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Government Shutdown Redux

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BY MARK ZANDI, JUSTIN BEGLEY, BRENDAN LACERDA AND BERNARD YAROS

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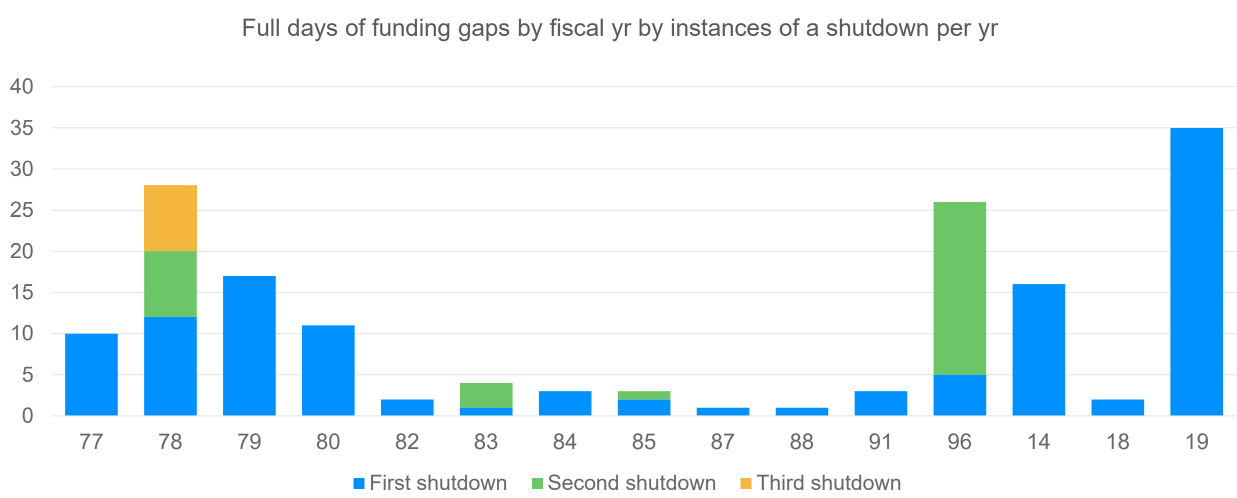
Shutdowns past

Government shutdowns have become increasingly commonplace in recent years. If the government shuts down in coming days, there will have been more than 20 shutdowns since the late 1970s, of which more than half have involved government employees being furloughed (see Chart 1). That is when the courts ruled that nonessential government activities must stop if lawmakers fail to provide the necessary funding.

Chart 1: Shutdowns Are Generally Short



Sources: Congressional Research Service, Moody's Analytics

Note: Several yrs since 1977 have had multiple shutdowns.

Notable government shutdowns include the 21-day closure in 1995-1996 when then Republican House Speaker Newt Gingrich battled President Bill Clinton over government spending priorities. In 2013 (fiscal year 2014), the government was shuttered for 16 days by House Republicans over their objections to Obamacare. And the longest ever shutdown of 35 days occurred in 2018-2019, when President Donald

Trump shuttered the government over the refusal by the Democratically controlled House to provide more funding to build a wall on the border with Mexico.

The common denominators in these shutdowns were divided government with no party controlling both the presidency and Congress, frustration between the parties over differences on spending priorities including both the level and distribution of spending, efforts to address other policy and political issues, and perhaps most importantly, the desire to make a political statement.

Past shutdowns have lasted no more than a few weeks, mostly because political pressure to end them ratcheted up quickly. Once furloughed government employees stopped getting paychecks, lawmakers began to get angry calls and emails, and once government services were disrupted, most Americans became fed up and began assessing blame. Recalcitrant lawmakers, worried about their re-elections, relented.

Because previous shutdowns did not last very long, the economic impacts were small and temporary. The Congressional Research Service, in a recent note, found the hit to real GDP was no more than a few tenths of a percentage point in the quarter the shutdown took place, and the economy bounced back quickly in subsequent quarters. These estimates are similar to our own.

Shutdown present

This time, a few hard-right House Republicans form the roadblock to passing a federal budget. They want more spending cuts than lawmakers had agreed to just a few months ago in the Fiscal Responsibility Act that resolved the battle over increasing the Treasury debt limit. That agreement set spending caps to limit funding for fiscal 2024-2025, but there was a side deal that mitigated most of the cuts to nondefense discretionary spending, angering some House Republicans. Other Republican lawmakers are also opposed to more funding for Ukraine in that country's war with Russia. Some want to implement more stringent immigration rules. And still others want to stymie the myriad criminal investigations of former President Trump.

