With the time allotted to the so-called “super committee” having drawn to a close, U.S. congressional fiscal-policy negotiators failed to reach a deal.

Lack of agreement demonstrates the political system’s continued difficulty in grappling with extremely complicated and contentious fiscal policy questions, as demonstrated earlier this year during the debt-ceiling crisis. Perhaps more importantly in the near term, the poor atmosphere prevailing in Washington makes it less likely that Congress will take action before the end of the year to head off the aggressive fiscal tightening programmed for 2012.

As a result, the economy may feel negative “fiscal thrust” next year on the order of 2%/GDP. Resulting growth sluggishness would keep the Fed in play, most likely resulting in another round of asset purchases, this time perhaps focused on mortgage-backed securities (MBS). Meanwhile, parts of the world experiencing satisfactory (though far from booming) growth, like China and emerging Asia more generally, will continue to shine in relative terms, as should U.S. companies with operations in those areas. In this paper, we examine the current state of play in U.S. fiscal policy, the road to sustainability, risks along the way, and implications for 2012 of the super committee’s apparent failure.

Why was the super committee created in the first place?

The super committee, technically the Joint Select Committee on Deficit Reduction (JSCDR), came into being earlier this year in the wake of the debt-ceiling debacle. As part of the Budget Control Act of 2011 (BCA), which raised the ceiling but failed to avert a credit rating downgrade, Congress established the JSCDR to formulate a medium-term fiscal adjustment plan, with the goal of improving the deficit’s projected path by at least USD 1.2–1.5 trillion in total between 2013 and 2021. The BCA mandated automatic spending cuts cumulating to USD 1.2 trillion to kick in starting in 2013 if the super committee failed to reach an agreement or if Congress did not approve it.
U.S. policymakers are wrestling with the worst federal government financial position of the past 50 years, in the wake of the Great Recession and the policy response that sought to cushion the downturn. Two years into a frustratingly mild recovery, the federal deficit continues to exceed 8%/GDP, and the debt ratio has risen sharply. Congress intended the super committee and the backstop of the automatic cuts as a near-foolproof part of the large needed medium-term fiscal adjustment. Still, neither a super committee deal totaling USD 1.2 trillion nor the automatic cuts would fully restore the U.S. to a sustainable fiscal path; both would leave a need for additional adjustments down the road on the order of two percentage points of GDP.

How did the U.S. fiscal position get so bad?
Ten years ago, the federal government enjoyed perhaps its healthiest fiscal position in the post-war era, with annual surpluses that peaked at 2.4%/GDP in FY2000 and a debt ratio just above 30%/GDP. Policy choices since the mid-1980s had both raised revenues and cut spending as a share of GDP, with defense expenditures in particular falling sharply as the Cold War ended. Public finances also benefited from the strong growth of the 1990s and the drop in interest rates from their early 1980s high—though improvement in the cyclically adjusted ex-interest balance did most of the work.

Since then, federal government finances have deteriorated dramatically. The first phase of worsening reflected policy decisions of the early 2000s, especially the Afghanistan and Iraq wars, which sharply raised military spending; the Bush tax cuts, which pushed down personal income tax receipts; and to a lesser extent the Medicare Part D prescription drug benefit (Exhibit 1). Decent growth during the 2004–2007 period helped mask the underlying worsening, but the headline balance in any case shifted from surplus to deficit, a swing of nearly 6%/GDP between 2000 and 2004 (Exhibit 2).

Conditions did improve between 2004 and 2007, but the subsequent Great Recession dealt a killer blow to the federal government’s fiscal position. The explosion of the deficit, which hit a postwar high of 10.1%/GDP in 2009, owed partly to direct cyclical effects (lesser income tax receipts, for example, and higher unemployment benefits), but more to policy decisions taken to counter economic weakness. These took place on both the revenue (especially the Making Work Pay tax cut and then the 2011 payroll tax relief) and spending sides (especially the spending stimulus contained in the ARRA law, which kicked in during 2009). As a result, in 2009 revenues dropped to their lowest level as a share of GDP since 1950, while spending hit a postwar high measured on the same basis. The economy’s mild recovery and the waning of some of the stimulus efforts have narrowed the gap since 2009, but FY2011 nonetheless finished with a deficit equivalent to 8.6%/GDP. The debt ratio, which edged upward in the mid-2000s, exploded higher during the recession and its aftermath, reaching 67% in 2011, a 30-point move in four years’ time (Exhibit 3).

