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Crash Landing

Part 1. Introduction

The United States of America, the world's most powerful and prosperous nation, is paying its bills with IOUs.

Our nation emerged from the travails of World War II with a debt greater than its income (measured by its gross domestic product, or GDP). For the next 35 years, in an uneven trend with fits and starts, our country generally followed a path of virtue. By the 1970s, the public debt was only about one-fourth of our collective income. This was not so much the result of the eight actually balanced budgets over the 28 years from the end of 1946 through 1974 (the highest and lowest debt years as percentages of GDP, respectively). In fact, the debt measured in dollars by 1974 was almost half again as large as that of 1945. However, the economy grew substantially faster than the debt over those years, which made the debt much easier to manage, and much less of a burden on the economy and the taxpayers.

Over the next 30 years, however, apart from a near-decade of surpluses and very small deficits (for which both political parties claim the credit, in a dispute that remains unresolved), the growth in debt outran the economy. Then, the recession that began in December of 2007, and the financial panic that surrounded it, drove the already elevated debt to new heights. By the end of the last fiscal year (2010), once the statistical dust settles, the debt will have exceeded 60 percent of the GDP. By the end of the decade, without significant changes of policy, the debt is likely fully to equal our GDP. Almost all of the progress that was made since the end of World War II to reduce the debt burden on our taxpayers will have been lost. And even worse, the debt will threaten the future prosperity, and even the economic stability, of our country.

The American people seem restless because of the apparently troublesome federal budget and the rapidly growing public debt.[1] Still, there are few signs of real urgency among our elected policymakers, and certainly there is no consensus about what sacrifices are needed to address the problem, and only reluctant discussions across the political aisle.[2] Should the public even care? Should the voters communicate a sense of urgency to their elected policymakers?

To begin to answer those questions, the public needs to know: What are the potential consequences if the nation fails to address the federal budget problem? The current budget woes are far beyond any peacetime experience of this country since its founding. Other countries have become equally beset by rising debt, though their experiences reflect different circumstances or different times. Still, those lessons need to be understood, and to be translated into the here and now. ***It can happen here***.

What follows is a story – really, six stories. First comes a created background story of the next two years – told retrospectively, in the fashion of a newspaper or magazine. This story takes our nation to the brink of an eminently likely crisis of excessive debt. Following that are five alternative stories – told similarly, as retrospective newspaper or magazine articles – of how the following years might unfold. None of these alternative futures is pretty. The happiest (or least-unhappy) ending requires a crisis-driven scramble to head off the worst consequences of continuing weakness and neglect. The four other alternative futures, however, are far worse. Their consequences range from economic stagnation to financial catastrophe. If our nation follows any one of those paths, today's children and their succeeding generations will lead poorer and more stressful lives.

As we contemplate what CED believes to be these very real possibilities, we must ask ourselves: Is this the future we want? Or even for the more optimistic: Is this a future we want to risk?

We provide yet another possible ending – starting with the same fiscal risk that we see on the horizon today, but proceeding to a self-realization to rededicate our people and their elected policymakers to responsibility and sacrifice for the well-being of future generations. To us, this course leads to a far better outcome for the American people.

Today's generation of elected leaders must accept responsibility for the condition of our economy. They must choose our future. And the citizens of today must follow, or guide, or drive them to the best path, if we are to achieve a sound and secure future.

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1 For example, in January 2002, 35 percent of poll respondents ranked reducing the budget deficit as a "top priority" (respondents were permitted to name more than one issue as a "top priority"); in January 2010, that had increased to 60 percent. The Pew Research Center for the People and the Press, "Energy Concerns Fall, Deficit Concerns Rise: Public's Priorities for 2010: Economy, Jobs, Terrorism," January 25, 2010, http://people-press.org/reports/pdf/584.pdf.

2 For example, the Congress has not passed a Budget Resolution in 2010, and the President's Fiscal Responsibility and Reform Commission has struggled to reach bipartisan consensus.

Sleepwalking to the Brink

How Politics and Money

Drove the World's Leading Nation

To a Financial Crisis

Sunday, July 29, 2012. For almost a century, the United States has been a constant in global finance and business. Even in the financial meltdown of 2007-2009, U.S. Treasury securities were perceived as a safe haven for investors, a destination for a "flight to quality." Events of the last two months have shaken those perceptions of the United States as bedrock for investors. Though the changes of recent weeks have seemed sudden, they began in that earlier financial crisis, and even before. This week, as market players are called upon to react to recent events, many say that they still are trying to understand just how the seemingly certain core of their financial world came to this uncertain juncture. With such high stakes in the coming decisions, even the most jaded market movers want to understand the past.

One Wall Street trader, who wished to remain anonymous to protect the identity of his firm, is typical. "It is totally unreal," he said at the close of trading on Friday. "The world has changed completely in my years on the Street. It has happened quickly, but it has also happened so slowly, if you know what I mean. Years of imperceptible changes have added up to something profound – profoundly threatening, really. It is hard to go back and see each individual step that got us here."

***Analysis*.**

Contributions from staff reporters in New York and Washington.

Just two years ago, after months of financial turmoil, the U.S. economy finally showed signs of finding its feet. Growth resumed in late 2009. Employment stopped falling, and began to turn around – although never with the rapid rebound that had followed the deepest previous recessions of the post-World War II era. After nerve-wracking hesitation and uncertainty, financial crisis in Greece was forestalled by cooperative action of the European Union and the International Monetary Fund, seeming to halt a possible contagion to other weak European states. With considerable excess productive capacity in the United States, and also around the world, because of the tepid global

recovery – in part because the reach of the financial crisis into Europe weakened the economic outlook there – inflation, which had been feared by many because of the extraordinary anti-recessionary financial measures undertaken by the Federal Reserve and the Treasury, never became an issue. America and the world took the time for a sigh of relief.

Still, to the public at large, the nation's climbing debt levels in the wake of the financial crisis were vaguely disquieting. After the plunging home values and under-water mortgages that set off the crisis and the fallout for retirees, typical working people reacted adversely to the notion of rising debt, especially as it weighed on their plans for retirement and on their legacies for their children. The notion of rising ***public*** debt seemed less immediately pressing than the private debt of their households. Most people were less than familiar with the history of debt crises elsewhere around the world. Greece had given people some image of what government irresponsibility could do, though they correctly recognized that the United States and Greece were in almost all respects quite different.

The mid-term election of 2010 yielded large-scale change in the Congress. The two parties, as was their wont, pointed fingers at each other over the budget and every other issue. For the voters, there was a typical sentiment that those in office "owned" the economy and the budget; sophisticated analysis of who had been right, who had been wrong, and who was responsible did not capture the public imagination. The result was a "throw-the-bums-out" election of proportions comparable to the strongest in history. The nation was left with a divided government, because the party in power was not successful in defending its many vulnerable seats; but some incumbents of the minority party suffered too. So with the major reshuffling of the Congress beginning in 2011, there was no chance for either party to dictate a legislative agenda before the next presidential election in 2012. Gridlock ensued.

The modest upturn in the economy continued. The president and his party claimed that this improvement indicated that they had been right all along, and that the country was finally seeing the fruits of the policies of the past two years. The opposition countered that their new strength in the Congress, stalling the Administration's agenda, caused the economic growth.

The public debt itself seemed to recede, slightly, as an economic issue. With modest economic recovery came some limited but visible relief from the large deficits. The sense of comfort was fed by continued low interest rates. With inflation remaining quiescent, interest rates rose little. So although the public debt rose, the cost of debt service in the budget hardly budged. There seemed to be little need to forgo spending, or raise taxes, because of the higher debt. Thus, continuing large budget deficits seemed almost benign. Talk even of "deficits don't matter" began to return: Deficit alarmists had been crying "wolf" for years, and the problem never materialized; the alarmists had been wrong before; so surely they would be wrong again. There remained a sense of American exceptionalism: that "it can't happen here."

So for these reasons, politics returned somewhat to usual, with the budget deficit smoldering in the background. The President's "fiscal responsibility commission" had failed to reach a bipartisan agreement, and even though it had presented a menu of ideas judged to be balanced and sound by nonpartisan experts, it had been largely ignored. Some of those ideas were included in the President's subsequent budgets, but those budgets were "dead on arrival," in the language of Capitol Hill. The Congress and the President fought those budgets to standstills before splitting their differences, with little or no change in the overall direction of spending and revenues. Debt accumulated beyond past danger signals, topping 60 and approaching 70 percent of the GDP, but no one reacted. Attention was diverted. Within the United States, with the budget apparently on hold, policymakers jockeyed for position for 2012, and debated the wars in the Middle East, climate change, immigration, and implementing health reform. Around the world, the financial markets focused on the troubled countries in Europe more than the United States. The change in the financial markets was at first gradual, almost imperceptible – but then frighteningly sudden.

The President's new budget in the election year of 2012, and the statements of his opponent, followed the pattern of four years before. The opposition party said that the President had caused the deficit with his policies of the previous years of his term; the President said that the bed was on fire when he got in it. In these positions, both sides were apparently sincere. The problem was that each argument reflected only a partial view of the complex reality, and the conflict made it difficult for the typical voter to make his or her own informed choice. But beyond sincerity, each party believed that it held a political winning hand. The opposition believed that the electorate could be convinced and reminded that a President of four years had to own the economy and

its consequences, while the President remembered and spoke continually of the colossal problems that he found when he raised his hand to take the oath of office.

Each party sought to outdo the other in ruling out any pain. The President's party pledged once again to avoid any tax increases on all but the best-off two to three percent of households, and strongly defended the largest and fastest-growing benefit programs – Social Security, Medicare and Medicaid – and the new health-care reform. But even among themselves, the President and his own Congressional delegation often disagreed. Some ruled out any entitlement reductions – or even proposed increases. Some proposed large tax increases on the well-to-do, while others denied that there was a budget problem at all. The opposition again pledged not to increase ***any*** taxes, and had already committed during the health-reform debate of 2009-2010 not to cut Medicare. Some political and economic "talking heads" blamed the electorate for failing to understand what was needed to right the budget. Other commentators blamed the candidates for failing to talk straight to and educate the electorate. But either way, the debate took on an air of what in retrospect clearly was unreality. Few voters seemed to worry, because it had happened so many times before.

In competing to be the most definitive in defending Social Security and Medicare and opposing tax increases, both parties showed that they had learned all too well the political lessons of the previous 20 years. The electorate always told pollsters that they wanted straight-talking candidates, but then proceeded to pummel the candidate who first said that he or she would impose any pain to reduce the budget deficit. So in the 2012 campaign, no candidate would go first. Instead, the contenders offered pledges of deficit reduction from economic growth (which had always been assumed in the nonetheless disturbing budget numbers) and from spending cuts in unspecified programs, or in "waste, fraud and abuse," or in foreign aid, or welfare, or other inconsequentially small programs. Thus, even before the campaign was in full swing, both sides had explicitly foresworn every essential step of a deficit reduction program that would be in scale with the true size of the problem.

