Not So Fast: U.S. Recovery Falters as Fiscal Cliff Looms

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The U.S. economic recovery struggled to maintain its footing last year, rocked by a series of shocks that included the Arab Spring's oil price spike, the earthquake and tsunami in Japan, the U.S. debt ceiling debacle and subsequent credit rating downgrade, and the broadening of the euro-area debt crisis to Spain and Italy.

Despite all that, economic data at the turn of the year provided grounds for optimism that the expansion was moving onto a stronger growth track as the impact of these setbacks faded. Real gross domestic product (GDP) expanded at a 3% annual rate in the fourth quarter of 2011, and employment growth rose to an average of 205,000 per month in the three months through February of this year from a 123,000 average over the prior three-month span.

Most recently, however, job growth has fallen below 100,000 per month, and GDP growth has slowed to a 2% annual rate, raising concerns about another spring/summer slump. Though modest, the steadiness of the growth profile suggests that the recent downshift in job growth owed more to unusually warm winter weather (which pulled forward jobs that would normally show up in spring data) than to an underlying loss of momentum.

Silver Linings?

Moreover, there are underlying reasons for optimism amid the change in sentiment. As the overhang of vacant housing units began to recede more quickly last year, for example, new housing construction finally began to move higher. After reducing the annual rate of real GDP growth by a full percentage point in the three years to mid-2009, and contributing nothing to the first two years of the recovery, residential construction began to contribute modestly to growth last fall.

Similarly, as household deleveraging progresses, the weight of debt service on consumer finances has eased. Total principal and interest payments on mortgage debt and non-mortgage consumer credit fell to 11% of disposable income in the first quarter of this year—a 16-year low. Less income going to pay off previous purchases leaves more money for current purchases.

Yet the housing headwind has not entirely subsided and should keep real GDP growth in a 2.0% to 2.5% range through next year. There are still roughly one million more vacant housing units than would be normal relative to the current housing stock. This persistent overhang, while receding, will continue to dampen the pace of recovery for the foreseeable future.

Housing recoveries from deep recessions typically add 1.0 to 1.5 percentage points to the annual rate of GDP growth; we expect about a 0.5-percentage-point contribution through 2013.

In a similar vein, the improvement in consumer finances has been significant, but there is substantial deleveraging still to come. Household debt has fallen to 104% of disposable income, 20 percentage points below its mid-2007 peak but still 20 points above the level that prevailed before the 2000s debt boom. The sustained focus on debt reduction means that consumer spending growth will not get the credit boost typical of previous recoveries.

Developments in the business sector also are sending mixed messages. Corporate finances are relatively healthy after aggressive restructuring during the recession and early stages of the recovery. Firms have cut their interest costs to historic lows, and profit margins are at all-time highs. But elevated uncertainty in the outlook appears to be a significant factor weighing on business decision-making, including hiring and capital expenditures.

The Fiscal Cliff

Another major source of uncertainty and risk in the outlook is the so-called fiscal cliff of tax increases and spending cuts scheduled to take effect next year.

The expiration of the Bush-era tax cuts and the more recently enacted payroll tax holiday, the extension of federal emergency unemployment benefits, and the imposition of across-the-board spending cuts (sequestration) triggered by the failure of the congressional "super committee" to reach a long-term deficit reduction deal last fall collectively would amount to a tightening of fiscal policy equal to roughly 3.0% of GDP.

The Fiscal Cliff

Congressional Inaction Could Slash Gross Domestic Product (GDP) in 2013

Expiring Provision	$ Billions	% of GDP
Employer payroll tax reduction	110	-0.7
Unemployment insurance	50	-0.3
Bush-era tax cuts: upper income	50	-0.3
Bush-era tax cuts: moderate income	150	-1.0
Mandated spending cuts	75	-0.5
TOTAL	**$435**	**-2.8%**

Sources: Bureau of Economic Analysis, Haver Analytics, Congressional Budget Office, J.P. Morgan, Macroeconomic Advisers, Nomura, and T. Rowe Price.

Policymakers are aware that such a blow could well tip the economy back into recession. We—like most forecasters—assume that about half of the force of these measures will be deferred into 2013. An additional 12-month extension of the Bush-era tax cuts would fit this bill. Alternatively, an extension of just the middle-income tax cuts and a deferral of the super committee budget sequestration would have a similar impact.

