



Inforum Economic Outlook



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University of Maryland
December 13, 2011



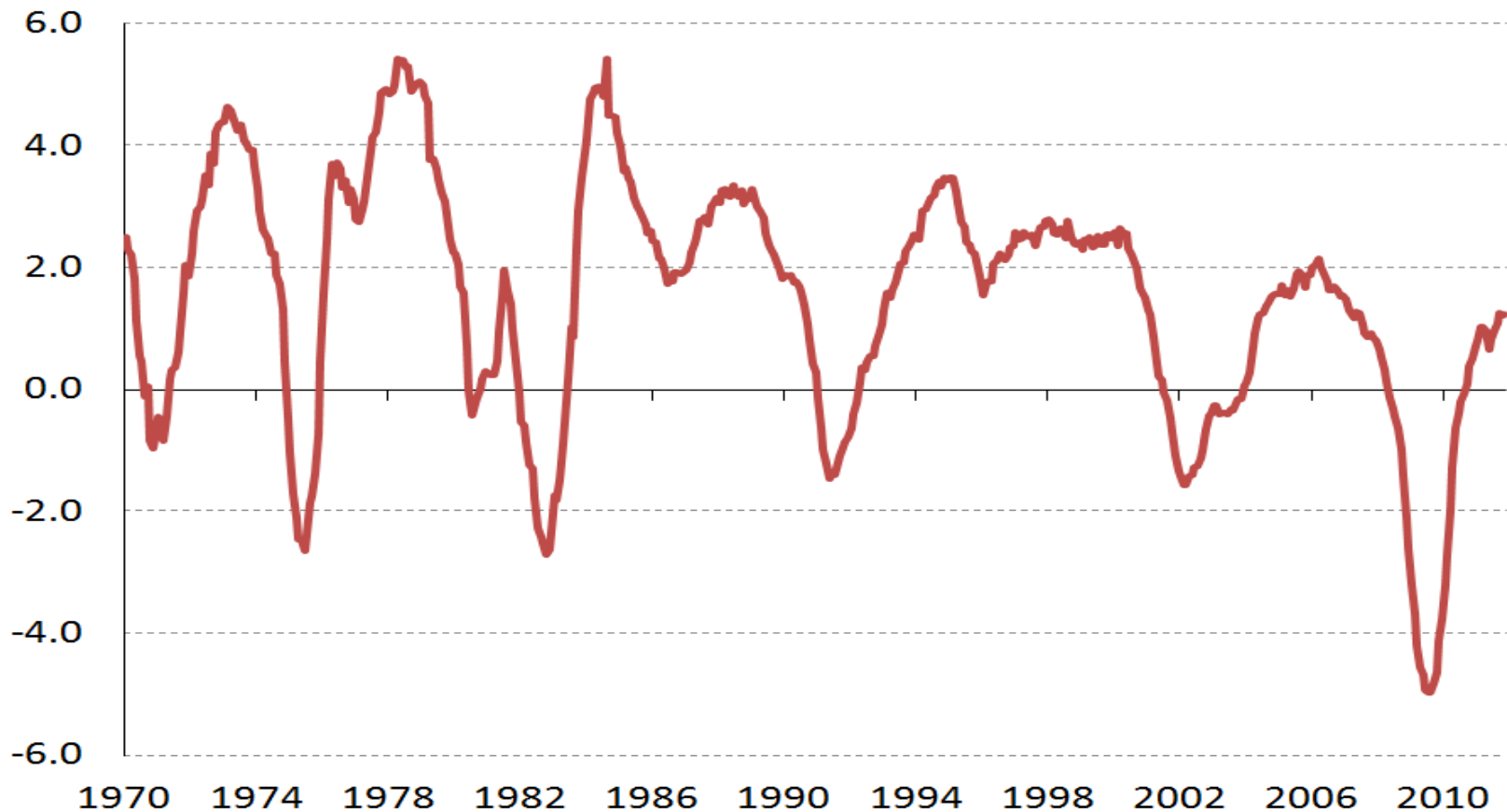
The Short Run Overview

- ⊕ Substantial headwinds, especially consumer debt overhang, to dampen U.S. growth through next year.
- ⊕ Europe is in recession, its crisis is a significant risk.
- ⊕ U.S. economic growth could muddle through with continued Fed easing.
- ⊕ Better fiscal policy could help, but poison political environment prevents it.
- ⊕ Employment situation is especially damaging.
- ⊕ Depending development in EU. we could see much more “unconventional” monetary policy over next year.



Employment: Deep Recession, Weak Recovery

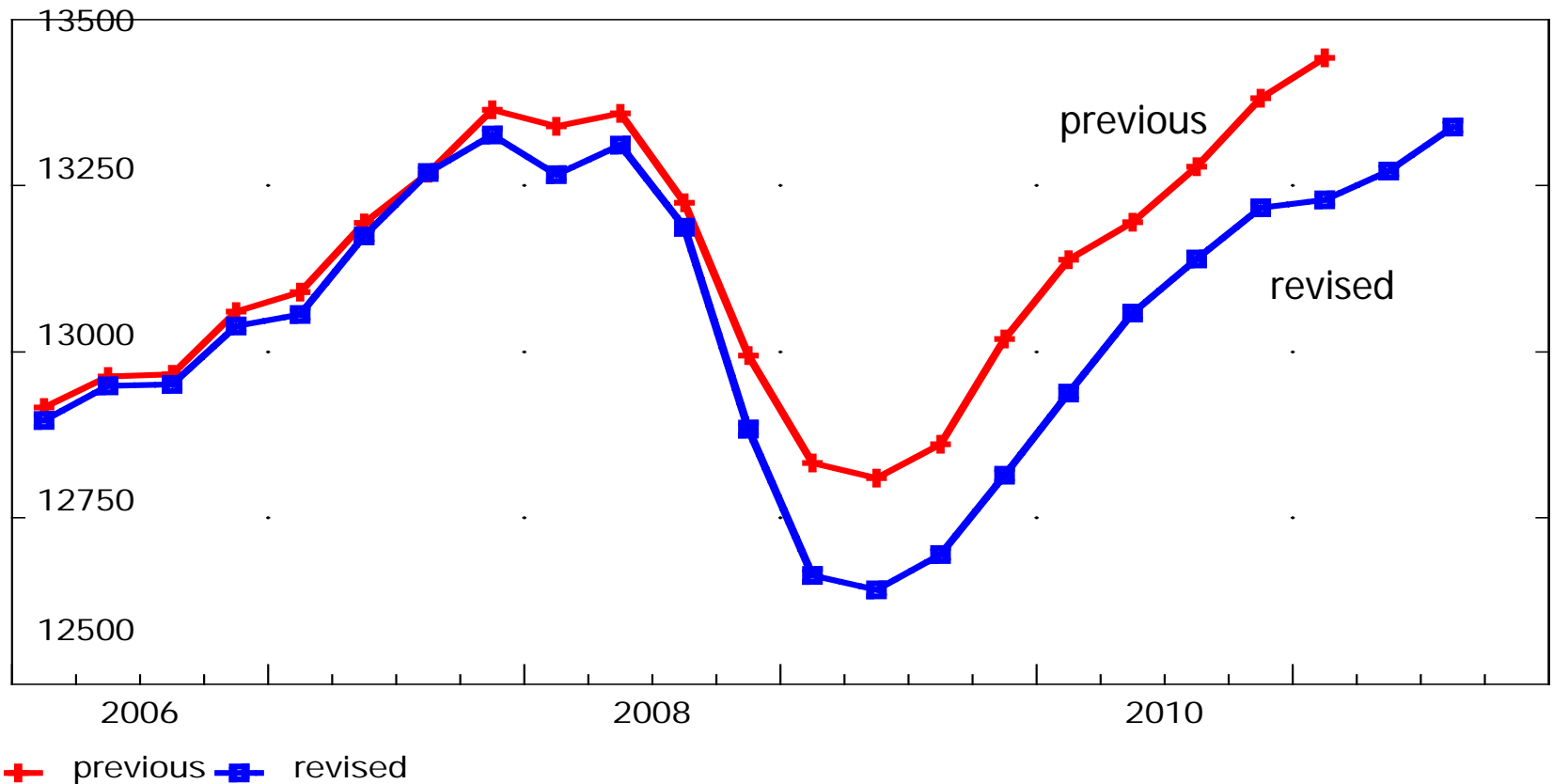
Employment year-on-year percentage growth





August GDP revisions show recession was deeper than previously thought.

Real GDP billions of 2005\$





Outlook Overview

Real (Inflation-Adjusted) Quantities, Average Annual Growth Rates, Percent											
	<u>00-08</u>	<u>08-09</u>	<u>09-10</u>	<u>10-11</u>	<u>11-12</u>	<u>12-13</u>	<u>13-14</u>	<u>14-15</u>	<u>15-20</u>	<u>20-25</u>	<u>25-35</u>
Gross domestic product	2.0	-3.5	3.0	1.8	2.2	2.7	3.0	3.2	2.8	2.2	2.4
Personal consumption	2.4	-1.9	2.0	2.2	2.0	2.1	2.4	2.6	2.4	2.0	2.2
Nonresidential structures	0.7	-21.2	-15.8	5.1	6.2	9.1	6.8	6.1	4.8	2.1	2.1
Equipment investment	2.2	-16.0	14.6	10.8	12.3	5.3	3.1	4.9	5.1	3.8	2.7
Residential investment	-3.3	-22.2	-4.3	-1.7	4.4	8.2	8.6	14.2	7.5	1.2	2.4
Exports	4.2	-9.4	11.3	6.8	3.6	4.9	7.7	6.6	5.7	4.8	4.1
Imports	3.4	-13.6	12.5	4.7	3.1	3.5	3.6	4.3	3.7	3.2	2.6
Government	2.2	1.7	0.7	-1.9	-1.1	0.5	0.7	0.8	0.9	0.8	1.0
GDP deflator	2.6	1.1	1.2	2.2	1.9	1.7	1.8	2.1	2.1	2.2	2.1
Consumption deflator	2.4	0.2	1.8	3.2	2.2	2.0	2.4	2.3	2.4	2.4	2.2
Population	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.9	0.9
Labor force	1.0	-0.1	-0.2	-0.2	0.3	0.9	1.1	1.1	0.9	0.8	0.9
Employment	0.4	-4.5	-0.6	0.7	0.9	1.3	1.4	1.6	1.4	0.9	1.0
Labor productivity	1.8	2.5	2.8	0.9	1.3	1.5	1.5	1.4	1.3	1.3	1.3
Potential GDP	3.0	2.2	1.6	2.2	1.8	1.7	2.0	2.4	2.3	2.3	2.3
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2020</u>	<u>2025</u>	<u>2035</u>
Unemployment Rate	5.8	9.3	9.6	9.0	8.6	8.3	8.1	7.6	5.2	5.5	5.3



Rogoff and Reinhart: What has history taught us?

- ✦ Recovery from financial crises are protracted, because of the long, slow painful process of deleveraging.
- ✦ 2010 view that we weathered the storm were premature.
- ✦ Monetary policy ineffective (liquidity trap).
- ✦ Fiscal Policy: Stimulus is necessary, but could be relatively ineffective because...
- ✦ Explosion of government debt inevitable from financial crisis.
- ✦ Seldom do countries simply “grow” their way out of debts.
- ✦ **Rather, countries face the choice of inflating debts away or restructuring/defaulting.**
- ✦ Today, currency and capital regimes affect that choice.



What's holding back the recovery?

Expected:

- ✦ Fiscal retraction
- ✦ Weak consumer balance sheets, stagnation of housing prices, deleveraging

Unexpected:

- ✦ Japanese tsunami
- ✦ Higher energy and commodity prices
- ✦ Financial turmoil in Europe (significant contagion risk)

Self-inflicted:

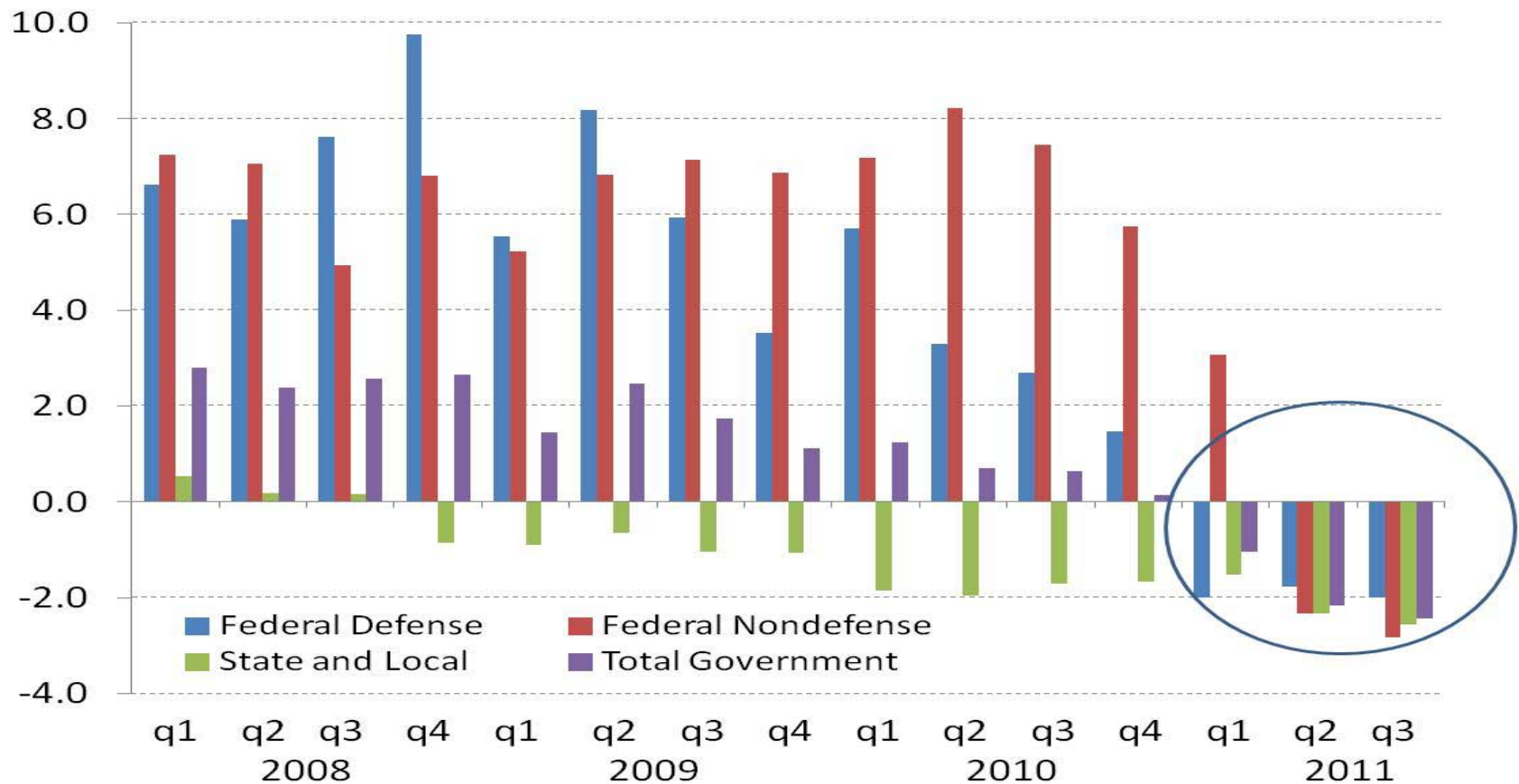
- ✦ Uncertainty: Political paralysis in U.S. and E.U.
- ✦ Strife over fiscal, monetary, financial, and regulatory policy.



