

FLIRTING WITH DEFAULT

ISSUES RAISED BY DEBT CONFRONTATIONS IN THE UNITED STATES

PIIE BRIEFING No. 14-1

February 2014
Washington, DC



**Peterson
Institute for
International
Economics**

1750 Massachusetts Avenue, NW
Washington, DC 20036-1903
(202) 328-9000 Fax (202) 659-3225
www.piie.com

CONTENTS

1	Introduction: The Costs of Behaving Badly <i>Adam S. Posen</i>	1
2	Economic Fallout from Crisis-Driven Fiscal Policy <i>David J. Stockton</i>	3
3	Impact of US Fiscal Uncertainty on Household Saving Behavior <i>Tomas Hellebrandt</i>	6
4	Market Impact of US Fiscal Confrontations <i>Ángel Ubide</i>	9
5	Legal Uncertainties Surrounding Debt Ceiling Battles <i>Anna Gelpern</i>	12
6	Threats of Default and Dollar's International Role <i>Joseph E. Gagnon and Kent Troutman</i>	14
7	US Fiscal Uncertainty and Emerging-Market Capital Flows <i>Douglas A. Rediker</i>	17

This report was funded by a grant from the Peter G. Peterson Foundation.
The statements made and views expressed are solely those of the individual authors.

1

Introduction: The Costs of Behaving Badly

ADAM S. POSEN

The willful fiscal crackup of the last two years is going to cost the United States, dearly, unless our politicians' behavior markedly improves. For decades, Americans could count on good fiscal governance—especially compared with the rest of the world. Even if the US federal government ran deficits, or put off some harder long-term choices, our basic budgetary processes worked unlike those of so-called banana republics. As a result, everyone worldwide, whether a VA patient in Louisville or a US Treasury bondholder in London, could count on the US government making its payments. Being able to take that fact for granted meant the US economy had lower interest rates and greater stability than anywhere else. That in turn meant the dollar was everyone's envy and safe haven, which brought more investment into our secure economy.

The bad behavior of Congress in repeatedly failing to pass budget legislation, or to bring the debt ceiling into line with spending, and ultimately explicitly threatening default on US government debt, makes our fiscal politics no better than anyone else's—and in some ways a lot worse. The whole budget decision-making breakdown of 2012–13 was completely avoidable in economic terms, which if anything increases the reputational damage. It was a completely self-inflicted wound.

There is no other known example of a solvent democracy flirting with default through sheer political stubbornness. While many democracies with fragmented party systems spend themselves into crashes—think of Italy in the 1970s or Argentina repeatedly—the crashes only came when they had run out of credit. On the economic fundamentals, the US government would still be perfectly capable of rolling over its debt at historically low interest rates, and the dollar remains strong. Yet, the dysfunctionality of US fiscal policy has too high of a chance to become an ongoing reality.

The direct costs of these fiscal follies are already substantial, as the essays in this report make clear. David Stockton argues, for example, that the fiscal uncertainty of last year already took 1 percent off of US real GDP, or \$150 billion a year, and increased unemployment by 0.5 percent or 750,000 people. And the arbitrary manner of the cuts hit government functions in the most backwards fashion, cutting public investment and high-impact services for the poor, maximizing their immediate damage.

The continuing uncertainty about US fiscal decision-making, and the recurrent risk of a repeat, is now dragging down American productive investment. Households understandably tend to raise their savings and lower their risk taking when economic uncertainty increases. Companies were already sitting on unprecedented amounts of cash, reluctant to take risks for a variety of reasons, good and bad, after the recent economic crisis. Between the two, the fiscal follies have sharply diminished recovery of capital expenditure that was forecast for late 2013 and 2014, which will further limit growth both in the near term and of productivity in the long term. For all the talk about uncertainty for businesses arising from Obamacare or Federal Reserve policies, the impact of ongoing fiscal policy volatility on foregone investment will be much higher.

Worse still, global markets have priced in a default risk on US treasuries, where there had been none. Whether this is permanent or merely lasting is unclear, but it is new ground. While small, perhaps 10 basis points (1/10th of 1 percent) on average at present, this risk premium represents a profound change. The majority of financial contracts that were written to treat US treasuries as the ultimate safe collateral and means of settlement now have to be redone to allow for some divergence between AAA assets and treasuries—and that imposes a need for long-term investors and counterparties to hedge, resulting in a higher cost of all transactions. And US taxpayers will consequently foot the bill for higher rates demanded by markets on newly issued US government debt from now on.

Adam S. Posen is president of the Peterson Institute for International Economics in Washington, DC.

The most overlooked and perhaps most lasting harmful effect of the fiscal follies will be the severely diminished ability of the United States to conclude international economic negotiations. For the most part, the US government have historically gone into economic discussions, whether trade negotiations, G-7 or G-20 summits, or International Monetary Fund (IMF) debt program discussions, with three strong cards: the ability to set the initial agenda; the financial strength to hold the line when there were disputes; and the credible tactic of demanding a good deal lest Congress object. All that leverage is now diminished. At the IMF–World Bank and G-7 meetings in October 2013, the first agenda item was criticism of the United States (deserv- edly). Nothing else got tackled. The Obama administration’s ambitious trade opening agenda of concluding Trans-Pacific and Trans-Atlantic partnerships is stalled because of negotiating partners (rightly) doubting the ability of the US government to win congressional approval.

Some adjustment of US economic dominance is inevitable, as the size and income level of the United States shrinks relative to the rest of the world. An unintended acceleration of that long-run process through domestic political failure, however, serves no one’s interests—least of all the United States. Yet, unquestionably this entirely self-inflicted wound is speeding up America’s decline as well as undermining economic recovery.

People and their elected representatives can legitimately disagree with each other about the speed and seriousness needed to tackle US public debt problems. They certainly can disagree about the way that such problems would be dealt with, whether through tax increases or spending cuts, of any given combination. There is no room for disagreement, however, that a budget process that threatens recurrent deadlock and even possible default on US government debt is seriously harmful to American well being and international standing. There is no need for America’s legislators to behave as badly as their counterparts in far poorer and less solidly democratic countries do—and there certainly are significant costs of even threatening to do so.

2

Economic Fallout from Crisis-Driven Fiscal Policy

DAVID J. STOCKTON

The conduct of fiscal policy in the United States over the past several years has been characterized by conflict, confrontation, and stalemate. This contentious process has resulted in heightened uncertainty about spending, taxes, and debt that has impeded economic recovery. The uncertainty surrounding US fiscal policy has resulted less from an unusually uncertain economic environment than from deliberately manufactured “crises” intended to force difficult fiscal decisions. This messy approach might be excused, or perhaps even embraced, if it was delivering beneficial outcomes, but that has not been the case. Instead, crisis-driven fiscal policy has restrained economic activity without resolving longer-term fiscal sustainability. Recent budget agreements offer hope that policymakers may be ready to break this destructive cycle, but many other difficult decisions loom, including another encounter with the federal debt ceiling—and, hence, the potential remains for continued volatility and uncertainty.

In just the past two and half years, we have experienced the threat of default on US federal debt in the summer of 2011, the last minute negotiations to head off a plunge over the fiscal cliff at the end of 2012, the imposition of the sequester spending cuts in March 2013, the government shutdown in October 2013, and the threat once again of default on US Treasury securities last fall. These serial fiscal crises have distorted budget choices and produced ill-timed fiscal consolidation while intensifying uncertainty in the broader global economic environment. Meanwhile, the credibility and soundness of policymaking in the United States has been damaged in ways that may have longer-lasting effects on economic and financial relationships around the world.

US Treasury securities, universally regarded as a completely safe asset, have enabled the US government to borrow on favorable terms in global financial markets, a benefit of the United States’s strong economic foundations, deep financial markets, and confidence that US policymaking will be reliable and sound. But repeated actions that threaten the possibility of default are challenging that underlying presumption, with negative consequences on markets, including higher private borrowing rates and reduced incentives for private investment.

For example, in a study prepared for the Peterson Foundation (2013),¹ Macroeconomic Advisers (MA)—a macroeconomic consulting firm—constructed a measure of fiscal policy uncertainty going back to the mid-1980s. The index was created by modifying a broader index of policy uncertainty that was developed by Scott Baker, Nicholas Bloom, and Steven Davis (2013).² The Baker et al. policy uncertainty index combines information based on mentions of economic policy uncertainty in the news, the value of expiring tax provisions, forecasters’ disagreements about government spending one year ahead, and forecasters’ disagreements about inflation one year ahead. MA makes two adjustments to this measure of policy uncertainty; they exclude the disagreements about the inflation forecast on the assumption that this reflects monetary policy uncertainty, and they cyclically adjust the resulting index to limit the possibility that the measure of fiscal policy uncertainty is *caused by* a weak economy rather than *causes* a weak economy. The resulting measure is plotted in figure 1.

