U.S. Economic and Regulatory Outlook: Implications for Corporate Leaders

At Harvard Business School | February 26, 2013

Overview

The short-term economic and regulatory outlook for the United States is not terribly optimistic. A massive deleveraging in the household and corporate sectors must continue, while deleveraging in the government sector must commence. It is simply not sustainable for government revenues to represent 18% of GDP while expenditures are 24%. Other challenging realities include an uncertain tax situation, sequestration, increasing regulations, and rising healthcare costs.

The panelists were in agreement that future economic growth requires the U.S. government to act with urgency in closing the federal government's revenue/spending gap, clarifying and simplifying the tax code, and addressing growing healthcare costs. The time to act is now—out of necessity, and because interest rates remain low.

The long-term outlook is more encouraging. Despite the political gridlock and ugliness of the moment, the panelists were hopeful that the country's leaders will make progress in putting America on a more solid fiscal path. Greater certainty about the future will encourage investment and spur economic growth.

Context

Former HBSAB president Rick Williams, president of The Equity Company, Inc., and Directors Roundtable chairman Jack Friedman set the stage for the panel discussion. They described the current economic recovery as fragile; highlighted the political gridlock in Washington, DC and the uncertainty surrounding sequestration; and put the country's massive debt into perspective by noting that the federal government spends $4 billion per day more than it takes in. Joe Basile then moderated the discussion, asking panelists to summarize the realities they see, to comment on what worries them most, and to offer predictions of the future.

Heath Tarbert, Steve Paglicua, John Campbell, Joe Basile, and Rob Kaplan (left to right).

CO-HOSTED BY

Harvard Business School Association of Boston (HBSAB)
and
Directors Roundtable

MODERATOR

Joe Basile
Managing Partner of Weil, Gotshal & Manges LLP

PANELISTS

Prof. Rob Kaplan
Senior Associate Dean at Harvard Business School, former Vice Chairman of Goldman Sachs

Steve Pagliuca
Managing Director, Bain Capital

Rick Bailine
Principal in Charge, McGladrey's Washington National Tax Office

Prof. John Campbell
Chair of the Harvard Economics Dept. until the end of 2012

Heath Tarbert
Chair of the Financial Regulatory Reform Working Group, Weil, Gotshal & Manges LLP; previously Special Counsel, U.S. Senate Banking Committee

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Key Themes

REALITIES

In a broad-ranging conversation, panelists described what they see in terms of the economy and regulation.

Reality: A massive deleveraging is taking place among households and corporations, but not yet by the government.

Professor Kaplan said, "The reality is the Western world is going through, for the first time in our lifetime, a deleveraging." For the past 50 plus years debt increased, which helped fuel increased economic growth. But with the fiscal crisis of 2008, three sectors have had to face up to reality:

- **Household sector.** In the United States the household sector was historically leveraged with all forms of debt, made possible because of sustained home appreciation. Since the home bubble burst, this sector has been slowly working to repair itself. Deleveraging is occurring but will take time.
- **Corporate sector.** The corporate sector, particularly the financial sector, was overleveraged. With the help of the government, this sector has deleveraged and is now fairly well capitalized. In general, today, the corporate sector is well capitalized and has terrific access to capital.
- **Government sector.** The government sector in Europe is starting to try to deleverage, with little progress thus far. The U.S. government is only at the beginning of the deleveraging process.


Rob Kaplan

Deleveraging is ugly and traumatic, and there is no playbook. All things being equal, it hurts GDP growth and asset values. However, the Federal Reserve and European Central Banks have adopted very aggressive monetary policy actions in order to facilitate the needed deleveraging. But the U.S. government must begin, which involves making difficult and unattractive choices. Now is the right time because money is easy and interest rates remain low—but central banks can't maintain these conditions forever. Professor Kaplan warns that we should not be comforted by the easy access the U.S government currently has to debt financing. He points out that companies and countries are financeable—until the moment they are not. Then, drastic actions may be required, which could severely damage GNP and employment. For example, if interest rates suddenly increased by 300 basis points, the cost of carrying huge government debt would increase dramatically—potentially leading to a crisis. We must get on a path to deleveraging in order to keep this from happening.

Reality: A huge gap exists between what the government takes in and what it spends.

Mr. Pagliuca paraphrased de Tocqueville, who wrote that most democracies fail in 200 years because the governed ask too much of the government. The U.S. has existed about 200 years and faces an enormous crisis.

The crux of the problem is that federal revenue is 18% of GDP while spending is 24%. As a result, we've added $15 trillion to the national debt since 1982 and are adding $1 trillion

> "We need to deleverage while we still can. The sooner we get started the better."
> Rob Kaplan


Steve Pagliuca

more each year. Rising healthcare costs are a major factor. Healthcare represents 22% of the federal budget and is projected to account for 33% in 10 years. Policymakers must face reality and develop a plan to eliminate this gap.

