The Economic Consequences of Falling Off the Fiscal Cliff – If Oil Prices Decline

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The fiscal cliff encompasses a set of budgetary measures that will take effect if the US Congress and the Obama administration cannot agree on alternative spending cuts and revenue increases by December 31. The cliff was created in August 2011 when Republicans and Democrats failed to agree on budget changes then. As a solution, they proposed empowering a high-level committee to negotiate an agreement by November 2011. The law stipulated that large tax increases and expenditure reductions would occur if the committee failed.

The committee failed. Thus, large tax increases and severe spending cuts will take effect January 1, 2013. Table 1 presents the numbers. The nonpartisan US Congressional Budget Office (CBO) created this table and Macroeconomic Advisers (MA) updated it. I reproduce it here with MA's permission. As the last row indicates, the negative fiscal cliff effects will amount to more than four percent of GPD in 2013 and 2014.

Table 1. Elements of the Fiscal Cliff
(Contribution to Deficit, Billions of Dollars, Calendar Years)

	2013	2014
Expiration of Payroll Tax Holiday	(116)	(119)
Expiration of Emergency Unemployment Benefits	(30)	(31)
Reduction in Medicare Reimbursement Rates	(14)	(16)
New Taxes under the Affordable Care Act	(22)	(24)
3.8% Tax on Unearned Income	(17)	(18)
0.9% Medicare Surtax	(5)	(6)
Expiration of Personal Tax Provisions	(316)	(319)
For Taxpayers with Incomes Above Certain Thresholds	(61)	(75)
Other Tax Provisions Enacted in 2001, 03, & 0 [sic]	(90)	(111)
Estate and Gift Tax Provisions	(12)	(28)
Indexed & Increased AMT Exemption Amount	(103)	(42)
Interaction of Extending 2010 Tax Act & AMT Provisions	(51)	(62)
Expiration of Major Business Tax Provisions	(59)	(68)
Partial Expensing of Investment Property	(54)	(52)
Section 179 Expensing	(5)	(6)
Expiration of Other Tax Provisions	(42)	(34)
Automatic Reductions in Spending Specified in BC, [sic]	(78)	(96)
Defense Discretionary	(37)	(51)
Nondefense Discretionary	(29)	(32)
Medicare	(6)	(6)
Other Mandatory	(7)	(7)
Total Impact on Deficit	(676)	(706)
As Percent of (Projected) GDP	(4.2)	(4.2)

Source: CBO; Joint Committee on Taxation; Macroeconomic Advisers.

Most readers have likely taken macroeconomics course at some point in their career. (Many will assert the course was inflicted on them.) They will recall the concept of a "multiplier," which was first introduced by John Maynard Keynes. According to the theory, a cut in government expenditures or of investment will have a multiplier effect, initially causing real GDP to fall by more than the amount cut. Recently Bradford Delong and Lawrence Summers published work that suggests the multiplier under current economic conditions is between 0.8 and 1.5.[1]

Simulations done using MA's model of the US economy produce precisely this result. As can be seen Table 2, they find that full implementation of the measures scheduled to take effect on January 1 would reduce US real GDP almost six percent from projected levels in the first quarter of 2013. GDP would then fall four percent from the baseline forecast in the second quarter. GDP is more than three percent below the projected baseline scenario at the end of 2013.

Table 2. GDP Growth Projection by Quarter through 2013 with and without Fiscal Cliff (Percent Change from Prior Quarter)

	Q4:2012	Q1:2013	Q2:2013	Q3:2013	Q4:2013
CE: No Cliff	2.9	2.6	2.1	2.0	3.0
MA: Cliff	2.9	(3.3)	(2.0)	1.1	2.5
Difference		(5.9)	(4.1)	(0.9)	(0.5)

Note: Consensus Economics (CE) estimates converted from year-over-year change to change from prior quarter. MA estimates shown as difference from baseline.

Source: PKVerleger LLC.

In Table 2, I also show the consensus forecast for US GDP growth by quarter through 2013, as published by Consensus Economics in its October *Consensus Forecasts*. Note that Consensus Economics follows the European convention of publishing projections of growth by quarter on a year-over-year basis, while US economists project GPD changes from the prior quarter at annual rates. I converted the Consensus Economics estimates to the US basis to facilitate comparison.

The oil market impact of this decline would be substantial. The decreasing US GDP would cut US petroleum consumption between six hundred thousand and one million barrels per day. Consumption in other countries would be affected as well because the US recession would

[1] J. Bradford Delong and Lawrence Summers, "Fiscal Policy in a Depressed Economy," *Brookings Papers on Economic Activity*, Spring 2012, p. 244.

depress growth elsewhere. In total, world demand and the call on OPEC would likely be between one and 1.5 million barrels per day less.

The results shown in Table 2 emphasize the grave nature of the US predicament. Failure to reach an agreement will have serious short-term implications. Ironically, though, the CBO believes that imposition of the tax increases and budget cuts would be beneficial in the long run. It expects that growth would pick up after 2013. Furthermore, it thinks the economy could reach capacity, with unemployment falling to 5.5 percent, by 2018.[2] Thus some experts may argue that the United States should accept the short-term economic pain.

News of failed fiscal cliff negotiations will not be received well by financial or commodity markets. Prospects of a five-percent drop in GDP from projected levels as well as spillover effects should lead to a rapid decline in crude and product prices. The uncertainty associated with the impasse will affect prices in a way similar to the impact after the Lehman Brothers collapse. For those who have forgotten (and no doubt everyone wishes they could), it is perhaps useful to recall the history.

