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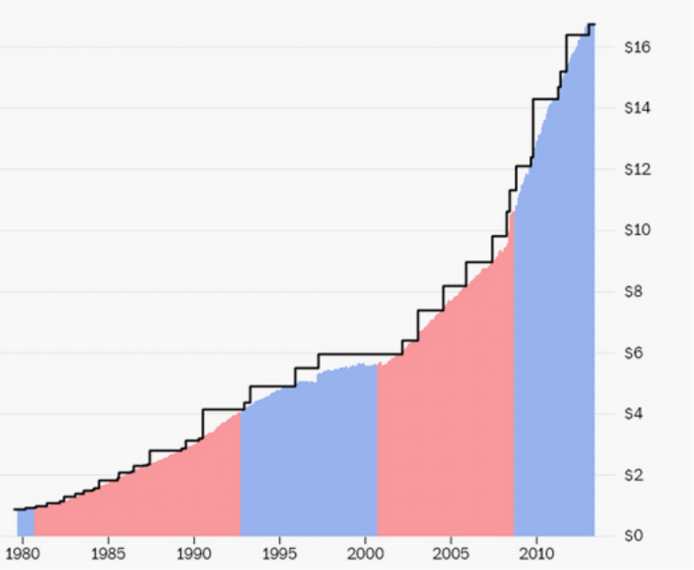
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

The History of the U.S. Statutory Debt Limit

Introduction

U.S. Constitution empowers the Legislative Branch of the Federal Government – the U.S. Congress – with control of the public purse. Congress established the statutory debt limit in 1917 as a mechanism to restrain government borrowing via public bond issuance of U.S. Treasurys and must authorize any increase in the limit. Once the limit is reached, Congress cannot borrow further, impeding its ability to pay the Government's bills. While the current debt limit of $16.7 trillion (U.S.) was reached last May 19th. the U.S. Department of the Treasury has been using creative financing measures to keep the government operational. Recently, as widely reported in the mainstream media, those efforts will be exhausted by October 17th. according to Treasury Secretary Jack Lew. On several occasions, U.S. President Barack Obama has stated that failure to raise the statutory debt limit will result in default. In point of fact, however, default would occur only if the federal government failed to honour its outstanding U.S. Treasury obligations, likely leading to another sovereign debt credit rating downgrade.



U.S. Statutory Debt Limit. Sources: Congressional Budget Office / U.S. Dept. of the Treasury

As can be discerned from the chart on the right, since 1980, the U.S. statutory debt limit has been raised a total of 42 times by both Democrat (in blue) and Republican administrations (in red).

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The Bane of Budgetary Brinkmanship

As recently reported in The Economist magazine, by mid-October, the U.S. federal government will reach its statutory debt limit, known as the 'legal debt ceiling.' Unless Congress raises that ceiling, America will soon be unable to pay all its bills. In other words, unless Democrats and Republicans can work together, America will have to choose which of its obligations not to honour. It could slash spending so deeply that it causes another recession, or it could default on its debts, which would be even worse and unimaginably more harmful than a mere government shutdown … America enjoys the 'exorbitant privilege' of printing the world's reserve currency. U.S. Treasurys are considered a safe haven, which is why the government can borrow so much, so cheaply. While America may not lose these advantages overnight, anything that undermines its creditworthiness – as the current farce in Washington surely does – risks causing untold damage in the future. Not only would America have to pay more to borrow, but also, the repercussions of an American default would be both global and unpredictable.

