Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Longbrake Letter*

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"The 'animal spirits' of which Keynes spoke are on the prowl across the United States. Their mood is ugly. The spirits are wary and troubled. . . . I found a mood of deep unease in an America that seems to have descended into tribalism — not ethnic, but political, economic and social. Uncertainty is pervasive. The government's rescue of Wall Street combined with the acute difficulties of a middle class struggling to get by on stagnant or falling incomes has sharpened resentments." — Roger Cohen, The New American Normal, New York Times, September 27, 2010.

I. Reprise — Credit Boom and Bust

We labeled the recent recession the "Great Recession" because we knew it was a more severe one than any other in recent times. Now, as recovery languishes and unemployment has stagnated at a very high level, we are beginning to understand that not only was the Great Recession truly different but also that recovery will not follow a more traditional path of accelerating growth.

Economists, such as Kenneth Rogoff, Carmen M. Reinhart and Vincent Reinhart, have documented that recoveries following credit booms and busts, unlike recoveries following economic activity, investment or inventory overshoots, not only progress more slowly but also are especially vulnerable to new setbacks.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

The financial panic of 2007-2008 was the inevitable consequence of over-consumption fueled by excessive debt creation and unsustainable escalation in asset prices, particularly the unprecedented and widespread bubble in housing prices.

While the near catastrophic phase of debt deleveraging in the financial system appears to have passed (although some like Christopher Whalen believe much unrealized rot (credit losses) remains due to "kick the can down the road" accounting conventions and regulatory policies), the imbalances that built up over years and crescendoed in a paroxysm of speculation and overindulgence during the bubble years remain extremely large and will take years to unwind.

Similar historical episodes demonstrate unambiguously that recoveries following credit busts entail slower growth for an extended period. A recent study by Carmen M. Reinhart and Vincent Reinhart documents details for 15 country episodes. They found that the median decline in annual per capita GDP growth over a ten-year period following a financial crisis was 1.0% (2.1% post-crisis versus 3.1% pre-crisis). The unemployment rate averaged five percentage points higher in the decade following the crisis than in the decade before the crisis and in ten of the fifteen episodes the unemployment rate had not fallen back to the pre-crisis level after ten years. Median housing prices were 15% to 20% lower in the post-crisis decade. Debt deleveraging took an average of seven years.

CHART 1 – Household Debt to GDP – 1975-2010

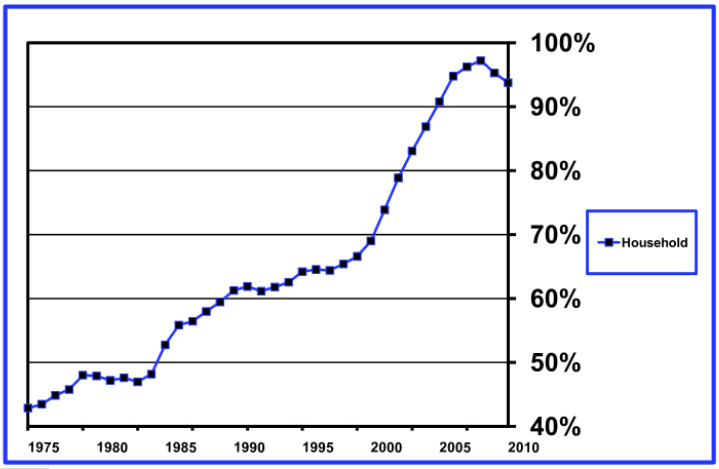

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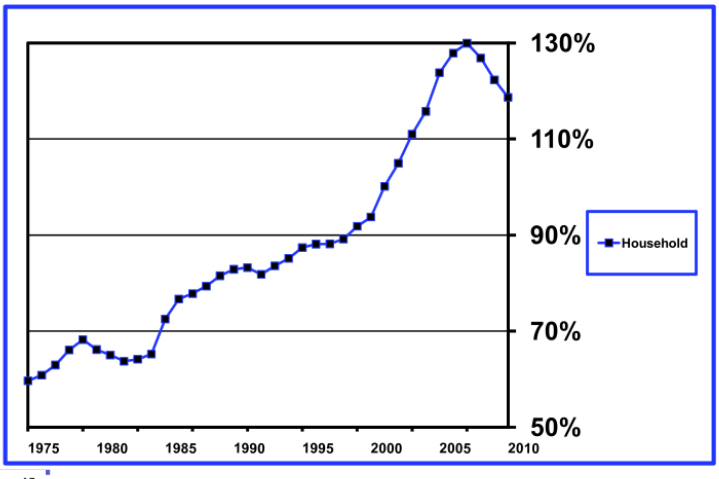
CHART 2 – Household Debt to Disposable Income – 1975-2010



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The consumer debt to GDP ratio (**Chart 1**) peaked in the first quarter of 2009 at 98.3% and the consumer debt to disposable income ratio (**Chart 2**) peaked in third quarter of 2007 at 130.2%, suggesting that at least another four to six years of debt deleveraging remain. Goldman Sachs estimates that deleveraging will take six to ten additional years and forecasts that the consumer debt to disposable income ratio will fall to 78%, a level last experienced in the early 1990s, before stabilizing.

