

Press Release



Wall Street Journal Finds Financial Market Reaction to Cliff Would Be Severe

DECEMBER 5, 2012

NOTE:

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Republican economist Douglas Holtz-Eakin says in a report to be released Wednesday by the American Action Forum, the right-leaning think tank he leads, that the CBO's estimates understate the depth of a "fiscal cliff" recession next year because economic models can't fully account for financial-market effects.

Stock markets declined during the financial crisis in 2008 much faster than businesses pulled back, exacerbating the corporate downturn.

If lawmakers toy with going over the cliff, "I think you're going to get a sharp reaction in consumer confidence and markets," said Mr. Holtz-Eakin, former head of the Congressional Budget Office. "You don't put those genies back in the bottle easily." He said he doubts investors and consumers would believe a deal would be reached in the new year if it can't be done this year. "There's no reason to have great confidence in that story," he said. "I don't want to run the experiment and find out if I'm wrong."

Weighing Consequences of a Temporary Dive Off Cliff [Wall Street Journal](#)? December 5, 2012? By Sudeep Reddy

Some Democratic lawmakers and economists say the White House and Congress could wait until January to complete a deal on the fiscal cliff, without doing much harm to the economy.

But going over the cliff even temporarily-triggering a combination of tax increases and spending cuts at the start of next month and then quickly undoing them-could hurt the economy in some important intangible ways, such as by prompting sharp market declines and damaging confidence, critics of the strategy say.

If no deal is reached, the Bush-era tax cuts will expire on Jan. 1, raising tax rates. President Barack Obama wants to extend the cuts for all but the top 2% of earners, while Republicans want to include top earners in the extension and instead raise revenue by limiting deductions.

Sen. Patty Murray of Washington was the first Democratic leader to say a temporary cliff dive might be necessary, and others have joined her in recent weeks. Republican lawmakers maintain that all tax cuts should be extended now, saying any delay will damage the economy.

Here are three key elements to consider if the White House and Congress weigh a temporary cliff dive:

Direct economic effects

Some economists prefer the term “fiscal slope” to “fiscal cliff” because most of the direct economic effects would be gradual. The Congressional Budget Office forecasts a recession next year only if the tax increases and spending cuts continue for months.

The Obama administration has some leeway to delay spending cuts and change tax withholding from paychecks if officials expect to reach a deal early next year.

Striking an agreement in early 2013 would create the equivalent of a “fiscal bungee jump,” said former Obama administration economist Jared Bernstein, now at the Center on Budget and Policy Priorities, a nonpartisan group. “If you start down it and you don’t get too far, you won’t do too much damage,” he said. This approach rests on the idea that investors will expect a deal by early next year. “If there’s signaling on a compromise, I think markets will be OK,” Mr. Bernstein said.

Markets

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Confidence

During last year’s fight over raising the federal debt ceiling, consumer confidence remained generally stable through most of the battle until late July. Then it started falling, a trajectory that continued after a deal was reached in early August. The economy stumbled for months. The tone of that fight appeared to have soured consumers and businesses about longer-term prospects for the economy.

Today, consumer confidence is around a five-year high, amid falling gasoline prices and rising home prices. Confidence among businesses is weaker, based partly on worries about the fiscal cliff and the broader global slowdown. Eventually, the two trends will need to reconcile.

Alan Krueger, chairman of the White House Council of Economic Advisers, cautioned that a quick trip over the cliff would likely hurt confidence and the economy over time. The effects on household spending of a temporary increase in tax rates “are not all that great” if consumers know it’s temporary, he said.

“What’s, to me, much more worrisome is the psychological effects of falling off of the cliff,” he told the Economic Club of Washington last month. “I think it would mean to many people that the government is not capable of solving problems....That’s obviously not very good for confidence. I think the uncertainty of not addressing these problems will have an effect on business behavior and then later on household behavior.”

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