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Westpac Institutional Bank

United States fiscal folly

Default temporarily averted. Now what?

- **US lawmakers have agreed on a package of fiscal reforms as part of the deal to raise the debt ceiling.**
- **The announced package does nothing to stabilise, let alone improve, long-term fiscal health. Instead it just delays necessary remedial fiscal action, yet again.**
- **In light of Friday's deep negative GDP revisions, which describe a deeper recession and a far more timid recovery, it seems unlikely that the US can simply wait to passively grow out of this problem.**
- **The conclusion is that it seems that the financial and economic instability associated with the fiscal malaise** *at all levels of Government* **has a considerable way to run.**

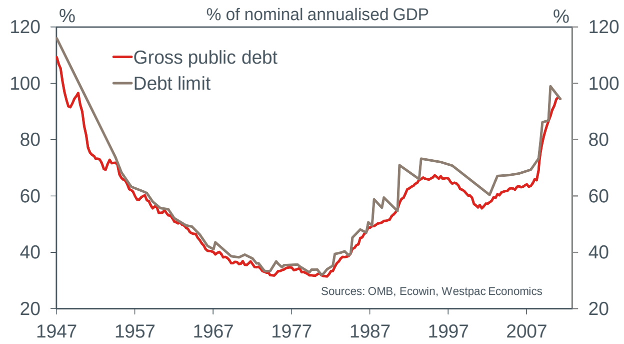
President Obama and Republicans in Congress have finally struck an agreement on raising the debt ceiling. The deal itself – as best we can tell – provides for an immediate $900bn increase in the debt ceiling and an additional 2012 debt ceiling increase of at least $1.2trn. It is hoped that the cumulative $2.1trn increase in the ceiling should see the US through until after the 2012 election.

To offset the initial increase in the debt ceiling, the plan proposes $917bn in spending cuts over the coming decade. The second tranche of the deal will be offset by dollar for dollar savings over the coming decade. The plan is for these savings to be found via a newly established committee; if not, the legislation calls for mandatory spending cuts across a number of areas.

Regardless of the specific details, as it stands, this package cannot even be regarded as a baby step towards a grand bargain. It does nothing to help stabilise the long-term fiscal position. Rather, by pushing announced spending cuts out beyond the political horizon, it just prolongs the 'delay and dither' status quo.

From our perspective, the raising of the debt ceiling, which should be a minor administrative matter, has taken on far too much prominence. The fundamental issue is that there still seems to be next-to-no political will to face the US economy's underlying macro-financial issues – this is a huge concern.

The debt ceiling: formality becomes a debacle



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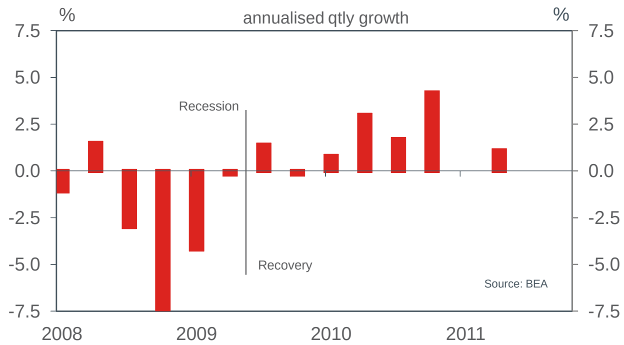
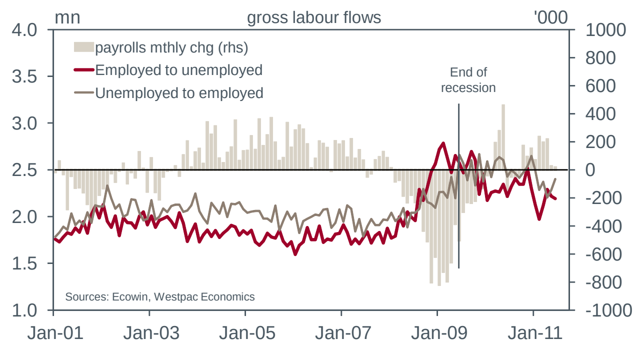


Jobs growth mainly due to less firing



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Before discussing the very poor state of the US fiscal situation, it is important to highlight the current state of the economy. After all, income, activity and asset prices are what determine government revenue growth (or the lack of it). Since the official baseline revenue forecasts (discussed below) were compiled, the US economy has under performed, particularly on the jobs front. As such, they should perhaps be regarded as the ceiling for possible outcomes, and an optimistic ceiling at that. This is particularly true on the revenue front, which depends principally on jobs.

