Meketa Investment Group Global Macroeconomic Research Series

Fiscal Cliff

July 2012 *Issue Five*

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Since the Global Financial Crisis, the United States has seemingly weathered the deleveraging storm better than other developed nations, even leading to claims of a "de-coupling" from the debt issues plaguing Europe and other parts of the world. One of the main drivers of this relative strength has been continued government support to assist a sluggish private sector. A number of tax increases and spending reductions are scheduled to take effect at year-end, however, in what has become known as the "Fiscal Cliff." In this paper, we examine the details of the expiring stimulus, its potential impact on economic growth, and the possibility of last minute modifications.

Double Whammy – Tax Increases AND Spending Cuts

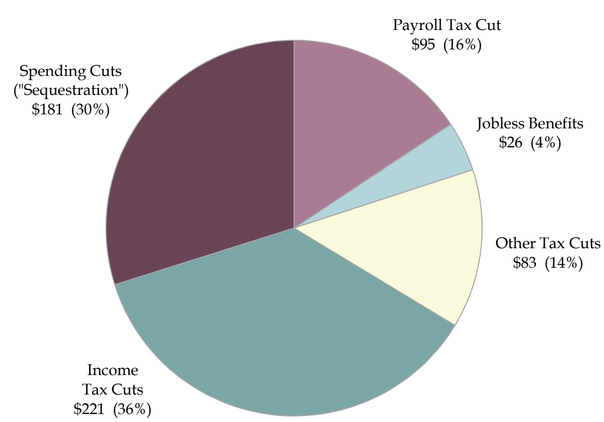
In the aftermath of the Global Financial Crisis, the U.S. government dramatically increased its spending to help offset the effects of a sharply contracting private sector. Increased deficit spending, coupled with declining tax receipts, resulted in the country's debt/GDP ratio surpassing 100% earlier this year. While this unprecedented degree of government stimulus has certainly had a stabilizing effect on the economy in the near-term, it has also raised serious concerns over its long-term consequences.

While most politicians agree that something needs to be done about America's ballooning deficit, this is roughly where the common ground ends. Numerous recent attempts at fiscal reform have failed due to a lack of agreement on the critical details of how this reform should be implemented (e.g., spending cuts vs. tax increases). The most critical failure in this regard was Congress' so-called "Super Committee" last fall. The Committee was tasked with orchestrating a "grand bargain" between Republicans and Democrats on the right mix of policy adjustments to rein in the deficit. As an added incentive, the legislation that established the Super Committee mandated automatic spending cuts at year-end 2012 should they fail to reach agreement. Unfortunately, that is exactly what happened.

Roughly half of the automatic cuts will come from defense programs, which the Congressional Budget Office (CBO) estimates at $65 billion in 2013 and $1.2 trillion over the next ten years. At least as painful, given the country's employment situation, will be the expiration of the extended unemployment benefits (from 26 weeks to 99 weeks) introduced in the wake of the Global Financial Crisis. These extended benefits currently provide over $3 billion per month to roughly 3.1 million unemployed persons who have used up their standard 26 weeks of benefits.

Spending cuts are only part of the problem. Making the "Fiscal Cliff" even steeper is the fact that a number of key tax rates are scheduled to rise at exactly the same time. In fact, the largest single component of the "Fiscal Cliff" is the expiration of the "Bush tax cuts" that were first enacted in 2001, and subsequently extended in 2010. Without Congressional action, tax rates will increase on wages, capital gains, dividends, and estates. Furthermore, the number of people subject to the Alternative Minimum Tax (AMT) will increase sharply. Also included is the expiration of a 2

FISCAL CLIFF COMPONENTS ($BN, YOY)[1]



[1] Source: Congressional Budge Office, "Economic Effects of Reducing the Fiscal Restraint Scheduled to Occur in 2013," May 2012.

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percentage point cut in the payroll tax, along with other tax breaks that will either end or shrink, including a credit for college tuition. The end result is that roughly $607 billion of combined tax increases and spending cuts are slated to automatically kick in at year-end.

Further complicating matters is that the statutory limit (i.e., the "debt ceiling") on public debt of $16.394 trillion is expected to be reached again in November or December of this year, based on current revenue and spending trends. The Treasury has the tools to delay this by another month or two, if need be, but the last thing politicians need with the Fiscal Cliff looming is another standoff over the debt ceiling.