It was during the campaign year that the U.S. fiscal colossus began to crumble.

The budget outlook at the start of 2012 had the deficit down from its peak of 2009 but still much higher than would be sustainable, and then rising into the future. To avoid offending the voters, the President made no painful decisions in his budget. When the nonpartisan Congressional Budget Office evaluated that budget, it projected resulting deficits significantly higher than claimed by the President himself. The opposition candidate was not required to present a formal budget, of course, and broad-brush campaign promises cannot be subjected to detailed analysis. However, to appear no less attractive to the voters, the candidate proposed even less by way of specific steps to cut spending – and of course pledged never to raise taxes.

Predictably, budget experts in the policy community began to repeat more loudly the unavoidable conclusion, which in truth they had believed for some time (and specifically, in several preceding election campaigns): Neither potential president was positioned to take any significant steps on the budget for the next four years. As this realization spread to the financial markets, global confidence that the United States eventually would face up to and solve its fiscal problems finally began to deteriorate.

Meanwhile, ostensibly positive developments from overseas made the U.S. picture even more troubling. In Europe, three years of pain and budgetary retrenchment began to bear fruit. Greece, Portugal, Italy, Spain and Ireland, which two years before had been in danger of default, clearly had made good on their fiscal-responsibility programs. Their debt began to sell more freely on financial markets. The threat to the European banks that held much of their debt, and to the rescue program that had been assembled by the European Union and the International Monetary Fund, was lifted. The markets sent the euro up, not just because of the positive economic news, but also because of the positive signal of the accomplishment of the Community's mission of imposing fiscal discipline and safeguarding its currency.

At the same time, China began to show signs of steadying maturity in the international financial community. The administered value of the renminbi had been raised in small amounts over the preceding years, and now rumors began that the value would be allowed to float in bigger steps toward its market value. Anticipation of a rising Chinese currency spread.

On the surface, the success in Europe and the maturing of China as a financial market were in turn a relief for the U.S. economy. The fear of European economic and financial collapse had put a damper on U.S. markets, and that in turn made both consumers and businesses more cautious. During Europe's

downturn, weaker U.S. consumer and export demand had yielded weaker business investment, which fed back into consumer demand in a vicious cycle. Now, that restraint was over. And a more mature Chinese market economy was expected to be more predictable.

But the supreme irony was that such good news carried bad news. With apparent economic recovery, central banks around the world, including the Federal Reserve, accelerated their programs of raising interest rates from what had been low, stimulative levels toward their historical norms. Though the accumulation of U.S. public debt thus far had seemed benign because of the extraordinarily low interest rates, the debt had grown so large that even a move toward normal rates quickly made the debt-service cost problematic. And as the euro and the renminbi became more attractive, naturally enough, the dollar began to fall relative to them, and U.S. securities became less attractive to foreign investors.

So slowly at first, but then at an accelerating pace, higher budget deficits and the reduced political prospect that they would be addressed frightened investors, who raised interest rates still further, which made the budget deficit even worse. This basic adverse feedback loop was further worsened by the impact of this development on the rest of the economy. Consumers were just working their way above the surface from their under-water mortgages, and broader economic growth raised the prospect of the first healthy demand for housing in years; but rising interest rates dragged that process to a grinding halt. Businesses newly interested in investment suddenly faced rising borrowing costs, slowing that component of growth. State and local governments had been squeezed by the economic slowdown and the tepid recovery, and rising interest rates did not help their plans for renewed public investment. So the federal budget was worsened by the direct impact of rising interest rates, and then the rising interest rates slowed the economy, which worsened the budget still more.

The rest of the world reacted to this adverse feedback loop. Some years before, the petroleum-producing countries of the Middle East had spoken privately about changing the peg of the oil price from dollars to a currency index or "basket," or even to some other currency, and rumors of those conversations spread and raised doubts about the dollar. But from 2009 through 2011, with the European economies so weak and the Chinese currency held artificially low, those Mid-East discussions ceased. Now, with the rise of potential alternatives to the dollar, open discussions of choosing a successor to the dollar for pricing oil were heard again.

And on another front, the adverse U.S. political prospects for budget action along with the rising deficit forecasts led bond-rating agencies to begin to downgrade U.S. Treasury securities. In a concrete sense, these rating downgrades had little practical consequence, because Treasury securities continued to be sold at auction – rather than being placed starting at estimated market rates, like all other U.S. debt securities. However, with the rating downgrade, foreign governments that had held much of their reserves in dollar-denominated securities, but had deliberated privately about changing their investment decisions, began to shift their purchases slowly toward the yen, the euro, and even the renminbi, to give their portfolios some measure of diversification. These shifts were unannounced, but close watchers of the Treasury market detected the movements and reported on them. The news moved quickly from the computer worksheets in the back offices of the financial industry into the popular press. The psychological impact on investors was like a slow-motion car crash; what seemed at first like a painful but tolerable pressure became more and more intense at a quickening pace.

Thus, as the campaign year wore on, the hitherto relaxed attitude on the budget turned to tension. Previously, the opposition candidate assailed the budget deficit but said little about solutions, while the President blamed his predecessor, touted the limited steps already taken and the vague promises in his current budget, and hoped for accelerated economic growth. But now, with the economy slowing and interest rates rising – ironically, the weak economy, by calling the Treasury's ability to service the debt into question, helped to drive interest rates up – the entire population began to feel the strain. Prospective purchasers of new homes and autos – a small but significant group – were being priced out of those markets. Even worse, those households that had variable rate loans – including most entrepreneurs with small business loans – found their payments going up. Those small businesses were losing revenues at the same time as their debt-service costs grew. People – which is to say, voters – began to demand answers, and the more-sophisticated press began to raise meaningful questions of the candidates.

The problem could have been addressed and solved by sitting policymakers, but unfortunately, the political campaigns had infected the halls of government. Congressional leaders tried to run interference for their presidential candidates – and for their own colleagues, who

were running for reelection. The Congress tried to postpone action on the required annual appropriations bills to avoid making painful and potentially politically damaging decisions. With divided control, it was easy for the opposition to say "no" without offering specific alternatives. With interest rates and debt-service costs rising much faster than forecast, the public debt limit was reached during the campaign, well before it had been expected. The Treasury Secretary reached into his tool kit for all of his authorities to finance the government without issuing new debt and therefore breaching the limit, and at first appeared in the clear to avoid a crisis before election day.

These machinations solved the superficial political problems. However, after the first moments of relief in financial markets, investors quickly concluded that the fundamental problem of excessive U.S. borrowing and debt was not being solved, but only postponed – for yet another four years. Confidence in the willingness of Americans to face up to and solve their problems, which had been eroding for weeks and months, finally collapsed.

Concern intensified into anxiety, and then accelerated into panic. Public confidence was deteriorating rapidly. It became clear that the candidates and the sitting Congressional leadership could no longer ignore the issue, but would have to act – or at least say much more specifically what they would do. But in keeping with the politics of the day, that meant assuring the voters that the problem could be solved without sacrifice or pain.

What evolved amounted to a public negotiation, in which the parties never met privately, but instead put their offers on the table as proposed legislation. It was an unfair fight, in that the President had to govern, while the opposition candidate could posture and make unrealistic claims – just up to the point where the public would hold the opposition accountable for the painful consequences of the financial market paroxysms in the absence of an agreement. But it did amount to a real negotiation – because with divided control of the Congress, votes from both parties were needed to pass any legislation, including the required annual appropriations bills, spending reductions and tax increases to reduce the deficit, and an increase in the debt limit to allow the Treasury to go back to normal operations in the financial markets.

Each side in this Kabuki dance believed that it was driven by the purest of motives – within the irrational constraints imposed by the politicized Washington environment. That is, each side believed that its goal for policy was the right one, and that if it could only hold on long enough and squeeze the other party hard enough, right would prevail.

The President believed that the electorate would come to see that the objective of his party – to protect basic entitlements for the most vulnerable, paid for with higher but arguably still moderate taxes imposed on the most well-to-do – was the best choice. In the President's perception, that was what had happened during the last partisan budget wars over 1995-1997, and he firmly believed that it would happen again. The opposition would cave in the negotiations, a face-saving compromise would give the President most of what he wanted, and the political and financial crisis would end happily.

Not surprisingly, the opposition held a very different view. They believed that the voters, offended by the large budget deficits of the last four years and the rescues for failing financial institutions, corporations and homeowners, would come to understand that the nation needed smaller government, reduced entitlements, no or limited tax increases – or even lower taxes on the most successful – and the "freedom to fail." After all, every American hoped to be successful, and even those with modest incomes now would want the prospect of lower taxes when they achieved their expected successes, and would work harder with that incentive. There had been a clear political reaction, including the "Tea Party" movement, to the higher spending under this President. So the opposition, like the President, believed that popular opinion would force the other side to "cave" in the implicit public negotiations, and that the ultimate face-saving deal would lean heavily their way, instead of the President's, and the problem would be solved.

At the same time, as real as this public negotiation was and as pure as the motives on each side, from the outside and at the end of the day, it arguably was driven by street- (or even gutter-) level politics. Neither side – neither the President nor the opposition party – believed that their negotiation would end in stalemate. But both sides also believed that they would win if a stalemate did occur. The opposition believed that a financial meltdown would doom the President's reelection campaign. The President believed that perceived minority intransigence would sweep him back into office, and his Congressional party with him. Thus, with the wisdom of hindsight, the failure of the election-year budget negotiation was foreordained.

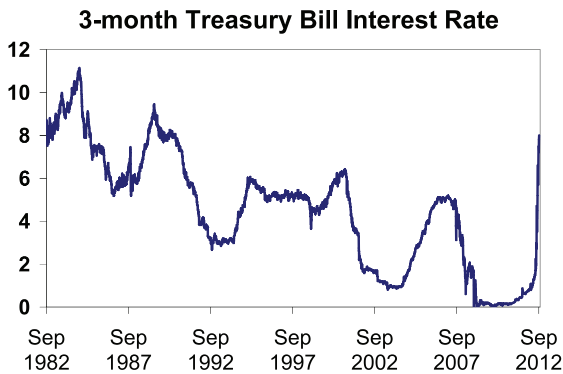
Neither side wanted a breakdown, but each side believed that in the event of a stalemate, it would win both politically and substantively – and so each side acted in the end in a fashion that made the negotiations fail. One participant in the process, who insisted on anonymity, said afterward that "…it was like watching World War I unfold on a theater stage before your very eyes."