The economic context

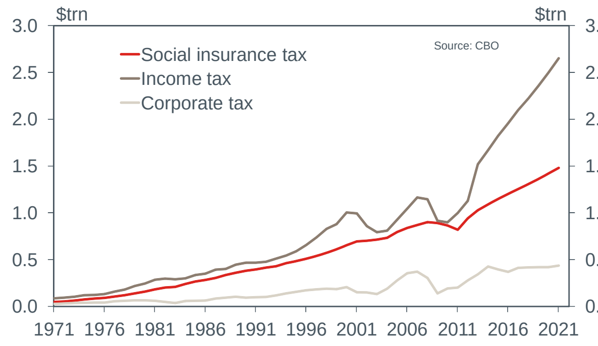
We have long held the view that the US economy would under perform. Briefly, we expected that growth would remain soft owing to a need for households to deleverage and weak, spasmodic job creation that would be insufficient to lower the unemployment rate in a material way.

That being our starting point, it is saying something when we indicate that the scale of the Bureau of Economic Analysis' annual revisions went beyond our pessimistic expectations. The level of real GDP as at March 2011 was revised down by $216bn, or 1.6%. While the revisions stretched back to 2003, the vast bulk of the markdowns were from the beginning of 2008 to Q1 2011. The US economy is now estimated to have contracted by –0.3% in 2008 (previously 0%) and by –3.5% in 2009 (previously –2.6%). By sector, broad-based downward revisions to personal consumption expenditure on non-durable goods and services were the primary driver of the overall revisions. Gross private domestic investment was also marked down; non-residential construction and equipment investment both proved to be weaker than initially estimated, but they were not marked down as much as consumption.

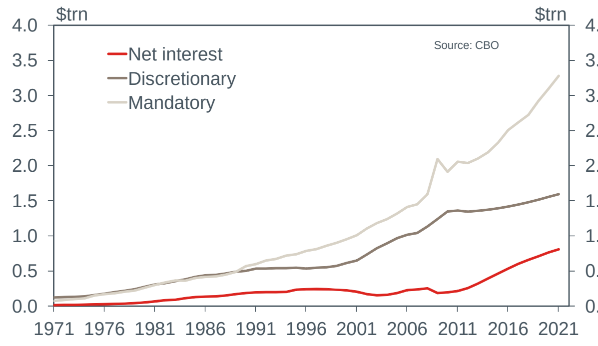
Although the year-average outcome for 2010 was broadly unchanged at 3.0%, abstracting from base effects we see that growth through 2010 and into 2011 proved to be much weaker than initially estimated. Of particular note: Q4 2010's 3.1% annualised outcome was revised down to 2.3%, due to softer consumption and government spending; and Q1 2011 was revised from a 1.9% annualised outcome to just 0.4% – this is but a third of the bottom-of-the-range 1.2% forecast for the advance release we compiled back in April. All told, this indicates that the recession was particularly deep (and more in line with the scale of contraction seen in other major developed markets) and that the recovery has been historically weak. The December 2007 peak in activity is still yet to be regained two years after the NBER-defined end of the recession (June 2009). Further, while the Q2 outcome of 1.3% annualised was almost exactly as we had forecast, it may also be vulnerable to downward revision.

