



# U.S. ECONOMIC AND REGULATORY OUTLOOK

## IMPLICATIONS FOR CORPORATE LEADERS

Co-hosted by [Harvard Business School Association of Boston](#) and [Directors Roundtable](#)

Distinguished Guest: Professor Peter Diamond  
2010 Nobel Laureate in Economics & Institute Professor Emeritus at MIT

### EXECUTIVE SUMMARY

Harvard Business School, Burden Hall  
Boston, Massachusetts  
January 18, 2012



**Weil**

Executive Summary by:



# U.S. Economy and Regulatory Outlook: Implications for Corporate Leaders

- Special Guest: **Peter Diamond**, Co-winner of the 2010 Nobel Prize in Economics & Professor Emeritus, MIT
- Distinguished Panelists:
  - Stephen E. Allis**, National Principal in Charge of Government Affairs, KPMG LLP
  - Alexandra (Alex) Nunez**, Political Director for Senator John F. Kerry
  - Heath P. Tarbert**, Leader of Financial Regulatory Reform Working Group, Weil, Gotshal & Manges LLP
  - Christopher J. Wolfe**, Managing Director & Chief Investment Officer for the Private Banking and Investment Group, Merrill Lynch Wealth Management
- Moderator: **Joseph Basile**, Managing Partner of the Boston office, Weil, Gotshal & Manges LLP

## Overview

The economic and regulatory outlook for 2012 is not particularly upbeat. America has a short-term jobs crisis and a long-term debt problem, and corporations must comply with enormous amounts of costly new regulations, which are expected to stick regardless of the outcome of the 2012 election. In addition, there are concerns about the Eurozone's economic stability and about an economic slowdown in China. This comes amid an acrimonious political environment in the United States, where compromise is nonexistent.

For investors and corporate leaders there is uncertainty, an aversion to risk, a reluctance to make long-term investments or decisions, and an emphasis on cash. Leaders are focused on weathering the storm, and are hoping for more certainty and clarity—particularly around regulation—and a better political environment after the election.

However, with uncertainty comes opportunity. There are opportunities for companies sitting on cash, and attractive possibilities in specific industries. Investments could look more attractive later in the year. Also, for firms viewing regulation strategically, new business opportunities may emerge.

a ripple effect, and China's economy shows signs of slowing.

Mr. Tarbert believes the greatest risk the U.S. faces is overconfidence in believing the worst has passed. Instead of a recovery like in 1991, there could be prolonged stagnation similar to the 1930s. Professor Diamond hopes the world can avoid a major economic disaster in 2012, such as a disorderly Greek or Portuguese default. Ms. Nunez sees business and political leaders keeping their heads down, trying to survive and hoping that the tide will turn.

- **Unemployment is a short-term crisis; the national debt is a long-term problem.**

Professor Diamond asserted that unemployment is a crisis requiring immediate action. The national debt is a serious long-term problem, though not the crisis many have painted it as. Mr. Wolfe agreed that job creation is the bigger issue.

*"We have an unemployment crisis and a debt problem, even though many in Washington, DC don't act like it."*  
— Peter Diamond

## Unemployment

America's labor market is dynamic. As evidence, in November 2011, 4.1 million people were hired and 4 million people separated from an employer. However, significant problems exist. Among them:

- *Long-term unemployment.* When the financial crisis hit, unemployment rose and many individuals have remained unemployed for more than a year. In 2010, 29% of the unemployed had been out of work for at least a year, up from 16% the year before. The longer a person is unemployed the more difficult it is to regain employment, and the lower the eventual earnings on average.
- *Unemployment among young people.* The rate of unemployment remains high among young people. These individuals are missing out both on wages and on critical experience. This lack of experience will depress their wages for years.
- *Drop in postings.* While millions are hired each month, the number of job postings is down significantly, from 4.0 million in November 2007 to 3.2 million in November 2011.

## Context

After an introduction by KPMG's Pat Canning, the panelists offered their perspectives on the economic and regulatory outlook and responded to questions from the moderator and audience.



