

VAKIFBANK GLOBAL ECONOMY WEEKLY

Rising Fiscal Battle in U.S.: New Budget Plan and Its Economic Impact ?

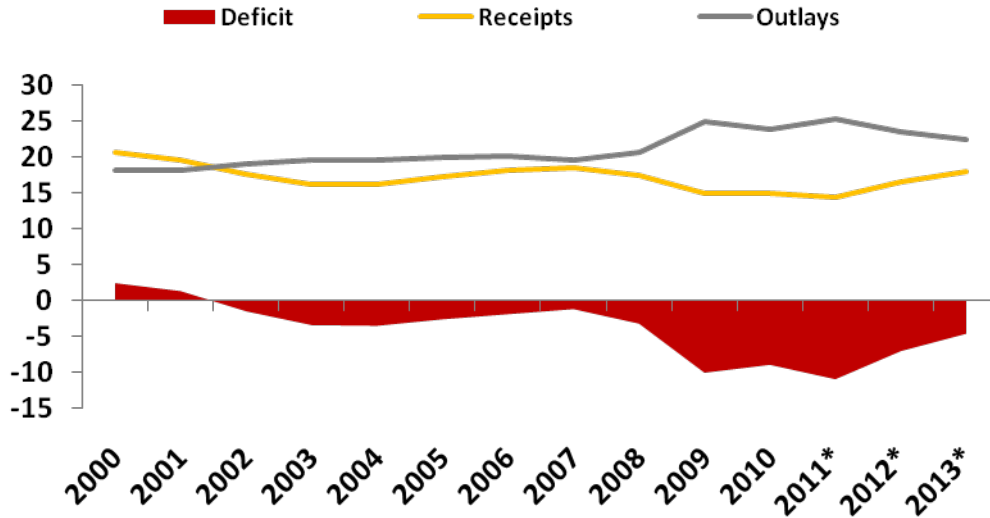





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US budget deficit is expected to reach 1.1 trillion dollar in 2012

Budget Totals (in billions of dollars as a percent of GDP)



-  According to President Obama’s FY2012 budget figures, budget deficit is projected to be 1.64 and 1.1 trillion dollars in 2011 and 2012, respectively.
-  Outlays are expected to decline and receipts are expected to increase after 2011. Hence, deficit is estimated to decrease since then.
-  Aforementioned budget projects foresee 2.7% GDP growth and 9.3% unemployment in 2011.

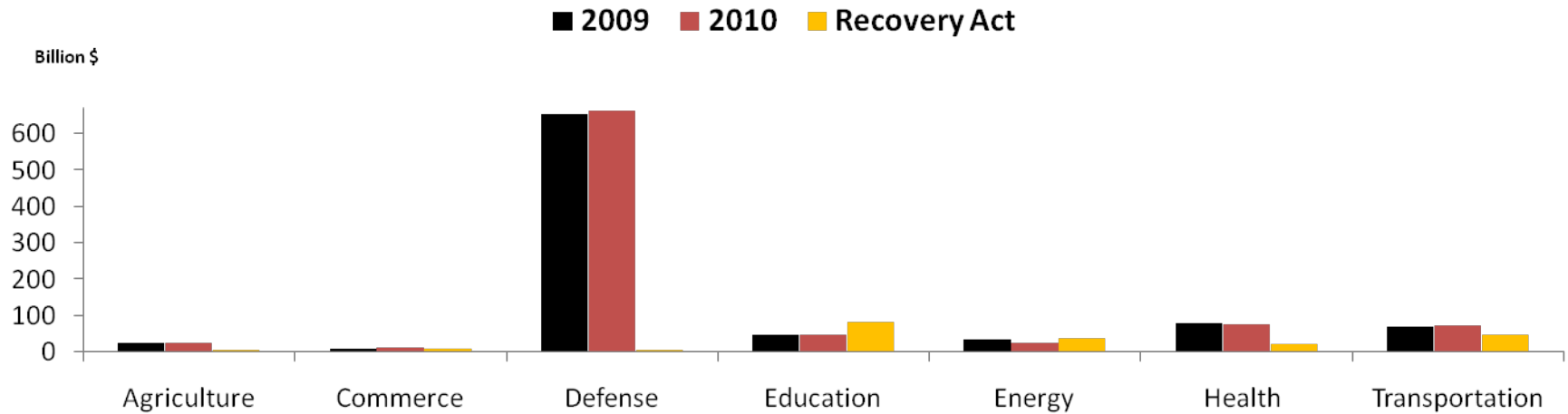
Source: Office of Management and Budget

2012 US Budget Projections

%	2011	2012	2013	2014	2015	2016
GDP Growth Rate	2.7	3.6	4.4	4.3	3.8	3.3
Unemployment Rate	9.3	8.6	7.5	6.6	5.9	5.5

