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HPS**insight**

THE PATH FORWARD
Current Economic Challenges

Executive Summary

Economic conditions are consistent with the deleveraging challenges articulated by many economists (most notably by Carmen Reinhart and Ken Rogoff). In this report we find:

- The primary cause of the economic crisis in 2008 was a credit bubble, which caused inflated asset prices and elevated levels of debt, seen most notably in the housing market.

- When the credit bubble burst during the financial crisis, unemployment rose and asset prices fell, but the elevated levels of debt remained.

- Since the financial crisis in 2008, households and financial institutions have been working to reduce the debt accumulated in the years leading up to the collapse. This process has become known as "deleveraging" and generally involves the use of income to reduce outstanding loans rather than fund spending or investment.

- As individuals simultaneously increased savings to pay down debt, reduced demand prolonged the recession and tempered economic growth, again impacting individuals and creating a vicious circle that impeded true recovery.

- These and other factors have contributed to the extended economic stagnation we are currently experiencing. Our economic output (in real GDP) is 8 percent below trend, with unemployment elevated above 9 percent, and expected to remain there until 2013.

Introduction

We are three years into an historic economic slump and no policy out of Washington during that time has successfully addressed the full extent of the problem. Whatever the impact has been (positive or negative) from the extraordinary efforts of the Federal Reserve, the President's stimulus, and various other actions, it is undeniable to say that despite all the good-faith efforts, our economic challenges continue.

This report is the first in a series of three intended to jumpstart a discussion of the economic policy path forward in conjunction with the return of Congress from summer recess, the President's joint address to Congress on the economy, and the first meeting of the Joint Select Committee on Deficit Reduction.

In this first report, we have worked to outline in a digestible form a view of the major cause of our extended economic slump. In the reports that follow, we will look at the major policy choices that exist to address our current problems, as well as the potential political path toward real action on the economy.

This report has been prepared independently by Hamilton Place Strategies with the invaluable efforts of Ashley Smith and Russell Grote. No third party funded this work and our conclusions are our own. The analysis here has been conducted simply to further a public dialogue on the political and economic choices facing the country.

Hamilton Place Strategies

Matt McDonald
Partner

Economic overview

The United States economy is in the midst of prolonged economic stagnation. Unemployment remains above 9 percent, growth projections have continually been revised down, and the chances of a double-dip recession are increasing. This report provides a background to the crisis that helps describe the interplay between household debt, stagnant incomes, and cautious behavior of creditors, all of which have contributed to a period of slow growth in the U.S. economy.

The prolonged stagnation we are experiencing now is driven in large part by the bursting of the credit bubble, the collapse in asset prices, and the effort by households to rebuild balance sheets through deleveraging. As households all cut back on spending at the same time to climb out of debt and rebuild their savings, the impact to the total economy was negative and sustained. (See Exhibit 1)

Exhibit 1

THE PATH TO STAGNATION

- Over the course of the period between the late '90s and 2007, consumers built up significant debt
- When the economy contracted, they were faced with falling incomes and elevated debt

- Consumers reacted by increasing their savings rates and paying down debt
- As savings increase, spending decreases

- As consumers simultaneously deleverage, this process puts downward pressure on prices and reduces aggregate demand, causing long-term economic malise

