moneycontrol PRO

US faces a fiscal cliff: Crisis or farce?

The debate over whether the US debt ceiling needs to be raised will revive pernicious fears about fiscal deficits

SASHI SIVRAMKRISHNA

SEPTEMBER 20, 2021 / 09:07 AM IST

US President Joe Biden (Image: Associated Press)

Brace for the upcoming global headlines in the next few weeks: US likely to fall off the fiscal cliff, the US government runs out of money, the US government hits its debt ceiling, will the US government default on debt?

Although the US has never really fallen off the cliff completely – or put bluntly, never defaulted on debt – the episode could nonetheless have important repercussions. For instance, between December 2018 and January 2019, more than 300,0000 government employees were furloughed for a month. Also, as reiterated by the US Treasury Secretary and former Chairperson of the Federal Reserve, Janet Yellen, concerns over the fiscal cliff can trigger uncertainty shocks and economic volatility. In a global economy that is only recently witnessing a return to some sense of normalcy after an extended period of uncertainty on account of the pandemic, heated exchanges between the Democrats and Republicans over the debt ceiling as well as the looming possibility of a taper tantrum amidst inflation concerns is likely to inflame already frayed nerves and undermine a robust recovery.

Although the US Congress has raised the debt ceiling 78 times since the 1960s, the fact that it keeps going through the process repeatedly is perhaps only to instil fear that there are limits over deficits and debt, and their limitlessness should not be taken for granted. More importantly, the US fiscal cliff sends a message throughout the world: after all, if the US – with the dollar as the international reserve currency – faces fiscal constraints, then other countries too face similar if not even more austere ones. It is no wonder then that several countries have formalized self-imposed fiscal constraints through the passing of legislations on deficits and debt.

The position of the US government is presently quite precarious if one believes that the debt ceiling will actually be imposed. On August 1, the debt ceiling of $28.5 trillion became effective and from then on, the government has had to live off balances held in Treasury General Account (TGA), which is now about just a couple of hundred billion. Before it reaches zero, Congress must agree to raise the debt ceiling or else the government will not be allowed to add to debt, although it can refinance its maturing debt. At the same time, during the time the episode plays out, the Treasury will

announce “extraordinary measures” to keep the government from defaulting on its payments. This will include, for example, suspending investments in Thrift Savings Plan’s G Fund and Exchange Stabilization Fund, at least for a short period of time. Once the debt ceiling limit is raised by Congress, the funds would be made whole.

One danger of the fiscal cliff debate is that it will once again shift the focus of public debate to fiscal constraints rather than appreciating its remarkable role in preventing the US economy from sinking into a depression on account of the pandemic. While the fiscal deficit rose sharply from 4.6% of GDP in 2019 to about 15% of GDP in 2020, US GDP declined by just about 3.5% in 2020 in spite of the lockdowns and systemic disruptions during the pandemic. With continuing fiscal support of more than 10% of GDP in 2021, the US economy is likely to achieve a growth rate of around 6% in 2021. While the deficits will return to 4% levels in 2022, GDP growth will remain above 5%. The debt to GDP ratio will stabilize at about 102% over this decade. All this assuming that there are no further disruptions from the pandemic.

The debate over the fiscal cliff is a part of a wider debate over fiscal deficits and public debt that delineates macroeconomic discourse into competing schools of thought. The decline of the Keynesian era post-1970s led to the rise of a new macroeconomics that advocated monetary rather than fiscal policy. Theories were propounded calling for fiscal prudence and consolidation in order to keep inflation low and stable to support private sector-led growth. The business cycle, it was claimed, had been tamed once and for all. However, the financial crisis of 2008 saw a return to Keynesian fiscal policies, but only for a short while. The return to austerity was slowly creeping back into macroeconomic discourse only to be disrupted once again by the pandemic. The strong budgetary interventions by the Biden administration to the pandemic were a clear sign in the changing stand over fiscal policy as compared to the tentative approach of President Obama after the 2008 global financial crisis.

The rise of Modern Money Theory (MMT) and the wide coverage it has received recently in the US popular media has made people question whether a state with its own sovereign currency does in fact have the power to create money without artificial financial limits. If this wasn’t possible, how did the US government spend an additional 3 or 4 trillion dollars during the pandemic without first raising taxes to fund expenditures? As MMT repeatedly argues, borrowings are never a constraint for fiscal spending as the state “borrows” dollars or its own financial liabilities that only it issues in the first place. And as expected, the borrowings came in substantial measure from the Federal Reserve, commercial banks and institutional investors along with the increased spending.

It is virtually impossible that the US Congress will not raise the debt ceiling on this occasion like all the others in the past. The Republicans would not want being held responsible for an austerity-induced recession at this precarious juncture. The question, however, remains whether the whole fiscal cliff episode will revive fears over deficits and debt rather than advancing fiscal policy as an instrument that can be harnessed not just in times of acute crises but also in achieving sustainable growth.

Sashi Sivramkrishna studies macroeconomics from a Modern Money Theory (MMT) perspective.