America’s Endless Budget Battle

By Kenneth Rogoff *Mon, Oct 7, 2013*

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Perhaps investors are becoming inured to the United States’ annual debt-ceiling debacle, now playing out for the third year in a row. But, as the short-term antics become more routine, the risks of long-term dysfunction become more apparent – a point underscored by the shutdown of the federal government.

President Barack Obama is right to complain of blackmail. The US Congress cannot expect to use the threat of default – that is, a weapon of mass financial destruction – as a normal means of extracting concessions. Unfortunately, because Obama himself has established a history of making concessions in the face of congressional brinkmanship, the debt-ceiling debate has morphed into more than just a short-term political fight.

Increasingly, the battle over the US government’s debt ceiling reflects a deeper constitutional power struggle between the president and Congress. This struggle, if left unresolved, could profoundly weaken the government’s ability to make significant economic decisions in the future.

Of course, a breakdown in political civility would hardly make the US unique; all too many countries suffer some degree of political dysfunction. It would take some doing to match (or exceed) Italy’s record of governmental paralysis. But if Congress continues to hijack US economic policy, it bodes ill for the economy’s otherwise bright long-term prospects.

At least for now, the rest of the world has seemingly unbounded confidence – reflected in very low borrowing rates – in America’s capacity to put its house (of representatives) in order. No one can imagine that a country with so many unique economic advantages would risk such a damaging self-inflicted wound as default would cause.

But this time could be different. Obama needs to force his Republican opponents to blink, and there is no guarantee that they will. In the past, it was Obama who blinked, knowing that even if a catastrophic debt default was largely caused by congressional Republicans, he would likely absorb some of the blame in the next election. Now that re-election is behind him, Obama could be inclined to take more risks, with an eye toward securing his economic legacy.

What will that legacy be? Despite the federal government’s destructive impulses, the US economy is showing great resilience and looks set to become stronger. Of course, Obama would love to see this trend continue, as would almost everyone else. Unfortunately, a US debt default, even a technical one, would have unforeseeable consequences that could threaten the recovery.

Consider what happened when the Federal Reserve misplayed its hand with premature talk of “tapering” its long-term asset purchases. After months of market volatility, combined with a reassessment of the politics and the economic fundamentals, the Fed backed down. But serious damage was done, especially in emerging economies. If the mere suggestion of monetary tightening roils international markets to such an extent, what would a US debt default do to the global economy?

Much of the press coverage has focused on various short-term dislocations from counterproductive sequestration measures, but the real risk is more profound. Yes, the dollar would remain the world’s main reserve currency even after a gratuitous bout of default; there is simply no good alternative yet – certainly not today’s euro. But even if the US keeps its reserve-currency franchise, its value could be deeply compromised.

The privilege of issuing the global reserve currency confers enormous advantages on the US, lowering not just the interest rates that the US government pays, but reducing all interest rates that Americans pay. Most calculations show that the advantage to the US is in excess of $100 billion per year.

There was a time, during the 1800’s, when the United Kingdom enjoyed this “exorbitant privilege” (as Valéry Giscard d’Estaing once famously called it when he served as French President Charles de Gaulle’s finance minister). But, as foreign capital markets developed, much of the UK’s advantage faded, and had almost disappeared entirely by the start of World War I.

The same, of course, will ultimately happen to the dollar, especially as Asian capital markets grow and deepen. Even if the dollar long remains king, it will not always be such a powerful monarch. But an unforced debt default now could dramatically accelerate the process, costing Americans hundreds of billions of dollars in higher interest payments on public and private debt over the coming decades.

Ironically, the debt-ceiling fight is not really about debt. The Republicans are hardly debt hawks when they control things. The last Republican presidential candidate, Mitt Romney, and his vice-presidential running mate, Paul Ryan, campaigned in 2012 on a program that would likely have added trillions of dollars to the US debt over the next ten years, owing to tax cuts and increased defense spending. Rather, the debt-ceiling debate is about the size and reach of government.

Yes, the US should worry about its soaring public debt – and about the rising pension and health-care costs that loom large. Despite baseless politically motivated claims to the contrary, the academic research still overwhelmingly suggests that very high debt is a drag on long-term growth.

Of course, Americans should worry just as much about the quality of education and infrastructure – not to mention the natural environment – that they are leaving to future generations. But, above all, they need to leave a legacy of civil political decision-making. That essential feature of effective government is now at risk.

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