Estimating the Impact on GDP Growth

Assuming no Congressional action, estimates of the hit to 2013 U.S. GDP implied by the full "Fiscal Cliff" vary widely. Unfortunately, they vary from bad to worse. The Congressional Budget Office (CBO) forecasts a fiscal tightening of roughly 3.9% of GDP in calendar year 2013, resulting in a reduction of GDP between 3% and 5% using average multiplier assumptions. The CBO further notes that the last time the United States experienced a fiscal tightening of this magnitude was after President Lyndon Johnson asked Congress for a special wartime "surcharge" on individual and corporate income taxes to help the country pay for the Vietnam War. The result was not comforting. Throughout most of 1968 and early 1969, real GDP in the U.S. was expanding at about a 5% pace and unemployment was below 4%. By the end of the year, the economy was in recession.

The textbook formula for calculating GDP helps illustrate the potential impact of the Fiscal Cliff on economic growth.

GDP = Consumption + Investment
+ Government Spending + Net Exports

At roughly two-thirds of total GDP, consumption expenditures represent the most meaningful contributor to GDP growth. Higher taxes would depress GDP growth by lowering disposable income. In turn, lower consumption (i.e., demand for goods and services) may cause businesses to further decrease the investment component of the equation above. Likewise, a decrease in government spending, while perhaps beneficial over the long-term, would have a near-term negative impact on GDP growth. Lastly, lowering our fiscal deficit may lead to a strengthening of the U.S. dollar, which would hurt exports as they would be more expensive to the rest of the world. Thus, the "Fiscal Cliff" as it stands today would be particularly damaging in that it has the potential to negatively impact each component of the GDP equation.

History Lesson – 1937

The Great Depression offers a cautionary tale of how policy errors prolonged the last deleveraging process in the U.S. Many people think of the Great Depression as one continuous economic decline stretching from 1929 to the onset of World War II. In reality, there were two separate economic contractions that straddled a sharp recovery period. From 1929 to 1933, the U.S. lost 46% of its GDP after an excessive build up of debt led to an acute deleveraging cycle. But the recovery after Franklin Roosevelt took office in 1933 and implemented substantial fiscal stimulus was quite astonishing. Real GDP increased 11% in 1934, 9% in 1935, and 13% in 1936. Unemployment fell from 25% to 14% over this same period[1].

Thinking the economy was now well on its way to recovery, and growing increasingly nervous about inflation, fiscal policy turned sharply contractionary in the following year (e.g., Social Security taxes were collected for the first time in 1937). Monetary policy followed suit (e.g., bank reserve requirements doubled from 1936 to 1937) and the combination quickly choked off the recovery in what is now considered by many economists as one of the great economic policy errors of all time. In

1 Source: "Lessons from the Great Depression for Economic Recovery in 2009", Council of Economic Advisors, March 9, 2009.

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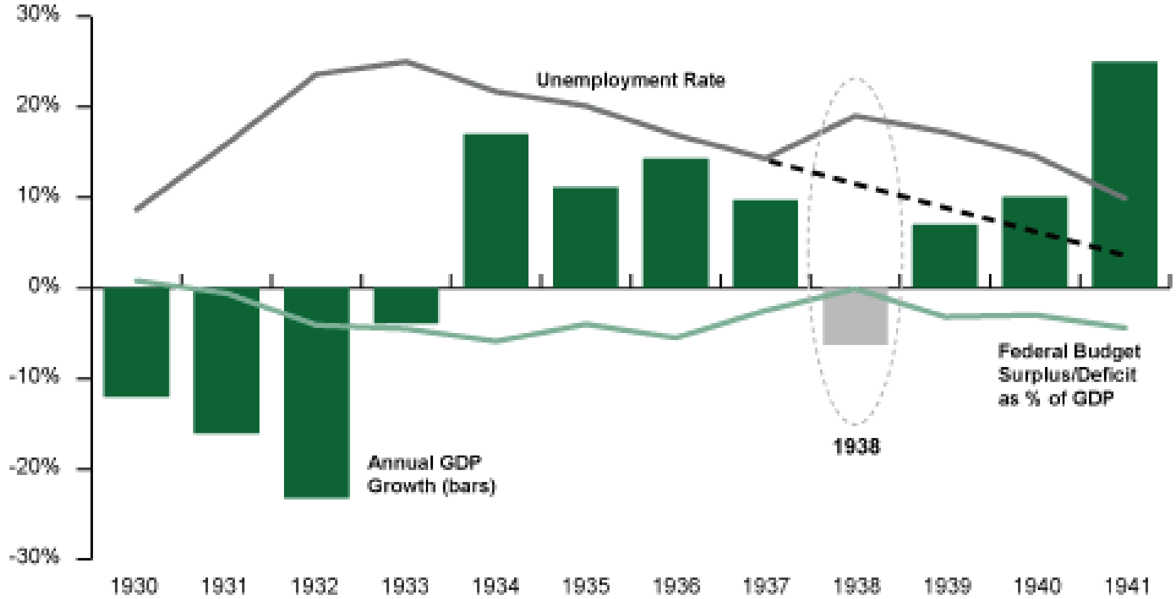
GDP Growth, Unemployment Rate and Federal Budget Balance: 1930-1941