II. Consumer Angst

1. Household Income Inequality and Stagnation in Real Income Growth

Easy access to credit during the bubble years masked stagnation in household real income growth. Also worrisome is increasing income inequality as reflected in the higher growth rate of real income for the highest 5% of households versus the lowest 20%. **Chart 3** shows that real household income grew 72% for the highest 5% from 1967 to 2007 before slowing to a gain of 69% over the last two years, while real household income grew just 25% for the lowest 20% from 1967 to 2007 but has slipped to a gain of 21% over the last two years.

Chart 4 shows real household income growth for the last 12 years from 1997 to 2009. The chart shows that after an increase in real incomes from 6% to 8% from 1997 to 1999, real incomes have decreased for all households over the last ten years. The smallest decrease occurred for the top 5% and that decline was only about 2% from 2007 to 2009.

CHART 3 – Household Income Inequality 1967-2009
(percentage increase in real income)

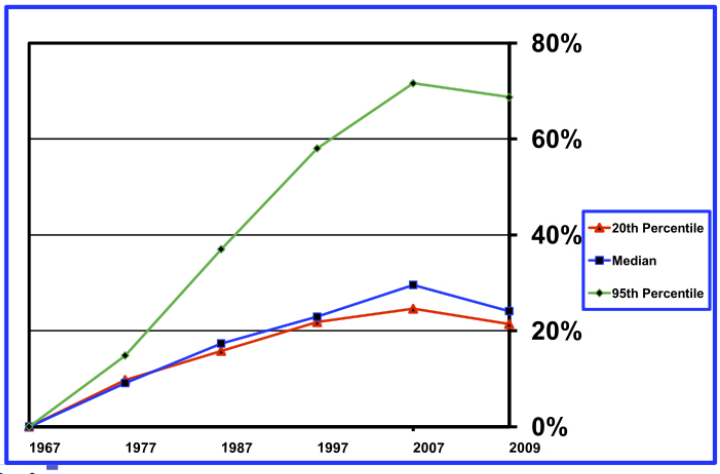

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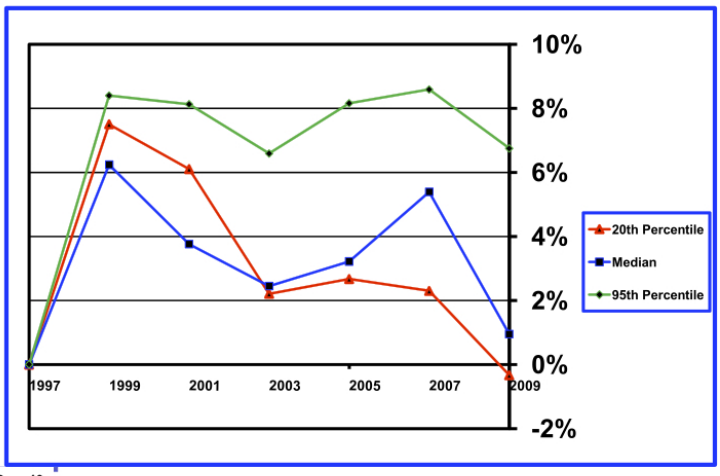
CHART 4 – Income Inequality 1997-2009
(percentage increase in real income)



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2. The Rich Are Taking an Ever Increasing Share of The Total Income Pie

Another way of looking at growing income inequality is to compare the share of total household income accounted for by the richest 1% of households over time. In the late 1970s the top 1% received 9% of total income. By 2007 the top 1% received 23.5%, an amount, according to Robert Reich, author of "Aftershock", last seen in 1928 prior to the Great Depression.

3. Financial Stress Worsening

An indicator of growing financial distress among households is the "economic security index" compiled by Professor Jacob Hacker of Yale University. According to Professor Hacker 12% of households experienced a drop of income or spending power of more than 25% during the previous year in 1985. This percentage grew to 17% in 2002 and is expected to exceed 20% when data are compiled for 2009.

4. Anxiety and Anger

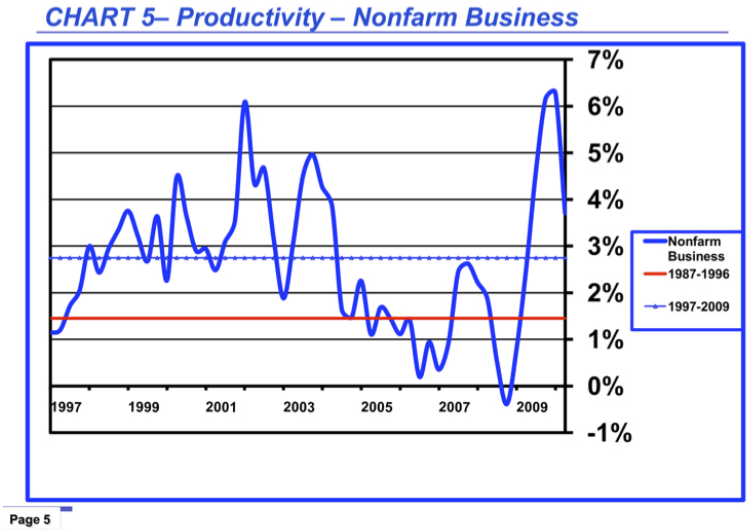
Stagnation in inflation-adjusted income growth and spending power and escalating levels of financial distress began well before the onset of the Great Recession. For a while easy access to credit and the bubble economy masked this developing problem, but the credit bust and persistent high unemployment and underemployment have blown this false façade away. The vast bulk of American society is bewildered by what has happened in their lives. What they know is that they are hurting and that government intervention appears to have done little, if anything at all, to improve their situations or provide hope for a better future.

