Cozen Currents: Getting to Yes on the Debt Limit

The Cozen Lens

- The political dynamics of the House Republican conference reflect the fractious “five families” of “The Godfather.” Getting all of them on the same page to negotiate over the debt ceiling will be a challenge for House Speaker Kevin McCarthy (R-CA).
- Friendshoring and industrial policy were supposed to work toward the same end, a reduced reliance on China, but an inherent tension has emerged between the two policies.
- The Federal Reserve is at a crossroads with personnel, policy, and politics that will have major implications for the economy and the 2024 elections.

Getting the Five Families to Yes on the Debt Limit

The Five Families. The movie “The Godfather” can shed light on the political dynamics of the House Republican conference.

- House Speaker Kevin McCarthy’s (R-CA) majority has been likened to the “five families” of the Godfather movie franchise for its lack of unity. The House’s five families are not mutually exclusive, but this framework provides a model to showcase the challenges McCarthy faces in keeping his fractious conference on the same page.
- The “families” from least to most conservative include the Problem Solvers Caucus, the Republican Governance Group, the Republican Main Street Caucus, the Republican Study Committee, and the House Freedom Caucus. Though small in number, the Freedom Caucus exerts significant influence over the majority, as shown by McCarthy’s speakership fight in January. The Study Committee is deeply conservative but does not have the same degree of an adversarial relationship with GOP leadership as the Freedom Caucus.
- McCarthy has taken a bottoms-up approach to leadership rather than top-down. He doesn’t rule his conference with an iron fist, a marked contrast from Senate Minority Leader Mitch McConnell (R-KY) or his predecessor, former House Speaker Nancy Pelosi (D-CA). A notable percentage of his conference haven’t served in the majority before and are new to governing. The Freedom Caucus came into being to challenge GOP leadership, and now it’s in the position of driving the House GOP agenda. The debt limit is the first major test of McCarthy’s speakership.

McCarthy’s Proposal. Last week, McCarthy released House Republicans’ opening gambit in debt limit negotiations.

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The Limit, Save, Grow Act of 2023 would either increase the debt ceiling by $1.5 trillion or suspend it through March 31st of next year, whichever occurs sooner (likely the former). In return for taking action on the debt ceiling, the legislation includes some $4.5 trillion in deficit reduction. The bulk of the cuts are in discretionary spending. It would reduce total FY24 spending to FY22 levels, a reduction of about $131 billion, and then cap future growth at one percent for 10 years, a reduction from the baseline of over $3 trillion.

- Other provisions include work requirements for Medicaid and stricter enforcement of work requirements for Supplemental Nutrition Assistance Program (SNAP) and Temporary Assistance for Needy Families (TANF), the Lower Energy Costs Act (one of the House GOP's top legislative priorities), the Reins Act (requires congressional approval for federal regulations with $100+ million impact), and overturning President Biden's executive action on student loan debt relief. At the behest of the House Freedom Caucus, McCarthy also included measures to overturn the Inflation Reduction Act's (IRA) IRS funding and clean energy tax credits.

- The House is expected to vote on the Limit, Save, Grow Act this week. All eyes will be on McCarthy to see if he can deliver the votes, and he doesn't have many to spare. McCarthy is dealing with the same narrow margin that confronted Pelosi last Congress: 222-213.

The Path Forward. The fate of the Limit, Save, Grow Act in the House this week will determine the next round of the debt-ceiling situation.

- If the bill passes, it would allow Republicans to cohere around a clear position going into negotiations with the White House. It's unclear what would come next, however, as Democrats will not vote to undo part of the IRA. Would the Freedom Caucus accept limits on their ambitions? A similar dynamic occurred last Congress when progressives swallowed a bitter pill in scaling down Biden's envisioned Build Back Better agenda, accepting the narrower IRA and not blocking the Infrastructure Investment and Jobs Act. McCarthy could use his bill as a starting point and negotiate something to claim victory and satisfy the Freedom Caucus.

- If the bill fails, it would deal a significant blow to McCarthy's bargaining position and underscore the fractures within the conference. This would signal to governance-oriented Republicans that another option is needed, such as a discharge petition to raise the debt limit or letting Senate Republicans take the lead in negotiating with Democrats. This could leave McCarthy vulnerable to an ouster engineered by the right wing. He's already taken great steps to appease the Freedom Caucus, and when push comes to shove on the debt limit, moderates could flex their own muscles and advocate a solution to the debt limit dispute.

- The struggle over the debt ceiling is next likely to come to a head when revised estimates of the X-date, i.e., the date when the federal government defaults, are released taking Tax Day revenue into account. The Congressional Budget Office announced last week that it would publish its next X-date projection in May. The impact of the debt limit standoff is already being felt in aspects of the financial markets, with credit default swaps at their highest level since 2011.

The Evolution of Industrial Policy

You've Got a Friend in Me. After the pandemic caused a renewed focus on supply chains, friendshoring emerged as a way to make them more secure without forcing companies to reshore.

- One of the primary appeals of friendshoring was that it was a means to reduce reliance on

China. Instead of having manufacturing concentrated there, companies were encouraged to move to the US or allied countries in an effort to reduce possible national security risks.

