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POLITICAL PULSE

Let's Hope the Politicians are Lying

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Donald Luskin

Boehner and Obama both say we're heading for default. Game theory likely says otherwise.

After a week, the US government shutdown has the feeling of a fake emergency -- much alarm but little reality, rather like the onset of the budget sequesters earlier this year (see "Do the Sequesters Matter?" February 8, 2013). *But from this unreality no real pressure has emerged to drive a political solution. And now, as we warned over a month ago, the negotiations to end the shutdown with a continuing resolution have become mingled with the higher-stakes game of raising the statutory debt limit to avoid a Treasury default* (see "A Little Distant Gunfire" August 29, 2013).

- This flirtation with the possibility of default is a test of our strategic proposition that in 2013 the world is a stronger and safer place, in which adverse events no longer have to be assumed to be systemic threats leading to global financial contagion (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- So far so good, as we've expected (see "On the Pending Government Shutdown" September 30, 2013). *But an actual default would be a serious test indeed.*
- *So the questions are: will a default happen, and how bad it would be if it did?*

Our baseline scenario is that there will not be a default. But to be sure, it is a concern that politicians at the highest levels of power are taking the extraordinary step of making statements that open up mindspace for it.

- Last week the President of the United States strongly implied that investors ought to prepare for the real possibility of default. He said on CNBC, "this time's different. I think they should be concerned."
- And yesterday House Speaker John Boehner (R-OH) said on ABC, when asked if Obama continues to refuse to negotiate the country is going to default, "That's the path we're on."
- It's alarming that the President and the man two heartbeats away from the presidency would court panic by speaking so recklessly. By all the norms of comportment, we're accustomed to leaders saying things more like Obama said a week before the panic bottom in March 2009, that "buying stocks is a potentially good deal

Update to strategic view

US MACRO, US STOCKS, US BONDS: With the shutdown only a fake emergency, there has been insufficient pressure to end the impasse of the continuing resolution, and now the matter has become merged with the mid-month debt limit. Obama and Boehner have made reckless statements about the possibility of default. Such statements erode norms, and make default slightly more likely. But the logic of game theory suggests that there will be some form of compromise as there was at the year-end fiscal cliff, because neither side wishes to risk reputation damage. There are many possible solutions. The wild card is that the global economy is now robust to risks of financial contagion, so a technical default would likely cause only a short-term disturbance in markets, creating a risk-on opportunity. The problem is that if the politicians deeply believe that, then the game theory calculus changes because they won't perceive default as having as much reputation risk.

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if you've got a long-term perspective." So when they say the opposite, we must, well, "be concerned."

- The risk is that for Obama and Boehner to violate norms to this extent in the service of their feud erodes the inviolability of a far greater norm -- that the United States must never default on its debt.
- On the other hand we know that politicians lie. For example, in the same CNBC interview Obama said, "during the course of my presidency I have bent over backwards to work with the Republican party."
- And we know from repeated and recent experience that seemingly intractable political deadlocks do get solved at the last minute. For this one not to, we'd have to believe that "this time's different," as Obama put it -- no doubt unknowingly uttering what experienced investors call "the most expensive words on Wall Street."

One of our Washington insider contacts is fond of quoting from 1998's Oscar Best Picture *Shakespeare in Love*, likening its description of show

business to today's political climate: *"The natural condition is one of insurmountable obstacles on the road to imminent disaster… Strangely enough, it all turns out well." How? "It's a mystery."*

There's no shortage of possible solutions. Remember, as hardened as the parties' positions now seem to be, the impasse has all along operated under an implicit compromise: the Democrats have demanded only that the debt limit be raised for a specific period of time -- no one has ever suggested that it be perrmanenty suspended.