In 2006 and 2008 a majority of the American electorate increasingly understood that Republican economic policies were not addressing their economic concerns. Democrats were the beneficiaries of this angst. But as we approach the mid-term elections in a few days, a majority of the American electorate is poised to vote for Republicans, not because the Republicans have answers — they don't, but because they believe that Democratic policies have not addressed their economic concerns effectively. In other words,

neither political party has developed an effective set of policies to reverse income stagnation and growing inequality. But, it is the party currently in power that bears the brunt of unfilled hopes, frustration, anxiety and anger. ***Democrats seem likely to lose control of the House of Representatives and it seems increasingly possible that they will lose control of the Senate as well.***

5. The Productivity Conundrum

Inflation-adjusted wages generally increase over longer periods of time in line with increases in productivity. Productivity growth has accelerated to a much higher level since 1996 as shown in **Chart 5**, averaging 2.75% annually from 1996-2010 compared to 1.45% from 1987-1996. The corresponding annual increase in median inflation-adjusted income was 0.30% from 1987 to 1996 and 0.18% from 1996 to 2009. Not only did median income increase considerably less than growth in productivity, but the disparity worsened substantially during the higher productivity years from 1997 to 2010.



If the vast bulk of households did not benefit from increasing productivity gains, then who did? The answer is partly that the very top of the income

pyramid — the richest 1% — collected much of the gains and much of the remainder was in the form of business profits, which have accounted for an increasing share of GDP in recent years. Although much of business profits is retained within the businesses themselves, rather than being distributed to investors through dividends or share repurchases, the retained portion of profits shows up in rising stock prices and thus in increasing investor wealth. Time series data also show that inequality in the distribution of wealth has grown in line with changes in the distribution of income. Thus, growth in both wealth and income increasingly has flowed to the wealthiest Americans.

This state of affairs has lead Robert Reich to comment that "...when the distribution of income gets too far out of whack, the economy needs to be reorganized so that the broad middle class has enough buying power to rejuvenate the economy over the longer run." If Robert Reich is correct in this conclusion, then failure to address processes and policies that direct income and wealth gains primarily to the wealthy will ensure continuing subpar economic performance in coming years.

6. Misguided and Failed Economic Policies

However, policies to redistribute income and wealth are hardly a cure-all. Policies also need to encourage innovation and investment in new and emerging technologies and increase the skill levels of workers and match their capabilities to the kinds of jobs that a growing, vibrant economy will require for ongoing success. With this in mind, it is disappointing that investment in infrastructure is being starved. Governor Christie's cancellation of the second Hudson tunnel project, for example, may have addressed short-term funding issues, but seems short-sighted in terms of making the investments today that will be critical to future growth tomorrow.

Similarly, the Obama administration's focus on demand-stimulus subsidy programs, such as the housing tax credit and cash for clunkers, had no apparent lasting impact in building a stronger base for future economic activity. Arguably, the dollars spent on such programs would have produced far better results over the longer term if they had been put into bold programs to invest in energy independence, research and development and infrastructure. That did not happen because of political constraints on the amount of stimulus spending and because the focus of policymakers was to try to reignite aggregate demand as quickly as possible.

Unfortunately, it takes a long time to realize the benefits of long-term investment. Perhaps the approach to policy would have been different in early 2009 had policymakers understood that demand stimulus has limited impact when an economy is recovering from extreme debt over-leverage and had policymakers understood that long-standing economic policies had already undermined economic growth and their continuation would continue to weaken the productive capability of the U.S. economy over time.

While there is some debate about the consequences of growing income and wealth inequality and there is also debate about the need to redirect economic policy from a focus on near-term demand stimulus to strengthening the ability of the economy over a longer time period to create jobs and improve the overall standard of living, such debate is not yet central in our political process. Instead we are debating whether and how to extend the Bush tax cuts. We are discussing the "evils" of a growing federal deficit with a focus on curtailing government spending. While deficits will matter in the long run and, therefore, their importance should not be discounted, spending, even deficit spending, that invests in building a strong economic base for future growth must become a priority consideration for policymakers and America's political parties. Unfortunately, there is little in the mid-term campaign rhetoric that provides much hope that the imperative of the need for such a focus and debate will be forthcoming. ***Does this portend, as the Chinese seem to believe, that America is destined for a slow decline as a world economic power?***

III. Financial Market Performance — Why Are Both Stocks and Bonds Rallying?

1. Basics of Stock Prices

Simply put, stock prices are the discounted present value of the flow of cash earnings in perpetuity. To derive a price for a stock one must determine values for two variables: first, a forecast of future cash earnings and second, a value for the discount rate. In markets, values for these variables are determined collectively by numerous participants in an auction process. Since the future is uncertain and new information is constantly coming to the fore, prices will vary, often considerably, over time as expectations for

future earnings and the appropriate discount rate change.