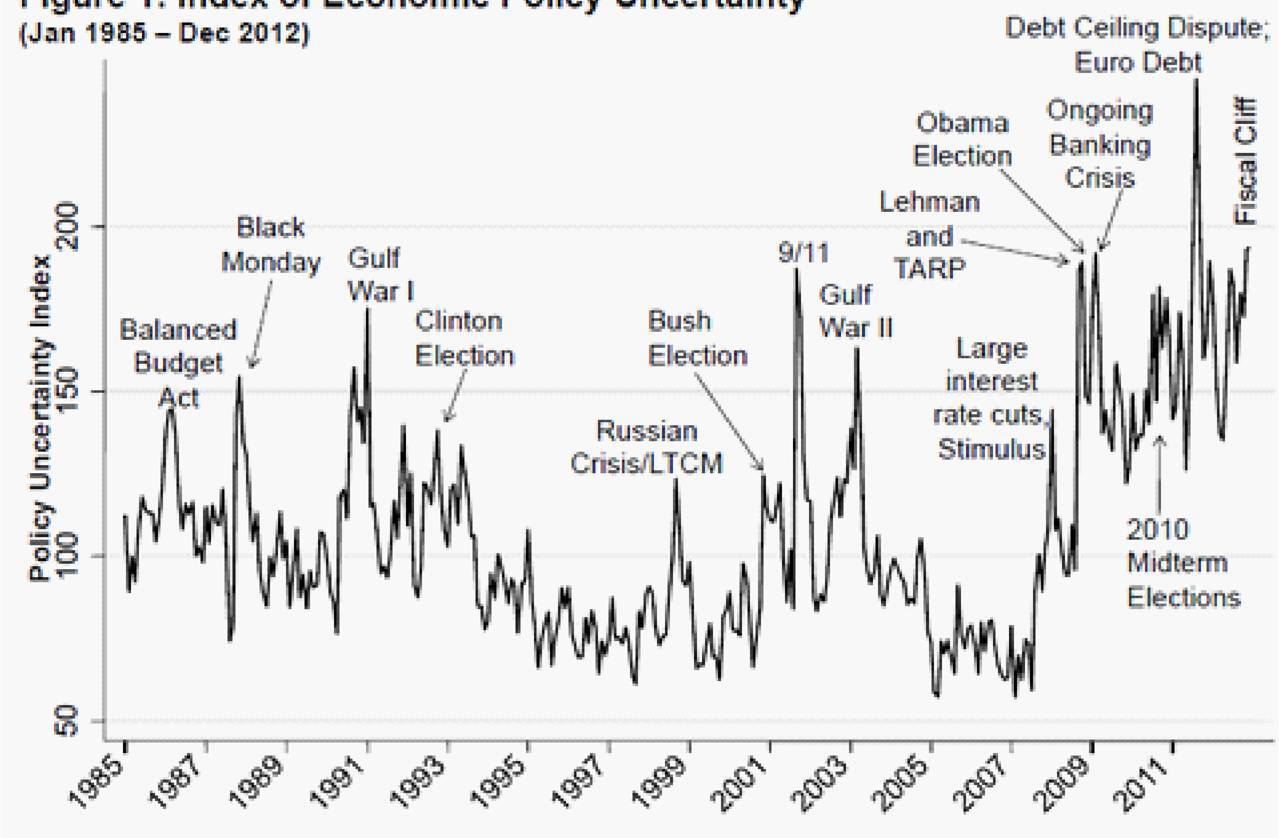
The Debt Ceiling and Playing With Fire

Excerpted from a presentation made earlier this year to the U.S. House Ways and Means Committee and published in the New York Times, Simon Johnson, former chief economist of the International Monetary Fund warned: "Congressional Republicans are again threatening not to increase the ceiling on the amount of federal government debt that can be issued. The decision to turn the debt ceiling into a confrontation is a big mistake for the Republicans and extending the indecision is likely to prolong the agony of uncertainty and have damaging economic consequences for the country … In most countries, decisions about government spending and revenue bring with them an implied, even automatic decision about how much debt to issue. Spending minus revenue in a (fiscal) year gives you the annual deficit (a flow), while government debt is a stock of outstanding obligations. To complicate matters, bear in mind that some of these fiscal flows have already been committed, for example, in terms of interest payments due on existing debt, salaries for active military personnel and Social Security payments. You cannot suddenly grab more revenue out of thin air.

