Durability of Economic Recovery

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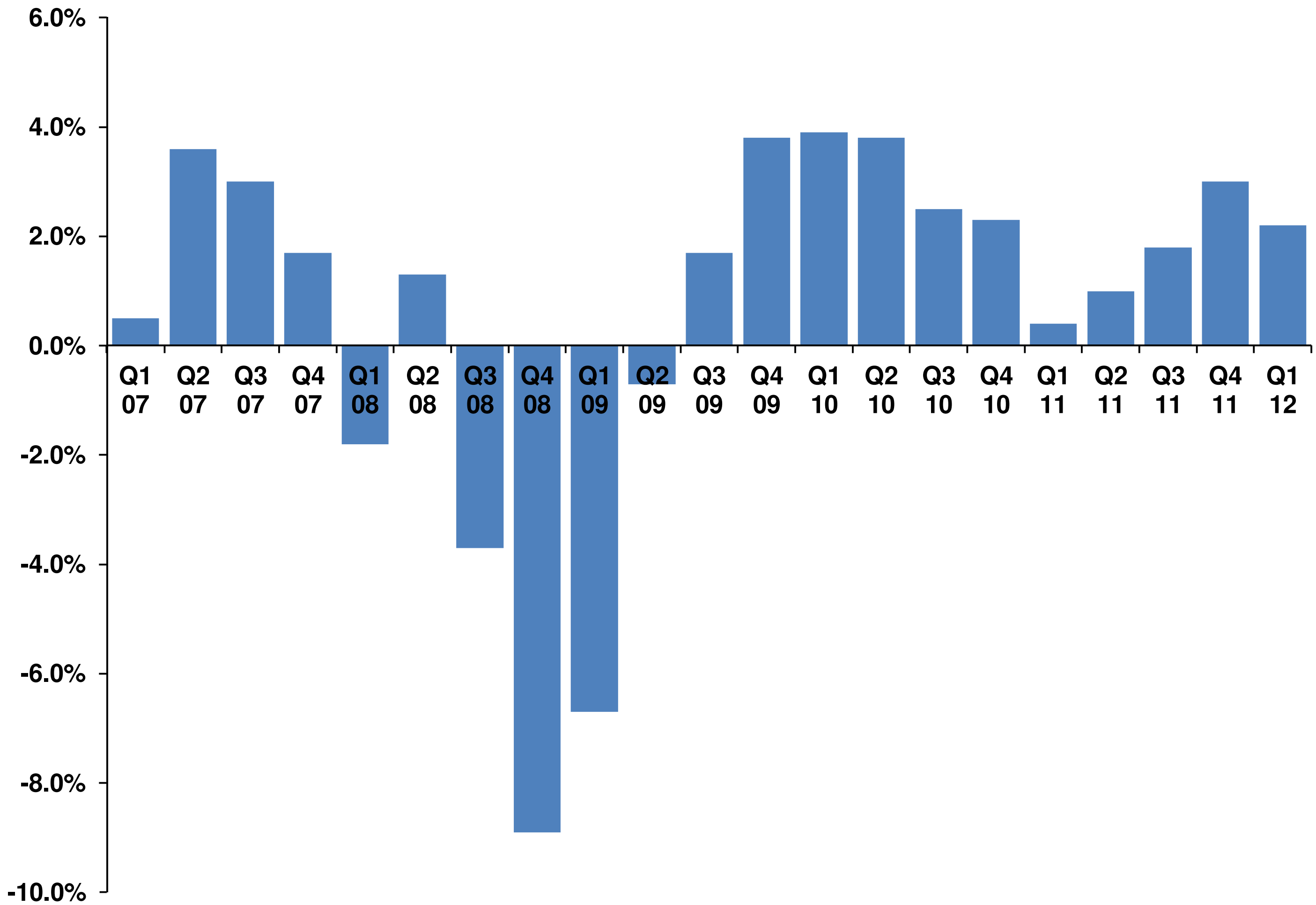
My 2011 Forecast

- Stock market
  - Forecast: +7%; Actual: +5.53% DJIA and 0.0% S&P500
- Real GDP growth
  - Forecast: 3.5%; Actual: 1.6%
- Unemployment
  - Forecast: <9% at year end; Actual: 8.5% (unemployment decline is odd given weak GDP growth—discouraged workers)
- Inflation
  - Forecast: Low but rising inflation; Actual: Core inflation increased from 1% to 2%; non-core rose even more
- Overall economic growth was weak considering the gap in the labor market; concerns about Europe and credit quality seemed to keep demand weak

