

*Economics Group*

# 2013 Economic Outlook

## Growth in an Era of Fiscal Constraint



A moderate, subpar pace of growth should continue to be the story in 2013, as consumers, businesses and governments adjust to the new normal of fiscal constraint. Elected leaders will feel the pressure to rein in budget deficits with the understanding that fiscal policy will be dictated by the choices made today and the long-run growth of the economy.

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## **Executive Summary**

The number 13 has long been viewed with dread and suspicion in many societies. Although the origin of these fears is not conclusively known, one widely held belief is that it takes a minimum of 13 loops in a rope to make a hangman's noose, anything less than that would not do the job. There were also reportedly 13 attendants at the Last Supper. Friday the 13th is often considered an unlucky date (and Tuesday the 13th in Spanish speaking countries), and tragedies that have been associated with the number 13 often take on larger-than-life significance. One of the most notable examples is the failed Apollo 13 mission to the moon, which nearly ended in disaster when an oxygen tank exploded on April 13th. Many buildings and hotels avoid having a 13th floor altogether. There is even a medical condition, triskaidekaphobia, for those with irrational fears about the number 13. With this sense foreboding, Congress and the Obama Administration have set the economy up to begin 2013 in the most precarious of positions, with taxes set to increase dramatically and federal spending set to be cut.

Ever since the presidential election was decided, concerns about what has become known as the fiscal cliff have taken center stage. The cliff involves six major components: the Bush-Obama tax cuts, which expire on December 31; the sequestration, which begins with the new Congress on January 3; the temporary 2 percentage point cut in the social security tax (payroll tax), which expires on December 31; the new taxes associated with the Affordable Care Act, which begin on January 1; the ending of federal funding for extended unemployment benefits and bonus depreciation on capital equipment outlays, which end on December 31. Congress also needs to come up with a fix for the Alternative Minimum Tax (AMT) by the end of 2012 or as many as 34 million taxpayers will find themselves with an unexpected tax liability for 2012.

How did all of these momentous tax and spending decisions get pushed to the same time? The answer is remarkably simple. Congress and the Administration simply kicked the can just far enough down the road to get past the election, extending tax breaks to the end of 2012 or passing laws that put the effective date for new taxes at the start of 2013. All of this has been known to policymakers and analysts for a long time. Any outlook for 2013 has to include some assessment as to how the issues comprising the fiscal cliff will be dealt, to which we devote Chapter 3 of our outlook. Forecasts are not based on "ifs," however, and we begin ours with the latest available economic data, build in what we believe is virtually certain to occur in the way of monetary and fiscal policy and also incorporate global economic influences, and a brief discussion of demographics and long-term potential economic growth.

Our 2013 forecast remains cautious to say the least. Real GDP growth appears to have slowed to around a 1 percent annualized rate during the final quarter of 2012, as businesses have put expansion and hiring plans on hold ahead of the fiscal cliff negotiations. We expect growth to get off to a slow start in 2013, as higher taxes hit households at all income levels. Federal government spending will also contract modestly. We expect growth to rebound modestly by the middle of the year, as the economy moves further away from the fiscal cliff and homebuilding gains momentum.

Europe's economic and financial troubles will continue to weigh on global economic activity in 2013 but we expect conditions to gradually improve over the course of the year. With much of the developed world mired in recession or growing exceptionally slowly, global economic growth will likely depend more upon what happens in the developing world. Fortunately, growth is holding up better there and should firm up a bit over the course of the year.

Fiscal policy remains the main event and what happens with the fiscal cliff will have far reaching influences. Even after the immediate questions surrounding the Bush-era tax cuts and sequestration are resolved, long-run challenges will remain. We review some of the long-run budget challenges and conclude that restoring soundness to the nation's finances will inflict significant costs on economic growth. When you factor in demographic changes and slower productivity growth, potential real GDP growth has likely slowed to a pace well below what was seen in recent decades, which will present a new set of challenges to households, businesses and policymakers.

## 1. The 2013 Economic Outlook

This section explores our expectations for domestic economic growth in the coming year.<sup>1</sup> Due to the current fiscal policy negotiations, it is important to understand the assumptions of our baseline forecast, of which select components will be discussed in this chapter, as well as the effect certain decisions regarding tax and spending policies will have on our forecast. Our baseline forecast assumes the expiration of the short-term payroll tax cut, the extended unemployment benefits and the “bonus” depreciation on capital equipment. This chapter will quantify our forecast and lay the groundwork for the following chapters, which will discuss the implications such modest economic growth will have on the consumer as well as potential headwinds to our forecast in terms of fiscal policy decisions and the changing face of the American workforce.

### Uncertainty Weighed on 2012

The U.S. economy continues to bounce from event to event with seemingly little change to its underlying momentum. The presidential election produced no significant net change on the policy front. President Obama was re-elected and Congress remains divided, with Republicans controlling the House and Democrats controlling the Senate. The financial markets reacted negatively to the initial result, as it suggests the resolution of the fiscal cliff will be no easier than it was previously. The stock market’s instant reaction also caused attention to shift to the fiscal cliff immediately, which means getting the presidential election behind us increased the general anxiety level rather than reduced it. Europe’s ongoing financial crisis and recession also appear to be weighing on U.S. economic growth.

*The year is ending on a weak note, and we expect growth to slow during the early part of 2013.*

All the uncertainty surrounding the presidential election and policy mix has taken a toll. This year is ending on a relatively weak note. While real GDP growth for the third quarter was revised up to a 2.7 percent annualized rate, the source of the upward revision came from a larger buildup of inventories, a rise in exports, and increased federal government spending (Figure 1). Real final sales rose at just a 1.9 percent rate and final sales to private domestic purchasers, which is the best indicator of the economy’s underlying momentum at a time when global economic conditions are weakening and government budgets are tightening, rose at just a 1.7 percent pace in the third quarter and is up 1.9 percent over the past year (Figure 2). Our early assessment of the fourth quarter puts real GDP growth at around a 1 percent pace and we expect growth to slow during the early part of 2013, as higher taxes cut into take-home pay and businesses put off hiring and investment decisions until the rules of the road, in regard to taxes and spending decisions, are finalized.

Figure 1

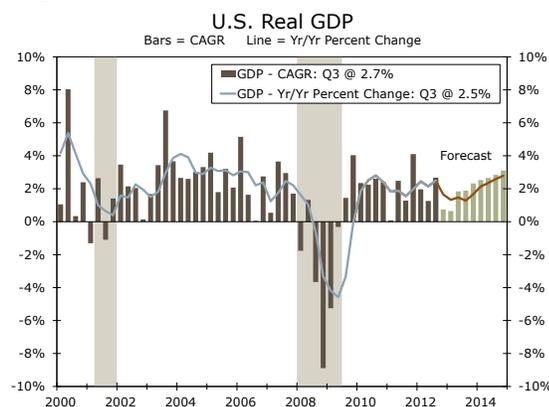
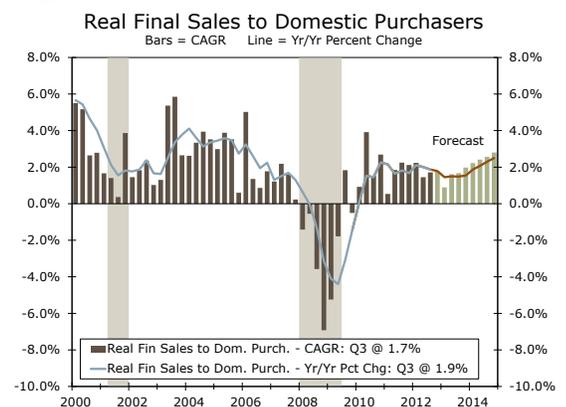


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

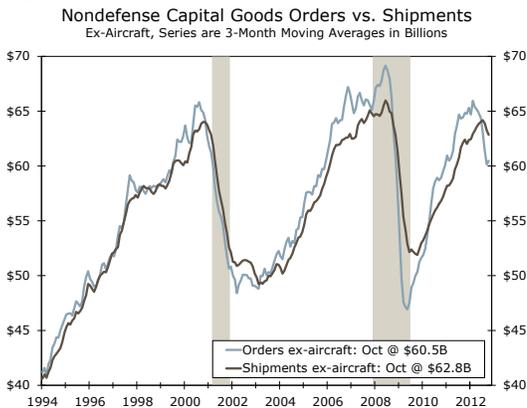
<sup>1</sup> A complete forecast table for domestic growth can be found on page 20. In addition, our forecasts for economic growth in select international economies can be found on page 21.

Businesses have reacted to this continued uncertainty by putting off key decisions on investment and hiring. Orders for nondefense capital goods excluding aircraft have tumbled over the past few months and are currently more than 7 percent below year-ago levels. Moreover, new orders are trending below shipments, which in the past has been a warning of recession (Figure 3). Hiring has not pulled back anywhere near as much, however, but hours worked have leveled off. A whole host of businesses have also announced plans to alter their employment strategy now that the new healthcare law is an absolute certainty. Even with these changes, we expect nonfarm payrolls to rise roughly in line with their gains of this past year and look for the unemployment rate to remain in line with the current rate through 2013.

