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

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The Longbrake Letter[*]

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I. Weak U.S. Economic Recovery Continues — Potential for Upside Breakout Fades — Risk of Slowing Growth in Coming Months Remains Significant

Weaker U.S. data reports over the last two months have reaffirmed the tenuousness of the recovery from the Great Recession. For the second month in a row the employment report fell short of expectations. It wasn't a terrible report overall, but it did dash hopes which burgeoned earlier this year that faster economic growth was just around the corner. The "Advance Estimate" of first quarter real GDP growth was a disappointing 2.2%. Final sales, which nets out inventory accumulation, grew just 1.6%. The sizeable output gap remained at a lofty 5.4% in the first quarter and would have increased were it not for inventory accumulation.

Other data reports support a "treading water" assessment. For example, the daily Rasmussen survey of consumer confidence is currently approximately the same as the post-Great Recession high reached in early 2011, and still well below a level consistent with strong economic growth. The same is true for the National Federation of Independent Businesses' Optimism Index. While it remains at an historically depressed level it improved in April and has recovered to its post-Great Recession high, also reached in early 2011.

In my March and April letters I posed the following question:

Is this another false start or have we finally achieved break out? The answer now is clear and the answer is "No".

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What I said earlier and what I reiterate again is that the economy is recovering from the severe damage the credit and housing bubbles inflicted but this will continue to be a slow and extended process — there are no quick or easy fixes. Worse, the ongoing fragility of the economy makes it unusually vulnerable to negative shocks.

In my December review of the economic outlook for 2012 I cited four risks to the outlook, all of which had the potential to undercut economic growth. These included events in Europe, developments in China, potential further declines in U.S. housing prices and the potential for significant withdrawal of fiscal stimulus in the U.S. To these four, I should have added the potential for yet another oil and gas price shock, which actually occurred early in the year.

During the early months of 2012 it appeared that some of these risks — Europe and housing, for example — had diminished. The potential impact of other risks, while significant in the long run, appeared to be minimal in 2012. Thus, for example, even though the U.S. faces a "fiscal cliff" at the end of 2012, no action of consequence is likely until after the presidential election. As for China, economists generally agree that China cannot continue to force extraordinary growth through infrastructure investment without risking an eventual hard landing and consequently it must restructure its economy to increase consumption. However, the broad consensus believes that a hard landing is not a likely near-term prospect and that China has plenty of time to initiate economic reforms. This is far from certain as commentary in Section VI will make clear.

Stronger economic data in the U.S., particularly for employment in January and February, combined with the apparent dampening or deferral of the major risks, contributed to building optimism. The bull/bear investors intelligence survey spread widened to 31.5 in late March. Since then that spread narrowed to a still robust 22.6 in the last week of April as data reports increasingly fell short of expectations.

While optimism on balance is still the order of the day, risks may be on the rise once again. This on again, off again cycle is somewhat reminiscent of the period between July 2007 and October 2008 when periodic financial market crises were followed by several weeks of relative calm during which many market participants believed the worst had passed. We learned that such optimism was misplaced and that the lulls between crises occurred because it took time for temporary fixes to lose traction and it took time for deteriorating economic conditions to bring other problems and weaknesses to the fore.

This is not to presuppose that another climactic crisis lies ahead for the U.S. and global economies. Rather, the point is that the fundamental problems that are troubling the U.S. and global economies remain in place and are far from resolved. As long as this remains the case, periodic crises will erupt and recovery of the U.S. economy will continue to be fitful just as it has been over the last three years.

A brief summary of the significant risks follows.

Europe. Conditions in Europe are rapidly moving from bad to worse and a true existential crisis for the European Union and the Eurozone is approaching. But, the climax is not yet at hand and could be months or even years away. Timing will depend on the severity of the recession that is underway and on whether the European Financial Stabilization Facility and European Stability Mechanism in combination with the International Monetary Fund will be able to provide financing to governments, such as Spain and Italy, which could lose access to public market debt financing in the not too distant future.

Recession is gathering momentum and is proving to be worse than forecast. Manufacturing is contracting and was significantly worse in April in virtually every European country. Even Germany's purchasing managers index (PMI) declined from 48.4 to 46.2

Economic conditions continue to deteriorate rapidly in Spain, with the unemployment rate nearing 25%. The Spanish government is reported to be ready to recapitalize Bankia in a range of €7 to €10 billion. Bankia has €32 billion in troubled assets, primarily real estate loans. It is the successor institution to seven Spanish savings banks (cajas) which were merged and received €4.5 billion in loss coverage from the government in 2010.

Inevitably, as the sovereign debt crisis has deepened in Europe, political repercussions are emerging. In the last month, the Dutch government has fallen, French president Nicolas Sarkozy was defeated in his re-election bid, and centrist parties were decimated in Greek parliamentary elections. Political forces on both the right and the left are gaining traction and nationalism and populism is on the rise.

Renewed financial market crisis in Europe, which seems increasingly likely to occur in coming months, will have negative consequences for the U.S. economy.

China. GDP growth has slowed a bit in China, partly as a consequence of internal policy to limit property speculation and inflationary pressures, but also partly as a result of a slackening export growth, as global growth and particularly European growth slows. China's monthly trade surplus rose to $18.4 billion in April. But, the details were quite negative. Imports have risen only 0.3% over the last year versus expectations of 10.9% and exports have increased 4.9% versus expectations of 8.5%. These data imply that Chinese growth is slowing much more than common belief.

ISI's diffusion index of U.S. companies' export sales and sales in China corroborates a slowdown in Chinese growth. As of May 4, the index had fallen to 46.1, the lowest level since the second quarter of 2009 when China was in the early stages of recovering from the global collapse in trade following Lehman's failure on September 15, 2008. A diffusion index value below 50 indicates declining sales.

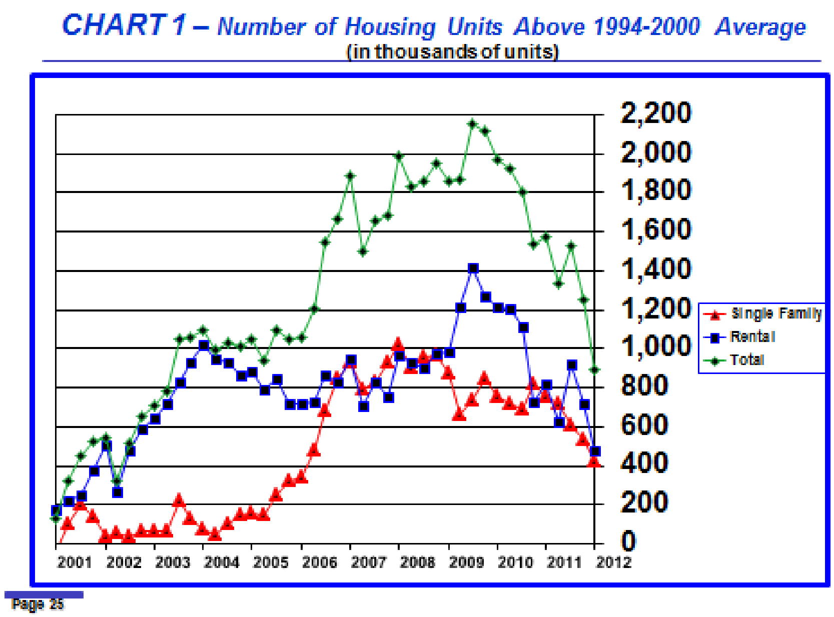
The worsening European recession will place additional downward pressure on Chinese exports. When exports collapsed in 2008, Chinese policymakers countered the consequences with massive infrastructure investment. Annual growth in fixed asset investment spiked from 25% in 2008 to 33% in 2009. And, after a very brief slowdown to an annual rate of about 6%, GDP growth reaccelerated to approximately 12% in 2010. However, this resulted in an even more lopsided GDP mix heavily and unsustainably weighted toward investment. In recent months annual growth in fixed asset investment has fallen to a still very high 15% and real GDP growth over the last 12 months has fallen to 8.1%.

Chinese policymakers are well aware that structural reforms to rebalance the economy from investment toward consumption are necessary and that this transition needs to get underway quickly and substantively. The recent sacking of Bo Xilai, Communist Party Secretary in Chongqing municipality, is indicative of the economic policy debate which is in process concerning economic restructuring policies.

China's economic challenges are much more significant than generally recognized. Exploration of these challenges is the subject of Section VI of this month's letter. While a hard landing in China is unlikely to take place during 2012, the trend toward slower growth will limit U.S. exports to China and serve as a modest headwind for U.S. GDP growth.

Housing. Housing risks stem primarily from the potential for prices to fall further as foreclosures accelerate in the wake of the recent state attorneys general settlement with the five largest loan servicers. Falling prices erode household wealth, feed pessimism and weigh on consumer spending.

However, as can be seen in **Chart 1**, the passage of time is slowly re-



ducing excess supply. Excess housing units have fallen from a high of 2.2 million in the second quarter of 2009 to 900,000 during the first quarter of 2012. Excess supply has declined for both rental and owner occupied units. At the current rate of improvement, excess supply should be eliminated in one to two years, depending on the rate of new household formation which appears to be accelerating.

Residential housing investment has been a modest contributor to real GDP growth over the last two quarters, adding 0.25% in the fourth quarter and 0.40% in the first quarter. Nonetheless, housing is still a long ways from becoming a driver of significant economic growth but the downside risks have lessened.

Fiscal Policy. Reductions in federal, state and local spending on goods and services adjusted for inflation continue unabated. Real expenditures fell $19.0 billion in the first quarter of 2012. In addition, adjusted for inflation, transfer payments, such as unemployment insurance, fell $0.7 billion in the first quarter of 2012 and payroll and personal taxes rose $30.2 billion. The combined fiscal drag from these three sources was $49.9 billion or equivalent to 1.49% of the 2.20% growth in real GDP during the first quarter. Fiscal drag over the last four quarters amounted to 1.12% of the real GDP growth rate of 2.08% over the same period.

Going forward, the major fiscal policy risk prior to the election is increasing uncertainty as to what might happen after the election. An increase in uncertainty can influence decision making. Generally, it is argued that an increase in uncertainty delays hiring and spending decisions. A recent empirical study, “Measuring Economic Policy Uncertainty”, authored by Scott R. Baker and Nicholas Bloom of Stanford University and Steve Davis of the University of Chicago, found that between 2006 and 2011 the increase in a policy-uncertainty index they constructed was associated with a 3.2% decline in real GDP and a 2.3 million increase in unemployment.