GDP % Change

(quarterly, 2007-present)



Source: U.S. Dept. of Commerce: Bureau of Economic Analysis

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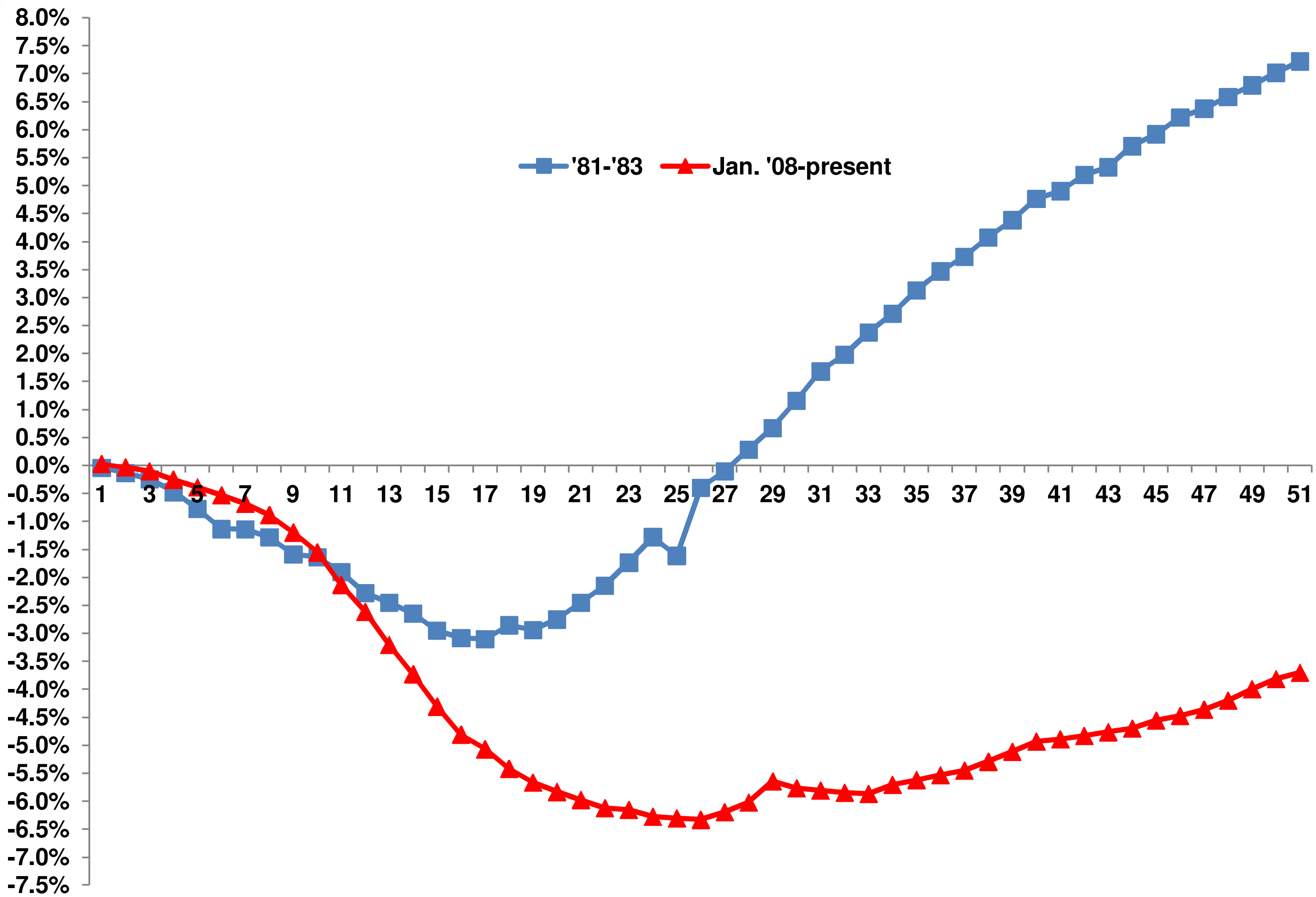
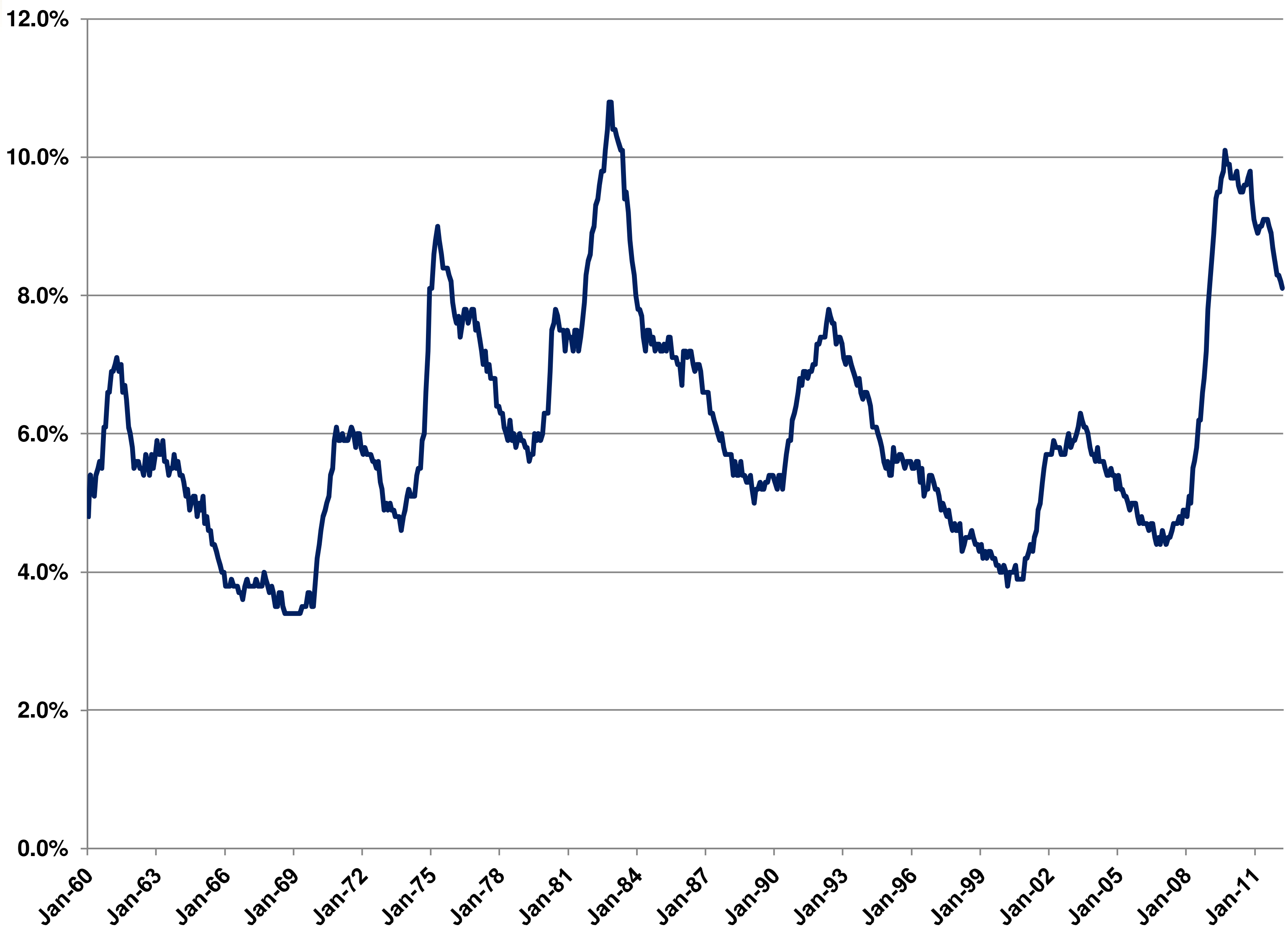
Job Loss Comparison



