

## A Federal Shutdown Could Derail the Recovery



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- Odds are uncomfortably high that the federal budget impasse will prompt a government shutdown.
- The Obama administration has shown significant spending restraint in its recent budget, but House Republicans want deeper cuts.
- While cuts and tax increases are necessary to address the nation's long-term fiscal problems, cutting too deeply before the economy is in full expansion would add unnecessary risk.
- The House Republicans' proposal would reduce 2011 real GDP growth by 0.5% and 2012 growth by 0.2%. This would mean some 400,000 fewer jobs created by the end of 2011 and 700,000 fewer jobs by the end of 2012.
- A government shutdown lasting longer than a couple of weeks would do much more damage to the economy.
- Lawmakers are likely to split the difference between the administration and House Republican proposals. This isn't ideal fiscal policy, but the economy will be able to manage through it.
- A compromise could send an encouraging signal about the more serious budget battles to come.

The political war is intensifying over the federal budget. Lawmakers are at loggerheads over how to cut government spending, raising prospects that government services will halt temporarily while the debate is resolved. Significant government spending restraint is vital, but given the economy's halting recovery, it would be counterproductive for that restraint to begin until the U.S. is creating enough jobs to lower the unemployment rate. Shutting the government for long would put the recovery at risk, not only because of the disruption to public

services but also because of the potential damage to consumer, business and investor confidence.

### **The near-term fight over funding**

Washington's most immediate battle is over near-term government spending. The catalyst is the chance of a federal shutdown March 4, when current funding will run out. The Obama administration's recently unveiled budget plan calls for significant spending restraint through the remainder of this fiscal year, but House Republicans want even greater cuts. Their proposal would cut spending by about \$100 billion more than in the administration's plan and would put spending \$60 billion below fiscal 2010 levels.

It is laudable that policymakers are focused on reining in government spending. Much greater cuts will be needed, along with tax increases, to address the nation's daunting long-term fiscal challenges. Even under the most optimistic assumptions, the current fiscal year's deficit will exceed \$1.3 trillion, equal to 9% of GDP. If the economy continues to improve as anticipated, and there are no significant policy changes, the deficit will shrink over the next few years, settling around a level equal to 5% of GDP. This is the so-called structural budget deficit. Left alone, it will cause interest payments on the nation's debt to balloon, producing a fiscal crisis. Policymakers will eventually need to cut annual spending and/or raise taxes to shrink the deficit by \$400 billion, bringing it down to a sustainable level at no more than 2.5% of GDP.

### **Too much cutting too soon**

While long-term government spending restraint is vital, and laying out a credible path toward that restraint very desirable, too much cutting too soon would be counterproductive. The economy is much improved and should continue to gain traction, but the coast is not clear; it won't be until businesses begin hiring aggressively enough to meaningfully lower the still-high unemployment rate. The economy is adding between 100,000 and 150,000 per month—but it must add closer to 200,000 jobs per month before we can say the economy is truly expanding again. Imposing additional government spending cuts before this has happened, as House Republicans want, would be taking an unnecessary chance with the recovery.

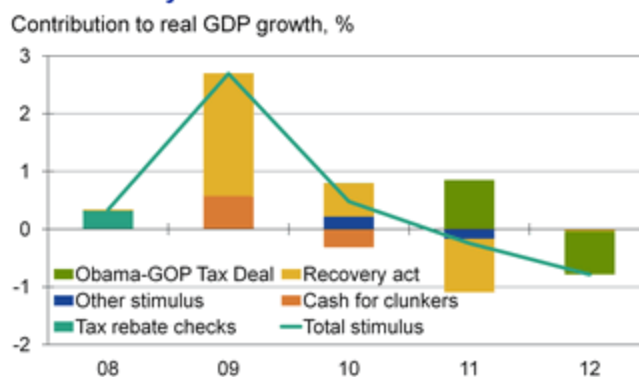
This is particularly true given the added threat presented by rising oil prices. Unrest in the Middle East has pushed up the price of crude oil by about \$10 per barrel; West Texas Intermediate is selling for almost \$100 per barrel, and a gallon of regular unleaded gasoline has risen to about \$3.25 nationwide. If sustained, these prices will shave about 0.2% from real GDP growth in 2011, a disappointing but manageable outcome. If oil prices approach \$125 barrel, and gasoline reaches \$4 per gallon, growth will slow sharply and unemployment will begin rising again. Should fuel prices return to their all-time high near \$150 per barrel for oil and \$4.50 per gallon for gasoline, the economy would sink back into recession. Such a price spike seems unlikely, but handicapping events in the Middle East with any precision is practically impossible.

### **Policy at odds with itself**

Additional spending cuts would also be at cross-purposes with the government's other economic policies. The Federal Reserve is holding short-term interest rates close to zero and purchasing hundreds of billions of dollars in long-term Treasury bonds, in an effort to hold down long-term interest rates. The Fed's credit-easing efforts are scheduled to continue through June, and the central bank is likely keep interest rates near zero through 2011. Monetary authorities clearly remain nervous about the economy's near-term prospects.

