Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter*

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I. For the Moment U.S. Recession Fears Have Receded But Risks of Significant Negative Shocks Remain Extraordinarily High

Growth is a little better than expected in the U.S. and anxieties have abated somewhat. But, the crisis in Europe has gone from bad to worse and perhaps much worse is in the offing.

In this month's letter I review developments in Europe and then examine how the U.S. economy is performing and policy interventions, including the pending report of the congressional Joint Committee on Deficit Reduction. Special topics this month include a discussion of trends in income inequality in the U.S. and the evolution of "Occupy Wall Street."

1. United States

Employment growth in the U.S., while not very strong, doesn't appear to be deteriorating. When August payroll employment was first reported the increase was exactly zero. At the time, coming hard on the heels of the political tragic-comedy of the debt ceiling debate and with plunging consumer confidence, there was much talk that recession was imminent. However, the quality of initially reported statistics is often poor and this turned out to be the case for the August payroll employment report. That figure has been revised upwards twice since then and now stands at a respectable, although not strong, increase of 104,000. September employment growth, which was

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originally reported as 103,000, has been revised up to 158,000. The first estimate for October was 80,000.

Over the last four months payroll employment has grown 479,000 or 120,000 per month. During the same period the unemployment rate has fallen from 9.2% to 9.0%.

There is solid evidence that economic activity has slowed a bit during 2011, but the data do not indicate that recession is imminent. Nonetheless, the economy is very fragile, which makes it vulnerable to negative shocks. Unfortunately, there is an abundance of possible negative shocks:

- The situation in Europe continues to deteriorate. Europe almost certainly is in recession and this will negatively impact the U.S. economy, although the extent of those impacts will unfold over time and will depend on the severity of Europe's recession.
- Europe's sovereign debt problem is far from contained and could spiral out of control at any moment with severe negative repercussions for global financial markets.
- U.S. fiscal policy will depress economic growth in 2012 unless Congress extends unemployment benefits and reduced payroll taxes. While most assume one or the other or both will be extended, the politics of the Super Committee charged with finding $1.2 to $1.5 trillion in budget deficit reductions over the next ten years may lead to a replay of the August debt ceiling fiasco.

2. Europe

While a disorderly default of Greek sovereign debt, which most believe would have triggered financial contagion in Europe, appears to have been avoided, the European financial system has already been severely damaged and confidence in other nations with high sovereign debt to GDP ratios, most particularly Italy, has plummeted. Financial stress weighs heavily on economic growth. In addition, austerity policies to increase taxes and decrease government spending with the objective of reducing the burden of debt also are depressing economic growth. Both phenomena have pushed the euro zone into recession. Unfortunately, recession will only serve to aggravate the European sovereign debt problem.

II. Latest Plan to Save the Euro Is Deeply Flawed

In the ***October Longbrake Letter*** I summarized why the European monetary union is at risk of failing. The underlying flaw is that there is currently no mechanism to enforce fiscal discipline among the 17 members. Correcting this flaw will take time and will require member nations to cede authority for fiscal management to some central body. The absence of fiscal discipline has resulted in enormous economic imbalances among the member countries which cannot be easily, painlessly or quickly resolved. Moreover, it is far from certain that members would be willing to give up sovereignty over their own fiscal affairs. But the monetary union needs to find a way to contain the evolving sovereign debt crisis to provide time for policymakers to address productively the issue of fiscal integration.

However, nationalism is a deeply embedded historical driver of European politics, which appears to be reasserting itself. This argues against success in pursuing fiscal integration. And, without fiscal integration, the monetary union eventually is likely to fail.

While markets initially rejoiced at the most recent crisis stabilization plan, upon examination it clearly falls into the category of "too little too late." The plan has three components: a third plan to bailout Greece (the first two have proved to be inadequate); recapitalization of European banks, and expansion of the European Financial Stability Facility (EFSF).

1. Greece Bailout — Iteration Three

Greece is the weak link. But it is the "canary in the coal mine" rather than the cause of all ills. It exploited the flaws in the monetary union to stimulate growth. It did nothing to manage labor costs or labor productivity with the consequence that its exports became increasingly uncompetitive. This deterioration in competitiveness was masked for a long time because it was easy to borrow — no one was worrying about the amount of sovereign debt Greece was accumulating. Also, Greece either intentionally lied about the size of its sovereign debt or it simply didn't really know because of poor data collection and reporting methods.

When the market finally focused on the severity of Greece's sovereign debt problem in the Spring of 2010, the textbook remedy was to force Greece to reduce the size of its annual budget deficit with the expectation that the public debt-to-GDP ratio would eventually fall. The flaw in the textbook solution was that the size of Greece's debt-to-GDP ratio had already reached a level at which austerity measures would depress GDP to such an extent that this would overwhelm any improvement in Greece's budget deficit. The net result would be that the public debt-to-GDP ratio would rise and the situation would worsen rather than improve. This is exactly what has happened.

In return for short-term loans to enable Greece to meet its immediate payment requirements, policymakers required Greece to raise taxes and cut government spending. It was expected that those actions would eventually reduce the numerator of the public debt-to-GDP ratio. It was assumed that after an initial modest decline in GDP, GDP growth would resume and the denominator of the ratio would rise. As a result, through growth and austerity Greece's finances would correct.

This policy remedy was not realistic, as many pointed out at the time. Austerity depressed economic growth much more than expected with the result that tax collections fell short of expectations. Thus the numerator rose while the denominator of the ratio fell and Greece's public debt-to-GDP ratio exploded. The response perversely has been to require even greater austerity, which simply will only serve to make matters worse.

The only way to resolve Greece's sovereign debt problem is to restructure its debt. Iteration 2, cobbled together in July 2011, grudgingly accepted the need for debt restructuring but designed a convoluted "voluntary" program which reduced the present value of Greek debt by 21%. The stated objective was to achieve a 90% participation rate. The reason for a voluntary program was to avoid a formal event of default and the triggering of loss payments pursuant to credit default swap agreements.

By late August two things became apparent. First, the International Monetary Fund (IMF) determined that Greece was not in compliance with the conditions of the bailout agreement and refused to agree to release of an 8 billion euro bailout payment. Greece needs this money by mid-December to meet debt payment obligations and avoid default. Second, the Greek economy continued to deteriorate and markets concluded that the 21% voluntary reduction in the present value of Greek debt was woefully inadequate.

These realities and escalating financial market turmoil in Europe led to a third iteration of Greece's bailout plan, which was announced on October 27, 2011. There were two components — additional austerity requirements and a substantial modification of the "voluntary" restructuring program.

Greek Debt Restructuring. Although still "voluntary," private investors would be asked to accept a 50% reduction in the value of their holdings of Greek sovereign debt. The stated intent would be to limit Greece's public debt-to-GDP ratio to no more than 120% by 2020. This target ratio, based on historical experience is dangerously high and probably is based on overly optimistic assumptions about Greek economic growth.

To reduce the loss for private investors (banks), European governments would provide 30 billion euros. Where this 30 billion in euros would come from and how it would be used is unclear. If the 30 billion were applied to current losses, it is estimated that the realized loss for investors would be closer to 35% than to 50%. In the days following the announcement Greek 10-year debt traded down to 30% of par value, implying a 70% loss. Thus, the market, at least for the moment, believes that yet a fourth bailout plan will eventually be required with even deeper loss rates.

Additional Greek Austerity Requirements. The latest Greek bailout plan requires additional austerity measures, including cutting government employment by 100,000, and approval by the Greek parliament. It also stipulates that implementation of the requirements will henceforth be directly monitored. However, as the Greek economy has imploded, predictably "austerity fatigue" has led to declining public support. GDP has fallen 12% over the last two years; -7.2% over the last four quarters and may fall an additional 10% over the next year. Unemployment continues to rise, reaching 17.2% in July. Further increases are likely.

