MOODY'S ANALYTICS

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A Budget Battle Postmortem

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The 16-day federal shutdown and political brinkmanship around the Treasury debt ceiling hurt the economy. The hit to fourth quarter real GDP is estimated at $20 billion, equal to half a percentage point of growth. Instead of picking up pace as previously expected, U.S. growth will remain stuck near a lackluster 2%.

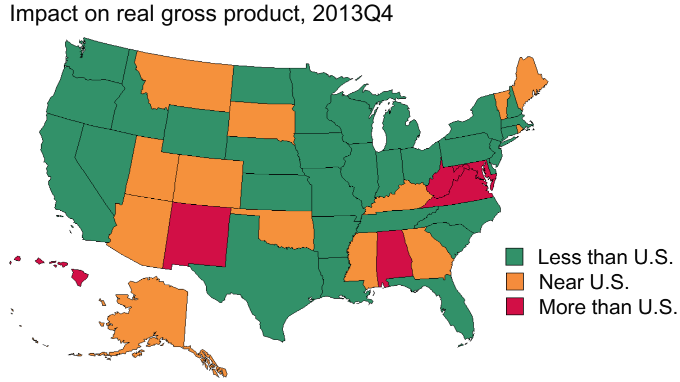
Lawmakers' agreement to extend funding for the government and suspend the debt limit into early next year forestalled worse economic damage, but as long as lawmakers stay deadlocked over the direction of the federal budget, the economic recovery will not gain momentum. Consumers and businesses will remain on edge, holding back spending, investment and hiring. Although global investors continue to view the U.S. as the safest place to put their money, their confidence is being shaken by Washington's dysfunction.

Shutdown fallout

Approximately half of the hit from the budget battles to fourth quarter GDP is directly due to the government shutdown. Federal and consumer spending are the biggest casualties, but international trade, housing and business investment were also disrupted. Nearly all regions of the country were hurt, although some were hurt much more than others (see Chart 1).

Shutdown Hurts Some States More Than Others

Impact on real gross product, 2013Q4



Sources: BLS, BEA, Moody's Analytics

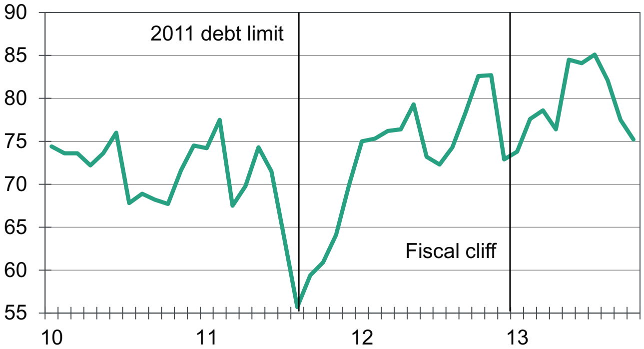
The furlough of 400,000 federal employees between October 1 and 17 will reduce the contribution of federal government spending to real GDP. Even though these workers will receive back pay, their lost work hours will be counted as reductions in real gross domestic product. This was the case in the last major government shutdown in 1995 and 1996; the economic fallout was most evident in reduced real federal government spending.

The delay in paying furloughed workers, and another 1.2 million federal employees who worked but were not paid during the shutdown, appears to have crimped consumer spending. In addition, we estimate that a couple of hundred thousand private sector employees, many at defense contractors, could not work because of the shutdown and are unlikely to receive back pay.

More broadly, consumers found both the shutdown and talk of a possible Treasury default upsetting. Various surveys, including the daily Rasmussen and Gallup surveys, and the monthly University of Michigan survey, found confidence weakening (see Chart 2).

Chart 2: Budget Battles Weaken Confidence

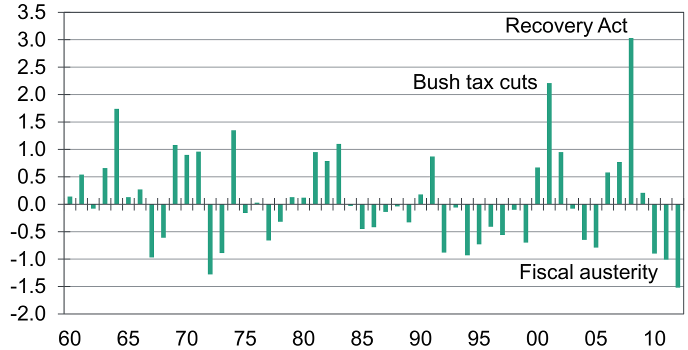
University of Michigan consumer confidence index



