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I. America’s Crumbling Social System

There is ample evidence that all is not well in the United States – America’s social system is crumbling.

In a landslide, New York City recently elected Bill de Blasio to be its next mayor. Growing income inequality and the widening gap between rich and poor was the central theme in de Blasio’s successful dark-horse candidacy. In his election night victory speech, de Blasio described income inequality as “… that feeling of doing well, while so many slip further behind” and identified it as “the defining challenge of our time.”

Thinkers from across the political spectrum increasingly are talking and writing about evolving trends in America’s economic and social system. Overall, there is worry and concern, although there is substantial difference of opinion about the significance of these trends and how America’s economy and society might be affected. Thus, not all would agree with the title of this Section – “America’s Crumbling Social System.”

This month’s letter explores trends in income, wealth, and cultural inequality. While I attempt to present the various viewpoints in a balanced fashion, my own viewpoint is manifest and it is one of deep concern, but it is also one of hopefulness that some favorable counter developments are already underway and potential solutions exist, which policymakers could adopt and implement.

Discussion begins by defining the elements of an ideal social system and then documents how America’s social system has steadily moved farther away from the ideal in recent decades. Trends in income, wealth, and cultural inequality are indicia of the decline. The ascendancy of shareholder wealth maximization, efficient markets theory, and the operation of free markets as the dominant economic model has been coincident with these trends and has amplified them. Concurrently, America’s social contract has shifted from a high-wage to a low-wage orientation. Collectively, the American social system has become less inclusive and more extractive – increasingly serving the interests of the few at the top of the income and wealth pyramids.

Decline in America’s social system can be arrested through transformative change of the dominant cultural and ideological hegemony. Transformative change will not

come easily because those who benefit from the current system are invested in preserving it and they command great economic and political power.

Nonetheless, initiatives are already underway which are setting the stage for potential transformative change. Foremost is the emergence of business organizations with governance structures that are alternatives to the predominant shareholder wealth maximization corporate form. These business alternatives include traditional non-profit service providers but increasingly extend to social enterprises. Changes in laws and the development of broad-based networks of supporting intermediaries, including faith-based organizations, which build relationships, provide skills training, and enable access to low-cost financing are essential for successful growth of these alternative businesses. Successful transformative change is not guaranteed. It will take a long time to evolve and will need to be nurtured in many ways. But, successful implementation of these kinds of changes will result in a strong, inclusive social system that benefits all Americans.

Examination of growing income inequality in the U.S., its impacts and consequences on economic activity and American culture and society, and potential responses to reverse adverse trends is included in Sections II – VIII.¹

In the remainder of this month’s letter, I provide updates about the U.S. Economic Outlook – Real GDP Growth in Section IX, Consumer Income and Spending in Section X, Employment in Section XI, Business Activity in Section XII, Monetary Policy, Inflation, and Interest Rates in Section XIII, and Fiscal Policy Developments in Section XIV.

In the Appendix, which summarizes prospects for key issues for 2013 and beyond, which I outlined in the December Longbrake Letter, I have updated comments to reflect recent developments.

II. Ideal Social System

Before exploring the issue of income inequality and its impacts on the economy and America’s social system, it will be useful to do some stage setting by describing the parameters of an “Ideal Social System.” This relies to a large extent on the work of Daron Acemoglu and James Robinson² and Woody Brock.³

Based on Acemoglu and Robinson’s extensive case studies, we learn from history that nations that have and sustain inclusive economic and political systems create more income and wealth for their citizens over time and that income and wealth is distributed more evenly. Woody Brock specifies the necessary components for an ideal social system, which also has the virtue of being inclusive.

Brock posits that an ideal social system has three components: (1) a constitution, (2) the economy, and (3) the political system. The constitution is an essential component of the ideal social system because it contains enforceable rules that govern behavior in the economy and the political system. Religion plays a companion role in establishing values, beliefs, and norms that frequently complement the rule of law in guiding desirable behaviors.

1. **Norms for an Ideal Constitution**

Constitutional norms provide for the rule of law and equal protections and treatment of citizens. The U.S. constitution, the first ten amendments (Bill of Rights), and subsequent amendments meet the norms for an ideal constitution. In state capitalism, such as practiced in China, there is no meaningful constitution. The party and the state are the constitution. This means that the interests of the power elite, rather than society as a whole, govern outcomes.

Religious and faith traditions lay out behavioral and ethical expectations, especially as they define how individuals should behave in transactions with others. They are a powerful complement to a constitution, a body of written laws, and judicial decisions.

Faith traditions and written constitutions are necessary conditions for achievement of an ideal social system, but to be sufficient to assure achievement of an ideal social system, society must embrace them and believe without question that all will be held to account. Human beings are motivated by self-interest and the pursuit of self-interest, left unchecked, will block achievement of an ideal social system.

2. **Norms for an Ideal Economy**

According to Brock there are six norms necessary to achieve an ideal economy:

- Efficiency (non-wastefulness)
- Stability
- Freedom (actions and decisions occur without the necessity to secure permission)
- Privacy
- Distributive justice (“fairness” – the glue that keeps society working)
- Incentive structure compatibility
The sixth norm of “incentive structure compatibility” must permeate the five other norms.

Faith traditions complement the functioning of economic institutions. This is true for all six norms but the linkage is particularly important for “distributive justice.”

3. **Norms for an Ideal Government**

According to Brock, “politics is about eyeball-to-eyeball bargaining between interest groups.” An ideal government is one in which multi-lateral bargaining achieves “good” compromises that serve the collective interests of society well. An ideal government is efficient (same norm as in the ideal economy), fair (embodies notion of distributive justice), and unbiased.

4. **Interaction between the Three Components**

The economic and political systems overlap. The extent of the overlap is determined by how much economic activity the political system seeks to control. The constitution and the political system also overlap. The constitution constrains the power of government and establishes rules for balancing the needs of society and the rights of individuals.

Achieving the optimal overlaps is crucial to optimizing social welfare over the long run. Conceptually, this appears to be straightforward. But, in practice there is wide disparity in political beliefs about the extent to which the political system should exercise control over the economic system. Too much political control can stifle innovation, impede efficiency, and threaten freedom; too little political control can lead to instability and impinge upon distributive justice.

5. **Comparing Liberal Democratic Capitalism and State Capitalism**

Brock believes that the troubles afflicting developed countries which have liberal democratic capitalism models stem primarily from flaws in the government component. Politicians seize on voter insecurities to promise more and more benefits which cannot be paid for in the long run. The underfunding of U.S. entitlement programs is a case in point.

In the case of state capitalism, the government directly controls too large a part of the economy through government-owned and government-regulated companies. These companies have enormous incentive to maintain and grow the extent of their control. This frustrates competition and over time economic efficiency and growth suffer. The absence of any meaningful constitution assures that dominance and oppression by such companies will serve the narrow interests of their elites rather than society as a whole.
China’s economic and political system is an example of state capitalism. China’s economic success to date has benefited from its ability to mandate an investment/trade based strategy through state-controlled enterprises. However, this strategy is fast approaching a dead end, which China’s current leadership acknowledges. Significant reforms in China’s economic and political institutions that move in the direction of greater inclusiveness will be necessary to sustain China’s rapid growth. Such reforms are not in the interests of many of the beneficiaries of the existing economic model. This is not to say that China’s leadership will fail to implement the necessary reforms, but it is clear that implementation will be resisted and ultimate success is not assured.

6. **Causes of the 2008 Financial Meltdown**

But, the virulence of the 2008 financial markets panic and the lethargic economic recovery in its aftermath have spawned debate about the virtues and shortcomings of liberal democratic capitalism.

Woody Brock cites four causes of the 2008 global financial meltdown.

First, the Efficient Market Theory, which the political and financial elite came to rely upon, is deeply flawed – the reasons are discussed in Section III below. According to Brock, this theory is “poor” because “… it neither explains nor predicts real-world data and … at a deeper level its Basic Assumptions are indefensible. The Basic Assumptions of the Efficient Market Theory include: (1) participants do not make mistakes, (2) all risks can be hedged (when (1) and (2) are combined, they imply that leverage does not matter), and (3) everyone possesses all relevant information and knows how to price correctly. Models based on this theory grossly underestimated volatility and derivative instruments designed in reliance on the theory did not perform as expected.

Second, theories of the efficacy and benefits of market deregulation were misguided. Blind adherence to “the market knows best” belief leads to disastrous outcomes.

Adherence to “the market knows best” belief diminishes or limits the legitimate role of government in assuring outcomes that serve the collective interests of society well and opens the way for narrowly-based financial and political elites to rig the system to serve their interests.

Third, according to Brock, the emergence of a “pathological” incentive structure contributed significantly. The hallmark of the incentive structure involved de-linking performance and risk. This outcome was at the root of the breakdown in underwriting in the securitization market. But it also was reflected in adoption of
governance structures such as limited liability corporations and the substitution of corporate governance for partnership governance in investment banking companies.

Fourth, and most important of all, was the runaway use of excessive amounts of leverage, which, as Hyman Minsky postulated, migrated from hedge to speculative to Ponzi financing.⁴

Most unfortunately, these four causes interacted and reinforced each other to create an unprecedented Ponzi-financed global boom. The magnitude was huge and so, too, was the damage caused by collapse of the boom.

7. Inclusive Versus Extractive Societies

Acemoglu and Robinson’s historical case histories demonstrate that the success or failure of a nation is directly linked to whether its political and economic institutions are “extractive” or “inclusive”. Extractive institutions are structured to serve the interests of elites and to extract income and wealth from the masses. Inclusive institutions are distinguished by broad participation of all segments of a nation in ways that prevent entrenchment of elites.

Inclusive institutions embrace the rule of law and individual rights. They enable free entry of new businesses. This encourages investment and innovation which eventually create great wealth.

Extractive institutions control economic and political processes to serve the interests of the elite. They often are distinguished by open corruption of those in power or accomplish similar outcomes through laws and regulations which protect the interests of the elite. Societies with extractive political and economic institutions discourage investment and innovation. Laws, rules, and practices block and the ever-present threat of confiscation inhibits attempts by non-elites or outsiders to establish new businesses.

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⁴ Minsky defines three levels of credit creation. The first, called “hedge financing”, occurs when borrowers have the ability to meet their contractual debt payments of interest and principal through cash flows generated by activities financed by the loan. The second, called “speculative financing”, occurs when cash flows are sufficient to cover interest on the debt but insufficient to repay principal, thus requiring repeated refinancing of the debt. The third, called “Ponzi financing”, occurs when cash flows are insufficient to cover either interest or principal payments on the debt so that debt and interest must be refinanced and the amount of the debt constantly grows. Unless regulation intervenes there is a natural tendency for credit creation to progress over time from hedge to speculative to Ponzi. This progression unfolded during the housing bubble. Economies and financial systems are stable when credit creation is limited to hedge financing. However, fragility builds as speculative financing takes hold. And, when Ponzi financing emerges it is only a matter of time before a Minsky moment arrives when forced selling of overvalued assets causes the financial system to implode.
Acemoglu and Robinson argue that political and economic institutions, whether they collectively are extractive or inclusive, are self-perpetuating. This results either in a virtuous circle of economic development and wealth creation in the case of inclusive institutions or a vicious circle that discourages economic development and wealth creation in the case of extractive institutions. Unfortunately, history indicates that extractive institutions are the rule and inclusive institutions are the exception.

Success of the U.S. economy and political system since the founding of the republic in 1776 has rightfully been attributed to the inclusive underpinnings of the U.S. constitution and system of government. It has also benefited historically from the role religious institutions have played both in guiding behaviors consistent with inclusiveness but also in partnering with government in founding and operating a variety of public educational, medical and charitable organizations.

Many, including Acemoglu and Robinson, now question whether corporate and political elites are inexorably accumulating power as they pursue an agenda of self-interest. Recent economic and political events in the U.S. suggest that that the U.S. economic and political system is drifting away from inclusiveness and toward extractiveness.

Why did the housing bubble and financial asset speculation using extensive leverage careen out of control before the inevitable financial crash occurred in 2008? Many, such as Henry Kaufman, foresaw the debilitating consequences of the crash for millions of Americans. Why did our business and political leaders do next to nothing and why have so few been held accountable in the aftermath? And, why did the values, beliefs, and norms of our faith traditions have little apparent impact? The answer would appear to be that increasingly America’s leaders, believing in the efficacy of shareholder value maximization and in the ability of free markets to regulate outcomes in the overall collective interest, permitted power to accumulate in the hands of those bent upon serving their own interests in extracting wealth and maximizing their incomes. The effectiveness of traditional governance, including religious values, beliefs, and norms, eroded as the new ideology of shareholder value maximization and free markets gained ascendance.

8. **What Can Be Done To Change Societies?**

There is no natural process to create inclusive institutions. Elites cede power only if threatened with loss of power. Often this requires revolution. But, revolution does not necessarily change the outcome. Extractive institutions remain entrenched and the only change is that one power elite is substituted for another. Change comes about when there are nascent inclusive institutions with strong leadership which is able to capture the support of the masses to effect significant and lasting change in a
nation’s political and economic institutions. This happened in many parts of Europe following the discovery of the Americas by Christopher Columbus. Once established, the economic success of inclusive societies in Europe created pressure for change in extractive societies. Some migrated over time to predominantly inclusive political and social institutions; others, such as Russia, have never changed.

But, can inclusive institutions be so weakened that power elites’ natural extractive tendencies gain the upper hand? Acemoglu and Robinson do not address this question. However, it is an important one because some believe that the U.S. is straying from a predominantly inclusive society toward an extractive one. For example, the apparent capture of the political elite by the financial elite in the U.S. is an example of how powerful the extractive tendencies of elites can be. It is possible that Acemoglu and Robinson might argue that the ascendency of Wall Street cannot long continue because of the deep entrenchment and power of America’s inclusive institutions.

Culture and social norms are important. Acemoglu and Robinson do not give much credit to culture in establishing and perpetuating inclusive political and economic institutions. However, culture in terms of social norms and values plays an important role. But, having said this, and reflecting on Charles Murray’s book *Coming Apart*, there is some question as to whether America’s culture is changing in ways that are facilitating the emergence of the extractive power of America’s financial elite. If this is so, it is not absolutely certain that the tradition of the dominance of U.S. inclusive political and economic institutions will continue to drive economic development and wealth creation.

### III. Shareholder Wealth Maximization and Free Markets

Over the last 50 years finance theorists extended the neo-classical economic theory of competition to financial instruments and markets. The neo-classical economic theory of competition is highly idealized and is based on rigid simplifying assumptions that are not consistent with observed behaviors. Financial economics theory is subject to the same limitations. However, the elegance of mathematical models that flowed directly from the assumptions and the utilization of these models in designing and pricing a plethora of financial instruments coupled with the fact that the models appeared to be reasonable in “normal” times, led many theorists and practitioners alike to blindly embrace the theory and models as accurate and complete. The theory dictates that market participants should seek to maximize value and based upon the theory’s assumptions, the operation of the market will

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assure that no participant benefits at the expense of another participant – the optimal collective outcome will always be achieved. In time this mantra of “the market knows best” came to dominate beliefs and behavior. Regulation was judged to be intrusive and unnecessary. In effect, Brock’s third pillar – the constitution/rule of law – was replaced with assumption that the market would do the job. Obviously, we know from hard experience that it did not.

1. **Neo-Classical Economic Theory**

Neo-classical economic theory was developed in the late 1800s and early 1900s. It is based on the theory of perfect competition, which results in the maximization of aggregate economic welfare. The theory is based on simplifying assumptions of human behavior that describe in broad general and ideal terms behaviors of participants in the economy.

Neo-classical economists understood that the real world is far more complex than the world assumed under the tenets of perfect competition. They realized that the actions of individuals do not adhere strictly to the simplifying assumptions. Nonetheless, the theory of perfect competition is a useful construct for understanding how an economy functions. By comparing the idealized assumptions to actual behaviors, economists and policymakers can better understand how to govern the economy to maximize aggregate public welfare, given the inherent self-interested and sometimes irrational behaviors of individuals.


Modern finance had its genesis in the 1950s. The defining event was Harry Markowitz’s doctoral dissertation on portfolio theory. Development of modern financial theory proceeded rapidly during the 1960s and 1970s and keyed off of the neo-classical theory of perfect competition.

3. **Assumptions of the Financial Economics Theory**

- All participants are rational
- All participants have access to complete information
- All participants share the same decision-making framework for using information to make decisions
- The decision-making framework is accurate and complete

All of these assumptions are oversimplifications of observed real world behaviors. The fourth assumption, if accepted uncritically, is especially problematic. What the term "accurate and complete" means is that the decision-making framework is stable and does not change over time. But that assumption is patently inconsistent with the
rapid development of new financial technologies and the constantly evolving structure of the global economy and financial markets.

Financial economics theory posits that if all of these assumptions hold (which they do not), the collection of all individual decisions, which is “The Market”, will assure optimal outcomes both for individuals and the community as a whole. Thus, any form of intervention will lead to a suboptimal outcome.

4. Operationalization of Financial Economics Theory

Had financial economists been content to stay in the world of theory as had neo-classical economists financial economics theory would have remained a useful device for understanding the imperfect working of financial markets.

However, the theory, which assumes that financial events (phenomena) are random and normally distributed – both simplifying theoretical assumptions –, was operationalized through the development of market-traded financial instruments. The assumptions of randomness and normal distribution are a simplification of the fourth assumption that the decision-making framework is stable over time.

