

# Another global meltdown at stake as US plays fiscal Russian roulette

Adam Creighton

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**ECONOMISTS everywhere were desolate yesterday. The US Department of Labour failed to update the country's unemployment rate, one of the biggest pieces in the world's economic jigsaw puzzle, something it normally does on the first Friday of the month.**

Whether it shifted from 7.3 per cent remains a mystery, along with the far more worrying prospect that US bondholders might not receive the \$US16 billion in interest due on November 15.

The department's operations are collateral damage in an internecine political war in Washington, DC. over the size and scope of the US government; a war that risks plunging the world into recession and prompting a financial crisis that could dwarf the last.

So far, the fight over the start date of US President Barack Obama's signature "Obamacare" health reform has shut down the government. But if congress refuses to lift the official debt ceiling by October 17, when the stock of US public debt is set to bump up against its \$US16.7 trillion limit, it risks shutting down the world's financial system too, with disastrous consequences for the economy and the US's reputation.

"A threat not to pay interest on US government bonds is a threat to blow up the world; it would be a bloody catastrophe," says John Cochrane, professor of finance at the University of Chicago.

"A default of even a few hours on any US bond would undermine a key, long-standing assumption underpinning the world's financial system: that US government debt is risk-free," says Justin Wolfers, senior fellow at the Brookings Institute in Washington. He suggests banks worldwide would immediately mark down the value of US bonds outstanding and would be scared to lend to each other.

The US government is planning to borrow \$US642bn, or US18c for every dollar it spends this year, equivalent to about 4 per cent of US GDP.

While defaulting on debt might prompt catastrophe, hitting the debt ceiling might not.

"Depending on how ruthless the administration wanted to be with other spending it could keep paying interest and last for a long time, even if the congress refused to lift it," says Stephen Kirchner, a research fellow at the Centre for Independent Studies.

On Tuesday, for the first time in 17 years, the US government partially shut down. An enraged Republican-controlled House of Representatives refused to give the Obama administration authorisation to spend from October 1 - the start of the new US fiscal year - in turn forcing more than 800,000 public servants to stand down without pay and freezing "discretionary" US government spending, or about 35 per cent of the US government's \$US3.5 trillion budget.

Early in 2010, before the Republicans regained control of the house on the back of Obama's waning, recession-induced popularity, the Democrat-controlled congress passed Obama's signature Affordable Health Care Act, known as "Obamacare" - a \$US100bn-a-year increase in tax and spending that mandates health insurance for the third of Americans without it.

It was due to start on Tuesday, but house Republicans, now in control, wanted a delay of a year in return for renewing the government's licence to spend. The President, along with his sympathetic Senate, have refused to negotiate.

Adam Lockyer, a lecturer at the US Studies Centre at the University of Sydney, says the Republican Party has been mugged by its "grass-roots" Tea Party wing, which is opposed to expanding government at any cost.

"The house Speaker, John Boehner, and Senate minority leader, Mitch McConnell, are more traditional Republicans, but the Tea Party's power in the Republican 'caucus' means they have to continue to block supply," he says, suggesting Boehner is scared of losing his powerful speakership.

"Democrats, after all, are only seeking the money for Obamacare; the legislation itself passed back in 2010 before the make-up of the congress changed," Lockyer says.

"The public hates all sides in DC right now," he adds, pointing out congress's approval rating among Americans has dropped to a record low of 10 per cent; but he, like many others, suggests the Republicans will probably give ground because the US public appears to be blaming them.

"They haven't learnt their lesson: the last time the Republicans played silly buggers 17 years ago the government shut down for 21 days and Clinton went on to win a resounding second term," he says.

To most Australians, Canadians and British, substantial government involvement in health care is natural, but not in the US, where small-government ideology still enjoys widespread

popularity. Chris Edwards, a senior fellow at the Cato Institute in Washington, tells Inquirer Obamacare barely scraped through in 2010 and remains deeply unpopular.

"The Republicans have failed comprehensively to explain to the public their strategy, but they wouldn't be doing this if Obamacare was popular," he says, noting more than 50 per cent of Americans were against and 38 per cent for it in the latest polls.

Cochrane is sympathetic too: "The conventional wisdom is to deplore the Republicans, but they never voted for Obamacare; personally, I think the Tea Party types are principled," he says, adding that it is healthy for a country to debate vociferously such a big reform. "This is the conversation Greece should have been having 10 years ago."

Kirchner says Tea Party activists are reading from a script with bipartisan endorsement. Republican elder Newt Gingrich this week was at pains to point out that shutdowns have already occurred - 17 times since 1976 - and are a normal part of the US governmental process.