The figure shows that the average level of fiscal policy uncertainty since the beginning of 2011 has been more than 50 percent higher than the average over the 1986 to 2010 period. Moreover, there were pronounced peaks in fiscal policy uncertainty around the August 2011 debt downgrade, the December 2012 fiscal cliff, and the October 2013 government shutdown/debt limit confrontation. MA demonstrates that this measure of fiscal policy uncertainty is negatively correlated with stock prices and

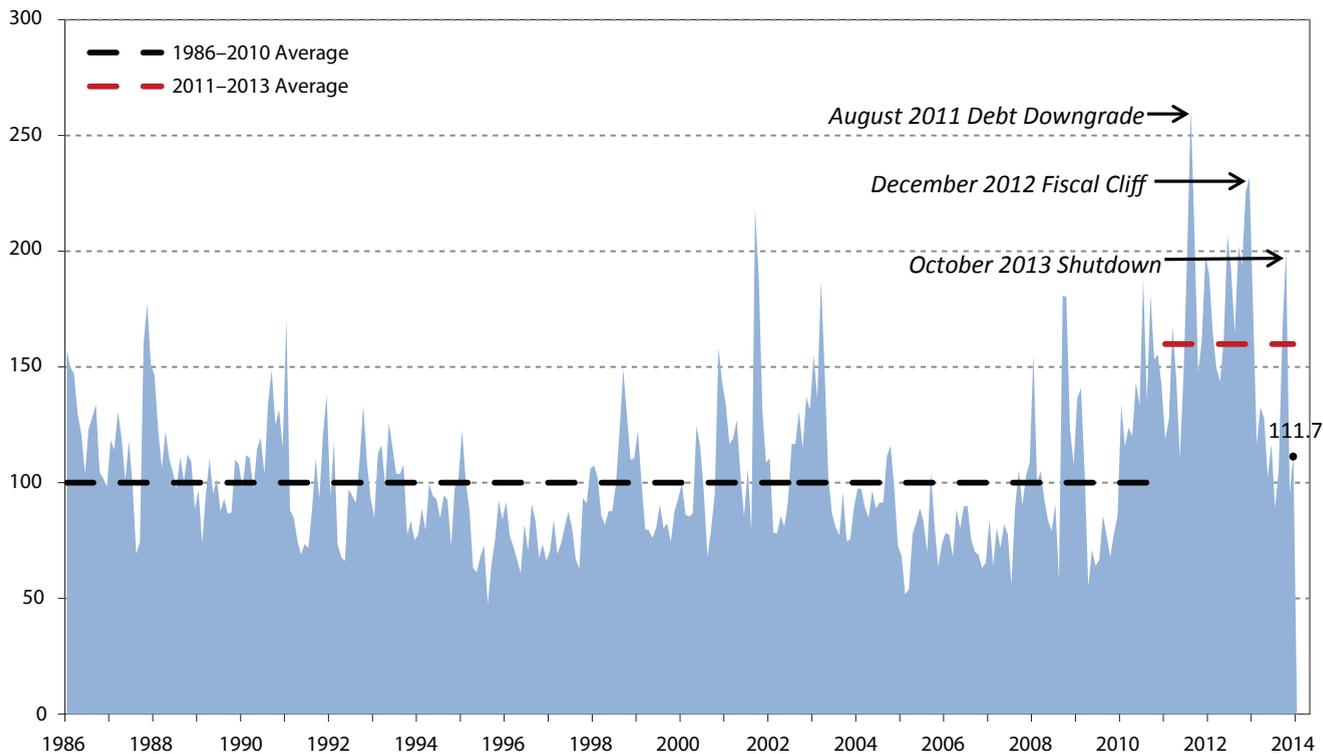
1. http://pgpf.org/sites/default/files/10112013_crisis_driven_report_fullreport.pdf.

2. <http://www.policyuncertainty.com>.

David J. Stockton, senior fellow at the Peterson Institute for International Economics, is also senior adviser at Macroeconomics Advisers, LLC.

Figure 1 Fiscal policy uncertainty

index: average of January 1986–December 2010 = 100



Source: Baker, Bloom & Davis at www.policyuncertainty.com; Macroeconomic Advisers, LLC.

positively correlated with private credit spreads (the cost private borrowers face relative to the cost of borrowing faced by the federal government). Indeed, the MA estimates suggest that private borrowing spreads have been lifted nearly 40 basis points by heightened fiscal uncertainty since 2010. If that increase was fully reflected in higher mortgage interest rates, it would translate into roughly a \$450 higher annual mortgage payment on the existing home in the United States.^{3,*}

Using their large-scale econometric model, MA estimates that the heightened fiscal policy uncertainty of the past few years depressed the level of real GDP by about one percentage point and correspondingly raised the level of the unemployment rate by a bit more than ½ percentage point. One percentage point on the level of real GDP translates into a loss of \$150 billion each year. To be sure, some of the cause and effect of this relationship could run in the reverse direction, in the sense that poor economic performance could lead to greater uncertainty about fiscal responses. Other recent factors, such as the euro crisis, could also have contributed to lagging performance. But most of the evidence supports the proposition that fiscal policy uncertainty has affected financial conditions and economic performance.

Damage done by manufactured fiscal crises has been slow and not always visible, accumulating over time. It has not only raised the cost of borrowing but also has done reputational damage by undermining confidence in the United States as a destination for portfolio and direct investments. Domestically, eroding confidence in government makes it more difficult to address pressing economic issues. Internationally, our foreign partners increasingly doubt US reliability in economic, political, and security endeavors. The budget standoff in the fall of 2013, for example, caused frustration and disbelief among business people, foreign officials, and private investors forced to worry about the consequences of a potential default. Everyone believed that default, or even hitting the debt limit, was a very low probability, but the potential consequences were so large that prudence required people in these worlds to contemplate their exposures and plan for the unthinkable.

3. The median price of an existing home in the United States is about \$200,000. The calculation assumes a 20 percent down payment and a 30-year mortgage of \$160,000.

* This sentence corrects an earlier version, which stated erroneously that higher mortgage interest rates would translate into a \$470 per month higher mortgage payment on the median existing home in the United States.

These fears were a blow to the credibility earned by US policymakers from their initial aggressive policy responses to the financial and economic crisis of 2008, including the prompt and sizable fiscal stimulus packages enacted by the Bush and Obama administrations and the massive efforts by the Federal Reserve to provide liquidity and monetary support.

One underappreciated cost of the United States's recent fiscal dysfunction has been an overreliance on monetary policy to support the recovery, particularly the employment of such unconventional policies as the massive purchases of long-term securities and the issuance of forward guidance about the likely path of interest rates, both of which produce side-effects that are more uncertain than conventional monetary policy. A more predictable and less front-loaded fiscal policy would have allowed the Federal Reserve to ease back more promptly from their unconventional policies.

These negative effects are not irreversible. A return to a deliberative budget process would help greatly. The recently enacted budget agreement is a constructive and hopeful step forward. Members of Congress should also disavow threats of default to force difficult fiscal decisions and instead rely on the budget process to establish priorities and set policy. Holding the US government hostage is costly even if the hostage is ultimately released. A less confrontational atmosphere could have the added benefit of paving the way for adjustments of entitlement programs and tax reform that will be required to place the budget on a sustainable path in coming years.

3

Impact of US Fiscal Uncertainty on Household Saving Behavior

TOMAS HELLEBRANDT

A failure of the US Treasury to meet interest payments and redemptions on maturing debt would precipitate a financial crisis in the United States and around the world similar to that experienced following the failure of Lehman Brothers in 2008. Economic activity would collapse, unemployment would surge, and credit conditions faced by households would be tightened severely. Beyond these effects, however, the precise effect of a failure to reach a debt ceiling deal on household finances is highly uncertain. We would be in uncharted territory and as the experience of the Lehman's collapse showed the scale of such tail events is impossible to forecast.

In contrast to the experience following the most recent financial crisis, there would be little room for fiscal and monetary policy to mitigate the negative impact on household finances. In fact, fiscal policy would be forced into an unprecedented contraction by the requirement to immediately balance the budget resulting in severe cuts to Social Security benefits as well as Medicare and Medicaid expenditure.

