Economic Watch

US

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Economic Analysis

US
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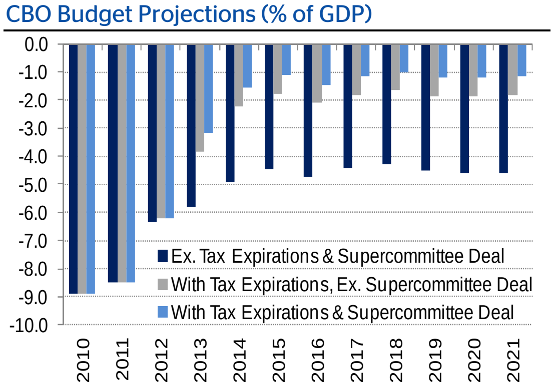
No Deal Reached in Deficit Reduction Talks

Implications of the Supercommittee Stalemate

- **The 12-member Supercommittee failed to reach an agreement, triggering $1.2tr in automatic spending cuts which begin in 2013**
- **Expiring Bush tax cuts may increase revenues to 20% of GDP in 2013, but expiring payroll tax cuts and unemployment benefits will impact growth**
- **Lack of an agreement merely pushes tax reform to next year's elections, putting pressure on candidates to prevent a runaway debt-to-GDP ratio**

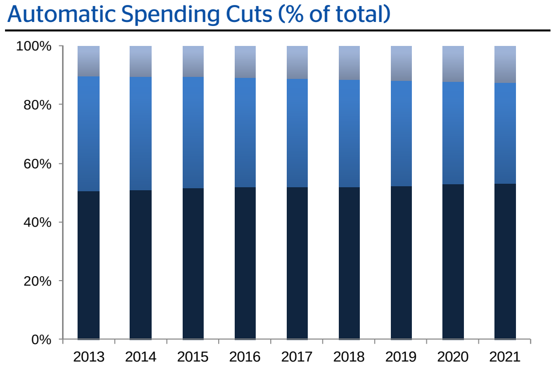
The debt ceiling agreement in August laid out the Supercommittee's task of finding at least $1.2tr in deficit reductions over the next decade. Unfortunately, the unofficial November 21st deadline has approached with nothing but an announcement of failure from the committee members. While the difficulty to reach an agreement is just another notch in the country's fiscal woes, the stalemate at least triggers a safety net of $1.2tr in automatic spending cuts over the next decade. Approximately $109.3bn in spending cuts per year will begin in January 2013, targeting both military and domestic programs but limiting cuts to most entitlement programs such as Medicare. Furthermore, lack of compromise regarding tax reform means that the Bush tax cuts will expire as scheduled at the end of 2012, much to the Republicans' dismay. President Obama's payroll tax cuts, which are estimated to be worth at least $900 to the average worker, will also expire in 2012. Based on the Congressional Budget Office (CBO) projections, the fiscal deficit under this no-deal scenario should decline significantly in 2013 and then level off to a more sustainable level throughout the next few years. However, the impact on GDP could be substantial. In 2012, before the spending cuts are triggered, most of the impact will come from expirations of Obama's payroll tax holidays and unemployment benefits, which were expected to add 1-2% to growth next year. Allowing these provisions to expire (worth approximately $168bn together) with no offsetting increase in government spending could reduce GDP growth by 1% for 2012. The Bush tax cuts, which reduced the tax rate for the wealthiest Americans, will expire at the end of 2012 and will generate additional tax revenue for the government in 2013. The CBO estimated that allowing the Bush tax cuts to expire would increase tax revenues from 15.3% of GDP in 2011 to more than 20% of GDP in 2014.

Chart 1
CBO Budget Projections (% of GDP)



Source: BBVA Research & CBO

Chart 2
Automatic Spending Cuts (% of total)



Source: BBVA Research & CBO

The political uncertainty highlighted during the debt ceiling negotiations in August led to the S&P credit ratings downgrade, even though Congress eventually came to an agreement. Although the Supercommittee has accepted defeat, credit agencies have confirmed their ratings for the time being. Moody's has made it clear that the Supercommittee's failure would be a negative but not a "decisive" factor for a downgrade given that the automatic spending cuts provide a sufficient safety net for deficit reduction. Fitch has a more stable outlook for the US and may be more likely to change to a negative outlook than downgrade the credit rating. S&P has also confirmed its credit rating. However, concerns have increased that the government may attempt to lessen the impact of the automatic trigger. For instance, members of the Republican party have plans to introduce legislation that will further limit the sequestration cuts targeted towards military programs. Obama has announced that he will veto any such proposals as it could severely hurt the sustainability of the deficit reduction plan and would likely result in a credit ratings downgrade.

Although the stalemate was mostly expected, market reactions were volatile. Stocks fell sharply and bond yields declined as investors fled to less-risky assets. Elevated risk perception and flight to safety continue to support Treasuries, with limited alternatives worldwide. Increased fiscal and political uncertainties foster a slow growing economy, putting downward pressure on interest rates for the short and medium term. The fact that S&P downgraded the US credit rating in August makes it all the more likely that they could do so again if conditions warrant. If this were the case, Treasury yields could increase and lead to elevated borrowing costs for the US government. However, given similar uncertainties in the rest of the developed world, Treasuries may continue to be viewed as the safest investment.

The Supercommittee's failure leaves a lot to be resolved with the 2012 presidential election, with political indecision translating into increased fiscal uncertainty. Political brinkmanship has been at play since the tedious summer negotiations, with both parties seemingly more focused on protecting their reputations for election purposes rather than saving the US economy from financial collapse. Tax reform has been at the center of the battle. While both parties agree that the solution is to cut exemptions to allow for lower tax rates, their ideas conflict on the exact structure of the reform. Democrats can be satisfied with the no-deal scenario given their focus on the Bush tax cuts which would add close to $3.7tr to the deficit over the next 10 years if they were extended. On the spending side, Republicans worry that significant cuts to defense programs could compromise national security, while Democrats want to protect the benefit programs that remain so sensitive to the party's political stance. Ultimately, the political brinkmanship will continue through the elections while each side fights to improve on the consequences of the Supercommittee's failure. Action of any kind is unlikely to happen before the end of 2012 and depends heavily on the outcome of the presidential elections.

Bottom line: No deal is better than a bad deal, for now

At the very least, the failure to reach an agreement triggers the $1.2tr in automatic spending cuts and allows the Bush tax cuts to expire at the end of 2012. As long as Congress does not counteract the sequestration, the US appears to be on track for fiscal sustainability. However, lack of significant tax reform will require additional attention leading up to the 2012 elections. While spending cuts and tax increases may be positive for the budget deficit and fiscal sustainability, the combination and timing of these changes might not be optimal for the US economy given current circumstances. Furthermore, with growth estimates less than 3% for both 2012 and 2013, spending cuts and payroll tax expirations could leave the US even more vulnerable to problems in Europe. Overall, our baseline scenario accounts for the $1.2 in automatic spending cuts so the impact of the Supercommittee's failure to our growth projections should be very limited.