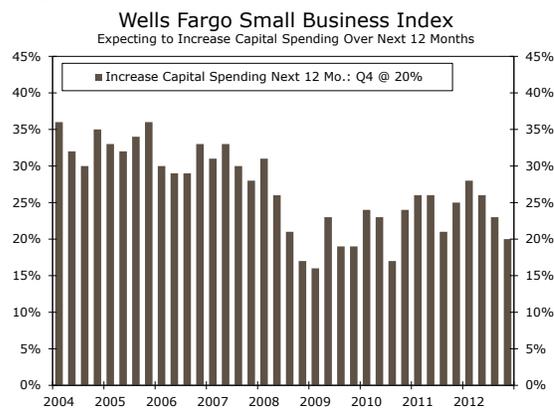
***Uncertainty has weighed on the investment and hiring decisions of businesses.***

Small businesses remain unusually cautious. The Wells Fargo Small Business Index tumbled 28 points during the fourth quarter, which was the largest drop in four years. The quarterly survey, which was taken shortly after the presidential election, was led lower primarily by increased concerns about future conditions. Fewer businesses see revenue growing over the next 12 months, while more see them declining. Businesses are also concerned that they have less ability to control expenses, which has led to even more caution about investment and hiring decisions (Figure 4). For the 18th consecutive quarter, more businesses plan to reduce capital expenditure than to increase them.

**Figure 3**



**Figure 4**



**Source: U.S. Department of Commerce, Gallup, Wells Fargo Bank and Wells Fargo Securities, LLC**

The still massive U.S. trade deficit means that any slowdown in private final demand is falling on overseas producers. This is precisely what happened in the third quarter, when international trade made a small contribution to economic growth, as exports rose modestly and imports declined. Sustaining even modest growth in exports will be difficult in 2013, particularly at the start of the year when the Eurozone is likely to be in recession. Growth is holding up better in Asia, however, and exports are still eeking out modest gains.

***Sustaining even modest growth in exports will be difficult in 2013.***

***Another Year of Moderate Growth***

Given the high degree of uncertainty surrounding fiscal policy and the worsening economic situation in Europe, the outlook for the coming year is even more fraught with risk than usual. We are maintaining a slightly optimistic view and see overall economic growth advancing around a 1.4 percent pace in 2013, compared to around a 2.2 percent pace in 2012. Growth would be significantly worse than that if all of the policy changes making up the fiscal cliff were to take effect nearly simultaneously at the start of the year, as is current law.

***We see overall economic growth advancing at a 1.4 percent pace in 2013.***

We expect the fiscal cliff to be resolved in a way that does not result in willy-nilly cuts to government programs. Taxes will almost certainly increase. The temporary 2 percentage point reduction in Social Security taxes will not likely be renewed, raising taxes by that percentage on the first \$110,000 of income for all workers. The new taxes associated with the Affordable Care Act will also take hold and some portion of the Bush-era tax cuts will likely be reversed, most likely on those earning more than \$250,000 a year. Federal funding for extended unemployment

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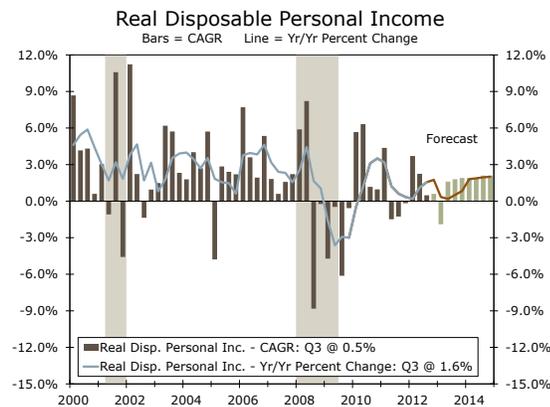
**Most of the weakness in personal consumption growth will be at the start of the year.**

insurance likely will end as well, and bonus depreciation for capital equipment purchases may also not be extended. We project federal government outlays to decline modestly over the next several quarters. The shift to austerity will present a new headwind for the economic recovery but likely will not uproot it. This is not a shift to the austerity programs that have befuddled much of Europe. Businesses and households will adjust and carry on.

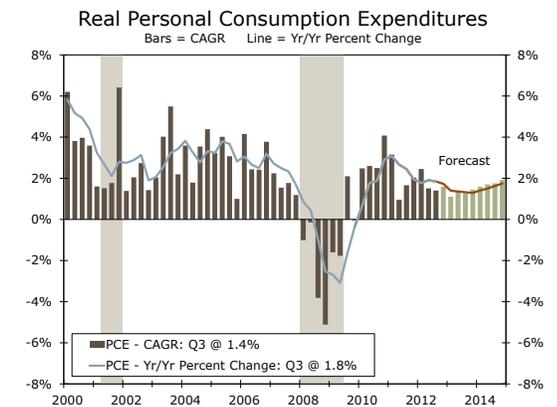
While overall growth should be slower, the composition likely will change significantly. Consumer spending, which has shown surprising strength given the lack of income growth, will almost certainly slow at the start of the year. Higher payroll taxes and the expiration of federal funding for extended unemployment benefits will cut into income at the lower end, while higher marginal tax rates and the new taxes associated with the Affordable Care Act will cut into discretionary income at the upper end (Figure 5).

While slower, consumer spending should remain in positive territory and regain momentum by Spring (Figure 6). There is significant pent-up demand for motor vehicles, which will be lifted by some replacement demand from all of the vehicles lost in Hurricane Sandy. We also suspect that the income data for the prior year may have been understated, providing consumers with a little more cushion to absorb tax increases. Consumer confidence improved significantly in the Fall, even with adverse shocks from the weather and financial markets. The adjustment to the higher payroll tax will take a toll, however, as we expect it to hold real personal consumption growth to just 1.3 percent in 2013. Most of the weakness likely will be at the start of the year. We expect spending to pick up modestly during the second half of 2013 and grow 1.6 percent in 2014.

**Figure 5**



**Figure 6**



**Source: U.S. Department of Commerce and Wells Fargo Securities, LLC**

The extreme caution expressed by businesses, both large and small, means that capital spending will likely remain sluggish throughout the year. The latest factory orders data do show some slight improvement, however, and we believe that businesses are being overly cautious. Investment outlays will likely bounce back once there is some resolution to the fiscal cliff, even if the outcome is less friendly to business than is currently hoped. After a slow start, we expect business fixed investment to rise at a 3.0 percent annualized rate during the second half of the year.

**Residential construction will be a clear area of improvement in 2013.**

The one clear area of improvement in 2013 should be residential construction. Homebuilding will likely strengthen, even as overall economic growth weakens. Homebuilders are now positioned for a more normal recovery. The improved outlook stems from a variety of factors, most specifically a reduction in the amount of effective competition that the overhang of foreclosures presents to new construction. Though, there are still plenty of foreclosures left in the pipeline. An estimated 2.1 million homes are in foreclosure and another 1.57 million have mortgages that are seriously delinquent. Many of the best properties, which are those in the best location and generally in the best condition, have already been sold, however. Moreover, lenders are pursuing short-sales to a much greater degree today and these homes tend to sell at less of a discount than foreclosures.

The underlying fundamentals for new home construction have also improved considerably. Two and a half years of private sector employment gains are finally boosting household formations. While a larger proportion of those new households have chosen to rent rather than buy, homebuilders reported significant gains in buyer traffic this Fall and the NAHB/Wells Fargo Homebuilders' Index rose to 46 in November, which is its highest level in six years. With inventories of new homes near 50-year lows, any rise in demand will translate into significantly stronger building activity. We expect single-family starts to rise nearly 27 percent in 2013.

Strong demand for apartments is another reason to be optimistic about the housing outlook. Vacancy rates on apartments tumbled 1.0 percentage point over the past year and are now well below 5 percent. The drop in vacancies has driven rents up 3.7 percent and much more than that for the best class "A" properties. Rising rents and expectations for continued strong demand are attracting new investment. We expect multifamily starts to jump 32 percent in 2013 and another 13 percent in 2014.

The rise in apartment rents may present a bit of a challenge to the inflation outlook. Residential rent and homeowners' equivalent rent account for nearly 40 percent of the core Consumer Price Index. We see core inflation running toward the top of the Fed's 2 percent comfort zone, but do not foresee inflation becoming a problem in 2013. Food and energy prices remain a wild card, but with global economic growth sluggish, pressures are more likely to lessen than intensify.

***Inflation should  
not be a problem in  
2013.***

Having said this, it is important to point out that while the future of the U.S. housing market looks promising, the path to growth in this new environment of fiscal constraint could still be threatened by the different alternatives being discussed in Washington, D.C. If the Simpson-Bowles proposal is taken as a starting point, we could see a greater push to end, entirely or partially, the subsidies on mortgage interest. It is true that anything done here will likely be met with fierce resistance by the industries affected, and thus, it is difficult to foresee what the outcome will look like. However, if the political system ever gets to the point where we have a major fiscal reform, we would think that even this subsidy will be fair game.

