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Economic Watch

United States

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Economic Analysis

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Sequestration debate reemerges in 3Q13

- **Market's won't tolerate another failure to increase the debt ceiling**
- **Impact of sequestration less adverse than previously expected**
- **Diminishing impact from sequestration in 2H13 reaffirms our baseline scenario**

In July 2011 negotiations over the debt ceiling broke down and resulted in a downgrade of the U.S. credit rating by Standard & Poor's from the coveted AAA to AA+. In response to the downgrade, congress passed the Budget Control Act (BCA) which established among other provisions, an increase to the debt ceiling, spending caps and automatic cuts, known as sequestration if Congress failed to agree on a deficit reduction bill of at least $1.2tn over a ten-year period. In essence, the BCA limited Congress ability to over spend. After failing to reach a bipartisan agreement during the Joint Select Committee on Deficit Reduction, the sequestration provisions set forth in the BCA were set to be implemented on January 1st of 2013, but were delayed in a last minute effort. The year-end 2012 resolution passed by Congress and the signed into law by the White House, temporarily increased the debt ceiling, and softened and delayed many of the sequestration provisions. However, not permanently increasing the debt ceiling and only temporarily adjusting the spending cuts has led to a reemergence of both debates in 3Q13, albeit in later stages of their development.

Prior to 2011, Congress had increased the debt ceiling over 75 times without much partisanship yet recently, the debt ceiling has become a political weapon used to hold the budgetary process hostage. From a rational perspective, increasing the debt ceiling should be apolitical and not be a part of the budgeting process, which allocates future resources. Despite a push to politicize the debate, it is impossible to undo past obligations without effectively defaulting or reneging on those liabilities. Thus, raising the debt ceiling should be a simple procedural vote that would allow the government to meet past obligations, not commit to future spending.

Table 1
Budget Control Act and Sequestration

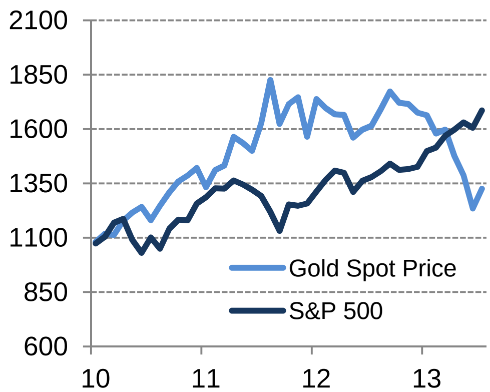
	Dollar Cuts ($bn)	Annual Cuts (%)	Pre-Sequester Caps ($bn)	Post-Sequester Caps ($bn)
Non-Defense	$54.7			
Discretionary	$36.6	7.2%	$506	$469.4
Medicare	$11.2	2.0%		
Other Mandatory	$6.9	7.2%		
Defense	$54.7			
Discretionary	$53.9	9.8%	$552	$498.1
Mandatory	$0.7	9.8%		

Source: Office of Management and Budget Estimates

Uncertainty to Rise if No Debt Ceiling Agreement Reached

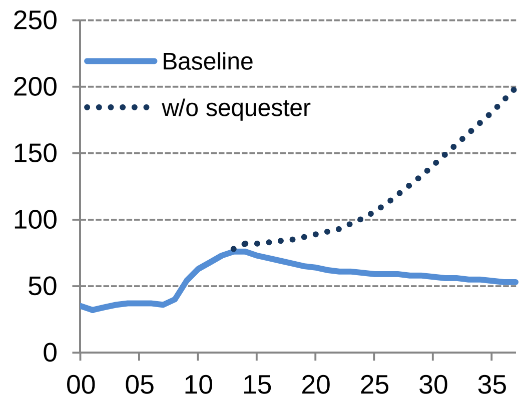
Failure to authorize an increase in the debt ceiling during the next legislative session will likely roil treasury and equity markets, and stifle growth. In 2011, when the U.S. credit rating was downgraded real interest rates plummeted, as the 10yr TIPS dropped 48bps. Equity markets volatility was also the highest since 2008, falling as much as 7%WoW. In an effort to shift away from market volatility and uncertainty, investors also traded to safe assets such as gold, which jumped 12.7%MoM.

