The Heated Debt Ceiling Debate: The Summer of 2011

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On August 2, 2011, administration officials have announced that the United States has an obligation to its people and therefore needs to increase its statutory debt ceiling through negotiations by the Congress and the administration on the terms of how the debt-ceiling will be increased. As with many negotiations that are made, the positions of the different parties have clashed because it is difficult to agree on how to cut government expenditures and where to down-size spending. Democrats insist that they will not vote for an increase in the debt limit that does not permit borrowing through 2012. This is why Republicans have called this request a "blank check" and are working on a short-term deal currently. House Speaker John Boehner proposed his two-step plan that will prevent a national default by dramatically cutting spending and allowing a debt limit increase of $1 trillion, to be later followed by another increase of $1.6 trillion. This GOP debt plan, that was passed by the House of Representatives on Friday July 29th, 2011, links any debt increase with spending cuts, therefore, the $1 trillion in spending cuts would be made effective immediately along with spending caps over the next ten years. Though this plan is known as a two-step approach, it really includes multiple steps: cuts that exceed the debt hike, caps to control future spending, a balanced budget amendment put in place, entitlement reforms and savings, and no tax hikes. The House Speaker stated that this proposal was, "far from perfect but is a responsible, common sense proposal that meets our obligations to the American people and preserves the full faith and credit of the U.S."

In order to avoid a debt default, a deal needed to be reached before Congress can increase the U.S. government's $14.3 trillion borrowing limit. While both parties continue to have different views on the requirements linked to spending cuts along with the timetable to be assigned, both agree that long-term spending cuts need to be imposed in order to control the rapidly growing federal budget deficit. To not drag the fragile economy, an agreement was made that will include a balanced approach and is a serious down payment on the debt. It was a process that took far too long and had a negative impact on consumer confidence, business optimism and the economy as a whole. A bipartisan committee also will be working and by November, a plan will need to be proposed on further reducing the deficit, and everything will be on the table in this stage, including tough cuts. The debt ceiling and deficit talks are crucial to discretionary fiscal policy, which has a direct impact on the federal budget. This all has a direct impact on the economy in terms of which path the economy will take and how strong the recovery process can be.

Avoidingdefault, shared sacrifice, and a balanced budget is what democrats want. Republicans need to give up some of their tax breaks, was emphasized by the President. Cutting spending is tough and it is a challenge to pick and choose which areas to cut spending on because one must consider the long run repercussions of these decisions that are being made on the economy. Entitlements and social programs are a top priority because the government has an obligation to the American people. A deal was reached to raise the debt limit and cut the nation's spending, but there is still major voting to be done by Congress. $1 trillion will be cut in the next ten years, making sure cuts do not happen too abruptly to disrupt the economy. $ 2.4 trillion is the total in deficit reduction that is in the plan, meaning that both parties need to round up support. The most important issues that many people are wondering is where will the cuts be made and who will be hurt the most. More people will fall into poverty and more job loss will take are two main concern. Deficit reduction negotiations Regardless of whether we raise the debt ceiling and how we raise it, the U.S. triple-A rating will most likely be downgraded.

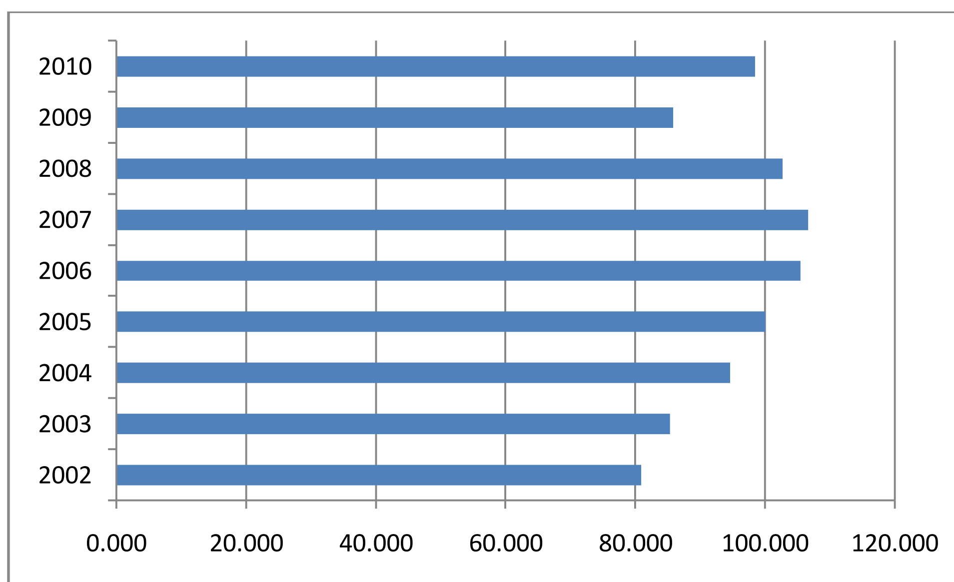
In fact, Moody's Investors Service highlighted the, "rising possibility that the statutory debt limit will not be raised on a timely basis, which would lead to a default on US Treasury debt obligations." Due to the rising concerns with the long-term stability of the U.S. economy, warnings of the possible downgrade were made back in April by Standard & Poor's Rating Services when it changed the outlook categorization of the U.S. government debt from stable to negative for the first time in history. Moody's expects no immediate downgrade, but will give the U.S. a negative outlook.

