Retirement Savings Will Suffer if Congress Does Not End the Budget and Debt Ceiling Stalemate

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WORKING FOR AMERICA'S RETIREMENT

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Overall Economic Impact

ABSTRACT: An analysis was conducted to determine the economic impact of the debt limit debate in the summer of 2011 and the economic implications for another standoff in 2013 leading to default on the United States government's debt. The analysis shows that the failure to raise the debt limit in a timely manner two years ago severely disrupted the macro-economy of the United States, thereby significantly slowing the economic recovery in 2011. These economic disruptions had negative impacts on the three main pillars of the economy: consumer confidence, job creation, and the equity markets. Private retirement savings are primarily held in investments that respond to these developments in the economy. Protracted negotiations over federal government spending and the debt limit in the coming weeks and months, which already resulted in a federal government shutdown and could result in debt default, pose significant risks to the retirement security of Americans. In the 2011 debt ceiling debate and ensuing months, private pension assets declined 26% relative to where they would have been. Estimates of the effect on retirement savings suggest losses in excess of 20 percent should Congress fail to raise the debt ceiling in 2013, and the United States default on its debt.

As the U.S. Congress faces another impasse over budget negotiations and increasing the debt ceiling, political pundits consider the effect this will have on the economy. Many dismiss the current budget debate and the looming debt ceiling standoff as simply politics.[1] However, the impact of this stalemate is far-reaching, affecting both the entire economy as well as the return on investments, including the trillions of dollars held in retirement savings. With experience as our guide, we know that failure to pass a budget leads to closure of the Federal government. Further, in addition to many other economic conditions and events, which still persist, the uncertainty of the debt ceiling negotiations during the spring and summer of 2011 caused significant disruptions to our economy, slowing the recovery. However, should the current political standoff lead to a U.S. default on its debt, the current situation will threaten not only the U.S. economy, but also will create ripple effects throughout the world economy.

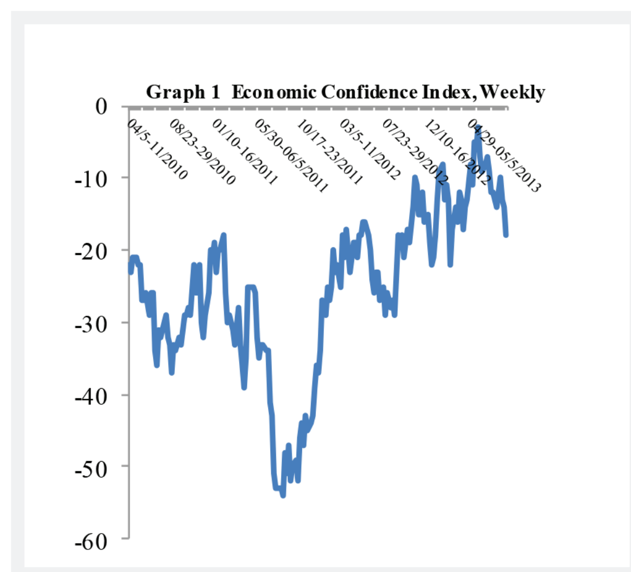
Experience tells us that the current political stalemate will – in the least – wreak havoc on the U.S. economy. Should the stalemate extend to the debt ceiling and cause the U.S. to default on its obligations, the effects could be far reaching. One recent article by the Council on Foreign Relations explains the gravity of the potential default saying,

[1] Refer to the Kiplinger Report, www.kiplinger.com. .

"Most experts agree that the potential negative consequences of a debt-limit debacle are much greater and far-reaching than that of a shutdown—particularly given the risk of a government default that would jeopardize the full faith and credit of the United States. The impact of a shutdown, while painful to the workers who are furloughed and the citizens who are temporarily denied certain government services, is limited to the symbolic message of political paralysis it presents to markets." [2]

We know that financial markets do not respond well to uncertainty. Yet, we do not know exactly how they would respond to the potential debt ceiling impasse and default. What is known is that it will precipitate a downturn in financial markets that will surpass the impact of the 2011 debt ceiling debate.

The current political standoff is likely to create significant turmoil in the U.S. economy. A recent article in the Washington Post identified three economic indicators that demonstrated a significant response to the uncertainty of the previous debt ceiling debate – consumer confidence, job creation, and the S&P 500.[3] As the following three graphs indicate, the uncertainty caused sharp declines in consumer economic confidence, slowed the job creation activity established in the previous quarter, and pushed the stock market to historic lows.

