Sydney Morning Herald

Obama stares into the abyss

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July 30, 2011

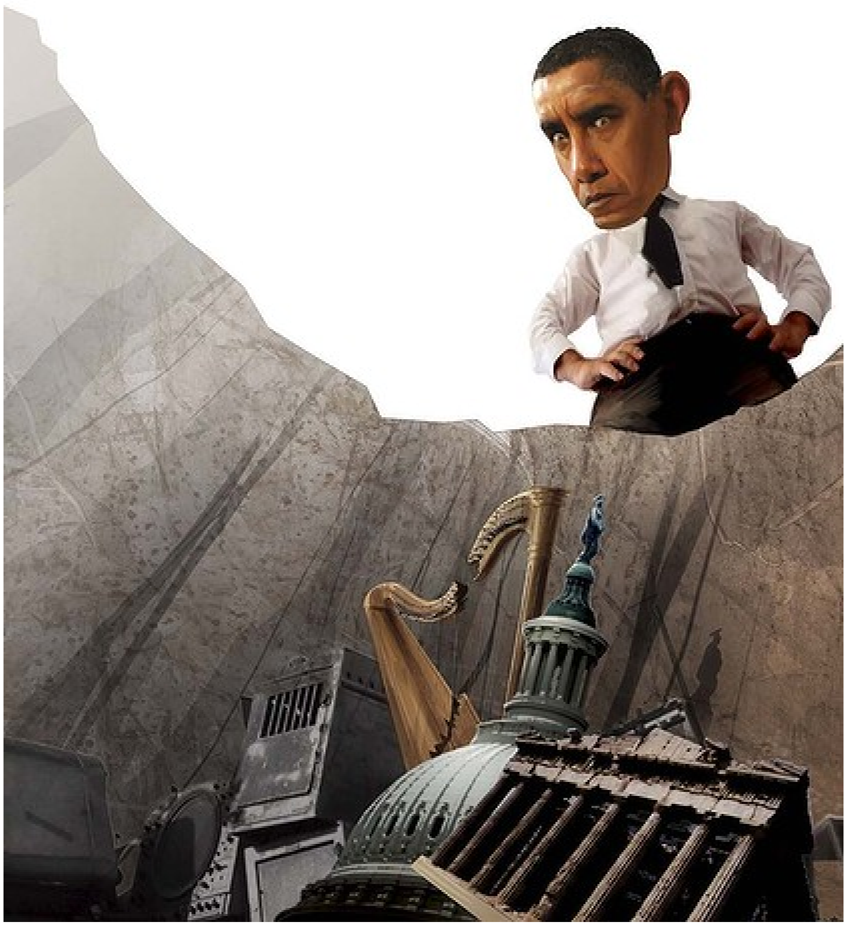

Illustration: Michael Mucci

The indebted US is desperately trying to dodge a downgrade, writes Simon Mann.

Barack Obama turns 50 on Thursday. With a bit of luck, the American President might also be celebrating the Houdini-like escape of the world's biggest economy from defaulting on its debt - that's if compromise can finally break the chains of one of the most partisan Congresses in history, and America's borrowing limit is raised so that Washington can keep paying its bills.

Still, that might prove to be cold comfort.

Regardless of a deal on the debt ceiling, Obama stands to become the first president to preside over the loss of the nation's coveted AAA credit rating which, in itself, would be just as damaging to an already slowing recovery as a default proper.

Hoping to break the debt deadlock ... the US President, Barack Obama, centre, meets with the House Speaker, John Boehner, left, and the Senate Majority Leader, Harry Reid, in the White House. *Photo: AFP*

Extending America's ability to borrow without a deeper overhaul of its spending to rein in its $US1 trillion-plus annual deficits, risks the wrath of international credit rating agencies. "It's not just about the debt limit but a question about the sustainability of the fiscal situation," Mark Calabria, of the Cato Institute, summed up for *The Washington Examiner*.

That the agencies should hold the near-term fate of the US economy in their collective hands, indeed, amounts to rude irony.

It was those self-same arbiters of financial good health that had marked as top-notch many of the riskiest Wall Street securities that proved the accelerant for the global financial crisis, which collapsed economies, put millions of people out of work and prompted Keynesian pump-priming by governments worldwide to avert a depression.

"If you think deficit-reduction is being driven by [Republican] John Boehner or [Democrat] Harry Reid, think again," argued the liberal economist Robert Reich this week. "The biggest driver right now is Standard & Poor's."

Twisting his knife, Reich continued: "Had [the ratings agencies] done their job and warned investors how much risk Wall Street was taking on, the housing and debt bubbles wouldn't have become so large - and their bursts wouldn't have brought down much of the economy."

But that, too, is of little consolation, because on Capitol Hill it was executives of the big ratings agencies who were again dictating terms this week, unwilling to articulate what it would take for the US to avoid a downgrade of its creditworthiness, but imparting a message nonetheless.