The main problem is that no one knows what would happen if the federal debt were to hit its legal ceiling. Would the government be forced to default on some (U.S. Treasury) obligations to bondholders? Would there be some other form of default, for example, in terms of nonpayment for goods and services already contracted? Or would there just be complete chaos in our fiscal affairs – a throwback to the mid1780s, before the Constitutional Convention in Philadelphia and before Alexander Hamilton took the public debt firmly in hand? In the past, the potential for confusion around binding debt limits was well understood. Therefore, the debt ceiling was raised without too much fuss and the party in opposition would typically object in principle, but not muster a real fight. Plenty of other ways are available for Congress to affect revenue and spending without throwing everything into disarray by insisting upon a stock of debt that is inconsistent with previous commitments. This changed in the summer of 2011 when some Republicans decided to entrench themselves behind the idea that they could force the federal government to default if they did not get what they wanted. For some, this was about forcing big spending reductions, but for others federal government default was actually the goal.

In the summer of 2011, I warned about the effects of this confrontation over the debt ceiling, contending that it would create a great deal of uncertainty and slow the economic recovery. I particularly stressed the damage that would be done to the private sector, exactly contrary to what the House Republicans asserted that they wanted. In July, I also testified to this effect before the House Ways and Means Committee, although I cannot say my arguments had any impact upon Republican thinking. Research by Scott Baker and Nicholas Bloom of Stanford and Steven Davis of the University of Chicago looks carefully at what has generated uncertainty about policy over the last 25 years or so. Their chart below outlines that while the financial crisis of 2008 and its aftermath greatly elevated policy uncertainty in general, the debt ceiling confrontation in the summer of 2011 produced the highest level of uncertainty since 1985, when their analysis begins.

Figure 1: Index of Economic Policy Uncertainty
(Jan 1985 – Dec 2012)

