The Longbrake Letter*

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September, 2012

I. Central Banks to the Rescue - Will It Be Enough?

Both the European and American economies remain deeply troubled. In Europe the challenge is existential. In America it is less dire but still the challenge of how to return the economy to full employment is daunting and the little progress that has occurred so far has come at great cost.

Within a period of one week the European Central Bank and the Federal Reserve have announced aggressive monetary policies which will provide prodigious amounts of liquid funds to their economies in coming months.

Although there are differences in the details, the root cause of the travails in both the European and American economies was overreliance on debt leverage for many years to stimulate economic activity.

In Europe, the European Project was aimed at creating economic and political interdependencies to foster economic growth and avoid a return to Europe's troubled history of internecine warfare. That objective has been achieved in part but the structures of the European Union and the monetary union were deeply flawed in ways that have become apparent over the last three years. Implementation of the European Project fostered enormous credit bubbles in the peripheral countries and contributed to an unsustainable divergence in individual country competitiveness. The common currency prevented unwinding of the accumulated stresses and imbalances through currency devaluation leaving internal devaluation as the only alternative. That alternative, unfortunately, has required fiscal austerity and forced deep recessions. It is also nourishing populist and nationalistic political movements. The remedy for now is for the European Central Bank to

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print a lot of money and throw unlimited amounts of liquidity at banks and challenged governments. Unlimited liquidity can prevent a stampede for the exits, but by itself liquidity cannot cure deeply embedded structural problems. It can only provide time for other measures to be crafted, implemented and hopefully have impact for the better.

In America, we understood far too late the consequences of the huge build up in household debt leverage and the misallocation of resources that the accompanying housing bubble spawned. When the financial crisis struck with great virulence in 2008 the Federal Reserve provided massive amounts of liquidity and in so doing unquestionably averted a collapse of the financial system and a repeat of a 1930s-style depression.

Fiscal policy came to the rescue as well in America by supporting household incomes which had been depleted by unemployment and heavy debt burdens. Fiscal policy was expected to reignite consumer spending and fuel a virtuous circle of job growth, income growth and spending growth. But the debt burden was too great and the typical credit mechanisms which traditionally fuel recovery were deeply impaired. As a consequence massive government spending did not lead to a self-sustaining economic recovery. Instead it resulted in socializing household debt. Even as households began the long difficult process of reducing their overdependence on debt, the federal government's debt burden exploded. In the aggregate, the total debt in the America as a percentage of GDP has stalled at a very high level, though its composition has shifted from households to the government.

In both Europe and America, the ability of fiscal policy to help restore economic vitality has been exhausted through over use to the point that it has become part of the problem. The U.S. faces a fiscal cliff on January 1, 2013. There is no talk about further fiscal stimulus. The focus is entirely on cutting the deficit, how that should be accomplished and how rapidly deficit cutting should be implemented.

In Europe, while there is chatter about growth policies, the order of the day is compliance with the Fiscal Stability Pact which mandates budget deficit cutting within tight time frames. This task is not an easy one because austerity depresses economic activity and reduces tax revenues forcing additional spending cuts and tax hikes. It is a virulent, not a virtuous, circle.

Unlike fiscal policy, monetary policy still has potential left to help treat

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economic woes, or at least that is what many policymakers believe.

Even though the traditional role of monetary policy of stimulating additional borrowing is impaired by still dysfunctional credit markets, monetary policy easing can still have other benefits.

In America, extension of the time period for the federal funds rate to remain effectively at zero and additional asset purchases should be positive for stock prices for two reasons. First, we know from experience and statistical analyses that similar policies have lowered long-term rates and flattened the yield curve over the last four years. Depressing long-term bond yields makes dividend yields on stocks more attractive and provides price support for stocks.

But, given low long-term interest rates and the guarantee that they will remain low for an extended period, stock prices have not risen as much as would be expected. This is probably because of the enormous uncertainties posed by the European sovereign debt crisis and the U.S. fiscal cliff. The equity risk premium is more than 200 basis points above its long-term norm of approximately 6%. This suggests that if these policy uncertainties could be resolved favorably, stock prices would rise and perhaps to a considerable degree. Although uncertainties surrounding the fiscal cliff have not diminished one bit, near-term financial risks in Europe have lessened considerably. Overall financial conditions in the U.S. have eased substantially since earlier this year. In fact, the recent rally in stock prices and the plunge in volatility provide evidence that the impact on financial asset prices is working as intended.

Second, long-term rates that are guaranteed to stay low for a long period of time encourage greater risk taking. This encourages yield curve maturity mismatching by financing the purchase of long-maturity financial assets with short-term funding. It also encourages moving from low-yield, low-risk assets to higher risk assets, such as high yield bonds. Credit spreads have tightened dramatically since earlier this year.

A byproduct of higher stock prices is greater wealth and some of the increased wealth will eventually boost consumer spending.

Further, monetary easing helps ease financial conditions by compressing credit spreads on riskier assets. Research indicates that easier financial conditions have a favorable impact on GDP growth.

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Nonetheless, the link between financial asset prices and employment is indirect at best. Many bankers have had plenty of money to lend for a long time and few creditworthy places to put it. They are skeptical that greater amounts of liquidity at slightly lower interest rates will result in any material change in lending activity. In fact, bankers are worrying about the ever compressing margin between asset and funding rates and their ability to earn an acceptable return on capital in a low-rate, flat-yield curve world. Or, put in economist terms, when the financial system is caught in a liquidity trap no amount of liquidity at low prices will have any appreciable impact on lending and economic activity.

Those who worry about the future fret about the explosion in the Fed's balance sheet. To them the Fed is printing money even if that money is currently relatively idle in a liquidity-trap world. Once the economic recovery begins to gather momentum, they worry that the all too abundant liquidity will fuel inflationary expectations and unleash a virulent bout of inflation. The reality is that we really don't know how all of this will play out. There is little precedent to study. Perhaps the Fed's policy is just what is needed to get the economy going again and avoid the deflationary consequences of a debt deleveraging world. But, what if the Fed's policy has the unintended consequence of reigniting speculative and excessive debt creation?

What we know from history is that when policymakers tinker in a way that creates large economic imbalances, those imbalances eventually will have to be unwound. And we also know from history that the unwinding process often is ugly and painful.

So the question in Europe and America is not just one of whether the monetary policy initiatives of the ECB and the Fed will be enough but also one of whether those policies will lead to further imbalances and yet more trouble down the road.

In this month's letter, I begin by reviewing recent developments for U.S. and global GDP growth (Sections II and III). This is followed by a discussion of U.S. personal income, consumption and employment (Sections IV and V). The final five sections provide updates on U.S. monetary policy, the U.S. presidential election, U.S. fiscal policy and developments in Europe and China.

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II. U.S. Real GDP Growth

1. Real GDP Growth Likely To Continue To Be Disappointingly Slow

Three years into the recovery from the Great Recession, real annual GDP growth has averaged just 2.2%. This compares to average annual real GDP growth of 4.6% over the first three years of recovery following the 1981-82 recession, which was the worst recession since World War II prior to the Great Recession.

Repeated rounds of monetary and fiscal stimulus, which have exceeded in magnitude policy stimulus following all previous post-war recessions, have not yet been successful in driving a self-sustaining recovery.

As time has passed, failure of the recovery to conform to expectations has prompted a search for reasons. Early optimism by many for a traditional quick and strong recovery has been replaced by the reality that the current lethargic recovery is not an aberration but a direct result of consumer debt deleveraging, an impaired credit creation mechanism and an extended excess housing inventory correction.

Monetary Policy. Monetary policy stimulates demand by lowering the cost of borrowing and increasing the value of financial assets. Monetary policy has been successful in increasing the value of financial assets, but in all other respects favorable impacts of policy have been limited. Tighter consumer credit underwriting standards and consumer debt reduction is blocking demand stimulation. Driven by low interest rates, housing construction traditionally leads recovery and helps ignite a self-sustaining economic expansion. However, excess housing inventory and falling home prices have prevented housing construction from playing this traditional role.

These are the principal reasons the current economic recovery has fallen short. This is the bad news. But, there is good news. Excess housing inventory is shrinking, housing prices have stabilized in many markets and housing construction is beginning to contribute, albeit in a relatively small way, to real GDP growth. Consumer credit standards have relaxed for auto loans and credit cards, but credit standards remain extremely tight for mortgage credit. Thus, the healing process is underway and the impediments to

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more rapid recovery are slowing diminishing.

Fiscal Policy. Fiscal policy supports recovery by directly creating jobs through spending programs and indirectly increasing jobs by increasing spendable income through transfer payments and reduced taxes. However, in the current recovery a portion of fiscal stimulus has been diverted to consumer debt deleveraging rather than to consumption. Moreover, infrastructure spending which directly creates jobs and has a relatively high multiplier effect, which with a lag creates additional jobs, has been limited in favor of transfer payments, which have lower multiplier impacts. Thus, the impact of fiscal policy on the speed of economic recovery has been limited by consumer debt deleveraging and a suboptimal mix of policy initiatives.

Fiscal stimulus during recoveries is financed through borrowing. This increases the public-debt-to-GDP ratio. Customarily the increase in this ratio is temporary because GDP growth accelerates leading to a more rapid increase in the denominator of the ratio and tax revenues expand leading to slower growth in the numerator of the ratio. The result is that the ratio first stabilizes and then declines. This has not happened in the current recovery because of slow nominal GDP growth.

Combined with monetary policy fiscal policy has prevented a 1930s-type depression but has been insufficient to initiate a self-sustaining expansion that quickly returns the economy to full employment. Moreover, the public-debt-to-GDP ratio has risen from 36% at the beginning of the Great Recession to a dangerously high 72% currently. Politicians understand that letting this ratio rise much further will threaten economic prosperity in the future. Thus, there is general agreement that fiscal stimulus needs to be ratcheted back, although as yet there is no agreement about how to accomplish this.

Slow GDP Growth Likely To Continue. Ordinarily the slow but steady elimination of impediments to economic growth could be expected to result in more rapid GDP growth in coming quarters. Unfortunately this boost in growth is likely to be offset by a contraction in fiscal stimulus. Thus, it is highly likely that the current 5.9% output gap will continue to close very slowly.

In the longer run, GDP growth depends on population and productivity growth. Both have slowed. Annual population growth has slowed from 1.0% prior to the Great Recession to 0.7% currently. Annual productivity growth

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has slowed from 3.4% over the seven-year period from 1997 to 2004 to 1.6% over the last eight years. CBO expects annual productivity to be 2.2% over the next 10 years; my estimate is a less optimistic 1.6%.

Slower population and productivity growth mean slower full-employment potential GDP growth ranging between approximately 2.35% and 2.85%. The Federal Reserve's range is 2.3% to 2.5%. This means that growth needs to be above 3.0% on a sustained basis to have any material impact on reducing the sizable output gap. Reduction in the amount of fiscal stimulus in coming quarters makes this an unlikely prospect.

Slow Growth Implications. First, employment growth will continue to be slow. Second, wage growth will be held back by high unemployment and could edge lower. Third, spending growth will limited by the first two implications. Fourth, inflation will likely remain in check because of weak demand and slow growth in wages. Fifth, interest rates will remain low for an extended period of time and this will be reinforced by the Fed's quantitative easing policy.

2. 2012 Q2 GDP Estimates

Second quarter GDP growth was marked up to 1.7% in the "Preliminary Estimate" from 1.5% in the "Advance Estimate". Details of the "Preliminary Estimate" are shown in **Table 1**.

- **Consumption**. While the estimate of personal consumption growth bumped up from 1.05% to 1.20%, it was still very weak.
- **Investment**. Growth in both nonresidential and residential investment slowed even more than reported in the "Advance Estimate".
- **Net Exports**. As expected, updated data indicate that net exports added to growth rather than subtracting from growth as indicated in the "Advance Estimate". Exports grew faster and imports grew more slowly. This added 0.63% to the second quarter GDP growth estimate.
- **Inventories**. Inventories were revised down -0.55% from growth of 0.32% to shrinkage of -0.23%.

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- **Government**. Finally, while the contribution of government to growth continues to be negative, the revised estimate was less negative and was almost entirely due to ongoing shrinkage in state and local expenditures.

Table 1
2012 Second Quarter GDP Growth

	Advance Estimate	Preliminary Estimate	Final Estimate	First Quarter
Personal Consumption	1.05%	1.20%		1.72%
Private Investment				
Nonresidential	.54%	.43%		.74%
Residential	.22%	.43%		.43%
Inventories	.32%	-.23%		-.39%
Net Exports	-.31%	.32%		.06%
Government	-.28%	-.18%		-.60%
Total	**1.54%**	**1.74%**		**1.96%**
Final Sales	**1.22%**	**1.97%**		**2.35%**

In summary, while the top line GDP real growth estimate improved only marginally from 1.54% to 1.74%, there were material changes in most of the components. Perhaps most significant, the apparent second quarter collapse in "Final Sales" from 2.35% in the first quarter to 1.22% was revised up considerably to 1.97%, still disappointing, but indicative of an ongoing weak recovery in GDP growth.