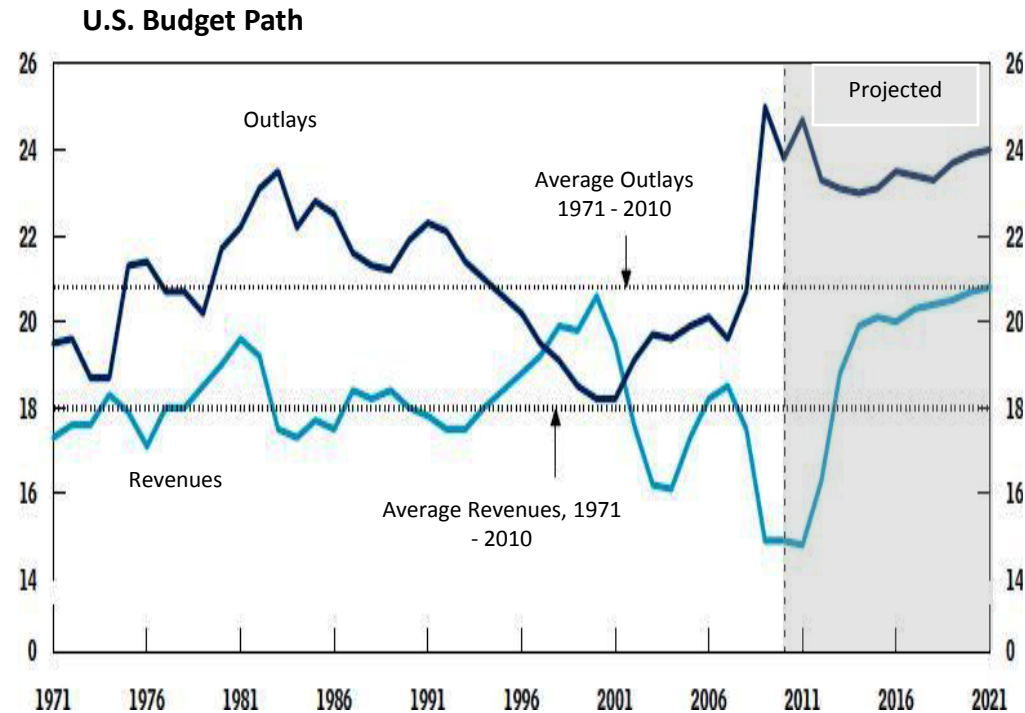
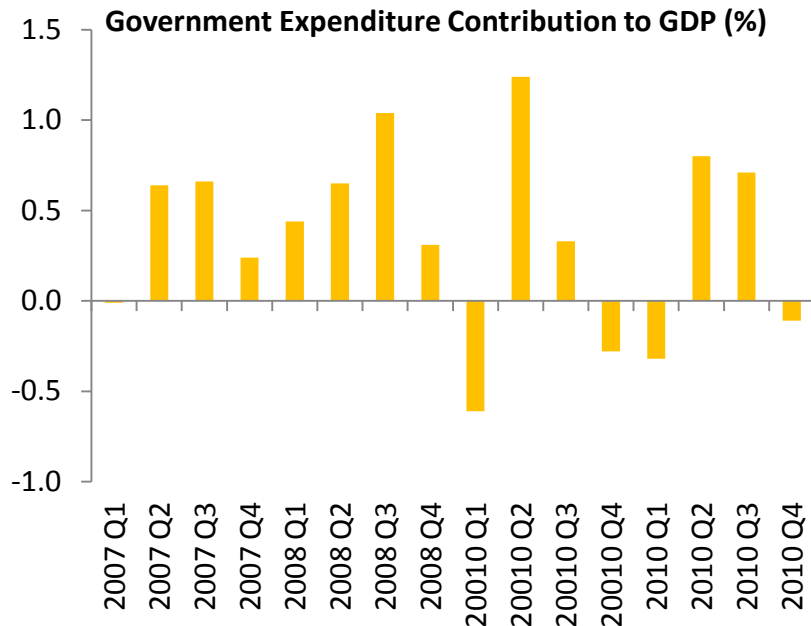
Source: Office of Management and Budget

A New Era of Responsibility...