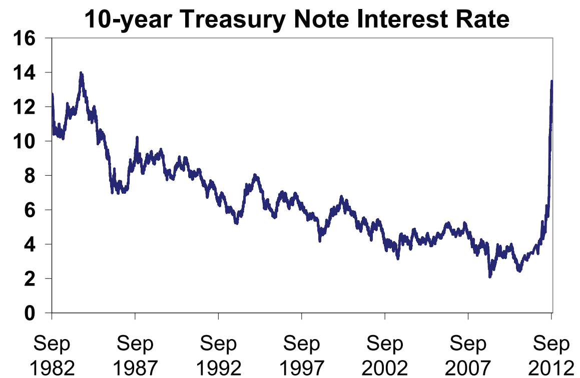
The implicit negotiation broke down in predictable fashion. The President and his Congressional leadership put forward a package of appropriations bills with modest savings, limited reductions in Medicare physician and hospital reimbursements for savings in entitlements, and small tax increases focused on high-income individuals and corporations. Provisions of the 2001 and 2003 tax cuts, which had been extended temporarily only for lower- and middle-income taxpayers, were extended further. The full expiration of these tax cuts could have raised significant revenue to address the deficit. Coupled with those provisions was an increase in the debt limit to allow the Treasury to raise new cash to fund the operations of the government.

The opposition rejected that offer. They countered with reinstatement of the expired tax cuts for upper-bracket taxpayers from 2001 and 2003, repeal of the most costly features of the new health reform (which had not yet taken effect), a new voucher program for Medicare, an optional Social Security system for current workers with reduced benefits but supplemental private accounts, much larger but unspecified future reductions in appropriations for non-defense spending (but increases for defense and other security programs), and a smaller increase in the debt limit.

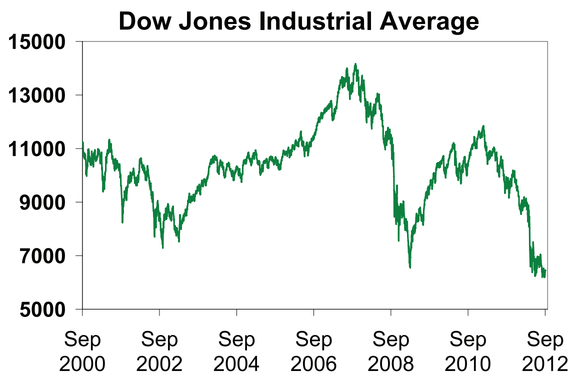
Neither side's offer came close to solving the actual budget problem. Each side believed that the other would provide new concessions to close the actual gap. Instead, the President's counteroffer reduced targets for future appropriations slightly more than his original plan, and the opposition's response squeezed Medicare reimbursements a bit more and made the increase in the debt limit somewhat larger. There was no movement with any meaningful consequence for the budget problem.

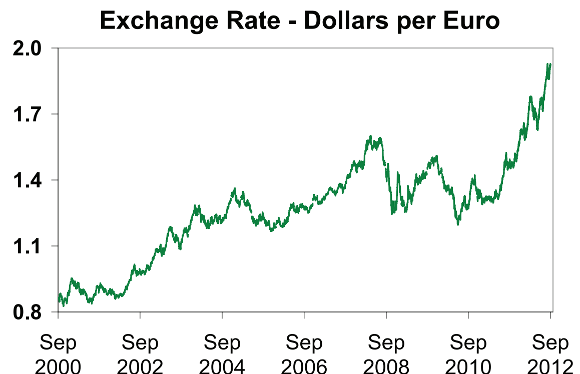
So in the very early hours this morning, after firing rhetorical shots wrapped in hints of counteroffers from late Friday through Saturday evening, the two sides accused each other of refusing to negotiate in good faith, and of lacking a fundamental understanding of the needs of the nation's economy. Each side announced that this difference can be resolved only by the voters in the election, still 13 weeks away. Markets were unsettled at the close on Friday, and key market participants are divided on how investors will react at the Monday opening. Some believe that the long track record of the United States addressing its problems, even if sometimes after ugly political disputes, will maintain calm. The fact that financial problems in Europe and Japan still conceivably could recur, and that China remains an untested quantity in international finance, suggest that the United States will continue to be perceived by investors as a "safe haven." This optimistic view will be measured by a limited Treasury auction tomorrow, and much larger auctions on Wednesday (the quarterly refunding auction) and Thursday. Although the Treasury is barred by the debt limit from issuing additional securities, its auctions to refinance maturing debt with sales of short-term bills and notes are sure to be watched closely by market participants and policymakers at home and abroad.





Interest rates have spiked, and major economic indicators have deteriorated during the budget breakdown.





But meanwhile, seasoned market players looking back on more than 30 years of budget battles in Washington are shell-shocked over what they have seen. "I've watched this argument go back and forth for decades," one trader who insisted on anonymity said this weekend. "But I never thought that it could come to this." After a brief pause, this trader added, "Now I wonder what else I never thought I would see is going to happen."

A second highly placed market player expressed his anxiety in political terms. "Look, I'm a rock-ribbed conservative. I deplore big government. I hate taxes. But if I could turn the clock back, give a little ground, and stop this landslide short of what might happen in the next trading day, would I do it? You bet I would."

An economist who served in government under two past administrations expressed similar anxiety. "We had just better hope that the financial markets don't panic, and the economy keeps growing, until we settle this thing. The Treasury and the Fed borrowed massively to shore up banks and stimulate the economy a couple of years ago. We can't maneuver like that now. If anything goes wrong, we'll be like an ocean liner with no rudder and no lifeboats. Washington had better get real, and fast."

But political figures still have not gotten that message. One liberal congressional leader expressed no remorse. "We swept the board in the 2008 election, but we gave our people virtually nothing in the next two years. We were punished for that in 2010. If we don't stand fast now against the conservative agenda, what good are we?"

Or as a conservative House member said, in direct opposite, "We are on the brink of a major political triumph. We will kill the liberal agenda for good if we just hold our ground until election day."

Part 3.1. Alternative Futures, 2012 –

What would the next step for our economy and our society be? No one knows for sure, because our nation never has fallen to such depths, and our financial markets and their linkages to our economy are extraordinarily complex. However, there are several likely alternatives, and the following subsection explains one.

Quake From Treasury Default Spreads

More Dominoes Fall – President Calls for Calm

Sunday, October 14, 2012. The economic fallout from August's default by the United States Treasury continues to spread, with signs that its reach will be far broader than was originally anticipated. The financial markets have frozen in near panic, and numerous businesses and banks have felt the repercussions. The President and his election opponent are being pressed on the campaign trail for a response to the crisis, but their reactions have been limited to mutual accusations of failure to bargain in good faith.

The Treasury was unprepared to react when the August 1 auction of securities, which was to achieve the quarterly refunding of large numbers of maturing Treasury bills, notes and bonds, unexpectedly was far undersubscribed. Market observers reported that buyers simply did not want to make commitments to government securities after the markets became increasingly convinced that resolution of the federal budget crisis was likely to wait for perhaps years after November's presidential election. Without the cash needed to redeem the maturing securities, the Treasury turned to the Federal Reserve. But the Fed refused to intervene, citing the need to maintain its credibility in the international financial markets. As a result, the Treasury was forced to postpone redemption of the maturing securities.

Analysis.

Contributions from staff reporters in New York and Washington.

Some opinion, even on the part of well known economists and financial market players, had suggested that a Treasury default would affect only isolated individual investors and foreign governments. However, the last 48 hours have demonstrated that the reach of the default extends in a web that is widening in all directions.

Immediate reaction from markets and investors was sharp and swift. Treasury prices fell across the board, raising yields even above the nervous levels of the past few weeks. A securities analyst from London who requested anonymity was blunt. "Investors thought that they could redeem U.S. Treasury securities upon maturity without question," he said. "Now, we see that is not true. If you cannot redeem maturing securities, you cannot sell earlier-term securities. If you cannot sell, the wise man will not buy."

Government finance experts fear that U.S. access to the credit markets could be constrained for years. As one academic explained, "For an individual or a business, the good side of bankruptcy is that you get out from under some of your debt. The bad side is that you have difficulty borrowing for some time to come. After all, prospective lenders fear that it could happen again. For the federal government, this is a long stride beyond the past debt-limit scares, when Treasury secretaries borrowed from the government's own trust funds. This is a failure to make scheduled redemptions. Even if the government recovers quickly, lenders in the future will fear that it could happen again. And if this drags on, well, as an 'owner' of America, I'm embarrassed, and also quite nervous."

The Treasury has been struggling to maintain some order in the nation's finances. There is no clear directive stating which claims against it that the nation should pay first. Redeeming some maturing Treasury securities, while perhaps maintaining some financial credibility, would discriminate against those whose maturing bonds were not redeemed. Meeting all other claims against the government on time might delay the moment when the Treasury can redeem the outstanding matured bonds and thereby perhaps restore some of the nation's financial honor. Reports indicate that the nation is updating its financial strategy by the hour. All federal agencies, including domestic operations, embassies abroad, and even the Pentagon have been told to put their operating decisions on hold.

The fallout quickly spread to the private sector. Among the first institutions to report direct dislocations were banks and insurance companies. Beyond the problems from the turmoil in the securities markets broadly, financial institutions had counted on redemptions or sales of their Treasury securities as the ultimate backstop to meet their obligations. Some banks halted lending activities, and a few even were forced to postpone interest payments to their insured depositors in the face of unusually large, nervous requests for withdrawals. Ironically, some of the worst affected banks, suffering runs on their deposits, had been following what were thought to be the most conservative practices by holding relatively larger quantities of ostensibly gilt-edged U.S. Treasury securities. Some insurance companies have had to postpone payments on annuities, and even claims on losses because of fires, accidents and deaths.

One example of the bizarre fallout is the situation of Lisa Jones, of Clifton, Maryland, who is holding the mortgage loan of her late mother after inheriting the house, and the mortgage, four months ago. The bank is pressing Jones for the payments that have been due since her mother died, but Jones does not have the cash in her own budget, which is stretched to the limit already. Her mother took out a modest life insurance policy as protection for this eventuality, but the insurance company is delaying payment because its own entire portfolio has suffered in the chaos following the government default, and it cannot redeem the Treasury bonds that it purchased to cover its

own risk. The bank says that in the past it has offered short-term loans to help, but it is cash-constrained because of its own problems redeeming Treasury securities. "Everyone says that they want to help. My mother did all the right things. The late fees are piling up, and the bank threatens to foreclose on the house," Jones says. "Where do I go?"

