Public debt and its political implications economics essay

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The debt limit or so called debt ceiling is the total sum of money that the US government is allowed to borrow in order to cover the existing expenditures: national defense, interest on the national debt, Medicaid and Medicare benefits and other expenditures. The debt limit enables the government to cover the spending that was negotiated between Congresses and Presidents in the past. Nevertheless, it does not apply for new, unbudgeted expenditures. If the debt ceiling limits the government to pay for expenditures that are legal obligations (e. g. interest on the national debt, government employee wages, etc.), the debt ceiling can lead to the default of the US (US Department of the Treasury, 2012).

The U. S. Debt-Ceiling Crisis and the Budget Control Act of 2011

In May 2011, the Treasury declared that the debt ceiling of US $14. 29 trillion had been reached, but that " extraordinary measures" could prevent a default and keep government operational. For several months after this announcement, the debt ceiling was in the center of a political battle between the Republicans, who controlled the House of Representatives since the 2010 elections, and President Obama and the Democrats who controlled the Senate. The Republicans insisted on revenue increases and spending cuts as condition for their approval of an increase in the debt ceiling. Both parties could not come to a compromise and by the end of July, the country's default approached. Finally, an agreement between President Obama and Congressional leaders was reached by the night of July 31, 2011 (Eells, 2013).

On August 2, 2011, President Obama signed the Budget Control Act (BCA) that raised the debt ceiling and thus averted the looming, first-ever US government default. The Budget Control Act authorized the increase of the debt limit in three installments. First, the President can require the immediate increase of the debt limit by US $400 billion. Second, the debt limit can be increased by additional US $500 billion, if a joint resolution of disapproval is not enacted. Thirdly, the President can require an additional amount between US$1. 2 trillion and US $1. 5 trillion that is also the subject to congressional disapproval (Heniff et al., 2011).

The first two debt increases, totaling US $900 billion, should be compensated by reductions in future federal spending. The BCA also determined caps on annual expenditures over the following ten years. Estimates on federal spending reductions by the Congressional Budget Office (CBO) totaled US$917 billion. For the years 2012 and 2013, the limits on security and non-security spending are separate. For the eight years thereafter, the spending cap will be effective on a single discretionary category (Heniff et al., 2011).

Another part of the BCA was the establishment of a Joint Select Committee on Deficit Reduction. This Committee is tasked with proposing means to reduce the federal deficit by at least US $1. 5 trillion over the next ten years. As a result, the BCA provides at least one dollar of spending cuts for one dollar in debt ceiling raise (Heniff et al., 2011).

However, if the Joint Committee fails to produce spending cuts of at least US $1. 2 trillion, then the President will be authorized to increase the debt ceiling by US $1. 2 trillion that need to be compensated by a combination of

the spending cuts nevertheless produced by the Joint Committee and across-the-board spending cuts, including military expenditures, education, transportation, Medicare etc. (GAO, 2012).

The political battle between Republicans and Democrats had several negative consequences. The delays in raising the debt limit in 2011 resulted in additional borrowing costs for the Treasury of about US $1. 3 billion only in the fiscal year 2011, which do not include the multiyear effects on potentially increased interest expenses for Treasury securities of future issues. Other challenges for the Treasury in managing the federal debt under the effects of these delays were the complexity, the time spent and the technical issues that arose before the staff. Moreover, the Treasury’s employees had to focus on extraordinary actions instead of focusing on its important debt and cash management responsibilities and staff development (GAO, 2012).

The US debt passed the 100%-of-GDP mark after the government’s debt ceiling was increased. The new borrowing enlarged the US debt to US$14. 58 trillion, surpassing the US $14. 53 trillion size of the U. S. economy in the year 2010 and moving the USA into a fiscal situation similar to countries whose public debt is higher than their annual gross domestic product: Japan (229%), Greece (152%), Italy (120%), Ireland (114%) and Iceland (103%). The last time the U. S. debt exceeded GDP was in 1947 after World War II and the deficit was due to extraordinary war spending (Money News, 2011).

