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

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Reset Necessary*

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Now that the dust has settled on the dust up of the election, and once the stock market flushes out its post-election drop and reverts to normal, we can look around and see what we have. It seems to me that we have the makings of a major reset required, some of which has commenced and some of which is still to come.

First, the necessary: Tax reform and deficit reduction

First and foremost, of course, is the looming phase out of the Bush tax cuts, the end of the payroll tax deduction, and the sequestering established by Congress when the answers about the outcome of the 2012 elections were still in doubt. Maneuvering through that will be both economically and politically difficult, and it is unclear whether the election provided the ability or the impetus for the parties to work together to resolve the problems inherent in any reasonable resolution. We'll soon see.

One cynical inside-the-beltway "good idea" is that Congress can best make headway on the problem by permitting the Bush tax cuts and the payroll tax deduction to expire in December, permitting taxes for many in the population to increase. That would make heroes out of those in early 2013 who can then solve the problem by instituting tax cuts. For those few for whom it is important, the Norquist pledge will be met and at the end of the maneuvering, taxes will be higher on those earning higher incomes, and about the same on the rest. But that "good idea" requires thought and planning, so more likely is some kind of a gentle kick of the can during the Lame Duck until Spring and the arrival of the new Congress.

The key participants were very close to a decent solution a year and a half ago, but the aspirations of politicians and the looming presidential election interfered. Perhaps with that behind, a solution can be reached. Certainly some leadership needs to be shown.

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Radical events and new elements

In the past few years, the economy has experienced a plethora of jolts and rare events, most of which have been harmful. Housing is always listed as example number one, and it certainly has failed to carry its share of the economy since its market collapsed in 2008-2009. More expansively, every major segment of the society — government, business and consumer — overleveraged itself. The result was an economy that was running on mystery fuel, and when the little man behind the curtain was finally exposed, we discovered just how bad it had become.

We saw our country debt downgraded, with hints of further downgrades to come. The leverage exuberance was contagious, and what was always seen as solid gold securities — U.S. mortgage backed securities — were revealed as more like tin. Unfortunately, by then they had spread globally as well as throughout the U.S., and hence we had a global downturn, out of which we have not yet come. Unemployment remains very high by normal standards, and even illegal immigration from Latin American countries slowed, stopped, and for a while, reversed itself.

Money cost almost nothing, and Federal Government expenditures to stop the bleeding resulted in a major backlash against the concept of bailouts, against those who received the bailouts (correction, against large corporations that received the bailouts), and against statutes and regulations that permitted them. Hence, Congress passed the Dodd-Frank Act, a landmark piece of federal legislation whose major purpose seemed to be to avoid any economic activity that might result in a loss to a consumer or any other segment of the economy. Congress fought the previous war and feels confident that never again will the same kind of events create an economic free fall.

President Obama's reelection, as well as the disaster that was the Gingrich/Tea-Party inspired slate of Republican candidates, insured that that Act will not be significantly changed in the next few years, and office holders will be those bearing allegiance to the purposes of that Act. Congress itself will be more liberal than before the election, but as of yet, we don't know who will occupy the senior cabinet positions should there be the expected changes at Treasury, State, and others.

The necessary resets

Maybe there are a few that believe there will be a major reform of the federal income tax code, but they have history against them. The most that can be said for certain is that there will be a slight shift in tax burden to the higher individual income brackets. It is doubtful that there will be any significant increase in the number of Americans that currently pay no federal income tax, and that number will stay around the 47 percent level that caused such a problem for Gov. Romney when he extrapolated that into something more heinous.[1]

As for eliminating and rationalizing the code generally, good luck. In 1954, those who wanted tax reform had the advantage of having a marginal tax rate as high as 91 percent, a popular president who was behind tax reform, and a dedicated supportive staff on the Joint Committee on Taxation. With those elements, supporters were able to introduce a tax reform bill in March and pass it by early summer of the same year. In 1986, the year of the next major tax reform, the country had President Reagan, who not only was foursquare behind it but introduced a detailed program. He was supported by established leaders of Ways and Means and Finance who could count votes (Rostenkowski and Packwood) and by an intellectual zealot in Senator Bradley. We'll see if the stars align with this president and congress.

Going forward, it appears that any corporation or group that is "big" in the financial sector will have to persuade the public that it is good, with the going-in assumption being that it is not. While no one knows for sure and won't until there is a vote on an issue that raises the question, it does appear that both the House and the Senate are more liberal now than before the elections, and on the Too Big To Fail question, there now may be more members (see, for example, the new junior senator from Massachusetts) willing to join across party lines to try to find some "solution" to the TBTF "problem."