Not surprisingly, polls indicate that 60% of the Greek public disapproved the new bailout plan and only 15% approved of the way in which the government was handling the crisis. Thus, while the Greek government headed by George Papandreou had had little difficulty in getting parliament to accept and implement the two previous bailout plans, austerity fatigue and defections within Papandreou's party cast doubt on his ability to push a third bailout plan through Parliament.

Failure of Greece to accept the revised bailout plan, as became clear in recent days, most likely would have led to Greek default and exit from the euro. This in turn would probably have triggered a run on European banks and resulted in enormous escalation in the sovereign debt crisis for Ireland and Portugal, but more importantly for Italy and perhaps Spain.

Political Resolution — Government of National Unity. After a week of dramatic political developments in Greece, the situation appears to have been resolved in a way that will lead to the Greek Parliament's acceptance of the third bailout plan and the additional austerity requirements. Thus, the potential for financial contagion has been allayed, or perhaps we will find with the passage of time that the more appropriate verb is "delayed." Of course, events in Italy could also spin out of control and trigger contagion.

Political resolution was achieved ultimately in Greece through a political agreement for George Papandreou to step down as prime minister and for a government of national unity to be formed to implement the requirements of the bailout plan. Eventually, after the passage of a few months, new elections are likely to be held.

For the time being, a government of national unity removes the threat of a disorderly Greek default and potentially disastrous consequences for European banks and members of the European monetary union.

As for Greece, this solution is perhaps the best of difficult and painful alternatives. Greece is faced with a deepening recession, rising unemployment and a declining standard of living which most likely will extend for several years. The alternative of exit from the euro probably would have far worse consequences for Greece, not to mention the rest of Europe, at least in the short run. A bankrupt Greece would have no access to credit now or for a long time to come. Thus bankruptcy would force immediate downsizing of the government, insolvency of most of the Greek banks and severe devaluation of the drachma — the replacement currency to the euro. The flow of trade would also be decimated. Thus, Greek politicians have made the right choice, but unfortunately, it is not one that assures a good long-term outcome.

While debt restructuring will resolve Greece's sovereign debt problems, it will do nothing to improve its competitiveness. In the absence of the ability to adjust exchange rates, Greece is faced with years of low economic growth and deflation until its cost of producing goods and services is once again competitive. Whether Greece socially and politically can endure such a lengthy adjustment process remains to be seen. A government of national unity has bought time, but ultimately its ability to hold to the economic course dictated by the troika of the IMF, the European Commission and the European Central Bank (ECB) will prevail only as long as the Greek public is willing to endure the consequences. What this portends is that Greece's willingness to stay the course and remain a member of the European Monetary Union remains very much in jeopardy.

Prospects. Eventually there will have to be a fourth Greek bailout for several reasons. The Greek economy will decline more than expected both because of the impacts of additional austerity measures but also because of declining exports courtesy of the emerging euro zone recession. Greece's budget deficit is about -9.5% of GDP so far in 2011 and it's hard to ascertain how the combination of additional austerity measures and recession will result in any substantive improvement. The 50% reduction in the value of Greek debt is not sufficient. An expected 120% public debt-to-GDP ratio by 2020 is optimistic and too high in any event to establish a healthy foundation for Greek GDP growth. It's difficult to believe that the Greek people will accept the status quo of rising unemployment and falling living standards indefinitely.

All of this implies either a fourth bailout plan will eventually become necessary or Greece will eventually have to exit the euro, hopefully in an orderly and managed way unlike the prospect of messy and disorderly default that appears to have been averted for the time being.

Greek turmoil has provided clarity to the markets that disorderly default of a country and exit from the euro zone is a credible possibility and it has exposed the inadequacies of the recent sovereign debt crisis containment plan. Until more credible bank recapitalization plans are structured and specific plans for assuring solvency of Italy and Spain are implemented, fear and volatility will continue to drive financial markets and the European sovereign debt crisis will worsen.

2. Ring-Fencing European Banks

Restructuring Greek sovereign debt means that many European banks would incur substantial financial losses. But financial market concern extends well beyond Greece to the possible eventual need to restructure Irish and Portuguese debt and even Italian and Spanish debt. It is recognized that the solvency of certain European banks at current capitalization levels is at risk, if the worst case unfolds.

In response to these concerns, the plan requires European banks to achieve a 9% core tier one capital ratio target within nine months based on sovereign debt exposures and capital positions as of June 30, 2011 and sovereign debt prices as of September 30, 2011. These parameters indicate a need to increase capital by 106.45 billion euros.

However, prior to the October 27, 2011 plan, the IMF on October 18, 2011 published its own estimate that European banks need to increase capitalization by 300 billion euros. This differential is dramatic and highlights the inadequacy of the European Union's plan.

Moreover, the plan is flawed in that it gives discretion to banks as to how to meet the capital ratio target and provides too much time. Bankers will be reluctant to raise new capital because it will dilute existing shareholders. Indeed with the market value of common equity averaging around 50% of book value, even if banks attempted to raise new equity capital in the public market they might not be able to do so. Thus, compliance more likely than not will be achieved by shrinking assets rather than raising capital. This will cause more stringent financial conditions which will have a strong pro-cyclical impact on the emerging euro zone recession. The lengthy time provided to achieve compliance means that European banks will be unprepared to absorb losses in the near term should the sovereign debt crisis escalate in coming weeks and months.

Unfortunately, financial markets already appreciate the insufficiency of the bank recapitalization plan and this is contributing to downward pressure on bank stock prices, rising costs of bank debt financing and indirectly to rising yields on the sovereign debt of more exposed countries such as Italy.

Private capital markets are not prepared to provide capital buffers to European banks in the quantity that is required to defuse insolvency concerns.

The alternative would be for bank recapitalization to be forced through a Tarp-like government intervention. It is not clear that this would be possible given the current governance structure of the European Union which requires approval of any action individually by each of the 17 monetary union member country parliaments. Governance is also a sticking point for beefing up the size of the European Financial Stability Facility (EFSF).

European banks play a considerably larger role in financing the European economy than the role of American banks in the U.S. economy. U.S. banks fund 31% of credit needs with the remainder provided by the stock market (51%) and the bond market (18%). In Europe, banks provide about 80% of credit needs. The significance of this difference should not be overlooked. The health of European banks is extremely critical to the well-being of the European economy. An appreciation of this fact coupled with inadequate recapitalization and further coupled with inadequate EFSF capacity (described below) strongly imply that the unfolding European recession will turn out to be worse than expected.

Another little understood risk is the substantial dependence of many eastern European economies on European Union banks. It seems inevitable that capital pressure on EU banks will have negative impacts on eastern European banks and economic activity.

3. Beefing Up the European Financial Stability Facility (EFSF)

Defusing the sovereign debt crisis requires assuring markets that debt restructuring and the potential of sovereign debt default will not spill over to other potentially vulnerable countries. As long as there is anxiety about the possibility of loss, creditors will be loathe to lend to high risk countries and to the extent they are willing to lend they will charge high interest-rate premiums to compensate for the perceived risk. For example, the EFSF recently cancelled a 3 billion euro 10-year bond issue to help finance Ireland's bailout program because of a lack of buyers.

Higher interest costs and government austerity measures in combination tend to increase the public-debt-to-GDP ratio on balance and in so doing exacerbate investor anxiety about potential losses. Providing additional liquidity, such as the ECB program to buy sovereign debt, is insufficient to allay such concerns. Because of the supply and demand effect, an ECB sovereign debt purchase program can reduce the rate of interest, at least temporarily. But, reducing interest rates on a sustained basis and eliminating bouts of illiquidity requires affirmatively shifting the risk of loss from investors to governments.