As a result of the debt increase, Standard & Poor’s (S&P) downgraded its USA long-term sovereign credit rating from ‘ AAA’ to ‘ AA+’ on August 5, 2011. The lowering of the long-term sovereign credit rating by S&P reflects the

rating agency's believe that the " the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than was envisioned when agency assigned a negative outlook to the rating on April 18, 2011" (Swann et al., 2011). S&P believed that the fiscal consolidation plan that was agreed by Congress and the President was not sufficient to stabilize the general government debt burden by 2015. Additionally, the political positions of Republicans and Democrats were still far apart and the two parties only agreed on minor savings in discretionary expenditures. The Select Committee had to provide more comprehensive solutions. The political disputes diminished the government's capability to manage public finances and distracted attention from the ultimate goals of a more balanced budget and improvement in economic growth.

S&P's prospect on the long-term rating is unfavorable. The agency can even decrease the long-term rating to ' AA', if, for instance, the US government cuts its spending less than was negotiated or the new arising fiscal burdens over the next two year period.

The other two major rating agencies, Moody's and Fitch, kept their top credit ratings, although they pointed out that downgrades could follow if the US government fails to implement debt reduction measures or an economic slowdown happened (Detrixhe, 2011).

After raising the debt limit to US $15. 2 trillion in August 2011, Congress increased the debt limit to US $16. 394 trillion in January 2012. By the end of August 2012, the amount of debt reached US $15. 977 trillion, which is

approximately US $417 billion below the debt limit. As the government borrows roughly between US $100 billion and US $125 billion a month, the debt was estimated to hit the limit in December 2012 (Sahadi, 2012).

By December 31, 2012, the USA reached its debt ceiling, but the Treasury declared that it can pay outstanding debt obligations and other bills for the next two months. This means that a new political battle, between Congress and the White House, for another increase in the debt ceiling will start in the near future.

Effects of the US government shutdowns in 1995-1996

In 2011, the US government was close to defaulting on its public debt. The potential negative consequences of a default are more severe than that of a shutdown. Nevertheless, recent shutdowns can give an example of potential harmful effects of such fiscal issues on the public and economy. In history, the US government has experienced several shutdowns (Figure XY) that occurred when Congress fails to adjust funding for the current fiscal obligations. In this situation the government can no longer borrow funds, but the federal government can continue to operate, given the Treasury has the opportunity to generate additional revenues or to implement special measures. Nevertheless, the continuing incapability to borrow would result in a default (Masters, 2013).

Figure XY. Appropriations Funding Gaps: Fiscal Years 1977-1998

Fiscal

Year

Date gap Commenced

Full day(s)

of gaps

Date gap terminated

1977

Thursday 09-30-76

10

Monday 10-11-76

1978

Friday 09-30-77

12

Thursday 10-13-17

Monday 10-31-77

8

Wednesday 11-09-77

Wednesday 11-30-77

8

Friday 12-09-77

1979

Saturday 09-30-78

17

Wednesday 10-18-78

1980

Sunday 09-30-79

11

Friday 10-12-79

1982

Friday 11-20-81

2

Monday 11-23-81

1983

Thursday 9-30-82

1

Saturday 10-2-82

Friday 12-17-82

3

Tuesday 12-21-82

1984

Thursday 11-10-83

3

Monday 11-14-83

1985

Sunday 9-30-84

2

Wednesday 10-3-84

Wednesday 10-3-84

1

Friday 10-5-84

1987

Thursday 10-16-86

1

Saturday 10-18-86

1988

Friday 12-18-87

1

Sunday 12-20-87

1991

Friday 10-5-90

3

Tuesday 10-9-90

1996

Monday 11-13-95

5

Sunday 11-19-95

Friday 12-15-95

21

Saturday 1-6-96

Figure : Appropriations Funding Gaps (Source: U. S. Library of Congress, Congressional Research Service)

The longest US government shutdown was a shutdown in the years 1995-1996. The U. S. government was shut down for 21 days between the December 16, 1995 and January 6th, 1996 due to the budgetary mismatches between Democratic President Bill Clinton and Republican Speaker of the House Newt Gingrich. In 1995, Clinton denied to cut steeply Medicaid, Medicare and other non-defense expenditures for the 1996 budget. Gingrich responded with the threat that Congress would not approve the increase in the debt ceiling. This would lead the USA to default on its outstanding debt. The first shutdown lasted five days from November 13 until 19 when both parties made an agreement to balance the budget in seven years period. However, the White House and Congress could not agree how this procedure would be accomplished resulting in the second US shutdown for 21 days. Negotiations between the President and Congress over the next 21 days resulted in the agreed seven-year balanced budget plan. The plan consisted of the tax increases and the little spending cuts (Fiscal Politics & Policy from 1970s to the Present).