Some might argue that there would be an offsetting benefit to household finances realized in the long run as a result of slower accumulation of debt and resulting reduction of the burden of future taxes. But such a benefit, if it occurs at all, is likely to be small. The kind of procyclical fiscal contraction in the midst of a financial crisis that would be forced on the US government would most likely lead to a permanent erosion of the tax base as protracted high unemployment and reduced investment by firms would erode the stock of human and physical capital. With less revenue the government would have less leeway to respond to lower debt by reducing taxes.

Households may therefore interpret the political brinkmanship and conflict surrounding debt ceiling negotiations as increasing the likelihood of a severe but highly uncertain negative shock to their finances, which might impact their spending and saving behavior in different ways.

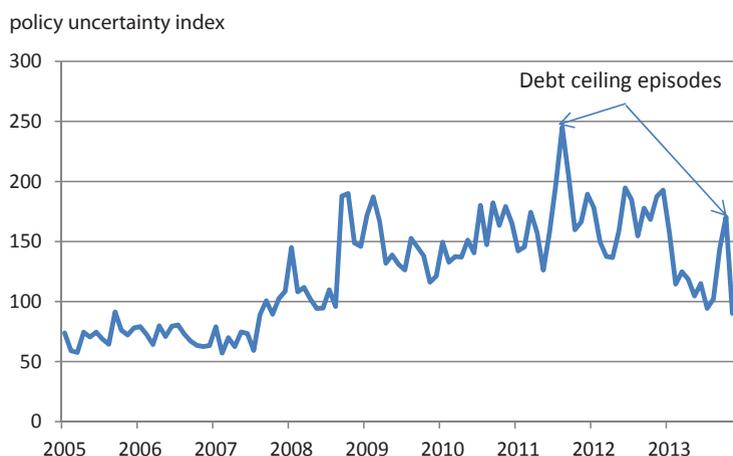
For most households, for example, the main motivation for saving and accumulating wealth is to smooth consumption over the life cycle—to provide for retirement and to create a buffer of resources available during periods of unemployment or low income. The greater the uncertainty about future income and employment prospects, the more likely households are to save for precautionary purposes. The precautionary motive for saving diminishes as household wealth rises, however. In addition, expansion of credit availability and lower interest rates reduce the return to saving and encourage consumption.

Accordingly, political conflicts over the debt ceiling could increase the household saving rate through all these channels. Increased risk of recession and unemployment is likely to increase the desired buffer of savings held by households for precautionary purposes. Increased uncertainty about the macroeconomic outlook is likely to suppress asset prices because of an increase in the premium required by investors to compensate them for the higher risk of holding an asset. Lower asset prices reduce aggregate household wealth and therefore increase the saving rate.

In the same vein increased risk of sovereign default as perceived by financial markets will result in higher risk premiums on sovereign debt, which increases real interest rates throughout the economy. Higher real interest rates encourage households to postpone consumption and increase their saving rates.

Tomas Hellebrandt has been research fellow at the Peterson Institute for International Economics since January 2013.

Figure 1 Index of economic policy uncertainty, 2005–13



Source: www.policyuncertainty.com.

Assuming the conflict over increasing the debt ceiling is eventually resolved without default, the effect on the level of household savings should be temporary. As uncertainty reverts to its normal level, asset prices should increase, interest rates should fall, and households should reduce their desired buffer of precautionary savings. The aggregate saving rate would then fall and consumption would grow temporarily above its normal rate while it reverts to its long run trend path.

This discussion of household behavior has assumed that households engage in continuous optimization, rationally weighing each piece of new information and adjusting their behavior in order to maximize their welfare. Some economists have pointed out that actual behavior in the real world often departs from this standard, however. For example, keeping oneself well-informed and constantly reoptimizing is time-consuming and costly. Households may rationally choose to save a constant share of income each month and only change their behavior in response to significant changes in their expected financial situation.

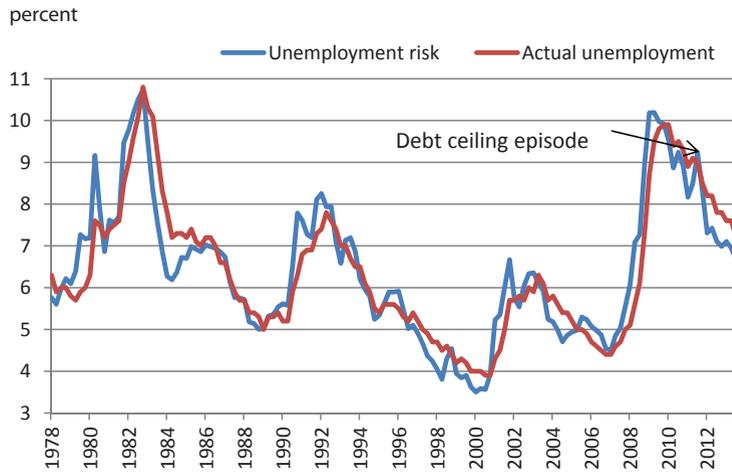
This kind of ‘rational ignorance’ would greatly reduce the effect on household behavior of short-lived periods of elevated uncertainty. A widely used measure of policy uncertainty, using data on newspaper coverage of policy uncertainty combined with tax code expiration data and data showing the degree of disagreement among professional forecasters about policy-related macroeconomic variables, has indeed spiked during the two most recent periods of debt ceiling negotiations in 2011 and 2013 (figure 1). But in both cases the period of elevated uncertainty seems to have been short-lived, which suggests that the response of households was likely limited.

This and similar indices have been used to assess the effect of uncertainty shocks on investment and aggregate economic activity. There have not been many studies looking specifically at consumer behavior. The few studies that exist tend to find that uncertainty shocks do have an effect on household consumption that is statistically, though not always economically, significant. The relevance of these studies may be limited because they combine short-lived changes to uncertainty with changes that are sustained for longer periods.

The index of economic policy uncertainty is also of limited use because it does not draw on any direct information on household views and attitudes about the economy. Christopher Carroll and coauthors have employed an alternative measure of uncertainty as perceived by households. They use a measure of household expectations regarding unemployment one year ahead constructed from Thomson Reuters/University of Michigan Survey of Consumers. This represents uncertainty in the sense that job security and so certainty in one’s income stream is related to the slack in the labor market. This measure is found to be an important determinant of the household saving rate.

However, household expectations of the future unemployment rate are unlikely to respond dramatically to the increased likelihood of a low probability event, such as a US default. To see whether this is the case figure 2 shows the measure of uncertainty used by Carroll updated to the latest data. The blue line shows the measure of uncertainty while the red line shows the actual unemployment rate. There was a spike in perceived unemployment risk around the time of the 2011 debt ceiling debate but none

Figure 2 Household perceptions of unemployment risk, 1978–2013



Source: Thomson Reuters/University of Michigan Survey of Consumers and author's calculations.

in 2013. On closer inspection the spike in 2011 occurred in August—that is, *after* the last-minute deal was reached to end the crisis (August 1). Thus the more likely explanation for the increase in uncertainty was the fall in global stock markets at the time, linked to fears of contagion of the European sovereign debt crisis to Spain and Italy.

Thus the measure of household uncertainty, which has been shown to have an important effect on consumption and saving behavior, shows little sign of responding to the political standoff over the debt ceiling. It should be stressed, however, that this benign conclusion tells us nothing about household behavior in the event of an actual default. Such an event would most likely result in a sustained period of crisis and uncertainty adversely affecting household wealth and credit conditions and resulting in rapid and justified surge in household concerns about their employment prospects and their financial security. Household consumption would surely plummet in such a scenario and contribute to collapsing demand.

4

Market Impact of US Fiscal Confrontations

ÁNGEL UBIDE

The US government shutdown and the near default on its debt in 2013 produced an apparently tame market reaction. Indeed it would be almost impossible to pinpoint that period in a chart of the S&P index. Under the surface, however, market reactions signaled that they took the matter seriously but that they believed that no matter what the Congress did, the Federal Reserve would ultimately respond and ensure that the disruption remained short lived.

While it is hard to tell from market behavior, these fiscal games erode, little by little, the credibility—and thus the intrinsic value—of US treasuries and the US dollar. Consider, for example, the evolution of the market outlook and expectations regarding the shutdown and the debt ceiling. For all the rhetorical fireworks in advance of the event, most analysts and market participants did not expect the shutdown to occur on October 1 and therefore had not incorporated it into market prices. Once the shutdown became reality, the consensus slowly concluded that the shutdown would last several weeks, increasing the odds of a breach of the debt ceiling.

As a benchmark for comparison, it is useful to assess the market impact of October relative to the previous debt ceiling scare in August 2011 and to the scare in mid-2013 over the Federal Reserve's announcement that it would taper its monetary stimulus program of bond purchases known as quantitative easing (QE).