The famous Black-Scholes option-pricing model embedded the assumptions of randomness and normal distribution. This model was relied upon to develop pricing methodologies for a plethora of financial derivatives using historical data. The historical data were presumed to be normally distributed and to be stable over time. In other words, the pricing algorithms assumed that future price variability could be defined by and explained by past price variability.

These pricing models appeared to work well over a variety of market circumstances. As a consequence, the mathematical elegance of the model and the apparent accuracy of how it explained financial market behaviors strengthened the political movement toward deregulation and embrace of “The Market” as an effective and efficient market governance mechanism.

5. Failure of the Theory of Financial Economics

But, people lost sight of the reality that financial phenomena are neither random nor normally distributed. They lost sight of the reality that the model is not stable but ever changing as technological innovation and global competitiveness has evolved.

The macroeconomic consequences of growing income/wealth inequality had no place in the theory of financial economics.

Myopia and faith in the efficacy of micro financial theory blinded people to the building macroeconomic fragility.
There were warnings along the way that the assumptions underlying the
collection and pricing of financial derivatives were deeply flawed. The collapse of
Long Term Credit Capital, a mathematically-based arbitrage operation, in 1998
exposed the limitations of the assumption of normally distributed events. The reality
was that the distribution had large fat tails in times of extreme duress. This hardly
was a startling revelation. The centuries-long history of booms and busts and of
speculation indicates that extreme events and fat tails are a natural occurrence in
human existence.

Yet, the elegance of the theory and its operationalization led to uncritical belief in its
efficacy. As financial markets embraced the theory and developed lucrative financial
instruments based on it, self-interest entrenched commitment to its tenets and led to
the capture of government policy and regulatory processes.

Thus, in this way modern finance theory contributed to rising income inequality and
was a significant contributor to the escalation of unchecked market euphoria during
the bubble years.

Perhaps disturbingly, in spite of the failure of the application of modern finance
theory in recent years in governing market processes, the pricing of financial
derivatives continues to be based on the simplified theory. Moreover, the beliefs,
vested interests and political influence of the financial elite remain relatively
unchanged.

It is in this vein that a debate about the future of capitalism is just beginning to
emerge. The risk is that the debate will not develop into a substantive and critical
evaluation of the causes of income inequality and the shortcomings of the
application of simplified financial theory to the operation of financial markets. Without
such an in depth assessment solutions, which have broad-based consensus, will not
emerge. We have already witnessed the consequences of the current paradigm. So,

clearly the status quo is not an optimal outcome. Indeed, adherence to the status
quo could either lead eventually to social unrest and political reform under duress or
alternatively it could foster the gradual decline in America’s economic, financial and
political ascendancy.

6. **Asset Price Bubbles**

Asset pricing theory, which was developed by Myron Gordon⁶, is based on the same
general assumptions of financial economics theory. It posits that the price of an
asset is determined by the discounted expected return of holding an asset for one

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time period. This price depends upon three factors: any cash payment received during the period, the expected price at the end of the period and the discount rate. However, numerous studies have found that actual fluctuations in asset prices do not conform to the dictates of theory.

In a recent article, John Williams⁷, president of the Federal Reserve Bank of San Francisco, quipped: “We economists like to explain things using highly stylized models. We build make-believe worlds, populate them with creatures that act according to strictly prescribed rules, and analyze what happens. … Often the simplest model – with patently unrealistic assumptions – yields the keenest insights into how a market or an economy works. … Much of the research on asset prices continues to rely on highly stylized models with identical agents, rational expectations, and optimizing behavior.”

If the assumptions of the theory held without exception, asset prices would never lead to price bubbles. In fact asset price bubbles form rather frequently. Williams states that the actual behavior of asset prices can be explained by replacing the assumption of rational expectations with people’s perceptions of what they believe will happen in the future. The record clearly shows that people’s expectations of the future depend on what has happened in the recent past. Thus, if prices have risen, the collective expectation is that they will continue to rise. This introduces a positive feedback loop that propels asset prices into bubble territory.

Williams concludes that asset price models need to incorporate an assumption of procyclical investor optimism and cites Charles Kindleberger’s seminal work: “The lesson of history is clear: asset price bubbles are here to stay. They appear to be a consequence of human nature.”

IV. Income Inequality

This section documents changes in income inequality in the U.S. over time.

1. Widening Income Inequality

Income inequality has been worsening steadily for 45 years. Chart 1 shows that real spending power for the lowest 20% of the U.S. population has increased just 15%

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over the last 45 years while real income has increased nearly 70% for the top 5%. The skew is even more dramatic for the top 1%.
Chart 2 shows that real incomes have declined 6% for the lowest 20% of the population over the last 15 years while rising 6% for the top 5%. The small increase for the top 5% isn’t a good result, but decline for the bottom 40% is a disaster.

2. Income Inequality – What the Data Say

Two papers, one a theoretical economic analysis prepared by two International Monetary Fund economists, Michael Kumhof and Romain Ranciere⁹, and the other a white paper authored by Anant Thaker of the Boston Consulting Group and Elizabeth Williamson of the Frontenac Company¹⁰, assert that the 2007-09 financial and economic crises were a direct outcome of income and wealth inequality that built up over 40 years.

Kumhof and Ranciere provide time series data for the share of income received by the top 5%.

These data indicate the following for share of income earned by the top 5%:

- 1920 – 24%
- 1929 – 34%
- 1983 – 22%
- 2007 – 34%

During the same two periods (1920 to 1932 and 1983 to 2007) Kumhof and Ranciere found that the ratio of household debt to GDP nearly doubled in the earlier period and more than doubled in the latter period and reached a higher level in 2007 than in 1932.

Thaker and Williamson report share of income data for the top 1%, which was originally compiled by Piketty and Saez¹¹, updated by Thaker and Williamson for 2008, and further updated by Piketty and Saez for 2011 and 2012:

- 1920 – 16%
- 1929 – 24%
- 1968 – 8%


2007 – 24%
2011 – 20%
2012 – 23%

The Great Recession resulted in a temporary setback for the top 1 percent, but most of the lost ground had been recovered by 2012. According to a news report by Annie Lowrey\textsuperscript{12}, Saez and Piketty also reported that incomes for the 99 percent grew 1 percent in 2012, but incomes for the top 1 percent grew 20 percent, and incomes for the top 0.1 percent grew 32 percent.

Piketty and Saez use two different data series to track the debt to GDP ratio. The earlier series is individual and non-corporate private debt to GDP and the recent series is the more common ratio of household debt to GDP:

- 1920 – 60% (individual and non-corporate private debt to GDP)
- 1932 – 95% (individual and non-corporate private debt to GDP)
- 1968 – 60% (individual and non-corporate private debt to GDP)
- 1968 – 40% (household debt to GDP)
- 2007 – 95% (household debt to GDP)

The pattern in both measures in the years preceding the 2008 crisis is clear and eerily similar.

3. **Mechanism through Which Growing Income Inequality Leads to Financial Crisis**

According to Kumhof and Ranciere, the triggering event causing income inequality to widen and reliance on debt to grow was a shift in relative income bargaining power in favor of the top 5% relative to the bottom 95%. Once this shift in bargaining power commenced it set in motion a series of events that over several decades inexorably led to rising inequality and debt burdens.

First, as the share of income of the bottom 95% shrank, that group attempted to maintain consumption through borrowing. Second, as the top 5% gained income, and thus wealth, that group needed to find ways to invest its accumulating wealth. Accordingly, it provided the funds that the bottom 95% borrowed.

Borrowing was enabled by financial innovation, such as subprime mortgages and home equity loans. All of this activity facilitated tremendous growth in the financial sector of the economy.

As the financial sector grew relative to the rest of the economy its political power grew as well. This led to adoption of policies that promoted and protected the interests of the financial elite, which in turn reinforced the building inequality. One can place deregulation, reduced capital requirements and other “free market” elements into this basket. And, as described in the next section, the evolution of the social contract between employers and employees from a high-wage to a low-wage paradigm, coupled with the ascendancy of shareholder wealth maximization in driving corporate behavior, reinforced the shift in bargaining power.

However, the trends in widening income inequality and growing debt burdens, according to Kumhof and Ranciere, cannot continue indefinitely. A financial crisis eventually erupts because there is an ultimate limit to how much debt households can support. Increases in debt and decreases in savings reduce a household’s ability to manage through a life crisis – illness, loss of job, divorce and so forth.

Sum this increase in financial vulnerability across millions of households and in the aggregate the economy’s ability to withstand a shock, such as a sudden and sharp increase in oil prices, steadily erodes. Also, as we now know, runaway speculation in housing propelled a bubble in prices which was aided and abetted by abundant and cheap debt, steadily diminishing credit underwriting standards, and a laissez-faire attitude on the part of government regulators perhaps swayed by the belief in “The Market” as an efficient regulator or perhaps inhibited by the political power of the financial elite.

And, the greater are the excesses during the bubble period, the harder will be the crash when it eventually unfolds.

While the 2008 financial crisis apparently marked the limit for accumulation of household debt relative to income, the forces driving ever increasing income inequality still appear to be in play. But, there is also probably a limit to the extent of income inequality. As income inequality escalates, the macro economy becomes increasingly fragile. This already appears to be manifested in the stubbornly high rate of unemployment, low productivity and anemic GDP growth. The crash, when it finally arrives, could be horrific and the convalescence period would likely be painful and extended.

4. **Kumhof and Ranciere’s Theoretical Economic Bargaining Power Model and Income Inequality**

Kumhof and Ranciere constructed a simple theoretical model which describes almost exactly the sequence of events summarized above. The benefit of a simple model, which explains real world phenomena well, is that it can be used to test how events might continue to unfold given different policy interventions.
Kumhof and Ranciere’s simple model consists of two groups of households – investors who comprise the top 5% of the population and workers who comprise the remaining 95%. Investors derive utility from consumption and wealth. Workers derive utility only from consumption. In addition to the utility functions for investors and workers, the model includes an aggregate production function for the economy in which returns to factors of production incorporate a variable for workers’ bargaining power. Capital and loans are also included in the model.

A change in relative bargaining power is introduced to the model and imbalances build over successive iterations. A crisis event can be introduced to the model at any iteration.

The performance of the model can be tested through simulated scenarios.

5. **Policy Responses to Financial Crisis**

Once the crisis unfolds, the impact of policy responses can be tested. There are two types of solutions.

One solution is to restructure debt by moving it from creditors to taxpayers – the socialization of debt. This is what Ireland did with its banks. This solution also is being applied in part to the Greek sovereign debt problem and more generally is the approach in principle that the European Financial Stability Facility and European Stabilization Mechanism incorporate. The model reveals that this solution buys time but ultimately is relatively ineffective in curing the problem of overleverage because individuals, not directly but as taxpayers, ultimately are still saddled with excessive debt.

An alternative solution is to grow out of the problem. This involves increasing economic growth so that the debt burden, which remains unchanged in nominal terms, shrinks in relative terms as income increases. The challenge, of course, is to devise a policy that stimulates growth without creating additional leverage.

Austerity, which focuses on reducing debt, is a counterproductive policy because it results in depressing income and in so doing increases the burden of debt relative to income. This wrongheaded policy has driven the collapse in the Greek economy (GDP has declined by about 25%) and is damaging other European economies including Portugal, Spain and Italy in particular.

Kumhof and Ranciere use the model to demonstrate that the only way to grow earnings of workers successfully over time and reduce the debt burden is to restore the original income bargaining power balance. This solution results gradually over time in a reversal of income inequality. But, it takes a very long time to unfold. They
do not explain how this might be accomplished but it would appear to require changing the now dominant low wage social contract.

There is a third solution, of course, and that is to tinker a bit with policy but do little of substance. The initial U.S. response was socialization of debt through tax cuts and a significant increase in debt-financed spending. That policy shifted the debt problem from households to taxpayers. But, what is the real difference between households and taxpayers? However, the rapid escalation in the public debt led to policy reversal, which has stabilized the public debt-to-GDP ratio at a much higher level but at the apparent cost of stubbornly high levels of unemployment and slow growth in incomes.

With weak income growth overleverage and the accumulated debt burden has been an ongoing drag on economic recovery. It will take a very long time to return to a more normal economic environment and unresolved income inequality will remain an ever present threat both to the economy and to social/political stability.

6. **Reducing Income Inequality Is the Only Effective Long-Term Solution to Reduce Potential for Financial Crisis**

If one accepts Kumhof and Ranciere’s model at face value, the only effective long-term solution is to alter relative income bargaining power between investors and workers. If this can be done, over time the distribution of income would shift back toward workers and debt burdens would shrink. That is what the model shows and that is what happened between 1932 and 1968.

But powerful forces stand in the way of implementing such a solution. First and foremost is the absence of a political consensus that purposeful intervention is required to alter the balance of income bargaining power between workers and investors. Part and parcel to this is the entrenchment of vested interests (economists call them rent seekers) in the status quo which have nothing to gain personally by permitting a change in relative bargaining power. These vested interests generally are the same people that Kumhof and Ranciere define as investors. Their entrenchment is supported by U.S. political campaign financing, which was exacerbated by the Supreme Court’s Citizens United decision permitting individuals to establish “super PACs”. It is hard to alter or break entrenched power alliances between the political and financial elite.

There are other obstacles which may be subject even less to successful intervention. An example is competition in a globally-integrated communications and technology era, which has rendered geographic and political boundaries meaningless. How does America grow income when competitive pressures from other countries constantly limit the ability of workers to negotiate?
7. **What Prompted the Shift in Relative Bargaining Power Between Workers and Investors Beginning in 1967?**

There were many contributing factors but no apparent single catalyst:

- Federal tax rates have become less progressive over time as the composition of taxes has shifted toward payroll taxes. This phenomenon was documented recently by the Congressional Budget Office.

- The Congressional Budget Office documented that changing transfer payments programs, particularly Social Security and Medicare, are contributing to growing income inequality.

- Wall Street, which is a collective term for large powerful corporations, seems increasingly to have inordinate sway in guiding policies in both the Democratic and Republican parties. Some believe this is a direct result of political campaign finance. For example, why is the House Financial Services Committee the largest in the House of Representatives with nearly 15% of the members serving on it? Others, disparagingly, have referred to this development as “crony capitalism”. Crony capitalism involves interest groups successfully using their financial power to lobby for legislative and regulatory outcomes that serve their narrow economic interests. In extractive societies, the financial elite capture the political elite.

- The amount of sales and employment accounted for by larger businesses is growing, which Nouriel Roubini suggests is contributing to the growth of less competitive and margin-increasing oligopolies. This appears to be the case particularly in banking.

- Union membership has declined precipitously partly as the consequence of the shift toward a service-based economy. Labor unions during much of the 20th century helped assure that the benefits of technical change were spread broadly. But the changing composition of the economy from manufacturing to services and the political ascendancy of deregulation after the mid-1970s contributed to rapid decline in the influence of labor unions. This tilted the balance of power toward management and investors, with the effect that more of the benefits of productivity flowed to management and investors and less flowed to labor. These developments have negated John Kenneth Galbraith’s principle of “countervailing power” in which big labor, big business and big government struck a balance of power.

- The addition of 3.5 billion people to a more integrated global workforce has reduced demand for lower skilled jobs in the U.S. When demand declines relative

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to supply, wages fall. The opposite impact has occurred for higher skilled jobs – demand has increased relative to supply. The combination of these naturally leads to a widening of income inequality.

- The explosion in communications technology has reduced the importance of geographic boundaries in constraining economic activity.
- Benefits of increasing productivity do not automatically flow to all participants in the labor force. In the first order they go to those with greater skills. The benefits of productivity can be spread across the entirety of the population, but this requires affirmative government policies. Until recently this was enabled by a broad political consensus to build a combination of safety net and social welfare programs.
- Financial liberalization, as statutory and regulatory limits to competition were modified or discarded, has contributed significant gains in the share of income garnered by people employed in financial services.
- The belief in “The Market” as an effective and efficient regulator of financial and economic activity has decreased support for raising the minimum wage.

Most of these causes would be hard to remediate and may even be irreversible. Going forward it is not clear exactly what political and policy changes would restore relative income bargaining power between workers and investors. But the status quo and benign neglect are clearly not answers.

8. Does Growing Income Inequality Matter?

Intuitively speaking, the answer to the question of whether income inequality matters is “Yes”. History tells us that when the divide between the “haves” and the “have nots” becomes extended, at some point the masses rise up against the privileged few. This is a fairness/economic justice issue.

Branko Milanovic\textsuperscript{14} reported that between 1988 and 2008, incomes of the world’s top 1 percent rose 60 percent while there was no change in incomes for the bottom 5 percent. Milanovic provides evidence that inequality results in lower economic growth. This finding has to do with the increasing scarcity of human capital with respect to physical capital. Scarcity puts a premium on developing a high skill level which depends on education and training. Milanovic argues that widespread education is difficult to establish in societies with widely disparate income distribution. In this regard, it is both interesting and worrisome to note that except for higher education, the quality of education in the U.S. has fallen considerably in recent years compared to other nations. This implies, at least circumstantially, that

growing income inequality and declining educational opportunity and quality in the
U.S. are linked.

V. Evolution from High-Wage to Low-Wage Social Contract

Embedded in American society is an implied social contract which specifies the roles
and behavioral expectations of each segment of society with respect to each other.
While the social contract is shaped by the constitution, it is not static. It evolves over
time as beliefs, values, and norms change. The contract is impacted by
technological change. But, it is also influenced by power structures and whether
those structures are predominantly inclusive or extractive. Thus, it is entirely
possible that the social contract that prevails at a particular moment in time may not
conform to the norms of an ideal social system.

