Testimony of

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on

Impact of a Default on Financial Stability and Economic Growth

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Introduction

Chairman Johnson, Ranking Member Crapo, members of the Committee, thank you for the opportunity to appear before you once again. My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of more than $15 trillion.

I am honored to appear before the Senate Committee on Banking, Housing, and Urban Affairs to testify on the "Impact of a Default on Financial Stability and Economic Growth." Members of ICI serve more than 90 million shareholders, including half of all U.S. households. Much of our policy work accordingly focuses on the effect that actions—or inactions—in Washington have on investors and financial markets.

Funds and their investors have a significant stake in the stability and predictability of the market for U.S. Treasury securities. The most recent ICI data show that as of June 30, funds registered under the Investment Company Act of 1940[1] (1940 Act) held more than $1.7 trillion in securities issued by the Treasury and U.S. government agencies—accounting for more than 10 percent of their assets. Mutual funds and their investors are not uniquely at risk, however, because the health of the Treasury market underpins all financial markets. U.S. Treasuries trade in the deepest, most liquid market in the world. Their interest rates set the benchmark for other debt issuers—and as the "risk-free rate of return," these rates factor into the pricing of a wide range of other assets, including stocks and real estate.

Today, fund advisers and the investors they serve are watching Washington's approach to debt and deficits with alarm. They see on all sides—at both ends of Pennsylvania Avenue—a lack of action on our nation's current fiscal policies. They are deeply concerned about the potential results of this inaction.

After all, there are two things that individuals, households, businesses large or small, or nations must do to maintain a high level of creditworthiness:

- They must pay their bills on time, when they come due; and
- They must avoid taking on an unsupportable level of debt—more debt than they can reasonably afford to service and pay.

For our nation, a violation of either of those principles would be ruinous. One failure—default, which we are here to discuss today—could lead to a sudden crisis and degradation of the United States' financial and economic standing. But the other failure—to bring our debt under control—is equally insidious, equally destructive, and, on current trends, even more likely.

[1] Data include mutual funds (long-term funds and money market funds), exchange-traded funds, closed-end funds, and unit investment trusts. Total net assets of these funds on June 30, 2013, were $15.4 trillion. "Agency" securities include those issued by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Banks, and the Federal Farm Credit Banks.

With that perspective in mind, and on behalf of more than 90 million Americans saving and investing to meet their financial goals through mutual funds, I am here today to state unequivocally that no one should take lightly the prospect of a default on the United States' debt obligations. The credit of the United States most emphatically should not be put into question.

Let me say with equal force, however, that those who dismiss or minimize our current budget problems also are playing with fire. The risks they are taking may be less immediate, but they are no less consequential—and the longer our nation delays action, the larger and more difficult the necessary corrective steps become.

My testimony that follows outlines the risks of a default on debt for investors, including registered funds and their shareholders; our economy; and our standing in the world. It then discusses the long-term outlook for national debt and the hazards of failing to address our budget imbalances.

The Uncharted Waters of a Treasury Default

Since September 2007, the gross national debt[2] has risen by $7.9 trillion, or an average of $1.3 trillion each year. The debt ceiling that is at issue today—$16.7 trillion—is 85 percent greater than the debt six years ago. It is also larger than the U.S. economy—at 105 percent of GDP—for only the second time in our history, the first being immediately after our nation bore the costs of protecting freedom in World War II.

How has the United States managed to fund its national debt at such historically high levels? Some factors are obvious. Our nation has the largest and one of the most dynamic economies in the world. Our stable government, steady social institutions, and strong rule of law help make our securities a safe haven for investors. We actively promote the free flow of capital around the globe—including substantial purchases of U.S. Treasury securities by foreign investors. The dollar's status as the world's reserve currency—used as a store of value for foreign central banks and as the means of exchange to price such crucial commodities as oil—makes Treasury securities an attractive holding for those investors.

But one crucial element in the United States' success in funding its debt is the Treasury market itself. U.S. Treasury securities trade in the deepest, most liquid market in the world. Every day, trading in Treasury securities just by "primary dealers"—the 21 brokers with which the Federal Reserve Bank of New York conducts open market operations—exceeds $500 billion.

The Treasury market depends for its stability first, on the unquestioned "full faith and credit" of the United States and second, on the certainty of its regular operations. Both of those features are at risk as Treasury runs through the "extraordinary measures" it has used since mid-May to maintain sufficient

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[2] The debt ceiling applies to gross national debt, which includes both debt held by the public and debt held by governmental agencies and trust funds, most notably the Social Security Trust Fund and government retirement plans. Discussion of federal debt and its economic impact usually focuses on debt held by the public, which was $12.0 trillion as of August 30, 2013. My testimony carefully distinguishes between these two concepts.

financing for government operations. According to the Treasury Department's latest projections, those measures will be exhausted by October 17—one week from today.

