

Economic Watch

US

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Economic Analysis

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2012 Presidential Vote-Share Model

- Stakes are high given the need for structural reform
- Our vote share-model predicts a photo-finish assuming current macroeconomic conditions continue
- Simulations indicate that the battle for the White House will intensify political brinkmanship
- Voters must proactively reverse congressional deadlock to revive gains in living standards through effective policy

US Competitiveness and the 2012 Election

The advantages of the US economy remain solid. Key strengths such as the size of the economy, innovation capacity, technological readiness and labor market flexibility are not under immediate stress from political brinkmanship and inefficiency. However, to remain competitive in the 21st century, the US is in need of structural reforms and fiscal improvements. The 2012 presidential election will present unique challenges. Tight budgets will force candidates to weigh personal and partisan agendas with maintaining a sustainable fiscal track for the coming decades. In addition, as President Obama pointed out in his State of the Union address, and as evidenced by the World Economic Forum (WEF) and congressional approval ratings, American politics must change. First, congress must address the imbalances between the elected and the electorate. We believe this means aligning public goals with the personal incentives of elected officials. Second, the partisan and Congressional impasse must end. In other words, there must be a concerted effort to promote compromise, which will improve inefficiencies of the legislative process. Confronting these bureaucratic inefficiencies will improve the probability that reforms such as taxation, fiscal sustainability, health care, education, immigration, and infrastructure will succeed. If action is delayed beyond 2013, the negative feedback loop generated by prolonging the harsh reality that change is needed, could negatively impact generations of Americans lowering living standards and increasing income inequality even further.

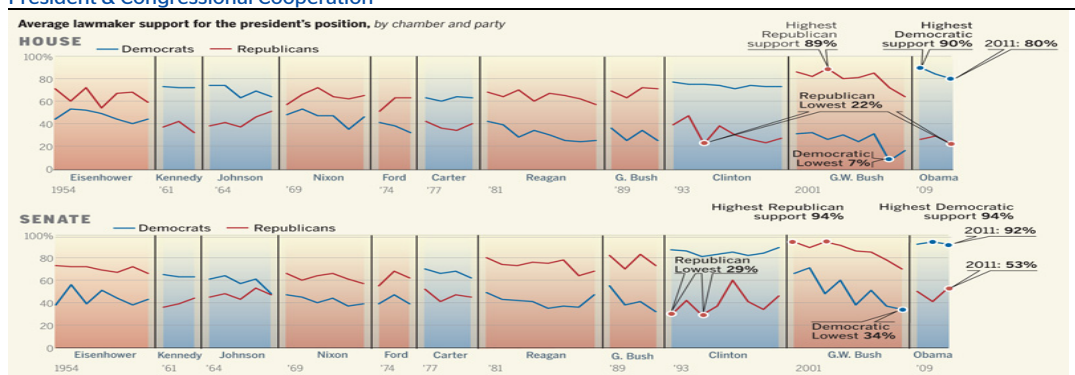
Chart 1
World Economic Forum Competitiveness & Institutional Ranks

Country/Economy	GCI 2011-2012	GCI 2010-2011	Trust in Politicians	Political Bribes	Cronyism	Wastefulness	Transparency
Switzerland	1	1	13	10	11	8	3
Singapore	2	3	1	3	3	1	1
Sweden	3	2	4	4	1	10	7
Finland	4	7	14	5	9	11	6
United States	5	4	50	42	50	66	50
Germany	6	5	37	22	19	40	28
Netherlands	7	8	12	13	7	14	16
Denmark	8	9	9	2	4	18	8
Japan	9	6	55	9	10	78	38
United Kingdom	10	12	44	20	20	53	18