- *In extremis*, to avoid default the president could either invoke section 4 of the 14th amendment to the Constitution, or use *ad hoc* emergency powers. Either would raise constitutional questions -- but by the time the Supreme Court settled the matter, the crisis will have long passed.
- Or the Treasury could issue high-coupon bonds which would auction at a premium (the debt limit only pertains to face value, not the amount raised).
- As a stop-gap, the Senate could pass and the president could sign into law the Full Faith and Credit Act passed by the House in February, raising the debt limit to any extent necessary to service debt and Social Security payments.
- More likely among short-term fixes would be a series of stop-gap bills, suspending the debt ceiling for just days or weeks at a time, could be passed and signed into law.
- Ultimately we're looking for one of the longer-term stable solutions being discussed now, including some form of mini-"grand bargain," getting a continuing resolution and a debt limit hike with some combination of slightly lower spending levels; a trade-off between some sequester relief and long-term entitlement reform; a *pro forma* commitment to a path for revenue-neutral tax reform; and a face-saving concession to limiting Obamacare by repealing the tax

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[About us]

Recommended Reading

Obama Rewrites Debt-Limit History
Kevin Hassett and Abby McCloskey
Wall Street Journal
October 3, 2013

Founding Fathers Liked Shutdowns
Newt Gingrich
Time
October 3, 2013

Grover Norquist on Ted Cruz: 'He pushed House Republicans into traffic and wandered away'
Interview by Ezra Klein
Washington Post
Wonkblog
October 2, 2013

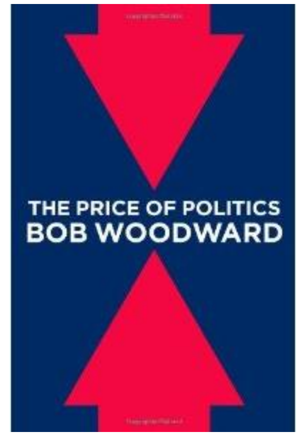
Why Boehner doesn't just ditch the hard right
Interview with Robert Costa by Ezra Klein
Washington Post
Wonkblog
October 1, 2013

[Reading home]

on medical devices (which influential Democratic senator Dick Durbin (D-IL) said last week was "on the table").

- Any solution like those would have to pass the House with predominantly Democratic votes. Reportedly Boehner told his House colleagues as much on Friday, saying that's what he'd do if there were no other way to avoid default.
- That's how a similar compromise got done to solve the year-end "fiscal cliff" crisis, resulting in the passage on January 2 of the American Taxpayer Relief Act (see "Tax Hikes Have Consequences" January 2, 2013).
- Then, like today, it seemed as though the Democrats were poised to destroy the speakership of John Boehner and smash the GOP brand for good -- with the GOP presumed to bear the brunt of the blame for the crisis. Then there were prominent Democrats who were openly advocating deliberately going over the cliff to achieve those aims, and at the same time automatically raise taxes on the "rich" to fund their policy agenda, and have a free hand to then cut taxes back to pre-cliff levels for favored constituencies (see "Step by Step, Toward the Cliff" September 25, 2012).
- But in the clinch it didn't happen. Even flush with the victory of the 2012 elections just weeks before, the Democrats couldn't be sure who, really, would take the blame for falling off the cliff. To end the crisis, the Democrats ended up scaling back significantly on their policy objectives.
- *This time around the blame game is just as risky. That's why both sides are so busy creating narratives that hold the other responsible for the crisis. But the reality is that in a default, surely both sides would lose, as polls already show -- and arguably the president most of all, because he, being chief executive, is held ultimately responsible for anything that goes terribly wrong.*
- *Obama's approval ratings have already slipped since the shutdown began on September 30 (please see the chart below).*
- *And this time around there are no policy objectives to be gained by default comparable to the automatic tax hikes to be gained in the fiscal cliff.*