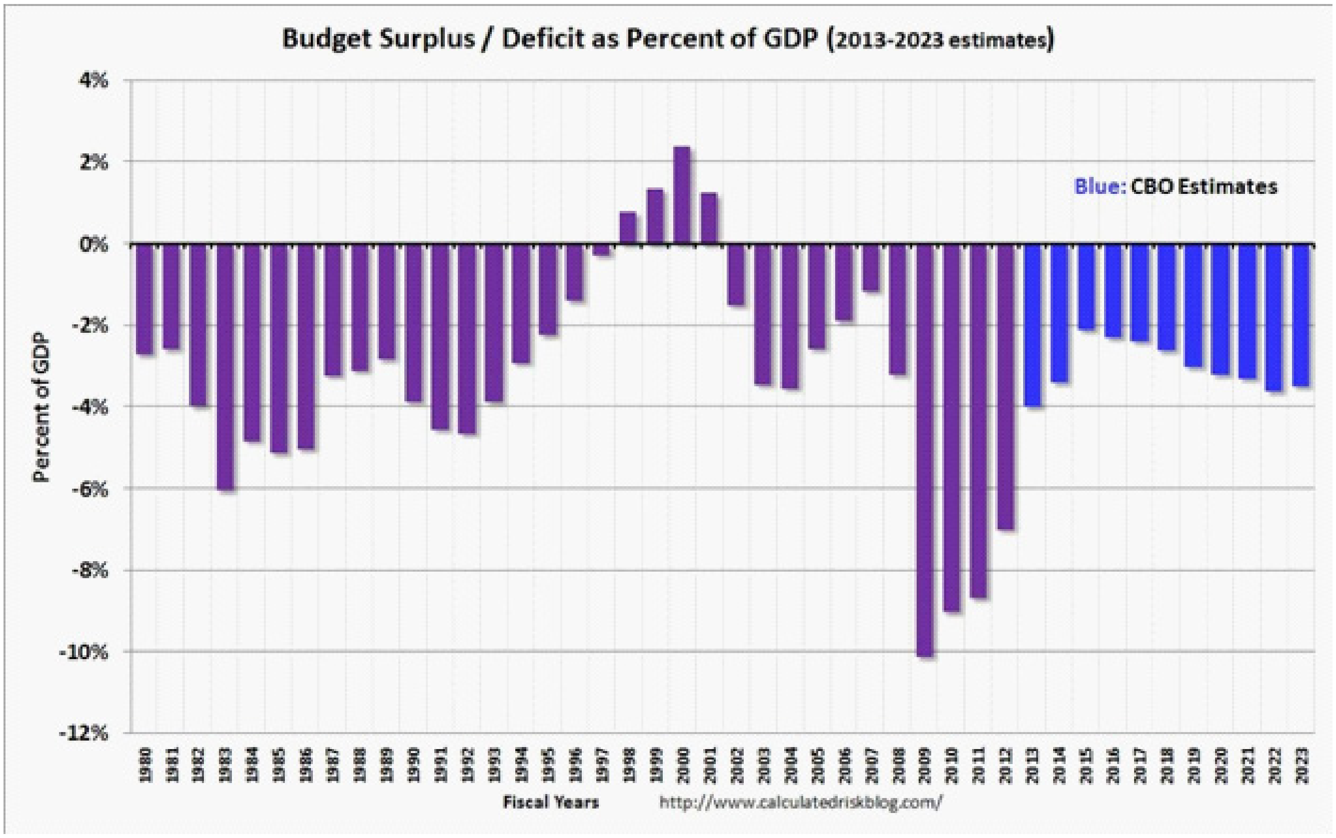


Uncertainty about policy creates doubts in the minds of people about what is going to happen to the economy. The natural response in the face of heightened uncertainty is to delay making decisions. People do not go on vacation or purchase a car and business owners and companies do not hire people unless they absolutely need them. Slap everyone in the face with such concerns after a big financial crisis and you get a slower economic recovery and fewer jobs. Most economists would say there is no chance that the United States would ever default. This would be (deemed) an act of collective insanity far in excess of anything ever seen in this country or anywhere in the world. However, what really matters is not the view of analysts and commentators. The real issue is whether decision makers throughout the country think that default or some other disruptive event could occur. The evidence (noted above) from Professors Baker, Bloom and Davis is clear. The debt ceiling battle during the summer of 2011 made people more uncertain about what was to (eventually) unfold in this regard. This is consistent with the fact that August 2011 was a very weak month for job creation. According to the U.S. Government Accountability Office, this political confrontation also influenced the yields on U.S. Treasurys to higher levels. Uncertainty of this kind increases risk premiums around the world, because investors want to be compensated for higher risks. This also put more pressure on European sovereign debt yields at an inopportune time … In any event, this is an irresponsible way to operate (government) fiscal policy. The Republicans should take the debt ceiling (issue) off the table.”