Sources: University of Michigan, Moody's Analytics

Chart 3: Significant Fiscal Austerity

Real GDP growth impact of federal fiscal policy, fiscal yr, ppts



Source: Moody's Analytics

The loss of income and confidence unsurprisingly weakened retail activity. Chain store sales growth came to a standstill, according to the International Council of Shopping Centers, and a survey conducted by the National Retail Federation indicates that consumers will spend less on Christmas this year than last. Christmas sales generally decline only during recession years. ShopperTrak, meanwhile, reports that foot traffic at retailers fell off significantly, particularly in the Washington DC area, and anecdotal reports from automakers suggest that potential buyers turned more cautious.

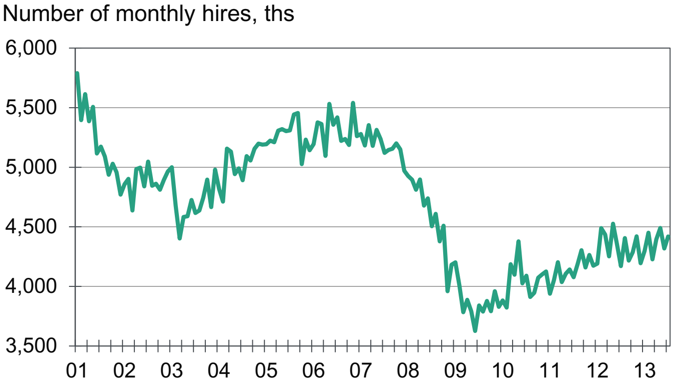
Although retail should revive now that the budget showdown has eased, consumers are unlikely to become enthusiastic spenders any time soon, given the prospects for another round of political brinkmanship in just a few months.

The shutdown also disrupted exports and imports, as many products need permits from government agencies to be shipped. Mortgage loans could not be closed as quickly because lenders were not able to get needed information from the IRS and Social Security Administration. Fannie Mae, Freddie Mac, and the Federal Housing Administration provided workarounds, but there were delays nonetheless. Small-business loans backed by the Small Business Administration did not go through, and tourist destinations across the country were hobbled as national parks, museums and monuments were closed.

None of these individual disruptions is severe enough to seriously harm the $16-trillion U.S. economy, but together they add up. And while the problems should be sorted out now that the government has reopened and federal employees are back to work, the economy took a meaningful blow at a time when it was more constrained by fiscal austerity—government spending cuts and tax increases—than at any time since just after World War II (see Chart 3). The economy will bounce back from the shutdown, assuming lawmakers do not do it again in just a few months, but growth will remain lackluster for longer than it would have otherwise.

Chart 4: Uncertainty Weighs on Hiring

Number of monthly hires, ths



Sources: BLS, Moody's Analytics

Consequences of uncertainty

More pernicious and persistent is the damage to fourth quarter GDP from political uncertainty.[1] Consumers, businesses and global investors were palpably dismayed by both the shutdown and the possibility that the U.S. government might not pay all its bills on time.

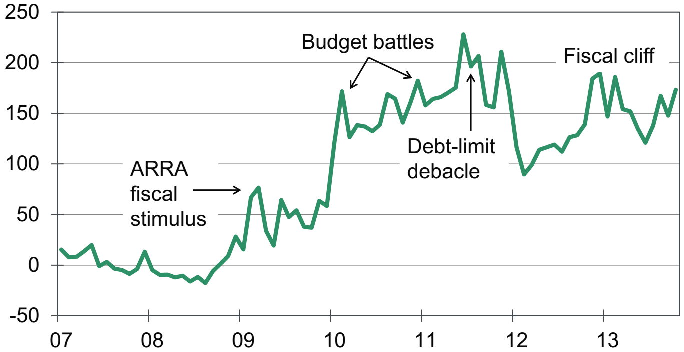
Uncertainty is corrosive to growth. Businesses grow more reluctant to invest and hire, and entrepreneurs become less likely to attempt startups (see Chart 4). Financial institutions grow cautious about lending, and households are more restrained in spending. Although many factors contribute to the current climate of uncertainty, Washington's heated budget battles are a major contributor.

This is evident in the Moody's Analytics political uncertainty index. The index is based on the credit default swap-implied expected default frequency for five-year Treasury bonds, the present value of future expiring tax provisions, and the share of businesses that cite legal and regulatory issues as their biggest problem in the Moody's Analytics weekly business survey.[2] The index is set to equal 0 in 2007, the year before the recession. The higher the index, the greater the uncertainty.