No one yet knows what effect the establishment of SIFI rules on those entities determined to be SIFIs will have, but it, at a minimum, will have a drag on expansion of activity. For those entities not accustomed to the federal bank regulator perspective, the introduction to that will take years

[1]He also missed another important point — payments for individuals constituted 65 percent of federal spending in 2011. Transfers from individual to individual by the Federal Government are now at 20 percent, up from 3 percent in 1935. See, Nicolas Eberstadt, "A Nation of Takers: America's Entitlement Epidemic." For a different perspective of the same numbers, see William Galston's comments in the same book.

to absorb.

In addition to that background noise, the dozens of rules promulgated by the regulators implementing what Congress directed them to do in DFA will be moving from proposals to finalized regulations. In housing finance, it is fair to say, for example, that the pendulum on what loans the government believe should be made has moved dramatically from where it was in 2000, and the result will be a resetting downward of expectations on the portion of Americans that will own their own home. Seventy percent is no longer a realistic goal — 64percent is a more likely goal. In this case, therefore, the resetting may simply move us back to the norm that existed for decades in the U.S. Rental may become more of a staple for many Americans.

At the same time, credit counseling may not be as good a business as it recently has been, since the chances of subprime or "bad" loans being made will have dropped precipitously. Mortgage servicers will be able to reduce their staff of special servicers in a couple of years, and should the proposed rules implementing such provisions as the Qualified Mortgage provision be finalized, the book of mortgage loans should be pristine. It's hard to see rates dropping further, so re-fis may not be as significant on the income statement going forward, and securitization will depend upon (a) what happens with the GSEs and any successor to them, and (b) whether or not premium recapture rules will be finalized as proposed in the QRM proposals. College and professional school costs have gone through the roof, so the normal response will be a degradation in the number of U.S. citizens who will receive college degrees. Medical degree costs may turn prohibitive.

Who knows what the Volcker rule will bring, but at a minimum, a change in the way many major institutions have done business, and a likely shift to foreign institutions of that market.

In the capital arena, the last notes have not yet been played, but it is clear that there will be more capital in financial institutions than ever before. In particular, bowing to the belief that big is bad, the largest institutions will be required to carry an unusual amount of lead in their saddle bags as they race around the track in competition with the global banks of the world. They just will have to adjust, and expectations of the support they can give to the U.S. economy will have to be reset.

Unemployment may never drop to what most think of as "normal," that is, around 4 percent. Europe as a booming market for our products and services will step aside for some period of time, hopefully, not too long, and many of the BRICs will pause and take a breath. We will probably continue to be a destination country for large numbers of people moving from South to North, and for some, though not as many, moving from Asia to here. We will get less white year by year, and with the increase in new births that generally follow such migrations, our population will grow. That will at least help support our social safety net for seniors, unlike some countries that are neither having "enough" of either children or migration. How the increased population will drive living standards and economic activity is unclear.

At some point, changes in technology will have to slow down — maybe. But that will not happen soon, and government policy and the public's absorption of change will simply have to adjust to it. We may soon be partitioning off a segment of the population — generally the older segment — that is not totally comfortable with the use of and relationship to personal and public technology advances.

The relatively poor selection of candidates for some of the major offices, and the development of a class of elected members who have done nothing during their career other than be elected members of something or other may cause society to rethink the wisdom of a primary system that caters to the fanatical fringes of the electorate in determining the candidates for the general elections and the election of members without non-elected experience.

Movements of populations from the rural areas to the cities has accelerated over the past 50 years, and will only continue to grow. Points of view and characteristics that were ideal for rural life may not be as desirable for life in congested urban areas, and serious thought will probably be given to some foundational questions. In particular, this may be true when the demographics move from a group homogenous in ethnicity, race and religion to a much more diverse group. There is no real good historical model for what our population mix is becoming. We are not alone in that — Europe faces many of the same issues.

The effect on the simple equation of supply and demand will be more and more intense. Adaptability in commercial and consumer sectors will be crucial, since the foundations of what people can do and what they want and are willing to buy will shift from what have been the guiding rules to what are now the new rules. Resetting of expectations in the government sector will be more difficult, since America is now quite different from what it was, is much less the creative independent minded group of individuals, and is much more a welfare state than it has been.

All of this will take place within a dynamic future shock, to reference one of the seminal books on the subject.[2] Resetting appropriately will be the biggest challenge the present group of business, social and political leaders will face. It won't be easy.

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[2] Alvin Toffler, Future Shock (1970).