How does one think about the U.S. fiscal outlook?
What is a “baseline”?
The first step in considering fiscal adjustment options is to estimate what will happen to federal government finances in coming years in the absence of corrective action—based on laws now on the books (or which Congress is likely to pass with little debate) and the outlook for growth, inflation and interest rates. According to press reports, the super committee spent considerable time in its early weeks attempting to agree on such a fiscal “baseline,” a detailed set of projections.
for the next decade. Why the difficulty? Seemingly a technical issue, construction of a baseline actually involves considerable discretion along with some guesswork about what future Congresses are very likely to do. Additionally, these efforts depend crucially on outlooks for economic variables that may differ sharply across analysts (or policymakers).

Indeed, fiscal forecasters need to approach their task with humility, as public finance outcomes over the medium term tend to differ sharply from expectations. The government’s forecasts included with the FY2001 budget proposal, made at the end of the Clinton era, serve as a case in point (Exhibit 4). At that time, the Office of Management and Budget (OMB) figured that the late-1990s surpluses would persist indefinitely, with the federal government balance in the black to the tune of 2.0%/GDP, on average, between 2001 and 2010, and the debt ratio declining toward zero. Instead, thanks in part to circumstances—two recessions, especially the Great one in 2008-2009—and in part to the policy choices mentioned above, the government ran a deficit of 3.5%/GDP on average during that period. Indeed, a gap equal to more than three percentage points of GDP opened between forecast and reality in the very next fiscal year. Changing economic and political winds greatly affect the course of public finances, even over fairly short periods, and any medium-term baseline projection needs to be taken merely as a template for fiscal policy decisions that inevitably will need constant tweaks and corrections down the road. Note that Congressional Budget Office’s (CBO) baseline deficit projection for the FY2012-2021 period shrank by USD 1.2 trillion (equal to the amount of deficit reduction sought by the super committee) just between March and August of this year, mostly because of different economic projections.

With that caveat in mind, the so-called “current policy” baseline projected by CBO represents a reasonable starting point for fiscal-outlook discussion. Both OMB and CBO make baseline projections, but CBO tends to adopt somewhat more conservative assumptions for economic growth than does OMB, arguably making its forecasts more suitable for thinking about risks to creditworthiness. The “current policy” path calculated by CBO differs from the agency’s main, or “current law,” baseline outlook in that it incorporates certain changes that Congress will likely make to existing laws. For example, the “current law” baseline assumes, among other things, that the Bush tax cuts will expire on current schedule at the end of 2012. The current policy baseline, by contrast, includes the indefinite extension of the lower tax rates, the adjustment of the alternative minimum tax to prevent its reach from swelling automatically, and the Medicare “doc fix,” a provision that Congress routinely passes to prevent a large drop in payments to Medicare providers that has been notionally required for a number of years. CBO calculates two versions of the current policy baseline, one including the deficit reduction meant to be arrived at by the super committee (USD 1.2 trillion figure cumulatively between FY2013 and FY2021) and one without those trims.

**What does the baseline show for the next decade?**

Rather than the sideways movement that one might assume, CBO’s current policy baseline actually shows fairly sharp improvement in public finances during the next few years, for several reasons (Exhibit 5). First, much of the 2009 stimulus effort either already has run its course or will end soon (including temporary tax cuts). Second, CBO assumes that economic conditions improve gradually, with the “output gap”...
closing over a multi-year horizon and providing a direct boost to public finances. Third, the Budget Control Act of 2011 already put in place a system of caps on discretionary spending (including defense), accounting for a bit more than half of the total projected improvement—although the law simply lays out overall limits on such spending without spelling out any details on how the restrictions will be satisfied. The ongoing, gradual rise in federal health-care spending provides a partial offset, in particular stymieing additional improvement in the overall position after the next few years.