I will leave it to others to describe the mechanics of what will happen if the debt ceiling is not raised by that date. I also will avoid parsing the differences among "technical default," "selective default," and "actual default," or whether missing a Social Security payment is equivalent to missing an interest payment or failing to redeem a maturing Treasury bill.

All such discussion misses the key point: the United States, like any other major debtor, must maintain the confidence of its creditors—or risk the consequences.

What makes the Treasury market so deep and so liquid is the certainty of investors that the U.S. Treasury will pay its obligations, on time and in full, when interest or principal become due. Whether corporate treasurer, fund manager, or retiree, an investor holding a Treasury bill, note, or bond has always known that an upcoming interest payment or maturing security is "as good as cash."

Conversely, investors with cash know that the Treasury Department auctions new debt securities on a predetermined, regular schedule. This predictability is another strength of this market.

If the debt ceiling is not increased and at some point the Treasury cannot honor an interest payment or redeem a maturing security, investors holding affected securities will not have the cash they expect. If they have cash needs, they must find a buyer willing to assume the risk of an uncertain date for payment. Risk and uncertainty always bear a price, so the original Treasury investor must suffer a loss on securities that were deemed "as good as cash."

Once Treasury has exercised the option to delay payments, investors will learn a lesson that cannot and will not be unlearned—even after all missed or delayed payments have been made good. That lesson is simple: Treasury securities are no longer as good as cash—they carry a future risk of further missed payments. That risk will be priced into the interest rate that investors demand, and into traders' reluctance to treat Treasuries as liquid.

We already can see early signs of these effects developing in the market, as the October 17 debt-ceiling deadline approaches. Unsure about its future ability to borrow, the Treasury Department is scaling back its auctions of bills—squeezing the supply of securities that are in high demand and undermining the predictability of Treasury issuance.

Rates on the Treasury securities most at risk have risen sharply. Yields on Treasury securities maturing between October 17 and October 31 rose from around 2 basis points on September 24 to between 20 and 25 basis points on October 8. The price of credit default swaps on six-month and one-year Treasury securities—basically, the premium for insurance against default on those securities—hovered between $11,000 and $12,000 per $10 million of coverage in mid-September. By this week, these premiums were over $50,000.

We saw similar rate spikes in 2011, when a previous stalemate over the debt ceiling brought the U.S. to the edge of default. In the weeks before the 2011 debt ceiling impasse was resolved, yields on maturing Treasury securities rose sharply. The rate on the Treasury bill set to mature on August 4, 2011, climbed from slightly above zero in early July to almost 30 basis points by the end of that month. Even as Congress and the White House averted a default, the confrontation reflected so badly on the nation that Standard & Poor's felt compelled to issue its historic downgrade of the United States' AAA sovereign debt rating.

The effects of a default would quickly spill beyond the Treasury markets and into the broader economy. As noted, failure to meet interest payments or to redeem maturing Treasury securities could directly hit the finances of those who depend on Treasuries in their cash management—individuals, businesses, nonprofit institutions, and state and local governments. These entities in turn may struggle to meet their obligations to suppliers and creditors, undermining economic activity and damaging confidence.

When the asset valued by millions of investors for its "risk-free" nature suddenly assumes unanticipated risk of illiquidity or default, these investors and others will rapidly adjust their expectations—and grow increasingly cautious. Rising rates on Treasury securities could be expected to drive up interest rates for other borrowers and increase the cost of capital for corporate issuers and state and local governments. Homebuyers hoping to price mortgages during the default period could face unpredictable swings in rates, and other variable-rate household borrowing could be affected.

The damage would not be limited to our shores. The U.S. dollar is the world's reserve currency not because foreign banks and investors own huge stacks of greenbacks, but because they have access to highly liquid, low-risk securities denominated in dollars—namely, Treasuries. Default, as Fitch Ratings has noted, would undermine "investor confidence in the full faith and credit of the U.S.... This 'faith' is a key underpinning of the U.S. dollar's global reserve currency status and reason why the U.S. 'AAA' rating can tolerate a substantially higher level of public debt than other 'AAA' sovereigns." Lack of confidence in U.S. Treasuries is likely to reduce the value of the dollar relative to other currencies below what it otherwise would be.

These multiple shocks—cash shortfalls, higher interest rates, diminished confidence, and international impacts—would be likely to undermine economic activity and growth. Their effects would also persist well beyond any resolution of the debt ceiling standoff and repair of defaults.

How would this turmoil affect registered funds and their investors?