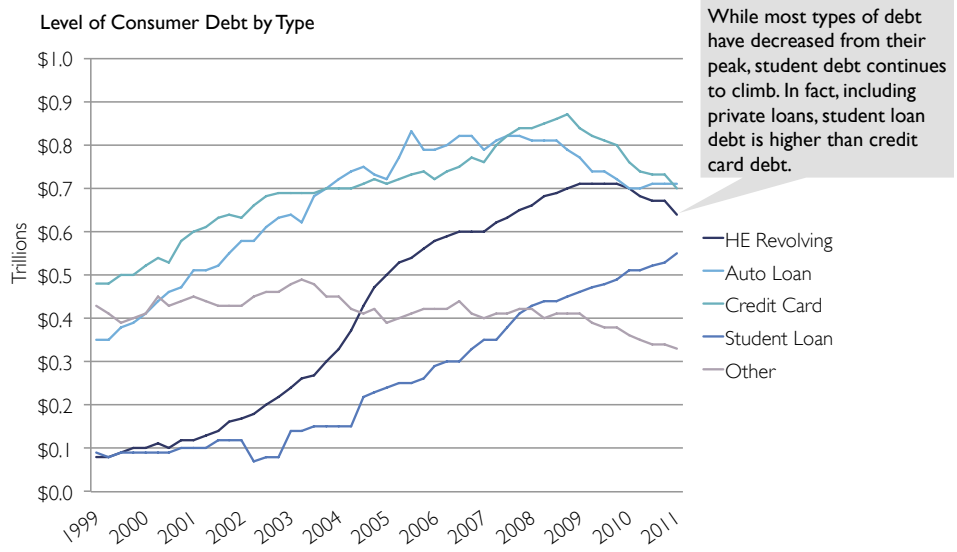
The credit bubble

From the '90s through the late 2000s, cheap credit helped to fuel an asset bubble that would eventually collapse. This was most prominently seen in the housing market. Cheap credit (inappropriately low interest rates relative to risk) made it easy for people to borrow money to purchase a home. With limited housing stock and an increase in demand because of more people looking to purchase, prices were bid up. In hot markets, it was not uncommon for houses to be on the market for a single day before purchase. The expectation of rising

prices in turn incentivized both more aggressive bidding by consumers and looser lending to finance purchases.

Exhibit 2

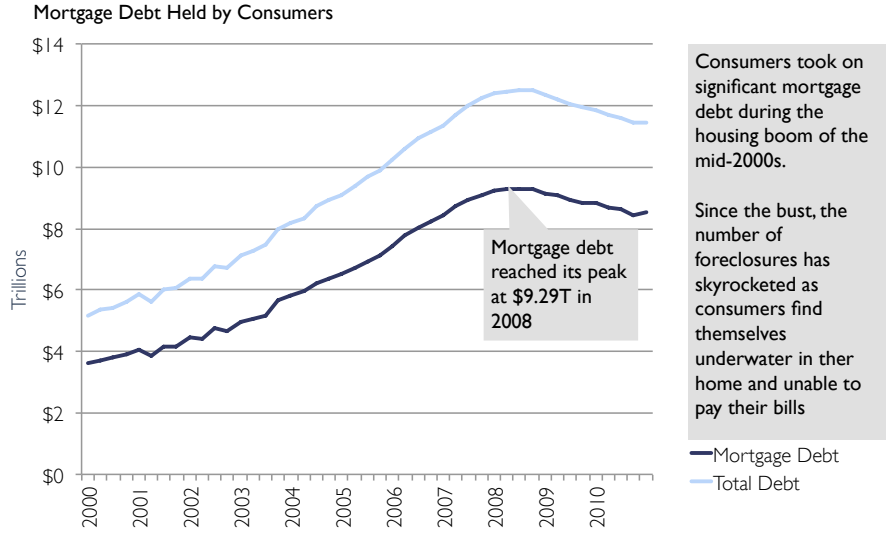
CONSUMERS INCREASED NON-MORTGAGE DEBT, FOLLOWED BY DELEVERAGING



Source: Federal Reserve Bank of New York

Exhibit 3

MORTGAGE DEBT WAS THE LARGEST FACTOR IN THE EXPLOSION OF CONSUMER DEBT



Source: Federal Reserve Bank of New York

Housing was not the only area where individuals increased their debt. There were also dramatic increases in auto loans, credit cards and student debt. In fact, household levels almost doubled from 2000 to 2007. Mortgage debt increased to $9.29 trillion dollars from under $4 trillion in 2000, while both credit card and auto loan debt peaked above $800 billion from under $5 billion. (See Exhibits 2 & 3)