Gressle (1999) showed the effects of the US government shutdown on the public and economy. The first and the second shutdowns in 1995-1996 years resulted in the furlough of an estimated 800’000 and 284’000 federal employees respectively. The second shutdown had vast effects on all sectors of the economy. A good example is the health care sector where new

patients were not accepted into National Institute of Health (HIN) Clinical Center and the hotline calls to HIN regarding health problems were not answered. Around 20’000-30’000 applicants for US visa were not served each day resulting in million dollar losses for airlines and tourist industries. The closure of 368 National Parks led to the loss of 7 million visitors and US$14. 2 million per day in tourism income by locals.

After the 1995-1996 shutdowns, President Clinton improved his image (Lader, 2008). The majority of Americans understood that both shutdowns were due to the Republican obstinacy. Nevertheless, the shutdowns in 1995-1996 showed the aftermaths of divided government and the shift of the political policy to the rightwing.

Fiscal Cliff

There are a lot of expressions for the issue often called fiscal cliff: fiscal slope, austerity crisis or fiscal obstacle course. However, all of them describe the same process, particularly, the automatic tax increases and spending cuts that take effect on January 1, 2013. However, the first person who popularized the term “ fiscal cliff” was the chairman of the Federal Reserve, Ben Bernanke. The chairman used this expression in a speech to a congressional committee in February 2012 in reference to a combination of spending cuts and tax increases set for January 1, 2013. Afterwards, the phrase was used widespread (Geoghegan, 2012).

The majority of analysts predict that the implementation of the tax and spending cuts on January 1, 2013 will have no significant influence on the economy as a whole in the short run. At the same time, the long-term effects

of these measures would be tremendous. If a deal can not be reached by the White House and Congress, it might have uncertain effects on the economy such as a market panic, a drop in consumer spending, a decrease in business investments, etc. The Congressional Budget Office calculated that the budget deficit would decrease by US $0. 5 trillion from 2012 to 2013 and the economy would slow down due to a resulting recession. Almost all Americans would experience a rise of their tax bills with the estimated increase at US $3’500 and an after-tax income decline by 6. 2% for the average family (Lowrey, 2012).

On Tuesday January 1, 2013, Congress approved a deal to end the long partisan dispute over the fiscal cliff. The main changes that were set were “ the end of last years’ temporary payroll tax cuts (resulting in a 2% tax increase for workers), the end of certain tax breaks for businesses, shifts in the alternative minimum tax that would take a larger bite, a rollback of the “ Bush tax cuts” from 2001-2003, and the beginning of taxes related to President Obama’s health care law. At the same time, the spending cuts agreed upon as part of the debt ceiling deal of 2011 will begin to go into effect” (Kenny, 2013).

The agreement leads to the increase of the tax rate from 35% to 39. 6 % for single persons who earn US $400’000 and for couples with an income above US $450’000 per year. Americans should also pay higher taxes on dividends and capital gains with the tax rate rising from 15% to 20%. Also, the tax for estates with a value above US$5 million will be taxed by 40% (previous rate 35%), but Republicans succeeded in indexing the threshold of US $5 million

to inflation and thus smoothing the effects of the estate tax for wealthy Americans (Ungar, 2013).

Among other changes were the extension of an additional year of unemployment benefits for nearly 2 million Americans, the “ doctor fix” related to Medicare and tax credits for college tuition that were extended for another five years (Ungar, 2013).

