Dear CBI member –

President Obama yesterday signed a bill allowing the US to borrow another $2.4 trillion dollars, taking the debt ceiling to $14.3 trillion. There are acres of newsprint breaking down the detail of how the deal was reached and what's in it. Here is an initial analysis from the CBI team in Washington DC, focusing particularly on likely real economy impacts.

Immediate disaster has been averted – although nobody really knows how bad that disaster would have been. Optimists can say that the US avoided defaulting on its debt, and therefore US Treasuries can continue to be regarded as risk-free investments. Realists point out that the US issues such a large percentage of the world's AAA-rated sovereign debt that investors don't really have anywhere else to go, and would probably have continued to buy Treasuries anyway. Pessimists suggest that the last few months have fatally wounded America's reputation for sensible economic policy-making.

Other than averting immediate disaster, the bill doesn't have that much to recommend it. The consensus opinion of macroeconomists is that it cuts too much now, and not enough later. The bill imposes about $1 trillion in spending cuts over the next decade. These are phased in, with about $25bn in cuts in 2012 and $47bn in 2013, followed by deeper cuts after that. Even these relatively small cuts are estimated to shave 0.2% from GDP growth next year – not good, when job growth is desperately needed. But even more significant, the bill does not extend a 2% cut in payroll taxes and unemployment insurance. These cuts were introduced in December 2010 as an effort to boost the economy – but they expire at the end of this year. Letting them lapse is potentially a much greater drag on growth than the spending cuts. J.P. Morgan Chase estimates that the cuts and the tax reset combined will cut GDP growth by 1.5% in 2012. In boardrooms around the world, companies may well be downgrading the share of profits they expect from the US market.

Broken down by sector, defence and homeland security companies seem immediately to have the most to worry about. The final version of the bill includes $350bn in 'security' spending cuts. (The wording is significant: all earlier bills focussed on defence spending alone. 'Security' spreads the pain from the DoD to include the CIA, the Departments of Homeland Security, Veterans Affairs, and State.) Although it sounds like a lot, $350bn is manageable: back in early 2011, the then-Secretary of Defence Robert Gates had already instructed the DoD to find $400bn in cuts, and budget accordingly.

The trouble for the defence sector will come in stage 2 of the plan. The bill sets up a 12-person congressional committee and charges it with finding another $1.5 trillion in cuts, to add to the first round of $1 trillion. If that panel is not able to find at least $1.2 trillion in cuts, an automatic trigger is pulled, and $1.2 trillion in spending is cut automatically. That would come approximately 50% from the defence budget, and 50% from entitlement spending (things like healthcare). The theory, quite clearly, is to make that outcome unpalatable to Republicans and Democrats alike. The defence industry clearly hopes so: Marion Blakey of the Aerospace Industries Association said the potential second round cuts of $600bn were "so draconian that it's hard to believe they are even on the table."

But a range of industries involved in healthcare provision – including pharmaceutical and medical device firms, and homecare / hospice service providers – might actually benefit from the trigger being pulled. The special committee is likely to look at a range of ways to cut the cost of programs like Medicare and Medicaid, including for example by extending the number of programs for which pharmaceutical companies are required to provide products with rebates, expanding the use of generic drugs, and making sure home-care benefits are provided without a copay. All of these measures have been defeated in recent months: they'll be back on the table now. So for this sector, the broad cuts implied by the trigger, which apply across the board and are subject to a 2% cap, might be the better result.

One outcome is definite: expect to see defence and healthcare lobbyists out in force during the next six months. Those two sectors already top the table for lobbying spending. They'll stay there for the next five months – and perhaps working for opposing outcomes.

There are other industries that know they are in the cross-hairs. It seems likely that any proposals for new sources of revenue, or closing tax loopholes, that have been on the table in recent months will be revisited. Likely targets: the oil and gas industry, which President Obama has said gets $4bn of unwarranted tax breaks, and corn growers – there will be no return of the 45 cents per gallon subsidy for ethanol. Private equity and hedge funds, which have thus far always managed to defeat changes to the taxation of carried interest, are also targets again.

Broadcasters were one of the few winners from the bill. Contrary to expectations, it didn't include any revenue raised from spectrum auctions. In Senator Reid's earlier version of the bill, there was a provision for $12bn of new revenue from spectrum auctions. Broadcasters opposed it, because it lacked protection for some existing TV broadcasts. The special committee is likely to look again at spectrum auctions - $12bn is not to be sniffed at – but in a more detailed way.

In summary, at the macroeconomic level, the impact of this package will depend on whether the immediate spending cuts and lapsing tax breaks will substantially impair a sputtering economy – and then, in the medium to longer term, whether it is too little to fix the big, structural spending problems. At the sectoral level, there will be differential impacts, depending above all on exposure to public spending (federal and state) as a source of demand. For individual companies, the immediate threat of higher interest rates and contracted credit that would have followed a default has been lifted – but the ongoing uncertainty about demand remains, likely keeping hiring subdued.

Finally, in contrast to the situation in the UK, the Budget Control Act includes no tax increases at all. Signing it into law, President Obama noted "Since you can't close the deficit with just spending cuts, we'll need a balanced approach where everything is on the table". The experience of the Bowles-Simpson Commission in finding common ground to raise taxes was that you had to put more on the table in order to generate trade-offs and a sense that everyone was sacrificing – a 'grand bargain' approach. Will we see a significant effort to reform the US tax code – including anything from the repatriation of foreign earnings, the tax treatment of debt versus equity, or even a shift towards consumption taxes and a VAT?

Time is against them. The special congressional committee must come up with its recommendations by 23 November, and Congress must vote on them by 23 December. In other words, yesterday's deal averted immediate disaster – but set the stage for the next round of crisis talks in only four months time.

If you have any comments or questions about this issue, please feel free to get in touch.

With best wishes
Rhian

Miss Rhian Chilcott
Director, International
The CBI
1110 Vermont Ave, NW
Suite 1200
Washington DC, 20005
USA

Tel: +1 202 530 0510
Mob: +1 202 352 3431
E-mail: rhian.chilcott@cbi.org.uk
Web: www.cbi.org.uk/washington