In the version of the baseline that excludes the JSCDR cuts, the primary fiscal deficit shrinks by 4.4 percentage points of GDP from FY2011 to FY2014, with about half that swing occurring in the current fiscal year, 2012. The primary deficit subsequently continues to narrow, but more gradually, stabilizing at just over 1.5%/GDP in the second half of the forecast horizon. Adding in the JSCDR cuts, which are assumed to fall equally throughout the period, further narrows the primary gap by about 0.5 percentage points of GDP per year, leaving the steady-state primary deficit at roughly 1.2%/GDP by the end of the current decade. Under these circumstances, the public debt ratio would continue to rise gradually, arriving in the neighborhood of 80%/GDP by 2021. By comparison, combining the “current law” baseline, which most significantly includes the expiration of the Bush tax cuts as well as no AMT patch, with the JSCDR cuts puts the primary balance into surplus by 2014 and in the black by about 1.5%/GDP on average in the years around 2020. The public debt ratio would decline slowly, hitting 61%/GDP by the end of the forecast horizon. Exhibits 6 and 7 compare the projected paths for revenue and primary spending under these scenarios.

**How do entitlement programs fit into the U.S. fiscal outlook?**

Within this overall baseline, estimates for spending on entitlement programs deserve separate attention. Social Security spending projections do not involve much guesswork, given the defined-benefits nature of the program and slow-moving trends in incomes and retirements. Forecasters expect Social Security spending to rise slowly in coming years, climbing...
about 0.4-0.5 percentage points of GDP between now and
2021, with very minor differences between the CBO and OMB
outlook (Exhibit 8). Health care, though, represents a different
story, both in the pace of expenditure growth and in its uncer-
tainty. Federal spending on health care—mostly Medicare and
the federal portion of Medicaid—has risen faster than nominal
GDP growth for many years, though the spike in 2009–2011
reflects cyclical effects (as more people qualified for benefits
during the recession and as the federal government picked up
a larger share of Medicaid spending). Considerable dispute
surrounds the extent to which the health care reform law will
slow spending growth in the main two programs, which will
continue to depend in large part on the types of services pro-
vided to retirees under Medicare. Health care reform will,
however, add expenses in the form of subsidies for individual
insurance purchases and the growing (though still fairly minor)
Children's Health Insurance Program. Putting all this together
requires considerable estimation. CBO assumes that total fed-
eral health spending rises from 5.5%/GDP in 2012 to 7.3% in
2021, or nearly two percentage points of GDP, a major factor
in keeping the primary balance in deficit throughout the base-
line projection period (Exhibit 9).

What’s a sustainable fiscal position for the U.S.?
Another question without a simple answer is: what constitutes
debt sustainability? Most observers would likely agree that fis-
cal policy should generally aim, over time, for a public debt
ratio that is stable or declining from a reasonably low level.
But what’s reasonable? After all, Japanese public debt
amounts to more than 200%/GDP, and the Japanese govern-
ment is currently borrowing 10-year money for less than 1%.

That circumstance probably reflects the very high domestic
saving rate, however, and no one is seriously suggesting that
the U.S. follow the Japanese path. Instead, a plausible goal
might be to prevent U.S. public debt from rising over the 75%/GDP
level within the next few years (compared with 67% at
the end of FY2011) and to put it on a downward path thereaft-
er. Recent academic research has identified 90%/GDP as a
line above which economic growth in industrial countries
tends to slow, although the U.S.’s status as a reserve currency
issuer might loosen that constraint. In any case, allowing the
debt ratio to climb above the 75% mark would severely limit
fiscal flexibility in the event of another recession (note that
the low starting level of debt entering the Great Recession cre-
ated space for stimulus, whereas a similar effect from the cur-
cent debt level would almost certainly not be feasible).