We know that if Congress does nothing tax increases and spending reductions amounting to 4% to 5% of GDP will take effect at the beginning of 2013. Most of us also assume that Congress will not let this happen. But, what we don’t know for sure is how the various issues will be resolved and how long it will take. It is entirely possible, depending importantly upon which party wins the presidency and upon the political composition of the House and Senate, that no agreement will be reached until after the new Congress is seated in early January and after the president is inaugurated on January 20.

Compounding this uncertainty, the federal debt is on a pace to hit the debt ceiling at about the time of the election on November 6. We know from last year’s debt ceiling fight that the Treasury Department can cobble together funding for roughly two to three additional months after the debt ceiling is reached. This would stretch the drop dead date to sometime in late January. Moreover, political polarization of the Republican and Democratic parties has not diminished one iota. Thus, there is strong reason to expect a repeat of last year's political dysfunction.

It is for all of these reasons that the impending fiscal cliff could prove to be a significant negative factor contributing to slower GDP growth in the second half of 2012.

Oil and Gas Prices. Oil prices rose 23% between September and March. In the past oil and gas price spikes have depressed consumer confidence and consumer spending. This year's shock is about half the size of the oil price shock which occurred in early 2011 and which contributed to a significant slowing in real GDP growth. In the last few days oil prices have declined about 7%. It is too early to conclude whether this decline marks a trend reversal. If it does, that would over the next couple of months reverse much of the negative effects of prices rises which occurred in recent months. But, because supply flexibility is limited, a sustained decline in oil prices strongly implies declining demand and that is not a good news story, especially if it is the result of a slowdown in global growth. Thus, the recent decline in oil prices has both favorable and unfavorable implications for future GDP growth.

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As you can tell from this summary, risks to U.S. economic growth remain substantial and, if anything, have intensified somewhat over the last month.

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In this month's letter, I review recent developments in GDP growth and explore future prospects for potential GDP growth. Then I discuss personal income, consumption, consumer debt and employment. This is followed by an update on developments in Europe. The final section examines China's unbalanced economic model and discusses challenges and risks that lie ahead as Chinese policymakers attempt to design a more balanced and sustainable economic model which still results in a high rate of GDP growth.

II. U.S. GDP

1. 2012 Q1 GDP Advance Estimate

The "Advance Estimate" of first quarter GDP growth was 2.20% versus the consensus expectation of 2.5%. While first quarter growth was stronger than the fourth quarter to fourth quarter 1.70% rate of GDP growth in 2011, final sales growth (GDP net of inventory accumulation) fell from 1.91% in 2011 to 1.61% in the first quarter of 2012. This is not supportive of the view that the economic recovery is gaining momentum. Both first quarter growth and 2011 growth were below the level which is necessary to shrink the GDP output gap. Based on the Congressional Budget Office's estimate of potential GDP, the output gap was 5.38% at the end of the first quarter.

Table 1 provides details of the composition of GDP growth.

Table 1
First Quarter 2012 GDP Estimates

	Advance Estimate	Preliminary Estimate	Final Estimate	2011
Personal Consumption	2.04%			1.53%
Private Investment				
Nonresidential	-.22%			.79%
Residential	.40%			-.03%
Inventories	.59%			-.21%
Net Exports	- .01%			.06%
Government	-.60%			-.44%
Total	**2.20%**			**1.70%**
Final Sales	**1.61%**			**1.91%**

Impact of Auto Production and Sales. Auto production and sales were very strong in the first quarter. If auto production had been in a "normal" range, first quarter GDP would have risen only 1.1%. Without the auto spending surge, consumer spending would have been closer to the 2011 growth rate of 1.53% rather than the reported 2.04% in the first quarter.

Inventory accumulation would have been close to zero.

Auto production increased about 10% from the fourth quarter of 2011 to the first quarter of 2012 from an annual rate of 9.2 million to 10.1 million vehicles. Much of this increased production was sold as households replaced aging vehicles at an accelerating rate. However, some of the increase ended up in higher inventories. Auto production is running more than 20% ahead of last year's pace.

Rising auto spending by consumers has been facilitated by easier access credit. Greater reliance on credit is reflected in the consumer saving rate which declined from 4.52% in the fourth quarter to 3.95% in the first quarter and is well below the 5.04% saving rate in the first quarter of 2011. If the consumer saving rate stabilizes, growth in auto purchases will slow unless disposable income growth accelerates. However, disposable income growth is actually slowing. Unless this trend reverses, it seems likely that spending on autos will diminish in coming quarters.

Auto production is scheduled to increase about 5% in the second quarter to 10.5 million vehicles. According to ISI's company surveys, through May 4 auto dealers report that sales continue to be relatively strong. Thus, auto production and sales should continue to benefit GDP growth during the second quarter. However, this kind of momentum can only be sustained if employment and disposable income growth accelerates, which is not consistent with the recent slower growth rate in both measures. ISI's auto dealer weekly sales survey should provide timely guidance about the direction of auto sales.

Residential Investment. The 0.40% contribution of residential housing investment to GDP growth in the first quarter is a significant positive development. This increase follows a 0.25% contribution to GDP in the fourth quarter of 2011. Two consecutive positive quarters lends credibility to the view that housing has bottomed. While many serious problems still confront housing and housing finance, housing no longer is likely to be a negative factor for GDP growth. However, until further progress is made in resolving the many problems afflicting housing and housing finance, housing is not likely to be a particularly significant contributor to GDP growth for the next few quarters.

Nonresidential Investment Spending. Investment spending, which was the star of GDP growth in 2011, became a drag on growth during the first quarter. Notwithstanding warm weather, which should have been favorable for construction, commercial construction declined at an annual rate of -12% during the first quarter. The other component of "nonresidential investment", equipment and software, grew at only a 1.7% annual rate in the first quarter compared to 16.2% and 7.5% in the third and fourth quarters of 2011, respectively. Based on this trend, it would appear that bonus depreciation pulled a significant amount of business investment forward into 2011.

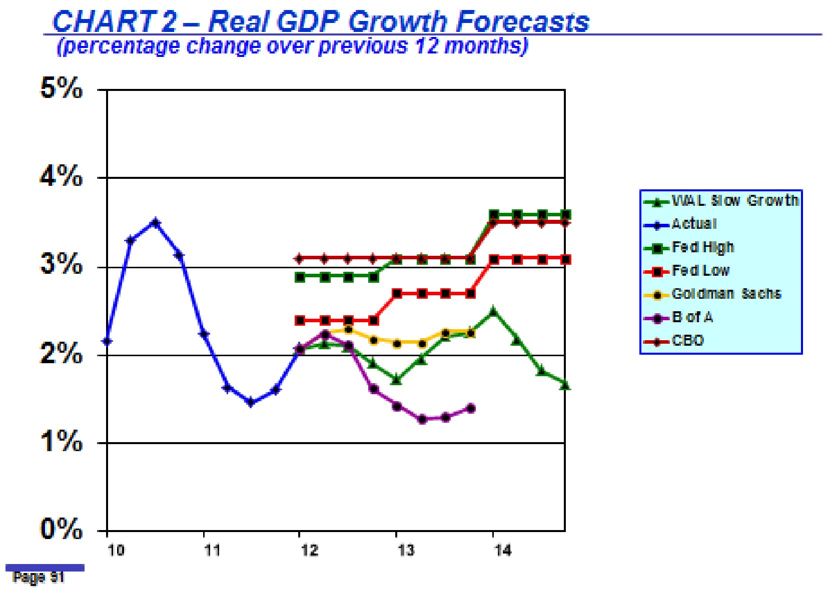
Government Spending. The decline in government spending on goods and services continues unabated. While most of the decrease in government spending during the first quarter stemmed from declining national defense spending, state and local governments decreased spending for the seventh consecutive quarter. As the nation approaches the fiscal cliff at the end of 2012, it seems more likely than not that government spending on goods and services will continue to contract. This negative momentum is compounded by shrinking government transfer payments to households.

2. GDP Forecasts for 2012 and Beyond

Chart 2 shows several GDP forecasts: the Federal Reserve's high and low; B of A; GS; the Congressional Budget Office (CBO); and my "WAL Slow Growth" scenario.

At the April Federal Open Market Committee (FOMC) meeting, participants revised economic projections for real GDP growth, unemployment, PCE inflation and core PCE inflation. Participants raised the range for real GDP growth in 2012 from 2.2% to 2.7% in January to 2.4% to 2.9%. However, participants lowered projections for 2013 and 2014. As a result, the FOMC's high real GDP growth estimate is now very similar to CBO's projection.

Both GS and B of A forecasts remain on the pessimistic end of the spectrum and are below the FOMC's low forecast for 2012. Even with the FOMC's modest reduction in the 2013 GDP projection, GS and B of A forecasts remain well below the Fed's low projection. The Blue Chip consensus estimate for GDP growth is 2.4% in 2012 and 2.7% in 2013.



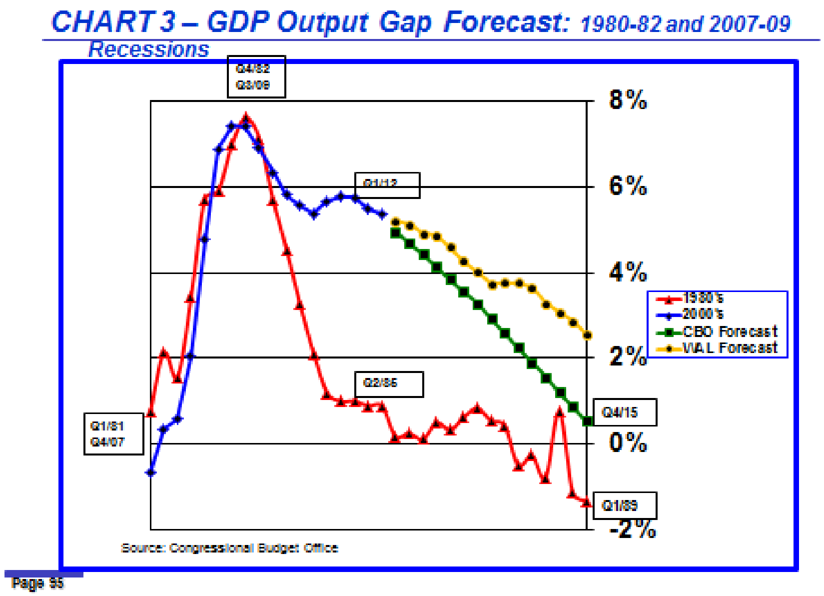
GDP growth averages 2.2% for the next seven quarters in GS's forecast and 1.6% over the next seven quarters in B of A's forecast compared to the FOMC's median of approximately 2.8%, CBO's 3.1% and the Blue Chip consensus of 2.6%.