Rising interest rates have squeezed numerous private borrowers, who have adjustable-rate mortgages and other loans, while some businesses have receipts that are set in dollar terms by longer-term contracts. Small businesses have reported particular problems in meeting their obligations. Business investment has essentially halted, as credit markets are frozen and loans are available at stratospheric interest rates if at all. Retail and wholesale businesses cannot refinance their routine inventory holdings. John Holden, who has run a used car dealership outside of Newark, New Jersey for 13 years, uses short-term credit to finance his selection of two to three dozen cars. "Times are tough, and we cover a segment of the market that serves people who need transportation and can't buy new. We should be doing well," he says. "We've been in this community, we've established our reputation as trustworthy with both consumers and our bank. Now the bank can't or won't offer to renew financing. Even if you can find a new bank, it means starting from scratch, which takes a lot of time, and establishing that relationship all over again. And every bank I've seen says they have no money to lend."

State and local governments have been shut out of the credit markets as well, tarred by the federal government default, hurt by the federal government's inability to deliver on its grant payments for Medicaid and other joint federal-state programs, and priced out of the credit markets by high interest rates on bonds and outright rejections from hard-pressed banks. As a result, governments cannot finance their ongoing highway and school construction projects, and because of the repercussions for their operating budgets, even day-to-day operations. Teachers, police and fire personnel, whose jobs were threatened in the 2007-2009 financial crisis and its continuing fallout, are under the gun again. Many have been asked to work without pay until the federal default is resolved. Teachers in the Bridgeport, Connecticut school district have spent six months on furlough over the last three years. Now, they have been asked to work without pay for one week out of four until further notice, with no commitment that the pay will be made up. "They say that we have cushy union jobs and benefits," said Sandra Gallard, the head of the teachers' local. "That isn't true, given the jobs and the conditions, but it certainly isn't considering that often we aren't being paid anyway. And the stress, year after year, of not knowing whether you will have a job. We have married couples where both teach, and they have children. The city has nowhere else to save money. They're squeezing the firefighters and the police, too."

Reported auto and home sales have fallen to near-zero levels, with financing essentially unavailable. Practical fallout for families is painful, as people who cannot buy or sell homes cannot move to take new jobs, or cannot buy automobiles to get to work. Meanwhile, even families not in need of new home or auto loans face rising payments on their existing variable-rate consumer loans, or cannot access new credit. Martha Whitmarsh has watched her monthly payments on a credit line that she used to pay medical bills double in the last three months. "And I have never missed a payment. Until now," she says, worriedly.

Ironically, economists and others who believed that default would eliminate a taxpayer burden – servicing the debt – now say that they are rethinking that assumption. They have discovered that the eliminated burden was essentially an income tax obligation on current and future taxpayers who now have significantly reduced incomes on which to pay those taxes in the first place.

Now, analysts are hoping that the President and his November election opponent can find an agreement that will restore functioning financial markets so that economic activity can resume. The bitter battle of press releases continues, but exchanges of new legislative offers may resume this week. The President, in a previously scheduled campaign event, called for calm, and appealed for patience on the part of holders of federal bonds that are overdue for redemption.

The standing of the United States around the world clearly has been shaken. The Prime Minister of France, whose financial institutions have been hit by the failure of the federal government to redeem its securities, and whose economy is threatened as a result, has publicly called on the United States to address its fiscal problems. Perhaps most pointedly, the Prime Minister was overheard making a private, somewhat sarcastic reference to "old America."

Outright default is not the only potential outcome of a debt redemption crisis. The following is another – which is equally harrowing:

Emergency Government Cutbacks Continue

Treasury Attempts to Fund Social Security Payments; Contractors Protest Repeal of "Prompt Payment" Law

Sunday, September 30, 2012. The United States Treasury is scrambling to limit the impact of its surprising struggle to refinance the nation's maturing debt last month. Effects have been felt broadly and continue to spread. Numerous businesses and banks have felt the repercussions, and the financial markets anxiously await signs that normal operations will resume. The President and his November election opponent are being pressed on the campaign trail for a response to the crisis, but their reactions have been limited to mutual accusations of failure to bargain in good faith.

The Treasury was unprepared to react when the August 1 auction of securities, needed to roll over a large volume of maturing Treasury bills, notes and bonds, unexpectedly was far undersubscribed. Market observers reported that buyers simply did not want to make commitments to government securities after the markets became increasingly convinced during the presidential election campaign that resolution of the federal budget crisis was likely years away. Without the cash needed to redeem the maturing securities, the Treasury turned to the Federal Reserve. But the Fed, citing the need to maintain its reputation as the guardian of the currency, refused to intervene.

Analysis.

Contributions from staff reporters in New York and Washington.

As a result, the Treasury has been scrambling to raise the cash to remain current on its debt redemptions ever since. Even after the minimal expected safety margin of government cash balances was cut to the bone, further emergency measures have been needed. In the end, the government avoided default on its bonds by raising cash through reneging on tens of billions of dollars of its obligations to contractors, employees, and program beneficiaries.

Hospitals and doctors have been among the first and most seriously affected. Those providing services to the elderly through Medicare have had their payments delayed. States waiting for federal grant payments to cover Medicaid reimbursements of doctors and hospitals have had to delay their payments as well. Some healthcare providers have refused to participate in the Medicare and Medicaid programs until regular payment procedures are restored. "I have watched Medicare reimbursements fall ever further below my costs for years," said Jane Goodwell, a physician in Springfield, Illinois. "I've been reluctant to accept new Medicare patients, but I have continued to do so because so few other doctors in the area have. Now, not only am I reimbursed well below my costs, but I have to wait for the check. I'm being asked personally to finance a federal government program. It's time to stop." Goodwell's hospital, Springfield Surgical Center, is torn between the reluctance of its practicing physicians to put up with Medicare's new payment delays, and its need to keep its operating rooms utilized between more-lucrative patients with private insurance. On the other side of the figurative desk are newly Medicare-eligible patients. When asked if she has found a physician, Mary Biggs of Springfield says, "No, not yet. The doctors of my friends on Medicare aren't accepting patients anymore. They all say that the payment delays are the last straw."

These delays in payments were made possible by a somewhat surprising but perhaps unwelcome act of bipartisanship. The Congress voted to repeal the Prompt Payment Act, under which the federal government had previously been obligated to pay its accounts within set numbers of days of billing. This has affected not only doctors and hospitals, but a wide range of government contractors. Since then, contractors have received scrip rather than cash. Some small contractors already have gone out of business, because they have been unable to meet their own obligations. David Michaelson of Desert Foods provides food to the cafeterias of the large Sandia national science laboratories near Albuquerque, New Mexico. He says that the scrip payments are worthless to him. "Some of my suppliers are from Mexico. What do they want with U.S. government funny money?" he says. "Others are large regional firms with headquarters states away. The people I deal with can't accept a handshake as payment, even though they know and trust me." Michaelson also says that the service he receives from his suppliers has deteriorated, because they prefer to deal with businesses that service private firms, simply because they are now more likely to pay on time. "Maybe the best thing that could happen for me would be for the economy to get so bad that even the private buyers can't pay," he says with an angry laugh.

As of the last federal government payday, which varies by agency, federal employees also have been paid in scrip rather than cash. Many of the people who work at the Sandia lab are so affected. Local governments and communities with heavy concentrations of government employees, some of which also have many government contractors, have been forced into "creative financing" arrangements because their populations are short of cash. This creates enormous difficulties, because such scrip is not a fully secure or convenient medium of payment. Reports of "scrip counterfeiting" have been heard, but legal sanctions on perpetrators of such acts are not well established. Meanwhile, small businesses are struggling because their suppliers almost universally do not accept such scrip, and bank lending is frozen because of the financial crisis. For example, Michaelson of Desert Foods has tried to get a credit line from his bank, without success. "They say they are worse off than I am," he laments.

Surprisingly to some, even the American military has not been immune. Servicemen and women have had their paychecks delayed. Military contractors have suffered the same prompt-payment stretch-outs as suppliers to the civilian government. Perhaps most painfully, physicians, nurses and other employees at veterans and military hospitals have had to work without pay for weeks. As one doctor put

it, "I saw my career as a challenge, not a sacrifice, even though the pay was below the levels of the private sector. I also believed that I was serving my country, even though my sacrifice was nothing compared with the young men and women I treat here. But what does it tell you when there is no paycheck at all? My family is hurting, and the private surgeons I know think I'm a chump." This doctor noted that his military hospital has had to stretch out its purchases of supplies. "There haven't been any tragedies. Yet," he reported.

Troops on base in the United States have had support from their own military institutions, but there may be limits. Groceries and other goods and services are delivered by the private sector, and suppliers' forbearance is wearing thin. Troops overseas see less understanding from their surrounding communities. "Some people are always friendly, but generally we are tolerated because we have money to spend," said one Army enlisted man. "Now, we have no money to spend. Draw your own conclusions."

The next test of the makeshift federal financing system will come tomorrow, when Social Security benefit payments are due. Those payments should have been arranged last week, but the Treasury is still rushing to round up the necessary cash to authorize the deposits into beneficiaries' bank accounts. The symbolism of the struggle to make the high-profile Social Security payment, not to mention the possible dislocation for elderly and disabled beneficiaries, has not been lost on the public. Some interest groups who have insisted that Social Security is safe because of the putative balance in the program's trust fund have been working to explain to their constituencies how the lack of cash in the Treasury's general fund has rendered their past claims inoperative. Social Security Administration spokesmen explain that the program is governed by the same Antideficiency Act that applies to all other agencies, and if the federal government does not have cash, it cannot write checks.

Cashing in the trust fund's securities technically reduces the debt, but the law is unclear as to the permissible timing for redeeming the trust fund's "special securities" for cash, relative to actually paying the benefits. In an even more bizarre legal conflict, the law provides no guidance as to who should be paid first if the Treasury is short of money. The Treasury, for simplicity, has followed a first-in-first-out rule. So with unpaid bills at the head of the line, cash raised for Social Security technically should be used to pay those non-Social Security bills first. Legal battles over any government decisions could tie the federal paymaster's operation in knots.

The uncertainty regarding Social Security has had enormous adverse consequences, and not all are based on the facts of the situation. Rumors have spread, despite the best efforts of the Social Security Administration to maintain calm with sound information – although, in fact, those efforts have been hindered by the inability of Social Security to make financial commitments for advertising and mailings because of the debt crisis. Still, volunteer groups find that misinformation spreads faster than the truth – over the Internet, and through old-fashioned conversation. Mary Rogers of Sarasota, Florida, has seen the effects. "My neighbors are so upset," she reports. "I've spoken with relatives who have researched the situation, and told me when the checks are likely to be paid. But some of my older friends don't have family support, and they believe everything they hear. They spread it around, and the story gets more inaccurate with each telling. And then there are the salesmen who promise to get your benefit paid if you pay them an up-front fee. A couple down the block fell for that scam. It's disgraceful."

