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Economics Group

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Federal Government Sector: Risks to the Outlook

As fiscal policy decisions among policymakers in D.C. slowly unfold, we stop and take a look at the potential downside risks to our baseline forecast for federal fiscal policy. We see more downside than upside risks.

The Risk of a Stalled Fiscal Policy Agenda

There are several fiscal policy risks we see for the second half of this year: the risk of a partial federal government shutdown, a risk of a partial default related to a failure to lift the debt ceiling and the inability of Congress to enact tax policy changes. While we see a low probability of a government shutdown or a partial default on the federal debt, the risk remains that both of these issues may not be addressed in time given the gridlock that has emerged in Congress. The probability of a partial government shutdown appears higher, in our view, given that the funding bill appears more contentious than the debt ceiling, which typically garners votes from moderate Republicans and Democrats. The stakes are also lower for shutting down the government, potentially making it the more palatable route should the recent political frustrations of policymakers bubble over.

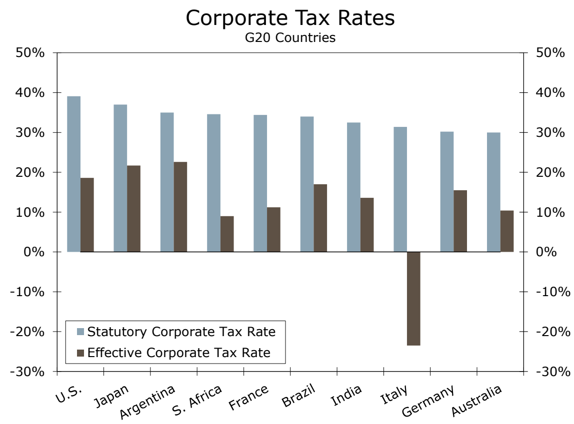
Another risk from this sector is that the modest tax cuts we have assumed for next year might not be enacted. We have had the same view of tax cuts all year: a five percentage point reduction in the corporate tax rate, paid for in part by a tax cut for repatriated corporate profits, and individual tax cuts similar in style to the 2001 Bush tax cuts. So what happens to our forecast if we remove all fiscal stimulus? In February, we wrote that after including our fiscal policy assumptions, we upwardly revised our 2018 GDP growth forecast by 0.2 percentage points.* Thus, the removal of these assumptions would reduce our 2018 growth forecast by roughly 0.2 percentage points and lower our expectations for inflation next year.

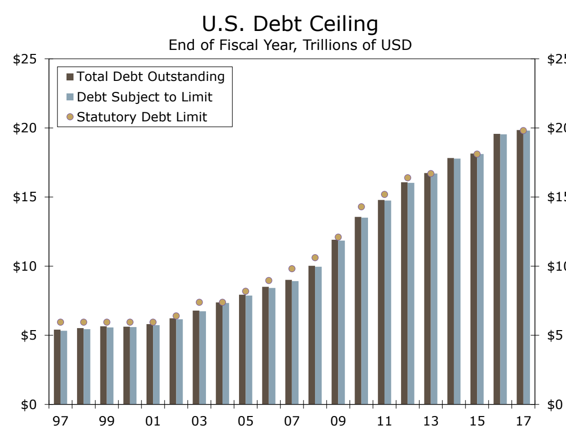
Tweet Risk?

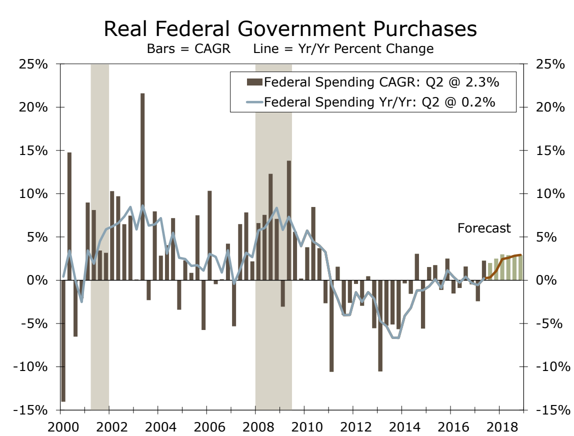
Besides the downside risks mentioned above, we would like to introduce another type of risk that we call, for lack of a better term, tweet risk. Tweet risk in our view is unforecastable policy changes or suggestions of policy changes that have the potential to impact markets and the economy communicated through the President's or his advisors' tweets or other executive actions. While we respect the need to have unfiltered communications to constituents, the possibility of misinterpretation of these announcements is quite high. In terms of unforecastable policy changes, it is within the authority of the president to unilaterally impose tariffs, which can be large and long-lasting if argued on grounds of protecting national security. We see the risk of faster inflation related to the imposition of tariffs as another key risk in H2.

Are There Any Upside Risks?

While we have mostly focused on downside risks, there are a few upside risks to the government sector, including the potential for Republicans and Democrats to work together on lowering health insurance premiums, which would boost real disposable income. In addition, it is possible that the final version of the tax cut bill contains larger cuts that we have forecasted. All of these factors would provide greater upside risk to our baseline forecast.







Source: Congressional Budget Office, U.S. Dept. of the Treasury, U.S. Dept. of Commerce and Wells Fargo Securities

*Silvia, J.E. and Brown, M.A. (2017). "Fiscal Policy and Our Economic Outlook." Wells Fargo Economics Group.

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