If history is a guide, these House Republicans will quickly give up their fight once there is a shutdown and voter ire mounts. The shutdown will last no more than a few weeks. But there is good reason to worry that a shutdown will drag on. Republicans have only a four-vote majority in the House, and Republican House Speaker Kevin McCarthy has a tenuous grip on his caucus given current House rules that even a single member of Congress can challenge his leadership. Thus, getting almost anything through this Congress, let alone a contentious budget, is prohibitively difficult. It is hard to imagine lawmakers would take it this far, but it is not unimaginable.

Shutdown scenarios

Given the uncertainty of this drama, Moody's Analytics considers several scenarios that should bookend the possible outcomes. The most optimistic is that lawmakers come together at the last minute and pass a continuing resolution to temporarily fund the government and keep it open. The CR would likely be for just a few weeks, but it would give lawmakers more time to work through their differences and pass a budget that funds the government through fiscal 2024.

While this "No Shutdown" scenario becomes less likely with each passing hour, one way it could come to pass is if the House takes up the CR recently passed by the Senate. There is general agreement in the Senate that a shutdown is bad economics and bad politics. However, odds are that Speaker McCarthy will block a vote in the House should the Senate-led CR make it to his desk since it would almost surely cost him his speakership. More than a few House Republicans would be angered if the CR passed the House over their opposition and with votes from House Democrats. Even though the No Shutdown scenario is not likely, it is a good benchmark to compare with alternative scenarios.

The most likely, or "Baseline" scenario, is that the government shuts down on October 1 and remains closed for two to three weeks. As in most prior shutdowns, the Baseline scenario assumes that voters quickly assess blame for the shutdown and the political pressure to end the impasse swiftly intensifies. Hard-right House Republicans are considered the obstructionists in this go-around and are the focal point of the electorate's ire. The holdout House members relent and agree to a CR that provides the few weeks necessary to reach a budget deal, which we assume is ultimately much like what was agreed upon in the Fiscal Responsibility Act. To help hard-right Republicans to go along, additional funds are provided for border security—a demand toward the top of their priority list.

Finally, we consider a pessimistic scenario that assumes the shutdown drags on through the end of the year. Despite the mounting economic damage and intense political pressure, in this "Quarter-Long Shutdown" scenario, hard-right Republicans and Speaker McCarthy hold their ground, and their demands for more government spending cuts cannot be dismissed. Lawmakers finally come to terms as the new year approaches by agreeing to a CR that includes a 1% across-the-board cut to defense and nondefense discretionary spending beginning in 2024. These were the cuts included in the Fiscal Responsibility Act if the government was still operating with a CR at the start of 2024. Lawmakers had thought any cuts to the defense budget would be so unpopular with Republicans and the nondefense cuts with Democrats that they would find a way to pass a budget and avoid them. But in this dark scenario, they fail to do so. We also assume border security funding and additional funding for the Ukraine war are part of the deal.

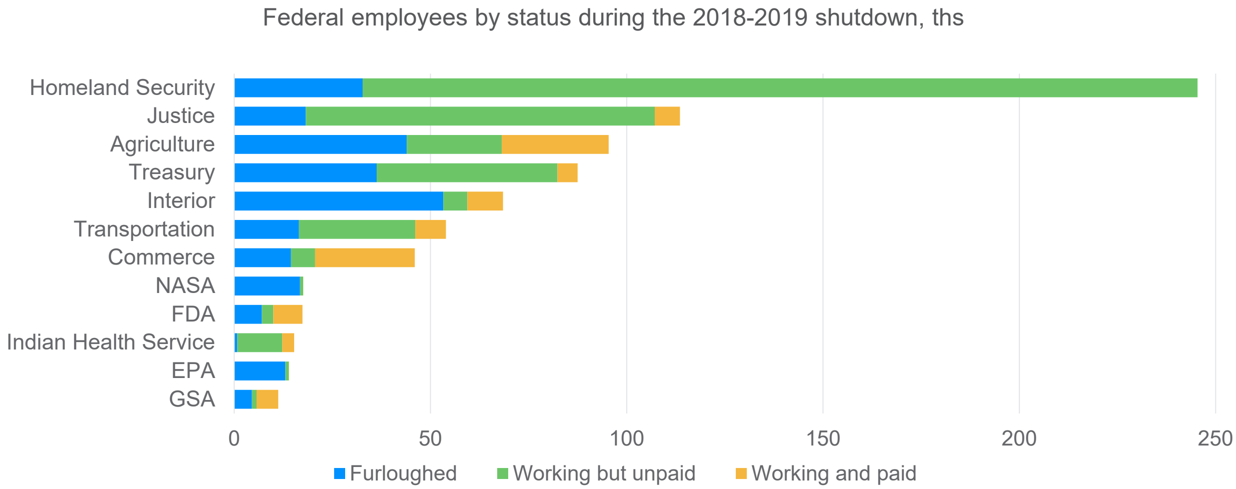
While the No Shutdown and Quarter-Long Shutdown scenarios are unlikely, they provide bookends to the distribution of possible outcomes. The Baseline scenario is designed to represent outcomes that encompass approximately half of the distribution, including shutdowns that last a few days to just over a month. However, the risks to the Baseline are skewed decidedly to darker scenarios that feature even longer and more contentious shutdowns.

