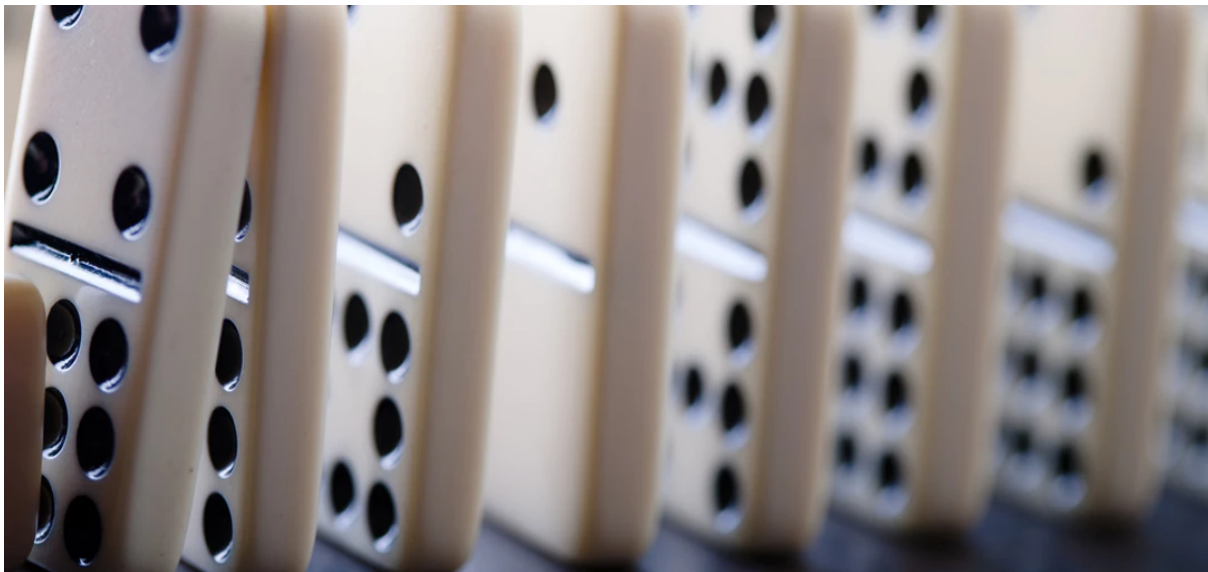


# The Dominoes of Default, 2015



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Imagine a scenario that should be unthinkable but everyone knows is plausible: Congress fails to raise the debt ceiling by the deadline set by the Treasury Department. Talks have broken down and political paralysis sets in. Washington begins to drift into a previously unseen abyss.

First, with its ability to take on higher levels of debt fully exhausted, Treasury does its best to pay its bills with the little cash it has left on hand and the revenue it has flowing in. That works for a few days, until big payments of Social Security benefits and military pay come due. Millions won't get paid. A market panic, media frenzy, and public uproar are well underway.

For a time, to stave off a full-fledged crisis, Treasury ensures bondholders get paid. But even that strategy could fail. Shaken confidence in the government's ability to repay what it owes means investors will demand higher interest. And some investors may not show up for Treasury auctions altogether. That could prevent Treasury from simply replacing old bonds with new ones, or "rolling over" its debt.<sup>1</sup>

If that happens, the U.S. could default for the first time in its history.

The consequences of default would be massive and would reach every corner of the U.S. economy. Otherwise mundane transactions would no longer be routine and could force rational actors in the financial markets to do uncharted things. For example, Treasuries are often used as collateral in the market for short-term borrowing between financial institutions, which has more than \$4 trillion in daily turnover.<sup>2</sup> What if the holder of collateral believes a defaulted Treasury security no longer carries the same value as it did before and demands cash? This could have a cascading effect throughout the economy.

Below, we explore the five most tangible effects of default for middle-class families and Main Street businesses in the U.S. Because the U.S. has never defaulted, these projections are inexact. We do know that some effects would begin before an actual default, when the possibility of one seems to rise.<sup>3</sup> All effects would be worse the longer the default drags on and the damage could vastly exceed what's projected here.

