COUNCIL on FOREIGN RELATIONS

Center for Geoeconomic Studies

Global Economics Monthly
September 2013

Fiscal Cliff Redux: Last Chance to Get It Wrong?

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OVERVIEW

Bottom Line: There's a strong consensus that this fall's fiscal showdown will result in a compromise agreement, but a deal may be harder to get than markets anticipate.

Have pity on the U.S. fiscal analyst. Over the last three years, U.S. policymakers have repeatedly walked up to the edge of the cliff and threatened a leap into the abyss with unseemly enthusiasm. Dire scenarios have been predicted and analyzed, but each time policymakers have stepped back at the last minute. The can has been kicked. It is not surprising that markets have become somewhat numb to concerns about this fall's looming spending and debt limit confrontations.

Will this time be different? The current consensus is that it will not. After a noisy debate, there will be an agreement on federal spending for the 2014 fiscal year and an extension of the debt ceiling. Yet there is no clear path forward to reaching a deal that navigates the political tripwires, is passed by both houses, and is signed by the president. To complicate efforts, this is likely to be the last major fiscal battle before the 2014 midterm elections. Odds are rising that these issues may not be settled until January 2014, and the risks of an impasse are higher than markets now anticipate. This suggests that some market turmoil may be in the cards (and indeed necessary) before then.

Round 1: An Unproductive and Noisy September

The first test comes in September, when members of Congress return from time home at barbeques, town halls, and rallies, emboldened by their supporters to promote hard-line positions. Expect a lot of talk of defunding Obamacare from conservative Republicans, and other strategies that use a threat of shutdown to achieve an economic or social agenda. So far, this talk has come almost exclusively from Republicans who opposed earlier fiscal deals, suggesting that it is still possible to assemble a majority for passing a budget without such conditions. Republican leaders are confident they can avoid a shutdown, and it is reasonable to assume that at this stage they will succeed. But watch for how much momentum this movement gains as a measure of Republicans' appetite for confrontation.

In any event, with only nine legislative days scheduled in September with both houses in session, it is hard to imagine much progress being made before September 30, the close of the federal government's fiscal year. The time will be used for message votes, particularly in the House, as each side stakes out its positions for the bigger battles to come. It is most likely that, unable to agree on a full-year budget, Congress will pass a short-term continuing resolution (CR) to fund the government at around current levels for perhaps two to three months. Analysts put the chance of a government shutdown at or below 30 percent. That sounds about right.

Round 2: A Debt Limit Deal?

Treasury Secretary Jack Lew has announced that the government will exhaust the extraordinary measures it has been taking and will hit the debt limit in mid-October; other estimates put the deadline around the end of October or early November. While there would be scope to extend the deadline by delaying some payments, there are large Social Security and Medicare payments due on November 1, and a substantial debt-service payment due on November 15. This means that negotiations could drag out for a while before a technical default on interest-bearing debt takes place. In the past, though, the threat of delayed benefit payments has been enough to force agreement.

In the 2011 debate over raising the debt limit, ideas—mostly bad—were floated for avoiding a debt-limit increase: a platinum coin, using the Fourteenth Amendment to raise the debt ceiling, delegation of congressional authority, or

prioritization of payments (a strategy that the Obama administration appears to have the authority to enact but is loath to acknowledge due to the tricky politics of choosing who gets paid). None of these ideas will look any more appealing the second time around. I expect the administration to again rule out these options.

At this point, only a small group of legislators believes that the debt limit does not have to be raised, but there is no agreement on the conditions for its increase. Republican leaders in particular need some concession from Congressional Democrats, and it is hard to see what that would be. Proposals to link the deal to approval of the Keystone pipeline, a delay in the Affordable Care Act individual mandate by one year, or some significant entitlement reform do not appear to be acceptable to the Obama administration. Finally, a grand bargain that includes revenue and entitlement reform seems a more difficult task now than in 2011–2012.

If a deal cannot be made in time, and Republicans believe that linking spending and debt-limit negotiations strengthens their bargaining position, another short-term debt ceiling increase is possible. This would ensure that the debt ceiling decision and funding for the government are tied together. But the continuation of the impasse through the end of the year would not be good for markets looking for resolution and more certainty.