3. Final Sales Are Improving Slowly

Although the recovery has been very weak, gradual improvement is taking place. Real growth in "Final Sales", which deducts changes in inventory accumulation from GDP, is a better measure of underlying demand than real GDP growth. Inventory accumulation tends to be procyclical, decreasing more rapidly than other components of GDP during a recession and rising more rapidly during recovery.

Chart 1 compares real GDP and final sales growth rates from 2008

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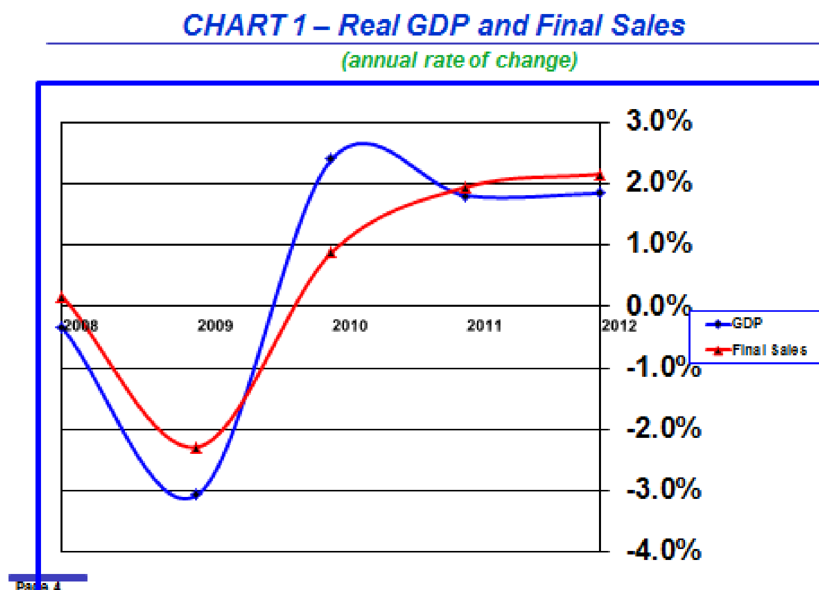

to 2012. **Chart 1** shows visually how inventory accumulation amplifies GDP cycles relative to final sales. It appears that final sales growth may have stalled just slightly about 2.0% in 2012. This bears watching because unemployment will not decline unless final sales grow at a rate well above 2.0%.

4. 2012 Q3 and Q4 GDP Estimates

Goldman Sachs. Goldman Sachs (GS) expects GDP to expand at a 2.3% annual rate in the third quarter and 2.0% in the fourth quarter, while B of A expects growth to decelerate to 1.3% in the third quarter and 1.0% in the fourth quarter, primarily as a consequence of slowing employment and business investment due to the impending fiscal cliff.

GS expects a slight pickup in consumer spending, slow improvement in residential housing construction, expansion of industrial production with an increase in the ISM manufacturing index from 49.6 to 52.0, somewhat better employment growth and slowing core inflation. While all of these

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factors are positive, their impact is likely to be very modest. Thus, the GS forecast is not one of accelerating recovery but rather one of sluggish growth which is insufficient to make any real dent in the sizable output gap. However, it should be noted that GS's current activity index (CAI), which approximates the real GDP growth rate, was 1.4% in July. This implies there is downside risk to the GS forecast. GS also notes the recent improvement in real disposable income growth and an improvement in financial conditions as causes for a little more optimism. As I pointed out in my ***August letter***, the improvement in real disposable income appears to have been a first quarter phenomenon.

Bank of America/Merrill Lynch. Bank of America/Merrill Lynch's (B of A) rationale for sharply lower GDP growth in the third and fourth quarters is based upon continued weak growth in services and negative impacts on business investment, consumer durables and exports of manufactured goods. B of A believes that uncertainty about future fiscal policy will prompt businesses to delay investment in equipment and software and consumers to postpone purchases of autos and homes. In addition, Europe's recession and slower global growth will reduce demand for U.S. exports. B of A's most recent third quarter GDP tracking estimate is 1.4%, which is close to its forecast of 1.3%.

Other Forecasts. In the Philadelphia Fed's survey professional economists lowered their consensus estimate of third quarter GDP growth from 2.4% to 1.6% and fourth quarter from 2.6% to 2.2%.

Investment. As I have discussed in previous letters, business investment accounted for a large portion of GDP growth in 2011. However, business investment growth has been slowing steadily during 2012. In fact, the annualized three-month moving average growth rate in "core" capital expenditures was -1.7% in July. Investment in equipment and software, which comprises approximately 11% of GDP, slowed from an annual growth rate in 2011 of 11.0% to 5.4% in the first quarter, 4.7% in the second quarter, and is on track to shrink further in the third and fourth quarters. Uncertainty surrounding fiscal policy could worsen this outlook, if businesses delay making decision on investments.

Trade. Reflecting slowing global growth, growth in U.S. exports and imports has turned negative during the third quarter. The net effect appears likely to reduce third quarter GDP growth.

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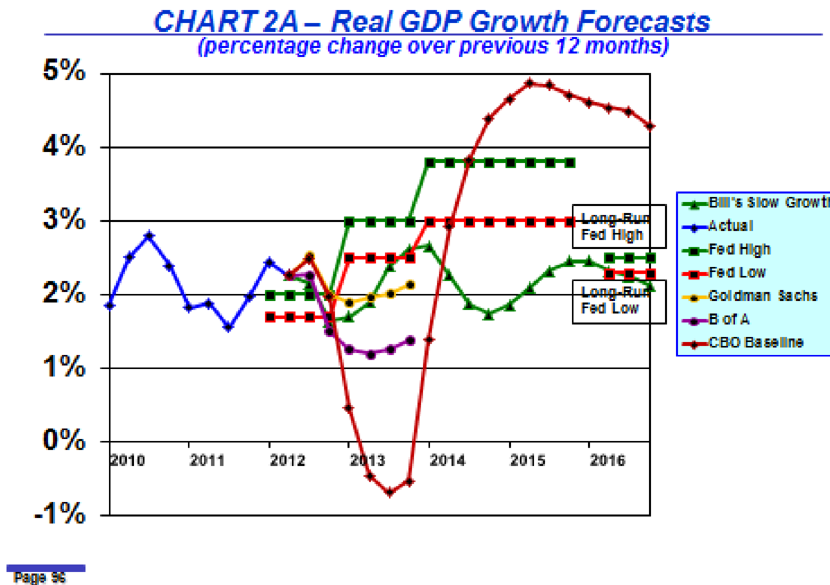
5. GDP Forecasts for 2012 and Beyond

Chart 2A shows several GDP forecasts: the Federal Reserve's high and



low; B of A; GS; the Congressional Budget Office (CBO); and "Bill's Slow Growth" scenario.

CBO Forecast. CBO's forecast is not a likely one because it assumes Congress will take no action and let all current law tax increases and spending reductions take effect on January 1, 2013. The aggregate impact of fiscal contraction over calendar year 2013 equals approximately 4% of GDP. According to the CBO forecast, GDP would contract at an annual rate of 3.9% in the first quarter and 1.9% in the second quarter before recovering in the third and fourth quarters. Growth would decline -0.3% for the full year and -0.5% on a fourth quarter to fourth quarter basis.

FOMC Projections (See Table 3 below). The FOMC's revised September projections for real GDP growth were marked down for 2012 reflecting two quarters of slower than expected growth. Surprisingly, compared to its June projections the FOMC raised its central tendency forecast

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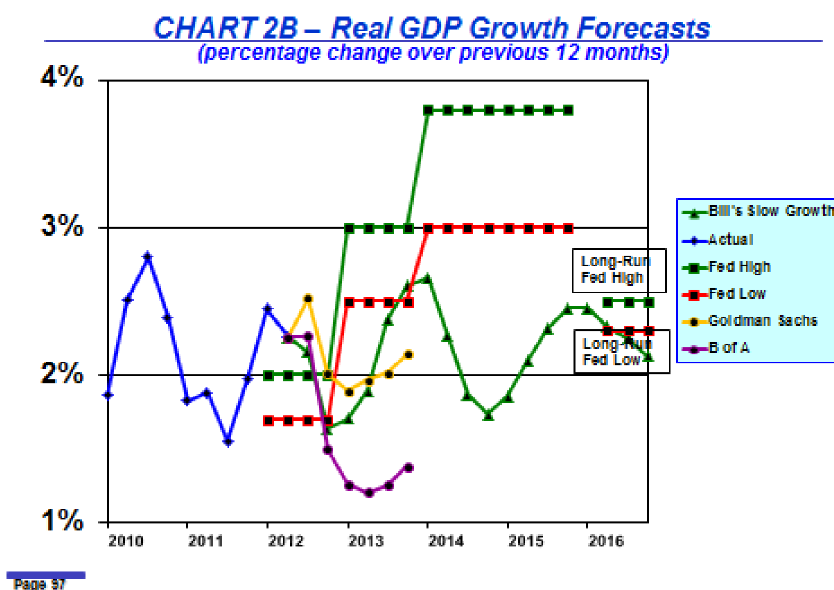
ranges for 2013 and 2014 to an even more optimistic level relative to other forecasts. Over the last three years the FOMC's GDP forecasts have been consistently too optimistic. This optimistic bias has a material impact on the FOMC's projections for the unemployment rate and inflation. If history repeats and the FOMC is forced to mark down its GDP projections in coming quarters, it will probably also have to mark up its projection for the unemployment rate and, possibly, mark down its projections for inflation.

Other Forecasts. CBO's GDP growth projection in **Chart 2A** is for its ***baseline scenario*** in which Congress take no action so that all spending cuts and tax increases take effect on January 1, 2013 as scheduled.

B of A's forecast is one of the most pessimistic; GS's forecast, which had been among the more pessimistic, is now close to the consensus. Nonetheless, GS's forecast is lower than the FOMC's revised low forecast for 2013, and B of A's is substantially more pessimistic.

Chart 2B eliminates CBO's recession forecast. By reducing the range



of the scale, it makes it easier to see the differences in the other forecasts.

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GDP growth averages 2.1% for the next six quarters in GS's forecast and 1.5% in B of A's forecast compared to the FOMC's median of approximately 2.4%. The current Blue Chip consensus forecast pegs GDP growth of 1.8% in 2012 and 2.5% in 2013 compared to the Fed's revised projection median of 1.85% in 2012 and 2.75% in 2013. The International Monetary Fund (IMF) recently lowered its U.S. GDP growth forecasts to 2.0% in 2012 and 2.25% in 2013.

"Bill's Slow Growth" scenario projects GDP growth in 2012 and 2013 similar to the GS forecast; higher than the B of A forecast; and similar to the FOMC's 2013 low projection. Average GDP growth over the next six quarters for "Bill's Slow Growth" forecast is 2.1%.

6. GDP Output Gap and Potential GDP

Since the end of the Great Recession real GDP growth has averaged just 2.2% annually. The Federal Reserve believes the long-term potential real GDP growth rate lies between 2.3% and 2.5% (see **Chart 2B**); CBO estimates that the potential real GDP growth rate is currently about 1.8% and should rise gradually to 2.5% by 2017, averaging 2.2% over the next ten years. GDP growth of 2.25% or less is insufficient to reduce unemployment; it fosters slow growth in consumer incomes and spending; it keeps downward pressure on inflation; and it slows the important process of debt deleveraging.

Chart 3 shows CBO's forecast for the GDP gap, which is simply the difference between CBO's real GDP forecast and its estimate of potential GDP divided by potential GDP. CBO revised its estimates of potential GDP growth in August. As a result, the gap at the end of the second quarter, which was initially reported to be 5.41%, was a somewhat larger 5.90% and now does not fully close until the end of 2017, rather than the end of 2015.

