U.S. Economic Flash

Sequestration presents downside risks to growth

Congress' delay of its self-imposed sequestration measures, provisioned in the second phase of Budget Control Act (BCA), reduces the probability of negative growth in 1Q13. The first phase of the BCA which applied accelerating spending caps to the federal budget during 2012-2022 resulted in a precipitous (15%) drop in 4Q12 federal spending that slowed GDP growth to an annualized -0.1% QoQ. Allowing the sequestration measures to take effect would add downside risk to our baseline growth scenario in 2013.

Sequestration is inherently more punitive than phased caps (Part 1 of the BCA), which have only been partially implemented in 2012. The implementation of the phased caps alone overshadowed strong underlying private consumption and investment trends in 4Q12. Allowing sequestration to occur would ultimately bias our expectations for growth downward. For example, estimates calculate the full implementation of the sequester provisions (Part 2 of the BCA) will produce $132 billion in 2013 spending cuts – five times greater than 2012. Given that there is a low probability that a longer term less austere agreement will be reached, the effects of the BCA could be felt as early as 2Q13. Under this scenario, economic output could have peak losses of 1.4%.

While the distribution of the budgetary impact of sequestration is homogenous the extent to which states rely on federal spending varies. Thus, the economic impact in states that are more dependent on federal spending and have less industrial diversity will be magnified. The defense clusters in the northeast and eastern seaboard certainly would not fare as well in the short-run. More diversified states, with industrial strengths such as high-tech and energy, should be able to buffer the impact and avoid contracting in 2013. On net, the Sunbelt should be no worse off than the rest of the country. However, because Alabama relies on federal defense and non-defense dollars, additional spending cuts could threaten the state's economic wellbeing. If there is no budgetary agreement before March, economic output could decline by 1.2% and 2.2% in the Sunbelt and Alabama, respectively.

Table 1
Economic Impact of Budget Control Act Caps & Sequestration

	Defense*	Non-Defense*	Total*	Defense**	Non-Defense**	Total**
Sunbelt	31.3	31.4	62.7	0.6%	0.6%	1.2%
ex. Sunbelt	63.2	89.1	152.3	0.6%	0.8%	1.4%
Total	94.5	120.5	215.0	0.6%	0.8%	1.4%

Source: The Economic Impact of the Budget Control Act 2011 on DOD & non-DOD Agencies
***$bn**
****Share of 2013 GDP**

Chart 1
Share of National Defense Expenditures (% of GDP)

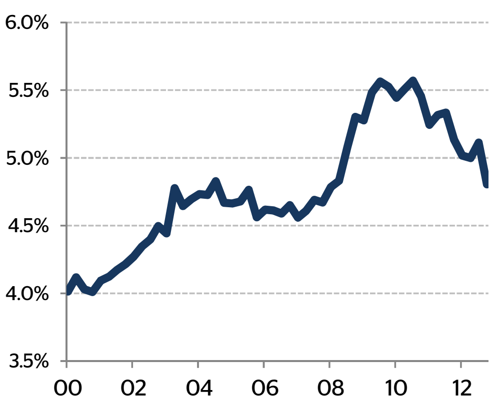


Table 2
Sunbelt Exposure to Sequestration in 2013[1] (Defense, right column)

	Impact*		Jobs (k)		GDP ($Bn)	
Alabama	2.2%	1.3%	39	27	3.9	2.3
Arizona	1.8%	1.1%	49	35	4.9	3.0
California	1.1%	0.6%	225	135	22	11
Colorado	1.5%	0.6%	43	18	4.2	1.6
Florida	1.0%	0.5%	79	42	3.6	3.6
Indiana	3.9%	2.1%	24	15	2.4	1.3
Maryland	3.6%	1.1%	115	39	11.5	3.4
New Mexico	3.4%	0.5%	28	5	2.9	0.4
Texas	1.1%	0.6%	159	99	16	8.6
Virginia	4.7%	2.6%	208	136	20	11.8
Sunbelt	2.2%	0.6%	623	362	62	31
Total	1.8%	0.6%	2137	1090	215	94

Source: BBVA Research, Haver Analytics ,The Economic Impact of the Budget Control Act 2011 on DOD & non-DOD Agencies
***Share of 2013 GDP**

- ## Drop in defense expenditures pushes US growth to lowest since 2009

Federal spending as a share of GDP has gradually declined since reaching the10-year high in 3Q10. This trend underlies a more general reduction in government contribution to growth. The CBO estimates that spending as a share of GDP will fall to 21.5% of GDP by 2017, which is a 16% decline from the 2009 peak[2]. In the short-run, the effect of the reduced federal spending would have a non-trivial impact on economic output. To underscore this point, cuts to defense spending decreased U.S. GDP growth by 1.1pp in 4Q12.

