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After the U.S. Election: What Lies Ahead?

by Allen Sinai*

I. Introduction

After one of the most significant Presidential Elections ever against a backdrop of troubled U.S. and global economies, volatile financial markets, and political upheaval in much of the world—what lies ahead for the U.S. economy?

As the largest economy in the world, as goes the U.S. economy so will the Global Economy!

At best, what most likely lies ahead is relatively slow growth, much as has been the case since the Recovery began in June 2009. But, if all works out reasonably well, 2013 should be a better year than 2012 and 2014 better than 2013. In 2012, the U.S. economy disappointed, growing only about 1.7% in real GDP, Q4-over-Q4. A sticky-high unemployment rate persisted. Growth in corporate revenues and profits declined sharply. U.S. federal budget deficits remained unsustainably high and public debt increased relative to GDP.

In The Basic Prospect, or Baseline outlook, in 2013 real economic growth is expected to rise 2%-to-2-1/2%, by yearend the unemployment rate having moved gradually down below 7-1/2%, price inflation to run between 2% and 3%, and corporate profits to be up 7%-or-so after having flattened-out in the second half of 2012. The Federal Reserve will provide ongoing support to the economy with its new “Open-Ended” Quantitative Easing—near zero short-term interest rates throughout the year and by increasing its balance sheet to keep long-term interest rates low. On a bottoming-out of the European downturn, a resumption of stronger growth in China and Asia ex-Japan and a better economy in the U.S., the Global Economy should grow faster

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in 2013 than 2012, rising 2-1/2% to 2-3/4% in a transition from near-recession in 2012, when growth was a little over 2%, to solid expansion. For 2014, the expectation is for the Global Economy to grow 3%-or-more.

At worst, in the aftermath of the Election, the U.S. could suffer a recession if the so-called Fiscal Cliff, a 10-year \$7-1/2 trillion Draconian contraction in fiscal policy, set in current law, hits in full force. Or, on what may be more likely, something less than the full force of the Fiscal Cliff could result, but still a sizable fiscal contraction on tax increases and federal spending cuts resulting from negotiations between the Congress and Administration to reduce the federal budget deficit and maintain expansion. If this were the result, something worse than The Basic Prospect could occur and a watered-down Fiscal Cliff still would drag the U.S. economy lower, with 2013 ending up looking like 2012 or even weaker.

Section II discusses the Basic Prospect, or Baseline outlook, for the U.S. economy beyond the Election. *Special attention is paid to the “Ifs,” or “Macro Risks,” surrounding the Baseline, since, in looking ahead, the list is long enough and potentially negative enough to end up determining the outlook in ways not easily seen at this time. Seven “Ifs” or “Macro Risks” to the Baseline are indicated—Ifs that need a favorable resolution for the Baseline to occur. A couple already are favorable. But odds on The Basic Prospect are only 55%, an indication of the considerable uncertainty from these Ifs and other possible scenarios that may evolve.*

In Section III, the key assumptions and risks underlying the Baseline are indicated. These include: 1) the so-called “Fiscal Cliff” and its potential to damage the U.S. and Global economies; 2) the “European Crises”—the entrenched and still worsening downturn in Europe and its possible ramifications; 3) the China prospect going forward and its potential global impact; 4) large declines in the growth of U.S. companies’ revenues and earnings and company reactions to them; 5) Federal Reserve monetary policy; 6) the growing U.S. sovereign debt burden and its potential to restrain the U.S. economy going forward; and 7) Geopolitics—especially the Mideast. “Washington” policy possibilities and possible effects are briefly examined in Section IV, which also provides some perspectives on what might lie ahead for longer-run economic and societal priorities and issues.

In the aftermath of the Election, in particular this coming year, how the U.S. goes so will the world. Though China should do better, becoming a positive force, rather than negative, in the coming year’s world economy, Europe could do worse, with additional negative effects on the Global and U.S. Economies. *The uncertainty of the U.S. Election aftermath and how Washington deals with its fiscal issues will be critical as the U.S. once again grapples with an unprecedented macro policy problem—what to do about weak economic growth and high unemployment in the face of unsustainably high federal budget deficits and debt relative-to-GDP?*

II. The “Basic Prospect” and its Key Assumptions

The Basic Prospect, or Baseline, for the U.S. and Global economies in 2013-14 is stronger expansion after flirtation with a global recession in 2012. It is for continuing expansion, somewhat stronger and more widespread than in recent years, led by consumption (about 70% of real GDP) and residential construction, i.e., housing (about 3% of the economy). The

Basic Prospect has an unusually large number of “Ifs” associated with it, i.e., “Macro Risks,” that could impede, abort, or somehow change the prospect and its probabilities.

An entrenched private sector upturn, led by consumption and housing, will be hard to dislodge and should provide sufficient support to maintain expansion. But, the pace of growth and interaction of the U.S. economy with the rest-of-the-world will depend very much on fiscal and monetary policy actions taken in the U.S., along with how other global regions do insofar as can affect the U.S..