The Moody's Analytics index rose significantly during the heated debate over the American Recovery and Reinvestment Act—the $830-billion fiscal stimulus—in early 2009. It surged during the budget debate in early 2010 and rose to a record high during the Treasury debt-ceiling showdown in the

Chart 5: Political Uncertainty Is High

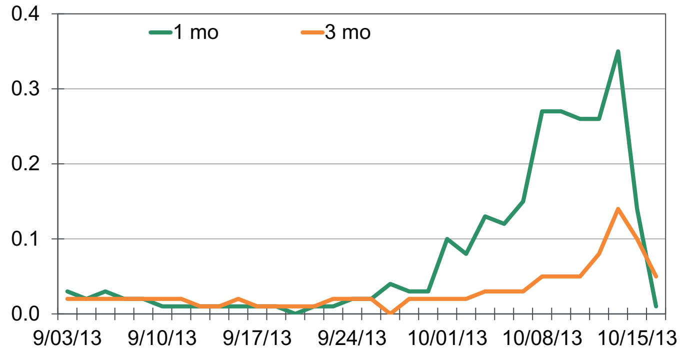
Political uncertainty index, 2007Q4=0



Source: Moody's Analytics

Chart 6: Global Investors Worry About Default

Yield on U.S. Treasury bills, %



Sources: Treasury, Moody's Analytics

summer of 2011 (see Chart 5). Uncertainty also increased as Congress approached the so-called fiscal cliff in late 2012 and rose again as the recent fiscal impasse unfolded.

Political uncertainty constrains business investment, especially in research and development. The result is reduced hiring and slower GDP growth. A statistical analysis shows that increased political uncertainty from 2008 through the third quarter of 2013 (and thus not including the latest spike around the shutdown) lowered real GDP by close to $150 billion, reduced employment by 1.1 million jobs and raised the unemployment rate by 0.7 percentage point.[3]

If political uncertainty had simply remained at its 2007 level, the unemployment rate today would be 6.6% instead of 7.3%. If not for the logjam in Washington, the economy would now be much closer to full employment.[4] Other researchers measuring the fallout from uncertainty on the economy find even greater effects.[5]

With Washington's budget battle set to extend into early next year at least, political uncertainty will remain high, and its weight on the economy heavy. This by itself should not undermine the recovery, assuming lawmakers do not actually shut the government down again or not pay its bills. Yet just the threat that they might will make it difficult for the economy to gain much traction.

Worried global investors

Global investors were also disconcerted by Congress' willingness to entertain the possibility of the U.S. not meeting all its obligations. Interest rates on one-month Treasury bills spiked from near 0% to 0.35% just before the debt limit deadline (see Chart 6). T-bill rates fell after the agreement was struck, but three-month rates remain elevated, reflecting nervousness over what might happen early next year.

Long-term Treasury bond yields also rose during the shutdown; 10-year rates gained about 10 basis points. While many factors could be behind the increase, there was little economic news during the period, as the government stopped releasing key data. Speculation about the Federal Reserve tightening monetary policy also ceased given the weakened economy. Thus the increase in long-term rates was likely due to investor worries about lawmakers' willingness to pay the government's bills. Indeed, long-term rates quickly fell back to pre-shutdown levels after the agreement.

This contrasts with the decline in long-term rates during the Treasury debt limit debacle in summer 2011. The European debt crisis was in full swing, and despite the political tumult here, global investors rightly saw the U.S. as much safer than any other place they could put their money. This is much less the case today; with Europe more stable, capital has begun flowing back there. Although the U.S. remains the safest global haven, it is steadily becoming less so.

Global investors may also have begun to question U.S. lawmakers' commitment to meeting the nation's financial obligations. Some congressmen and senators mused openly that a U.S. default might not be all that bad for financial markets and the economy. Others argued that the Treasury could prioritize payments, putting bondholders ahead of Social Security recipients and military families.

But even if this were technically feasible, it would likely be deemed irrelevant by investors, given the inevitable legal challenges from those not getting paid on time. The Supreme Court would almost certainly need to weigh in. If Social Security recipients or Medicare providers were paid on time, bondholders would reasonably ask how long the Treasury would continue to pay them, given the inevitable political pressures. Would Congress allow Chinese and Japanese creditors to come before American senior citizens or doctors?[6] Such perceived risks would cause global investors to demand higher interest rates.

