Washington Flirts with a Debt Disaster

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Lunacy abounds in every field, though it seems to appear most prominently in Hollywood and Washington, D.C., where the media takes notice.

Monday's warning from Wall Street on the debt, coincided with a full moon, which triggered on the same day: a statement of theology, a statement of theory, and the truth about the impending federal debt ceiling.

First, we had a statement of theology: Prominent anti-tax activists went on the attack. Any tax increase, even closing tax loopholes, dooms the Republic, they proclaimed. The problem isn't that we have too few taxes, but that we have too many federal programs. So, this belief system posits, any notion that taxes should increase by any means is inherently heresy.

Second, this was followed by a statement of theory: *Politico* ran a guest editorial on the debt ceiling by Jagadeesh Gokhale, a senior fellow at Cato Institute and a former senior economic adviser to the Federal Reserve of Cleveland. Gokhale asserted that "a temporarily frozen debt limit could instead signal U. S. lawmakers' resolve to get our fiscal house in order" and termed a technical default "a temporary suspension of fiscal operations to promote a more prudent fiscal course."

Third, we received the truth from the marketplace: JP Morgan's fixed income analytical group, who provide research and analysis to large market participants, produced almost simultaneously its analysis of what a technical (one or two day) default would do to markets globally. One cannot do the entire work justice in a short blog; but, the JP Morgan group concluded, among other things:

that any delay in making a coupon or principal payment by Treasury would almost certainly have large systemic effects with long-term adverse consequences for Treasury finances and the US economy.

Well, what a fine mess Secretary Geithner has gotten us into this time!

The theologians believe that under no circumstances should taxes be raised, even if necessary to get the congressional votes to raise the debt ceiling. If you do so, you will go directly to political Hell and not collect $200.

The theoretician speculates that a short-term technical default by Treasury might actually be good for the economy long-term and that any harm in the short run would be offset by such a demonstration of fiscal seriousness.

The truth, told by folks who lose their jobs when they are wrong, is that even a technical default would have serious long-term consequences to both the Treasury and the U.S. economy.

As we've said before—most notably in response to the notion that having "30 good Republicans in the Senate" is better than having a Republican-controlled Senate—theologians don't mix well with governance.

Theorizing retains a critical role in the effort to discover truth, but serves much less well in the practical world of trying to handle the finances of the world's largest economy.

The truth speaks of the real world as it perceives matters now.

For Treasury, credit markets are the real world; indeed, credit markets may be the only universe that the world's largest debtor nation needs to pay attention to.

As debate continues among those who call for quick action on the debt ceiling and those who believe we can in theory shock government painlessly into saving $120 billion or that low taxes are so sacred that any attempt to raise revenue will bring on damnation, it's good to keep something in mind.

However much we might dislike it, for the Treasury, the truth resides in market reaction.

The rest remains a matter for college sophomores in late night discussions over controlled substances, and for gatherings of the faithful.

Topics:debt, deficit, Republicans, Wall Street