The slow start to the New Year means that interest rates will likely remain exceptionally low. The Federal Reserve will continue with its mortgage-backed securities purchase program and will begin a new Treasury purchase program after Operation Twist winds down at the end of 2012. In its latest statement, the Fed strengthened its communication strategy announcing specific economic targets that need to be reached in order to begin to tighten monetary policy, thus moving away from interest rate forecasts tied to specific dates. Specifically, the Fed will target an unemployment rate at or below 6.5 percent and inflation expectations for one to two years ahead to be no more than 0.5 percentage point above the longer-run goal of 2 percent. Given our forecast for the domestic economy, we expect the target federal funds rate to remain unchanged over the course of 2013. Treasury yields will also likely remain low, although we expect to see yields rise modestly once the issues surrounding the fiscal cliff are resolved.

***Interest rates likely  
will remain  
exceptionally low.***

**The consumer accounts for between 50 percent and 70 percent of GDP in advanced economies.**

## 2. Global Consumption: Relying More on Developing Economies

In the previous chapter we laid out our forecast for the domestic economy in 2013, demonstrating the toll domestic uncertainty and global fiscal restraint will take on both business and consumer spending through dampened growth prospects. However, not only will U.S. consumers feel the pressure of this new fiscal conservatism, global consumers are also facing economic woes (as will be highlighted in Chapter 4) and due to the globalization of today's economies, one country's pain is felt around the world. Moreover, with the consumer accounting for anywhere between 50 percent and 70 percent of GDP in advanced economies, it is vital to evaluate the state of the consumer.

World consumption will remain constrained in 2013 as a large number of individuals in developed countries adjust to the new normal of fiscal restraint. This means that, again, consumers in the developing world will be the key to worldwide consumer demand, as consumers in the developed world deleverage and adjust to the new environment. And within this new environment, developing country governments will have a lot to say in terms of policy decisions to help consumer demand plow ahead. This is especially true for Chinese policy decisions, which will be important in determining the pace of economic growth throughout the world.

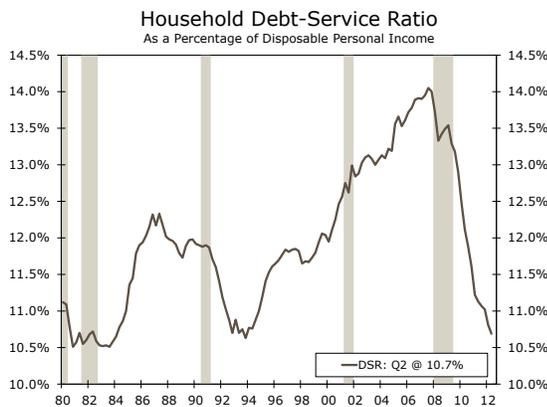
### U.S. Consumer Demand

**U.S. consumer demand should remain positive, but sluggish, in 2013.**

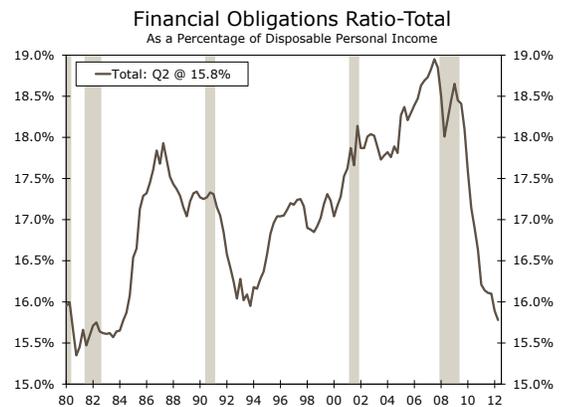
As noted in Chapter 1, we expect growth in U.S. consumer demand to remain positive, but sluggish, during the next several years, as American consumers continue to both deleverage as well as build a liquidity cushion that will help them deal with the still-high levels of uncertainty embedded in the U.S. political landscape. Hopefully, some uncertainty will be lifted by the end of 2012 if the political system is capable of achieving a temporary agreement on the fiscal situation, but we still remain cautious on such an outcome.

It is true that some of the U.S. consumer debt and liabilities measures have improved considerably and that U.S. consumers are in a much better position today than before the crisis. For example, U.S. household debt service as a percentage of disposable personal income was down to 10.7 percent during the second quarter of 2012 from a high of 14.1 percent before the Great Recession. Furthermore, this low of 10.7 percent is close to the trough reached after the recessions of the 1980s and 1990s (Figures 7 and 8). Thus, from the household debt-service ratio perspective, U.S. households should feel much better today and ready to take on more debt.

**Figure 7**



**Figure 8**



**Source: Federal Reserve Board and Wells Fargo Securities, LLC**

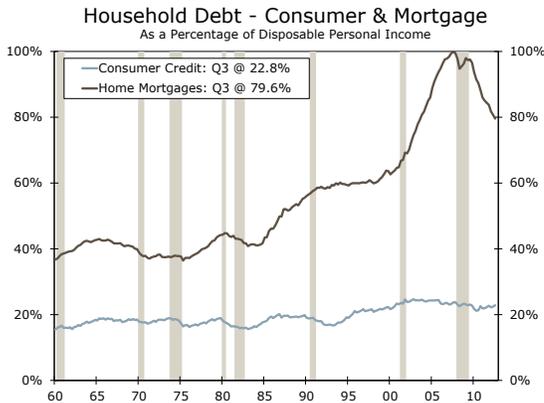
**Debt levels are still very high compared to historical standards.**

However, while these ratios are in great shape compared to previous years and could be pointing to a consumer turnaround, debt levels are still high compared to other historical periods. The measure that concerns us the most is debt as a percentage of disposable personal income which, even though it has come down considerably since the end of the mortgage boom, is still much higher than historical levels, and could limit U.S. consumers' ability to drive economic growth (Figure 9).

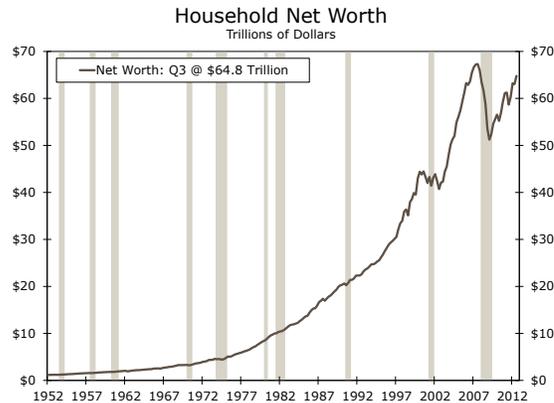
Consumer and mortgage debt as a percentage of disposable personal income has come down from a high of 125 percent before the Great Recession to about 102 percent today, mostly due to a strong decline in mortgage debt, either because U.S. households are paying down mortgage debt faster or debt is being discharged. Mortgage debt as a percentage of disposable personal income is still much higher today than it has been in the past. This may signal that U.S. households are still not prepared to start adding to debt just yet. However, as we saw before, the debt-service ratio is low due to much lower interest rates on that debt than existed back in the 1970s and 1980s. Furthermore, a large percentage of this debt (almost 80 percent) is mortgage debt, which tends to be long-term and at a fixed interest rate.

***Households may not be prepared to begin adding debt just yet.***

**Figure 9**



**Figure 10**



**Source: Federal Reserve Board and Wells Fargo Securities, LLC**

Thus, out of the total debt, only about 20 percent is from consumer loans, which tends to be variable in nature and may be an issue in a higher interest rate environment together with some mortgage debt that has an adjustable rate. This means that in an environment of low interest rates as the United States has and is expected to have until at least the first half of 2015, the prospects for consumer finances are relatively benign compared to other periods in recent U.S. history.

Of course, not all is rosy for U.S. households. The rate of unemployment is still too high for the consumption party to start. Plus, household net worth took a big hit during the Great Recession, and while net worth has come back considerably since the end of the Great Recession, it is still below the peak before the collapse of housing (Figure 10).

***Consumers in the Rest of the World***

As noted earlier, consumers in the developed world are not in a much better position to consume than their American peers. This is especially true for European consumers. While Eurozone consumers have been “helped” by a strong currency over the past several years, economic conditions in the euro area are so dire that the benefits accruing to consumers due to a strong currency, i.e., better purchasing power, are more than offset by the economic malaise affecting the region. As we discuss further in Chapter 4, our expectation is for the region to continue to lag the rest of the world for the next several years as the Eurozone continues to solve its current problems by implementing strong fiscal tightening policies that will further limit the ability of Eurozone consumers to help worldwide economic growth. The Eurozone is clearly in recession following four consecutive quarters of contraction. Real GDP in the Eurozone is almost 1 percent below year-earlier levels. We currently expect economic activity in the Eurozone to decline again in the fourth quarter of 2012, before growing modestly in 2013.

***Consumers in the Eurozone may not be in a position to help world demand.***

***Demand from consumers in the developing world will not be as robust as has been previously.***

Thus, the global economy will need to count on demand from consumers in the developing world. However, this time around, the help from these economies' consumers will not be as robust as it has been over the past several years. One of the biggest reasons for this is the slowdown in Chinese economic growth and the ensuing weakening in commodity prices. Much of the strength in emerging market demand over the past decade or so has been motorized by a strong increase in commodity prices. Today, while commodity prices continue to be elevated, they have come down from recent historic highs and are expected to remain at current levels or weaken even more, depending on the strength in Chinese and world economic growth.<sup>2</sup>

Consumers in developing economies will be able to rely on a strong currency effect, which will allow them to keep consuming at a relatively healthy clip. The reason for this strength in emerging economies' currencies is the need for developed countries to keep expansive monetary policies, which tend to weaken their own currencies and thus put upward pressure on emerging market currencies, just as the world has seen since the beginning of this century.