Since the earliest days of the American Republic, mutual funds have been engaged in the markets for U.S. government debt. In 1788, a pair of bankers in Amsterdam organized the first of what became more than 30 investment trusts formed to speculate on the debts issued to finance the Revolution by the Continental Congress, the Continental Army's quartermaster and commissary corps, and the states. These complicated schemes could be "possible only as long as the United States did not default on its

interest payments."[3] Fortunately, even in those shaky early days of independence, the United States honored its obligations—and it has done so ever since.

Earlier, I reported that funds registered under the 1940 Act held more than 10 percent of their assets in Treasury and U.S. government agency securities. Such holdings are pervasive—as of June 30, 30 percent of mutual funds held these securities—as even equity funds rely upon Treasury securities for cash management and liquidity. The 90 million Americans invested in funds thus share significantly in the risks associated with a Treasury default.

It is important to note, however, that registered funds and their investors are not *uniquely* at risk. Nothing about the structure or activities of registered funds makes them or their investors any more vulnerable to the hazards of a Treasury default than any other investment product or investor. The damage of a default—or even of a second near-miss in a little over two years' time—would be visited upon every American who saves, who borrows, or who participates in the economy. No class of Americans will be immune to the impact.

Given these effects, let me repeat my earlier message: no one should take lightly the prospect of a default on the United States' debt obligations. The credit of the United States emphatically should not be put into question.

Outlook for Fiscal Policy and the Risks of 'Slow Default'

The first fiscal year of the United States government was 1789. The national debt held by the public[4] did not reach $1 trillion until 1983—the 194th fiscal year in our history. Contrast that with our recent history: in four of the last five years (2009 through 2012), debt held by the public grew by more than $1 trillion.[5]

The massive deficits of the past several years were accumulated as our government fought the financial crisis and the subsequent recession and slow recovery. Future economists and historians will have to sort out whether these huge deficits were justified or had the effects that their advocates have claimed for them. However that may be, even the most ardent supporters of fiscal stimulus, beginning with John Maynard Keynes, would tell you that budget deficits incurred to counter a recession should be a temporary expedient.

The tax and spending bargains reached so painfully in the past three years have slowed the growth of debt, at least for the short term. But CBO's latest long-term projections show that progress will be

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[3] "The Origin of Mutual Funds," in *The Origins of Value: The Financial Innovations That Created Modern Capital Markets* (William N. Goetzmann and K. Geert Rouwenhorst eds., Oxford University Press 2005), at 264.
[4] As noted previously (Note 2), debt held by the public is the concept most commonly used in discussions of budget policy and its economic impacts. CBO's long-term projections, for example, are expressed in terms of debt held by the public. The discussion in this section will follow that convention.
[5] White House Office of Management and Budget, "Historical Tables," Table 7.1, available at http://www.whitehouse.gov/omb/budget/Historicals.

short-lived: by 2018, the debt held by the public will be rising again as a share of GDP. After that, CBO notes, "growing deficits would ultimately push debt back above its current high level." CBO projects that by 2038, under current law and budgetary policies, federal debt held by the public will reach 108 percent of GDP.[6]

CBO also estimates an "extended alternative fiscal scenario" that projects deficits and debt under arguably more realistic budget assumptions: that the current spending caps of sequestration end, that spending constraints on Medicare and other federal health programs are not maintained, and that discretionary spending resumes its historic growth rates. Under this alternative scenario, CBO projects that debt will reach 190 percent of GDP in 2038.[7]

Those two projections are based on CBO's best estimate of the impact of deficits and debt on economic growth. CBO points out that its projections are very sensitive to its forecasts of interest rates and economic growth. Moderate changes in those projections can drive the estimates of the debt burden up or down significantly.

For example, CBO estimates that a 75 basis point increase in interest rates over its forecast would drive the debt held by the public to 132 percent of GDP in 2038, compared to 108 percent of GDP in the current-law baseline.[8] Similarly, a reduction in the long-term economic growth rate of 0.5 percentage point drives the debt held by the public to 156 percent of GDP in 2038.[9]

Let me point out two events that could make these downside risks more likely—resulting in a greater debt burden than CBO's baseline.

First, nearly half of the debt held by the public is held by foreign investors. A rapid change in foreign investors' willingness to hold Treasuries could significantly increase the government's interest costs, in excess of the rates CBO used in its forecasts.

The sensitivity of interest rates has been demonstrated by recent events involving the Federal Reserve—the largest domestic holder of tradable Treasury securities, holding $2.1 trillion as of October 3.[10] The mere suggestion by Fed officials earlier this year that they would slow purchases of Treasury bonds under their "quantitative easing" policies drove interest rates on the 10-year Treasury bond up by as much as 125 basis points (1.25 percentage points).

