Economics

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US Spending Cuts: what's in store in the next seven months?

The US government on Friday (March 1, 2013) announced its programme of "sequestration", thereby cutting back on $ 85 billion of federal funding over the next seven months (ending October 1, 2013). The significant aspect of this process is that it will not be a one shot affair, but will be sustained over a period of nearly a decade, up to 2021. Therefore, any implication of such a move has to be in the context of the next 8-9 years.

Broadly speaking, defense and non-defense discretionary expenditures of the government would each see a cut of about $ 43 billion during this period; which in percentage terms translates to a 13% reduction in the defense expense bill and 9% of non-defense spending for the government.

Big picture: why the need for sequestration?

President Obama first took to office facing a 10 year deficit of more than $ 8 trillion, which was only accentuated by the recession in the US economy. Simultaneously, spending programmes of the government were faced with problems of duplication and ineffective targeting that reinforced deficit concerns. To further aggravate fiscal issues for the US government, debt levels for the state have reached rather unsustainable levels. As is common knowledge, deficit gaps of governments are bridged through debt borrowings which have ballooned, a dilemma well recognised as the "fiscal cliff" for the US.

As of August 2011, the Budget Control Act (BCA) established the need to put into effect $ 1 trillion of discretionary spending cuts budgeted to aid in deficit reduction by $ 1.2 trillion, also bringing a political debate on the fiscal cliff to a planned consensus. The BCA also included a provision for automatic trigger of sequester effective from January 2013 if no actions were taken.

Budget plans presented by the President for the year 2013 chart out deficit reduction to the tune of $ 1.2 trillion over the next decade (2012-2021) in order to bring the deficits to more sustainable levels, in the range of 3% of GDP, from current levels of 8.5% in 2012 and budget estimates of 5.5% in 2013.

The first step towards this considerable diminution of deficit was taken with the announcement of the sequestration programme effective for seven months.

Impact of sequestering on the US economy

Discretionary spends of the government have generally grown by about 2% annually, implying that a deficit reduction of at least $ 2 trillion by 2021, would entail reducing government spending by more than $ 900 billion during this period.

Defense spending

Discretionary spends for defense, as per the budget for 2013 are estimated to register a contraction of 5% over realised levels of 2012. With sequestering coming into effect now, there is an additional 13%

reduction for such spends under schedule. Various fragments of defense spending would take a hit; for instance, Navy operations and maintenance would contract by nearly $ 3.5 billion, spends on research funding (under the National Science Foundation) would drop by $ 290 million and the Nuclear Regulatory Commission will likely lose $ 52 million. The impact will necessarily be on all related industries through backward linkages.

Non-defense spending

In terms of non-defense spends - education, healthcare and housing are expected to be impacted the most –

- Education-related cuts would aggregate about $ 725 million less, potentially leading to lay-offs of school teachers and staff against an inability to meet associated payroll expenses and benefits
- Medicare payments to health care providers, health care plans and drug plans would witness reduction of 2% in government expenditure and,
- The Affordable Housing Program would see a budget cut of $ 10 million.

Economic growth

Estimates provided by the Congressional Budget Office, suggest that sequestration would result in US GDP dropping by 0.6%. It is also said that it could affect as many as 750,000 jobs. Budget 2013 is based on the underlying assumption of 3% real GDP growth and 1.7% inflation (GDP-chained price index) during the financial year. This would imply that the World Bank and IMF projections of 1.9%-2.0% growth in 2013 for the US appear likely in the face of pull-back in government expenditure.

The unemployment scenario in the US undoubtedly would turn grimmer in the face of such spending cuts. It was estimated earlier that more than 700,000 fewer full time jobs would be created in the next few years. However, with lay-offs increasingly simultaneously, the unemployment rate could settle well above the current rate of 7.8%. Indeed, Budget 2013, excluding the impact of sequestration, has already set the estimated unemployment rate at a high of 8.6%.

Is there an alternative?