> Lehman Brothers filed for bankruptcy on September 15, 2008. The previous Friday Dated Brent traded for $96.64 per barrel and WTI at $95.24. Seven days later on September 19, Brent dropped to $93.77 while WTI rose to $100.
>
> Prices oscillated through the end of September even as Congress debated and initially refused to pass the Troubled Asset Relief Program.
>
> Prices then fell from $95 per barrel at the end of September to $60 at the end of October as other financial institutions such as Merrill Lynch appeared on the verge of failure and required assistance.
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> Prices dropped a further $12 in November and reached their low at $36 per barrel at the end of December.

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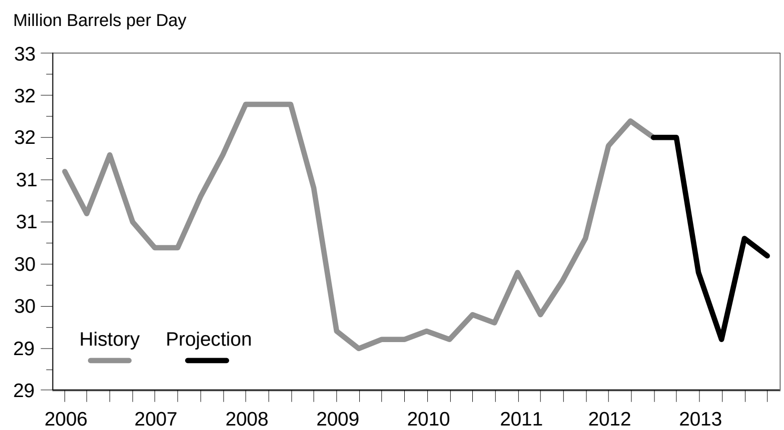
[2] Congressional Budget Office, "Economic Effects of Policies Contributing to Fiscal Tightening in 2013," November 2012 [http://goo.gl/VPRdF].

In 2009, oil prices recovered quickly. The recovery was helped by OPEC's agreement to cut production in December 2008 and the decision by banks to use TARP funds to accumulate large crude and product inventories. IEA data reveal that stocks rose by almost one million barrels per day in the first quarter. The drop in production of two million barrels per day between the third quarter of 2008 and the second quarter of 2009 can be seen in Figure 1. Also shown is the cut OPEC will likely have to make in the first part of 2013 if members want to sustain $100 oil.

Banks will not assist OPEC in 2013 as they did in 2009. Changed regulations and limitations on fund availability will prevent such institutions from buying crude for storage. No stock accumulation should be expected.

Figure 1
OPEC Quarterly Crude Oil Production, 2006-2012, and Projection under Consensus Economics Forecast



Source: IEA; PKVerleger LLC.

A crude price decline of the magnitude experienced in 2008 should not be expected with the news of failed negotiations. Instead, absent an announced OPEC cutback, one should anticipate a more "modest" decline, say, to $60 per barrel for Brent in the first quarter. Prices should then increase slowly over the year, rising to perhaps $75 by year's end if producers refrain from large output cuts.

Consuming countries will cheer the oil price decrease. Oil producers might want to as well. A crude price decline to $60 would offset a significant portion of the fiscal cliff's economic impact. As can be seen from Table 3 (page 5), a price drop would neutralize almost half of the GDP loss.

MA prepared the economic results reported in Table 3. The table compares the impact of implementing the fiscal measures on December 31 with no oil price change to the impact assuming oil prices drop I suggest here. Without the price decline, the United States would clearly slump into recession. With a price reduction, recession would, according to this simulation, be avoided.

Table 3. Change in Real GDP by Quarter in 2013 in the "Cliff Case" with Continued High Oil Prices and with Lower Oil Prices (Percent Change from Prior Quarter)

	Q4:2012	Q1:2013	Q2:2013	Q3:2013	Q4:2013
MA: Cliff and High Oil Prices	2.9	(3.3)	(2.0)	1.1	2.5
MA: Cliff and Low Oil Prices	2.9	(0.8)	0.4	1.9	2.9
Difference		2.5	2.4	0.8	0.4

Source: MA; PKVerleger LLC.

An oil price reduction would also benefit every other economy. The OECD forecasts discussed above envision continued increases in Brent prices from $100 in 2012 to $115 in 2013 and then $5 per barrel in every year thereafter.

According to studies prepared by the International Monetary Fund, a fifty-percent cut in oil prices would add 1.25 percent to global GDP. Roughly speaking then, a drop in Brent price might boost world growth in 2013 from 3.4 percent as projected in the OECD forecast to 4.6 percent, close to the 4.9 percent rate achieved in 2012. Such a recovery would lay a foundation for a much healthier global economy in 2014 to 2020. The world oil market would clearly benefit.

A drop in crude prices to $60 in the first quarter of 2013, as suggested here, combined with a gradual recovery over the year could also provide significant support to the world's oil producers by reducing development of crude reserves in Alberta, Canada, the Bakken in North Dakota, and the Eagle Ford in Texas. Exploration will slow or stop and some production may be shut in if current discounts prevail. At the end of the week,

> WTI traded for $88 per barrel, $22 below Brent;
>
> Bakken traded at $28 per barrel discount to Brent; while
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> West Canadian Select traded for around $60 per barrel, according to Petroleum Argus.

If Brent falls to $60, much of the Bakken and Canadian output will be shut. Producers in locations as far away as Lagos, Moscow, and Baghdad will shed no tears.