Current fiscal drag is substantial....

Government consumption and investment

Year-over-year percentage change

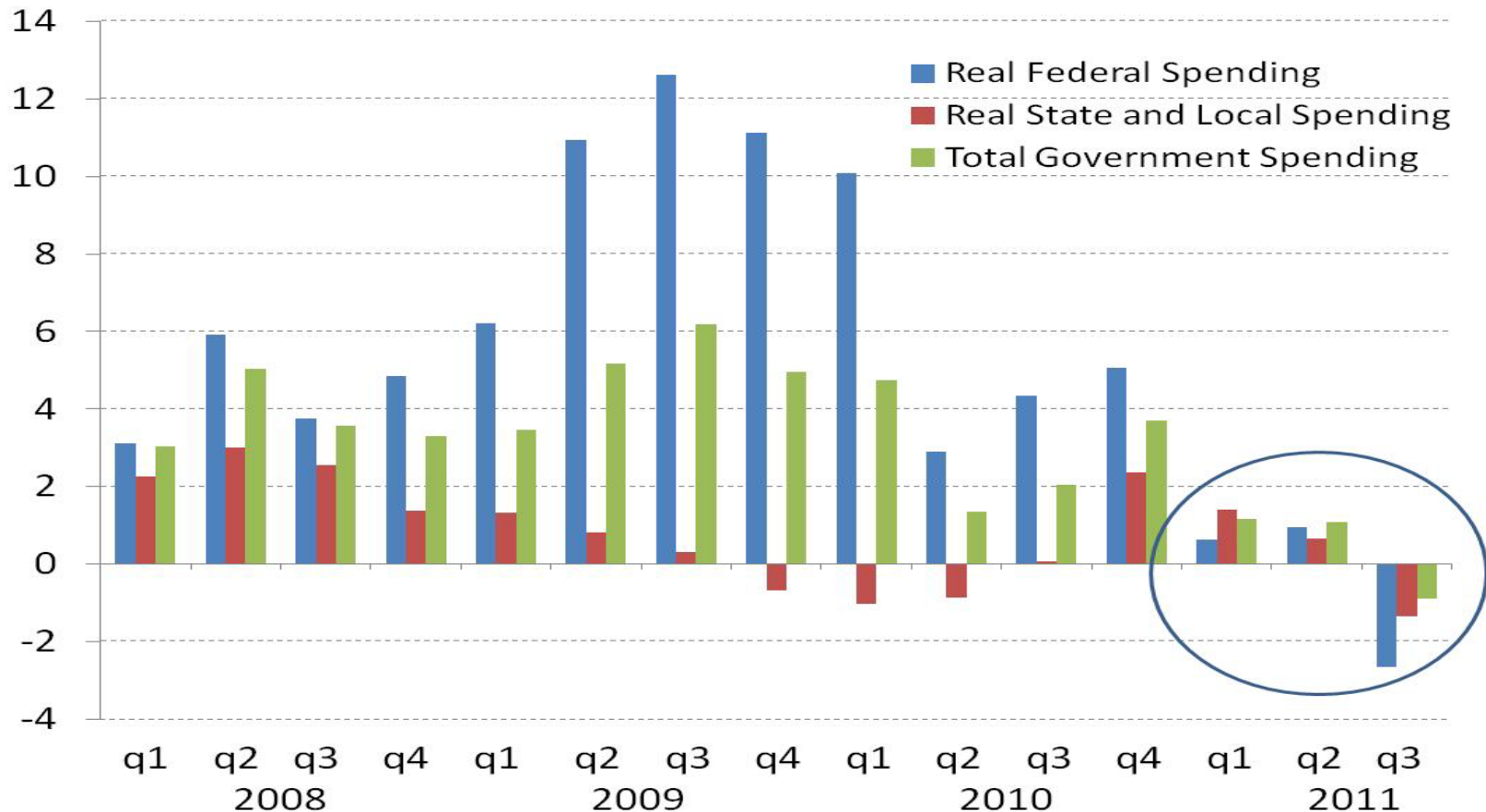




... even considering transfers.

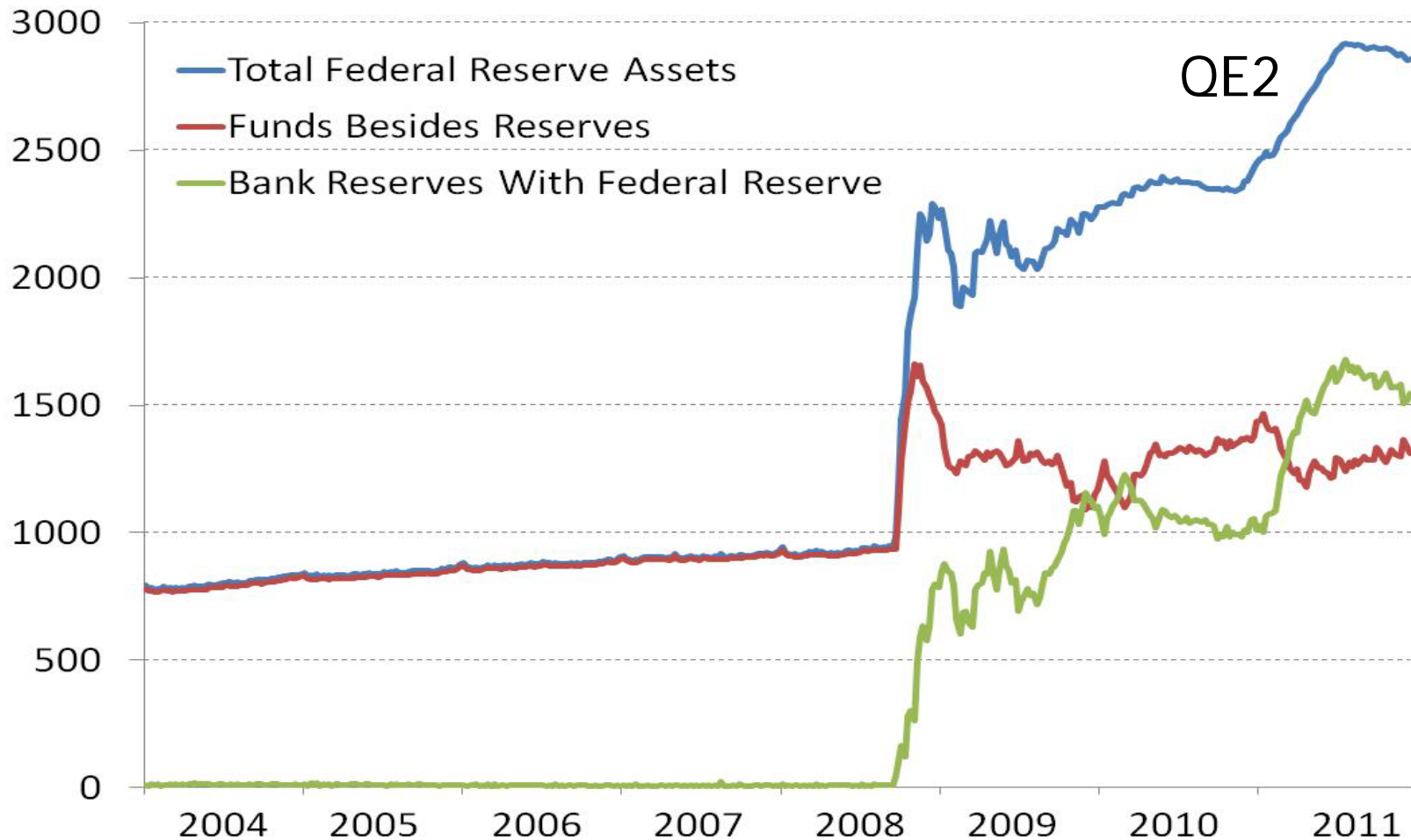
Real government spending

Year-over-year percentage change



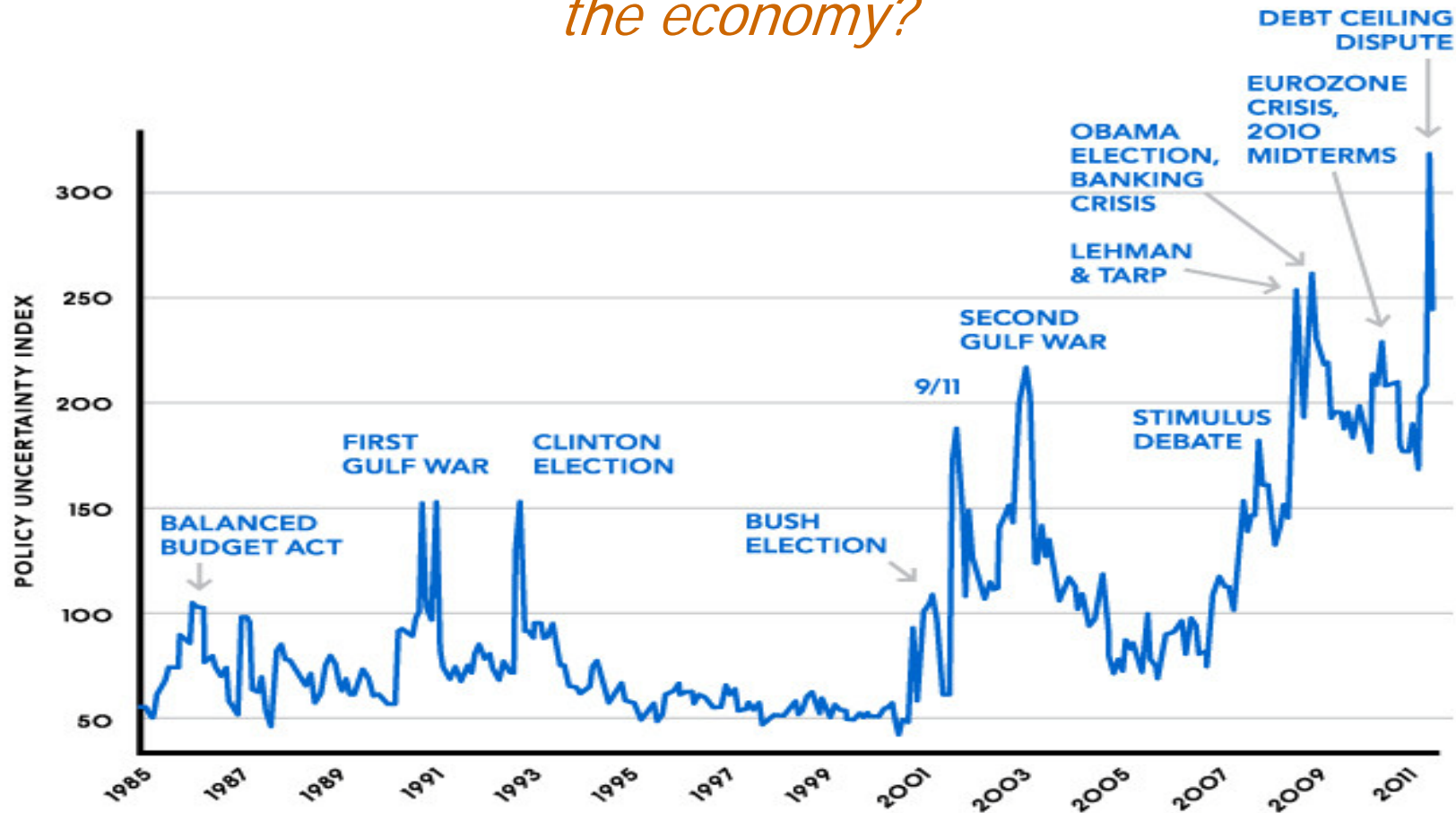


Monetary Policy: Liquidity trap intensifies...





How much does economic policy uncertainty weigh on the economy?



Source: Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty" 10 October 2011



Estimation of Excess Cash held by U.S. Nonfinancial Corporations

FRB Flow of Funds Data		
Table B102 Non-financial corporations		Billion \$
Liquid current assets, average 2010q3 - 2011q2		\$1,908
Short term liabilities, average 2010q3 - 2011q2		\$3,552
“Excess” liquid current assets ($.143 \times 3552$)		\$508
		Percent
Ratio liquid assets to short term liabilities ($\$1908/\3552)		53.7
Average ratio, 2002 – 2007		39.4
Difference		14.3



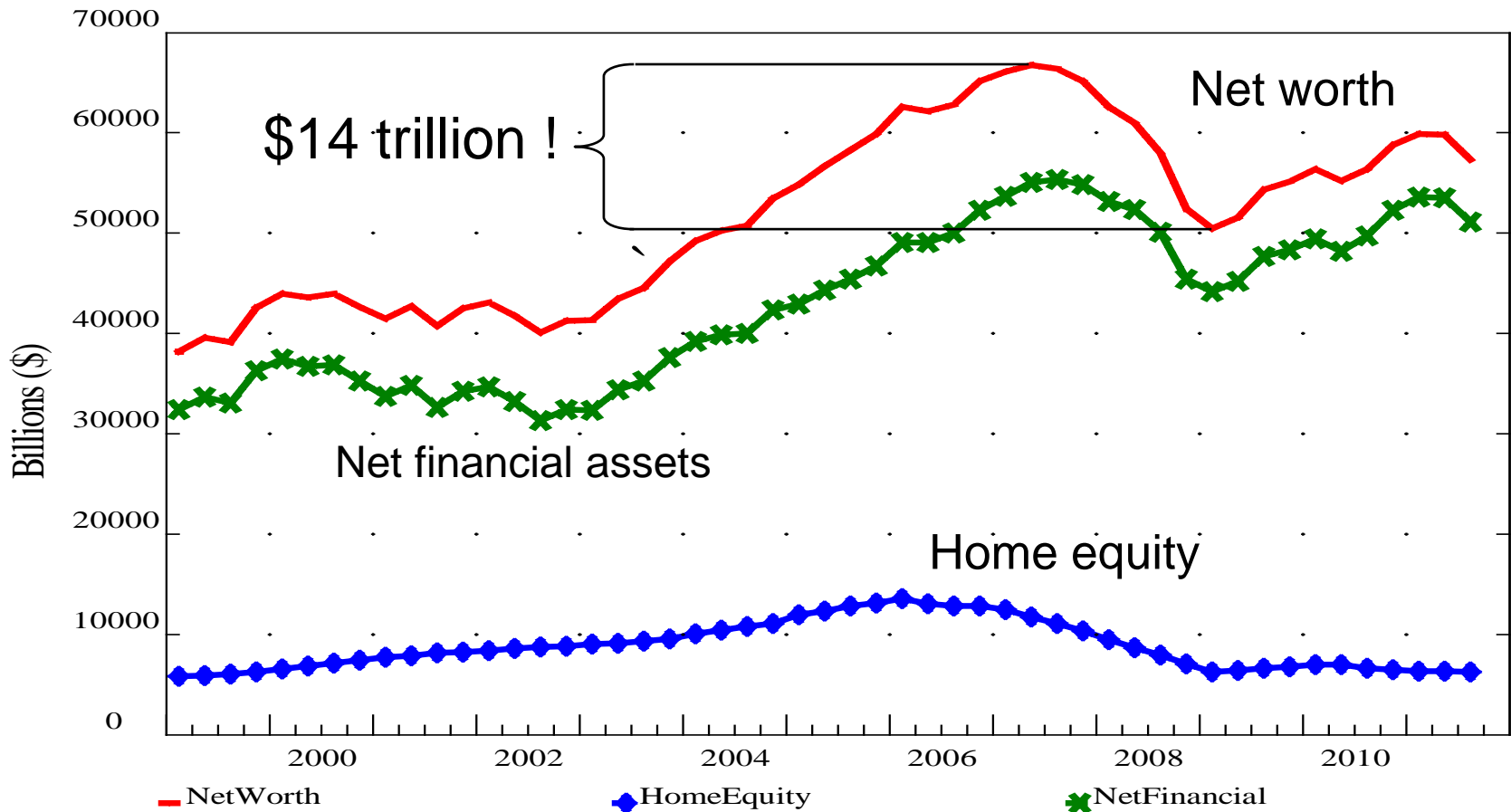
In U.S., the most significant problem remains: Balance sheet problems for consumers, banks and others.

