Moody's
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U.S. Fiscal Cliff Alternative Scenarios

FROM MOODY'S ANALYTICS

Essential expertise on the economic and consumer credit trends that impact your business and investments.

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U.S. Fiscal Cliff Alternative Scenarios

Whoever wins November's elections will have two big decisions to make by early 2013. The first is what to do about the fiscal cliff scheduled to hit next year. The second is how to achieve fiscal sustainability; that is, what long-term tax and spending changes will make future budget deficits small enough so that the nation's debt-to-GDP ratio stabilizes. What lawmakers decide will determine how the economy performs next year and for many years to come.

The fiscal cliff describes what will happen if the Bush-era tax cuts, this year's payroll-tax holiday, and the emergency unemployment insurance program all expire on schedule, just as government spending drops according to the terms of last summer's deal to raise the Treasury debt ceiling. Those would be on top of several temporary tax and spending adjustments that Congress normally extends each year, affecting the Alternative Minimum Tax (the so-called AMT patch) and Medicare's reimbursement schedule for doctors (known as the Medicare doc fix). If lawmakers do nothing before the end of the year, the resulting tax increases and spending cuts will total $728 billion in calendar year 2013, equal to 4.6% of GDP.

Fiscal sustainability is achieved when the national debt can be projected to grow roughly in line with GDP. The Great Recession, by contrast, resulted in a near doubling of the debt-to-GDP ratio over the past five years. Without changes to fiscal policy, the debt load will continue to outpace growth, ultimately triggering a financial crisis. Under reasonable economic assumptions, policymakers need to reduce the federal government's annual budget deficits by $3 trillion over the next decade to achieve fiscal sustainability.

This amount includes the $1 trillion in spending cuts agreed to as part of last summer's increase in the Treasury debt ceiling, but not the $1 trillion in automatic spending cuts, known as sequestration, that also were part of that deal. If the necessary changes are made, deficits later this decade will equal no more than 3% of GDP. Given the expected pace of GDP growth, that will stabilize the debt-to-GDP ratio.

Fiscal Cliff (“Cliff”) Alternative Scenario

This scenario has a 15% probability. There is a 30% probability that policymakers will decide to extend current policy and make no changes to tax and spending policy. The most likely scenario, with a 55% probability, is consistent with the Moody's Analytics baseline in which policymakers agree to a middle ground between the “Cliff” and “No Cliff” scenarios.

Policymakers could decide to do nothing, stick to current law, and let the nation go over the fiscal cliff. This, at least on paper, would solve the fiscal sustainability problem; higher tax revenues and lower spending would rein in future budget deficits enough to stabilize the debt-to-GDP ratio. But the cost would be another recession in 2013. Even a healthy economy would be unable to weather the fiscal headwinds this choice would generate.

The “Cliff” scenario shows that without a change in current law, real GDP for calendar year 2013 would fall 2.8 percentage points below what it would be if current policies were extended next year. This would bring a new recession early in 2013, pushing unemployment up to 9.2% by year's end. While the economy would regain its footing as the year progresses, GDP will remain nearly flat. This projection is similar to one made by the Congressional Budget Office.

Yet, this outlook may be too optimistic, and risks are decidedly to the downside. The U.S. economy is extraordinarily fragile, and with unemployment still above 8%, there are scenarios in which the recession would be deep enough to raise the unemployment rate beyond 10%. The Federal Reserve would be in no position to respond by lowering interest rates, as they already are exceptionally low. Fiscal policymakers likely would not respond, potentially reinforcing recessionary pressures. The economy's growth could be weak enough to negate the initial positive effect on fiscal sustainability.

No Fiscal Cliff ("No Cliff") Scenario

This scenario has a 30% probability. There is a 15% probability that policymakers will do nothing and let the nation go over the fiscal cliff. The most likely scenario, with a 55% probability, is consistent with the Moody's Analytics baseline in which policymakers agree to a middle ground between the "Cliff" and "No Cliff" scenarios.

Policymakers could decide to avoid the fiscal cliff altogether and extend current policy so that there will be no changes to taxes and spending in 2013. The U.S. economy would improve next year as a result, but there would be no progress toward long-term fiscal sustainability. Credit ratings agencies would likely downgrade U.S. Treasury debt, and subsequently other institutions supported by the federal government, including state and municipal governments and systemically important financial institutions.

Standard & Poor's downgrade of the nation's credit rating last summer, during the fight over the Treasury debt ceiling, had little material effect on financial markets. That would not be the case if all the ratings agencies acted together. Many money-market funds and other investment vehicles are committed to hold only the very highest quality bonds. Even without any action by the ratings agencies, a failure to make progress toward fiscal sustainability would signal that policymakers will not act until the budget is out of control and the nation is in a serious financial crisis.

Punting would help the economy in 2013 but would significantly weaken the fiscal and economic outlooks over the longer term. Running this scenario through the Moody's Analytics model shows real GDP expanding 2.9% in 2013, but meaningfully less than under the "Cliff" scenario over the next half-decade. Additionally, the unemployment rate would remain stuck above 6%. The balance of risks is again weighted to the downside, since fiscal sustainability becomes harder to achieve with a weakened economy and a higher debt load.

About Moody's Analytics
Economic & Consumer Credit Analytics

Moody's Analytics helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. Through its team of economists, Moody's Analytics is a leading independent provider of data, analysis, modeling and forecasts on national and regional economies, financial markets, and credit risk.

Moody's Analytics tracks and analyzes trends in consumer credit and spending, output and income, mortgage activity, population, central bank behavior, and prices. Our customized models, concise and timely reports, and one of the largest assembled financial, economic and demographic databases support firms and policymakers in strategic planning, product and sales forecasting, credit risk and sensitivity management, and investment research. Our customers include multinational corporations, governments at all levels, central banks and financial regulators, retailers, mutual funds, financial institutions, utilities, residential and commercial real estate firms, insurance companies, and professional investors.

Our web and print periodicals and special publications cover every U.S. state and metropolitan area; countries throughout Europe, Asia and the Americas; and the world's major cities, plus the U.S. housing market and other industries. From our offices in the U.S., the United Kingdom, and Australia, we provide up-to-the-minute reporting and analysis on the world's major economies.

Moody's Analytics added Economy.com to its portfolio in 2005. Its economics and consumer credit analytics arm is based in West Chester PA, a suburb of Philadelphia, with offices in London and Sydney. More information is available at www.economy.com.

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