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Aftermath of a Debacle: Raising the Debt Ceiling

Since early this year, I predicted that Washington would get through the 2011 government funding crises—possible shut-downs and a borrowing limit increase—with band-aids, cutting spending but not addressing the real drivers of future deficits, namely, entitlement reform and taxes. I predicted the stalemate on meaningful deficit reduction efforts could lead to a downgrade in the U.S.’s credit rating, severe negative reaction from China, and a market swoon beginning in May (when federal stimulus ran out and spending cutbacks began). Six months later, all this has come to pass.

I’ve suggested repeatedly that Washington will finally undertake meaningful, long-term deficit reduction only upon the occurrence of a “forcing event,” an external event that creates a looming crisis and forces Congress to take difficult action. I noted as examples of forcing events the consequences of China slowing its purchases of U.S. debt or the rating agencies revoking the AAA rating on U.S. Treasuries.

Events on the debt ceiling played out as I predicted. Hardliners in the Republican Party rejected a “grand plan” crafted by President Obama and Speaker Boehner that would have reduced the deficit by \$4T (the minimum amount regarded as needed by experts), because the plan called for tax increases. Thereafter, the parties could not identify even the \$2T in spending cuts the Republicans demanded to raise the debt limit through 2012.

Ultimately, the sides agreed on a cumbersome two-step process:

- \$900B in spending cuts to take effect over ten years beginning in 2012.
- The formation of a bipartisan Congressional committee to identify at least \$1.2T in additional cuts. The committee must produce a plan by mid-November and Congress must consider it in an up-or-down vote by year-end.

- If the committee fails to identify \$1.2T of cuts or Congress rejects the committee plan, the automatic imposition of across-the-board spending cuts of \$1.2T will begin in 2013 (“sequestration”). These cuts could not affect Social Security, Medicare, or Medicaid benefits. The cuts would be split evenly between defense and non-defense programs. (The hope is that the draconian defense cuts imposed by sequestration will prompt the Republicans to agree on an alternative plan in committee.)

Taken together, the hard-fought compromise provides cuts of only \$210 billion per year, not nearly enough to address projected annual deficits reaching \$1.6 trillion.

How did these perpetrators of a possible “forcing event” react to this deal? Not well. Standard & Poor’s carried through on its threat to downgrade U.S. debt in the wake of inadequate Congressional action, noting that “The [debt limit] plan falls short of what [is] necessary to stabilize the government’s medium-term debt dynamics. Republicans and Democrats have only been able to agree to relatively modest savings on discretionary spending. New revenues have dropped down on the menu of policy options [and] the plan envisions little change in entitlements, the containment of which [are] key to long-term fiscal sustainability.” *Standard & Poor’s Research Update (August 5, 2011)*.

China was equally circumspect. The Chinese government news agency issued a pointed warning that “China, the largest creditor of the world’s sole superpower, has every right now to demand the United States address its structural debt problems and ensure the safety of China’s dollar assets.” *Chinese Government News Agency (Xinhua), August 5, 2011*. Added China’s rating agency, “Neither the Democratic nor Republican Party has shown any consideration for the general interest [of Treasury holders]. The debt limit [agreement] does not improve the national solvency; rather the heavier debt burden on the government will cause the US sovereign debt crisis to further deepen. As a result the US solvency will continue a declining trend, and the accumulation of the contradiction between the lowering solvency and the rising debt add to the inevitability of triggering a sovereign debt crisis.” *Chinese Global Credit Rating Agency (Dagong), August 2, 2011*.

And the deadlines are not over. When Congress returns after Labor Day, it will have three weeks to settle on a federal budget for 2012. If Congress fails to pass a budget, on October 1 the federal government will shut down. The budget cuts incorporated into the debt ceiling compromise should smooth the way toward a 2012 budget agreement. But it is quite possible that the hard line Republicans—having avoided Armageddon by agreeing to raise the debt ceiling—shut down the government for a few weeks this fall to make their point.

Will the S&P downgrade and Chinese rhetoric cause the “forcing event” that finally prompts meaningful Congressional action? It depends on whether (and how quickly) these events finally “bring the deficit to main street.” Average Americans—facing higher gas prices, lower home values, and unemployment—do not yet personally feel the effects of the deficit. When they do, they will demand that Congress take action, giving politicians the necessary cover to take bold steps.

What will bring the deficit to main street? Ongoing deterioration in the markets, which affects 401(k) values. A precipitous rise in interest rates, making it more difficult to buy a home or car and for businesses to finance growth. Severe cuts in municipal services as states lose access to credit at reasonable rates. Higher gas and food prices as foreign governments continue to lose confidence and sell dollars to buy precious metals (and maybe even a QE3 as the Fed becomes concerned about negligible economic growth).

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A subsidiary issue is what the compromise will likely mean for taxes. The Republicans presumably will not agree to tax increases in the special committee, and the sequestration process does not impose them. But spending cuts under sequestration begin in 2013—the same time the Bush tax cuts are scheduled to expire. The President has threatened to use his “veto pen to ensure nearly \$1T in additional deficit reduction by not extending the high-income tax cuts.” *White House Fact Sheet, July 31, 2011.* (Regardless of the election results, Obama will still be in office when the cuts expire at the end of 2012.) But expiration of the Bush cuts actually would raise taxes *across the board*, not just for high income families as the President suggests. This sets up a fascinating dynamic—does the President sacrifice the middle class tax cuts to impose greater taxes on the wealthy and meaningfully address the deficit through revenue increases? It is shaping up as an epic year in Washington.



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