However, this strength in emerging market currencies will only partially offset the weakness brought about by the slowdown in world economic growth. The only potential surprise to this view could be the inroads made by Chinese policymakers to redirect Chinese economic growth from export-oriented or foreign-demand-driven to inward-oriented or domestic-consumption-driven. If Chinese domestic demand strengthens, this will be a nice addition to worldwide economic growth. However, any process that changes the current path and direction for Chinese economic growth will be implemented over the medium- to long- term and thus will have little short-term economic effect. Thus, we remain cautious regarding potential upside surprises to our low to moderate economic growth outlook.

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<sup>2</sup> We suspect the Chinese economy will continue to grow around 8 percent over the next couple of years. While seemingly strong, this is considerably slower than the double-digit growth rates experienced over the past five years. Our forecast for global economic growth can be found on page 21.

### 3. The U.S. Fiscal Outlook

In the next two chapters, we discuss the fiscal outlooks for the United States and Europe. As mentioned in Chapter 1, our outlook for the domestic economy is dependent on fiscal policy decisions that will have a significant influence over economic growth in both the short and long run. Decisions made in regard to spending and tax policy will directly affect the investment and hiring decisions made by firms, as well as those consumption and saving decisions made by consumers, who are already struggling with abnormally sluggish post-recession economic growth. Therefore, the improvement in the consumers' balance sheets that we discussed in Chapter 2 may be prone to downside risk. Moreover, fiscal policy decisions made today need to consider the long-term consequences of such decisions, particularly in an environment of shifting demographics, such as an aging population, a growing emphasis on education and an increasing share of women, minorities and immigrants in the labor force. We will discuss the implications of shifting demographics on our society in more detail in Chapter 5.

***Our outlook for the domestic economy is dependent on fiscal policy decisions.***

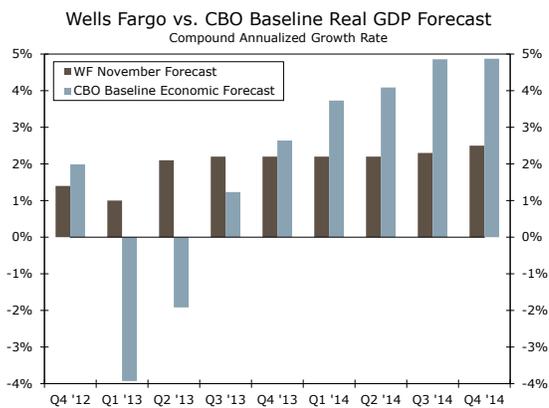
#### Restoring a Fiscal Balance

Now that the presidential election is over, business decision makers and consumers are shifting their focus to the next major issue: the fiscal policy challenges facing our nation in the form of the fiscal cliff and the need to again raise the debt ceiling. The reality of the fiscal outlook is that entitlement programs are on a path to eventual insolvency, government revenues continue to increase at a sluggish pace, demand for government resources continues to rise in light of the Affordable Care Act and cost overruns for social services programs in the wake of a slow economic recovery. The choices are clear: address the long-term budget or face another U.S. sovereign debt downgrade, which would increase the risk that longer-term overall interest rates move higher, in turn suppressing future economic growth.

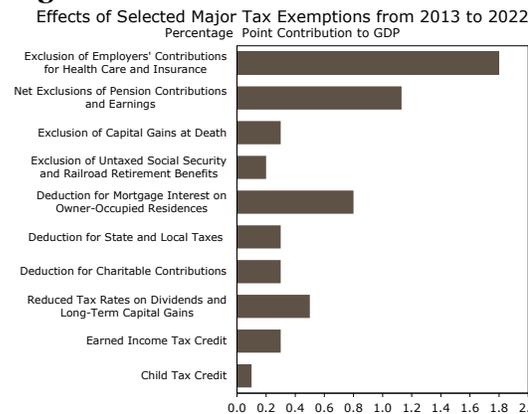
Under current policy, federal government spending is unsustainable at the current rate of economic growth.<sup>3</sup> The future paths of spending and revenue as a percentage of GDP forecasted by the Congressional Budget Office (CBO) are highly dependent on the economic assumptions made. Figure 11 highlights the main differences between our baseline forecast and the CBO's baseline forecast through the end of 2014.<sup>4</sup>

***Federal government spending is unsustainable at the current rate of economic growth.***

**Figure 11**



**Figure 12**



Source: Congressional Budget Office and Wells Fargo Securities, LLC

<sup>3</sup> Congressional Budget Office. (August 2012). An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022.

<sup>4</sup> It is important to note that the Wells Fargo baseline forecast assumes that following the short-term patch, a long-term deal is completed on tax and spending policy early next year. The CBO's baseline forecast assumes that existing law goes into effect next year with all of the tax cuts expiring and the budget sequestration occurring.

The tax and spending choices that are made over the next few years could have feedback effects that usually are not incorporated well into standard forecasting models. For example, consumer confidence and marginal propensities to consume could be adversely affected by fiscal tightening. As we discuss in more detail in Chapter 4, there is some evidence to suggest that fiscal tightening in Europe has had a more detrimental effect on GDP growth in individual Eurozone economies than most forecasters had initially anticipated. In other words, growth in the United States in the years ahead may not be as strong as the CBO projects.

#### ***Entitlement Reform***

***Entitlement reform is a key to reining in spending over the long term.***

One of the keys to reining in spending over the long term is the need to reform entitlement programs. The latest Social Security and Medicare Trustees Report has estimated that Social Security will be insolvent in 2033, and the Medicare program will be insolvent in 2024.<sup>5</sup> Reform is needed to put these programs on a fiscally sustainable path. Potential reform to Social Security could include re-indexing Social Security to a lower rate of inflation and adjusting age limits for Social Security eligibility. On the Medicare front, greater co-pays will be an essential component of sharing the cost of healthcare across income spectrums.

Medicaid presents several challenges for both state and federal governments. Medicaid continues to consume a greater portion of state budgets. In fiscal year 2011, for example, 20 states reported Medicaid's budget share exceeding the national average of 23.6 percent.<sup>6</sup> The ever-increasing share of state budgets devoted to the Medicaid program has in some cases even begun to crowd out state spending for other programs, such as education and human services. From a federal perspective, reforming Medicaid by passing along the costs to state governments is not a viable solution to addressing the rising costs of the program. Under the Affordable Care Act, states will already face sharp increases in outlays for the Medicaid program beginning in 2017 when they are expected to pick up the bulk of the costs of expanded health insurance coverage.<sup>7</sup> Simply passing the cost burden on to states could result in lower long-run economic growth as states would need to raise taxes and/or cut back on other government services to afford the costs of the healthcare program.

In addition to entitlement reform, other areas of spending will need to be addressed to provide long-term sustainability to the federal budget. To curb spending, tough decisions have to be made about the reduction and/or elimination of subsidy programs in the areas of energy and farming, just to name a few. Program funding for subsidies should be made on a cost-benefit basis and should have a justifiable reason why it should receive government funding. In many cases, these subsidy programs have become out of date and no longer serve their original intended purpose.

#### ***Reforms to Government Revenue<sup>8</sup>***

***Changes on the revenue side of the equation can also help close the deficit.***

In addition to some possible reforms to spending, changes on the revenue side of the equation can also help to close the federal deficit. Some politicians, most notably President Obama, have proposed raising income tax rates for some Americans. Others have suggested eliminating or capping certain deductions as a way to raise revenue. Under the capping option, taxpayers would only be allowed to deduct up to some threshold amount after which further deductions would not be allowed. The CBO has estimated that capping deductions at 15 percent would save the federal government \$150 billion by 2020.<sup>9</sup> Figure 12 highlights the effect on the federal budget from income tax expenditures, such as exclusions, deductions and tax credits. In addition to equality in the tax code, proposed tax policy must be evaluated to determine the incentive effects the policy would have for individuals and businesses, which would have effects on both short- and long-run economic growth.

<sup>5</sup> Social Security and Medicare Boards of Trustees. (April 2012). *A Summary of the 2012 Annual Reports*.

<sup>6</sup> The Council of State Governments. (July 2012). *Medicaid Spending: States Face Budget Dilemma After ARRA Bailout*.

<sup>7</sup> National Conference of State Legislatures. (June 2011). *States Implement Health Reform: Medicaid and the Affordable Care Act*.

<sup>8</sup> For more on taxes see our special report titled *Income Tax Analysis: Who Pays?* available by request.

<sup>9</sup> Congressional Budget Office. (November 2012). *Choices for Deficit Reduction*.