Table 1 summarizes some main parameters in the U.S. Baseline—real economic growth, inflation, unemployment, interest rates, profits, the stock market, U.S. dollar, federal budget deficit and sovereign debt, and growth in the Eurozone, European, and Global Economies.

Table 1
U.S. and Global Basic Prospect (Baseline, Odds 55%)
(November 15, 2012)

	Years (Q4-Over-Q4 Unless Otherwise Indicated)		
	2012E	2013F	2014F
Economy			
Real GDP (% Chg.)	2.2	2.4	2.7
Inflation and Unemployment			
CPI-U (% Chg.)	2.0	2.3	2.6
Unemployment Rate (%; Q4 Avg.)	8.1	7.5	7.0
Interest Rates (%; Q4 Avg.)			
3-mos. T-bill	0.13	0.25	0.22
10-yr. U.S. Treas.	1.78	1.63	1.75
Profits			
S&P500 Operating Earnings (\$s; Ann. Avg.)	100.9	107.5	115.6
(% Chg.; Ann. Avg.)	2.2	6.5	7.5
Equity Market			
S&P500 (Index; Ann. Avg.)	1378	1475	1605
S&P500 (Index; Q4 Avg.)	1410	1516	1639
S&P500 (% Chg.; Q4-over-Q4)	15.1	7.5	8.1
U.S. Dollar			
Dollar/Trade-Wted. (Nominal)	0.738	0.722	0.715
Dollar/Euro (Level)	1.288	1.323	1.357
Federal Budget Deficit			
(\$ Bils., Unified, FY)	-1,355	-1,088	-965
Gross Public Debt/GDP (%)	102.3	104.3	105.1
Eurozone (17 Countries)			
Real GDP (% Chg.; Ann. Avg.)	-0.7	0.3	0.5
Europe (EU, 27 Countries)			
Real GDP (% Chg.; Ann. Avg.)	-0.5	0.4	0.8
Global Economy (47 Countries, 93% of World Output)			
Real GDP (% Chg.; Ann. Avg.)	2.9	2.1	2.6

Source: Decision Economics, Inc. (DE).

In the U.S., the fundamentals surrounding consumer spending and housing are much improved compared with recent years, although spending prospects, while better, are nowhere near what used to be the case. Growth in real consumption is expected at 2.1% in 2013, only

a little better than the 1.9% in 2012. Real residential construction, led by much stronger home sales and housing starts, should rise by nearly 10-1/2%. A weaker area of activity will be net exports, reflecting continuing economic weakness in Europe and rising U.S. demands for imports. Better economic growth is set to occur in Asia ex-Japan, led by China. Japan is troubled and likely to see potentially massive monetary and fiscal stimulus on a shift in Japanese politics. Federal government purchases are expected to be lower. State and local government spending, on the decline since 2009, should turn somewhat positive.

The unemployment rate is forecast to move gradually lower, ending the year a little under 7.5%, about a one-half percentage point improvement from the fourth quarter of 2012. Inflation should be relatively stable, but pick up some, ranging between 2% and 3% on the CPI-U. Interest rates likely will remain quite low as the Federal Reserve eases more by further increasing the size of its balance sheet. S&P500 Operating Earnings are projected at \$107.50, a 6-1/2% increase over 2012. Continuing reductions in costs, particularly for labor; innovation; the use of new info-tech equipment and software in production; better revenues because of higher prices; and a pickup in the Global Economy are the sources. The stock market can mount a renewed set of increases; ending up roughly 7% plus, Q4-over-Q4, well over 1500 on the S&P500 and in excess of 14,000 for the D-J Industrials. New stock market highs could be set in 2014.

The U.S. situation should help lift global economic growth into a range of 2-1/2% to 2-3/4%. In 2012, the Global Economy rose only 2.1%, extremely close to a recession, defined as real economic growth of 2%-or-less.

Hurricane Sandy, the storm that devastated the East Coast of the United States in late October and early November and a continuing drought will depress the economy in the fourth quarter, but then *lift* it during the first half of 2013 by about \$200 billion, at an annual rate, on rebuilding, delayed spending from the fourth quarter, and insurance company payments to companies and individuals.

An analogy to the U.S. prospect and risks might be thought of as a spaceship (the U.S. economy) launched into orbit—mainly by the Quantitative Easing of the Federal Reserve (QE1 and QE2 in 2009 and 2010) and the 2009 American Recovery and Reinvestment Act—entrenched but low-flying and not so high as desired. Spinning around in space are meteorites that could hit and knock the spaceship off course. In the economic case, the analogy is negative shocks to the Global and U.S. Economies potentially from the Fiscal Cliff and the European and Eurozone Crises (meteorites). The Federal Reserve can be expected to keep applying bursts of propulsion with its new Open-Ended Quantitative Easing until the spacecraft reaches a certain altitude, one that can be maintained (stronger real economic growth and a lower unemployment rate). The Fiscal Cliff risk is for “Washington” to set aside in the near-term while looking for a solution to unsustainably high federal budget deficits and U.S. sovereign debt for the longer-term.

