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Letter from Washington

In the last letter we discussed the debt ceiling issue, how it relates to long-term deficit reduction, and how both parties were trying to use the debt ceiling to position themselves for the 2012 elections. At that time, most people never imagined that there would not be a resolution well in advance of the August 2nd default date.

Incredibly, we are today not apparently any closed to a resolution than a month or a year ago.

To recap briefly, the federal debt limit needs to be raised by the Congress so that the Treasury Department can continue to borrow money to fund government operations. Since 40 cents of every federal budget dollar is borrowed, raising the limit is critical to continuing governmental activity. If August 2nd arrives with no agreement then the result is debatable, but can in no way be good.

The Republican side of the argument is that the administration will not be authorized to incur more debt without offsetting spending reductions. The long-term goal is to stop increasing the federal debt, and to ultimately begin paying it down. Serious efforts at debt reduction will be rewarded with an upturn in the economy and increased employment, so it is critical that taxes be kept as low as possible to encourage growth. For the Republicans, the long-term systemic issue in the economy is in the uncontrolled increase in entitlement spending, and any solution must address modifications to the very popular Social Security and Medicare programs that will ensure their continued viability.

The Democrat side of the argument is that spending levels should be maintained to prop up the weak economic recovery, and that the delta between income and expenditure should be made up with tax increases levied on “the rich”. Any changes to Social Security or Medicare, hallmark Democrat programs, are not on the table. Increasing the federal deficit is not particularly important, and money spent to stimulate the economy in the Keynesian model will be returned in the form of tax revenue.

The two core competing interests --- not modifying entitlements and not raising taxes --- have collided, and the debt ceiling raise is being held hostage to the resolution. Essentially, will the US spend its way to prosperity or will it cut its way?

All of this might just be an academic discussion of opposing political points of view, but there is a significant downside to not raising the debt ceiling. The immediate outcome will be that the credit rating agencies will downgrade US debt from its AAA rating, which may be inevitable even if the debt ceiling is raised. This will result in increased costs of borrowing for the US Treasury, translated into higher interest rates for American businesses and consumers, perhaps sufficient in itself to snuff the tepid economic recovery and put the economy back into recession.

For the last several weeks President Obama has been negotiating the framework of a "grand bargain" with House Speaker Boehner. While both men appeared to be committed to a deal, they have been held in check by their respective congressional caucuses by the threat of the deal being voted down for violating the entitlements or no-tax pledges of either side. Negotiations have been conducted in private for the most part, but in the last week have spilled out into public. Boehner walked away from the process last Friday, accusing the President of "moving the goal posts" and reneging on previously agreed terms. An angry Obama proceeded to scold the Republicans for holding the country for ransom over the debt issue.

In not closing the deal with Boehner the President effectively benched himself, and the action has shifted back to the House where the Speaker is preparing a new plan. The House will vote on it, probably tomorrow, and then it will be up to the Senate to pass it on to the President to sign.

The whole process of negotiations and recriminations has made some interesting Washington theater, but the basic fact is that it has been largely symbolic. In any negotiation there must be a fundamental agreement on what constitutes a worthwhile outcome, and compromises are made to achieve it. In this case there is no fundamental agreement, and the 87 freshman Republican members of the House view not raising the debt ceiling as a worthwhile goal. They were elected to Congress in their view to bring some discipline to the deficit and to federal spending, and they are not willing to go along with a deal that doesn't make deep, painful spending reductions. Additionally, over 200 House Republicans have signed a no-tax pledge, and if they go along with a deal that raises taxes in any form they will be opening themselves up to primary challengers from the right. As Speaker of the House, Boehner is nominally the head of the Republican Party in the government, but he presides over a fractious and balkanized group that will not bend to party discipline on these issues. His ability to get any bargain reached with Obama passed through his own House is very limited.

Similarly, Obama has had to back away from tentative agreements reached when word leaked that Social Security and Medicare might be affected with no additional tax revenue as part of the deal.

There have been several different President Obamas on display over the last week. Initially he was professorial, trying to stay above the fray publicly, while intimately involved in private. When negotiations with Boehner broke down, we saw the petulant side. Then earlier this week the President made a strange prime time television address, in which he was almost mournful. In the address he restated his belief that higher taxes on "corporate jet owners and hedge fund managers" were not unreasonable, and then invited viewers to call their Congressman, underlining his own irrelevance to the process.

Obama has from the beginning tried to paint the debt ceiling increase as a class issue, with the US middle class being squeezed by Republican robber barons. While this is not helpful to the negotiations, it is probably pretty smart electoral politics, as he positions himself and to a lesser extent his party as the protectors of the little guy and the guardians of the middle class. If things really do go over the cliff and take the economy with it, he will be able to blame the Republicans as the perpetrators.

Today was the first day that the markets actually seemed to notice what was going on and had significant losses. Like most Americans, the markets believed that the debt ceiling was such a no-brainer that it would never get down to the last moment. More than most things, the spooked markets may bring things off top dead center and moving to resolution.

Regardless, there is now not enough time to get significant legislation passed through both houses and signed before the August deadline. The most likely outcome is a short-term extension (14 to 30 days) to avoid potential default, and then more of the same partisan trench warfare until a larger deal can be worked.

All of this uncertainty has had a negative effect not only on the markets but on the Department of Defense as well. Recall that earlier this year the DoD worked under a Continuing Resolution, and then had a year's worth of money dumped on it to spend in less than six months. One of Secretary Gates' last actions was to stand up a Pentagon working group to figure out how to incorporate the 10 year US$400B in reductions that the President has directed. Gates' effort was to look at US strategy and then decide where more risk was acceptable and to steer cuts toward those areas. In the various plans that are being discussed now in the Congress, defense cuts of US$800B – 1T are being discussed, and the DoD orderly planning process has been overtaken by political events.

Under normal circumstances the Republicans in Congress would support a robust defense appropriations process. In fact, the House Armed Services committee has already passed a 2012 authorization with a modest increase. This too will be overtaken by events, and the Republicans now are more willing to reduce defense overall in order to avoid raising taxes and the political consequences that would bring.

Cuts in the US$800B+ range would require widespread program terminations, large-scale personnel cutbacks, and would devastate the DoD planning and budgeting process for years to come. Against this backdrop, program managers now have to make year-end decisions and choices in a complete vacuum. Where in normal years, end of cycle sweep up money might be spent on nice-to-have things, that luxury is no longer available. In the major service acquisition commands, sweep up money will probably be held back at the highest command echelons and invested with the realization that 2012 will likely be the worst DoD budget year since the end of the Vietnam War. That would have been the case even at the US$400B level but the numbers now being discussed are so far off the charts as to be unimaginable.

We have arrived at a point in American political life where the term "ungovernable" is heard more and more often, and the basic assumptions no longer apply. One of those assumptions has always been that in times of national emergency the elected representatives would put partisanship aside and act in the best interests of the country.