The U.S. social contract has changed dramatically over the last several decades
from one characterized by high wages to today’s focus on low wages.

1. High-Wage Social Contract

In a recent study prepared for the New American Foundation, Freedman and Lind\(^\text{15}\)
describe how the U.S. has migrated over time from a high-wage social contract to a
low-wage social contract. They conclude that the low-wage social contract has
failed.

The high-wage social contract evolved in the early twentieth century, came of age
during the New Deal, and lasted until the 1970s when it was gradually replaced with
today’s low-wage social contract. Its development was driven by rapid
transformation of the U.S. economy from agriculture to manufacturing and by the
evolution of large corporations and burgeoning unions.

Henry Ford is often cited as the trailblazer of the high wage social contract. In early
1914 he raised the minimum daily wage for male factory workers from $2.34 for a
nine-hour day to $5.00 for an eight-hour day. The policy was extended to female
workers in 1916. In instituting this policy, Ford was not necessarily a benevolent
capitalist; his objective was to pay his workers enough so they could afford to buy
the cars he manufactured. Not only did he accomplish that objective, Ford workers
became more productive and they had an elevated loyalty and sense of pride in the
company.

High wages spurred consumption and fostered rapid growth in the economy. And the benefits trickled down to the masses resulting in rapid growth in the numbers of people who were able to achieve a middle class standard of living. This virtuous development was sustained by growth in unions which used their growing economic and political power to sustain the high-wage social contract. The ability of unions to negotiate high wages and benefits for their members set the standard overall which also benefited nonunionized workers.

Government did its part as well by providing programs such as the GI bill, which subsidized education and housing for veterans, a variety of safety net programs, such as unemployment insurance, and public works programs, such as the building of the interstate highway network. These initiatives were paid for through high taxes, but in a high-wage, rapidly growing economy, the burden of high taxes was tolerable.

John Kenneth Galbraith\textsuperscript{16} captured the essence of the high-wage social contract in his seminal book, \textit{The Affluent Society}. In an earlier book, he introduced the concept of “countervailing power” to describe the balance of power among big business, big government, and big labor (unions) in fostering and sustaining the affluent society. Unfortunately, prior to his death Galbraith acknowledged that countervailing power no longer described the functioning of the U.S. economic and political system.\textsuperscript{17}

2. Stakeholder Capitalism

One of the defining features of the high-wage social contract was stakeholder capitalism. Stakeholder capitalism involved corporations and businesses acting in ways that benefited all of their stakeholders rather than exclusively focusing on shareholders. Henry Ford clearly was a practitioner of stakeholder capitalism. Lou Pepper\textsuperscript{18}, CEO of Washington Mutual Savings Bank from 1981 to 1990, embraced the efficacy of stakeholder capitalism and referred to stakeholders as the four C’s – capital markets (shareholders-investors), crew (employees), community and customers. To Pepper all four constituencies were of equal importance. No one constituency’s interests could be fully satisfied without harming another constituency. This required balancing. Pepper’s insight was that by focusing in a

\textsuperscript{16} Galbraith, John Kenneth (1958). \textit{The Affluent Society}.


balanced fashion on all four constituencies shareholders would be well rewarded in the long run.

3. **Benefit Corporations and Non-Profit Social Venture Corporations**

Stakeholder capitalism among publicly owned companies has largely been replaced by shareholder capitalism. But some companies, usually privately held ones, still practice stakeholder capitalism.

According to Gar Alperovitz\(^{19}\), an obstacle to businesses including a social benefit mission is the legal requirement that decisions of corporations financially benefit shareholders.

Angus Loten\(^{20}\) reported that Blak Jones, who is an entrepreneur in Boulder, Colorado, donates 20 percent of his after tax profits to local projects devoted to activities such as reducing child poverty and protecting the environment. But, Jones worries that this could open him to shareholder lawsuits that he is not acting in the best interests of his shareholders.

Twelve states (California, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia) have enacted statutes creating a benefit corporation (B Corp), which permits businesses to use profits for social purposes.

Increasingly, non-profit organizations and cooperatives are competing alongside for-profit organizations to provide similar or the same goods and services to the public. Such organizations are required by law to provide benefits to the constituencies they serve. Direct competition with for-profit businesses often leads to accusations of unfair competition. Competition is unfair, it is argued, because the for-profit organizations are unable to charge prices sufficient to generate an adequate amount of profits to compensate shareholders. For example, credit unions are cooperatives that provide financial services primarily to consumers. They are largely exempt from taxation. This is seen by their for-profit shareholder-owned competitors, who provide the same kinds of financial services to the same customers, as providing an unfair advantage.

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4. **Low-Wage Social Contract**

Globalization, deregulation, the increasing role of services employment and the decline in manufacturing, the decrease in union membership, and more generally the ascendancy of financial economics theory with its singular focus on maximizing shareholder value all contributed to the replacement of the high-wage social contract with the low-wage social contract.

According to Freedman and Lind, an economic system defined by a low-wage social contract is one in which many jobs pay poorly. Rather than attempt to raise wages, public policy focuses on helping low wage earners through lower taxes, tax credits, and various types of cash and in kind subsidies. While Democrats and Republicans differ on program details, just as was the case when the high-wage social contract predominated, both political parties accept the reality of the low-wage social contract. Neither party has attempted to alter the foundational drivers of the low-wage social contract but instead has focused on ameliorating the consequences. For example, statutorily-mandated minimum wage rates have not kept up with inflation. While Democrats favor raising the minimum wage and Republicans generally do not because they see it as government intrusion into the operation of the free market, Democrats have not chosen to make raising the minimum wage rate a high policy priority.

Wal-Mart epitomizes how the low-wage social contract has come to dominate American business. Wal-Mart thrives by selling merchandise to consumers at low prices. It is able to do so partly through employment of technology to increase productivity, through large scale operations, and by importing goods from low production cost countries. But, the primary driver of its low-price strategy is low wages and benefits to employees. It is argued that low prices benefits consumers and is a direct outcome of efficiency gains driven by free market competition.

Low wages, however, by themselves depress consumer demand. The low-wage social contract in theory replaces spending power by reducing taxes, providing tax credits (Earned Income Tax Credit and Child Tax Credit), and extending subsidies, such as food stamps and child care.

Critics of income inequality analysis, such as Aparna Mathur\(^{21}\), argue that income is a poor measure of the standard of living; consumption is a better measure of well-being. Income transfers and subsidies support consumption. Freedman and Lind agree that in theory reduced taxes, tax credits and welfare programs can

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supplement low wages and maintain the standard of living. However, they argue that adjustments to income data to accommodate these factors do not close the gap for low wage earners. Various studies, such as one by Perry and Boudreaux\(^{22}\), reach contradictory conclusions, which reflect the difficulty of constructing a statistical measure for the standard of living and well-being. Also, Mark Thoma\(^ {23}\) summarizes studies that critique the argument that consumption inequality has not worsened.

The debate over how to measure well-being skirts the issue of power relationships. Income and political power are correlated. Transfers and subsidies to low-income wage earners may support consumption but they tend to breed dependency relationships. Krugman\(^ {24}\) asserted in an opinion editorial in the *The New York Times*: “The gap between the society’s meritocratic ideology and its increasingly oligarchic reality is having a deeply demoralizing effect.” Krugman argues that the concentration of income among a few at the top is undermining the values that define America.

Freedman and Lind argue that after-tax income is too low and inhibits consumption demand. That depresses overall economic growth. Prior to 2008, the shortfall in spendable income was offset in part by easy access to credit. But the credit binge had an unhappy ending which predominantly fell on those with the lowest incomes.

Freedman and Lind state that for the low-wage social contract to work the gains from productivity need to be shared with workers in the form of higher wages or passed on to consumers via lower prices. But, as shown in Chart 3, the share of income going to corporate profits has risen from 7 percent in 1990 to 12.5 percent in the second quarter of 2013. Between 1990 and 2012 real income declined 3.2 percent for the bottom 20 percent of households and 1.3 percent for those at the 40\(^{th}\) percentile of the income distribution. Real household income rose 18.5 percent for the highest 5 percent of the income distribution. These data indicate that most all of the benefits of improving corporate profits are flowing to a small segment of the population.

Thus, growth in the share of income going to corporate profits is an indicator of growing income inequality. Since 1960, that share of income going to corporate profits has averaged 9.3 percent, but the share has fluctuated over time. Chart 3


shows the annual share of corporate profits as a percentage of nominal GDP and a five-year moving average to make trends clearer. Corporations’ share of income today is slightly higher than it was in the 1960s, but after falling to a low point in the early 1990s it has been rising ever since.

**CHART 3 – Corporate Profit Margins 1960 – 2013**  
(as a percentage of nominal GDP)

**CHART 4 – Real Gross Private Investment Growth 1960 – 2013**  
(5-year average annual real rate of growth)
Defenders of the upward trend in the share of corporate profits argue that profits will be invested in plant, equipment and new innovations, which will boost productivity and GDP growth. This will raise income and presumably benefit all households. First, as **Chart 4** shows, the growth rate in real private investment has been declining, even as corporate profit margins have been rising. In fact, growth has been negative over the past five years. Second, productivity is not rising and real GDP growth is disappointingly low. So, it would appear that we have the worst possible outcome. GDP and income growth are well below historical trends and the gains that are occurring are going to corporate executives, traders, investors and the wealthy.

Productivity depends on investment, which depends on demand. If demand is anemic, the incentive to invest is limited. It’s hard to hard to see how a low wage social contract can stimulate economic growth in the way that history clearly shows the high wage social contract did.

VI. **Wealth Inequality**

There exists far less commentary about wealth inequality, primarily because of the scarcity of data and abundant measurement challenges.

Wealth and income inequality are presumed to have similar consequences. However, wealth and political power are highly correlated. Because wealth inequality is even more skewed than income inequality this implies that wealth matters more in determining who wields political power.

The Gini coefficient, which has a value bounded by 0 and 100, measures the degree of concentration. A value of 0 means that everyone has the same wealth or the same income; a value of 100 means that all income or wealth is held by a single household. Thus, the higher the value of the Gini coefficient is, the great is the concentration of income and wealth. According to Daniel Altman\(^\text{25}\), the Gini income inequality coefficient, based on U.S. Census Bureau data, was in the low 40s in the early 1990s, but the Gini wealth coefficient was in the mid-70s at that time. By 2010 the Gini wealth coefficient had risen to 80. In 2010, the top 10 percent of households controlled 20 times the amount of wealth as the bottom 50 percent. Thus, wealth is far more concentrated than income and the level of concentration is rising.

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According to a recent Pew Research Center Report, mean net worth of the top 7 percent in the wealth distribution increased 28 percent during 2010 and 2011 while mean net worth decreased 4 percent for the remaining 93 percent.26

Many have pointed out that younger workers have not been accumulating wealth and many older workers have not accumulated sufficient wealth to provide for adequate income in retirement. Annie Lowrey27 reported that an Urban Institute study found that people under the age of 40 have accumulated less wealth than their parents had at the same age, even though average household wealth has doubled over the last 25 years. There are many reasons including low-wage jobs, and rising reliance on debt, especially student loans. A Pew Charitable Trust study, “Retirement Security Across Generations,” found that between 2007 and 2010 those born between 1966 and 1975 (aged 35 to 44) lost half of their net worth and had higher levels of debt than previous generations at the same stage in life.28

1. Wealth Concentration Threatens Inclusive Economic and Political Systems

Trends in wealth concentration and the high level of concentration is important given Acemoglu and Robinson’s findings about the linkage between the financial elite and the political elite and the tendency of nation’s economic and political systems to be extractive.

One of Acemoglu and Robinson’s case studies concerns the rise of Venice in the early 14th century. The foundation of Venice’s rise to an economic and political power was the colleganza, which was an organization that financed trade expeditions. Initially the colleganza was open to anyone which enabled entrepreneurs to participate in financing merchant voyages alongside established businessmen. In other words, the colleganza initially permitted social mobility which enabled lower classes the opportunity to move into the upper classes. But, as time passed, the upper class felt increasingly threatened and moved politically to preserve their interests and status by blocking new participants in the colleganza. This political shift was called La Serrata, meaning “the closure”. Eventually the colleganza was abolished and the political/economic elite assumed full power. This marked the transformation of Venice from a vibrant inclusive economic and political system into an extractive one. As this transition took root, the decline in Venice’s economic and political power followed inexorably over several decades.

According to Chrystia Freeland\(^\text{29}\), America is following in the steps of Venice “… as the 1 percent pulls away from everyone else and pursues an economic, political and social agenda that will increase that gap even further – ultimately destroying the open system that made America rich and allowed its 1 percent to thrive in the first place.” America’s creeping Serrata is manifesting itself in the evolving division into upper and lower classes based on social and educational status.

2. **Stagnation of Social Mobility**

Richard Reeves\(^\text{30}\) argues that the stagnation of social mobility is a bigger problem than the widening of income inequality: “When the income gap of one generation becomes an opportunity gap for the next, inequality hardens into social stratification.” The loss of social mobility is correlated with increasing wealth concentration because control of wealth tends to pass from one generation to the next. Some move up and some move down, but it is better to be born of wealthy parents.

Social stratification – the division of Americans into classes – is supported by the higher education system and labor market practices which result in a process labeled “opportunity hoarding” by sociologist Charles Tilly. An example of opportunity hoarding is that the children of wealthy parents, who are less talented than those of poor parents, are more likely to get into a good college and to have the kinds of connections that lead to high paying jobs.

VII. **Evolution of American Culture and the Social Fabric**

There are other forces at work besides those which have impacted income and wealth inequality and the functioning of financial markets that are affecting American society. Cultural changes are also important drivers and regulators of individual and community well-being.

Even if solutions to the economic and financial causes of income and wealth inequality were found and implemented and were able to put the economy on a course to resolve the current economic imbalances and inequities, cultural change might limit or even block success.

Culture is shaped by many factors. Economic phenomena and financial markets are important influencers, but they are not the only important drivers of culture.


1. “The American Way of Life” – The Death of the Expectation of Upward Mobility

We used to hear mentioned frequently and believe in “The American Way of Life” and “The American Dream”. Nowadays we hear less about these aspirations. Why has that occurred? Perhaps it is because, unlike times past, these aspirations no longer seem to be true for a large portion of America’s population.

Charles Blow\(^{31}\) summarized findings of an Allstate/National Journal Hartland Monitor poll that documents the decline in the belief in “The American Dream”. While 56 percent expressed hope that their living standards would improve in the future, 59 percent were worried that their standard of living could decline and 85 percent said that it is harder to maintain a middle class standard of living than it was ten years ago. But when asked what they think has happened to others, over 80 percent responded that more Americans have fallen out of the middle class in recent years. The poll also indicated that Americans see less opportunity to “get ahead”, less job security, and less disposable income than prevailed for persons in the middle class in the past. Respondents expressed the view that getting a good education is key to staying in the middle class, but they worry about its cost and availability. And, when asked who is to blame for the decline in opportunity, respondents named Congress, chief executives of major corporations and large financial institutions.

But what did the concept of “The American Way of Life” embody? According to Charles Murray, it involved a civic culture that swept an extremely large portion of Americans of all classes into its embrace. This civic culture muted the importance of differences in income and wealth inequality. Even though there were broad income and wealth differences Americans engaged in an extremely broad middle-class dominated American life and that this was a good thing.

Or, as Friedman\(^{32}\) puts it, Americans believed that “a rising tide lifts all ships” and all would benefit from high productivity and greater economic efficiency. Friedman believes that the “social fabric” is at risk because so many Americans are “losing ground.”

Friedman asserts that liberals would remedy this by transferring wealth through taxes and income transfers; conservatives would rely on the free market to resolve the problem. But, as Friedman notes, the free market drives economic outcomes, not social ones. And, as discussed in this paper, the free market’s economic

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\(^{32}\) Friedman, George (2013). The Crisis of the Middle Class and American Power. Stratfor.
outcomes may well exacerbate social relationships by permitting an ever increasing skew in wealth distribution.

Robert Putnam\textsuperscript{33} doesn’t pull punches: “The American dream has morphed into a split-screen nightmare.” He laments that the social fabric of the 1950s and 1960s, which was the basis of the American dream gradually disappeared and has been replaced by a new upper class that reaps most of the benefits.

2. **Hollowing Out of the Middle Class**

Murray asserts that a new upper class and a new lower class are evolving, which in effect is hollowing out the old broad-based middle class.

Key attributes of members of the new upper class include:

- College bachelor or advanced degrees
- Shared tastes and preferences that set members apart from mainstream America
- Live increasingly in geographically separate markets (super-zips)

Key attributes of members of the new lower class include:

- High school education or less
- Defining cultural characteristic is withdrawal from America’s traditional core cultural institutions such as fraternal societies and churches
- Poverty (income) is not a key defining characteristic

3. **Murray’s Data Analysis**

Murray compared key data for white-only members of the new upper and lower classes as he defined them. The focus on whites only is intended to eliminate confusion and debate about the effects of race and ethnicity on changes in the data over time. Specifically, Murray compared data for 1960 to data for 2010 wherever possible for white males between the ages of 30 and 49. He intentionally omitted consideration of income differences.

As Murray defines it, the new upper class (college degrees) embraces 20 percent of white males between the ages of 30 and 49 and the new lower class (high school degree or less) includes 30 percent of white males between the ages of 30 and 49. The remaining 50 percent are in the middle class and have some education beyond high school.