The agreement prevents a significant increase of income tax for around 100 million American families that earn less than US $250’000 annually. However, the 2% payroll tax cut, that was originally part of the 2009 stimulus package, will expire (Montgomery and Helderman, 2013). The above measures will prevent the severe economic downturn that could happen in case of going over the fiscal cliff. President Obama pointed out in his brief statement that the new measures would produce US $620 billion in new tax revenues (Montgomery and Helderman, 2013).

In conclusion, the new measures that were set to avoid the fiscal cliff were not the ultimate goal of neither Republicans nor Democrats. Republicans are not satisfied with the tax increases and the lack of spending reductions, while Democrats complain about the provisions regarding estates. It seems that the political dispute will continue in the near future and the agreement signed on December 31, 2012 was just a short-term fix to avoid the fiscal cliff.

Foreign Holdings of US Public Debt and its Political Implications

A crucial point in analyzing the current situation of US public debt and its political implications is the detailed understanding of foreign holdings. As of July 2012 (most recent data), foreign countries owned a total of US dollar 5. 4 trillion of U. S. debt, which is approximately 34% of total debt outstanding of US dollar 15. 9 trillion. The three largest single foreign holders are the central banks of China, Japan and Brazil. Comparing the situation in July 2012 with the state in July 2002, one can see that the proportion of foreign holdings in US public debt outstanding has grown from approximately 19% to 34% (Treasury Direct, 2012). Figure XY shows that as of July 2012, China is the largest single holder of US public debt with a share of approximately 7. 2% followed by Japan with a corresponding share of about 7. 0% (US Department of the Treasury, 2012).

Figure : Foreign Holdings of US Public Debt (Source: Treasury Direct, 2012 & U. S. Department of the Treasury, 2012)

Given its low savings rate, the US economy is strongly dependent on foreign capital inflows from countries with high savings rates (for example China[1]) to meet its domestic investment needs and to fund the federal budget deficit. Important to understand is that the willingness of foreign countries to invest in the US economy and to purchase US public debt has helped to keep US real interest rates relatively low in the past, which until recently, contributed to a great extent to a fast US economic growth and enabled the country to consume more that it produces for a long time. Some renowned economists also argue that the US dependency on foreign savings was a

contributing factor to the US subprime crisis and the subsequent global financial crisis. However, the size and the recent growth of US public debt have raised concerns about the willingness of foreign countries to continue to invest in US public debt securities. For example, some Chinese analysts claimed that the government should diversify its reserves away from US dollar assets into assets of other currencies. An important short-term political implication of China's large holdings in US public debt is that, if China might suddenly decide to sell a large share of its holdings, this would induce other foreign investors to sell off their holdings as well, which could dramatically destabilize the US economy. Possible consequences can be the depreciation of the US dollar as its supply on foreign exchange markets increased and a large increase in US interest rates as a crucial source of funding for investments and the budget deficit is withdrawn from financial markets (Morrison and Labonte, 2012).

Therefore, China seems currently able to destabilize the US economy through the sale of a large share of its US debt holdings, which can be seen as a " financial weapon" (Sandbrook, 2012). In addition, in the long run, if China reduces its US securities, the US would need to replace it with other foreign or domestic investors to fill in the gap. Those investors would probably have to be acquired through higher interest rates compared to those of today. Increased interest rates would cause a fall in all kinds of interest-sensitive spending. The reducing of Chinese Treasury holdings would – all else equal – cause the foreign demand for US assets do decline, which would then lead to a dollar depreciation (Morrison and Labonte, 2012). All in all, given a large reduction in China's holdings of US public debt, the impact

on the US economy would still be dependent on whether this reduction takes place gradually or suddenly.

Some US policymakers also argue that China’s large holdings of US public debt give it leverage over the United States on economic and noneconomic issues. An illustrative example of this concern is Ding Gang, an editor of China’s People’s Daily[2], who wrote in an editorial in August 2011 that the People’s Republic of China should create a direct link between the amount of US Treasury holdings with the US arms sales to Taiwan. Gang states “ Now is the time for China to use its “ financial weapon” to teach the United States a lesson if it moves forward with a plan to sale arms to Taiwan. In fact, China has never wanted to use its holdings of U. S. debt as a weapon. It is the United States that is forcing it to do so. […] China has no choice but to use it as a weapon to defend itself when facing threats to China’s sovereignty” (Gang, 2011). Altogether, China’s holdings in US public debt can be seen as a strong instrument to put pressure on the United States with regards to political disputes between the two countries. As a result, the growing dependency of the US on China to purchase US Treasury securities to fund the country’s budget deficit has become a major concern to many US policymakers (Morrison and Labonte, 2012).