Recognizing the importance of reducing investor uncertainty, the plan announced on October 27, 2011, committed to increasing the size of the EFSF by leveraging the existing funds in the EFSF by 4 to 5 times or to about 1.4 trillion euros. The way it would work is that additional funds would be raised from private sources by creating a funding mechanism, such as a special purpose investment vehicle (SIV), which would be collateralized by a combination of sovereign debt and EFSF funds. In the event of a sovereign debt default or restructuring, the EFSF funds would absorb the first loss. Given the current size of the EFSF and existing bailout commitments to Ireland and Portugal, leveraging remaining EFSF funds by 4 to 5 times implies a credit guarantee of 20% to 25% of sovereign debt principal. Many analysts feel this will be insufficient and that the market will price in a 35% to 40% guarantee. If these analysts are correct, leverage potential, giving current EFSF funding, would decline.

If the objective is to assure markets that Italian and Spanish sovereign debt will not pose loss potential, a leveraged EFSF should be able to cover at least two years of funding needs for both countries. This objective is marginally met at an implied guarantee level of 20% to 25%, but is not met if markets price to a higher guarantee level. Thus, this part of the plan also seems inadequate. In the aftermath of the plan's announcement Italian debt yields rose to new highs and exceed 7% on November 8 in spite of continued ECB purchases.

There is another solution which no policymaker is willing to discuss publicly. That would be for the ECB to engage in an aggressive program of quantitative easing by purchasing sovereign debt. Of course, if the sovereign debt of any member country defaults the ECB would be saddled with the loss. However, the loss would end up being redistributed to member countries through recapitalization of the ECB.

Issuance of Eurobonds would also work, but would require all member countries' concurrence.

Summary. Thus, all three components of the latest European Union's sovereign debt crisis resolution plan are inadequate to defuse investor anxiety. The unfolding economic downturn will worsen outcomes in days to come. The crisis will continue and the European Union will be forced sooner or later to enhance the plan. What remains unclear and was highlighted by the recent Greek political drama is whether policymakers will be able to contain the centrifugal forces that are gradually tearing the European monetary union apart. The reemergence of nationalism argues that the monetary union in its current form is not likely to survive.

Italy now is squarely between the market's cross hairs.

Italy's prime minister Berlusconi has agreed to extensive reforms including changes in labor laws, reductions in unemployment benefits and increases in the retirement age. However, there is doubt that Berlusconi will be able to secure Italian parliament approval. Berlusconi has now agreed to resign once the reforms are adopted. As with all previous euro zone crises it seems likely that a solution will be patched together that stabilizes the situation in Italy. However, like all other solutions to date, it will probably not be sufficient and with the passage of time, crisis will re-erupt.

4. Implications for European Sovereign Debt Crisis for the U.S. Economy

MF Global's failure is the first notable U.S. casualty of the European sovereign debt crisis. While some might dismiss this event as a one-off occurrence stemming from the aggressiveness and hubris of Jon Corzine, the European sovereign debt crisis set the stage just as the housing price bubble set the stage for the U.S. financial crisis of 2007-09.

MF Global's sin was to make what it believed was a safe bet and failing to consider the market's perception of the inherent riskiness of that bet and how it might respond once the nature of the bet was disclosed. MF Global took a substantial position in deeply discounted short maturity European sovereign debt. The expectation was that the debt would mature at par and MF Global would reap a substantial profit. There was a big flaw in the strategy — a fatal one as I t turned out. In times of financial anxiety investors have a tendency to act first and then think. When MF Global disclosed its investment strategy, the knee-jerk reaction of many investors was to liquidate their holdings because of the perceived riskiness of substantial investments in European sovereign debt. This liquidity run set in motion a sequence of events that quickly added fuel to the fire, including a ratings downgrade of MF Global to junk status.

Is MF Global the canary in the coal mine? At the moment, it really does seem like a one-off event, but time will provide a more certain answer.

Many take comfort that the U.S. financial system's exposure to Europe is limited because of small direct holdings of European sovereign debt. This complacency is misplaced for several reasons.

First, U.S. money market mutual funds have been significant lenders to Europe. Approximately $1 trillion of their assets or about 40% of aggregate assets are invested in European debt, primarily European banks. As the European crisis has deepened U.S. money market mutual funds have begun to reduce their European investments. This withdrawal of funding forced the Federal Reserve to increase the amount and extend the maturity of dollar swap lines with the ECB. The Federal Reserve is not at risk because these dollar swap lines are over-collateralized with high grade collateral. However, the severe loss of liquidity in European banks has raised funding costs and reduced lending activity — factors that are contributing to the unfolding European recession.

Second, while U.S. banks have limited direct investments in European sovereign debt, their exposure to European banks is substantial. Their exposure to the French and German economies, for example, is approximately $1.2 trillion. U.S. banks have also underwritten a substantial amount of credit default swaps covering European sovereign debt. A tightening of financial conditions in Europe already has had spillover effects on U.S. debt spreads. In the event financial contagion engulfs European banks, risk aversion will escalate and financial conditions inevitably will tighten in the U.S. and weigh negatively on U.S. economic activity.

Third, recession in Europe will depress demand for U.S. exports.

Fourth, a euro crisis will increase the value of the dollar relative to the euro. This would make U.S. exports less price competitive both in Europe and in other nations whose currencies are not linked to the dollar.

Treasury Secretary Geithner certainly understands U.S. economic vulnerability to a European financial crisis. ***"Europe is so large and so***

closely integrated with the U.S. and world economies that a severe crisis in Europe could cause significant damage by undermining confidence and weakening demand."

Translated, this means that a severe European financial crisis would very probably lead to recession in the U.S. Barclays Capital has developed a U.S. recession forecast based on the Federal Reserve's 2010 assumptions utilized in its "Comprehensive Capital Analysis and Review." Salient findings include GDP declines in each quarter of 2012, with the deepest decline of -6% at an annual rate in the second quarter; an increase in unemployment to over 12%; the emergence of price deflation, just to summarize a few of the key outputs. This certainly seems extreme to say the least but it does accentuate the importance of containing or rather it might be more accurate to say, "managing," the unfolding euro zone sovereign debt crisis.

III. U.S. Economy is Struggling

As I mentioned in the introduction to this letter, employment is holding up better than expected. Other recent economic data have been a little stronger than expected including the "Advance Estimate" of third quarter GDP.

1. Advance Estimate of 2011 Q3 GDP

The "Advance Estimate" of third quarter GDP growth was 2.46%. **Table 1** provides details. Consumer spending was surprisingly strong given dismal consumer confidence and stagnant disposable income growth during the third quarter. Thus, while personal consumption's contribution to real GDP growth was in line with its potential of 1.7% (70% of 2.4% potential GDP growth rate), consumers had to reduce their saving rate from 5.1% in the second quarter to 4.1% in the third quarter to accomplish this outcome. Put somewhat differently, disposable income (at an annual amount) rose $17.0 billion in the third quarter; personal consumption increased $127.4 billion and personal saving fell $116.2 billion (the small differential is tied to non-consumption personal outlays).

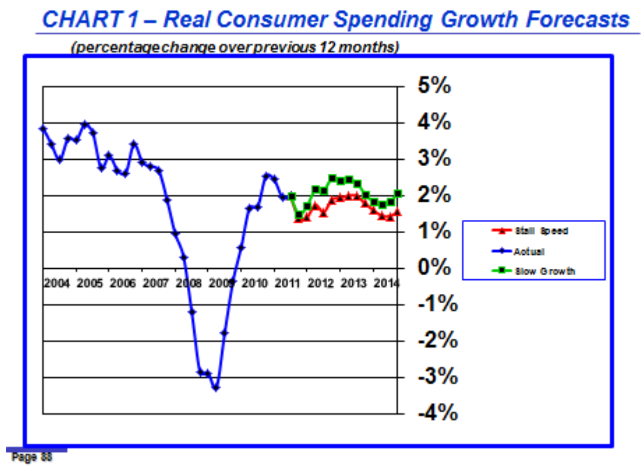
This is not sustainable. Either disposable income must grow faster or personal consumption growth will slow in coming quarters. Slow employment growth and declining wage growth do not bode well for acceleration in disposable income growth.