## **Domino Effects: Five Consequences of Default**

### **1. Treasury bond rates rise.**

The U.S. government does not collect enough in taxes to operate, so it must take on debt and sell bonds. Typical buyers of bonds are institutional investors (like pension funds), foreign countries (often sovereign wealth funds) and individuals (usually through mutual funds and 401Ks).

U.S. government debt is the most relied upon asset in the world given its enormous size, liquidity and transparency. Treasury securities are one of the lowest cost and most widely used forms of collateral for financial transactions. Investors believe that U.S. debt is “safe” because historically there's been virtually no chance that the United States government would ever default on these loans. As a result, Treasury bonds

pay a very low rate of return. Low risk means low interest rates.

If the government defaults, credit rating agencies would downgrade the rating of Treasury bonds. In 2011, the mere threat of default prompted the credit rating agency Standard & Poor's to downgrade the U.S.<sup>4</sup> And, in response to the 2013 debt ceiling scare, Fitch attached a negative outlook to its AAA U.S. rating, although it has since returned that outlook to stable. A downgrade by all three rating agencies would mean the U.S. would have to raise the interest rate it offers for these bonds in order to get investors to continue buying them. This is because their number one draw—a risk-free investment—would now be a fallacy.

Default would thus mean the cost of borrowing for the U.S. government would increase, perhaps dramatically.

- In 2011, both Pimco and J.P. Morgan estimated that a default would lift the rate on Treasuries by half a percentage point (0.5%).<sup>5</sup> Additionally, the 2013 debt ceiling scare showed that Treasury rates could rapidly rise by that amount even without an actual default. A Government Accountability Office (GAO) report concluded that the threat of default in 2013 catapulted market yields on U.S. Treasuries from 0.01% to 0.5%.<sup>6</sup>
- J.P. Morgan also estimated that the increased cost of government borrowing (the interest we pay on our publicly held debt) would bump up annual deficits by \$10 billion in the short run and by \$75 billion per year over time.<sup>7</sup>
- J.P. Morgan estimated that higher Treasury rates would cause our GDP to decrease by 1%.<sup>8</sup>
- For every 1% change in GDP growth, there is an estimated 0.46% change in total employment, according to economist William Seyfried.<sup>9</sup> Using his estimation, the U.S. would shed 684,480 jobs.<sup>10</sup>

To be clear, this is a conservative estimate as default is a “black swan” event that has no American precedent.

## **2. The stock market drops and 401(k)s take a dive.**

The financial services firm Janney Montgomery Scott estimated in 2011 that default would cause the S&P 500 index to lose 6.3% in value in three months.<sup>11</sup>

Using a conservative approach, what would the impact be on a typical 401(k)?

- According to the Employee Benefit Research Institute, the typical 401(k) of an investor in their 50s at the end of 2013 had \$211,424 in their portfolio.<sup>12</sup>
- A 6.3% loss in the S&P 500 would cost this portfolio \$13,319.

This, too, is a conservative estimate. Another possibility would be the liquidation of assets to raise cash. If investors start selling assets, prices will go down on all types of securities, including stocks, bonds, and real estate. We have had recent experience with mass liquidation during the financial crisis. From July 2008 to March 2009, the U.S. lost \$7.4 trillion in stock wealth or nearly \$66,200 per household.<sup>13</sup>

## **3. Mortgage rates rise.**

The rate that Americans pay for a mortgage is generally tied to the interest rate on Treasury bonds. Over the past ten years, mortgage rates have been 1.75% higher than Treasury bonds, on average.<sup>14</sup> Thus, if interest rates rise on Treasuries, mortgage rates would follow, ticking upward.

Bill Gross, former head of Pimco the world’s largest bond fund, said in 2011 that a failure to raise the debt ceiling would be “catastrophic—global investors would move money at the margin to countries that have their act together, interest rates might rise by 50 basis points overnight, the stock market would plunge.”<sup>15</sup>

What would this mean for the average home-buyer?

- A 50 basis point interest rate increase from 3.75% to 4.25% for a new 30-year fixed mortgage would immediately add \$18,678 to the lifetime cost on a median home loan of \$180,000.<sup>16</sup>

In turn, higher mortgage rates would add another blow to an already struggling housing market, pushing home sale prices down, and potentially leaving some borrowers underwater.