My "WAL Slow Growth" scenario projects GDP growth in 2012 and 2013 slightly below the GS forecast and stronger than the B of A forecast, particularly in 2013. Average GDP growth over the next seven quarters for the "WAL Slow Growth" forecast is 2.1%.

Essentially, GS and I do not expect a material change in growth momentum during the remainder of 2012. Merrill Lynch places a much greater emphasis on the negative impact on GDP growth it expects as uncertainty builds because of the approaching "fiscal cliff" at year end. Obviously, the FOMC expects GDP growth to accelerate as the year progresses, but with the shortfall in the first quarter, the slowing rate of improvement in the labor market and stagnating productivity growth, it is unclear how this can happen. Thus, I am a bit mystified as to why the FOMC raised its 2012 GDP projections, unless it was simply a reaction to the optimism that briefly prevailed earlier this year.

3. GDP Output Gap and Potential GDP

Chart 3 shows CBO's forecast for the GDP gap, which is simply the differ-



ence between CBO's real GDP forecast and its estimate of potential GDP divided by potential GDP. The gap does not fully close until the end of 2015. This estimate is consistent with the FOMC's monetary policy to maintain interest rates at exceptionally low levels until late 2014.

However, if the B of A, GS and my GDP growth projections, which are lower than CBO's, turn out to be more accurate, the GDP gap will close more slowly as shown in the "WAL Forecast" in **Chart 3**.

It is also possible that CBO's forecasts of both potential and actual GDP are too high. To be more specific, CBO assumes that nonfarm labor productivity grows approximately 2.12% over the next five years. My estimate is 1.33%. My estimate includes an adjustment for the depressing impact of the output gap on productivity growth, which amounts to a reduction of 24 basis points for each percentage point of the output gap. With an output gap of 5.38% in the first quarter of 2012, this adds up to a reduction in productivity of 1.27%. Adding this to the actual 12-month productivity rate of 0.53% in the first quarter results in a zero-output-gap productivity run rate of 1.80%, which is not significantly different from CBO's long-run estimate.

CBO makes no adjustment to its productivity estimate for the impact of the output gap. This implies that CBO's estimate of potential GDP is too high, but it also implies that CBO's forecast of actual GDP growth is also probably too high. By 2015 my estimate of potential real GDP is 3.1% lower than CBO's estimate and my actual real GDP forecast is 4.3% less than CBO's forecast. The result is that my estimate of the GDP gap declines but is still a relatively high 2.6% by the end of 2015; whereas, CBO's estimate of the gap by the end of 2015 is down to 0.5%.

With the passage of time we will know the answer as to which analysis is more accurate. What is important, however, is that the GDP output gap is likely to remain large for the next three years and will diminish only gradually. This should maintain downward pressure on inflation and limit employment growth.

Labor productivity is likely to remain low as long as the output gap remains large. Other factors also imply slower productivity growth. However, significant technological innovation could boost productivity as happened from 1997 to 2004. Nevertheless, it is more likely than not that potential and actual real GDP growth will be much lower in coming years and even CBO's scaled down estimates of potential growth might prove to be too high.

III. Personal Income, Spending and Debt

1. Income and Spending

Growth in consumer disposal income must accelerate to assure that the current fragile economic recovery strengthens sufficiently to reduce unemployment and the GDP output gap. This did not happen in 2011 and it did not happen in the first quarter of 2012 as is evident in **Table 2**. In 2011 personal income grew 4.65% but growth in disposable income was only 3.49% because income and payroll taxes grew at a much faster rate of 6.25%

Consumption growth during 2011 equaled 4.21%. However, because consumption growth exceeded disposable income growth, the consumer saving rate declined from 5.19% in the fourth quarter of 2010 to 4.52% in the fourth quarter of 2011.

This means that the improvement in unemployment during 2011 depended to a great extent, not on income growth, but on increased borrowing and reduced saving. This pattern cannot be sustained. Either disposable income growth must accelerate in 2012 or consumer spending must eventually slow.

Personal income and consumption data for the first quarter of 2012 indicate that the situation is worsening. This can be seen in the third and fourth columns of **Table 2**. Personal income grew at a reduced annual rate of 3.84%. Income and payroll taxes grew at an astonishing 9.24% annual rate, taking a huge bite out of disposable income. This resulted in an annual growth rate in disposable income of 2.98%.

The story the data tell gets worse. Consumer spending grew at a 6.65% annual rate during the first quarter. Thus, the amount by which consumer spending exceeded disposable growth rose from 0.72% in 2011 to 3.67% in the first quarter of 2012. As a consequence, the saving rate fell from 4.52% in the fourth quarter to 3.95% in the first quarter.

None of this bodes well for future consumer spending or GDP growth. Of course, it is entirely possible that subsequent data revisions will reduce the magnitude of the apparent problem, if more income is discovered. There is historical precedent for data revisions of this sort. But, strong spending on consumer durables, especially autos, is consistent with the story told by the personal income and spending data. Thus, unless employment accelerates, which is not what is currently happening, consumer spending is likely to slow to match disposable income growth. This would merely stabilize the saving rate at its current reduced level of 3.95%. If consumers pull back on spending and increase saving, an entirely possible outcome if angst and anxiety escalate, my GDP forecast will prove to be optimistic and B of A's forecast more prescient.

Chart 4 shows the nominal rate of growth in disposable income and consumer spending. The annual rate of growth in disposable income began slowing in late 2010 and has declined from its recent high of 4.9% in De-

Table 2
Change in 2011 Personal Income and Its Disposition
(in billions of dollars)

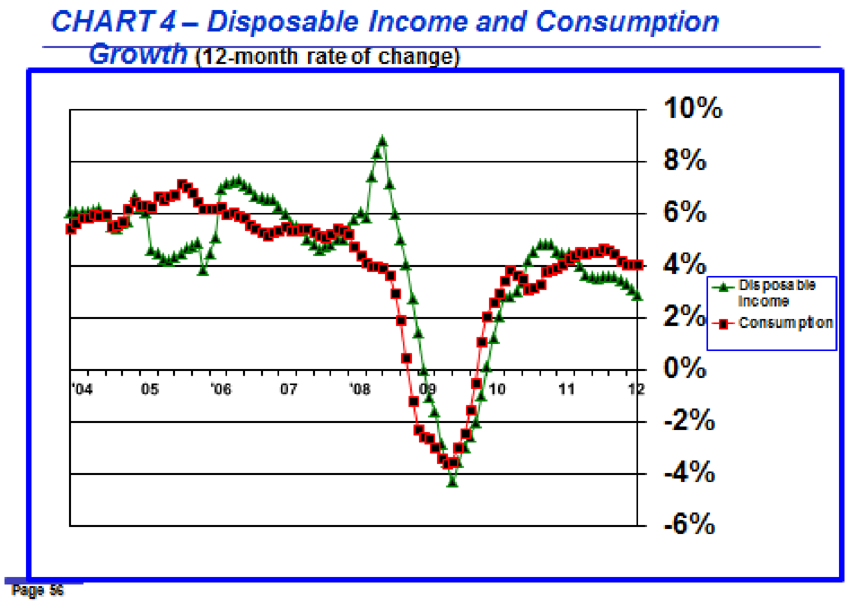
	Nominal 2011*	Pct. Change	Nominal 2012 Q1**	Annual Pct. Change
Personal Income	**$584.5**	4.65%	**$126.7**	3.84%
Compensation	389.5	4.84%	88.1	4.16%
Proprietors' Income	38.2	3.53%	17.3	6.17%
Rental Income	72.4	20.41%	12.5	11.50%
Asset Income	42.8	2.45%	15.2	3.40%
Government Transfers	- 8.1	-0.35%	9.4	1.61%
Less: *Personal Taxes*	139.7	6.25%	55.1	9.24%
Disposable Income	**395.2**	3.49%	**87.5**	2.98%
Less: *Consumption*	**452.4**	4.21%	**186.5**	2.98%
Personal Saving	**-57.3**	-9.74%	**-99.0**	-72.08%

*Measured from December 2010 to December 2011
**Measured from December 2011 to March 2012

cember 2010 to 2.9% in March 2012. Growth in consumer spending peaked later at 4.6% in July 2011, but now is declining and reached 4.1% in March 2012. These are not favorable trends.

Notice in **Chart 4** that spending growth tends to lead income growth. This relationship is consistent with changes in consumer confidence. However, over the last several months the relationship has reversed, with income growth leading spending growth. Until the March and April employment reports there was some reason to hope that income growth would pick up. Now a more likely outcome seems to be a decline in spending growth to match the lower growth rate in income.

Indeed, right on cue, the April Conference Board consumer survey revealed a sharp decline in auto buying plans from 12.3% in March to 9.3% in April. Based on ISI's survey of auto dealers this decline in buying plans



has not yet impacted actual sales. In addition, the Conference Board's survey indicated that big ticket buying plans declined from 48.4% in March to 41.6% in April and home buying plans decreased from 4.9% to 4.4%. Stay tuned. All of the evidence points to a slowing in consumer spending, which will pull down the rate of GDP growth.

2. Consumer Debt

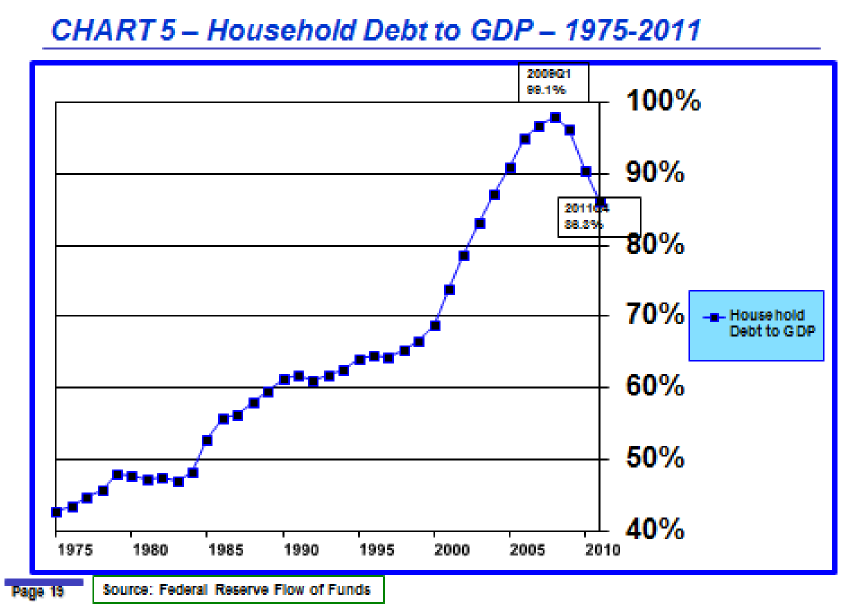
While mortgage debt continues to decline, consumer debt is growing again. It surged \$21.4 billion in March to a total of \$2.54 trillion. \$16.2 billion of March's increase was due to student loans and auto financing compared to an increase of \$11.6 billion in February. Credit card debt broke its recent contracting trend by rising \$5.2 billion in March.