Alongside the rumors surrounding Social Security are further rumors of an emergency income tax surcharge to raise cash for the federal government. Although no legislation has yet been introduced, reports indicate that both the Administration and the tax writing committees of the Congress have asked the Internal Revenue Service to consider design issues. One possibility reportedly is mandatory 10 percent increases in wage withholding, and mandatory 10 percent withholding on all interest and dividend payments and securities transactions, without changes in the actual tax owed – in effect a required interest-free loan from all wage earners and financial asset owners to the federal government. Another option is reported to be an actual income tax surcharge to accompany the new and increased withholding.

The standing of the United States around the world clearly has fallen. As one example, although the Chinese government's official statements have been polite, government subordinates – with apparent backing from their superiors – have spoken caustically with reporters, making frequent and seemingly scripted references to "the world's supposed financial leader."

Part 3.3. Alternative Futures, 2014 –

The two previous potential futures assumed that the Treasury turned to the Federal Reserve for a rescue, but the Fed refused. It is far from clear that the prospects would be any better if the Fed capitulated, as the following describes:

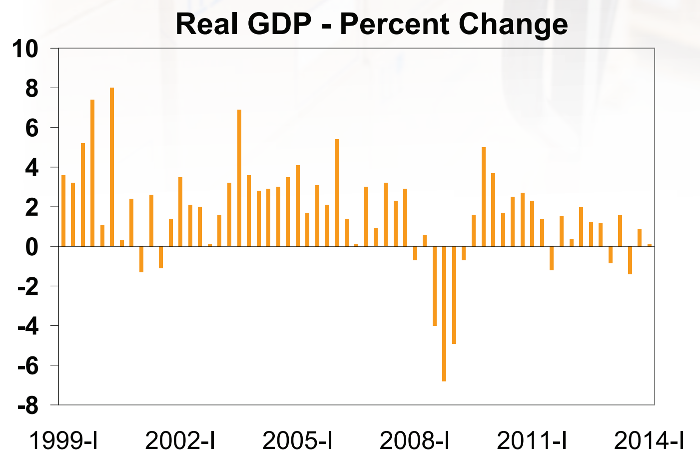
"Stagflation" Returns

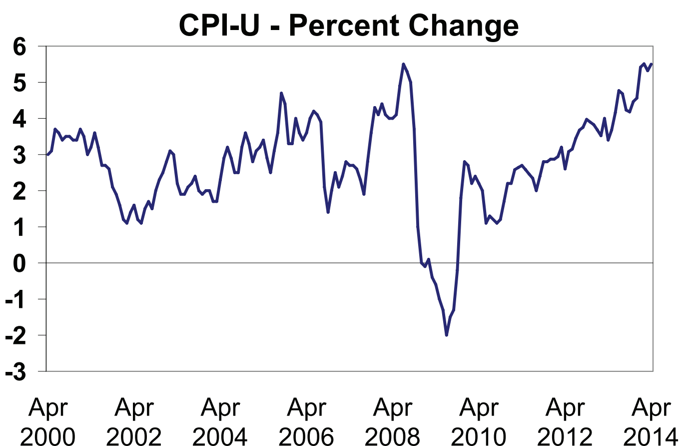
Economic Plague of the 1970s,

Thought to be Long Gone,

Is Back With a Vengeance

Sunday, May 18, 2014. Although economists sometimes vie with weather forecasters as objects of public ridicule, a long-standing truism of the dismal science has been that the economy might suffer slow growth or high inflation, but that it would not be subject to both at the same time. For a time in the 1970s, that truism proved false, in several years of what was then called "stagflation." After the recession of the early 1980s broke the back of inflation, stagflation disappeared, and the age-old economic truism enjoyed a popular rehabilitation. Now, however, stagflation is back with a vengeance, and many trace its resurrection to the decision of the Federal Reserve to stave off default by purchasing Treasury securities when private investors refused to support an auction to roll over the maturing debt almost two years ago.





Analysis.

Contributions from staff reporters in New York and Washington.

At that time, the Treasury turned to the Federal Reserve, which bought up excess securities despite reported significant internal dissent over the risk to its credibility in the international financial markets.

Financial markets reacted adversely, driving the dollar down. Some economists and other analysts had argued in recent years that such Federal Reserve intervention would calm the markets for Treasury securities, on the ground that guaranteed Fed purchases would assure

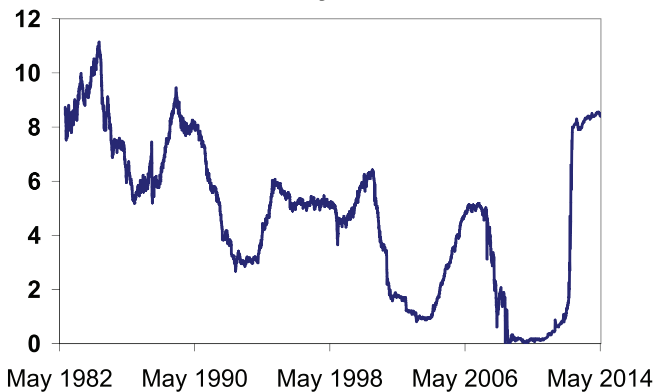
successful future auctions. These economists had concluded that "deficits don't matter," and advocated that the federal government ignore its budget deficits and the projected long-run shortfalls in Social Security and Medicare. However, once the financial markets decided that the deficit would not be addressed for several years, and that massive government borrowing would continue unabated, interest rates on Treasury securities spiked. Federal Reserve officials found again – as they had in previous episodes of rising interest rates, including the late 1990s and early 2000s – that they could not move the markets when sentiment was so strong.

The Fed has direct control over only short-term interest rates, and when the markets themselves drive the more economically important longer-term rates higher through a lack of demand for those securities, the Fed's tools have no immediate effect.

The Treasury's securities were already issued mostly with short maturities. Official spokesmen say that the short-term maturity of the debt has been unavoidable, because those were the securities that the market wanted to buy. However, as investors become increasingly risk averse because of the more rapid inflation, the maturity structure has become shorter still. This puts the Treasury on an accelerating treadmill, as increasing inflation drives investors even more toward shorter-term securities, and interest rates rise continually. Increases in the costs of everything the federal government does – from automatically indexed benefit payments to the prices of supplies for the military – will send the deficit higher, compounding the effect of higher interest rates. So the cost of servicing the federal debt accelerates upward.

For a time, the Fed tried to counteract this effect by buying longer-term securities – for the first time since the financial crisis of 2008 through 2011 – in an attempt to hold rates down.

But inflation continued to drift higher, pushed by higher costs of imports and the Fed's own feared loss of credibility both on international markets and at home. As a result, the credit markets continued to push rates upward. Large numbers of sophisticated market players bet that the Fed could not maintain its purchases of tens of billions of dollars of long-term bonds, and the Fed quickly had to capitulate. As one market player commented, "Sure, we had heard the theories of a few economists that the Fed has total control of interest rates. But the entire market was convinced otherwise. Those theories were just blown away like dead leaves in an early winter storm."



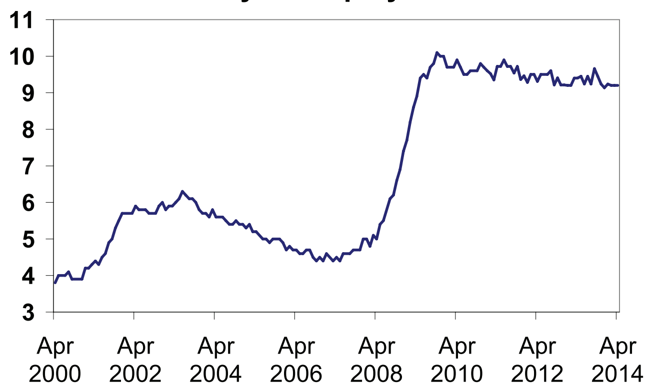
As a result, analysts say, commerce has been crippled from a double whammy. Higher long-term interest rates – even relative to the faster inflation – have shackled business investment, for everything from sophisticated plant and equipment to the prosaic financing of inventories. Moreover, the lack of credit for consumers to purchase new homes and automobiles has reduced the demand for such investment in the first place.

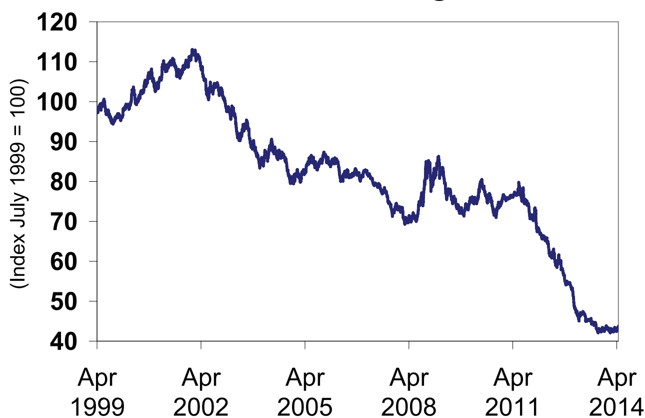
So far, the actions of the Federal Reserve to restrain prices have been less successful than anticipated. Some believe that the Fed actions raise concerns among foreign investors of a significant U.S. economic slowdown. That would make servicing U.S. debt even more difficult, and so foreign investors have driven down the value of the dollar along with the values of U.S. securities – at a pace that appears to be accelerating. This raises the prices of imported goods, thus fighting against the Fed in its anti-inflationary program.

Economists say that talk of inflation because of Federal Reserve money creation has become a self-fulfilling prophecy. Businesses have been forced to raise prices

to cover the rising costs of servicing their debt. Many businesses have short-term market financing that must be rolled over continuously, or have bank loans at adjustable rates. Businesses that purchase imports to produce their products or operate their businesses are hit even harder, because of the rapid decline of the dollar. Consumers are pinched as well by the rising prices of imports, meaning that businesses are caught between the increase in costs and the decline of sales.

One adversely affected business is Highway Imports of Richmond, Virginia, which sells Korean cars. "The factory tried to hold the line on U.S. prices for some time, but after a while that just wasn't possible," said Jim Hartman, who owns the dealership. "Our cars are the most economical on the market, including fuel efficiency as well as purchase price. Having the dollar fall by half makes competing very difficult." The business news across town, at a dealership family selling both Ford and General Motors called All-American Cars, is very different. "Because the imports have to deal with the drop in the dollar, we have been able to take some market share – although total sales haven't risen as much as we'd like, given the unemployment," reported Tom Brown, the sales manager. But he reports that dealers for domestic cars are not competing vigorously on price. "Look, with the inflation, manufacturing costs here are going up," he explains. "All of the imported components of the domestic cars, from steel to little bits of hardware to all sorts of things, have risen even more. So we can't hold our prices down. And with the import dealers in even worse shape and raising their prices plenty, we can allow our prices to rise just a little bit less and still have a competitive advantage."





