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## **CLIENT BULLETIN**

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### ➤ *Dancing on the Debt Ceiling*

For the next month you are going to be bombarded with news reports referencing the haggling going on in government over spending cuts and “raising the debt ceiling”. On or about August 2<sup>nd</sup>, the total accumulated debt of the federal government will reach \$14.294 **trillion**. This is the legislated maximum amount of money that the government can borrow, roughly similar to a limit on a credit card. The government actually hit the limit on May 16<sup>th</sup>, but by redeploying funds and suspending some investments into government retirement programs they have been able to postpone the final day of reckoning until August 2<sup>nd</sup>.

### ➤ *Debt Ceiling History*

Before diving into the issues, it is helpful to have some background on the debt ceiling. The ceiling 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. It first came about in 1917 when Congress was raising money to finance our participation in World War I. The original intent was to curb the appetite of lawmakers for deficit spending by trying to impose fiscal accountability. The original debt ceiling was set at \$11.315 **billion**. In practice this debt ceiling idea hasn't worked – Congress has voted to raise the debt limit 74 times since 1962, mostly without commotion.

### ➤ *What Happens August 3<sup>rd</sup>?*

If no agreement is reached to raise the debt ceiling, the Treasury has no authority to borrow, meaning it cannot issue new debt in order to meet its' obligations. This doesn't mean that the government would immediately default on its' existing debt which is in the form of government bonds held by U.S. investors, money market accounts, the central banks of China and Japan etc. Revenues would still come in from tax payments but it would mean a severe restriction on government spending. The federal government faces a \$1.6 **trillion** deficit this coming year so not being able to borrow that \$1.6 **trillion** of deficit spending would mean an immediate 40% cut in government spending beginning August 3<sup>rd</sup>.

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### ➤ ***Tough Choices***

If the debt ceiling is not raised and that 40% cut in spending were to be implemented, Treasury secretary Geithner would have some tough decisions to make about which payments should be made first and which should be skipped: \$210 billion of interest payments on the debt? Social security payments? Military pay? Not paying the interest on the debt would cause the government to technically default on its' debt which would in all likelihood trigger a financial crisis much worse than the one that followed the collapse of Lehman Brothers so that would most likely be the highest priority payment if it came to that.

### ➤ ***Political Chicken***

Politicians from both sides of the aisle are aware of the awful consequences of not raising the debt ceiling which is why, in the end, the most likely path is for some compromise to be reached before the August 2<sup>nd</sup> deadline. No majority in the House or Senate would want to explain to voters why they visited this calamity upon them. This won't prevent politicians, however, from playing a game of chicken using the debt ceiling as the ultimate consequence.

### ➤ ***Battle Lines are Drawn***

President Obama and many Democrats want Congress to increase the debt limit without any commitment to address the ongoing deficit – a “clean debt-limit hike”. Most Republicans, on the other hand, are concerned that government spending has risen to over 24% of Gross Domestic Product (GDP) and want to simultaneously correct the rapid growth in government spending in conjunction with a debt limit increase. With the advent of the internet and increasing awareness of the U.S. government's debt situation from the American public and government bondholders worldwide, it is likely that some reduction in government spending will go along with a debt ceiling increase. Income tax rate increases, another means of correcting the deficit situation, are probably off the table until after the 2012 elections. Bipartisan deficit reduction talks led by Vice President Joe Biden recently broke down and their work was handed off to a more senior group of negotiators led by President Obama and House Speaker John Boehner (R., Ohio).

### ➤ ***The Elephant in the Room Redux***

Making the negotiator's job even tougher is the decision whether to include Social Security, Medicare and Medicaid funding in the deficit reduction discussion or not. These three programs alone represent 58% of the federal government's current spending and over 80% of its' future financial obligations. According to one journalist, holding deficit reduction negotiations without addressing these programs would be like arguing over the bar bill on the Titanic.

*\*The information contained in this newsletter is of a general nature and should not be acted upon in your specific situation without further details and/or professional assistance.*