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The US shut-down

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No matter, slow growth or poor job possibilities, there is no scarcity of political drama in America. The latest to top the list on all 24-hour news channels and radio talk programs is "America shutdown".

The US federal legislature is deeply divided.

The continuing wrangle between President Obama's Democrat Party dominated Senate, the upper house, and the opposition, the Republican party dominating the lower House of Representatives is over federal government spending. Their failure to pass the budget for 2013-14 before the financial year ending on 30 September has led to a partial shutdown of American government from October 1.

About 700,000 "non-essential staff" of total 2.1 million-strong federal workforce will not get their salaries; national parks, museums and federal buildings are closed.

Bane of Presidential system

In a parliamentary system in between two general elections, if the government gets voted out of power when the budget is not passed, a new government enjoying the confidence is sworn in. The new government then picks up the threads and gets a new budget approved. The economy does not grind to a halt.

In the US, the President is not from the legislature. He is directly elected and cannot be replaced until the next election in 2016. So, the opposition continues to create hurdles for four years.

For the ultra conservatives among the Republicans, the bone of contention is the Patient Protection and Affordable Care Act, which represents the most significant regulatory overhaul of America's health system since 1965. It seeks to increase the quality and affordability of health insurance. It was passed by US Congress in 2010. Although upheld by the U.S. Supreme Court earlier this year, the Republicans are against the health reform and they want the Health Care Reform be delayed and diluted. That explains the standoff.

Standoffs are not new

There were 18 such instances in the past three decades.

The last one, which was 17 years ago, was a 21-day shutdown in November 1995. It is feared this time loss of GDP per day would be around US$300 million. If it is for 21-days, as was in 1995, aside from hurting consumer and investor confidence, the loss would be 1 percent of GDP.

More alarming is the impending expiry of debt ceiling on October 17, which limits the borrowing up to US$16.7 trillion. It requires to be raised by the US Congress.

If not raised, America would default on its debts. The Republicans know they can link the budget approval and raising the debt ceiling to the health care reform. Delaying the health care is the price for budget approval. It now looks the shutdown will last until October 17.

Likely Impact of Default

On Thursday, the Treasury Department issued a warning that a default would be unprecedented and “catastrophic.”

“Credit markets could freeze, the value of the dollar could plummet, US interest rates could skyrocket, the negative spillovers could reverberate around the world, and there might be a financial crisis and recession that could echo the events of 2008 or worse.”

Default in our region

Pacific region experienced one sovereign default so far. That was by Solomon Islands when high levels of both external and domestic debt in the late 1990s led the nation to default. It failed to meet external debt obligations of interest and instalment payments during1995-2004.

A possible debt default crisis was recently averted in Tonga. As the grace period was over for a loan of about US $ 60 million from Exim Bank of China, the first payment of US$ 7 million was due in the last week of September. The loan was for rebuilding roads and infrastructure in Nuku’alofa. As Tonga could not meet the obligation, it asked for the extension of grace period, which was granted by China, thereby avoiding debt default. It is reported that Tonga has asked an additional 5 to 10 year extension of loan.But there is no word from Exim Bank.

The July 2013 IMF Mission to Tonga has cautioned Tonga to avoid further external debt as its debt is 60 percent of its GDP. It has also warned against an excessive loan exposure to a single foreign currency.

The acceptable debt limits of poor countries are in the range of 40 to 50 percent of GDP. For those countries, whose domestic financial sectors are not well developed and hence domestic borrowing possibilities are limited, external debt is the only recourse for financing budget deficits. Since external debt is always in foreign currencies, debt servicing capacity is determined by foreign exchange earnings from exports and tourism services, and inward remittances.

America, the world’s engine of growth is different. Although its debt is more than 100 percent of its GDP, it is considered as a safe haven by the rest of the world. It has never defaulted. Its twin deficits, budget and external deficits have been willingly funded by China and Japan all these years. They had built huge trade surpluses in their bilateral trade with America.

They would hate to see a defaulting America.