

J.P.Morgan

Matthew E. Zames
Managing Director

April 25, 2011

The Honorable Timothy Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mr. Secretary:

As Chairman of the Treasury Borrowing Advisory Committee, I am writing to express my concerns regarding the urgent need to increase the statutory debt limit. A considerable degree of uncertainty already exists among market participants given the severe and long-lasting impact that even a technical default would have on the U.S. economy.

Any delay in making an interest or principal payment by Treasury even for a very short period of time would put the U.S. Treasury and overall financial markets in uncharted territory, and could trigger another catastrophic financial crisis. It is impossible to know the full impact of such a crisis on overall economic growth and on Treasury's financing costs. However, the lessons from the recent crisis suggest that several damaging consequences will likely result, ultimately raising Treasury's long-term funding costs and increasing the burden on the American taxpayer. These consequences stem from five developments that could likely occur if Treasury were to default on its obligations as a result of a failure to raise the debt limit in a timely manner.

First, foreign investors, who hold nearly half of outstanding Treasury debt, could reduce their purchases of Treasuries on a permanent basis, and potentially even sell some of their existing holdings. A worrisome precedent is the sharp decline in foreign sponsorship of GSE debt since Fannie Mae and Freddie Mac were placed under conservatorship. Despite assurances from Treasury officials regarding the U.S. commitment to these institutions, foreign sponsorship has yet to return to pre-conservatorship levels. If foreigners began curtailing their investment in Treasuries as a result of a default, Treasury rates, and thus Treasury's borrowing costs, would undoubtedly rise. A sustained 50 basis point increase in Treasury rates would eventually cost U.S. taxpayers an additional \$75 billion each year.

Second, a default by the U.S. Treasury, or even an extended delay in raising the debt ceiling, could lead to a downgrade of the U.S. sovereign credit rating. Indeed, Standard and Poor's decision to change the U.S. ratings outlook from stable to negative this week indicates a one-in-three chance that Standard and Poor's will downgrade the U.S. rating within the next two years. One reason cited for the change in the outlook is a material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges. It is possible that a default, or even a delay in acting on the debt ceiling, will be perceived as an increased indication of the political inability to forge a compromise on essential long-term fiscal reforms. The consequences of a ratings downgrade would be significant, with the potential for Treasury rates to rise by a full percentage point for each one-notch downgrade.

Third, the financial crisis you warned of in your April 4th Letter to Congress could trigger a run on money market funds, as was the case in September 2008 after the Lehman failure. In the event of a Treasury default, I think it is likely that at least one fund would be forced to halt redemptions or conceivably "break the buck." Since money fund investors are primarily focused on overnight liquidity, even a single fund halting redemptions would likely cause a broader run on money funds. Such a run would spark a severe crisis, disrupting markets and ultimately necessitating the same kind of backstops that Treasury and the Federal Reserve initiated in the aftermath of the 2008 crisis. Such further increases in Treasury's off-balance-sheet commitments are likely to be viewed negatively by investors and ratings agencies, which will potentially put further downgrade pressure on U.S. sovereign ratings.

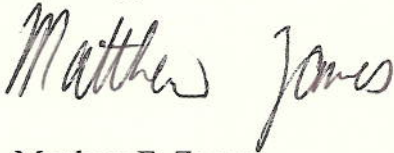
Fourth, a Treasury default could severely disrupt the \$4 trillion Treasury financing market, which could sharply raise borrowing rates for some market participants and possibly lead to another acute deleveraging event. Because Treasuries have historically been viewed as the world's safest asset, they are the most widely-used collateral in the world and underpin large parts of the financing markets. A default could trigger a wave of margin calls and a widening of haircuts on collateral, which in turn could lead to deleveraging and a sharp drop in lending.

Fifth, the rise in borrowing costs and contraction of credit that would occur as a result of this deleveraging event would have damaging consequences for the still-fragile recovery of our economy. In 2008, placing the GSEs in conservatorship combined with a tightening of credit standards caused mortgage spreads to widen by 1.5 percent, ultimately raising mortgage rates for consumers. A similar rise in mortgage and Treasury rates would adversely impact economic growth, potentially pushing the U.S. economy back into recession.

Finally, I would emphasize that because the long-term risks from a default are so large, a prolonged delay in raising the debt ceiling may negatively impact markets well before a default actually occurs. This is because investors will likely undertake risk-management actions in preparation for a potential default. For example, borrowers who rely on short-term funding markets, including the GSEs, may attempt to pre-fund themselves or hold excess liquidity through July, distorting money market rates. Additional effects could include large auction concessions, especially if Treasury were forced to delay auctions for cash management purposes. I would also expect to see weaker demand for Treasury securities as uncertainty increases on whether the debt limit will be raised. Both of these effects would negatively impact Treasury's borrowing costs.

Given the magnitude of the adverse consequences a default would have on Treasury borrowing costs and the health of the broader economy, action is urgently needed to increase the statutory debt limit. Swift action would also help ease the existing uncertainty in financial markets that could begin translating into real market impacts well before Treasury exhausts extraordinary actions at its disposal to postpone a default. Notwithstanding your significant efforts to date, your continued attention to this important issue is greatly appreciated.

Sincerely,

A handwritten signature in cursive script that reads "Matthew James".

Matthew E. Zames
Chairman
Treasury Borrowing Advisory Committee