GFC ECONOMICS

DAILY COMMENTARY

TIGHTER FISCAL POLICY UNDERPINS TREASURIES

Throughout his long tenure at the helm, the Federal Reserve Chairman has never been shy about sharing his thoughts regarding US fiscal policy matters. To the chagrin of many democrats, Mr Greenspan was a notable supporter of the Bush administration's tax cutting agenda of the first term. So when he suggested in a recent speech in Kirkcaldy, Scotland, that "the voice of fiscal restraint ...has at least partially regained volume", it is understandable the markets would respond enthusiastically. Ten-year yields dipped below 4.0% at one point last week. Of course, the fiscal projections are not without risks. The omission of potential costs associated with Iraq and Afghanistan beyond FY2005 is highly questionable. And the scope for cutting non-defence spending is circumscribed by the high level of commitments to mandatory programmes. Nevertheless, the FY2006 budget constitutes an important turning point. Any attempt to control spending marks a notable departure from the profligacy of the Bush administration’s first four years. Even if the curb in spending falls short of expectations, the effects of fiscal drag alone should eventually help to underpin the secular bullish argument for Treasuries.

How Credible Are The Fiscal Plans?

When the US economy started to turn down in response to the collapse of the dotcom bubble, the response from the authorities was both impressive and concerted. While the Federal Reserve was busy slashing short-term rates in 2001 - by an unprecedented eleven times in just twelve months - government officials were busy putting together the first of three fiscal packages. The Economic Growth and Tax Relief Reconciliation Act was passed in June 2001. This was duly followed by the Job Creation and Worker Assistance Act in March 2002, while a third piece of legislation was enacted in January 2003. The various headline-grabbing pronouncements of how much these fiscal packages were worth overstated the stimulus. Even so, the cut in tax rates was still substantial.

Just how much the stimulus was worth to the personal sector can be gleaned in part from the monthly income reports. Taking the differential between overall and disposable incomes suggests that the packages provided a boost of US$145.3bn and US$89.0bn in FY2002 and FY2003 respectively. Of course there are other benefits - notably from the cut in capital gains tax - which do not show up in these figures. Also, the Homeland Investment Act of last December is providing a significant potential boost that lies outside the scope of these numbers, which encapsulate the boost to the personal sector from lower income and dividend tax rates.

Nevertheless, these are significant sums, suggesting that at a minimum, the Bush administration's fiscal policy gave the economy a boost equivalent to 2.2% of GDP during FY2002 and FY2003. This amounts to a hefty stimulus, but that does not include the substantial rise in government spending witnessed during the first term. Real growth in Federal government expenditure averaged 4.9% y/y in the first four years of the Bush administration. That is by far the biggest increase in modern times. Spending rose by 0.4% y/y in the first Clinton administration, and 1.1% y/y in the second term. The first Bush administration presided over an increase of 3.9% y/y, while expenditure under President Reagan went up by 4.1% y/y and 2.4% y/y during his first and second terms respectively. Of course, higher defence spending has put the budget under considerable pressure since 9/11, but non-defence expenditure has still gone up by 3.7% y/y in real terms in the last four years. As the OECD figures show, the cyclically adjusted general government balance went from a surplus of 1.3% of GDP in 2000 to a deficit of 4.1% three years later.

Now the cycle has turned, and the growth in non-defence spending - in US$ terms - is forecast

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to slow in FY2006 to 3.3% y/y, helping to bring the deficit down to US$390bn from US$412.3bn in the year ending last September. In theory, the Bush administration should have little difficulty in forcing through the planned cuts in discretionary spending, which are subject to an annual appropriations process and, therefore, easier to control. But the projected savings are still quite modest, equivalent to an estimated US$20bn in FY2006. These savings could easily be offset by the continuing costs of maintaining US troops in Iraq and Afghanistan, for which no provision was made in next year's budget. Since the FY2005 budget was enacted, Congress has been forced to agree on two further supplementary budgets totalling US$104bn, just to cover the costs of a military presence through to the end of September. Of course, with more elections in Iraq due in December, it is unlikely that US forces will be withdrawn on any significant scale before the year-end. Since the new fiscal year begins on October 1st, even on the most optimistic reading of events in Iraq, there will have to be considerable extra costs incurred during FY2006. Given that the deficit is only expected to fall by US$37bn next year, it is not difficult to see how 'unanticipated' increases in defence spending could derail the administration's plans.

Furthermore, there are inevitably doubts over just how far the administration will be able to keep a lid on non-discretionary areas of spending. There is no automatic mechanism to impose restraint on these programmes, which generally operate on formulas that are not subject to annual review. President Bush has proposed sizeable savings on these mandatory-spending areas. Significant cuts in Federal high school funding and reforms to Medicaid will help to cut a cumulative US$137bn from the budget over the next ten years. But the President will need to expend some of the "political capital" he earned in last November's election victory to appease a somewhat hostile Congress and ensure these savings are realised.

Last but not least, doubts have been raised over the revenue projections, which play an important role in ‘halving’ the deficit by FY2010 from the original forecast for last year of US$521.0bn The Budget proposals call for a 0.8% rise federal taxation receipts as a share of GDP over this five year period. This has important implications. Firstly, the administration is acknowledging the significant fiscal drag built into the structure of today's tax rates. That much was evident from the data for CY2004, which showed that personal income tax receipts rose 0.2% as a share of GDP. The administration's plans are credible, since the average rise in tax revenue of 0.2% of GDP implied between FY2006 and FY2010 is in line with the fiscal drag for CY2004. Of course, the revenue assumptions also hinge on whether real GDP growth can be sustained at the 3.3% y/y forecast through this period. But leaving that aside, the fiscal drag is still an important element of the planned deficit reduction. If receipts rose in line with nominal GDP, the deficit would only fall to US$350bn or 2.2% of GDP by 2010.

From a bond market perspective, the fiscal drag in itself will mark an important shift from the considerable stimulus imparted by the tax cuts between 2001 and 2003. The revenue projections may prove too optimistic, particularly since corporate tax receipts - up by an average of 45.5% y/y in the twelve months to January - are unlikely to keep rising at this pace. Just how quickly the fiscal position improves may be more important for currency markets, where rightly or wrong, the rising Federal deficit has been seen as a major contributor to the record trade imbalances (see commentary of February 4th). But for the bond market, the degree of success enjoyed by the US administration in reducing the deficit may not be quite so critical. Federal government debt outstanding was still only 37.2% of GDP at the end of 2004, and is not onerous, although of course, there are legitimate doubts over the long run viability of the social security system. An overrun in the Federal budget deficit need not be negative for the bond market *per se*. It is quite clear that fiscal policy is going to be much tighter than it was during the first Bush administration. That in itself will be enough to underpin the secular case for lower Treasury yields.