***U.S. Fiscal Policy in the Short Run***

Over the next few months we expect a longer-term deficit reduction deal to take place as part of a resolution to the fiscal cliff.<sup>10</sup> Given our expected short-term solution to the fiscal cliff, we anticipate first-quarter 2013 economic growth to remain constrained to the 1.0 percent range due to the continued uncertainty over the future path of tax and spending policy. Throughout the rest of the year, the gradual pace of fiscal austerity will also weigh on growth, but not nearly as negatively as the significant cuts contained within the fiscal cliff. The likely tax increases will also reduce after-tax disposable income on the part of consumers, which, in turn, will keep real consumer spending in the 1.5 percent range for the year.

The uncertainty around future tax and spending policy should keep headline GDP growth around 1.5 percent in the first half of 2013 as businesses and consumers adjust to policy changes. The second half of the year will see stronger growth around 2.1 percent as the domestic fiscal policy challenges are addressed and businesses receive some certainty around future tax liabilities.

***U.S. Fiscal Policy in the Long Run***

Fiscal policy in the long run will be dictated by the policy choices made today to address the unsustainability of our nation's debt profile. Choices about tax policy must be made within the framework of the effects of tax policy on capital, labor, technology and entrepreneurship. Fiscal policy has the potential to significantly reduce long-run economic growth if tax reform, entitlement reform and spending reductions are not put into place in a thoughtful manner. A failure of policymakers to make tough choices in the short run will continue to result in slow economic growth, which, in turn, breeds greater income inequality over time. In addition, the problems created by our nation's fiscal issues will have ramifications on global capital markets; borrowing costs of the federal government could sharply and unexpectedly rise and/or be compounded by increased inflation risk and capital risk. The key to long-run fiscal policy balance and, to an extent, economic growth will depend on policymakers' ability to "stay the course" over the next several years and fulfill the commitment to long-run deficit reduction.

***Uncertainty  
around future tax  
and spending  
policy should keep  
GDP growth  
around 1.5 percent.***

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<sup>10</sup> See our recent report entitled *The Economic Impact of the Fiscal Cliff: An Update*, available by request.

#### 4. More Fiscal Austerity Ahead in the Euro Area

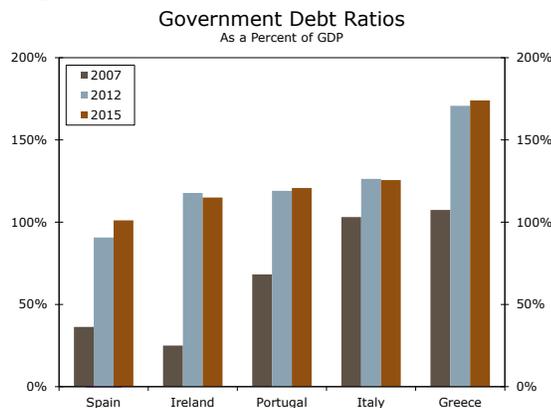
Much of Europe has been in an environment of fiscal consolidation for the past three years. Even if the United States does not go off the fiscal cliff, there will be fiscal tightening in the years ahead, and therefore, we can, and should, learn from the experience of Europe. The International Monetary Fund (IMF) projects the United States will register a government gross debt-to-GDP ratio of 107 percent in 2012, an alarming increase from the 67 percent experienced in 2007.<sup>11</sup> Unfortunately, the United States is not in good company with such drastic increases in sovereign debt. This chapter will discuss the sovereign debt issues of Europe and explain how debt grew to such unsustainable levels. In addition, we will discuss how weak economic activity has constrained additional progress to debt reduction. Furthermore, we will examine the tradeoff between making strides to improve structural deficits and the change in real GDP; a dilemma U.S. policymakers face with the fiscal policy decisions discussed in the previous chapter.

##### **European Sovereign Debt Crisis: Slow Progress Is Underway**

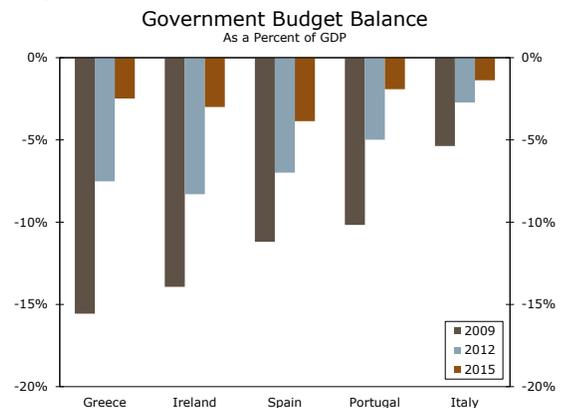
As is commonly known, many countries within the 17-member Eurozone have been struggling with a toxic combination of economic weakness and mushrooming sovereign debt for the past three years. In the case of Greece, the government's debt-to-GDP ratio has shot up from about 110 percent in 2007, the year preceding the global financial crisis (GFC), to 170 percent today (Figure 13). Although the Hellenic Republic may have garnered the most attention over the past few years, most other European countries have also experienced an alarming increase in sovereign debt. For example, Ireland, which many hailed as a model of fiscal rectitude before the GFC, has seen its debt-to-GDP ratio explode from 25 percent in 2007 to nearly 120 percent today. Among the five highly indebted countries in the euro area (i.e., Greece, Ireland, Italy, Portugal and Spain), only Spain has a government debt-to-GDP ratio that has not yet breached 100 percent. If the projections of the IMF come to fruition, however, the debt-to-GDP ratio of the Spanish government will move above 100 percent within the next two years.

***Much of the Eurozone is struggling with economic weakness and mushrooming debt.***

**Figure 13**



**Figure 14**



**Source: International Monetary Fund and Wells Fargo Securities, LLC**

***A number of self-reinforcing factors have led to the sharp increase in debt ratios.***

A number of self-reinforcing factors have led to the sharp increases in debt ratios. The initial shock was the effect of the GFC that caused a deep global recession, thereby depressing GDP (the denominator in the debt-to-GDP ratio) in most European countries. Nominal GDP in Ireland nosedived 10 percent in 2009 as the Irish banking system collapsed under the weight of the country's burst housing bubble, and all other countries in the euro area experienced negative GDP growth in the immediate aftermath of the GFC.

The numerators in the debt-to-GDP ratios also skyrocketed as budget deficits widened sharply. Some countries initially turned to fiscal stimulus to cushion the blow from the GFC. For example, the Spanish government enacted a fiscal stimulus program worth about 1.5 percent of GDP in 2008. Much more significant for most countries, however, was the induced budgetary effect from

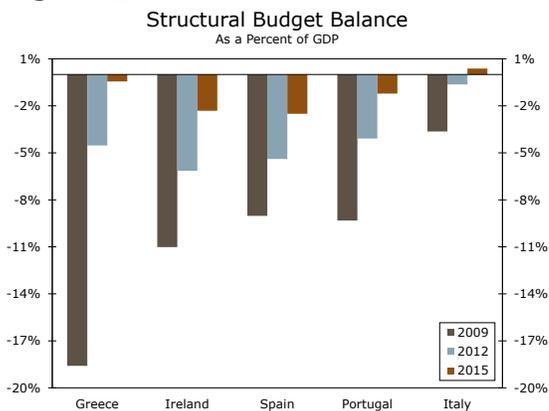
<sup>11</sup> International Monetary Fund. (October 2012). World Economic Outlook Database.

depressed economic activity that caused government revenues to wither. The revenues of the Irish government plunged 14 percent in 2009, and the Portuguese and Spanish governments saw their coffers weaken that year by 6 percent and 10 percent, respectively. The net result was an explosion in government deficits. The Spanish government posted a budget surplus equivalent to 2 percent of GDP in 2007. By 2009, the red ink in Spain's fiscal accounts was running at 11 percent of GDP (Figure 14). Among the five highly indebted countries, only Italy had a budget deficit that was less than 10 percent of GDP in 2009.

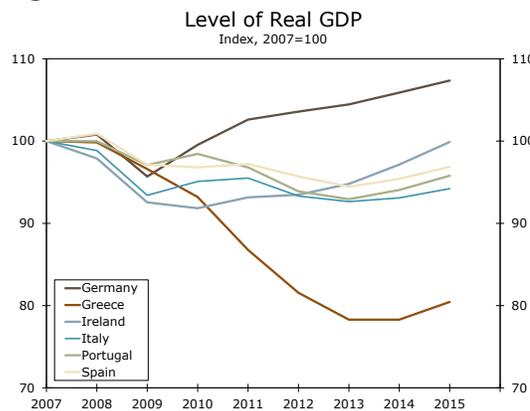
As Figure 14 also makes clear, government deficits have receded from their high-water marks of 2009. Although some governments loosened the fiscal taps in the immediate aftermath of the GFC, fiscal policy has turned universally restrictive in the highly indebted countries over the past few years as illustrated by the sharp decline in structural budget deficits since 2009 (Figure 15).<sup>12</sup> However, improvements in overall budget deficits in the highly indebted countries have been limited by weak economic activity that constrains growth in government revenues. In the most extreme example, the Greek government has implemented an incredible reduction in its structural deficit over the past three years that has totaled 14 percent of GDP. Despite this staggering amount of fiscal austerity in the Hellenic Republic, the overall government deficit has narrowed only 8 percentage points of GDP over that period as the economic depression—the Greek economy is more than 20 percent smaller today than it was in 2007—has weighed on revenue growth (Figure 14). Despite the implementation of revenue-raising measures via tax increases, the overall revenues of the Greek government have dropped 8 percent over the past four years.<sup>13</sup>

