Making Sense of A Senseless Shutdown

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For the first time since 1995-1996, the U.S. government has been shut down in a dispute over the federal budget. With the 2011 debt ceiling debate, then the 2012 fiscal cliff, and now this, it seems that governmental dysfunction has been normalized. Now that the shutdown has happened, we can start to assess the damage, as well as evaluate how the dispute is likely to play out.

Before we do, there are a couple of important things to keep in mind. First, we made it through the 1995-1996 shutdown, and we will make it through this one. Second, although there will be damage, it will be limited. Just as with the sequester spending cuts, the damage will be absorbed and the economy will return to growth. This too will pass.

What will it mean for the economy?

The immediate consequences are approximately 800,000 federal workers furloughed, suspension of "nonessential" federal services, and no pay for the remaining "essential" federal workers. There is a great deal of uncertainty as to exactly what might happen, and that uncertainty will be a key driver of the damage done to the economy.

The direct economic damage will take the form of reduced spending and reduced economic growth. Given the current federal budget, if the government were to shut down entirely, it would cost the economy about 0.5 percent of GDP per week. Much of the government will continue to function, however, so the damage won't be that bad. A range of 0.2 percent to 0.3 percent of GDP per week of shutdown seems reasonable and is in line with other estimates of the damage: 0.9 percent of GDP for a three-week shutdown, per Goldman Sachs, and 0.2 percent of GDP per week according to IHS, an economics consultancy.

For comparison's sake, the sequester spending cuts appear to have dampened economic growth by about 1.5 percent of GDP on an annual basis. A month-long shutdown would get us into the same range of economic damage. Not good, certainly, but survivable. And if the shutdown were shorter than that, the damage to the economy as a whole would be proportionately less.

What should we expect going forward?
The more significant effects, and risks, of the shutdown will be indirect. The two biggest are the increase in uncertainty, which could reduce both consumer and business spending, and the impact on the debt ceiling negotiations. The debt ceiling negotiations will be considerably more important than the shutdown-and the fact is that the shutdown will make them more difficult.

Combined with the pending debt ceiling negotiations, the shutdown will make everyone more uncertain about the future. Uncertainty is bad for the stock market-the last time we got close to a debt ceiling showdown, the market took a serious hit-and for the economy. The last time we saw similar fiscal uncertainty was with the fiscal cliff at the end of last year, when economic growth came to a stop.

At this point, there's no need to panic, as the damage is likely to be minimal and contained. As the standoff over government funding continues, however-and as we get closer to the much harsher spending cuts that will ensue if the debt ceiling negotiations fail-the stakes rise exponentially.

I will be watching the situation carefully and provide further updates as warranted. Please contact me if you have any questions or concerns.

Below is a short (less than 5 minutes) and very good video on the topic by Brad McMillan, CFA.

Sincerely,

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