Data Sources: GDP Growth - Bureau of Economic Analysis (BEA)
Unemployment - U.S. Bureau of Labor Statistics (BLS)
Federal Budget Surplus/Deficit - Office of Management and Budget (OMB)

1938, GDP fell by 3% and unemployment was back up to 19%[1]. While these policies were quickly reversed, this premature fiscal and monetary contraction effectively lengthened the Great Depression.

The Risk of "Kicking The Can"

While the risks of allowing the full "Fiscal Cliff" to hit the U.S. economy are rather obvious, there are also risks to further delays of much needed fiscal policy reform. But here it is critical to distinguish between short-term risks and long-term risks. The U.S. government absolutely can not maintain this level of deficit spending indefinitely. Eventually it will undermine confidence in the credit quality of the United States, leading investors to demand a higher rate of interest on U.S. government bonds to compensate for the added risk. This scenario must be avoided as rising interest rates can increase the cost of servicing debt faster than fiscal contraction can decrease it.

While the long-term risks are substantial, the short-term risks of continued deficit spending appear rather muted. Case in point, the yield on U.S. government bonds continues to hit all-time lows even as the country's debt levels continue to hit all-time highs. For the time being, the creditworthiness of the United States and its status as a "safe haven" during times of global economic stress, has resulted in an increasing demand for government debt despite our declining fiscal balance. Furthermore, the U.S. dollar's role as the world's reserve currency also contributes to a continual demand for dollar-based investments. In this way, the United States enjoys certain advantages when compared to the rest of the world. These advantages will likely allow for the flexibility to maintain expansionary fiscal policy longer than would be possible in other countries. These advantages are not immutable, however, and if taken for granted they will most certainly erode over time.

Thus, the short-term risks of the "Fiscal Cliff" must be weighed carefully against the long-term risks of continued deficit spending. While allowing the full "Fiscal Cliff" to hit the

[1] Source: Bloomberg

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economy at year-end would almost certainly result in a recession, and continuing this level of deficit spending indefinitely will almost certainly result in decreased creditworthiness and higher interest rates, in between these two extremes are shades of gray. Exactly how long investors will tolerate the United States' current fiscal trajectory is impossible to predict, but it is likely far longer than six months. For this reason, most public policy experts favor extending the current stimulus past year-end and avoiding the "Fiscal Cliff."

