The US Fiscal Crisis

Definition- The term, fiscal cliff, was first referred to by the US Federal Reserve Chairman Ben Bernanke. While addressing the House Financial Services Committee in February of this year, Bernanke described a massive fiscal cliff of large spending cuts and tax increases scheduled to occur on January 1, 2013. He was referring to a series of tax and budget bills which are set to expire at the end of this year if US Congress does not produce a viable solution.

In other words, starting 2013, a series of tax cuts will come to an end resulting in higher taxes for most Americans. In addition to it, automatic budget cuts will become applicable. This combination of higher taxes and lower spending will help US government reduce its budget deficit. However the severe and sudden fiscal contraction will have a major impact on the US economy which is just of the recession and witnessing uneven recovery. The impact will not be limited to US alone and could affect other countries as well. The US is world's biggest economy and any sharp slowdown will affect other economies causing another global crisis.

Automatic spending are harmful for the economy largely because they would be arbitrary and mostly across the board. Meanwhile, tax increase will reduce the amount of money people take home. Some fear that the fiscal restraint would result in a recession next year and cost thousands of jobs.

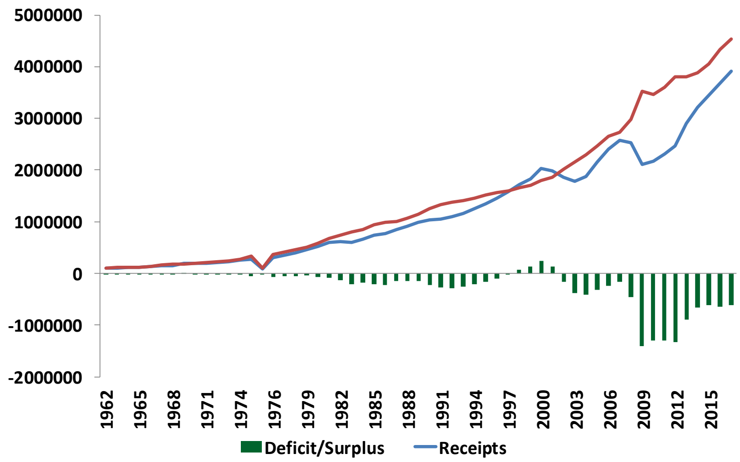
The new fiscal situation is estimated to have an impact of around $600 billion that includes about $500 billion from tax increases and other revenues and around $100 billion in across the board spending cuts. Higher taxes means less disposable income with people which will result in less spending and thereby lower demand. Decline in government spending will further affect domestic demand. Lower demand will thereby have an impact on production, employment and investment.

A case of severe budget cuts is present in the euro-zone where most economies are witnessing economic contraction. Since 2009, countries in the Eurozone have pursued deflationary fiscal policy i.e. reducing spending and increasing taxes to reduce their budget deficits. These austerity measures have led to sharp falls in the rate of economic growth.

Another area of concern it that the US debt is nearing its limit again and this would result in a debt ceiling fight similar to the one seen last year. The fight to raise the debt ceiling in 2011 resulted in sharp volatility in financial market and a rating downgrade by Standard and Poor (S&P) rating agency.

Background

Fig.1- US Federal Reciepts against Outlays (million US dollar)



Source: Bloomberg; KCSL Research - Data from 2012 are estimates

The US government has witnessed a budget deficit since 2002 and it has been above $1 trillion mark for last four years (Refer to Fig.1). The deficit widened substantially in last few years owing to a combination of economic slowdowns, tax cuts and spending increases. The euro-zone debt crisis, which has caused turmoil worldwide, has put focus on countries with huge debt ratios like US and Japan. US policymakers have acknowledged the need to deal with the rising debt level and government spending but to no avail.

The US is the only democratic country, besides Denmark, in which Congress has to approve borrowing separately from spending. In most other countries the authority to borrow money is inextricably tied to the authority to spend money. The US debt ceiling has been hit numerous times in last few years. To be exact, since 1960, Congress has raised the debt ceiling 78 times, 49 of them under Republican presidents.

An increase in the debt ceiling requires the approval of both houses of Congress. In 2011, US Department of Treasury announced that the borrowing authority of the US would be exhausted by August 2, 2011. The US house was divided as Republican Party held majority in the House of Representatives while Democrats were in majority in the Senate.

This division resulted in prolonged negotiations to raise the debt ceiling which was resolved on July 31 just days before the debt ceiling was expected to be hit. Debt ceiling was raised from 14.3 trillion to $16.4 trillion, an increase of $2.1 trillion. Republicans agreed on raising the debt limit on condition that US leaders will come up with measures to deal with the rising debt level. The agreement also included cutting the federal budget deficit by $2.5 trillion over the next decade.

