Секция 9
SOCIAL AND ECONOMIC DEVELOPMENT OF REGIONS IN RUSSIA AND ABROAD

THE INFLUENCE OF THE FISCAL CLIFF ON THE ECONOMY OF THE USA

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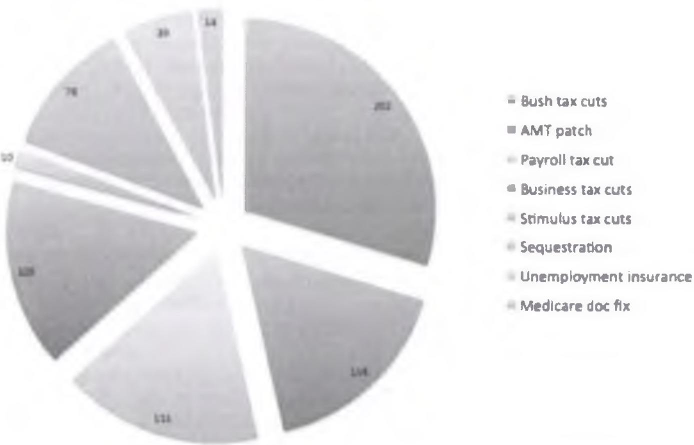
Attention to financial market participants are now concentrated entirely in anticipation of the debate over the issue of "financial cliff" in the U.S., one of the key threats to the global economic recovery in the near future.

The so-called "financial cliff", or failure of the termination of tax benefits of approximately $ 700 billion, coinciding with a reduction in government spending, it could happen as early as the beginning of calendar 2013, if Congress is unable to change the legislation. Failure to prevent the tightening of fiscal policy can strike enough to push the economy back into recession (reduction in GDP growth to 4.25%).

"Financial cliff" is a situation when government of the USA decides to permit so huge austerity that can damage financial system over the world. Recession in the USA every time affects on the global economy like crisis of 2008.

The austerity crisis's policies, by cost in 2013

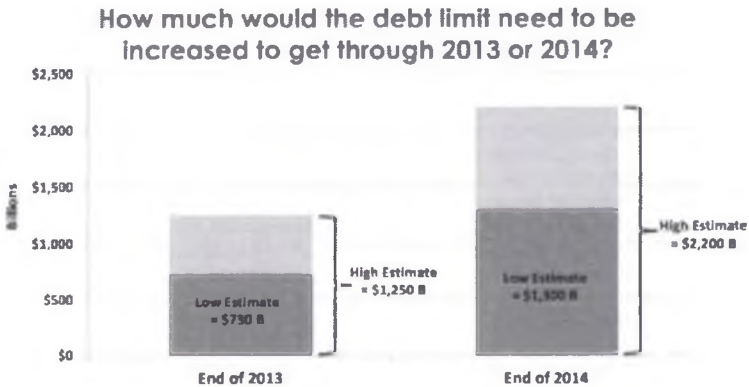


This chart represents the structure of the austerity crisis. The main part of it is taxes:
- 2001/2003 Bush tax cuts.
- 2009 stimulus.
- Payroll tax holiday.
- Alternative Minimum Tax.
- Extenders.

The second part is spending cuts:
- The sequester.
- Budget caps.
- Doc fix. The cuts, known as the "Sustainable Growth Rate" or SGR, require that growth in provider payments not exceed growth in Gross Domestic Product.

- Unemployment insurance.

Moreover, there is one more essential element – debt ceiling. When exactly the debt ceiling is next reached depends on how much the government actually spends and taxes in the coming months. But most analysts think the next debt-ceiling increase will come due around February. The Bipartisan Policy Center estimates will have to raise the debt limit by anywhere between $730 billion and $1.25 trillion to avoid the debt ceiling for all of 2013 (depending on whether the Dec. 31 fiscal changes measures are enacted or not) and between $1.3 trillion and $2.2 trillion in 2014.



The consequences of the government USA decision can be:

1) Analytics expect recession because US economy might shrink by 0,5 percent in the next year, unemployment rate can be at level of 9,1 percent that will be higher than current level – 7,9 percent.

2) Deficit reduction. In a short and medium run the deficit will be reduced because of reduction of expenditures and tax hikes. The CBO considers that public debt will fall to only 58 percent of GDP by 2022. However, if the government follows their policy the debt will be 90 percent of GDP. This situation presents on the chart below.

3) Tax increases. CBO estimates that if US government goes over the fiscal cliff, average tax bill will rise by 3,446 $ in 2013.

In the current situation Democrats and Republicans want to prevent the spending cuts as well as recession. They also want to prevent the tax increases. However, Democrats want to throw out the Bush tax cuts for incomes over 250,000 and the Republicans want to keep them in place. The Bush tax cuts for incomes below $250,000 still benefit people who make more than $250,000, because those are tax cuts on every dollar earned prior to the 250,000th dollar.

In this case we can use tools of a game theory and make the payoff matrix:

	Republicans agree to expire Bush tax cuts for incomes over $250,000	Republicans refuse to expire Bush tax cuts for incomes over $250,000
Democrats agree to preserve Bush tax cuts for everybody	~~8, 0~~ *(not possible)*	5, 10
Democrats refuse to preserve Bush tax cuts for incomes over $250,000	10, 5	8, 0

We have chosen these strategies because the government cannot just go over the fiscal cliff, in that case there will be a recession and debt ceiling problem and they actually cannot do nothing. Less likely that they just go over the fiscal cliff and make a deal in the end. It means that the government will wait for ending of tax benefits. In this case taxes automatically go much higher than either party wants and with this result they can find a way how to reduce them more easily.