Pat Canning

## Key Themes

- **The U.S. economy is still fragile and international events could have a negative impact.**

Mr. Basile cited a just-published World Bank forecast putting global economic growth for 2012 at 2.5%, down from a 3.6% forecast six months earlier. This reduced forecast is due to uncertainty about the U.S. economy as fiscal stimulus ends, the crisis in Europe appears to be deepening and could have



Joseph Basile

The big gun available, in Professor Diamond's view, is more fiscal stimulus. He sees it as badly needed and believes it can have a big impact. He would focus stimulus on infrastructure because an improvement in infrastructure would be good for the economy and is sorely needed. While critics argue that more stimulus will increase the debt, Professor Diamond sees this as a necessary short-term expense that will have both short-term and long-term benefits. Insofar as these are investments the country should make at some point, he sees this as a particularly good time to make them.

Addressing unemployment also requires improving the quality of America's labor force. Sustained funding is needed for education; America must run lots of experiments to identify what works and should be replicated.



Peter Diamond

### Debt

Professor Diamond argued that the country's debt is a problem, but it is a long-term problem that doesn't rise to the level of a crisis. To support this claim he focused on public debt that has to be rolled over. This debt represented less than 70% of U.S. GDP in 2011. Various Congressional Budget Office (CBO) projections put this figure at 60% to 80% of GDP in 2021. This definitely constitutes a problem and needs to be addressed, but these debt levels shouldn't stand in the way of short-term fiscal stimulus to spur job creation. (Mr. Wolfe agreed that the U.S. debt situation is not comparable to that of Greece.)

To resolve the debt problem, Professor Diamond recommended fixing Social Security through a combination of increased revenue and decreased benefits while also addressing the costs of health care. The sooner a fix takes place, the smaller the changes will need to be. Also, Professor Diamond believes that as America debates "who should pay" for government spending, the conclusion should be to increase tax rates on high earners. While Mr. Wolfe questioned whether this will do anything to solve the country's debt problem, Professor Diamond said it would help, but is just one part of an overall solution.

### Increased regulation—which is here to stay—creates costs and uncertainty for business.

Mr. Allis said the relationship between government and business has been fundamentally altered. This began with government intervention during the financial crisis, increased with massive stimulus that funded social programs as opposed to infrastructure, and has accelerated based on the philosophy of the activist Obama administration.

*"Over the past few years we have seen a different relationship between government and business. There has been an expansion in the size and reach of government."*

— Stephen E. Allis



Under the Obama administration there have been:

- **Massive financial reforms** (Dodd-Frank), which entail a sweeping restructuring of capital markets regulation based on 400 new rules. These rules are still being developed and could take years to implement.
- **Health care reform**, which will create an as-yet-unknowable number of new agencies, boards, and advisory bodies.
- **New environmental regulations.** While cap-and-trade legislation failed to pass the Congress, EPA embarked on an aggressive agenda of new regulations to limit pollutants.
- **Union support.** While the administration failed to get "card check" legislation passed, it has taken several administrative actions to promote unionization.

Even if Republicans win the 2012 election, Mr. Allis believes Dodd-Frank is unlikely to be repealed. Once legislation is enacted and regulation is in place, there is momentum that is hard to reverse.

The SBA estimated that the annual cost for business to comply with federal regulation is \$1.75 trillion. Mr. Allis said the slow process of creating and implementing regulation has created uncertainty in two fundamental elements of business planning: the flow of credit and the cost of hiring new employees.

As bad as the amount of regulation is today, Mr. Tarbert proclaimed, "You ain't seen nothing yet." This is because the rules for hundreds of new financial regulations still have to be written and implemented.

*"2012 will be a big year for financial regulation."*

— Heath P. Tarbert



He reiterated that Dodd-Frank is unlikely to be repealed and said that financial institutions that believe they aren't affected by Dodd-Frank might be mistaken. "Don't think there's not a target on your back,"

advised Mr. Tarbert, because this legislation cover players of all types and sizes. Also, international financial regulation—Basel III—could have enormous implications for financial institutions in terms of liquidity and capital requirements.