Economic fallout

The first economic casualty of a government shutdown will be federal government employees. Close to 1 million workers, about half of all federal employees, will be furloughed, while the other half will be considered essential by their respective government agencies and be required to report to work. This will be similar to what happened in the 2018-2019 shutdown, although in that shutdown lawmakers had already signed into law funding for some government agencies that accounted for almost one-third of all employees (see Chart 2). No one will receive a paycheck until the government reopens, though everyone will ultimately get back pay. Even so, the retroactive payments must wait until the government reopens, and the workers will not know when that will be, causing significant financial hardship in the meantime.

Furloughed government workers may be eligible for unemployment insurance but most are unlikely to apply given the tough eligibility rules in some states and the requirement that they repay the unemployment benefits they received once the shutdown ends and they receive their back pay. Essential workers who are required to work are not eligible for UI despite not getting a paycheck. It is worth noting that in

Chart 2: What Happened to Government Employees During the Last Shutdown



Sources: OMB, Moody's Analytics

the 2018-2019 shutdown, which lasted just about one month, some lower-paid essential workers such as TSA agents began to call in sick in large numbers, and air traffic controllers threatened to do so, making air travel difficult.

Next to take it on the financial chin will be private companies that contract with the federal government for a long list of goods and services—from office furniture to military equipment, and janitorial services to cloud computing. When the government is shut down, these companies do not get paid, and their employees are not able to work. Many of these contractors are smaller businesses unable to pivot as easily as larger firms, if they are unable to do business with the government. It is difficult to determine the number of government contractors adversely impacted, but several million workers could eventually be hurt.

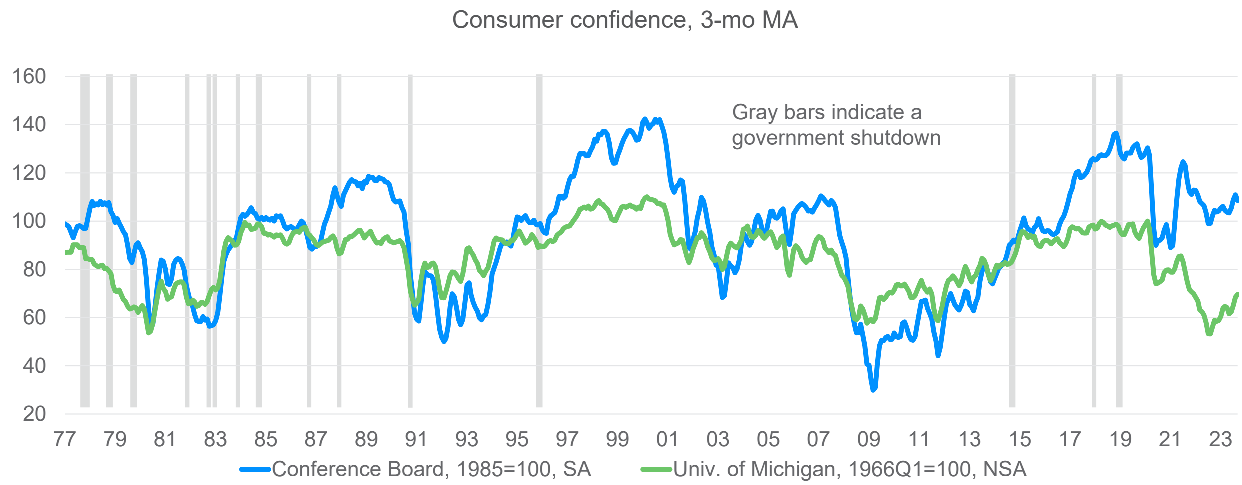
The government shutdown will quickly create widespread problems. None by themselves will exact a big economic cost, but together the costs quickly add up. A potential homebuyer in a flood zone, unable to get federal flood insurance, may not be able to close on her mortgage. Or a food processing plant, unable to get the appropriate certifications from an inspector from the Food and Drug Administration, may need to stop operations. Utilities and chemical companies may have difficulty getting the appropriate environmental certifications from the Environmental Protection Agency. And the Securities and Exchange Commission would not be able to do the work necessary for a privately held company to issue stock and go public.