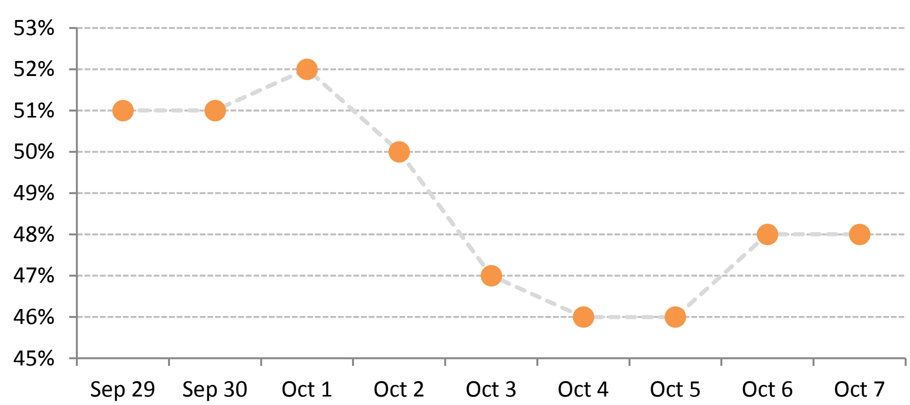
Note to clients



Last year we sent copies of Bob Woodward's *The Price of Politics* to individuals in client organizations who we thought would be especially interested.

We would be happy to provide additional copies. If you wish to have one, please email us at: tdemas@trendmacro.com.

Obama approval rating Sum of "approve" and "strongly approve"



Source: Rasmussen, TrendMacro calculations

- This is all perfectly in accordance with the typical logic of zero-sum games. In an iterated game -- one which the same players have to play each other again, later, as they do in Washington -- players usually select "minimax" strategies in which they seek to minimize large losses, rather than "maximax" strategies in which they go for the greatest gain.
- Our baseline expectation for the coming weeks is that the same logic will predominate.

To be sure, no one can rule out the risk that cooler heads will *not* prevail.

- Indeed, one cool head from the 2011 debt ceiling negotiation -- Treasury Secretary Tim Geithner -- is missing this time around. Having lived through the 2008-09 global financial crisis as New York Fed president, he had a great deal of respect for the unknown unknowns implicit in default, and so was a constant advocate of compromise. His successor, Jack Lew, was at Citibank's private equity and hedge fund groups, during the crisis -- causing it rather than coping with it, one might say. During the 2011 debt limit negotiations he was head of the White House Office of Management and Budget, and according to Bob Woodward's chronicle of the event, *The Price of Politics*, he was a most polarizing force.
- And Obama is now a lame duck president. He won't have to run as the man who presided over the first-ever US default. And having just suffered the humiliation of being repudiated by his own party twice in a single month -- first on Syria, and then on his Larry Summers nomination for Fed chair -- he might feel that not blinking in this crisis will restore his self-esteem.

How bad would a default really be? This brings us to heretical thoughts, which potentially disrupt our game theoretic analysis.

- The conventional wisdom holds that a US Treasury default would be a serious systemic blow to the global economy. So not surprisingly Lew played to that prejudice yesterday on no less than four of the Sunday morning political talk shows.
- But what if we are right, that the global economy is now a stabilized system, battle-hardened by six crisis years? It may well be robust to the shock of a Treasury default -- at least the technical kind of default this would be, not reflecting a true inability to service debt.
- *Good news: if that's the case, then the market consequences of a default would be modest in both depth and duration, and very much a buying opportunity for stocks, and a selling opportunity for bonds.*
- But let's explore the broader implications. What if the politicians fully believe the same thing? We've already commented that the present crisis is an expression of political entrepreneurship, made possible because the world is a more systemically stable place now (see "Once More unto the Debt Crisis, Dear Friends" September 25, 2013).

- *Bad news: if the politicians believe that a default would not be catastrophic -- at the maximum, that it would be only a fake emergency like the present shutdown -- then the probability of default goes up, because they would see it as less risky to their reputations.*

Bottom line

With the shutdown only a fake emergency, there has been insufficient pressure to end the impasse of the continuing resolution, and now the matter has become merged with the mid-month debt limit. Obama and Boehner have made reckless statements about the possibility of default. Such statements erode norms, and make default slightly more likely. But the logic of game theory suggests that there will be some form of compromise as there was at the year-end fiscal cliff, because neither side wishes to risk reputation damage. There are many possible solutions. The wild card is that the global economy is now robust to risks of financial contagion, so a technical default would likely cause only a short-term disturbance in markets, creating a risk-on opportunity. The problem is that if the politicians deeply believe that, then the game theory calculus changes because they won't perceive default as having as much reputation risk.