"Whatever you think of the tactic, president Reagan hit the debt ceiling in the mid-1980s and the Democrat-controlled congress similarly tried to extract policy concessions," says Kirchner.

When president Franklin Roosevelt took the US off the gold standard in the 1930s, the US government reneged on its promises to redeem paper obligations in gold. But since then it has never defaulted on its obligations, although it did come close in August 2011 when the Republican-controlled house refused until the last minute to raise the debt ceiling to enable the Obama administration to pay its bills. Rating agency Standard & Poor's later withdrew the US's AAA-credit rating.

Wolfers says the shutdown - which S&P estimates reduces real GDP growth by 0.3 percentage points every week it runs - doesn't worry economists much, but the potential for a default does.

"We had a whip around a few days ago at Brookings in a room full of senior former policymakers and consensus was there was 15 per cent chance the debt ceiling wouldn't be increased," he says.

"That's a surprisingly high number; it is in effect 15 per cent times a very big potential punch in the mouth." US betting agency Paddy Power is offering \$US4.50 on a \$US1 bet the US defaults on its loans by the end of the year, about a 22 per cent chance.

Of course, the US doesn't have to default on its debt: it could simply cut its non-interest spending by the same amount. "An overnight cut in spending equivalent to the current deficit, 4 per cent of GDP, would be the biggest fiscal contraction in history and certainly plunge the country into recession," warns Wolfers. He points out, however, that the US Treasury would struggle to determine how to allocate such massive spending cuts across different portfolios

But Cochrane mocks the notion big cuts in public spending would undermine economic growth: "Remember how the world was supposed to end earlier this year when the 'sequester' kicked in

and US spending was cut? Well there's been no impact," he says. "If you don't think the key to prosperity is the US government wastefully taxing and spending then you wouldn't worry much."

Whatever the truth, at least economists can estimate the impact of a cut in spending; far scarier is a default on any of the US's \$US16 trillion-plus stock of debt securities.

Wolfers chides the Tea Party for being so pessimistic about the US's fiscal outlook. "In a short space of time the deficit has dropped from around 10 per cent to around 4 per cent."

Indeed, the Congressional Budget Office, the government's independent fiscal forecaster, projects US budget deficits and the total stock of public debt relative to the economy will decline to about 2 per cent and 70 per cent respectively by 2016, before spending spirals out of control thereafter.

"Sure, over the next few decades healthcare costs are projected to rise unsustainably," says Wolfers, "but over the coming few years we can actually estimate confidently the deficit is shrinking and debt ratio falling."

Again, Cochrane demurs, suggesting the CBO's rosier outlook is predicated on the US returning to trend economic growth, which, as in Australia, has continually failed to happen since the GFC.

"When the US government has to roll over its \$US18 trillion-odd of debt at 4 per cent instead of near zero interest rates we'll see how sustainable it is," he quips. Interest payments currently make up about 7 per cent of US federal spending, or \$US223bn this year.

Like Gough Whitlam in Australia, Obama has an alternative to crashing: crashing through. Notwithstanding an unprecedented constitutional crisis, some legal scholars believe the President could ignore congress's debt ceiling because of a section of the US Constitution that obliges the government to honour its debts.

It is an academic debate that nicely reflects the uncertainty endemic in the US's three-pillar constitutional framework. That encapsulates the principle, popularised by 18th century French philosopher Montesquieu, that the executive, legislature and judiciary be separate.

A Washington Post article earlier this week, which went viral in Australia, lauded by contrast Australia's arrangement - where government and parliament are fused - for its political versatility, citing the dismissal of the Whitlam government as an example.

"You might find yourself wishing that the United States could follow Australia's example: fire everyone in congress, hold snap elections next month and restart from scratch," wrote Max Fisher.

Wolfers, an Australian, is dismissive of a system that allows a schizophrenic congress to foist laws on a president that result in a deficit, and then subsequently threaten to, and potentially withdraw, his power to borrow to implement them.

Lockyer agrees: "Compared to the Australian system, the US has more checks and balances, and so it is harder to get things done."

Wolfers says the Australian political system is "vastly better", nimbler and more conducive to reform. "If you look around the world you see countries with AAA-credit ratings tend to be strong two-party Westminster-style democracies," he says.

- See more at: <http://www.theaustralian.com.au/business/opinion/another-global-meltdown-at-stake-as-us-plays-fiscal-russian-roulette/story-fnc2jivw-1226733203752#sthash.sKePZJeu.dpuf>