• **Marriage**

<table>
<thead>
<tr>
<th>Year</th>
<th>Upper Class</th>
<th>Lower Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>94%</td>
<td>84%</td>
</tr>
<tr>
<td>2010</td>
<td>83%</td>
<td>48%</td>
</tr>
</tbody>
</table>

The sharp decline in marriage among members of the lower class is a significant negative cultural development. Unattached males tend to be less responsible. Revealing perhaps his personal biases, Murray argues that unattached males are less industrious.

• **Single-Parent Births**

<table>
<thead>
<tr>
<th>Year</th>
<th>Upper Class</th>
<th>Lower Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>1%</td>
<td>6%</td>
</tr>
<tr>
<td>2010</td>
<td>6%</td>
<td>44%</td>
</tr>
</tbody>
</table>

According to a Pew Center research study\(^{34}\), single moms make up 25 percent of households and single dads make up 6 percent. The total of 31 percent is three times the level that existed in 1960.

• **Incidence of Criminal Behavior**

- Upper Class: no change in incidence
- Lower Class: incidence has risen 4.7 times but has declined in recent years

• **Religiosity (defined in reverse as secular orientation)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Upper Class</th>
<th>Lower Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972-76</td>
<td>29%</td>
<td>38%</td>
</tr>
<tr>
<td>2010</td>
<td>40%</td>
<td>59%</td>
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</table>

According to Murray the importance of religiosity is involvement in community-based social value creation initiatives. Thus, a decline in religiosity, particularly among members of the lower class, reflects an increasing shift toward focus on self rather than on community. Religiosity is important because historically about half of American philanthropy and community volunteerism has been church related.

Furthermore, religious organizations account for much more non-religious social capital creation than that which flows from Americans with a secular-only orientation.

4. **Causes of Cultural Inequality**

Based on Murray’s assessment of data trends, he believes that significant cultural inequality has evolved in America. Further, he believes that resolving income and wealth inequality issues will not by themselves cure the deleterious impacts of cultural inequality.

- **Great Society and Substitution of the State for Non-Government Organizations.** Murray speculates about why the new upper and lower classes emerged and permitted cultural inequality to assume such a significant and negative role. One source was the social reforms of the 1960s embodied in Lyndon Johnson’s Great Society. The broadening of the social safety net and expansion of social welfare programs made it more feasible to have a child out of wedlock. The responsibility of the individual male to care for the child shifted to the state. There is ample evidence that children of single parents are less successful and create a variety of criminal and non-criminal societal costs much greater than occurs for children of dual-parent households.

In addition, the state increasingly deals with social problems which churches, fraternal organizations and community organizations used to deal with. It can be argued that while the delivery of programs by the state from a process standpoint is more comprehensive and fairer, this gain is more than offset by the loss of flexibility and human empathy that typically accompanies delivery of social services through non-governmental organizations.

- **Tilting the Balance from Community to Individual Rights.** For all the evils that the civil rights movement addressed in the 1960s and 1970s, it did result in strengthening the emphasis on individual rights. While not challenging the importance of this development, it is reasonable to question whether balance has been maintained between individual rights and overall community welfare.

- **Technology.** Technological innovation has increased the returns to education and may be contributing unintentionally to the separation between the new upper and lower classes.

- **Shift from a Manufacturing to a Services-Focused Economy.** Services focus less on groups and more on individuals. Developments in the workplace may in unintended ways be diminishing the strength of non-work place organizations. In
so doing, the shift toward services may be reinforcing the shift toward individual rights and away from community.

- **Internet and Social Networks.** At first glance the internet is a powerful vehicle for individual expression. However, social networks, such as Facebook, may be in the early stages of creating the infrastructure for a new set of non-governmental organizations. However, a further question is one of whether the evolution of social networks will reverse or simply reinforce growing cultural inequality.

5. **Consequences of Cultural Inequality**

Emerging cultural inequality is defined by a breakdown in the old social norms which governed behaviors deleterious to overall community welfare. According to Murray, the old social norms began to unravel as government programs diminished the importance of non-governmental organizations, such as religious denominations and churches. And the weakening of these institutions led to a weakening in the role of these institutions as enforcers of the social norms. Feedback loops kicked in and the decline in non-governmental organizations and the breakdown in social norms evolved over time and the negative consequences of growing cultural inequality grew.

The new upper and low classes are pulling apart and the middle class is shrinking. Michael Austin\(^{35}\) puts it starkly: “*We are indeed splitting into tribes in the country, but the pie is almost certain to continue shrinking rapidly for the vast majority of us.*” Charles Blow\(^{36}\) voices similar sentiments: “*America is quickly dividing itself into two separate nations, regional enclaves of rigid politics, as the idea of common priorities fades further into a distant past.*”

6. **What Is To Be Done?**

Murray’s analysis has been attacked, particularly from those of more liberal persuasion. His data, flawed as they may be, still point out substantive changes in America’s culture which are troublesome. He is better at providing analysis than he is at providing solutions.

The value of Murray’s book is that it challenges the prevailing view that increasing income inequality is the source of what ails America and all we need do is find


solutions to reverse income inequality. Murray correctly argues that the challenges America faces go beyond pure economic considerations and include cultural phenomena, social norms, and societal values as well. In short, we need to rethink not just the role of capitalism in our economy and society, we also need to rethink the balance between individual rights and community welfare and the roles of government and non-governmental organizations.

VIII. Can U.S. Economic and Social Decline Be Reversed?

Is the U.S. destined to continue declining as has happened to many once powerful nations throughout history? Understanding the causes is a necessary first step to identifying possible strategies to address the causes and implement initiatives that move society back toward an inclusive ideal social system. Necessary strategies exist, but knowing what they are does not mean they will be implemented. Human beings tend to be self-centered and have difficulty acting in ways that benefit the collective interest, especially when doing so might involve some personal cost or loss. Human beings are protective of what is close to and important to them. They tend to be risk averse and distrustful. History shows that the human condition in the absence of strong and enforced laws and norms of conduct and behavior tends toward the evolution of power elites and subjugation of the many by the few.

Elites find it difficult to cede power once they have accumulated it, especially if the elites believe that they know best and are acting in ways that they expect will serve the masses well. What today’s elites believe is best is embedded in the theory of financial economics and its components of shareholder wealth maximization, the efficient markets hypothesis, the asset pricing model, and operation of free markets. Although many have pointed out the flaws in the theory of financial economics, nonetheless its fundamental assumptions have become embedded in the economic, political, and legal systems. In this respect the theory of financial economics has assumed the status of an ideology in governing economic, social, and political activity. Thought of in that way, it is not much different than the theocratic governments of some nations.

It is in our long-term interests to find and implement solutions that move the U.S. back in the direction of the ideal inclusive social system. There are three possible sets of solutions. 37

1. **Social Movements and Societal Change**

   The first involves social movements intended to address economic, social, and political grievances in ways that assure ethical practices and improve distributive justice. Religious and non-profit organizations already are engaged in building and supporting social movements and can do much more. However, if the fundamental business governance structure, which is based on the theoretical dictum to maximizing shareholder wealth, remains in place replete with the interlocks between the financial and political elite, social movements at best will win small victories on specific issues, but the system will remain much as it is.

2. **Democratization of Wealth**

   Transformative change in the system requires diminishing the sway of the current corporate business structure, or even replacing it, with organizations and governance structures that are compatible with the norms of an ideal inclusive social system. That involves democratization of wealth.

3. **Investment in Infrastructure**

   The third set of solutions should be the easiest to implement, but will require a sea-change in current political thinking. It involves disciplined use of public funds to invest in infrastructure initiatives that the private sector either cannot or will not invest in. Such initiatives include education, research, transportation systems, and the environment. Such investments will have the dual benefit of creating new jobs immediately but also in galvanizing productivity gains that will lead to more jobs and a higher standard of living in the longer run. Government can greatly amplify such an investment program through partnerships with private and non-profit organizations.

4. **Substantial Cause for Optimism**

   Businesses have the ability to play a significant role in all three of these solutions. However, other than the commitment of a few individuals and a handful of businesses, it is difficult to visualize that businesses collectively will step up and lead the way. Values, beliefs, and norms, including the imperative of maximizing shareholder value, will need to change first. Such change, if it occurs at all, is more likely to come from outside the established business community and through new business governance structures.

   Transformation of the dominant cultural and ideological hegemony is essential to put the United States social system back on a path that celebrates inclusiveness and limits natural extractive tendencies of elites. Such transformation will not come easily
because those who benefit from the current dominant cultural and ideological hegemony are invested deeply in its preservation and they command great power.

But saying that transformation will be difficult is not the same as saying that it will be impossible. There is substantial cause for optimism.

There is growing understanding that the dominant corporate business model based on shareholder wealth maximization and efficient markets theory has contributed to financial instability and has aggravated inequality and the drift away from an inclusive culture and economy. Alternative forms of business organizations whose missions extend well beyond shareholder wealth maximization and whose governance structures are more democratic have been evolving and gathering momentum. Such organizations include non-profit institutions focused on providing services, but a few, and their numbers are steadily increasing, are social enterprises that earn revenues from providing goods and services that cover their costs. Growth in social enterprises will accelerate once a network of support organizations evolves and as more effective means than currently exist are devised to enable investors to finance long-term and working capital needs of these enterprises. Again, there are nascent initiatives that give cause for optimism.

What is important is that what is already underway and which holds promise for reversing the decline in America’s social system be nurtured.

Educational institutions and business schools can do their part by acknowledging the limitations of shareholder wealth maximization and efficient markets theory and the flawed operation of free markets by incorporating in curriculum and teaching pedagogies a broader perspective of how people, institutions, markets, and governments work and interact. Specifically, the predominant focus on the shareholder owned corporation needs to be replaced by a focus on all forms of business organization; the emphasis on profit maximization needs to be replaced by a multiple-goal framework that maximizes societal welfare. And, by the way, an expanded multiple-goal framework can be entirely consistent with achievement of economic efficiency.

Professionalization of social movement and change organizations can be nurtured by support organizations, such as community and private foundations. Also, faith-based organizations, which are the keepers of deeply-held beliefs and values and have substantial and frequently diverse membership, can greatly amplify the effectiveness of social movements by building relationship networks and providing skills training. Modern communications technology and social media are increasing the ability of faith-based organizations to serve as connectors.
State legislatures and the U.S. Congress can assist in two ways. First, twelve states already have statutes creating benefit corporations which are not compelled to have a singular focus on shareholders. More states could adopt this alternative corporate governance approach. Second, state legislatures and Congress could make more public funds available for investment in education, research, job training, and infrastructure construction. Much of this could be done through public-private partnerships involving alternative forms of business governance. Governments could also help develop financing models and intermediary financial institutions that connect non-profit social enterprises with investors.

Throughout its history, America has been the land of opportunity for many. In recent decades opportunity increasingly has been constricted to fewer and fewer. This trend has been accompanied by growing income, wealth, and cultural inequality. But, these trends can be reversed. Initiatives are underway which hold great promise, but the road ahead is filled with many obstacles. It behooves us to do what we can to nurture these initiatives. Success will result in a strong, inclusive American social system that benefits all Americans.

IX. U.S. Economic Outlook – Real GDP Growth

Annualized third quarter real GDP growth in the “Advance Estimate” was a greater than expected 2.8 percent. However, details, shown in Table 1, were not as strong as the headline number implied.

Table 1
Composition of 2013 and 2012 Quarterly GDP Growth

<table>
<thead>
<tr>
<th></th>
<th>Third Quarter 2013 Advance Estimate</th>
<th>Third Quarter 2013 Preliminary Estimate</th>
<th>Third Quarter Final Estimate</th>
<th>Second Quarter 2013</th>
<th>First Quarter 2013</th>
<th>Fourth Quarter 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Consumption</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Investment</td>
<td>1.04%</td>
<td>1.24%</td>
<td>1.54%</td>
<td>1.13%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonresidential</td>
<td>.20%</td>
<td>.56%</td>
<td>-.57%</td>
<td>1.13%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residential</td>
<td>.43%</td>
<td>.40%</td>
<td>.34%</td>
<td>.50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>.83%</td>
<td>.41%</td>
<td>.93%</td>
<td>-2.00%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Exports</td>
<td>.31%</td>
<td>-.07%</td>
<td>-.28%</td>
<td>.68%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government</td>
<td>.04%</td>
<td>-.07%</td>
<td>-.82%</td>
<td>-1.31%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2.85%</td>
<td>2.47%</td>
<td>1.14%</td>
<td>0.13%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final Domestic Sales</td>
<td>2.02%</td>
<td>2.01%</td>
<td>.21%</td>
<td>2.13%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private GDP</td>
<td>1.98%</td>
<td>2.08%</td>
<td>1.03%</td>
<td>3.44%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Consumer spending growth was the weakest since the second quarter of 2011 and inventory growth was strong. Because inventories tend to be highly volatile, a more informative measure of the underlying strength of real GDP growth can be derived by subtracting inventory growth. This measure is referred to as “Final Domestic Sales.” With the exception of the second quarter, “Final Domestic Sales” has been growing close to 2.0 percent annualized.

Private GDP, which eliminates both inventories and government expenditures, has averaged about 2.0 percent annualized growth over the last several quarters.

1. **2013 Q3 GDP – Advance Estimate**

*Personal consumption expenditures*, which account for 68.0 percent of real GDP, contributed 1.04 percent to third quarter GDP growth. Consumer spending growth was disappointingly weak. This weakness was offset by an outsized gain in inventories. Data revisions may transfer some of the inventory buildup into higher consumer spending. If that does not occur, then the apparent growth in inventories will be confirmed and the excess will have to be worked off in the fourth quarter. That would depress real GDP growth in the fourth quarter. To achieve sustainable GDP growth of 2.5 percent requires consumer spending to grow at an annual rate of 1.70 percent, not 1.04 percent indicated by the third quarter “Advance Estimate” nor by the average of 1.24 percent over the last four quarters.

Consumer purchases of durables were strong, but expenditures on services was weak.

*Consumption remains extraordinarily weak and will remain so as long as unemployment remains high and wage growth is slow.*

*Nonresidential investment* growth added 0.20 percent to GDP growth, but was decidedly lackluster. Nonresidential investment accounts for 12.5 percent of GDP but contributed only 7.2 percent of GDP growth in the third quarter. Investment in structures was very strong but this offset by a decline in equipment and software spending.

To a substantial extent, a significant improvement in real GDP growth in coming quarters will depend upon strong acceleration in private investment spending including residential. Indeed, this is exactly what most forecasters expect to occur. This is a very important assumption because above trend growth in investment is critical to accelerating employment and income growth, which, in turn are necessary outcomes if consumer spending is to strengthen. Fundamentals, such as growth in corporate profits, are supportive of acceleration in investment spending. This is a bit of a “chicken and egg” problem because stronger consumer spending depends upon
increased investment activity to drive employment and income, but increased investment activity depends upon expectations that consumer demand will improve. Thus, improvements in business and consumer confidence are important. Once investment growth rises a virtuous and self-reinforcing circle will set in with employment, income and spending steadily accelerating.

On balance recent forecasts of rising investment spending have turned out to have been overly optimistic. For example, in early 2013 GS forecast the annual rate of growth in nonresidential investment during the first three quarters of 2013 would be 4.0 percent. The actual reported growth rate was 2.5 percent. GS’s forecast growth for all of 2013 early this year was 4.5 percent; it’s revised 2013 forecast, which includes actual results for the first three quarters of 2013, is 2.4 percent.

*If investment activity does not accelerate in coming quarters, then growth in consumer spending is unlikely to improve much and growth in GDP will continue to fall short of consensus expectations.*

**Residential investment** accounts for 3.2 percent of GDP but contributed 18.6 percent of GDP growth during the first three quarters of 2013.

However, the rise in mortgage rates since early summer has resulted in lackluster housing data. These data indicate that residential investment growth is likely to weaken somewhat in the fourth quarter.

This sector of the economy has been growing faster than the rest of the economy for the last eight quarters. If growth in residential investment continues at its recent pace, it will add 0.4 percent to real GDP growth in 2013. However, during the first three quarters of 2013 the realized annual growth rate was 14.1 percent which was a little slower than GS’s original forecast of 15.6 percent. Although there is great excitement about the very large increases in housing prices, other indicators of housing activity and investment have not met expectations.

*Evidence continues to emerge that the much expected recovery in housing will be more gradual and take longer than was expected early in the year. What this means is that residential investment growth is likely to continue to fall short of expectations and could shave as much as 0.2 percent off of real GDP growth forecasts over the next few quarters.*

**Government expenditures** comprise 18.5 percent of real GDP and contributed a tiny 0.04 percent to third quarter GDP growth. State and local government expenditures, which had been declining steadily since the Great Recession, accounted for 0.17 percent on top of 0.05 percent in the second quarter and clearly have become a positive contributor to GDP growth.
Federal expenditures continue to shrink and reduced third quarter real GDP by 0.13 percent. However, the full impact of federal sequestration was not visible in second or third quarter data. A large decline seems likely when fourth quarter data are reported and this could depress fourth quarter real GDP growth significantly.

**Government expenditures will probably rise modestly during 2014 because state and local spending is expanding and federal government spending cuts will be smaller. Q4/Q4 growth could be about 0.4 percent, but Y/Y growth would actually be slightly negative in a range of -0.2 to -0.4 percent compared to -2.2 percent in 2013.**

**Net exports** contributed 0.31 percent to third quarter growth. The estimate of net exports in the “Advance Estimate” is not very reliable because it is based upon only two months of actual data and an estimate for the third month. Imports rose sharply in September trade data, which means that the contribution of net exports to real GDP should be revised down in the “Preliminary Estimate” by about 0.2 percent, resulting in third quarter real GDP growth of 2.6 percent. While this GDP component tends to be extremely volatile from quarter to quarter, over longer time periods its contribution to real GDP growth is close to zero.