***Fiscal policy has turned universally restrictive in the highly indebted European countries.***

**Figure 15**



**Figure 16**



**Source: International Monetary Fund and Wells Fargo Securities, LLC**

Although not as severe as the Greek economic collapse, the economies of the other highly indebted countries, which have undergone their own fiscal austerity programs, are 5 percent to 7 percent smaller today than they were in 2007. In that regard, there is some evidence to support the claim that fiscal austerity has retarded economic recovery in many individual economies in the Eurozone. Figure 17 shows that there has been an inverse relationship over the past three years between the improvement in the structural budget deficit and the change in real GDP in

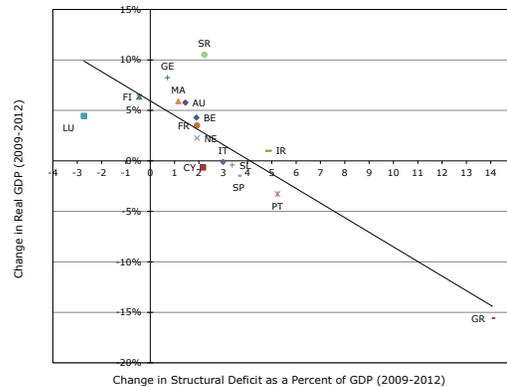
***Fiscal austerity may have slowed the economic recovery in many Eurozone countries.***

<sup>12</sup> Because the overall budget balance is affected by changes in government spending and tax revenues that are induced by changes in economic activity, analysts focus on the so-called structural balance when analyzing changes in fiscal policy. The structural balance is defined as the budget balance that would occur if the economy were operating at full capacity. It also controls for one-off factors that can influence the budget.

<sup>13</sup> The Greek government has slashed its expenditures by 18 percent since their highs in 2009, and the IMF projects that spending will be cut 13 percent further by 2016.

16 euro area countries. That is, those countries that have undertaken the highest degree of fiscal consolidation have tended to have suffered the sharpest declines in real GDP.<sup>14</sup>

**Figure 17: Fiscal Policy and GDP Growth in Euro Area Economies**



Source: International Monetary Fund and Wells Fargo Securities, LLC

**Continued Austerity Should Exert Headwinds on Growth**

As portrayed by the continued decline in structural budget deficits in Figure 15, fiscal policy in many European countries will continue to exert headwinds on economic growth in the euro area for the next few years. Indeed, the IMF forecasts that the highly indebted European economies, with the exception of Ireland, will experience another year of negative real GDP growth in 2013. Unfortunately, individual economies in the euro area have few policy levers to jump start economic growth. Monetary policy is the domain of the independent European Central Bank (ECB), which has a single mandate, namely, “price stability.” Even if the ECB wanted to ease policy significantly, it would have limited scope to do so. At 0.75 percent, the ECB’s main policy rate is about as low as it can go. Therefore, the ECB would need to turn to unconventional methods, such as quantitative easing, that have unknown efficacy. Most individual countries within the euro area send about half of their exports to other Eurozone countries. Therefore, due to the common currency, currency depreciation to improve price competitiveness vis-à-vis those trading partners is impossible.

Fiscal easing at this time is not really a realistic policy option in the highly indebted countries either. Any government suggesting that it was about to prime the fiscal pump in order to support economic growth would likely suffer a sharp rise in its borrowing costs. Therefore, governments in the highly indebted European countries will need to travel further along the path of fiscal consolidation with consequent negative implications for GDP growth.

Indeed, growth in some of the highly indebted countries could turn out to be weaker than some analysts forecast. Recent research by the IMF shows that the fiscal multipliers that have been used to forecast GDP growth in the Eurozone in recent years, not only by the IMF itself but by other institutions as well, have been too small.<sup>15</sup> That is, it appears that fiscal contraction in euro area economies has had a more depressing effect on economic growth in those countries than most analysts had originally expected. With interest rates about as low as they can go, fiscal contraction carries more of a punch than it does in an environment in which interest rates can decline significantly. Therefore, it could take a number of years for real GDP to return to pre-crisis levels in many of the highly indebted European economies. For Greece, it could be a decade or more before the pre-crisis level of economic activity is re-attained.

***Fiscal policy in many European countries will exert headwinds on economic growth for the next few years.***

***With interest rates about as low as they can go, fiscal contraction carries more of a punch.***

<sup>14</sup> There is a statistically significant relationship between the change in real GDP between 2009 and 2012 and the improvement in the structural budget balance during that period. The statistical significance is still maintained even if Greece is excluded as an extreme outlier.

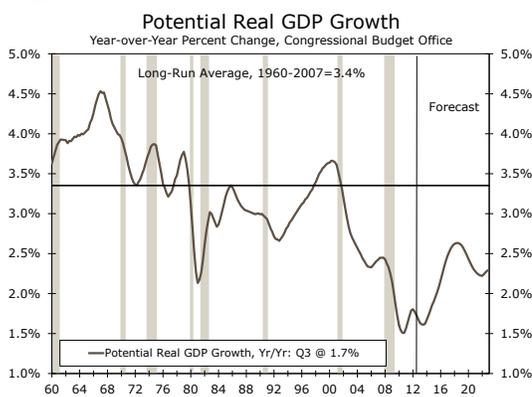
<sup>15</sup> International Monetary Fund. (October 2012). World Economic Outlook. Pp. 41-43.

## 5. Secular Trends: Growth and the Coming Demographic Shift

Until this point, our 2013 Economic Outlook has focused on the near term. However, a demographic shift in coming decades will have implications for long-run economic growth and fiscal policy. The most pressing issues are slower population growth and an aging population. Both factors will work to reduce the economy’s potential rate of growth and reinforce that the “new normal” is here to stay. In fact, based on CBO projections, potential real GDP will likely average slightly higher than a 2 percent annual pace from now through 2020, below the historical long-run trend of 3.5 percent (Figure 18).<sup>16</sup> In his November 2012 speech to the New York Economic Club, Federal Reserve Chairman Ben Bernanke stated that “output normally has to increase at about its longer-term trend just to create enough jobs to absorb new entrants into the labor market.”<sup>17</sup> The fiscal challenges are even more daunting as the population ages. Social Security and Medicare spending, which together currently are equivalent to about 10 percent of GDP, is expected to rise to more than 16 percent 25 years from now.<sup>18</sup> However, the United States is not alone. A shrinking labor force and aging population will also be major factors affecting economic growth in much of the developed world.

***A demographic shift in coming decades will have implications for long-run economic growth.***

**Figure 18**



**Figure 19**



Source: CBO, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

### ***Labor Force, Slowing Population Growth and an Aging Population***

Over the past half-century, the rate of participation in the United States’ labor force rose rapidly from 59 percent in the early 1960s to a peak of 67 percent in the late 1990s (Figure 19). The rise in the labor force participation rate during this period was due to the sheer size of the baby-boom generation entering the workforce, along with rapid growth in the participation of women. While cyclical factors appear to be playing a larger role as of late, the aging and retirement of baby boomers and leveling off in participation among women are longer-term trends that will continue to limit the labor force participation rate in the coming years. In fact, the CBO estimates that these demographic changes have caused a 0.5 percentage point reduction in the participation rate since 2007. Furthermore, this “demographic effect” will likely carry a greater burden in the years ahead, as the CBO projects a 1.2 percent reduction in the participation rate by 2016 and an additional 1.4 point reduction between 2016 and 2021.<sup>19</sup> Therefore, demographics alone could reduce the overall rate of labor force participation by more than 3 percent by the next decade.

***The aging and retirement of baby boomers will limit the labor force participation rate in the coming years.***

The slowdown in population growth is nearly inevitable as citizens live much longer lives and birth rates continue to decline. According to the U.S. Census Bureau, the annualized growth rate of the adult population was around 1.0 percent per year from 1970 to 2011 but is projected to slow

<sup>16</sup> Congressional Budget Office. (January 2011). *The Budget Outlook and Economic Outlook: Fiscal Years 2011 to 2021*.

<sup>17</sup> Bernanke, Ben S. (Nov. 20, 2012). *The Economic Recovery and Economic Policy*. Speech presented at the New York Economic Club, New York, NY.

<sup>18</sup> Congressional Budget Office. (June 2012). *The 2012 Long-Term Budget Outlook*.

<sup>19</sup> Congressional Budget Office. (March 2011). *CBO’s Labor Force Projections Through 2021*.

to an annualized rate of 0.8 percent in 2050.<sup>20</sup> That said, fertility rates are even lower in other developed countries such as Japan and Germany. China has its own problems with its imposed “one-child” policy.