Despite the challenges associated with regulation, regulation creates opportunity. In previous eras of big new regulations, companies developed entire new businesses to capitalize on opportunities born from regulation. Mr. Tarbert predicts that for many companies, regulation may become a driving force of their business strategy.

Professor Diamond argued that many laws and regulations need to be updated. Instead of having legislators write every detail—which would provide certainty but is far from desirable—it makes more sense for legislators to create a framework, with regulators filling in the details. He sees this as a preferable process, which unfortunately takes more time.

▪ **The acrimonious political environment is unlikely to change in 2012.**

In the aftermath of the passage of health care and financial reform (Dodd-Frank), Ms. Nunez said the political environment is extremely acrimonious, evidenced by the failure of the congressional “super committee” to agree on debt reduction. Mr. Allis sees continued potential gridlock in 2012.

As a result of the super committee’s failure, spending cuts of \$1.2 trillion were triggered through sequestration. Half of the cuts are defense related (a big deal for the defense industry); the other half are in discretionary spending. Ms. Nunez said she is frequently asked whether these cuts will actually take place. Her answer is “yes.” Changing sequestration requires congressional agreement, which seems unlikely.

*“Cuts are coming . . . cuts are real . . . and Congress is unlikely to agree on any changes to sequestration.”*

— Alexandra Nunez



Ms. Nunez said Senator Kerry is optimistic that conversations begun in the super committee on major issues such as entitlements can be continued after the election. She is hopeful that the election can serve as a “reset” and can lead to a new political climate in 2013.

▪ **Political and regulatory uncertainty is affecting corporate behavior and valuations.**

The economic, political, and regulatory climate has led to high levels of uncertainty among business leaders. When CEOs

are uncertain, they don’t make long-term decisions or investments. When investors see uncertainty, they expect lower returns, which results in lower valuations.

Mr. Wolfe said at the moment, corporations have good fundamentals and are sitting on lots of cash. However, they are uncertain, which causes them to be risk averse. This isn’t limited to the U.S.; business leaders are uncertain about the global economy. (Mr. Wolfe suggested that in addition to being reluctant to make investments, firms are hesitant to hire expensive full-time employees. As a result, companies have become “labor renters.”)

In this environment, Mr. Wolfe said investors want: 1) income; 2) quality and safety; and 3) cash flow. He anticipates the first six months of 2012 to be fairly difficult as investors look for greater clarity and certainty. But he is cautiously optimistic that the fog may lift in the second half of 2012 and there may be opportunities to take risk.

## Other Important Points

- **Income inequality.** There has been a growth in income inequality and a decrease in economic mobility from one generation to the next.
- **Cutting foreign aid.** Ms. Nunez said that in response to the country’s debt problem, the overwhelming reaction of constituents has been to demand cuts in U.S. foreign aid.
- **Oil prices.** Mr. Wolfe said oil prices have increased over the past 10 years because of growth in consumption, particularly from China and India; waning supply; and risk in the Middle East. His long-term forecast is \$100 to \$125 per barrel. Prices of \$200 to \$300 are unlikely absent a crisis. However, such prices would be problematic and unsustainable. He believes technical innovations will decrease oil consumption.
- **Health care costs.** Professor Diamond sees increases in health care costs driven by technology and financial incentives for companies to create products that provide better care, but not cheaper or more efficient care. He believes reducing health care costs requires changing the incentives.
- **Climate change.** An audience member stated that 97% of scientists believe human action has accelerated climate change. Ms. Nunez said Senator Kerry has been unsuccessful in passing climate change legislation. She believes a smaller-scale energy policy is possible. Mr. Wolfe said investors are contemplating the implications of a warmer earth and what it means for different geographies and sectors, such as agriculture and clean energy.

## Risks & Opportunities

Mr. Basile asked each panelist what they see as the greatest risk and most significant opportunity in 2012.