Source: WEF & BBVA Research

According to the WEF, the United States ranked 50th, 42nd, 50th, 66th, and 50th in trust of politicians, political bribes, cronyism, wastefulness and transparency, respectively. More simply, the United States ranks below Ethiopia, Tanzania, Cambodia, and East Timor, all of which are categorized as Stage 1 developed, in select key institutional rankings— institutional rank is one of 12 “pillars” which basically incorporates jurisprudence, government efficiency and fairness, and property rights. The flagging federal efficiency has led to a steady decline from an overall competitiveness ranking of 1st in 2009, to 2nd, 4th, and ultimately 5th in 2012. The descent of executive confidence and macroeconomics environment is not solely attributable to inefficient politics but rather a combination of mistrust in elected officials and lack of long-term planning. On long-term planning, debt management appears to be the key issue. Respectively, the WEF ranked the US 121st, 139th and 132nd in gross national savings, fiscal balance, and total government debt. Thus, the overhang from the rising debt levels is also a comparative disadvantage and will need to be addressed in the upcoming presidency.

Chart 2
President & Congressional Cooperation



Source: Congressional Quarterly

Republican Primary and Current Polls

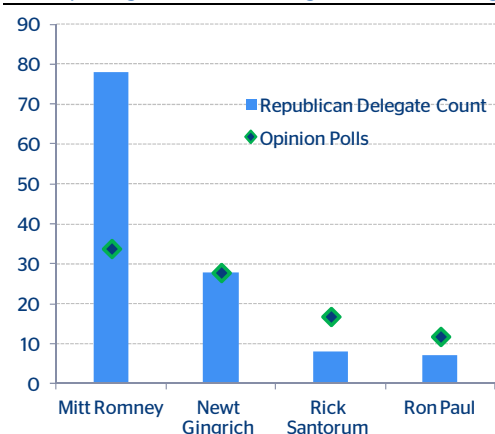
Can the US regain the competitive economic advantage enjoyed during the 20th century? Can the structural challenges be addressed in the next presidency? The answer is yes. However, some candidates currently support policies that may provide temporary relief but offer no solutions to long-run frictions—increased military spending or continued or expanded social policies. Others may confront long-term structural issues but ignore the need for short-run growth impetus — sharp fiscal contraction, for example. Today's challenges will require both a long-term and short-term perspective, a difficult accomplishment for short-natured politics. This ephemeral quality is most evident in congressional elects, and leads to a duration biases, which shifts attention to ear marks and pork barrel spending rather than structural reform. The president also has a brief window for which to enact structural policy considerations given that congressional resistance following the “100 day” period increases and that campaigning starts after their second year in office. We believe this short duration bias is fueling political impasse and will negatively impact structural reform in the near future regardless of the congressional majority or president elect. In fact, the evidence in chart 2 confirms that politicians are increasingly uncompromising and the legislative process is inefficient.

On balance, the front-runners for the Republican nomination have similar goals that are in line with the Republican caucus. None of the candidates, excluding Ron Paul, have shown a willingness to diverge from the conservative status quo and thus the probability that candidates promote a socially conservative agenda in addition to promoting decreased taxation and spending is high. Specific Republican Party objectives, as reported by the GOP website include education, national defense, economic— non-interventionist— policies, healthcare reform, and an all-of-the-above approach to energy independence. In addition, most candidates support tax overhaul but insist that it occur without tax rate increases. Mitt Romney, the former governor of

Massachusetts, favors a pro-employment platform aimed at reducing tax rates, spending, regulation, and government programs. Newt Gingrich, who previously resided over the House of Representatives, supports more extreme tax regulation but in the same pro-growth context. On monetary policy, most of the candidates favor a reversion to “Reagan” era monetary policy, which includes dollar strengthening and a more hawkish Federal Reserve. Gingrich has even indicated he would support a commission that explores the possibility of a reversion to the gold standard. Meanwhile Ron Paul, a House Representative from Texas, favors a libertarian position which promotes lean, non-interventionist (foreign policy) and state-centric government.

