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Playing chicken with the debt ceiling

If you want to see the lighter side of what some are calling a potential global economic morass, check out the cartoons about the current U.S. debt ceiling debate here:

<http://www.usnews.com/opinion/photos/budget-and-deficit-cartoons/42>, here:

<http://thepoliticalcarnival.net/2011/07/11/cartoons-of-the-day-debt-ceiling-2/> and here:

<http://mariopiperni.com/toons/political-cartoons-of-the-day-debt-ceiling-edition.php>.

Chances are, you noticed that Moody's Investors Service, the credit rating service, has placed the U.S. government's sterling Aaa bond rating on review for a possible downgrade. The reason was clear, but Moody's spelled it out anyway: there is uncertainty whether Congress will raise the U.S. government's debt ceiling by August 2. If it doesn't, the U.S. will join Venezuela (1998), Russia (1998), Ukraine (1998 and 2000), Pakistan (1999), Ecuador (1999 and 2008), Peru (2000), Argentina (2001), Moldova (2002), Uruguay (2003), the Dominican Republic (2005) and Belize (2006) as a nation that has recently defaulted on its bond obligations. And not only that: if no deal is reached, the government would have to stop paying military active duty pay and veterans' benefits, IRS refunds, Medicare, Medicaid, Social Security, unemployment insurance, defense contracts--or Congressional salaries.

With all this at stake, why are so many seasoned observers yawning instead of panicking? A recent analysis by the Bipartisan Policy Center typifies the view: it says that despite the brinkmanship in Washington, it is unlikely that the U.S. government will be allowed to go into default.

Why? There are a variety of reasons. Simon Johnson, former chief economist of the International Monetary Fund, says that the U.S. business sector would be livid if Congress were to inject such a high dose of uncertainty into the capital markets. Johnson also points out that ordinary Americans take their debt obligations more seriously than the citizens of many other countries. The U.S. has had its fiscal resolve tested (and faced the easy way out of defaulting on its bonds) after the Revolutionary War, the War of 1812, during and after the Civil War, and in World War I and World War II. "The simple fact of the matter," Johnson says, "is that when the going gets tough, the U.S. pays its debts." Is Congress ready to throw away 200 years of building the best credit history in, well, history?

The thing to understand about the negotiations is that Congress is a feedback mechanism; it takes action, and then, if there is a backlash, it may reverse itself quickly. We all know how teenagers play the game of "chicken:" they aim their cars at each other, and then at some point fear (or maybe common sense) takes over and they quickly return to their lanes. Anybody watching the first part of the game would predict a different outcome.

If the game of debt-ceiling chicken goes past August 2, the default would have an immediate impact on Treasury auctions. The government would have to pay more to get the Chinese government and U.S. retirees to accept the added risk that Congress might decide to refuse to pay what it owes. Raising government bond rates would, ironically, make our government's



current debt more expensive to finance, increasing the government's deficits--and make the problem that Congress is trying to fix much worse.

In addition, a temporary default would probably cause people to become a bit more nervous about everything else they took for granted, like the safety of the investment markets. Mohamed El-Erian, CEO of PIMCO (the largest bond investor in the mutual fund world) points out that in 2008, Congress denied the Bush administration's request for \$700 billion to prevent a financial-market collapse and economic depression. A dramatic 770-point drop in the stock market focused politicians' minds, bringing them back to the table – and to agreement.

Sources:

Bipartisan study on debt limit: <http://www.bipartisanpolicy.org/news/press-releases/2011/06/bipartisan-policy-center-releases-new-analysis-debt-limit>

Recent defaults: <http://www.davemanuel.com/2010/02/12/the-last-13-major-sovereign-bond-defaults/>

Simon Johnson: <http://www.project-syndicate.org/commentary/johnson20/English>

Eichengreen: <http://www.project-syndicate.org/commentary/eichengreen31/English>

El-Erian: <http://www.project-syndicate.org/commentary/elerian6/English>

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