U.S. Debt Ceiling - Who Will Blink First (Part II)
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Chances are, you noticed that Moody's Investors Service, the credit rating service, has placed the U.S. government's sterling Aaa bond rating on review for a possible downgrade. The reason was clear, but Moody's spelled it out anyway: there is uncertainty whether Congress will raise the U.S. government's debt ceiling by August 2. If it doesn't, the U.S. will join Venezuela (1998), Russia (1998), Ukraine (1998 and 2000), Pakistan (1999), Ecuador (1999 and 2008), Peru (2000), Argentina (2001), Moldova (2002), Uruguay (2003), the Dominican Republic (2005) and Belize (2006) as a nation that has recently defaulted on its bond obligations.

With all this at stake, why are so many seasoned observers yawning instead of panicking? A recent analysis by the Bipartisan Policy Center typifies the view: it says that despite the brinkmanship in Washington, it is unlikely that the U.S. government will be allowed to go into default.

Here is how it is most likely going to play out:

1. The U.S. will NOT default on its Treasury bill, notes and bonds. Interest and principal will be paid.

2. If an agreement to raise the debt ceiling is not reached in the next couple of days, Treasury Secretary Geithner will announce a timetable for when Social Security checks will not be paid, another date when Medicare payments will not be made, another date when Veteran's benefits will not be paid...IRS refunds will not be paid, and so on *including Congressional salaries!*

The appetite for not raising the debt ceiling will quickly evaporate and the senseless political posturing will come to an end and the deal, which everybody in Congress knows already, will be struck.

Why? There are a variety of reasons. Simon Johnson, former chief economist of the International Monetary Fund, says that the U.S. business sector would be livid if Congress were to inject such a high dose of uncertainty into the capital markets. Johnson also points out that ordinary Americans take their debt obligations more seriously than the citizens of many other countries. The U.S. has had its fiscal resolve tested (and faced the easy way out of defaulting on its bonds) after the Revolutionary War, the War of 1812, during and after the Civil War, and in World War I and World War II. "The simple fact of the matter," Johnson says, "is that when the going gets tough, the U.S. pays its debts." Is Congress ready to throw away 200 years of building the best credit history in, well, history?

The thing to understand about the negotiations is that Congress is a feedback mechanism; it takes action, and then, if there is a backlash, it may reverse itself quickly. We all know how teenagers play the game of "chicken:" they aim their cars at each other, and then at some point fear (or maybe common sense) takes over and they quickly return to their lanes. Anybody watching the first part of the game would predict a different outcome.

If the game of debt-ceiling chicken goes past August 2, the default would have an immediate impact on Treasury auctions. The government would have to pay more to get the Chinese government and U.S. retirees to accept the added risk that Congress might decide to refuse to pay what it owes. Raising government bond rates would, ironically, make our government's current debt more expensive to finance, increasing the government's deficits--and make the problem that Congress is trying to fix much worse.

We continue to view the debt-ceiling debate as a political, not economic, issue and believe that the matter will not be resolved until the 11th hour so as to extract the greatest concession or political gain possible. But a compromise will certainly be reached before August 2.

Sources:

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