Social platforms have received less attention given the extreme economic slack. Nevertheless, the Republican primary candidates do support a strict constructionist judicial approach, or in other words, a more passive judiciary. Rick Santorum—a former Senator for Pennsylvania—on the other hand, supports the most socially conservative agenda which includes sanctity of marriage protections and abortion legislation. 8

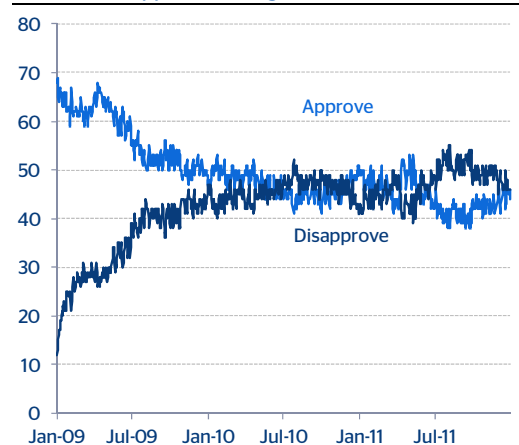
Chart 3
Primary Delegate Votes & Polling Results (% favoring)*



Source: Real Clear Politics & BBVA Research
*As of 6 February 2012

The variability in the Republican Primary, to date, is staggering and has produced a high degree of uncertainty regarding future candidates. For example, since September, four candidates have led in the unofficial polling results—two of which are no longer in the race. In addition, the three major primaries—Iowa, New Hampshire, South Carolina—have yielded three separate winners, a first in presidential primaries. The fact that Newt Gingrich has led opinion polls while simultaneously trailing Mitt Romney in delegate votes, which are the ultimate determinant of the nomination, further complicates the nomination. Given that no candidate secures a majority consensus in the remaining primaries, there is the possibility of an obscure procedural event known as a brokered convention. In essence, this is a procedure that places the nominating power in prominent party members. Gingrich's pledge to continue campaigning could be an attempt to reach a brokered convention, as was the case in 1952.

Chart 4
Presidential Approval Rating (%)



Source: Real Clear Politics & BBVA Research

BBVA Vote-Share Election Model

Regardless of the GOP primary process, the 2012 presidential election could be one of the most important since 1932, when a massive confluence of negative events drove FDR to respond with the New Deal. The current structural deficiencies could require equally drastic policies. Given the importance of the 2012 election for our 2013-2016 economic outlook, we developed a model that removes the qualitative bias or political preferences opting instead for an empirically based approach. This methodology also gives a first-mover advantage of predicting presidential outcomes before the presidential candidates are known. To clarify, our approach assumes that economic data such as stock market returns, market volatility, home prices, inflation, manufacturing activity coupled with Congressional majority and taxes, affect wealth and thus

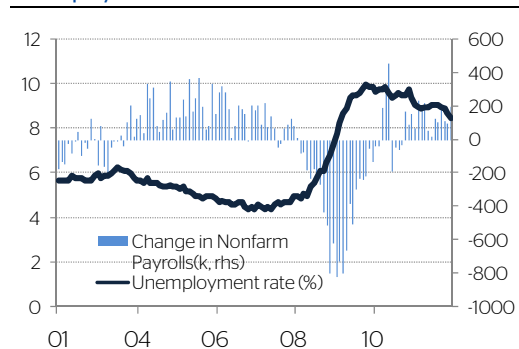
voter sentiment. A fundamental assumption of the model is that, if specified correctly, financial and economic variables will explain a majority of the vote-share that a given party will receive at the national level. For specification purposes we chose the share of the vote the Republican Party will receive given the aforementioned variables— conditioning the model for the Democratic Party, would produce comparable results.

Chart 5
VIX & Dow Jones (index)



