America Is Playing With Fire With Its Default Talk

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Abstract

In a contribution to the Christian Science Monitor, Donald Marron argues that the ongoing public discussion of a default poses a major threat to U.S. financial markets.

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America sometimes takes its exceptionalism too far.

Case in point: We are the only major economy that talks openly of default.

Government debt has ballooned throughout the developed world in the aftermath of the Great Recession. France and Britain are as deep in debt as the United States, for example, and Japan is much further in the hole.

But their leaders never mention the possibility of default. Why would they? If you have the ability to pay your bills, there's no reason to scare your creditors.

But that's exactly what we do in America. Treasury Secretary Timothy Geithner has been warning about the risks of default since January.

If we don't increase the debt limit by early August, he tells us, default becomes a real possibility. And that could pose grievous risks to our already weak economy.

Many Republicans play down that risk. Echoing famed investor Stanley Druckenmiller, some argue that a temporary default would be acceptable if it's part of a larger political strategy that brings future deficits under control.

But that is a dangerous game.

Large swaths of America's financial infrastructure have been built on the assumption that US Treasuries pay on time. And financial markets would likely punish the US with higher interest rates if we defaulted. That's what happened in 1979, for example, when back office snafus caused Treasury to unintentionally miss payments to some investors.

This time, Fitch, Moody's, and Standard & Poors are threatening to cut the US credit rating if we choose to default. Given the risks, most observers recognize that default is not, and should not be, an option. The US is not a deadbeat nation.

But does that mean the debt limit has to go up in early August? Some Republicans say no because of a simple fact: Every month, the federal government collects more in taxes than it pays in interest. With careful cash management (which would likely have to start before the August deadline), Mr. Geithner should be able to prioritize debt payments and thus avoid debt default.

As best as I can tell, that argument is correct, but it's hardly a reason for complacency. America is currently spending about $100 billion more each month than it collects in revenues. If we hit the debt limit, we won't be able to pay everyone who is rightly expecting to be paid.

Geithner can and should ensure that our debtholders get paid.

But someone – perhaps millions of someones – won't be paid on time. Contractors, federal workers, program beneficiaries, or state and local governments will suddenly find themselves short on their cash flow.

That won't be good for the economy. Even though it's not as bad as debt default, it still would paint the US as a deadbeat.

The US faces severe fiscal challenges in the years ahead. It's perfectly reasonable that lawmakers want to combine an increase in the debt limit with efforts to rein in future deficits.

But that worthy goal should not weaken our commitment to paying – on time and in full – the obligations that we have already incurred.

As the debt limit draws near, our leaders should stop playing with fire and craft instead a plan to rein in future deficits without threatening our struggling recovery.

That's a difficult balancing act, requiring tough compromises across the political spectrum. But as everybody knows on Capitol Hill and beyond, it would be the best step for the nation and our fragile economy.

It would also be exceptional.

Other Publications by the Authors

- Donald Marron