First, in August 2011 other problems were taking place at the same time, mostly in the euro area. The fiscal games of 2011 led to the downgrade of the United States by S&P, from AAA to AA. Markets had been debating for weeks the potential impact of a downgrade and concluded that it was not a big worry, as it was only one of the three rating agencies and therefore it would not trigger any major forced selling of US treasuries. (Some institutional investors are required to hold only AAA assets, and thus a downgrade could have led to selling of the downgraded assets. But because of differences in ratings across the major rating agencies, the rating agency rules typically require that at least one of the rating agencies maintain a AAA rating. With only S&P threatening the downgrade, markets felt no need to worry.)

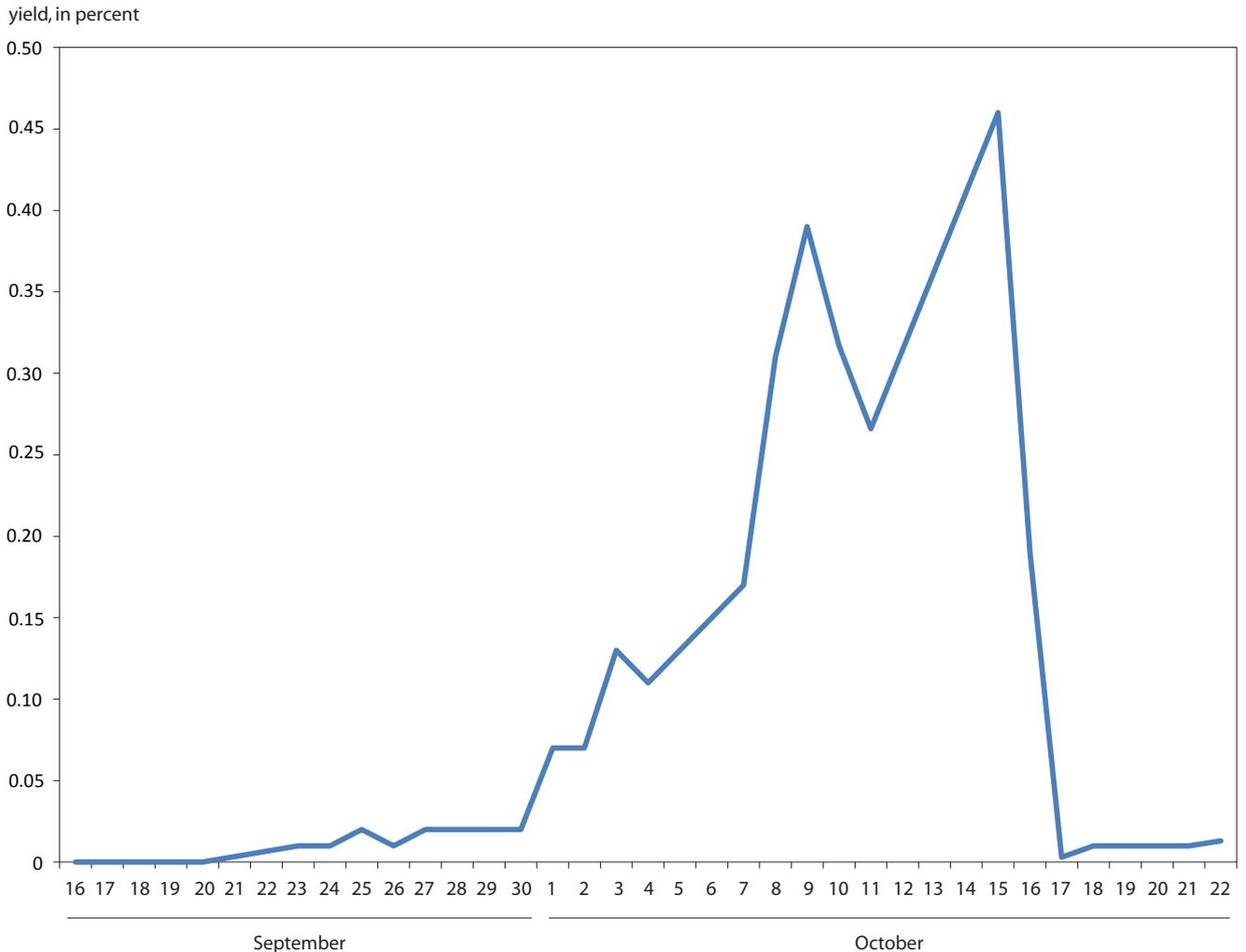
In the event, the downgrade came on a Friday and a violent selloff in stock markets ensued. Were markets wrong? No and yes. No, the downgrade didn't trigger any forced selloff in US treasuries—and in fact yields declined. But the downgrade increased the fear that the next country to be downgraded would be France, and that step could have potentially major consequences for the euro area crisis, because it would imply a downgrade of the European Financial Stability Facility, the regional fund set up to borrow and serve as a firewall for countries facing debt crises. This, and not the direct fear about the US fiscal outlook, was the cause of the stock market selloff.

By contrast, the market impact of the 2013 debt ceiling episode was felt mostly in the front end of the yield curve. One-month bills expiring in late October and early November did price some small probability of default (see figure 1). This extended into three-month bills and into the pricing of credit default swaps (CDSs). The probability of default implicit in 1-year CDSs for US debt moved above that of Mexican debt—thus signaling markets that this disruption was likely to last a few months. However, 10-year yields were barely affected. In fact, they moved much more during the taper scare of May-September than during the debt ceiling scare.

In other words, markets were sending a clear message that if a default were to happen, it would be just another “political game” and that while some specific coupon payments could perhaps be missed for a short period of time, Congress would eventually extend the debt ceiling, erasing doubts about the payment of US debt in general. In fact, drastically different from the 2011 episode, when stock markets tanked, stock markets and the US dollar barely moved (see figure 2), and the implicit volatility in the stock market and the dollar—a measure of market uncertainty—declined, rather than increased.

Ángel Ubide, senior fellow at the Peterson Institute for International Economics, is the codirector of global economics at the D. E. Shaw Group, a global investment and technology development firm.

Figure 1 One-month T-bill maturing on October 24, 2013



Source: Bloomberg.

Again, the taper talk in May-September had a bigger impact on stock prices and the dollar and on uncertainty than the debt ceiling scare. The stable situation in the euro area (including the fact that the European Central Bank [ECB] had by this point put in place its “outright monetary transaction” [OMT] of asset purchases) was apparently reassuring to markets. So was the implicit assumption that the Fed would act to stabilize markets, for example, by communicating any changes to operating procedures to handle a delay in coupon payments.⁴

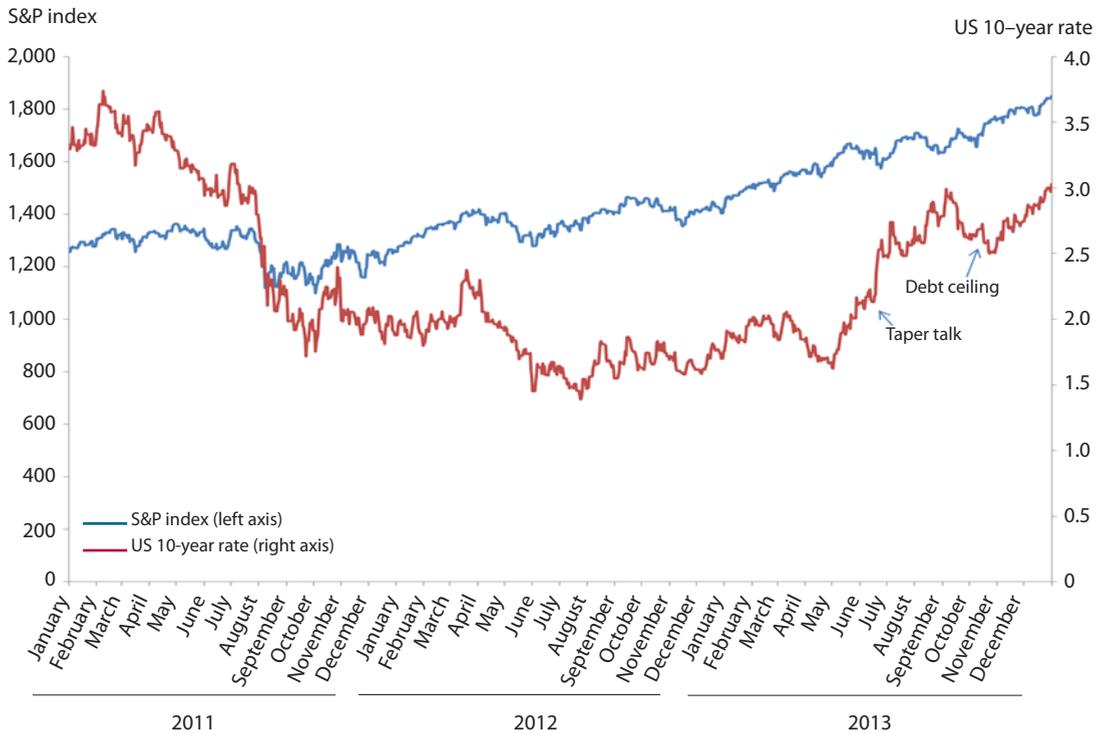
Despite this small and limited market impact, some changes in the plumbing of the financial system were influential. There were reports that counterparties and clearing houses were apparently refusing to accept treasury bills maturing in late October and early November as collateral, an indication of the default risk being taken seriously.⁵ Some institutions demanded discounts, or haircuts, on these bills, and apparently there were moves to rewrite legal documentation that would enable writing down of the collateral values of US treasuries.

