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## ECONOMIC OUTLOOK

*A Modest Bipartisan Growth Agenda*

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# A Modest Bipartisan Growth Agenda

By Jason M. Thomas and David M. Marchick

The U.S. economy enters 2015 with a degree of momentum largely absent in the earlier stages of the post-crisis recovery and expansion. Data from Carlyle's U.S. portfolio of businesses suggests that real GDP is expanding at a trend rate of close to 3%, up from the 1.5% to 2% average of the past three years. The labor market has improved markedly, with average monthly payroll gains of 250,000 per month and a 20% annual increase in job openings nationally. Hourly wage growth remains slow, but weekly earnings are increasing at a 2.5% annual rate as hours increase with production schedules. In addition, the sharp drop in the price of oil will add 2% (\$1,300)<sup>1</sup> to the average household's purchasing power in 2015, contributing as much as 0.5% to U.S. GDP.<sup>2</sup>

The improvement in macroeconomic conditions has occurred despite continued paralysis in Washington. In this environment, policymakers' first goal should be to avoid any action to disrupt these positive underlying economic trends. There is never an opportune time for a debt ceiling crisis, but past crises did result in greater fiscal discipline. However, policymakers can and should aspire to do more than avoid self-inflicted wounds. A modest bipartisan agenda, properly calibrated for the realities of contemporary Washington, could increase business confidence and accelerate growth. Below we outline a bipartisan growth agenda that we believe is modest enough to be enacted in a polarized Washington, but sufficiently robust to accelerate growth over the next two years.

## Fiscal Policy: Untie the Noose

Policymakers should avoid the temptation to pursue any incremental fiscal tightening. Policy changes since 2011 have stabilized public debt ratios, at least over the near-to-medium term. There is virtually no risk of a sudden spike in borrowing costs and no evidence that worries about deficits are currently depressing private sector spending.

Fiscal policy entering 2011 was not sustainable. Federal debt was set to grow nearly 30% faster than the economy over the next five years, pushing the net public debt from 62% to 80% of GDP by 2015. Large structural deficits of this sort can slow growth by creating uncertainty regarding the sustainability of public finances.<sup>3</sup> Households and businesses recognize future tax increases or spending cuts are likely, but are left to speculate about their timing and composition.<sup>4</sup> In these circumstances, deficit reduction may actually strengthen economic growth because increased confidence in the stability of public finances could spur

additional private sector spending that partly offsets the fiscal drag.

Policy changes since 2011 have reduced annual public deficits by nearly 4% of GDP and stabilized net debt ratios near 65% of GDP (Figure 1).<sup>5</sup> At 2.9% of GDP, the 2014 fiscal deficit was below its 40-year average of 3.1%. Historical data suggest this deficit is perfectly appropriate given the current state of the economy (Figure 2). Since 1964, an unemployment rate of 6.2% (the average during 2014) has been associated with a federal deficit of 2.8% of GDP (Figure 2). If, as some analysts suggest, the current unemployment rate is artificially depressed due to an increase in the share of discouraged workers, then current fiscal policy may actually be too restrictive.

Figure 1: Federal Debt Ratios

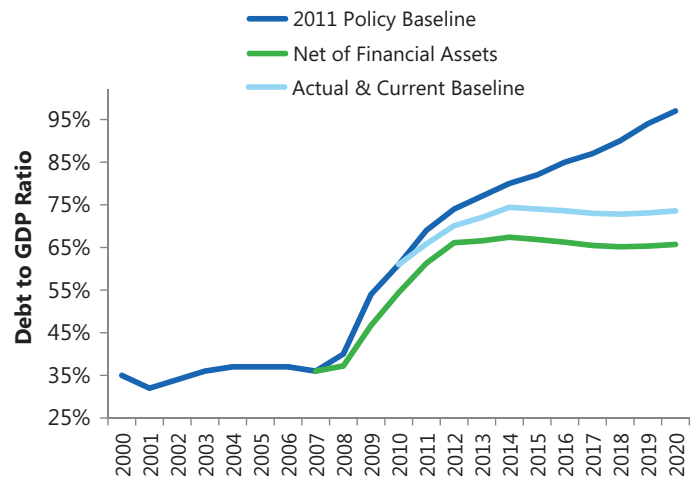
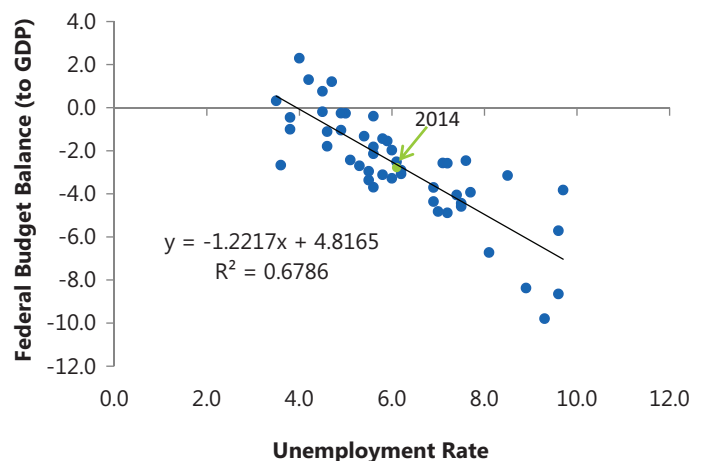