Source: Bureau of Labor Statistics

Unemployment Rate (1960-present)



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My 2012 Forecast as of January

- Stock market
  - Forecast: 10%. We already captured nearly that much in QI. I think the rest of this year will be choppy.
- Real GDP growth
  - Forecast: 3.5%. This is weak considering we still have 5 million fewer jobs than we did in January 2008.
- Unemployment
  - Forecast: 7.5% at year end
- Inflation
  - Forecast: Core inflation continues modest increase

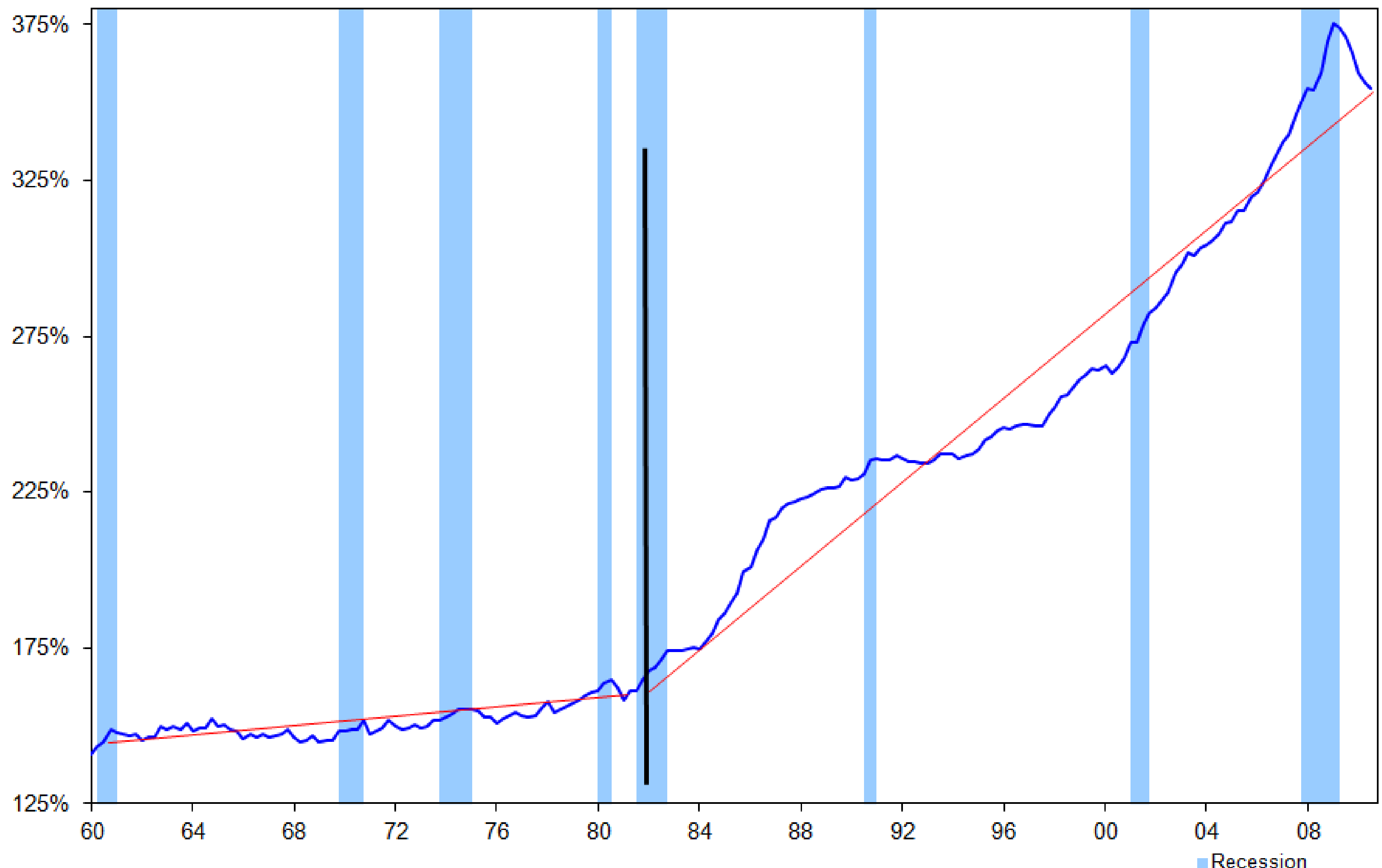
Challenges for Near Term Recovery

- Potential supply shocks: Unexpected disruptions related to energy/commodities or the Euro Zone
- Policy uncertainty: Clarity in tax policy and regulation of health care and finance will help investment climate
- Policy sustainability: Government entities in U.S. need to restore long-term fiscal balance
  - Did we replace the private debt problem of 2008 with a public debt problem? Is fiscal policy on an unsustainable path?
- Politics: Will we ever agree on anything again? The gulf is getting wider, the views more entrenched. This makes it difficult to solve problems effectively