Ideas about sustainability also depend on long-term projections
for growth and interest rates. The well-known debt sustainabili-
ty condition expresses the primary (ex-interest) fiscal balance
that keeps the debt ratio stable as a function of the debt ratio
itself and the difference between the real interest rate charged
on public debt and the growth rate of GDP. At the moment, the
U.S. government is benefiting from extraordinarily low Treasury
yields, which have pushed the effective real interest rate paid
on its debt well below even the somewhat meager current rate
of GDP growth. Over time, presumably interest rates will rise,
and probably by a larger amount than GDP growth will accel-
erate. A working assumption of 2.0%-2.5% seems reasonable for
GDP as a medium-term trend, alongside something like 2.5% for
real interest rates (nearly a percentage point above the post-
war average, even though the Treasury’s current efforts to fund
at the longer end of the curve will help lock in relatively low
average interest rates on public debt for a while).
Given those assumptions for growth and interest rates, the federal government should run a small primary surplus, on the order of 0.2%/GDP, to stabilize its debt ratio. A larger primary surplus, of around 1.0%/GDP, would steer the debt ratio gradually downward (by about one percentage point per year) (Exhibits 10 and 11). An even greater effort, say a primary surplus equivalent to 2.0%/GDP, would provide more protection for creditworthiness in the event of another severe recession, but perhaps lies beyond the realm of political feasibility. Of course, a more pessimistic outlook for growth would require a higher primary surplus to stabilize debt, as would a higher estimate for real interest rates (and vice versa). Assuming that the basic assumptions are at least reasonable, though, growth and interest rates fall into the category of issues to be monitored over time for future fiscal tweaking.

All this adds up to the federal government doing something a bit different from the past, though in balance terms not dramatically so. Between 1966 and 2007, the government averaged a 0.1%/GDP primary fiscal deficit, ranging from a 4.7%/GDP surplus in 2000 to a 3.4%/GDP deficit in 1983, and with primary surpluses in 17 of the 42 years. In other words, achieving a primary surplus in and of itself looks feasible. The challenge will lie in managing the long path from today’s large deficit to a surplus, and in balancing political views about the appropriate level of revenues and spending as a share of GDP.

What needs to be done to get to sustainability?

The road from the roughly 7.1%/GDP primary deficit recorded in 2011 to a 1.0%/GDP surplus will involve two forces. First, cyclical improvement in the economy—the gradual closing of the still-large output gap—will help public finances. Based on Organisation for Economic Co-operation and Development (OECD) and CBO estimates, the nearly full closure of the output gap by 2021 should improve the primary balance by about two percentage points of GDP. Second, the structural or cyclically adjusted primary balance will climb thanks to policy change. This fiscal effort will need to amount to about six percentage points of GDP. That distance exceeds by about two percentage points the improvement generated by policy decisions in the 1990s. As noted above, some of this adjustment appears “baked in the cake” based on current policies, but much of it still needs to be agreed upon.

In terms of the size of the government’s commitments, federal revenues averaged 18.2%/GDP between 1966 and 2007, without an obvious secular trend, while primary spending averaged 18.3%/GDP. Rising costs associated with aging will create “automatic” upward pressures on spending over time, though this issue will become more urgent after 2021 than during the coming decade. Achieving a persistent primary surplus over the medium term, though, will require either higher revenues on average than in the past, a reduction in old-age benefits, probably especially on the medical side, very low discretionary spending by historical standards, or some combination of the three.

How did the super committee fit into the medium-term outlook, and how should dollar values of “packages” be analyzed?

The overall dollar amounts attached to the various deficit-reduction proposals issued over the past year, including those under consideration by the super committee, can obscure as much as illuminate, in part because of the abovementioned baseline issue and in part because of differing saving distribu-
tions over time. But three basic principles apply. First, the figures represent cumulative savings over the nine-year FY2013-2021 period. Second, the numbers include a combination of “first-order” deficit reduction efforts (either spending cuts or revenue increases or both) and assumed debt-service savings that will result from a lower level of public debt. The debt-service savings rise over time. Third, spending cuts are generally presented as being linear across the period (i.e., a one-off reduction in FY2013 that continues until FY2021), whereas most revenue increases will tend to rise over time (as GDP grows and the tax base broadens). CBO’s pro-forma, USD 1.2 trillion assumption about the super committee outcome, for example, includes USD 1 trillion of “first-order” deficit trimming, divided equally among the nine years, along with USD 200 billion of debt service reduction, which trends upward over time. This translates into deficit reduction, relative to the baseline, equivalent to 0.7%/GDP per year, with primary deficit shrinkage of 0.7%/GDP in FY2013, gradually declining to 0.5%/GDP in the latter part of the period. A quick rule of thumb for calculating primary deficit reduction in FY2021 is to take the overall figure, subtract the roughly 15% that will represent debt service savings, divide the remainder by 9, and then compare the result with estimated FY2021 GDP of around USD 23.8 trillion. This approach will likely underestimate the FY2021 impact of a package that includes significant revenue increases, which are more likely to be back-loaded in their effect.