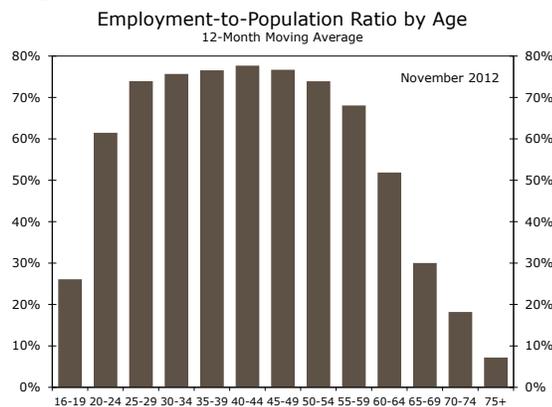
**The decline in labor force participation will likely reduce per capita real GDP.**

In addition to slower population growth, the first members of the baby-boom generation in the United States reached the age of 65 in 2008. Today, those aged 65 and older make up more than 13 percent of the population, which is about five working-age people for each person 65 years and older. By 2035, this demographic will change substantially with those aged 65 and older making up about 20 percent of the population, which will shift the ratio from five to just three and could fall further as life expectancies continue to increase. Over time, the projected aging of the population suggests a decline in the share of the working-age population and the share of the population that is employed (Figure 20). All else equal, the expected decline in labor force participation due to the aging population will likely reduce both per capita real GDP and per capita consumption below what these variables would be in the absence of a decline in labor force participation.<sup>21</sup>

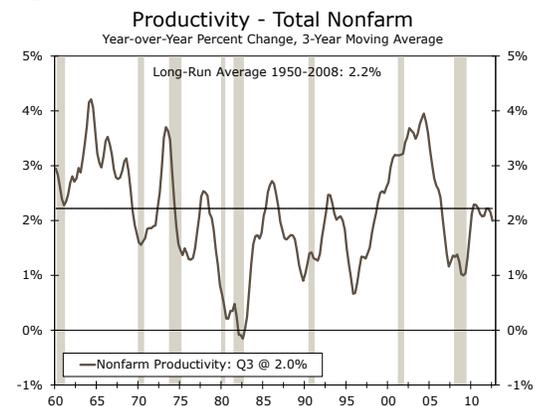
**Education and on-the-job training will help maintain solid productivity growth.**

All of these changes will pose immense challenges to policymakers. However, it is not all bad news. The retirement of the baby boomers means an enormous opportunity for those that are entering the labor force today as well as for those that remain in the labor force and have many years of productive work ahead. These entrants will be the ones benefiting from those that are retiring and their influence on the economy will tend to increase as they get the education and experience the productive process requires from them. Thus, education and on-the-job training would help to maintain solid productivity growth, a topic to which we now turn.

**Figure 20**



**Figure 21**



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

**Potential Output and Productivity Growth**

Productivity, which is output per hour worked, is the missing component in the potential output puzzle. Productivity growth can be divided into the following three distinct eras: a) 1948–1973, which is characterized as a period of strong productivity growth; b) 1974–mid 1990s, which is considered the slow productivity era; and c) the post mid-1990s, which is considered the “productivity resurgence.” Indeed, productivity during the 1948–1973 period grew at an average annual rate of 2.8 percent; the average productivity growth rate for the 1974–1990 period was 1.4 percent, while the “productivity resurgence” era of post mid-1990s saw an average annual pace of 2.7 percent. That said, productivity has decelerated since the 2007 downturn to only a 1.5 percent annual pace, and has yet to recover (Figure 21).

The puzzle today is how to maintain economic growth as the demographics continue to change adversely. One alternative is to raise productivity through, as noted above, education and on-the-

<sup>20</sup> U.S. Census Bureau. **Statistical Abstract of the United States: 2012.**

<sup>21</sup> Sheiner, Louise, Daniel Sichel and Lawrence Slifman. (2007). “A Primer on the Macroeconomic Implications of Population Age.” Federal Reserve Board’s Finance and Economics Discussion Series.

job training. This will raise productivity through the deepening of human capital. The “knowledge revolution” that started during the 1990s with the mass introduction of the computer in the work environment and the Internet boom that followed has helped, and will continue to help in this process.

However, not all is rosy in terms of productivity. In a previously published paper, the authors showed that there is statistical evidence to suggest that the “productivity resurgence era is associated with lower growth rates of per capita income, employment and consumer confidence.”<sup>22</sup> The authors employ four different estimation techniques to categorize and compare the relationship between the three productivity growth eras noted above (1948–1973, 1974–1995 and 1996–2011) and different measures of standards of living. They find that productivity growth and real per capita income growth follow a consistent pattern from 1948 to 1995; the 1948–1973 period of strong productivity growth is associated with strong growth in real personal income, and the period of slow productivity growth (1974–1995) is associated with slow real per capita income growth. However, the association breaks down during the 1996–2011 era. Despite stronger productivity growth over this time period, real per capita income actually experiences a declining growth trend and the correlation analysis fails to find a statistically significant relationship between productivity growth and other measures of standard of living, such as personal spending and wages and salary disbursements. The authors determine that identifying the “driving force” behind productivity growth, and specifically, the productivity resurgence, may explain why such a divergence in the historical relationships occurred. They suggest that the IT revolution and the increased use of outsourcing jobs may have boosted productivity growth without comparably improving standards of living, specifying that fewer employment opportunities and less income may result in such a shift in the sources of productivity. In summary, the study demonstrates that the perceived positive relationship between productivity growth and standards of living no longer holds up, and determines that in order to experience a comparable rise in standards of living; employment and income growth must be greater than and be driven by factors independent of productivity growth.

***The relationships  
between  
productivity  
growth and  
standards of living  
have broken down.***

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<sup>22</sup> Vitner, Mark and Azhar Iqbal. (2013). “Is Productivity Growth Too Strong for Our Own Good?” *Business Economics*, forthcoming. The full paper is available upon request.