Also, in a shutdown the government will stop collecting and publishing key economic statistics. While this may seem the parochial concern of economists like us, the Federal Reserve is reliant on these numbers to determine when to stop raising interest rates. Without them, it is much more likely that monetary authorities will make a mistake by either not raising rates enough and allowing inflation to take root, or by raising rates too high and unnecessarily pushing the economy into recession.

Perhaps most disconcerting, a lengthy shutdown will call into further question the ability of lawmakers to accomplish anything, even essentials such as paying on the nation's debt. The Treasury debt limit will need to be increased again soon, in early 2025, after the next election. Then there are the nation's increasingly daunting fiscal challenges. According to the Congressional Budget Office, without changes to current tax and spending policies and under reasonable economic assumptions, the nation's publicly traded debt-to-GDP ratio will rise from the current level of close to 100% to 115% a decade from now, and more than 180% in 30 years. At some point this fiscal trajectory will become unsustainable. But to change it lawmakers will need to make difficult choices. It is hard to see how this happens given how tough it is for lawmakers to simply keep the government operating.

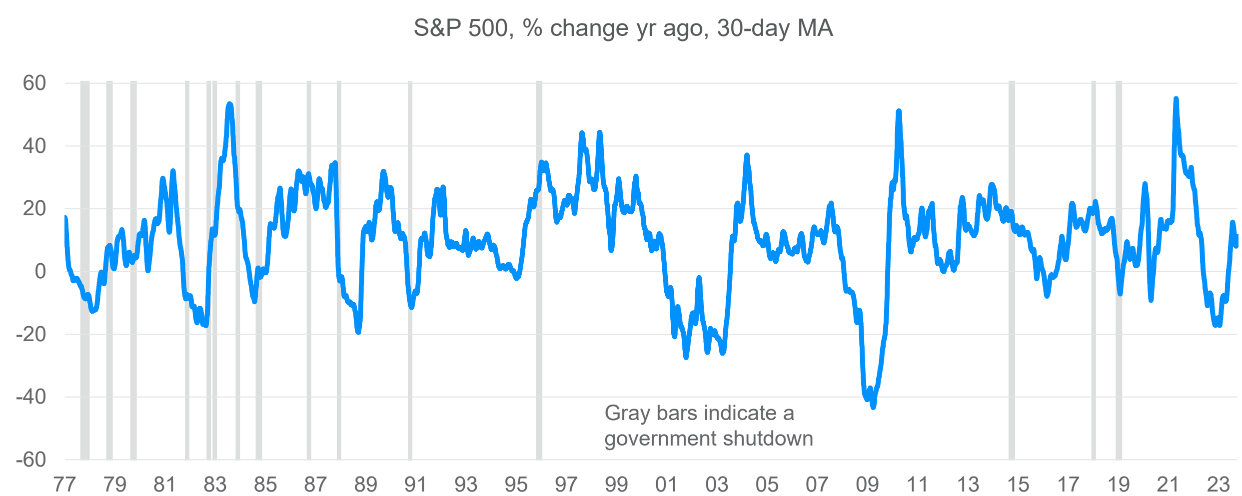
Past government shutdowns were not long enough to do much harm to consumer confidence and investor sentiment (see Charts 3 and 4). But that is not likely to be so if the shutdown extends for more than a few weeks, particularly given the fragility of the collective psyche. Indeed, the recent selloff in the stock mar-

Chart 3: Past Shutdowns Have Not Hurt Consumer Confidence Much…



Sources: The Conference Board, Univ. of Michigan, U.S. House of Representatives, Moody's Analytics

Chart 4: …Nor That of Stock Investors



Sources: Standard & Poor's, U.S. House of Representatives, Moody's Analytics ket is likely due at least in part to the impasse in Washington DC. A recession is ultimately a loss of faith by consumers and businesses, and a lengthy government shutdown will be sure to shake that faith.

