US Fiscal Cliff and Debt Ceiling: Apolitical blues

Economic research note

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- A deal has been done to avoid the worst of the Fiscal Cliff, with fiscal policy likely to tighten by around 1.5% points in 2013.
- However, the Fiscal Cliff deal has only delayed significant spending cuts by two months.
- This means that an agreement on spending cuts and the need to raise the $US16.4 trillion debt ceiling will need to take place by the end of February, at the latest.
- These negotiation are, once again, likely to be very acrimonious and the risk of significant volatility in US markets at this time remains high.
- The credit ratings agencies are also likely to take a dim view of any risk to the US debt ceiling and/or a delay in placing the US on a more sustainable medium-term fiscal path.
- The most disappointing aspect of these political machinations is that they threaten the ongoing recovery in the US economy – with recent economic data promising a much better 2013.

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US Fiscal Cliff and Debt Ceiling:

"You can always count on Americans to do the right thing – after they've tried everything else." Winston Churchill

Left alone, the so-called Fiscal Cliff in the US would have subtracted 4% points from GDP growth in 2013 – most likely taking the economy back into recession.

While market expectations seemed to be that a deal would eventually be done, the combative nature of the US political system meant that it took until the first day of the New Year before the worst of the Fiscal Cliff was avoided – with the deal implying around a 1.5% point contraction to GDP.

Risk markets rallied on news of the deal and the confirmation of a less aggressive tightening of fiscal policy for the year.

As detailed below, however, while some potential tax increases have been put off permanently and the deal did involve some more positive aspects, significant spending cuts have only been delayed by two months.

These spending cuts will need to be debated and agreed upon in mid-to-late February, the same time as the $US16.394 trillion debt ceiling will need to be raised.

Negotiations around the spending cuts and the debt ceiling will likely, once again, be very acrimonious and the risk of volatility in markets remains high.

The credit rating agencies are also likely to take a dim view, once again, on any signs that the US political process threatens the US's ability to repay its debt obligations and/or fails to negotiate a reasonable medium-term path to fiscal sustainability.

Significantly, it seems clear that the outlook for the US economy is improving. The housing market is recovering, private sector jobs are being created and the Federal Reserve is continuing to pursue an aggressive monetary policy easing process.

However, this more positive outlook remains under threat from the US political process and the need to raise the debt ceiling and put the US fiscal outlook on a more sustainable medium-term path. Political risk in the US will likely remain, therefore, a concern for markets as 2013 gets underway.

Fiscal Cliff deal:

The deal that was reached on the Fiscal Cliff still implies a contraction in fiscal policy for 2013 of around 1.5%. The main elements of the deal are as follows:

- Income tax rates will remain unchanged for all income earners with the exception of singles earning over $US400k and married couples earning a combined $US450k.
- Income tax rates for these high-income earners will rise by 4.6%pts to 39.6%.
- Higher income earners will also see their dividends and capital gains tax rate rise from 15% to 20%.
- Estate taxes will rise from 35% to 40% for estates with a value above $US5 million, with this limit to be indexed to the rate of inflation.
- An extension of payroll tax reductions was not included in the deal, meaning that payroll tax rates will rise by 2%pts to 6.2%.
- Increased unemployment benefits will be extended for another year.
- Tax credits for college tuition, created as part of the 2009 stimulus package, will be extended for a further 5 years.
- The Alternative Minimum Tax (AMT) rate will now be indexed each year, likely removing this as an issue for income earners.
- Some business tax benefits, such as the renewable energy tax credit, have been extended for a further year.
- A planned $US900 per year pay rise for members of Congress has been revoked.
- The so-called “sequestration” spending cuts, which amount to just over $US100bn, will only be delayed for two months.

The fact that the sequestration spending cuts have only been delayed for two months will put negotiations around government spending right in the middle of the debate over the debt ceiling.

As noted above, the state of the US political process all but guarantees that these spending cut and debt ceiling negotiations will be acrimonious and will likely cause significant market volatility.

Debt Ceiling:

The US debt ceiling is currently set at $US16.394 trillion. This limit was reached on 31 December 2012 – see chart.

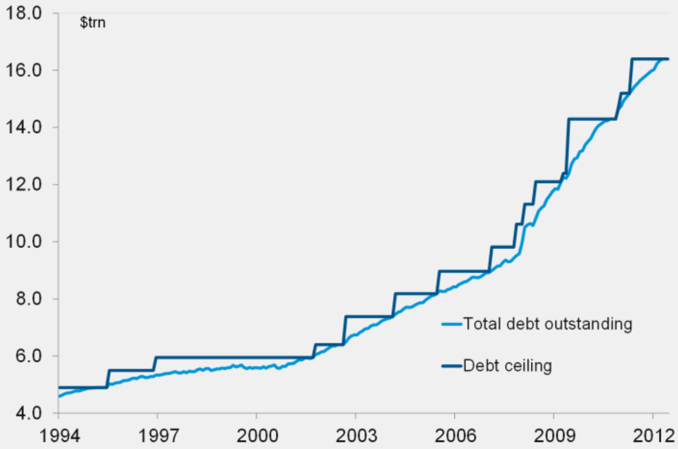
Treasury Secretary, Tim Geithner, has stated that the Treasury can use some accounting measures to push off the final date towards the end of February 2013.

It is also worth noting that Geithner has again expressed his desire to resign from his position early in 2013, most likely prior to the debt ceiling being raised.

If the debt ceiling is not raised by late February, then the US government will need to impose spending cuts of around 40% of all non-interest spending (ie. immediately balance the budget) to avoid missing interest payments on its debt obligations.

Such a dramatic cut in spending would clearly have a significant impact on the economy – but would avoid the damage to both US and global markets that would come from a ‘default” on US debt.

US debt ceiling and debt outstanding



Source: Bloomberg, data to 31 December 2012

Estimates are that the debt ceiling will need to be raised by around $US1.5 trillion to avoid this issue having to be addressed again prior to the 2014 mid-term elections.

A much larger increase (say $US3 trillion - $US4 trillion) would be required to push the issue beyond the 2016 Presidential elections.

As noted, negotiations over the debt ceiling will run into the debate over spending cuts – with Republican’s previously demanding that any increase in the debt ceiling be matched by future spending restraint.

The President will no-doubt argue for a more ‘balanced’ approach that involves both spending cuts and more revenue raising measures – putting the whole debate back squarely where it was with the Fiscal Cliff negotiations.

For further information

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