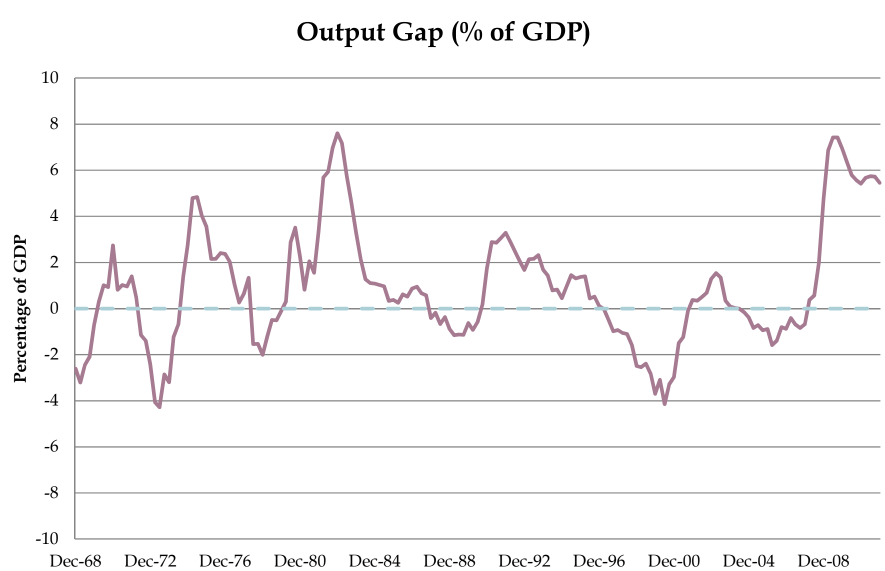
Inflation Risks

Another potential risk of extending fiscal stimulus for too long is the risk of "overstimulating" or "overheating" the economy. The current state of the U.S. economy, however, would indicate that there is little risk of overheating any time soon. This can be observed through the "output gap." The output gap is a measure of an economy's current GDP relative to its potential GDP at a given point in time. Estimating the potential GDP for an economy necessarily involves a number of assumptions and, thus, there are a number of different methods that can be used. Perhaps the most widely-cited measure of the output gap is calculated by the Congressional Budget Office (CBO). As shown below, while off its recent highs in late 2008/early 2009, the output gap remains at an elevated level not seen in thirty years. By this measure, the U.S. economy is still operating at a level well below its full potential. When combined with the persistently high unemployment rate, the current output gap makes it is difficult to see a catalyst for near-term inflation despite the magnitude of recent monetary and fiscal stimulus.

Last Minute Changes

Fortunately, the potentially disastrous effects of allowing the full "Fiscal Cliff" to hit the economy appear widely understood. This makes some degree of modification highly likely prior to year-end. Of course, any major adjustments will require politicians to bridge the same gaps that were apparently insurmountable less than a year ago. While the magnitude of the pending cliff will no doubt create an elevated sense of urgency, politicians will need to act more quickly than usual. With little, if any, progress likely to happen prior to the presidential election, Congress will have roughly six weeks to enact any changes prior to year-end.

Last fall, without significant time constraints, the Super Committee of Republicans and Democrats failed to reach an agreement on how to cut the deficit. Thus, the possibility of them reaching a similar "grand bargain" in six weeks seems quite remote. Moreover, a shift in control of Congress or the White House would likely exacerbate the time constraints. Thus, some combination of minor modifications and short-term extensions seems the most likely outcome.



Early Impact

Months before we reach the looming "Fiscal Cliff" deadline, the U.S. economy may already be beginning to feel the impact. While largely unquantifiable, it

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is possible that some of the recent economic slowdown is due to businesses and consumers pulling back spending in the face of uncertainty over their future tax rates. Furthermore, the extended federal unemployment benefits are already beginning to roll off for some states. While Congress renewed the extended benefits program in February, it also phased in a reduction of the number of weeks of extended aid and made it more difficult for states to qualify for the maximum benefits. In June, an estimated 70,000 people lost extended benefits, bringing the number of people cut off prematurely this year to close to half a million, according to the National Employment Law Project[1]. Lastly, some private sector government contractors have begun decreasing workforces and investments based on uncertain projects for 2013.

Due to the time constraints imposed by the November elections noted previously, this dynamic will likely only intensify as the Fiscal Cliff draws nearer. Even if last minute changes are made to soften the blow, the act of waiting until the last minute itself can have a contractionary effect on the economy and financial markets. The closer we get to the deadline without any compromise, the more uncertainty and anxiety will surround this issue.

Conclusion

Given the current state of the U.S. economy, allowing the full brunt of the "Fiscal Cliff" to hit at year-end would prove disastrous. Premature fiscal contraction has only served to exacerbate and extend past deleveraging cycles, and there is little reason to believe that this iteration would be any different. $607 billion of tax increases and spending cuts would be an overwhelmingly negative shock to an economy that is already showing signs of slowing. Fortunately, this is an unlikely scenario as the consequences of inaction appear widely understood. While a "grand bargain" does not seem likely by year-end, many components of the "Fiscal Cliff" are likely to be modified or delayed, significantly reducing the impact. Regardless of its modified form, however, the "Fiscal Cliff" will have a negative effect on a U.S. economy that appears ill-equipped to handle it. While the worst case scenario will likely be avoided, the looming "Fiscal Cliff" remains a cause for concern.

1 Source: The New York Times, "U.S. Winds Down Longer Benefits for the Unemployed," May 28, 2012.