by the US government. Had investors been concerned about default, they would have demanded higher interest rates to compensate them for that risk. We would have seen interest rates spike as negotiations over increasing the debt ceiling failed and the supposed default was about to occur.

The contrast to the situation today in some European countries couldn't be sharper. Interest rates have soared as the fear of default has increased in such countries as Greece, Ireland, Italy, Portugal, and Spain. Contrasted in the chart below, notice the spike in interest rates on Greek debt over the past eighteen months – moving up dramatically as rhetoric about default increased. In stark contrast, the rate of interest demanded on US debt has not shown any signs of such fear. In fact, as the stories have picked up regarding the US debt ceiling, the cost to the US government, as reflected in their borrowing costs, has slightly decreased.



Source: Bloomberg and One Capital Management, LLC.

The bigger concern right now is the possible downgrade of the US Government credit rating. This

is just a possibility right now. It's very important to note that rates are extremely low presently and there's room to go without creating a drag on the US economic recovery. The difference between the US and the strained European nations noted is investor belief that the US is safe while Greece and the others are viewed as at risk.

We would be remiss to not acknowledge that there were problems associated with the shutdowns in 1995-96. The main drawback was that some Federal "non-essential" employees had to miss a paycheck or two. That is certainly a non-trivial problem for those employees who did not have enough money saved up. Yet, the lost paychecks were soon replaced, with those employees getting paid vacations.

We should also remember that the fiscal standoff had some long-term benefits. The budget battles during 1995-96 ended up reducing the following year's deficit to only \$22 billion. And, surpluses were produced over the next four years.

Last Friday, at President Obama's press conference where he announced the debt ceiling talks broke down, the president stated that failure to increase the debt ceiling means default. Treasury Secretary Timothy Geithner claims "catastrophic" consequences.

We can only hope that the lessons of 1995-96 are remembered and that all of our elected officials vote for fiscal restraint. In the long run, a more balanced budget will preserve the environment for growth.