This Basic Prospect, ex-Hurricane Sandy, the Drought and Fiscal Cliff, is not so bad in the context of the subdued growth prospects for the U.S. and other Developed Economies after

the Great Recession, associated Financial Crisis of 2007-10, and the European and Eurozone Crises of 2011-12.

III. The “Ifs” or “Macro Risks”

What are the key “Ifs,” or “Macro Risks,” underlying the Basic Prospect that need resolution for the relatively sanguine Baseline outlook to occur? There are seven of them.

Table 2
The “Ifs” Surrounding The Basic Prospect
(November 15, 2012)

“Ifs” or “Macro Risks”	Direction of Movement	Assumption in The Basic Prospect	Worst or Bad Case
Fiscal Cliff	Negative	Two-stage “resolution” which holds tax rates for middle- and lower-income families at current levels, ends the temporary Social Security tax credit, and reduces and shifts the size and composition of government outlay reductions. How to tax upper-income families, who is and who isn’t wealthy, higher tax rates or not, base-broadening and which categories of deductions to tax in order to raise about \$1.5 trillion in tax revenues is put off, along with details on entitlements and federal government outlay reductions. About a \$4 trillion 10-year deficit reduction plan is agreed upon, in principle, and approximate targets for increases in tax revenues and reductions in outlays set with details to be determined in 2013. Taxes on capital income, capital gains and dividends, go up for higher income families.	Full force Fiscal Cliff hits on no agreement in Washington. There is a \$7-1/2 trillion 10-year deficit reduction and \$500 billion plus fiscal contraction in 2013. This would produce a 3-to-4 percentage point decrement to real GDP growth in each of 2013 and 2014 and a likely recession.
European and Eurozone Crises	Negative	Bottoming-out of the European (85% of Europe currently) recession over the next 3-to-6 months and a small recovery in 2013.	No bottoming-out of the European downturn in sight currently. A worsening European recession with more financial fallout and macroeconomic policies—monetary and fiscal—that are not stimulative would hold down Europe, reduce Chinese exports, hurt Asian economic activity, and together damage U.S. exports in an already weak U.S. economy.
China “Story”	Minus-to-Plus	The deliberate slowing-down of the Chinese economy turns to deliberate stimulation after achieving low inflation and on the risk still of a “Hard-Landing.” Asia ex-Japan and Japan benefit from a lift up in Chinese economic growth and so does the Global Economy.	Fledgling reignition of the Chinese economy fails and a “Hard-Landing” occurs—less than 7% growth year-over-year. This would weaken the Asian, European, U.S. and Global Economies.

Table 2 (Cont.)

S&P500 Company Revenues and Earnings	Negative	Big declines in revenue and earnings growth for companies end in 2013:Q1 and reverse direction on better U.S. and Global economic activity.	Less than the full force Fiscal Cliff and a worsening European downturn cause year-over-year declines in revenues and earnings such that corporations cut back significantly on spending and hiring. Lack of jobs holds down income and consumption spending.
Federal Reserve "Open-Ended" Quantitative Easing	Plus	The Federal Reserve periodically increases its balance sheet through outright purchases of long-term U.S. Treasury and mortgage-backed securities, stimulating "financial conditions" and then, with lags, raising U.S. economic growth.	"Printing money" has only transient effects on real economic activity. Inflationary effects show up earlier at a higher unemployment rate, hamstringing any further easing. Long lags in impacting the economy prevent any lift.
U.S. Sovereign Debt: A Ticking Time Bomb	Negative	Whatever progress is made on the Fiscal Cliff puts off the worst effects of unsustainably high federal budget deficits and debt for another, but later, time.	Failure to agree on a long-term program to reduce deficits and sovereign debt leads to a downgrade in the U.S. credit rating, stock market Correction or Bear Equity Market, and a U.S. recession.
Geopolitics: Middle East and Elsewhere	Negative	Uneasy truce between Israel, Hamas, and Iran and Syria. Smoldering with periodic flare-ups.	Israel invades Gaza and conflicts with Iran. The world confronts the Iranian nuclear capability, inflaming the Middle East. Crude oil price spikes up are the risk.

These Ifs or Macro Risks need to evolve as the assumptions indicate for The Baseline Prospect to be realized. Table 3 shows the Scenario Odds for five possibilities, depending upon how the Ifs work out.