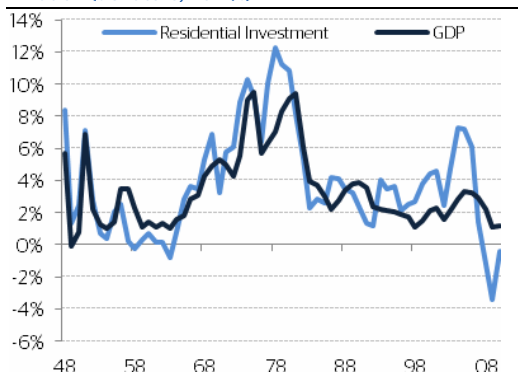
Source: Haver Analytics & BBVA Research

Chart 6
US Employment



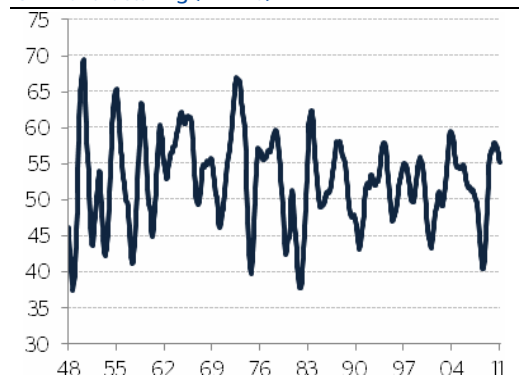
Source: Haver Analytics & BBVA Research

Chart 7
Inflation (deflators, YoY %)



Source: Haver Analytics & BBVA Research

Chart 8
ISM Manufacturing (12mma)



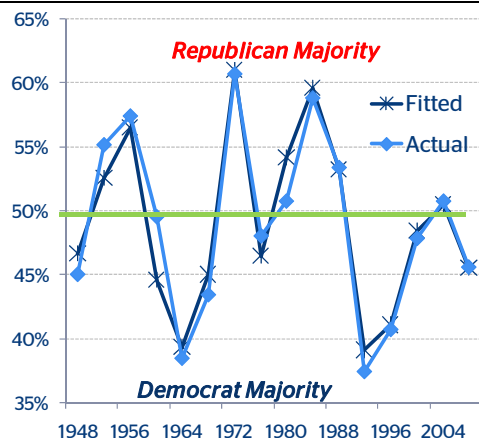
Source: Haver Analytics & BBVA Research

In total, with the continuation of the economy as is and under our baseline macroeconomic scenario, President Obama maintains the White House by a razor thin margin, similar to that of the Bush v. Gore election of 2000. However, under our baseline scenario, which assumes slower growth, lower inflation and rising home prices, the Republicans win the general election by 7.9%. Given that only Ronald Reagan was reelected with an unemployment rate above 6.0%, and apriori intuition, it is no surprise the republicans will win in a low growth scenario.

In addition, it is likely that social dissonance and voter frustration will increase if unemployment remains high and growth stagnates, which would bias voters to change. Therefore, we believe that President Obama will continue to push for economic stimulus that targets housing refinance programs, employment creation and income support in the form of unemployment benefits and payroll tax deductions, and all-of-the-above approach to energy production. Our model also suggests voters favor the democrats when uncertainty is high and thus in this case will favor the incumbent. As such, Republican's should push for policies that decrease market uncertainty. However, the extreme views in both parties limited the ability to compromise, as

evidence by the budget and debt ceiling debates, which prompted a steady drop in Congressional approval since March 2011. While both sides fight to blame the other, an increase in uncertainty will favor the Democrats. Thus, if the GOP decreases their rhetorical censure of president Obama, it could increase their vote-share.

Chart 9
BBVA Presidential Vote-Share Model (1948-2008)



Source: BBVA Research

Chart 10
BBVA Vote-Share Model (% of popular vote)

Scenarios	GOP	Dems
Current	49.5	50.5
Headwinds	53.9	46.1
Obama's Choice	43.1	56.9
Congressio Chaos	48.8	51.2
RiskyBusiness	55.7	44.2
Financial Contagion	43.0	57.0

Source: BBVA Research

On election strategy, the model suggests that the Republican primary nominee will do better if he can convince voters that the economic recovery is weak, while the President will improve his chances of reelection if he can prove that the Republicans are to blame for not enacting his economic proposals. This political brinksmanship will be ferocious and most likely extend into states that have a large number of electoral votes, where the economic recovery is underwhelming, and that have a non-partisan vote history (e.g. Florida, Ohio, and Pennsylvania). As a result, both campaigns will promise enhancers to certain groups that have a disproportionate impact on elections, but that in some ways go against the long-run solution. For example, extending unemployment insurance, delaying entitlement reform and subsidizing inefficient industries are unlikely to assure fiscal sustainability, solid job creation nor strong productivity growth.