Figure 2: Fiscal Policy and Unemployment, 1964-2014



1 Bureau of Labor Statistics, Consumer Expenditure Survey, September 2014

2 BLS, 2013 Expenditure Survey.

3 "Structural deficits" are those invariant to the state of the economy.

4 Baker, S. et al. (2013), "Measuring Economic Policy Uncertainty," Chicago Booth Research Paper No. 13-02.

5 This is the publicly held federal debt net of financial assets.

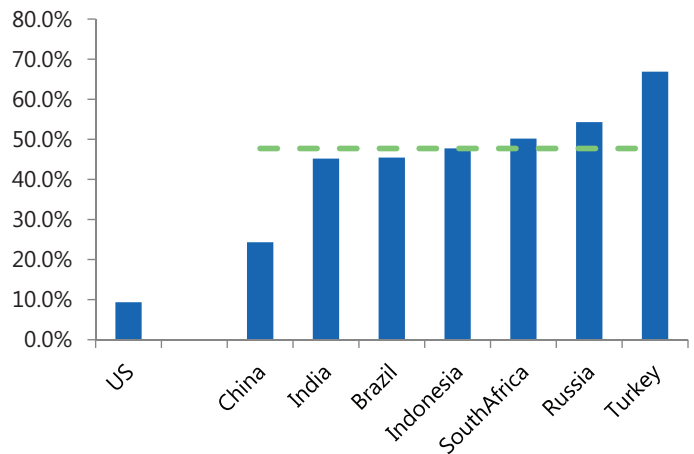
Today's low deficits are surely aided by record low interest rates. At 1.3% of GDP, 2014 debt service costs were 45% lower than in 1999 despite a public debt load almost twice as large. While it's true that deficits would be closer to 6% than 3% of GDP if interest rates reverted to 1990s levels, there is little reason to fear such an adjustment. Low interest rates have less to do with Fed policy than with a global excess of savings relative to desired investment. Today, investors are willing to pay governments for the privilege of lending them money, with nominal short-term interest rates negative in several European economies.<sup>6</sup> Current conditions will not last forever, but when interest rates eventually rise it is likely to be in an environment of strengthening growth that also boosts tax receipts. Fears of a rise in future financing costs provide no basis for an imprudent near-term fiscal tightening.

Indeed, a more appropriate fiscal policy would trade long-run entitlement savings for near-term sequestration relief. Policymakers should increase public investment through a compromise similar to the 2013 Ryan-Murray agreement to replace fiscal year 2014-2015 sequestration cuts with other savings. Under current law, discretionary outlays are expected to reach an all-time low share of the economy over the next two fiscal years.<sup>7</sup> This decline is part of a long-run shift in the composition of public spending away from purchases of infrastructure and services towards transfer payments (largely entitlements). In 2014, transfer payments accounted for 64% of federal spending, an increase of over 20 percentage points relative to the 1974 share of 43%.<sup>8</sup> Even modest increases in government investment in bridges, airports, military hardware, roads, and related services offset by future adjustments to benefit formulas would likely improve near-term economic performance.

### Trade: Capitalizing on Increased Competitiveness of U.S.

Among policy initiatives that enjoy bipartisan support, few would have as large a near-term impact on job creation and wage growth as trade expansion. The domestic natural gas revolution, decline in the price of capital, and sluggish wage growth since the financial crisis have dramatically improved the competitive profile of the U.S. economy. Between 2008 and 2014, aggregate production costs in the U.S. increased by just 9%, compared to average growth of nearly 50% in the largest emerging market economies (Figure 3). This cost differential is even greater when accounting for faster relative (total factor) productivity growth in the U.S. When coupled with natural advantages in innovation, labor market flexibility, and capital market development, the U.S. is currently an especially attractive place for businesses to invest and hire, even after accounting for the recent increase in the foreign exchange value of the dollar.