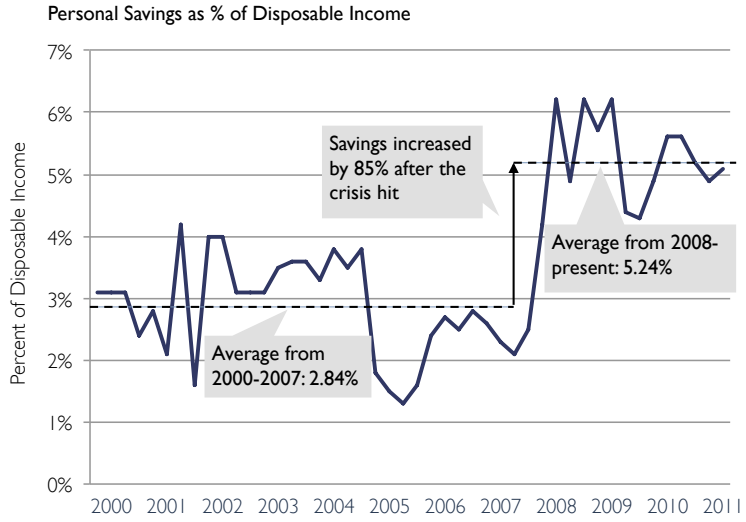
When the credit boom turned to bust in 2008, these high debt levels became unaffordable. The collapse in home values reduced household net worth and blocked refinance opportunities for those that were now "underwater." Following the collapse, the subsequent recession compounded the problem by reducing household income. At the same time, household debt remained at the previously elevated levels. In response, individuals have increased their savings rates to pay off their debts and improve their balance sheets.

The deleveraging response

During the boom, individual savings rates as a percentage of disposable income was below 3 percent. Then from 2008 to 2011, individuals almost doubled their savings rate. Increased savings were used to pay outstanding debts. While the abnormally low savings rates of the bubble period were unsustainable, a collective sharp increase in savings provided an additional, sustained shock to the economy. This trend was compounded by the elimination of home equity as a resource to finance spending. (See Exhibit 4)

Exhibit 4

WHEN THE RECESSION BEGAN, CONSUMERS DRAMATICALLY INCREASED SAVINGS

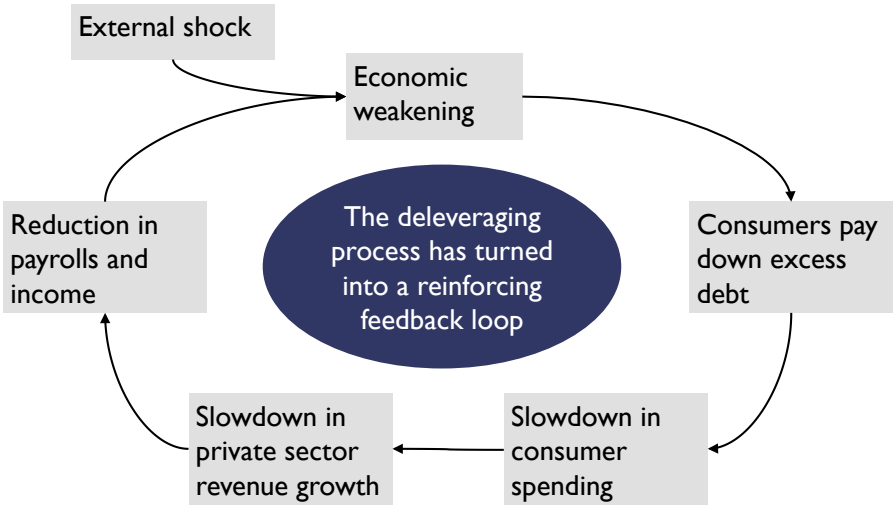


Source: Bureau of Economic Analysis

Companies accustomed to pre-crisis levels of consumer demand were now facing steep reductions in revenue. Given these conditions, companies increased lay-offs or shelved plans for new hiring until economic conditions improved. Less income and the threat of less income caused individuals to save more, in turn constricting demand and creating a vicious circle that has led to a prolonged stagnation. (See Exhibit 5)

Exhibit 5

WHEN ALL CONSUMERS DELEVERAGE AT ONCE, THE ECONOMY ENTERS A DOWNWARD SPIRAL



Other factors

While deleveraging helps explain our prolonged slump at a high level, other factors are evident and important.

