PERSPECTIVE

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GRIDLOCK IN AMERICA

All eyes are on the on-going European financial crisis. This is understandable, as it represents risk number one for the global economy and financial markets. However, the focus on Europe is drawing attention away from the fiscal risk playing out in America.

Washington is in the grips of extreme political gridlock. Congress has been unable - or perhaps unwilling is a better description - to pass a budget this year. The U.S. government is currently operating under a temporary "continuing resolution" that is set to expire on November 18th. During the summer, the parties had such difficulty in reaching a deal to raise the statutory debt ceiling that Standard & Poor's downgraded the federal government's long-term credit rating, citing political instability as a key motivating factor. While the debt ceiling was ultimately lifted, Washington could still not agree on the terms of offsetting fiscal consolidation. They agreed to around $900 billion in deficit reduction, but they could not find common ground on a remaining $1.5 trillion of fiscal savings over the next decade. With the Treasury department warning that America could not pay its bills if the negotiations continued, the political system dodged. They raised the ceiling and set up the Joint Select Committee on Deficit Reduction (JSC). The JSC - sometimes referred to as the Supercommittee - is composed of six Democrats and six Republicans. It has been tasked with finding the remaining fiscal savings and issuing a recommendation by November 23 of this year.

Now, a rational approach to fiscal adjustment would be to back-end load the fiscal pain. In other words, don't apply significant restraint in the near term when the economy is weak - do the bulk farther down the road when one would expect the economy to be stronger. This could well be what the JSC decides should they be able to reach an agreement. However, in order to incent the bipartisan negotiators to reach an agreement, the debt ceiling legislation included potentially steep near-term consequences for inaction. If legislation with $1.2 trillion in savings over the next decade is not enacted by January 15th of next year, this would trigger automatic spending cuts. The amount of the automatic cuts will depend on how much savings the JSC finds in their deliberations. For example, should the JSC find $600 billion in cuts, the remaining $600 billion would come automatically beginning in 2013. In the event that the JSC fails to reach an agreement and the full $1.2 trillion in cuts is triggered, the automatic cuts would amount to a steady $113 billion annual reduction in primary spending starting in 2013 and running over the next nine years.

From an economics perspective, what matters is the change in the cuts. With the automatic cuts implying a jump from $0 to $113 billion in 2013, the loss in annual economic growth, including second round effects on the economy, would likely be close to a full percentage point of economic growth. This is an enormous fiscal drag that runs the risk of stalling the economic recovery. Moreover, the lack of political consensus that the failure to reach an agreement would imply could lead credit-rating agencies to cut the federal government's credit rating.

The rational outcome is for political compromise and a deal that avoids the automatic cuts; but, the rational outcome may not occur in the current intense political environment.

Moreover, the fiscal risks go beyond the JSC. The American Recovery and Reinvestment Act (ARRA) of 2009 injected a significant amount of fiscal stimulus into the U.S. economy in 2009 and 2010 and was a key driver of the initial recovery. However, much of this stimulus was temporary and its subsequent unwind is now subtracting from GDP growth. In 2011, much of this drag was offset by additional temporary stimulus passed in late 2010: a 2% payroll tax cut and accelerated depreciation allowance for business investment. However, as 2012 approaches, Congress has still not decided on whether to pass an extension of the payroll tax cut. President Obama's American Jobs Act, which would have extended the payroll tax cut and expanded it to include employers, appears dead in the water. Should payroll taxes rise in January 2012, this alone would represent a drag of 0.5 percentage points from real GDP growth next year. Adding to this the expiration of emergency unemployment insurance, reductions in aid to state and local governments, and cuts from the first tranche of the deficit deal, total fiscal drag in 2012 would be around 1.6 percentage points.

Unfortunately, in 2013 the risks are even greater. Assuming the payroll tax cuts are extended through 2012, the 0.5 percentage point hit to growth will simply be moved into 2013. With the continued unwind of other programs and the cuts to spending specified in the first round of the debt deal, total fiscal drag in 2013 is set to subtract around 1.0 percentage points from economic growth. Moreover, at the start of 2013, the Bush tax cuts expire. Should they end completely, this would cut economic growth by another percentage point. None of this includes the automatic cuts related to the JSC. In the worst case scenario, government paralysis would lop a whopping 3 percentage points off economic growth, which would set the stage for a renewed recession. We don't expect this to happen, but it highlights the fiscal risk that is present.

The bottom line is that the United States is not Greece or Italy - America can pay its bills. It just needs the political willingness to do so. It is also evident that investors are not worried about a US government default. Just look at the incredibility low level of yields on Treasuries. They are certainly not pressuring politicians to make tough decisions on how to address the deficit.

Instead, the primary fiscal risk is to the economic outlook. The US government provided enormous stimulus to the economy to temper the impact of consumer deleveraging in the wake of the credit bubble bursting. At some point, fiscal restraint will have to happen. However, it should happen gradually and primarily when private sector demand is strong: and, that is not likely in the next two years. If the current gridlock is not overcome, the fiscal drag in 2013 will be enormous. And, financial markets will anticipate the economic consequences well before they actually bite. So, keep one eye on Europe; but, keep the other eye on how political developments unfold in Washington.