Moody's does expect to affirm the triple-A rating but is not at all sold on either plan by the democrats or republicans, emphasizing that there were better options that were not adopted. Therefore, Moody's is not completely ruling out a downgrade, but will do nothing immediately while S & P was looking for cuts of $ 4 trillion, which is not at all a proposed option by any of the deals that have been put on the table.In fact, J. P. Morgan Chase has stated that some financial companies have begun to shift from long-term investments to bonds that will be paid back in just seven days, the first week of August.

The Consequences of an Unprecedented National Default

If a compromise would not have been reached and a deal was not agreed upon, there would have been some major problems that many are fearful of. The value of the U.S. dollar will most certainly decline, which comes with a set of other problems. The depreciation of the U.S. dollar will cause U.S. consumers to face higher prices on foreign goods, which is a major burden for a country that is heavily dependent on foreign imports and is a debtor nation with an extremely large trade deficit. Figure 1 depicts the volume of U.S. imports.

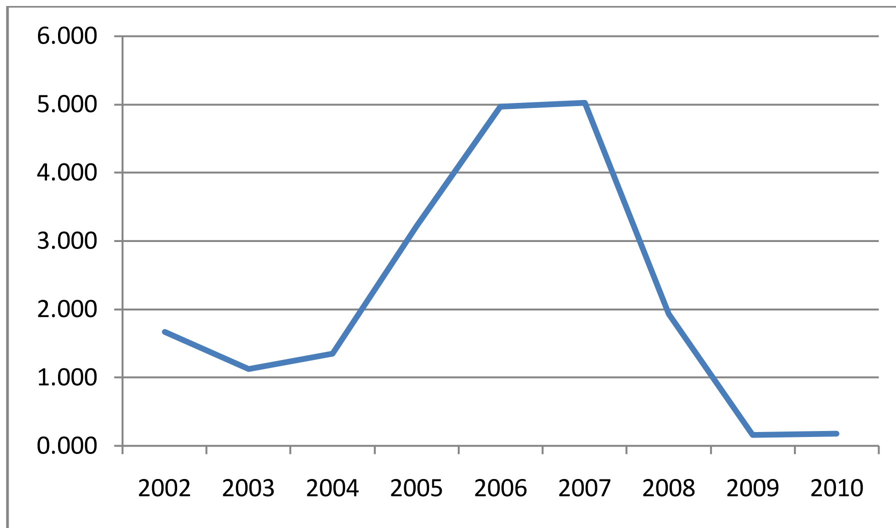
Figure 1 U.S. Volume of Imports



Higher foreign prices can lead to inflation in the U.S., which is another problem that comes with a depreciation in the value of the U.S. dollar. Feldstein (1986) stated that fiscal experiments and shifts in the federal government's deficit have powerful effects on the value of the U.S. dollar. Melvin et al. (1989) concluded that the expected future U.S. federal budget deficit is a main determinant of the foreign exchange value of the U.S. dollar. The authors stated that, "there is good reason to expect current and projected fiscal policy developments in the U.S. to have a significant impact on the international investment and exchange rates." Higher prices in the U.S. will impact interest rates, causing interest rates to rise because the demand for money by consumer will rise as a result of the increase in prices.

Higher interest rates in the U.S. means the cost of borrowing money will be on the rise. This causes student loans, car loans, and home mortgage loans to become significantly more expensive. Currently, the interest rates have been at a record low level in order to stimulate spending by consumers, businesses, the government and the foreign sector. Therefore, the main concern by many is that we cannot afford to see interest rates rise in a time when we are desperately in need of economic recovery and economic growth. If interest rates rise, this will not stimulate spending and will have an opposite effect instead, which can hinder our economic recovery process. In an economy that is already so fragile, the rise in interest rates can push it into another economic crisis. Figure 2 depicts U.S. interest rates.

