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In Search of Bargains, Grand or Bland

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OVERVIEW

Bottom line: The October U.S. budget agreement provides a short respite, with a new spending showdown likely in January. Although the debt limit extension may last until the summer, the costs of our crisis-driven fiscal policy are mounting.

Now that the smoke has cleared, what have we learned from the fiscal standoff in Washington? Here are five takeaways from the shutdown.

ANOTHER SHORT KICK OF THE CAN

October's continuing resolution to fund the government and raise the debt ceiling bought only a few months of breathing space. On the surface, the resolution did nothing to resolve the fundamentally different visions of government separating Democrats and Republicans. Democrats insist on additional revenue in any deal addressing entitlements, while Republicans insist that tax increases are off the table. As both sides have staked out maximalist positions, it is hard to envision a compromise during the short time frame set out for these negotiations.

Without any carrots or sticks to incentivize negotiators, the committee tasked with hashing out a budget deal by December 13 appears poised to fail. The more serious deadline is January 15, 2014, when spending authority will need to be renewed to avoid another shutdown and when sequestration would go into effect if spending is above current caps. The bottom line: Washington continues to govern by crisis.

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THE SEQUESTER IS THE DEFAULT OPTION

What then is the prospect for a deal by January 15? A grand bargain that includes both new revenue (probably through tax reform) and entitlement reform remains on the table, but is highly unlikely—less than a 10 percent chance. Somewhat more likely, perhaps 30 percent, is a small deal that uses modest cost savings from non-entitlement programs (e.g., farm subsidies) to ease the spending caps for the remainder of the fiscal year. This prospect—a bland bargain, in the words of Chris Krueger of Guggenheim Securities—provides a small upside risk for spending in the 2014 fiscal year but is unlikely to move the needle in terms of the economy's overall growth rate. Current law caps discretionary spending at $967 billion in the 2014 fiscal year and $991 billion in the 2015 fiscal year, compared to $986 billion in the continuing resolution that was just approved. Many House Republicans will oppose any increase in spending above the caps without entitlement concessions that Democrats are unlikely to make. At the same time, Republicans will want to avoid the political damage another shutdown would cause. Therefore, I do not expect "Obamacare" to be an obstacle to a deal. Here's the most likely scenario, which I put at around 60 percent: failure to find common ground will be reflected not in a shutdown but in a continuing resolution that locks in the sequester level of spending (or close to it), though perhaps allowing more flexibility on how the money is used.

THE "X-DATE" WILL BE CRITICAL FOR THE NEXT ROUND

Once the debt limit is reset on February 7, 2014, the Treasury Department will again utilize "extraordinary measures" and its cash balance to provide breathing space under the debt limit. The Bipartisan Policy Center, the usual go-to source for calculations of the date when the debt limit is reached (the "x-date"), believes that such extraordinary measures will only allow the Treasury Department to pay bills into March. Other economists agree, including Alec Phillips at Goldman Sachs. February and March are traditionally the worst months for Treasury balances, primarily due to tax refunds. Extraordinary measures will initially amount to about $200 billion—less than this past summer—because large semiannual payments to government funds do not fall due until June. However, higher tax revenue (on stronger growth and a rising stock market) and continued spending constraint could lead to a significantly lower deficit in the first few months of 2014 compared to this year. In that case, the Treasury Department could stretch the extraordinary measures to April 15, after which the usual April Treasury surplus from tax returns would extend the debt limit until the summer. Whether the x-date is March or June could make a huge difference politically. The closer the debt ceiling debate gets to an election, the more incentive Congress should have to quickly kick the can again rather than engage in another showdown.

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MARKETS DO NOT PROVIDE TIMELY DISCIPLINE

There is an apparent disconnect between the loud complaints of market participants and commentators (including myself) on the potentially catastrophic effects of going off the cliff, compared to the seemingly modest reaction of equity and fixed-income markets in the days leading up to October 17. Between September 30 and October 17, the Dow Jones Industrial Average fell only 0.9 percent, and subsequently reached new highs after the announcement of a deal. In sum, markets seemed sanguine about the prospect of a debt default.

In all likelihood, markets reflected the widely held belief that the "Churchill principle" would hold—i.e., that politicians would reach a deal at the last possible minute. After several previous showdowns in which policymakers avoided going over the cliff, it was reasonable to conclude that those worrying about the debt limit were Cassandras, those who typically predict misfortune or disaster. Markets will always have trouble in pricing extreme tail risk such as the possibility of a U.S. default. These concerns were also priced into markets gradually as the deadline neared and fears grew, so that we did not experience the kind of shocking market reaction that would have created political urgency to strike a deal. Further, a resilient U.S. economy and growing expectations that the Federal Reserve would delay its tapering of asset purchases also played a role. In fact, the perception that Federal Reserve policy would be responsive to fiscal drag provides an automatic stabilizer that acts as a powerful offset to any market disruption.

The lack of a hard deadline also contributed initially to a more muted market reaction. There was a great deal of confusion about when the debt limit became binding: first over when the

government would be unable to issue net new debt, then regarding when it would run out of cash to pay bills, and then when, if ever, it would default on its debt. Markets seemed to view these early deadlines as theater, reinforcing the sense that a deal was coming soon. Had we gone past October 17 without a deal, the market reaction likely would have been worse, but overall the markets have not disciplined the political process as hoped.

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THE MONEY MARKET IS GROUND ZERO

The shutdown and debt limit crisis will reduce U.S. GDP in the fourth quarter of this year by 0.25 to 0.5 percentage points, with some rebound likely in early 2014. The more significant costs from crisis-driven fiscal policy comes from reduced investment and lower consumer confidence, and in more subtle pressures on financial markets that depend on U.S. Treasury securities for liquidity and security.

In the days before agreement was reached, fissures developed in short-term money markets as some investors sold off their short-dated Treasury securities and some market makers began refusing to accept maturing bills as collateral. Reported efforts at moral suasion failed to encourage primary dealers to continue accepting paper, underlining the limits of voluntary rollovers. What are the implications? The adjustment in Treasury bill prices was small, but the change in yields, at around fifty basis points, was sufficient to cause some stress in markets that rely on these instruments for collateral and for funding their daily activities. For the banks, it meant greater difficulty arranging financing and a demand for more cash. For investment funds, it meant less leverage. No doubt, the Federal Reserve and Treasury Department had “break glass” scenarios had these problems intensified. Fortunately they did have to be used. Going forward, the question will be how markets will evolve to deal with the new risks posed when the “safe asset” becomes less secure. Such concerns likely intensify the pressure on the Securities and Exchange Commission to move ahead with long overdue money-market fund reform and other measures to strengthen the post-crisis financial architecture.

CONCLUSION

The U.S. economy has proven resilient to these recurrent and unnecessary fiscal showdowns so far, without the sharp economic consequences that one would associate with a significant event like an oil shock or the failed TARP vote. But that does not mean that there are not costs and longer-lived consequences of repeat governing by crisis. Let us hope Washington does better next time.

Looking Ahead: Kahn's take on the news on the horizon

China's Leadership Meets
A "go slow" approach to reform and lack of detail from the November 9–12 Central Committee meeting could disappoint markets.

Banking Disunion
Europe will announce more details of its upcoming banking review—if its nations can agree.

Treasury Complains
Last week's U.S. Treasury exchange rate report highlighting dissatisfaction with German and Chinese current account surpluses will be a talking point in November.