Some businesses report that they have fixed-dollar sales contracts that prevent them from raising prices even while their costs are rising and slack consumer demand makes it hard to increase sales. Many such businesses have been forced to declare bankruptcy, or even to close their doors. One such victim was Rapid Air, a manufacturer of filters for the auto industry based in Michigan. The firm was one of the survivors of the auto bankruptcies of the late 2000s, because it was noted for its efficiency. When sales picked up modestly, Rapid Air capitalized on its position to negotiate what its owner, Ray Webberly, thought would be a secure contract with some of the divisions of the big three automakers. Instead, he says, "I walked into a vise. Some of my workforce is unionized, so they have a pay escalator clause. I had always given comparable pay raises to the non-union workers. But my prices rise only at the rate I had negotiated, which I thought was generous. The car builders had the right to cut purchases somewhat, and sales have been slow. And as inflation zoomed, I couldn't pay the bills. I had to declare bankruptcy to try to keep the business going." But because of difficulty renegotiating contracts with his customers, Webberly says that his family-owned business is likely to close its doors for good at the end of the month.

In the longer term, economists express concern about a lessened incentive to save. Rising prices reduce the value of accumulated savings, and anticipation of future inflation makes buying now seem more attractive. After years of preaching to the American people that they should save more to build a stronger economy for the future, our nation's leaders now may find that such advice swims against a strong tide. "I don't know why I bothered to save at all," said James Gladwell, who retired near his former factory job in Indianapolis, Indiana. Gladwell spent most of his career at firms that offered 401(k) plans, and he always put aside at least a small part of his paycheck. "But the stock market has done poorly, and when I get my withdrawal check every month it buys less and less. Social Security will go up, someday, but this retirement check will buy me nothing before long."

Thus, a weak U.S. economy has none the less been visited by rapid inflation. Many market observers say that the credibility of the Federal Reserve as the defender of the value of the dollar has been called seriously into question. Increasing purchases of euros, yen and renminbi by oil-producing and money-center nations have shaken the privileged position of the dollar as the world's reserve currency, at least in relative terms. Market players fear that if the aura of the dollar is tarnished much further, remaining stores of dollars could be dumped onto the market, resulting in even sharper downward pressure on the greenback's value. Either the European Union or China, these financial observers say, could step forward as alternative financial and commercial centers. Each carries its own financial baggage, experts admit, but the dollar's precipitous fall from grace seems still to have considerable momentum – perhaps leaving even these untested currencies as viable alternatives.

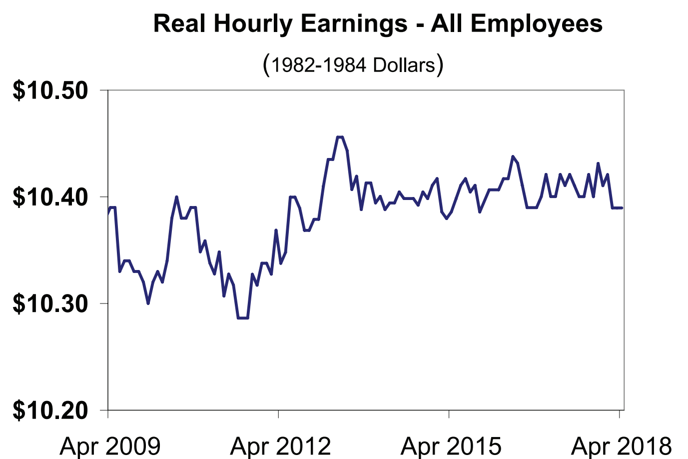
Economists say that prospects for an economic turnaround will not improve until the federal government achieves a firm grip on its finances. But they add that the bankruptcies of many businesses in the last six months have imposed a cost on the economy that cannot be recovered.

Even apart from a return of stagflation, excessive budget deficits can reduce standards of living, as the following alternative future explains.

Why Slower Wage Growth?

Incomes Have Turned Sluggish for a Decade; Economists, Politicians Worry

Sunday, May 20, 2018. Data on wages across the economy are among the slowest-moving indicators of progress. Interpreting the numbers is complex, not only because they change slowly, but also because changes in the underlying structure of the economy – including the numbers of different types of businesses, employing workers with different skills, in different jobs – confuse the picture. However, economists are coming to conclude from the figures of the last decade that wage growth has slowed significantly, which if true will have unhappy consequences for generations of Americans.



Following on the financial panic of 2007-2009, and through the last eight years in which the economy has

apparently recovered and expanded, wages have increased markedly less than in economic upswings in the past. Economists now surmise that the wage slowdown is not caused by the tepid pace of the economic recovery. The labor market regained what most would call full employment almost three years ago, but the trend of wages since has remained sluggish.

Analysis.

Contributions from staff reporters in New York and Washington.

Some economists argue that the slow growth of wages is not surprising, given that investment has grown slowly as well. Workers are generally believed to be paid according to their productivity, and more investment, including both modernization and giving workers more machines, computers, and other equipment with which to work, is thought to make workers more productive. The data indicate that this pattern has held true. Thus, with investment slow, productivity growth has been slow, and wage growth has been slow as well.

Another pattern that has followed the tenets of economic theory is that the wage slowdown has coincided with a period of large federal government budget deficits. Economists generally believe that large budget deficits drain the capital that would otherwise be available for business, thereby slowing productivity growth and wage growth.

Those same economists have warned that large deficits could create a financial meltdown, with a sudden spike in interest rates and a sharp drop in the value of the dollar. Because that has not happened, other economists and many politicians have concluded that "deficits don't matter." As a result, the popular clamor for deficit reduction that seemed so strong in the early part of the decade has seemed to die down.

But budget hawks argue that the absence of a financial explosion does not disprove the existence of a slow and dangerous burn. They contend that the sudden meltdown has been prevented by two forces, neither of which improves the prospects for longer-term continuing wage growth.

The first benign force cited by these economists has been that markets have remained tepid, largely because recurring economic weakness and financial instability around the world have maintained the dollar's status as a "safe haven." We remain "the best looking horse in the glue factory," as one economist[3] put it. Meanwhile, however, the federal government has continued to accumulate more debt, raising the prospect of a later but even worse debt meltdown.

Implementing this levitation of Treasury bond prices has been the increasingly common practice of banks and other financial institutions to accept deposits from the public at low interest rates and then invest those deposits in Treasury securities. The Treasury bills, notes and bonds have had comparatively low yields, but they also involve little risk, and purchasing them in large quantities involves little cost. So this strategy has enabled banks to earn modest but sure profits, and has helped the Treasury to finance the public debt. But the bank deposits that have been recycled into Treasury securities have not been available for lending to prospective homeowners, auto buyers, or small business entrepreneurs. This process is a clear demonstration of what economists call the "crowding out" of private investment by government budget deficits.

The second force has been a series of limited efforts by successive Presidents and Congresses to reduce the budget deficit. Episodic bursts of bad news on the budget have resulted in partial, ineffective responses – never enough to lay the problem to rest. Then, periods of good news – a few quarters of above-forecast economic growth, and smaller-than-expected deficits – have led policymakers back to complacency and recidivism. Experts say that none of the budget agreements of the past decade has come close to solving the problem. However, by nibbling away, policymakers have managed to fend off an out-and-out crisis.

But some economists say that the large deficits have in turn nibbled away at investment by business, and slow wage growth has been one of the by-products. Among economists who deny the primary role of budget deficits, there are two competing interpretations of the cause of the slower growth. More-conservative economists argue that the tax increases that have helped to keep the budget problem from getting totally out of hand have been enough to dull incentives to invest and work. Others policy observers from the liberal end of the spectrum argue that the tax increases have been too small to reduce incentives, but that reductions in the government's annual appropriations have restricted crucial public investment,

[3] This comment was actually made by Nariman Behravesh at CED's first hearing.

including for infrastructure, new technologies such as clean energy, and even defense modernization. The middle-of-the-road economists say that quicker deficit reduction, before the debt and debt-service costs grew so large, could have limited the debt and the necessary actions on both taxes and spending, thereby heading off the concerns from all parts of the political spectrum. Meanwhile, they cite the phenomenon of crowding out of private investment as a cause of sluggish growth of both wages and the total output of the economy.

Sluggish wages have had adverse consequences beyond limiting the incomes of consumers, and frustrating them with lower standards of living. The financial status of Social Security and Medicare has been downgraded repeatedly – not so much because their costs have exceeded expectations, but rather because revenues have fallen short. The official actuary has warned that action will be needed soon to restore their long-term financial balance. Of course, either higher taxes or lower benefits will merely compound the direct effect of slow wage growth on standards of living. Furthermore, uncertainty because of multiple changes to retirement programs has demoralized the elderly and their adult children, and reduced economic confidence generally.

Beyond the immediate economic consequences, sluggish growth in the United States is said by some to have reduced the nation's standing around the world. The image of the United States as a dynamic country on the cutting edge of technology and innovation has faded. Foreign policy decisions are increasingly cramped by concern about the reaction of our creditor nations, with growing shares of the public debt owned by overseas investors and governments. Limited budgets for defense and foreign aid have worsened the problem. As China's GDP has first equaled and then surpassed by a growing margin that of the United States, esteem for this nation overseas has sagged. Despite periods of tension, foreign lenders have continued over time to buy Treasury securities – with the result that the public debt continues to grow, raising the stakes for any future crisis.

Even as other nations have grown more prosperous over the years since World War II, the United States maintained the aura of a leader. If the current slowdown in wage growth continues, foreign policy experts fear that the recent apparent beginning of the erosion of American leadership could continue and accelerate. Many experts cite the role of budget deficits in that erosion. "I doubt that I would complain to my local banker that his lawn looked a little shaggy if I were late on my loan payments," mused one scholar.

Part 3.5. Alternative Futures, 2012 –

It would be politically difficult and painful for our elected leaders to scramble their way out of the kind of budgetary hole described prospectively at the outset of this statement. Here is one way in which it might happen.

A Narrow Escape

Markets Warned Political Leaders;

Why Were We So Lucky?

Tuesday, October 23, 2012. A measure of calm has returned to international financial markets today, after the United States Treasury's surprising struggle to refinance the nation's large maturing debt two months ago. Market participants say that the repercussions may be contained by the limited deficit-reduction agreement agreed upon by both parties yesterday, and the financial markets anxiously await further signs that normal operations will resume. The President and his election opponent plan to return to the campaign trail today, after breaking off for their emergency negotiations late last week.

The Treasury was unprepared to react when the August 1 auction of securities, needed to roll over maturing Treasury bills, notes and bonds, unexpectedly was far undersubscribed by investors who were unnerved by the two presidential candidates' apparent indifference over the federal budget crisis. As the Treasury scrambled to find the cash that was necessary to refund the debt, the international financial markets sent a strong signal to the candidates, as the dollar fell sharply and market interest rates on Treasury securities jumped. Still, the markets apparently were willing to give Washington some limited space in which to maneuver, in the opinion of some observers because investment alternatives elsewhere around the world appeared unsatisfactory. Market movements after the first 24 hours continued adverse, but remained short of outright panic.

