

President Obama and the fiscal cliff

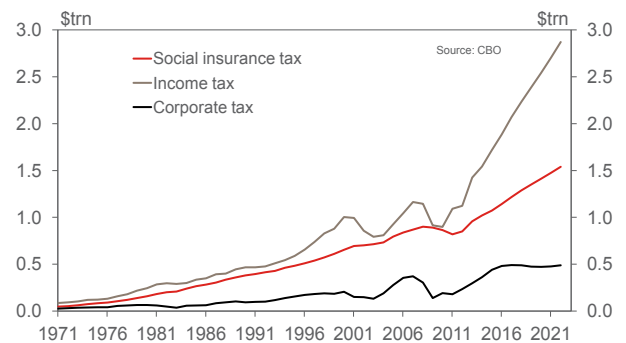
- Without an agreement over the fiscal cliff, the US is facing a potential 4ppt reduction in net government spending in FY2013 that would almost surely result in a recession.
- Yesterday's election result with the Democrats retaining the Presidency and the Senate and the Republicans holding the House means that the parties will need to compromise.
- As in 2011, another messy debate will likely end with a last-minute agreement, postponing austerity. But in doing so, Congress and President Obama are buying short-term momentum at the expense of medium to long-term prosperity. Fiscal retrenchment is inevitable as the US debt trajectory is clearly unsustainable.
- Given the scale of the debt stock and the implications of an ageing society, there is really only one solution: action to phase in a matching of receipts to expenditures. This action has to be realistic, but be mindful of the short-term damage that could be rendered on the fragile economy by an immediate fiscal tightening of the order of the current fiscal cliff.

In late 2010 there was an agreement between the two parties to postpone the Bush Tax cut expiry; extend the period of time emergency unemployment benefits could be claimed; and to grant a payroll tax holiday for 2011 (repeated in 2012). President Obama and the Republicans subsequently brokered an agreement over the debt ceiling, agreeing to a two-stage \$2.1trn increase. In return, the Budget Control Act called for \$1trn worth of automatic spending cuts between 2013 and 2022, equally split between civilian and military outlays.

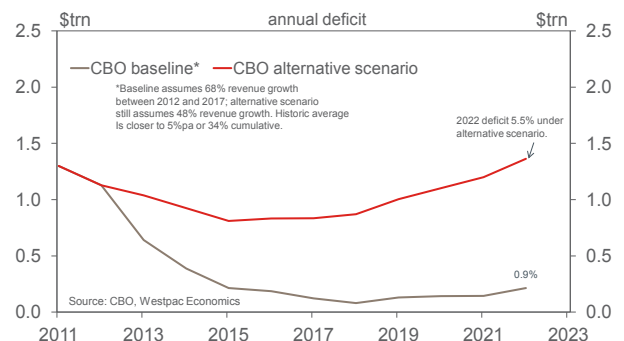
With the stimulatory measures set to expire and the automatic spending cuts due to commence on 1 January, the US is now facing a potential 4ppt reduction in net government spending in FY2013 that would almost surely result in a recession.

What's more, the current scenario is not a one off, with additional austerity scheduled for subsequent years. And the need to raise the debt ceiling with haste (or else face a public sector shut down) is further heightening concerns regarding year end. As at

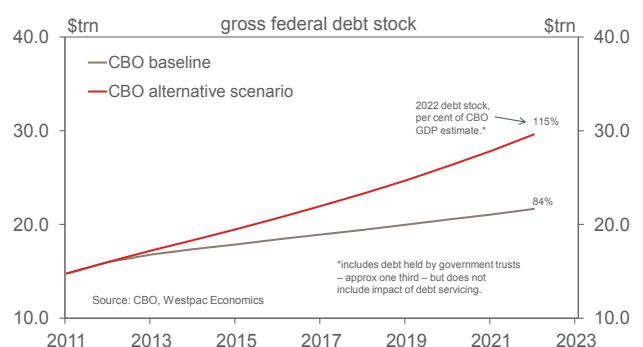
Government expects revenue to pick up - a lot



Weak revenue + strong outlays = big Fed deficit



Debt dynamics could be explosive



31 October, the total US Federal debt subject to the limit stood at \$16.22trn, just \$172bn shy of the ceiling; average monthly borrowing akin to that seen in the year to date would see a breach of the debt ceiling by year end.

Yesterday's election result with the Democrats retaining the Presidency and the Senate and the Republicans holding the House means that the parties will need to compromise to deal with this imminent threat. With the President now elected for a second term, there is some possibility that he will be more flexible in his own position than before the election. At that time, he was mindful of managing a range of diverse party interests who may have been important for his re-election. The precedent is with President Clinton in his second term, when he saw his legacy in terms of pragmatic results rather than principled gridlock. Less certain is whether there will be any flexibility coming from a disaffected Republican party.

As in 2011, another messy debate will likely end with a last-minute agreement, postponing austerity. But in doing so, Congress and President Obama are buying short-term momentum at the expense of medium to long-term prosperity. Fiscal retrenchment is inevitable as the US debt trajectory is clearly unsustainable. The growth of current Federal liabilities is the biggest concern, but the financial (ill)health of State and Local Governments (SLGs) is a close second.

Starting with Federal liabilities, the CBO's alternative scenario (updated in August) gives guidance on the implications of deferring the tough decisions. Under its 'alternative' scenario – primarily driven by the extension of the Bush tax cuts and the deferral of the automatic spending cuts – the CBO projects that the annual US budget deficit would average 4.9% of GDP over the coming decade, over four times the baseline scenario of 1.1% (the baseline scenario assumes that the Bush tax cuts end and the automatic spending cuts begin in 2013). That would result in the debt stock rising by an additional 17ppts of GDP by 2022, versus a 14ppt fall under the baseline.

