

Possible Shutdown, No Default

Brian S. Wesbury – Chief Economist
Robert Stein, CFA – Dep. Chief Economist
Strider Elass – Economist

Sometime in the next few weeks, Washington is going to turn its attention from Syria back to the budget.

Right now, the debt of the US government – or at least the amount of debt subject to a legal limit – is \$16.7 trillion. It's been stuck at that level since May, which is when the Treasury Department started taking “extraordinary” measures to avoid hitting the limit. These measures, like postponing payments to federal worker retirement plans and not reinvesting interest payments, are the kinds of accounting gimmicks that would land a private-sector CFO in jail. But in the public sector, where you make the rules...?

Despite horror stories, we don't think investors should lose any sleep about the debt limit. There will not be a default on US Treasury securities. Not even a temporary or technical default. No matter what happens, there is more than enough money coming from tax receipts to pay interest on the debt. Moreover, the Congress will pass an increase.

The only way to avoid this is if the government, overnight, started running surpluses. That may sound good in theory, but it's hard to see how it happens in the real world. If the government continued to pay interest on the debt and fully fund the Pentagon, Medicare, and Social Security, then all other spending would have to be cut about two-thirds across the board...immediately and permanently.

Even in the unlikely event that Congress waits so long to pass an increase in the debt limit that the Treasury Department runs out of accounting gimmicks, there still won't be a default. Regardless of what the Obama Administration says in public, Treasury would use incoming revenue to pay interest on the federal debt before it made other payments. Saying they would do anything else is just a bluff.

One plausible scenario is that, in exchange for lifting the debt limit, the president gives the GOP a temporary victory on part of the health law, postponing the individual mandate to buy health insurance for one year, just like he's already postponed the mandate on businesses to provide insurance.

The other big fiscal issue is the spending bills that fund the non-entitlement side of the budget, like the military, federal education spending, the EPA,...etc. Those need to be passed by October 1, in order to authorize spending, or we face a supposedly awful “government shutdown.”

We see at least a temporary shutdown, like the US experienced in 1995-96, as a distinct possibility. Despite the breathless, hand-wringing pundits, as we saw in the past, this type of a shutdown is not nearly as scary as it seems. Money still flows into the Treasury Department and money still flows out, for Social Security checks and the like. The military still operates. As long as the debt limit goes up, the debt still gets paid, without missing a beat.

The only change is that, in a shutdown, non-essential services stop and non-essential federal workers get furloughed. If you show up at a national park, you won't get in. Passports might not get issued. Federal grants will grind to a halt. That might be inconvenient, but it's not the end of the world.

If a shutdown happens, it would probably be a week at the very longest. In the end, we think the spending bills get passed and keep the lower spending targets that started with the Sequester back on March 1.

But, we are not worried about a prolonged shutdown. If it lasted much longer – a month, say – we suspect the spenders in Washington would end up losing the political battle, as many voters realized how little they missed what the government wasn't doing.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-9 / 2:00 pm	Consumer Credit– Jul	\$12.3 Bil	\$12.3 Bil		\$13.8 Bil
9-12 / 7:30 am	Initial Claims – Sep 7	330K	327K		323K
7:30 am	Import Prices – Aug	+0.5%	+0.6%		+0.2%
7:30 am	Export Prices – Aug	+0.1%	+0.1%		-0.1%
9-13 / 7:30 am	PPI – Aug	+0.2%	+0.0%		+0.0%
7:30 am	“Core” PPI – Aug	+0.1%	+0.1%		+0.1%
7:30 am	Retail Sales – Aug	+0.4%	+0.6%		+0.2%
7:30 am	Retail Sales Ex-Auto – Aug	+0.3%	+0.7%		+0.5%
8:55 am	U. Mich Consumer Sentiment- Sep	82.0	82.5		82.1
9:00 am	Business Inventories – Jul	+0.3%	+0.3%		+0.0%