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Westpac Institutional Bank

President Obama and the fiscal cliff

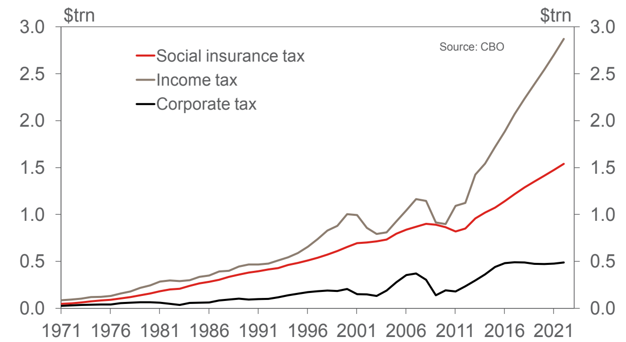
- **Without an agreement over the fiscal cliff, the US is facing a potential 4ppt reduction in net government spending in FY2013 that would almost surely result in a recession.**
- **Yesterday's election result with the Democrats retaining the Presidency and the Senate and the Republicans holding the 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.

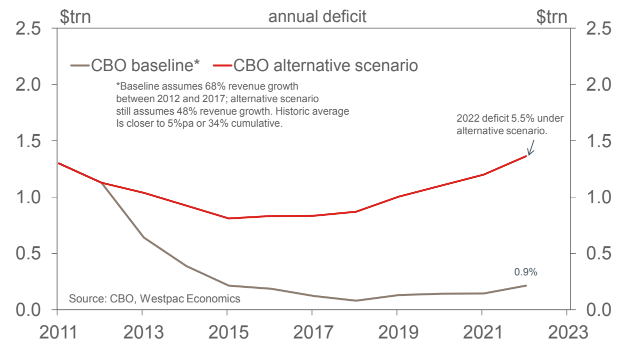
With the stimulatory measures set to expire and the automatic spending cuts due to commence on 1 January, the US is now facing a potential 4ppt reduction in net government spending in FY2013 that would almost surely result in a recession.

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

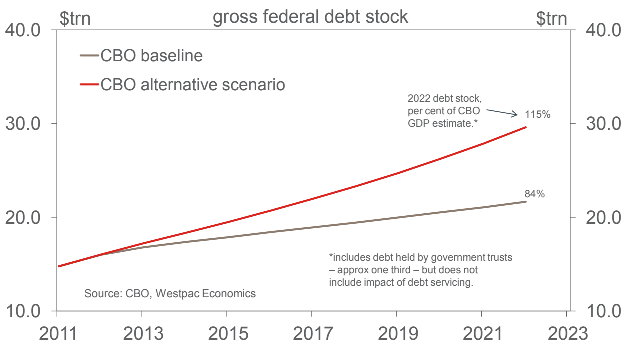
Government expects revenue to pick up - a lot



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 floored. 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.

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