- ✦ Effectiveness of monetary and fiscal policy are still held back by consumer deleveraging.
- ✦ Around 25% of mortgage holders are under water (NV-66%, AZ,MI,FL~50%,CA-42%).
- ✦ Modifications and refinancing -- why are we paralyzed?
- ✦ New (old) standards, large fees, incentive structure. Demonization of Freddie and Fannie.
- ✦ Hubbard: let underwater borrowers refinance.
- ✦ Banks reluctant to increase new lending w/o better feel for liabilities of mortgage-backed bonds and other bad debt. Litigation.
- ✦ Hampers new firm formation, especially important for new job creation.
- ✦ **There are no rapid mechanisms to reduce mortgage principal or expedite write-offs – and increase house prices.**



Household Net Worth: Looking Up, Slowly

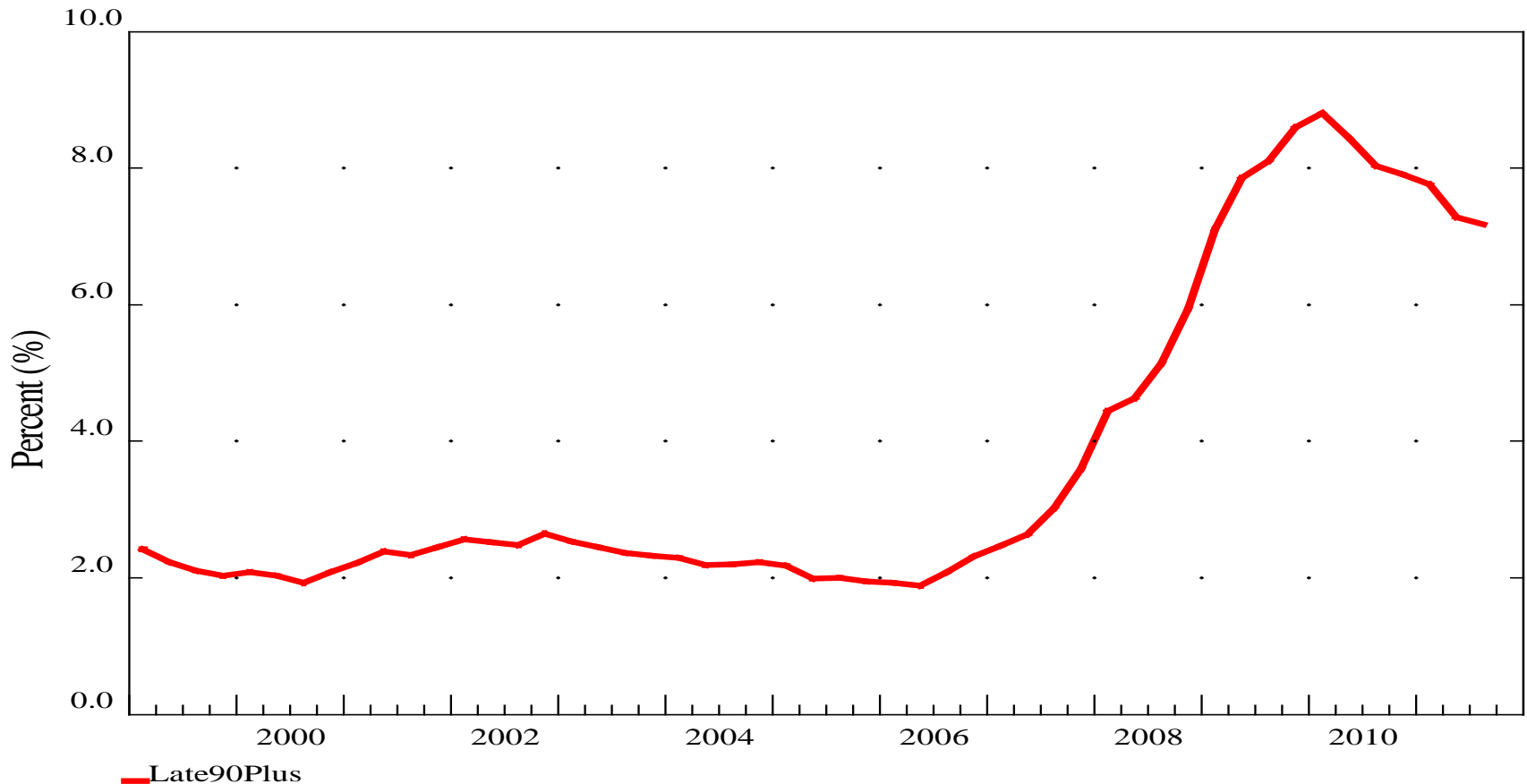
Household Net Worth, Billions of \$





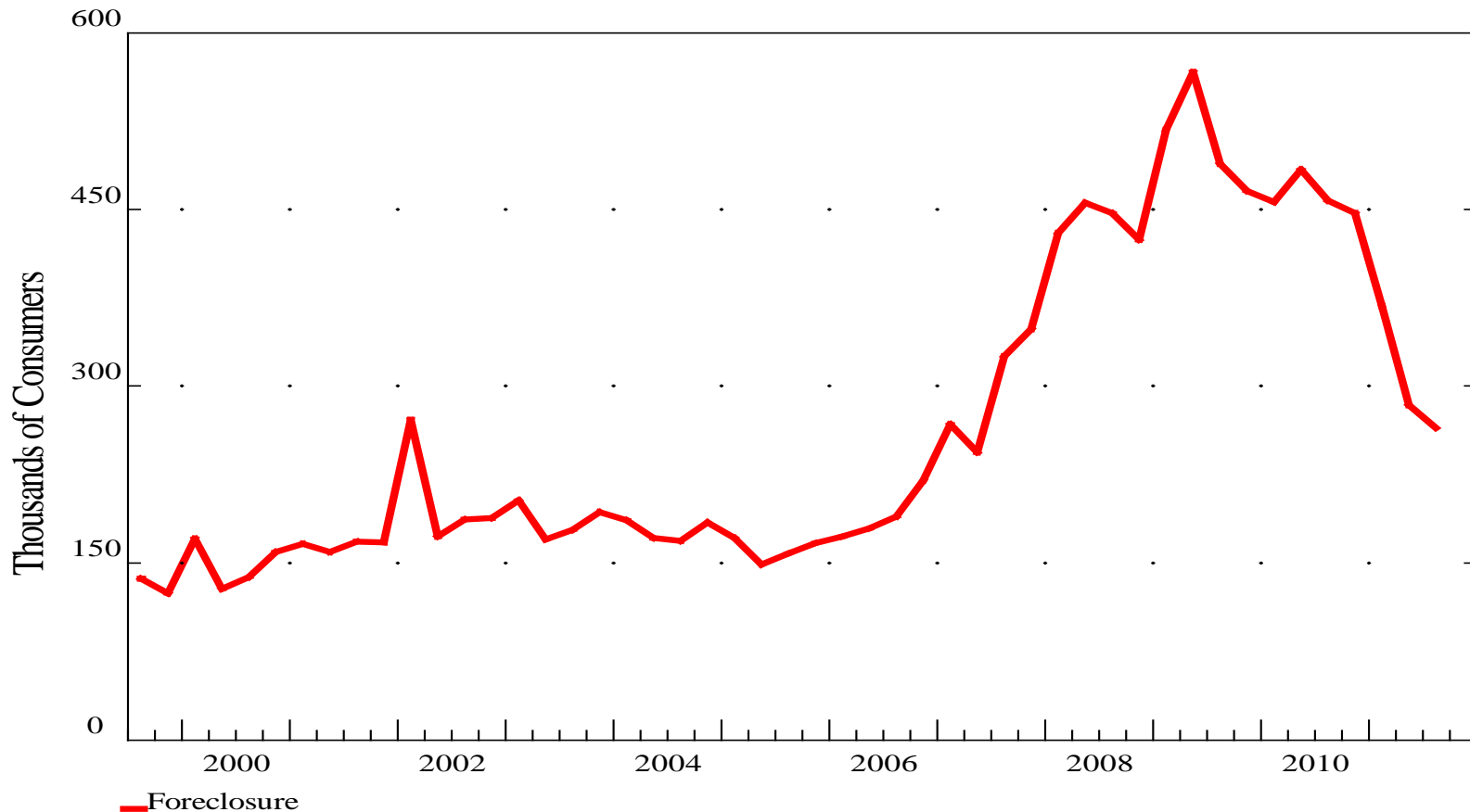
Total Balance by Delinquency Status

Percent Mortgage Balances 90+ Days Delinquent



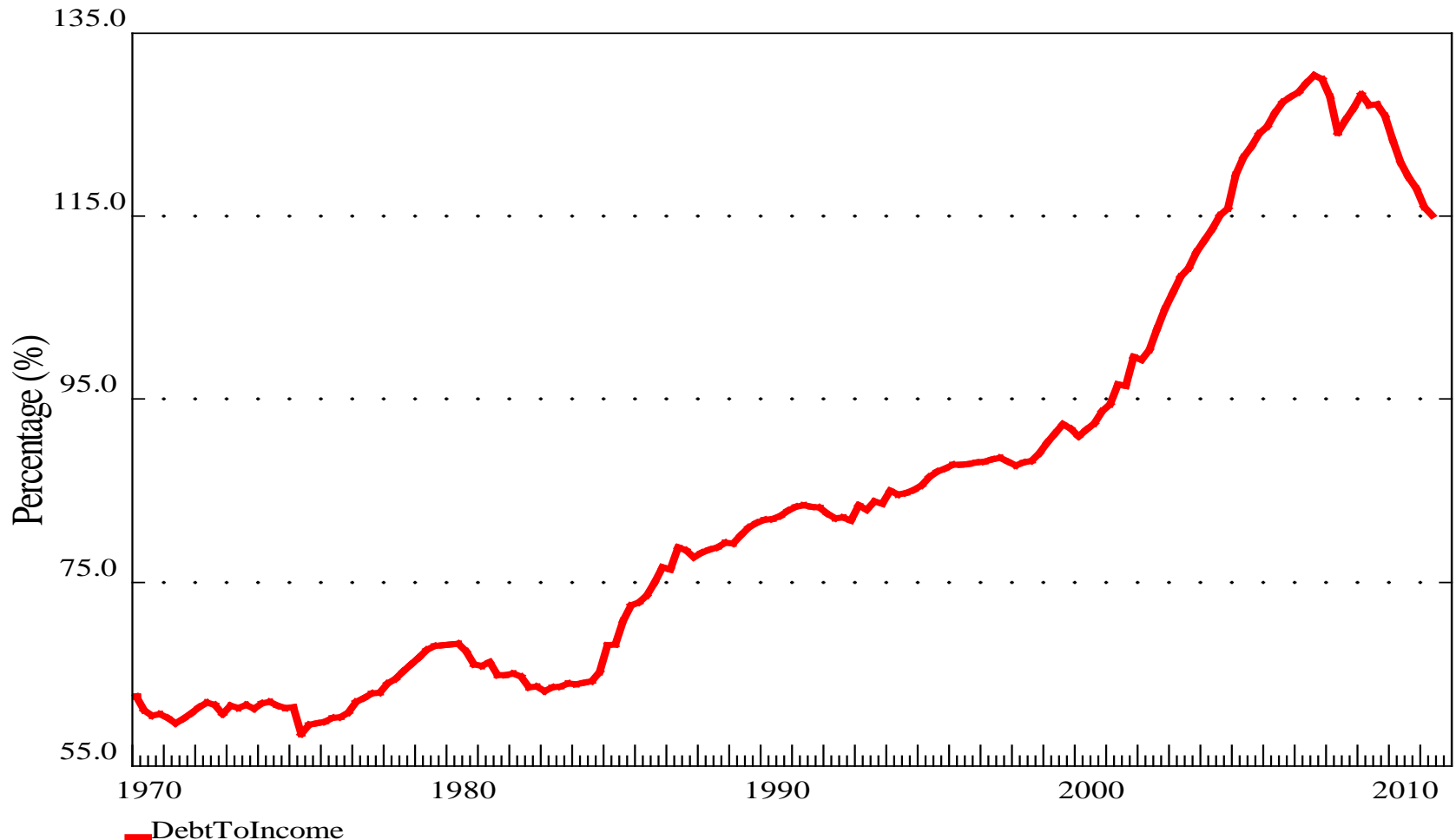


Number of New Foreclosures Thousands of Consumers





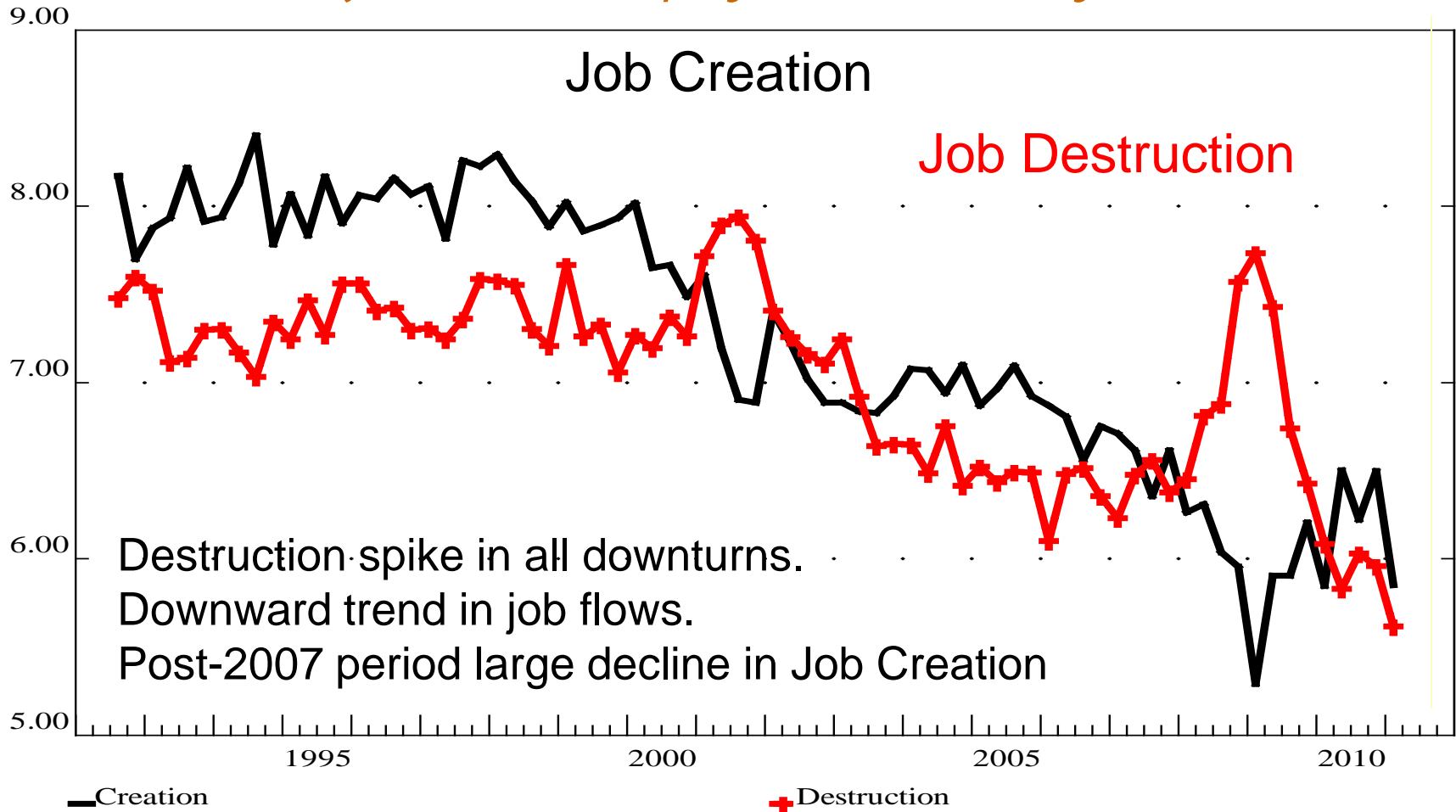
Household Liabilities Percent of Household Disposable Income