**Figure 3: Change in Aggregate Production Costs, 2008-2014<sup>9</sup>**



Securing Trade Promotion Authority (TPA) and completing the Trans-Pacific Partnership (TPP) would accelerate economic growth by opening markets to U.S. businesses and reduce obstacles to inward investment in the U.S. The TPP agreement would increase trade and investment linkages among 12 nations that combine to account for 40% of global GDP and one-third of global trade flows and improve labor and environmental standards in emerging market economies.<sup>10</sup> TPP would also benefit U.S. businesses by accelerating structural reforms in economies like Japan and Vietnam that protect certain industries from foreign competition or have large state-owned sectors. A free trade agreement of this breadth would likely provide an immediate boost to business confidence and domestic investment.

### Energy Infrastructure: Building on Progress

Since 2009, unconventional oil and gas exploration and extraction has accounted for 70% of net industrial investment in the U.S.<sup>11</sup> The boom in energy investment provided a major boost to the economy at a time when business investment growth in other sectors had been unusually subdued.<sup>12</sup> While the drop in the price of oil is likely to benefit the economy by increasing real incomes and reducing input costs in the transportation sector, it is almost certain to result in a sharp decline in exploration and production-related capex. To ensure the domestic energy revolution is sustained in this period of low prices, policymakers should seek ways to support a new round of energy-related investment focused on new transportation and storage infrastructure.

Much of the new oil and gas produced in the U.S. is located in parts of the country bypassed by the existing energy infrastructure. These bottlenecks result in a fragmented market that imposes huge deadweight costs on

<sup>6</sup> Bloomberg, January 19, 2015, prior to the announcement of the ECB asset purchase program, which further reduced yields.

<sup>7</sup> CBO, January 2015 Budget Baseline.

<sup>8</sup> CBO, January 2015 Budget Baseline.

<sup>9</sup> Carlyle Analysis of 2014 IMF WEO Database

<sup>10</sup> The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress, November 19, 2014.

<sup>11</sup> Carlyle Analysis of the Federal Reserve, G.17 Index. Net investment measures the change in productive capacity (gross investment minus depreciation of the existing stock of assets).

<sup>12</sup> Clare, P. and Thomas. J. (2014), "The Opportunities from Underinvestment," Economic Outlook, The Carlyle Group.

the economy, as producers accept depressed prices, while utilities and industrial users in other parts of the country experience seasonal shortages and price spikes. An estimated \$650 billion to \$900 billion of fixed investment is required to connect new shale plays with existing energy infrastructure and build new pipelines and storage facilities to accommodate the growth in domestic energy production.<sup>13</sup>

Policymakers can accelerate the pace of this investment by streamlining the permitting process.<sup>14</sup> A recent Government Accountability Office (GAO) report found that the regulatory review for the average interstate natural gas pipeline averages 558 days between pre-filing and certification.<sup>15</sup> The process is so time consuming because of the number of federal, state, and local agencies involved, the differences in practices across states, and the absence of a single “lead” agency charged with coordinating the process. The federal government can take steps to expedite the review process without undermining any necessary environmental assessments. Exact timing is not as important as the policy decision to consolidate the approval process and expedite review. Not every proposed pipeline will be built, but government should not erect barriers to fixed investment in cases where businesses are willing to put discretionary capital at risk.

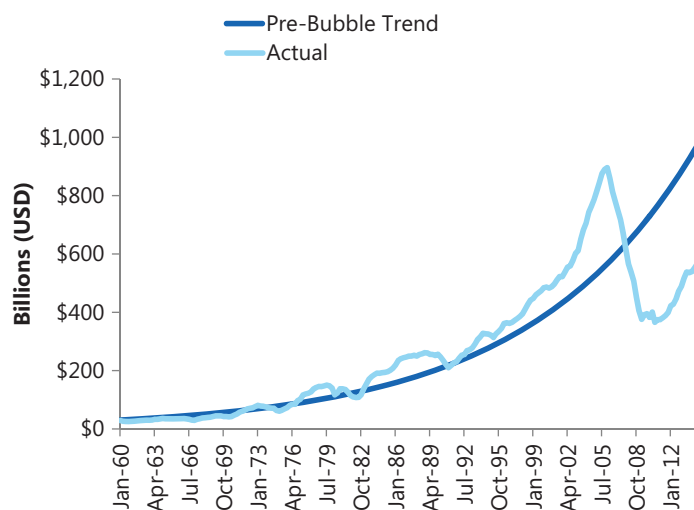
Policies should also be considered to facilitate the integration of natural gas markets. Oil markets are global, with differences in per barrel prices generally explained by grade, transportation costs, and other salient characteristics. The price of West Texas Intermediate and Brent crude oil, for example, generally track one another, with a correlation of nearly 90%.<sup>16</sup> The natural gas market, by contrast, is fragmented, due to transportation bottlenecks. The average price of natural gas in Japan was \$13.68 per million BTU in December 2014, about 5.5x higher than the average in the U.S. While there is no explicit ban on natural gas exports, policymakers could take steps to accelerate the authorization for liquefied natural gas (LNG) export permits.<sup>17</sup> Only five of the 37 non-free trade agreement (FTA) applications submitted to the Department of Energy since 2010 have been approved. Such delays and associated uncertainty unnecessarily slows U.S. growth by reducing fixed investment in gas liquefaction facilities and domestic producers’ potential export earnings.