**Table 3
DE Baseline and Alternative Risk Scenarios and Probabilities
(November 15, 2012)**

	Current
Baseline—The "Basic Prospect"	55%
"Recession 2013-14"—Full Force of Fiscal Cliff and Eurozone/European Crises	20%
Growth Recession on Less Than Full Force Fiscal Cliff	10%
"Delayed Takeoff"—Current Spending Holds Economy Back But "Takeoff" Later Occurs on Lagged Effects from Massive Monetary Stimulus and Quantitative Easing	10%
U.S. Sovereign Debt Crisis	5%

A. Fiscal Cliff

The Fiscal Cliff is the main near-term risk to the U.S. and global prospect for 2013.

What is the Fiscal Cliff?

This term was originally coined by Federal Reserve Chairman Ben Bernanke in Congressional Testimony last February.¹ It refers to the now well-known expiration of previously legislated tax reductions and current law set by the Congress last year that reduces federal government outlays as an “incentive” to reach agreement on the outsized and unsustainable federal budget deficits and growing U.S. sovereign debt burden relative-to-GDP.

In 2011, despite very similar recommendations by the bipartisan Bowles-Simpson Deficit Commission and Domenici-Rivlin Task Force on how to deal with deficits and debt, Congress and the President could not reach an agreement.² After deadlock, discussions culminated in a secret head-to-head set of meetings between House Speaker John Boehner and President Obama. But here, too, an agreement could not be fashioned.³

As a mechanism to “incent” Congress and whomever would be President to find agreement, legislation was passed that automatically would reduce federal government outlays across-the-board beginning in 2013, equally between defense and nondefense, approximately \$1.2 trillion over 10 years. Another \$900 billion of reductions in federal government outlays had been legislated in 2011 in a confrontational lifting of the federal government debt ceiling by Congress and the President.

In the law are a number of tax increases from tax rates legislated in 2001 and 2003 that will begin in 2013—increases in income tax rates and other taxes from current levels totaling approximately \$5 trillion over the next 10 years. These include expiration of the Bush income, capital gains, and dividend tax reductions that were legislated in 2001 and 2003. A social security tax credit, temporary in nature, legislated in 2010 for 2011 then again in 2011 for 2012 for all wage-earners, also expires. Other tax provisions such as the Alternative Minimum Tax (AMT) and a number of tax credits expire as well, in all recent years each time for the next year having been extended. Then, there are some tax increases for higher income families, defined as \$250,000-and-up, to help pay for the Affordable Care Act, commonly called Obamacare. These include a 3.8 percentage point rise in the capital gains tax and 0.9 percentage points on high-income families or the financing of ObamaCare. There are others, including increases in dividend tax rates which go back to ordinary income tax rate levels.

Thus, unless changed in legislation by the Congress that would be signed by the President, current law has a combination of tax increases and expenditure reductions beginning in 2013

¹ Bernanke (February 29, 2012). Testimony before the House Committee on Financial Services. Question and Answer discussion.

² Bowles-Simpson (December 2010) and Domenici-Rivlin (November 2010); also see Brimmer-Sinai (2012).

³ Woodward (2012).

that total approximately \$7-1/2 trillion over the next ten years. The composition is a little less than \$5 trillion in tax increases and a little more than \$2 trillion in expenditure reductions.

This result, or Fiscal Cliff, is topsy-turvy, nothing like anything anyone has recommended—Deficit Commission, Task Force, the President, or analysts. *The amount of the fiscal contraction is almost double any recommendations on how to deal with the U.S. budget deficit*, whether the Bowles-Simpson Bipartisan Commission, Domenici-Rivlin Task Force, President Obama, or the Republican House Leadership.

Even more perverse is the composition of the fiscal contraction—nearly 70% in tax increases and 30% in outlay reductions. The more typical recommendation on composition has been \$3 of outlay reductions and \$1 of revenue increases in a package of about \$4 trillion or less. The \$4 trillion deficit reduction is what was suggested last year by President Obama. Congress has been more in the \$2-to-\$3 trillion range. Such a fiscal contraction, if it were to occur, could reduce U.S. economic growth by 3-to-4 percentage points in each of 2013 and 2014 *and produce a recession.*⁴

Hence, the term Fiscal Cliff, which refers to the cliff-like fiscal contraction of \$500 billion plus in 2013—\$335 billion of tax increases, \$165 billion of expenditure reductions—and the estimated sharp declines in real economic growth that would occur. *Driving over the Fiscal Cliff means that legislation would not occur to change the current law.*

For sure, such a contraction in fiscal policy would go a long way toward solving, or postponing a day of reckoning, in the U.S. sovereign debt problem, where gross public debt relative-to-GDP is now over 100% and growing. But, at the same time, *it would abort the U.S. economic upturn, produce a recession, not just in the U.S. but also around-the-world, and be associated with huge losses in economic activity.* Equity bear markets would occur worldwide.

On Tuesday, November 6, 2012, the U.S. stock market cheered the end of the Election and its uncertainty. Just the end of an Election, by itself, lifts the sentiment of traders and investors—standard operating procedure. The Dow-Jones Industrials rose 133 points and the S&P500 Common Stock Index moved up 11 points.