Analysis.

Contributions from staff reporters in New York and Washington.

Then, market participants said that they were not satisfied when the presidential candidates and Congressional leaders met briefly last week, calling the result pure public posturing. After the talks were interrupted, the financial markets, which previously had relented based on a presumption that the United States would address its problems, spiked again, but even more sharply. The candidates and the Congressional leadership began to meet again, but pressure continued to build, and the perception became even stronger that they had no choice but to come to agreement.

Reports indicated that the meetings in the Capitol were highly contentious. Each side argued that the other would be blamed if failure led to another market paroxysm. But participants in the meetings reported a palpable sense that failure to reach an agreement could have unspeakable consequences.

News of the agreement yesterday has apparently calmed investors, as European markets at the opening showed meaningful gains after the days of wild fluctuations and large losses. Economists expressed confidence that success in implementing the agreement will facilitate a resumption of credit market activity for businesses and consumers, limiting the fears of the last weeks and re-charging the stumbling economic recovery. Statements by well placed officials near the Federal Reserve suggest that the Fed will hold interest rates down to keep the economy moving while government spending is cut and taxes are increased.

Implications for the election campaign are not clear, according to political experts. The President's team members are saying quietly that the achievement of an agreement will take the issues of a weak economy and panicky financial markets, which they had considered major electoral liabilities, off the table. They are unsure, however, whether claiming a political victory through taking the economy to the brink of disaster would be seemly, as well as whether it might threaten the ultimate legislative implementation of the deal in this charged political environment. The campaign leaders of the opposition candidate, in contrast, have begun touting more explicitly the candidate's leadership in pushing the negotiations to a successful conclusion.

As calm is returning, market players expressed relief, but described the outcome as a fortunate escape. Global markets had sent strong signals to Washington, but somehow held back from the worst crash, as if collectively attempting to convince – or compel – policymakers to respond. As one expert asked, shaking his head in relief and wonderment, "Why did the financial markets give our political leaders a second chance? And what would have happened if they had not?" Other market players express intense interest in the answer to the first question, but do not want to know the answer to the second.

Part 4. Conclusion: A Better Way?

None of these alternative futures look particularly encouraging. Is there a better way?

Through the power of word processing, let us rewind these futures back to the present – before the stage-setting that we saw in Part 2, above. Starting all over, could we see a better future unfold?

Budget Agreement Reached

Above Politics?

How President and Congress Turned the Finances Around

Sunday, September 11, 2011. When the President and the congressional leadership announced very early this morning that they had reached an agreement on a long-term, phased-in deficit reduction program, combined with a temporary stimulus to boost the tepid economy over the next year, both political and financial observers combined sighs of relief with looks of wonder.

Economists and Washington insiders alike were pleased at the success, but surprised as well – even though the talks had been ongoing for more than two weeks. "I said I would believe it when I see it," said Norman Ornerystein of the American Enterprise Institute after the public announcement of the agreement. "But right now, I'm not sure if that is true." Thomas Manners, another veteran watcher of Washington politics at the Brookings Institution, noted that this budget deal was the quickest to come to fruition in modern history. He pointed out, however, that budget agreements seldom have been the products of laborious research. "People know the issues walking in the door," he said. "What takes the time is not discovering the options, it's the players making up their minds to get to 'yes' and choose among them. This one clearly was urgent – heck, we have a genuine economic emergency out there – but even so, it is shocking, in a good sense, that these parties could overcome all of the partisan conflict that we have seen for so long." Another Washington watcher, political scientist, humorist and cartoonist James Thurber, announced immediately that he was working on a book about the budget deal, tentatively entitled, "The Night The Jaws Fell."

Reactions from Wall Street managers were similarly surprised, and almost euphoric. One trader, who wished to remain anonymous to protect the identity of his firm, is typical. "It is totally unreal," he said when he heard of the agreement last night. "The world has changed completely." He noted that the markets had begun to react positively as the talks had shown progress, but remained reserved because of the perceived likelihood of a political failure. "This changes everything," he concluded. "The sky is the limit for the stock and bond markets tomorrow."

But the remarkable turnaround in policy and policymaking in Washington left insiders asking how it happened. At least one reached a conclusion last night. "Look, I've been knocked around in many budget negotiations over the years," said Leon E. Piñata, former White House budget director and chief of staff, and also a former House Budget Committee chairman. "And one thing I've learned is that this country addresses its problems either in crisis or through leadership. This time, two people realized that if you want to call yourself a leader, once or twice you have to go first."

Analysis.

Contributions from staff reporters in New York and Washington.

The developments that led here, in retrospect, probably were more likely to yield tragedy than triumph. For almost a century, the United States has been a constant in global finance and business. Even in the financial meltdown of 2007-2009, U.S. Treasury securities were perceived as a safe haven for investors, a destination for a "flight to quality." But over the last year, events began to shake those perceptions of the United States as bedrock for investors. These changes had roots in the earlier financial crisis, and even before.

In the early years of this century, the United States lost its budget surplus and so started to accumulate debt. Even before the financial crisis that began in 2007-2008, this higher debt aroused worry in the financial markets. But in the crisis itself, while developed countries around the world found themselves in recession and with weak budgets, the United States added more debt than most.

There was a period of grace for this country. The extreme financial woes of some of the weakest nations, epitomized by Greece, attracted most attention. The status of the dollar as the world's reserve currency provided some insulation from our own troubles, as other countries and companies parked their money by buying up our debt. And investors all around the world began from the assumption that at the end of the day, the United States would face up to its problems and do what it had to do.

But whatever grace the nation had enjoyed began to erode rapidly in the past two years. The U.S. economy finally showed signs of finding its feet. Growth resumed in late 2009. Employment stopped falling, and began to turn around – although not yet with the rapid rebound that had followed the deepest previous recessions of the post-World War II era. After nerve-wracking hesitation and uncertainty, the financial crisis in Greece was forestalled by cooperative action of the European Union and the International Monetary Fund, seeming to halt a possible contagion to other weak European states. With considerable excess productive capacity in the United States, and also around the world, because of the tepid global recovery – in part because the reach of the financial crisis into Europe weakened the economic outlook there – inflation, which had been feared by many because of the extraordinary anti-recessionary financial measures undertaken by the Federal Reserve and the Treasury, never became an issue. America and the world took the time for a sigh of relief.

Still, to the public at large, the nation's climbing debt levels in the wake of the financial crisis were vaguely disquieting. After the plunging home values and underwater mortgages that set off the crisis and the fallout for retirees, typical working people reacted adversely to the notion of rising debt, especially as it weighed on their plans for retirement and on their legacies for their children. The notion of rising ***public*** debt seemed less immediately pressing than the private debt of their households. Most people were less than familiar with the history of debt crises elsewhere around the world. Greece had given people some image of what government irresponsibility could do, though they correctly recognized that the United States and Greece were in almost all respects quite different.

The mid-term election of 2010 yielded large-scale change in the Congress. The two parties, as was their wont, pointed fingers at each other over the budget and every other issue. For the voters, there was a typical sentiment that those in office "owned" the economy and the budget; sophisticated analysis of who had been right, who had been wrong, and who was responsible did not capture the public imagination. The result was a "throw-the-bums-out" election of proportions comparable to the strongest in history. The nation was left with a divided government, because the party in power was not successful in defending its many vulnerable seats; but some incumbents of the minority party suffered too. So with the major reshuffling of the Congress beginning in 2011, there was no chance for either party to dictate a legislative agenda before the next presidential election in 2012. Gridlock followed.

The modest upturn in the economy continued. The president and his party claimed that this modest improvement indicated that they had been right all along, and that the country was finally seeing the fruits of the policies of the past two years. The opposition countered that their new strength in the Congress, stalling the Administration's agenda, caused the economic growth.

The public debt itself seemed to recede, slightly, as an economic issue. With modest economic recovery came some limited but visible relief from the large deficits. The sense of comfort was fed by continued low interest rates. With inflation remaining quiescent, interest rates rose little. So although the public debt rose, the cost of debt service in the budget hardly budged. There seemed to be little need to forgo spending, or raise taxes, because of

the higher debt. Thus, continuing large budget deficits seemed almost benign. Talk of "deficits don't matter" even began to return: Deficit alarmists had been crying "wolf" for years, and the problem never materialized; the alarmists had been wrong before; so surely they would be wrong again. There remained a sense of American exceptionalism: that "it can't happen here."

The danger signs in the financial markets came surprisingly quickly.

With politics returned briefly to usual, the budget deficit smoldered in the background. The budget outlook at the beginning of the year had the deficit down from its peak of 2009 but still much higher than would be sustainable, and then rising into the future. To avoid offending the voters, the President made no painful decisions in his budget. The President's "fiscal responsibility commission" had failed to reach a bipartisan agreement, and even though it had presented a menu of ideas judged to be balanced and sound by nonpartisan experts, it had been largely ignored. Some of those ideas were included in the President's subsequent budget, but that budget was "dead on arrival," in the language of Capitol Hill.

When the nonpartisan Congressional Budget Office evaluated that budget, it projected resulting deficits significantly higher than claimed by the President himself. The opposition in the Congress was not required to present a formal budget, of course, and so their informal alternatives could not be subjected to detailed analysis. However, to appear no less attractive to the voters, they discussed even less by way of specific steps to cut spending, and of course pledged never to raise taxes.

It was at this point that budget experts in the policy community began to repeat more loudly the unavoidable conclusion, which in truth they had believed for some time: Neither party was positioned to take any significant steps on the budget for years. With this realization began the deterioration of global confidence that the United States eventually would face up to and solve its fiscal problems.

Meanwhile, ostensibly positive developments from overseas made the U.S. picture even more troubling. The apparent at least partial success of budgetary retrenchment in Greece, Portugal, Italy, Spain and Ireland made their debt sell more freely on financial markets. With the lessened threat to the European banks that held much of their debt, and to the rescue program that had been assembled by the European Union and the International Monetary Fund, the markets sent the euro up. At the same time, China's signs of steadying maturity in the international financial community raised anticipation of a floating, and more valuable, Chinese currency.

On the surface, the stabilization in Europe and China was in turn a relief for the U.S. economy. The fear of European economic and financial collapse had put a damper on U.S. markets, and that in turn made both consumers and businesses more cautious. Weaker consumer demand yielded weaker business investment, which fed back into consumer demand in a vicious cycle. Now, that restraint seemed to fade. And a more mature Chinese market economy would be more predictable.

But the supreme irony was that such good news carried bad news. With apparent economic recovery, central banks around the world, including the Federal Reserve, accelerated their programs of raising interest rates from what had been low, stimulative levels toward their historical norms. Though the accumulation of U.S. public debt thus far had seemed benign because of the extraordinarily low interest rates, the debt had grown so large that even a move toward normal rates quickly made the debt-service cost problematic. And as the euro and the renminbi became more attractive, naturally enough, the dollar began to fall relative to them, and U.S. securities became less attractive to foreign investors.