Table 1
2011 Third Quarter GDP Estimates

	Advance Estimate	Second Estimate	Final Estimate
Personal Consumption	1.72%		
Private Investment			
Nonresidential	1.54%		
Residential	.05%		
Inventories	-1.08%		
Net Exports	.22%		
Government	.00%		
Total	**2.46%**		

Prospects for Consumer Spending. Consumer spending grew 2.0% from the third quarter of 2010 to the third quarter of 2011, a slight improvement from 1.9% year over year growth in the second quarter.

Chart 1 shows forecasts for consumer spending growth for my "Slow Growth" and "Stall Speed" scenarios. In the "Slow Growth" scenario employment grows at about the same rate going forward as has occurred during the first ten months of 2011 but gradually rises during 2013 and 2014, with the unemployment rate falling to 8.1% by the end of 2014. In the "Stall Speed" scenario, employment grows only fast enough to maintain an unemployment rate of 9.1% through 2014. Both scenarios result in slower year over year spending growth over the next two quarters with annual growth bottoming in the "Slow Growth" scenario at 1.5% in the fourth quarter of 2011 and bottoming in the "Stall Speed" scenario at 1.4% in the first quarter of 2012. Thereafter spending growth improves to about 2.0% to 2.5%. Spending growth would be somewhat stronger if consumers continue to reduce their saving rate.



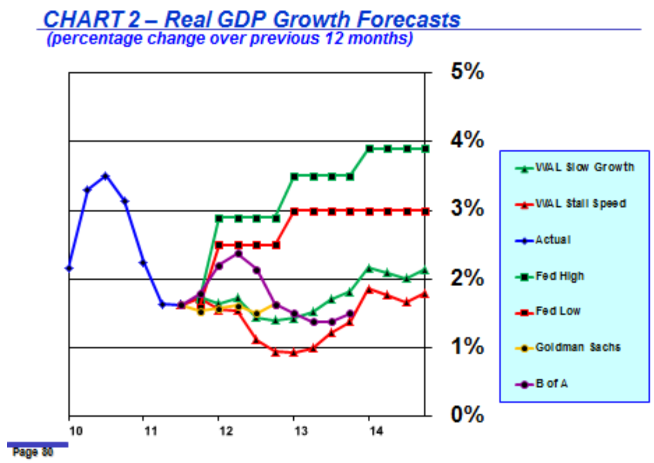
Spending growth does not return to the 3% plus level experienced in the early 2000's.This lower growth trend is caused both by slower employment growth and by significantly lower productivity gains.

Inventories. Another key number in the "Advance Estimate" is the sizable decline in inventories. This appears to be related to the increase in consumer spending . . . possibly related to catch up in auto purchases. In any event, inventories seem likely to rebound and provide some upside potential for GDP growth in the fourth quarter, which could offset a pullback in consumer spending.

Non-residential Investment. Non-residential investment over the last two quarters has been remarkably strong. This has been true for the two components — structures and equipment. Equipment was especially strong in the third quarter accounting for 78% of the increase. This strength seems surprising in light of the slow pace of economic recovery. Investment usually leads a recovery but its sustainability depends on accelerating demand, a phenomenon largely absent in this recovery. Goldman Sachs thinks strength in equipment investment is an "outlier" event, which means to me the recent momentum is unlikely to be sustained unless demand picks up soon. Transitory factors, such as bonus depreciation, may be at work.

2. GDP Forecasts

Chart 2 shows several GDP forecasts — Federal Reserve's high and low;



Bank of American/Merrill Lynch (BofA); Goldman Sachs (GS) and my "Slow Growth" and "Stall Speed" scenarios.

Both GS and B of A forecasts are quite pessimistic. GDP growth averages close to 1.6% for the next five to nine quarters. Both forecasts anticipate no improvement in the unemployment rate.

While the Federal Reserve has reduced its forecast growth rates considerably, they remain quite optimistic by comparison. The Fed's new forecast range is 2.5% — 2.9% in 2012 compared to 3.3% to 3.7% previously and 3.0% to 3.5% in 2013 compared to 3.5% to 4.2% previously. The Fed is also decidedly more optimistic about employment. It expects the unemployment rate to range between 8.5% and 8.7% by the end of 2012 and between 7.8% and 8.2% by the end of 2013.

Both my "Slow Growth" and "Stall Speed" scenarios project slightly lower GDP growth in 2012 than the GS and B of A forecasts. The "Slow Growth" forecast is slightly better than the B of A forecast in 2013.

Risks to forecasts of GDP growth are decidedly to the downside. The situation in Europe is worrisome. In the U.S. the risk is that Congress will let fiscal policy tighten too much in 2012. While neither of these risks may materialize, it's hard to discern anything that could result in significant improvement. We continue to live in the Reinhart-Rogoff world of an extended period of slow growth and high unemployment in the aftermath of an enormous financial crisis.

IV. Monetary Policy

1. October Federal Open Market Committee Meeting

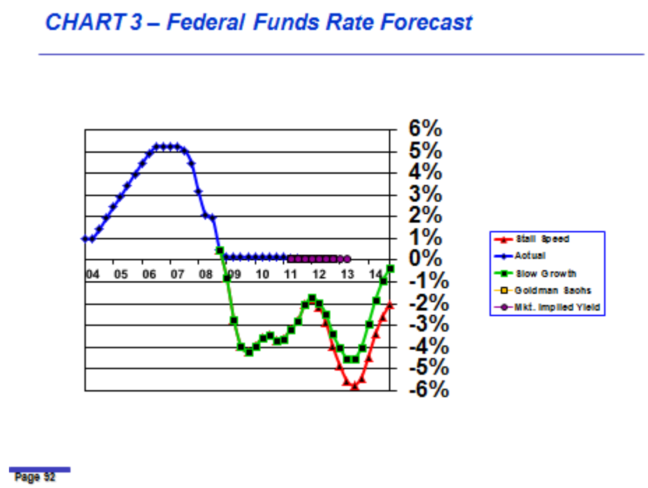
Aside from noting that economic growth has "strengthened somewhat" and consumer spending is increasing at "a somewhat faster pace," the Federal Open Market Committee (FOMC) took no policy actions at its October meeting. These minor statement adjustments were backward looking and merely stated what the recent data show. The major event was the revision of Federal Reserve forecasts. GDP forecasts were reduced substantially, but remain at the optimistic end of the range. Unemployment is now expected to decline much more slowly. There was virtually no change in the total and core inflation forecasts.

Forecasts were added for 2014 for the first time. Although the Federal Reserve's stated policy is not to increase the Federal Funds rate through mid-2013, the new end of 2014 unemployment forecast range of 6.8% to 7.7% implies that the Fed probably won't raise the federal funds rate until sometime in 2015. That time schedule is consistent with my "Slow Growth" Federal Funds rate forecast — see **Chart 3**.

Importantly, the FOMC did not change the statement that ". . . there are significant downside risks to the economic outlook." Chairman Bernanke, in the press conference following the FOMC meeting, said that the biggest downside risk is what is happening in Europe.

It seems likely that the FOMC will maintain its current policy stance unless the U.S. economic outlook darkens appreciably and especially if unemployment begins rising or inflation drops sharply.

However, it is also clear that the FOMC is prepared to ease policy further should the need arise. Further policy easing would most likely involve a



third round of quantitative easing, but with a focus on purchasing mortgage backed securities rather than Treasuries. The FOMC appears to be concerned that the increase in the yield spread of mortgage backed securities relative to Treasuries may be diluting the effectiveness of monetary policy.