Rapidly increasing student debt bears close watching as it has earmarks of the bubble in housing credit which occurred prior to the 2007-09 financial crisis. Student loans rose \$117 billion in 2011 to over \$1 trillion. \$700 billion of this total is unsecured credit on the federal government's balance sheet. Student loans are long-term debt with deferred repayment schedules. However, this credit can be used to support current consumption. As such it may explain in part the recent decline in the saving rate. The concern is the possibility that student lending, which is now provided almost entirely by the federal government, may be sowing the seeds of a future problem.

3. Household Debt

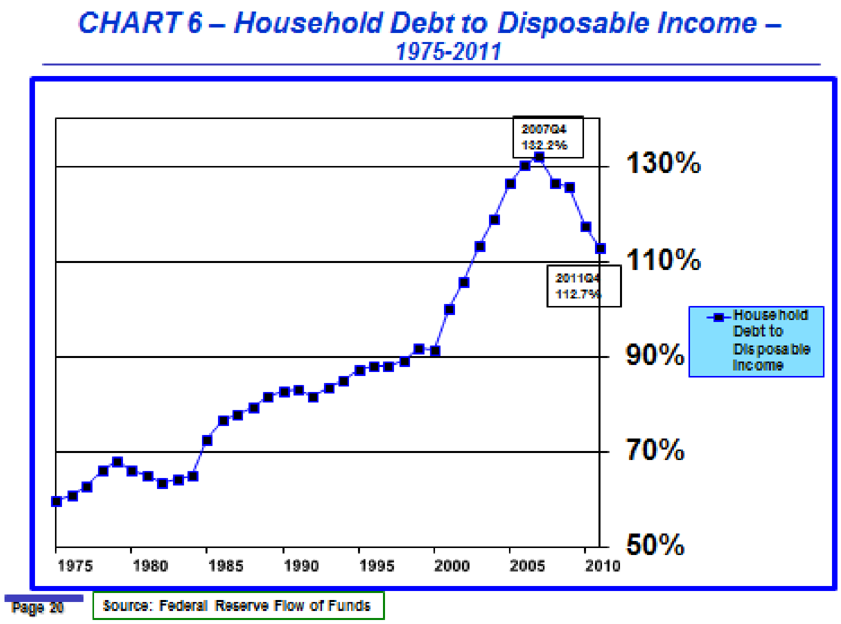
Household debt includes consumer debt and mortgage debt. The Federal Reserve's flow of funds report tallies outstanding household debt on a quarterly basis. Mortgage debt peaked at $10.62 trillion in the first quarter of 2008 and has declined steadily since then, reaching $9.84 trillion in the fourth quarter of 2011. Consumer debt peaked at $2.61 trillion in the third quarter of 2008; then troughed at $2.42 trillion in the third quarter of 2010. Since then consumer credit has risen gradually to $2.54 trillion in March.

There are different ways to evaluate the burden of household debt. One method is shown in **Chart 5**, which shows the trend in the ratio of household



debt to nominal GDP over time. The debt burden measured in this way is declining but still remains at an historically high level of 86.3%.

Another measure, which is shown in **Chart 6**, is the ratio of household



debt to disposable income. It tells a similar story to the ratio of household debt to GDP. The debt burden measured in this way fluctuated for many years in a modest range around 65% until 1985. It then rose steadily to 90% prior to the 2001 recession and then exploded to 132% during the housing bubble. This ratio has now fallen to 112.7% as of the end of 2011. It still is high which implies that a further decrease in this ratio, perhaps back to about 90%, is possible or even likely over the next few years. If non-mortgage debt remains constant, nominal disposable income rises about 4% annually, and 7.5 million mortgages averaging $200,000 each are liquidated over the next four years, B of A estimates that the household debt to disposable income ratio will fall to 90% by the end of 2015

It is axiomatic that household debt deleveraging is consistent with a lower rate of consumer spending growth. And, if B of A's analysis is reasonable, it implies that it will take another 3 to 4 years before household debt deleveraging will be completed.

Another measure of the household debt burden is the ratio of debt service payments (interest and principal) to disposable income. Because interest rates have fallen dramatically this measure tells a better story. If interest rates remain low, it could be argued that the debt-to-GDP and debt-to-disposable income ratios do not need to decline to levels that prevailed prior to 2000. However, were that to occur, households would remain quite vulnerable to a higher rate of inflation and accompanying higher interest rates.

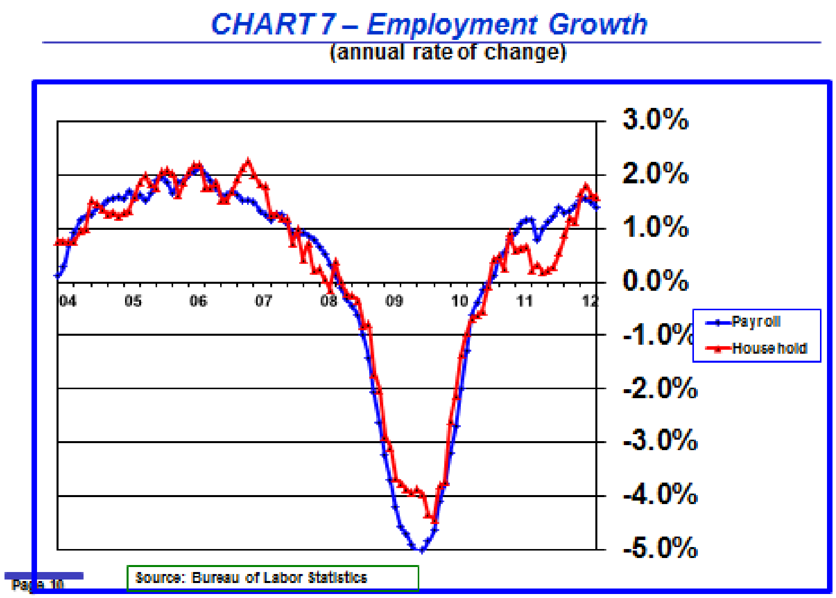
IV. Employment

April's employment report was disappointing. The 115,000 increase in payroll employment slightly exceeded the average monthly increase in household employment of 105,000, based on growth in the proportion of the population eligible to work and assuming a constant labor force participation rate. Part of the reason that the payroll report was not as bad as the 115,000 increase in April implies was that payroll employment data for February and March were revised upward by a combined 66,000.

1. Household and Payroll Employment Growth

Chart 7 shows that growth in household employment after lagging behind payroll employment during much of 2011 caught up early in 2012. However, over the last two months household employment has fallen 200,000 while payroll employment has risen 269,000. Over time these two measures of employment generally move together, which means that their divergence over the last two months is unusual.

Household employment survey data are never revised, but payroll employment data are revised several times. These adjustments historically have added to employment growth during economic expansions and subtracted from employment during recessionary periods. This cyclical regularity is driven by estimates of net business formation, or the so-called "birth-death" adjustment. Because we are currently in the expansion phase of the cycle, payroll adjustments for April 2011 through March 2012, when they are reported in January 2013 are likely to add to payroll employment growth. The further question is one of whether these positive adjustments will be small or large.



This cyclical regularity would make the divergence of the last two months even greater. Another partial explanation for the divergence is that the household survey has a large sampling error which might have led to overstatement of household employment gains in January and February. Over time such differences tend to even out. The principal takeaway, however, is that both payroll and household employment growth have slowed some over the last two months.

2. Job Openings and Turnover Survey (JOLTS)

Optimists were quick to emphasize the increase in job openings in the April JOLTS report to the highest level since the onset of the Great Recession as an indicator of accelerating labor market recovery. However, the more important data point in that survey — new hires — has been ignored. New hires actually declined in April. Intentions are one thing, but action is what is important.

3. Warm Weather Might Have Contributed To Recent Strong Employment Growth

Unusually warm weather in January and February might have accelerated hiring which ordinarily would not occur until springtime. If this has been the case, this acceleration in hiring should be reversed in April and May employment reports. GS has conducted extensive statistical analysis and finds that employment growth in "cold states" was about 70,000 to 120,000 above normal. Further, based on an analysis of weather-sensitive employment sectors, GS estimated that only 15,000 jobs in March were related to reversal of weather-related hiring. GS expects the remainder of the seasonal acceleration in employment growth to reverse in April and May, which implies that overall employment growth should be soft in both months. The soft April employment report appears to corroborate the GS analysis. This would imply that the May employment report should also be weak.

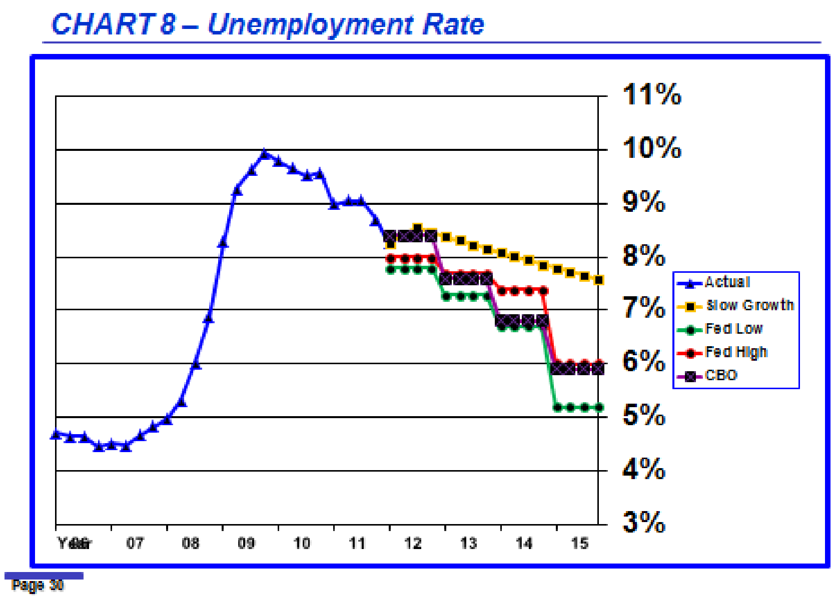
4. Unemployment Rate

Chart 8 shows projections for the unemployment rate for my "Slow Growth" scenario, the FOMC's high and low projections and CBO. The high and low FOMC unemployment numbers for 2015 are not forecasts; rather they are the FOMC's upper and lower bounds for the long-run non-accelerating inflation rate of unemployment (NAIRU).