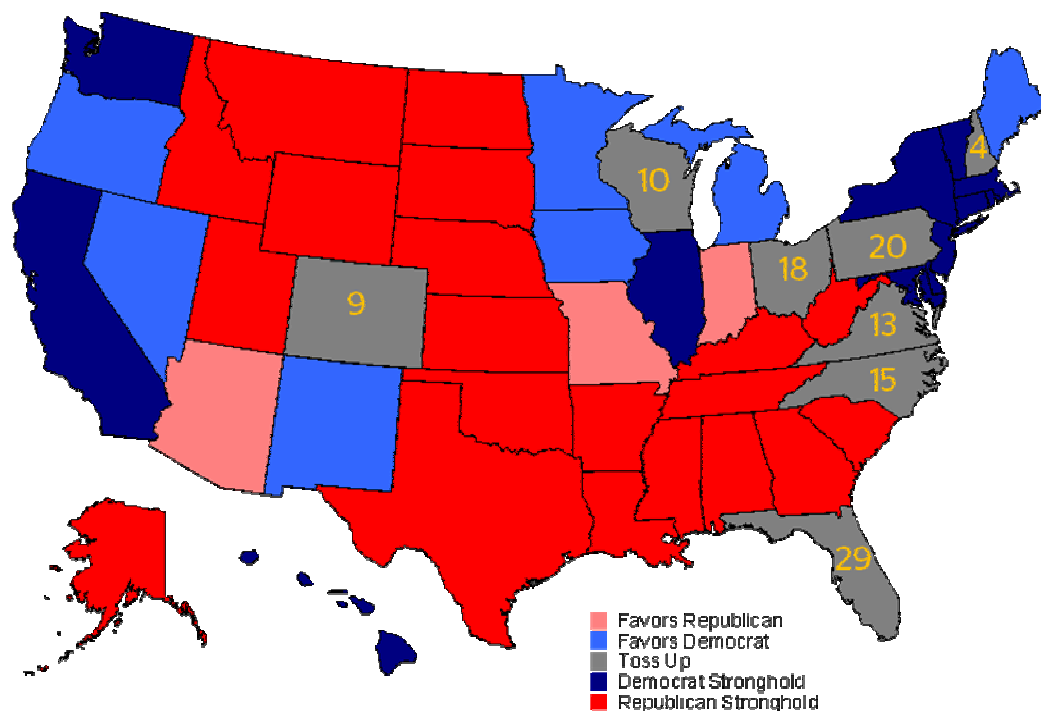
Lastly, the model can depend on willingness of voters to accept a divided government. In other words, if voters perceive the partisan or political impasse as a procedural impediment, they can favor a unified White House and Congress, and thus the Republicans win. However, for the impact to be significant there must be a strong majority (+/- 7.5%). In addition, our model results are supported by many opinion polls, which suggest that a general election between President Obama and a generic Republican candidate would be highly contested race with the slightest margin (less than 1%). Nonetheless, the polls also indicate that president Obama has an advantage over the current primary candidates and thus he could have impetus that is accounted for in our model.

2012 Election and Beyond

An election outcome that is able to realign political incentives with the needs of the electorate, will promote stronger growth and higher living standards in the coming decades. Given the importance of this election we developed an empirical approach to predicting presidential elections. According to our models, if economic conditions persist, the Republicans win the White House; on the other hand, if president Obama's policy push for economic expansion succeeds it is probable that the Democrats win. Nonetheless, it appears the high stakes and all-in approach of both parties will make policy creation impossible in 2012. Thus, the 2013 presidency, regardless of party, will require a strong leader who is prepared to promote difficult structural reforms amidst partisan polarization.

Chart 11

2013 Electoral College Projections (Orange: # of electoral votes)



Source: Real Clear Politics & BBVA Research

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