2. Effectiveness of Monetary Policy Appears To Be Limited In An Economy Recovering from a Severe Financial Crisis.

The U.S. economy is caught in a classic liquidity trap. A liquidity trap exists when monetary policy easing has limited to no impact in stimulating expansion in aggregate demand. It is characterized by zero short-term interest rates, low inflation rates or even deflation, limited attractive investment opportunities and a broken credit creation mechanism.

When a liquidity trap exists the ability of monetary policy to have a material favorable effect on economic activity is quite limited. Monetary policy works primarily through governing the price and availability of money and credit, which facilitate the financing of economic activity. The Fed can reduce interest rates by buying securities which increases the amount of liquidity available to consumers and businesses. In the case of consumers, lower rates make it cheaper and easier to access credit to buy things like cars and houses. For businesses, lower interest rates reduce the cost of capital hurdle rate and make investment more attractive.

When the credit system is functioning normally monetary policy is effective, but after fairly long lag times. Since the onset of the financial crisis in 2007, the credit system has not functioned normally. This has been particularly evident for home mortgages and small business borrowing. In both sectors underwriting standards remain more restrictive than in normal times and this limits access to credit for all but the most creditworthy and raises the cost of credit even for those who are qualified. In the case of home mortgages no private market exists as Fannie, Freddie and the Federal Housing Administration now account for 97% of all new mortgage loan originations. Thus, lowering rates in an impaired credit market is likely to be of very limited help.

Once in the liquidity trap, no matter how much liquidity the Fed provides, rates cannot go any lower than zero. Of course, long-term rates are still positive, which means that the Fed can drive down longer-term rates through monetary policy actions. This is what quantitative easing and "Operation Twist" are intended to accomplish. Yet, the impact will still be limited when the credit system is impaired.

Quantitative easing has another impact and one about which there is considerable debate whether that impact is helpful or harmful. By lowering longer-term interest rates, quantitative easing raises the value of long-dated assets, particularly stock prices. When Federal Reserve Chairman Bernanke announced the Fed's large scale asset purchase program in December 2010, raising the prices of risk assets was an explicitly stated objective. To the extent that stock prices rise, and they most certainly did rise until the recent market reversal, it creates additional financial wealth. We know that consumer spending is correlated with stock prices and economic theory posits that a certain portion of wealth will filter into current spending patterns provided that the increase in wealth is considered to be permanent.

But the dark side of rising stock prices is that it unleashes animal spirits, that is, speculation. And, speculation in this modern era of commodity trading and exchange traded funds, spreads far beyond equities. Earlier this year we experienced a conjunction of speculation with an insatiable demand for commodities by emerging economies. Unfortunately, the two phenomena reinforced each other and drove prices, particularly the price of oil, up sharply. American consumers are very sensitive to the price of gasoline and the sharp rise in its price depressed sentiment and crushed spending, as the second quarter GDP report confirmed.

3. Alternative Unconventional Monetary Policy Tools

We are in unusual times. Traditional policy tools, such as the federal funds rate, are totally ineffective. This has forced a search for alternative policy tools that might have some favorable effect on economic activity. To a certain extent this has been a trial and error process. And, as discussed in the previous section, the deployment of unconventional policy tools may have consequences as well as benefits. Theoretical analysis is helpful to a point, but there is no substitute for actual experience. Presumably, we will be a lot wiser in a few years after there has been time to analyze policies and outcomes and construct improved theoretical models.

In the meantime, the academic and policy communities are engaged a fundamental debate about various aspects of monetary policy. One thrust of the debate has to do with the appropriate focus of monetary tools. The statutory mandate is clear. The Federal Open Market Committee is charged with two objectives — maximizing employment and maintaining price stability. But the statute provides no guidance about the timeframe over which these two objectives are to be attained. Thus, the FOMC can choose to administer policy with a short-term focus or a long-term focus.

Generally, it is fair to assert that management of monetary policy primarily through frequent adjustments to the federal funds rate based on a Taylor Rule is short-run focused. Absent from serious consideration have been considerations of longer run economic trends such as trends in productivity, demographic changes, building trade imbalances, rapid growth in the use of debt and its cousin — speculative bubbles. Fed chairman Alan Greenspan even went so far as to assert that monetary policy had no place in influencing asset price bubbles.

Critics of the traditional short-run monetary policy focus suggest that policy may actually have served to increase the amplitude of short-run cycles rather than diminish them as intended. For example, when unemployment was relatively high and inflation, as conventionally measured, was low and stable, as both were during the early 2000's, the FOMC, following a Taylor rule, kept interest rates low. But that is exactly when the housing bubble began to build in earnest and low interest rates aided and abetted that process.

Chairman Bernanke has now acknowledged that monetary policy should play a role when asset price bubbles emerge. However, as yet there is no agreed upon analytical framework or defined policy responses.

Nominal GDP Level Target. Targeting the nominal level of GDP is one suggested means of moving monetary policy to a longer-term focus. It differs from the current focus on the inflation rate by targeting instead the level of nominal GDP. This shifts the focus from the real rate of growth in GDP to the nominal rate of growth. And, it puts greater weight on output and employment levels and less weight on short-term fluctuations in the inflation rate.

Goldman Sachs has constructed a simple model of the economy to test the efficacy of a nominal GDP level target. Using the model, GS finds that a nominal GDP level target improves economic performance "substantially" over time compared to the traditional approach of targeting the inflation rate. But, GS hastens to add that improved performance depends critically upon the Federal Reserve's commitment to stick with it and not change policy at the first sign of a rising inflation rate. And, of course, the market must believe that a short-term burst in inflation will not translate in a sustained higher rate of inflation. If the Federal Reserve's credibility about maintaining long-run price stability is called into question, inflation expectations will rise and a self-fulfilling process will take hold. The theory is sound, however, as long as the market believes that a nominal GDP level target embeds an acceptable long-term inflation rate. Then, inflation expectations will not change much during temporary periods of higher inflation.[1]

Chairman Bernanke during the press conference following the recent FOMC meeting reacted coolly to this proposal. He observed that it is an interesting idea, but not one that is likely to be implemented any time soon.

Forecasting the Federal Funds Rate. The FOMC has had an ongoing

[1] A detailed discussion of how a nominal GDP level target can be used to guide monetary policy can be found in US Economics Analyst: 11/41 — "The Case for a Nominal GDP Level Target." Goldman Sachs Global Economics, Commodities and Strategy Research. October 14, 2011. Also, see US Daily: "Sweden in the 1930s: A Pioneer of Price level Targeting." Sven Jari Stehn. Goldman Sachs Global Economics, Commodities and Strategy Research. October 19, 2011.

discussion about how to make monetary policy more transparent. A recent step in that direction occurred earlier this year when the FOMC stated that the federal funds rate would be maintained in a range of 0% to 0.25% at least until the middle of 2013.

Chicago Federal Reserve President Evans has proposed that the FOMC commit to a stable federal funds rate until the unemployment rate falls below 7%, unless the inflation rate rises above 3%. Arguably this would be an improvement over the current date-specific commitment because it would enable the market to track key indicators that guide changes in monetary policy. But, a criticism of Evans' proposal is that it focuses on only one economic variable which may not always be representative of the full range of economic phenomena. That is one of the arguments favoring nominal GDP level targeting because it a more comprehensive measure of economic activity.

Alternatively, rather than state a date certain, the FOMC could publish its forecast range for the federal funds rate on a quarterly basis just as it currently does for real GDP, the unemployment rate and the total and core personal consumption expenditures inflation rates. Central banks of New Zealand, Norway and Sweden already publish forecasts of their policy rates.