Two Issues Driving Politics & Policy

- Has the U.S. economy become too reliant on debt to finance growth? If so, what adjustments will be made to restore sustainability?
  - Financial market reform
  - Tax increases or spending cuts to restore public fiscal balance?
- What are the facts, causes and consequences of increased income equality?
  - Why have the 1% done so well? Will inequality increase or decrease from here?
  - Do we emulate or envy the 1%? Is their economic power being put to public or personal purpose?

Total Credit Market Debt
(As a Percent of GDP)



Source: BEA, Federal Reserve

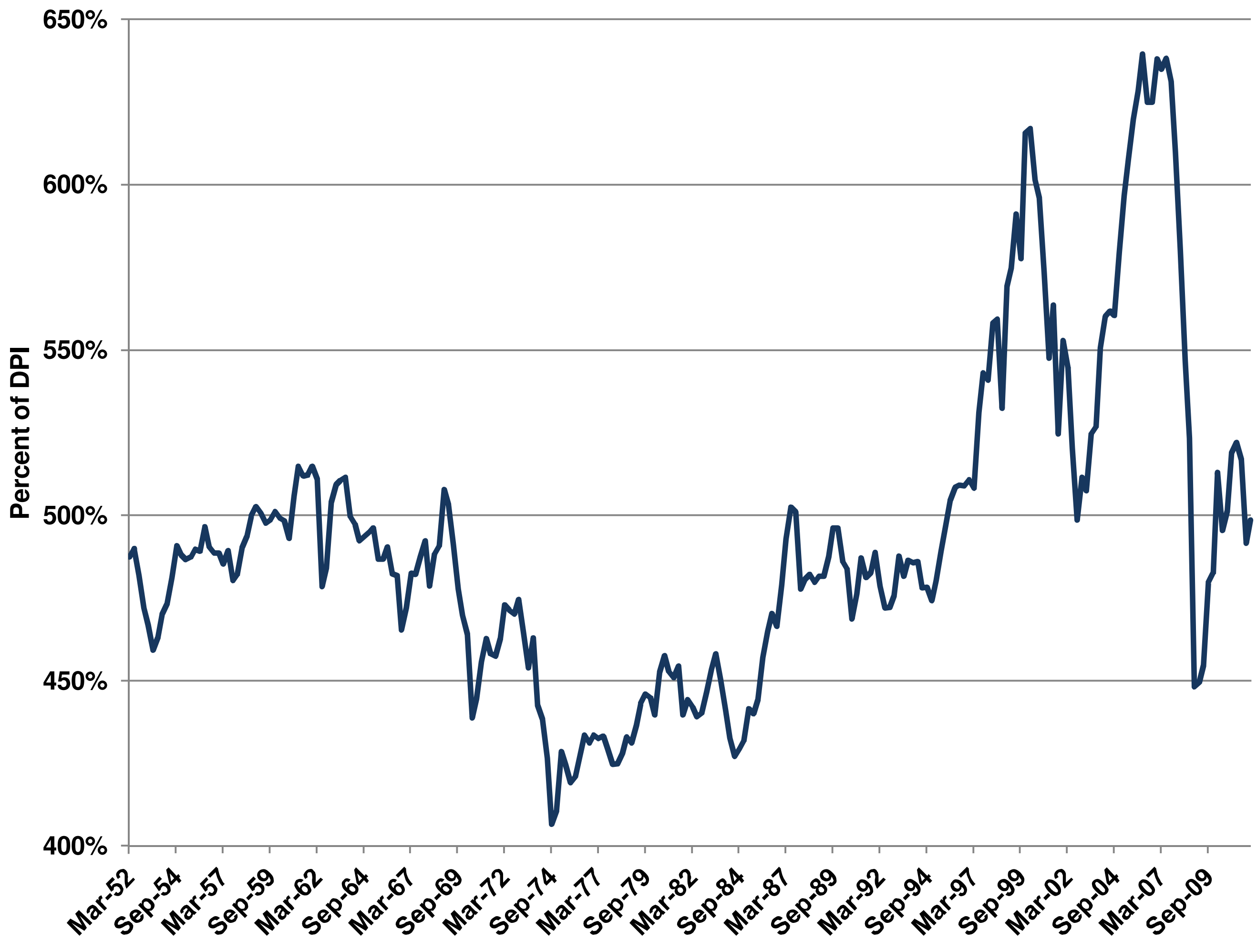
Is Our Problem Too Much Debt?

