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Money Market Funds and the Debt Ceiling: What Do We Know?

By Brian Reid

As the U.S. Treasury reaches the limits of its borrowing authority this week, markets and the media are focusing on the risk that the United States will default on its debt and fail to pay interest or principal on maturing Treasury securities, perhaps before the end of October.

Some of that attention has fallen on money market funds and how they would be affected by a default. I will explain in detail below, but here are three points worth remembering:

1. Money fund managers already are positioning their portfolios to minimize any impact of a default on the funds and their investors.
2. Outflows from money market funds have been minimal to date, and funds are easily accommodating these outflows. They hold large amounts of liquidity to meet redemptions.
3. No one knows exactly what will happen in the event of a default—which would be an unfortunate historical first in this country—but money market funds won't be uniquely affected.

Money Fund Managers Are Acting Prudently

In general, we know that money market fund managers are taking steps to ensure that their funds maintain continued high levels of liquidity as we approach the second half of October. Some funds are holding more cash; others are selling Treasury securities that mature in late October or early November. Some are investing in later-maturing Treasuries that are less likely to be affected in the immediate aftermath of a default.

We saw managers take similar action in the summer of 2011, when the United States faced another debt ceiling deadline in addition to market pressures from eurozone debt problems. At that time, money market funds experienced modest outflows—4 percent of total assets came out of prime funds, while 8 percent of total assets came out of government funds. But thanks in part to the minimum-liquidity requirements imposed on money market funds by the Securities and Exchange Commission in 2010, the funds met those redemptions and came through the summer of 2011 without experiencing any problems.

Current Money Market Fund Flows Are Modest

The latest ICI flow data show that outflows from money market funds were very modest and well within the range that the funds can easily accommodate, given their high liquidity levels (which greatly exceed the 30 percent weekly liquidity requirement set by the 2010 reforms). Taxable government fund outflows totaled less than 3 percent of assets in the week ending October 9, while prime funds even saw small inflows.

This Isn't an Experiment We Should Try

That said, let's be clear: a default by the U.S. Treasury is not an experiment that the United States should try. U.S. Treasury securities are generally regarded as risk-free assets that trade in the largest and most liquid market in the world. There is no benefit to turning U.S. Treasury securities, which currently are safe-haven assets, into a source of systemic risk.

Given the unprecedented nature of a default by the United States, it's hard to say with much precision exactly what would happen. But there generally are a few known facts to point out.

The first is that a money market fund could continue to hold Treasury securities that have defaulted if the fund's board determines that disposing of the securities would not be in the best interests of the fund and its shareholders. A board might decide, for example, that selling Treasuries into a roiled and unsettled market would harm the fund's portfolio more than it helps—particularly if it appears that default would be short-lived and the securities' value would be quickly restored.

Second, there's no reason to believe that a defaulted Treasury security would be valued at zero.

Instead, a money market fund manager would value a defaulted Treasury security in the same way that a manager would for any other fund: the manager would determine the value for each defaulted security. That value would reflect the prospects and timing for Treasury regaining borrowing authority and making good on any default.

This is not to say that a default would not have negative consequences—it certainly would. Once the U.S. Treasury exercised the option to delay payments, investors would learn a lesson that could not and would not be unlearned. Treasury securities—once viewed as risk-free—would from that point on carry a risk of default and would no longer be viewed "as good as cash." That greater risk and reduced liquidity would be priced into the interest rates on current and future Treasury securities, even after all missed or delayed payments had been made good.

The point is, everyone who invests, borrows, or works in the U.S. economy could be harmed by an unprecedented default on Treasury debt. Money market funds would not be uniquely affected.

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