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The Sequester Could Cause A Recession, But Wall Street Seems Unconcerned

By Mark Gongloff

Economists warn that harsh budget cuts due to start taking effect next week could hammer the economy, maybe even cause a recession. But Wall Street seems unconcerned.

The latest warning about the dangers of the "sequester" -- the $85 billion in congressionally mandated federal spending cuts due to kick in on March 1 -- comes from Bank of America chief economist Ethan Harris. In a research note on Friday, Harris writes that he expects this painful shot of austerity to slow GDP growth to just 1 percent in the second quarter, with job growth averaging less than 100,000 per month for those three months.

That is not exactly recession territory, but it is dangerously close. Harris's numbers match up pretty well with those of other private-sector economists, including Macroeconomic Advisers. The private research firm recently estimated the sequester would gouge about 1.25 percent from GDP growth in the second quarter, leaving growth at a paltry 1.2 percent. Macro Advisers said the sequester could cost the economy 700,000 jobs through 2014.

A less-optimistic economist, Charles Dumas of British firm Lombard Street Research, on Thursday suggested the budget cuts and uncertainty leading up to them could turn GDP growth negative in both the first and second quarters -- matching one common definition of a recession.

"Wall Street is blithely ignoring this," Dumas wrote in a note to clients.

True enough, though these budget cuts are due in just a week, with little or no sign that Republicans and Democrats will come up with a compromise to stop them, Wall Street is for the most part going about its business. Stocks wobbled briefly earlier this week, but that was just because of misguided worries that the Federal Reserve is going to stop pumping stimulus into the economy. Why would the Fed stop stimulating the economy when Congress is working so hard to slow it down?

The numbers involved in the sequester are not enormous -- maybe only $50 billion in actual spending cuts this year, estimates Harris, or about 0.5 percent of GDP. And many on Wall Street express doubt that politicians will let the budget cuts carry on for very long, particularly once we start seeing all of the actual effects of the cuts, including furloughs for government workers and smaller unemployment checks.

"A three to four week period of sequester cuts will have no measurable impact on GDP growth," independent economist **Bernard Baumohl** wrote on Thursday. Many on Wall Street agree and, having seen this movie a few times before, assume there will be yet another last-minute fix that will avoid the worst pain.

Still, any budget cuts are the last thing the economy needs right now. It is already staggering from the effects of the payroll tax increase that took effect at the beginning of the year, which itself could shave 0.5 percent from GDP growth. The payroll tax, the sequester and other effects of the "fiscal cliff" deal at the start of the year could carve 1.5 percent from GDP this year, economists have estimated. Meanwhile, gasoline prices are rising steadily, hitting $3.75 nationally, on average, this week, a record for this time of year. That could hurt consumer spending (except for consumer spending on gas, of course). The slower economic growth is, the more vulnerable the economy is to an unforeseen shock.

The stock market is not the economy. But it can't ignore the economy's weakness forever.

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