Table 3
Adjusted Sequestration under the Continuing Appropriations Resolution

	Before "Fiscal Cliff" Deal		After "Fiscal Cliff" Deal	
Sequestration in 2013	*$109.3bn*		*$85.3bn*	
	$bn	% of Budget	$bn	% of Budget
Defense	54.7		42.7	
Discretionary	54.6	9.4%	42.5	7.3%
Mandatory	0.1	10%	0.1	7.8%
Non-Defense	54.7		42.7	
Discretionary	38	8.2%	26.4	5.1%
Medicare	11.1	2%	11.2	2%
Mandatory	5.5	7.6%	5	5.3%

Source: Center For Budget and Policy Priorities

- ## March deadline to extend BCA draws closer

The prospects of nearing fiscal tightening dampen our outlook for economic growth. Under the current scenario, defense and non-defense discretionary funding will be cut $85.3 in March 2013. On the positive side, the projected $85.3bn reduction is approximately $24bn less than what would have occurred if the continuing resolution was not passed in January. The passage ultimately suggests that the economic impacts will be lower in 1H13. However, the kick-the-can measure pushes downside risks to growth into 2H13 and possibly 2014. Although we cannot pinpoint whether defense or non-defense spending cuts would have a greater impact on growth, the overall economic impact will exceed the reported spending cuts—economic multiplier greater than one.

Unlike discretionary spending, mandatory expenditures are largely exempt from the BCA sequestration. Entitlement programs such as Medicaid, Child Health Insurance Program (CHIP), Supplemental Security Income (SSI), and certain tax entitlements will be unaffected by the cuts. However, key sectors such as healthcare (Medicare payments to doctors), energy (mineral leasing payments) and agriculture (farm pricing support) are directly impacted by the cuts to mandatory non-defense programs.

- ## State-level impacts of sequestration

On balance, the impact of defense cuts will be shared evenly by the Sunbelt region and the rest of the country. The burden of the non-defense cuts will predominantly fall on areas outside the Sunbelt. The large impact to New Mexico's GDP, due to non-defense spending cuts, is the highest among the Sunbelt states. Other states such as Texas and California will experience symmetric impacts from cuts to defense and non-defense spending. Alabama and Arizona, however, rely more on federal defense spending. Ultimately, the Sunbelt's economic response to sequestration should be no worse than the rest of the country. The region's total impact could amount to 1.2% of its GDP whereas the rest of the country's economic losses could exceed 1.4% of GDP.

States geographically and financially tied to the Federal Government are at the greatest risk of contraction in 2013. Virginia is the most at risk state, followed closely by Indiana and Maryland. According to a recent study[1], Virginia could suffer peak job losses of 208k and an estimated $20.8bn in lost economic output – nearly 4.7% of the state's GDP. Of the fifteen states that will experience the largest impacts, New Mexico, Alabama, Arizona and Colorado are in the Sunbelt region. Estimated impacts in these states range from 1.5% to 3.4% of state GDP.