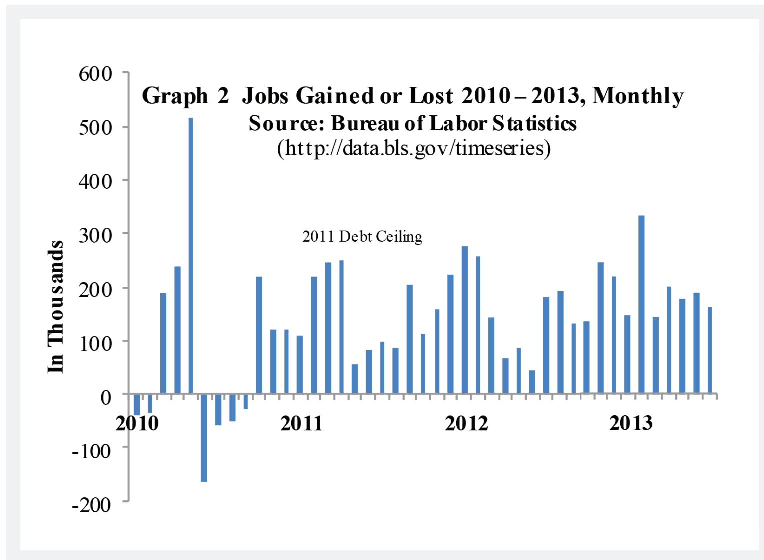


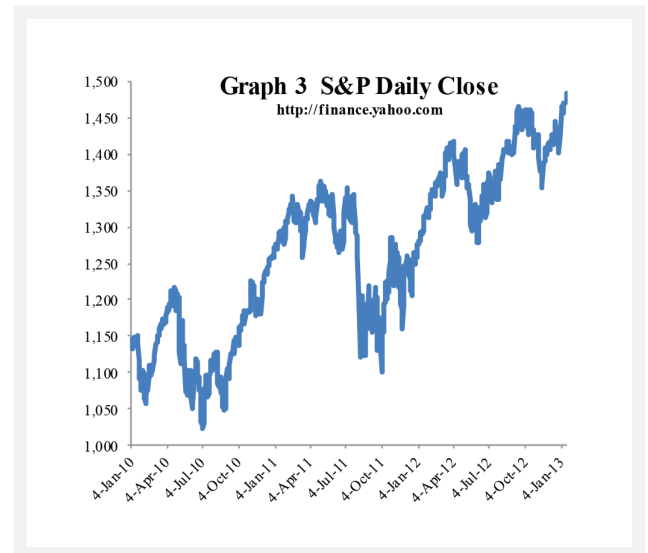
(SOURCE: http://www.gallup.com/)

Graph 1 presents the weekly economic confidence index. Prior to the debt ceiling debate during the spring and summer of 2011, economic confidence had been relatively stable. During the Congressional debate and eventual gridlock, the economic confidence index fell from a -20 to -54, a decline of more than 170 percent.
As consumer economic confidence declines, consumer spending also declines. This translates to fewer jobs being created, as consumer spending typically drives job creation.

[2] Refer to Jonathon Masters, *U.S. Debt Ceiling: Costs and Consequences, Council on Foreign Relations,* available at http://www.cfr.org/budget-debt-and-deficits/us-debt-ceiling-costs-consequences/p24751#p9.

[3] Refer to the *Washington Post*, published on January 18, 2013, 12:43 p.m. online at www.washingtonpost.com.





As Graph 2 depicts, net job creation had begun to increase during the first quarter of 2011. However, the uncertainty caused by the difficult political climate significanly stifled job growth for several months. During the debate, job growth fell from 254,000 jobs created in April to just 54,000 jobs created in the following month. The job creation level remained below 100,000 jobs until September, but it failed to reach the previous levels for another 5 months.

Graph 3 shows the dramatic effect that the debt ceiling debate had on the stock market, specifically in the S&P 500. Prior to the debt ceiling negotiations, the stock market demonstrated a steady recovery from the low levels of 2010. By spring of 2011, the S&P index increased to 1,356 from a low of 1,027. Following the debt ceiling debate and the inherent uncertainty, the S&P responded with a 23 percent decline. The S&P took nearly 7 months to recover ground lost during this market selloff.

These three indicators provide an overall sense of the economic impact that Congressional inaction on the debt ceiling could have. However, this is the broad view of the economic effect. The following section identifies the specific effects on financial markets and estimates the potential impact on savings – specifically retirement savings.