As discussed above, changes were made to market infrastructure to handle delays in coupon payments. And there was open discussion of the potential ratings action ensuing from a missing coupon payment—likely a “selective default” rating, similar to

4. See <http://www.bloomberg.com/news/print/2013-10-14/treasury-default-fallout-seen-contained-in-timely-fedwire-notice.html>.

5. See <http://online.wsj.com/news/articles/SB10001424052702303376904579136101622558282>.

Figure 2 US stock market and bond yields, 2011–13



Source: Bloomberg.

Greece after the losses imposed on creditors. Also discussed was the likelihood of a downgrade from the pre-default rating. Perhaps the market reaction was mild because the system was not ready to accommodate, and thus price, a default. If so, were a new episode to recur, after the changes introduced last year, markets could be more aggressive in pricing the deterioration of quality of US treasuries the next time.

The key difference between the debt problems of the United States and Europe in 2010–12 is that, whereas the ECB was unwilling to step in preemptively, the Fed was doing QE and not threatening to reject US treasuries as collateral if Congress failed to act. There was thus never a doubt that US treasuries would continue to be risk free. This, at the margin, lessens the market pressure on politicians to avoid using the debt ceiling as a political currency and could increase the odds of an accident and its potential impact.

What would happen if, as a result of repeated debt ceiling scares, markets were no longer to consider US treasuries risk free?

The definition of such assets is that they are “informationally insensitive.” In other words, investors do not worry about whether the principal will be repaid. This definition explains why US treasuries are valuable, and enjoy low interest rates, especially as collateral in financial transactions. If US treasuries were to come with more risk, they would follow the fate of the privately distributed asset-backed securities in 2007 and euro area periphery bonds in 2010: Interest rates would become pro-cyclical—a weakening of the economic outlook would lead to higher, not lower, interest rates; banks would face margin calls on their posted collateral and would have to deleverage; and the Fed would come under pressure to decide whether to apply discounts, or haircuts, on the US treasuries posted as collateral.

At the end of the day, in 2013, markets trusted the Fed and hoped Congress would reach the abyss but not jump. But in a growing world of multiple reserve currencies, these recurrent, self-inflicted fiscal crises will only further erode the attractiveness of the dollar as reserve currency.

As the euro area rebalances its economy, strengthens its institutional framework, and improves its external position—it is now running a 2 to 3 percent current account surplus compared with a 2 to 3 percent current account deficit in the United States the decline of the US dollar’s share in global reserves will likely continue, making it ever more risky for Washington to play with fire on the debt ceiling. The paper by Joseph Gagnon and Kent Troutman in this report discusses this issue at length.

Legal Uncertainties Surrounding Debt Ceiling Battles

ANNA GELPERN

Debt limit crises happen when the US Congress exercises its three powers at cross-purposes: It votes to spend more than the combined amount it has voted to tax and borrow. This puts the executive in a bind. It must spend the appropriated funds, but it has no authority to borrow or tax to raise new revenues. As some have suggested, its best course is one that is “least illegal.” It must also be one that does the least economic harm. Executive borrowing in defiance of Congress is often described as least illegal and economically costless. I argue instead that legal uncertainty surrounding such debt runs the risk of disrupting financial markets and inflicting economic damage to the United States and beyond.

The standoff of 2011 rattled global markets and launched an intense debate among legal scholars about the relative constitutionality of the leading options before the president to avoid debt default: borrowing over the debt limit imposed by Congress and withholding congressional appropriations so as to pay US treasuries.

Advocates of unilateral borrowing often point to the 14th Amendment to the Constitution, which says that the validity of federal debt “shall not be questioned.”⁶ The Supreme Court held that Congress violated this provision in 1933, when it repudiated the promise to link US government debt payments to the value of gold.⁷ Today some argue that refusing to raise the debt limit is tantamount to questioning the validity of the debt and therefore unconstitutional on the part of Congress.

Even if it were correct, this interpretation would be of little help to the executive scrambling to avoid market meltdown.

The Constitution reserves three core powers for Congress: the power to tax, the power to borrow, and the power to spend.⁸ Congress has passed laws to delegate some of these powers to the executive; however, the delegation is partial and conditional. The debt limit is an example of partial delegation of congressional borrowing power.⁹

Suppose the debt limit itself—or refusing to raise it—were held to violate the 14th Amendment. There is no provision yielding Congress’s borrowing authority to the president in such a case. Should the Treasury decide to borrow over the limit, it would invite two challenges: a challenge to its borrowing authority and a challenge to the “full faith and credit” status of the new

6. “The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned. But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations and claims shall be held illegal and void.” U.S. Constitution, XIV Amendment, Section 4. Note that the affirmation of federal debt is followed immediately by the repudiation of confederate debt.

7. *Perry v. United States*, 294 U.S. 330 (1935). The creditor still lost in this case, after the court held that Congress could outlaw payments in gold. Because gold would have no value under the circumstances, the court held that the plaintiffs suffered no damage.

8. Under Article I, Section 8, “the Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and General Welfare of the United States;” as well as “To borrow Money on the credit of the United States.” Under Article I, Section 9, “No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law...”

9. For much of the United States history, Congress authorized specific categories of debt. After World War I, it began delegating the ability to borrow an overall amount, specifying only the limit on total US government debt outstanding. The limit was a step away from micromanagement, not an intrusion on prior Executive prerogatives. The face amount of obligations issued under this chapter and the face amount of obligations whose principal and interest are guaranteed by the United States Government (except guaranteed obligations held by the Secretary of the Treasury) may not be more than \$____, outstanding at one time” US Code, Title 31, Section 3101(b) The Default Prevention Act of 2013 suspended this provision until February 7, 2014.

Anna Gelpern, nonresident senior fellow at the Peterson Institute for International Economics, is professor of law at Georgetown University.

debt.¹⁰ Even if both challenges were to fail in the end, the final verdict would not be known on the day the government must confront the impossible arithmetic of conflicting congressional instructions.

The same result would obtain with other theories of executive borrowing, such as those based on the inherent authority of the president to act in an emergency. The new Treasury securities issued in this scenario would exist in legal limbo, as a distinct category of US government obligations exposed to challenge until Congress chooses to ratify them retroactively—or until the lawsuits run their course.

In all, there is simply no clever legal way out of the basic conundrum where Congress has voted to spend more than the revenues and borrowing it has authorized. Spending power offers another example.

Like the power to borrow, the power to spend rests with Congress. Executive refusal to spend appropriated funds would prompt lawsuits against the executive for violating the Impoundment Control Act of 1974, passed in response to President Richard Nixon's attempts to withhold spending. The act is part of the framework for delegating congressional spending power.

Ignoring appropriation mandates rather than debt limits would affect financial markets indirectly, because it would not implicate the validity of US Treasury securities. However, depending on where the losses fall, failure to spend could result in serious economic dislocation and political backlash.¹¹

US government debt looks different to economists, capital market investors, bank regulators, and contract and constitutional lawyers. It is a funding vehicle for the federal government, a store of value and liquidity for investors around the world, a benchmark for pricing other assets, a contract, and a constitutional battleground. Policy suffers when these different perspectives fail to engage with one another.

Once the Treasury's cash management schemes are exhausted,¹² the president runs out of legal options. The remaining options—all illegal—comprise a political nonstarter (unilaterally raising taxes), economic disruption (withholding spending), and a financial market shock (unauthorized debt issuance). The extent of economic disruption would depend on the amount and kind of spending withheld. The extent of financial market disruption would depend on market reception of the unauthorized treasuries and the resulting two-tier treasury market. Lawsuits will come no matter what, in time to clarify policy choices for the crisis after next.