Source: Federal Reserve Board

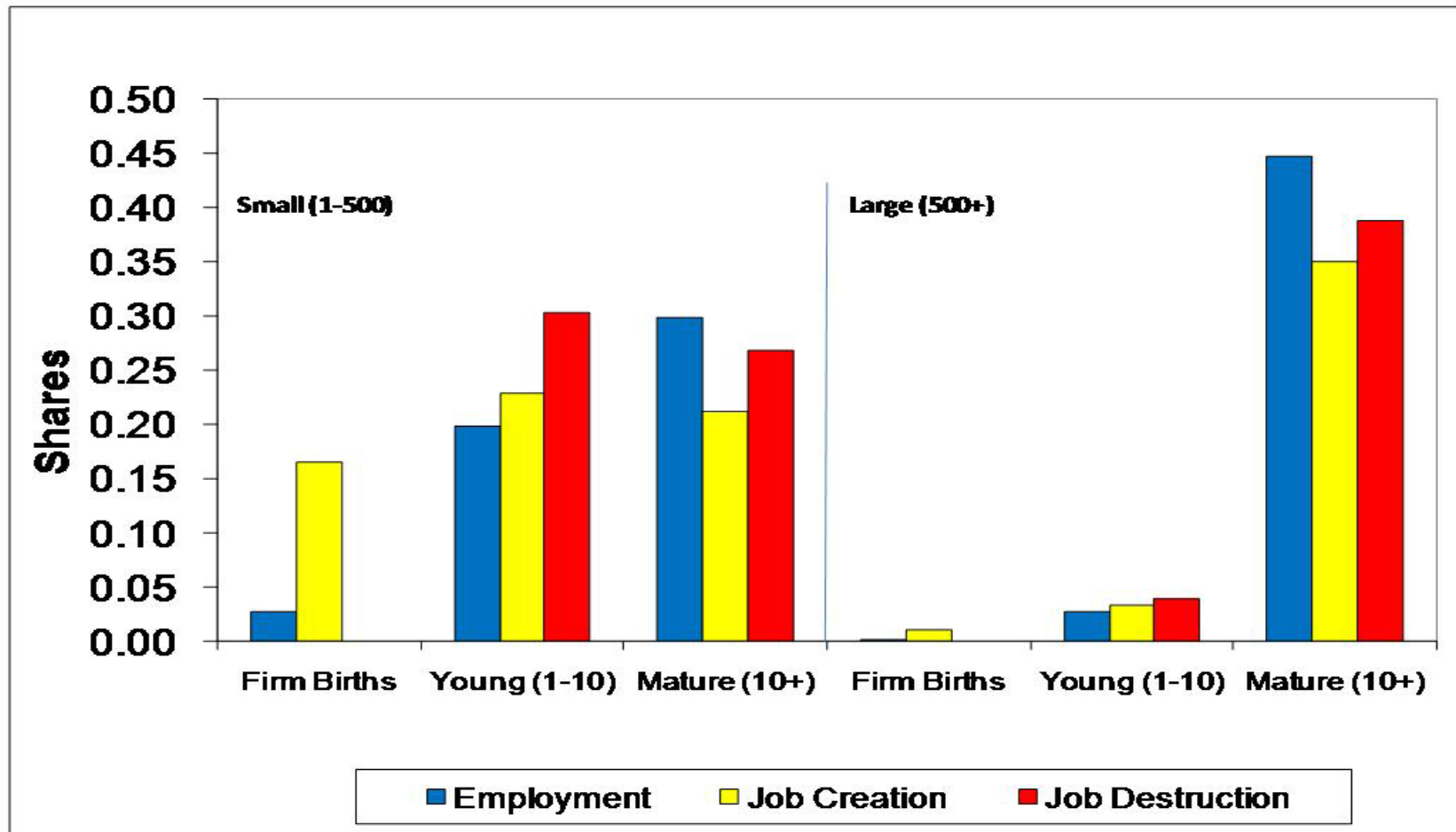


Aggregate Job Creation and Destruction (Percent of Employment, Quarterly)





Most "net" new jobs created from new firms.



Source: Davis, Faberman and Haltiwanger (2010)



Policy Options

Fiscal

- ✦ More fiscal stimulus to fill AD hole: Bond yields remain low, education and infrastructure provide “bang for the buck.”
- ✦ A SR stimulus combined with LR deal on raising revenue with tax reform and reducing future entitlements would be most effective.

Monetary

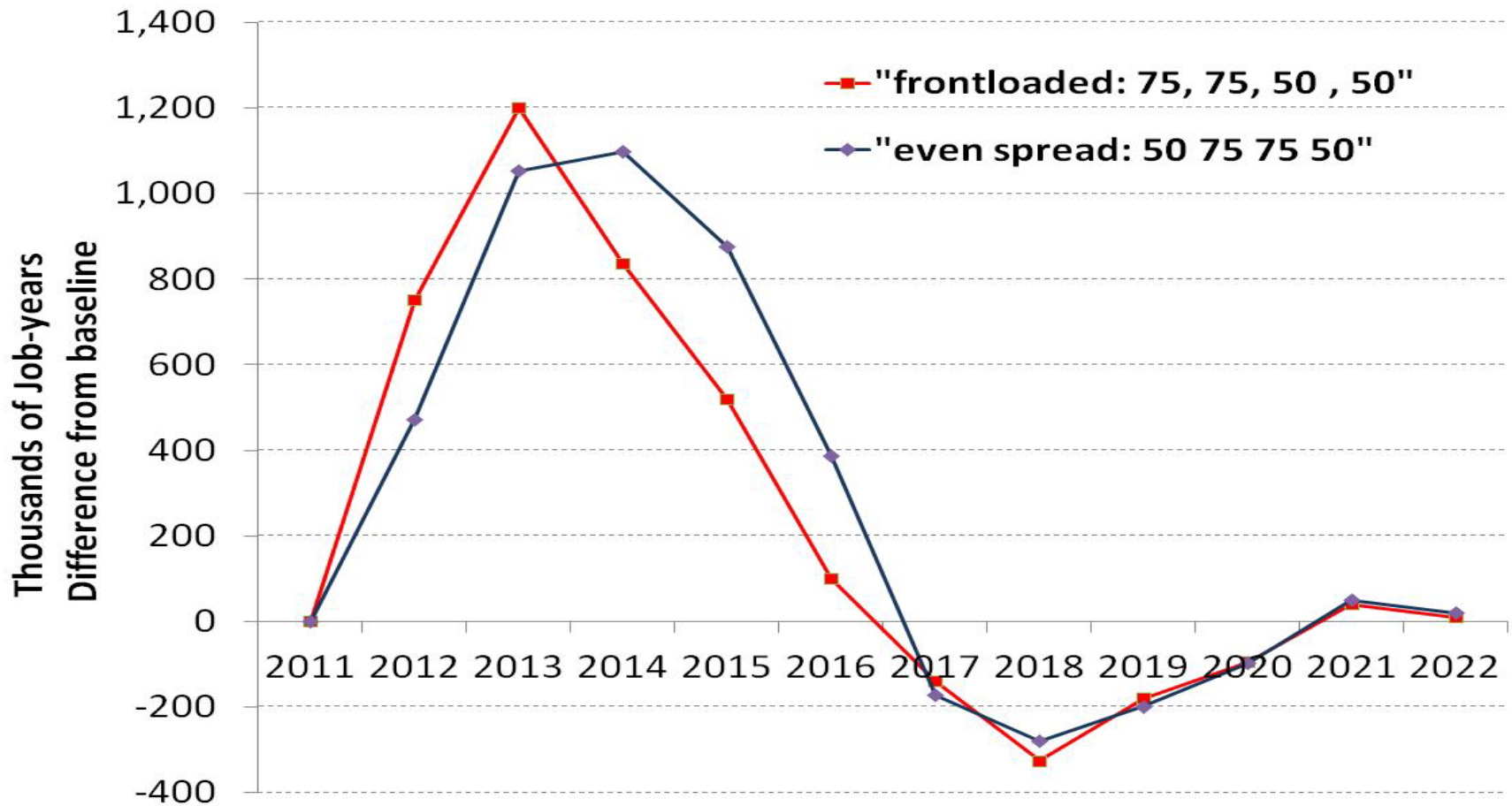
- ✦ Create temporarily high inflation to aid deleveraging.
- ✦ Price level targeting, GDP targeting.
- ✦ Does Fed have enough credibility?

Structural

- ✦ Quicker deleveraging, greater facilitation of mortgage restructuring.
- ✦ Tax reform (eliminate loopholes, reduce rates).
- ✦ Remove regulations and other restrictions (health and finance).
- ✦ New labor market measures (job matching, increase mobility).



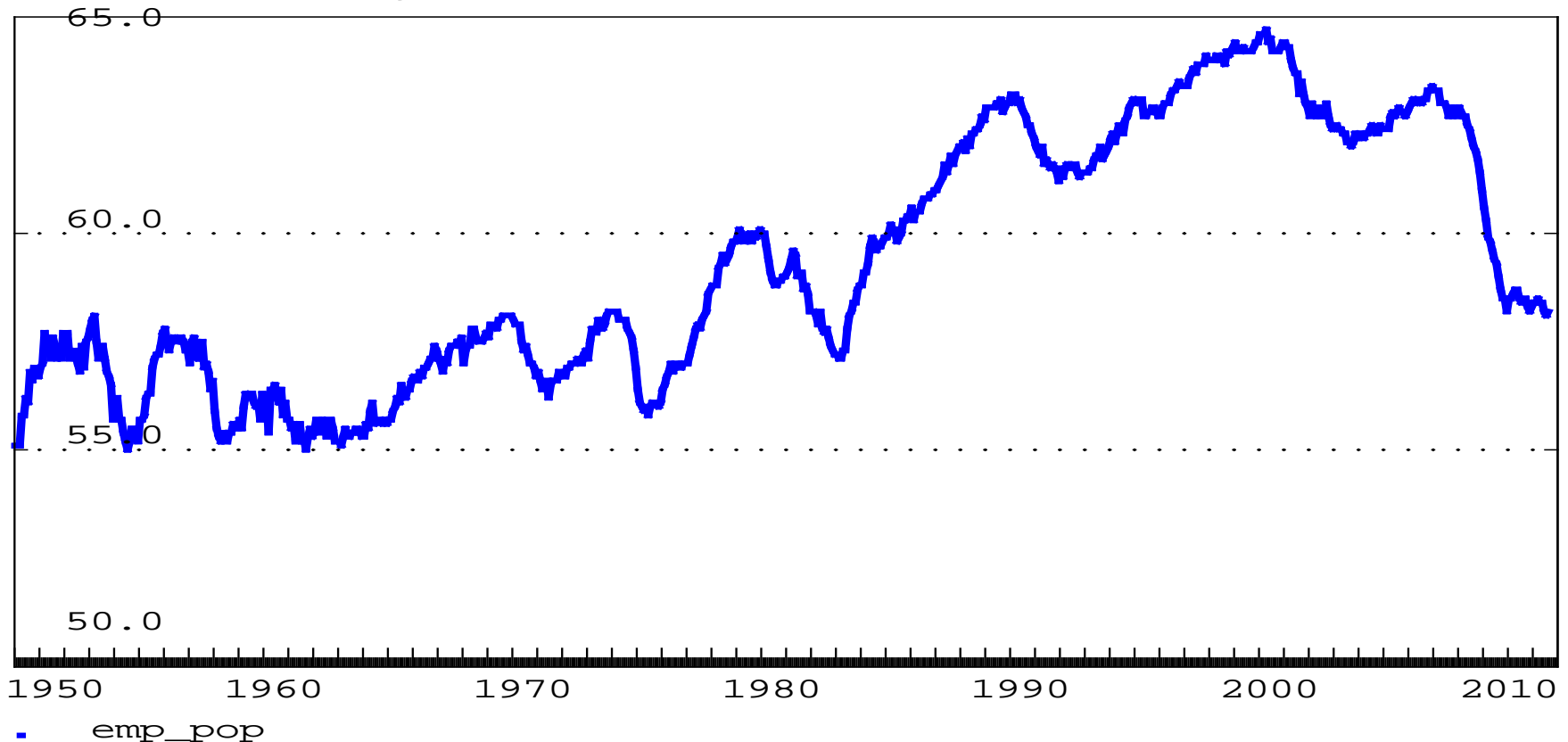
The truth about crowding out: \$250 billion Infrastructure Stimulus 2012-2015





