

April 11, 2011

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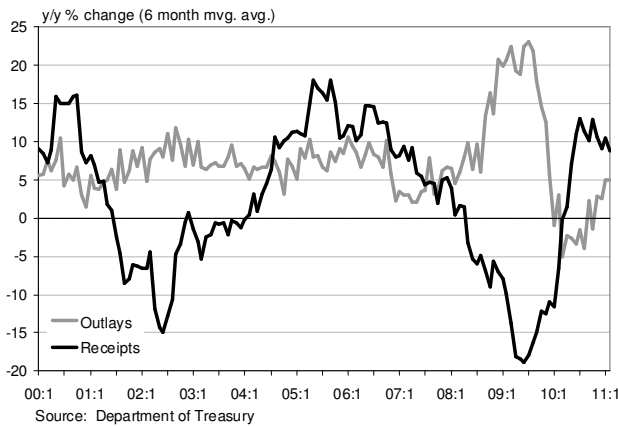
- *Headwinds for economic growth are beginning to increase, but incoming data suggest the economy will remain on an above trend growth path.*
- *Republicans have been emboldened by their success in reducing the 2011 budget. This will lead to a nasty fight over increasing the debt limit, but it is not clear what concessions they can demand from Democrats. The fight will be after the 2011 budget is complete and before the 2012 budget is due.*
- *Fiscal drag from budget cuts is unlikely to be a significant problem, but it does add to other headwinds that are developing.*

Following a week of high drama, the budget crisis has been averted. The Federal government will not shut down – at least not this month. However, the outcome of this fight is quite important. A month ago, the Republican leadership did not imagine they could secure an agreement reducing the budget \$39 billion over the final six months of the fiscal year on top of roughly \$20 billion already agreed upon. Never mind that the numbers are all highly suspect. They measure cuts from dubious baselines that do not represent current policies and they refer to budget authority rather than actual spending. The point is by making a credible threat to close the Government, Republicans obtained much larger cuts than even they thought possible. The terms of the debate have now shifted, and Republicans will move into the next fight emboldened by their success in reducing the 2011 budget.

The next fight will be over the need to increase the debt limit which, according to the Secretary of Treasury, will be sometime between early May and early July. Of course, this fight will be different since there is no threat of a Government shutdown, only the possibility the Government will be forced to stop borrowing. If this occurs, Government spending will be limited to the revenue flowing into the Treasury. In June, July, and August, this inflow is typically \$150 - 250 billion per month. Since interest on the public debt is less than \$35 billion per month and maturing debt can be rolled over without increasing the total debt subject to the limit, there is nothing inevitable about defaulting on the public debt. Still, deferring payment on \$ 50 - 100 billion per month in Government obligations is very serious. Many are concerned Republicans will refuse to increase the debt limit unless Democrats agree to additional large budget cuts.

This concern may be misplaced. While Republicans would certainly like to use the debt limit as a lever to force concessions from Democrats, it is not clear just what concessions they will demand. By the time the debt ceiling is reached, the 2011 budget agreement will have been struck, and the 2012 budget debate will have several months to run before the fiscal year begins on October 1. There will be no big budget issues pending

### Federal Outlays vs. Receipts



forward. If Congress does not increase the debt limit in a timely manner and markets react negatively, Republicans will be unable to dodge responsibility. Damaging the credit of the US government benefits no one.

The next opportunity for closing the Government will be on October 1 when the new fiscal year begins. Again, some type of funding resolution must be in place to allow continued operations. However, the 2012 budget debate will be fundamentally different. The 2011 debate was largely about the amount of money to spend; the 2012 debate will include whether to completely change the Medicare and Medicaid programs. Republicans are pushing for a Medicare overhaul which moves away from a Government run program toward a more market oriented approach. This means a clash between political ideologies that is far more difficult to resolve than a fight over money. Whether Republicans can use the threat of Government closure to win this fight remains to be seen.

One thing is clear: Government support for the economy has begun to decline. Spending cuts agreed to for 2011 are not likely to cause a serious drag this year, but they will be more significant in 2012. Additional cuts in the 2012 budget will add to the restraint. However, the impact should not be overestimated. The largest decline in fiscal support happened in 2010, with a smaller decline slated for this year. The economy has gained strength despite the withdrawal of fiscal support. Fortunately, the economy is now performing well with labor markets continuing to strengthen. New reports last week showed hiring plans rising, new claims for unemployment insurance continuing to drift lower, an increase in demand for temporary workers, and an increase in the Employment Trends index. Retail sales are holding up well and the ISM non-manufacturing index remains strong. High gasoline prices may have caused some consumers to switch from trucks to more fuel efficient vehicles, but total auto sales remain strong.

Fading fiscal support is only one of the economic headwinds that have gained strength over the past few weeks. Higher gasoline prices are another. Inflation, which is edging higher, is likely to become a third. In addition, temporary disruptions from the Japanese disasters will be apparent in Q2 data. These factors will keep investors concerned about the outlook for continued economic growth. While these factors are important, the economy's ability to withstand them is continuing to improve. Above trend growth remains the most likely path for the next year.

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