Wells Fargo U.S. Economic Forecast																					
	Actual								Forecast								Actual		Forecast		
	2011				2012				2013				2014				2010	2011	2012	2013	2014
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q					
Real Gross Domestic Product (a)	0.1	2.5	1.3	4.1	2.0	1.3	2.7	0.7	0.6	1.8	1.9	2.3	2.5	2.7	2.8	3.1	2.4	1.8	2.2	1.4	2.5
Personal Consumption	3.1	1.0	1.7	2.0	2.4	1.5	1.4	1.6	1.1	1.3	1.3	1.5	1.6	1.7	1.8	1.9	1.8	2.5	1.8	1.3	1.6
Business Fixed Investment	-1.3	14.5	19.0	9.5	7.5	3.6	-2.2	0.4	-1.8	2.3	2.8	3.3	4.4	4.9	5.2	5.4	0.7	8.6	7.1	0.5	4.1
Equipment and Software	11.1	7.8	18.3	8.8	5.4	4.8	-2.7	-0.4	-2.0	2.0	2.4	2.8	4.1	4.6	4.8	5.1	8.9	11.0	6.1	0.2	3.8
Structures	-28.2	35.2	20.7	11.5	12.9	0.6	-1.1	3.0	-1.0	3.0	4.0	5.0	5.5	6.0	6.5	6.5	-15.6	2.7	9.7	1.6	5.3
Residential Construction	-1.4	4.2	1.4	12.0	20.6	8.4	14.3	18.0	18.0	22.0	23.0	26.0	25.0	25.0	26.0	27.0	-3.7	-1.4	12.2	18.9	25.0
Government Purchases	-7.0	-0.8	-2.9	-2.2	-3.0	-0.7	3.5	0.5	-0.8	-0.7	-0.7	-0.7	-0.6	-0.5	-0.4	-0.3	0.6	-3.1	-1.3	0.0	-0.6
Net Exports	-416.6	-399.6	-397.9	-418.0	-415.5	-407.4	-403.0	-406.7	-404.0	-396.8	-387.7	-376.6	-367.4	-361.1	-354.7	-347.4	-419.7	-408.0	-408.2	-391.3	-357.6
Pct. Point Contribution to GDP	0.0	0.5	0.0	-0.6	0.1	0.2	0.1	-0.1	0.1	0.2	0.3	0.3	0.3	0.2	0.2	0.2	-0.5	0.1	0.0	0.1	0.2
Inventory Change	30.3	27.5	-4.3	70.5	56.9	41.4	61.3	53.0	41.0	40.0	36.5	35.5	35.0	35.0	36.0	37.0	50.9	31.0	53.2	38.3	35.8
Pct. Point Contribution to GDP	-0.5	0.0	-1.1	2.5	-0.4	-0.5	0.8	-0.2	-0.4	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	1.5	-0.2	0.2	-0.1	0.0
Nominal GDP	2.2	5.2	4.3	4.2	4.2	2.8	5.5	2.6	2.6	3.9	3.8	4.4	4.7	4.8	5.1	5.4	3.8	4.0	4.1	3.5	4.6
Real Final Sales	0.6	2.4	2.4	1.5	2.4	1.7	1.9	1.4	1.0	1.9	2.0	2.4	2.6	2.7	2.8	3.1	0.9	2.0	2.0	1.6	2.5
Retail Sales (b)	7.9	8.1	8.6	7.5	6.6	4.7	4.8	3.9	2.8	4.0	3.7	3.8	4.4	4.9	5.4	5.8	5.5	8.0	5.0	3.6	5.1
Inflation Indicators (b)																					
PCE Deflator	1.8	2.6	2.8	2.5	2.4	1.6	1.5	1.7	1.4	1.6	1.6	1.5	1.7	1.8	1.9	2.0	1.9	2.4	1.8	1.6	1.9
Consumer Price Index	2.1	3.3	3.8	3.3	2.8	1.9	1.7	2.2	2.1	2.5	2.4	2.1	2.1	2.1	2.1	2.2	1.6	3.1	2.2	2.3	2.1
"Core" Consumer Price Index	1.1	1.5	1.9	2.2	2.2	2.3	2.0	2.0	1.9	1.8	1.9	1.9	2.0	2.0	2.1	2.1	1.0	1.7	2.1	1.9	2.0
Producer Price Index	4.8	6.6	7.0	5.5	3.5	1.1	1.6	2.5	2.7	4.2	3.3	2.5	2.5	2.6	2.7	2.7	4.2	6.0	2.2	3.2	2.6
Employment Cost Index	2.0	2.2	2.0	2.0	1.9	1.7	2.0	2.0	2.1	2.0	2.0	2.0	2.2	2.1	2.0	2.1	1.3	2.6	1.9	2.0	2.1
Real Disposable Income (a)	4.4	-1.5	-1.3	-0.2	3.7	2.2	0.5	0.6	-1.9	1.6	1.8	1.9	1.9	1.9	2.1	2.1	1.8	1.3	1.1	0.5	1.9
Nominal Personal Income (b)	6.3	5.3	4.7	4.1	2.9	3.0	3.3	3.5	1.8	1.8	2.1	2.6	3.5	3.5	3.5	3.3	3.8	5.1	3.2	2.1	3.4
Industrial Production (a)	4.4	1.2	5.6	5.1	5.9	2.3	0.0	-2.8	0.6	3.5	4.1	4.1	3.5	3.8	4.1	4.1	5.4	4.1	3.4	1.2	3.8
Capacity Utilization	76.2	76.3	77.1	77.9	78.7	78.9	78.5	78.4	78.8	79.1	79.4	79.5	79.6	79.8	80.0	80.2	73.7	76.8	78.6	79.2	79.9
Corporate Profits Before Taxes (b)	4.6	10.8	4.7	9.2	10.3	6.7	8.7	5.0	4.8	5.2	5.4	5.8	6.2	6.4	6.6	6.8	26.8	7.3	7.6	5.3	6.5
Corporate Profits After Taxes	2.1	11.0	7.8	14.5	9.2	4.4	4.0	3.7	4.0	4.5	4.7	5.1	5.5	5.7	5.9	6.1	23.9	8.9	5.2	4.6	5.8
Federal Budget Balance (c)	-460.5	-141.1	-326.3	-321.7	-457.2	-125.3	-185.0	-320.0	-265.0	-195.0	-240.0	-205.0	-260.0	-195.0	-240.0	-205.0	-1294.2	-1296.8	-1089.2	-1020.0	-900.0
Current Account Balance (d)	-120.0	-119.1	-108.2	-118.7	-133.6	-117.4	-115.0	-125.0	-130.0	-130.0	-130.0	-135.0	-135.0	-130.0	-130.0	-130.0	-442.0	-465.9	-491.0	-525.0	-525.0
Trade Weighted Dollar Index (e)	70.5	69.2	72.8	73.3	72.7	74.5	72.7	73.0	74.0	75.0	76.0	77.0	76.0	75.0	74.0	73.0	75.4	70.9	73.2	75.5	74.5
Nonfarm Payroll Change (f)	192.0	129.7	127.7	164.0	225.7	66.7	168.3	139.7	120.0	130.0	145.0	150.0	155.0	160.0	165.0	170.0	85.6	153.3	150.1	136.3	162.5
Unemployment Rate	9.0	9.0	9.1	8.7	8.3	8.2	8.1	7.8	7.7	7.8	7.8	7.8	7.7	7.7	7.6	7.5	9.6	9.0	8.1	7.8	7.6
Housing Starts (g)	0.58	0.57	0.61	0.68	0.71	0.74	0.78	0.86	0.90	0.96	1.02	1.08	1.12	1.15	1.20	1.23	0.59	0.61	0.78	0.99	1.17
Light Vehicle Sales (h)	12.7	12.2	12.6	13.5	14.1	14.1	14.5	15.1	14.4	14.5	14.8	15.0	15.2	15.3	15.4	15.5	11.6	12.7	14.4	14.7	15.4
Crude Oil - Brent - Front Contract (i)	105.21	116.88	111.79	108.43	118.12	108.68	109.03	107.67	107.00	109.00	111.00	112.00	114.00	116.00	118.00	120.00	80.47	110.58	110.88	109.8	117.0
Quarter-End Interest Rates (j)																					
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3 Month LIBOR	0.30	0.25	0.37	0.58	0.47	0.46	0.36	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.34	0.34	0.40	0.30	0.30
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Conventional Mortgage Rate	4.84	4.51	4.11	3.96	3.95	3.68	3.50	3.40	3.40	3.40	3.45	3.50	3.60	3.70	3.90	4.00	4.69	4.46	3.63	3.44	3.80
3 Month Bill	0.09	0.03	0.02	0.02	0.07	0.09	0.10	0.08	0.10	0.15	0.20	0.25	0.30	0.30	0.35	0.35	0.14	0.05	0.09	0.18	0.33
2 Year Note	0.80	0.45	0.25	0.25	0.33	0.33	0.23	0.25	0.25	0.30	0.40	0.50	0.60	0.70	0.80	0.90	0.70	0.45	0.29	0.36	0.75
5 Year Note	2.24	1.76	0.96	0.83	1.04	0.72	0.62	0.65	0.65	0.75	0.90	1.00	1.10	1.20	1.30	1.40	1.93	1.52	0.76	0.83	1.25
10 Year Note	3.47	3.18	1.92	1.89	2.23	1.67	1.65	1.65	1.65	1.75	1.85	1.90	2.00	2.10	2.20	2.30	3.22	2.78	1.80	1.79	2.15
30 Year Bond	4.51	4.38	2.90	2.89	3.35	2.76	2.82	2.80	2.80	2.85	2.85	2.90	3.00	3.10	3.30	3.40	4.25	3.91	2.93	2.85	3.20

Forecast as of: December 13, 2012

- Notes: (a) Compound Annual Growth Rate Quarter-over-Quarter (f) Average Monthly Change
- (b) Year-over-Year Percentage Change (g) Millions of Units
- (c) Quarterly Sum - Billions USD; Annual Data Represents Fiscal Yr. (h) Quarterly Data - Average Monthly SAAR; Annual Data - Actual Total Vehicles Sold
- (d) Quarterly Sum - Billions USD (i) Quarterly Average of Daily Close
- (e) Federal Reserve Major Currency Index, 1973=100 - Quarter End (j) Annual Numbers Represent Averages

Source: U.S. Department of Commerce, U.S. Department of Labor, Federal Reserve Board, IHS Data Insight and Wells Fargo Securities, LLC

## Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2012	2013	2014	2012	2013	2014
Global (PPP weights)	2.7%	2.8%	3.5%	4.2%	4.1%	4.1%
Global (Market Exchange Rates)	1.5%	1.5%	2.2%	n/a	n/a	n/a
Advanced Economies <sup>1</sup>	1.2%	1.1%	2.1%	2.1%	1.9%	1.8%
United States	2.2%	1.4%	2.5%	2.2%	2.3%	2.1%
Eurozone	-0.5%	0.2%	1.9%	2.5%	1.7%	1.9%
United Kingdom	-0.2%	1.2%	2.0%	2.8%	2.4%	2.0%
Japan	2.1%	0.5%	1.5%	-0.1%	-0.4%	0.1%
Korea	2.2%	2.9%	3.8%	2.2%	2.0%	2.4%
Canada	2.0%	1.7%	2.7%	1.6%	1.9%	0.9%
Developing Economies <sup>1</sup>	4.4%	4.8%	5.2%	6.7%	6.7%	6.7%
China	7.7%	8.0%	8.3%	2.6%	2.8%	3.2%
India	5.4%	6.2%	6.5%	9.2%	8.0%	8.3%
Mexico	3.7%	2.7%	3.6%	4.2%	4.5%	4.5%
Brazil	0.9%	2.6%	3.5%	5.4%	6.1%	6.0%
Russia	3.5%	3.1%	3.7%	5.1%	6.2%	5.5%

Forecast as of: December 13, 2012

<sup>1</sup>Aggregated Using PPP Weights

## Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2012		2013			2014	2012		2013			2014
	Q4	Q1	Q2	Q3	Q4	Q1	Q4	Q1	Q2	Q3	Q4	Q1
U.S.	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	1.65%	1.65%	1.75%	1.85%	1.90%	2.00%
Japan	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%	0.75%	0.80%	0.90%	0.95%	1.00%	1.05%
Euroland*	0.15%	0.15%	0.15%	0.20%	0.30%	0.40%	1.40%	1.50%	1.65%	1.75%	2.00%	2.20%
U.K.	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	1.80%	2.00%	2.20%	2.30%	2.50%	2.80%
Canada	1.20%	1.20%	1.20%	1.25%	1.45%	1.50%	1.75%	1.90%	2.00%	2.40%	2.80%	3.20%

Forecast as of: December 13, 2012

\*10-year German Government Bond Yield

Source: IHS Global Insight, International Monetary Fund and Wells Fargo Securities, LLC

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