U. S. Debt Default Threat Unlikely to Vanish

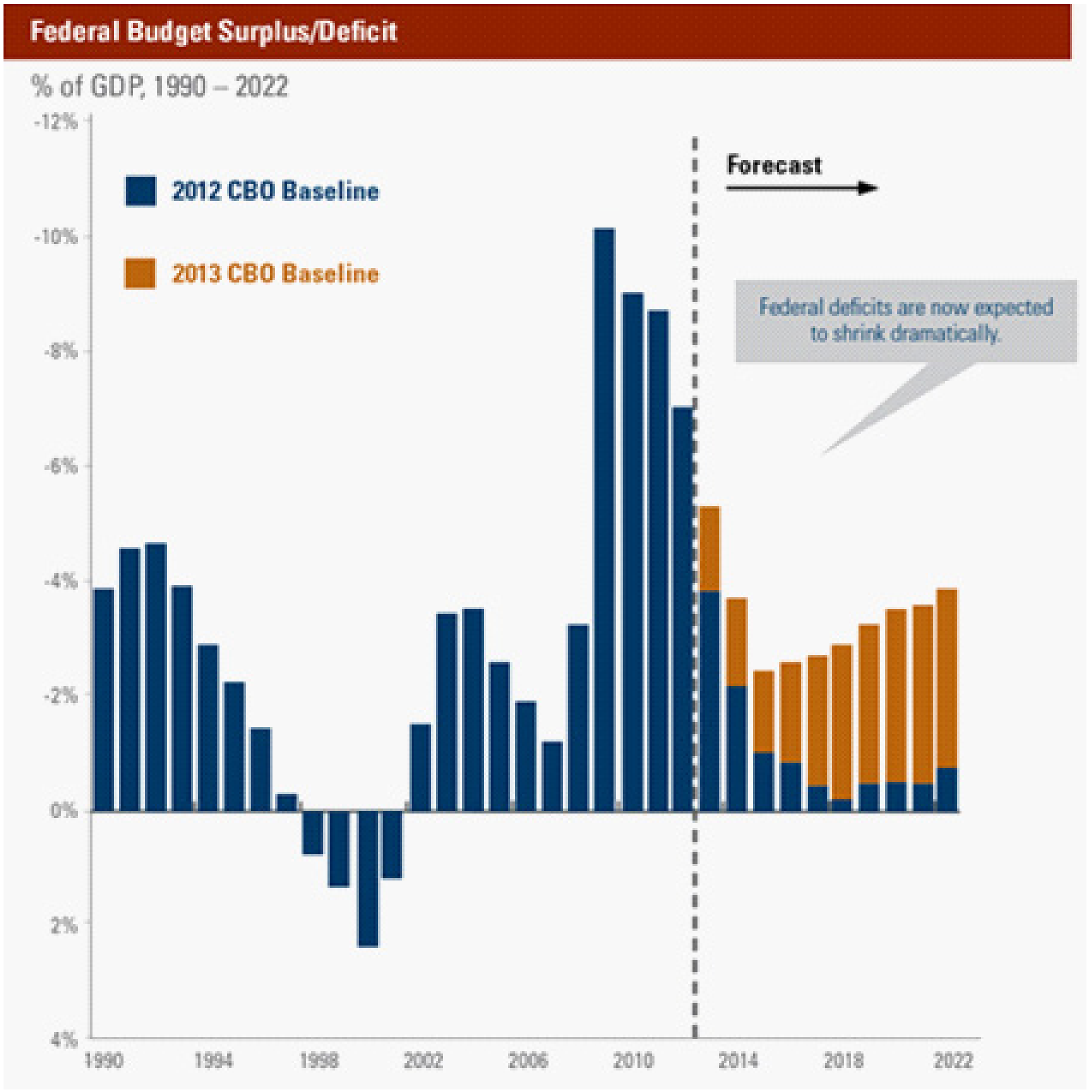
In a U.K. Daily Telegraph op-ed, Roger Bootle, managing director of Capital Economics writes: "With a temporary increase to the U.S. debt ceiling likely, investors risk repeating this crisis quite soon. There are two parts to the current episode. The first is the shutdown of large parts of the American government because of Congress" failure to pass a budget (for fiscal 2014). The second is its refusal to raise the statutory debt limit. Congress regularly reviews the debt ceiling and usually increases it without incident, thereby allowing the U.S. Department of the Treasury to continue borrowing. However, this is what the Republican majority in the House of Representatives has been refusing to do, since they are in a dispute with the Democrats and President Obama over a healthcare bill, popularly known as Obamacare. Historically, brief government shutdowns were commonplace in the 1970s and 1980s and one shutdown lasted 21 days in 1995-96. However, if the current shutdown continues, it could cause the fledgling American economic recovery to falter for all the usual Keynesian reasons.

However, if the statutory debt limit is not raised, this situation would be far more serious. There has been a real risk that the U.S. could default, i.e. fail to honour its obligations to pay interest on its debt, or redeem any maturing debt. This is often described in the financial media as an unprecedented and unthinkable event. In fact, there are one or two half-precedents. In 1979, the U.S. Treasury was briefly forced to delay some debt payments due to IT problems. A default is such a calamity because U.S. government debt is the bedrock of the global financial system. U.S. Treasurys are widely regarded as the ultimate safe asset. A failure to make due payments on these outstanding obligations could trigger a liquidity crisis. Some people have suggested that the resulting chaos and damage to the global financial system and the U.S. domestic economy could rival, or even surpass the Lehman Bros. crisis of 2008. Recently, the U.S. Treasury warned that October 17th. would likely be the day when it will exhaust its funds. Not only are large Social Security payments due on November 1st. but also, a big interest payment is due on November 15th.