Sure, if Congress could commit to reducing the nation's deficits by $US4 trillion ($3.6 trillion) over 10 years, the government would be "within the threshold" of doing what was necessary to retain its top-shelf standing, testified an S&P executive, Deven Sharma.

But what of the only two plans being championed in the corridors of the Capitol, those sponsored by the House Speaker, John Boehner, and the Senate Majority Leader, Harry Reid, and whose headline-spending cuts were perhaps half that amount?

Sharma was vague, conceding only that "some of the plans" bandied about in recent weeks were in the zone when it came to meeting the agency's AAA criteria.

But should S&P (and/or Moody's and Fitch) pull the pin on USA Inc in coming weeks, it is sure to inflict bruising consequences, no matter Robert Reich's plaintive tone: "Who is Standard & Poor's to tell America how much debt it has to shed in order to keep its credit rating?"

Though financial markets took a while to wake to the reality, content perhaps in what some took to be the US legislature's default position - "In Washington, it's always the 11th hour," was the sweating capital's apparent state of mind - by midweek Wall Street was taking its licks in daily falls, prompting CNBC's frenetic blow-by-blow coverage of trading to cut to ad breaks to the sounds of Paul Simon's *Slip Slidin' Away*. "You know the nearer your destination/The more you're slip slidin' away."

As news channels scrolled "Countdown to crisis" across the TV screens of Americans, just as publicly-displayed debt "clocks" in recent years have recorded grimly the relentless climb of America's borrowings beyond $US14 trillion, the hazy days of the northern summer were giving way to a searing new reality: that America was on the brink of something unique and ugly.

The die had been cast in this acrimonious debt debate long before the president's televised, prime-time warning to Americans this week. Outlining the implications of a default, Obama told them: "For the first time in history, our country's triple-A credit rating would be downgraded, leaving investors around the world to wonder whether the US is still a good bet.

"Interest rates would skyrocket on credit cards, on mortgages and on car loans, which amounts to a tax hike on the American people. We would risk sparking a deep economic crisis - this one caused almost entirely by Washington."

Caused by Washington? Well, yes, because the negotiations have been propelled by a certain artificiality: the US is not insolvent, and the debt ceiling has been raised routinely by Congress ever since it was first put in place in 1917 so that the US Treasury could issue bonds to pay for America's involvement in World War I.

The ceiling has been raised on 78 occasions since 1960 - 49 times during Republican administrations and 29 times while a Democrat has inhabited the White House. It has been hiked 10 times since 2000, as America borrowed to pay for wars in Afghanistan and Iraq and unfunded policies.

Presidents Reagan, Bush Senior and Clinton presided over increases to the national debt of between $US1 trillion and $US2 trillion. But the policies of George W. Bush - unfunded wars, two rounds of big personal income tax cuts and a generous expansion of subsidised prescription drugs for the elderly - added $US6 trillion more.

When the recession hit, tax receipts plunged, while remedial action - industry bailouts and a broad stimulus - started by Bush and carried on by Obama, racked up debt of many billions more. In Obama's 30 months in office, the debt has risen by $US960 billion a year.

An increase in the ceiling was always going to be necessary to accommodate the economy's rescue and then, optimistically, to maintain its recovery. The US bumped up against its debt ceiling back in May and authorities have been shuffling accounts and funds to stave off default until now - at least, until next week, when Treasury says its pea and thimble trick will finally be exposed.

Increasing the borrowing limit in the past had been a bipartisan decision, notwithstanding some grizzles and a little grandstanding. A freshman senator from Illinois in 2006 spoke against lifting the ceiling, for which Obama is frequently chided by gleeful foes.

But Republicans, who took control of the House of Representatives after last November's mid-term elections, made any increase in the borrowing limit conditional upon a deficit-reduction plan.

Many newcomers, backed by the conservative Tea Party, had campaigned hard in support of low taxes and limited government, an ethos long ingrained in the pioneering American psyche. Once empowered, some of them flatly refused to vote for an increase in the debt ceiling under any circumstances.

While Democrats generally agree that government spending must be checked, the parties disagree over the make-up of any deficit-reduction measures. Republicans have pushed for cuts in government spending and for further tax cuts to put the private sector back in the driver's seat of job creation; Democrats, generally, favour a mix of cuts and increased tax revenues garnered from the closure of tax breaks for the rich and big corporations. Obama identified more than $US800 billion of loophole savings over a decade.

But now, truly in the 11th hour, hope rests with the Boehner and Reid plans, and Congress has barely three days left to bridge their differences before Tuesday, the Treasury's nominated deadline for beating default.

Both plans nominate only spending cuts. But the major discrepancy between them is the corresponding size of the debt ceiling increase. Boehner's plan wants to increase the limit enough to get the government through to Christmas; Reid's to take Washington beyond next year's November elections. Indeed, Obama, already wary of a tough road ahead to a second term, says he would veto any bill that contained only a short-term "fix".