The value for the discount rate is composed of three parts, a risk-free real rate of return, an inflation component and a risk premium.

2. Basics of Bond Prices

The price basics for bonds are similar to those for stocks with one important difference. Instead of a forecast of an uncertain stream of cash earnings into perpetuity, which is required to determine a stock's price, the amount and timing of bond cash flows are defined with precision. However, the discount rate, as is the case for stocks, depends on the same three components — real risk-free rate, inflation component and risk premium.

3. Discount Rate

The risk-free real rate averages about 2.5% but fluctuates over the business cycle, rising when business activity is strong and falling when business activity is weak. The level of the real rate parallels the real rate of growth in the economy which is a function of population growth and productivity.

The risk premium varies across classes of financial assets. The risk premium rises if cash flows are expected to be more volatile over time (not an issue for bonds) and rises if the probability of default increases.

The discount rate increases in proportion to long-term expected inflation rates, but generally at greater than a one-to-one ratio because of the effect of taxes.

4. Long-Term Bond Yields

To the surprise of many market participants Treasury bond yields have fallen to unexpectedly low levels. This has prompted many to assert that a bond market bubble is underway, with the implication that bond prices are the result of speculative forces rather than rational application of standard valuation rules. This interpretation revolves around a mistaken view of the

future pathway of inflation. If inflation is likely to remain low for an extended period of time, it would be very reasonable to expect bond yields to be low. What is happening is that the inflation component of the discount rate is declining so that the discount rate is lower with the result that bond prices rise and yields fall.

Currently the 10-year Treasury bond yield is about 2.4% which is similar to the average long-term real rate of return. Since the return on U.S. government securities is considered to be risk-free, this implies a zero rate of inflation for several years or even possibly some deflation. Core consumer price inflation currently is 0.9%, so it is not zero, but it is in a declining trend. So, at first blush it would seem that the current level of 2.4% for 10-year Treasuries is too low. However, there is another consideration and that is that the real rate of return is not constant but tends to decline when there is slack in the economy. And, slack is enormous at the moment and likely to remain so for an extended period of time. When one combines the large amount of slack with prospects for declining inflation and extremely sluggish recovery in GDP growth, the current 10-year Treasury rate can hardly be considered to be abnormally low or bubble like. In fact it is probably very close to being a reasonable rate given current and prospective economic conditions.

That then raises the question of where long-term bond rates may be headed in coming months. Virtually all analysts expect that the Federal Reserve will announce the second round of quantitative easing at the November Federal Open Market Committee meeting. This will involve the purchase of long-term Treasury securities, and possibility agency guaranteed mortgage backed securities. This action will change supply and demand dynamics and will increase prices and decrease yields. The market has already anticipated this policy announcement and there is ample reason to believe that a substantial portion of the adjustment in bond prices already has taken place.

Does this mean that bond yields have already reached their lows? Some think so, but this is not necessarily so. Uncertainty remains as to the size of the Fed's likely purchases and the timing of those purchases. Also, there is uncertainty about how long the Fed will wait before it begins to reverse quantitative easing by selling securities and by raising the federal funds rate. There is also uncertainty about how low inflation might go and whether deflation might take hold. Finally, there is uncer-

tainty about how long the economy will continue to operate significantly below potential. If that uncertainty resolves over time in the direction of even lower inflation for a longer period of time and extended sluggish GDP growth, it is possible that both the inflation component and the real rate of return could decline from current levels, thus reducing the discount rate, raising bond prices and lowering yields.

If you are an optimist you believe that these uncertainties will be resolved in the direction of greater growth, reduced economic slack and renewed inflationary pressures. That outcome would lead to higher bond yields. However, if the uncertainties resolve in the other direction, then bond yields could very easily fall from current levels. In other words, the bottom is not yet at hand.

My econometric model suggests that the long lags in the process of adjusting inflationary expectations to a sustained level of lower inflation and the likely continuation of high unemployment and substantial slack in the economy will result in much lower 10-year Treasury yields over the next two years.

5. Implications of Declining Inflation for Stock Prices

What this means is that the discount rate for bonds is still likely, in my opinion, in a declining phase. This means that 10-year Treasury yields could decline well below 2.0% over the next two years.

It is important to understand that stock and bond returns are linked. Investors can choose to buy bonds or stocks. If risk-adjusted returns are low for bonds relative to stocks, then investors will sell bonds and buy stocks until the respective risk-adjusted returns are aligned and induce no further incentive to restructure portfolios. What this means is that if bond yields are likely to decline further in coming months because of declining inflation and continuing economic slack, then there will be upward pressure on stock prices. How can this be so? That is because as the discount rate on bonds declines, the discount rate on stocks will also decline. As long as expected earnings on stocks remain unchanged, the lower discount rate will result in higher stock prices.