Rating agencies are already registering their disapproval of the political process and its implications for the safety and soundness of U.S. Treasuries. The U.S. lost its AAA rating from Standard & Poor's in the summer of 2011, and Fitch put U.S. Treasury debt on negative watch for a possible downgrade due to the recent fiscal crisis.[7]

It will take time to determine whether investors are adding a risk premium to the interest rates on Treasury bonds. Early evidence suggests Treasury rates have risen by an average of 4 basis points across the yield curve. If sustained, this would add $5 billion to the nation's annual interest costs.[8] Investors are sure to demand more if Congress continues to manufacture fiscal crises.

Table 1: Government Spending Cuts Under the Sequester

$ bil, fiscal yrs

	2013	2014	2015
Total			
Budget authority	-85	-109	-109
Outlays	-44	-89	-102
% of outlays	1.3	2.7	3.1
Defense discretionary			
Budget authority	-43	-55	-55
Outlays	-22	-47	-52
% of outlays	3.3	7.0	7.8
Nondefense discretionary			
Budget authority	-29	-37	-37
Outlays	-13	-29	-34
% of outlays	2.1	4.7	5.6
Mandatory			
Budget authority	-14	-18	-18
Outlays	-9	-13	-16
% of outlays	0.4	0.6	0.8

Sources: Congressional Budget Office, Moody's Analytics

What now?

Under the legislation to end the current standoff and to reopen government, lawmakers have until mid-December to hash out a budget deal, until mid-January to pass legislation keeping the government open, and until early February to adjust the debt limit so that the Treasury can continue to pay all of its bills on time.[9]

The recent crisis has likely so chastened lawmakers that they will reach some kind of deal and avoid a similar crisis early next year. Such a deal would fund the government until the end of fiscal 2014 in September and increase the debt limit so it will not be an issue again until early 2015, after the midterm elections. Given the beating lawmakers took in the polls and the proximity of the election, it is hard to see them going down the same path then.

Adjusting the sequester

The deal will most likely include an adjustment to the across-the-board spending cuts that began with budget sequestration this past March. With no change in current law, a second round of sequestration is slated to begin this January, with the hit to the economy next year estimated at about half a percentage point from real GDP growth.

The sting from sequestration has thus far been mitigated by the fact that cuts have been made largely through one-off adjustments such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. With this low-hanging fruit now gone, future cuts will have to come more from reductions in operational budgets. Given the indiscriminate nature of sequestration, this will be especially disruptive to government programs.

Continued sequestration would particularly affect the Pentagon (see Table). Sequestration cuts in fiscal 2013 were divided evenly between spending on security—defense, homeland security and international affairs—and nonsecurity areas. But in 2014 and beyond, the split will be between defense and nondefense, requiring that a greater share of cuts comes from the Pentagon's budget. The Defense Department also paid for a substantial portion of its 2013 cuts by eliminating unobligated balances and, without that cushion this year, will be forced to make deeper cuts from payrolls and operations.

Lawmakers may decide to scale back cuts to the defense budget and give nondefense government agencies more latitude on how to trim their expenses.

Policy mishmash

The deal could also include a variety of tax and spending provisions that have at least some bipartisan support. Repeal of the unpopular medical device tax, which was expected to provide about $30 billion over the next decade to help fund the Affordable Care Act, is a likely possibility. There is also some support for more infrastructure spending. Finding agreement on how to pay for these initiatives will not be easy, but there is a reasonable possibility lawmakers will figure out a way. One suggestion is for some modest cuts to future Medicare spending.

Less likely but still possible is the adoption of the chained consumer price index in calculating Social Security benefits and tax liabilities. The chained CPI is a more accurate measure of inflation than the current CPI used in budgeting, accounting for changes in consumers' spending behavior as relative prices change. (For example, if apples rise in price more quickly than bananas, consumers will buy fewer apples and more bananas). As a result, it grows more slowly than the headline CPI. If it were adopted, Social Security benefits would increase more slowly and tax revenues would rise more quickly, saving the federal government about $130 billion over the next decade, and more after that.

There is also an outside chance lawmakers could enact revenue-neutral corporate tax reform. Closing loopholes in the corporate tax code and using the resulting extra revenue to cut marginal rates would be a positive economic step. U.S. marginal corporate tax rates are high by international standards, even after accounting for exemptions, deductions and credits that lower effective tax rates. Loopholes also make the tax code complex and inefficient. Permanently lowering marginal corporate tax rates would improve the competitiveness of U.S. companies and thus aid long-term economic growth.