But then came the results of the Election and the *setting for after* the Election—the same President; the same divided country; the same Republican House less a few seats; the same Democratic Senate with the same personalities, the very people who did not, and could not, agree on a deficit reduction program in 2011 and who led in establishing the Fiscal Cliff—Senator Harry Reid with his sidekick House Minority Leader Nancy Pelosi; House Speaker John Boehner and his lieutenants Paul Ryan and Eric Cantor; President Obama and Vice President Biden.

On the same lineup with the same problem as before and a history in Washington of failing to agree, an ongoing correction in the U.S. equity market intensified on the uncertainty of the Washington deliberations and an increased risk of recession because of the Fiscal Cliff and its

⁴ Sinai, Allen (June 2012). Also, Congressional Budget Office (CBO) (November 2012).

uncertain prospect. Both the S&P500 and D-J Industrials declined over 5% in the week after the Election. Equity markets around-the-world also fell, reflecting the global nature of the U.S. problem.

As of this writing, the U.S. Congress, its leaders, and President Obama have been jockeying back and forth on differences relating to the Fiscal Cliff, the mix of tax increases and spending reductions, details of any changes, and how to bridge the problem, eventually probably with a two-stage approach—agreeing on what can be agreed upon to preserve the U.S. economic expansion and postponing until next year the issues that need more time and are more difficult. Already, because of the uncertainty of the deliberations and what might happen, capital spending by U.S. business and hiring are being curtailed. Other cautious actions are being taken by business on the potential effects from the across-the-board reductions in federal government outlays.

B. European and Eurozone Economic and Financial Crises—Still Ongoing

A second “If,” and a big one, has to do with the ongoing recession in Europe, one that is affecting 85% of European (EU) GDP, which represents a large portion of global GDP.⁵

The downturn began in the Eurozone, first Ireland, Greece and then Portugal, spreading as a result of tight trade interactions within Europe, imposed and some voluntary fiscal contraction and austerity, a sharp deceleration in Chinese and Asian real economic growth and disappointing growth in the U.S. economy.

The weakness within and outside the Eurozone and Europe hurt exports. The financial fragility of a number of countries led to funding needs for a limited number of them which, in turn, was met by tough lender conditionality, essentially austerity. This weakened the Eurozone economy further. A financial crisis within Europe on tumbling values of sovereign debt in troubled and potentially troubled economies, contraction of loan asset values on bank balance sheets, a credit crunch, and bailout necessity at the sovereign level for a number of countries intensified the downturn, ultimately spreading to other countries than the original ones. The monetary policy of the European Central Bank (ECB), although attempting to be accommodative was, and has been, crisis-centered rather than setting up to provide the monetary stimulus that all of Europe needs—a lower key policy interest rate to weaken the Euro, the provision of credit to the banking system potentially linking to economies, but even more necessary, as has been the case with some other central banks, expansion of the ECB balance sheet and a commitment to maintain it until the European economies improve substantially.

On the fiscal side, the prevailing policy has been contraction and austerity, cyclically quite counterproductive and an impediment to achieving lender-set deficit-to-GDP targets. Countries in reasonably good financial condition hesitated to collectively lend to insolvent countries or those who might become so and these delays worsened the crisis and economic

⁵ The economies of the European countries in recession comprise a larger portion of global GDP than China, the second largest world economy.

downturn. Lender conditionality has been quite punishing—always the case in these types of situations.

The failure of the political economics of European (the Troika) policymaking to come together has made the European situation considerably worse, with long delays in recognition of the downturns, the forming of policy, implementation, and which policies to use. The dissonance across the leadership in so many countries of Europe and changes in governments also have contributed to an intensification of the downturn.

Currently, the high-frequency data on the European situation do not provide visibility on any bottoming-out of the downturn. An exception is the U.K., which seemed to move out of a three-quarter recession in 2012:3, at least temporarily, as the Olympic Games and Jubilee pumped up U.K. real GDP. Monthly and other high-frequency data provide the anatomy of what is going on and can change quickly depending upon internal and external effects in the various economies. On the monthly data, Germany also is in recession, as well as France.

As for macroeconomic policies, although lender conditionality and austerity have been eased somewhat, giving some countries more time to meet deficit reduction targets, relaxing terms on debt repayment, or from the ECB a program that could provide unlimited support to the sovereign debt of a country in need of a bailout—the kind of policy stimulus, monetary or fiscal, that might, with lags, suggest a coming upturn, is not yet present.

For the near-term, the Eurozone and European downturns, both of which began in 2011:4, will continue, now having spread through Europe including northern tier countries such as Germany and France. Growth in Eurozone real GDP is expected to have been in a range from -0.5% to -1% (Table 2 above) in 2012 and for Europe, in general, about -0.5%. In 2014, only a meager recovery is expected, 0.5% in the Eurozone and 0.8% in Europe.