Mr. Pagliuca recommended a 10-year plan where taxes are increased 0.3% of GDP each year (from 18% to 21 % of GDP) and spending is decreased by 0.3% (from 24% to 21% of GDP). A clear path to balancing the budget would provide stability, enable business leaders to better plan for the future, and boost economic growth.

"Putting us on a path to a balanced budget would actually increase economic growth, give stability to the United States, have more investment, and get the economy going again."
Steve Pagliuca

Reality: Interest rates remain extraordinarily low, as does the risk appetite among investors.

Professor Campbell said that at the beginning of the century there were reasonably high real interest rates, an extremely low risk premium, and investors had a huge appetite for risk. In the aftermath of the financial crisis, the situation is reversed: interest rates are low, as is the risk premium and the appetite for risk. This isn't just a U.S. phenomenon; similar patterns prevail across the globe. Investors want safe or super-safe assets.


John Campbell

The high demand for safe assets and their limited supply has allowed interest rates to remain low, as seen through the extraordinarily low yields of U.S. treasuries. In comparison to treasuries, the returns for equities look fairly good.

Benefits of low rates are that they encourage refinancing, which helps deleveraging and helps restart consumption; they help the U.S. government refinance its debt; and they allow banks to recapitalize. A downside is that organizations such as universities and governments which have long-term liabilities (such as defined benefit plans) face financial difficulties.

Reality: Most people don't understand critical aspects of the American Taxpayer Relief Act and of sequestration.

Mr. Bailine highlighted three elements of the American Taxpayer Relief Act of 2012 and three aspects of sequestration that most people do not know but should.

American Taxpayer Relief Act of 2012

1. **While this bill is about individuals' taxes, it will have a significant impact on middle market businesses.** The bill is about individual taxes and there are few corporate provisions. But this doesn't tell the full story because about 40% of all business revenues are generated by pass-through entities, like partnerships or subchapter S corporations. This bill will have a significant impact on those who receive the pass-throughs, which includes many owners of middle market businesses.
2. **The Act is not balanced.** Despite talk of the need for a balanced approach to addressing the government's fiscal issues, the Act lacks balance; it raises revenues but does nothing to address government spending.
3. **The Act was perceived as a huge defeat for the Republicans.** Despite the fact that Republicans had pushed to make the Bush tax cuts permanent for years and that this bill makes 98% of these cuts permanent, this was seen as a huge win for Democrats and a defeat for Republicans. This sets the stage for the looming battle over spending cuts.

"This bill will hit middle market businesses in a pretty significant way."
Rick Bailine

Sequestration

Rick Bailine

1. **Spending cuts under sequestration are lower than stated.** The media has reported that sequestration will result in $85 billion in spending cuts for the balance of fiscal 2013. But the Congressional Budget Office estimated that federal spending cuts will only be $44 billion this year.
2. **Sequestration only slows the growth of government spending.** Even with sequestration, the federal government will still spend more in fiscal 2013 than in 2012. All that is reduced is the growth in spending.
3. **Sequestration is not the end.** Sequestration is just one more step in the ongoing battles in Congress over government spending.

Reality: Regulations will increase in 2013 but this isn't the greatest challenge for the financial sector.

Heath Tarbert

Mr. Tarbert offered his take on the regulatory environment, particularly for the banking and financial sector.

1. **Financial reform is here to stay.** With President Obama reelected, Dodd-Frank won't be repealed. Further, while there is some buzz about Dodd-Frank being reopened to make technical corrections, this is highly unlikely as it would open a Pandora's box that many in Congress would prefer to avoid.
2. **There will be important regulatory developments in 2013.** With Dodd-Frank here to stay, more of the statute will be written and implemented. This includes regulations dealing with systemic risk; money market funds reform; the Volcker Rule, which involves proprietary trading, private equity, and hedge fund activities by large banks; derivatives; and capital and liquidity.
3. **The key changes in the financial industry will be driven by economic factors; not regulation.** Banks must continue to deal with an environment of low interest rates and more capital, which puts pressure on the return on equity. Consolidation is likely, with more M&A activity.

Reality: To be successful, private equity investors will have to transform companies.

In the view of Mr. Pagliuca, from the mid-1980s until 2008, private equity had a strong tailwind. The economy was strong, interest rates were low, the stock market continued to rise, and private equity investors could make money through multiple expansion. In the current environment, private equity investors can no longer count on favorable returns through multiple expansion. Good returns require transformation and globalization.

