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Hitting the debt ceiling would be much worse than a government shutdown

By: Ezra Klein - January 15, 2013

Repeat after me: Breaching the debt ceiling is not the same thing as a government shutdown.

A lot of Republicans seem to believe it is, or at least seem to be trying to believe that it is, and for good reason. Taking the debt ceiling hostage is a tricky political play. On the one hand, the appeal is that breaching the debt ceiling is so dangerous that the Obama administration can't possibly let it happen. That's where the leverage comes from. On the other hand, unleashing economic chaos unless you get your way is a tactic more closely associated with Bond villains than successful political parties.

So an odd two-step has emerged. On the one hand, Republicans argue that the president will have to negotiate over the debt ceiling, as the consequences of holding back will be disastrous. On the other hand, they argue that breaching the debt ceiling really wouldn't be that bad. So long as we keep paying our bondholders back, the financial markets should remain calm. All we'd see is a government shutdown.

Let's assume, for a moment, that the Treasury Department actually can choose which bills to pay and which to ignore. That assumption is legally, technically and politically questionable, as Brad Plumer explained. Note that the one time we actually did default on our debt, it was the momentary result of a computer glitch, and the markets freaked out. The idea that we'll simply rewire all our payment software over the next month so we can pick and choose which payments to make and we won't see even the slightest problem requires a faith in government IT departments that I find surprising coming from the Republican Party. But ignore all that. Would the markets really be so calm in the face of the United States government doing something it has never done before and purposefully breaching the debt ceiling? The investors I asked pretty much laughed in my face.

Mark Spindel, chief investment officer for Potomac River Capital, didn't mince words. Over e-mail, I asked him whether we could breach the debt ceiling but keep paying off bondholders without causing markets to flip out. "Ezra," he wrote back. "This is insane.

"If Congress (and to a lesser extent the President) continue to appear as dysfunctional as they do, then the markets will be bothered."

That said, they may not be bothered in precisely the way we expect. One scenario Spindel laid out — and that other investors mentioned to me — is that the interest rate on government debt might actually fall. "I could easily see Treasuries rallying (especially on the wacky scenario you propose). The government is broken, people would up their savings rate, equities would get killed, and we'd enter some kind of awful mini recession."

Thomas Gallagher, a principal at the Scowcroft Group, also focused on the effect on the economy. "Running the government on a cash basis would have a bigger impact that the cliff," he wrote in an e-mail. "The cliff was almost 5% of GDP, and keeping the debt ceiling where it is would produce a drag of about 7%." That is to say, the economic damage of breaching the debt ceiling, even if all went well, is about 40 percent more than going over the fiscal cliff, and that's before you factor in the reaction from the financial markets.

Lee Sachs, a Wall Street veteran, was assistant Treasury secretary for financial markets from 1999 to 2001 and a counsel to Treasury Secretary Timothy F. Geithner from 2009 to 2010. As such, he's a guy who has actually had to deal with the financial markets when Washington began terrorizing them. His e-mail response to my question could best be described as bemused. "As long as we are through the looking glass…" he began.

"The analogy I would use is if you were considering lending money to or buying the bonds of a company that was paying interest on outstanding debt, but wasn't paying its employees or suppliers in an effort to save cash, would you make the loan or buy the bond without some sort of substantial yield premium?" He asked. That's a particularly important point when it comes to government debt as we have to "roll over" hundreds of billions of dollars in debt over the course of each month. The idea that the market will treat those auctions as normal is optimistic, to say the least.

Michael Tanner, a Cato Institute scholar who favors holding the debt ceiling hostage, addressed this concern in an article for the National Review. "Theoretically, there could be a problem if no one is willing to buy the new securities," he writes. "More likely is the possibility that Treasury might have to offer higher interest rates on this rolled-over debt, a not insubstantial concern: A one-percentage-point increase in interest rates could cost taxpayers more than $100 billion per year." This is, he says, an acceptable price to pay for forcing the Obama administration to cut spending. Of course, if things don't go quite as Tanner hopes and Republicans fold without securing big spending cuts, this is one way a debt-ceiling crisis could lead to much larger deficits.

"Markets are hard to predict," says Sachs. "But even if there's 'only' a 65% probability the markets go haywire, its a risk we cannot afford to take. You don't play Russian roulette even though you believe the odds are in your favor."

I want to stress that all of these responses are considering a best-case scenario in which we manage to reorganize our payments with no legal uncertainty and no technical glitches. And even then, what we're talking about is economic damage on a scale much larger than what we were considering in the fiscal cliff paired with much more fear on the part of the markets and much more potential for things to go awry in catastrophic fashion. The consequences, too, will be more lasting: Now that we've purposefully breached the debt ceiling once, the markets will have to consider the possibility that we could begin doing it regularly.

Of course, if Republicans just want to use a government shutdown as leverage, they have an opportunity coming at the end of March, when the next bill to fund the government needs to pass. Everyone agrees that would be a far less dangerous than breaching the debt ceiling. But for that reason, Republicans know full well that Democrats aren't really afraid of it, and so it doesn't give them much leverage.

This, then, is the Republican dilemma: What if they convince themselves that breaching the debt ceiling won't be that bad, and then it is bad — far worse, even in an optimistic scenario, than the fiscal cliff, which they also weren't willing to risk — and they take all the blame? The likeliest answer is they'll quickly fold, and in addition to having discredited debt-ceiling brinksmanship as a viable political tool, they'll have discredited themselves, as well.