CBO also revised its "Current Law" ***baseline*** forecast of GDP growth to incorporate the impact of the fiscal cliff. This forecast assumes Congress will take no action to reverse automatic spending cuts and tax increases that take effect on January 1, 2013 under current law. CBO's forecast includes a recession in 2013 with the output gap rising sharply to 7.9% of GDP by the third quarter of 2013. Thereafter gradual recovery occurs. My GDP forecast assumes there will no recession in 2013. Fiscal policy will be restrictive and

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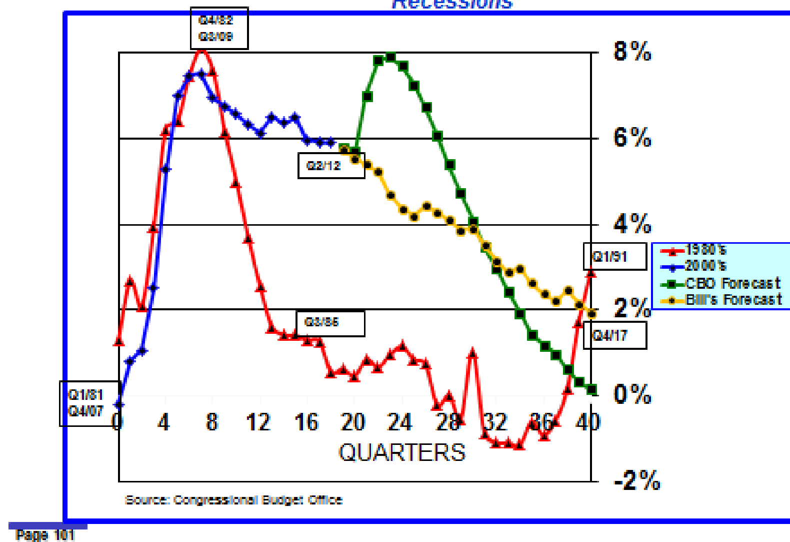

will adversely impact GDP growth in 2013 but Congress will act to lessen spending cuts and tax increases.

III. Global GDP Growth

Global growth continues to slow very gradually. According to B of A, manufacturing is contracting in 21 of the 26 countries it monitors and is expanding in only 4. Industrial production fell 1.7% in India and 4.0% in Brazil for the 12 months ending in June. Industrial production was up 8.9% in China in August over the prior year, but is in a decelerating trend.

GDP fell at an annual rate of -0.7% in Singapore and by the same amount in the European Union during the second quarter. Japan's GDP grew at an annual rate of 0.7%. Korea's GDP was up only 2.3% over the previous year. China, which only reports growth over the previous 12 months, is expected to report 7.4% in the third quarter, down from 7.6% at the end of the second quarter.

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China's trade data looks increasingly weak and is likely to weaken further in the second half of 2012. China's exports grew just 2.7% over the 12 months ending in August and imports declined -2.6%. As a consequence, China's trade surplus increased. Slowing growth in Chinese exports is due to weakening global demand. The decline in imports is concentrated in commodities. There is evidence that China accumulated excessive inventories of raw materials and is now attempting to reduce these stockpiles. For example, Chinese imports of Indonesian nickel have fallen from 4.0 metric tons in May to 1.43 metric tons in July. Exports fell 14.8% in July compared to June and have fallen for three consecutive months.

In many respects the story of global economic growth is not unlike that of the U.S. In the wake of the 2007-09 global financial meltdown, most all governments pursued aggressive monetary and fiscal policies. For a time this resulted in high rates of growth. But the extended slow healing of a fragile U.S. economy, the sovereign debt crisis in Europe, and substantial imbalances in China and India inevitably have put a damper on the global growth rate. We live in a highly interconnected global economy. Policy stimulus cannot paper over serious imbalances forever. The good news is that global rebalancing is underway. The bad news is that it will be accompanied by much slower global growth in coming quarters.

IV. Consumers

1. 2012 Personal Income, Disposable Income and Spending

Consumer personal income and disposable income data are reported on a monthly basis but are revised several times over subsequent months. Thus, one can never be sure whether the story recently released data tell will be the same story several months hence.

Data for 2012, shown in **Table 2**, indicate that disposable income growth has accelerated significantly from 2.46% in 2011 to an annual rate of 5.22% over the first seven months of 2012. This improvement is almost too great to be credible as it does not reconcile with slow employment growth and stable to declining growth in hourly and weekly wages.

It seems likely that disposable income growth will slow during the re-

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Table 2
Change in 2011 and 2012 Personal Income and Its Disposition
(in billions of dollars)

	Nominal 2011*	**Pct. Change**	**Nominal 2012 Jan.-July****	**Annual Pct. Jan.-July Change**	**Annual Pct. Apr.-July Change**
Personal Income	**$458.1**	**3.64%**	**$415.7**	**5.47%**	**3.37%**
Compensation	269.2	3.34%	272.9	5.61%	2.28%
Proprietors' Income	21.0	1.83%	35.3	5.17%	3.70%
Rental Income	70.7	19.50%	26.2	10.37%	5.45%
Asset Income	25.9	1.56%	63.6	6.46%	8.49%
Government Transfers	4.3	0.19%	49.1	3.62%	2.46%
Less: ***Personal Taxes***	-112.7	5.05%	-93.6	6.84%	3.77%
Disposable Income	**278.5**	**2.46%**	**353.5**	**5.22%**	**3.17%**
Less: ***Consumption***	**435.8**	**4.04%**	**239.6**	**3.66%**	**1.46%**
Personal Saving	**-157.4**	**-28.63%**	**114.0**	**49.82%**	**47.73%**
Personal Saving Rate	**4.24%**		**3.87%**		**4.04%**

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

mainder of 2012. The surge in income growth is limited to the first quarter of 2012. Disposable income grew at an annual rate of 7.88% in the first quarter compared to 3.17% from April through July, for a blended annual growth rate of 5.22% over the first seven months of 2012. There is reason to believe that the BEA revised first quarter salary data to include a one-time adjustment for higher bonus and deferred income. Assuming that this revision was not seasonally adjusted, it could account for what appears to be a temporary one-quarter boost in disposable income growth.

Also perplexing is the improvement in government transfer payments. No new tax legislation has taken effect in 2012. Some of the increase was in social security payments but most was in Medicaid, which flipped from a decline of $24.4 billion in 2011 to an increase of $22.5 billion over the first seven months of 2012.

Personal taxes are up sharply in 2012, but much of this increase is linked to higher growth in the components of personal income. However, the 6.84% annual rate of increase is considerably higher than the 5.47% rate of increase

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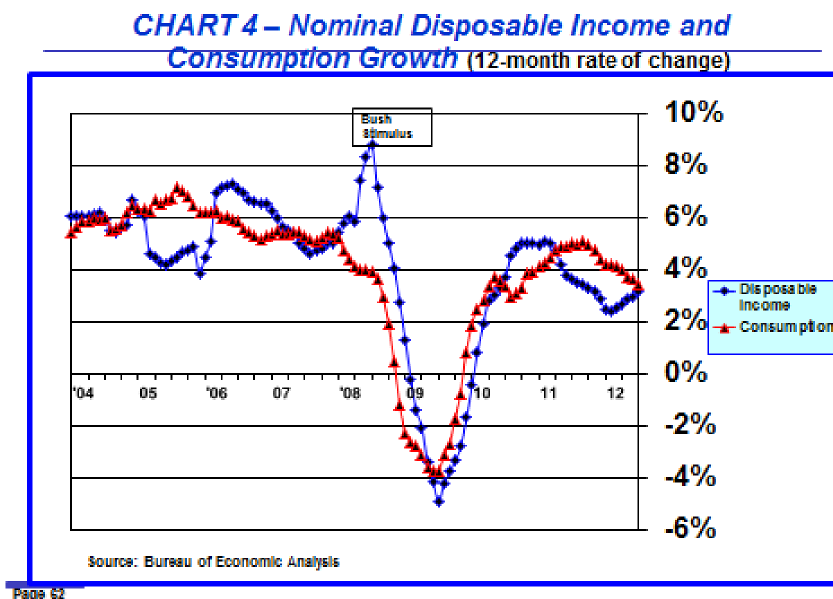
in personal income.

Taken at face value the acceleration in disposable income growth so far in 2012 supports GS's optimistic outlook for increased consumer spending growth in the second half of 2012. But notice in **Table 2** that the personal saving rate over the first seven months of 2012 is 3.87%, which means that consumer spending growth needs to remain slower than disposable income growth, if the 2012 saving rate is to equal 2011's saving rate of 4.24% by the end of 2012. Possible downward revisions in disposable income growth and the low saving rate do not bode well for stronger consumer spending growth over the remainder of 2012. Indeed, growth in consumption slowed sharply from April through July to 1.46% and the saving rate edged up to 4.04%.

2. Disposable Income and Spending — Long-Term Relationship

Chart 4 shows the nominal rate of growth in disposable income and con-



sumer spending from 2006 to the present. The annual rate of growth in

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disposable income began slowing in late 2010 and declined from its recent high of 5.1% in February 2011 to 2.4% in February 2012, but rose to 3.2% in July 2012. Growth in consumer spending peaked later at 5.1% in September 2011, but now is declining and reached 3.5% in July 2012. Even with the recent improvement in income growth, the growth rate in consumption still exceeds the growth rate in disposable income.

Notice in **Chart 4** that spending growth tends to lead income growth. This relationship is consistent with changes in consumer confidence. When confidence declines consumers reduce spending in anticipation of harder times ahead. To a certain extent such anticipation can be self-fulfilling.

However, over the last several months the relationship has reversed, with income growth leading spending growth. This reversal suggests that consumers are trying to maintain their standard of living in spite of slower income growth.

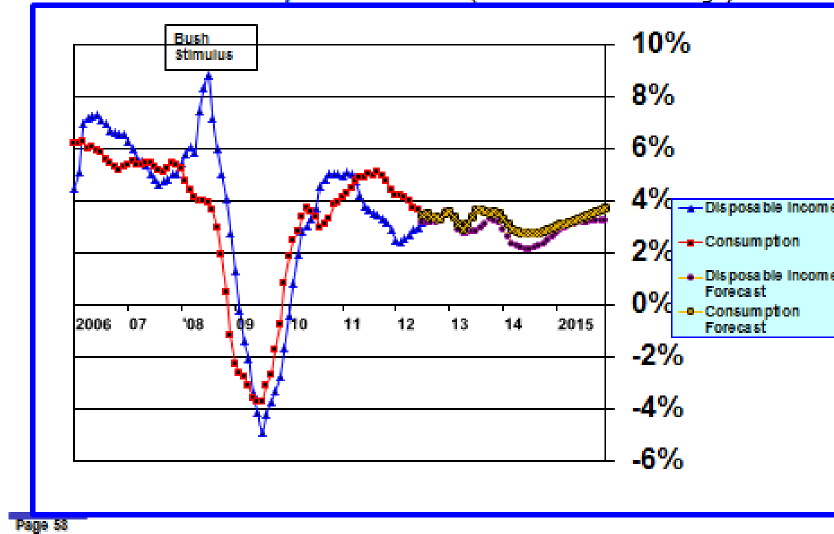
3. Disposable Income and Spending — Forecast

Chart 5 shows the forecast growth rate for nominal disposable income and consumption through 2015 based on "Bill's Slow Growth" forecast. The forecast projects a decline in nominal spending growth and an increase in nominal disposable income with convergence occurring by late 2012. Thereafter, both growth rates remain mired at low nominal levels ranging between 2.1% and 3.7% and averaging about 3.0%. This is about half the level of the average nominal growth rate of approximately 6% between 1985 and 2007. This significant decrease is due in part to a fall in the inflation rate, in part to slower population growth, and in part to lower productivity growth. Of these three factors lower productivity growth is the most important because it signals slower improvement in the standard of living.

4. Other Factors Influencing the Willingness of Consumers to Spend

Consumer Confidence. There is a positive correlation between the strength of consumer expectations about future performance of the economy and their willingness to spend. B of A's pessimistic GDP forecast for

CHART 5 – Forecast Nominal Disposable Income and Consumption Growth (12-month rate of change)



the second half of 2012 is based in part on its forecast that consumer anxieties about how Congress might resolve tax and spending issues and how those decisions might impact employment prospects and take-home pay will prompt consumers to delay spending, particularly for big ticket items such as autos. To date, auto sales have held up well. In fact, sales of light vehicles increased from an annual rate of 14.1 million in July to 14.5 million in August. The strength in auto sales appears to be supported by an increase in lending to subprime borrowers, which currently comprises about 25% of total auto loans.

Consumer confidence measures remain mired at recession levels as they have ever since the Great Recession began in December 2007. The University of Michigan's expectations index edged down in August to 65.1 which is the lowest it has been since December 2001 in the aftermath of 9-11. In an interview, survey director Richard Curtin commented that "...half of those surveyed said their financial situation was worse today than it was five years ago ...and a vast majority expect there to be no wage growth in the year ahead."

Household Net Worth. Net worth rose 2.4% in the 12 months ending

March 2012. There should be a further modest improvement when second quarter data are released on September 20, 2012. Housing and stock prices, two of the primary drivers of changes in net worth, were relatively stable during the second quarter. In addition, household debt should be stable or edge down a bit.