How does sequestration fit it?
The Budget Control Act approved by Congress earlier this year, which established the super committee, includes a trigger for automatic spending cuts, often referred to as “sequestration,” in the event that the JSCDR fails to reach agreement on USD 1.2 trillion in deficit reduction during the FY2013-2021 period. These automatic cuts would take effect in January 2013 and would bridge the gap between whatever the super committee decides and the USD 1.2 trillion figure. The cuts would fall on both mandatory and discretionary spending, but with a portion of mandatory spending excluded, CBO estimates that about 70% of the savings would come on the discretionary side (with the remainder roughly split between mandatory spending categories and debt service savings). Cuts to discretionary spending would further reduce these outlays, on top of the caps on discretionary spending growth already included in the Budget Control Act (and which are incorporated in the CBO baseline). Of course, with the automatic cuts more than a year in the future, Congress could move to avoid their taking effect, making the current deadline slightly artificial. As one possibility, Congress as a whole could put together a fiscal adjustment package worth at least USD 1.2 billion during the course of 2012, although the November general election would likely interfere with any such effort. Alternatively, Congress could simply vote to eliminate or postpone the automatic cuts. That move would require bipartisan support to head off a likely filibuster.

What’s in store for fiscal policy in 2012?
Under current policy, fiscal policy will tighten significantly in 2012. The end of discretionary stimulus spending and the expiration of the payroll tax cut and extended unemployment benefits will do much of the work. Even assuming that Congress extends the “doc fix” and patches the AMT, as seems likely, CBO expects the primary fiscal deficit to narrow from 7.1%/GDP in FY2011 to about 4.8%/GDP in FY2012, with a decent chunk of the hit being felt all at once in January. With most of that swing coming from structural policy moves, the economy will face a very strong fiscal headwind in the year ahead. It seems likely that most of this negative fiscal thrust will make itself felt in the form of slower growth, to the tune of 1.5-2.0 percentage points of GDP (in other words, the “multiplier” associated with the primary balance swing should approach 1). With interest rates (both short- and long-term) already quite low, not much offset in the form of easier financial conditions will be forthcoming. And with much of the rest of the world also growing sluggishly and tightening fiscal policy (and considering that the U.S. is not a particularly open economy to begin with), the U.S. seems unlikely to be able to offload much of its weakness to foreigners in the form of reduced net imports. Effective fiscal tightening on the order of 2%/GDP represents a frightening prospect given that growth has averaged 1.4% in 2011 to date and 2.5% thus far during the expansion.

The super committee’s failure in and of itself, and possible attempts by the full Congress to get the deficit-reduction process back on track, should not greatly affect the 2012 outlook. The JSCDR was mostly looking for deficit reductions during the FY2013-2021 period, and the automatic cuts will occur only in 2013. Still, White House proposals for additional near-term stimulus have run into a brick wall in part because of the poor atmosphere generated by the year-long fiscal battle between Democrats and Republicans and the resulting uncertainty about the medium-term path for public finances. A super committee agreement that at least represented a first step toward fiscal sustainability might have created political and economic room for emergency legislation to be passed in December that would
head off a portion of next year’s fiscal adjustment. An extension and perhaps enlargement of the payroll tax cut, for example, represents an option that could be implemented quickly and one that would be straightforward to reverse in 2013 or 2014 (possibly gradually). The inconclusive end to the super committee process makes such legislation considerably less likely.