Multinational corporations could also be encouraged to repatriate their sizable overseas profits through a temporarily lower tax rate. The onetime boost to revenues could be used to pay for other parts of the deal such as repealing the medical device tax or funding infrastructure development.

Conclusions

Washington's recent budget battles have been painful to watch and harmful to the economy. Political brinkmanship creates significant uncertainty and anxiety among consumers, businesses and investors, weighing on their willingness to spend, hire and invest.

Despite this, the economic recovery is four years old and counting, and the private economy has made enormous strides in correcting the problems that triggered the Great Recession. Business balance sheets are about as strong as they have ever been, the banking system is well-capitalized, and households have significantly reduced their debt loads. The private economy is on the verge of stronger growth, more jobs and lower unemployment.

The key missing ingredient is confidence in Washington. A grand bargain that includes substantial entitlement and tax reform is probably too much to hope for, and while it would be a big plus for the economy, it is not absolutely necessary. What is necessary is that lawmakers do no more harm. That is, fund the government so it remains open and remove or raise the debt limit so it no longer can prevent the U.S. from making good on its obligations. If lawmakers can just accomplish this in the next few months, then the still-fragile recovery will quickly evolve into a sturdy, self-sustaining economic expansion that could last for years.

Endnotes

1 This accounts for the other half of the half percentage point hit to real GDP growth in the fourth quarter.

2 Credit default swaps measure the cost of purchasing insurance in the case of a default on U.S. Treasury debt. The cost of CDS reflects investors' expectations regarding the odds of a default or expected default frequency.

3 These results are based on a structural vector autoregressive model of the U.S. economy. The model is used to estimate the extent to which surprise changes in political uncertainty produce changes in GDP, unemployment, the hiring rate, investment, jobs, Treasury rates, and several other economic variables.

4 It is difficult to statistically distinguish between political uncertainty and policy uncertainty. Political uncertainty is created by political brinkmanship and dysfunction in government. Policy uncertainty is created by potential changes in government spending, taxes and regulation. The 2011 showdown over the Treasury debt limit was especially hard on the economy since it created a great deal of political uncertainty, but also involved large changes to spending and tax policy. The current government funding and debt limit debates may have less economic impact, as they appear to involve more political than policy uncertainty. Despite current legislative efforts to defund Obamacare, such defunding seems very unlikely, and no other major policy changes are being debated, at least so far. Also mitigating the economic impact of the current debate is that businesspeople, consumers and investors appear to be increasingly desensitized to the political vitriol with each budget battle.

5 Leduc and Liu conclude that "without policy uncertainty, the unemployment rate in late 2012 would have been close to 6.5%, 1.3 percentage points lower than the actual rate." See "Uncertainty and Slow Labor Market Recovery," Leduc and Liu, Federal Reserve Board of San Francisco Economic Letter, July 22, 2103. http://www.frbsf.org/economic-research/publications/economic-letter/2013/july/us-labor-market-uncertainty-slow-recovery/ In a study by Macroeconomic Advisors for the Peterson Institute, they conclude that since late 2009, fiscal policy uncertainty has "lowered GDP growth by 0.3 percentage points per year, and raised the unemployment rate in 2013 by 0.6 percentage points, equivalent to 900,000 lost jobs." See more at: http://pgpf.org/sites/default/files/10142013-the-cost-of-crisis-driven-fiscal-policy.pdf

6 Chinese investors own $1.3 trillion in Treasury debt, and Japanese investors an additional $1.1 trillion. Together they own almost 20% of the outstanding publicly traded Treasury debt. Global investors in total own about half of publicly traded Treasury debt. See: http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt

7 Moody's continues to maintain its Aaa rating on Treasury debt. Moody's Analytics is a separate independent subsidiary of the Moody's Corp. with an arm's-length relationship with the rating agency, Moody's Investors Service.

8 This estimate is based on the same structural vector autoregression model used to determine the impact of increased political uncertainty on economic growth.

9 Treasury will be able to use "extraordinary measures" to keep borrowing probably through mid-March. It is possible, although less than likely, Treasury may be able to keep paying all of the government's bills until April when it has a large cash surplus. If so, the Treasury would probably miss its first payment sometime in May or June.

About the Author

Mark Zandi

Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, *Meet the Press*, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis,* is described by the New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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Moody's Analytics added Economy.com to its portfolio in 2005. Now called Economic & Consumer Credit Analytics, this arm is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.

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