References

- Amar, Akhil Reed. 2013. G.O.P Stand on Debt Gives Checkbook to Obama. *New York Times Room for Debate Blog*, October 3.
- Buchanan, Neil H., and Michael C. Dorf. 2012. How to Choose the Least Unconstitutional Option: Lessons for the President (and Others) from the Debt Ceiling Standoff. *Columbia Law Review* 112: 1175–243.
- Jackson, Howell E. 2012. The 2011 Debt Ceiling Impasse Revisited. In *Is U.S. Government Debt Different?* ed. Franklin Allen et al. Philadelphia: Wharton FIC Press.
- McConnell, Michael W. 2012. Origins of the Fiscal Constitution. In *Is U.S. Government Debt Different?* ed. Franklin Allen et al. Philadelphia: Wharton FIC Press.
- Posner, Eric. 2013. Three Ways Obama Could Raise the Debt Ceiling on His Own: The Controversial, Risky Options if Congress Doesn't Act. *The New Republic*, October 6.
- Tribe, Lawrence H. 2011. A Ceiling We Can't Wish Away. *New York Times*, July 7.

10. For example, an investor might sue a fund manager for buying “illegal”—hence potentially worthless—debt, in contravention of a fund mandate. Plenty of potential plaintiffs would bring such a lawsuit for purely political reasons; such a lawsuit is likely enough to dissuade conservative fund managers from taking the chance.

11. The executive's ability to prioritize spending is another subject of legal controversy. The political risk of picking and choosing among government beneficiaries would likely prompt the president to follow a “first in first out” (FIFO) approach to disbursements.

12. Options beyond the scope of this [note] may include, for example, redeeming Treasury securities in the Social Security fund to pay benefits.

6

Threats of Default and Dollar's International Role

JOSEPH E. GAGNON AND KENT TROUTMAN

The United States has gone through two debt ceiling scares, one in 2011 and another in 2013. Despite the warnings of dire consequences of even close brushes with default, no ill consequences have afflicted the dollar. But that does not mean that a future debt ceiling scare or default would have no impact. Even a serious threat of default would cause the dollar to depreciate, which by itself would be beneficial for the US economy at present, albeit at the expense of the rest of the world. Because of the dollar's preeminent role in global markets, even a partial US default would be an economic calamity, reverberating throughout the world.

One sign of stability for the dollar despite the recent crises, including the greatest economic downturn in the United States since the Great Depression, is that the dollar's share of foreign exchange reserves has been roughly stable over the past two decades (figure 1). The dollar thus remains by far the world's leading reserve currency, and there has been no noticeable change in its share since the US debt ceiling scares of 2011 and 2013.¹³

The continued stability of the dollar's reserve-currency status reflects the widespread conviction that outright default, or even a significant delay in payment, will not be part of any resolution of the ongoing debt debate in the United States. The strength of this conviction is evident in the lack of any increase in yields on US Treasury securities with remaining maturities greater than a few weeks, even during pivotal moments of the debt ceiling debate.¹⁴

That said, if foreign governments were to become seriously concerned that the US Treasury might default on some or all of its obligations, there would surely be a rush to exchange dollar reserves for other currencies. This would cause a crash in the value of the dollar, which by itself would greatly shrink the dollar's share of foreign exchange reserves in value terms. Whether the dollar's share would decline by more than the decline in its exchange value depends on whether foreign governments would be more or less determined to sell dollar assets than other investors. Because every transaction must have a buyer and a seller, foreign governments could succeed in selling off dollar reserves only to the extent that other investors were willing to buy more dollar assets.

Any sharp depreciation of the dollar has the potential to be disruptive, but a depreciation motivated by fears of US default would be especially damaging. The existence of an unquestioned safe asset is essential for efficient, smooth, and liquid financial markets. US Treasury securities are the world's most important risk-free assets; they form the basis for pricing all other dollar-denominated assets and, to some extent, for pricing assets in other currencies, too. The global financial crisis that ensued after the downgrading of AAA-rated US mortgage assets and the default of Lehman Brothers demonstrates how damaging losses on previously perceived safe assets can be. There is no doubt that even a partial default by the US Treasury would cause a far greater calamity.

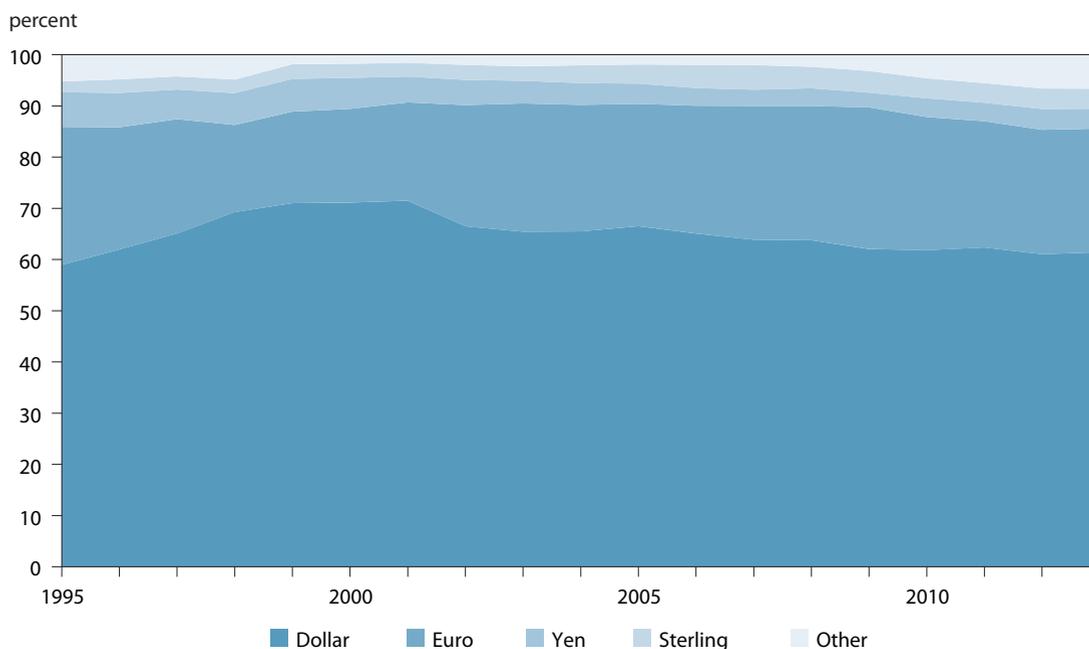
Aside from the effects of these financial strains, dollar depreciation would tend to shift global spending toward US exports and away from exports of other countries. This shift in demand would be beneficial at present from the US perspective and detrimental from the perspective of some of its trading partners, especially those suffering from economic slack. One would expect a dollar crash to put upward pressure on US bond yields, but in Gagnon (2009) one of us shows that bond yields rise during and after currency

13. The most recent data are for September 30, 2013, which was just before the resolution of the latest installment of the debt ceiling debate on October 17, 2013.

14. There was a small increase in yields on Treasury securities with very short maturities, reflecting market concerns about a possible temporary delay in payment. But this increase was not consistent with any appreciable risk of default or major delay in payment.

Joseph E. Gagnon, senior fellow at the Peterson Institute for International Economics since September 2009, was visiting associate director, Division of Monetary Affairs (2008–09) at the US Federal Reserve Board. Kent Troutman has been research analyst at the Peterson Institute for International Economics since August 2013.

Figure 1 Currency composition of foreign exchange reserves, 1995–2013



Note: Shares are based on holdings of countries that report a currency breakdown. Prior to 1999, euro data are the sum of holdings of German marks, French francs, Dutch guilders, and European Currency Units (ECU). All data are end of year except 2013, which is September 30.

Source: International Monetary Fund.

crashes only when inflation is already high and rising before the crash. To be sure, losses from financial turmoil associated with default would outweigh any gains to the US economy from dollar depreciation.

The dollar's preeminent role in the world economy guarantees that the damage of a US default, or even the serious threat of a default, would reverberate far beyond US borders. But the subsequent decline in the dollar's reserve-currency role would not itself have major consequences (beyond its abruptness), provided that other currencies with perceived zero default risk were available. The main candidates are the euro and the Chinese renminbi, with potential supporting roles for sterling and the yen.¹⁵ At the moment, the euro area is still struggling to emerge from a sovereign debt crisis caused by substantially delayed payments on Greek government debt and concerns about possible defaults or delays in debt repayments of other member governments. And many market participants are concerned about China's ability to smoothly rebalance and reform its economy away from a highly leveraged investment-driven growth model. Thus, the timing is not good for a switch to a new reserve currency. But China and the euro area may be better placed in five or ten years.