So slowly at first, but then at an accelerating pace, higher budget deficits and the reduced political prospect that they would be addressed frightened investors, who raised interest rates, which made the budget deficit worse. This basic adverse feedback loop was further worsened by the impact of this development on the rest of the economy. Consumers were just working their way above the surface from their under-water mortgages, and broader economic growth raised the prospect of the first healthy demand for housing in years; but rising interest rates slowed that process. Businesses newly interested in investment suddenly faced rising borrowing costs, which threatened that component of growth. State and local governments had been squeezed by the economic slowdown and the tepid recovery, and rising interest rates put a chill on their plans just as the very first signs of meaningful economic growth gave some reason for hope. So the federal budget clearly would be worsened by the direct impact of rising interest rates, but as the rising interest rates slowed the economy, the budget would be worsened still more.

The rest of the world began to react to this adverse feedback loop. Some years before, the petroleum-producing countries of the Middle East had spoken privately about changing the peg of the oil price from dollars to a currency index or "basket," or even to some other currency, and rumors of those conversations spread and raised doubts about the dollar. But in the financial crisis and its aftermath, with the European economies so weak and the Chinese currency held artificially low, those Mid-East discussions ceased. Now, with the rise of potential alternatives to the dollar, discussions of a successor to the dollar for pricing oil began again.

And on another front, the adverse U.S. political prospects for budget action along with the rising deficit forecasts raised the volume level of discussions by bond-rating agencies of a potential downgrade of U.S. Treasury securities. In a concrete sense, these rating downgrades would have had little practical consequence, because Treasury securities would continue to be sold at auction – rather than being placed starting at estimated market rates, like all other U.S. debt securities. However, just the talk of a rating downgrade led foreign governments that held much of their reserves in dollar-denominated securities, but which had previously deliberated privately about changing their investment decisions, to begin actually to shift their purchases slowly toward the yen, the euro, and even the renminbi, to give their portfolios some measure of diversification. These shifts were unannounced, but close watchers of the Treasury market detected the movements and reported on them. The news moved quickly from the computer worksheets in the back offices of the financial industry into the popular press. The psychological impact on investors began to build discernibly.

These early warning signs – in both the financial markets and the "real" indicators of employment and production – were not qualitatively different from the flashing red lights of the last decade. Some might even argue that those red lights had been flashing for 30 years, with some brief periods of respite along the way. The warnings might have been ignored, as they had on most occasions in the past. However, experts consulted over the last two weeks have cited two differences.

First, as the budget and debt problems have accumulated, the warning signs have become stronger and more broadly based. So having adverse comment about U.S. fiscal behavior echoed from the bond-rating agencies to the oil-producing countries to the stock market made these concerns more immediate and harder to ignore.

And second, and in a sharp departure from earlier years, the U.S. business community began to speak out. Business leaders had been reluctant to "raise their heads out of the foxhole," as one put it in a not-for-attribution interview, after all of the adverse publicity of the Enron-WorldCom management scandals of the 1990s, and then the financial meltdown and scandals of the decade of the 2000s. But perhaps because of the realization that there was so much at stake, for their businesses and for their children and grandchildren, businessmen and women began to speak out. The "shock value" of a business voice after years of silence on public issues did garner attention. But perhaps more important was the open acknowledgment that a fair solution to the budget crisis would require sacrifice on all sides – including from themselves – which gave the business message additional credibility.

Whatever motivated the President, he reportedly determined in his own mind that the budget crisis had risen to a level far above politics, with the potential of catastrophic economic consequences. Privately, he reached out to an opposition leader in the Congress to propose serious discussions to lead to a resolution of the crisis to be completed early – well before the presidential election, and before the nascent financial-market reaction could build dangerous momentum. A few White House and Congressional staff members – all of whom demand anonymity – maintain that the President and this political opponent had spoken privately over several months. The reports indicate that both had agreed on the seriousness of the problem, and that they would be willing to raise their conversations to the level of a substantive negotiation if the risk to the economy became real. Three months ago, the President concluded that the risk had escalated, and with the agreement of the opposition leader, the private talks began.

In the initial one-on-one negotiation, the President and his political opponent decided in substantial part to go back to the ideas in the report of the President's bipartisan commission (though that report had not received the necessary super-majority approval at the time). However, those proposals needed to be modified to achieve bipartisan agreement in this changed environment. This one-on-one negotiation could not go far, because as Washington insiders know, no one person can speak for even one party in the Congress. As the foundation for a bipartisan agreement was built and the talks broadened, a few more members of the Congressional opposition, and then members of the President's party, were drawn in. Because even a meeting

of one person in Washington never remains a secret for long, news of the talks soon came out.

The legendary awkwardness of business in Washington was manifest immediately. Everyone wants to be a party to every negotiation. The original Congressional bargainers were limited to members who believed in the need for an agreement. Many who later asked to join the negotiation fervently wanted to sink it – either because they feared the loss of what they believed to be a winning political issue, or because they opposed the steps that would need to be taken to solve the budget problem. Among these, many members of the President's party believed that the budget could be tamed without pain through a massive infrastructure program. Many from the opposition believed that big tax cuts would increase growth to unprecedented and redeeming heights. The President imposed discipline by holding the meetings in the White House, and the opposition leader backed the President and held his ground with his own members.

Sources say that debate among the negotiators was extremely sharp. Although they had convened because they believed that the cause was urgent, they held widely differing values. The deficit chasm was enormous, and "giving ground" could not be measured only in dollars, and not only at one moment in time. For example, the two parties reportedly differed when it was tentatively agreed that the final program should be divided roughly equally between spending cuts and tax increases, and it was pointed out that by the end of ten years' worth of savings needed to hit their budget targets, much of the money saved would be in the form of forgone interest costs. The negotiators argued over whether the interest savings should be counted as spending reductions, which would reduce the amount of other spending cuts needed relative to revenue increases.

Another sticking point came on choices of budget targets, because budget outcomes are affected by economic growth. Some members of the Congressional opposition, in particular, reportedly argued for a "growth bonus" in the accounting if their policy recommendations were accepted. With difficulty, the negotiation held together on a principle of using cautious assumptions about the economy to force the negotiators on both sides to accept the difficult choices.

The sluggish economic recovery complicated the discussion. On the one hand, the evident concerns in the financial markets had made the budget issue urgent. On the other hand, the weak economic recovery, still stumbling from the financial crisis of the end of the last decade, made many economists cautious about the restraining effects even of spending increases and tax cuts that unquestionably would be necessary in the longer term. The first indications of an economic slowdown in China raised worries in the United States, as they had in the rest of the world. The President reportedly represented vigorously the concerns of members of Congress of his party about the hardship that they see in their states and districts.

Accordingly, the two sides struck a bargain to enact a short-term stimulus program, which the opposition party did not want, in exchange for some changes in both the character of the stimulus – compared with the similar effort in 2009 – and in the deficit-reduction program. The opposition demanded temporary tax cuts as a part of the stimulus, and the absence of some spending increase proposals. In the deficit reduction, the opposition asked for some additional spending restraint. The deal was struck along those lines.

The near-term stimulus necessarily entailed a delay in the timing of the deficit-reduction program. That raised concerns that the deficit reduction might be repealed even before it took effect, possibly through a shifting of the political winds between now and then. It also risked a lack of credibility for the financial markets. Although the staying power of the deal cannot be certain, indications over the negotiation period were favorable. Several leading financial market players commented that if a bipartisan deal could be struck, and if both sides claimed ownership firmly, then the chances of the deal making its way to its effective date would be credible. Also positive were statements from the Federal Reserve Chairman. Although he was careful to refrain from commitments on any political deal that was not final, the Chairman said – as clearly as he says anything – that a strong bipartisan agreement would have his support, and that the Fed would try to hold interest rates down to facilitate a more robust economic recovery.

Also troublesome was the treatment of health care, especially in light of last year's reform law. The opposition clearly was bitterly opposed to the law, but the budget deal could not reach its targets without additional savings in health care, and the complexity of the law made it intractable in this small-group negotiation. To reach an accommodation, the President stipulated that the reform law was not the final word on the issue, the opposition accepted further targeted savings, and both sides accepted principles and a deadline for a new reform process.

Although the announcement tonight strongly indicates that the negotiated agreement will be enacted into law, Washington was far from unanimous on the deal. Both the President and the opposition leader will face intra-party argument. Members of the ideological wing of the President's party already have derided him for, in their view, having given up too much. Even the leadership of the President's party was heard to grumble that the President should have included them earlier and with more authority in the negotiations.

On the other side, the opposition's ideological extreme clearly believes that tax increases in any form should not have been a part of the deal. They also have complained that making a deal with the President took him off of the political hook, when the weak economy and a potential renewed financial crisis left him vulnerable in the 2012 election.

On that point, political seers are divided. They tend to agree that the President himself would be at increased risk with a poor economy and financial dislocation. On the other hand, they concede a chance that had a deal not been reached, the perceived best efforts at an economic remedy by the President, coupled with evidence of opposition intransigence, could have rebounded to the President's advantage. Thus, the political opposition quite possibly had no viable alternative but to negotiate in good faith. Analysts also believe that a more stable economic environment will work to the advantage of all Congressional incumbents – ironically, even some who oppose the deal that achieved that security.

With the conclusion of the negotiations, the agreement is to be converted to legislative language and taken to the floor of the Congress late this week. Approval is expected relatively quickly by Washington standards, with a goal of enactment including the annual appropriations that are a part of the package by the beginning of the next fiscal year on October 1.

But meanwhile, seasoned market players looking back on more than 30 years of budget battles in Washington are shell-shocked over what they have seen. "I've watched this argument go back and forth for decades," one trader who insisted on anonymity said this weekend. "But I never thought that I would see something like this."

A second highly placed market player expressed his surprise in political terms. "Look, I'm a rock-ribbed conservative. I deplore big government. I hate taxes. I certainly wouldn't seek a deal exactly like this. But it does look as though I will be sleeping a lot better at night. And if the concern is that the taxes will make us less competitive, well, our competitors are going to be raising taxes too. For sure."

One way or the other, whatever the views of political watchers, economists, or market players alike, it was a Washington story for the books. Or as another Wall Street veteran said, "However long this deal lasts, I'm just glad this budget nightmare is over for a while."

A great deal of damage already has been done by the nation's accumulation of debt, and today's economy makes the environment uncertain and the choices difficult. But with a willingness to find a middle ground, this story can have a "happy ending." Our leaders have addressed difficult problems in the past, and they can – and should, indeed must – do so again. Every American should work toward that end.

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