The tax cuts and benefit extensions lawmakers agreed to late in 2010 are also providing substantial temporary support to the economy. In addition to extending marginal personal tax rates for two years, the deal provided for a 2% payroll tax holiday in 2011, an extension of emergency unemployment insurance benefits through the end of the year, and—perhaps least appreciated in terms of its economic impact—the expensing of all business investment this year. The deal ensured that fiscal policy, which would have significantly weighed on the economy in 2011, will be largely neutral instead. Fiscal restraint was appropriately put off until 2012, when the expansion is likely to be in full swing.

## Fiscal Policy Turns Restrictive



Source: Moody's Analytics

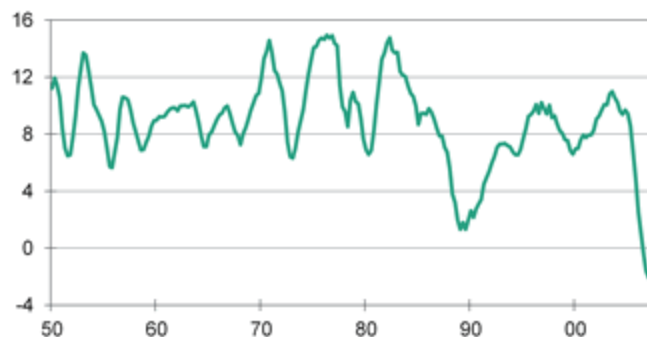
While the government spending cuts proposed by House Republicans for this fiscal year mean only modest fiscal restraint, this restraint is meaningful. If fully adopted, the cuts would shave almost 0.5% from real GDP growth in 2011 and another 0.2% in 2012. There would be almost 400,000 fewer U.S. jobs by the end of 2011 than without the cuts and some 700,000 fewer jobs by the end of 2012. The fallout will extend into next year because it takes time for budget cuts to filter through the economy. In all likelihood, the proposed House cuts would not undermine the current recovery; still, it is not necessary to take the chance.

### No crowding out yet

This wouldn't be true if the current budget deficits were crowding out private investment, but they aren't. Business demand for credit has recovered modestly, and households continue to lower their debt obligations. Interest rates also remain extraordinarily low. Some of this is due to the Fed's credit easing, but global investors also remain willing buyers of U.S. debt even at low interest rates. Ten-year Treasury bonds are yielding 3.5%, fixed mortgage rates are near 5%, and borrowing costs for below-investment grade, or "junk", corporate bonds are 8%—about as low as they have ever been. Global investors won't remain avid buyers of U.S. debt for long if policymakers don't tackle the nation's long-term fiscal problems; yet markets today appear unconcerned about the near-term deficits.

### No Evidence of Crowding Out

Private nonfinancial credit market debt outstanding, % chg yr ago



Source: Federal Reserve Board

This could change if policymakers remain deadlocked and the government suffers a prolonged shutdown. The 1995-1996 experience suggests that a brief shutdown need not be disruptive; in those years, nonessential functions of the government were stopped briefly twice after the Clinton administration and the Newt Gingrich-led House reached an impasse. By that measure, a week-long shutdown in mid-March of 2011 would cost the economy about 0.2% in annualized real growth in the first quarter. Growth would rebound in the second quarter, and there would be no discernible impact by year's end.

A shutdown that lasted into April would be a problem, however. Not only would this disrupt a wide range of government operations and significantly cut the output of government workers, but the hit to confidence could be serious. Consumer, business and investor sentiment is much improved from the depths of the recession, but it remains extraordinarily fragile. A government shutdown lasting more than a week or two could easily undermine confidence as questions grow about policymakers' ability to govern. This would be fodder for a new recession.

### Hitting the debt ceiling

Even more disconcerting would be a shutdown emerging from an impasse about the federal debt ceiling. Judging from the Treasury's near-term financing needs, the current debt ceiling will become a binding constraint on government operations no later than June. The longer it takes Congress to raise the ceiling,

the greater the fallout on financial markets and the economy. Global investors who own Treasury debt will receive their interest and principal payments, but the spectacle of legislative gridlock on this issue may convince markets that U.S. policymakers will have even more trouble making hard future policy choices. Interest rates could spike, stock prices and the value of the U.S. dollar could fall, and the economy would suffer severe harm.

While these dark scenarios highlight the threat of a serious policy misstep in the next several weeks, the very seriousness of the threat improves chances that policymakers will come to terms. The most likely scenario is thus a political compromise that roughly splits the difference between the administration and House Republican proposals, with spending cuts in fiscal 2011 of closer to \$30 billion.

This isn't ideal fiscal policy, but the economy will be able to manage through it. And if the compromise is reached relatively gracefully, it could send an encouraging signal that policymakers can navigate the much more difficult budget battles still to come.

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