Publishing federal funds rate forecasts alongside forecasts of other key economic variables would enable market participants to understand the conditions under which the FOMC would be likely to change the federal funds rate. FOMC GDP and unemployment rate forecasts have been consistently optimistic and, thus, inaccurate. It is argued, however, that accuracy of the forecast is not what is relevant. What is important is the conditional linkage of the federal funds forecasts with the forecasts for other key economic variables. If the forecasts of specific variables turn out to be wrong, it is argued that market participants should be able to discern how the FOMC likely would adjust monetary policy with respect to setting the federal funds rate.

Chairman Bernanke does seem sympathetic to expanding the quarterly FOMC economic forecasts to include more economic measures, including federal funds rate forecasts, which could provide more information about the future course of monetary policy. It is also clear that Chicago Federal Reserve President Evans' proposal and possible variants of it are under consideration by the FOMC.

Summary. These two proposals are not alternatives. Both could be adopted. Income level targeting would move monetary policy toward more of a long-term focus, while publishing federal funds rate forecasts would help market participants better understand the FOMC's reaction function; that is, how it chooses to administer the federal funds rate based on changes in key economic variables.

V. Fiscal Policy

Policymakers are confronted with an enormous fiscal challenge. Budget deficits, if sustained for any length of time at current levels, will lead the U.S. down the same pathway in a few years as Greece is experiencing currently. Yet, if the deficit is reduced substantially and quickly it could very well throw the economy back into recession. This would be self-defeating because declining GDP growth would undo much, if not all, of the intended deficit cutting. The challenge is one of pulling back a little now and a lot more later on as the economy strengthens. Finding the right balance between short-term fiscal policy and stabilizing/reducing the public-debt-to-GDP ratio over the long run involves understanding the ***fiscal speed limit*** — see the ***October Longbrake Letter*** for an explanation of the ***fiscal speed limit***.

If existing temporary stimulus measures, such as the 2% payroll tax cut and extended unemployment benefits, are permitted to expire and spending cuts are implemented pursuant to the Budget Control Act, fiscal policy would subtract more than $270 billion or about 1.7% from GDP in 2012. Unquestionably this would have a substantial adverse impact on the U.S. economy in an election year.

1. Budget Deficit Math

Fiscal 2011's budget deficit was $1.3 trillion or 8.5% of GDP. If nominal GDP growth averages 4.5% over the next few years (real growth of 2.5% plus 2.0% inflation), the budget deficit, inclusive of interest expense, can grow at approximately the same rate and maintain a stable public-debt-to-GDP ratio. This aligns with the Federal Reserve's forecasts. But remember that the Fed's forecasts have been optimistic in the past and even with the recent downward revisions they remain at the optimistic end of the spectrum.

Annual growth in the public-debt-to-GDP ratio roughly equals the difference between nominal GDP growth (4.06% in fiscal 2011 consisting of 1.62% real growth plus 2.44% inflation) and the deficit as a percentage of nominal GDP (8.54%). The public-debt-to-GDP ratio grew 4.85% in fiscal 2011, which is a little greater than the 4.48% increase implied by the simple math.

Now, if nominal GDP grows at 4.5% annually as the Fed expects in the long run, the annual deficit would need to be reduced by nearly 4.0% just to maintain the debt-to-GDP ratio at its current level. That percentage reduction translates into about $600 billion annually or about $500 billion in a combination of spending cuts and tax increases with the remaining $100 billion coming from interest savings.

According to the Congressional Budget Office, the annual budget deficit would decline by a bit more than 2% if the output gap were eliminated. This would eventually reduce the amount of annual spending cuts and tax increases by about half. This is why the 10-year target deficit reduction is $4 trillion and not a much larger number.

But, if annual nominal GDP growth is only 3.5% in the next few years, $750 billion in spending cuts and tax increases would be required to maintain a constant debt-to-GDP ratio.

Obviously, faster growth, and I do not mean inflation driven growth, would greatly ease the challenge of bringing the budget deficit under control. Unfortunately, the balance of risks is for slower, rather than faster growth, if for no other reason than the withdrawal of federal budget stimulus will slow the rate of growth.

2. Congressional Super Committee (Joint Committee on Deficit Reduction)

The Budget Control Act (BCA) created a 12-member select committee of Congress which is required to present proposals for budget deficit reduction to the Congress by November 23, 2011. BCA specifies the following:

- The joint committee is directed to agree on $1.5 trillion in deficit reduction over ten years and is required to forward its recommendation to both houses of Congress by November 23, 2011.
- Provided that the joint committee recommends at least $1.2 trillion in deficit reduction to Congress, Congress may adopt the recommendations by simple majority without amendments and must take action by December 23, 2011. In other words, Congress must vote the recommendations up or down by simple majority. If both houses of Congress adopt the joint committee's recommendations, the president must still sign the legislation for the recommendations to become law.
- If the joint committee fails to agree on at least $1.2 trillion in deficit reduction, whatever recommendations the committee does reach agreement on will be forwarded to Congress for action. However, the difference between the amount of the recommendations and the minimum $1.2 trillion would result in automatic across-the-board spending cuts beginning on January 1, 2013. The automatic cuts would be divided equally between security and non-security spending, but Social Security and certain low-income programs would be exempted and cuts in Medicare would be limited to a maximum of 2%.
- If both houses of Congress pass a balanced budget amendment, the automatic spending cuts feature of BCA would not take effect.

As numerous analysts and think tanks have pointed out, the ten-year $1.5 trillion deficit reduction target does not meet Chairman Bernanke's first "good" fiscal policy objective of putting U.S. fiscal policy on a long-run sustainable path. It is simply not a large enough target. The $1.5 trillion target was an inadequate political compromise because it has been impossible to date for Republicans and Democrats to agree that the only way to achieve long-term fiscal sustainability requires restructuring entitlement programs **and** restructuring the tax base, tax deductions and tax rates. Democrats steadfastly have resisted serious consideration of entitlement reform and Republicans are locked into a narrow philosophy of cutting spending and tax rates.

Perhaps the Super Committee will seize the moment and craft the "Grand Bargain" which would include a much higher long-term deficit reduction target, would address entitlement reform and would set out a process to restructure and increase tax revenues. But given the strong political rhetoric and the looming 2012 presidential campaign, few hold serious hope that the Super Committee will recommend the "Grand Bargain." Indeed, most think the committee won't come close to the $1.5 trillion target.

3. The November 23 Deadline Looms But Republicans and Democrats Are Far Apart

First, as can be seen in **Table 2** below, neither set of proposals come close to the 10-year $4 trillion in deficit reduction necessary to stabilize the public-debt-to-GDP ratio. While the Democratic proposal appears to be considerably larger than the Republican proposal that is only because of $860 billion more in tax increases and about $150 billion in assumed interest savings connected with the higher tax revenues. Take this $1 trillion away and the Republican plan is larger.

About the only area of total agreement has to do with conversion to using the chained CPI for indexing purposes. There is absolutely no agreement on revenues. $800 billion of the $1.3 trillion in Democratic revenues come from permitting the Bush tax cuts for high income earners to expire. $400 billion in revenues in the Republic plan come from miscellaneous user fees; none come from tax increases.

Entitlement spending cuts differ in size and composition with the Republican plan exceeding the Democratic plan by about $300 billion.

The Republican plan provides for no stimulus spending.

With interest savings added all the Republicans and Democrats need to do is agree upon approximately $1 trillion in deficit reduction to avoid triggering across the board cuts beginning in 2013. This appears to be doable; however, few are optimistic at this moment that the two parties will be able to come to an agreement that reaches that target.

There has been some talk about extending the deadline. This would require Congressional action. Extending time is unlikely to accomplish anything just as extending time during the debt ceiling debate accomplished nothing until the government was within a day of running out of cash to pay bills.