6. Earnings Prospects for Stocks

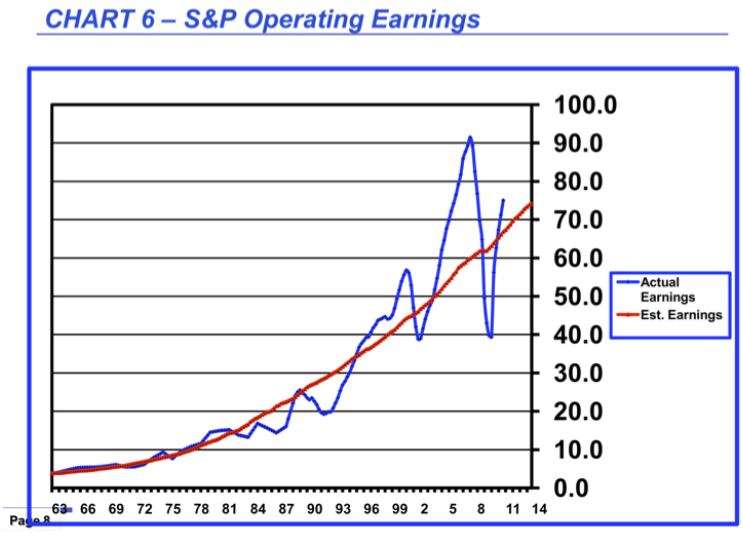
As a reminder, stock prices depend both on expected earnings as well as on the discount rate.

Operating earnings on large publicly-traded stocks have made a remarkable come back from the depths of the Great Recession. S&P 500 operating earnings over a 12-month trailing period peaked at $91.47 in the second quarter of 2007 and bottomed at $39.40 in the third quarter of 2009. By the second quarter of 2010, operating earnings had recovered to $67.29 and are expected to increase to $71.22 in the third quarter and $74.99 in the fourth quarter.

While many are optimistic that the recovery in operating earnings will continue unabated, thus spurring stock prices to higher levels, such optimism is not entirely consistent with a lethargic economic recovery.

There is a long-term and very strong relationship between GDP and S&P 500 earnings. The correlation between the two is 98% over a 62-year period. For example, actual S&P earnings were $67.29 in the second quarter of 2010; a simple regression model predicts the amount to be $65.29. The predicted amount within a plus one standard deviation range is $78.34. Thus, second quarter 2010 S&P operating earnings were well within the historical expected range given the level of GDP.

Chart 6 shows that S&P operating earnings greatly exceeded the long-term relationship with GDP during the bubble years and then plunged below expected levels during the depths of the Great Recession. While the recent level of actual S&P earnings is nearly aligned with that based on the long-term relationship with GDP, the expected levels for actual earnings in the third and fourth quarters of 2010 exhibit a growing divergence from those predicted by the model. If there has not been a systematic shift in the relationship between S&P 500 operating earnings and GDP, then slow growth in GDP going forward should translate into slow growth in S&P 500 earnings.



7. The Growing Divide Between a Handful of Large Businesses and a Plethora of Small Businesses

There is reason to believe that the historic relationship between S&P operating earnings and GDP may indeed have shifted. In the aftermath of the Great Recession an unusual and disturbing dichotomy has developed between the very largest companies and small businesses. Large businesses are flush with cash and are experiencing strong earnings growth. However, according to the monthly survey conducted by the National Federation of Independent Business, small businesses remain mired in a recessionary state.

Earnings for the S&P 500 were up 99% year-over-year in the first quarter of 2010, but aggregate corporate profits, as measured in GDP, which includes all corporations and not just the 500 largest, were up only 37% and proprietors' income was up a miniscule 1%.

The divergence between large and small companies may have a great deal to do with the bifurcation in global growth. Emerging economies have resumed rapid growth in the wake of the global recession while recovery in developed countries, such as in the U.S. and European nations, has been modest. Large companies tend to have globally diversified operations, so it

is likely that larger companies are benefitting from the resumption of rapid growth in emerging countries. Small U.S. companies generally are much more directly limited in the scope of their operations to the United States.

There may be other factors that are favoring revival and stronger earnings growth in larger companies relative to smaller companies. These include easier access to credit — a net of 14% of small businesses reported in September that credit is harder to get, reflecting no improvement in several months; and greater ability because of scale to take advantage of smaller competitors' weaknesses.