As part of an agreement to resolve the debt-ceiling crisis, Congress passed the Budget Control Act of 2011 on August 2, 2011. The Act provided for a Joint Select Committee on Deficit Reduction (the "super committee") to produce legislation by late November 2011 that would decrease the deficit by $1.2 trillion over ten years. If the committee failed to do so, it would result in automatic across-the-board cuts (known as "sequestrations") beginning January 2, 2013.

The Super committee which included six Republicans and six Democrats confirmed on 21st November, 2011 that its work had ended without a deal which means US will face automatic spending cuts starting 2013. The automatic cuts would be split equally between security and non-security programs. The looming automatic cuts can be averted now if US policymakers reach a deal before the deadline.

In addition to the budget cuts, several temporary tax cuts are scheduled to expire at the beginning of the 2013 calendar year, including the 2001 and 2003 Bush tax cuts on income, capital gains, and estate tax, which had been extended in a 2010 tax deal, as well as a payroll tax cut that began as a result of the 2010 deal and had been extended in an early 2012 tax deal. President George W. Bush and Congress enact deep "temporary" tax cuts in 2001 when stocks market tech bubble burst. Bush and Congress cut taxes further in 2003 to support the economy. In 2009, Obama, enacted $787 billion stimulus, including expanded temporary tax breaks for children, education. With economy still under pressure, Obama agrees to extend Bush tax cuts for two years in 2010 which are scheduled to expire at the end of this year.

Year	Regular Marginal Tax Brackets (%)					
Current	10	15	25	28	33	35
2013 Expectations	15	15	28	31	36	39.6

The table above gives a general idea as to how the tax increases will affect American tax payers. The table includes the new tax brackets which will be applicable from next year. The average American falling in the tax break of 10% would now face a tax rate of about 15%. As per Bloomberg calculation, on Friday, Jan. 4, 2013, middle-class Americans who get paid that day would see take-home pay decline by an average of about $25. The tax hikes would result from the expiration of the payroll tax holiday and the George W. Bush tax cuts. In the second week of January, about 2 million jobless Americans receiving unemployment benefits would stop receiving checks. Over the following weeks, the initial distress will build into something even worse.

Economic Impact of the Fiscal Cliff

Federal debt held by the public currently exceeds 70% of the nation’s gross domestic product, or GDP, a percentage not seen since 1950. This means that the debt government owes to the public stands at 70% of GDP. Further changes in deficit depend on how US policymakers alter the tax increases and spending cuts due to take place next year.

As per US Congressional Budget Office (CBO) estimate released in May earlier this year, given the current law assumption i.e. the new tax increases and spending cuts will come into effect , the budget deficit was expected to shrink by $607 billion in fiscal year and about $560 billion taking into consideration that economic effect from the change in deficit. Of the $607 billion, about $339 billion is expected from changes in revenue policies and $103 billion from changes in spending policies which includes the automatic cuts enforced under Budget Control Act. Another $105 billion cut in form of other changes mostly in revenue. In this estimate, deficit for 2012 was estimated at $1171 billion and was expected to reduce to $612 billion, a drop of $560 billion.

As per CBO's November update, US budget deficit stood at $1089 billion in fiscal year 2012 and is expected to shrink to $641 billion in fiscal year 2013 (or 4.0% of GDP), almost $500 billion less than the shortfall in 2012. The lower estimate is due to a downward revision of 2012 deficit. Under an alternative scenario, which assumes that all expiring tax provision are extended indefinitely and the automatic spending reductions which are set to take effect in January 2013 do not occur, the deficit would total $1.0 trillion.

From a longer perspective, the budget deficit is expected to shrink markedly, from nearly $1.1 trillion in fiscal year 2012 to about $200 billion in 2022 and debt would decline to 58% of GDP in 2022. If, instead, lawmakers maintain current policies by preventing most of those changes from occurring, annual deficits would average nearly 5% of GDP over the next decade, and debt held by the public would increase to 90% of GDP 10 years from now and keep rising rapidly thereafter.

CBO also believe that fiscal tightening will lead to economic conditions in 2013 that will probably be considered a recession. Real GDP is seen declining by 0.5% between the fourth quarter of 2012 and the fourth quarter of 2013 and the unemployment rate rising to about 9% in the second half of calendar year 2013. In the alternative case, i.e. assuming the fiscal cliff is avoided, real GDP would grow by 1.7% between the fourth quarter of 2012 and the fourth quarter of 2013, and the unemployment rate would be about 8% by the end of 2013.

	2012	2013	
		With	Without
Budget Deficit (billion)	-1089	-641	-1037
Deficit as % of GDP	7.00%	4.00%	6.50%
Unemployment (%)	8.20%	9.10%	8.00%
GDP growth(%)	2.10%	-0.50%	1.70%

Source: US Congressional Budget Office (CB); KCSL Research

In case the US goes over the fiscal cliff, the impact will not be limited to US economy itself. According to study by Fitch Rating, a US fiscal shock would be exported to the rest of the world via a sharply weaker US dollar and asset prices, lower US price inflation and heightened risk of deflation, and the impact on commodity prices.