Empirical studies indicate that changes in wealth filter into consumer spending over time in an amount ranging between 3% and 6% of the increase in wealth. My econometric analysis indicates that improving housing and stock market wealth should add about 7% to nominal consumer spending in 2012 or about $29 billion of the forecast $422 billion increase in spending.

V. Employment

August's employment report disappointed market expectations but was generally consistent with the pattern of very weak employment growth that has persisted since March.

1. Payroll and Household Reports

Payrolls grew 96,000 in August compared to the consensus expectation of 130,000. The prior two months were revised down by a combined 41,000. Monthly payroll growth has averaged 143,000 so far this year, but only 105,000 over the last six months.

The household employment survey revealed that 118,000 jobs were lost in August, bringing the loss in jobs to 313,000 over the last two months. Household employment has increased only 36,000 since February. These data reflect a very stressed labor market.

Over the longer term the payroll and household surveys track each other reasonably well but can diverge considerably on a month-to-month basis. While the household survey is never revised, the payroll survey is benchmarked annually to adjust for the entry and exit of small establishments. During periods of economic expansion benchmarking usually adds jobs to the payroll survey. The next benchmarking of payroll data will occur in January 2013 and will update payroll data through December 2012.

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Other employment measures deteriorated in August. The private payroll diffusion index, which measures the percentage of industries increasing employment, edged down to 50.2 in August compared to 54.3 in July. The deterioration in the manufacturing industry sub-index was much worse — 36.4 in August versus 50.6 in July. Collectively, manufacturing industries added 15,000 payroll jobs in August, but the momentum is clearly negative. Temporary employment, usually viewed as a leading indicator of labor market trends, declined 5,000 in August. The number of people looking for work for five weeks or less rose 133,000 and the median duration of unemployment rose from 16.7 to 18.0 weeks.

2. Unemployment Rate

Unemployment fell 250,000 in August and the unemployment rate improved to 8.1% from 8.3% in July. While this might seem to be good news, it is actually very bad news. The labor force shrank 368,000 in August and the number employed fell 118,000. This means that the entirety of the reduction in unemployed workers was the result of exit from the labor force rather than becoming reemployed.

There is little optimism among forecasters about the potential for significant reductions in the unemployment rate over the next two years. **Chart 6** shows projections for the unemployment rate for "Bill's Slow Growth" scenario, the FOMC's high and low projections and CBO's **baseline scenario**. The high and low FOMC unemployment numbers at the far right of the chart are not forecasts; rather they are the FOMC's upper (6.0%) and lower (5.2%) bounds for the long-run non-accelerating inflation rate of unemployment (NAIRU), often referred to as the natural rate of unemployment.

At its September meeting the FOMC tightened slightly its projected range for the unemployment rate in 2013. Reflecting its new found optimism for GDP growth in 2014, the FOMC reduced its project range for the unemployment rate in that year to 6.7% to 7.3%. It also added for the first time a projection for 2015 in which the unemployment rate continues to drop rapidly to a range of 6.0% to 6.8%. While not shown, GS forecasts that unemployment will fall only to 8.0% by the end of 2013 and B of A forecasts that unemployment will remain relatively stable and will be 8.2% at the end of 2013.

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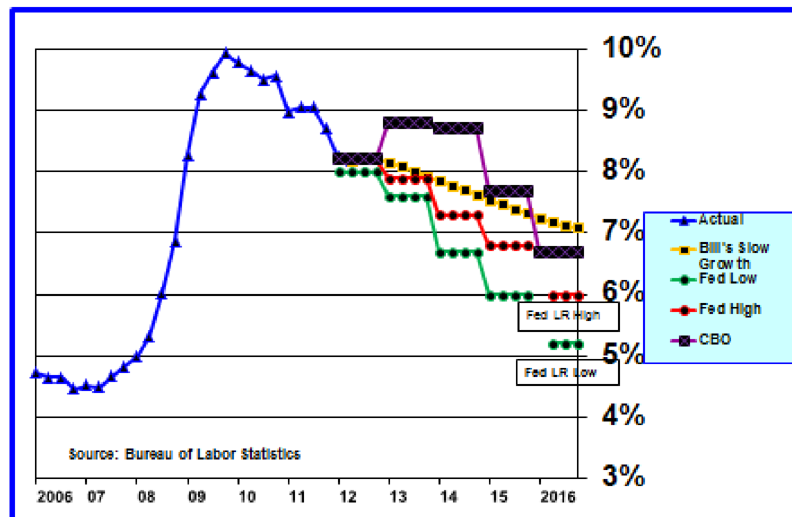

"Bill's Slow Growth" scenario projects a decline in unemployment to 7.9% by the end of 2013, 7.6% by the end of 2014 and 7.3% by the end of 2015. Unemployment rates could be lower than that if the recent phenomenon of workers dropping out of the labor force continues.

CBO's **baseline scenario** unemployment rate forecast assumes that Congress takes no action to prevent scheduled spending reductions and tax increases from taking effect on January 1, 2013. Recession follows and unemployment rises from 8.1% currently to an average of 8.8% in 2013 and 8.7% in 2014. The unemployment rate peaks at 9.1% in the fourth quarter of 2013.

3. Growth in Wages

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 at a very low level. Indeed, preliminary data for August suggest hourly and weekly wage rates are heading lower. This

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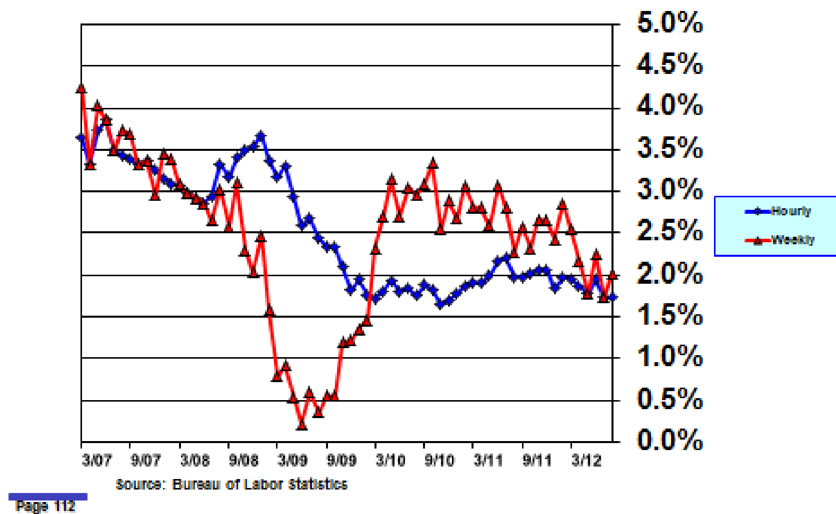
incipient trend may be revised away in future reports, but it is indicative of the absence of any bargaining power on the part of labor.

Chart 7 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 been relatively stable since then, although the latest data point shows only 1.7% growth over the last 12 months. 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, which is currently the case. 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. Indeed, the length of the workweek peaked at 34.6 hours in February and has since declined to 34.4 hours in August. This is not a good news story because it means that the

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rate of growth in take home pay has fallen from approximately 2.9% a year ago to 2.0% currently. This weakening trend in weekly wage increases is an important reason why the reported acceleration in aggregate personal and disposable income growth is suspect. Weekly wages have increased at an annual rate of 1.3% so far in 2012, but wage and salary disbursements, according to the national income accounts data, have increased at an annual rate of 6.0%, but the rate of increase has been only 2.2% over the last four months, which is more in line with the weekly wage data. My sense is that the BLS's weekly wage data are more reliable than the BEA's national income account data in gaging consumer spending power.

VI. Monetary Policy

At the conclusion of each meeting the Federal Open Market Committee (FOMC) releases a short statement that includes its assessment of the outlook for economic growth, the outlook for inflation, its policy stance and policy initiatives. At each quarter-end meeting, the FOMC publishes its projections for the next three years for real GDP growth, the PCE (personal consumption expenditures) price index, the core PCE price index, which excludes food and energy prices, the unemployment rate and the expected federal funds rate (see **Table 3** below for the September economic projections). Also, the Chairman of the Federal Reserve holds a press conference quarterly in conjunction with publication of updated economic projections.

1. September FOMC Meeting

With only one dissenting vote from the perennial dissenter Jeffrey Lacker, president of the Richmond Federal Reserve Bank, the FOMC approved an aggressive expansion of quantitative easing and extended its guidance for "exceptionally low levels for the federal funds rate" from the end of 2014 to mid-2015. Perhaps the only aspect of the FOMC's decision that could be characterized as timid was the mid-2015 date rather than an end of 2015 date. There was no timidity in what will now become known as QE3. The FOMC adopted an open ended program of purchasing $40 billion in agency mortgage-backed securities monthly until such time as the outlook for the labor market improves "substantially". This policy will be implemented in

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the context of the FOMC's price stability mandate. What this means is that if, for some reason, inflation or inflation expectations move above an acceptable level, the FOMC would probably reduce or eliminate its large scale asset purchase program.

There are two more FOMC meetings this year. The next meeting is scheduled for October 23 and 24 and there is one in December. No further significant policy actions appear likely until 2013 at the earliest.

Growth Outlook. Relative to its August statement, the FOMC upgraded its summary statement on growth from *"... economic activity decelerated somewhat over the first half of this year"* to *"... economic activity has continued to expand at a moderate pace in recent months."* It acknowledged *"that growth in business fixed investment appears to have slowed"* The statement on housing was modestly more upbeat: *"The housing sector has shown some further signs of improvement, albeit from a depressed level."* The sentence about household spending was also a bit more positive: *"Household spending has continued to advance"* versus *"Household spending has been rising at a somewhat slower pace than earlier in the year."* There was no significant change in the statement regarding the labor market.

Inflation Outlook. In September the FOMC stated that: *"Inflation has been subdued"* and noted that *"prices of some key commodities have increased recently."* The wording in August was that *"Inflation has declined since earlier this year."* Although this might be interpreted as reflecting at slightly greater concern about trends in inflation, the FOMC repeated word-for-word that *"longer-term inflation expectations have remained stable"* and repeated its policy statement, also word-for-word: *"The Committee also anticipates that inflation over the medium term likely would run at or below its 2-percent objective."*

Risks to the Outlook. The FOMC used very strong and blunt language: *"The Committee is concerned that, without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions."* The sentence about significant downside risks posed by global financial markets was unchanged from the August statement.

Policy Stance. Three policy changes were announced and policies in process were reaffirmed. First, the Committee extended the time period for

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"exceptionally low levels of the federal funds rate" from late-2014 to mid-2015. It could be argued that this change merely maintains the status quo since eight months has elapsed since the late-2014 date was established in January and this only extends the guidance by six months.

Second, the FOMC announced an open-ended large scale asset purchase program involving purchase of $40 billion in agency mortgage-backed securities monthly until such time as the labor market improves substantially or inflation threatens to breach the FOMC's price stability target of 2%. *"If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."*

Third, the FOMC added a new strong qualitative statement of its long-term intent: ***"To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for considerable time after the economic recovery strengthens."***

Operation Twist, which has been underway since June, will continue unchanged through the end of the year. According to the FOMC statement, coupled with the new asset purchase program, this will add about $85 billion monthly to the Fed's holdings of long-term securities through the end of 2012. The FOMC also reaffirmed the policy of reinvesting principal maturities and prepayments in new long-term asset purchases.

In addition to supporting more rapid economic recovery and a stronger labor market, the FOMC expects its policy actions to: *"...put downward pressure on longer term interest rates, support mortgage markets, and to help make broader financial conditions more accommodative."*

2. Economic Projections

GDP growth and unemployment rate projections were upgraded for 2013 and 2014 and the first projections for 2015 were introduced (see **Table 3**). The FOMC's upgraded projections are very optimistic relative to nearly all other forecasts. A cynical interpretation might be that the FOMC believes so fervently in the efficacy of its newly announced aggressive QE3 policy to

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Table 3
Economic Projections of Federal Reserve Board Members And Federal Reserve Bank Presidents, September 2012

Variable		Central Tendency				
		2012	2013	2014	2015	Longer Run
Real GDP %	*Sept*	*1.7 - 2.0*	*2.5 - 3.0*	*3.0 - 3.8*	*3.0 - 3.8*	*2.3 - 2.5*
	June	1.9 - 2.4	2.2 - 2.8	3.0 - 3.5		2.3 - 2.5
Unemp. Rate %	*Sept*	*8.0 - 8.2*	*7.6 - 7.9*	*6.7 - 7.3*	*6.0 - 6.8*	*5.2 - 6.0*
	June	8.0 - 8.2	7.5 - 8.0	7.0 - 7.7		5.2 - 6.0
PCE Inflation %	*Sept*	*1.7 - 1.8*	*1.6 - 2.0*	*1.6 - 2.0*	*1.8 - 2.0*	*2.0*
	June	1.2 - 2.7	1.5 - 2.0	1.5 - 2.0	2.0	2.0
Core PCE %	*Sept*	*1.7 - 1.9*	*1.7 - 2.0*	*1.8 - 2.0*	*1.9 - 2.0*	
	June	1.7 - 2.0	1.6 - 2.0	1.6 - 2.0	1.8 - 2.0	

lift economic activity that it needed to make sure that its economic projections are consistent with this belief. Not all share the FOMC's beliefs and optimism and many fret about the long-term potential consequences of the Fed's ballooning balance sheet.