Baseline impact

A brief government shutdown as envisaged in the Baseline scenario will by itself only modestly hurt economic growth (see Tables 1 and 2). We estimate it will reduce annualized real GDP growth by 0.3 percentage point in the fourth quarter, largely due to the reduction in the hours worked by furloughed government employees. Those hours cannot be made up. Consumer spending will soften initially as government and contract workers, fearful their incomes will be disrupted, turn more cautious. But spending quickly bounces back once the government reopens, and there is no discernible impact on spending in the quarter.

However, the timing of the shutdown is especially problematic as the economy grapples with a host of headwinds. The United Auto Workers strike continues and is broadening to include more of the Big 3 automakers' factories. If the UAW strike lasts through the end of October as we anticipate, it will reduce annualized real GDP growth in the fourth quarter by another estimated 0.3 percentage point. This includes the direct impact of lost auto and parts production as well as the multiplier impacts on suppliers and auto dealers and the hit to spending due to the income lost by workers impacted by the strike.

Student loan borrowers must also resume making payments on their debts in October. This includes 24 million borrowers with average monthly payments of $300, which amounts to a total increase of more than $85 billion in annual payments. Of course, not all borrowers will resume payments, in part because President Biden through executive order has told student loan servicers not to report delinquent borrowers to the credit bureaus. Borrowers will prioritize other obligations before paying on their student loans. Still other borrowers will move into income-driven repayment plans, reducing their monthly payment. And many borrowers have other financial resources and will not cut back their spending dollar for dollar with their student loan payments. Accounting for all this, annualized real GDP growth in the fourth quarter will be reduced by an estimated almost 0.3 percentage point.

Then there is the economic fallout from higher oil prices and long-term interest rates. The price of a barrel of West Texas Intermediate has jumped to more than $90 per barrel, and if it simply remains there, it will be up about $10 per barrel in the fourth quarter compared with the third. Because the U.S. produces about as much oil as it consumes, the ultimate impact of higher prices will be largely a wash, but the early impact is decidedly negative as after-inflation household incomes suffer and inflation expectations rise, potentially pushing up wage growth and pressuring the Federal Reserve to further tighten monetary policy. The higher oil prices will shave an additional 0.25 percentage point from annualized fourth-quarter real GDP growth.

The runup in 10-year Treasury yields to more than 4.5% will also weigh on growth in the fourth quarter, if more or less sustained, which seems likely. Yields averaged closer to 4% in the third quarter. With fixed mortgage rates firmly over 7.5% and the average coupon on existing mortgages near 3.5%, homeowners are locked in and home sales have gone into a deep freeze. House prices had stabilized but now appear set to resume their decline, and stock prices are also struggling with the higher rates. Given this, higher rates will knock an additional almost 0.2 percentage point from annualized real GDP growth in the fourth quarter.

Table 1: Economic Consequences of Shutdown Scenarios (Quarterly)