It is possible, but not likely, that Congress will craft a cliff-reducing agreement this year. Certainly, competing views on how to avoid this wall of tax increases and spending cuts will be a prominent issue in this year's election. More probable would be an agreement during the lame-duck session of Congress to delay the impact of all of these measures for three to six months, leaving them for a new Congress and presidential administration to address.

This breather would avoid the near-term fiscal tightening and might also encourage a change in the terms of the debate. In the first instance, this would mean resorting less to short-lived tax and spending measures that recur as political and economic issues and hamper planning in the private sector (and economic growth in turn).

Beyond this change of mindset, the crux of a politically acceptable "grand bargain" to curb budget deficits and stabilize the national debt over time has two essential elements: (1) cutting the growth of expenditures, with a focus on entitlement reform, and (2) raising tax revenue, with an emphasis on broadening the tax base by restraining increases in statutory tax rates while reducing tax breaks such as certain deductions and exclusions.

Fiscal Reform

The need for fiscal reform is evident. Federal government expenditures spiked from 18.5% of GDP in mid-2008 to 23.5% from mid-2009 to late 2010. That ratio has since fallen to 22% and should slide further in the near term.

However, according to the Congressional Budget Office, expenditures will trough at 19.3% of GDP—a full percentage point above their historical average—before rising unremittingly as fast-growing entitlement spending consumes an increasing share of national income.

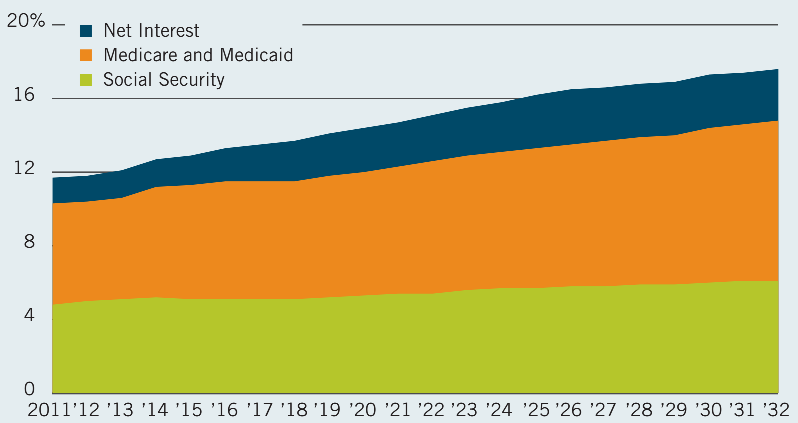
With an aging population and relatively high medical care inflation, outlays for Social Security, Medicare, Medicaid, and interest on outstanding debt will consume a growing share of national income, rising from 10.4% of GDP currently to 12.6% in 2022 and 14.8% in 2032. (See chart below.)

On the other side of the ledger, U.S. general government tax revenues (encompassing federal, state, and local levels) at 32% of GDP is one of the lowest rates of collection of the 31 developed countries in the Organization for Economic Cooperation and Development. Last year, federal government revenues were a historically low 15.4% of GDP compared with the historical average of 18.2%.

There seems to be growing recognition of the need to avoid the looming fiscal cliff and a self-inflicted economic wound at the turn of the year. Beyond that, meaningful progress toward structural reform of our entitlement programs and tax code that promises longer-term budget sustainability could give the economy a more immediate lift by reducing uncertainty and boosting confidence.

Adjustments in the household and business sectors are laying the groundwork for sturdier growth over time, and the Fed has already contributed much of what it can to ensuring a stronger recovery. Supportive fiscal policy choices could prove to be the linchpin to a faster recovery.

U.S. Mandatory Outlays as a Percent of GDP



Source: Congressional Budget Office.

General Government Revenue for U.S., Selected OECD Countries

Country	% of GDP*
Norway (highest)	56.7%
Euro area	44.8
Germany	43.7
United Kingdom	40.1
Canada	38.5
Total OECD	36.5
United States	**31.7**
Australia	31.6
S. Korea (lowest)	31.4

*Based on 2010 annual data.

Source: Organization for Economic Cooperation and Development (OECD).

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