Time to End Confrontations Over Federal Borrowing Limits

Recurrent threats to force a U.S. debt default could end in catastrophe. There are better ways for Congress to oversee its fiscal responsibilities — and it's time to use them.

BY JEFFREY E. GARTEN NOVEMBER 4, 2015

I have been teaching a course at Yale University called "Managing Global Catastrophes." We study all kinds of mega-disasters, including the 9/11 terrorist attacks, the 2004 Indian Ocean tsunami, the Haitian earthquake, the collapse of Lehman Brothers, the BP oil spill, the Fukushima radiation leak, and the Ebola epidemic. For the past few years, I have been anticipating adding a new case based on a U.S. debt default, but each time Congress threatened to cause the U.S. Treasury to stop servicing its contractual obligations — as it did in 2011, 2012, and 2013 — Armageddon was averted by a five-minutes-to midnight deal with the administration.

Until just a few days ago, Congress was threatening to force yet another U.S. default — according to Treasury Secretary Jack Lew, Washington would have run out of funds to service its debts by Nov. 3 — but on Oct. 28, outgoing Speaker of the House John Boehner gathered enough votes for a two-year budget accord that, among other things, allowed the United States to fulfill its borrowing needs until March 15, 2017. Soon after, the Senate followed suit, and this past Monday, on the eve of the projected default, President Obama singed the legislation into law. But here is why I won't stop planning to add a module to my course on a big U.S. default — at least not yet.

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Very little has changed

Despite the new two-year de facto moratorium on confrontations over U.S. debt, many of the underlying fault lines haven't changed. Boehner couldn't rally even half of his 247 Republican colleagues to support his bill; instead, the support came from across the aisle — from all 187 Democratic congressmen and women. It is a fair bet that those on far-right of the Republican Party haven't yet given up on the idea that withholding permission for the United States to issue debt gives their camp great leverage to radically reduce spending and cut back on government programs. Beyond that, the dynamics of soaring fiscal deficits due to the baby boomers' need for ever more Social Security, Medicare, and Medicaid entitlements haven't changed, providing ample opportunities in the future for Congress to scream about rising deficits and hold up successive administrations whenever the authorized borrowings reach the prevailing debt ceiling.

But this time around the circumstances that allowed for a compromise were especially unique. Boehner unexpectedly announced his resignation from Congress in late September, effective at the end of October, a move that threw his party and the House into chaos. When Rep. Paul Ryan emerged as the overwhelming favorite for the speaker's post, the need to give him as clean a slate as possible became clear to the majority of the House. Boehner "cleaned the barn," as he famously said, but only with the help of Democrats. Absent this highly unusual change of command under such tight deadlines, including Boehner's willingness to defy his party, another polarizing debt ceiling crisis seemed assured.

It’s a classic example — one that’s perhaps most fundamental to the lessons of my course on global disasters — of how big crises can and often do creep up after a spate of smaller ones with similar features. Epic eruptions are often preceded by a series of brush fires that are contained one way or another without massive fallout. This causes such problems to be seen by top management as being more or less routine. And because officials become inured to how close they have come to catastrophe, they never take the time to examine the institutional and cultural roots of the events that went awry. But then one day the unthinkable happens: Those very same factors finally combine with something else and morph into something truly destructive.

Thus, the technical problems that caused the Challenger shuttle to explode in 1986 were just a bigger version of what happened several times over the previous few years — that is, the devices called “O-rings” that were designed to seal the seams between the booster rocket and the space ship kept coming loose. The BP oil spill was a more spectacular example of lapses in safety that had occurred elsewhere in the decade before, including an explosion in a Texas refinery. In the case of the collapse of Lehman Brothers, long before its denouement the firm was notorious for operating on the edges of extreme risk.

When it comes to the debt ceiling, the real danger is that we think that because previous defaults have been averted in the past, we will always scrape by. It is easy to assume that Congress and the administration will, at the very last minute, always come to their senses. Also, we can convince ourselves that no matter what happens, there is no alternative to the dollar for most investors around the world because it is so ubiquitous and so easily tradable, and so backed by the rule of law, that they will have no choice but to tolerate Washington’s follies.

But with three confrontations in the last few years, and with last week’s averted train wreck, the warning signs couldn’t be clearer that Washington handles its debt with a dangerously cavalier and irresponsible process that could easily go off a cliff and fundamentally undermine its creditworthiness. In that event, the United States would suspend its contractual payments to holders of trillions of dollars of U.S. securities at home and abroad, not to mention American citizens entitled to Social Security and medical reimbursements. Washington would also have to stiff soldiers’ and air traffic controllers’ salaries, and suspend payments to all defense and civilian government contractors, bringing many government services to a halt.

The incalculable costs

No one can predict the costs of such a calamity, especially in the global arena. Over one-third of U.S. government debt is held abroad, and no one really understands the full extent of the world economy's interconnections, as we know from the 2008 financial crisis. (Since then, global markets haven't become any simpler.) But here is my own assessment, based on many discussions with officials on Wall Street and Washington, plus previous hands-on experience in both worlds.

