The Big Freeze

The Conservative Pledge to Freeze the Debt Ceiling Is a Looming Disaster

David Min October 2010

Introduction

By law, a statutory limit restricts the total amount of debt the federal government can accumulate. Only Congress can raise this limit. On the heels of the worst recession since the Great Depression, this "debt ceiling" is projected to be reached sometime in February 2011. Increasingly, conservatives are pledging to vote against any increases to the debt ceiling—even if this means shutting down the federal government. This reckless pledge would have disastrous consequences for the U.S. economy and the global financial markets, and would severely worsen the long-term budget situation to boot.

This conservative pledge has historical antecedents. In the fall of 1995, congressional Republicans refused to raise the debt ceiling for a period of about six months, until they reversed course in March 1996 in response to plummeting poll numbers. This original "debt ceiling crisis," as it's become known, was extraordinarily costly, roiling the financial markets and forcing two government shutdowns.

The consequences of refusing to raise the debt ceiling would be even more costly today, given the precarious state of the U.S. economy and global financial markets, and potentially could be disastrous. Unlike in 1995, when our economic outlook was good, we are currently fighting our way out of the Great Recession and coming off of the worst financial crisis since the 1930s.

Nonetheless, led by the advice of Newt Gingrich, the former House Speaker who was the architect of the 1995-96 debt ceiling crisis, many conservatives are clamoring for a repeat of this past episode in recklessness.

The budgetary consequences of this conservative pledge would be catastrophic and far-reaching, forcing the immediate cessation of more than 40 percent of all federal government activities (excluding only interest payments on the national debt), including Social Security, military operations in Iraq and Afghanistan, homeland security, Medicare, and unemployment insurance. This would not only threaten the safety and economic security of all Americans, but also have dire impacts for the economy and job growth.

In short, the economic consequences of such a large and precipitous drop in spending would be crushing, and almost certainly result in a severe drop in economic growth and employment at a time when we can least afford it.

Moreover, such a move could lead to a panic in the international financial markets. Following the 2008 financial crisis, we have seen debt crises hit Ireland, Greece, and Italy, with fears that this could spread further and cause a global economic downturn. The financial markets are on edge today, with U.S. Treasury bonds being the safe haven for most investment capital. Refusing to raise the debt ceiling would recklessly disrupt the sale and purchase of new Treasury bonds, and could potentially cause a run on outstanding Treasurys as well, as investors sought other investments. This could have catastrophic consequences for our economy as well as the economic stability of the rest of the world.

Refusing to raise the debt ceiling would also exacerbate the problems with our long-term budget outlook. The budget deficit right now is the result of two distinct sets of changes since 2001, when we last had a budget surplus. First, a series of long-term policies enacted by the Bush administration—most notably the Bush tax cuts of 2001 and 2003, the decision to fight two major wars without raising taxes, and the passage of an unfunded Medicare Part D prescription drug program—created permanent structural budget deficits that will remain with us over the long term unless they are addressed. Second, the poor economy caused a drop in tax receipts alongside higher "countercyclical" spending, such as for unemployment insurance and food stamps.

Implementing a debt ceiling freeze ignores the first set of issues and makes the second set of issues worse by forcing a massive multitrillion dollar hit to an already struggling economy and threatening to take us into a second Great Depression. This is hardly responsible policymaking. So let's delve a little deeper into the consequences of such conservative folly. As we will demonstrate, the results of a replay of 1995 in 2011 would be the height of recklessness for our economy and global financial markets.

A replay of 1995

The most recent pledge to freeze the federal debt ceiling is notable because congressional Republicans tried the same thing following their takeover of Congress in 1995. That fall, Republicans refused to raise the debt ceiling unless then-President Bill Clinton agreed to enact major planks of the radical "Contract with America" proposed by the Republican Party, such as a $270 billion cut to Medicare, steep cuts to education funding, and massive deregulation measures. Indeed, then-Speaker of the House Newt Gingrich at one point threatened to force a default on the national debt if Republicans did not get their way.

This standoff, which lasted until March 1996, ended with the Republicans backing down as the public increasingly became turned off by the government shutdowns that resulted.

The "1995-96 debt ceiling crisis," as it is known, caused significant turmoil for our economy, forcing the Department of Treasury to suspend all new debt issuances and causing two temporary shutdowns of all "nonessential" federal government activities, including a cessation of toxic waste cleanups, disease control activities, and a suspension of many law enforcement and drug control operations, among many others. Ultimately, this episode cost the American taxpayer over $800 million, and rattled the confidence of international investors in U.S. government bonds.

Indeed, it was only through the use of some fairly extraordinary measures by President Clinton's Treasury Department, including a temporary use of retirement funds for former government employees, that the United States managed to avoid defaulting on its national debt during this period. Unfortunately, such measures would not be as effective today, as analysts at Deutsche Bank found. They worry that if it happened today the federal government would "not be able to stave off a government shutdown (or possible suspension of bond payments) for long."

The precarious budget situation

Conservatives' call for a debt ceiling freeze looks even more senseless when one considers that our economy is struggling to recover from a severe recession. Because economic growth remains anemic, tax receipts are flat after falling sharply, which makes it particularly difficult to balance the budget. Refusing to raise the debt ceiling would essentially force the federal government to balance the budget

immediately, at a time of cyclically low revenues. While this may sound appealing to deficit hawks and deficit peacocks alike, it would actually have catastrophic consequences, both in the short term and the long term.