3. Will The Fed's Aggressive Monetary Policy Easing Make Any Difference?

Even though the traditional role of monetary policy of stimulating additional borrowing is impaired by still dysfunctional credit markets, monetary policy easing can still have other benefits.

Extension of the time period for the federal funds to remain effectively at zero and additional asset purchases should be positive for stock prices for two reasons. First, we know from experience and statistical analyses that similar policies have lowered long-term rates and flattened the yield curve over the last four years. Depressing long-term bond yields makes dividend yields on stocks more attractive and provides price support for stocks.

But, given low long-term interest rates and the guarantee that they will remain low for an extended period, stock prices have not risen as much as would be expected. This is probably because of the enormous uncertainties posed by the European sovereign debt crisis and the U.S. fiscal cliff. The equity risk premium is more than 200 basis points above its long-term norm

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of approximately 6%. This suggests that if these policy uncertainties could be resolved favorably, stock prices would rise and perhaps to a considerable degree. Although uncertainties surrounding the fiscal cliff have not diminished one bit, near-term financial risks in Europe have lessened considerably. Overall financial conditions in the U.S. have eased substantially since earlier this year. In fact, the recent rally in stock prices and the plunge in volatility provide evidence that the impact on financial asset prices is working as intended.

Second, long-term rates that are guaranteed to stay low for a long period of time encourage greater risk taking. This encourages yield curve maturity mismatching by financing the purchase of long-maturity financial assets with short-term funding. It also encourages moving from low yield, low risk assets to higher risk assets, such as high yield bonds. Credit spreads have tightened dramatically since earlier this year.

A byproduct of higher stock prices is greater wealth and some of the increased wealth will eventually boost consumer spending.

Further, easing also will help ease financial conditions by compressing credit spreads on riskier assets. Research indicates that easier financial conditions have a favorable impact on GDP growth.

Nonetheless, the link between financial asset prices and employment is indirect at best. Many bankers have had plenty of money to lend for a long time and few creditworthy places to put it. They are skeptical that greater amounts of liquidity at slightly lower interest rates will result in any material change in lending activity. In fact, bankers are worrying about the ever compressing margin between asset and funding rates and their ability to earn an acceptable return on capital in a low-rate, flat yield curve world. Or, put in economist terms, when the financial system is caught in a liquidity trap no amount of liquidity at low prices will have any appreciable impact on lending and economic activity.

Those who worry about the future fret about the explosion in the Fed's balance sheet. To them the Fed is printing money even if that money is currently relatively idle in a liquidity-trap world. Once the economic recovery begins to gather momentum, they worry that the all too abundant liquidity will fuel inflationary expectations and unleash a virulent bout of inflation. The reality is that we really don't know how all of this will play out. Perhaps

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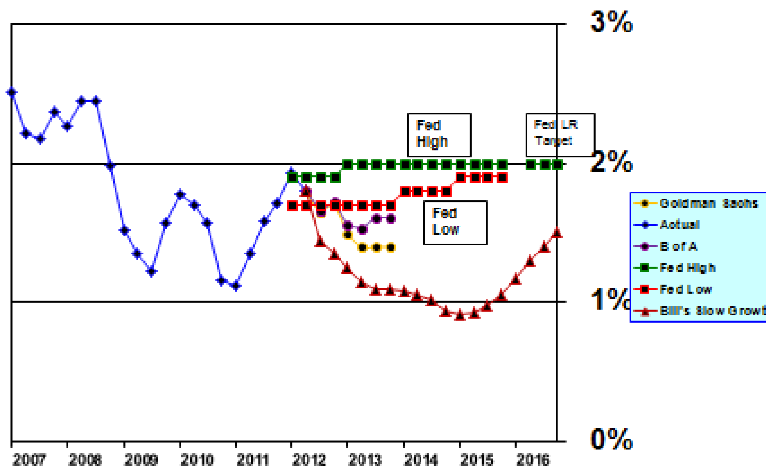
the Fed's policy is just what is needed to get the economy going again and avoid the deflationary consequences of a debt deleveraging world. But, what if the Fed's policy has the unintended consequence of reigniting speculative and excessive debt creation?

What we know from history is that when policymakers tinker in a way that creates large economic imbalances, those imbalances eventually will have to be unwound. And we also know from history that the unwinding process often is ugly and painful.

4. Inflation

Chart 8 shows the FOMC's high and low projections for inflation. Both

CHART 8 – Core PCE Inflation Forecasts
(percentage change over previous 12 months)



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B of A's and GS's forecasts track below the low FOMC projection. While these forecasts do not reflect serious concern about potential deflation, all of them project a lower rate of inflation than the FOMC believes is desirable. "Bill's Slow Growth" scenario projects an even greater downward trajectory for inflation. This more pessimistic projection indicates the direction of

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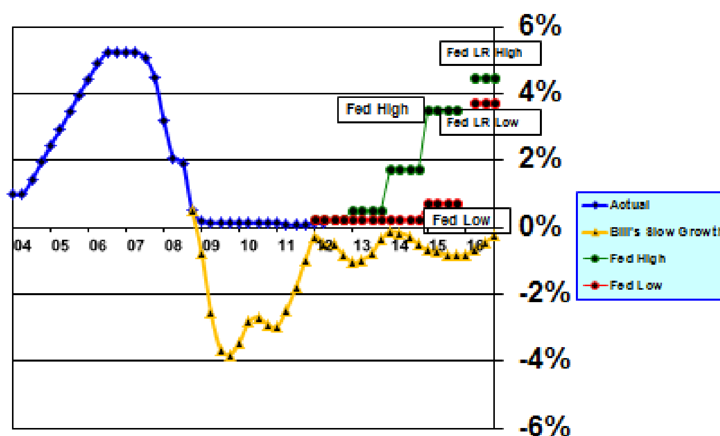
risks to inflation but probably overstates the extent of that risk. Because wages are sticky in the downward direction, downward pressures on inflation, notwithstanding the very large output gap, are likely to be contained.

5. Federal Funds Rate

The FOMC's high and low range for its federal funds rate projections is shown in **Chart 9**. The FOMC does not report its projections in this way.

CHART 9 – Federal Funds Rate Forecast



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I derived the high and low boundaries of the central tendency range by eliminating the three highest and three lowest projections. This is the same methodology the FOMC uses for the central tendency ranges for projections of other economic variables.

Comparing the distribution of FOMC participant estimates for the federal funds rate between the June and September meetings reveals a systematic downgrading which is supportive of the change in guidance from late-2014 to mid-2015. 13 of the 19 participants do not expect the first federal funds rate increase to occur before 2015 and one of those does not

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expect the first rate hike to occur until 2016.

In June the median federal funds rate estimate for the end of 2014 was 0.50% and the average of all 19 estimates was 1.11%. In September the median fell to 0.25% (consistent with current policy) and the average was 0.80%. There were no estimates for 2015 in June. The September projections indicate a median federal funds rate of 1.00% by the end of 2015 and an average of 1.72%. As discussed in the next paragraph, my econometric model indicates that the federal funds rate should remain at zero well into 2016. The only caveat to that forecast is that it is based on slow recovery in the labor market. If the Fed's more optimistic view about economic recovery and a more rapidly falling unemployment rate turns out to be on the mark, then the Fed's current rate guidance is reasonable. But, my advice is to view the rate outlook as a range of possibilities in which the Fed's view is at the more optimistic end of the range, notwithstanding the fact that the average is a collection of 19 individual estimates. By the way, one of the 19 does believe that the federal funds rate will be effectively zero at the end of 2015 and 2 believe it will only rise to 0.50%.

The only alternative federal funds rate forecast shown in **Chart 9** is "Bill's Slow Growth" scenario. It implies that the FOMC could have extended its guidance for maintaining exceptionally low levels for the federal funds rate beyond mid-2015. In fact, Bill's Slow Growth" scenario suggests that the first increase in the federal funds rate might not occur until mid-2016 or later.

VII. U.S. Presidential and Congressional Elections

Congress will be in session for only a few more days prior to the presidential election. Legislation dealing with various aspects of the looming fiscal cliff will be deferred until after the election and probably little of real consequence will occur until the next Congress convenes in January. All Congress is likely to do prior to the election is to pass a continuing resolution to fund the government through March 31, 2013. There probably will be votes on various Republican and Democratic tax bills but none will be enacted.

Both political parties have elected to take their policy views to the people. The Republican nominee, Mitt Romney, sharpened the focus of the

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debate when he selected Paul Ryan to be his running mate. Ryan is the author of the Republican budget which slashes spending, drastically reforms Medicare and cuts the budget deficit over a ten-year period. The House of Representatives has passed the Ryan budget several times. The Senate has rejected it.

Resolution of fiscal cliff issues will turn on the outcome of the elections and the outcome is far from certain. The presidential race is close to a dead heat and the Senate could go either way. Most political analysts believe Republicans will retain control of the House, perhaps with a smaller majority.

1. Obama's Job Approval Rating and National Election Lead

Historically, when an incumbent president's job approval rating is less than 50%, re-election is not assured. Obama's approval rating has been consistently less than 50% for many months (see **Table 4**).

Table 4
Obama Job Approval Rating and Presidential Election Lead

Date	Obama Job Approval	Obama Election Lead*
August 14	48.0%	+4.0%
August 21	48.7%	+2.5%
August 28	47.9%	+1.1%
September 5	47.2%	+0.1%
September 12	49.6%	+3.6%

*Average of Polls

Subsequent to the Democratic convention, Obama's lead over Romney widened out to +3.6% as Obama benefited from the traditional post-convention boost. However, the disappointing employment report on September 7 may limit this bounce.

Many believe the key to the presidential election's outcome will be independent voters. Polls indicate that each party will likely capture the votes of about 90% of those identifying themselves as preferring their party. With

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respect to independents Republicans currently have a small edge. There is some polling evidence that Romney's favorability rating has improved among independent voters. If that trend holds it would likely boost Romney's election prospects.

2. Obama's Polling Margin in Key States

As we know from the 2000 election, a candidate can win the popular vote, but lose in the Electoral College. Thus, it is important to monitor the electoral vote count and watch closely contested states. **Table 5** shows

Table 5
Presidential Election — State Matchups

State	Obama Lead*
Colorado	+3.4%
Florida	+2.0%
Iowa	+0.2%
Michigan	+4.0%
North Carolina	-3.5%
Ohio	+3.0%
Pennsylvania	+7.7%
Virginia	-0.8%
Wisconsin	+1.4%

*As of September 12, 2012

Obama's lead over Romney in key states as of September 12, 2012. With the exception of Pennsylvania, all polling results are within the margin of statistical error. Because state polls are usually based on small sample sizes, the margin of error is generally much greater than it is for a national poll.

It takes 270 electoral votes to win. Recent polling results suggest Obama has 237 (167-solid, 19-likely and 51-lean); Romney has 206 (156-solid, 25-likely and 25-lean); and 95 are too close to call. Keep your eyes on Colorado, Florida, Iowa, New Hampshire, Nevada, Ohio, Virginia and Wisconsin.

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VIII. The Fiscal Cliff Is Less Than Four Months Away

Congress, in its infinite wisdom has scheduled spending cuts and tax increases amounting to more than $700 billion annually to take effect on January 1, 2013. In addition, the federal debt ceiling will become binding at about the same time.

1. Components of the Fiscal Cliff

Table 6 shows the components of the fiscal cliff and the values of each based on analysis conducted by CBO. The first column in **Table 6**

Table 6
Components of the Impending Year End Fiscal Cliff

2013 Fiscal Policy Shock

- *Enormous Fiscal Shock ($607 billion FY2013; $720 billion Calendar 2013) Hits January 1, 2013*

	FY 2013	Cal. Year 2013
Bush Tax Cuts	$221	$255
Payroll Taxes	$95	$112
Other (e.g. AMT)	$65	
ObamaCare	$18	$21
Automatic Spending Cuts	$65	$109
Unemp. Benefits	$26	
Medicare Physicians	$11	
Other	$105	
Total	**$607**	**$720**
Dynamic Feedbacks	($47)	
Adjusted Total	**$560**	

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Source: Congressional Budget Office

is for fiscal year 2013, but since the fiscal year begins on October 1 and all of the fiscal cliff items are effective January 1, the numbers in this column

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cover only nine months. The next column extrapolates some of the items to a full 2013 calendar impact. Collectively, if Congress does nothing, there could be a negative shock equal to as much as 4.5% of GDP.

