Economy Picking Up but Facing Challenges this Fall

David J. Stockton says that despite the budget sequester, US economic growth is accelerating, but another bout of budget confrontations in the fall could disrupt the recovery.

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Steve Weisman: The United States economy looks like it wants to take off, but it also faces potential impediments later in 2013, in particular the Fall. This is Steve Weisman at the Peterson Institute with David Stockton, senior fellow at the Peterson Institute, to look at the economic situation in August and look ahead a little bit. David, there are signs that the economy is picking up in spite of some discouraging signs earlier this year. Tell me about that first.

David Stockton: I think indeed the economy does look like it's in the process of improving. We've seen rather impressive growth in payroll employments over the past six months of roughly 200,000 jobs a month. We've seen clear improvement in the housing market, both in terms of increased construction, increased sales, and higher prices. And household balance sheets have strengthened rather considerably in terms of both the asset side, improving household wealth, and in terms of continued reduction in household debt service burdens and household debts. So I think there are certainly forces that are suggesting that the economy in fact is poised to accelerate as the fiscal restraint begins to ease. But as you know, there is still certainly some significant risk that we face in the fall.

Steve Weisman: The biggest headwind faced over the last year has been the sequester, which you and others said was preventing the economy from growing as much as it might have. What's your assessment now on that factor?

David Stockton: I think that in fact looks to have been the case. We had a fairly soft first half of this year with growth running around one and three quarter percent. We saw accompanying that relatively soft growth a very significant reduction in government spending probably associated both with the earlier budgetary cutbacks, as well as this year's sequester. And we've seen some softness in consumer spending in the first half that was likely related to the increase in tax rates that occurred earlier this year and the end of the payroll tax holiday.

Steve Weisman: Does the sequester expire at the end of the fiscal year on October 1st?

David Stockton: The law currently in place is still going to imply that the Congress needs to meet very strict spending caps for years to come. There's still very considerable restraint currently baked in the legislation that is going to imply that we're not certainly going to get any relief. We're not going to get deeper fiscal drag over the course of the next year. In fact the fiscal drag is likely to ease up some. But we're certainly not going to get any support from fiscal policy going forward.

Steve Weisman: What are the big decisions that have to be made this fall that could impact on the recovery?

David Stockton: I see a confluence of factors and decisions that are going to take place that really are going to have an important bearing on the outlook for the second half. On the fiscal side, clearly at the end of this fiscal year at the end of September, Congress has yet to enact a budget. Enacting a budget still seems like a very low probability event at this point. The question is what does Congress do? If the Congress were to enact a continuing resolution, clearly spending could be sustained with the stringent caps that they're going to be operating under. But there's been some talk, certainly among House Republicans, of not passing any spending bills that include any funding for so-called Obamacare. The President has indicated that he would veto any efforts to defund Obamacare, so we're heading to yet another fiscal confrontation.

Then even if Congress does pass a continuing resolution and we avoid a shutdown at the end of September, somewhere between mid-October and mid-November, we're likely to face the need to pass another increase in the debt ceiling. That looks like it's going to be another contentious issue. I think no matter what, it's going to be a fiscal mess in terms of what is likely to be a pretty contentious and pretty ugly conversation.

All that would be difficult enough for the US economy if we weren't also facing the likelihood that the Federal Reserve is going to begin tapering its quantitative easing [QE] policy. Right now it certainly looks like the most likely time for that would be in September. In addition to the tapering of QE, we face the President's nomination of a replacement for Ben Bernanke at the Federal Reserve.

So I think if one looks at the September-October time period, one could certainly see plenty of reasons for considerable financial turmoil. In the best of circumstances, we have experienced some turmoil but the underlying strength of the economy proved solid enough and decisions are reached quickly enough, both on the fiscal and monetary side, that that's just a bump in the road. Clearly there are some possibilities that we could have a more difficult period in which the financial volatility actually had some significant effect on the pace of the recovery in the second half.

Steve Weisman: Let me ask you a final question. What if these bumps in the road turn out to be just bumps and there isn't a shutdown and there isn't a default resulting from the fight over the debt ceiling and there's a smooth transition at the Fed. What is your best projection for unemployment in the second half of the year and then 2014?

David Stockton: I think under those circumstances, which I do think are in fact the most likely circumstances, we're going to have a lot of contentious discussion, but in the end, parties will behave reasonably responsibly and we'll get through this period. If that's the case, I think we can see unemployment moving into the low sevens by the end of this year and perhaps into the upper six percent range in 2014. I do think if we get through this period with relatively minimal damage with the passing of the deepest part of the fiscal drag on the economy, we should see an acceleration later this year and into next year that moves the economy to above-trend growth.

Steve Weisman: David, thank you very much.

David Stockton: Thank you, Steve.