While mild in real GDP terms, the widespread and long European recession poses a significant risk to the Global and U.S. economies.

The transmission mechanisms have been, and continue to be, weakening exports within Europe and across-the-world, particularly the exports of China. China's economic weakness, in turn, has depressed trade flows within and across Asia and then together a lack of demand from Europe and Asia has reduced U.S. exports. In real terms, U.S. exports rose to a new record in the second quarter of 2012 but then slowed with growth declining 1.6%, at an annual rate, in the latest report on third quarter GDP. With the U.S. economy growing in the 1%-to-2% range, U.S. import growth has slowed, limiting the declines of U.S. net real exports and thus the negative impact on real GDP. The pattern of weakening U.S. trade flows matches that of the Global Economy. Numerous businesses—financial, transactional, and trade-related—have been negatively affected.

Domestic demands in much of Europe also have weakened as economies have contracted in the face of austerity-driven increases in taxes, reductions in central government outlays, falling pensions, difficult financial conditions, a credit crunch, and the disarray in confidence and politics that such a circumstance creates.

Ultimately, an economy in recession will bottom-out and begin to rise again as shifts in growth occur that ignite an upturn. In the absence of macroeconomic policies to facilitate a turnaround, however, the European downturn has lasted longer and likely will continue to do so, and be deeper than otherwise might the case.

The European risk to the world economy is that the downturn might decelerate even more, injecting yet another negative impulse into the Chinese, Asian and Japanese economies, particularly for exports. Financial conditions would deteriorate more; Spain and Italy might require bailouts in order to stay solvent; and the, as yet, relatively resilient economies of France and Germany might not remain so. In aggregate, negative impulses to exports stemming from Europe and Asia together would reduce U.S. exports, weaken the U.S. industrial sector, lead to less jobs creation, and potentially limit consumer spending—the expected pillar of growth in The Basic Prospect.

C. The China “Story”—A Positive Going Forward

One “If” that is a plus is China and a bottoming-out in Chinese economic growth from a sizeable deceleration from near 12%, year-over-year, to near 7-1/2% during 2011-12. The nearly five percentage point growth decrement was intentional, motivated by restrictive Chinese macroeconomic policies.

While occurring, the policy-induced movement from a boomy and frothy economy with inflation in the 6%-to-7% range to a desired 2%-or-so rate of inflation motivated a sizeable negative impulse to growth throughout Asia and most certainly was a source of weaker growth in German exports and for Europe. The Chinese objective to slow growth had a ripple effect throughout the world economy, principally through trade flows. Decelerating growth in China, in Asia, then in Europe together impacted on U.S. exports to limit its growth, in turn, reverberating through North America and into the world economy and contributing to a weaker pace of activity.

However, China’s growth rate now has slowed to around 7-1/2% year-over-year and inflation is in the 1%-to-2% range, an apparent “Soft Landing.” To prevent further deceleration, stimulative monetary and fiscal policies have been implemented. The internal dynamics of the Chinese business cycle, along with stimulative macroeconomic policies, and the ending of political uncertainty over a new set of leaders and government transition likely will lead to increased growth over the next several years; in turn, lifting the pace of exports in Asia and providing stimulus to the rest-of-the-world.

D. Earnings Weakness—A Negative

A third Macro Risk of concern is the sharp declines in revenues and earnings that U.S. companies have suffered in the last few quarters.

Taking the S&P500 companies as a sample of the U.S. economy, the latest data (2012:3), when aggregated, show revenues, year-over-year, up by just under 2%. S&P500 Operating Earnings flattened-out in the third and second quarters on a year-over-year basis, rising 0.1% in Q3 and declining 0.1% in Q2. This compares with revenue and earnings growth in 2011

that ranged from high single-digits to low double-digits. Profit margins have remained near 10% throughout this time, benefiting from tight cost management, productivity improvements, and the substitution of capital for labor in production.

In many U.S. business cycles, declines in the growth of company revenues and earnings have been precursors, with lags, of a recession. This is because companies tend to cut back on hiring, spending, production and inventories in the face of what might be perceived as permanently lower sales and earnings. Sometimes long lags occur before companies come to such a conclusion. But in more recent business cycles, companies have not hesitated to quickly reduce capital spending and limit hiring on revenue and earnings weakness.

The “If” is in the forecast of revived growth in revenues and earnings during 2013. Solid consumer spending and a better U.S. economy along with a bottoming-out of the European downturn and an improvement in Chinese economic growth would reverberate into higher U.S. company revenues and earnings and higher earnings growth by the second quarter of 2013.

But, the projection of renewed growth in revenues and earnings is itself linked to the forecast of solid U.S. consumer and housing spending and assumptions that the European downturn will bottom-out, Chinese economic growth pick up, better growth in Asia ex-Japan occur, and a solid expansion continue in North America. *In turn, these all depend upon an assumed agreement in Washington that averts the full-force of the Fiscal Cliff.*

E. The Federal Reserve and Monetary Policy—Positive Support

This Macro Risk is a positive one, with the Federal Reserve set to maintain accommodation and to ease monetary policy further *until* the U.S. labor market and the unemployment rate improve significantly.