Even those who don't have excess debt may be adjusting to a perceived "new normal" of stagnant incomes. If people feel that their incomes will not grow in the future, they will be less likely to borrow, invest and spend. Likewise for businesses, if they perceive reduced demand indefinitely or other uncertainty in the economic or regulatory environment, they are going to wait to hire or expand until the last possible moment.

While debt levels and stagnant income growth explain deleveraging by debtors, both fail to address the behavior of creditors. Typically, when households pay creditor institutions such as banks, the bank will turn around and lend the money back into the economy. However, following the financial crisis, banks are rebuilding their own balance sheets both by necessity and by regulatory

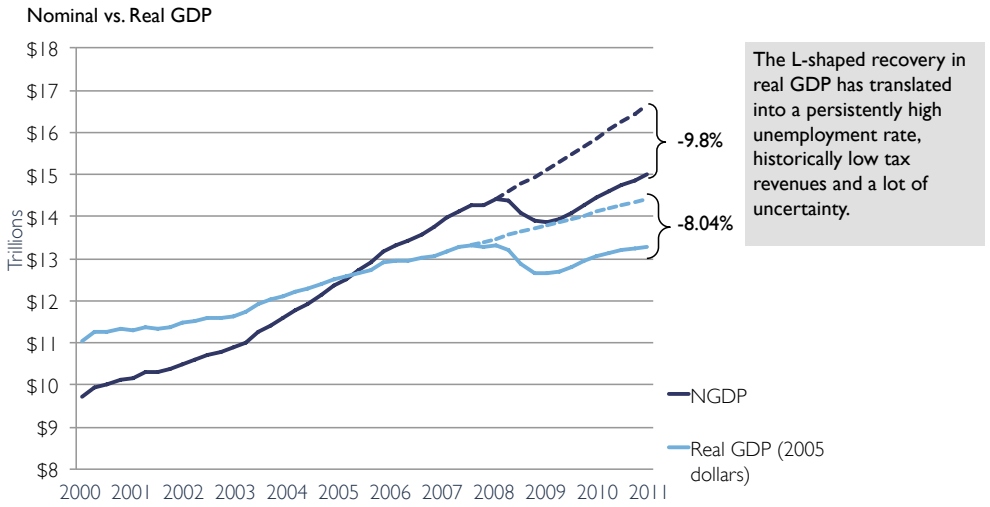
mandate through the stockpiling of safe assets such as cash and U.S. Treasury bills rather than loaning money to businesses and consumers. This has the effect of cash remaining on the sidelines of the economy rather than sparking a more robust recovery.

End result: stagnation

In truth, all of these are contributing dynamics and are causing significant pain for the economy. Real output is 8 percent below trend and unemployment is elevated at 9.1 percent. The U.S. economy is producing well below its capacity and the impact on individuals and families has been disastrous. (See Exhibit 6)

Exhibit 6

THE RESULT: A PROLONGED ECONOMIC SLUMP



Source: Bureau of Economic Analysis

The danger now for the U.S. is that the extended duration of the economic slump will have a detrimental impact beyond the current period. Most worrying for policy makers is the potential for cyclical unemployment becoming structural unemployment as workers' skills deteriorate.

This danger makes it extremely important that Washington gets the economic policy right. We will address those policy options in the next report on the economic path forward.

About Hamilton Place Strategies

Hamilton Place Strategies is a policy and communications consulting firm based in Washington. As a firm, our focus and expertise lie at the intersection of government, business and media. Our deep experiences on all of these dimensions allow us to serve industry leaders seeking to navigate the paths between Washington and the private sector.

HPS works with clients on a host of challenges, from crisis management and reputation building to policy analysis and business strategy. Our support includes outside advisory, as well as transformational work to directly improve client capabilities.

Our collective prior work entails decades of experience at the highest levels of government, business and communications, including work in Congress, the White House, the Office of Management and Budget, the Treasury Department, the Financial Crisis Inquiry Commission, Presidential campaigns as well as management consulting.

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