Also as domestic demand falls, US imports would drop faster than exports, and the resulting improving trade balance would need to be matched by deterioration in trading partners' balances, causing growth to slow. The potential contagion effects from greater stress in the US financial sector and asset markets could further amplify the negative effects on the global economy.

The Conundrum

The US debt has risen to unsustainable levels and policymakers need to act. However with the economic condition weak and fiscal crisis waiting at the start of the year, US policymakers have to choose between addressing the concern of slow economic growth and pushing ahead the worry of higher debt levels or work right now to address the problem the debt problem but witnessing a sharp slowdown as a result.

US policymakers could address the short-term economic challenge by eliminating or reducing the fiscal impact scheduled to occur next year without imposing comparable restraint in future years but that would have substantial economic costs over the longer run. Alternatively, they could move rapidly to address the longer-run budgetary problem by allowing the full measure of fiscal restraint but that would have substantial economic costs in the short run.

If policymakers want to minimize the short-run costs of narrowing the deficit very quickly while also minimizing the longer-run costs of allowing large deficits to persist, they could enact a combination of policies- changes in taxes and spending that would widen the deficit in 2013 relative to what would occur under current law but that would reduce deficits later in the decade relative to what would occur if current policies were extended for a prolonged period.

In considering policy changes that would reduce budget deficits, lawmakers and the public may weigh several factors. A related consideration is how policy changes would influence the pace of economic recovery and longer-term economic performance.

US Nearing the Debt Limit Again

As part of the agreement reached last year, the current statutory debt limit is $16.394 trillion. As of November 27, 2012, debt subject to that limit stood at $16.279 trillion, $115 billion below the statutory ceiling. The Treasury anticipates that borrowing will reach the current limit near the end of December 2012. However, because the Treasury can take certain measures that it has used previously when borrowing approached or reached the debt limit, CBO expects that the department will be able to continue funding government activities without an increase in the debt limit until mid-February or early March. President Barack Obama President Obama wants to do away with Congress when it comes to raising the country’s legal debt limit however this proposal is not acceptable to Republicans.

Current Scenario

In a bid to avert the crisis, US policymakers have started negotiations however there has been no significant progress so far. Both President Obama and Republicans agree that they cannot raise taxes for all Americans as it would hurt growth however there has been no consensus over how to cut the deficit. President Obama is proposing $1.6 trillion in higher taxes and $400 billion cut in Medicare and other benefits. He wants to include an extension of 2% payroll tax cut and spend $50 billion in 2013 to boost the economy. He intends to raise income tax rates on the top 2% of earners.

On other hand, Republicans have proposed that the Bush tax cuts be extended in their entirety. Republicans called for $800 billion in new revenue achieved through closing loopholes and capping deductions, $900 billion in health care and other mandatory spending cuts, $300 billion in spending cuts for discretionary spending, and $200 billion gained by changing the way the government calculates cost-of-living adjustments for Social Security and Medicare. This was rejected by the Democrats.

After days of impasse, US House Speaker John Boehner, on December 16, offered $1 trillion in higher tax revenue over 10 years and an increase in the top tax rate on people making more than $1 million a year. In return, Boehner is asking for $1 trillion in spending cuts from government benefit programs like Medicare. The White House has not accepted the Boehner proposals.

Impact on Commodities

In case policymakers fail to reach a deal and US goes over the fiscal cliff, the sudden contraction in the economy will affect demand for commodities which will be negative for price. Gold, which usually is considered a safe haven asset, will also come under pressure amid a sell-off across the financial markets. Gold has been behaving like a commodity for more than a year and large sell-off across the market will affect the metal as well.

If US leaders reach a deal to avert the crisis, market sentiments will improve for commodities. However this will be momentary and market focus will shift back to the unsustainable US debt. As part of the deal to avert the crisis, US policymakers will have to agree on some measures to cut budget deficit. If these measures are not considered apt to correct the debt problems, market sentiment could turn negative again. Moody's Investor Services earlier this year warned that it would downgrade the US AAA credit rating of government officials don't deal with the nation's debt problems. A rating downgrade for US, the biggest economy, will be negative for most asset classes.

What Lies Ahead?

The US policymakers will continue to discuss measures to avert the fiscal crisis over coming days and this will keep market confidence shaky resulting in bouts of selling pressure. Year-end position squaring could add to volatility in market. However US leaders are expected to reach a deal to avert the full impact of fiscal tightening. They may agree on some measures of spending cuts and tax increases.

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