While not shown, the GS and B of A unemployment forecasts both remain frozen at 8.2% through the end of 2013; the unemployment rate in my "Slow Growth" scenario also is projected to be about 8.2% at the end of 2013.

The FOMC's unemployment projection is more optimistic with a range of 7.3% to 7.7% by the end of 2013. At the recent April FOMC meeting this range was lowered from the 7.4% to 8.1% range contained in the FOMC's January projections.

In spite of the decline in household employment in both March and April, the unemployment rate actually declined from 8.3% in February to 8.1% in April. This occurred because the size of the labor force, the denominator of the unemployment rate, declined 506,000 while the numerator, the number of unemployed workers, dropped 306,000. On the surface it appears



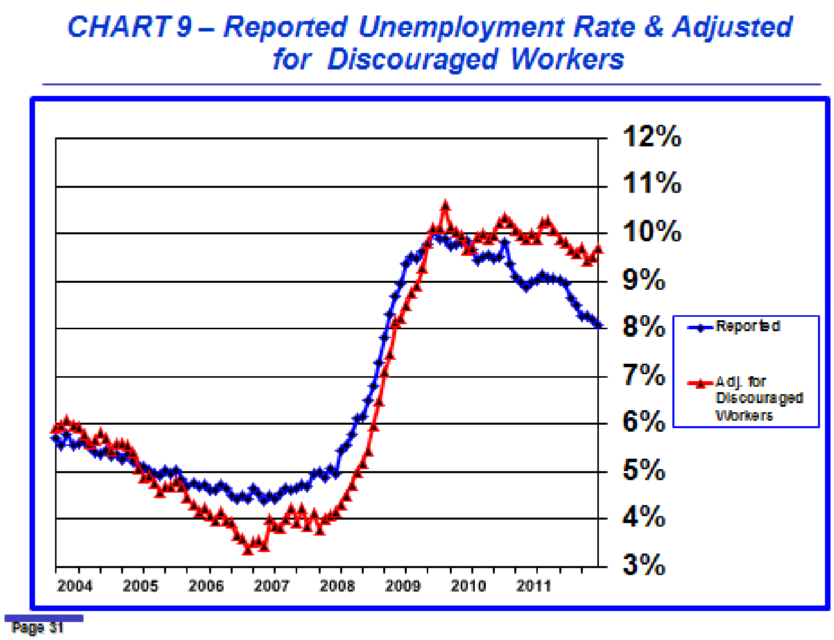
that the unemployment rate improved simply because unemployed workers dropped out of the labor force. If that is what actually happened, it is a perverse result and indicates a very weak labor market. When the same phenomenon occurs in two successive months it is harder to dismiss it as a simple statistical sampling fluke.

5. Labor Force Participation Rate

Another disturbing fact in both the March and April employment reports was a further decrease in the ratio of the labor force to the population eligible to work. This ratio is commonly referred to as the participation rate. It fell from .6388 in February to .6358 in April. If the labor force participation rate had not changed there would be an additional 728,000 unemployed workers and the unemployment rate would have risen to 8.5% instead of falling to 8.1%.

Labor force participation has not been this low since September 1981. Some of the recent decline in the participation rate is the natural result of changes in the age distribution of the labor force over time. But some of the decline also stems from discouraged workers who have dropped out of the labor force.

Since the onset of the Great Recession B of A estimates that demographic factors account for 49% of the decline in the labor force participation rate, amounting to a decrease of 1.20 percentage points. Cyclical factors accounted for a 1.25 percentage point decline in the participation rate. This translates into about 3.0 million cyclically discouraged workers. If these workers were still counted as unemployed, the unemployment rate would be about 10.0% instead of 8.1%. **Chart 9** compares the reported



unemployment rate with an adjusted rate that includes the entry and exit of discouraged workers.

Using a different analytical method, GS found that about 1/3 of the decline in the labor force participation rate is due to cyclical factors. GS's analysis indicates that the discouraged worker problem while considerable is not quite as severe as B of A's analysis indicates.

Both B of A and GS project that demographic factors will continue to depress the labor force participation rate by about 0.3 percentage points annually. This decline will be offset by reentry of discouraged workers as the labor market improves. However, continued weakness in the labor market of the sort that occurred in March and April and the ongoing expiration of extended unemployment benefits at the rate of about 150,000 per month during 2012 will increase the number of discouraged workers and that would drive the participation rate down further.

B of A cites four reasons why it believes that the 1.25 percentage point decline in the participation rate due to cyclical factors is temporary and will reverse:

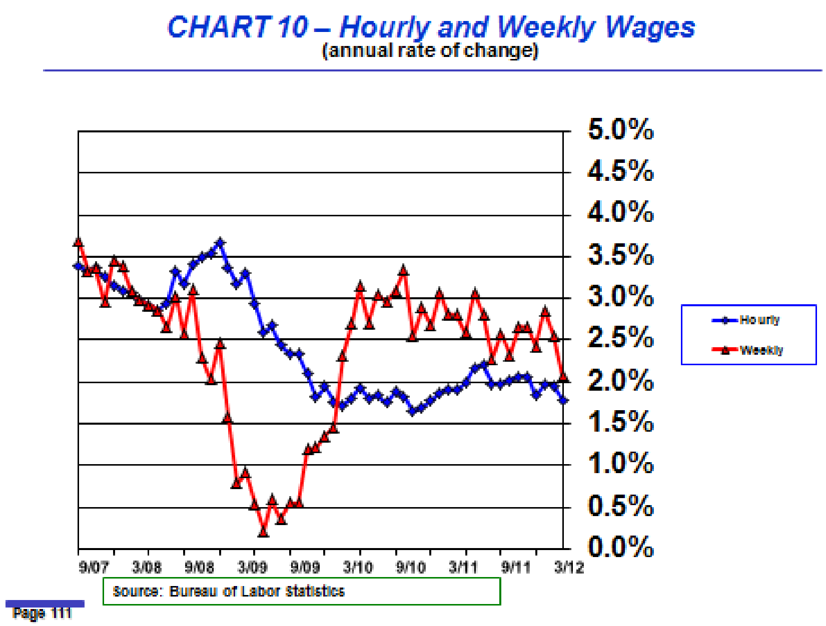
- The drop in the participation rate coincided with the collapse in the labor market — this is the discouraged worker argument.
- The drop in the participation rate is spread over all age cohorts except for the 55+ cohort — older workers have no choice but to seek employment because the Great Recession destroyed a lot of wealth older workers anticipated would fund retirement.
- When labor market conditions improve discouraged workers will return because they will take will want to take advantage of the opportunity to rebuild wealth rather than accept a permanently lower standard of living.
- The duration of unemployment eventually leads some workers to drop out of the labor market and return to school.

B of A's overall argument is that all of these factors are temporary and will reverse once employment conditions improve. The historical pattern in **Chart 9** supports this line of reasoning.

6. Growth in Wages

While a declining participation rate is making it appear that unemployment is a diminishing problem, it is clearly a false positive. It creates the illusion of a tightening labor market. If the labor market really is tightening wage rates would begin to rise and that development would threaten subsequent increases in inflation. However, wage rate increases are stuck at a very low level and show no evidence whatsoever of rising. Furthermore, what really is important for economic recovery is significant growth in disposable income. This cannot happen when employment growth is limited and wage rate growth is not improving. That is clear in the disposable income data and is corroborated by the 1.60% 12-month rate of growth in household employment and 2.08% rate of growth in weekly earnings, which translates into total income growth of 3.71%, which is not much different from the 4.16% rate of growth in wage compensation in the first quarter of 2012 (see **Table 2**).

As is evident in **Chart 10**, growth in the hourly wage rate and weekly



wages continues to be very weak. **Chart 10** shows that from 2007 to the end of 2009 the annual rate of growth in hourly wages decelerated from about 3.5% to less than 2.0% and has remained near 2.0% ever since. In fact, the 12-month rate of increase declined to 1.78% in April. As long as the unemployment rate remains unusually high, labor will have very little bargaining power and this is likely to limit increases in hourly wages for the foreseeable future.

Weekly wage growth is more volatile than hourly wage growth because it incorporates the length of the workweek. When the length of the workweek is stable, the two measures will track each other closely. Divergences occur during and following recessions. During recessions employers tend to cut the length of the workweek before shedding workers. The opposite happens in recoveries — employers increase hours before adding workers. The recent convergence of the two measures means that the length of the workweek has stabilized. But this is not a good news story because it actually means that the rate of growth in take home pay has fallen from nearly 3% a year ago to 2% currently.

V. European Sovereign Debt Crisis Enters a New Dangerous Phase

As recession worsens in Europe, political turmoil is building as evidenced by recent developments in the Netherlands, France and Greece. The threat to the continued existence of the European Union (EU) in its present form is building rapidly. While the focus has been on ***economic crisis*** and sovereign debt problems for the last two years, ***political crisis*** is rapidly taking center stage.

Ultimately, political forces, more than economic forces, will define the future of the EU and the Eurozone (EZ). Many seem to think that the twin economic and political crises will create pressure sufficient to correct a fundamental flaw in the EZ by compelling members to accept some form of fiscal union to complement the monetary union. ***This is wishful and unrealistic thinking***. The political forces which have been unleashed are strongly pushing in the opposite direction — not toward greater integration but toward ***populism*** and ***nationalism***, which involve the reclaiming of national sovereignty. The political elite who fervently believe in the importance of a united Europe are rapidly losing ground to fringe political movements on both the right and the left which do not share the goal of union.

1. Economic Crisis

In the April Longbrake Letter I included a country-by-country assessment of developments in Europe and the EZ and reiterated my view that the EU will not survive as currently configured. The fundamental problems are two-fold. First, in some countries sovereign debt-to-GDP ratios have risen to unsustainable levels. Second, the economies of many of these same countries are no longer competitive with the economies of stronger European countries, particularly Germany. Evidence of the second problem is persistent trade deficits.