	2023Q1	2023Q2	2023Q3	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4
Real GDP								
No Shutdown, 2012$ bil	20,283	20,386	20,535	20,577	20,620	20,680	20,754	20,833
Annualized % change	2.00	2.06	2.95	0.83	0.84	1.16	1.44	1.52
Baseline, 2012$ bil	20,283	20,386	20,535	20,561	20,616	20,678	20,753	20,831
Annualized % change	2.00	2.06	2.95	0.50	1.08	1.21	1.46	1.52
Difference from No Shutdown, ppt	0.00	0.00	0.00	-0.33	0.24	0.05	0.01	-0.00
Quarter-Long Shutdown, 2012$ bil	20,283	20,386	20,535	20,396	20,505	20,604	20,689	20,804
Annualized % change	2.00	2.06	2.95	-2.69	2.15	1.95	1.67	2.23
Difference from No Shutdown, ppt	0.00	0.00	0.00	-3.51	1.31	0.79	0.22	0.71
Nonfarm employment								
No Shutdown, mil	155.2	155.9	156.4	156.7	156.8	156.9	157.0	157.2
Change, ths	966	667	489	349	98	79	107	126
Baseline, mil	155.2	155.9	156.4	156.7	156.8	156.9	157.0	157.1
Change, ths	966	667	489	288	130	92	113	126
Difference from No Shutdown, ths	0	0	0	-61	-30	-18	-12	-12
Quarter-Long Shutdown, mil	155.2	155.9	156.4	156.0	156.1	156.4	156.6	156.9
Change, ths	966	667	489	-404	148	254	205	325
Difference from No Shutdown, ths	0	0	0	-753	-704	-529	-431	-232
Unemployment rate								
No Shutdown, %	3.50	3.57	3.78	3.86	3.97	4.01	4.10	4.15
Baseline, %	3.50	3.57	3.78	3.89	3.98	4.02	4.10	4.16
Difference from No Shutdown, bps	0.0	0.0	0.0	3.1	1.2	0.5	0.3	0.3
Quarter-Long Shutdown, %	3.50	3.57	3.78	4.24	4.26	4.20	4.23	4.19
Difference from No Shutdown, bps	0.0	0.0	0.0	37.5	29.1	18.6	13.8	4.0
Consumer price index								
No Shutdown, 82-84=100	301.3	303.4	305.6	308.0	310.2	312.1	313.9	315.6
% change yr ago	5.77	4.05	3.41	3.19	2.93	2.89	2.71	2.45
Baseline, 82-84=100	301.3	303.4	305.6	308.0	310.2	312.1	313.9	315.6
% change yr ago	5.77	4.05	3.41	3.18	2.93	2.89	2.71	2.45
Difference from No Shutdown, ppt	0.00	0.00	0.00	-0.00	-0.00	-0.00	-0.00	-0.00
Quarter-Long Shutdown, 82-84=100	301.3	303.4	305.6	308.0	310.1	312.0	313.6	315.3
% change yr ago	5.77	4.05	3.41	3.16	2.90	2.84	2.64	2.39
Difference from No Shutdown, ppt	0.00	0.00	0.00	-0.02	-0.03	-0.04	-0.07	-0.06
10-yr Treasury yield								
No Shutdown, %	3.65	3.60	4.06	4.03	4.01	3.98	3.91	3.86
Baseline, %	3.65	3.60	4.06	4.03	4.01	3.97	3.91	3.86
Difference from No Shutdown, bps	0.00	0.00	0.00	-0.18	-0.18	-0.13	-0.10	-0.07
Quarter-Long Shutdown, %	3.65	3.60	4.06	4.01	3.98	3.93	3.89	3.85
Difference from No Shutdown, bps	0.00	0.00	0.00	-2.21	-3.69	-4.28	-2.72	-1.66

Note: Forecast begins 2023Q4.

Sources: BEA, BLS, Federal Reserve, Moody's Analytics

Table 2: Economic Consequences of Shutdown Scenarios (Annual)

					% change	
	2022	**2023**	**2024**	**2025**	**2023-2024**	**2024-2025**
Real GDP						
No Shutdown, 2012$ bil	20,014	20,445	20,722	21,120	1.35	1.92
Annualized % change	2.06	2.15	1.35	1.92		
Baseline, 2012$ bil	20,014	20,441	20,720	21,119	1.36	1.93
Annualized % change	2.06	2.13	1.36	1.93		
Difference from No Shutdown, ppt	0.00	-0.02	0.01	0.01		
Quarter-Long Shutdown, 2012$ bil	20,014	20,400	20,651	21,089	1.23	2.12
Annualized % change	2.06	1.93	1.23	2.12		
Difference from No Shutdown, ppt	0.00	-0.23	-0.12	0.21		
Nonfarm employment						
No Shutdown, mil	152.6	156.1	157.0	157.6	0.59	0.36
Change, ths	6.3	3.5	0.9	0.6		
Baseline, mil	152.6	156.1	157.0	157.6	0.59	0.37
Change, ths	6.3	3.4	0.9	0.6		
Difference from No Shutdown, ths	0.0	-15.2	-17.8	-4.9		
Quarter-Long Shutdown, mil	152.6	155.9	156.5	157.4	0.40	0.56
Change, ths	6.3	3.3	0.6	0.9		
Difference from No Shutdown, ths	0.0	-188.2	-474.0	-168.7		
Unemployment rate						
No Shutdown, %	3.64	3.68	4.06	4.17		
Baseline, %	3.64	3.68	4.06	4.17		
Difference from No Shutdown, bps	0.00	0.77	0.55	-0.03		
Quarter-Long Shutdown, %	3.64	3.77	4.22	4.19		
Difference from No Shutdown, bps	0.00	9.37	16.38	2.34		
Consumer price index						
No Shutdown, 82-84=100	292.6	304.6	312.9	319.8		
% change yr ago	7.99	4.09	2.74	2.20		
Baseline, 82-84=100	292.6	304.6	312.9	319.8		
% change yr ago	7.99	4.09	2.74	2.19		
Difference from No Shutdown, ppt	0.00	-0.00	-0.00	-0.00		
Quarter-Long Shutdown, 82-84=100	292.6	304.6	312.8	319.5		
% change yr ago	7.99	4.08	2.69	2.16		
Difference from No Shutdown, ppt	0.00	-0.01	-0.05	-0.03		
10-yr Treasury yield						
No Shutdown, %	2.95	3.83	3.94	3.84		
Baseline, %	2.95	3.83	3.94	3.84		
Difference from No Shutdown, bps	0.00	-0.05	-0.12	0.33		
Quarter-Long Shutdown, %	2.95	3.83	3.91	3.87		
Difference from No Shutdown, bps	0.00	-0.55	-3.09	2.50		

