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Fiscal-Cliff Deal No Recipe for a Robust Economy

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Further budget fights threaten to keep US growth and hiring sluggish for much of 2013

Housing is rebounding. Families are shrinking debts. Europe has avoided a financial crackup. And the fiscal cliff deal has removed the most urgent threat to the U.S. economy.

So why don't economists foresee stronger growth and hiring in 2013?

Part of the answer is what Congress' agreement did (raise Social Security taxes for most of us). And part is what it didn't do (prevent the likelihood of more growth-killing political standoffs).

By delaying painful decisions on spending cuts, the deal assures more confrontation and uncertainty, especially because Congress must reach agreement later this winter to raise the government's debt limit. Many businesses are likely to remain wary of expanding or hiring in the meantime.

One hopeful consensus: If all the budgetary uncertainty can be resolved within the next few months, economists expect growth to pick up in the second half of 2013.

"We are in a better place than we were a couple of days ago," Chad Moutray, chief economist for the National Association of Manufacturers, said a day after Congress sent President Barack Obama legislation to avoid sharp income tax increases and government spending cuts. But "we really haven't dealt with the debt ceiling or tax reform or entitlement spending."

Five full years after the Great Recession began, the U.S. economy is still struggling to accelerate. Many economists think it will grow a meager 2 percent or less this year, down from 2.2 percent in 2012. The unemployment rate remains a high 7.7 percent. Few expect it to drop much this year.

Yet in some ways, the economy has been building strength. Corporations have cut costs and have amassed a near-record $1.7 trillion in cash. Home sales and prices have been rising consistently, along with construction. Hiring gains have been modest but steady.

Bernard Baumohl, chief global economist for the Economic Outlook Group, thinks the lack of finality in the budget fight is slowing an otherwise fundamentally sound economy.

"What a shame," **Baumohl** said in a research note Wednesday. "Companies are eager to ramp up capital investments and boost hiring. Households are prepared to unleash five years of pent-up demand."

The economy might be growing at a 3 percent annual rate if not for the threat of sudden and severe spending cuts and tax increases, along with the haziness surrounding the budget standoff, says Ethan Harris, co-director of global economics at Bank of America Merrill Lynch.

Still, Congress' deal delivered a walloping tax hike for most workers: the end of a two-year Social Security tax cut. The tax is rising back up to 6.2 percent from 4.2 percent. The increase will cost someone making $50,000 about $1,000 a year and a household with two high-paid workers up to $4,500.

Mark Zandi, chief economist at Moody's Analytics, calculates that the higher Social Security tax will slow growth by 0.6 percentage point in 2013. The other tax increases — including higher taxes on household incomes above $450,000 a year — will slice just 0.15 percentage point from growth, Zandi says.

Congress' deal also postpones decisions on spending cuts for military and domestic programs, including Medicare and Social Security. In doing so, it sets up a much bigger showdown over raising the government's borrowing limit. Republicans will likely demand deep spending cuts as the price of raising the debt limit. A similar standoff in 2011 brought the government to the brink of default and led Standard & Poor's to yank its top AAA rating on long-term U.S. debt.

Here's how key parts of the economy are shaping up for 2013:

— JOBS

With further fights looming over taxes and spending, many companies aren't likely to step up hiring. Congress and the White House will likely start battling over raising the $16.4 trillion debt limit in February.

Many economists expect employers to add an average of 150,000 to 175,000 jobs a month in 2013, about the same pace as in 2011 and 2012. That level is too weak to quickly reduce unemployment.

The roughly 2 million jobs Zandi estimates employers will add this year would be slightly more than the 1.8 million likely added in 2012. Zandi thinks employers would add an additional 600,000 jobs this year if not for the measures agreed to in the fiscal cliff deal.

Federal Reserve policymakers have forecast that the unemployment rate will fall to 7.4 percent, at best, by year's end. Economists regard a "normal" rate as 6 percent or less.

— CONSUMER SPENDING

Consumer confidence fell in December as Americans began to fear the higher taxes threatened by the fiscal cliff. Confidence had reached a five-year high in November, fueled by slowly declining unemployment and a steady housing rebound. Consumer spending is the driving force of the economy.

But the deal to avoid the cliff won't necessarily ignite a burst of spending. Taxes will still rise for nearly 80 percent of working Americans because of the higher Social Security tax rate.

Since the recession officially ended in June 2009, pay has barely kept up with inflation. The Social Security tax increase will cut paychecks further. And with the job market likely to remain tight, few companies have much incentive to hand out raises.

Thanks to record-low interest rates, consumers have whittled their debts to about 113 percent of their after-tax income. That's the lowest share since mid-2003, according to Haver Analytics.

Yet that hardly means people are ready to reverse course and ramp up credit-card purchases. Most new spending would have to come from higher incomes, says Ellen Zentner, senior economist at Nomura Securities.

"We don't see the mindset of, 'Let's run up the credit card again,'" she says.

The holiday shopping season in 2012 produced the worst year-over-year performance since 2008. Shoppertrak, a consulting firm, estimates that sales grew just 2.5 percent, down from an earlier forecast of 3.3 percent.

— HOUSING

Economists are nearly unanimous about one thing: The housing market will keep improving.

That's partly because of a fact that's caught many by surprise: Five years after the housing bust left a glut of homes in many areas, the nation doesn't have enough houses. Only 149,000 new homes were for sale at the end of November, the government has reported. That's just above the 143,000 in August, the lowest total on records dating to 1963. And the supply of previously occupied homes for sale is at an 11-year low.

"We need to start building again," says Patrick Newport, an economist at IHS Global Insight.

Sales of new homes in November reached their highest annual pace in 2½ years. They were 15 percent higher than a year earlier. And October marked a fifth straight month of year-over-year price increases in the 20 major cities covered by the Standard & Poor's/Case-Shiller national home price index.

Potential homebuyers "are more likely to buy, and banks are more likely to lend" when prices are rising, says James O'Sullivan, chief U.S. economist at High Frequency Economics. "It feeds on itself."

Higher prices are also encouraging builders to begin work on more homes. They were on track last year to start construction of the most homes in four years.

Ultra-low mortgage rates have helped spur demand. The average rate on the U.S. 30-year fixed mortgage is 3.35 percent, barely above the 3.31 percent reached in November, the lowest on records dating to 1971.

Housing tends to have an outside impact on the economy. A housing recovery boosts construction jobs and encourages more spending on furniture and appliances. And higher home prices make people feel wealthier, which can also lead to more spending.

"When you have a housing recovery, it's nearly impossible for the U.S. economy to slip into recession," Zentner says.

— MANUFACTURING

Factories appear to be recovering slowly from a slump last fall. The Institute for Supply Management's index of manufacturing activity rose last month from November. And a measure of employment suggested that manufacturers stepped up hiring in December. Factories had cut jobs in three of the four months through November, according to government data.

Another encouraging sign: Americans are expected to buy more cars this year. That would help boost manufacturing output. Auto sales will likely rise nearly 7 percent in 2013 over last year to 15.3 million, according to the Polk research firm. Sales likely reached 14.5 million last year, the best since 2007. In 2009, sales were just 10.4 million, the fewest in more than 30 years.

And if Congress can raise the federal borrowing limit without a fight that damages confidence, companies might boost spending on computers, industrial machinery and other equipment in the second half of 2013, economists say. That would help keep factories busy.

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