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The "Cliff Compromise": What's Next for the Economy?

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Hello, I'm Ethan Harris, co-head of Global Economics Research. Recent events in Washington played out pretty much as we expected, with Congress reaching a compromise to avert the "fiscal cliff" at the last minute.

[INSERT LOWER 3RD]
Tax increase for upper-income earners
And 2% increase in the payroll tax
The main components of the agreement are a tax increase for upper-income earners; and a two percentage point increase in the payroll tax.

[INSERT LOWER 3RD]
Permanent "patch" for the AMT and
extension of many deductions
At the same time, a resolution was reached to permanently "fix" the Alternative Minimum Tax and many tax deductions were extended, including mortgage debt relief.

Unfortunately, while many of the important questions surrounding future tax rates were resolved, there is still much left to do. As we have noted, we believe this will involve a multi-stage, and probably messy, process in Washington through at least the end of March. Three fiscal challenges lie ahead.

[DISSOLVE GRAPHIC]
Fiscal Challenges Ahead
End of February
Deadline to address $100 billion in spending cuts
By end of 1Q 2013
U.S. government will hit its debt ceiling
March 27, 2013
Funding for all discretionary programs runs out
First, the cliff compromise only delayed about a $100 billion in spending cuts for two months. Second, the US government will hit its debt ceiling before the end of the first quarter. If the debt ceiling is not increased the government will have to immediately balance its books, cutting spending by about a trillion dollars. Finally, funding for all discretionary programs runs out on March 27 and absent new legislation all nonessential government spending would have to stop. As these decision points approach the markets could be volatile. However, our hope, and expectation, is that Congress will pass legislation to avert these shocks in exchange for moderate spending cuts.

[INSERT LOWER 3RD]

Tax increases and potential spending cuts
could total about $335 billion

All told, the tax increases in the cliff legislation and potential spending cuts could amount to about $335 billion. That is very close to what we have been expecting all along. We estimate that could have a negative impact of about two percent on the nation's Gross Domestic Product in 2013.

[INSERT LOWER 3RD]

Current forecast for economic growth:
1% in 1Q, rising to 1.5% for all of 2013

We still expect a soft start to the year, with economic growth of about one percent in the first quarter, rising to about 1.5 percent for the full year.

However, despite all the ongoing uncertainties, we do see some positive signs.

[DISSOLVE GRAPHIC]

Positive Signs Ahead

- Recession is unlikely
- Amount of fiscal drag is slightly less than anticipated
- Economy and markets have proved resilient
- The private sector has recovered from 2008-2009 financial crisis

A recession is unlikely. The amount of fiscal drag that will result from the cliff compromise is slightly less than we had initially anticipated. The economy and markets have proved quite resilient to the challenges in Washington. And the private sector has recovered significantly from the 2008-09 financial crisis and should help reignite the recovery in the months ahead.

Provided the debt ceiling is resolved relatively cleanly, we expect to see a clear rebound in growth in the second half of the year.

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