Admittedly, U.S. public finances do face a crunch over coming decades, as expenditures threaten to well exceed revenues. However, America is not at that point yet and there is still time for plenty to be done … The mere threat of a U.S. default is hugely important for global markets. For at least the last 70 years, America has been regarded as the mainstay of the world's financial system. However, it is a well known fact that the U.S. has been losing its share of global gross domestic product (GDP) since its economy has grown only moderately, while the economies of east Asia have forged ahead. For several years now, people have debated when the size of China's economy will surpass America's and when China might assume the mantle of global economic leadership. Even if a U.S. debt default is avoided, many people will see a clear sign that America's days of unquestioned economic supremacy are numbered. Indubitably, those individuals responsible for managing China's huge investment in U.S. Treasurys have experienced anxious moments. However, among the Chinese leadership, surely some are rubbing their hands with glee witnessing what America has been doing to itself.

The U.S. Government Shutdown and Possible Debt Default

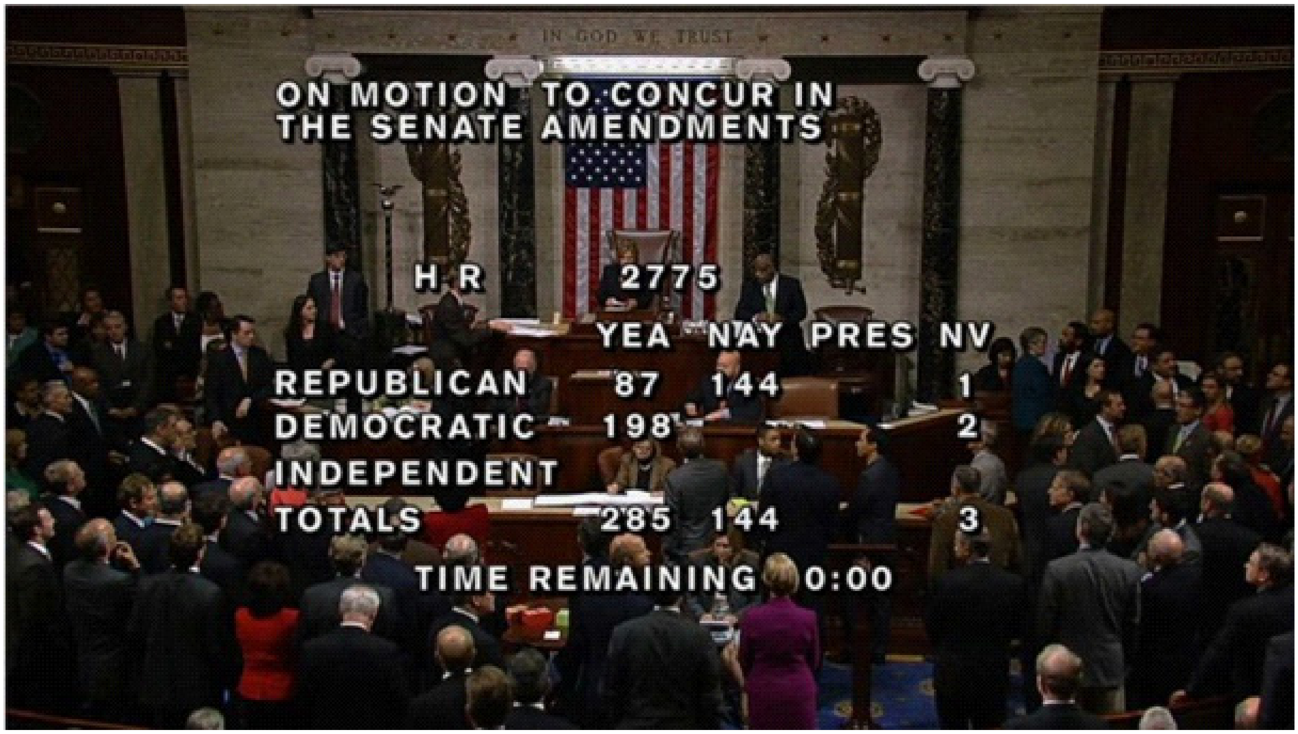


Source: Congressional Budget Office

In a recent Global Research article, Professor Michel Chossudovsky asserts: “The U.S. government shutdown and financial climax, associated with a deadline date, leading to a possible debt default of the U.S. Government represents a money making opportunity for Wall Street. Several overlapping political and economic agendas are unfolding. Is the shutdown – implying the furloughing of tens of thousands of public employees – a dress rehearsal for the eventual privatization of important components of the federal State system? A staged default, bankruptcy and privatization is occurring in Detroit (with the active support of the Obama administration), whereby large corporations become the owners of municipal assets and infrastructure. The important question: is a process of State bankruptcy – which is currently afflicting local level governments across the land – possible in the case of the central government of the United States of America? This is not a hypothetical question. A large number of developing countries under the brunt of IMF ‘economic medicine’ were ordered by their external creditors to dismantle the State apparatus, fire millions of public sector workers, as well as privatize State assets. The IMF Structural Adjustment Program (SAP) has also been applied in several European countries. Will this gamut of deadly economic reforms engineered by Wall Street and the Federal Reserve be conducive to widespread civil disorder across the United States? While the declaration of a national emergency or martial law is not envisaged, reports confirm that the Department of Homeland Security (DHS) is currently engaged in acquiring heavily armoured tanks, which have been seen roaming the streets.”