## Housing Credit: Increase Private Capital and Credit Availability

The recovery from the financial crisis has been so tepid,

in part, because of continued weakness in housing market. Private residential construction activity remains about \$400 billion below its pre-bubble trend, a shortfall equal to 2.3% of GDP. Some of the decline is explained by the deceleration in population growth to an annual rate of 0.7% from a pre-crisis trend of 1.0%, but this difference is overwhelmed by the depreciation of the existing capital stock, which amounts to \$350 billion annually.<sup>18</sup> The underinvestment is instead likely explained by a lack of access to mortgage credit among first-time home buyers. Although overall fixed residential investment has fallen considerably, multifamily construction (apartments) is growing at the fastest rate in more than 20 years.<sup>19</sup>

**Figure 4: Private Fixed Residential Investment<sup>20</sup>**



Increasing access to housing credit is a politically difficult subject because the government remains the dominant provider of mortgages through its control of Fannie Mae and Freddie Mac. When including the Federal Housing Administration (FHA) and Veterans Affairs (VA) mortgages, taxpayers are responsible for underwriting the credit risk of nearly 90% of all new mortgages.<sup>21</sup> Rather than expand the taxpayer-backed credit box through liberalization of FHA underwriting guidelines, Congress and the Administration should seek ways to transfer credit risk to the private sector. In a world where global fixed income investors are starved for yield, Fannie and Freddie should increase their issuance of credit risk sharing securities that transfer the first layer of credit losses from Fannie Mae and Freddie Mac to investors.<sup>22</sup> At the same time, new programs should be developed to expand amount of credit risk transferred to private mortgage insurance firms and the lenders that originate loans. Increasing private participation in mortgage credit markets holds the potential to increase mortgage credit availability without burdening

13 The range represents results from “North American Midstream Infrastructure through 2035: Capitalizing on Our Energy Abundance,” ICF International, March 2014; and “Oil & Natural Gas Transportation & Storage Infrastructure: Status, Trends, & Economic Benefits,” IHS International, December 2013.

14 H.R. 161, the “Natural Gas Pipeline Permitting Reform Act” (and its Senate companion) is an example of such legislation.

15 GAO, “Interstate and Intrastate Natural Gas Permitting Processes Include Multiple Steps, and Time Frames Vary,” GAO-13-221.

16 Quotes from S&P Capital IQ Database.

17 H.R.6, “The Domestic Prosperity and Global Freedom Act” (and its Senate companion) is an example of such legislation.

18 Federal Reserve, B.102.

19 Census, New Residential Construction, January 2015

20 Bureau of Economic Analysis, NIPA Table 1.5.5

21 FHFA Conservators’ Report, 2013.

22 See, for instance STACRs (Freddie Mac): [http://www.freddiemac.com/creditriskofferings/stacr\\_debt.html](http://www.freddiemac.com/creditriskofferings/stacr_debt.html); and Connecticut Avenue Securities (Fannie Mae): <http://www.fanniemae.com/portal/funding-the-market/credit-risk/conn-ave.html>



taxpayers with undue risk.

## Tread Carefully on Corporate Tax Reform

Noticeably absent from our list of bipartisan growth initiatives is corporate tax reform. The U.S. business tax system is excessively complex and imposes an estimated \$4.4 billion in annual compliance costs. There are surely more efficient ways to collect revenue from domestic businesses and in the medium term we need comprehensive tax reform. At the same time, a major debate over tax reform, which creates the appearance that such reform could be accomplished, could depress business spending today, precisely at the time when business leaders are just regaining the confidence to make significant investments in new plant, equipment, products and technologies. Major tax policy changes could significantly influence after-tax returns on new investment projects and lead risk-averse business managers to defer marginal investments until it becomes clear how comprehensive tax reform will affect their particular business. Tax reform could be beneficial, but policymakers must consider the risks attendant to a lengthy process that consumes significant time and attention, stalls investment, but ultimately fails.

## Conclusion

The U.S. economy appears to be growing steadily and looks especially strong relative to its trading partners. In this environment, Congress and the Administration should take a Hippocratic approach to economic policy in 2015 and first do no harm. But this is not sufficient. There are several policy measures ranging from trade promotion to energy infrastructure, and mortgage credit that enjoy bipartisan support and could accelerate growth. These seemingly small steps could also serve to build confidence and lay the necessary groundwork for more comprehensive reforms in the future.

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