#### **4. Small business and consumer credit tightens and chokes the recovery.**

Once the dominoes of default begin to fall—rising Treasury bond rates, declining stock markets, rising mortgage rates—lending to small businesses and consumers will constrict.

Why would lending tighten? In short, there would be less money made available to people and businesses to borrow, i.e. far less liquidity.

This liquidity shortage would be a direct result of uncertainty and volatility in the markets. When there is economic uncertainty and volatility, credit gets squeezed because banks want to keep as much money in reserve as they can.

What credit is still available would be costly because banks would increase their interest rates on loans. Small business owners would have a difficult time getting a loan from their bank for start-up costs or business expansion—or have to pay rates that they simply could not afford.

Consumers would have trouble securing a car, student, or personal loan. Credit card rates—which are also tied to Treasury rates—would rise, making purchases more expensive and having the result of depressing retail sales. Less spending by consumers and small businesses could help send the economy into a recession.

#### **5. The dollar loses its “special status.”**

In many ways, the U.S. dollar is just like any other commodity that is bought and sold. When there are more sellers than borrowers its price and status drops.

Foreign holdings of U.S. dollars are enormous, because the dollar is the world's "reserve currency." Countries keep trillions of American dollars in reserve in case of economic or national security emergencies. For example, China has \$1.24 trillion and Japan has \$1.19 trillion in reserves.<sup>17</sup> If a foreign government undergoes an economic upheaval, they can dig into their reserve of American dollars and weather the storm. According to the International Monetary Fund, the U.S. dollar's share of other countries' official foreign exchange reserves has held steady around 60 percent since the financial crisis.<sup>18</sup>

But political and economic volatility in the form of a U.S. default would compel investors to sell some of their holdings. According to *The Economist*, "The defeat of proposed legislation, the election of a particular politician or the release of an unexpected bit of economic data may all cause a currency to strengthen or weaken against the currencies of other countries."<sup>19</sup>

A U.S. default may convince institutional investors and sovereign wealth funds that the dollar is not where their reserves should be kept. Currency reserves can be revoked; the British Pound was formerly the dominant currency for trade, but the dollar became the currency of choice after the U.K. amassed a huge debt due to the costs of World War I. Even without the threat of default, many economists argue that China's currency—the renminbi—is on its way to challenging the dollar (For more, read our report, [Pound. Dollar. Renminbi?](#)). A default would hasten China's challenge and increase the odds that the renminbi actually overtakes the dollar. Recent history shows economic events in the U.S. can prompt other countries to adjust their reserve holdings, according to a 2011 J.P. Morgan report. For example, the 2008 economic downturn led other countries to decrease their holdings of Fannie Mae and Freddie Mac debt.<sup>20</sup>

If investors liquidate their holdings of U.S. dollar assets, the value of the dollar would decrease and inflationary pressures are likely, though not certain, to occur. During the 2013 debt ceiling scare, Steve East of Height Analytics warned that a default would drive down the value of the dollar because there would be a “flight to quality” to more secure currencies such as the Euro, the Yen, the Swiss franc, or the monetary metals such as gold and silver.<sup>21</sup>

What might that mean on Main Street? On the one hand, if the U.S. dollar loses its “special status” and the value of the dollar decreases, exports like commercial airplanes and computer chips become cheaper. The downside is more significant. Not only would imports like oil and electronics become more expensive, but there would also be additional upward pressure on borrowing costs, making it even more expensive to take out a mortgage or a business loan.

## Conclusion

If the U.S. defaults, it will have done so by choice, effectively inviting an economic crisis. Washington could quickly correct its course, but if markets have lost faith in the U.S. government, it could be too late. Even a brief default could throw so much sand in the gears of our economy that another much worse scenario might play out.

Sure, the immediate brunt of a U.S. government default would be felt by Wall Street. However, everything from increased costs of mortgages to losses in 401(k)s would mean average Americans will eventually have to deal with the consequences.

Policymakers must come to the table and figure out a solution before the dominoes of default begin to fall.

*This paper is an updated version of 2011 and 2013 reports by the same name, authored by Jim Kessler and Lauren Oppenheimer.*

### TOPICS

**BUDGET** 89

**FINANCIAL SERVICES** 70

## END NOTES

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