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Debt-Ceiling Deja Vu Could Sink Economy

By Betsey Stevenson and Justin Wolfers - May 28, 2012

Europe is crumbling. China is slowing. The Federal Reserve is dithering. Yet the biggest threat to the emerging U.S. economic recovery may be Congress.

John Boehner, the leader of the House Republicans, has promised yet another fight with the White House over the debt ceiling -- the limit Congress has placed on the amount the federal government can borrow.

If this sounds familiar, it's because we suffered through an identical performance last summer. Our analysis of that episode leads to a troubling conclusion: It almost derailed the recovery, and this time could be a lot worse.

Sometime around the end of this year, the federal government will bump up against its $16.4 trillion borrowing limit, as a direct result of spending and tax laws enacted by Congress. To raise the limit, legislators must pass a separate law. In principle, the extra level of approval can serve as a useful mechanism, forcing Congress to debate its priorities. But refusing to raise the limit wouldn't free the government of its existing spending obligations. Rather, it would leave the government with no choice but to default on its debts.

In other words, congressional Republicans are taking the government's creditworthiness hostage when they threaten not to increase the debt ceiling. Politically advantageous as this may be, it is terrible economics. To understand why, let us consider the economic effects of last year's debt-ceiling debate. If we know our history, perhaps we will not be doomed to repeat it.

Confidence Drop

High-frequency data on consumer confidence from the research company Gallup, based on surveys of 500 Americans daily, provide a good picture of the debt-ceiling debate's impact (see chart). Confidence began falling right around May 11, when Boehner first announced he would not support increasing the debt limit. It went into freefall as the political stalemate worsened through July. Over the entire episode, confidence declined more than it did following the collapse of Lehman Brothers Holdings Inc. in 2008. After July 31, when the deal to break the impasse was announced, consumer confidence stabilized and began a long, slow climb that brought it back to its starting point almost a year later. (Disclosure: We have a consulting relationship with Gallup.)

Businesses were also hurt by uncertainty, which rose to record levels as measured by the number of newspaper articles mentioning the subject. This proved far more damaging than the regulatory uncertainty on which Republican criticisms of Barack Obama's administration have focused (more on that subject in a Bloomberg View editorial today). Employers held back on hiring, sapping momentum from a recovery that remains far too fragile.

Growth in nonfarm payrolls decelerated to an average 88,000 a month during the three months of the debt-ceiling impasse, compared with an average of 176,000 in the first five months of 2011 (see chart). Payroll growth subsequently recovered and has averaged 187,000 jobs a month since. Despite the rebound in job growth, employment is likely still below where it would otherwise have been.

There are also more visible permanent scars. The sense that the U.S. political system could no longer credibly commit to paying its debts led the credit-rating company Standard & Poor's to remove the U.S. government from its list of risk-free borrowers with gold-standard AAA ratings. Just as a poor credit score raises the interest rate you pay in the long run, so a worse credit rating will probably raise the interest rate on our national debt.

Economic Sabotage

All told, the data tell us that a debt-ceiling standoff is an act of economic sabotage. The only way to avoid this conclusion is to argue that consumers and employers were reacting to some other economic factors. But the debt ceiling was the dominant economic story at the time. No other news fits the data as well. Although the European debt crisis was a rising concern throughout 2011, the real trouble in Europe arose in the period when consumer confidence and employment were recovering.

The next debt-ceiling battle could be worse, because the stakes are even higher. In addition to the threat of default, the U.S. is facing the so-called fiscal cliff: a raft of spending cuts and tax increases that will happen at the end of this year unless Congress acts to postpone them. Another stalemate would almost certainly plunge the economy into a deep recession. Our best alternative -- in fact, our only hope -- is for Congress to set aside partisan politics and work together with a common goal of helping our country out of the Great Recession.

(Betsey Stevenson and Justin Wolfers, both professors at the University of Pennsylvania's Wharton School, are Bloomberg View columnists. The opinions expressed are their own.)

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