



Re-electing the Status Quo

Some Fiscal Drag; No Recession

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Post election, the major challenge in Washington will be to steer the country away from the year-end fiscal cliff. That cliff, which is the result of expiring Bush-era tax rates and the spending cuts that Congress agreed to in August 2011 as part of the debt-ceiling deal, represents a potential fiscal drag of 5% of GDP—enough to tip the US economy into recession, according to the Congressional Budget Office.

Despite divided government, we think that a majority of incumbent politicians recognize that risk. Thus, **we expect action to mitigate and delay higher taxes and spending cuts**, resulting in fiscal drag of 1%-2% of GDP, not 5%.

Some elements of the cliff have already been addressed. For example, the US Congress has approved a continuing resolution to fund the government into 2013. Moreover, the debt limit will not be breached at year end but rather in later February or early March.

However, the existing Bush-era tax rates are still set to expire at the end of 2012 and, absent any congressional action, would result in a sizeable tax increase. Most of the political disagreement centers on extending current rates in one area: high-bracket taxpayers. **We think it likely that existing rates will be extended for most taxpayers for one year**—with some compromise for upper income brackets—to give politicians time to address this in 2013.

Finally, the impending across-the-board mandatory spending cuts would also cut defense—an outcome we think Congress will avoid. Thus, **the full effect of the fiscal cliff will likely be mitigated and delayed**. The remaining economic drag stems from expiring payroll-tax relief and extended jobless benefits, both of which have little political support for renewal. All told, Morgan Stanley economists forecast that modest fiscal drag will dampen US GDP growth to a rate of 1.4% in 2013 from 2% this year.

Next year, Washington needs to address the alarming out-year fiscal deficits—a problem that, left unaddressed, could lead to another US credit downgrade and financial market instability. Stay tuned.

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