



# Cash ViewPoint

## Understanding the U.S. Debt Ceiling Debate and its Impact on Money Market Funds

On Monday, May 16 the U.S. Treasury reached its debt ceiling of \$14.294 trillion.

### What is the debt ceiling?

A statutory limit has restricted total federal debt since 1917 when Congress passed the Second Liberty Bond Act<sup>1</sup> in order to finance U.S. participation in World War I. It is a limit set by Congress on the total amount of debt that the federal government can have outstanding at any one point in time. The original intent of the debt ceiling was to curb the appetite of lawmakers for deficit spending by trying to impose fiscal accountability.<sup>1</sup> This hasn't really worked in practice, with Congress voting to raise the debt limit 74 times since 1962, 10 of those times since 2001 (see Figure 1). Although Congress votes separately on the budget and the debt, the two are intrinsically linked - like love and marriage, "you can't have one without the other." Whereas the budget resolution instructs the federal government on how much it can spend, the debt ceiling provides the federal government with the authority to pay for it, if expenditures exceed revenues. So basically every time Congress agrees on a budget which includes deficit spending, it also implicitly agrees that the Treasury needs to issue more debt.

Figure 1: Debt Ceiling Increases Since 2001

Date	New Debt Limit (\$ billions)
June 28, 2002	6,400
May 27, 2003	7,384
Nov. 19, 2004	8,184
March 20, 2006	8,965
Sept. 29, 2007	9,815
July 30, 2008	10,615
Oct. 3, 2008	11,315
Feb. 17, 2009	12,104
Dec. 28, 2009	12,394
Feb. 12, 2010	14,294

Source: Congressional Research Service

### What happens once the debt ceiling is met?

Once the limit is reached, the Treasury has no authority to borrow, meaning it cannot issue new debt in order to meet interest payments and to finance the primary deficit.

### Why was the Treasury able to extend the May 16 deadline for raising the debt ceiling to Aug. 2? Can the deadline be extended again?

Even before hitting the debt ceiling on May 16, Treasury Secretary Geithner put into motion a series of measures with

(Continued)

the aim of creating breathing room under the debt ceiling until Aug. 2. Actions taken included suspending investments in and redeeming debt issued to federal retirement funds, and suspending the issuance of State and Local Government Series (SLGS) Treasury securities,<sup>2</sup> thereby bringing the debt back down below the ceiling and allowing the government to continue borrowing. Also helping extend the deadline is the fact that tax revenues this year were stronger than expected (i.e., a smaller deficit requires less debt financing). Ultimately, however, when all of these measures are exhausted, there will be a date after which the deadline cannot be extended.

---

## What will happen after Aug. 2 if an agreement is not reached?

Assuming Aug. 2 is a hard deadline, if an agreement is not reached to raise the debt ceiling by that point, even though the U.S. Government would still be solvent, it could be in default if it does not pay the interest coming due on its outstanding debt obligations. A "technical default" means that the Treasury could continue to service its debt, without an increase in the debt ceiling, by rolling debt that is maturing and prioritizing the payment of interest from general revenue. We believe there is broad-based political consensus to ensure that interest payments will be met even if an agreement is not reached by August 2. However, this would require the Treasury to defer other non-interest payments, such as Social Security or Medicare payments, tax refunds, or civil service salaries, such that expenditures net of interest payments equal revenues. The point is that at the end of the day someone - be it a social security beneficiary or defense contractor - will not get paid by the U.S. Government. But there are precedents of some short term fixes that provide ways around this. During the 1995-96 government shutdown, for example, Congress authorized the Treasury to issue debt strictly to meet upcoming Social Security payments that did not count towards the debt ceiling until a certain date, and issued non-marketable debt that did not count against the debt ceiling.<sup>2</sup>

---

## How will the debt ceiling debate affect money markets?

Short-term yields had been trending lower in the weeks leading up to the May 16 deadline as the supply of short-term money market instruments had dried up, especially since the Treasury began rolling back its Supplemental Financing Bill (SFB)<sup>3</sup> program from \$200 billion to \$5 billion back in February.

More recently, concerns of an economic slowdown, flight to quality on the back of European peripheral debt concerns, and the introduction of the new FDIC assessment rule on April 1 put additional downward pressure on yields.

Our working assumption is that this debate will ultimately be resolved and that the debt ceiling will be increased. However, even in the absence of an actual default, contentious political wrangling over the debt ceiling has generated increased global economic tensions and uncertainty, which could translate into increased volatility across equity and fixed income markets. In managing the headline risk associated with the debt ceiling debate, we have been actively stress-testing our portfolios and believe they are well positioned if the markets experience high levels of volatility.

Either way, supply constraints are expected to persist in the near future, keeping money market yields low, possibly edging lower. Even following a resolution in which the debt ceiling is raised, it is expected to take several weeks until supply constraints ease as the SFB program resumes.

Invesco Global Cash Management continues to monitor developments as they unfold. Recognizing the uncertainties such developments could generate, we are actively managing our maturities and exposures. We are holding higher levels of liquidity to help manage any short-term headline risk.

The current macroeconomic environment requires an in-depth understanding of global economic and business fundamentals. Our credit team has developed and strictly adheres to a rigorous set of criteria for evaluating credit risk and identifying high-quality securities while our portfolio management team has constructed the money market portfolios keeping in mind our commitment to the preservation of principal, liquidity and our ability to respond quickly to ongoing economic developments.

**An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in such a Fund.**

1 Congressional Research Services, "The Debt Limit: History and Recent Increases," May 16, 2011

2 treasury.gov, "Secretary Geithner Sends Debt Limit Letter to Congress," April 4, 2011 & May 2, 2011

3 A program enacted by the Treasury Department consisting of a series of Treasury bill auctions, in which the proceeds from these auctions are held in a dedicated account at the Federal Reserve Bank of New York. Funds in this account help to offset the reserve impact of recent Federal Reserve lending and liquidity initiatives by draining reserves from the banking system.

---

## NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

**An investor should consider the investment objectives, risks, fees and expenses carefully before investing. Please read the prospectus or other offering documents carefully before investing. For this and more complete information, contact your financial advisor or visit [invesco.com/fundprospectus](http://invesco.com/fundprospectus).**

The opinions expressed herein are based on current market conditions and are subject to change without notice. All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision. As with all investments there are associated inherent risks. This does not constitute a recommendation of the suitability of any investment strategy for a particular investor. Past performance is not indicative of future results.