In the event of a default, even a temporary one, those institutions and individuals buying U.S. Treasury obligations would demand higher interest rates. The increased cost of servicing the U.S. debt would drive up budget deficits and likely put a monkey wrench in America's already slow recovery. Since U.S. Treasuries have traditionally been considered risk-free, and since the bonds of other nations and bonds of companies around the world are priced using U.S. Treasuries as the benchmark, the entire global financial system would be repriced, with the likelihood of a precipitous drop in commercial lending. Worrying about a decline in the value of their net assets, investors in mutual funds that in turn invest in U.S. Treasuries would likely withdraw substantial amounts of their money, with a contagious effect on the trillion-dollar mutual fund industry. Since Treasuries are used for collateral in lending between and among big financial institutions, the reduction in value of that collateral would also spread throughout the entire financial system, causing a further lending contraction, if not a total seize-up of the global credit machine.

I could have understated the impact or exaggerated it slightly, but directionally nothing I said hasn't been echoed by JP Morgan, UBS, and others, including former Secretary of the Treasury Tim Geithner when he told Congress in April 2011 that "default would cause a financial crisis potentially more severe" than the crisis of 2008.

Beyond the financial costs are the more intangible and perhaps irreversible political ones. The willingness of other countries to continue to have confidence in the United States as the leader of the global financial system could wane. The impact might not be evident right away, but the establishment of alternatives to the U.S.-dominated system — efforts such as the creation of the Chinese-organized Asian Infrastructure Investment Bank that includes well over 50 governments as members but *not* the United States — could be accelerated. The central role of the U.S. dollar in the world economy could gradually erode faster than might otherwise happen, undermining the enormous political influence it gives the United States and the substantial advantages it provides American multinationals.

Since our credibility in economic and financial circles would have taken an enormous hit, a U.S. default would overnight undercut our diplomatic efforts to persuade emerging markets to pursue a host of economic reforms, and we would lose significant influence in European financial circles. In terms of the impact on America's global reputation, just imagine the level of outrage in Washington, Wall Street, and corporate America if Germany or Japan or China reneged on its respective international financial obligations.

Reform the system now

It is not up for debate whether Congress has the power to tax and authorize federal expenditures — and ultimately to control the system of Federal Reserve banks. That is imbedded in the Constitution. The key fact, however — the one that makes its recent threats to prohibit U.S. borrowing beyond certain limits so preposterous — is that the Treasury borrows only to finance what Congress has already appropriated and authorized. In other words, Congress's allowing the debt ceiling to be raised is a redundant activity, because the legislature has already mandated the U.S. government to spend the money by having passed bills instructing the administration to do certain things. To *not* approve a higher debt ceiling is, in the words of *Wall Street Journal* reporter Nick Timiraos, "like running out of the restaurant before paying the check."

Given the possibility that we will see more debt confrontations; given the astronomical costs of a default that is either accidental or deliberate; and given that the debt ceiling is ridiculously redundant in the first place, the process must be fixed before it reemerges as a potentially destructive confrontation. But we shouldn't wait too long. Now is the time to do it when Speaker Ryan has at least a potential honeymoon period, however slight. If the reform isn't made soon, the urgency of finding a better process will fade until shortly after a new president takes office, possibly plunging the country again into a credit crisis and, at a minimum, setting an acrimonious political atmosphere for another several years. At worst, of course, this time a true credit calamity could occur.

The solution: Congress should eliminate the current system in which it votes periodically to lift the debt ceiling. Instead, when the House and Senate pass annual budget resolutions, a parallel projection of the implications for the federal debt should be attached. A vote in favor of the budget resolution would mean a vote in favor of the estimated debt level itself and in favor of the U.S. Treasury being able to borrow what it needs to service that debt. If Congress felt the debt was too high, it would be incumbent on it to reduce the projected budget deficits with either more taxes or less spending before passing any budget resolutions. Congress might even want to set, as a guideline for policy, a target range for the level of the debt as a percentage of GDP ten years into the future, as a 2011 Government Accountability Office report discussed. Or it might use some other ratio such as a projection of the cost of interest payments as a percentage of the federal deficit.

I am not pretending this kind of rational outcome would occur without a herculean political effort. Among other things, the congressional leadership would have to mount an extensive education program for House members who do not understand the redundancy of imposing a debt ceiling after they have authorized expenditures, or do not understand the stakes involved in reckless brinksmanship of borrowing authority. The need to change mindsets is another reason why the process to reform the dynamics of approving federal borrowing should begin now.

The advantage of establishing a new approach to the debt is that Congress would maintain its oversight of fiscal policy, but it would extinguish its own repeated tendency to engage in negotiation that is deeply counter to any conceivable notion of the national interest. We are playing with fire that could quite easily rage out of control, and it’s time to put away the matches. And under those circumstances, I could forget about adding a new case to my course on global catastrophes.

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