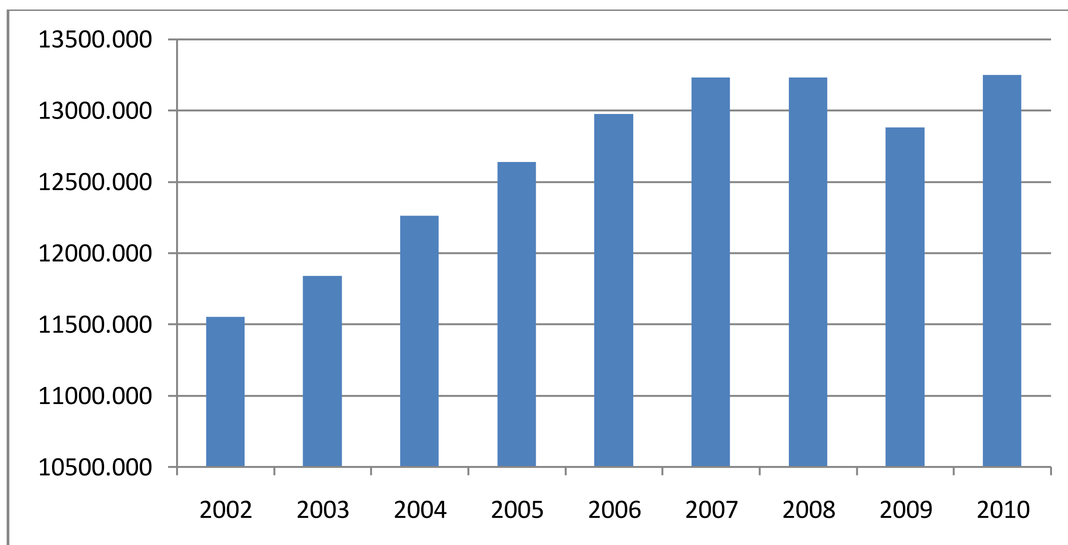
Figure 2 U.S. Interest Rates



This is already a time when our economic growth has come to a halt. The second quarter of 2011 came with only a 1.3% growth rate in gross domestic product, which was a devastating blow to an economy already suffering from 9.2% unemployment rate. During the first quarter, from January through March, total output grew at only a 1.8% growth rate. Therefore, the annual growth rate of GDPin both quarters of 2011 has fallen short of the economic goal of achieving a 3.0% growth rate. Many economists have noticed that their optimistic predictions have been inaccurate as the months have gone by throughout the year of 2011. This is a major factor in explaining why the U.S. unemployment rate has been stagnant. Figure 3 depicts U.S. real GDP, in billions over the recent years.

Cutting government spending, though argued by many that it is needed, will surely have a negative impact on economic growth, while state and local governments cut down on their spending, the federal government is taking the same step. The reason why gross domestic product is at jeopardy when spending cuts take place is because employers, businesses, and companies are unable to hire during those times which hurts the growth rate of gross domestic product. The uncertainty that the U.S. economy brings with it has wreaked havoc on the U.S. unemployment rate, a problem in and of itself that needs a high amount of attention currently. This same situation of uncertainty has hurt businesses as well, both small and large and has exacerbated the economic crisis and symptoms.

Figure 3 U.S. Real GDP (in billions)



In fact, the debt ceiling debate has already begun to hurt the economy in many ways. First and foremost, the U.S. stock market suffered its worst week in a year at the end of July 2011 because of the postponed voting on the debt ceiling debate. Stocks have slipped because after weeks of debate, there is still so much disagreement with regards to how to reduce the debt. Many agree that is it not a revenue problem, but more of a spending problem. Stocks will continue to slip with growing fears that the largest economy should not be missing its payments and obligations. Many of these macroeconomic variables are intertwined and connected. Regardless of what indices we look at, be it the unemployment rate, the GDP growth rate, the housing market prices, everyone is in agreement that this economic crisis is still a major issue with a struggling recovery process on the way. Treas (2010) looks at how American have suffered during these very stressful and trying times, exposing some serious systematic issues. This helps to transition over to the reasoning and logic behind why people want to see structural changes and improvements, so as to avoid another great recession. Therefore, we are at a stage and these times are a critical passage. Reform is needed as well as the reorganization of government. We cannot afford to mismanage the cutting of government spending cuts. Many are for a balanced budget but are not for cutting spending on Medicare and on other programs, so that is why there is a large problem. Lowering tax rates would help to stimulate spending but this means a decrease in government revenue, during a time that it really needs the funds. The economy is definitely in a very sticky situation and a very sensitive situation.

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*All data for the figures are from the International Financial Statistics of the IMF.