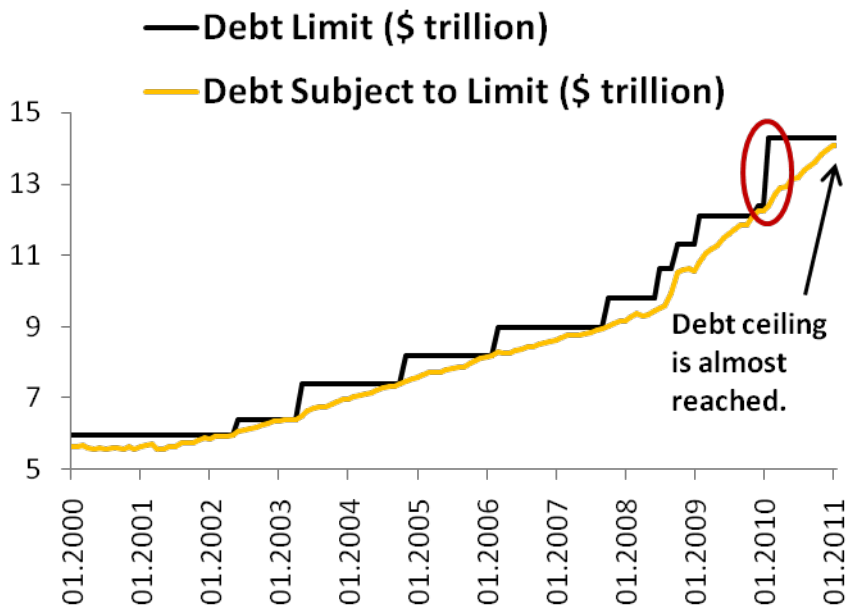
Source: Office of Management and Budget

- ✔ A new era which relies on sustainable deficit levels and expenditure reduction, has just emerged.
- ✔ This era includes \$75.5 billion in supplemental appropriations for 2009 and \$130.0 billion for 2010 to support ongoing overseas contingency operations, while increasing efforts in Afghanistan and drawing down troops from Iraq responsibly. However, 2012 proforma budget proposes an excessive decline in defense expenditures. In 5 years experience, \$78 billion saving will be achieved.
- ✔ On the ground of developing industry and increasing population, \$8 billion will be spent for building high speed rail roads .
- ✔ Debt limit is projected to be \$3.14 trillion, but it will probably increase due to necessary health and education reforms.









- The role of government expenditure in GDP growth has been increasing in the crisis period as a result of the stimulus measures. In the coming periods, US Government may have a negative effect on growth.
- The budget deficit from 2012 through 2021 would average about 6% of GDP. Cumulative deficits will reach almost \$12 trillion over the 2012 – 2021 period.
- Annual revenues would average about 18% of GDP. Revenues as of GDP are projected to increase repeatedly, from 15% of GDP to 21% by 2021.
- There are no negative signs about foreign investors confidence in their U.S. Treasury holdings. But stable budget deficit would have an unfavorable effect on this situation.

Debt ceiling is a limit set by Congress on the amount of debt which the federal government can legally borrow...






Source: Bloomberg





-  The first limit was set in 1917. Since 1962, the debt ceiling has been raised 74 times and the most recent increase to \$14.294 trillion was made in February 2010. It was the sharp increase amounting \$1.9 trillion.
-  Treasury Department finances annual deficit by issuing bonds but if the debt limit is reached, it must be raised by the Congress. Hence, it theoretically provides the Congress to control the national budget deficit.

-  The Treasury estimates that debt ceiling will be reached sometime between March 31 and May 16. Hence, debt ceiling should be raised before March 31.
-  However, Republicans in the Congress want spending cuts in the budget proposal in exchange of their votes for increasing debt ceiling.
-  Democrats claimed that if debt ceiling isn't increased, it could threaten the confidence in credit markets, damage the trade outlook and could subsequently create a recession worse than the 2008 crisis.
-  In addition, if the debt ceiling isn't increased, it could cause a government shutdown like in 1995.

The emergence of a situation similar to the 1995-1996 may be possible...

-  President Obama's new budget, which was released last Monday, divided Democrats and Republicans regarding the increasing debt ceiling and spending cut.
-  However both sides agree on spending cut, there exists disagreement about which items should be cut and to what extent.
-  If disagreement between Democrats and Republicans continues, the emergence of a situation similar to the 1995-1996 may be possible.

1995-1996

-  Democratic President Clinton and the Republican-controlled Congress disputed over spending cuts about health care, education and environment in 1995. Clinton was unwilling to make the budget cuts that the Republicans wanted, while Republicans refused to raise the debt limit.
-  Disagreement between Democrats and Republicans was not resolved and resulted in government shutdown. This was a situation that some services provided by the federal government completely or partially stopped.
-  However, government shutdown did not provide an increase in saving. The total cost of the shutdown was \$700- \$800 million including \$400 million payment to furloughed federal employees who did not report to work.
-  Since the recent developments are very similar to the 1995-1996 experience, it is important to examine how the market reacted to the budget battle in 1995.

How this budget battle may affect the market?

B The market did not react too much to the political debate which resulted in government shutdown in 1995-1996.



Source: Bloomberg

The impact of budget battle on market was limited in 1995-1996. However the question marks on U.S. fiscal policy may constitute a risk on the market where the uncertainty is high.

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