

U.S.

Economic Watch

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Economic Analysis

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State of the Union: A Nation Challenged President pivots to the center, focuses on business initiatives

- **Bipartisan sentiment to lead to spending cuts; details remain up in the air**
- **Obama plans to reorganize government, revamp regulations, reform corporate taxes**
- **President underlines challenge of international economic competition**
- **Speech stresses lean but effective government, innovation, education, infrastructure**

Executive Summary

Last night's State of the Union provided clarity to the business community. Obama vowed to reduce corporate taxes and burdensome regulation. The speech also revealed newfound bipartisan efforts evolving from the November Republican election gains and the recent assassination attempt in Tucson. The President emphasized his desire to cut the deficit, work with the opposition and move to the center. Agreement on deficit reduction alone is monumental as the deficit is so large an issue that it almost makes irrelevant all other topics. It is extremely encouraging that both sides agree to cut; the location of those cuts remains to be determined. However, lurking beneath this bipartisan charm and renewed love of free enterprise are serious disagreements over the drivers of structural change. Republicans remain wary of Democrats' "investments" in education and innovation, while Democrats remain wary of limited government's effect on poverty. The President's targets (Table 1) are ambitious and if achieved would substantially improve the competitiveness of the United States. Both sides still disagree on the merits of targeted Federal expenditure on public goods that accelerate structural change. The government appears ready to start cutting the fat. But if they go so far as to cut muscle, the country will have new problems.

Research and incentives, improved business environment, responsibility for the budget

The President's speech essentially described the United States as at an economic crossroads for structural change. Driving this moment of self-reflection are the twin pressures of globalization and technological innovation which have disemboweled 1950's-style blue collar job growth in the United States. At the same time, the President noted, the United States is still home to some of the best innovation, creativity and universities in the world. As "the future is ours to win," these world-class features of the US economy must be reinforced and efforts must be redoubled to "out-innovate, out-educate and out-build the rest of the world." According to Obama, this will require a new mindset where the country is willing to struggle and meet a major challenge along the lines of the technological race conducted against the Soviet Union in during the 20th century.

A large component of meeting this challenge will come from a revived educational and physical infrastructure. Education, according to the President, is essential to the nation's capacity for innovation as advanced degrees are necessary for technological dynamism. Obama mentioned his desire to make the education tax credit permanent, reconfigure the No Child Left Behind education reforms, and renew spending on education. At the same time, immigration policy is intricately-linked with education-led innovation as it "makes no sense" that "as soon as [immigrants] obtain advanced degrees, we send them back home to compete against us." The President pointedly mentioned that immigration must be reformed "once and for all" despite its difficulty as a subject for both parties. Infrastructure represents another leg of how America will

counteract international competition. According to Obama, the nation must more effectively move people, goods and information. The President desires a redoubling of infrastructure efforts by investing in energy, high speed rail, attracting private investment, and focusing on the merits of projects rather than political objectives.

Encompassing all of these above aims will require improvements to the environment for business. Obama declared his desire to lower the corporate tax rate without adding to the deficit, purportedly through expanding the base and closing loopholes. The business environment will also be aided by the administration's trade agreements, global trade talks, and the administration's push for an expanded role for exports in the economy. An overarching element of an improved business environment is Obama's call for a review of government regulation, with an eye towards removing burdensome or outdated rules without jeopardizing common-sense safeguards. At this point the discussion arrived at the only major partisan moment of the speech when the President discussed health care. Acknowledging the Republicans' negative feelings on last year's health care legislation, the President said he remains open to ideas that will improve it, but he does not desire any back-tracking, commenting that "instead of re-fighting the battles of the last two years, let's fix what needs fixing and let's move forward."

Taking responsibility for the budget represents the final, but perhaps most crucial, segment of the President's vision for making America more internationally competitive. To begin the discussion, Obama proposes to freeze annual domestic spending for five years (around \$400bn in savings over a decade) and severely reduce the share of discretionary spending in the economy. He also proposed simplifying the tax code, vetoing any bill that contains earmarks and conducting a major merger, consolidation and reorganization of government agencies. The President highlighted Federal workers' frozen salaries and cuts identified by the Department of Defense as confidence-building measures in the developing effort to reduce the national debt. At the same time, the President underlined that gutting spending on innovation and education will not help the nation in the long run. The President's desire to cut the deficit is a nod to both party's aspirations, but he made two important stands in contrast to the Republican Party. First, Obama implicitly said he would not privatize social security. Second, the President said he would not desire making permanent the tax cut for wealthy individuals. All of these comments increase the probability that Obama will include some, but not all, of the bipartisan fiscal commission's recommendations in his forthcoming 2012 Federal budget.

Implications for Universal Banks

What a difference a year makes: prior to last year's State of the Union, Obama was lambasting "fat cat" bankers and the "recklessness" of Wall Street. After an electoral backlash against government spending and intrusion, the Obama administration pivoted to the center with pro-business policies, appointments of major CEOs to executive branch advisory positions, corporate and individual tax reform, and plans for deficit reduction. All of these efforts are extremely encouraging for the fiscal stance of the US. No consensus on cutting the deficit would have been disastrous for the economy.

Last year we recommended that universal banks assume a greater role in the President's vision for exports and we reaffirm this recommendation this year. With the President increasingly dependent on pleasing business leaders and on shifting the economy towards exports, an international and universal bank operating in dozens of emerging markets could offer a strong partner to the Obama administration. Universal banks could provide more extensive support to infrastructure finance and trade credit in conjunction with government agencies like the Department of Energy, Department of Transportation or the Export-Import Bank. Additionally, banks with multinational exposure and competency in international transactions would also be useful to the President's export promotion goals.

Nonetheless, it is apparent that a disconnect still exists over the drivers of structural reform. Obama emphasized the same Hamilton Project philosophy of needed public investments in infrastructure, education and innovation as he did in last year's State of the Union. Republicans,

however, have become more orthodox over the past year due to the influence of the Tea Party and remain focused on limited government. It is unknown if the Tea Party will see education investment in the same light as the Democratic Party. It will take more than respectfully sitting together and refraining from shouting “you lie” to generate millions in new jobs. Secondly, while the post-Tucson environment is pleasant, it is unlikely to last. Assassinations are a rare occurrence in US politics and thus they have a severely chilling effect on political discourse. It is clear that twelve months from now – closer to the Presidential election – we will see a return to the kind of “you kill my cat, I kill your dog” politics of the 24-7 news cycle. Given that the Republican nomination for President is wide open, the competition will be fierce.

Table 1

The President’s Goals for the United States

- *One million electric cars by 2015
- *80% clean energy usage by 2035
- *High speed wireless coverage to 98% of Americans in five years
- *Double exports by 2014
- *Highest proportion of college graduates
- *Freeze annual domestic spending for five years
- *Bring discretionary spending to the lowest level since Eisenhower

Source: BBVA Research

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