To date the policy solution has been austerity which is intended to reduce debt-to-GDP ratios by decreasing government deficits and by improving competitiveness through wage deflation and other structural reforms. However, as time has passed and recession in much of Europe has taken hold and worsened, it is becoming increasingly clear that austerity, rather than serving to defuse the sovereign debt problem and resolve the competitiveness problem, is having the opposite effect. It is like trying to quench a fire by throwing gasoline on it.

What is in play is the ***fiscal speed limit***. If austerity causes GDP to fall too fast, the sovereign debt-to-GDP ratio will rise rather than fall. That is because government tax revenues fall faster than spending reductions and the denominator, GDP, also falls. The increase in the cost of debt, which Spain and Italy are experiencing, exacerbates the problem. When the fiscal speed limit is breeched and the debt-to-GDP ratio is already at a high level, it usually leads relatively quickly to a sovereign debt market riot and a bailout. This is what has already happened with Greece, Ireland and Portugal. Both Spain and Italy have been in the cross-hairs since last summer, but a full-scale riot has yet to occur.

Policy initiatives bought time, but some of these initiatives, such as requiring banks to increase capital, unleashed recessionary pressures. It takes time for a recession to develop and to damage growth and increase credit losses. Once underway, however, a recession usually gathers momentum for a period of time. Expansive monetary and fiscal policies can slow or reverse this momentum. The ECB eased monetary policy and the LTRO (long-term refinance operation) program, by providing unlimited liquidity to financial institutions, helped ease credit conditions. However, fiscal policy has not been expansionary. To the contrary, austerity has served as an accelerant and re-enforced recessionary pressures. Not surprisingly the consequences have been greatest for the peripheral European countries with the weakest economies, the highest sovereign-debt-to-GDP ratios and the greatest mandate to reduce budget deficits.

2. Political Crisis

Citizens of a country will endure economic hardship for a time, particularly if there is hope that endurance of hardships is temporary and necessary to create a better future. But, if faith is lost in the efficacy of policy initiatives, it is usually only a matter of time before social and political instability consumes a country. With the indecisive election outcome on May 6, Greece has now reached that point.

Ascendancy of political crisis was already well underway before the Greek election. European Parliament President Martin Schultz said on April 26 that the collapse of the EU is a realistic possibility because member states are reclaiming power, xenophobia is on the rise, as are calls to reinstate border controls to restrict the free movement of people. Consistent with the thrust of Schultz' observations, there has been an increasing trend by governments and leaders toward unilateral decision making and the bypassing of consultation with the European Commission and the European Parliament over the last year.

Resurgence of ***nationalism*** is a natural response to economic crisis as political leaders give primacy, not to the union, but to their own nation's well-being. This is because their political survival depends not on the electorate of the union as a whole but on their own nation's electorate. Similarly, ***populism*** naturally gains strength as economic hardship afflicts a country's citizens with the loss of social benefits and perceived competitive threats from immigrants. Unlike the United States where citizens think of themselves as Americans first and citizens of individual states second, the exact reverse is true in Europe. Other than among the political elite there is no emotional allegiance to the importance of the EU.

While financial markets cheered the European Fiscal Compact, this treaty with its concomitant forced austerity on individual member nations flew in the face of the re-emerging importance of individual country sovereignty. And, as evidence has accumulated that austerity has contributed to a worsening of economic conditions, this has served to reinforce the centrifugal forces of nationalism.

While the Greek and French elections on May 6 punctuated how rapidly Europe's political crisis has evolved, the crisis is hardly confined to those two nations. Political parties on the right and on the left are gaining ground in most European countries. Support weakened for traditional parties in German state elections on May 6 and 7. Germany's Pirate party gained 8.5% of the vote in Schleswig-Holstein which was the same percentage that the Free Democratic Party, a member of Germany's ruling coalition, received. German national polls indicate that if a national election were held today, the Pirate Party would receive 13% of the vote.

In Italy the fringe Five Star Movement won 20% of the vote in the city of Parma and 14% of the vote in Genoa.

These are not isolated events. Rather they are symptomatic of a growing rejection of the current ruling political elite which forged the EU and EZ. As the political center is hollowed out and as fringe parties, which align themselves with nationalism and populism, gain ascendancy, it becomes increasingly difficult to see how the EU and EZ can survive as currently configured. Increasingly, the drivers of political developments will be national sovereignty and class awareness. This will mark a return to the Europe that predated the EU and not to a stronger union.

3. Greece

Greek Economy Is In Free Fall. The Greek economy is in free fall. GDP fell 6.8% in 2011 compared to an IMF forecast decline of 2.6% when the first bailout was put in place in spring 2010. Most of 2011's GDP decline occurred in the fourth quarter.

Since the onset of the crisis Greek GDP has fallen 14% and a further decline of 5% is expected in 2012; industrial production has declined 25%; the money supply has plummeted 30% as depositors moved their euros to non-Greek banks; and unemployment has risen above 21%. Austerity requirements in the latest bailout agreement will only serve to accelerate economic collapse. The budget deficit was 10% of GDP in both 2010 and 2011. The 2011 deficit target was 8%. Getting to a primary surplus by 2013, even though interest rates on new Greek debt have been cut, seems nigh on to impossible.

Latest Greek Bailout Cannot Succeed. The fundamental reason that the bailout will fail is that the Greek economy is simply uncompetitive with other members of the European Union. No amount of debt forgiveness or bailout funds can solve this problem.

Greece's uncompetitiveness has many facets. First, the prices of Greek goods and services need to decline relative to prices in other European Union countries. This could be accomplished in a single stroke if Greece could devalue its currency — but it doesn't have its own currency, so this is not an option. That is, it is not an option unless Greece exits the European Union and the Eurozone. The probability of just such an outcome is rising rapidly.

Second, Greek wages need to decline relative to wages in other countries. It does not matter whether they are already lower, which they are, than wages in other European countries. They just need to decline. While this is a good textbook solution, it is not a politically viable solution because it requires high levels of unemployment to force wage deflation. Greek unemployment is already 21% and rising. Moreover, deflation will raise the value of debts denominated in the euro and increase the likelihood and cost of bankruptcies. In short, deflation is an ugly, destructive solution.

Third, Greece could try to boost productivity. That is easier said than done because it means breaking entrenched social and institutional contracts. Moreover, productivity enhancing reforms take a very long time to bear fruit.

No amount of austerity or economic restructuring will cure Greece's uncompetitiveness. Indeed, austerity is worsening the problem. Greece can resolve the competitiveness problem by leaving the euro and devaluing its substitute currency — the new drachma. Of course, this solution will not be without significant consequences and costs for Greece. But, this alternative is rapidly becoming the only realistic alternative.

Political Reasons Why the Bailout Will Fail. Political chaos has now engulfed Greece. The outcome of the May 6 parliamentary election resulted in no party having the ability to form a new government.

The centrist parties — New Democracy and Panhellenic Socialist Movement (PASOK) — polled 32% of the vote compared to 77% in the 2009 elections. Under Greek law these two parties won 149 seats. It takes 151 votes in the 300-seat parliament to form a government. Under Greek law the party winning the most votes has three days in which to form a government. The leading vote getter was New Democracy, but it gained only 18.8% of total votes cast. Within 24 hours of receiving the mandate from the president to form a government, Antonio Samaras, the leader of New Democracy, announced that he was unable to do so. Samaras had attempted to form a coalition with the stipulation that it would be committed to the euro but would renegotiate the bailout agreement.

Thus, the mandate to form a new government passed to the second highest vote getter — the Coalition of the Radical Left, otherwise known as Syriza. Syriza's 38-year old leader, Alexis Tsipras, has demanded that austerity measures be cancelled.

If Syriza cannot form a government, PASOK, as the third highest vote getter, will be given the mandate to do so. However, since PASOK was a willing coalition partner in a New Democracy led government, and New Democracy was unable to line up 151 votes, it is unlikely that PASOK could succeed where New Democracy failed.

There are two more steps under Greek law if the three highest vote getters fail to form a government. The fourth step is for the president to request the three leading parties to form a coalition government. If this, too, fails, the president is required to form an interim government and schedule another election within 30 days.

Another election seems probable and would likely be held on June 10 or 17. Political momentum appears to be building for Syriza. Assuming that is the case, it should do better in another election and could well end up with the highest percentage of the vote. This could well be sufficient to enable Syriza to form a government of left leaning parties. That is because Greek law automatically allocates 50 parliamentary seats to the party with the highest vote total.

Consequences of Greece's Exit from the EU. Greek rejection of bailout terms and eventual exit from the EU are increasing plausible, if not likely. The next bailout payment is not due until August, so there would be approximately two months' time from a second election, presumably won by Syriza, for the EU, European Central Bank and IMF to renegotiate a bailout with the new Greek government.

German opinion is already moving in the direction of favoring Greece's exit from the EU. This suggests that the kinds of concessions a Greek government might demand as the price for it remaining in the EU will be unacceptable. The power of Greek nationalism seems likely to trump the threat of severe economic consequences if Greece leaves the EU.

If Greece leaves the EU it will inflict consequences on other EU nations, particularly Cyprus, whose banks have an extremely large exposure to Greek banks. Fitch has already publicly stated that if Greece leaves the EU it will place bond ratings of all EZ countries on negative outlook. Moreover, Fitch has suggested that downgrades are possible for Cyprus, Ireland, Italy, Portugal and Spain due to the risk of contagion of banks and bond markets in those countries and the possibility of capital flight.

In other words, Fitch is suggesting that Greece, in spite of its small size, might be the triggering event for a full-scale European financial crisis just as Lehman's failure was for the U.S. financial crisis in 2008. This is not a forecast, but it is a non-trivial risk.

4. France

France rejected Nicolas Sarkozy and elected Francoise Hollande as president on May 6. This was a significant development which has implications for the future of the EU. However, the unfolding political drama in Greece, for the moment, has pushed events in France into the background. During the campaign Hollande proposed that the Fiscal Compact should be renegotiated to include policies that stimulate economic growth and job creation. He did not define what those policies should entail, but the implication is that deficit targets would need to be relaxed. Assuming that to be the case, the German government has already signaled that it will reject growth policies that increase debt levels. Hollande has not yet taken office and seems likely not to be a boat rocker in the early going. Nonetheless, unlike Sarkozy he is unlikely to agree uncritically with German views and policies. The German-French relationship will change as time passes and how it evolves will depend importantly on German flexibility, or the lack of it.