The benefits of being a major reserve currency are hard to quantify but rather small. Perhaps the most important benefit is being able to borrow at a slightly lower rate of interest (Warnock and Warnock 2009). The costs of being a reserve currency mushroomed over the past 15 years, as foreign exchange reserves grew much faster than the global economy. Most of the reserve buildup reflects a perverse flow of capital from developing economies, where capital is scarce, to the United States and Europe, where capital is abundant (Gagnon 2012). Within the United States and Europe, reserve inflows in the early to mid-2000s supported excessive and unsustainable investment in real estate. In the current environment of prolonged excess capacity in the major advanced economies, reserve currency status and the resulting official capital inflows are associated with a significant and undesired drain on aggregate demand (Bergsten and Gagnon 2012). If this excess foreign reserve accumulation can be reversed in coming years, then both the benefits and the costs of being a reserve currency will be small.

15. In order for the renminbi to become a major reserve currency, China would have to relax restrictions on its purchase and use by foreigners.

The dollar's role as a reserve currency is likely to remain large as long as the United States maintains sound economic policies. A serious threat of default by the US Treasury could cause other currencies to take over much of the dollar's role. But loss of the dollar's dominant position is not by itself important to US economic well being and would be the least of our worries in the event of a default or the serious threat of default.

References

Bergsten, C. Fred, and Joseph Gagnon. 2012. *Currency Manipulation, the US Economy, and the Global Economic Order*. Policy Brief 12-25. Washington: Peterson Institute for International Economics.

Gagnon, Joseph. 2009. Currency Crashes and Bond Yields in Industrial Countries. *Journal of International Money and Finance* 28, no. 1: 161–81.

Gagnon, Joseph. 2012. *Global Imbalances and Foreign Asset Expansion by Developing-Economy Central Banks*. Working Paper 12-5. Washington: Peterson Institute for International Economics.

Warnock, Francis, and Veronica Warnock. 2009. International Capital Flows and US Interest Rates. *Journal of International Money and Finance* 28: 903–19.

7

US Fiscal Uncertainty and Emerging-Market Capital Flows

DOUGLAS A. REDIKER

The world's financial system remains largely lubricated by US dollars and US dollar-denominated Treasury securities. In spite of recent self-inflicted surges in dyspepsia, most financial actors, investors, central banks, and governments remain largely, though not entirely, comfortable ascribing risk-free status to US treasuries. In fact, one of the great ironies of market behavior over the past several years of US brinksmanship has been the tightening of US treasury yields as a result of its safe haven status at times of market volatility and uncertainty resulting from the potential risk of default on the part of the very same US Treasury. It takes a moment to intellectually reconcile the increase in demand for US treasuries upon the news of a rating agency downgrade of the creditworthiness of US government in August 2011. And yet, that is what happened.

The US Treasury benefits from a lack of alternatives to its safe haven status. Both in terms of currency exposure and liquidity, the United States is unparalleled in international markets. So, in spite of repeated threats of default and fiscal misbehavior, global central banks and financial investors around the world continue to provide, and the United States continues to benefit from, enormous capital inflows.

But the US Treasury as the world's safe haven should no longer be taken as a given. Over the past decade, US economic and political actions have compelled rating agencies to call into question US AAA status and allowed (forced?) the world's largest investors to consider alternative destinations for their capital in times of stress and uncertainty. Perhaps the most unlikely of beneficiaries have been emerging-market countries that have had to develop infrastructure, markets, and opportunities to absorb enormous capital inflows.

In the event of a return of political and fiscal uncertainty in the United States that again causes concerns about potential default, global investors have increasing alternatives. One could well expect to see strong capital flows into emerging-market countries at both the sovereign and corporate levels.

Repeatedly playing political brinksmanship in the United States and assuming the world's investors will accept "there is no alternative" to accepting US dysfunction poses an increasing risk. The ability to revert to "business as usual" for the United States following repeated self-inflicted brushes with default will inevitably diminish as other sources, destinations, and intermediaries for capital continue to develop as alternatives. Unlikely though it may seem, repeated bad political and fiscal behavior on the part of the United States might result in an acceleration of the development of alternatives around the world. Some of the main beneficiaries may well be emerging markets.

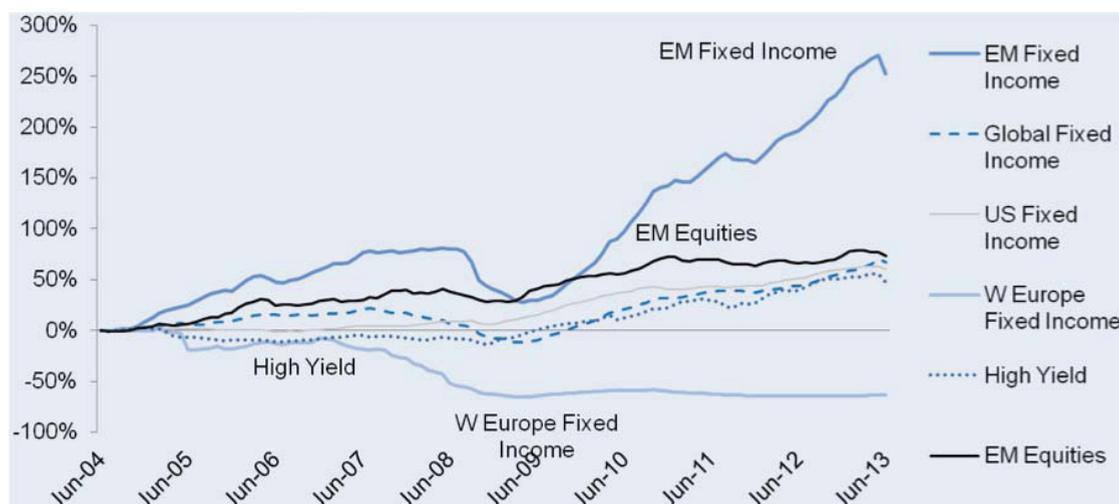
Potential shifts in international investor sentiment and behavior are not trivial to the United States. Non-US investors own roughly \$25 trillion in US dollar assets and the dollar dominates global foreign exchange markets, with roughly 87 percent of all foreign exchange transactions involving the dollar.¹⁶

But "there is no alternative" is not a healthy investment strategy and global investors know it. While there is no active hunt for the next global safe haven destination to replace the United States, continuing US fiscal and political dysfunction is having an

16. *Source:* Bank for International Settlements, *Triennial Central Bank Survey* 2013.

Douglas A. Rediker, visiting fellow at the Peterson Institute for International Economics, formerly represented the United States on the Executive Board of the International Monetary Fund from 2010 to 2012. He thanks Joyce Chang at JPMorgan for her assistance on this paper.

Figure 1 Cumulative flows as percent of AUM indexed to June 2004



AUM = assets under management; EM = emerging market

Sources: EPFR Global, JPMorgan, Bloomberg, AMG.

impact. As a result of increasing risks of default, global investors have begun considering not only the technical and legal implications of potential US failures to meet their payment obligations but also how to seek alternatives to this uncertainty.

While not directly analogous, the financial crisis of 2008–09, with ground zero in the United States, caused significant loss of confidence in the United States around the world. This loss of confidence in the United States resulted in a significant surge in capital flows to emerging-market economies, as investors sought to shift assets from the United States to more broadly diversified portfolios. Since 2008, foreign ownership of emerging-market government debt has almost tripled, increasing from 8.2 to 22.4 percent on a debt stock weighted average basis.¹⁷ Capital flows to emerging markets as a percentage of assets under management dramatically increased (figure 1).

As the US economy has recovered and political dysfunction, budget, and debt ceiling uncertainty has receded, global investors have begun reversing some of these capital flows, with recent figures indicating a shift back from the emerging markets to the United States. In May 2013, suggestions that the US Federal Reserve was considering tapering its quantitative easing program contributed to this reversal with capital flows migrating sharply away from emerging markets and back to US markets (table 1).

A threat to return to times of debt ceiling debacles, fiscal cliffs, possible default and fiscal armageddon would almost certainly result in increased uncertainty and very likely lead to a reversal again of these recent outflows and a return to postcrisis capital flows seen in the 2010–13 time frame and perhaps signal a more permanent shift towards greater diversification.