2. **Longer-Run Trend in Total Real GDP and Private GDP**

**Chart 5** compares total real GDP growth from 2008 through the third quarter of 2013 with a measure of private sector real GDP growth, which is derived by subtracting changes in inventories and government spending from total GDP. (Also, see the last line in Table 1.)

There are two takeaways from **Chart 5** – one good, and one troublesome. The good story is that private sector real GDP growth was about 3.5 percent in both 2011 and 2012. However, this measure decelerated to 2.5 percent in the first three quarters of 2013 compared to the first three quarters of 2012 and reflects the negative effects of higher personal and payroll taxes.

Although the recent decline in private GDP growth is troublesome, as the shock effect of higher taxes on personal income disappears in 2014 there is reason to be hopeful that real private GDP growth will return to the 3.5 percent level. It is this expectation along with acceleration in investment spending that underpins forecasters’ consensus that real GDP growth will accelerate to an above trend level in 2014.
3. GDP Forecasts for Q4

Although third quarter GDP growth exceeded expectations, estimates of fourth quarter GDP growth have been reduced. Part of lowered expectations is due to the impacts of the federal government shutdown in October. Table 2 shows GDP forecasts/projections for the fourth quarter of 2013 and for the full years 2013 through 2016.

B of A expects 1.7 percent growth in the fourth quarter, including a 0.5 percent reduction due to the federal government shutdown, which will be reversed in the first quarter of 2014. B of A’s forecast for 2013 GDP fourth-quarter-to-fourth-quarter (Q4/Q4) growth is 2.0 percent and 1.7 percent year over year (Y/Y).

GS’s forecast for the fourth quarter is marginally weaker than B of A’s forecast – 1.5 percent Q4, 2.0 percent Q4/Q4, and 1.6 percent Y/Y. GS’s current activity index (CAI) was 2.5 percent in September and October. Normally, real GDP approximates CAI, but the government shutdown and the overshoot in third quarter GDP led GS to reduce its fourth quarter growth estimate to 1.5 percent.

Fourth quarter forecasts prepared by Economy.com and the Blue Chip Average, which are shown in Table 2, appear to be too high based upon recent data reports.

Bill’s “Slow Growth” Q4/Q4 forecast is 1.9 percent and 1.6 percent Y/Y. Bill’s “Strong Growth” Q4/Q4 forecast is 2.2 percent, reflecting a strong finish to the year, which increasingly appears to be unlikely. Y/Y growth of 1.7 percent, however, would
be only slightly higher than in the “Slow Growth” scenario, which is the more likely outcome.

Table 2
Real GDP Growth Forecasts – B of A, GS, Global Insight, Economy.com, Blue Chip Average, Bill’s “Slow Growth”, Bill’s “Strong Growth” and FOMC High and Low Projections

<table>
<thead>
<tr>
<th></th>
<th>2013:4 Q4 to Q4</th>
<th>2013 Y/Y</th>
<th>2014 Y/Y</th>
<th>2015 Y/Y</th>
<th>2016 Y/Y</th>
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</thead>
<tbody>
<tr>
<td>B of A</td>
<td>1.7</td>
<td>2.0</td>
<td>1.7</td>
<td>2.7</td>
<td></td>
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<tr>
<td>GS</td>
<td>1.5</td>
<td>2.0</td>
<td>1.6</td>
<td>2.9</td>
<td>3.3</td>
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<tr>
<td>Global Insight</td>
<td>1.6</td>
<td>1.5</td>
<td></td>
<td>2.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Economy.com</td>
<td>2.1</td>
<td></td>
<td>1.6</td>
<td></td>
<td>3.1</td>
</tr>
<tr>
<td>Blue Chip Average</td>
<td>2.4</td>
<td></td>
<td>1.6</td>
<td>2.6</td>
<td>2.9</td>
</tr>
<tr>
<td>Bill’s Slow Growth</td>
<td>1.9</td>
<td></td>
<td>1.6</td>
<td>2.2</td>
<td>1.8</td>
</tr>
<tr>
<td>Bill’s Strong Growth</td>
<td>2.2</td>
<td></td>
<td>1.7</td>
<td>2.9</td>
<td>2.6</td>
</tr>
<tr>
<td>FOMC – High</td>
<td>2.3</td>
<td></td>
<td></td>
<td>3.1</td>
<td>3.5</td>
</tr>
<tr>
<td>FOMC – Low</td>
<td>2.0</td>
<td></td>
<td></td>
<td>2.9</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Table 3
FOMC Central Tendency Real GDP Growth Projections Compared to Actual Results – 2011 to 2015

<table>
<thead>
<tr>
<th>Meeting Date</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>Long Run</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 2011</td>
<td>3.70</td>
<td>3.95</td>
<td>4.00</td>
<td></td>
<td></td>
<td></td>
<td>2.7</td>
</tr>
<tr>
<td>Apr 2011</td>
<td>3.30</td>
<td>3.65</td>
<td>4.00</td>
<td></td>
<td></td>
<td></td>
<td>2.7</td>
</tr>
<tr>
<td>June 2011</td>
<td>2.75</td>
<td>3.10</td>
<td>3.75</td>
<td></td>
<td></td>
<td></td>
<td>2.7</td>
</tr>
<tr>
<td>Nov 2011</td>
<td>1.70</td>
<td>2.90</td>
<td>3.35</td>
<td>3.60</td>
<td></td>
<td></td>
<td>2.6</td>
</tr>
<tr>
<td>Jan 2012</td>
<td>2.55</td>
<td>3.10</td>
<td>3.55</td>
<td></td>
<td></td>
<td></td>
<td>2.6</td>
</tr>
<tr>
<td>Apr 2012</td>
<td>2.55</td>
<td>3.10</td>
<td>3.60</td>
<td></td>
<td></td>
<td></td>
<td>2.6</td>
</tr>
<tr>
<td>June 2012</td>
<td>2.05</td>
<td>2.85</td>
<td>3.40</td>
<td></td>
<td></td>
<td></td>
<td>2.6</td>
</tr>
<tr>
<td>Sep 2012</td>
<td>1.80</td>
<td>2.90</td>
<td>3.40</td>
<td>3.35</td>
<td></td>
<td></td>
<td>2.6</td>
</tr>
<tr>
<td>Dec 2012</td>
<td>1.80</td>
<td>2.60</td>
<td>3.40</td>
<td>3.35</td>
<td></td>
<td></td>
<td>2.6</td>
</tr>
<tr>
<td>Mar 2013</td>
<td></td>
<td>2.50</td>
<td>3.20</td>
<td>3.15</td>
<td></td>
<td></td>
<td>2.5</td>
</tr>
<tr>
<td>June 2013</td>
<td></td>
<td>2.30</td>
<td>2.90</td>
<td>3.05</td>
<td></td>
<td></td>
<td>2.5</td>
</tr>
<tr>
<td>Sep 2013</td>
<td></td>
<td>2.10</td>
<td>2.75</td>
<td>2.95</td>
<td>2.85</td>
<td></td>
<td>2.3</td>
</tr>
<tr>
<td>Actual Q4 to Q4</td>
<td>2.01</td>
<td>1.95</td>
<td>1.99*</td>
<td>3.42*</td>
<td>3.24*</td>
<td>3.03*</td>
<td></td>
</tr>
<tr>
<td>Actual Y/Y</td>
<td>1.85</td>
<td>2.78</td>
<td>1.65*</td>
<td>2.88*</td>
<td>3.35*</td>
<td>3.11*</td>
<td></td>
</tr>
<tr>
<td>Long Run Potential</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2.2-2.5#</td>
</tr>
</tbody>
</table>

*GS forecast
#Bill’s “Slow Growth” long-run potential = 2.12%; Bill’s “Strong Growth” long-run potential = 2.48%
As Table 3 shows, the FOMC’s real GDP growth projections have been persistently overly optimistic. Following a well-established pattern, the FOMC reduced its GDP projections for 2013, 2014 and 2015 and introduced a more modest projection range for 2016 at its September meeting. Nonetheless, the 2013 Q4/Q4 projection of 2.1 percent still appears to be too high.

4. GDP Forecasts for 2014 and Beyond

As Chart 6 and Table 2 show, most forecasters expect GDP growth to accelerate in 2014 and 2015 as negative fiscal drag diminishes and unemployment gradually declines.

Both B of A and GS forecast strong residential and business investment growth in 2014. GS’s Y/Y forecast is 8.1 percent and B of A’s is 8.6 percent. Since investment comprises 15.7 percent of real GDP, these forecasts imply that investment will contribute between 1.27 percent and 1.34 percent to real GDP growth in 2014. If consumer spending continues at its recent trend level of 1.24 percent, then real GDP should grow between 2.51 percent and 2.58 percent in 2014, provided that none of the other GDP components contribute anything. B of A forecasts Y/Y 2.72 percent GDP growth in 2014 and GS forecasts Y/Y 2.88 percent. In addition, the FOMC’s median central tendency projection of 2.75 percent (Table 3) is consistent, although the FOMC’s high-low projection range of 3.1 percent to 2.9 percent is slightly higher (Table 2).
Other real GDP growth forecasts for 2014 range from 2.5 to 3.1 percent. So, there appears to be substantial consensus.

For the last couple of years both B of A and GS’s forecasts have been at the pessimistic end of the spectrum and their conservatism has proved well founded. However, both are now are optimistic that growth will accelerate in 2014 and that the case for that call is strong. First, fiscal policy will not be highly contractionary as it has been over the last two years. Recovery in state and local spending will marginally exceed a small negative impulse from federal spending. Second, corporate profits are high and balance sheets are strong. This should stoke a sizable increase in investment spending. Note, however, that investment depends primarily on sales growth and shrinking capacity. Excess capacity remains high and sales growth has been very weak. Third, banks have rebuilt capital and are more willing to lend. Note, however, that willingness to extend credit requires demand for credit and so far demand has been slake and shows little sign of improving. Fourth, housing prices are rising, excess inventory has diminished considerably and household formation is accelerating. Residential investment should increase further from already relatively strong levels in 2013. Note, however, that access to mortgage credit remains constrained and higher home prices and interest rates is reducing affordability and will depress demand. Fifth, households have reduced debt burdens and rising prices for houses and financial assets is boosting wealth, which should increase consumer spending. Note, however, that the increase in wealth is almost entirely concentrated at the top of the distribution. Wealthy households have a much lower propensity to spend.

Bill’s “Strong Growth” scenario of Y/Y 2.91 percent growth in 2014 is consistent with the consensus, but Bill’s “Slow Growth” scenario projects only Y/Y 2.17 percent growth. About 57 percent of the difference in the 2014 GDP growth rates during 2014 is due to 8.8 percent private investment growth in Bill’s “Strong Growth” scenario, similar to B of A and GS, compared to 6.2 percent in Bill’s “Slow Growth” scenario.

While investment growth could accelerate sharply during 2014, the recent increase in mortgage rates, tighter financial conditions, and increased policy uncertainty, if sustained, pose significant downside risks.

Although FOMC projections have been systematically overly optimistic in the past, FOMC projections for 2014, 2015, and 2016 are similar to those of most forecasters.

Bill's real GDP forecasts for 2015 and 2016 are lower than other forecasts for both scenarios. The principal difference has to do with my view that investment growth and, therefore, productivity growth will remain low relative to historical levels. Slow
investment growth will hold back employment growth and retard income growth, which implies that consumer spending growth will remain mired near recent low levels. A detailed analysis of the case for low investment growth, low productivity growth, and below consensus real GDP growth was presented in the September Longbrake Letter.

5. Impact of Financial Conditions and Uncertainty on GDP Growth

Recent economic research conducted by GS has established a strong linkage between changes in financial conditions and subsequent changes in real GDP growth.\(^{38}\) Such a linkage has long been understood to exist, but GS has established and tested models which link conditions in financial markets to subsequent developments in the real economy. These models measure both the magnitude and timing of changes in financial conditions on real GDP growth. Financial conditions tightened in early summer during the taper tantrum but have moderated somewhat since then. The government shutdown did not adversely affect financial conditions, but the stronger than expected October employment report did. Overall, although financial conditions have fluctuated during the year, the impact on real GDP appears to be slightly negative, but to a very limited extent.

Policy uncertainty also impacts economic activity.\(^{39}\) Higher uncertainty leads to reduced risk appetite and delays in hiring and investment activity. Macroeconomic Advisers’ statistical analysis indicated that policy uncertainty reduced real GDP growth annually during 2010, 2011, 2012, and 2013 and raised the unemployment rate by 0.6 percent.

Various measures indicate that uncertainty declined considerably during the first half of 2013. Then, policy uncertainty exploded with the government shutdown and the threat not to raise the federal debt ceiling. The shutdown had limited direct effect on economic activity because most federal spending was not impacted. There were some indirect impacts, which both B of A and GS estimate will subtract 0.5 percent from fourth quarter real GDP. However, this impact is temporary and will reverse in the first quarter of 2014.


6. Recession Risks

There is little talk among forecasters currently about recession risk. The consensus is that recovery will continue and growth will accelerate in 2014.

Various models of recession risk indicate a very low probability – generally 10 percent or less. These models generally compare the current values of a plethora of economic variables with their values experienced during recession.

But, there is a contrary view, which is not based on traditional analysis or models.

Charles Gave of GKResearch, based upon comparing the cost of capital with the growth rate in corporate profits, believes that recession risks are rising. His research indicates that when the cost of capital, which he measures as the Baa corporate bond yield, exceeds the growth rate in corporate profits, as approximated by the real GDP growth rate, by 250 basis points, a recession follows. Gave’s theory was explained in the September Longbrake Letter. The Baa interest rate has been rising recently and is not far from the “recession frontier”. That frontier could be breached with a small incremental increase in the Baa bond yield, a small decline in inflation, or a combination of both.

X. Consumer Income and Spending

At the end of 2013 personal income, consumption expenditures, and saving were very volatile from month to month. This was caused by timing of income recognition in late 2012 to optimize tax burdens in anticipation of changes in fiscal policy. This led to a substantial increase in reported income in late 2012. Also, there appears to be some seasonality in the data in conjunction with timing of certain types of incentive compensation. The monthly data are not seasonally adjusted.


To provide a better sense of trends, Table 4 shows data which compare percentage changes for 2011 and 2012 and the 12-month periods ending in June, July, August, and September 2013. The 12-month periods simply take the difference between data for a month in 2012 and the same month in 2013. This method omits the anomalies in the year-end 2012 data. By showing four successive 12-month periods, one can get a sense of the underlying trend in various income categories. However, as a caution, the data will be revised many times in the future. So, what appears to be a trend now may be revised away later.

Growth in personal income and disposable income has been weaker so far in 2013 than it was in 2011. This difference is due entirely to the change in the payroll tax
rate, which is explained further below. Moreover, growth rates in both income measures are improving as 2013 progresses.

Table 4

Percentage Change in Nominal Personal Income and Its Disposition for 2011, 2012 and 12 Months Ending June, July, August, and September 2013

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Personal Income</td>
<td>4.63%</td>
<td>7.94%</td>
<td>3.16%</td>
<td>3.40%</td>
<td>3.78%</td>
<td>3.68%</td>
</tr>
<tr>
<td>Compensation</td>
<td>2.81%</td>
<td>6.80%</td>
<td>3.28%</td>
<td>3.17%</td>
<td>3.32%</td>
<td>2.87%</td>
</tr>
<tr>
<td>Proprietors’ Income</td>
<td>11.05%</td>
<td>5.07%</td>
<td>9.25%</td>
<td>10.39%</td>
<td>11.32%</td>
<td>12.25%</td>
</tr>
<tr>
<td>Rental Income</td>
<td>19.44%</td>
<td>7.28%</td>
<td>9.01%</td>
<td>9.36%</td>
<td>9.73%</td>
<td>10.30%</td>
</tr>
<tr>
<td>Asset Income</td>
<td>4.59%</td>
<td>18.90%</td>
<td>3.32%</td>
<td>4.66%</td>
<td>4.97%</td>
<td>6.13%</td>
</tr>
<tr>
<td>Government Transfers</td>
<td>0.17%</td>
<td>4.06%</td>
<td>3.58%</td>
<td>3.54%</td>
<td>4.49%</td>
<td>3.79%</td>
</tr>
<tr>
<td>Less: Personal Taxes</td>
<td>4.50%</td>
<td>9.47%</td>
<td>14.44%</td>
<td>13.65%</td>
<td>13.31%</td>
<td>12.45%</td>
</tr>
<tr>
<td>Disposable Income</td>
<td>3.63%</td>
<td>7.52%*</td>
<td>1.97%</td>
<td>2.39%</td>
<td>2.89%</td>
<td>2.91%</td>
</tr>
<tr>
<td>Less: Consumption</td>
<td>4.13%</td>
<td>3.73%</td>
<td>3.23%</td>
<td>3.01%</td>
<td>3.18%</td>
<td>2.73%</td>
</tr>
<tr>
<td>Personal Saving</td>
<td>-4.40%</td>
<td>74.14%</td>
<td>-19.26%</td>
<td>-9.18%</td>
<td>-2.55%</td>
<td>6.37%</td>
</tr>
<tr>
<td>Personal Saving Rate</td>
<td>5.67%</td>
<td>5.61%</td>
<td>5.05%</td>
<td>5.00%</td>
<td>4.97%</td>
<td>4.99%</td>
</tr>
<tr>
<td>Adj. Personal Income</td>
<td>3.77%</td>
<td>7.84%</td>
<td>4.04%</td>
<td>4.26%</td>
<td>4.63%</td>
<td>4.50%</td>
</tr>
</tbody>
</table>

*2.68%, if tax-avoidance timing impacts on “Compensation” and “Asset Income” are removed

#Growth rate in personal income, assuming no change in the payroll tax rate. The payroll tax rate was lowered by 2 percentage points in 2011 and restored to its original level in 2013.