However, the probability that China would suddenly reduce its holdings of US public debt is highly questionable because of the fact that doing so could potentially have a significant negative impact on the Chinese economy as well. The important causality which takes away China’s incentive to sell is the fact that any Chinese attempt to sell a large portion of its US debt holdings could, on the one hand, dramatically reduce the value of its

remaining holdings in international markets. On the other hand, a negative demand shock in the United States would also dramatically reduce US demand for Chinese exports, either through an appreciation of the Chinese Yuan against the US Dollar or a reduction in the US economic growth (especially if other foreign investors sell their US asset holdings as well and the United States are forced to raise interest rates in response) (Morrison and Labonte, 2012). This is especially severe because of the fact that China was the United States' largest supplier of goods imports in 2011. US goods imports from China totaled U. S. dollar 399 billion in 2011, a 9. 4% increase from 2010 and up 299% since 2000. Imports from China into the United States accounted for 18% of overall US imports in 2010 (Office of the United State Trade Representative, 2012). A sharp reduction of US imports from China could therefore have a significant negative impact on China's economy, which heavily depends on exports into the United States for its economic growth. Moreover, in the case of China, economic growth is also seen as a vital source of political stability and therefore in the interest of the government. Consequently, it can be argued that the US and Chinese economies are mutually dependent[3]on each other, which, as a matter of fact, gives China very little leverage over US policy (Morrison and Labonte, 2012). The former US Treasury Secretary Lawrence Summers called the mutual damage which would occur to the US and Chinese economies the " balance of financial terror" (Dorn, 2008). For some time, this " balance of financial terror" as well as the global financial system has kept China off from exploiting their power position (Dorn, 2008).

Nonetheless, regardless of the “ balance of financial terror”, growing bilateral tensions over the US public debt between the United States and China can clearly be observed. For example, the government-controlled Chinese newspaper Xinhua News Agency expressed a lot of criticism on US economic policies regarding the US public debt situation:

“ With its debt approximating its annual economic output, it is time for Washington to revisit the time-tested common sense that one should live within one’s means” (Xinhua News Agency, July 2011).

“ The days when the debt-ridden Uncle Sam could leisurely squander unlimited overseas borrowing appeared to be numbered as its triple A-credit rating was slashed by Standard & Poor’s (S&P) for the first time on Friday. China, the largest creditor of the world’s sole superpower, has every right now to demand the United States to address its structural debt problems and ensure the safety of China’s dollar assets” (Xinhua News Agency, August 2011).

To relieve further bilateral tensions between the two countries, China should pursue a more market-liberal path and the United States should abstain from implementing protectionist measures. Doing this, the US-China relationship should develop peacefully and global prosperity will continue. Consequently, the “ balance of financial terror” would collapse and give way to free trade and capital freedom (Dorn, 2008).

In conclusion, the main political issue from the perspective of the United States is not China’s large holdings of US public debt per se, but rather the high US reliance on foreign capital in general and whether this reliance is

sustainable in the future (Morrison and Labonte, 2012). Policymakers in the United States should therefore think about the medium- and long-run implications of the country’s high amount of public debt held by foreigners. To do that in an appropriate way, they have to take into account and to understand the economic and political relationships between the United States and its debt holders, with China leading the way. A first step to mitigate the problem is to launch political measures so that the United States increases its level of savings in the long-term in order to reduce the vulnerability to a possible shift away from US assets by foreign investors (Morrison and Labonte, 2012).