Most assume Congress will reach some kind of compromise that avoids the full impact of the fiscal cliff. But, ideological differences between Republicans and Democrats are significant. And, of course, political dynamics will turn on the outcome of the presidential and congressional elections.

Bush Tax Cuts. Both parties agree that the Bush tax cuts should be extended to those earning less than $250,000. A compromise, suggested by some Senate Democrats, would be to extend the cuts for everyone earning less than $1 million.

Payroll Taxes. Neither party appears to have a great deal of enthusiasm about extending the 2% payroll tax cut. CBO assumes in its alternative economic scenario that this tax break will not be renewed.

Alternative Minimum Tax (AMT) and Other Tax Breaks. AMT has always been extended and will be again. The Senate Finance Committee legislation on tax extenders provides a reasonable guide for other tax breaks. The current legislation implies that about $16 billion in tax benefits would disappear over calendar year 2013.

Affordable Health Care Act. This is the 3.8% tax on investment income primarily impacting high income individuals which is scheduled to take effect in 2013. The probability of repeal, given the Supreme Court's decision, is low.

Automatic Spending Cuts (Sequester). Neither party likes this requirement of the Budget Control Act because it has a heavy impact on defense spending. Entitlement spending and some low-income household tax programs were exempted. It seems likely that the sequester will eventually be replaced by targeted spending cuts. But, it will be very difficult to achieve political consensus. There is the possibility that the automatic spending cuts will become effective as scheduled if Congress cannot reach agreement prior to January 1. Of course, it is also possible that the Congress may defer the effective date of the sequester to buy time to work out a compromise. In the long run only a small portion, if any, of the $109 billion in automatic spending cuts is likely to take effect.

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Extended Unemployment Benefits. This benefit is already on a phase-out schedule. Further extension, if any, is likely to be limited.

Medicare Physicians "Doc Fix". Unless the "Doc Fix" is extended, payments to providers would be cut 27%. Such a cut is so onerous that Congress has always deferred implementation in the past and is likely to do so again.

Other. Although this is a big number, it is composed of many items. Some are probably included in the Senate Finance Committee tax extenders legislation. However, it isn't clear which of these or the potential amount that might actually take effect on January 1, 2013.

2. Potential Economic Consequences of the Fiscal Cliff – CBO Analysis

Uncertainty about what Congress will do could depress economic activity in the second half of 2012. That is B of A's view. B of A expects GDP to grow only 1.3% in the third quarter and 1.0% in the fourth quarter. Other forecasters are less concerned. All of the forecasts discussed in Section II, except for B of A, do not include a negative uncertainty impact in 2012 for the impending fiscal cliff.

It is likely that most of the fiscal cliff issues will not take effect. GS expects the overall negative impact of fiscal policy on GDP in 2013 to average about -1.0%, with the largest impact occurring in the first quarter and diminishing quarter-by-quarter during the remainder of 2013.

In August, CBO released two economic forecasts. The ***baseline scenario*** presumes all spending cuts and tax increases mandated by current law take effect as scheduled and Congress makes no changes. The ***alternative scenario*** assumes that the Bush tax cuts are extended, implementation of AMT provisions is deferred, the cuts in Medicare physician payments are deferred, the sequester is repealed and the impact of certain other expiring tax provisions, which are usually renewed, is retained.

Table 6 indicates that the ***baseline scenario*** would reduce the deficit by about $560 billion in fiscal year 2013 and close to $700 billion in calendar year 2013. The difference in CBO's fiscal year 2013 deficit between the

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baseline and alternative scenarios is $396 billion (about 2.5% of GDP); the difference rises to $537 billion (about 3.2% of GDP) in fiscal year 2014.

Table 7 shows the CBO's fiscal year deficit estimates and the aggregate

Table 7
Annual Budget Deficits and Public-Debt-To-GDP Ratio Under CBO Baseline and Alternative Scenarios
(percent)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
BUDGET DEFICIT											
Baseline	7.3	4.0	2.4	1.2	1.0	0.6	0.4	0.6	0.6	0.9	1.1
Alternative	7.3	6.5	5.6	4.6	4.5	4.2	4.2	4.6	4.8	5.1	5.5
Bill-CBO	7.5	6.5	5.5	4.7	4.6	4.4					
Bill - Slow Growth	7.5	5.9	4.4	3.4	3.2	3.0					
PUBLIC-DEBT-TO-GDP RATIO											
Baseline	72.8	76.1	76.6	73.8	70.8	67.9	65.2	63.2	61.4	59.8	58.5
Alternative	73.8	78.6	82.3	82.5	82.5	82.5	82.9	84.1	85.7	87.5	89.7
Bill-CBO	72.3	75.8	79.0	80.8	82.1	83.1					
Bill - Slow Growth	72.3	75.4	77.6	78.4	78.7	78.9					

debt held by the public as a percentage of nominal GDP for the ***baseline*** and ***alternative scenarios***. Estimates are shown for 2012 — 2022. For comparative purposes the same data derived from Bill's "Slow Growth" scenario are shown for 2012 — 2017. In Bill's "CBO — Slow Growth" scenario, the annual fiscal deficits are assumed to be the same as CBO's ***alternative scenario***. However, Bill's annual deficits differ due to small differences in forecast nominal GDP. Also shown in **Table 7** is Bill's "Slow Growth" scenario which on balance incorporates a somewhat more rapid decline in annual budget deficits than those in CBO's ***alternative scenario***.

CBO forecasts that GDP will rise 1.7% in 2013 under the ***alternative scenario*** versus declining -0.5% under the ***baseline scenario***. The ***baseline scenario*** catapults the economy into a sharp recession during the first half of 2013. Most, including myself, expect Congress to take action to avoid this outcome. However, the ***alternative scenario***, while avoiding an immediate recession, leads to a steady and troublesome increase in the public-debt-to-GDP ratio.

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My sense is that Congress will try to find a middle ground between the two scenarios which stabilizes the public-debt-to-GDP ratio between 75% and 80%. Once the economy strengthens, the risks of lower deficits will diminish. Thus, an optimal strategy would be to stabilize the public-debt-to-GDP ratio over the next three years and then begin to bring it down gradually. Bill's "Slow Growth" scenario, as shown in **Table 7**, incorporates a stabilization assumption occurring over the 2014-17 period. Hopefully by the end of that period the economy would be healthy enough to handle the risks of more aggressive reduction in annual budget deficits.

3. Mechanics of the Sequester

Everyone detests the sequester mandated by the Budget Control Act. Thus, it is likely to be eliminated. However, because it automatically goes into effect on January 1, 2013, unless Congress acts to eliminate it or defer the effective date prior to January 1, 2013, it will have at least a temporary impact. Because no one knows what Congress will do, preparations are already under way to implement the requirements of the sequester.

Congress passed a law in August requiring the Office of Management and Budget (OMB) to provide specifics of how the sequester is to be implemented. OMB was given 30 days to prepare this report.

Beginning January 1, 2013 federal expenditures will be reduced at an annual rate of approximately $109 billion, evenly split between defense (95%)/homeland security (5%) and other discretionary domestic programs. Certain spending programs benefiting low-income households are exempted. Approximately $17 billion of the $55 billion reduction in discretionary spending will come from a 2% reduction in Medicare reimbursement rates; the remaining $38 billion comes out of other discretionary domestic spending. These cuts amount to a 10% reduction in the defense budget and 8% reduction in other discretionary spending.

Percentage spending cuts apply equally to each budget category. Only within a budget category will there be flexibility to allocate the cuts. For example, there are 2,500 different accounts within the Defense Department's investment budget and each must be cut by the same percentage.

Because the sequester is so blunt and onerous, it is unlikely to be permit-

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ted to take effect. However, a political compromise to eliminate it is likely to result in tighter aggregate spending caps, which would retain some of the intended impact of the sequester but permit judgment as to exactly what programs should be cut.

4. Medicare

As currently designed Medicare expenditures will grow much more rapidly than GDP. Medicare tax revenues are insufficient to cover burgeoning expenditures. Thus, if no changes are made, the federal government will have to borrow to meet the shortfall between revenues and expenditures. This is the primary contributing factor in CBO's projected increase in its alternative budget scenario in the public-debt-to-GDP ratio from 72% in 2012 to 90% in 2022.

There are three factors driving the Medicare budgetary problem. First, the population is aging which means that a growing percentage of the population will receive benefits over time. Second, health care costs are rising about 1.5 percentage points faster than the growth rate in nominal GDP. Third, Medicare tax revenues are insufficient to cover projected expenditures.

Reform of Medicare will require Congress to address four issues:

- **The amount of the cost the beneficiary should pay for directly**. If the amount is too small, beneficiaries will not have the incentive to use medical services judiciously. If the amount is too large, lower income seniors will have difficulty bearing the cost and might postpone or not seek treatment. Delay in treatment generally leads to higher overall costs in the long run.
- **Administration of Medicare**. Medicare currently does a weak job of controlling expenses. Insurance companies aggressively control costs but at high administrative expense. The question is one of whether a more cost effective administrative system can be devised to manage service usage and charge rates.
- **Service usage**. This involves determining how a third party regulates the doctor-patient decision to use medical services.

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- **Providing incentives that reward desirable outcomes cost effectively**. The current system encourages numerous and expensive tests, many of which are probably unnecessary.

Republicans favor implementing a voucher system that is indexed to inflation. Patients would be required to pay directly for a portion of medical services through deductibles and co-pays. Importantly, because the vouchers would be indexed to the general inflation rate rather than to the medical inflation rate, which has been running about 1.5% higher annually, it is presumed that medical expense increases would be forced to rise no faster than the overall inflation rate. Co-pays and deductibles would provide user incentives to manage the cost of health care. But, as pointed out in the first issue above, program design would need to be carefully structured to avoid discouraging patients from using needed medical services.

Democrats generally favor an administrative approach that controls expenditures to providers. However, if cost controls are too onerous, the quality of medical services could deteriorate. Administrative cost control is subject to political pressures as witnessed by the never-ending deferral through the “Doc Fix”.

These alternative approaches deal only with the demand for medical services. Neither political party addresses supply. Every student of economics learns that price is determined by the intersection of supply and demand. Lowering the cost of Medicare requires both an increase in supply and limitations on demand for medical services. Supply currently is arbitrarily restricted through medical school physician graduate quotas. Supply is also constricted though the way in which proprietary medical facilities are administered.

5. Ryan Budget

Paul Ryan is the principal architect of the Republican 10-year budget. While this budget has passed the House of Representatives several times, the Senate has rejected it. The importance of the Ryan budget has increased because of Romney’s decision to make Ryan his vice presidential running mate. If Romney wins and the Republicans win both the House and Senate in November, the stage will be set for the Ryan budget to be the principal

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vehicle for crafting congressional resolution to the various elements of the fiscal cliff.

Ryan's budget reduces the 10-year projected deficit total by about the same amount as the Simpson-Bowles Fiscal Commission's recommendations, but there are some importance differences in details. As originally proposed in April 2011 the Ryan budget would:

- Reduce discretionary non-security spending to 2006 levels; freeze spending at those levels for five years and then permit subsequent increases to match inflation.
- Defense would be cut $78 billion and then permitted to rise at the rate of inflation.
- Repeal all spending and tax increases in the Affordable Care Act; block grant Medicaid; and restructure Medicare to a premium support (voucher) system for those currently under the age of 55 under which beneficiaries will choose an eligible insurer (takes effect in 2022; those 55 and over would continue to participate in the existing Medicare program; subsidies would be provided for low-income individuals); eliminate scheduled cuts in payments to providers (Doc Fix).
- Institute tort reform.
- Mandate a process to assure solvency in Social Security, if the program is projected to become insolvent.
- Reduce various tax expenditures programs such as farm programs, food stamps, federal retirement, and student loans.
- Extend permanently all of the Bush tax cuts.

One little known fact about the Ryan budget is that it mandates $897 billion in unspecified spending cuts over ten years. While the public generally supports the policy of cutting government deficits, there is considerable opposition to cutting specific programs. The reality of the Ryan budget is that the deficit reduction target cannot be achieved unless popular programs are cut. But, enumerating what programs are to be cut would cost votes. So, details are left to be resolved at a later time when the elections are over and, presumably, the Republicans are in control of the legislative agenda.