However, growth in the primary component of personal income – wage and salary compensation – has not been improving and declined in September based on preliminary data. Thus, the improving trend in personal income growth is being driven entirely by rising growth rates for proprietor’s income, rental income, and asset income.

Growth in disposable income is being helped by all of these factors plus a slow deceleration in the rate of growth in personal taxes. Next January the rate of growth in personal taxes will drop sharply on the anniversary of both the increase in payroll taxes and the increase in tax rates on high income individuals.

Changes in the payroll tax rates in recent years have distorted the growth rate in personal income. That is because payroll taxes are netted from personal income.
That doesn't affect the growth rate in personal income if the payroll tax rate remains constant. However, Congress reduced the tax rate in 2011 and then returned it to its original rate in 2013. The bottom line in Table 4, labeled “Adj. Personal Income”, shows what the growth rate in personal income would have been in each period, if the payroll tax rate had never been changed. The adjusted data tell an interesting story. The reported growth rate in 2011 was 4.63 percent, but if the payroll tax rate had not been reduced it would have been 3.77 percent. When the payroll tax rate was returned to its former level in 2013, the adjusted personal income growth rate as of September would have been 4.50 percent rather than the actual rate of 3.68 percent, which was depressed by the increase in the payroll tax rate. Note that the difference in the two growth rates in 2011 and 2013 is virtually identical except with the opposite signs. When the effect of the changing payroll tax rate is removed it becomes clear that personal income growth has actually been strengthening. This should become apparent in the reported data beginning in January 2014 when there is no year-over-year change in the payroll tax rate.

All-in-all, the story told in Table 4 is an encouraging one.

2. Consumption

Although less definitive, data in Table 4 suggest that the growth rate in consumer spending is rising gradually. However, the 12-month growth rate of 2.73 percent remains substantially below 2011 and 2012 growth rates. If disposable income growth continues to rise, consumer spending growth should edge up, but probably to a lesser extent as consumers seek to restore savings balances. Whenever the growth rate in spending exceeds the growth rate in disposable income the gap is filled by drawdowns on savings.

Prospects for faster income growth in coming months will also improve with employment growth. While employment growth has been good, it has not been great. Moreover, a disproportionate amount of new jobs has been in the part-time and lower wage categories.

This implies that because consumption growth exceeds income growth, the risks remain tilted in the direction of slow recovery in consumption growth and this will continue to depress real GDP growth. Those risks can be offset either through stronger income growth or further declines in the saving rate. But, if consumers decide to increase their savings rate, spending growth would slow and set in motion adverse feedbacks that would depress economic activity. At the moment that risk appears to be remote because employment is improving slowly, wage rate growth is stable and may be on the cusp of improving, and credit for consumer goods, especially autos, is readily available.
3. **Disposable Income and Spending**

Chart 7 shows the nominal rate of growth in disposable income and consumer spending from 2004 to the present. Growth rates are calculated as changes in quarterly averages year over year. This method smooths timing anomalies to a certain extent, although major events such as occurred at the end of 2012 will still impact the observed trend for the following 12 months.

The annual rate of growth in disposable income began slowing in early 2011 and declined from 5.5 percent in April 2011 to 2.9 percent in September 2012, but then surged to 5.3 percent in December, followed by a resumption of the decline to 2.7 percent in September.

Chart 7 shows that growth in consumer spending, after peaking at 5.2 percent in September 2011, slowed to about 3.7 percent in July 2012, remained at that level until December 2012 and has since declined further to 3.0 percent in September 2013.

![Chart 7 – Nominal Disposable Income and Consumption Growth](chart.png)

Source: Bureau of Economic Analysis

4. **Outlook for Nominal Disposable Income and Spending**

As can be seen in Charts 8A and 8B, I expect nominal consumer disposable income growth will slow in coming months. This trend is not in doubt because of the 12-month moving average calculation method. However, recovery in income growth in my econometric analysis from recent levels does not occur until late 2014, which is at odds with other forecasts. A partial explanation involves my expectation that
inflation will remain near recent low levels. Since nominal wage growth tends to follow the trend in inflation in the long run, low inflation will retard improvement in wage growth. Thus, most of the increase in the growth rate in disposable income will have to come from improved employment growth. Of course, above trend employment growth will slowly close the employment gap and as the gap closes, eventually that will result in upward pressure on nominal wages.

Chart 8A shows my “Slow Growth” scenario forecast for growth in nominal consumer disposable income and consumption through 2016. The story Chart 8A tells is not a strong one. It is a story that is consistent with low labor force growth, paltry productivity gains, low inflation and meager increases in wages and salaries.

Chart 8B shows my “Strong Growth” scenario forecast for growth in nominal consumer disposable income and consumption through 2016. Higher rates of growth in employment and productivity in the “Strong Growth” scenario lead to stronger growth in nominal disposable income and consumption on an escalating basis during 2014-2016. Importantly, most of the effect of the faster growth in employment on inflation in this scenario is offset by the benefits of increased productivity. This means that the improvement in real income and consumption growth is nearly the same in the “Strong Growth” scenario as the improvement in nominal income and consumption growth.
Notice that in **Chart 8B** nominal disposal income growth exceeds nominal consumption growth in 2016. This means that the saving rate, based upon the assumptions underpinning the "**Strong Growth**" scenario, will increase in 2016.

**CHART 8B – Forecast Nominal Disposable Income and Consumption Growth – Strong Growth** (12-month rate of change)

5. **Real Consumer Spending Forecasts**

**CHART 9 – Real Consumer Spending Growth - Forecast**

(percentage change over four previous quarters)
Chart 9 shows forecasts for quarterly real consumer spending growth at an annualized rate. B of A and GS expect real consumer spending to rise 1.8 percent during 2013. Bill’s “Slow Growth” forecast indicates growth of about 1.9 percent in 2013.

My “Slow Growth” scenario forecasts much weaker real consumer spending growth in 2014, 2015, and 2016 than either GS or B of A. My “Strong Growth” forecast is higher than GS’s and B of A’s forecasts through late 2014 but underperforms GS’s forecast after that.

GS and B of A believe real consumer spending will accelerate during 2014, reaching 3.0 percent toward the end of the year. Y/Y growth is 2.44 percent for all of 2014 for GS and 2.19 percent for B of A. (B of A’s Y/Y 2013 forecast is lower than GS’s because B of A assumes a slower ramp up to a 3.0 percent growth rate by the end of 2014.) GS projects that real consumer spending growth will be 2.84 percent in 2015 and 2.60 percent in 2016. Table 5 shows forecast real consumer spending growth rates.

Table 5

Real Consumer Spending Growth Rate Y/Y Forecasts – B of A, GS, Bill’s “Slow Growth” and Bill’s “Strong Growth”

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</thead>
<tbody>
<tr>
<td>B of A</td>
<td>1.66</td>
<td>2.36</td>
<td>2.07</td>
<td>1.85</td>
<td>2.19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GS</td>
<td>1.66</td>
<td>2.36</td>
<td>2.07</td>
<td>1.80</td>
<td>2.44</td>
<td>2.84</td>
<td>2.60</td>
</tr>
<tr>
<td>Bill’s Slow Growth</td>
<td>1.66</td>
<td>2.36</td>
<td>2.07</td>
<td>1.87</td>
<td>1.76</td>
<td>1.89</td>
<td>2.10</td>
</tr>
<tr>
<td>Bill’s Strong Growth</td>
<td>1.66</td>
<td>2.36</td>
<td>2.07</td>
<td>1.93</td>
<td>2.31</td>
<td>2.56</td>
<td>2.48</td>
</tr>
</tbody>
</table>

GS’s forecast is derived from a model that includes consumer disposable income, consumer sentiment, financial and housing wealth, credit availability, and deviations in the actual consumer saving rate from the long-run target level as variables. Real spending growth in GS’s model accelerates in 2014 primarily because the drag of higher taxes in 2013 no longer impacts spending in 2014. It is not clear why this should happen as consumers tend to adjust their saving rate to maintain consumption when income growth varies rather than changing consumption. Notice that the real rate of growth in consumer spending only dropped about 25 basis points in 2013 in the face of increased taxes. Rising employment and a modest increase in wage rates to a range of 2.0 to 2.5 percent from 2.0 percent in 2013 results in a further modest increase in real spending.
Real consumer spending growth forecasts are lower in Bill’s “Slow Growth” and “Strong Growth” scenarios than GS’s forecasts. Bill’s forecasts are derived from a model that includes hours worked, productivity, financial and housing wealth, and the saving rate as variables. Hours worked and productivity replace GS’s consumer disposable income variable. The principal difference between GS’s and Bill’s models has to do with reduced growth in disposable income in Bill’s model because of slow growth in productivity. Higher productivity growth in Bill’s “Strong Growth” scenario narrows the shortfall and by 2016 the gap between GS’s forecast and Bill’s “Strong Growth” forecast is small.

6. Consumer Confidence

Measures of consumer confidence dropped sharply during the federal government shutdown. Weekly and daily surveys have recovered only partially since the shutdown ended.

However, the University of Michigan’s consumer sentiment index fell to 75.2 in October from 77.5 in September. Its recent peak was 85.1 in July. Expectations fell further in October to 63.9 and are now at the lowest level since January when the year-end fiscal follies unsettled consumers.

According to the Conference Board’s survey, overall consumer confidence fell to 71.2 in October from 80.2 in September; the present situation index fell from 73.5 to 70.7; the expectations index plummeted from 84.7 to 71.5. The differential between jobs easy to get minus jobs hard to get improved deteriorated from -22.2 in September to -24.5 in October. This is not indicative of a robust labor market.

ISI’s weekly company surveys have been relatively stable over the last five months. Its diffusion index peaked at 52.3 in the week of June 7th, edged down to 50.7 November 8th, then rose a tad to 51.0 in the week of November 15th. This is indicative of an economy that is neither gaining nor losing momentum.

Rasmussen conducts a daily consumer confidence poll. Prior to the government shutdown the Rasmussen index averaged 100 during September and was 103 on October 1st. By October 9th the index had fallen to 92. After the shutdown ended, the index edged back up to 96 and then stalled. However, to put matters into perspective, this index fell to the mid-60s during the federal debt crisis in July and August 2011.

*Overall, consumer confidence measures are not particularly robust, which reflects the on-going lethargic improvement in employment and incomes. Confidence measures do not suggest acceleration in economic activity but*
more of the same – an economy muddling along but showing gradual improvement.

XI. Employment

October’s payroll employment report was much stronger than expected, but the companion household survey was extraordinarily weak. Employment increased 204,000 according to the payroll survey but decreased 737,000 in the household survey. Furloughed federal government workers had no impact on the payroll survey, but depressed the household survey by 507,000. However, the employment decline in the household survey was 230,000 more than could be explained by the government shutdown. The participation rate fell precipitously to 62.85 percent from 63.19 percent in October. Rarely do these two employment surveys diverge to this great an extent. The consensus of opinion has been to accept the payroll report as indicative of an improving employment situation and to discount the flawed household survey. We will have to wait for the November household survey to see whether participation really fell so much. If it did, then the measured unemployment rate is likely to fall a lot in November.

Chart 10 shows growth trends in employment for the payroll and household surveys. Over the long-run the employment growth rate in the two surveys is generally the same. Over shorter periods of time, growth rates in the two surveys often diverge and that most definitely was the case in October. The household survey, from which the unemployment rate is calculated, is based on a monthly survey of 60,000 households and is never revised. The payroll survey is based on data from large employers and supplemented by extrapolation of recent trends for small employers. Payroll data are periodically updated based on detailed employment information from state-level employment statistics.

Chart 10 indicates that payroll employment is growing at an annual rate of approximately 1.7 percent and household employment is growing at an annual rate of 0.2 percent. Payroll growth is above the trend level of 0.7 to 0.8 percent, but household employment growth is below.

Yet, the labor market is still extremely weak. There are 1.5 million fewer people employed than in January 2008 according to October’s payroll data and 2.8 million fewer according to the household survey. The unemployment rate is 7.3 percent versus a pre-Great Recession low of 4.4 percent. But, if approximately 2.8 million discouraged workers are counted, the current unemployment rate would be in the vicinity of 9.1 percent. According to CBO, full employment will be reached when the unemployment rate falls to 5.5 percent, which would require 2.8 to 5.5 million
additional workers to be employed currently, depending upon how many discouraged workers actually exist.

**In summary, the good news is that the labor market is healing gradually. It appears to be weathering reasonably well intensely negative fiscal policy. The bad news is that the labor market remains unusually weak and has a long ways to go to return to robust health.**

1. **October Payroll Report**

Employers added 204,000 jobs in October, considerably above expectations of 125,000. Revisions to August and September added another 60,000 jobs, resulting in a total increase of 264,000. This brought the recent three-month average monthly increase to 202,000 compared to a 12-month average monthly growth of 186,000.

2. **October Household Jobs Report**

Over the first ten months of 2013 household employment growth has increased 26,000 monthly compared to the 201,000 monthly average in 2012.

Average weekly hours worked were 34.4 in October compared to the 12-month average of 34.47. The length of the workweek appears to be relatively stable. When the length of the workweek is stable it generally indicates an absence of pressure to retain workers as output slackens (declining length of the workweek – weak labor
market) and an absence of pressure to resort to overtime work (lengthening workweek – tight labor market).

3. **Temporary Discouraged Workers or Permanent Structural Unemployment?**

*Household employment remains 2.81 million below the pre-Great Recession peak. The question of whether people are too discouraged to look for work in today’s difficult labor market or whether they have chosen to leave the labor force permanently is of paramount importance to the conduct of monetary policy.*

![Chart 11 – Reported Unemployment Rate & Adjusted for Discouraged Workers](chart.png)

Unemployment rose to 7.3 percent of the labor force in October – the number of unemployed workers rose 17,000, while 720,000 left the labor force – those eligible and willing to work. The participation rate (those willing to work – includes both employed and unemployed workers – relative to those eligible to work) declined from 63.19 to 62.85 percent. The employment-to-population ratio, which measures the number of people who have jobs relative to the number eligible to work, fell from 58.62 to 58.27 percent.

In recent months the unemployment rate declined more than expected, partially because employment growth was a little stronger but also because more workers dropped out of the labor market than expected. **Chart 11** shows my alternative unemployment measure, which adjusts for discouraged workers. In October, my
alternative unemployment rate was 9.07 percent compared to BLS’s reported rate of 7.28 percent. This difference of 1.79 percent amounts to 2.8 million discouraged workers, or probably more accurately 2.3 million if furloughed federal employees are added back in.

What is important from a policy standpoint is whether workers who have stopped looking for jobs, and thus are no longer counted as unemployed, will reenter the job market when jobs become more plentiful or whether their exit is permanent because there are no jobs that fit their skills and there won’t be any in the future.

If discouraged workers re-enter the labor market as unemployment falls this will retard the speed with which the unemployment rate falls. Put differently, it might take longer for the unemployment rate to fall to the monetary policy guideline of 6.5 percent or to the full-employment rate of 5.5 percent. To date the preponderance of analysis supports the expectation that many discouraged workers will re-enter the labor force as labor market conditions improve but that reentry will not occur to a meaningful extent until the unemployment rate, as conventionally measured by BLS, falls well below 6.5 percent.

4. **Labor Force Participation and Employment-to-Population Ratios**

![Chart 12 - Labor Force Participation and Employment-to-Population Ratios](image)

While the focus of debate has been on discouraged workers and the labor force participation ratio, another important measure of the health of the labor market is the employment-to-population ratio which measures the percentage of people eligible to
work who have a job. Trends in both the labor-force-participation ratio and the employment-to-population ratio are shown in Chart 12. The denominator of both ratios is the same – total number of people eligible to work. The difference in the numerators of the two ratios is the number of unemployed workers – those who say they are looking for work.

When the Great Recession hit, the employment-to-population ratio plummeted from 62.9 percent in December 2007 to 58.2 percent in December 2009. What is troubling is that this ratio has not recovered to any significant extent. It was 58.3 percent in October 2013. What this means is that almost all the new jobs created since December 2009 have only been sufficient to accommodate new entrants into the labor force. Or putting this differently, few jobs lost during and just following the Great Recession have been recovered.

5. Labor Market Slack – Goldman Sachs Estimate

In a recent study GS concluded that current labor market slack equals about 4 percent of the labor force plus marginally attached workers. (See the September Longbrake Letter for an explanation of GS’s methodology.) GS believes the participation gap, which is approximately 2 percent of the labor force, will close much more slowly than the unemployment gap. GS also observed that since the late 1980s it has taken longer and longer for the participation gap to close once economic recovery is underway.

GS notes that there have been numerous studies and most indicate that between 50 and 75 percent of the decline in the participation rate is due to cyclical factors. GS concludes from the work of others and its own analysis that the total unemployment gap is about 4 percentage points, which is substantial.