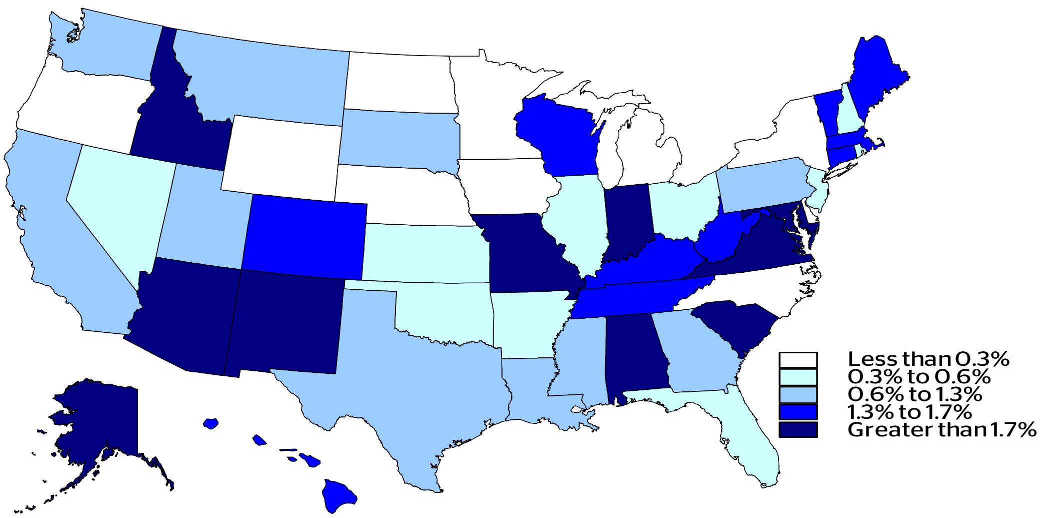
[1]The Economic Impact of the Budget Control Act 2011 on DOD & non-DOD Agencies, Fuller (2012)
[2]The Budget and Economic Outlook Fiscal Years 2013 to 2023, Congressional Budget Office(2013)

Other more diversified states such as California, Texas, Florida and New York would also see a sizable reduction to GDP, but their underlying economic strength and diversity translate into a lower overall economic impact. For example, California and Texas are estimated to lose $22.6 and $20.8bn of economic output in 2013, respectively, from the caps and sequestration. Although these amounts are non-trivial, they are only around 1.1% of state GDP. New York is similarly expected to lose over $7.0bn in economic output; however, this sum is less than half a percent of its GDP.

Our analysis suggests that the risk scenario for the Sunbelt region is more moderate than the rest of the country. However, we do not believe that Sunbelt region will avoid economic hardship. In particular, Alabama could see peak economic losses of 2.2% of annual economic output and the Sunbelt region, as a whole, could experience 1.2% of lost economic output. The former suggest possible contraction while latter suggest economic slowdown but overall positive economic growth. While a long-term, less austere bill remains a possibility, underlying trends in consumer spending and investment should, nevertheless, support U.S. growth in our baseline scenario of 1.8%.

Map 1

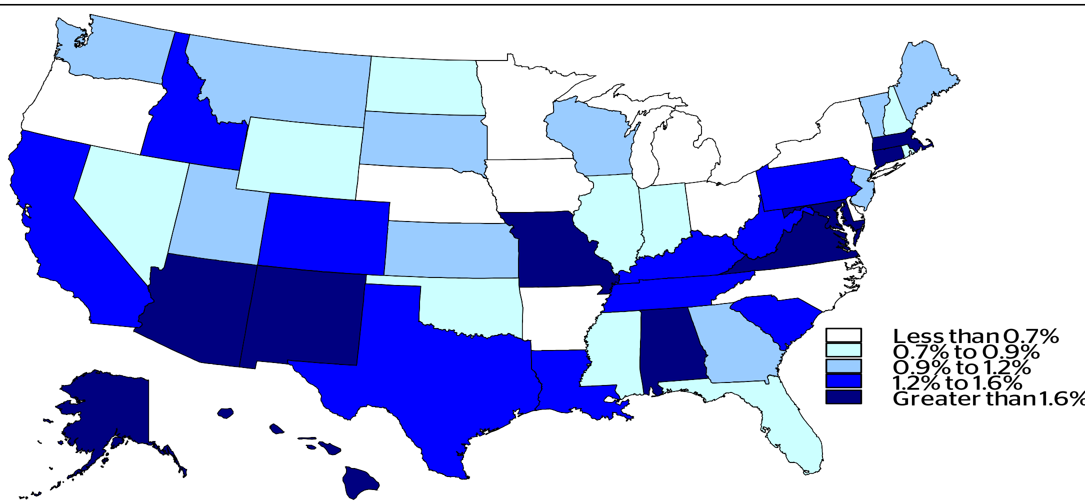
Economic Impact of Sequestration as a Share of State GDP*



Source: BBVA Research, Haver Analytics ,The Economic Impact of the Budget Control Act 2011 on DOD & non-DOD Agencies
***2013 GDP is estimated using 2011 growth rates**

Map 2

State Level Job Losses as a share of the Labor force



Source: BBVA Research, Haver Analytics ,The Economic Impact of the Budget Control Act 2011 on DOD & non-DOD Agencies