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How a Reckless U.S. Threatens Global Stability

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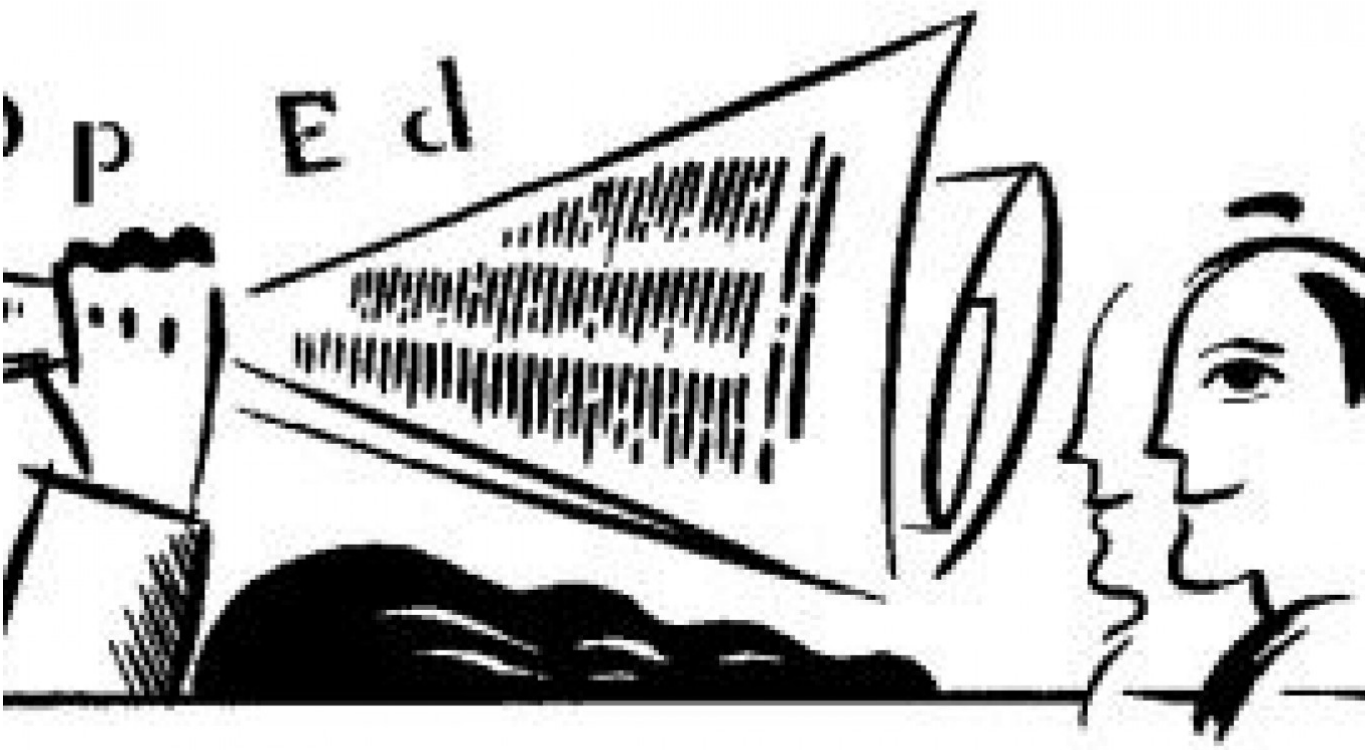

While the world's developed countries face growth and employment shortfalls, developing countries are confronting huge challenges in adapting to increasingly volatile capital flows. They are adjusting their growth patterns to sustain economic development. And yet the U.S.'s political dysfunction has come to marginalize these and other crucial issues. It is all very difficult to fathom.

The threat of a default on U.S. sovereign debt has been lifted — for now — but the deeper problem persists. For U.S. Republicans and Democrats, negotiating a fiscal grand compromise appears to carry higher costs than playing a game of brinkmanship, even at the risk of default. Surely this involves a collective miscalculation of the longer-term costs.