Panelist	Risk	Opportunities
Diamond	<ul style="list-style-type: none"> <li>A disorderly default in Europe, by Greece or Portugal</li> </ul>	<ul style="list-style-type: none"> <li>Avoiding disaster</li> </ul>
Allis	<ul style="list-style-type: none"> <li>Potential collapse of Eurozone</li> <li>Potential increased slowdown in Chinese economy</li> </ul>	<ul style="list-style-type: none"> <li>Locating operations or selling into geographies that are weathering difficulties the best (emerging markets)</li> <li>“Green and gray.” Green = clean energy; gray = opportunities from changing demands of aging population (i.e. growth in home care)</li> </ul>
Nunez	<ul style="list-style-type: none"> <li>Significant delay in implementation of Dodd-Frank, prolonging uncertainty</li> </ul>	<ul style="list-style-type: none"> <li>Political reset post-election; fresh ideas and enthusiasm to deal with hard issues</li> </ul>
Tarbert	<ul style="list-style-type: none"> <li>Overconfidence in believing America’s economic woes are over</li> </ul>	<ul style="list-style-type: none"> <li>Innovation</li> </ul>
Wolfe	<ul style="list-style-type: none"> <li>Greatest risks are things that can’t be anticipated</li> <li>Risks in credit default swap market</li> <li>A policy mistake, perhaps by a central bank such as China</li> </ul>	<ul style="list-style-type: none"> <li>For investors, opportunities for good value in equity ownership</li> </ul>



## Speaker Biographies

### Special Guest



**Peter Diamond** was one of the three winners of the 2010 Nobel Prize in Economic Sciences (officially titled the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel). He is an Institute Professor Emeritus at MIT where he taught from 1966 to 2011. Professor Diamond has

written on public finance, social insurance, uncertainty and search theories, macroeconomics and behavioral economics, including the books, *Saving Social Security: A Balanced Approach* (with Peter R. Orszag), *Reforming Pensions: Principles and Policy Choices*, and *Pension Reform: A Short Guide* (both with Nicholas Barr), and *Behavioral Economics and Its Applications* (edited with Hannu Vartiainen).

### Distinguished Panelists



**Stephen E. Allis** is National Principal in Charge of Government Affairs at KPMG LLP in Washington, DC. Mr. Allis heads the department responsible for representing KPMG's interests in all matters of public policy before the Federal and state governments and for assisting non-U.S. practices in achieving their government

affairs goals. Prior to joining KPMG, Mr. Allis was COO of Newmyer Associates, one of Washington's oldest and most highly regarded public affairs consulting firms. In that capacity, Mr. Allis counseled some of the world's largest companies on their government relations and public relations strategies and programs. Prior to joining Newmyer Associates, Mr. Allis was VP of Clifford L. Brody Associates, consultants to money-center and large regional banks on the impact of pending legislation and regulation. He earlier worked on Capitol Hill as Legislative Assistant to Representative Lawrence J. DeNardis (R-CT). Mr. Allis was graduated magna cum laude from Harvard University.



**Alexandra (Alex) Nunez** is the Political Director for Senator John F. Kerry. She has worked for Senator Kerry for almost 7 years in several capacities, previously handling the military portfolio and acting as domestic policy advisor. Alex is currently responsible for federal

appropriations work, the judiciary portfolio and acts as liaison between the DC office and Massachusetts. She frequently travels to the Commonwealth to meet with elected officials, higher education institution, business leaders, advocates and hospitals to communicate the Senator's agenda. Prior to landing in Senator Kerry's office Alex worked in media consulting at Murphy Putnam LLC and as a press assistant to Congressman Richard Gephardt. Alex has her Bachelor's Degree in Government and Politics from

University of Maryland and her Master's in Public Policy from Catholic University.



