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Fiscal Cliff, Sequester, Shutdown: What Next?

The latest showdown in Washington raises a whole host of questions and conjectures about what will come after the agreement struck yesterday by the U.S. Senate. A closer look at the most crucial issues involved is therefore in order.

From Political Farce to Economic Instability

Viewing the federal government shutdown of the past two weeks as political farce may help mitigate the gnawing anxiety over how large a threat it represented to the world economy. In fact, however, this most recent tug-of-war has thrown a new quandary into bold relief: the economy is increasingly at the mercy of politics at its very worst. In other words, our economic future may be shaped by partisan wrangling, even of the most ludicrous variety. This is not just an umpteenth American specialty, either. It is a tendency inherent in the lingering crisis that has bedeviled the advanced economies for over five years now, and it introduces a new kind of risk—unpredictable, uncontrollable risk with the potential to wreak havoc. While the too-big-to-fail syndrome may still look like it can shield us from the disaster scenario—federal government default—we would be well-advised to brace ourselves in this new phase for serial drama over the issue of U.S. sovereign debt and fiscal policy.

- **Plenty of room for more political strife.** Our outlook hasn't changed since our article of last March titled "The U.S. Budget: No, we can't." Contrary to common belief, the U.S. authorities are in no position today to manage down the national debt and keep the economy on its feet at the same time. A combination of weak growth and mushrooming social welfare costs—to deal with mounting poverty and the social breakdown it inevitably spawns—has stretched the country's public finances to the limit. This predicament leaves only two options open. The first is to slash social spending—in essence what the Republicans are calling for. The second is to tax the wealthiest citizens and corporate earnings much more heavily—as advocated by the Democrats. The proposal to institute a federal sales tax (or value-added tax) could also be added to the list—but it stands little chance of adoption, given the widespread bias in favor of existing State and local taxes. In any event, each of these options would take a bite out of GDP, and none of them could be pushed through without another bout of political arm-wrestling. What's more, with every such replay, confidence among economic agents grows dimmer.

Though the Republicans have just suffered defeat, yesterday's deal gives them a role in hammering out a final budget for fiscal year 2014, so we can expect yet another protracted stalemate in Washington. The U.S. economy is unlikely to come away unscathed.

- **How much fiscal tightening in 2014?** Behind all the debates and the measures that will ultimately make their way into the FY 2014 and subsequent budgets lurks the question of how much fiscal tightening the U.S. economy will be forced to handle. With the 2013 primary deficit still as high as an estimated 4.5 percent, Republican demands for cuts may well exceed all assumptions entertained thus far by the economics community. The national debt is running at 106.5 percent of GDP, nominal GDP growth is 2.9 percent, and the ten-year Treasury rate stands at 2.7 percent. This means that to stabilize the debt ratio as of 2014, the primary deficit would have to be reduced by some 4 percentage points of GDP—an unprecedented adjustment, and twice as large as in 2013. Moreover, this assumption is at odds with the consensus among mainstream economists, most of whom foresee a significant reduction in fiscal tightening in 2014. Needless to say, such a drastic cutback target would have a huge impact on growth expectations for next year and would create a very real danger of recession.

- **When will the downgrade occur?** No doubt about it: the current political and economic situation has greatly increased the risk that the U.S. federal government's credit rating will be cut. While this week's compromise certainly provides a breather (despite a warning by Fitch Ratings), the most likely outcome is still an across-the-board downgrade for U.S. sovereign debt, either prior to January 15th (when temporary funding for government operations expires) or after Congress passes a budget that threatens to kill growth—as it seems bent on doing.

- **What rates? What policy from the Fed?** In the last two weeks, the U.S. bond market apparently couldn't decide whether to worry more about default or economic slump, so ten-year yields fluctuated only slightly. The deal between Democrats and Republicans should usher in a market rally, especially since the macroeconomic data released in the last two weeks (the ADP Employment Report, the Monthly Survey by the New York Fed, and the Fed's Beige Book) are not exactly encouraging. However, with drawn-out, complicated negotiations in the cards, a safe bet is that yields will soon head back upwards. All this bears out our view that the Fed probably won't contemplate tapering its asset purchases in the near future. In addition, there is even a fairly good chance it will expand QE in the event of a U.S. sovereign debt downgrade—or an inordinately draconian FY 2014 budget.

- **What does it all mean for growth?** The unknowns in the economic outlook for the U.S.—and consequently for the rest of the world—are substantial, and it makes no sense to blame them primarily on a two-week halt in federal government services. After all, the shutdown is expected to shave just two tenths of a percentage point off of fourth-quarter GDP growth. Just how badly it may damage overall sentiment is largely a matter of conjecture at this stage. But we can be entirely sure of one thing: low-grade political theater never has and never will boost confidence or growth.

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