Financial Markets and Retirement Savings

During the first debt ceiling negotiations, Matthew E. Zames, a managing director at JPMorgan Chase and the chairman of the Treasury Borrowing Advisory Committtee provided an account of the effect on financial markets from Congressional inaction.[4] Ultimately, Mr. Zames identified the following five developments that would occur if the Congress did not increase the debt ceiling. These developments include:

- Foreign investors will sell their existing holdings of Treasury debt and refuse to purchase future securities;
- Delays in increasing the debt ceiling (and a default) could lead to a downgrade of the U.S. sovereign credit rating;
- Loss in consumer economic confidence could trigger a run on money market funds;
- Default or long delays in increasing the debt ceiling could lead to a sharp drop in lending from disruptions in the Treasury financing market; and
- Increased borrowing costs and credit contractions will have damaging effects on the fragile recovery.

Most economists cite many of the same concerns that Mr. Zames articulated during the first debt ceiling negotiation.[5] The general concensus is that markets will respond in anticipation of the actual stalemate as well as during the negotiations. This anticipated effect on financial markets will have a devastating effect on retirement savings.

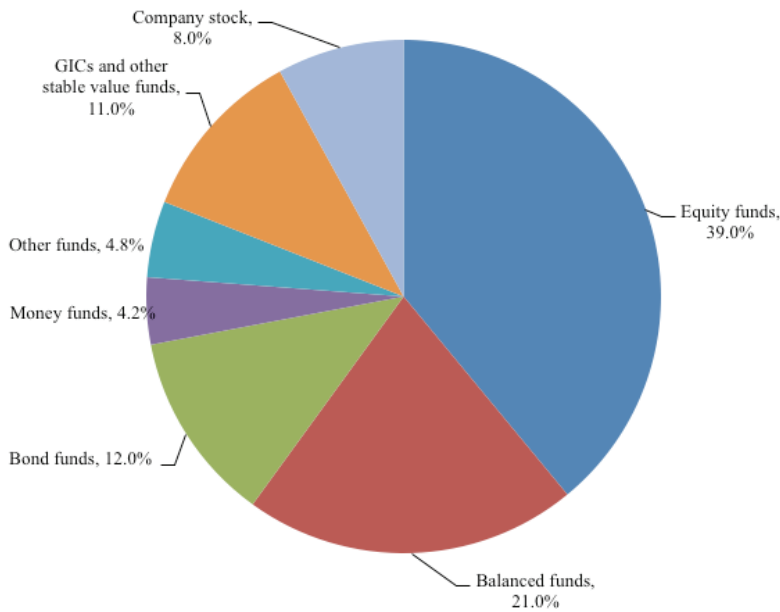
Retirement savings totaled $20.9 trillion at the end of the second quarter 2013.[6] Private retirement savings comprised the largest component of this total, with nearly $11.1 trillion in employer-sponsored defined contribution plans and individual retirement arrangements.[7] These private assets are held in investments that will respond to the overall economic and financial consequences of debt limit negotiations.

[4] Refer to the *New York Times,* Economix, What Happens if the Debt Ceiling Isn't Raised? by Catherine Rampell. April 26, 2011.

[5] Refer to Bloomberg News (Debt-Ceiling Déjà vu Could Sink the Economy, 2012) and the Economist (2012).

[6] Refer to Investment Company Institute, Release: Quarterly Retirement Market Data, Second Quarter 2013, accessed at http://www.ici.org/research/stats/retirement, September 2013.

[7] Ibid.



Graph 4 shows the distribution of assets held in private retirement accounts. As the graph indicates, more than half of all assets would experience significant losses, should the Congress engage in a protracted debt ceiling debate allowing for a U.S. default.

Estimates of the effect on retirement savings suggest that ***private pension assets could experience losses exceeding $2.4 trillion (in excess of 20 percent).*** Based on past experience, this current impasse predicts significant disruption to financial markets and yet another significant risk to retirement security. According to the Urban Institute, during during the recent economic recession, private pension assets lost approximately $1.7 trillion (nearly 30 percent) in value.[8] During the 2011 debt ceiling negotiations and the months following the negotiations (that resulted in the downgrade of the U.S. credit rating), private pension assets declined an estimated 26 percent over their projected growth trajectory. The losses reflect the cumulative effect of the market valuation decline and the loss in earnings associated with that decline.

The potential exists for significant losses for all investment vehicles. These losses could deplete pension assets, creating adverse conditions for retirement savings. Each financial shock absorbed by private pension investment affects the retirement decisions and financial security of plan participants. Delays in resolving the budget impasse and failing to address the debt ceiling will, without question, ***significantly*** slow economic growth and erode private pension assets.

[8] Refer to Soto, Mauricio, How Is the Financial Crisis Affecting Retirement Savings? Urban InstituteFact Sheet on Retirement Policy, December 3, 2008, Update