the fiscal mess

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A partial shutdown of the federal government started on October 1, and as of October 7, there is no end in sight. Mandatory spending has continued and essential federal workers have been kept on the job, but roughly 800,000 federal civilian workers have been furloughed and many federal agencies are functionally closed. The House, Senate and president are negotiating to resolve the impasse that caused fiscal year 2014 to start without either a budget or a continuing resolution to fund the government.

Simultaneously, the House, Senate and president are negotiating to increase the federal debt ceiling. In late January, Congress passed a law allowing the Treasury Department to issue debt as needed to fund the government through May 18, 2013. The debt ceiling has not been raised since then, but that has not yet been a problem because of larger federal revenues and "extraordinary measures" taken by the US Treasury to keep the government funded. Such measures cannot last forever. Sometime in the second half of October, the US Treasury, lacking the legal power to borrow more, will run out of the capital necessary to pay federal bills, meet the interest payments on federal debt, and fund many federal programs. In that event, a severe shutdown would start, and the government would enter a state of "technical default" on its obligations.

Anxieties over this fiscal mess have unsettled financial markets. In 9 of the 11 trading sessions from September 19 to October 3, the *S&P 500® Index* fell. Treasury yields and commodity prices also declined somewhat. Things may yet get worse before they get better.

How will this fiscal mess play out? Below, we present three plausible scenarios for the resolution of the current crisis.

SCENARIO #1: A DEAL IS MADE

Our baseline scenario, to which we assign a 70% probability, is that the House and Senate negotiate a compromise deal that is acceptable to the president. This would involve passing a continuing resolution, which would end the federal shutdown and keep the government operating at current levels for at least six months. The deal would also raise the debt ceiling enough to allow the Treasury to keep borrowing what it needs into summer 2014. There would be no default.

We expect this deal will be reached during the Columbus Day weekend. The federal shutdown would have lasted two weeks. After a deal is announced, there will likely be a relief rally in the stock market. Long Treasury yields could rise on greater economic optimism, but risk spreads should narrow somewhat.

We estimate that a two-week shutdown would reduce real GDP growth by roughly 0.3 percentage points (annualized) in the fourth quarter of 2013, with a similar addition to growth in the first quarter of 2014 as things return to normal. We doubt there will be much impact on private-sector payrolls. In our view, the Fed decided not to taper its quantitative easing program (QE) at the September Federal Open Market Committee meeting largely because of serious concerns about the impending fiscal mess.

The downside to this scenario is that there could be another fiscal mess in the summer of 2014 as both political parties use budget issues to sharpen their differences heading into the mid-term elections of 2014. We would see another round of unsettled markets.

SCENARIO #2: KICK THE CAN DOWN THE ROAD

A second scenario, to which we assign a 20% probability, is that negotiations over the budget and debt ceiling fail to come to a rapid conclusion. Neither political party wants the shutdown to continue because of popular discontent, and neither party wants to force a default. As a result, the two parties agree to a temporary ad-hoc solution: a short-lived continuing resolution and a debt ceiling hike are passed to end the shutdown and avoid default while negotiations continue. "Short-lived" may mean no more than two to four weeks. The advantage of this scenario is that the economic damage caused by a more prolonged shutdown

and a technical default would be avoided. The disadvantage is that the ongoing tensions of political confrontation would continue, and markets would remain on edge about the possibility of future default. Business and consumer uncertainty would rise, straining the economic recovery.

SCENARIO #3: DEFAULT AND SHUTDOWN

Accidents sometimes happen, even though no one wants them to. This third scenario, to which we assign a 10% probability, is that a political accident happens. In this grim scenario, national politics are so polarized and contentious that neither party is willing to make the necessary compromises to reach a mutually acceptable budget deal. The result is that the partial federal shutdown would last over three weeks. More significantly, the debt ceiling would not be raised, and sometime in late October, the government would delay paying bills and would probably miss some interest payments, creating a technical default. Moreover, the Treasury's legal inability to borrow would force the federal government to adopt a balanced budget essentially overnight, which would force the government to cut spending substantially more than it is currently. There are no financial constraints on the US government's ability to borrow; the US is not Greece. Rather, the issue would be a failure of political will.

No one can confidently forecast what would happen to the US or global economies if the federal government were to drive off this cliff. But, I think we can say that there may well be a financial panic. And the combination of a financial panic, a sudden and sharp cutback in federal spending, and a surge in uncertainty could easily trigger a recession. The Fed may be forced to engage in emergency lending to financial institutions, as it did in 2008, and it might have to buy massive amounts of Treasurys to settle the bond market. The major ratings agencies would likely downgrade US debt.

The economic and financial fallout from default and shutdown would likely be so severe that I believe Congress and the president would act quickly to end the crisis with a budget and debt ceiling deal. The technical default would end, and all debtors would be made whole, including back interest. The analogy here is when, in September 2008, a disgruntled House surprised everyone by voting down the Troubled Asset Relief Program (TARP) legislation, triggering a massive stock market selloff. A few days later, a chastened House voted again and passed TARP, to the relief of markets.

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