A second event that could worsen the debt outlook would be a larger than anticipated impact of the higher debt burden on economic growth. Economists generally agree that high levels of government

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[6] Congressional Budget Office, *The 2013 Long-Term Budget Outlook,* September 19, 2013 ("CBO, Long-Term Budget Outlook"), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/44521-LTBO2013.pdf, at 3.
[7] *Id.* at 84.
[8] *Id.* at 97.
[9] *Id.* at 95.
[10] Federal Reserve Board, "Factors Affecting Reserve Balances: Federal Reserve Statistical Release H.4.1," October 3, 2013, available at http://www.federalreserve.gov/releases/h41/current/h41.htm#h41tab1.

debt are associated with slower economic growth,[11] but the mechanisms through which higher debt levels may cause economic growth to slow are not fully understood. A more sluggish pace of economic growth could cause the debt burden to worsen more than the baseline forecast.

Beyond these worrisome events, we must also recognize that the composition of our federal budget is shifting in ways that will make it increasingly difficult to establish and maintain any discipline on spending. This trend involves the accelerating trajectory of growth for "mandatory spending"—programs, such as Social Security, Medicare, and veterans' benefits, which are funded automatically each year. It is these programs, outside the annual spending process, that increasingly drive the federal budget.

In its near-term forecast for 2014 to 2023, CBO projects that mandatory outlays will represent 61 percent of federal spending over the next 10 years.[12] Interest payments on the national debt—another unavoidable cost—will account for 11 percent. Discretionary spending will account for just about one-quarter of federal spending—27 percent. In fact, mandatory spending has become so dominant that eliminating all non-defense discretionary spending would just barely balance the budget over the forecast period.

The dominance of mandatory spending is growing. By 2038, CBO says, federal spending for health care and Social Security will be running at twice the average level of the past 40 years, while "total spending on everything other than the major health care programs, Social Security, and net interest payments would decline to … *a smaller share of the economy than at any time since the late 1930s*" (emphasis added).[13]

It is inconceivable that the U.S. electorate or political system would allow the discretionary activities of the federal government—defense and domestic alike—to shrink to the scale that prevailed prior to World War II. Given that reality, it is difficult to maintain even the relatively pessimistic view of the CBO's baseline projection for the course of the national debt, absent significant reform and controls on mandatory spending.

Rather than address the growth of mandatory spending, however, recent policy has tended to tilt the balance further. The automatic cuts of sequestration, for example, apply only to discretionary spending—leaving mandatory programs unscathed.

Let me be clear—the programs funded through mandatory spending are very important. For example, on many occasions, ICI has expressed strong support for Social Security as the foundation of Americans' retirement security. Fulfilling our social contract by putting Social Security on a sustainable footing for the indefinite future is nothing less than a moral obligation.

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[11] Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, "Public Debt Overhangs: Advanced-Economy Episodes Since 1800," 26 *The Journal of Economic Perspectives* 69, Summer 2012.

[12] ICI calculations based on Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/44172-Baseline2.pdf.

[13] CBO, Long-Term Budget Outlook, *supra* note 6, at 3.

But paying our own bills—as a nation, as a generation—that, too, is a moral obligation. The Father of Our Country, George Washington, warned against "ungenerously throwing upon posterity the burden which we ourselves ought to bear."[14] Yet that is exactly the course that we are following.

Conclusion

The imperative need to increase the national debt ceiling and ensure that Treasury can borrow to finance the government focuses urgent attention on the prospects and consequences of a default on Treasury securities. Make no mistake: that is an event our nation must avoid. For generation after generation, since 1789, the United States has stood behind its financial obligations. Ours should not be the generation that fails to do so.

It is no less imperative, however, to focus on the less dramatic—but equally insidious—threat that our nation faces from growing and unsustainable levels of debt. Even the relatively optimistic CBO baseline forecast paints a dire picture. The longer we delay decisive action, the worse our problems become and the harder they are to fix.

The 90 million American investors that ICI's member funds serve are investing for a brighter future—a secure retirement, a better education, or a solid financial foundation. They need responsible action by their government to protect the health of the economy and the financial markets on which they depend. They want Congress and the Administration to work together to put America on a path of fiscal responsibility.

The health of our markets, the prosperity of our nation, and the security of future generations all depend upon it.

Thank you for your attention.

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[14] "Washington's Farewell Address 1796," posted by The Avalon Project, Lillian Goldman Law Library, Yale Law School, available at http://avalon.law.yale.edu/18th_century/washing.asp. For a more complete discussion of Washington's views on the national debt, as expressed in his Farewell Address, *see* Paul Schott Stevens, "'Warnings of a Parting Friend: Today's Fiscal Crisis and U.S. National Security," National Strategy Forum Review, Winter-Spring 2012, at 20; available at http://www.nationalstrategy.com/Portals/0/documents/Winter-Spring%202012/Stevens-Warnings%20of%20a%20Parting%20Friend.pdf.