



Cliff, shmiff

### **Much ado about little**

So the fiscal cliff has been averted – or at least postponed. After a week in New York I am even less impressed with the significance of either the deadline or of the fiscal cliff as such.

The whole debate around the fiscal cliff (as opposed to the issue of whether the US needs to deal with its underlying fiscal imbalances, which is a different story) rests on two assumptions. First, that fiscal policy has a long-term effect on output growth; and second, that the timing was crucial lest the US economy fall into recession. Tim Congdon of International Monetary Research (<http://www.imr-ltd.com>) has demonstrated (using US data) that the first assumption is wrong. With reference to the second (even assuming the first assumption is right) Constance Hunter has rightly referred to the whole issue as the fiscal bunny slope (<http://www.economonitor.com/constancehunter/2012/12/03/the-fiscal-bunny-slope-whether-a-patch-or-a-grand-bargain-there-aint-gonna-be-no-cliff/>), pointing out that any impact of the fiscal measures will be gradual.

So does it matter that Congress has reached an agreement, implementing some measures, avoiding others and postponing a third group? Yes, in some ways it does. First, because although the medium and long-term impact of fiscal policy on output growth is negligible, there can be a short-term impact. This is primarily related to the hype surrounding the issue. If companies and households believe that falling over the fiscal cliff will cause the economy to fall into recession, they may adjust their behaviour accordingly and it could become a self-fulfilling prophecy. Hence the interesting current situation in the US, where hard data is generally mildly positive, but sentiment data is generally negative, a point reinforced by the relatively positive data from the December ISM manufacturing survey published today. If weak sentiment is connected with the failure of politicians to reach a deal, the fact that a deal was reached should show up in stronger sentiment data from January onwards.

Second, it should dampen future anxiety by showing (in fact, confirming yet again) that politicians are ultimately anxious to avoid being perceived to be actively pushing the economy into recession (again assuming that fiscal policy has an impact). This could hopefully eliminate some of the excitement about future deadlines. Because deadlines there will be: the US government debt ceiling was reached just before the end of the year and is not covered by the latest agreement, so this will have to be dealt with in one or two months; planned spending cuts are only postponed for two months; and more fundamentally, the real issue for US public finances, namely for how long a country can be taxed like a small-government economy, but sustain public spending like a big-government economy, has not been addressed. Dealing with this means actually doing something about entitlement spending – Medicare, Medicaid and Social Security – which will be a real political minefield and hence full of opportunities for extreme posturing.

Going beyond this debate, the outlook for US output growth in 2013 remains reasonably positive, reinforced by activity in some other parts of the world (China, Australia, Canada) also looking somewhat better (unsurprisingly, new export orders rose strongly in the ISM survey). This should be good news for

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equities in 2013, but with a significant change from 2012. Over the past year, bonds tended to drive markets, meaning that bonds and equities moved in the same direction (recently up). This year, the driver is likely to be equities, which means that bonds should do badly – although this is to some extent subject to central banks desiring otherwise and acting on this desire.

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