For these reasons, GS argues that the FOMC’s 6.5 percent unemployment guideline should not be considered to be the threshold for raising the federal funds rate because considerable labor market slack would still prevail at this level.

Debate is likely to continue and the market will probably continue to find the intricacies of the debate confusing and so will tend to focus on the conventionally measured 6.5 percent unemployment rate guideline. It seems likely that the FOMC will need to clarify the 6.5 percent guideline more explicitly at a future meeting. FOMC members, including Chairman Bernanke, have observed that the FOMC considers many measures of labor market strength in addition to the unemployment rate. At the recent September FOMC meeting members discussed this issue. However, until the FOMC changes its policy statement market confusion is likely to continue.
6. Implications of Substantial Labor Market Slack

What does all of this mean? First and foremost, the collapse in the employment-to-population ratio (total number employed to total number eligible to work) means that the U.S. economy is a lot smaller than it could be based on historical employment patterns. That means there is less income per capita and less wealth. Americans are not as well off as they could be if a greater proportion of them were employed.

Second, the U.S. has no unemployment objectives other than “full employment”. As discussed above, we are not even sure how to measure what “full employment” is. We do not know how to determine whether someone is discouraged. We do not have any objective for what the employment-to-population ratio ought to be. Therefore, we have few specific policies aimed at creating jobs.

7. Unemployment Rate

Because the FOMC has linked monetary policy explicitly to the BLS’s U-3 unemployment rate, it is important to track this data point and various forecasts of when the unemployment rate is expected to reach 6.5 percent, which is the FOMC’s stated threshold for considering whether to raise the federal funds rate. And, as was discussed in the previous sections, the discouraged worker phenomenon and its impact on the participation rate is critically important in ascertaining just how meaningful the 6.5 percent unemployment rate guideline, as conventionally measured, is. The evidence, such as it is, suggests that the labor market will probably still be quite weak even when the U-3 6.5 percent rate is penetrated.

According to BLS, the number of unemployed workers is down 934,000 since 2013 began. The unemployment rate was 7.28 percent in October. Over the last year since October 2012 unemployment has decreased 1.0 million and the unemployment rate has decreased from 7.87 to 7.28 percent.

Chart 13 shows the FOMC’s high (red line and circles) and low (green line and circles) unemployment rate projections for 2013, 2014 and 2015. The FOMC’s projections imply that the first increase in the federal funds rate will occur in early 2015. That presumes, of course, that as soon as a 6.5 percent unemployment rate is reached the FOMC would start raising the federal funds rate. That, however, is far from certain, particularly since the labor market is considerably less strong than the current 7.3 percent unemployment rate implies.

I have included in Chart 13 unemployment rate forecasts for both my “Slow Growth” (yellow line and squares) and “Strong Growth” (purple line and squares) scenarios. The “Slow Growth” unemployment rate projection is slightly above the upper end of the FOMC’s range and the “Strong Growth” unemployment rate tracks
slightly above the lower end of the FOMC’s range. The unemployment rate forecast in the “Strong Growth” scenario reaches the 6.5 percent threshold in early-2015. However, the unemployment rate in the “Slow Growth” scenario does not reach 6.5 percent until mid-2015. Should the FOMC elect to reduce the guidance unemployment rate to 6.0 percent, Bill’s scenarios indicate that the first increase in the federal funds rate would occur between early 2016 and early 2017.

San Francisco Federal Reserve Economists in a recent study concluded that recovery in the labor market has more momentum than it did a year ago and expressed optimism that improvement in the labor market could accelerate in coming months.40

8. **Growth in Wages**

Growth in hourly wages is an important measure of labor market strength. An increasing rate of growth would be evidence of a strengthening labor market in which labor, particularly in scarcer job categories, is gaining more bargaining power. As can be seen in Chart 14, the rate of growth in hourly wages has fluctuated in a narrow band in the vicinity of 2.0 percent for the last four years. This is good news because the large output gap and high unemployment rate, which have persisted for several years, have not put further downward pressure on wage rate growth.

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However, Chart 14 shows a slight improvement in the 12-month moving average rate of growth from 1.85 percent in November 2012 to 2.07 percent in October 2013. The 12-month rate of change in weekly wages rose to 2.46 percent in October. The comparable measure for hourly wages was 2.16 percent in October. Chart 15 compares monthly hourly wage rates with a 12-month moving average. Although the recent upward trend seems to be gaining some traction, a similar acceleration in
early 2011 petered out and reversed. We can hope that the recent acceleration will be sustained. GS believes that it will, but the rate of increase will be subdued and will be in the 2.0 to 2.5 percent range at the end of 2014.

XII. Business Activity

Business activity is positive but is also indicative of a weak economy. Business investment continues to be lackluster.

1. Recent Developments

ISM Manufacturing Index rose to 56.2 in September from 55.7 in August. Values of this index above 50 mean that manufacturing activity is expanding. The production subcomponent held at a high level of 62.6, but the new orders subcomponent eased to 60.5, indicating slightly slower future growth in manufacturing activity. The employment subcomponent improved from 53.3 to 55.4. Manufacturing continues to be a bright spot in an otherwise lackluster economy.

ISM Services Index declined sharply in September to 54.4 from 58.6 in August. The business activity subcomponent fell to 55.1 from 62.2 and employment dropped to 52.7 from 57.0. However, new orders remained robust at 59.6. Services cover a much greater portion of the economy than manufacturing. Nevertheless, both indices exceed 50, indicating that economic activity is expanding.

Small business optimism (NFIB – National Federation of Independent Business) edged down slightly in September to 93.9 from 94.1 in August. This measure has improved in recent months but remains at an historically depressed level. Unfortunately, pessimism is building once again. The measure of businesses expecting the economy to improve fell to -10% from -2% (this measure subtracts pessimistic responses from positive responses).

Small businesses, and specifically newly started small businesses, historically have been the main drivers of job growth. Last month I reported that the NFIB measure of small business hiring plans jumped in August. Unfortunately, that was a reporting error and the measure declined from +10% in August to +9% in September. While any positive number signals favorable employment conditions, the current positive level remains well below the historical average that has prevailed during good economic times.

Rising hiring plans are only part of what needs to happen to spur faster employment growth. The other necessary ingredient is a substantial increase in new business formation, which has been severely depressed in recent years. Although established small businesses have not cited access to credit as a significant problem, it seems
probable that tight credit availability has constrained new business formation. In a recent study, GS concluded that as credit standards continue to ease small business employment growth will pick up in coming quarters but will still underperform historical norms.41

New businesses not only have been the primary source of employment growth historically, they have also been engines of productivity growth. Thus, a substantial increase in small business formation would have favorable effects on employment, income and productivity. While this may occur naturally as the economy continues to heal, there remains the question of whether structural changes in the economy and potential adverse consequences of macro fiscal and monetary policies will dampen new business formation.

**GSAI (Goldman Sachs Activity Index)** fell to 50.0 in September from 56.6 in August. As is the case for the ISM indices, a value above 50 connotes business expansion. Importantly, the employment index was a sub-50 reading of 44.5, which is not positive but is tempered by the fact that it has been below 50 for several months.

Before tax **corporate profits** rose to 12.53% of GDP in the second quarter just short of the all-time high of 12.60% recorded in the fourth quarter of 2011.

2. **Business Investment and Capital Stock**

Net growth in the real net private stock of capital, as measured by the 5-year average rate of growth, has fallen from about 3.5% in the mid-1950s to 1.2%. While business investment spending has recovered from the depths of the Great Recession, it has risen only to its long-term average which is considerably below levels experienced during vigorous economic expansions. The recent decline in nonfarm productivity growth is especially worrisome because it indicates the consequences of weak investment spending and the declining rate of growth in the real net private stock of capital.

XIII. **Monetary Policy, Inflation and Interest Rates**

Up until and immediately following the September 18th FOMC meeting monetary policy dominated the news. But more recently monetary policy debates have been eclipsed by the unfolding federal budget and debt ceiling battle.

Although Chairman Bernanke had consistently reiterated prior to the September 18th FOMC meeting that monetary policy decisions are data dependent, the market in its collective wisdom was convinced that the FOMC would announce the

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commencement of tapering of large scale asset purchases and that tapering would focus initially in a reduction of $10 to $15 billion per month in Treasury securities purchases while leaving mortgage backed securities purchases untouched.

Thus, the market was taken by surprise by the FOMC’s announcement that tapering would not begin. While my sense is that Chairman Bernanke probably believed that the market was not listening to what he was saying prior to the meeting, the market’s misinterpretation can be traced back to Bernanke’s own commentary after the June FOMC meeting where he openly talked about the possibility of tapering later in the year and gave the example of a 7.0% unemployment threshold and a mid-2014 date as a possible end to quantitative easing. These statements were always conditioned upon the performance of the economy and were based on achievement of the FOMC’s projections, particularly for real GDP growth. The market did not interpret the conditional statements in the way in which Chairman Bernanke intended. The upshot of all of this is that the FOMC’s communications have become more opaque and less transparent.

Recently released minutes of the September 18th FOMC meeting reveal a lively debate about the pros and cons of commencing tapering. The decision appears to have been a close call and more reflective of the views of voting members than all members including non-voting members. The decision also appears to have been influenced by the downside risks posed by the pending federal budget and debt ceiling issues, which have now been realized. The market now better appreciates the importance of the “data dependent” guidance, but the FOMC has provided little concrete guidance on what data measures are important to watch other than the flawed unemployment rate.

Thus, the FOMC and Chairman Bernanke have lost a degree of credibility. The tightening in financial conditions that occurred following Bernanke’s congressional testimony in May and the June FOMC meeting eased slightly on the day of the FOMC’s meeting but have changed little since then. For example, the 10-year Treasury rate was 2.69% on September 18th and 2.70% on October 11th.

1. **September FOMC Meeting**

The FOMC modified several parts of its statement to make it clearer that data will drive key monetary policy decisions.

**Assessment of the Economy.** In July the FOMC said: “Labor market conditions have shown further improvement in recent months....” The September statement modified this declarative statement: “Some indicators of labor market conditions have shown further improvement in recent months....” This modification clarified two things. First, it made it clear that the FOMC is watching many labor market
indicators, not just the unemployment rate. Second, it also made it clear that not all labor market indicators are improving. One such indicator is probably the participation rate. The FOMC added a sentence stating its concern over the recent tightening in financial conditions.

**Monetary Policy Statement.** Lest there be any doubt its data dependent focus for tapering asset purchases, the FOMC added the following language in the policy section of the FOMC statement: “In judging when to moderate the pace of asset purchases, the Committee will, at its coming meetings, assess whether incoming information continues to support the Committee’s expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective. Asset purchases are not on a present course, and the Committee’s decisions about their pace will remain contingent on the Committee’s economic outlook …“

2. **Updated FOMC Economic Projections**

Table 5

<table>
<thead>
<tr>
<th>Variable</th>
<th>2013 (Sep)</th>
<th>2013 (June)</th>
<th>2013 (Mar)</th>
<th>2013 (Dec)</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>Longer Run</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP %</td>
<td>2.0 - 2.3</td>
<td>2.9 - 3.1</td>
<td>3.0 - 3.5</td>
<td>2.5 - 3.3</td>
<td>2.2</td>
<td>2.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>2.3 - 2.6</td>
<td>3.0 - 3.5</td>
<td>2.9 - 3.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2.3 - 2.8</td>
<td>2.9 - 3.4</td>
<td>2.9 - 3.7</td>
<td>2.3 - 2.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemp. Rate %</td>
<td>7.1 - 7.3</td>
<td>6.4 - 6.8</td>
<td>5.9 - 6.2</td>
<td>5.4 - 5.9</td>
<td>5.2</td>
<td>5.8</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>7.2 - 7.3</td>
<td>6.5 - 6.8</td>
<td>5.8 - 6.2</td>
<td>5.2 - 6.0</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7.3 - 7.5</td>
<td>6.7 - 7.0</td>
<td>6.0 - 6.5</td>
<td>5.2 - 6.0</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>7.4 - 7.7</td>
<td>6.8 - 7.3</td>
<td>6.0 - 6.6</td>
<td>5.2 - 6.0</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>PCE Inflation %</td>
<td>1.1 - 1.2</td>
<td>1.3 - 1.8</td>
<td>1.6 - 2.0</td>
<td>1.7 - 2.0</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>0.8 - 1.2</td>
<td>1.4 - 2.0</td>
<td>1.6 - 2.0</td>
<td>2.0</td>
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<tr>
<td></td>
<td>1.3 - 1.7</td>
<td>1.5 - 2.0</td>
<td>1.7 - 2.0</td>
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<tr>
<td></td>
<td>1.3 - 2.0</td>
<td>1.5 - 2.0</td>
<td>1.7 - 2.0</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Core PCE %</td>
<td>1.2 - 1.3</td>
<td>1.5 - 1.7</td>
<td>1.7 - 2.0</td>
<td>1.9 - 2.0</td>
<td></td>
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<tr>
<td></td>
<td>1.2 - 1.3</td>
<td>1.5 - 1.8</td>
<td>1.7 - 2.0</td>
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<td></td>
<td>1.5 - 1.6</td>
<td>1.6 - 2.0</td>
<td>1.8 - 2.1</td>
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<td></td>
<td>1.6 - 1.9</td>
<td>1.6 - 2.0</td>
<td>1.8 - 2.0</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

September FOMC projections for key economic indicators are shown in Table 5 along with projections from previous FOMC meetings for comparative purposes.
FOMC members reduced real GDP growth projections for 2013 and 2014 at its September meeting. Note that the initial range for the real GDP growth projection for 2016 is lower than the range for 2015. That suggests that the FOMC expects the output gap to have closed considerably by 2016 and that growth will begin slowing towards its long-term expected range of 2.2% to 2.5%. The FOMC’s long-term expected potential rate of real GDP growth at full employment is exactly consistent with my 2.2% to 2.5% range (see Table 3 above).

There were only small changes in the projections for the unemployment rate, the PCE inflation rate and the core PCE inflation rate.

3. **Janet Yellen’s Optimal Control Approach to Monetary Policy**

Now that President Obama has nominated Janet Yellen to be Ben Bernanke’s successor as chairman of the Board of Governors of the Federal Reserve, which also means that she will chair the FOMC, it is important to understand her recent work on “optimal control”.

Optimal control involves keeping the federal funds rate lower for a longer period of time than traditional analytical approaches indicate would be the case. The consequence is two-fold. First, under an optimal control approach, the unemployment rate is expected to fall more quickly to the desired full-employment level because federal funds rate increases are deferred for a period of time. Second, inflation rises above the 2% target, but not by much. However, once the federal funds rate is normalized, the inflation rate quickly falls back to the target of 2%.

For optimal control to work as the Federal Reserve’s econometric model indicates, inflation expectations must remain well-anchored. There is reason to believe that this can be accomplished by crafting explicit guidance language as to what the FOMC intends to do and what measures its actions should be judged by. One implication of an optimal control policy is that the federal funds rate would need to be maintained at the zero boundary well after the unemployment rate falls below 6.5%. At the very least the FOMC would need to change its current 6.5% unemployment rate guidance. Also, the FOMC would need to make it clear that temporary increases in core PCE inflation above 2.0% would not lead to increases in the federal funds rate so long as the increase did not exceed a certain level, say 2.5%, and as long as the employment target had not yet been achieved. All of this would require careful crafting of guidance language to assure that market expectations and FOMC policy are in sync. The FOMC’s clumsy handling of tapering guidance is illustrative of just how important being transparent and establishing credibility is to the effectiveness of monetary policy.

4. **Prospects for PCE Inflation**
Core PCE inflation was 1.23% in August and total PCE inflation was 1.15% (see Chart 7). Compared to core PCE inflation, total PCE inflation is much more volatile and has been negative for short periods of time in the past. For that reason the FOMC prefers to focus policy deliberations on the core PCE inflation measure.

PCE inflation is well below the FOMC’s target level of 2% and is not much above the lows experienced briefly in mid-2009 and late-2010 when the FOMC was concerned about the threat of deflation. In its assessment section of its September policy statement, the FOMC acknowledged that “Apart from fluctuations due to changes in energy prices, inflation has been running below the Committee’s longer-run objective,” but added that “… longer-term inflation expectations have remained stable.” In the policy section of its statement, the FOMC in effect dismissed the threat of lower inflation or deflation: “The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, but it anticipates that inflation will move back toward its objective over the medium term.”

### Table 6

**Core PCE Inflation Forecasts – B of A, GS, Bill’s “Slow Growth”, Bill’s “Strong Growth” and FOMC High and Low and Total CPI Inflation Forecasts – Global Insight and Economy.com**

<table>
<thead>
<tr>
<th>Core CPE</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>B of A</td>
<td>1.2</td>
<td>1.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GS</td>
<td>1.2</td>
<td>1.5</td>
<td>1.6</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Bill’s Slow Growth</td>
<td>1.1</td>
<td>1.6</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Bill’s Strong Growth</td>
<td>1.1</td>
<td>1.6</td>
<td>1.3</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>FOMC – High</td>
<td>1.3</td>
<td>1.7</td>
<td>2.0</td>
<td>2.0</td>
<td></td>
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<tr>
<td>FOMC – Low</td>
<td>1.2</td>
<td>1.5</td>
<td>1.7</td>
<td>1.9</td>
<td></td>
</tr>
<tr>
<td>Total CPI</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Insight</td>
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<td>1.6</td>
<td>1.7</td>
<td>1.9</td>
<td></td>
</tr>
<tr>
<td>Economy.com</td>
<td>1.4</td>
<td>1.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Blue Chip Average</td>
<td>1.5</td>
<td>1.9</td>
<td>2.2</td>
<td>2.3</td>
<td>2.4</td>
</tr>
</tbody>
</table>

As can be seen in Table 6 (Chart 11 shows historical core PCE price index data and data from Table 6 in graphical form), most forecasts of the core PCE inflation index indicate that inflation should rebound from its August level of 1.2% to 1.4% to 1.5% in 2014, which is consistent with the lower bound of the FOMC’s central tendency range for 2014. However, in 2015 and 2016 my core inflation forecasts edge down a bit while other forecasts moves modestly higher but remain below 2%.
5. Federal Funds Rate

Chart 12 shows the FOMC’s central tendency range for high and low projections for the federal funds rate for 2013, 2014, 2015, and 2016. The purple line (circles) is the average of projections for the 19 FOMC members (7 governors and 12 presidents). The projections imply that the first increase in the federal funds rate will take place either very late in 2014 or in early 2015, although two do not expect the first increase to occur until 2016.