In light of the new activity profile, it is hardly surprising that we have seen virtually no net jobs created in this recovery. While it is true that the level of payrolls employment is 524k higher than at the end of the recession, this is only due to the 757k jobs created in the past six months. The reason this is a concern is that these outcomes are yet to pass the filter of the benchmark revision process; in recent years, this

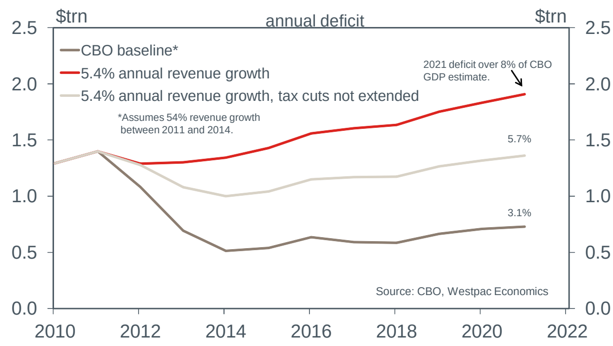
Government expect revenue to pick up - a lot



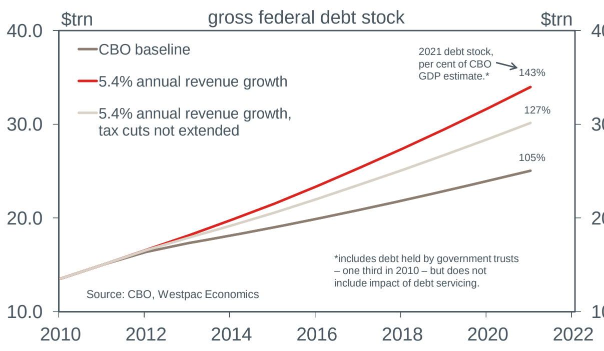
Spending is dominated by mandatory outlays



Weak revenue + strong outlays = big deficit



Debt dynamics could be explosive

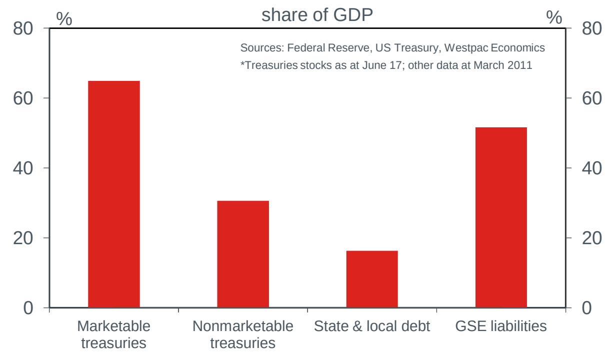


process has led to large downward revisions to the level of payrolls employment as jobs assumed to have been created in new firms were shown to have never existed – the business births/deaths adjustment for the past six months currently stands at 402k.

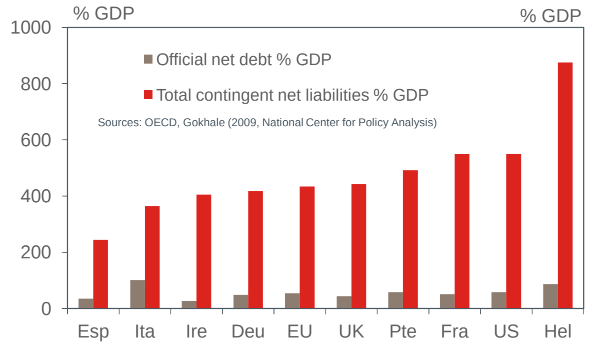
Given the frailty of the payrolls estimation procedure, it is constructive to look to the household survey for a clearer read on the labour market, despite its inherent volatility. According to the household survey, 644k jobs have been lost since the end of the recession. Granted, much of this decline is due to the 445k jobs lost in June, but even if we ignore this read, that still leaves the level of employment 200k lower than at the end of recession.

