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As Debt-Ceiling Battle Grinds On, Be Careful What You Wish For

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Draconian deficit cuts could pose threat to faltering U.S. economy.

As the standoff over raising the U.S. debt ceiling drags on, Americans are sick of the entire exercise. Over two-thirds of the respondents to a Pew Research Center poll said they wanted the matter settled -- even if it means compromising with the side of the debate with which they disagree.

The disagreement, of course, is over how to reduce the federal budget deficit -- whether by spending cuts alone or a combination of reduced spending and increased revenues. What's not commented about is that both sides of the political aisle are in favor of deficit reduction. I cannot recall such unanimity on federal fiscal policy since the early days of the Reagan administration, when Democrats tried to one-up the Republicans with tax cuts. Today, there is equal unanimity about the need to reduce the deficit, which is hardly a surprise given the shortfall equals nearly 10% of the economy, a level not seen previously except during war time.

Yet there is another side of the argument. Draconian deficit cuts could stifle the economy, which already is faltering. Federal Reserve Chairman Ben Bernanke, while warning for the imperative need to bring the federal budget under control in the long term, has cautioned against too rapid fiscal tightening.

David Levy, the chairman of the Jerome Levy Forecasting Center, is even more emphatic: "Leaving aside the possibility of a European downturn and financial debacle, the biggest threat to the domestic economy through 2012 is the potential for a sharp, short-term deficit reduction."

Similarly, Richard Koo, the chief economist of the Nomura Research Institute, who has watched the policy blunders in Japan over that nation's two lost decades of nil economic growth, asserts that there are worse things than the "manufactured crisis" over the debt ceiling.

"Even more depressing is the fact that the spending cuts and other deficit-reduction efforts sought by the Republicans are the worst possible economic option for the U.S. today. This is because government borrowing and spending is the only way to prop up the economy when the public sector is deleveraging at a time of zero interest rates."

Both Levy and Koo point out that the U.S. economy has been sputtering as the much-maligned $787 billion Obama stimulus package is winding down. The impact is being felt most directly on state and local governments, which no longer will have benefit of federal largesse as of July 1, the beginning of the fiscal year in most states. The effect has been most apparent in the plunge in government payrolls for the past several months.

And as states balance their budgets, payments to localities are being slashed. Again, this is favored across the political spectrum. In New York, Democratic Gov. Andrew Cuomo enjoys high approval ratings from voters of both parties for getting a balanced budget approved on time -- a rare occurrence in the dysfunctional state capital of Albany. Across the Hudson River, Chris Christie, New Jersey's GOP governor, also earns plaudits for his pugnacious fight to balance his state's finances. So, fiscal propriety cuts across state and political lines.

Yet, as Koo and Levy persuasively argue, there is another side to the fiscal debate. Austerity can backfire, curbing growth and thus tax revenues, and widening the deficit in the short term while worsening the plight of those hurt by stagnant growth.

That is apparent in the U.K., where economic growth slowed to virtually nil in the second quarter (0.2% at an annual rate) amid fiscal austerity. Apologists for the sorry showing said the holiday for Royal Wedding shaved perhaps a quarter percentage point from the quarter's annualized growth. But the weak growth is raising calls for fiscal and monetary measures to spur the economy.

Excessive fiscal tightening could have a similar effect in the U.S. Second-quarter gross domestic product is likely to be reported in the 1% annual range, in part because of inventory shrinkage, when the numbers are released Friday. Of course, the sunny-side-up crowd will invoke Japan's earthquake tragedy as having disrupted supply lines as the all-purpose excuse for lagging growth.

As Up and Down Wall Street pointed out in the print edition of Barron's this week, the end of the Federal Reserve's QE2 securities purchase will mean a halt to the expansion of Federal Reserve and commercial bank credit, the fuel for growth of the economy, according to Northern Trust's economists Paul Kasriel and Asha Bangalore. A contraction on the fiscal side will have an unfortunately complementary effect.

The real danger would be if short-term, Draconian budget cuts works against the urgent need for long-term reform by slamming the brakes on the economy. As things stand, Citi economist Steven Wieting writes that Congressional Budget Office projections show the main federal entitlements -- Social Security, Medicare, Medicaid and other health programs -- will absorb all federal tax revenues in a couple of decades. That would leave nothing for defense, debt service or any other federal function.

The problem, as Wieting has stated previously, is that the U.S. wants to spend like Europeans but want to be taxed like Americans. The solution is to bring revenues and spending into a long-term balance without causing short-term harm. Ultimately, economic growth is the answer to our deficit problems. That seems to be lost in the current debt-ceiling debate.