The Role of U. S. Public Debt in the Global Economy

Undoubtedly, the United States still plays an exceptional role in the global economy. First of all, the country is the largest economy in the world. Secondly, it clearly dominates the global monetary system: The United States’ capital markets are among the most liquid ones (Schuman, 2011) and the special status of the dollar as the world’s reserve currency has become an crucial aspect of America’s power, allowing the country to borrow effortlessly and maintain an assertive foreign policy (Warnock, 2010). In addition, the US dollar is the primary currency used in foreign exchange transactions and trade. Also, as already mentioned in the chapter before, countries such as China and Japan store their national wealth to a large extent in US public debt. The perception has always been that the United States has a safe haven status, meaning that when investors get nervous, they increase dollar-based assets, and especially also US public debt (Schuman, 2011). Having said all this, given the exceptional status of the

United States in the world economy, the global economic and political consequences of the development of US public debt are substantial. Increasing US public debt bears the risk of a fundamental change in the perception of the safe haven status of the United States. Schuman (2011) speculates on what would happen if this change in perception comes true[4]: US Treasury securities would be seen as riskier than before and would consequently lose their attractiveness. As a result, interest rates would increase in the United States, raising borrowing costs in the economy and making it more difficult for the US government to finance debt and budget deficits. This can potentially lead to a significant decrease in investments and consumption. The US dollar will presumably depreciate, which will devaluate currency reserves around the globe. All those effects taken together will have negative consequences on the growth of the US economy, lowering living standards for Americans and eventually leading to a slower growth of the world economy. To put it simple, a loss of confidence in the United States as a safe haven results in higher interest rates, which will automatically have negative consequences on the world economy (International Monetary Fund, 2012). Therefore, the exceptional role of the United States makes its public debt situation dangerous for the shape of the global economy due to the fact that overwhelming debt amounts can cause effects that potentially destabilize the world economy.

In addition, the ten-year US Treasury bond has the status of the world's risk-free asset, meaning that the United States is the basic standard by which risk in financial markets is assessed (Warnock, 2010). This is sometimes referred to as the risk-free standard and is a basic convention regularly used

in all different kinds of valuations in the daily business world. In particular, the risk-free standard is an important measure in the context of corporate and asset valuation (Damodaran, 2008). Loosing the safe haven status of the United States – as a possible consequence of the above-described developments – means loosing the risk-free standard convention, resulting in global efficiency losses and higher risks of economic and financial fragmentation (Schuman, 2011).

Although the United States' exceptional status in the world economy makes its debt situation risky, that status obviously gives the country particular protection as well. A meaningful example of this protection is the warning of Standard & Poor's to downgrade the United States from its traditional prized AAA credit rating in April 2011 (Schuman, 2011): This warning was a strong signal that Standard & Poor's was not concerned about the special status of the US in the global economy, meaning that if the country is not able to get its debt situation under control, it will be confronted with a downgrade similar to those of Greece, Spain or Japan. However, financial market participants acted against what economic intuition and theory tells us. US Treasuries weakened immediately after Standard & Poor's announcement, a clear indication that investors were selling them. Nevertheless, they returned to their old strength shortly afterwards, suggesting that investors even bought US public debt after Standard & Poor's warning instead of selling them to a large extent (Schuman, 2011). Moreover, some reactions of major US bondholders indicated that they are not concerned about the country's financial condition. For example, at the time Japanese Finance Minister

Yoshihiko Noda mentioned: “[…] basically we continue to believe that US Treasuries are an attractive product for us” (Channel NewsAsia, 2011).

A further crucial point in the context of the role of US public debt in the global economy is the argument that US policymakers have been relying – probably subconsciously – on the exceptional status of the United States (Schuman, 2011).[5]The particular role of the US in the global economy leads to the outcome that the country does not have to face dangers other nations could never avoid. A political implication of this behavior is presumably that – according to some critical authors and journalists – the United States are one of the few heavily indebted developed economies that does not have a credible plan to control deficits and debt[6](Schuman, 2011). To put it in simple words, US policymakers have possibly been banking on being like American International Group (AIG) or General Motors (GM) in America or UBS in Switzerland, acting as if the country is too big to fail[7].

In conclusion, one can state that a debt crisis in Portugal for example can potentially create uncertainty through world financial markets, and if a larger country such as Spain fell into crisis, this uncertainty could have destabilizing effects. But US public debt bears the risk of crashing the entire operating system of the global economy. Hen