A new version of Quantitative Easing launched in September 2012 involves open-ended easings that will keep short-term interest rates essentially at zero for as long as is necessary to achieve an unemployment rate much closer to full employment—a full employment unemployment rate estimated at about 5-1/2%. In addition, the central bank has indicated that it will purchase additional securities to add to its balance sheet in order to keep “financial conditions” supportive to the economy and labor market. These financial conditions refer to the level and structure of interest rates, the U.S. dollar, the equity market, and whatever derivative effects flow from Federal Reserve actions that impact other asset prices.

What is new about the latest version of Federal Reserve policy is its open-ended nature, with very likely a tying of additional easing to economic variables like the unemployment rate and inflation rather than, as previously, a calendar date. With the current “targets” for full employment and price stability, the apparent promise is “permanence” for easier monetary policy of quite some time—quite different from QE1 and QE2.

Research at the U.S. central bank and elsewhere suggests that Quantitative Easing has been successful in reducing interest rates, lowering the U.S. dollar, and raising stock prices which, in turn, have helped bring about the now very evident recovery and expansion in housing and

a substantial improvement in the financial position of households. Improvement in household financial positions is a prerequisite to stepped-up consumer spending.

Already having virtually guaranteed that short-term interest rates will remain close to zero well into 2015, the open-ended Quantitative Easing set into motion in September 2012 makes highly likely a long period of quite low long-term interest rates as well. Low interest rates make a currency relatively less attractive compared with others where interest rates might be higher, or expected to move higher. Lower interest rates help stock valuations. Long-term interest rates affect the cost of capital for business, hurdle rates, and investments. And, low long-term interest rates, particularly mortgage rates, can lead to stronger housing activity, higher housing prices, an improved stock market, and an increase in household wealth. Increased household wealth, with lags, adds to consumer spending and, in turn, supports the U.S. and world economies.

F. U.S. Sovereign Debt—A Negative Put Off?

Yet another risk to the U.S. economic prospect is outsized U.S. federal budget deficits and growing public debt relative-to-GDP—a \$1.3 trillion federal budget deficit this past year and gross public debt over 100% of GDP and rising.

Very simply, with federal budget deficits over \$1 trillion a year for the last several years and gross public debt now over 100% of GDP and growing, the sovereign indebtedness of the United States makes it almost impossible for the government to engage in another round of net fiscal stimulus.

Standard policy for increasing growth, generating more jobs, and reducing the unemployment rate would be to reduce taxes and/or raise federal government spending. But, at this point, the U.S. simply cannot afford any new deficit-financed fiscal stimulus. To reduce the deficits and growth of debt requires increasing taxes and lowering federal government outlays. But, such actions could reduce economic activity further where economic growth is already subdued and anemic.

*Hence, the #1 policy problem and puzzle for policymakers—how to grow the economy faster and lower the unemployment rate without raising the federal budget deficit or how to reduce the federal budget deficits and growing debt relative-to-GDP while maintaining reasonable economic growth? Or, what policies might increase economic growth and lower the unemployment rate while, at the same time, reducing deficits and the growth of debt relative-to-GDP?*⁶

Easier monetary policy can provide needed stimulus but, here, too, there are constraints. Federal Reserve monetary policy has put short-term interest rates at a zero lower bound and there are long lags between easing and effects on the economy.

For sure, there will have to be some plan to take down the unsustainably high deficits and to lower the growth of debt relative-to-GDP.

⁶ For a pass at this, see Doug Holtz-Eakin and Allen Sinai (2010).

Too much fiscal restriction, e.g., the Fiscal Cliff, would be counterproductive. Too little, e.g., \$1 or \$2 trillion of deficit reductions over the next 10 years, could leave gross public debt growing faster than growth in nominal GDP thus increasing the ratio of gross public debt-to-GDP.

Whether the U.S. can find the right combination of reductions in federal government outlays and increases in taxes to lower federal budget deficits and the path of debt relative-to-GDP without taking down the economy is the challenge.

In any case, the sovereign debt risk to the U.S. economy, as a point of crisis, is viewed as subdued for awhile as the U.S. political system comes to grips with the problem. But, insufficient actions in the coming year could result in a lowering of the U.S. debt credit rating, bring disarray in U.S. financial markets, and be a detriment to the Basic Prospect.

G. Geopolitical

Yet another risk to the Baseline lies in potential conflict in the Middle East and the turmoil of change in this region on societal and political upheaval.

The possibility of all-out conflict between Israel, Palestine and/or between Israel and Iran, and confrontation with the world on the apparent Iranian drive for nuclear weapons leaves an ongoing geopolitical risk to the U.S. prospect.