Elevated, chronic underemployment is eating away future prosperity

Employment to population ratio, percent



Source: Bureau of Labor Statistics



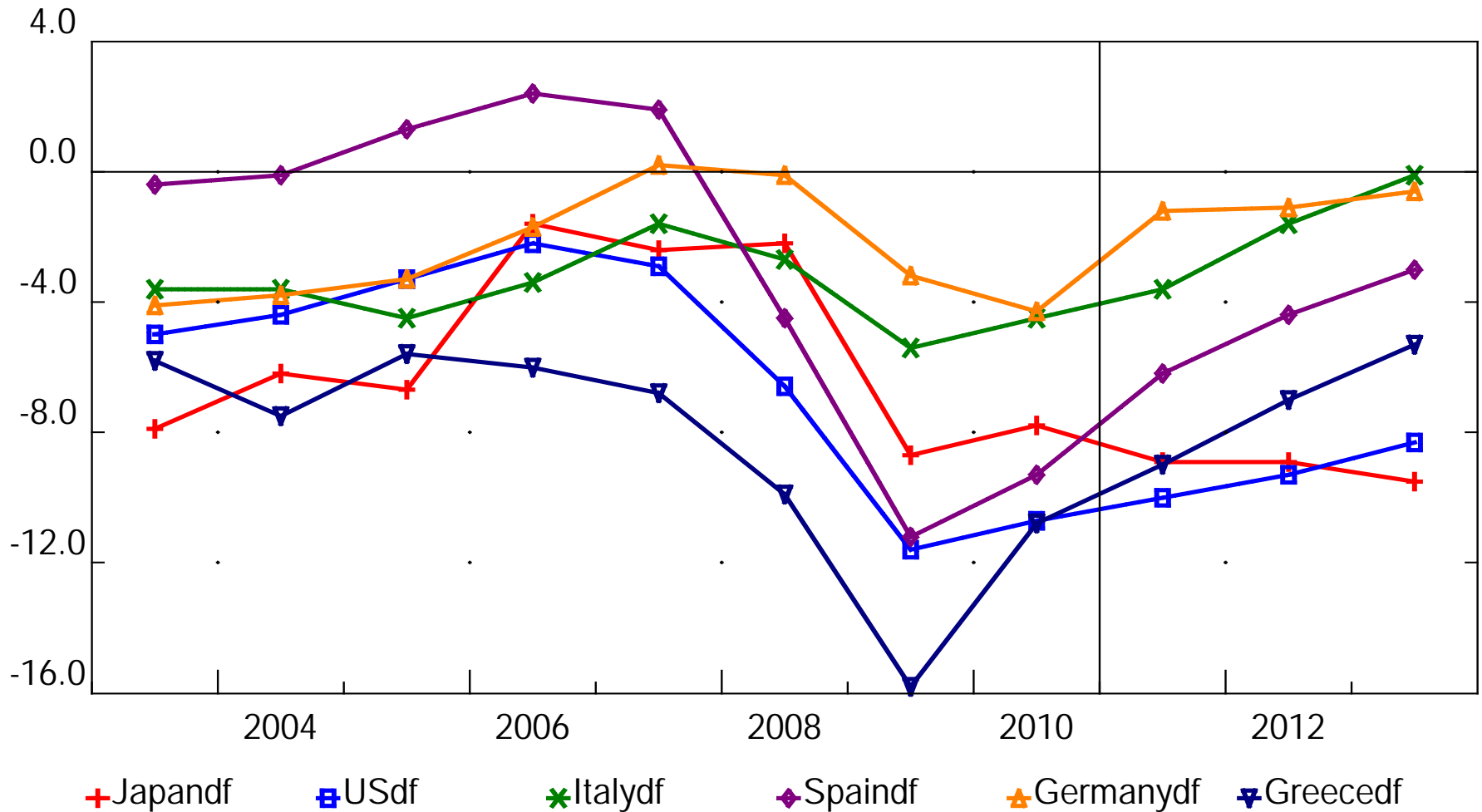
Europe's problem is a banking crisis!

- ✦ The problem has been badly misdiagnosed: It is not spendthrift governments!
- ✦ Busting of the private sector housing/credit bubble sent economies into recession.
- ✦ The solution on offer – Austerity – is wrong. How can more recession lead to lower deficits?
- ✦ Europe cannot grow out of debt, GIIPS cannot depreciate within euro unless inflation rises faster in Germany.
- ✦ There will be a banking crisis before wages can adjust. Let's hope for the best, but expect the worst.
- ✦ “Banks will be nationalized” Carmen Reinhart
- ✦ ECB will have to monetize, let's get on with it ...



Deficit to GDP ratio

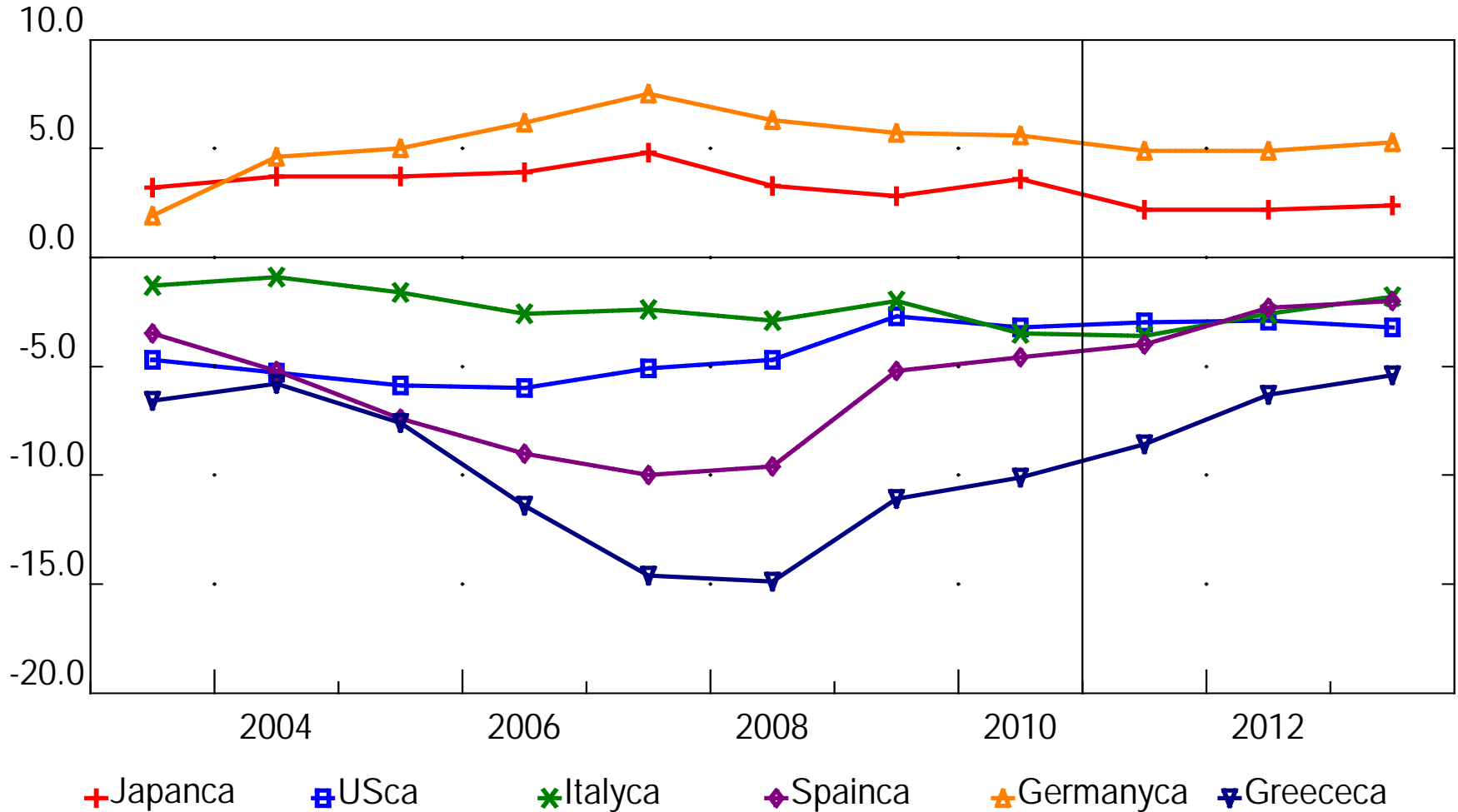
Japan, US, Italy, Spain, Germany, Greece

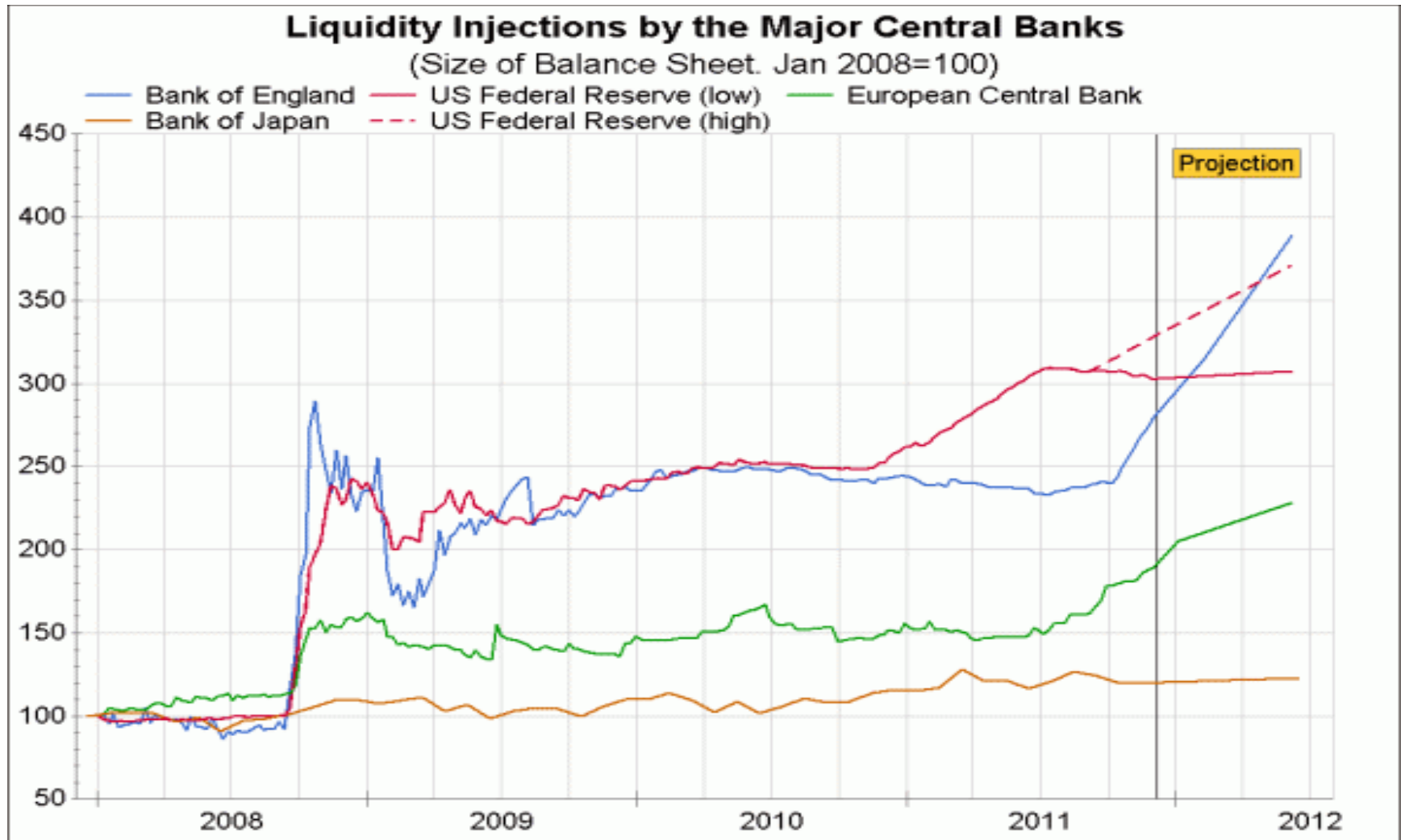




Current Account/GDP

Japan, US, Italy, Spain, Germany, Greece







EU is already in Recession

European Real GDP Growth					
	2008-9	2009-10	2010-11	2011-12	2012-13
INFORUM*	-4.0	1.4	1.5	-0.1	0.9
OECD**	-4.2	1.8	1.6	0.2	2.5
Economist***	-4.2	1.7	1.5	-0.3	0.9
* Austria, Belgium, France, Germany, Italy, Spain, UK					
** Euro area, Table 1.1 <i>OECD Economic Outlook</i> , November 2011					
*** Euro area, World 5-year forecast table, December 1, 2011					

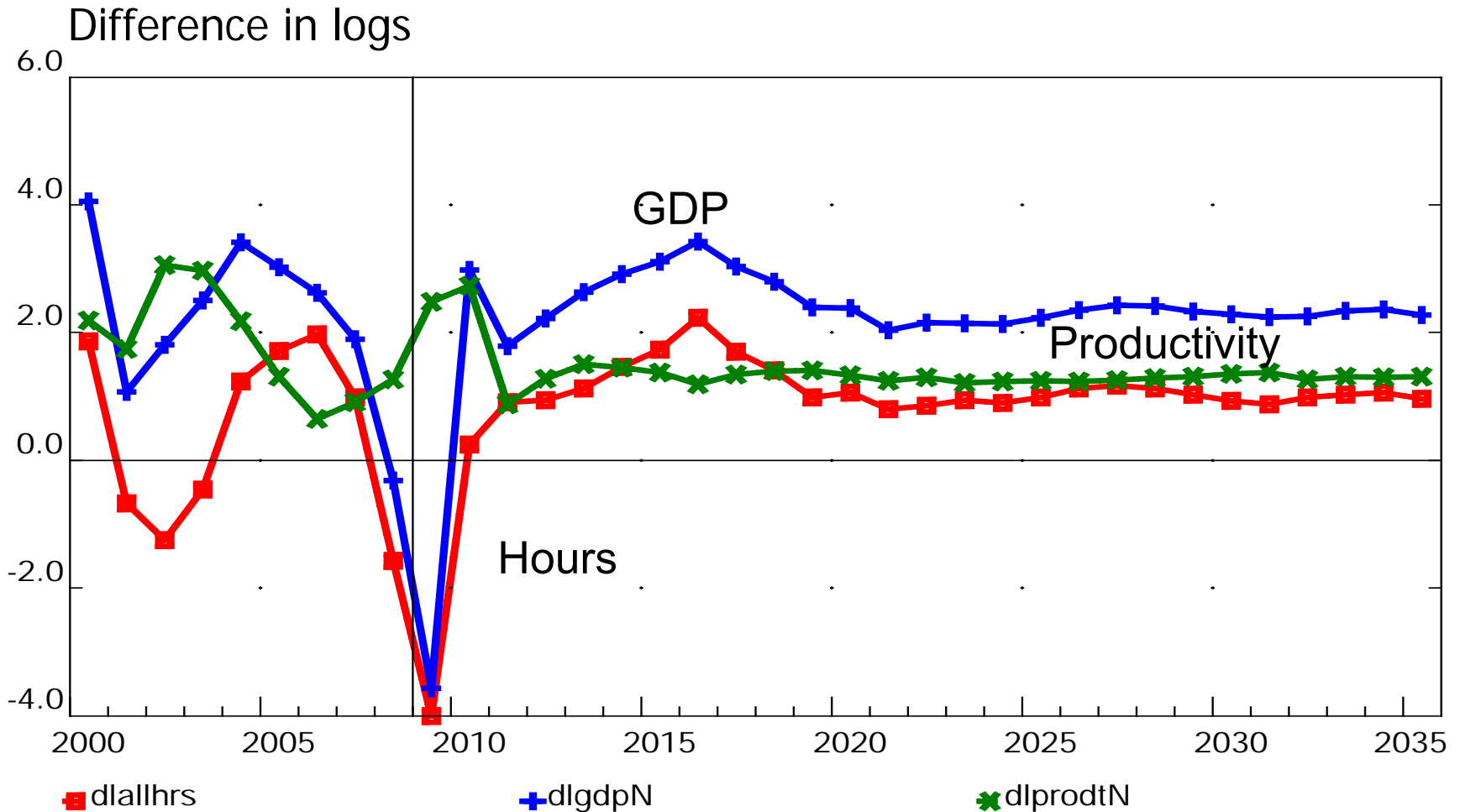


Longer term forecast (to 2035):

- ❖ Potential GDP growth between 2.0 – 2.5%.
- ❖ Forecast assumes gradual rebalancing of private, government and external accounts.
- ❖ Weaker dollar, rising savings rate changes economic structure toward exports and away from consumption.
- ❖ Long run consequences of current fiscal recklessness will be a larger long term debt ratio.
- ❖ Health care spending (with or without reform) will dominant future of government spending and domestic production growth.
- ❖ All roads lead to tax reform. To pay for entitlements, government revenues will have to rise. How this is accomplished is important.