Reality: The rationale for the CFPB is questionable, but it may still have some value.

Professor Campbell disagreed with the basic rationale for the formation of the Consumer Finance Protection Bureau (CFPB). This rationale was that consumers were confused about mortgages and because of their confusion took out risky loans. He believes the credit crisis arose not due to confusion but because borrowers and lenders thought house prices would continue to go up, which isn't a consumer protection issue.

> "Most of the changes in 2013 [in the financial sector] will be driven by fundamental economic factors; not regulation."
>
> Heath Tarbert

However, he still believes there are good arguments for consumer protection and he supports the creation of the CFPB. One argument is that confused consumers pay excessive fees, which is a consumer protection issue. Also, financial service firms can create confusing products where naïve consumers subsidize sophisticated consumers, which is a fairness issue and blocks the emergence of better products.

Mr. Pagliuca wasn't convinced that the CFPB was necessary because adequate regulations existed to protect consumers. The problem was that those regulations were not enforced. Since existing agencies don't seem to care enough about protecting consumers, perhaps the CFPB is the best way to do so.

> "My expectation is that we have to plan to live with low rates for a while longer."
> John Campbell

WORRIES

Beyond these challenging realities, panelists described some of their greatest worries. These included:

- **Tax uncertainty.** Mr. Bailine is worried about uncertain tax rules that make it extremely difficult for business leaders to make plans and investment decisions.
- **Reaching for yield.** Professor Campbell sees it as likely that some investors with a specific return target will do whatever it takes to get there, which will entail risky behavior.
- **Investment volatility.** Professor Kaplan termed this a challenging time to be an investor because of the fact that risk-free assets yield almost no return. He advised individual investors to focus on their asset allocation and financial needs. He summarized John Bogle of Vanguard's rule of thumb: take your age and keep that percentage of your assets in bonds. Kaplan said this might not be sensible for many investors but is prudent for those nearing retirement.
- **Healthcare costs.** High healthcare costs hurt the competitiveness of American businesses. While the Affordable Care Act (ACA) provides coverage for about 30 million Americans who lack it, ACA doesn't address cost issues. Mr. Pagliuca is hopeful that these cost problems will get so much attention that policymakers will be forced to solve them. Mr. Bailine sees other problems and unintended consequences in the ACA. For example, since the individual mandate has been deemed a tax, the IRS will be involved. The IRS has concluded that companies need to offer healthcare only to employees, and not their families, which will create problems for workers' family members.
- **Existential threats.** Mr. Tarbert believes CFOs of financial institutions may be worried about capital requirements, but CEOs are concerned about mishaps that could become existential threats, like major regulatory violations, a massive trading loss, fraud, or a major security breach. These are activities that could hurt a firm's reputation and trigger hundreds of lawsuits.
- **Access to capital by small businesses.** The panelists see large businesses doing well but see access to capital as an issue for small and mid-sized businesses. Banks' capital requirements and their increased aversion to risk have choked off lending to smaller businesses.
- **Lack of investment to create jobs.** Mr. Pagliuca said that bringing many manufacturing jobs back to the United States is unrealistic. In emerging markets manufacturing capacity can cost less than $3 per hour compared to $34 in America. Those jobs aren't coming back. To create jobs the U.S. needs greater long-term investments in education and knowledge industries, but that isn't happening.

- **The consequences of government spending cuts.** Mr. Friedman wondered if cuts in government spending will cause bankruptcies and personal suffering. The panelists were in agreement that if significant spending cuts were made in the short term, they could create chaos. But if made in a sustained way over a long period, they could be managed. Mr. Bailine pointed out the sequester will cut $1.2 trillion in government spending over 10 years, but total government spending during that time is projected at around $44 trillion.

PREDICTIONS

- **Prediction: Greater volatility.** Professor Kaplan expects a much more volatile environment ahead. He encouraged business leaders to be prepared, manage their liquidity and leverage, and protect themselves on the downside.
- **Prediction: Continuing Congressional battles over spending and taxes.** While sequestration was the hot topic du jour (at the time of this gathering) Mr. Bailine expects ongoing battles in Congress.
- **Prediction: Continued low interest rates.** Professor Campbell sees continued low interest rates and suggests that business and financial sector leaders plan for this.
- **Prediction: America will get on a path to solve these problems.** While difficult to imagine at this moment, Professor Kaplan closed the session on an optimistic note, predicting that the country will get on a path to solve its problems in the near future. He believes that perhaps this ugly, challenging series of conflicts in Washington D.C. may foreshadow real progress in facing our challenges.

"This may be what progress looks like, even though it doesn't feel like progress."

Rob Kaplan

All photographs by Rick Williams.