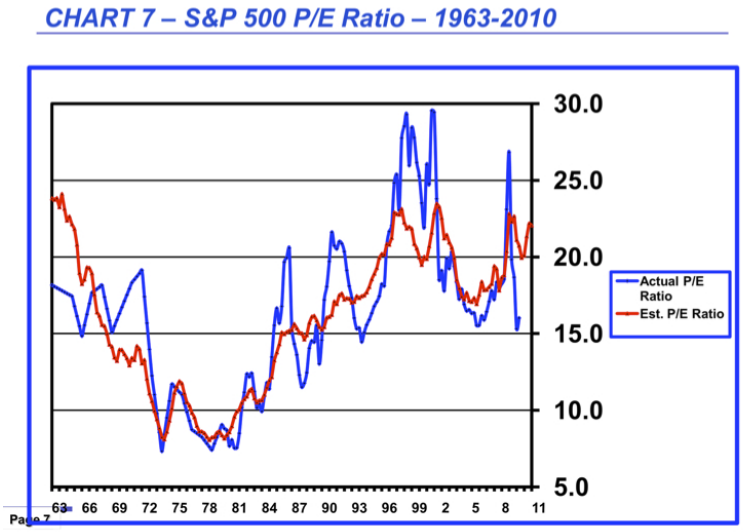
8. Prospects for the S&P 500 Stock Price Index

If large companies' earnings continue to grow, and many professional investment managers feel strongly that that is likely, then the S&P 500 stock price index is likely to continue edging up. But that may be the end of the good news. As long as smaller companies continue to languish economic recovery will remain sluggish and unemployment will remain stuck at a very high level. In other words, the stock market may well continue its ascent and that will continue to stoke the risk trade

There is another reason that the S&P 500 stock price index may continue to rise and that has to do with the possibility that the discount rate will fall. If that occurs, then higher earnings would be discounted at a lower rate which would reinforce upward pressure on stock prices.

A sense of what might be possible can be derived by estimating the S&P 500 earnings-price (E/P) ratio, which is the inverse of the more familiar price-earnings (P/E) ratio. The E/P ratio is a proxy for the current discount rate if it can be assumed that future earnings will grow at a constant rate. If this assumption holds, then the expected value of the S&P 500 stock price index can be derived by dividing current S&P 500 earnings, the E, by the discount rate implied by the E/P ratio. (While there is some complexity to the math, when there is a constant rate of growth in future earnings in perpetuity the discount rate can be reduced by the growth rate and the resulting adjusted discount rate can be applied to current earnings to derive the expected price level. Thus, the E/P ratio equals the discount rate less the rate of growth.)

Variations in the E/P ratio over time depend on four components: real rate of return, inflation component, risk premium and expected earnings growth rate. A simple regression of the E/P ratio on the inflation rate can isolate the effect of inflation on the E/P ratio. The constant term in the regression combines the effects of the real rate (positive sign), which is expected to be relatively constant over a long period of time, the risk premium for S&P 500 stocks (positive sign), which is also expected to be relatively constant over time, and the growth rate in earnings (negative sign) which has been a relatively constant function of GDP growth over the last 62 years. Then, a forecast of the E/P ratio can be derived simply by forecasting a future pathway for inflation.



The results of the regression of the S&P 500 E/P ratio on the consumer price index are shown in **Chart 7** for the P/E ratio, which is the inverse of the E/P ratio. Variations in inflation explain 84% of the variations in the E/P ratio over a 47-year period from 1963 to 2010. The constant term in the regression is 2.62%, which is close to the expected value for the real rate of return. This implies that the risk premium for stocks and the expected growth rate in earnings over time are approximately equal and offset each other. Importantly, it takes an average of seven quarters for the E/P ratio to adjust to changes in the inflation rate. This lagged response is reasonable

because sustained shifts in the rate of inflation only become apparent with the passage of time. Finally, the coefficient of the inflation variable is greater than one which means that when inflation rises, the E/P ratio rises by more than the rate of inflation. This result is consistent with the effect of inflation on after-tax returns.

Chart 7 very clearly shows the spike in the actual S&P 500 P/E ratio during the stock market bubble of the late 1990s. This same phenomenon is apparent in **Chart 8** for the actual S&P 500 stock price index relative to the forecast index. The spike in the actual P/E ratio is 2009 resulted from the short-lived crash in S&P operating earnings during the Great Recession.

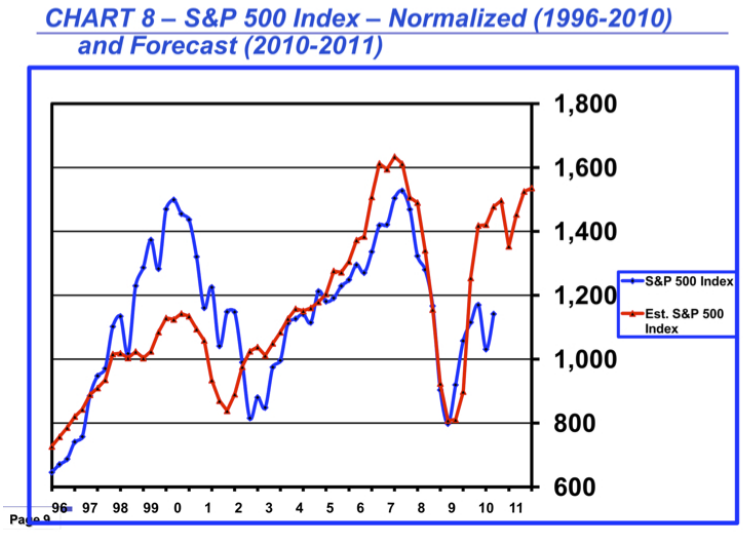


Chart 8 combines the effects of S&P 500 earnings forecast, shown in **Chart 6**, with the forecast of the E/P ratio shown in **Chart 7**.