**Heath P. Tarbert** currently leads the Financial Regulatory Reform Working Group at the international law firm of Weil, Gotshal & Manges LLP, where he is recognized for his transactional and regulatory expertise related to U.S. and foreign banks. He was recently Special Counsel to the U.S. Senate Banking Committee, where he

was a lead expert and negotiator on the various legislative proposals that culminated in the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act. Earlier in his career, Heath served as Associate Counsel to the President of the United States and as a law clerk at the Supreme Court of the United States. Heath obtained a J.D. and S.J.D. from the University of Pennsylvania, and a D. Phil. from Oxford University. Heath is a member of the Bars of England & Wales (Solicitor), the State of New York, and the District of Columbia.



**Christopher J. Wolfe** is the Managing Director and Chief Investment Officer for the Private Banking and Investment Group at Merrill Lynch Wealth Management. Mr. Wolfe draws on more than 20 years of global investment experience, including stints managing a large-cap U.S.

equity mutual fund and U.S. equity hedge fund, to provide asset allocation and portfolio construction guidance to Private Wealth Managers and their clients. The author of the monthly *C/O Outlook*, he also serves as Head of Global Customized Solutions, with responsibility for coordinating strategies with the Merrill Lynch investment teams in Europe, the Mideast, Africa, Latin America and Asia. Prior to joining Merrill Lynch, Mr. Wolfe was the head of investment strategy for Rockefeller Financial.



**Joseph Basile** (Moderator) is Managing Partner of the Boston office of Weil, Gotshal and Manges LLP, and a member of the firm's Corporate department. He specializes in representing corporate clients and investment funds in their most challenging transactional matters. His practice focuses on complex

domestic and cross-border M&A transactions, control and minority investments, joint ventures and strategic alliances in the U.S., Europe, Latin America, and Asia. He is a member of the Board of Fellows of Stonehill College, a member of the Board of Directors of the Massachusetts Business Roundtable and co-chair for the Board of Advisors of the Joseph W. Martin, Jr., Institute for Law and Society. He is also a former member of the Massachusetts State Ethics Commission. Mr. Basile is a graduate of Stonehill College and Harvard Law School.



KPMG was pleased to partner with Harvard Business School Association of Boston and Directors Roundtable to co-host the event 'U.S. Economic and Regulatory Outlook: Implications for Corporate Leaders' on January 18, 2012 in Boston, Massachusetts.

KPMG's professionals help organizations understand the implications of the complex regulatory landscape and its impact on growth, innovation and other strategies by modifying business practices as well as organizational structures across all facets of the business. To learn more, please visit the [Public Policy and Regulatory Reform](#) page on the [KPMG Institutes](#).



Weil, Gotshal & Manges LLP was pleased to partner with Harvard Business School Association of Boston and Directors Roundtable to discuss the outlook for government policies on taxes, spending, and regulations, and how corporate leaders can respond. Weil's Financial Regulatory Reform Working Group is a multidisciplinary collection of lawyers focused on providing timely, practical guidance and commentary concerning regulatory developments such as the Dodd-Frank Act and Basel III. For more information, please visit Weil's [Financial Regulatory Resource Center](#) and [Financial Institutions Regulatory practice page](#).

Support by our corporate sponsors is very important to the financial and professional vitality of HBSAB.

We are deeply grateful for their support.

Corporate sponsorship does not imply that HBSAB, Harvard Business School or Harvard University endorses in any way the sponsor organizations or their products.

THESE SUMMARIES REFLECT BULLSEYE RESOURCES, INC.'S, GOOD FAITH CONDENSED SUMMARIZATION OF THE HARVARD BUSINESS SCHOOL ASSOCIATION OF BOSTON (HBSAB) AND DIRECTORS ROUNDTABLE SESSION ON THE U.S. ECONOMIC AND REGULATORY OUTLOOK. THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE SESSIONS. IN NO WAY DOES HBSAB, DIRECTORS ROUNDTABLE, OR BULLSEYE RESOURCES, INC. ASSUME ANY RESPONSIBILITY FOR THE INFORMATION CONTAINED HEREIN, OR ANY DECISIONS MADE BASED UPON THE INFORMATION PROVIDED IN THIS DOCUMENT.