Increased international flows to emerging-market countries over the past decade have had two related and broadly positive impacts on emerging-market countries' domestic capital markets. First, the increase in foreign inward capital has created a need to develop domestic debt capital market infrastructure, including the technical, market, and legal foundations to support domestic debt issuance and investment. Second, domestic emerging-market asset managers, insurance companies, and pension funds have significantly increased their assets under management and their ability and willingness to deploy those assets in domestic capital market based investments. JPMorgan estimates that some \$1.3 trillion, approximately 80 percent of emerging-market fixed income is now held by these domestic institutions (figure 2). No longer are domestic emerging-market capital-raising options limited to foreign-currency issuance on international markets to attract foreign capital. These domestic markets and institutions are now resilient enough both to support inflows of foreign capital and to continue to issue in domestic currency and on domestic markets.

17. Source: JPMorgan.

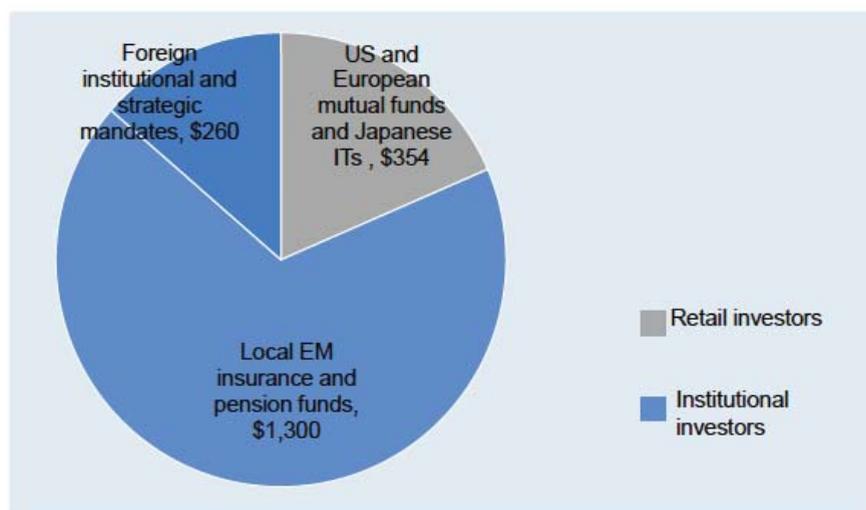
Table 1 Inflows to asset classes (billions of US dollars)

Asset Class	Jun-Dec	2013	2012	2011
EM Fixed Income	-39.8	10.3	97.5	43.2
EM Equities	-47.0	-28.4	53.0	-46.8
US IG Corporates	-18.7	39.6	134.4	73.7
US HY Corporates	-6.0	-5.1	29.4	15.6
US Equities	83.8	162.5	-54.6	-54.1
Global Equities ex-USA	72.6	158.1	33.0	6.6
Munis	-69.0	-63.3	46.0	-17.9
Mortgages	-30.7	-35.3	31.2	4.6

EM = emerging market

Note: Estimates denote mutual fund flows except for EM fixed income, which includes strategic flows.

Source: EPFR Global, JPMorgan, Bloomberg, AMG.

Figure 2 Assets under management (billions of US dollars)

EM = emerging market

Source: JPMorgan estimates, official sources, EPFR, Bloomberg.

This increased development of domestic capital markets has increased the attraction of capital to private issuers as well as sovereigns. Since the financial crisis began, emerging-market corporates have benefited from an almost tripling of investment from investors, with annual average emerging-market corporate issuance increasing from \$89 billion to \$242 billion from the pre- to post-financial crisis periods. Even with the trend to an overall reversal of capital flows away from emerging markets in late 2013, emerging-market corporates issued a record \$359 billion in debt in 2013 (figure 3).

The almost certain consequence of these strong capital inflows would be significant emerging-market currency appreciation. As we saw over this recent period of strong emerging-market capital inflows and appreciation, this could result in both economic benefits to emerging-market countries receiving these inflows and credit and the risks that necessary reforms could be stalled, postponed, or delayed indefinitely, potentially increasing the risks to their economies in the longer term. But, in part as a consequence of these strong capital inflows post-financial crisis, the overall economic foundations of emerging-market countries are, in the aggregate, more resilient and soundly based than ever before.

Figure 3 Emerging-market corporate external debt gross issuance

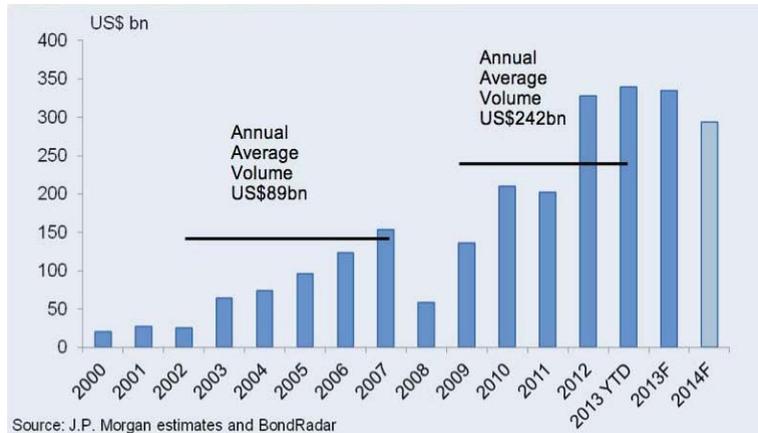
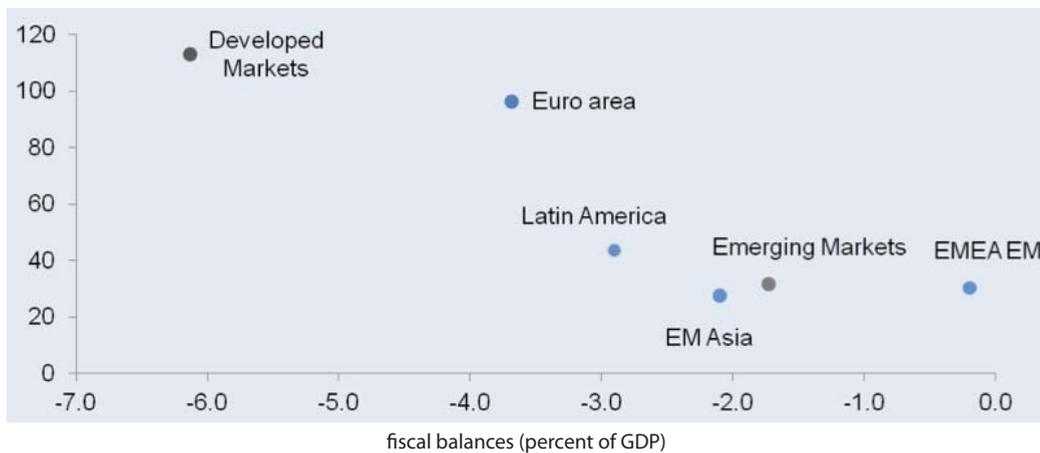


Figure 4 Government debt and fiscal balance ratios are one-third the level of developed-market countries

general government debt (percent of GDP)



Source: JPMorgan estimates and local country sources. Includes private and public sector debt.

Perhaps ironically, after years of scolding from the developed West, global emerging markets in the aggregate, by some basic metrics, now boast more sustainable and solid external accounts than does the aggregated developed world (figure 4). This represents a striking turnabout from only decades ago.

Possible emerging-market government policy responses to these potential capital inflows and currency appreciation could well include a ramping up of capital and/or macro-prudential controls. This would represent a reversal in recent policymaking, in which several emerging-market countries including India, China, and Brazil have begun the gradual process of loosening macro-prudential controls. These controls, which by design impede the free flow of capital, would be the result of a broad global reallocation and diversification away from the United States and not due to the inherent attraction of the country receiving the capital.¹⁸

18. While it is likely that increased uncertainty and loss of confidence in the United States could result in increasing capital flows into emerging markets, it is unlikely that there would be redenomination of debt as a result. Such re-denomination of debt has only really occurred during deep financial crises, generally originating in the emerging-market countries themselves, for example, in Argentina. Such redenomination would not likely be a response to a financial or economic crisis emanating from the United States unless such crisis were to reach the level where the US dollar's role as the dominant reserve currency were to be called into question. For the purposes of this exercise, such a scenario is unlikely.

In conclusion, it is dangerous for the United States to take it for granted that repeated political and economic games of chicken will not have longer-term consequences. Expecting the US dollar and Treasury securities to remain resilient has been a smart bet so far. But relying on “there is no alternative” is a lousy strategy. Global investors are gradually considering broad diversification as a possible alternative to the United States as a safe haven. American economic misconduct, indeed malpractice, would only speed the process of compelling investors to seek alternative places to put their money.