It is little comfort that the unemployment rate is currently near the level expected by the Congressional Budget Office (CBO) in 2011. This is only so due to the continued decline in the participation rate: had it been unchanged since the end of the recession, the unemployment rate would be 10.6%; had it remained unchanged since the beginning of the recession, the unemployment rate would be 11.8%. Clearly the labour market is not in good shape and by extension the budget's automatic stabilisers are not providing the kind of bottom line fiscal improvement one might expect at this point of a typical post-war recovery.

Marketable debt significant, but not whole story



Current liabilities are an even bigger issue



An absence of revenue amidst an abundance of spending

We have long seen the raising of the debt ceiling as being merely a procedural matter; the real area of concern is the ongoing disconnect between outlays and revenues and what that means for the future debt and deficit trajectory.

There is a gaping disconnect between federal revenue and outlays as well as between the CBO's growth assumptions and reality (as proxied by history).

A historically-weak recovery is extremely unlikely to bring about a historically-strong increase in revenue: particularly not the 54% increase over the three years to 2014 that the CBO forecasts (based on expected strong jobs growth and the cessation of the Bush tax cuts). Both of these assumptions are highly questionable. Indeed, given the Federal government's reliance on income and social insurance taxes – both of which are levied on the employed individual – even the 5.4% annual revenue growth seen historically (which compounds to a 17% increase over three years) seems like it will be difficult to achieve.

Given the entrenched nature of much of Federal spending – specifically the sacred status of defence and the lack of political consensus on reducing the already relatively (un) generous social welfare system – an undershoot on the revenue side would see the annual budget deficit beyond FY2011 slowly trend up towards $2trn. This is a stark contrast to the sub-$1trn deficits that both the White House and CBO publicly expect. Further, it shows that the cuts associated with yesterday's debt ceiling increase to be of marginal benefit – at best. The $2trn figure does not include any additional interest expense incurred on borrowings above the CBO baseline. [As a reference point, every basis point increase in the average yield on the federal debt translates into a little over $1bn in added servicing costs.]

In terms of the gross debt stock, the net effect of such a deficit trend would be a gross liability of more than 140% of GDP by 2021 – this includes marketable and non-marketable US Treasury's (USTs). How much more will depend on how far the actual activity profile deviates from that assumed by the CBO.

Fiscal issues are magnified at the sub-national level

Unfortunately, there is further cause for concern at the state & local government (SLG) level. SLG spending has contracted by 2.5% over the past year and by 4.4% since the end of the recession. This reduction in spending has largely come about through large-scale job losses in essential services and administrative areas – they now total over 500k. Looking forward, state governments need to close an estimated $100bn budget gap in FY2012 – in part due to the end of Federal government support. At the local level, nominal growth in local government's primary source of revenue (property taxes) has all but stalled, putting them in a precarious position.

While it is not our expectation that we will see large scale local government defaults and/or demands from state governments for a default mechanism for themselves in the near term, both levels of government will remain under severe financial pressure. As a result, it seems almost certain that

SLGs will continue to weigh on activity and job growth with pro-cyclical policies.

A final point on inter-generational equity

The above discussion largely focused on official liabilities. Contingent liabilities are in fact many times larger: although they are hard to measure precisely owing to their open-ended nature. Future pension and health benefits are the major items. At the SLG level, the Centre for Retirement Research – as cited by the CBO – points to SLG pension liabilities being underfunded to the tune of $2 to $3trn at present – the scale of this liability is comparable to the total outstanding official debt of the SLGs.

At the Federal level, 90% of the assets of the main pension fund – the G fund – are government debt. Herein we see that the prospects of current and future pensioners are intimately tied to the solvency of the sovereign. Further, it points to a time when it will be necessary to sell these 'non-marketable' Treasuries to provide for pension outlays as they exceed income flows from the stock. It is either that or actually use social insurance taxes to pay out benefits, as originally intended. Finally, long-run Federal health liabilities are difficult to estimate, but with an ageing population they are likely to be multiples of annual GDP.

In sum, given all of the above, there are a multitude of reasons to be very concerned about the fiscal health of the US. The state of the economy - summarised in the sluggish labour market - highlights the difficulty. A material change in attitude among politicians and policymakers is required.

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