Table 2
Democratic and Republic Deficit Reduction Proposals
(in billions of dollars)

Democratic			Republican		
Revenue		**-1300**	**Revenue**		**-440**
Chained CPI	-70		Chained CPI	-40	
Tax increases	-230		Dynamic effects of tax reform	-200	
Tax reform instructions	-1000		Misc. fees	-200	
Medicare		**-400**	**Medicare**		**-500**
Provider Payment Cuts	-200		Medicare Premiums	-200	
Other	-200		Provider payments & cost sharing	-300	
Medicaid		**-75**	**Medicaid**		**-185**
Social Security		**-125**	**Social Security**		**-125**
Chained CPI	-125		Chained CPI	-125	
Other Mandatory		**-300**	**Other Mandatory**		**-340**
Chained CPI	-50		Chained CPI	-60	
Other cuts	-125		Non-Medicare/caid health	-100	
Chained CPI	-250		Chained CPI	-125	
			Non-health cuts	-180	
Discretionary		**-400**	**Discretionary**		**-250**
Defense	-200				
Non Defense	-200				
Stimulus		**+220**	**Stimulus**		**0**
Payroll tax cut	110				
Unemployment benefits	50				
Infrastructure	60				
Interest Savings		**-510**	**Interest Savings**		**-350**
Total Deficit Reduction		**-2890**	**Total Deficit Reduction**		**-2190**

Of course, Congress can always reverse itself later and remove the automatic spending reduction triggers if the target 10-year reductions are not met. However, this would be very difficult to accomplish with a split Congress in an election year. Also, such an action would greatly increase the likelihood of a credit downgrade of U.S. Treasury debt.

We will know much more about where all of this is heading in a few days.

4. Flat Tax Proposals

It started with Herman Cain's 9-9-9 proposal. Other Republican presidential candidates, notably Rick Perry, followed with their own flat tax plans. The Simpson-Bowles tax commission a year ago recommended total reform and simplification of the tax code. The primary thrust was to reduce significantly tax expenditures, such as the mortgage interest deduction, and reduce marginal tax rates. The proposal also recommended substantial restructuring of Medicare.

Perhaps the best thing that can be said is that debate about tax reform is squarely on the table. However, we are a long ways away from forging political consensus on how to reform the tax code.

Flat taxes, such as a national sales tax, are relatively simple to administer. But, they are very regressive which means that they have the effect of shifting the tax burden from wealthier to poorer people.

Interestingly, while Republic presidential candidates flock to flat tax proposals, polls of the American public reveal that most Americans (70%) prefer a tax system that raises more money and is fairer (2/3) in the sense of shifting the tax burden toward wealthier people. In this respect President Obama's tax proposals resonate with the American public. However, the President's standing in other matters is at a low ebb and this is drowning out his position on taxes.

It will be interesting to observe how the tax debate develops and whether it eventually leads to significant reform. In the next section I discuss trends in income inequality and some of the societal risks that growing inequality is spawning. There are many causes of growing inequality, but tax policy is an important contributor.

VI. Income Inequality

Income inequality has increased considerably over the last 30 years and has returned to disparities that last existed in 1928 just prior to the Great Depression. Income distribution in the U.S. is now more unequal than many developed and emerging economies, including countries such as India, Turkey, Argentina and Kenya. These developments naturally raise concerns about whether they will lead eventually to adverse consequences for economic growth and social and political stability.

1. Congressional Budget Office Study[2]

On October 25, 2011, the Congressional Budget Office released a study on trends in the distribution of income between 1979 and 2007. The results of the study indicate that income inequality has widened considerably.

Highlights include:

- Inflation-adjusted income including government transfer payments and taxes increased between 1979 and 2007:
  - ✓ 62% on average;
  - ✓ 275% for the top 1%;
  - ✓ 65% for those between the 81st and 99th percentiles;
  - ✓ 40% for those between the 21st and 80th percentiles; and
  - ✓ 18% for those between the 1st and 20th percentiles.
- The share of total income:
  - ✓ Increased from 8% to 17% for the top 1%;
  - ✓ Increased from 35% to 36% for those between the 81st and 99th percentiles;
  - ✓ Decreased from 50% to 43% for those between the 21st and 80th percentiles; and

[2] "*Trends in the Distribution of Household Income Between 1979 and 2007.*" Congressional Budget Office. October 2011.

    - ✓ Decreased from 7% to 5% for those between the 1st and 20th percentiles.

- Government transfer payments became less progressive, which means that wealthier households received a larger share of transfer payments in 2007 than in 2009.
    - ✓ The share of government transfer payments for those between the 1st and 20th percentiles decreased from 50% to 35%.
    - ✓ This was caused primarily by growth in Social Security and Medicare payments to elderly people who are in higher income brackets on average.
- Tax payments became less progressive.
    - ✓ Overall the average federal tax rate fell by a small amount (less progressive).
    - ✓ The composition of tax payments shifted from progressive income taxes to less progressive payroll taxes (less progressive).
    - ✓ Income tax payments became slightly more concentrated for high income households (more progressive).
    - ✓ The less progressive impacts of the first two factors were greater than the progressive impact of the third.

2. "Material Well-Being" versus Income Inequality

The U.S. Census Bureau recently released data indicating that the percentage of Americans below the poverty level has increased dramatically in recent years. This conclusion was based on pre-tax income data. Critics claim that reaching conclusions about poverty based only on pre-tax income data is erroneous because factors other than income are important to "material well being."

In a carefully researched academic study, Bruce Meyer of the University of Chicago and James Sullivan of Notre Dame argue that family consumption expenditures is a much better indicator of economic well-being.[3] Family

[3] Bruce D. Meyer, University of Chicago and NBER, and James X. Sullivan, University of Notre Dame. "*The Material Well-Being of the Poor and the Middle Class Since 1980.*" AEI Working Paper #2011-04, October 25, 2011.

consumption expenditures is a better measure because it reflects all resources available to a household to support consumption. For example, income measures are typically underreported, particularly for lower income households. Narrow income measures also omit recognition of the consumption value of durable assets, such as cars and homes, and the value of government insurance programs, such as Social Security, Medicare and Medicaid. Moreover, narrow income measures frequently do not adjust for differential effects of government transfer programs and changing marginal tax rates.

The authors also argue that official inflation measures, which are used to deflate reported income to determine changes in the standard of living, are systematically biased upwards. This results in an understatement of increases in the standard of living or, alternatively, an overstatement of the decline in the standard of living.

Well-Being of the Middle Class. Meyer and Sullivan use median values to describe the middle class. The Census Bureau's official measure of pre-tax median income rose 20% between 1980 and 2000, but fell 5% between 2000 and 2009 — rising about 14% overall. Adjusting the official income data to reflect more completely available household financial resources and deflating by an un-biased measure of inflation, the authors conclude that median after-tax income plus noncash benefits rose by 58% between 1980 and 2009. Consumption expenditures, the authors' preferred measure of well-being, rose 54% over the same period.

Well-Being of the Poor. The authors define "poor" as those households in the 1st to 10th percentiles. The Census Bureau's official measure of pre-tax median income rose about 11% between 1980 and 2009. However, the median after-tax income plus noncash benefits measure rose 44% and the consumption expenditures measure increased 54%.

Poverty. Meyer and Sullivan conclude that contrary to the Census Bureau's official poverty statistics consumption poverty fell 2 percentage points between 2000 and 2009 and 10 percentage points overall between 1980 and 2009. In other words, fewer families were below the poverty line in 2009 compared to 2000 and 1980.

3. Significance of Improvements in Material Well-Being

While income inequality has unambiguously worsened, it is possible that improving living standards, even for the poorest 10%, might limit the potential social and political repercussions of growing income inequality. This might be true particularly for older people, who are a growing segment of the population. Retired persons frequently have low incomes but their resources available to support consumption are considerably greater when wealth and government health insurance programs are factored in.

That said, however, there are other potential consequences of growing income inequality.

