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All paths in U.S. lead to parsimony

Jonathan Ernst/Reuters

A man dressed as Captain America poses as dozens of Tea Party supporters rally near the U.S. Capitol against raising the debt limit in Washington, July 27, 2011.

Tim Shufelt Jul 27, 2011 – 6:09 PM ET | **Last Updated: Jul 27, 2011 6:24 PM ET**

All the proposed outcomes of the U.S. debt-ceiling debacle share one constant: fiscal retrenchment.

The viable plans before Congress all include substantial spending cuts, the immediate need for which is now being professed by leadership from both parties, the U.S. President, the ratings agencies and the International Monetary Fund.

What fiscal tightening will mean, however, for the wobbly U.S. economy depends on the timing and severity of the cuts.

“Given the state of the U.S. economy, it’s very, very vulnerable to contractionary shocks, and this is certainly one of them,” said Sherry Cooper, chief economist at BMO Capital Markets.

“They’re running a lot of risks here,” she said, noting a reduction to BMO’s forecast for U.S. growth next year to 2.8% from 3.0%, with room to fall further.

While stimulus spending has contributed to recent trillion-dollar deficits, many economists credit the 2009 stimulus bill for preventing a longer, deeper recession.

“To throw that lever into reverse now, before the recovery is fully established, makes no sense,” Ian Shepherdson, chief U.S. economist at High Frequency Economics, said in a note. “The first thing you learn from studying the aftermath of financial crises is that premature fiscal tightening is extremely dangerous.”

Undoubtedly, the country has been accumulating debt at an alarming rate in recent years.

The deficit for the current fiscal year is forecast to reach US$1.5-trillion, or almost 10% of GDP, which is in the same neighbourhood as Greece’s budget shortfall.

Public debt in the United States has risen by close to 10 percentage points per year over the p ast three years and now exceeds 60% of GDP.

“The U.S. is on an unsustainable trajectory,” said Nariman Behravesh, chief economist with IHS Global Insight. “Without some corrective action, the cost of entitlement programs in particular are going to explode. They have to fix it.”

But that’s not to say the United States does not have time to work with, he explained. “You don’t want to start cuts in the middle of a very sluggish growth period.”

Markets are clearly not urgently concerned with deficit spending as they continue to facilitate government borrowing at very low rates, Ms. Cooper argued.

“The U.S. has no problem financing its deficit. There is no issue around solvency or liquidity,” she said. “It’s very different from the Greek situation, for example.”

Any concern that the United States could have trouble meeting its obligations has not translated into a downgrade of its top-notch credit rating.

At least not yet, said Tad DeHaven, a budget analyst at the Cato Institute. “They’ve gotten away with it thus far, but this is one of those things that could change and change quick.”

The chances of one or more of the three major rating agencies stripping the U.S. of its AAA rating have risen dramatically, in fact, with Standard & Poor’s calling for US$4-trillion in spending cuts over the next ten years.

House Speak John Boehner’s plan, which comes up for vote on Thursday, puts only about US$1-trillion in cuts on the table, with more to later be prepared by a bipartisan panel.

But when compared to annual government spending in the range of US$3.8-trillion, the estimate for fiscal 2011, Mr. Boehner’s proposed cuts of $100-billion a year amount to a “drop in the bucket,” Mr. DeHaven said.

Substantive fiscal restraint, he said, would demonstrate to investors and markets a commitment to restore budgetary balance.

“You’d be heading off the potential for massive tax increases and problems associated with mounting debt. I think that would bring some positive long-term certainty. And the folks that do the hiring and investing prefer to do so on the long-term,” he said.

But the fear remains that considerable tightening could further depress consumer confidence and undercut household spending.

“Consumption makes up two-thirds of the economy, so this is very troubling,” Ms. Cooper said. “If they’re smart, they’ll back-end load it, because the economy is so vulnerable at this stage.”

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