What may be surprising to some is the forecast of an increase in the S&P 500 stock price index over the next few quarters to the peak achieved prior to the onset of the Great Recession. Because the forecast of S&P earnings over the next several quarters is essentially flat to expected level for the third quarter of 2010, the entire forecast increase in the S&P 500 index is due to the lagged adjustment of the discount rate to the decline in the consumer

price index that has already occurred.

9. A Word of Caution Is In Order

Models are based on historical data relationships and forecasts derived from them presume that structural relationships among the variables remain constant and unchanging. Thus, one should not assume this analysis that further increases in the S&P 500 stock price index is probable. All the model says is that if past relationships hold, if earnings remain constant and inflation remains low, there will be upward pressure on stock prices. Should inflation fall further and should earnings increase from current levels as seems possible, then those outcomes would add further upward pressure to stock prices. Short of a resumption of recession, the proverbial double-dip, the distribution of risks going forward favors higher, not lower, stock prices.

IV. Currency Wars

1. Recent Developments

Prior to recessing for the mid-term election campaign, the U.S. House of Representatives passed legislation with a large bi-partisan majority which would permit tariffs to be imposed on certain imports from China. The U.S. also filed two complaints with the World Trade Organization on September 15th regarding Chinese trade practices. The proximate cause for these actions is rooted in the long-standing Chinese practice of pegging the value of its currency, the yuan or renminbi, to the dollar in a way that provides China a systematic trade advantage stemming from sustained and intentional undervaluation of its currency relative to the dollar.

Beset by entrenched deflation and a moribund economy, Japan recently acted preemptively by intervening directly in currency markets to drive down the value of the yen, which had been appreciating in value against the dollar and the renminbi. Appreciation of the yen had made Japanese exports more expensively relative to exports of countries whose currencies were depreciating in value relative to the yen. The purpose of Japanese intervention was two-fold: first, to devalue the yen and in so doing increase the attrac-

tiveness of Japanese exports and, second, to reduce ongoing deflationary pressures and hopefully turn deflation into modest inflation. Japanese action to devalue its currency was coupled with significant quantitative easing. Both policy actions are intended to boost Japanese GDP growth and turn deflation into inflation.

Chinese management of the value of its currency with the intention to gain competitive advantage in global markets and boost its GDP growth rate has been successful for several years. This result has not been lost on other countries and increasingly, and perhaps because of the more difficult economic environment subsequent to the Great Recession, more and more countries have either acted or are considering acting to manage their currencies to promote domestic growth.

Brazil, one of the rapidly growing emerging economies, has taken measures recently to devalue its currency. Brazil's finance minister forthrightly observed that if other countries seek to devalue their currencies to gain competitive advantage in global trade, a "currency war" would result.

Additional quantitative easing, which the Federal Reserve is expected to initiate in November, is intended to stimulate the U.S. economy by lowering interest rates and making borrowing cheaper and thus more attractive. But, quantitative easing will also contribute to a decline in the value of the dollar. In fact, this has already happened in anticipation. This will improve the competitiveness of U.S. exports and over time should help boost U.S. GDP growth and diminish the size of the trade deficit. But, as long as China continues to peg the renminbi to the dollar products of other countries not only become less competitive to U.S. exports they also become less competitive to Chinese exports.

Unfortunately, the stage is set for a series of small retaliatory moves by other countries which have the potential to escalate into an all out trade and currency war. Were this to happen it would have negative consequences for all.

2. Importance of Free International Trade and Floating Currency Exchange Rates

For every good or service sold and exported by a country, there must be a buyer in another country. Thus, the accounting model is straightforward. In the aggregate, trade surpluses and deficits of all countries sum to zero. This simple accounting identity holds no matter what.

But, the aggregate level of global trade can increase or decrease, depending on actions individual countries take. If one country seeks to boost its growth rate it can do so by undervaluing its currency and running a trade surplus. This means that other countries will run a trade deficit and will produce less than they might have been able to in a world where currency exchange rates were not managed for individual country advantage. If one or more countries attempt to offset such an advantage, either by devaluing their currencies or altering the price of imported goods by imposing tariffs, the aggregate level of global trade will fall and aggregate global growth will also fall.

For more than 200 years since the time of Adam Smith and David Ricardo it has been an unambiguous law of economics that unimpeded trade between nations benefits all. The law is rooted in the economics of specialization. For example, two families can meet life's basic needs by raising their own food and making their own clothes. But, if one family specializes in raising food and the other specializes in making clothes and the two families trade food for clothes, both families will be better off. The same is true for nations. Another classic trade example, still used in basic economics texts today, was the raising of sheep and production of wine in England and Portugal. Both countries could do so, but the Portuguese climate was more favorable to raising grapes and the English climate to raising sheep. By specializing and then engaging in trade total production increased in both countries and their citizens' incomes rose.