Setting aside the external impact on the global economy, the damage to domestic stability and growth from anything other than a short-term technical default would be so severe that the political system could not withstand the backlash. Domestic and foreign holders of U.S. Treasury bills would regard a deliberate, unforced default as a betrayal of trust.

Some are reassured by this fact because it suggests that a real default will not happen. And that means that the fragile global economy — dependent, at least for now, on a single country for its main reserve currency — can withstand U.S. political shenanigans.

That may be true, and it may be the only practical choice in the short run. But the U.S. pattern of decision-making, or non-decision-making, has already created additional risk. It will surely be reflected in upward pressure on interest rates, at which point the Federal Reserve will enter the picture.

Far from tapering its monthly purchases of long-term assets, one can easily imagine a scenario in which the Federal Reserve's already substantial balance sheet would have to expand even more quickly to counter the negative economic effects of an unplanned and rapid rise in borrowing costs. And this comes at a time when many, including me, believe that strengthening U.S. economic growth makes an orderly withdrawal from policy-assisted growth the wise course, both domestically and internationally.

Outside the U.S., even a technical default would have profound effects. The eurozone still faces rebalancing and structural challenges, but it has managed to create a window of stability in sovereign-debt markets. In the case of a U.S. default, however, it would start to attract capital inflows, causing the euro to rise, adding to already-substantial headwinds to growth and employment, and making recovery in its damaged peripheral economies nearly impossible. Measures to counter "excessive" capital inflows — of the type introduced in Brazil and Malaysia — might be needed.

China and other sovereign holders of U.S. debt face capital losses over and above those implied by the inevitable appreciation of their currency. One is reminded of the external consternation expressed during the 2008 crisis at the possibility of a default on debt carrying an implicit government guarantee.

In March 2009, Zhou Xiaochuan, the governor of the People's Bank of China, argued that the dollar's role as the main international reserve currency was not in the interest of the global economy — or of the U.S. itself. In an expanding global economy, the supplier of the reserve currency is pushed to run current-account deficits — and hence toward a leveraged-growth model that systematically erodes its strength and independence as it becomes increasingly reliant on foreign capital and foreign-asset ownership.

Now we can see that the global economy is dependent not only on the strength of the reserve-currency country, but also on its values, particularly on its continued willingness to put critical international commitments ahead of domestic disputes. The ongoing U.S. governance crisis has called this into question.

The long-run effects of the U.S. default threat will be overwhelmingly negative. For starters, it will reinforce the notion that policies and policy disputes are to be conducted with a view to domestic issues and interests, independent of the systemic global effects, even as those effects grow larger. Indeed, some factions within the U.S. political system do not appear to understand the large adverse feedback effects on the domestic economy from a disruption in the global financial system.

Second, external holders of U.S. sovereign debt will almost certainly begin to view Treasuries as risky assets and, where possible, to diversify away from them. That is not necessarily bad. Although wholesale dumping of U.S. sovereign debt is highly unlikely since this would be self-destructive for many countries, including China, transitions could be bumpy.

Third, the willingness to hold U.S. creditworthiness hostage for domestic political purposes will almost surely accelerate the decline of U.S. influence in global economic governance and management. In the short to medium term, that decline may create a vacuum and lead to volatility and heightened risk because, as many have noted, there are few candidates to replace the U.S.

To be fair, the trend toward diminished U.S. influence — and, ultimately, shared responsibility for global economic governance and stability — was already underway, and in a sense is inevitable. The hope was that the transitions would be gradual and stable, with the U.S. playing a leadership role as it has in most of the post-war period.

Finally, the U.S. default risk may revive Zhou's 2009 agenda, which was perhaps premature at the time, and accelerate the search for a workable alternative to the single-country reserve-currency model, which has outlived its usefulness. In the end, no one wants the global system to be vulnerable to a single country's domestic political fights.

The global economy faces tremendous trials in the coming years: growth, employment and distributional challenges in many advanced and developing countries; far-reaching institutional reform in Europe; the complex middle-income transition in China; and the continuing need to reduce poverty worldwide. Managing them effectively requires designing a system of global governance in which one country's internal politics cannot jeopardize all countries' prospects.

The immediate threat is gone. But this is no time for a sigh of relief and business as usual.

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