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How Debt Showdowns Encourage Credit Bubbles

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Again and again, as politicians in Washington, DC clash over the federal debt, Americans have been subjected to the spectacle of last-minute crisis maneuvers amid loud threats to shut down government or refuse once-routine adjustments to the debt ceiling. After each clash ends, debt showdowns tend to be written off. But they actually are quite dangerous – and not just because the most extreme showdowns could force the United States into default.

Even if the nation's credit rating remains untarnished, history teaches us that U.S. debt battles can leave a trail of volatile financial policies in their wake. When politicians want to promote a growing national economy but are pressured against raising taxes or taking on officially backed debt, they may turn to easy-credit policies. Such policies can seem like the easy way out, because they foster economic growth by encouraging citizens to lend and borrow more money. But they open the door to bubbles, scandals, and bailouts.

A Tradition of Budget Battles and Bubbles

The strategy of turning to credit to avoid budget battles and higher taxes is an old one. After the American Revolution, easy credit for homesteaders revealed the problems. In lieu of raising taxes, the nation's founders counted on land sales to raise the funds needed to pay off the debts incurred during the War for Independence. By 1800 the government had not sold enough land to pay down the desired amount of debt, so it tried to speed sales by extending credit for land purchases through the Land Banks. Twenty years later, a speculative bubble burst leading to the economic downturn of 1819. Amid cries that loose credit encouraged the bubble, the U.S. government forgave $21 million in unpaid debts.

In our own era, my research documents similar burst-bubble cycles goosed by housing policies.

- At the close of the 1960s President Lyndon B. Johnson faced fiscal crisis. The Vietnam War was escalating at the same time that Great Society programs drove up social spending, and the housing market was freezing in a mounting credit shortage. As the government quickly approached the debt ceiling, Republicans tried to force cuts in social spending by refusing to raise the debt limit to the levels the president wanted. Johnson dealt with the situation in part by expanding credit. He spun off the housing credit agency Fannie Mae and reorganized it to encourage lending off the federal books.

- Fannie Mae also got authority to issue mortgage-backed securities. From the beginning, government officials saw in these instruments the promise of free-flowing credit and encouragement for growth through the housing market. To grease the system, the government agreed to assume some of Fannie Mae's risks, notably by providing it with a $2.5 billion line of credit and guaranteeing its mortgage-backed securities. The loose easy credit this system encouraged led to huge housing bubbles – and set the stage for the 2008 financial meltdown and ensuing U.S. and global economic downturn.

The Upsides of Federally Encouraged Credit

America's expansive credit policies have not always been bad. Some have a clear record of success. In the New Deal, for example, President Franklin Delano Roosevelt used expansive credit to alleviate mounting deficits, though this time much more carefully. His initiatives helped struggling families keep their homes by allowing them to refinance existing mortgages, and later made it easier for families to acquire new mortgages. These programs worked by making sure credit flowed into housing, sometimes by having the government act as a broker, banker, or an insurance company. Roosevelt liked these programs because they were, on the whole, cheaper than other kinds of programs, and private investors were more willing to lend money knowing that the federal government would stand behind mortgages.

Specifically, the Federal Housing Administration's mortgage insurance program has long encouraged the

growth of U.S. housing. Mortgage insurance means more money for people to buy homes, which in turn encourages jobs and profits for homebuilders, companies that supply homebuilders, and manufacturers of the many appliances and goods needed to equip new homes. By making sure credit flows, the federal government since the New Deal has been able to encourage such good economic results without raising taxes or issuing national debt to fund the expanded economic activity.

But the Downsides Can be Serious

Nevertheless, the history of the Land Banks, Fannie Mae, and federally-backed mortgage securities shows that things can go very wrong, in several ways:

- Some credit policies have government assume all the risks, while private companies take all the profits. This encourages excessive risk-taking – and shafts the taxpayers when bubbles burst.

- Especially in times of debt showdowns, politicians can be tempted to back credit-creation measures not because they are optimal for economic growth or social wellbeing, but because they appear to cost government little and allow politicians to avoid blame.

- Credit policies can be very complex and full of hard-to-trace provisions. As Suzanne Mettler has argued in her book *The Submerged State*, hidden programs may stoke special-interest politics, discourage democratic accountability, and undercut citizen trust.

What American Citizens Can Do

All Americans should recognize that debt showdowns threaten more than national credit ratings. They can also push politicians into unwise easy-credit policies, especially during periods of economic instability. Recent economic bailouts, for example, relied on loans and credit guarantees – and our politicians may respond to current debt showdowns with more federal backing for easy private credit. We should all demand a stop to debt-showdown politics – and when budget wars happen, we must keep an eye out for the credit-handout policies that so often follow, opening the door to still more economic and fiscal troubles when things go awry.

Read more in Sarah Quinn, "Lemon Socialism and Securitization," *Trajectories* 20, no. 2 (2009): 3-5.