5. Spain

On April 26, S&P downgraded Spanish sovereign debt two notches to BBB+ while maintaining a negative outlook. On May 8, yields on 10-year Spanish bonds rose to 6.0%.

Reasons Why A Spanish Sovereign Debt Bailout May Be Inevitable. First, although Spain's sovereign-debt-to-GDP ratio appeared to be at a manageable level of 70% in 2011, it is expected to rise to at least 79% in 2012 as deficits continue and GDP shrinks. However, what is only now beginning to be understood is that the Spanish government has provided explicit and implicit debt guarantees for regional governments and private projects which, if included, would increase the debt-to-GDP ratio by 50%. Moreover, the total Spanish debt-to-GDP ratio aggregated across all economic sectors was 344% in 2011 and rising. The same ratio in the U.S. was 250%.

Second, the end of the housing construction boom will reduce GDP growth by as much as 2.0% over the next couple of years, with nothing in the wings to replace it. Housing prices have fallen 22% from the peak and are expected to fall another 15% to 20%.

Third, when prospective loan losses are factored in many Spanish banks are woefully undercapitalized and solvency is at risk. At the very least, credit conditions will tighten further with detrimental impacts on economic growth. The Spanish government appears ready to provide €7 — €10 billion in new capital to Bankia to help cover losses embedded in €32 billion of troubled real estate loans and assets. The government is also considering a plan to permit banks to transfer troubled real estate loans to a new entity. The intent would be to concentrate troubled asset management in a single entity and remove that pressure from the nation's banks. Missing so far from this proposal is a means of financing the new entity and covering the inevitable losses.

Fourth, Investors are already anticipating the worst as they have withdrawn €100 billion from Spanish banks in the last year. Capital flight has not been an issue because the ECB's unlimited LTRO liquidity program has enabled Spanish banks to replace lost funds with cheap 1% three-year funds. However, reportedly Spanish banks purchased additional Spanish sovereign debt to serve as collateral for LTRO loans. While the banks are earning a fat arbitrage spread, rising Spanish interest rates are rapidly eroding the market value of these recent purchases. Think about the inanity of this circularity. The Spanish government recapitalizes capital-deficient Spanish banks by issuing sovereign debt that Spanish banks purchase. It looks an awful lot like a Ponzi scheme.

Fifth, at 24.4% Spain has the highest unemployment rate among developed countries, although Greece is a close second. Moreover, within the EU Spanish labor is extremely uncompetitive. A solution to uncompetitiveness is wage deflation, but this will serve only to drive unemployment up to even greater heights. Already disgruntled labor unions have engaged in general strikes, including one on March 29, protesting government austerity and social reform policies.

Sixth, when the time inevitability arrives when the market loses faith in Spain's ability to solve its economic and sovereign debt problems on its own, it is difficult to see how the EFSF and the ESM will have enough resources to provide a credible bailout. This risk is greater than a cursory look at the numbers might suggest because a Spanish meltdown is more likely than not to be accompanied by the market's loss of confidence in Italy as well.

On April 11th Prime Minister Rajoy stated that Spain will continue to implement reforms and insisted that Spain will not require a bailout now or in the future. What else can he say? In the meantime the cost of Spanish sovereign debt remains at a high level. A market riot is not yet at hand, but one must wonder just how far off the day of reckoning might be. As suggested above, developments in Greece could serve as the trigger.

6. Italy

For the moment Italy is not in the eye of the storm. Unlike Greece, Prime Minister Mario Monti is under no immediate pressure to hold elections and his popularity continues to hold at a relatively high level. But, Monti has had very limited success in persuading the Italian Parliament to enact significant structural reforms. Thus, there will be little progress in improving Italy's competitiveness. This means that time is not on Italy's side. Matters will slowly worsen as Italy's and Europe's recessions progress. But, matters could change abruptly if financial contagion engulfs Spain. As the U.S. financial markets crisis of 2007-08 demonstrated, contagion starts with the weakest link — Greece — and then spreads over time to other relatively weak links. Italy is not at the head of the list of weak links, but its weaknesses are well understood by the financial markets and its large public sovereign debt relative to GDP makes it particularly vulnerable to contagion.

7. Germany

Germany's economy is faring relatively well and German exports remain strong. But because half of its exports are to other members of the EU, Germany cannot entirely escape the consequences of the European recession that is unfolding.

Germany is doing relatively better than other EU members for two reasons. First, it engaged in significant restructuring following the union of East and West Germany in 1989. Over time this restructuring put Germany's economy on a very competitive footing vis–vis other EU members. Second, German economic policy intentionally has emphasized high value manufacturing and exports. This has enabled Germany to run large and persistent trade surpluses which have helped Germany create jobs.

But, global trade surpluses and deficits add to zero in the aggregate. Thus, Germany's trade surpluses are offset by trade deficits in other EU members. And, unfortunately, this relationship has contributed to a growing competiveness gap between Germany and trade-deficit EU nations, such as Greece and Spain. This is an example of the rich getting richer and the poor getting poorer. Reversal of the competitiveness gap is not possible unless Germany acquiesces to eliminating its trade surplus. But, this would mean permitting an increase in German inflation and an increase in unemployment. Germans are paranoid about inflation. And, an intentional policy of deflating the trade surplus and losing jobs to other countries is politically unpalatable. The German public attitude is that they have worked hard and have sacrificed to get to the current state of prosperity while other countries have been undisciplined and shiftless. So, why should they sacrifice to benefit undeserving other countries? This means that Germany cannot and will not change its policy stance and will continue to emphasis the importance of fiscal discipline.

Thus, German policy is contributing powerfully to the centrifugal forces which are tearing the EU apart. This is unfortunate because the German polite elite, given Germany's 20th century history, truly believe in the importance of European unity. But that goal and German policy are badly misaligned.

In coming weeks Germany will be under increasing pressure to endorse growth policies that weaken the force of fiscal austerity. Germany will argue that growth policies should focus on structural reforms and not on renewed deficit spending. While this is a prudent long-term view, it is one that takes a long time to produce beneficial results. Because of the rapidly building political pressures of nationalism and populism and the growing political power of fringe political parties, short-term considerations are likely to block substantive structural reforms.

Germany, which has been driving EU economic policy, is likely to find itself increasingly isolated as other countries, such as France, attempt to redefine EU economic and fiscal policies. All of this implies that Germany may eventually determine that it in its best interests to narrow the scope of the EU to a few countries which have compatible economic discipline and cultures.

8. United Kingdom

Although the United Kingdom (UK) is not part of the EZ, it is conducting its own experiment with fiscal consolidation. So far the results of this experiment are hardly an endorsement of the efficacy of a fiscal consolidation policy initiative, especially at a time of massive debt deleveraging in the private sector. UK GDP declined in both the fourth quarter of 2011 and the first quarter of 2012.

VI. China — Soft or Hard Landing?

Fragmentary data reports hint that China's growth may be slowing even more than market participants believe to be the case. Both exports and imports have slowed dramatically. The growth in imports over the last year by only 0.3% is particularly noteworthy. China's slowdown is corroborated by ISI's survey of U.S. company export sales to China and sales in China. ISI's diffusion index is 46.1, which means that sales are contracting. The index is at the lowest level since mid-2009 at the end of the Great Recession when Chinese policy was aggressively stimulating growth in imports.

Hard landing bears worry about rapid deceleration in China's growth rate and the potential for a financial crisis. Soft landing advocates, who greatly outnumber the bears, believe Chinese policymakers will be successful in managing a slowdown in growth and a gradual restructuring of the economy without incurring a financial crisis.

There is an element of faith in the beliefs of soft landing advocates. More in depth analysis suggests that the risk of hard landing, while no means certain, is higher than generally believed.

1. Investment in Infrastructure Is Resulting in Increased Imbalances in the Chinese Economy

China has achieved extraordinary GDP growth rates by force-feeding investment in infrastructure. This has been accomplished primarily through aggressive lending predominantly to state owned enterprises. This has resulted over time in an ever increasing share of Chinese GDP being composed of investment and concomitantly a decreasing consumption share.

As we know from the U.S.'s technology/dot com and housing bubbles, investment can accelerate economic growth for a period of time. But over-investment leads in the longer run to speculation, declining investment efficiency and an excessive build up in debt. This same investment cycle pattern is occurring in China. We know from our own experience that investment cycles which morph into speculative bubbles always end badly. So why should China be different? The response from soft landing advocates is that the command and control nature of the Chinese economy will enable Chinese policymakers to manage the unwinding of excesses without incurring the climatic bubble bursting correction. Perhaps so, but the math is daunting and troublesome.

In 2011 China's real rate of GDP growth was 9.2% of which 54% or 5.0% came from investment. By comparison the U.S. GDP investment component accounts for about 13%. If in 2012 China's investments in infrastructure merely match the amount that occurred in 2011, China's GDP growth rate would fall to 4.2%. The math is straightforward. To sustain a 9.2% GDP growth rate, China must increase investment at a 13.5% higher rate. But the consequence would be that the investment component of 2012 GDP would rise to 56.1%. The GDP imbalance would grow greater. The same phenomenon would reoccur in 2013 and would continue until in succeeding years. It should be noted that the annual rate of growth in Chinese fixed investment has decelerated from 40% in mid-2009 to 15% in the fourth quarter of 2011.

Suppose, as Chinese authorities have suggested, overall Chinese GDP growth is targeted to rise at least a 7.0% rate in 2012 rather than 9.2%. This would lessen, but not eliminate, the growing investment imbalance problem. Investment would now need to grow only 9.4% in 2012, but this still would mean that the investment share of GDP would grow from 54.0% to 55.2%. Annual import growth of 0.3% currently implies that fixed asset investment is probably growing at a slower rate than 9.4%. If this is so, as the year progresses, China could easily fall short of the 7.0% GDP minimum growth goal.

Of course, if Chinese policymakers can raise the rate of growth for the rest of the economy above 4.2%, this would lessen the extent of the problem. Just to hold the investment component constant and achieve overall GDP growth of 7.0% would require the rest of the economy to grow at a 7.0% rate. This increment in growth would have to come primarily from consumers. But, for this to have any reasonable chance of occurring, consumer incomes and spending would have to rise at even faster rates than they have to date. And, very importantly, consumers would have to save less.

But, here is the rub. If consumers save less, the banks will be starved of the cheap funds that have financed the investment boom. Remember how credit quality appeared to be very high in the U.S. as the housing bubble built to a crescendo. So, don't be misled by record Chinese banking profits and very low levels of nonperforming loans. These comforting numbers are an automatic result of an accelerating investment boom.