If the alternative scenario came to pass, the US Federal government would have a gross debt liability of around 115% of GDP by 2022. What's worse, taking the debt projections out further – as the CBO did in June – indicates this course of action would set in motion an essentially irreversible deterioration in the Federal debt stock, all else equal. According to the CBO, under the alternative scenario, 'debt held by the public' (net debt) would rise from 67% of GDP in 2011 to 90% in 2022 and 199% by 2037. There is also a real risk that the CBO's revenue projections will prove (very) optimistic, resulting in a gross debt burden well above 230% in 2037.

In addition to these Federal liabilities, the US also has a significant stock of contingent liabilities in the form of SLG's marketable debt and their pension and health liabilities. The SLG liabilities are contingent for the Federal Government in the sense that, should SLG authorities be unable to pay, the Federal Government would have to intervene in order to allay fears over the US' credit worthiness. SLG current debt liabilities sum to around 20% of GDP, or 25% if 'trade payables' are also included (as they should be). Estimating pension and health care liabilities is an inexact

science. Small differences in baseline assumptions can give very different final numbers. An estimate of pension liabilities produced by the Pew Research Centre (assuming an 8% rate of return on assets) suggests the unfunded gap was around 9% of GDP in 2010. Halve the rate of return, double the estimate. Note that health care liabilities are an additional impost.

Combined with Federal gross debt – which includes the Federal Government's pension liabilities, but not their health care commitments – SLG liabilities would take the US' current total general government debt to around 127% of GDP. Or, if the SLG contingent pension liabilities are included, nearer 145%. Clearly, the current level of total general government debt could therefore easily be regarded as unsustainable by itself; as evinced by its trajectory, this concern will only grow with time.

Politicians remain unwilling to meet this challenge as there is scope to delay and hope for growth; their logic is simple, but flooded. Given the scale of the debt stock and the implications of an ageing society, there is really only one solution: action to phase in a matching of receipts to expenditures. This action has to be realistic, but be mindful of the short-term damage that could be rendered on the fragile economy by an immediate fiscal tightening of the order of the current fiscal cliff. In short, the immediate fiscal cliff must be averted, but a comprehensive strategy with bilateral support on tax, health, and entitlement reform must be established.

The election result, in not delivering the Presidency and a majority in both houses to the same party, will make this challenge formidable. However, to ensure that a long-term plan remains resilient to the passage of time, bilateral agreement is probably necessary anyway.

Bill Evans

Global Head of Economics

Elliot Clarke

Economist

Contact Details

Dominick Stephens , Chief Economist	Ph: (64-9) 336 5671	dominick_stephens@westpac.co.nz
Michael Gordon , Senior Economist	Ph: (64-9) 336 5670	michael_gordon@westpac.co.nz
Felix Delbrück , Senior Economist	Ph: (64-9) 336 566	felix_delbruck@westpac.co.nz
Nathan Penny , Economist	Ph: (64-9) 3365669	nathan_penny@westpac.co.nz

This information has been prepared by Westpac Institutional Bank, a division of Westpac Banking Corporation, ABN 33 007 457 141 incorporated in Australia ("Westpac") and is current as at the day of publication. It is subject to change without notice but Westpac is not obliged to update or correct it. Recipients should not forward or reproduce (in whole or part) this information unless Westpac consents however Westpac accepts no liability for the actions of third parties in this respect. This information does not constitute investment advice or an offer to subscribe for any financial instrument or to enter into a legally binding contract. It has been prepared without taking account of your personal objectives, financial situation or needs. You should seek your own independent legal and/or financial advice before proceeding with any investment decision. Any forecasts given are predictive only and past performance is not a reliable indicator of future performance and may be affected by known or unknown risks and uncertainties. Except to the extent that such liability under any law cannot be excluded, Westpac makes no representation or warranty, express or implied, and does not assume any responsibility or liability for this information or any errors or omissions to it. The distribution and use of this information may be restricted by law in certain jurisdictions. Persons who receive this information should inform themselves about them and observe any such restrictions:

If you are reading this in New Zealand: Westpac's current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained from any branch of Westpac New Zealand Limited or free of charge, at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Disclosure Statement for Westpac New Zealand QFE Group Financial Advisers Act 2008 <http://www.westpac.co.nz/assets/Who-we-are/About-Westpac-NZ/QFE-Group-Financial-Advisers-Act-Disclosure-Statement.pdf>).

If you are reading this in the United Kingdom: Westpac Banking Corporation is registered in England as a branch (branch number BR000106) and is authorised and regulated by The Financial Services Authority. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised and regulated by The Financial Services Authority. This communication is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as "relevant persons"). The investments to which this document relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this document or any of its contents. In the same way, the information contained in this document is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Services Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on this document to any third party. In particular this communication and any copy of it may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

If you are reading this in Australia: This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac. Australian customers can obtain Westpac's financial services guide by calling 132 032, visiting www.westpac.com.au or visiting any Westpac Branch.

If you are reading this in Singapore, China or Hong Kong: This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Regulatory Banking Commission.

In you are reading this in the United States of America: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency and is not affiliated with either: (i) a broker dealer registered with the US Securities and Exchange Commission; or (ii) a Futures Commission Merchant registered with the US Commodity Futures Trading Commission.