Sources: BEA, BLS, Federal Reserve, Moody's Analytics

While none of these headwinds by itself could push GDP negative in the fourth quarter, collectively they threaten to do so, even with only a two- to three-week government shutdown as envisaged in the Baseline scenario.

Quarter-Long impact

There is little doubt real GDP will decline in the fourth quarter if the shutdown drags on through the remainder of the year as envisaged in the Quarter-Long Shutdown scenario. Indeed, we estimate that annualized real GDP growth will contract 2.7% in the quarter. The loss of federal government and private sector jobs pushes the unemployment rate up 0.5 percentage point to 4.3% by early 2024.

The economy bounces back in early 2024 once the government reopens and federal government employees and workers at private contractors return to work and receive their back pay. A recession is thus avoided. However, this depends critically on how well consumer and investor confidence weathers the shutdown. In past shutdowns, the level of angst was not high enough to cause households and businesses to pull back on their spending and payrolls. But in this scenario the length of the shutdown does weigh on consumer confidence, and stock prices decline. Still, though sentiment bends, it does not break. Most importantly, businesses look past the shutdown to instead focus on their perennial labor shortages, and they avert significant layoffs. Of course, this is a tenuous assumption and recession risks will be extraordinarily high. Even if the economy skirts recession, it does not fully recover the GDP and jobs lost until early 2026.

Moreover, long-term interest rates (which decline when the government is shut down and the economy is weakening) quickly increase once the economy rebounds with the government's reopening. Rates ultimately settle several basis points above what they would have been if a shutdown had been avoided. This reflects the heightened concern global investors will have after such a long shutdown with the inability of lawmakers to do what is necessary to prudently manage the nation's fiscal affairs. This includes increasing the Treasury debt limit in a timely way, which lawmakers will need to do again soon after the next election, and ultimately putting the nation's fiscal outlook on a sustainable path.

Conclusions

The current brinkmanship in Washington DC over funding the government and avoiding a shutdown is painful to watch and harmful to the economy. If history is a guide, the shutdown should be short, limiting the economic damage. But history may be a poor guide given the current thin Republican majority in the House, Kevin McCarthy's tenuous hold of the Speakership, and the strident position of hard-right Republicans. The shutdown could go on for months and not weeks. There is never a good time for such dysfunction, but this is an especially inopportune time with recession risks high as the economy struggles with the Federal Reserve's aggressive rate hikes. One takeaway from this scenario analysis is that lawmakers, knowing that the still-resilient economy already faces many headwinds, would have to engage in serious malpractice to push it into recession. Let us hope those lawmakers do not put this analysis to the test.

About the Authors

Mark Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and is the lead director of PolicyMap, a data visualization and analytics company, used by policymakers and commercial businesses.

He is a trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public. Dr. Zandi frequently testifies before Congress and conducts regular briefings on the economy for corporate boards, trade associations, and policymakers at all levels.

Dr. Zandi is the author of Paying the Price: Ending the Great Recession and Beginning a New American Century, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis, is described by The New York Times as the "clearest guide" to the financial crisis. Dr. Zandi is host of the Inside Economics podcast.

Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania.

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