# Economists: Breaching the Debt Ceiling "Uncharted," But "Not...a Catastrophe"

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Apocalyptic talk flies around about the consequences of breaching the debt ceiling—that is, letting the federal government run out its borrowing authority and failing to let it run up the credit cards any further. Establishment figures warn that, with the goverment spending far more than it takes in in the form of tax revenues, the leviathan on the Potomac will not only be unable to pay its bills if the debt ceiling isn't raised, but that it could default on payments on its existing debt and cause an international financial crisis. Not incidentally, that would raise the price of future borrowing to the U.S. as the federal government became a higher-risk customer. President Obama claims "every economist out there is saying" that "millions of Americans—not just federal workers—everybody faces real economic hardship" if the debt ceiling isn't raised.

But, is it true? Does every economist out there see doom if the debt ceiling isn't raised?

To find out, Reason approached several prominent economists and asked them a simple question: Reason Magazine is doing a piece on the debt ceiling, and we were wondering what your take is on the consequences of breaching it? Will it be a catastrophe or not? We've already mentioned Nobel Prize-winner Vernon Smith's answer, but he wasn't the only one to chime in, nor was he the only one to see a potential upside to keeping the debt ceiling where it is.

New America Foundation / photo on flickrBruce Bartlett is a one-time Ron Paul staffer who went on to become Vice chairman of the Joint Economic Committee of Congress under President Reagan and a senior policy analyst for President Bush the first. He's since become something of a Keynesian and refers on his Twitter feed to fiscal hawks as "wankers." About the debt ceiling he told Reason, "I have no idea. I think we are entering uncharted waters and only a fool would do such a thing."

Short and pithy and unenthusiastic about leaving the debt ceiling unhiked—but not really a prognostication of doom.

Harvard UniversityGreg Mankiw, Chairman of the Council of Economics under President Bush, the second, and now chairman of the Department of Economics at Harvard University, agrees about the degree of uncertainty inherent in breaching the debt ceiling.

"It is hard to say for sure, as it is largely uncharted territory. My sense is that if the Treasury prioritizes debt service over other spending, then the bond market should not fear default on government bonds. However, the administration has asserted that such prioritization is impossible, which strikes me as implausible.

The one clear risk is that the sudden reduction in government spending could contract aggregate demand and push the economy into recession."

Chapman UniversityBy contrast, Vernon Smith, professor of economics at Chapman University's Argyros School of Business, and 2002 co-winner of the Nobel Prize in Economics, takes the prospect of a frozen debt ceiling, and even a debt default, in stride.

"No, it will not be a catastrophe. The U.S. is one of the few countries in the world and in history that has NOT defaulted on its debt; consequently we suffer the consequences of the curse of a reserve currency. The great housing-mortgage market bubble, 1997-2006, was fueled by a massive inflow of foreign investment funds. This is the other side of our deficit on trade account which looks like a sweet deal in which foreigners send us more goods and services value than we send them. But it has negative consequences and cannot be sustained indefinitely."

By Smith's take, making the United States less attractive as a destination for foreign investment might spare us future bubbles, and so have an upside.

Mercatus CenterAlso seeing a silver lining in the debt-ceiling cloud is Lawrence H. White, a former visiting scholar at the Federal Reserve Bank of Atlanta, professor of economics at George Mason University, and a member of the Mercatus Center Financial Markets Working Group. Like Mankiw, he points out that the federal government can still service debt even without a hike in the debt ceiling. He also suggests that a freeze of further borrowing might be what it takes to force the federal government to reduce spending.

"Reaching the debt ceiling does not imply default on 'full faith and credit' Treasury debt, because the Treasury has more than enough income to make the interest payments due on the debt. But it does imply that other spending will have to be cut in order to pay the interest due on existing debt without borrowing more. I'm in favor of reducing that other spending, so that result doesn't strike me as a catastrophe."

Harvard UniversityThe one economist who spoke to Reason and is willing to invoke the "C" word is Harvard University's Jeffrey Miron. A Senior Lecturer and Director of Undergraduate

Studies in the Department of Economics at Harvard University, and a senior fellow at the Cato Institute, Miron says there is no reason that hitting the debt ceiling necessarily means defaulting on the debt—the government has option to avoid that. He fears, though, that poor management could lead to disruptive effects. He warns, too, that while there are few good paths to shrinking gvernment and eliminating bad policy, standing firm on the debt ceiling is unlikely to be the exception.

“I think there's a moderate to good chance it'll be a catastrophe. 'Catastrophe' is bit strong, but there's a moderate to good chance it'll be extremely disruptive and costly, in part because of the way people handle it. That said, there are certainly things they could do in the short term to manage it even if we hit the debt ceiling. For example, we could prioritize which payments we make. Every single day, we're paying interest or credit orders, social security checks, salaries of government employees, on and on and on. We have more than enough revenue to keep paying the interest payments, the explicit debts. People equate getting to the debt ceiling with default-that's not right. It doesn't necessarily have to happen this way. We could send people to whom the government owes money IOUs, and if people believe those IOUs will be paid within 6 weeks or a month that doesn't necessarily have to be so disruptive. We could tell everyone, we're only give you 90 cents on the dollar and we'll give you IOUs for the rest. The benevolent libertarian might say, well, what are the really stupid things the government spends money on, let's cut those because they're bad for the economy anyway. It is certain to be disruptive, asset markers are likely to react quite negatively. It's certainly something we want to avoid.

I understand why people who are thoughtful advocates of small government see it as, we don't have any clout left to reduce government. Hanging tough on the debt ceiling is the only arrow left in the quiver. So even though it might be disruptive, we have to play it. My heart says it won't work out that way. If we end up having some disruptive effects, the history of government policy is that in bad times we create more bad policy. You're not going to get rid of existing bad government policies. So, I think it's not the most effective way of shrinking government, meanwhile understanding that it's hard to shrink government.

So...There you have it. Breaching the debt ceiling is a venture into uncharted territory with uncertain consequences. It may well have a downside and even be foolish—with a chance of "disruptive effects." But there is a potential for beneficial outcomes, too, *if* failing to hike borrowing limit reduces the likelihood of future bubbles and forces reductions in federal spending.

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