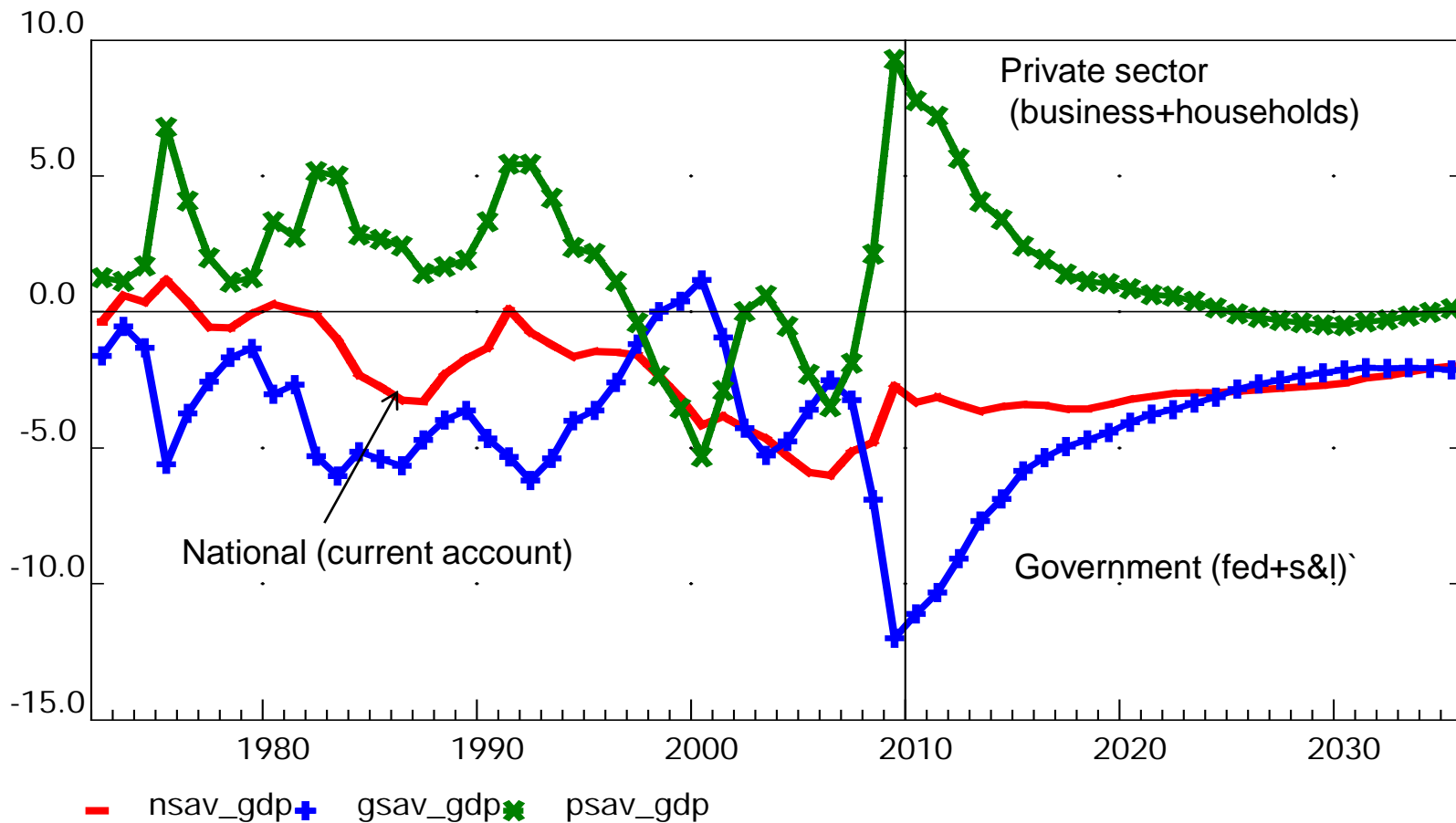


*Long term potential growth is just above 2.0%
(strong productivity, low labor force growth)*





Long Term Overview: Nominal Balances Converge to (almost) Zero Net Lending as Percent of GDP

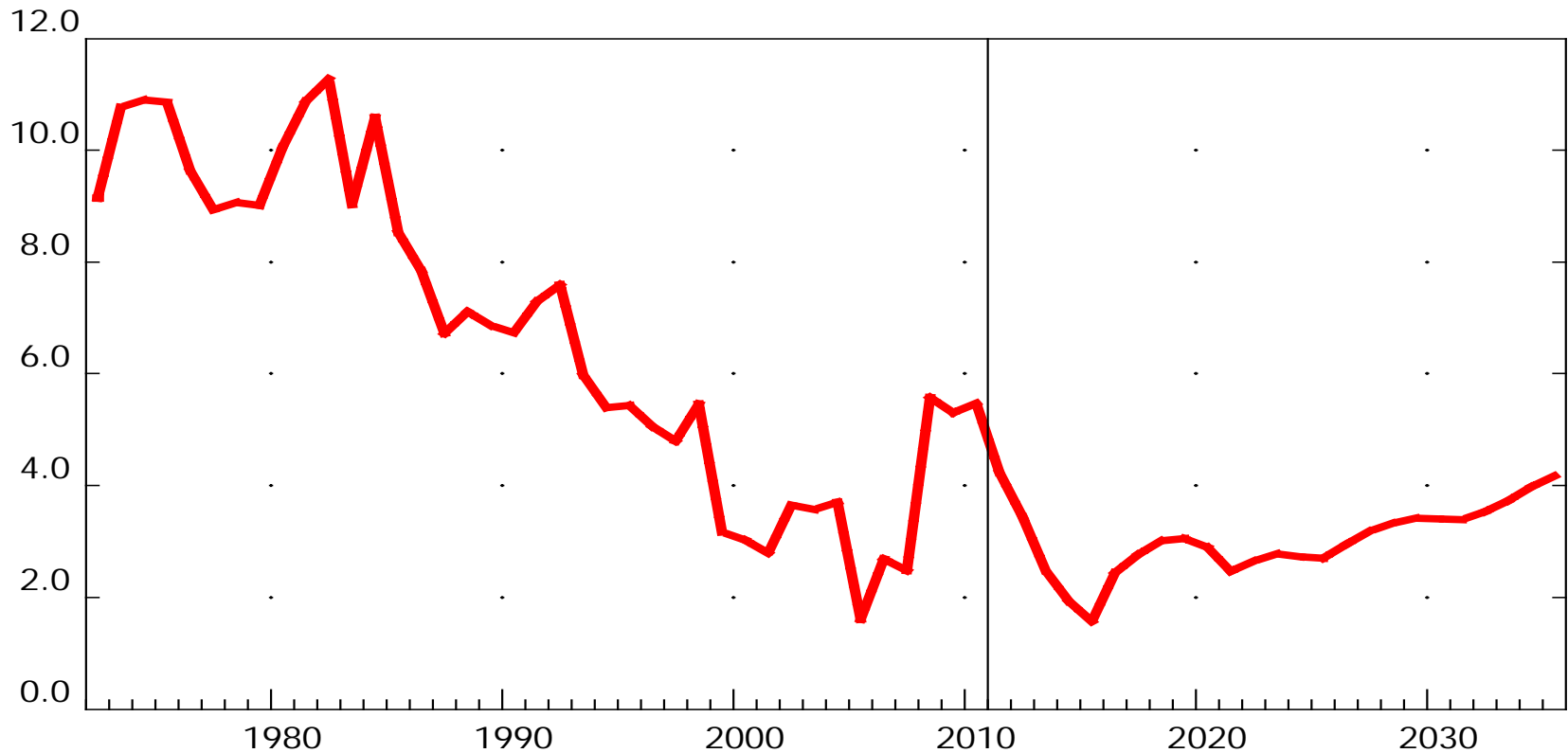




Household Savings Rate

Near term spurt because of deleveraging. More realistic expectations will drive slow consumption growth