2. Authoritarian Capitalism versus Liberal Democracy Capitalism

Under Deng Xiaoping's leadership, China discarded the communist economic model and adopted capitalism. But China's approach to capitalism is tailored to state control, which means Communist Party control. To date authoritarian capitalism has been enormously successful in accelerating Chinese economic growth. Many in the developed world are envious of the ability of Chinese policymakers to respond quickly to global economic changes and adopt policy changes that mitigate the consequences. Given the success of Chinese policymakers in managing the Chinese economy during turbulent times, it is not surprising that uncritical thinking leads most to expect that the successes of authoritarian capitalism in the past guarantee success in the future. But, then most of these same people did not believe that the housing bubble would have the dramatically negative consequences which we are experiencing today.

3. Woody Brock's Model for Comparing Authoritarian Capitalism and Liberal Democracy Capitalism

Woody Brock recently published a book entitled *American Gridlock: Why the **Right** and **Left** Are Both Wrong.*[1] Brock posits that an ideal social system has three components: the economy, the political system and a constitution. The constitution is an essential component of the ideal social system because it contains enforceable rules that govern behavior in the economy and the political system.

Norms for an Ideal Constitution. These norms provide for the rule of law and equal protections and treatment of citizens. The U.S. constitution and first ten amendments (Bill of Rights) meet the norms for an ideal constitution. In authoritarian capitalism there is no meaningful constitution. The party and the state are the constitution. This means that the interests of the power elite, rather than society as a whole, govern outcomes.

Norms for an Ideal Economy. According to Brock there are six norms:

- Efficiency (non-wastefulness)
- Stability

[1] H. Woody Brock. *American Gridlock: Why the **Right** and **Left** are Both Wrong*. John Wiley & Sons, Inc., 2012.

- Freedom (actions and decisions occur without the necessity to secure permission)
- Privacy
- Distributive justice ("fairness" — the glue that keeps society working)
- Incentive structure compatibility

The norm of "incentive structure compatibility" must permeate the five other norms.

Norms for an Ideal Government. According to Brock "politics is about eyeball-to-eyeball bargaining between interest groups." An ideal government is one in which multi-lateral bargaining achieves "good" compromises that serve the collective interests of society well. An ideal government is efficient (same norm as in the ideal economy), fair (embodies notion of distributive justice), and unbiased.

Interaction Between the Three Components. The economy and political system overlap. The extent of the overlap is determined by how much of economic activity the political system seeks to control. The constitution and the political system also overlap. The constitution constrains the power of government and establishes rules for balancing the needs of society and the rights of individuals.

Achieving the right overlaps is crucial to optimizing social welfare over the long run.

Comparing Liberal Democratic Capitalism and Authoritarian Capitalism. Brock believes that the troubles afflicting developed countries which have liberal democratic capitalism models stem primarily from flaws in the government component. Politicians seize on voter insecurities to promise more and more benefits which cannot be paid for in the long run. The underfunding of U.S. entitlement programs is a case in point.

In the case of authoritarian capitalism, the government directly controls too large a part of the economy through government-owned and government-regulated companies. These companies have enormous incentive to maintain and grow the extent of their control. This frustrates competition and over time economic efficiency and growth suffers. The absence of any meaningful constitution assures that dominance and oppression by such companies will serve the narrow interests of their elites rather than society as a whole.

Without question China is a deeply flawed authoritarian capitalistic model. Michael Moran in The Reckoning: Debt, Democracy and the Future of American Power observes that the *"The import/assimilate/reinnovate' model ... does not foster a climate of original innovation" in China.*[2] *" ... [S]omething is retarding China's transition from copycat manufacturer to innovative top dog. The kind of manufacturing that accounts for nearly all of China's export earnings relies on low-cost inputs, including labor, as opposed to the value-adds of quality and technology that underpin an advanced economy's manufacturing sectors, notably Japan, Germany, and the United States."*

Chinese government officials are not oblivious to the long-run threat to economic growth posed by the tight nexus of state owned enterprises and banks. In early April Prime Minister Wen Jiabao stated that banks are reaping "easy" profits and called for breaking up the large bank monopoly. But, the large banks are an integral part of China's authoritarian capitalist model. Breaking them up could well undermine the political power of the Communist Party which is tightly aligned with the state-owned enterprises which, in turn, depend on financing provided by the large banks.

4. China Needs to Rebalance Its Economic Model

As we have seen, China has achieved high GDP growth rates through an investment-manufacturing-export economic model. To accomplish this consumption has been repressed. Massive overinvestment and an explosion of debt is also a consequence. The manufacturing-export aspect of China's economic model creates large trade surpluses. This is the essence of China's unbalanced economic model.

Overinvestment based on excessive leverage always ends badly when the rate of investment growth inevitably slows. Slowing investment growth is well underway in China. Moreover, trade surpluses are sustainable only as long as other countries run trade deficits. The economic and sovereign debt pressures on European nations and on the U.S. argue for a lessening of

[2]Michael Moran. *The Reckoning: Debt, Democracy and the Future of American Power*. Palgrave Macmillan, 2012.

collective trade deficits in liberal democratic capitalistic economies in coming years. As this occurs, China's policy of creating large trade surpluses will become increasingly difficult to sustain.

For these reasons China must move aggressively to restructure its economy to avoid the potential for a hard landing. It may already be too late, but assuming it is not, there is question whether it will be possible to transform policy aggressively given the entrenched interests of the power elite in China's political system.

There are several rebalancing options suggested by Michael Pettis.[3]

Option #1 — Gradual Transfer of Income from the State to Households. This would involve raising the real rate of interest (stop subsidizing investment financing), increasing the value of the renminbi (decrease the size of the trade surplus), raise wage rates and lower income and consumption taxes.

Under this option subsidies would be removed gradually giving private businesses and households time to adapt. Ideally, the negative employment impact of reduced subsidies would be offset by growing household consumption demand. Pettis points out, however, that removal of subsidies will have inflationary consequences, but food prices would not be greatly affected, which would lessen the potentially socially disruptive aspects of higher inflation.

But the real problem with Option #1 is that it might involve too little, too late. That has to do with the growth gap between investment and the rest of the economy, which, as I cited above was about 13.5% for investment in 2011 and 4.2% for the rest of the economy. Worrisome imbalances will continue to build until the growth rate in investment is equal to or less than the growth rate in the rest of the economy.

Option #2 — Aggressive Transfer of Income from the State to Households. This is the same as the first option except that the policy would be implemented over a much shorter period of time.

Option #2 achieves rebalancing more quickly but the risks are enor-

[3] Chinas rebalancing options are set forth and evaluated in an EconoMonitor blog, dated April 9, 2012, entitled *The Ways China Can Rebalance* by Michael Pettis.

mous. First, rapid removal of existing subsidies probably would precipitate extensive financial distress in an already overextended banking system. Unemployment would rise quickly, as it did temporarily at the end of 2008. In the short run, the benefit of removing subsidies could easily be overwhelmed by falling household incomes become of the sharp rise in unemployment. Moreover, this option brings with it the potential of igniting a deflationary feedback loop of ever increasing debt defaults and declining incomes.

Option #3 — Directly Transfer Wealth from the State Sector to the Private Sector. This would be accomplished through privatizing state-owned assets and using the proceeds to directly or indirectly boost household wealth.

This option would involve giving state-owned land to rural farmers, distributing shares in state-owned companies to households and by selling public assets and using the proceeds to support the social safety net and offset loan losses. The major obstacle to this option is that it would reduce state power, which in turn would threaten the authority of the Communist Party. In other words, this option may well be a nice theoretical concept which would be impossible to implement because of the political power structure.

Option #4 — Absorb Private Sector Debt. This also would result in a wealth transfer to households. The primary private sector debt in question has to do with the five large Chinese banks. Pettis refers to this option as the "Japan solution". While it would be easy to implement politically, Japan's legacy of high government debt, deflation and lethargic growth is not attractive.

Option #5 — Cut Fixed Asset Infrastructure Investment and Hire Displaced Workers. Curtailment of fixed asset infrastructure investment would drastically reduce GDP growth and increase unemployment. The government could mitigate the consequences by reemploying displaced workers in activities that would help build a consumer economy.

Presumably rehiring of workers would be financed by massive government deficit spending. In and of itself this is not necessarily bad, provided it accelerates the growth in the consumer economy and cushions the shock of subsidy withdrawal. However, to the extent that this adversely impacts the interests of the state-owned enterprises and the power elite, resistance to this option could be considerable.

5. The Importance of the Sacking of Bo Xilai

The sacking of Bo Xilai brought to the fore an economic debate and power struggle that has been taking place within the Chinese political elite about the future direction of economic policy.

Bo Xilai, who was Communist Party Secretary in Chongqing municipality, was utilizing state-led investment to stimulate the local economy and simultaneously redistributing wealth to improve the welfare of local citizens. Not only was this strategy a partial fallback to the policies of Mao Zedong, it also relied on placing ever greater reliance on infrastructure investment, thus pushing an already unbalanced economic model to even greater extremes. Much has been made of Bo's cult of personality and populist charisma. Undoubtedly that was a factor in his sacking. But, my sense is that the underlying cause had to do with the economic model he was constructing and espousing and the belief of other Chinese government officials that economic structural change needs to diminish the role of the state and increase the role of private enterprise.

Bo's replacement is Zhang Dejiang. Most recently Zhang served as Party Secretary in Zhejiang province where the economic model is directed toward encouraging the growth of small- and medium-sized private businesses. From statements Zhang has made since assuming his post in Chongqing it is clear he intends to redirect economic development in the image of what is going on in Zhejiang province. But it is equally clear that this is the direction the Chinese Party intends to take throughout China.

Shifting economic development emphasis from state-owned enterprises to private businesses brings with it considerable risk to the long-term authority of the Communist Party. As wealth grows in a society and more and more people benefit the importance of privacy and freedom will grow apace. China's political system is not compatible with such an emerging trend, as Woody Brock has pointed out.

6. Conclusion

In conclusion, difficult times are ahead for China. It is inevitable that GDP growth will slow. The threat of a hard landing is significant but is not a certainty. Chinese policymakers seem to have a grasp of what needs to be done but implementation challenges are enormous and political considerations will make implementation exceedingly difficult. Slow U.S. growth and pending fiscal consolidation and European economic decline remove a degree of flexibility that Chinese policymakers desperately need. We should hope for their sakes and the sake of the well-being of the global economy that Chinese policymakers thread the needle. But, we should not be sanguine about their ability to do so.

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