Most negative would be outright confrontation and conflict in the Middle East that led to restrictions in the supply of crude oil and higher crude oil prices. Spikes up in oil prices, if sustained, lead to higher energy costs and increased prices across eventually a wide spectrum of goods and services; in turn, restraining the consumer, business, and economy growth and bringing at least a transient increase of inflation.

The recessionary thrust of any oil price spike emanating from a Mideast Crisis is the worry.

In recent years, there has been only one instance of an unbridled increase in crude oil prices that contributed to a U.S. downturn. This was in 2007-09. During that time, however, other economic and financial disruptions were occurring so that high crude oil prices aggravated a situation that was not that strong anyway.

IV. Concluding Perspectives—“Washington” at the Center

For the U.S. economy in 2013 and beyond, also to an extent the Global Economy, more-than-usual, before-and-after the significant U.S. Election of 2012—“Washington” is at the Center!

If all goes well, the U.S. and Global outlook for 2013 looks reasonably bright as compared with recent years—real economic growth likely stronger, albeit not strong, and the Global Economy as well, as the U.S. consumer sustains the upturn, helped by a strong housing recovery, a bottoming-out of the European recession and then some sort of recovery, and China, after several years of decelerating growth, reviving somewhat, taking Asian economies up and then all together—the U.S., Europe, and China growing more and business activity on the rise.

But, surrounding this relatively sanguine outlook, The Basic Prospect or Baseline, is a number of “Ifs,” risks that need to be resolved favorably in order for the U.S. and Global Economy to sustain expansion at a stronger pace in 2013-14 than in 2011 and 2012.

At the center of these “Ifs” or “Macro Risks” lies Washington and whether current law remains as now—legislation and expiring legislation that, unless changed by the Congress and President, will click-in with a huge dose of fiscal policy restraint, the so-called Fiscal Cliff, a 10-year program of well over \$7 trillion in deficit reduction, nearly \$5 trillion of tax increases and close to \$2 trillion of spending reductions, almost 70% tax increases and close to 30% reductions in federal government outlays. Such a fiscal contraction would constitute a dose of high-level austerity and likely reduce U.S. real economic growth in 2013 and 2014 by 3-to-4 percentage points each year. This surely would mean a recession. As the largest economy in the world, as the U.S. goes so would go the world economy—a global recession on any U.S. downturn, bear equity markets around-the-world, job losses and higher unemployment, and in most parts of the world, little that could be done about this consequence.

The Fiscal Cliff is the most significant near-term risk to the U.S. economy. In the Baseline forecast, the assumption is made that agreement will be reached in Washington on a two-stage program of maintaining current tax rates for most and reducing the size and remixing the reductions set for federal government spending.

The first stage agreement is assumed to maintain current income tax rates for most families and to set an overall ten-year revenue goal as part of a \$4 trillion deficit reduction program and also the expenditure targets—details in all to be worked out in 2013. Issues relating to tax rates, who is taxed more and by how much, entitlements and how to limit their growth, priorities on where the federal government spends its monies, and the related impacts on the U.S. economy and others essentially would be put off and “settled” in 2013.

The time left post-Election to settle all the issues of taxation and federal government spending in the context of a plan to reduce federal budget deficits and the growth of debt relative-to-GDP, while managing somehow to prevent a significant downturn in U.S. economic growth, is a tall order. It is assumed to get figured out, at least roughly, in goals and targets.

Odds on The Basic Prospect are not high, only a little more than 1-in-2 given that Washington is at the center of what might transpire and the poor performance of policymakers, not just in Washington in terms of settling issues that relate to the economy, but others as well including Berlin, Brussels and Tokyo. The record of political leaders in handling matters of economic policy, particularly in these recent troubled times, has not been good.

In the U.S., a classic long-standing struggle between philosophies and objectives having to do with societal priorities underlie much of the debate and division.

On a \$4 trillion ten-year program of deficit and debt reduction, President Obama, Democratic leaders and left-of-center politicians want to tax more, especially at higher income levels, in setting the goal on tax receipts, and cut spending less, particularly for social programs that

provide income support for many Americans and on spending for societal objectives like infrastructure and education.

Republican politicians, right-of-center and right-leaning citizens, want to curtail and rein-in federal government expenditures, especially entitlements, currently near 25% of the economy, and to use the funds saved to stimulate growth through tax reform, lowering, or at least holding constant tax rates for everyone while broadening the tax base.

Other issues relate to the taxation of capital income, who pays what taxes and how much, and reflect differences and divisions in the population at-large, having to do with societal inequality, which in the U.S., on income and wealth, many would argue is egregiously high.

How Washington resolves these issues on behalf of the American people in the near- and longer-term is *the* question-of-the-day and could well determine whether-or-not the relatively sanguine Basic Prospect, or Baseline, for the U.S. economy comes to pass.

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