Round 3: Spending and Sequestration

Until recently, I expected that the debt-limit deal would address spending for the remainder of the fiscal year, and that may still be the case. Any debt-limit extension that includes future spending cuts will in effect set spending levels going forward. However, the hard deadline for agreement on spending is not the debt limit, but the next round of sequestration, which if needed would come into effect in mid-January. I would not be surprised to see the spending battle continue through the end of the year.

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Past law has set discretionary spending for the 2014 fiscal year at $967 billion, $21 billion below fiscal year 2013 levels. If there is a short-term CR, and Congress agrees in October or November to full-year spending above this level, it would then have a few months to debate whether to ease the caps and come up with offsetting cuts before another round of sequestration takes place in mid-January to reduce spending to the capped levels. At this point, many Democrats and defense-oriented Republicans appear to be interested in such a deal. If they fail, the lower level of spending implied by the sequester would prevail. The automaticity of those cuts would, in my view, reduce the risk of a subsequent government shutdown.

There are few obvious spending cuts, or "low-hanging fruit," available to ease the impact of the 2014 fiscal year sequester. Farm subsidies (if a farm bill is eventually passed and the savings from reducing subsidies are not used for other purposes) are one possible source of savings. Discussion has also centered on chain-linked consumer price index (CPI), a proposal to change the inflation index used for a range of benefits (including Social Security) and tax brackets. Last year, the Congressional Budget Office scored that change as potentially saving $340 billion over ten years, which means that even if narrowly targeted (e.g., exempting Social Security benefits) there is more than enough savings to avoid sequestration. But as CFR Adjunct Senior Fellow Peter Orszag has pointed out, the likely gains from a shift to chain-linked CPI appear to have declined in recent years. Still, the odds favor some agreement to exchange future cuts for some easing of the 2014 fiscal year caps.

MACRO CONSEQUENCES

A government shutdown, should it occur, is unlikely to have significant macroeconomic consequences. Federal discretionary spending constitutes only about 40 percent of total government spending, and in a shutdown more than half of that would be designated as essential and exempted from the shutdown. This means that less than 20 percent of spending would be affected and if the shutdown is brief, much of the lost spending would be made up subsequently. Goldman Sachs economists have estimated that a shutdown scenario would have modest effects (see Table 1): a seven-day shutdown, for example, could reduce growth by one-fourth of a percentage point at an annual rate.

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Table 1: A Brief Shutdown Would Have Modest Macroeconomic Effects

	Quarterly Spending ($bn, ann.)	Estimated Effect of Shutdown Scenarios ($bn, annualized)		
	Q2 2013	2-Day	7-Day	21-Day
Civilian Compensation	249.1	-2.6	-9.0	-26.9
Services	251.0	0.0	-0.6	-3.4
Goods	98.7	0.0	-0.9	-2.7
Investment	278.0	0.0	0.0	-3.8
Total Potentially Affected Spending	**876.8**	**-2.6**	**-10.4**	**-36.8**
% of GDP	**5.3**	**0.0**	**-0.1**	**-0.2**
Growth effect (pp, qoq ann.)		**-0.1**	**-0.3**	**-0.9**

Source: Department of Commerce, Goldman Sachs Global Investment Research.

The downside risk is that Congress will need a near-death experience on the debt limit, provoking a sizeable market reaction, to achieve a resolution.

With agreement on spending at or near the caps, the fiscal drag next year will be modest and unlikely to threaten the economic recovery. The fiscal drag from ongoing fiscal consolidation has been smaller than expected so far. This in part reflects exaggerated fears earlier this year about the sequester, as well as higher than expected revenue exempted. The deficit and debt will continue to decline. An agreement that allows spending above the caps in return for cuts in the out years represents an upside to the outlook. The downside risk is that Congress will need a near-death experience on the debt limit, provoking a sizeable market reaction, to achieve a resolution.

In sum, a path through this fiscal debate that avoids a government shutdown and a debt-limit breach seems the most likely scenario. But, as in the past, these debates are likely to go to the wire, and the risks of standoff at each stage seem sufficiently great that at some point market confidence will be tested. Against the background of a Federal Reserve transition and continuing growth uncertainties in Europe and China, there is reason for concern.

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

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China's shadow banks, 2.0: Concerns are rising that funding pressures could return in September. Is the central bank prepared to squeeze again?

EM crisis watch: Emerging markets are worried that Federal Reserve tapering will trigger capital outflows, deleveraging, and crises. Will this be like 1997?