4. Potential Consequences of Growing Income Inequality

Debt Leverage. Both private and public debt leverage have risen in tandem with increasing income inequality. This is not a spurious correlation. Consumption continued to rise in the lower income segments even as income growth slowed. This was facilitated by enormous growth in household debt. The effects of this phenomenon can also be seen by the decline in the saving rate prior to the 2007-09 financial crisis. The saving rate declined much more for lower income households than for higher income households.

Government Insurance Programs. Social Security and Medicare have greatly reduced the need of households to save for retirement, thus enabling households to consume more of current income. Unfortunately, there is a timing issue. The government should be saving more to offset reduced saving by households. But, as we know, the government hasn't been doing this. Budget deficits have been very large and government insurance programs, especially Medicare, are not being funded adequately on a current basis to cover future financial obligations.

5. Causes of Growing Income Inequality

Globalization. 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 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.

Technological Change. 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.

Decline of Labor Unions. 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-1970's 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.

Less Progressive Taxes. This phenomenon was documented recently by the Congressional Budget Office (CBO) study. The tax system in the U.S. has become less progressive as the composition of taxes has shifted toward payroll taxes.

Government Transfer Payments. The CBO study also documented that changing transfer payments programs, particularly Social Security and Medicare, are contributing to growing income inequality.

Increasing Size of Corporations. Nouriel Roubini refers to this cause as "the growth of less competitive and margin-increasing oligopolies." An example, perhaps, which is a public focal point, is mega banks.

Capture of the Political Elite by the Financial Elite. 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.

6. Does Growing Income Inequality Matter?

Intuitively speaking, the answer to this question 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.

But there is also evidence that inequality results in lower economic growth. See the recent IMF study authored by Branko Milanovic.[4] 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.

VII. Occupy Wall Street

Very clearly income inequality is one of the factors that led to the spontaneous eruption of "Occupy Wall Street." Occupy Wall Street has spread to most major cities in the U.S. and appears to have some staying power. However, as one commentator put it: "Is it a moment or a movement?" If it is a moment, it will fade away. If it is a movement, it will grow into a force that will eventually have broad social and political impact. Barely two months into this phenomenon, it is unclear whether Occupy Wall Street will have any lasting impact.

[4] ***IMF Study.***

1. Drivers of "Occupy Wall Street" Protests

Anne-Marie Slaughter recently wrote in the *New York Times* that "...the twin drivers of America's nascent protest movement against the financial sector are ***injustice*** and ***invisibility***, the very grievances that drove the Arab Spring."[5]

Injustice is about economic inequality and the capture of the political and economic systems in America by the financial elite to serve their interests to the detriment of the other 99%. The core grievance is that the economic hardships millions of Americans are enduring have been caused by the practices of big financial institutions and the enormous political power Wall Street wields over the U.S. government. In a recent poll, 47% viewed the activities of Wall Street as harming the U.S. economy while 38% expressed the opposite view.

Invisibility is about a dysfunctional political system dominated by narrowly-based partisan political agendas which are unresponsive to the grievances of millions of Americans. Simply put, millions of Americans are hurting because America's economic system is not working for them and they don't feel the government is listening to them or responding to their grievances. As Ms. Slaughter wrote, "*In the words of one protester interviewed in San Francisco, '**We don't have a government for "we the people" anymore.**'* "

An extension of the ***invisibility driver*** is ***crony capitalism***. This involves the financial elite, Wall Street, capturing the political elite, Congress, to serve its narrowly-based economic interests. When capitalism serves the interests of a few rather than the many it loses accountability and overall economic performance tends to decline.

Currently, the financial elite is arguing that increasing government regulation in the form of the Dodd-Frank Act is creating economic uncertainty and holding back economic recovery. Polls reveal that the public generally is sympathetic to the argument that there is too much government regulation. But the polls also indicate that the public distrusts large corporations and Congress. That does not add up to the public agreeing that business can be relied upon to do the right thing or that business should be permitted to do

[5]Anne-Marie Slaughter. "Occupied Wall Street, Seen From Abroad." *The New York Times*. October 6, 2011.

as it pleases.

Another driver is that the economy isn't recovering and it isn't creating jobs. As time passes and little progress occurs, financial anxiety continues to build and patience erodes as insecurity, anger and hopelessness spread.

In sum, the drivers of "Occupy Wall Street" are broken economic and political systems and a growing sense that our financial and political elites either don't know what to do or, worse, are locked in an incestuous relationship to preserve their own interests and power.

2. Will "Occupy Wall Street" Evolve Into a Movement That Has the Potential to Impact Political and Policy Making Processes?

The answer to this question is not yet clear. But, in a very short time two things have happened. First, the protests so far have had durability and have spread to many other geographical locales from the initial venue of Zuccotti Park in New York City near Wall Street. Second, media coverage which mushroomed initially, has continued at a fairly high level.

Movement Criteria. Many have been quick to point out that a few protests and some news media coverage do not guarantee that significant change will follow. For that to happen, the protests need to evolve into a movement. Movements generally develop from a crisply defined grievance and explicitly stated solutions. This was the case for the civil rights movement and the Viet Nam War protests. Although each of these movements started from protests based on emotion and anger and only later evolved into movements with defined agendas and structured leadership.

Economic injustice and governmental dysfunction are much more broadly-based grievances and lack the kind of specific issue focus that spawn and propel movements. Also, there is not yet a well-defined list of solutions. However, perhaps that is the relevancy of the Arab Spring for "Occupy Wall Street." The Arab Spring was about challenging governments which catered to narrow elites and which had become unresponsive to the people. Perhaps that grievance is also deep-seated in America and that will be sufficient to perpetuate and expand the protests to the point where they transform into a movement which then might have the potential to force fundamental political and economic change.

Movements which have impact typically have the following attributes:

- **Single identifiable or charismatic leader.** "Occupy Wall Street" has no identifiable leader, although that was also the case for the Tea Party movement in the early days.
- **Creation of an institution which can influence and martial public opinion.** "Occupy Wall Street" has yet to evolve into an institutional framework.
- **Define an action agenda; develop a program.** There are many grievances but no action agenda or program yet exists.
- **Engage in the political process.** This poses a challenge because many "Occupy Wall Street" protesters believe that both political parties have been captured by Wall Street. But, politicians aren't likely to respond unless they believe that the movement has become powerful enough to change election outcomes.

In the words of Stephen Zunes, professor of politics at the University of San Francisco, "*Successful movements focus on developing a well-thought-out strategy, clearly articulated political demands, a logical sequencing of tactics, well-trained and disciplined activists, and a recognition that colorful protests are no substitute for door-to-door organizing among real people.*"[6]

It has also been pointed out that successful movements usually begin as expressions of anger and then evolve into more defined movements that express specific concerns. Occupy Wall Street does not yet have a specific agenda and there are no leaders. So, it may fade away. But, the underlying issues of economic justice and government dysfunction are crying for attention and change. That makes me think that we have not heard the last of Occupy Wall Street or some successor to it.

Certainly, Senator John McCain senses the breadth of our current malaise. He predicted on November 8, 2011 that a third political party will emerge in response to Americans' economic frustrations and said it might well be called "the Fed-Up Party."

[6]Stephen Zunes. "Protests Are Not a Movement." *The New York Times*. October 7, 2011.

In a recent column, Thomas Friedman summarized what Occupy Wall Street is all about and what needs to happen: "***Capitalism and free markets are the best engines for generating growth and relieving poverty — provided they are balanced with meaningful transparency, regulation and oversight. We lost that balance in the last decade. If we don't get it back — and there is now a tidal wave of money resisting that — we will have another crisis. And, if that happens, the cry for justice could turn ugly.***"[7]

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[7]Thomas L. Friedman. "*Did You Hear the One About the Bankers?*" New York Times. October 29, 2011.