What are the medium-term risks?
Carrying out a large-scale, multi-year fiscal adjustment effort poses a myriad of implementation challenges, beyond the matter of getting the basic, overall numbers to add up. The following represent some of the more obvious potential problems:

1. Congressional decisions do not bind future Congresses: Any Congress can vote to reverse a decision made by a previous Congress. The United States has not enjoyed much success in the past with “automatic” deficit-cutting mechanisms, which have generally proven easy to override. Staying the course over the next eight to ten years of deficit reduction will likely add significant strain to an already stressed political system.

2. Discretionary spending is being squeezed to historically low levels. Non-defense discretionary spending has averaged about 4.0%/GDP over the past 40 years and, during that period, has never dropped below 3.2%/GDP (Exhibit 12). With the discretionary spending caps already approved this year, but before considering possible additional cuts from the JSCDR, CBO projects non-defense discretionary spending to drop to 3.1%/GDP (a new record low) in 2016 and 2.7%/GDP in 2021 (Exhibit 13). The caps introduced this year simply set limits rather than specifying specific cuts, meaning the difficult choices lie ahead. Cutting these outlays to such a low level will significantly affect a broad range of popular programs, including veterans’ health care, student loans and grants to state and local governments in areas like education, not to mention infrastructure spending. Lowering spending in this fashion may not prove politically feasible and might not be desirable from the perspective of public goods provision.

3. Federal health spending rises with national health care costs. Addressing the prospective increase in Medicare and Medicaid costs likely requires a broader, national effort to rein in overall health care spending. After all, per-beneficiary costs of these programs have climbed in line with those faced by privately (or self-) insured people. Their rising share of national health care spending has simply reflected rising eligibility (as, to some extent, the population has aged and joined Medicare, and as Medicaid has been expanded). The health care reform battle of 2010 demonstrated the difficulty in getting a handle on rising health care costs generally, complicating efforts to “bend the cost curve” in the federal health programs.

How should investors behave in a fiscally constrained world?
Barring a sudden change in the political climate, U.S. fiscal policy seems likely to tighten significantly in 2012. During FY2011, the structural primary deficit shrank by just 0.3%/GDP, but despite this modest headwind, GDP growth averaged only 1.6% during the period. Of course, the oil price shock, and other increases in commodity prices, damaged growth
significantly, and this drag appears to have lifted. Still, a fiscal drag equivalent to nearly two percentage points of GDP would likely leave the U.S. economy growing at a below-trend pace.

Implications of another spell of weak U.S. growth for investments include:

- **More quantitative easing from the Fed, with an MBS flavor.**
  Below-trend growth will likely put upward pressure on the unemployment rate, in turn paving the way for another round of easing by the Fed—similar to the dynamics that led to both QE2 and Operation Twist. Under the dual mandate, the Fed would have little choice but to at least consider additional support for the economy. The Federal Open Market Committee (FOMC) appears to be focusing on communications strategies in the near term, but voting members including Dudley and Tarullo have recently spoken in favor of the possibility of further asset purchases. This time around, MBS might become the focus, partly because of concerns that the Fed could end up owning too much of the Treasury market and partly because of housing’s persistent sluggishness (though whether lower mortgage rates would provide effective stimulus for this sector represents an open question). In any case, the Fed would likely remain a presence in the medium- to long-term tenors of the Treasury curve.

- **Equity themes to include U.S. multinationals and Asia.**
  Sluggish growth in the U.S. would put a premium on companies with significant operations outside the country, especially in relatively robust Asia. While tech-oriented (and thus G3-exposed) stocks in Asia would likely continue to struggle, more domestically focused plays in the region might outperform, given the probability of policy easing in China (where inflation is starting to drop) and its neighbors by early 2012 and the unspectacular-but-satisfactory growth likely to result. This theme might extend even to Japan, where exports will face the twin obstacles of weak U.S. and euro area growth and the strong yen, but where the local economy should benefit from reconstruction spending now in the pipeline.

- **Support for commodities.**
  In the past two years, commodities have drawn support from the combination of decent growth in emerging market Asia and near-zero G3 policy rates (and low yields along the curves). These two conditions should remain in place in 2012, continuing to provide tailwinds for cyclical and supply-constrained commodities.