Conclusion – The U.S. Congress Kicks the Statutory Debt Limit Issue Down the Road

Unsurprisingly, all 144 votes in the U.S. House of Representatives cast on the evening of October 16th. against raising the statutory debt limit and funding the federal government to January 15, 2014 were Republican ballots. In other words, 144 members of the House – presumably, mostly aligned to the Tea Party faction – actually voted in favour of the United States of America defaulting on its outstanding obligations – U.S. Treasury notes and bonds – because of their unhappiness with the Affordable Care Act (Obamacare). Can there be anything more irresponsible than such behavior by a politician as that by an elected member of the House? Ostensibly, the bipartisan agreement to end the government shutdown and extend the statutory debt limit is a major defeat for the ultra-conservative wing of the Republican Party.



The tally of votes cast in the U.S. House of Representatives. **Source: Washington Post**

The above notwithstanding, as reported in the Washington Post, while the bipartisan agreement ends a period of disruption that has slowed down the U.S. economy –the (two-week government) shutdown removed more than $20 billion (U.S.) in direct government spending and related economic activity – it creates new potential perils for the economy, setting in place more deadlines in just a few months. The agreement does almost nothing for America's existing economic challenges, including automatic spending cuts (the sequester) that are worsening the problem of high unemployment and a long-term debt challenge posed by mounting costs in Medicare, Medicaid and Social Security. Under the terms of the bipartisan agreement, lawmakers in both parties will spend the next three months trying to construct another agreement which could alleviate some of these long-term risks.

At Longwave Analytics, we have oftimes warned of the U.S. political minefields, not only concerning the overly bloated and dreaded lobbyist system, but also, the inexorable tendency for American politicians to denigrate opposing party members as enemies, rather than as political adversaries. As elected representatives of the people, their sworn oath is to work for the best interests of the country as a whole and not to treat compromise as a blasphemy. Small wonder the Congressional approval rate hovers around an all-time low of 10%. **See also, Economic Winter, Federal Governments: The U.S. Republic and the Canadian Constitutional Monarchy – February 22, 2012.**

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