The theory is simple and unassailable. History conclusively shows countries that have turned inward and closed their borders to international commerce have declined in economic power relative to countries that have kept their borders open. For example, China, which in historical times was the most prosperous nation on the globe, forbid shipbuilding in the 1400's and eventually banned foreign trade. As a result, it was Europe that rose to international preeminence through the era of discovery and subsequent mer-

cantilist economic policies that emphasized trade Today, more than 500 years later, China has reopened its economy to the outside world and is rapidly reemerging as a global economic power. Unfortunately, China has chosen to accelerate this process for domestic policy purposes by undervaluing its currency.

A more recent example of the folly of protectionism is the Smoot Hawley Tariff Act of 1930, which raised U.S. tariffs with an eye towards protecting American farmers. Ample academic research pinpoints this legislation as playing a pivotal role in exacerbating the Great Depression. In the aftermath of the Great Recession some countries have begun to play similar "beggar-thy-neighbor" games.

3. Threats to U.S. Free Trade and Floating Currency Exchange Rate Policies

U.S. policy embracement of free trade and floating exchange rates has been steadfast for several decades, although there has been much griping over the years about consequences for U.S. jobs.

While nations as a whole benefit from trade, some individuals and organizations are adversely impacted. For example, if an American company decides to offshore information technology (IT) jobs to India because the cost of labor is more economical, jobs of American IT workers are eliminated. Certainly those who lost their jobs don't feel good about free trade. Proponents of free trade counter that new U.S. jobs are created as India spends the dollars it receives from outsourced IT jobs on American goods and services.

To cushion the impact on Americans who lose their jobs to foreign competition, the U.S. Congress enacted the Trade Expansion Act of 1962, which created the Trade Adjustment Assistance (ATT) program. This Act also created the office of the Special Trade Representative and granted powers to the president to negotiate reductions in tariffs with other countries — a precursor of the more recent "fast track" trade promotion authority that was extended to the president in 2002. However, "fast track" authority expired several years ago and has not been renewed.

A variation of the concern about lost jobs has to do with depressed

wages for U.S. workers. Paul Krugman, professor of economics at Princeton University has said: "*. . . it's hard to avoid the conclusion that growing U.S. trade with third world countries reduces the real wages of many and perhaps most workers in this country. And that reality makes the politics of trade very difficult.*" Krugman goes on to say that this issue has gained greater importance as U.S. imports from developing nations have grown from 2.5% in 1990 to 6% in 2006. This has impacted adversely the wages of less skilled people in particular. Krugman concludes that this is a significant issue but the answer is not protectionism but a strengthening of the social safety net.

Another reason for opposition involves concerns about national security. If America becomes overly dependent on foreign nations for critical commodities, such as oil, won't its national security be threatened if a key commodity is withheld, potentially with hostile intent? The 1973 OPEC (Organization of Petroleum Exporting Countries) is a recent case in point. Even more recently, intense opposition scuttled the proposed foreign management of certain U.S. ports and blocked the proposed acquisition of Unocal, a U.S. oil company, by the Chinese state-owned CNOCC.

There is also concern that trade is too often a one-way street. The U.S., it is argued, plays fair but other countries do not. For example, during Japan's rapid rise in the 1970's and 1980's it retained significant trade barriers to U.S. goods. A different form of seeking an advantage involves holding a country's currency at an artificially low level. Keeping the foreign currency low relative to the dollar makes the prices of U.S. imports cheap and the prices of exports expensive, resulting in a trade deficit for the U.S. with that country. Japan engaged in currency management during its period of rapid growth and China is doing the same today.

4. Risks of Retaliation Are Rising

In an era when unemployment is stuck at a stubbornly high level and prospects for rapid improvement are absent, it becomes much easier to cast about for scapegoats to blame for the problem. This is why the game that China is playing — with other countries beginning to attempt to emulate China's policies — is a dangerous one. It is easier to play the game when the global economy is hitting on all cylinders and economic growth is robust for major powers. But that is not the case today.

Even respected internationalists, such as C. Fred Bergsten of the Peterson Institute for International Economics have begun to attack China. Bergsten in testimony before the House of Representatives in September asserted that "... elimination of the Chinese misalignment would create about half a million U.S. jobs, mainly in manufacturing and with above-average wages, over the next couple of years." While other knowledgeable analysts do not necessarily agree with Bergsten, in the current increasingly charged environment the risk is that statements such as Bergsten's could take on larger-than-life proportions and guide policy formulation in a direction that spurs an escalation in retaliatory action, resulting eventually in an all-out currency and trade war.

China needs to help defuse the situation by letting the renminbi appreciate more rapidly against the dollar and by hastening the restructuring of its economy to emphasize domestic consumption rather than trade. But China's internal domestic need to continue creating millions of jobs to maintain social and political stability weighs against rapid restructuring of its economy. Thus, China is walking a tightrope. History is not particularly supportive of an outcome that is optimal for all. More often outcomes are driven by national interests and internal political pressures. This is not only true for China; it is also true for the U.S. Thus, one can hope for a rational global perspective to prevail, but one should prepare for that not to be the outcome.

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