A $1.3 trillion deficit is projected for FY 2011, on a total budget of $3.8 trillion. If we assume that the Obama administration did not want to default on the national debt, and thus continued to make interest payments on outstanding U.S. Treasury obligations ($244 billion), then being forced to balance the budget next year would mean cutting over 40 percent of all other expenditures.

But some federal spending is more important than others, right? Let's assume that we keep certain "sacrosanct" programs whole, not cutting Social Security ($728 billion), defense spending during a time of war ($701 billion), Medicare ($507 billion), Medicaid ($262 billion), and benefits for military veterans ($126.5 billion). If we did that and then eliminated spending on all other government programs, we would still be looking at a small deficit. Yet such a move would mean no FBI, no Department of Justice, no Homeland Security, no border security, no education funding, no unemployment insurance, no school lunches, no national parks, no food stamps, no student loan funding, no air transportation safety, no drug enforcement, no food and drug safety, etc. etc. etc., ad nauseum.

Such severe expenditure cuts would be devastating in two ways. First, they would eviscerate the basic services and protections offered by our federal government, leaving our country in perilous danger from a myriad of threats and many of its most vulnerable citizens without a safety net. Americans would be vulnerable to increased crime, drugs, terrorism, food safety, and air traffic safety, to name just a few. And these spending cuts would slash the social obligations we have promised to military veterans, the elderly, and students, among others. Such large spending cuts couldn't simply be confined to nonessential services. They would cut to the very core of the protections and core benefits provided by the federal government.

Second, these large spending cuts would increase unemployment and severely dampen economic growth, destroying any prospects of a sustained economic recovery. The resulting job loses and the steep cuts to unemployment insurance, food stamps, and other federal safety net expenditures would create a reverse "multiplier effect" that would cause a large dip in economic growth.

The precarious state of the global financial markets

The conservative pledge to freeze the debt ceiling would also lead to some fairly momentous problems in the world's financial markets. Following the financial crisis of 2008-2009, which exposed problems with many private financial instruments that were previously thought to be safe, such as money market funds and AAA-rated asset-backed securities, investors sought safe haven by investing in sovereign debt. Unfortunately, sovereign debt crises in Greece and Ireland have caused significant uncertainty in European financial markets, and as a result, investors have flocked to the perceived safety of sovereign debt issued by the United States, which has never defaulted in its history.

A freeze on the debt ceiling could erode confidence in U.S. Treasury bonds in a number of ways, creating further and wider panic in financial markets. First, by causing a disruption in the issuance of Treasury debt, as happened in 1995-96, a freeze would cause investors to seek alternative financial investments, even perhaps causing a run on Treasurys. Such a run would cause the cost of U.S. debt to soar, putting even more stress on our budget, and the resulting enormous capital flows would likely be highly destabilizing to global financial markets, potentially creating more asset bubbles and busts throughout the world.

Second, the massive withdrawal of public spending that would occur would cause significant concern among institutional investors worldwide that the U.S. would swiftly enter a second, very deep, recession, raising concerns about the ability of the United States to repay its debt. Finally, the sheer recklessness of a debt freeze during these tenuous times would signal to already nervous investors that there was a significant amount of political risk, which could cause them to shy away from investing in the United States generally.

Taken together, these factors would almost certainly result in a significant increase in the interest rates we currently pay on our national debt, currently just above 2.5 percent for a 10-year Treasury note. If in the near term these rates moved even to 5.9 percent, the long-term rate predicted by the Congressional Budget Office, then our interest payments would increase by more than double, to nearly $600 billion a year. These rates could climb even higher, if investors began to price in a "default risk" into Treasurys—something that reckless actions by Congress could potentially spark—thus greatly exacerbating our budget problems.

The U.S. dollar, of course, is the world's reserve currency in large part because of the depth and liquidity of the U.S. Treasury bond market. If this market is severely disrupted, and investors lost confidence in U.S. Treasurys, then it is unclear where nervous investors might go next. A sharp and swift move by investors out of U.S. Treasury bonds could be highly destabilizing, straining the already delicate global economy.

Imagine, for example, if investors moved from sovereign debt into commodities, most of which are priced and traded in dollars. This could have the catastrophic impact of weakening the world's largest economies while also raising the prices of the basic inputs (such as metals or food) that are necessary for economic growth.

In short, a freeze on the debt ceiling would cause our interest payments to spike, making our budget situation even more problematic, while potentially triggering greater global instability—perhaps even a global economic depression.

The very idea of a federal debt freeze among the radical right in our country, while they continue to ignore responsible deficit reduction measures and continue to focus on the wrong policy solutions, exemplifies their obstinacy as much as their short-sightedness. A freeze on the debt ceiling, or shutting down the federal government will not reduce the federal budget deficit and will in fact increase it over the long run by tipping the global economy into depression. Voters may assume that conservative candidates will not live up to their pledge of recklessness once they understand the consequences. This is a risky gamble, particularly given the precedent already set by conservatives in 1995.

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