percent

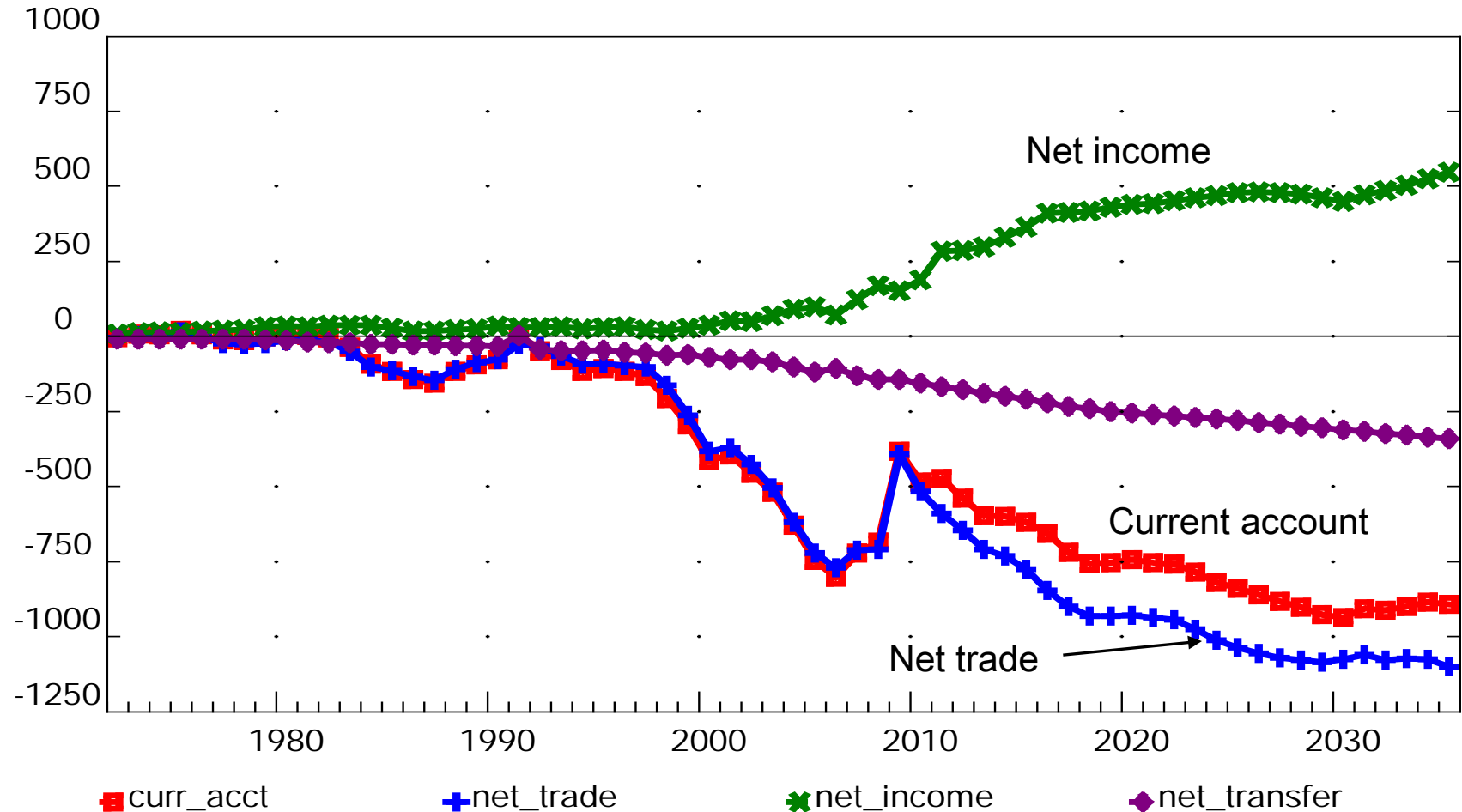


— savrat



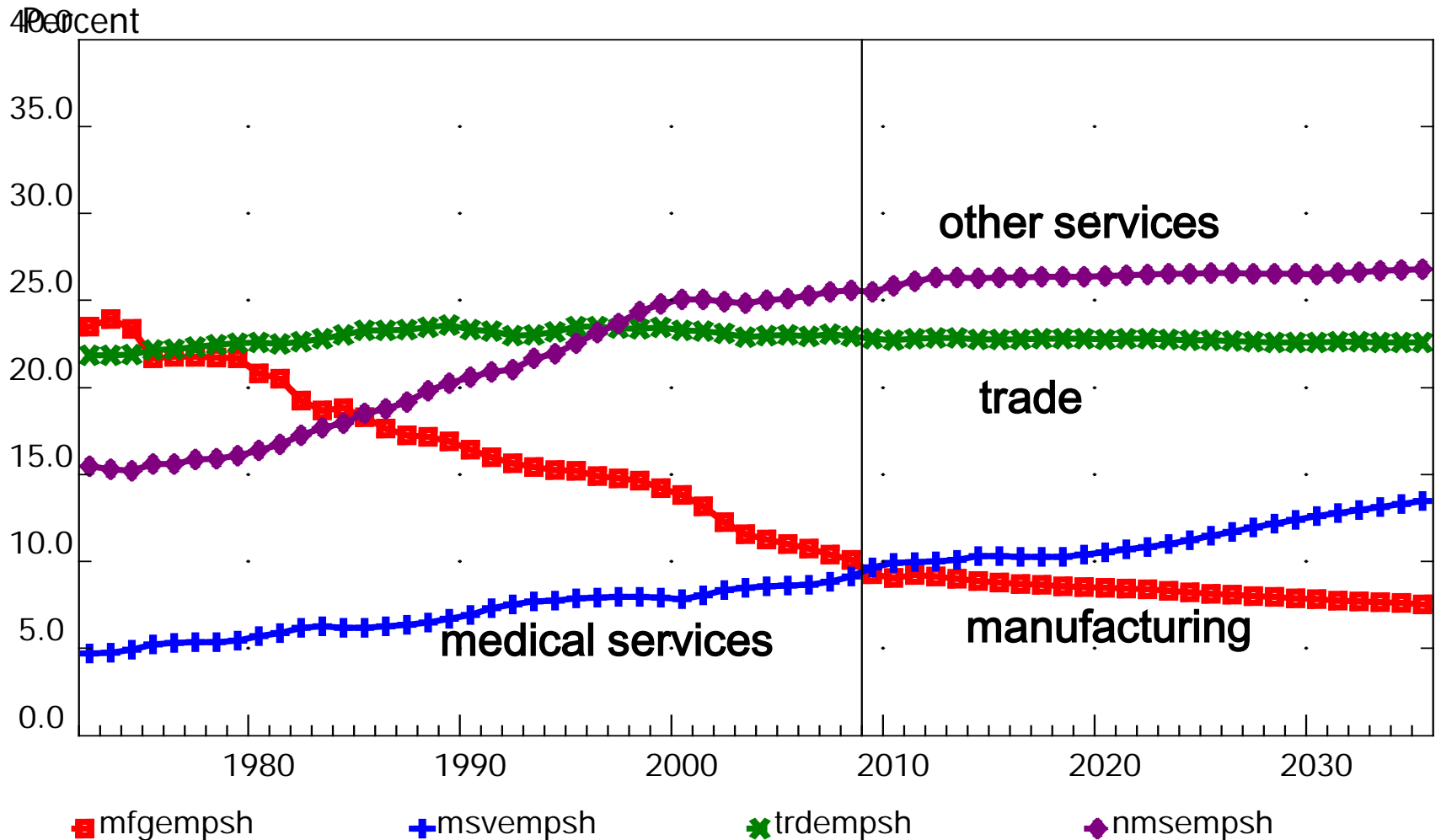
Current account deficit: soft landing

Billions of dollars



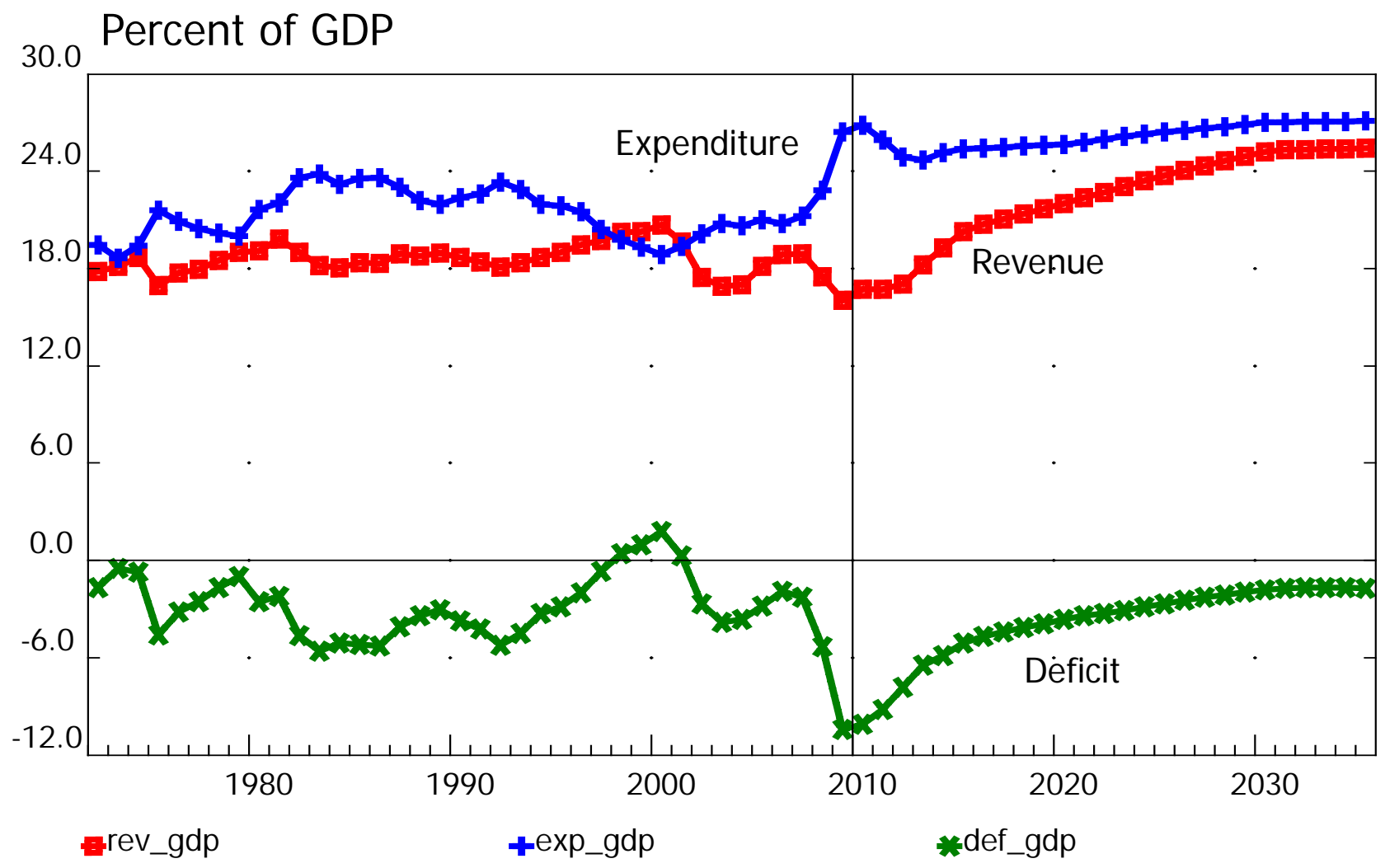


Industry employment shares: Productivity growth must come from all sectors





Federal expenditures, revenues and deficit





Reducing The Federal Deficit

- *The Moment of Truth*, Report of the National Commission on Fiscal Responsibility and Reform, Dec. 2010. (Bowles-Simpson or NC).
- *Restoring America's Future, Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*, Bipartisan Policy Center (Rivlin-Domenici or RD).
- *Choosing the Nation's Fiscal Future*, National Research Council and National Academy of Public Administration, January 2010 (NRC).
- *The Long-Term Budget Outlook*, Congressional Budget Office, June 2010 (CBO).



Reducing the Federal Deficit

Objectives and Method

- ✦ Stabilize debt/gdp (60% ?)
- ✦ Curtail discretionary spending growth, perhaps to level of inflation.
- ✦ Reform (reduce) entitlements. What do we mean by means testing?
- ✦ Comprehensive tax reform
- ✦ Cap expenditures/revenue at x% of GDP.
- ✦ Reform budget process.

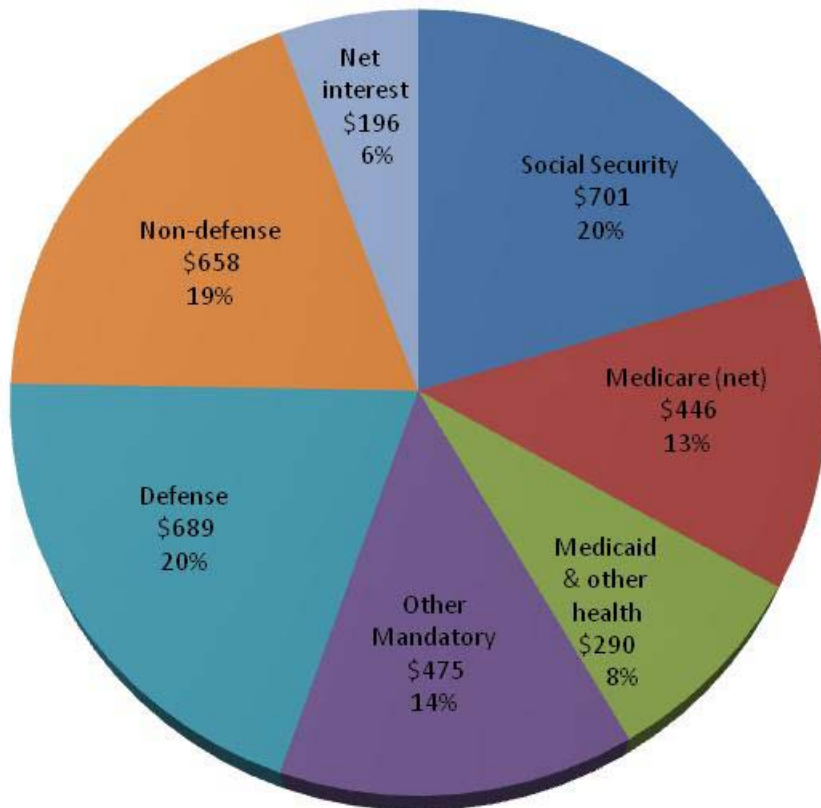


Federal Priorities: Entire Increase due to Social Security and Health Care

Federal spending by function (billion \$)

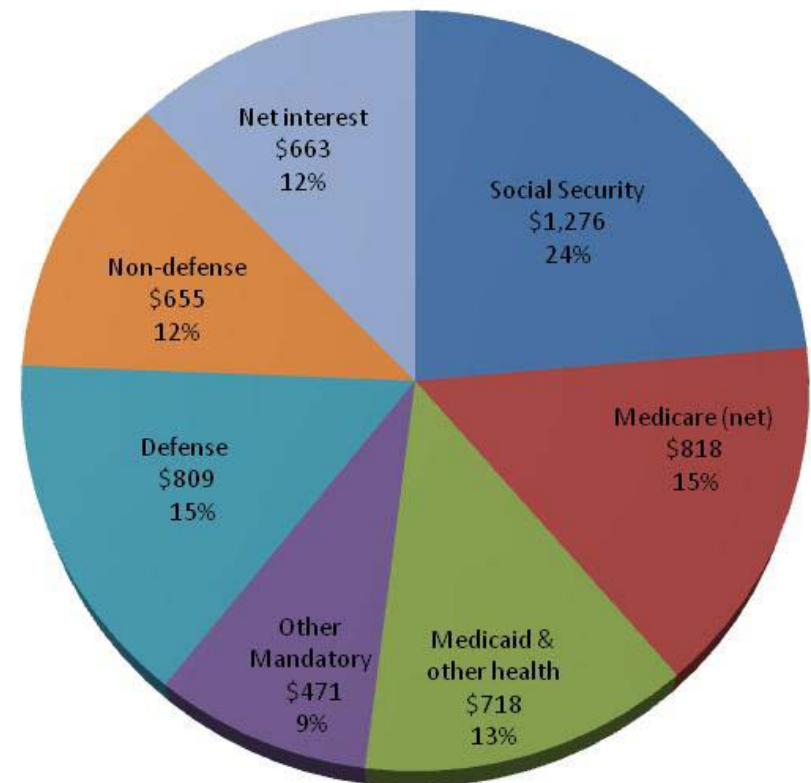
2011

Total Outlays: \$3597 Deficit: \$1284



2021

Total Outlays: \$5409 Deficit: \$440





Worst idea of deficit reduction

- ✦ Establishing an arbitrary cap on expenditures and revenue (21% in NC).
- ✦ Health care will grow as proportion of economy. Federal share of health care will increase.
- ✦ Baumol's Disease (Can it be cured?)
- ✦ Interest



Level/Share of Federal Revenue is less relevant than how it is raised

- ⊕ High marginal income taxes can retard growth.
- ⊕ Corporate income taxes are very inefficient.
- ⊕ Income exclusions for health care insurance, mortgage interest, and other goodies are extremely regressive and counterproductive. As are payroll taxes.
- ⊕ Energy taxes should include externalities.
- ⊕ Move away from taxes on capital and labor and toward taxes on consumption and energy (or carbon).
- ⊕ Radical tax reform will be key to future.



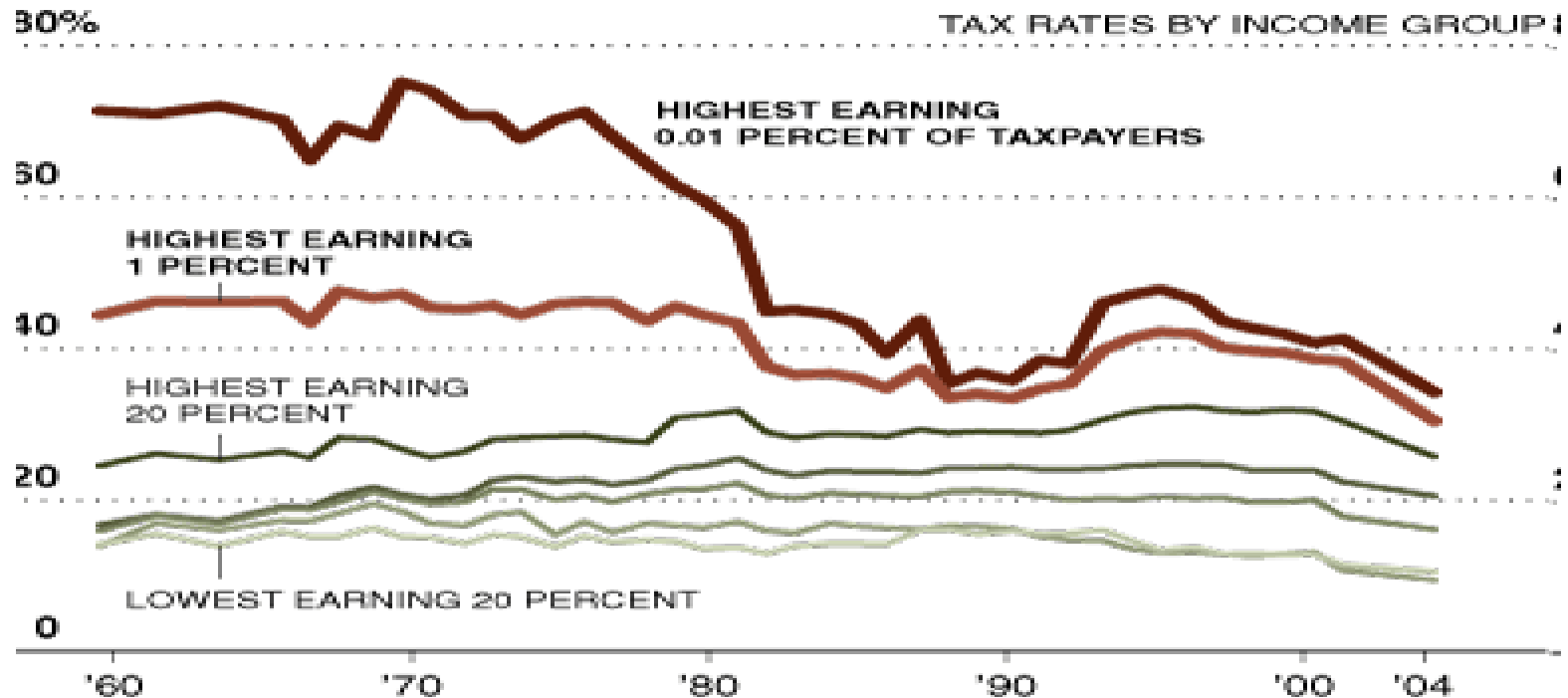
Tax Reform: How can we tax labor and capital less and consumption more?