Given the deep-rooted adverse impact of sequestration, political forces are bound to clash in the upcoming sessions of the federal government. The Congress is scheduled to release revised budget estimates for remaining part of fiscal 2013 (that ends on September 30, 2013) on March 27, 2013. One can expect some debate on the possibility of replacing the ‘sequester’ with a combination of increased tax revenue from millionaires and ending of agriculture subsidies in the new funding bill. However, given the limited change in taxation policies announced in Budget 2013 and expectation of moderate revenue collections in the face of slowing economic growth, there seems little scope for change in this scheme.

What about QE?

As the US economy continues on a moderate growth path, with employment scenario and labour markets not entirely recovering, speculation on continuance of quantitative easing is abound. With infusion of ample liquidity and low near-zero interest rates, the highly accommodative monetary policy of the Fed would have to be analysed for risk and return and inflation dynamics. Purely based on interest rate structure, US bonds would become relatively unattractive for investors. The Federal Reserve will probably continue with its low interest rate regime.

The dollar however, may continue its upward move, particularly in the context of declining strength of Euro as economic weakness in the Euro zone continues to persist. The general demand for dollars on account of its anchor currency status has further been backed by such adverse movements for the Euro, which partially serves as an alternative currency.

Impact on Global Economy

The US accounts for nearly 22% of World GDP and moderation in the US economy is bound to impact global growth prospects. Estimates incorporating impact of sequestration are expected to be in line with the lower growth estimates presented by both World Bank and IMF for global economic growth, in the range of 2.4%-3.5% in 2013 (and 3.1%-4.1% in 2014). In general, QE has not materially boosted growth and in the event of continuation of such a policy by the Fed, it is felt that growth prospects are not expected to change dramatically.

Developments in the US and Euro economies would have significant impact on sentiments in capital markets and would hence, influence the direction of capital investment flows across countries.

The USA has looked like one of the better performing economies prior to this announcement and was supposed to move up the curve gradually. Any negative development that restricts activity in the U.S. could have a magnified impact on the economic prospects for the rest of the world. As the euro market remains weak, export-oriented economies in Asia and Latin America have become progressively dependent on U.S. demand to lift their exports. Some of these countries such as China, Mexico, Canada, and UK could see a moderation in GDP growth if U.S. demand growth falters as a result of the government spending cuts.

Impact on India

The monetary and fiscal stance adopted in the US would impact growth prospects in India through three routes, namely – trade flows, capital markets, particularly foreign investments and commodity prices.

- The US has accounted for about 10.0%-11.0% of India's exports in the last three years. In the event that sequestration leads to lower consumption demand for imported goods in the US, export flows from India would moderate thereby widening the current account deficit for India. Also, software exports to the US could contract.
  - Depreciation of the rupee against the dollar could further worsen the terms of trade and enlarge the CAD for India, but given the scale of expenditure cuts and our dependence on USA, may not be significant. Therefore, impact on rupee through this route would be limited.
  - But it should be remembered that global trade would slow down in general, which can affect prospects of export oriented economies, which can in turn affect our exports indirectly over a period of time. Therefore, in short run the impact would be muted but could become significant over a longer time frame of 3-5 years.

- Pessimism in US economy would cause funds to move to other countries with the emerging markets expected to benefit the most from such movement of funds. India has so far been a beneficiary of a surge in global liquidity on account of the QE policies pursued by both the Federal Reserve and the ECB. This will continue.
- A slowdown in the USA and similar impulses in other countries which are linked to US prospects would mean that commodity prices would tend to remain bearish for some more time. This would help at the margin to keep imported inflation down for India.

Therefore, the overall impact for India could be marginally positive in the form of continuation of foreign funds flows.

Contact:

Madan Sabnavis
Chief Economist
Madan.sabnavis@careratings.com
91-022-67543489

Krithika Subramanian
Associate Economist
krithika.subramanian@careratings.com
91-022-67543521