Chart 1
S&P 500 & Gold (Index & $)



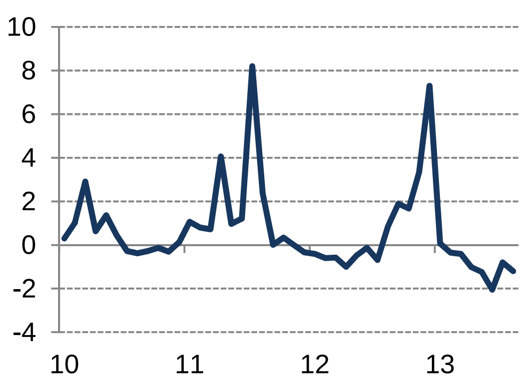
Source: BBVA Research & Bloomberg

Chart 2
Federal Debt Held by the Public (% of GDP)



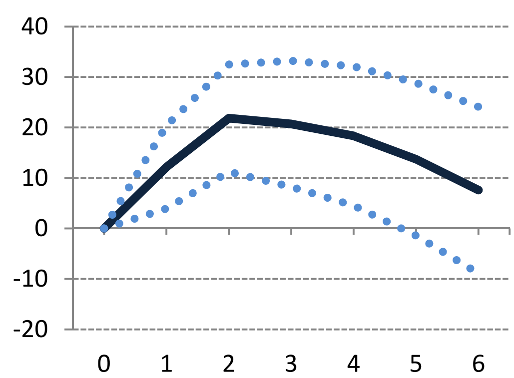
Source CBO

Chart 3
BBVA Policy Uncertainty Index (mean=0)



Source: BBVA Research

Chart 4
Response of the Unemployment Rate to a Policy Uncertainty Shock (bp, dotted lines=95% confidence interval)



Source: Haver & BBVA Research

Furthermore, not increasing the debt ceiling in a timely manner could generate high levels of policy uncertainty, which would create economic headwinds, at time when the U.S. economy remains vulnerable. For example, the direct effect of the aforementioned scenario would be a 70bp increase in the unemployment rate and a $2.6b reduction in consumption and investment. The pass-through to the real economy could be even greater, if the shock brings into question the U.S. creditworthiness. Currently, our policy uncertainty index is below its long-run average, which indicates market participants are unfazed by current debate. However, if the debate escalates it could reinforce market participant's negative expectations regarding the creditworthiness of U.S.

Higher Growth Amidst Sequestration Headwinds

While the impact from policy uncertainty can be significant, sequester remains the biggest domestic question mark for growth moving forward. That being said, the impact of sequestration in 2013 has been less adverse than some analysts expected. For example, even though government expenditure component of GDP subtracted 0.9% in 2Q13 GDP, actual growth remained positive and increased 2.5% QoQa. Moreover, the fiscal drag has decelerated over the past three quarters which is in line with our baseline for moderate growth in the 1H13 in spite of sequestration and a pickup in 2H13.

It appears market participants also overestimated that impact that sequestration would have on the public employment. The Department of Defense, for instance, originally estimated that all 750K of its employees would be furloughed for 22 days in FY12 but in actuality only 650K employees were furloughed for only 6 days. Moreover, public employment figures have not declined to the extent that would be expected given the actual decline in the federal spending and government contributions to GDP would suggest. According to the Federal Reserve Bank of San Francisco, "...despite all the attention federal spending cuts and sequestration have received, our calculations suggest they are not the main contributors to this projected drag".

The fact that growth remained positive amidst headwinds from sequestration bolsters the argument that policy makers should shift their focus to long-term structural challenges rather than short-term budgetary stimulus. The CBO estimates that if the sequester were to be reversed, the economy could grow an additional 0.7pp in 3Q14 and add as many 900K jobs. However, the immediate impact of reversing sequester would be higher cyclical and structural deficits. Moreover, in the long run, reversing sequester would reduce policymaker's ability to use fiscal policy to combat future business cycles or financial crises and reduce potential growth.

Bottom Line

While exclusive, the debates that surround raising the debt ceiling and sequestration have become more politically charged. Weaponizing the debt ceiling puts the U.S. credit rating at risk, which can have real effects on the economy. Thus, the debt ceiling should and will likely be increased before the October target. That being said, the impact of sequestration in 2013 has been less adverse than previously expected and thus it may be more beneficial to focus on more pressing structural issues such as education, infrastructure and healthcare. As a result, we maintain our baseline scenario of 1.8%YoY for 2013 but recognize that if current consumption and investment trends continue to tilt to the downside, a downward revision is not unlikely.