### Appendix

#### A bit of history

Federal government finances have gone through five phases in the post-war era (which for our purposes we will define as 1952 to the present, leaving aside a period of large fluctuations immediately following the end of the Second World War).

1. From 1952 to the early 1970s, broad stability prevailed, with modest annual deficits and no great changes in underlying revenue and spending trends. The combination of small primary surpluses, generally strong GDP growth, and low interest rates allowed for a sharp decline in the debt ratio, which peaked at 108.7%/GDP in 1946 after enormous war-related deficits and dropped to 23.9%/GDP by 1974.

2. During the next decade, federal finances gradually worsened as spending growth accelerated—a trend exacerbated to some degree by the rise in interest rates during the late 1970s—and revenue growth suffered from persistent economic weakness. Mandatory spending climbed in the mid-1970s as social insurance programs began to cost more, and the late-1970s defense buildup reversed what had been a gradual decline in defense expenditure as a share of GDP. Real spending growth ran at 4.3% per annum between 1975 and 1983, with revenues climbing at only a 1.3% pace. The primary balance dipped into persistent deficit, with the headline shortfall averaging 3.3%/GDP. The debt ratio began to climb, moving above 30% by 1983.

3. The following 17 years brought gradual and eventually dramatic improvement, thanks to a series of policy initiatives, with an extra push from falling interest rates and strong growth in the late 1990s. Tax increases in the mid-1980s and again in the 1990s played a significant role, as did a precipitous decline in defense spending as a share of GDP following the end of the Cold War. Non-defense discretionary spending also dropped in the late 1990s to its lowest level in decades relative to GDP. By the end of this phase, the government was running large surpluses—2.4%/GDP in 2000. Revenues peaked at 20.6%/GDP in 2000, while spending dropped to 18.2%/GDP in 2000. The debt ratio continued its climb until 1993, topping out at 49.3%/GDP, before trending lower thereafter as balances improved, growth accelerated, and interest rates dropped. Federal debt equated to 34.7%/GDP in 2000.

4. Conditions worsened again during the 2001-2007 period, with the recession and then policy changes putting the federal...
5. Into an already weakened fiscal position, the financial crisis and recession caused an extraordinary widening of the deficit, sending revenues plunging and spurring large-scale stimulus. In 2009, revenues dropped to their lowest level as a share of GDP since the late 1940s, and spending hit its highest point on the same basis since World War II. The combination of large deficits (which began already in 2008) and the initial fall in GDP sent the debt ratio soaring, to an estimated 67.3%/GDP at the end of FY2011.

Disregarding the outlier years of 2009-2011, during the 1952-2008 era, federal revenues averaged 18.0%/GDP, with primary spending equal to that figure and total spending at 19.9%/GDP. The numbers rise slightly if only the years after 1966 are considered, reflecting the creation of the health-care programs in the 1960s. While it has fluctuated somewhat around its long-run mean, revenue generally has not followed secular trends, other than for its jump in the late 1990s and subsequent fall. Its composition did undergo a structural change during the 1950s and 1960s, with corporate income tax and excise taxes becoming much less important, replaced by social insurance taxes (the Social Security and Medicare payroll levies). The personal income tax take generally held steady in the postwar era, though it did rise to an unusually high level as a share of GDP in the late 1990s before dropping to a post-1952 low in the immediate wake of the Bush tax cuts, thus serving as the main driver of the overall revenue up-and-down move during that period (Exhibit 14).

Spending, by contrast, climbed steadily from the late 1960s to the early 1980s, moved lower from then until 2000, and rose thereafter. Defense has represented the most volatile category of spending and the portion that increased most strongly in the early 2000s, though in level terms (as a share of GDP) it remains far below its 1950s and 1960s highs. Non-defense discretionary spending has also ranged fairly widely, moving up in the 1970s and then dropping nearly two percentage points as a share of GDP during the following 20 years. Mandatory spending took a step up in the late 1960s and early 1970s as Social Security benefits became more generous and the health-care programs kicked in. Between 1975 and 2007, though, mandatory expenditure did not change much in relation to GDP, averaging just under 10%, with mostly cyclical fluctuation. The subsequent recession boosted mandatory spending significantly, thanks in large part to greater reliance on Medicare and the explosion in unemployment claims (but also because TARP spending in 2009 came under this category). Interest spending rose gradually from the mid-1970s to the late 1990s and then slipped back (Exhibit 15).