- As part of this shift, there were also opportunities for the US to bolster connections with some countries by encouraging companies to move their business from China to more trusted nations instead. This partner building could also be achieved by purchasing goods from allied countries rather than China, such as critical minerals used in electric vehicle (EV) batteries from Australia.

A Clash of Domestic and Geopolitical Goals. While friendshoring offers clear benefits, it also creates a conflict with efforts to bolster domestic manufacturing through industrial policy.

- Friendshoring and the US industrial policy push have some overlapping goals of trying to reduce reliance on China, but the goal of the latter was to create incentives that would encourage companies to see the US as a viable location to move their operations. Politicians' hoped that this would bring high-skilled jobs to the US and contribute to the growth of domestic manufacturing.

- But the two policies have also clashed, most prominently in determining what would meet the sourcing requirements for the EV tax credits under the Inflation Reduction Act. At the heart of this is the Treasury Department's expansive interpretation of what constitutes a free trade agreement and the White House's willingness to execute narrow trade deals that allow goods from allied countries to count toward these requirements.

- Bipartisan members of Congress have been frustrated with this move, arguing that the Biden administration's interpretation is not what Congress intended. The difference between the two ends of Pennsylvania Avenue can be attributed to lawmakers' greater focus on bringing jobs to the US, and their home states and districts in particular. The White House cares about jobs as well, but has backed this broader interpretation to foster friendshoring potentially at the expense of some firms moving to the US due to the geopolitical benefits.

Swiper No Swiping. In addition to the domestic controversies, the US's industrial policy created some unintended international tensions that have led to other countries launching their own subsidy programs.

- Part of the reason that these partners felt the need to begin offering their own incentives was to ensure that they did not lose jobs as businesses eyed moving to the US where their work could be subsidized. Lawmakers had not intended this kind of poaching when drafting the legislation, but a decision by Volkswagen to pause an EV battery factory in Europe in favor of prioritizing one in the US brought this issue to the fore.

- The Biden administration's interpretation of the EV sourcing requirements may help mitigate this some, as fewer companies will feel they have to move to the US to qualify for the benefits so long as their country can reach an agreement with the US. Navigating this will be important as supporting the growth of the EV industry is an area on which officials want to cooperate since they believe there is a pathway for all to benefit by collectively reducing reliance on China.

The Fed at Several Crossroads

Filling a Dove-Shaped Hole. The White House is expecting to make a decision soon on who to replace as the Federal Reserve Board vice chair, facing competing priorities from Democratic constituencies.

- Lael Brainard stepped down from the vice chair role two months ago to be President Biden's top White House economic advisor. Brainard's departure from the number two position created a hole of institutional knowledge. She chaired four of the eight Board committees and was a part of the "Fed troika" on setting the federal funds rate.

- Brainard was seen as a strong dovish influence on rate hikes, counseling caution in the name of potentially higher unemployment. Whoever replaces her will try to replicate her level of influence in this next phase of the aggressive rate-hike campaign the Fed has undertaken.

- Janice Eberly, a noted dove and a former Treasury assistant secretary for economic policy under Obama, has been a front-runner for the spot since Brainard stepped down. But Democrats like Senator Bob Menendez (D-NJ) are clamoring for Latinx representation. A narrow Senate majority and a prolonged absence from Senator Dianne Feinstein (D-CA) underscores the difficult balancing act of choosing someone who can be appealing and approvable for Senate Democrats.

To Raise or Not to Raise. The most aggressive rate hike campaign in over 30 years has been nearly unanimous among the Federal Open Market Committee (FOMC) participants, but cracks are emerging.

- Right now, the rate hiking ambition of Federal Reserve Board Chair Jerome Powell is at an uneasy place after the collapse of Silicon Valley Bank (SVB) and distress of other regional banks. Chicago Fed President Austan Goolsbee, a voting FOMC participant, recently called for "prudence and patience" given the recent financial headwinds.

- Fed economists are predicting a "mild recession" later in 2023. Many economists outside of government are similarly worried. FOMC participants, on the other hand, are mostly not.

- This uncertainty leaves both markets and Democrats worried. No president in 100 years has won re-election with a recession between the midterms and Election Day.

Crisis of Credibility. The Fed’s real influence is the trust and faith the markets hold in it. The SVB collapse has opened a new avenue of critique for both progressives and conservatives to question that trust.

- The Fed’s base of support are Senate institutionalists. But between challenges with monetary policy and bank supervision, it’s easier than ever for senators that previously supported Powell to harbor reservations about the Fed and its leadership.

- The SVB collapse emboldens Fed-skeptics on the left and right. An odd-couple pairing of Senators Rick Scott (R-FL) and Elizabeth Warren (D-MA) last month released legislation that would create independent oversight of the Fed. Governor Ron DeSantis (R-FL), a likely Republican presidential candidate, is calling Powell a "complete disaster."

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A squishier middle of institutional support only facilitates the attacks on the left and right that chip away at the credibility of the Fed, making all of its responsibilities more challenging. An uncredible Fed is an ineffective one.