Ultimately, a compromise could rely on the two pieces of legislation somehow dovetailing or for legislators to turn to a "break-the-glass" option proffered by the Republican senator Mitch McConnell. His plan allows for a staged rise in the debt ceiling in return for spending cuts and a little political theatre that would give Congress the right to record votes of disapproval.

With nerves fraying fast, business groups were champing yesterday, demanding that action be taken to avoid a default. And newspaper editorials barked in increasingly desperate tones a similar instruction: "The debate over raising the debt ceiling has passed the point of usefully concentrating the mind on the need for debt reduction," declared *The Washington Post*.

"Now the hanging moment is nigh. It is time for the remaining grown-ups in Washington - and we trust there are some - to figure out how to help the country slip off the noose. The debt ceiling needs to be lifted. The alternative is unthinkable."

Though D-Day looms, some analysts - and hard-nosed Republicans such as the 2012 presidential candidate Michele Bachmann - argue that the government could continue to avoid default beyond Tuesday by prioritising its payments. First, pay investors their interest on US-backed securities, dispatch August's 70 million cheques to social security recipients and pay the military.

Contends Bachmann, staunchly opposed to any rise in the debt ceiling, the move would force the government to cut its cloth accordingly. But with not enough to go around, government workers would miss out, as would grant recipients. Disruption would be severe, warn economists and Treasury officials. And the notion of staving off default would be unsustainable.

Ironically, it was a hero of the Tea Party clan, to which Bachmann aligns herself, who previously warned of the dangers of not raising the debt ceiling. "The full consequences of a default - or even the serious prospects of a default - by the United States are impossible to predict and awesome to contemplate," wrote Ronald Reagan in the 1980s.

Even now, default or no default, America's standing is being undermined by Washington's political rancour. "Our aura is diminished," the chief economist of Moody's Analytics, Mark Zandi, conceded last week. "You know people really view the US as the AAA, the gold standard, and I think we're tarnishing that."

While Standard & Poor's says it takes account of the political environment when looking to adjust sovereign ratings, Moody's and Fitch have avoided passing judgment on the political mayhem. The former has said it won't downgrade the US unless Washington defaults on its loans, while Fitch officials indicated that a default would prompt it to put the US on "rating watch negative", a pointer to a possible downgrade.

And analysts have found the exact impact of a cut in the nation's credit rating difficult to quantify. Some say the likely rise in interest rates might be contained to 0.25 percentage points in the short term, provided the psychological blow of a downgrade inspired new political resolve to find a proper path to correcting America's runaway deficits.

But JP Morgan Chase assesses the extra burden on the federal government to be anything up to $US100 billion a year in additional interest payments, exacerbating an already stretched balance sheet, and with knock-on consequences severe enough to plunge the economy back into recession.

"That's a huge number: we're talking about, sort of, a long-term and permanent increase in US borrowing costs," Terry Belton, the global head of fixed interest strategy, told reporters on a conference call.

Already, Washington pays $US250 billion a year servicing its debt - more than it spends on education, transport and public housing combined. But as well as increasing the federal government's costs, a downgrade would impose higher costs on cash-strapped states straining to meet their constitutional requirement of a balanced budget.

Moody's has already placed five of 15 AAA states - Maryland, Virginia, New Mexico, South Carolina and Tennessee - on review for a possible downgrade because of their heavy reliance on federal government subsidies.

Even if America avoids a default on Tuesday, the legacy of these tortuous times will be a steep political price. But who should pay it? "The reality is that the debt limit will be raised one way or another," *The Wall Street Journal* said matter-of-factly in its editorial. "And the only issue now is with how much fiscal reform and what political fallout."

The journal took aim at Republican conservatives for their "crack political thinking" in undermining Boehner's efforts. And while plenty of Americans in opinion polls have regularly backed Obama's call for increased revenues to be a part of any attack on the deficit, growing numbers express bemusement at his inability to take matters by the scruff of the neck.

That could change, should the 44th president take the advice of the 42nd, Bill Clinton, and unilaterally lift the borrowing limit under the guise of the 14th amendment of the constitution, which says the public debt of the US "shall not be questioned". The White House says it is not countenancing such a move. But desperate times may call for desperate action.

Obama had in recent weeks thrown into the mix his so-called "grand bargain", a $US4 trillion deficit-reduction plan over 10 years that threatened to strain relations with his political base.

But his vision - and both plans now competing at the death knock - do not address America's under-funded entitlements programs, foremost its Medicare scheme of subsidised care for the elderly, which are on an unsustainable fiscal trajectory.

Staving off default now, only to have the ratings agencies downgrade America anyway, would be akin to Obama winning the battle but losing the war.

And "presidents bear most of the blame for that type of thing," said Mark Calabria, the director of financial regulation studies at the Cato Institute, observed in his interview with the *Examiner*.

"If someone gets laid off, they don't think back to the process that got them there. He's the economic steward," Calabria said.

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