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Time for a debt ceiling stare-down

By JAGADEESH GOKHALE | 6/7/12 9:42 PM EDT

Political analysts are already wringing their hands raw over the prospect of another debt ceiling faceoff between Democrats and Republicans.

But we should have one — the more contentious, the better.

Treasury Secretary Timothy Geithner says that Congress should avoid another such debate because of “drama and the pain and the damage that they caused the country.” He’s correct about the drama — but it was beneficial.

The only pain and damage that resulted was probably to him and his staff — who had to figure out ways to keep the federal spigot open in case the Treasury’s borrowing authority expired during early August last year. Financial markets and the economy provide no evidence for the treasury secretary’s “pain and damage” claims.

The conventional wisdom that a vigorous debate on increasing the debt limit will cause financial Armageddon is wrong, as I suggested earlier. Indeed, a temporarily frozen debt limit would bolster legislators’ resolve to get our fiscal house in order and could prove salutary.

Markets shrugged off last year’s contentious budget negotiations between House Speaker John Boehner (R-Ohio) and President Barack Obama, Standard & Poor’s downgrade of Treasury securities and the supercommittee’s failure, which triggered the automatic spending sequesters that no one likes. Conventional wisdom was proved wrong then and is likely to be proved wrong again early next year.

Take Treasury interest rates. The argument that they were governed by fear, as people shifted portfolios toward safer securities, is meritless. Treasury interest rates continued to decline even after the debt limit was increased in August. Interest rates started to rise, finally, in December — when better news emerged about the economy’s performance. Evidence from U.S. interest rate spreads in mid-2011 also didn’t indicate any increased likelihood of a coming recession.

The stock market also remained rock steady during the entire debate period. The broad S&P 500 equity index remained flat over the first seven months of 2011, averaging 1312 through July 31, and fluctuated less than during the corresponding periods of 2009-10. On Aug. 1, 2011, it was 1286 — higher than at the beginning of the year. It fell only after Standard & Poor’s downgraded Treasury debt — a decision that significantly dented that agency’s reputation as an astute evaluator of all things financial. After a brief post-

downgrade decline, the S&P 500 index increased smartly as the economy improved during the last quarter of 2011.

These market outcomes suggest that the debt-limit debate may actually have strengthened the economy rather than damaged it. Indeed, the debt limit written into U.S. law may prove to be an important — if not the strongest — lever for prying fiscally prudent policies out of recalcitrant future Congresses.

The last debate spawned two alternative procedures for cutting federal spending: an agreement on automatic cuts worth $1.2 trillion and the congressional supercommittee, charged with seeking an even broader budget deal, if possible.

Earlier work by the Simpson-Bowles commission, the Gang of Six and the Rivlin-Domenici panel provided examples of the types of fiscal adjustments that the supercommittee might consider. But it failed, perhaps because of its poor design or because it was less ambitious than those alternative efforts and could not be seen as settling for less.

Nonetheless, the debt-limit debate did deliver significant budget cuts. Though those cuts are a long way from eliminating the long-term federal budget imbalance, they will make the task easier.

It's useful to consider the alternative to a bruising debt-limit debate aimed at curtailing federal spending and eliminating tax loopholes. A perfunctory increase in the debt limit merely increases the likelihood of an eventual violent market reaction — like we're seeing in Europe's debt-saddled countries. Greece and Spain are already experiencing great depressions, with unemployment rates in excess of 20 percent. Other European dominoes are struggling mightily to claw back from a debt-driven economic implosion.

If we are to avoid the same fate, Boehner would be well advised to go at it hammer and tongs — to achieve the largest spending and debt-reduction agreement possible.

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