The deficit reached 10.1%/GDP in 2009, a postwar high. It narrowed to 8.9%/GDP in 2010 and an estimated 8.5%/GDP (USD 1.3 trillion) in fiscal year 2011, which ended in September. The FY2011 gap represented a considerable improvement on estimates made earlier in the year, with the CBO having projected a 9.8%/GDP deficit as recently as January. Tax receipts surprised favorably, and mandatory spending lagged expectations. Still, the FY2011 outcome represented the third-largest deficit, as a share of GDP, in the postwar era, with revenues three percentage points of GDP below their long-run average and spending about three points above. Fiscal year 2012 began on October 1, but policy decisions taken in coming weeks will significantly affect the outcome, especially with respect to tax-rate changes that may or may not take effect January 1.
A significant but not precisely known portion of the current yawning deficit owes to the lingering effects of the recession on both revenue and spending. OMB calculates a cyclically adjusted government balance, which for 2010 it put at 5.6%/GDP, compared with the 8.9% actual outcome. CBO recently estimated that the 2012 deficit, which it projects at 6.2%/GDP in its baseline scenario, would instead be 4.0% if the economy were operating at potential. In other words, the deficit should narrow by a little more than two percentage points of GDP over time, assuming the economy returns to something like full employment. These estimates take into account only the automatic changes in revenue and spending that occur with economic swings, such as increased unemployment insurance payments and weak tax receipts. They do not include the effects of policy choices, such as the stimulus spending of recent years or the 2011 payroll tax cut. The expiration of some of these counter-cyclical policies accounts for much of the improvement between 2011 and 2012 in CBO’s baseline scenario. In general, automatic stabilizers play a smaller role in U.S. fiscal policy than in many other countries. The OECD calculates a 0.34 elasticity of the U.S. fiscal balance to changes in GDP, compared with a 0.44 average for the OECD as a whole and 0.48 for the euro area countries. While these figures are subject to uncertainty, they do suggest that most of the moves in U.S. fiscal outcomes in the past few decades have come from policy decisions—admittedly, some of which have been taken in response to business-cycle swings—rather than from cyclical effects per se. The OECD’s calculation of the U.S. general government cyclically adjusted balance, for example, rose by 5.1 percentage points of GDP between 1993 and 2000, implying that roughly 80% of the overall improvement in public finances during that period reflected policy, rather than strong growth (Exhibit 16).

EXHIBIT 16: ESTIMATED CYCLICALLY ADJUSTED FISCAL BALANCE

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- Twelve in 2012: What politics can mean for markets in the year ahead
  2011 has been extraordinary in a number of respects, including the influence of politics on financial markets. In this paper, Rebecca Patterson, Chief Markets Strategist, describes reasons why politics could play an even bigger role in the markets in the year ahead.

- Risky business... Don’t de-risk, right risk
  More firms are seeking to de-risk their pension plans, but some strategies are not feasible in a low yield environment. By blending broadly diversified return-producing and liability-matching assets, sponsors can “right risk” their plans, providing for growth while moderating unrewarded interest rate risk.

- Price/earnings investing: One picture requires a thousand words
  While price-earnings ratios do offer investors some useful, actionable, and potentially profitable signals, they only work for certain types of investors—those willing to rebalance frequently and shift allocations meaningfully from year to year.

- A New Fiscal World Order: Implications for investors
  Given concerns over the extreme market turmoil, U.S. debt downgrade and European sovereign worries, the volatile events in August 2011 marked a turning point for global economies. Amid fiscal tightening and deficits, a “new fiscal world order” means thinking differently about investing.

- Strategic Emerging: The role of emerging markets in a long-term portfolio
  Emerging market assets, while acknowledged as an important element of the investment universe, have lagged in their acceptance as a strategic asset class.
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