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According to a CBO analysis, if Ryan's budget were adopted as proposed, federal spending net of Social Security, Medicare and Medicaid would fall from 12.5% of GDP in 2011 to 6.75% in 2023, 5.75% in 2030, 4.75% in 2040 and 3.75% in 2050. Historically, the percentage of GDP going to such spending has never been less than 8% in any year since World War II. Romney has committed to maintain a defense budget of at least 4% of GDP.

So, there are fudges in the Ryan budget. But, of course, these would be fixed in the future. The point of the Ryan budget is to reduce the size of the federal government to a substantial degree by shrinking many of the social welfare programs that became standard policy over the last 80 years.

6. U.S. Treasury Debt Downgrade Risk

Moody's stated on September 11, 2012 that it is likely to downgrade U.S. Treasury debt from Aaa unless Congress takes action during 2013 to stabilize the public-debt-to-GDP ratio within the next few years. Moody placed the Treasury debt rating on negative outlook a few months ago. S&P and Fitch have issued similar statements.

IX. Recent Developments in Europe

Step by step European policymakers are stitching together policies that have calmed financial markets. The strategy appears to be one of buying as much time as possible to enable Eurozone (EZ) member countries to meet requirements of the Fiscal Stability Pact and restructure their economies to eliminate competitive imbalances that sowed the seeds of the sovereign debt crisis. In a monetary union, competitive imbalances cannot be resolved through the currency exchange rate mechanism. They can only be resolved through what is called "internal devaluation", which involves cutting government spending, reducing wages, removing laws and regulations that limit internal competition and then waiting for those measures to take effect and remove competitive differentials with other EZ member countries.

Internal devaluation is synonymous with austerity. It means recession, even depression, and risks political backlash. It is a painful solution mech-

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anism and one that takes a long time to work. But, that is the course that the EZ is on. For the moment, calm has been restored to financial markets because imminent risks of a financial market crisis have been defused, primarily by the European Central Bank (ECB). Only time will tell us whether the policies being put in place will work. I remain extremely skeptical. But, what is clearer now is that we won't have an answer to that question for a much longer period of time than I previously thought.

In the meantime European recession continues to develop and, not surprisingly, incoming data reports generally are worse than what had been forecast.

1. German Constitutional Court Decision Permits ESM

On September 12, 2012, the German constitutional court refused to issue an injunction prohibiting ratification of the European Stability Mechanism (ESM) by the German Bundestag. This was the last consequential hurdle standing in the way of implementing the ESM. The court did dictate that the liability the ESM poses to German taxpayers must be well defined and that the Bundestag must approve any increase in Germany's capital contribution above €190 billion. As currently designed the ESM will have a €500 billion lending capacity. Germany's share is 27.1%, but its required capital contribution is €80 billion; the remainder of Germany's 27.1% will eventually come through marketplace debt. The issue of defining liability was important when there was a possibility that the ESM would seek a banking license to leverage its lending capacity. However, the ECB's decision to buy unlimited amounts of EZ member country sovereign debt on the secondary market, coupled with the ESM's ability to buy new issue sovereign debt, eliminates for the time being the risk financial crisis will erupt and prevent market access to financing as has already occurred for Greece, Ireland and Portugal.

2. ECB Purchase of EZ Member Country Sovereign Debt — Outright Monetary Transactions (OMT)

On September 6, 2012, the ECB confirmed a policy, first articulated by ECB president Mario Draghi in August, to buy unlimited amounts of EZ member

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country sovereign debt on the secondary market once a member country has signed a memorandum of understanding (MOU) replete with significant conditions. The new policy has a name and an acronym — "Outright Monetary Transactions (OMT). The intent of OMT is two-fold. The first is to assure liquidity for sovereign debt and attempt to keep markets open for primary issuance of sovereign debt. If primary markets are closed, then the ESM is empowered to purchase directly issued sovereign debt. The second objective is to reduce the cost of borrowing and yield spreads on the debt of EZ member countries.

It seems very likely that Spain will be forced to sign such an agreement in coming weeks.

OMT has the following requirements and structure:

- An EZ country must sign an MOU before the ECB will initiate purchases of its sovereign debt on the secondary market.
- Purchases will occur only in the secondary market; purchases in the primary market will be made by the EFSF or ESM.
- Purchases of sovereign debt will be limited to maturities of one to three years. The intent of this requirement is to maintain a steep yield curve and enable banks to earn duration mismatch profits.
- There is no preset limit on the amount of purchases the ECB may make.
- Seniority will not be required; ECB purchases will be pari-passu with sovereign debt held by the private sector.
- There will be no targets on yields or yield spreads.
- Any purchases will be sterilized so as not to have a stimulative monetary policy impact. Sterilization most likely will be accomplished by offering an equivalent amount of term deposits to banks.
- Purchases will be disclosed once a week, but after bonds are purchased.

While German Chancellor Merkel endorsed OMT, The German Bundesbank was apoplectic and put out a public statement that the plan amounts to "financing governments by printing bank notes."

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Although no purchases will occur until after an MOU is signed, rates on Spanish debt immediately plunged. The threat to purchase bonds was sufficient to force speculators to liquidate short positions. And, of course, this is exactly the intent of the ECB's policy. This means that for now the risk of a speculator-induced financial crisis has been removed. This provides more time for other policies to work.

3. Purchase of Sovereign Debt By the ESM Is Unlikely To Be A Long-Term Viable Solution

Unless real progress is made in restoring economic growth and in shrinking sovereign debt-to-GDP ratios, secondary market purchases of Spanish and Italian sovereign debt to stabilize yields is unlikely to be successful in the long run. The situation is similar to a country trying to defend the value of its currency. Speculators drive down the value of a currency by selling it. However, countries can reverse the downward pressure on the value of the currency by buying it, thus restoring the supply-demand balance at the current exchange rate. But, if the underlying problems leading to speculator sales of a currency, such as substantial trade deficits or high inflation, are not resolved, there will be repeated speculative attacks on the currency which increase in scope over time. Eventually, a country will exhaust its capacity to buy back its own currency and defend its value. The denouement is usually a dramatic currency crisis which is resolved through devaluation, capital controls and heavy damage to the country's economy.

Key to defense of a currency is significant progress toward resolving imbalances that prompt speculative attacks and having sufficient capacity to purchase the currency to gain the time necessary to implement economic reforms. Similarly, key to keeping sovereign debt yields down is progress in Spain and Italy in reducing budget deficits, reducing their debt-to-GDP ratios and increasing economic growth and competitiveness.

Also key is the capacity of the ESM to purchase sovereign debt in the primary market to provide time for reform policies to become effective. The ESM's resources as currently configured are inadequate, although ECB purchases of sovereign debt on the secondary market go a long ways toward mitigating this limitation. When measured against the size of the ESM, the outstanding amount of Spanish and Italian sovereign debt dwarves by many times over the capacity of the ESM. The conclusion is straightforward. The

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ESM with the assistance of the ECB should be able to fend off speculative attacks on Spanish and Italian sovereign debt for a period of time. If the size of the ESM is increased, the time period for fending off speculative attacks could be extended.

However, the odds of long-run success are doubtful. Deteriorating economic conditions and ongoing divergences in competitiveness may result in troubled countries, such as Spain, being dependent on the ECB and ESM for financing for years. Moreover, only broader-based structural reforms in the economic, political and fiscal governance of the EZ and EU are necessary for a viable monetary union. Liquidity can buy time but liquidity cannot solve the fundamental problems.

4. Spain's Monumental Capital Flight Problem

If one is concerned that a bank will fail and that funds in the bank, if it fails, will be recoverable only in part or not at all, the prudent action is to withdrawn those funds and move them to a safer place. The same is true for countries in the EZ. If a country is forced to exit the EZ and issue a new devalued currency, investors, banks and businesses will incur substantial losses. It is better to be the first one out than to be left holding the bag. This is what fuels contagion and panic.

Capital flight is an especially big risk in the EZ because there are no cross-border capital controls. This enables massive capital flight at the first hint of possible exit, no matter how remote the prospect of it actually occurring might be. The problem of capital flight is that it starves an economy of the credit it needs to finance economic activity. There are mechanisms in the EZ, primarily the Target2 clearing system, that prevent capital flight from becoming an instantaneous liquidity problem which forces failure, as occurred in the case of Lehman Brothers. So liquidity can and has been replaced in troubled EZ countries such as Greece and Spain.

But this does not mean all is well. Liquidity has to come from somewhere, whether it is ECB LTROs or Target2 clearing balances. In spite of Germany's adamant opposition to debt mutualization because it transfers liabilities and potential losses of other EZ member countries to German taxpayers, ECB purchase of sovereign debt and Target2 clearing balances are just another means of achieving debt mutualization. But, the greater

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consequence is disruption of the credit granting mechanism within the impacted country. Austerity is already contributing to the economic downturn in Spain, but unwillingness, indeed inability, of Spanish banks to extend credit is also contributing to the economic damage.

During the second quarter capital flows out of Spain amounted to an astounding 50% of GDP. Data indicate that the outflow was broad-based. It involved outflows of funds for securities and bank deposits and both residents and nonresidents participated. Foreigners sold Spanish securities equal to 19.4% of GDP; Spanish residents moved deposits and other financial assets out of the country amounting to 16.7% of GDP; and foreigners liquidated banking claims in Spain amounting to 15.3% of GDP. Spanish residents continued to move substantial amounts of funds out of the country in July.

Perhaps the ECB's OMT program will be sufficient to stanch the outflows. It will be two or three months before the data will become available.

If this were not enough, several of Spain's regional governments are no longer able to borrow in private markets. Matters will continue to get worse as Spain's economy descends in ever deepening recession. A full-scale EU bailout is just a matter of time. When it comes it will tax the financial capacity of the EFSF/ESM and could result in a substantial amount of secondary market bond purchases by the ECB, perhaps far more than currently anticipated.

5. Crisis Recap[1]

There are four sets of economic problems confronting the EU: (1) bank solvency and tight financial conditions, (2) high sovereign debt-to-GDP ratios, (3) economic recession and (4) significant differences in competitiveness among member nations of the EZ. In addition political movements involving populism and nationalism are developing which threaten to undermine solutions intended to save and strengthen the monetary and political union and establish a fiscal union.

Bank Solvency and Tight Financial Conditions. Many European banks have high levels of troubled loans and sovereign debt whose market

[1] This section repeats commentary contained in the ***July Longbrake Letter***. It is retained as a reminder of the breadth and depth of the problems facing Europe.

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value is considerably less than book value. Many troubled loans are carry overs from aggressive lending prior to the global recession in 2008 and 2009. But, increasingly, recession is adversely impacting the quality of many other loans.

The decline in the value of bank assets and increasing credit quality issues have been exacerbated by the regulatory mandate to increase capital ratios and liquid assets. The easiest way to increase capital ratios is by curtailing lending and selling assets. However, such a response has resulted in a severe credit crunch which in turn is fueling recession. And in due course recession will lead to more credit defaults. It is a vicious circle and there is not yet light at the end of the tunnel.

For these reasons bank capital ratios, when marked to market, are declining and insolvency risks for weaker banks are escalating.

Banks with the weakest capitalization are experiencing deposit runs. The European Central Bank's (ECB) long-term refinancing operation (LTRO) late last year and early this year provided approximately €1 trillion in three-year liquidity at a 1% interest rate. LTRO has prevented liquidity insolvencies so far at individual banks.

High Sovereign Debt-to-GDP Ratios. High sovereign debt ratios and large current budget deficits raise investor doubts about a country's ability to service debt. As debt ratios rise, nations move from "hedge" to "speculative" to "Ponzi" financing. High levels of both debt and budget deficits lead at first to increasing interest rates. But, when markets begin to doubt a country's ability to service its debt, the market's willingness to provide financing shuts down and a bailout becomes necessary. So far this has happened to Greece, Ireland and Portugal. However, Spain is approaching the danger point and there is increasing discussion about the probable need for bailout assistance.

To date, bailouts provided by the European Financial Stability Facility (EFSF) and the International Monetary Fund (IMF) have come with severe conditionality requirements. Taxes must be increased, spending must be reduced, stringent budget deficit targets must be met and actions must be legislated to improve competitiveness. Collectively these conditional terms have imposed severe austerity on the nations receiving bailout funds and have spawned deep economic recessions.

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As time has passed, it has become apparent that austerity, rather than solving a country's sovereign debt problems, is making matters worse. This is because the denominator of the sovereign debt-to-GDP ratio is falling faster than the numerator. This is the same phenomenon as Irving Fisher's debt-deflation cycle — the more you pay the more you owe.