B of A expects the first federal funds rate increase to occur in the summer of 2015 and GS puts the timing in early 2016.

My “Slow Growth” and “Strong Growth” forecasts are shown by the yellow line (squares) and brown line (diamonds). My “Slow Growth” forecast indicates that the federal funds rate is not likely to increase until 2017 or later, which is inconsistent with FOMC guidance and my forecast that the unemployment rate should fall below 6.5% in early 2015. In my “Strong Growth” forecast, the first increase in the federal funds rate occurs in early 2017.
6. **10-Year Treasury Rate**

*Chart 13* shows forecasts for the 10-year Treasury rate for my “Slow Growth” (purple line and diamonds) and “Strong Growth” (red line and triangles) scenarios. GS’s forecast is also shown (yellow line and circles).

My forecasts have been revised to include the GSFCI (Goldman Sachs financial condition index) as a variable. For forecasting purposes GSFCI is assumed to remain constant at a neutral level. There is a very strong positive relationship between GSFCI and the level of the 10-year Treasury rate. When financial conditions tighten the 10-year rate rises, and when financial conditions get easier, the 10-year rate falls. This is intuitive, but the econometric analysis indicates that the historical relationship is an extremely strong one. But having said that, in the long-run the level of the 10-year rate depends on the employment growth rate, the employment gap, inflation, and productivity, and not on financial conditions. Financial conditions explain volatility in the 10-year rate around the expected long-term level.

As can be seen in *Chart 13*, my 10-year forecast remains near its current level until early 2014 and then falls about 50 basis points to approximately 2.25% by early 2015 and then rebounds to about 2.75% by the end of 2015. In contrast, GS’s forecast does not decline, but rises only about 50 basis points to 3.25% by the end of 2014 and rises a further 25 basis points to 3.50% by the end of 2015. The principal difference between my forecasts and GS’s by the end of 2015 is that I
forecast inflation to be about 25 basis points lower and the employment gap to be a little higher.

What is important to note is that none of these forecasts indicates a surge in the 10-year rate for a very long time. Indeed, the 10-year rate should fluctuate in a narrow range around 2.75% for at least the next year and move only modestly higher after that.

**CHART 13 – 10-Year Treasury Rate Forecasts**

XIV. **Fiscal Policy Developments**

Fiscal policy has taken its toll on the U.S. economy during 2013. In January there was the substantial increase in tax rates for high-income earners and higher payroll taxes for wage earners. This translated into a more than a 13% annual rate of growth in personal taxes. Then in March the sequester took effect and forced cuts in federal spending. Now the government shutdown is having three negative impacts. First, it is further depressing government spending, although most of these effects will reverse once the shutdown ends. Second, and more importantly, the shutdown is interrupting economic activity that depends on federal government approvals. And, third, the level of policy uncertainty has soared. Studies indicate that increases in policy uncertainty, when sustained for a period of time, reduce economic activity.

1. **Impact on Fourth Quarter Real GDP**

Assuming that the government shutdown ends by mid-October, GS expects fourth quarter GDP to be depressed by 0.3% primarily because of reduced pay to
furloughed government employees. Since Congress has passed a bill to pay back pay once the shutdown ends, this negative impact would completely reverse in the first quarter of 2014. However, if the shutdown extends for a longer period of time, the hit to real GDP would cumulate at the rate of about 0.15% per week. The negative consequences could be larger than this, if the shutdown extends, because of disruption of business activity dependent upon furloughed government workers. For example, because the National Zoo in Washington, DC is closed, private owned restaurants that cater to visitors have already seen their business activity implode.

Policy uncertainty rose in September and continues to rise. GS estimates that the September increase in policy uncertainty will reduce fourth quarter real GDP growth by 0.2%. Because uncertainty continues to build, the negative impact is likely to be greater and might spill over into the first quarter of 2014.

2. Impact on Financial Conditions

To date there has been a negligible effect on financial conditions. That could change quickly, however, it no action is taken by October 17th to deal with the federal debt ceiling.

3. Congressional Budget Office Long-Term Budget Outlook

In the midst of congressional warfare over the 2014 federal budget and the debt ceiling, CBO released an update of its long-term budget outlook which extends 75 years to 2088. The public debt to GDP ratio falls from its current level of 71% to about 68% by 2018, but then reverses course, rising to 71% in 2023, 93% in 2035, 129% in 2050 and 233% in 2085. Annual budget deficits rise from 2.1% of GDP in 2015 to 3.3% in 2023, to 6.1% in 2035, 7.8% in 2050 and 13.5% by 2085.

CBO notes that the outlook would be even worse if Congress eliminated sequestration or extended expiring tax preferences.

The problem is due entirely to the entitlement programs of Social Security, Medicare and Medicaid. With sequestration assumed, there is little left to squeeze out of discretionary spending. Of course, cutting entitlement expenditures is not the sole solution to the problem of exploding debt. Tax increases and tax reform could also be part of the solution.

To date, the so-called “Grand Bargain” which would involve a combination of entitlement and tax reform has gotten nowhere because Republicans have insisted on spending cuts including reductions in entitlement spending and refused to consider any substantive tax increases. Democrats have refused to consider any substantive changes to entitlement programs. Thus, stalemate has reigned.
In recent days Republicans in conjunction with a short-term increase in the debt ceiling and a resolution to fund the government have suggested a Senate-House conference to explore entitlement reforms, such as means testing Medicare and/or changing the inflation adjuster for social security, which could offset some distasteful sequestration spending cuts. However, although tax reform is likely to be included, the old issues of tax increases for Republicans and benefit cuts in entitlement programs for Democrats do not yet appear to be on the table.

While the situation calls for compromise and a “Grand Bargain” approach would a framework for compromise, the ideologues among Republicans and Democrats still appear to be unwilling to give any ground.

It will be interesting to see whether the proverbial “kick the can down the road” strategy emerges at the eleventh, or even at the twelfth hour, or whether Congress regains its sanity and sets in motion a sincere process to negotiate a “Grand Bargain”. I am not holding my breath on the latter outcome.
APPENDIX: Outlook – 2013 and Beyond – Summary and Highlights of Key Issues

Observations about the 2013 U.S. and global economic outlook and risks to the outlook were contained in the December Longbrake Letter and are included below without any changes. As events unfold during 2013, this will enable the reader to track my analytical prowess. Current assessments follow each item with the following identifiers: “+” tracking forecast; “-” not tracking forecast; “?” too soon to know.

1. U.S.

- **Q4 2012 real GDP** growth projections range from 0.5% to 1.8%; tracking estimates based on October and November data are consistent with growth of approximately 1.0%.
  - “Final Estimate” was +0.14%; much weaker than expected.

- **2013 real GDP** growth projections range from 1.5% to 3.0% but with a preponderance of the forecasts falling in the lower end of the range. The drag from tighter fiscal policy will offset gradual improvement in the household and business sectors. Growth should improve gradually over the course of the year. The balance of risks, particularly U.S. fiscal policy but also global growth, is weighted toward slower GDP growth.
  - First quarter GDP growth was a much weaker than expected 1.14%; the “final estimate” of second quarter growth was 2.47%; forecasts for all of 2013 Q4/Q4 are clustered between 1.8% and 2.0%; the Federal Reserve has reduced its projection but continues to be slightly more optimistic with an expected Q4/Q4 central tendency range of 2.0% to 2.3%.

- **Real GDP output gap** will remain very high and close little, if at all, during 2013.
  - The output gap was 5.80% in the first quarter a little higher than that level in the first quarter of 2012. (Because of substantial GDP data revisions, CBO will revise need to revise its estimates of the output gap; this has not occurred yet.)

- **Employment** should grow about 125,000 per month, somewhat more slowly than in 2012.
  - Data revisions indicate that employment grew 183,000 monthly in 2012; employment growth will be much stronger than 125,000 monthly in 2013; over the first eight months of 2013 payroll growth has averaged 180,000 per month. (Data for September have been delayed because of the federal government shutdown.)
• **Unemployment rate** should edge down to about 7.5%. A lower rate is not very likely unless more discouraged workers exit the labor force.
  ✓ -/+ The unemployment rate has edged down from 7.85% in December to 7.28% in August, but a substantial number of additional discouraged workers has dropped out of the labor force, bringing the labor force participation rate to 63.22%, the lowest level since August 1978. (Data for September have been delayed because of the federal government shutdown.)

• **Consumer disposable income and spending growth** will remain weak and could decline from 2012 growth rates if employment growth slows and wage and salary increases remain under pressure. Growth will be a lot weaker if Congress permits the payroll tax cut and extended unemployment benefits to expire.
  ✓ + Through August both disposable income (7.52% in 2012; 2.76% in 2013) and consumer spending growth (3.73% in 2012; 3.10% in 2013) have been much weaker than in 2012.

• **Household personal saving rate** will probably continue to decline gradually; however, it could rise if employment and income prospects worsen materially.
  ✓ + The saving rate rose at the end of 2012 primarily because of acceleration in capital gains realization to avoid higher tax rates in 2013, but the saving rate has been lower over the first eight months of 2013 (4.97% in 2013 vs. 5.61% for all of 2012).

• **Export and import** growth will probably continue to slow gradually due both to slower U.S. growth but also due to deepening recession in Europe.
  ✓ + The 12-month moving average measure of the trade deficit fell from 3.26% of GDP in December to 2.94% in July; both export and import growth rates are slowing, but import growth is slowing more rapidly. (Data for August have been delayed because of the federal government shutdown.)

• **Manufacturing** growth will be subdued reflecting recession in Europe and slower growth in the U.S. The order backlog index was a very low 41.0 in November.
  ✓ - Purchasing managers index moved from weak to strong expansion in July, August, and September.

• **Business investment** spending has slowed sharply because of fiscal cliff concerns and could rebound if there is a satisfactory resolution of major fiscal issues. Capital expenditure plans are cautious based both on concerns about growth and political uncertainty.
+ **Business investment growth was very strong in the fourth quarter, no growth occurred over the first six months of 2013, key fiscal issues remain unresolved and policy uncertainty is rising.**

- **Housing investment** is one of the brighter prospects. However, increased activity is likely to be concentrated in multi-family rather than single family. Housing starts are likely to increase 25% in 2013 to approximately one million. Housing prices should rise between 2% and 3%.
  - Starts averaged 906,500 over the first eight months of 2013, up 16.0% from 783,170 in 2012; multi-family starts account for 61.5% of the increase, but only 32.4% of total starts.
  - Housing prices are rising much, much faster, but the recent sharp rise in mortgage rates probably will slow the rate of increase or stop it altogether.

- **Monetary policy** – the Federal Reserve has committed to purchase $85 billion in securities every month including $40 billion in mortgage backed securities and $45 billion in U.S. Treasury securities.
  - Monthly purchases of $85 billion are likely to continue until December at which time the Federal Reserve may begin to taper the amount of monthly purchases; however, federal budget and debt ceiling issues could negatively impact economic activity and delay tapering beyond December.

- **Inflation** will remain below the Federal Reserve’s 2% objective at least through 2015. Concerns about increases in inflation in the long-term are misplaced.
  - August PCE inflation was 1.15% and core PCE inflation was 1.23%.

- **Federal Funds rate** is not likely to increase before mid-2015 and might not increase until late 2016 or early 2017.
  - Too early to tell, but sometime between early-2015 and early-2016 appears most likely at this time. My models suggest the federal funds rate will not be raised until late 2016 or sometime during 2017.

- **Fiscal policy** will be contractionary in 2013, but will become less of a factor in ensuing years.
  - Fiscal policy was more contractionary during the first half of 2013 than most had expected because Congress permitted automatic spending cuts to take effect as scheduled on March 1st; fiscal policy is now expected to subtract at least -2.0% from GDP in 2013 and -0.5% in 2014; the deficit is shrinking more rapidly than expected and could be only 3.8% to 3.9% for fiscal 2013.
• **Potential structural rate of real GDP growth** has declined significantly and could decline further in coming years unless a concerted public initiative is undertaken to invest in education, research and public infrastructure.
  √ **Too early to tell, but I remain firm in my conviction:** productivity fell at an annual rate of -1.7% in the first quarter (revised data) and rose 2.3% in the second quarter; however, productivity is up only 0.3% over the last year.

2. **Rest of the World**

• **European financial markets** are likely to remain relatively calm thanks to the activist role of the European Central Bank.
  √ **To date calm has prevailed but political uncertainty is rising in Italy and Spain:** the Cyprus bailout/bail-in was a significant negative development early in the year; however, that crisis passed without any lasting consequences.

• **European recession** is spreading to stronger countries and worsening in peripheral countries.
  √-/+ **Eurozone countries collectively eked out small positive GDP growth in the second quarter; however, peripheral countries and Italy are still in recession:** fundamental structural problems have not been addressed – Europe’s crisis is quiescent for the moment but far from over.

• **European banking union** will do little to solve deep-seated European and Eurozone structural problems.
  √ **The EU has issued a policy paper but no action is expected anytime soon.**
  √ **Germany has persuaded other EU members to eventually amend treaties to require a separation of the ECB’s monetary and supervisory responsibilities** – this move is seen by some as a delaying tactic on the part of Germany; insurance protocols have been recommended, but no action is likely any time soon.

• **European political dysfunction, populism and nationalism** will continue to worsen gradually.
  √ **Coalition governments in Italy and Greece appear increasingly fragile, but have managed to hold together:** Portugal, Ireland and Greece may need another bailout; nontraditional euro-skeptic parties are gaining strength in several European countries.

• **China** appears to have achieved a **soft landing** and economic activity will strengthen modestly.
+ Soft landing achieved early in the year, slowing occurred in mid-year, but recent data suggest growth on track to meet lower end of China’s target range.
+ Second quarter year-over-year growth was 7.5% at lower bound of expectations.

- China’s new leadership understands the need to design and implement economic reforms and avoid repeating a massive infrastructure spending program.
  + Accumulating evidence that transition toward a more consumer-focused economy has begun
  + Implementation of reforms not expected until late 2013 or early 2014 after the Third Plenum of the 18th Central Committee meets in November; however, there are indications that the current leadership is preparing the way for significant reforms.

- Global growth is likely to be fairly steady in 2013 but will depend on developments in the U.S. and Europe.
  + Global growth is trending at last year’s level of about 3%, slowed a bit in the second quarter, but appears to be firmer in the third quarter; slower growth in emerging countries has been offset by modestly better growth in developed economies.

3. Risks – stated in the negative, but each risk could go in a positive direction

- U.S. fiscal policy tightens more than expected.
  + Automatic spending cuts kicked in on March 1st and were not modified during fiscal year 2013.
  + The federal budget deficit is falling much more quickly than expected.
  + Another budget crisis is underway and has resulted in the shutdown of the federal government; the debt ceiling is also an issue causing policy uncertainty to escalate.

- Europe’s recession deepens more than expected; financial market turmoil reemerges; political instability and social unrest rises more than expected threatening survival of the Eurozone.
  - Economic data indicated in the first quarter that the recession was worse than expected, however Eurozone countries collectively posted a small positive increase in GDP during the second quarter; structural problems largely remain unaddressed; Eurozone countries are likely to muddle along for a while, but
strong recovery seems unlikely and resumption of crisis is still a distinct possibility.

- financial markets have remained calm and the Cyprus crisis passed without creating lasting damage; however, bank credit is difficult to obtain; new political instability and/or additional bailouts in 2014 could reignite a financial markets crisis.

- Political instability and social unrest are not yet serious, but trends are unfavorable in several countries – Italy, Greece, Spain, Cyprus, and Portugal.

- Chinese leaders have difficulty implementing economic reforms; growth slows more than expected.
  - Too early to tell about implementation of reforms, but early signs are encouraging that reforms will be announced late in the year.
  + Growth forecasts are being revised lower

- Global growth slows more than expected.
  - The trend in global growth is about the same as last year, but slightly slower growth occurred in the second quarter which is expected to be offset by slightly stronger growth in the third quarter; B of A revised its global growth forecast for 2013 from 3.2% to 3.0%.
  + Brazil's economy slowed earlier this year and India and Indonesia are experiencing capital outflows and slower growth.

- Severe and, of course, unexpected natural disaster occurs.
  - Nothing of any consequence has happened so far this year.

- Disruption of Middle East oil supply, stemming from hostile actions involving Iran and Israel, occurs.
  - Political turmoil in Egypt and civil war in Syria have not had any material impact on global oil prices.

- New North Korea attacks South Korea, which spooks global financial markets.
  - There was a lot of saber rattling early in 2013, but this potential crisis has disappeared from view.