The Return of Fiscal Policy Uncertainty

The Republican-controlled Congress is writing appropriations bills that imply enough fiscal drag to cause a growth recession in 2016 and abort the anticipated monetary tightening. Given strong Democratic opposition to such spending restraint, a budget impasse is looming that could shut down the federal government this fall but, in any event, is already raising fiscal policy uncertainty—a downside risk to our forecast.

BACKGROUND
Now controlled by the requisite Republican majorities, both the House of Representatives and the Senate earlier this year passed resolutions for the fiscal year (FY) 2016 budget that set top-line numbers for spending and taxes, and differences between the two plans were then reconciled in a Conference Report, marking the first time since 2009 that this stage of the budget process worked as envisioned in the Congressional Budget Act of 1974. The Republican blueprint calls for unspecified tax reform but, even more notable, cuts in non-interest outlays that, between fiscal years 2016 and 2018, would reduce such spending by 2 percentage points of GDP below an updated CBO baseline (Chart 1) that, in FY 2016, anticipates spending will drop to the path established under the March 2013 sequestration order. The Conference Report tilts this spending restraint away from defense expenditures by raising Overseas Contingency Outlays not subject to spending caps.

MACRO IMPACT OF THE CONFERENCE REPORT
Our latest forecast assumes a path for spending similar to the CBO baseline, so adoption of the Republican budget would create much more fiscal drag than we now assume. To estimate the potential consequences, we allocated the spending cuts implied by the Conference Report across main components of federal primary (that is, non-interest) spending and then used our macro model to simulate the impact on key macro variables relative to our current base forecast. The results are summarized in Charts 2 through 6.

Under the spending paths set forth in the Conference Report, GDP growth is reduced 0.9 percentage point in 2016 (to 1.9%) and 0.5 percentage point in 2017 (to 1.8%), both

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2 In our “BASE506” forecast, published July 8, 2015, federal consumption and gross investment subtracts modestly from GDP growth over the horizon of the short-run forecast as discretionary spending retreats to the path implied by the 2013 sequestration order. However, the forecast holds total primary spending as a share of GDP roughly constant through 2017. So, relative to our forecast, the Conference Report implies a reduction in primary spending of $342 billion (at an annual rate) by the end of 2017.
below “trend.” Consequently, the unemployment rate, rather than inching below 5% in 2016 and 2017, rises toward 6%; the model sees this as a growth recession, but in fact the unemployment rate has never risen this much without the economy falling into an outright recession. The extra slack in the labor market interrupts the return of inflation towards the Federal Open Market Committee’s (FOMC) 2% target. Instead, core inflation peaks at 1.8% in 2017 and then subsides towards 1.5%. The implications for monetary policy are potentially dramatic. For example, while no doubt the FOMC’s response would be more nuanced, the stylized monetary rule in our model suggests the Committee would abort the widely expected tightening and be forced instead to push the funds rate back towards zero. The expectation of this reversal in monetary policy would prevent the 10-year Treasury note from reaching the 4% shown in our base forecast; rather, it would peak below 3.5% in 2017 and decline below 3% by 2020.

**LOOMING FISCAL IMPASSE**

Meanwhile, a completely predictable fiscal impasse is building. As of July 15, the House had passed Appropriations Acts for 6 subcommittees and reported bills for 5 more, each consistent with the Conference Report. Democrats object to both the magnitude and allocation (between defense and non-defense outlays) in the spending restraint implied by the Report, and the President has vowed to veto Acts that trim discretionary spending even back to the CBO baseline. It seems unlikely that a compromise on spending can be reached by September 30, the end of the fiscal year. More likely is the adoption of a Continuing Resolution (CR), perhaps through year’s end, that affords time for continued negotiations. While both parties profess a desire to avoid it, a shutdown of the federal government this fall cannot be ruled out entirely.

**FISCAL SPEED BUMPS**

The looming budget impasse is just one aspect of the growing uncertainty surrounding fiscal policy as we approach several other speed bumps on the fiscal road ahead. On March 16 the debt ceiling was re-instated. This has compelled the U.S. Treasury to resort to “extraordinary measures” to meet the nation’s financial obligations, but such measures are projected to be exhausted around the end of this fiscal year. At the end

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3 Commerce, Justice, Science; Defense; Energy and Water; Legislative Branch; Military Construction and Veterans’ Affairs; Transportation, Housing & Urban Development.

4 Agriculture; Financial Services; Interior and Environment; Labor, Health and Human Services, Education; State and Foreign Operations.
of July the current highway bill expires and the Highway Trust Fund runs out. As discussed above, on October 1 the spending caps set under the Bipartisan Budget Act end and, without Congressional Action, spending will default to levels set under the 2013 sequester. Without special action by December 31 on dozens of “tax extenders,” taxes will rise next year by over $100 billion at an annual rate. In 2016, it is projected that the trust fund for Social Security Disability Insurance will be exhausted. These milestones occur during a lame-duck Presidency, under divided government, against a polarized political backdrop, and during a building Presidential election campaign. Our forecast assumes all of these are resolved without major political incident, with no implications for our fiscal assumptions, and without creating new fiscal uncertainties that could undermine economic growth.

**HEIGHTENED FISCAL POLICY RISK**

These optimistic assumptions create a downside risk to our forecast. While we do judge it to be unlikely, the sort of near-term fiscal restraint implied by the Conference Report cannot be ruled out entirely. Furthermore, while how each fiscal speed bump will be negotiated is uncertain, what does seem assured is heightened fiscal uncertainty. Indeed, it is already on the rise. Chart 7 updates through June an index of Fiscal Policy Uncertainty (FPU) constructed by Macroeconomic Advisers and based on the work of Baker, Bloom, and Davis. Following the budget accord of 2013, which placed fiscal policy on autopilot through FY 2015, this measure of FPU fell to its lowest level since early 2009. Since then, however, it has risen unevenly and we will not be surprised if it continues climbing through the fall. Elsewhere we have shown that fiscal policy uncertainty is positively correlated with risk spreads in financial markets that, in turn, are inversely correlated with economic growth. Therefore, we consider the return of fiscal policy uncertainty a downside risk to our forecast. Just how large a downside risk will depend on how and when policymakers resolve the looming budget impasse.

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5 The House and Senate are at odds over funding for transportation. A likely compromise is a five-month extension of funding at current levels to afford time for continued negotiations, perhaps in the context of comprehensive tax reform that adjusts the current federal gasoline tax.


7 See “The Cost of Recent Fiscal Policy Uncertainty,” Macroeconomic Advisers’ *Macro Focus* (Volume 8, Number 10; November 6, 2013).

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