Recession. Responses to the first two problems have led to recession in many European countries. Because of the high level of economic integration in the European Union recessions in the various European countries are mutually reinforcing. Even Germany is likely to become infected.

To make matters worse, global economic growth has slowed rapidly in 2012 and will contribute to deepening recessions in Europe. Recent data releases all point to greater than expected declines in economic activity in many European countries.

Competitiveness. By and large the countries with the worst banking and sovereign debt problems are also the least competitive. When a country has its own currency it can restore competitiveness by devaluing its currency. This solution is not available in a monetary union. In Europe uncompetitive countries have only one option and that is to restore competitiveness through internal deflation. This means cutting wages, reducing pension benefits, modifying social safety net benefits and so forth. This is not only very painful and difficult politically to enforce, this solution also clobbers economic activity. In short, while it is a theoretical alternative to currency devaluation, internal devaluation will lead to the death of the patient long before the cure has a chance to work.

There is an alternative to internal devaluation and that is transfers of funds from strong countries, such as Germany, to weak countries. This is not a substitute for restoring competitiveness but it provides time and lessens the pain. Germany and other strong countries oppose monetary transfers because they fear moral hazard — once financial pressures have been lifted, recipient countries might return to the "bad behaviors" that got them into trouble in the first place.

Political Pressures. All 17 members of the Eurozone (EZ) are parliamentary democracies. This means that elected governments can be voted out of office. This has already happened in several countries.

Agreeing to policy changes, particularly if they involve treaty changes

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takes a very long time. Time is working against elected governments. Fringe parties are gaining traction and are feeding off of discontent. ***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. 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.

Ultimately, political forces, more than economic forces, will define the future of the EU and the 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 and political union to complement the monetary union. The political forces which are in the process of being unleashed are strongly pushing in the opposite direction — not toward greater integration but toward the reclaiming of national sovereignty. The political elite who fervently believe in the importance of a united Europe are losing ground to fringe political movements on both the right and the left which do not share the goal of union.

Summary. In coming months the EZ and EU will undergo significant change. The political elite are committed to the European Project of integration. Indeed, there is emerging agreement that the time has come to move in the direction of greater economic and fiscal integration to complement the monetary union. Reuters, citing an article in *Der Spiegel*, reported on August 26, 2012 that German Chancellor Merkel "...wants an EU convention to create a new treaty for closer European political unification to overcome the problem of sovereign debt crisis. However, the sheer complexity of reaching agreement and the cumbersome process of ratification of governance changes greatly limit the odds of success. As recession spreads and deepens, political centrifugal forces will build and will increasingly diminish the chances for broad-based acceptance of significant reforms. In this regard, the recent EU summit was disappointing because other than bank supervision no other integration issues were mentioned.

There is practically nothing in the reforms under discussion which would address in any material way the severe lack of competitiveness in the weaker countries. With recession deepening and sovereign debt and banking prob-

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lems worsening, already committed bailout financial resources are inadequate. The important question is whether there is capacity among the strong countries to provide additional financial resources in the quantity that might eventually be needed to avoid sovereign defaults.

I continue to believe that the complexity of the problems and the enormity of the obstacles to effecting meaningful and timely reform weigh against survival of the EZ and EU in their present forms, although I do not underestimate the commitment of the political elite to the European Project. I do believe that some kind of union will survive, but it will probably involve fewer countries. Assuming that this comes to pass, the resulting union is likely to involve a much greater degree of fiscal, economic, funds transfer and political integration alongside the established monetary union.

6. Future Prospects for the EU and EZ — Economist Magazine Analysis[2]

In its August 11, 2012 edition, *The Economist* news magazine published an article which superbly described the European financial crisis and spelled out in detail risks and costs of the crisis. The article was formatted as a memorandum to Angela Merkel, the German chancellor and articulated two policy options.

The Current Impasse. Policy to date (Plan A) has been to preserve the euro. German taxpayer funds have been committed to rescue facilities but have been disbursed subject to strict conditionality that requires recipient countries to reduce fiscal deficits and adopt policies that improve competitiveness. Implementation of conditions is subject to central oversight. Fiscal transfers/debt mutualization has been rejected because such measures would subject German taxpayers to unlimited funding of rescues and would result in moral hazard — recipient countries would have little incentive to mend their ways. The result of Plan A has been deep recessions in peripheral EZ countries and spillover negative consequences for other economies including Germany.

The memorandum correctly observes that Plan A isn't working and that the situation is dangerously unstable.

[2] "The Merkel Memorandum." *The Economist*, August 11, 2012, pp. 19-22.

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The Case for Plan B. *"Plan B seeks to save the euro by surgery, excising states that cannot cope rather than clinging to the vain hope that they can regain their health within the euro zone."*

Plan B has two options: exit of Greece; or wider exit of other troubled EZ countries. The memorandum sketches out a cost-benefit analysis of these options.

Can An Exit Happen In the First Place? Can a country be forced out of the EZ? There is no express provision for exit of a country in the Maastricht Treaty, but the treaty banned financial rescues and that could be interpreted to preclude exit. However, laws are malleable and both the EFSF and ESM are rescue funds which arguably are inconsistent with the Maastricht Treaty ban, but nonetheless they exist and have not been challenged. Indeed the German constitutional court has ruled twice, once on the EFSF and on September 12, 2012 on the ESM. While the court imposed some conditions it did not find either rescue facility unconstitutional.

Practical limitations to exit include the challenging logistics for the exiting country in launching a new currency and the likelihood of massive capital flight (bank runs). While both pose significant challenges, the memorandum concludes that each could be dealt with. Capital flight and linked contagion across more than one country is the most serious risk, but the memorandum insists this problem could be managed by the exiting country instituting a bank holiday and capital controls.

Thus, exit is possible. But, the memorandum does acknowledge the possibility of potentially severe contagion risks in non-exiting countries.

An Exit of Greece Alone. One should assume that if Greece exits the EZ, money lent to Greece and other claims should be considered to be a total loss. Costs would include the €130 billion already lent; €40 billion in Greek bonds held by the ECB; €100 billion in Target2 clearing balances resulting from capital flight out of Greece; and perhaps €10 billion to help German banks absorb Greek losses. Germany's share of these losses would be approximately €120 billion or about 4.5% of GDP.

Benefits include eliminating what increasingly looks like a never-ending sinkhole of unrecoverable financial assistance. Arguably Greece's expulsion from the EZ would put teeth into conditionality and prompt other EZ countries receiving financial assistance to take seriously the importance of adher-

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ing to rescue terms. The biggest benefit would be to Greece, which would revalue its new currency and restore trade competitiveness, thus bringing a quicker end to its economic depression.

If Greece's exit from the EZ were sufficient to end Europe's sovereign debt crisis, the memorandum argues that the costs would be considerably less than the present value of continuing to provide financial assistance over time to keep Greece in the EZ.

However, perhaps the fatal flaw of pursuing this option is that it could/-would lead to a game of dominoes in financial markets as speculators attack the next weakest EZ country, thus forcing additional bailouts.

Going for Broke. Because of the significant risk of disorderly contagion following Greece's expulsion from the EZ, a better plan might be to restructure the EZ in one fell swoop by forcing several weak countries (Greece, Ireland, Portugal, Cyprus and Spain) out of the EZ simultaneously. Net foreign liabilities in these five countries range between 80% and 100% of GDP. This reality has already triggered massive capital flight, which deepens dramatically the cost of providing financial assistance. In addition, these countries, with the exception of Ireland, must continue to pursue draconian internal devaluation policies to restore competitiveness. That means ongoing economic depression for a considerable period of time. Exit, establishment of country-specific currencies, and devaluation of those currencies would enable all five countries to restore competitiveness and extricate themselves from the debilitating consequences of internal devaluation.

Going for broke would come as a shock. Thus, it would be important to ring fence Italy and France by requiring a banking union and accepting debt mutualization in the remaining EZ countries. The benefit would likely be that implementation of this option would bring a decisive end to the European sovereign debt crisis. But, such an outcome is not absolutely assured.

Costs would amount to €1.15 trillion and Germany's share would be €385 billion or 15% of GDP. In addition, Germany would need to recapitalize its banks bringing the total estimated cost to €496 billion or 19% of GDP and raising Germany's public-debt-to-GDP ratio from 81% to 100%.

Conclusion. Perhaps based on historical experience that "the first loss is the best loss", the memorandum concludes by recommending the option

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involving broader restructuring of the EZ and expulsion of five countries. In other words, the option of expelling only Greece may be inevitably followed later by a forced broader restructuring of the EZ and during the interim time period the costs to Germany would rise substantially.

In a footnote, The Economist article states that Chancellor Merkel *"... concluded that despite the advantages of Plan B compared with her current strategy, she was unwilling to countenance the associated risks — at least for the moment. She ordered the memo to be shredded, resolving that if the euro area is to fragment, it will not be at her behest."*

This footnote states the reality of the situation. It is easier to engage in theoretical assessment of least cost solutions than it is to deal with the practicality of such solutions in a highly complex political environment. It is for this reason that a muddle through, hope for the best, incremental approach to dealing with the European crisis will be the most likely course. It is a course that stretches out the time period of the crisis and one that contains a high risk of ever-growing costs and consequences should it eventually fail to resolve the crisis.

X. China — Slowing Growth Continues

China's year over year GDP growth slowed to 7.6% in the second quarter. Moreover, evidence of a significant slowing in China's growth rate continues to accumulate. Growth is expected to slow further to 7.4% in the third quarter and probably is headed to 6%, or lower, in coming quarters. Industrial production continues to slow and was 8.9% in August, down from recent double digit rates. Exports grew only 2.7% year over year in July and imports fell 2.6%, leading to an expansion in China's trade surplus. The slowing in imports is not good news for exporters of commodities, such as Australia. There is plenty of evidence that China is in the throes of an inventory correction cycle that has a ways to run yet. Slowing growth in exports reflects declining Chinese competitiveness, an increasing exchange rate and slowing global demand for Chinese exports.

Most market participants continue to have faith that Chinese policymakers will engineer a reacceleration in growth by easing monetary policy, encouraging bank lending and implementing more aggressive infrastructure

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spending.

But, as I discussed in detail in the ***May Longbrake Letter***, China has less room to stimulate its economy aggressively than it did in late 2008. Policymakers appear to be well aware that if they elect to pursue a new aggressive stimulus program by boosting investment and bank lending, it risks exacerbating already significant and troublesome imbalances. China needs to develop its consumer economy and reduce reliance on infrastructure investment and exports to propel GDP growth. This will entail a reduced rate of growth during a transition period. If handled correctly, China can avoid a hard landing, but it is also not the policy approach that leads to the kind of soft landing most market participants are anticipating. Increasingly it appears that policymakers are pursuing policies to rebalance China's economy by reducing overreliance on investment and developing internal consumption capacity. These policies will not provide a significant boost to global trade as market participants generally currently expect.

What seems clear at this juncture is that China will not be able to counter a global growth slowdown as it did in 2009. What is less clear is whether China's policymakers will be able to engineer a restructuring of the economy with only a modest reduction in growth. Slowing growth in the U.S., recession in Europe and slowing growth in major emerging economies such as Brazil, Korea, Taiwan and India, will make the job of rebalancing much harder and put Chinese policymakers to the test. Hopefully, they will be able to engineer a necessary transition in China's economy which avoids a sharp slowdown but also avoids reigniting speculative growth based on overinvestment in real estate and infrastructure.

Key to rebalancing will be a shift in the composition of GDP growth toward consumption. This will require changing policies to increase household income. Existing policies have repressed consumption and boosted saving. These policies have been an intentional and necessary component of an investment-driven economy. Shifting from investment to consumption requires forcing up real interest rates to discourage borrowing which finances investment.

Rebalancing in the long term will be good for global growth because Chinese demand for imports will rise as a consumption-based economy develops. This will lead to a reduction, and perhaps an eventual elimination, of China's large trade surplus. Again, this will be a healthy development

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for the global economy. However, it seems likely that policy will be able to slow investment growth faster than saving growth. What this means is that in the short run China's trade surplus is likely to grow, as is happening currently. So, while rebalancing is the right policy in the long run to assure sustainable growth and social and political stability, the transition from the current overreliance on investment and exports, as is the case for all major structural transitions, will pose challenges and dislocation as both China and the rest of the world adjust.

Though fraught with risk, embarking upon such a transition and managing the consequences as best as possible will be better for both the Chinese and global economies in the long run. The alternative, which the market seems to expect, of repeating the 2008 stimulus program would boost Chinese and global growth for a period of time but at a cost of significantly exacerbating global imbalances. In the end such a strategy would culminate in a crash of the Chinese economy and perhaps worse.

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