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6 Unwanted Outcomes of the Debt Deal

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Will it work? That's the first question surrounding the recent debt deal hammered out at the last second between Democrats and Republicans, which is supposed to close the huge gap between government spending and revenue by up to \$2.4 trillion over the next decade. But there's another question that's just as important: Will the deal cause any new problems it wasn't supposed to?

Unintended consequences are a fact of life in Washington, as policymakers intent on accomplishing one thing through changes in law or policy fail to anticipate other ways that markets, businesses, and consumers might react. And big actions can sometimes have big negative effects. The enactment of Prohibition in the 1920s was meant to enhance America's probity, for instance, but it also drove legitimate liquor merchants out of business and opened a lucrative new black-market business to organized crime. Social Security has saved many seniors from poverty, but many economists also believe it discourages people from saving as much as they should for retirement.

[See 11 countries that make America look good.]

For all the rancor, there were good intentions behind the recent deal to cut government spending and start reducing the national debt, which stands at about \$14.3 trillion, nearly the size of the entire U.S. economy. The debt problem is a real issue, not a partisan one; if it keeps growing unchecked, America's debt will become unsustainable, requiring far too much taxpayer money just to pay interest on all the money the government borrows. The Budget Control Act that President Obama signed on August 2 will begin to address the problem, with widespread spending cuts that will be modest over the next two years, then intensify.

The politicians who orchestrated the deal insist it's a meaningful first step toward more affordable government. But economists and investing firms now trying to predict the second- and third-order effects aren't so sure. Here are some of the unintended consequences that could result from the deal:

A slowing economy. Economists were relieved that the immediate spending cuts weren't deeper, because the economy is getting weaker and may not be strong enough to handle a big drop in demand by the government. Over the next 14 months, cuts from the deal will amount to roughly \$71 billion, which is relatively small in a \$15 trillion economy. Forecasting firm IHS Global Insight estimates the cuts will lower GDP growth by only 0.2 percentage points. But even that is not comforting. "These are not catastrophic effects," says IHS economist Nigel Gault, "but the question is whether we should be tightening fiscal policy at all in such a weak economy."

[See 10 ways to create jobs.]

The debt deal contains nothing that will boost growth or address the nation's biggest economic problem: a shortage of jobs. Nor is there anything in there meant to make American businesses more competitive or stimulate the economy in any way. Some backers of the deal argue that cutting government spending and lowering the national debt in itself will boost the economy, because it will drive more investment toward the private sector and help keep taxes low. That may be true, but even if it is, the payoff won't materialize for several years because businesses and consumers alike remain worried about the economy and reluctant to spend in the absence of a tangible upturn.

More pressure on the national debt. A slowing economy that leaves unemployment high will prolong a big problem for the government: falling revenue from income and other kinds of taxes. A recession that pushed unemployment higher would cut into tax revenues even more. The less income the government takes in, the more it has to borrow. Martin

Hutchinson of Reuters Breakingviews notes that if economic growth is slightly lower than the government forecasts, it could wipe out at least \$900 billion worth of savings that the debt deal is supposed to produce--nearly half of the total tally. Even lower growth would mean even weaker results, suggesting that the whole ordeal we just went through could end up being counterproductive.

[See 3 things the debt ordeal accomplished.]

More quantitative easing by the Fed. Nobody wants to see a third big bond-buying program--already dubbed QE3--and that includes Federal Reserve Chairman Ben Bernanke and most of his central bank colleagues. Even though the Fed has done more to stave off financial calamity than any other government agency, it's become a whipping boy for government-bashers, and Tea Partiers in particular, who want Washington to keep its hands off the economy. Plus, the Fed has exhausted its most effective monetary-policy tools--since it has already driven interest rates as low as they can go--leaving it dependent upon more arcane measures to shore up the economy.

The Fed, however, may have no choice but to act if the economy continues to weaken and Congress keeps sitting on its hands. Forecasting firm Roubini Global Economics says the U.S. economy has hit "stall speed" and that "QE3 now seems unavoidable" on account of weak employment and the coming drag on growth from the new government cutbacks. Other investing firms are less sure the Fed will act, but they're gaming out scenarios all the same and trying to figure out who the winners and losers will be if the Fed launches a third bond-buying program. The irony, of course, is that the strongest advocates of smaller government also tend to be the Fed's loudest critics. So efforts to reduce the government's role in the economy via spending cutbacks may be the very thing that drags the Fed back into an activist role.

[See 3 ways the debt deal fails America.]

A downgrade of America's credit rating. In mid-July, Standard & Poor's said it would likely drop America's credit rating from AAA, the highest level, to AA, unless Washington came up with a credible plan to cut the national debt by about \$4 trillion over the next decade. The debt negotiators have essentially dared S&P to do it, since the big plan they came up with after weeks of fighting will only cut about \$2.4 trillion in the best-case scenario. So while there's relief over the end of the debt standoff, the politicians failed to follow the fairly clear guidelines S&P laid out. A downgrade could result within the next two months.

A loss of confidence in Washington. Debt-deal negotiators like Mitch McConnell, John Boehner, and Harry Reid seemed pleased with themselves as they finally announced an agreement--and then split town for a monthlong recess. But holding the economy hostage to a last-minute deal that didn't accomplish all that much in the end could leave a lasting distrust of political leaders that sours the broader economy. In surveys by Pew Research, 72 percent of respondents had a negative impression of the debt negotiations, while only 2 percent felt positive about the ordeal. "Ridiculous," "disgusting," "stupid," and "terrible" were some of the most common words people used to describe negotiations led by their esteemed representatives in Washington.

[See how a debt downgrade would harm America.]

Business leaders are dismayed as well. "We believe that the recent debt debate caused consumers and businesses to become more cautious," investment bank UBS told its clients in an analysis that followed the agreement. "This is likely to extend the economic soft patch that began earlier this year." Business leaders routinely grouse about Washington, but they increasingly view partisan politics as less of a sideshow and more of an actual impediment to economic growth. That makes them even less willing to invest in America, and hire.

Even more uncertainty. For a while, there was hope that all the ugly bickering might produce a decisive debt deal that cleared the way for agreement on several contentious issues, so the government could turn to other pressing matters--like the jobs crisis. Instead, the final deal left all of the toughest matters to be decided later, beginning with a "supercommittee" of an equal number of Republican and Democratic lawmakers that has to come up with \$1.5 trillion in spending-cuts-to-be-named-later by the end of this year.

Also to come: Huge fights over reforming Medicare, Medicaid, and Social Security, and another battle over whether to extend the tax cuts that expire at the end of 2012. Every one of those issues threatens a political smackdown that could be at least as disruptive as the one we just endured. The deal "leaves enormous uncertainty over the future of fiscal policy," says Gault of IHS. "Most key issues remain unresolved." For anybody running a business, that basically means the government may call a halt to the economy every few months. They'll plan accordingly.

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