- Fundamental identity: One person's debt is another's asset
  - Has anyone ever said "Our problem is too many assets"?
- The underlying problem in most financial crises is correlated mistakes in valuation of an asset
  - Asian Crisis, Tech Bubble, Housing Bubble
  - Overvaluation leads to over consumption, then correction
  - Housing bubble worse—financial institutions had big exposure
- Root cause of valuation mistakes: complexity, poor information, lack of transparency, misaligned incentives.
- Bad contracts cause bad debt. Debt is not inherently bad!

Is Our Problem Private Debt?

- Are households borrowing and spending too much?
  - Credit card debt
  - Student loans—10% owe more than $50K; average is over $20K
  - Mortgages
- Better regulation can reduce these problems by increasing transparency and reducing conflicts of interest, but some people get rich off of these “problems”
- Most detailed research shows that households approaching retirement **are** saving enough
- **Private debt *per se* is not the problem**

Household Net Worth as Share of Disposable Income



Source: Federal Reserve

Is Our Problem Public Finance?

- Current worry: Have we made another mistake in valuing future value entitlements or tax liabilities? If so, we may be over-consuming today
  - Loss of confidence in value of future entitlements can increase saving and reduce consumption today
  - Assessing sustainability of government borrowing is VERY complicated. Keeping government finance simple and transparent is important so policy makers can't trade the future for the present.
- Our inability to agree to some obvious adjustments (e.g., raise retirement age incrementally in future) is troubling
- **Public finance may be a real problem**

Facts on Income Inequality

- Inequality is rising in many countries
- In the US over the last three decades:
  - After tax incomes of top 1% quadrupled
  - After tax income share of top 1% doubled
  - CBO: Federal income tax became slightly more progressive
- U.S. taxation is relatively light in the middle
  - Top 1% earned 20% of income and paid 40% of US fed income taxes (and other people take credit!); top 1% paid 24% in the U.K.
  - At UW, 83% of total philanthropy comes from 1% of alumni!
  - OECD study: U.S. income tax is as redistributive as Scandinavia
  - Overall U.S. tax burden is low because of no national sales tax

Contributors to Income Inequality

- Mostly natural causes related to globalization and technology. Likely to self-correct through labor supply.
  - Globalization and technological change have increased returns to education and reduced returns to basic labor—manufacturing has been under global competitive pressure.
  - Success of new knowledge economy startups has led to concentration of wealth among funders/owners—at 28 years of age, Mark Zuckerberg may be worth nearly $20 BILLION.
  - Success of young founders seemed to spill into executive compensation, abetted by complexity.
  - Economic segregation is eroding access to good education and equality of opportunity.
- We must preserve equality of opportunity

Likely Consequences

- Pressure to increase marginal tax rates on high earners and increase transfer payments to equalize outcomes.
- Possible erosion of incentives for motivated producers.
- Money is pouring into politics to protect economic interests. That will not produce thoughtful policy.
- Conclusion: The heightened focus on top “1%” is dangerous.
  - We should put sharper focus on bottom “20%” that really need help.
  - Irony: the 1% is already doing a great deal to help them.

Fundamentals Shaping the Future

- Globalization and Technological Change
  - Preponderance of wealth creation in new industries: information technology, telecommunications, life sciences
  - These new industries are disproportionately reliant on a highly educated workforce
- Demographic shifts placing a fiscal burden on governments
  - Entitlement programs based on stable “dependency ratios” are burdensome with rapidly rising ratios
  - Entitlement programs may crowd out traditional public infrastructure investments absent tough decisions

My Long Term Forecast

- U.S. will remain among the most successful developed economies
- U.S. economic strength comes from abundant land and capital (human and physical) and economic institutions that have provided strong incentives to take risks and work hard
  - Low population density means immigration still an option
  - History of entrepreneurialism enabled U.S. to benefit from globalization and technology change
- U.S. challenge – rally around pragmatic leadership focused on reform of public and private finance, health care, education; openness to immigration; and rewarding innovation.