Now we can make assumptions:

1. These are the only strategies available to both players, and each player has to pick just one of them.

2. The numbers accurately represent the political outcomes associated with each combination of strategies,

3. The party leadership wants to maximize their own political payoff (i.e. they are narrowly self-interested, not willing to fall on any swords for the good of the country), and

4. Both parties are aware of each other's strategies and corresponding payoffs (i.e. all political information is perfect and complete)

Let's look at the top-left cell: in this case each side insists the other gets what it wants and the same result you can see at the bottom-right cell, because two sides could not come to an agreement. However, it was mentioned that it would never, ever happen, because the parties just never do that.

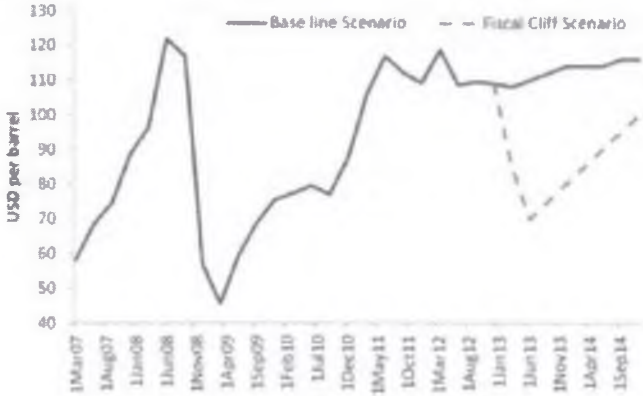
Bottom-left outcome: This is what would happen if the Republicans caved in to the Democrats: the two sides agree to extend the Bush tax cuts on everybody except for incomes over $250,000. The fiscal cliff is (mostly) averted, but taxes go up on the really high-incomes. This makes the Democrats look awesome, because they got exactly what they wanted — the rich pay their fair share, taxes don't go up on the poor and middle class, and the U.S. doesn't fall into a recession — so Democrats get a big payoff — 10 points. Meanwhile, the Republicans begin to look silly, not only because they look like wimps but also because many have violated the Grover Norquist tax pledge, so they get a small payoff — 5 points. But, like the Democrats in the top-right outcome, their payoff isn't zero, because after all, the fiscal cliff has been (almost) entirely averted, nobody sees a big tax increase except for a small number of people at the very top of the income distribution, and even those high-income earners manage to avoid the scheduled tax increases on the income they earn before the 250,000th dollar. (and nobody cared about that Grover Norquist stuff anyway). Total payoffs: (10, 5).

Bottom-right outcome: This is what happens if the two sides can't come to an agreement, and is arguably the most interesting case. In this situation, both sides refuse to give in — the Democrats insist on expiring the Bush tax cuts for top incomes, and the Republicans refuse to let that happen — so we go over the fiscal cliff. Everybody's taxes increase, including those at the top of the income distribution. But as I have it here, the Democrats still get a big payoff (8 points), and the Republicans get an even worse payoff than if they'd caved in (0 points). Because, what would immediately happen if we went over the fiscal cliff? The Democrats would immediately pressure the Republicans to cut taxes on the lower and middle-income earners — i.e. to push everybody below the top of the income distribution back up onto the cliff — and the Republicans would have no choice but to go along with it. In this case the Republicans don't get what they wanted — taxes on the highest incomes have gone up, by even more than if they'd just caved in — and the Democrats get almost what they wanted, i.e. a tax increase on the highest incomes but not on anybody else. ("almost" because there would be a brief and irreversible period between January 1 and whenever Republicans agreed to lower taxes when taxes would go up on everybody, which is not what the Democrats want, and certainly worse than the bottom-left outcome). Total payoffs: (8, 0).

By now it should be clear, intuitively, the bottom-left outcome is the Nash equilibrium: it's the best that Republicans can do, given the options available to the Democrats.

Consequences of the fiscal cliff dilemma for oil market. Despite the fact that the U.S. government after the re-election of Obama is compartmentalized, the basis of our baseline scenario is the following assumption: the U.S. economy manages to avoid the problem of "financial cliff" because both parties (Democrats and Republicans), in the end, find a temporary compromise and postpone the solution for the future. However, we continue to believe that the uncertainty regarding the "financial cliff" will put downward pressure, the market will be more careful, which will reduce the average cost of Brent to $ 109/barrel in Q4.

The short-term effect that the U.S. economy is still faced with the problem of "financial cliff" and the demand for oil will drop by 800 thousand, could lead to a sharp drop in commodity prices (other things being equal) by about 35%, to $ 75/barrel Brent (on the basis of short-term elasticity of demand). Baseline scenario – "postponing in the closet" – can still cause short-term sell-off in the oil market.



In that case, if the politicians have drawn conclusions based on last year's events, then during the "lame duck session" (the last session of the Senate of the current convocation) can avoid the deterioration of perception of risk. However, the risk that we will see more intricate political process, which can cause significant short-term sales of risky assets, including oil. In this case prices from time to time can significantly lower than the average forecast. It means that incomes from selling oil can be declined in the nearest future and Russian government will have to lay on it too much and seek another possibility for boosting their budget and make all social programs working.

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