- ✦ Reduce/Eliminate tax expenditures, especially:
 1. Convert health care premium income exclusion to tax credit (voucher). (~\$160 billion in FY2010)
 2. Phase out mortgage interest deduction (~\$110 bill in 2010).
- ✦ Use proceeds to lower and flatten rates.
- ✦ Lower Corporate tax rates (phase out eventually)
- ✦ Unify rates across earned, dividends, capital.
- ✦ Higher energy taxes/Carbon tax
- ✦ National Sales (RD) or Value Added Tax.



Lower Taxes for the Highest Earners

Since the 1960s, the total federal tax rate has fallen for low earners, risen for relatively high earners and fallen significantly for very high earners.



Numbers include income taxes, capital-gains taxes, payroll taxes, estate taxes, gift taxes and corporate taxes (which are effectively paid by stockholders). 2004 tax rates are based on 2004 tax law applied to 2000 income adjusted for income growth.



“Tax Expenditures”

TOP 5 COSTLIEST TAX BREAKS FY2009-2013

Mortgage interest deduction **\$573B**

Health care subsidy for work-based plans **\$568B**

Exclusion of retirement plan contributions* **\$460B**

Lower tax rate on dividends/cap gains **\$419B**

Earned income tax credit **\$261B**

*Includes traditional pension plan as well as 401(k) contributions.

SOURCE: JOINT COMMITTEE ON TAXATION



Tax subsidies for health are unfair and boost (wasteful?) expenditures

Insurance Person	Employer Provided		Individual
	A	B	C
Premium Cost (including employers)	12000	12000	12000
Income	150,000	50,000	50,000
Tax bracket	30%	15%	15%
Tax subsidy	3600	1800	0
Net cost	8400	10200	12000



Entitlement Reform: Social Security

- ⊕ Increase cap on payroll taxes.
- ⊕ Change COLA to better reflect inflation.
- ⊕ Reduce benefits for richest, strengthen safety nets for poorest.
- ⊕ Increase retirement age.
- ⊕ Cover new S&L workers.
- ⊕ Little sentiment for private retirement accounts.



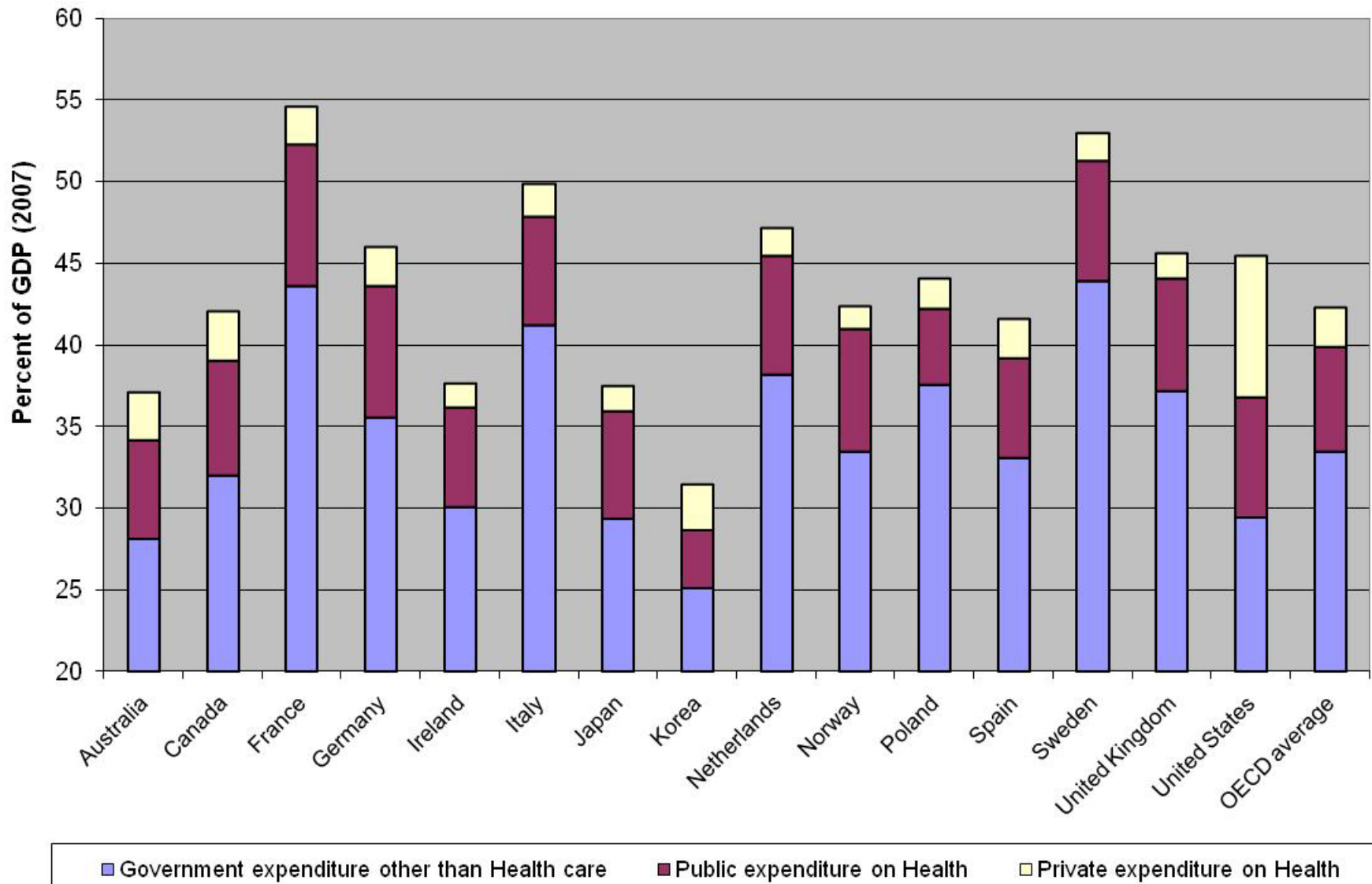
Entitlement Reform: Medicare

- ❖ **Restrain Rising Health Care Costs**
 - ❖ Replace/cap employer-provided health benefits exclusion.
 - ❖ Reform medical malpractice laws.
 - ❖ Excise tax on corn syrup (RD).

- ❖ **Ryan-Rivlin plan for Medicare**
 - ❖ ST: More cost sharing by increasing premiums, copayments and coinsurance.
 - ❖ LT: "Premium Support" voucher system with catastrophic caps.

- ❖ **Cap Medicaid growth**

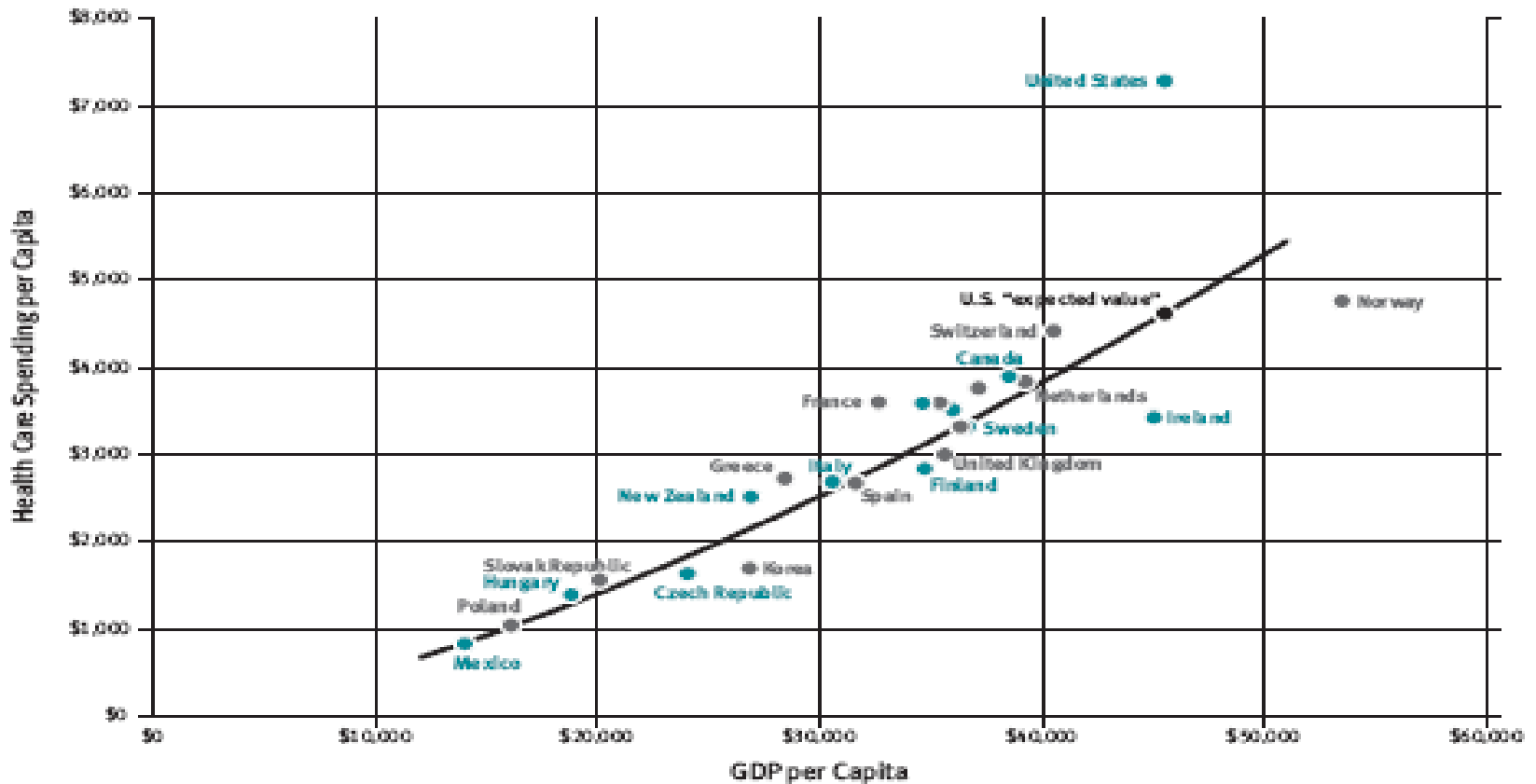
Government and Health Care Expenditure





The U.S. pays much more for Health Care...

Figure B-4: Relationship between national income per capita and health care spending, OECD Countries, 2007

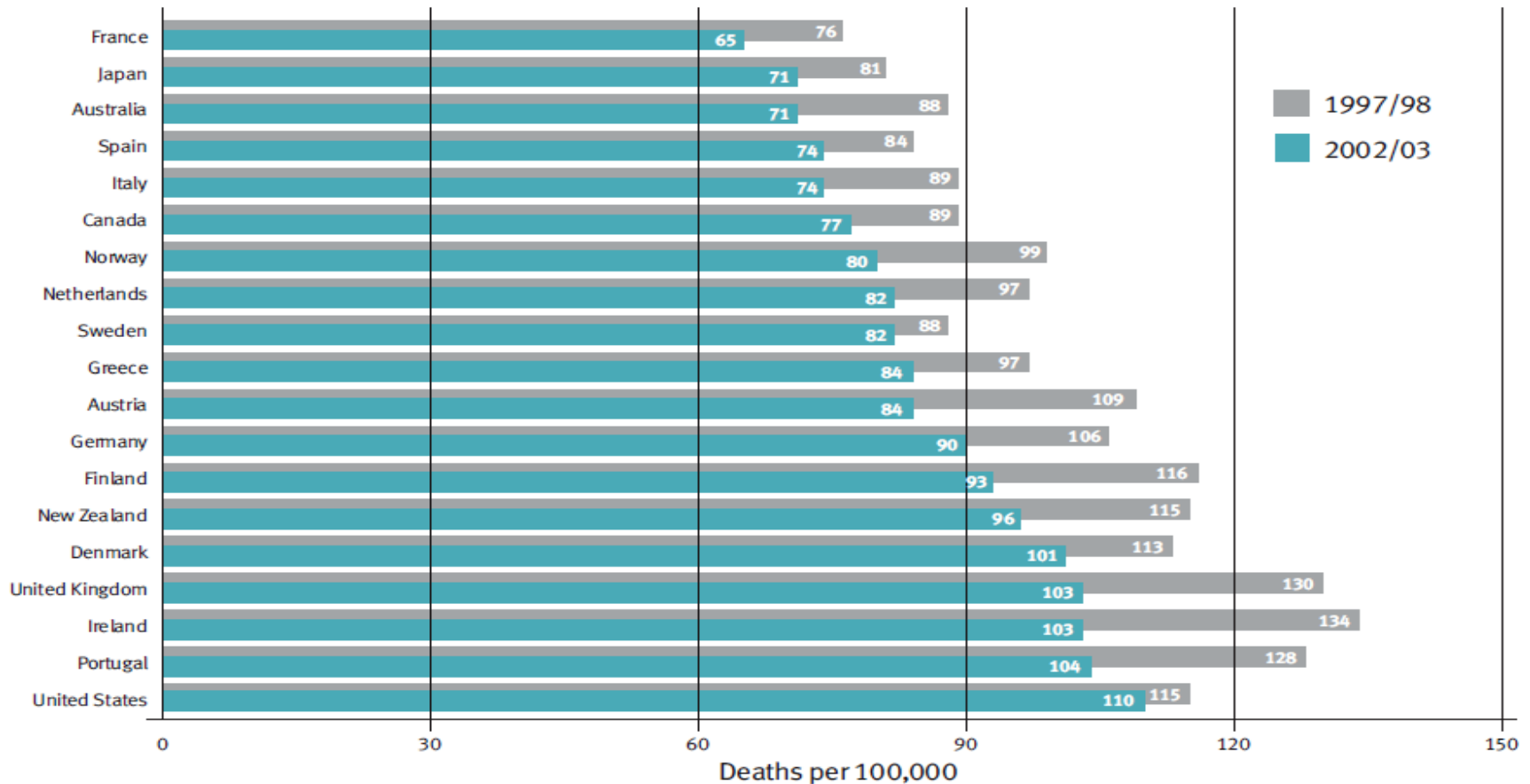


Source: OECD Health Data 2009



But health outcomes are generally inferior.

Figure B-3: Mortality amenable to health care, selected countries 1997 to 2003



Source: Nolte and McKee, 2008



How much do you pay for employer-provided insurance?

Average Annual Worker and Employer Contributions to Premiums and Total Premiums for Family Coverage, 1999-2009



* Estimate is statistically different from estimate for the previous year shown ($p < .05$).

Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999-2009.



Inforum Economic Outlook



Thank you!

