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

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The Longbrake Letter*

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I. Stronger U.S. Employment Report Cause for Guarded Optimism

September's employment report exceeded expectations. Payroll employment increased 114,000, which was met consensus expectations of 115,000, but July and August were revised upwards by a combined 86,000.

Household employment rose by a whopping 874,000, which caused the unemployment rate to fall from 8.1% to 7.8%. The strength of the increase in household employment, and therefore the decline in the unemployment rate, is suspect because there was a very large 400,000 one standard deviation sampling error inherent in the household employment survey. What this means is that from time to time the household survey can produce an "outlier" result, which appears to be what happened in September. These blips average out over several months. Thus, the average monthly increase of 239,000 over the last 12 months is a reasonably reliable indicator of employment strength. This average is consistent with steady, but slow, improvement in the labor market.

Thus, while September's household report probably overstates the degree of improvement in the labor market, both that report and the payroll report are consistent with a slowly healing labor market. Importantly, there is some evidence that uncertainties about the impending fiscal cliff are beginning to prompt employers to delay hiring. The third quarter plunge in business confidence, as measured by the Business Roundtable, from 89.1 to 66.0 may be a harbinger of a fourth quarter slowdown in employment growth. International Strategy and Investment Group asked a survey question: "Is the 2013 fiscal cliff having an impact on your current spending

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and hiring plans in the U.S.?" 43% of businesses surveyed said yes to this question in September compared to 16% when the same question was asked in May. Small business confidence, as measured by the National Federation of Independent Businesses, also edged down in September. Notably, capital spending and hiring plans both deteriorated. FedEx cut its earnings outlook by more than 10%, citing slowing global growth and suggesting that matters could get worse in 2013.

Eroding business confidence is at odds with several measures of consumer confidence which have been improving in recent weeks. However, business people tend to be more forward looking than consumers, which suggests that business people's worries about the consequences of the presidential election and the fiscal cliff escalated during the third quarter and may translate into decisions in the fourth quarter that have negative impacts on the economy.

Other data reports in September have been slightly better than lowered expectations. Housing continues to improve, albeit gradually from a very low level. Financial conditions, thanks to the Fed's aggressive monetary policy, have continued to ease and stock prices are higher. The purchasing managers' manufacturing index moved back into expansion territory. However, offsetting these positives, growth in household incomes has been decelerating since the sharp acceleration in the first quarter of the year. And, consumer spending has been weaker in recent months.

Early estimates of third quarter GDP growth are tracking between 1.4% and 2.0%, which, if realized, would result in an increase in the size of the output gap. The output gap is still hovering in the vicinity of 6%, which is a very high and unhealthy level.

Recession is deepening in Europe and growth appears to be decelerating more rapidly in China than expected. However, other indicators of global economic activity have improved modestly over the last month and financial conditions have eased a little.

All-in-all, economic activity in the U.S. is grinding higher but not at a rate sufficient to make much, if any, real progress in reducing the sizable output gap. Global risks and the impending fiscal cliff in the U.S. threaten to slow growth during the fourth quarter and early 2013. And, recession, while not likely, is possible if Congress fails to address fiscal cliff issues on a timely basis following the November 6 elections.

President Obama has a minuscule lead over Governor Romney. Thus, the outcome of the election remains very much in doubt. The same is true for control of the U.S. Senate.

So, while September's data reports were cause for guarded optimism, they were not sufficiently strong to be cause for celebration.

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 four sections provide updates on the U.S. presidential election, U.S. fiscal policy and developments in Europe and China.

II. U.S. Real GDP Growth

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 6.0% 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 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 ten years; my estimate is a continuation of the 1.6% experienced over the last eight years.

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.

1. Slow Growth Implications

There are several implications. First, employment growth will continue to be slow. Second, wage growth will be held back by high unemployment and appears to be stuck slightly under 2% annually. Third, spending growth will be 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

Second quarter GDP growth was marked down to 1.3% in the "Final Estimate" from 1.7% in the "Preliminary Estimate". Details of the "Final Estimate" are shown in **Table 1**.

Table 1
2012 Second Quarter GDP Growth

	Advance Estimate	Preliminary Estimate	Final Estimate	First Quarter
Personal Consumption	1.05%	1.20%	1.06%	1.72%
Private Investment				
Nonresidential	.54%	.43%	.36%	.74%
Residential	.22%	.43%	.19%	.43%
Inventories	.32%	-.23%	-.46%	-.39%
Net Exports	-.31%	.32%	.23%	.06%
Government	-.28%	-.18%	-.14%	-.60%
Total	**1.54%**	**1.74%**	**1.25%**	**1.96%**
Final Sales	**1.22%**	**1.97%**	**1.71%**	**2.35%**

Except for government, which was slightly less negative, the contributions of all other components to GDP were reduced in the "Final Estimate". Consumption and residential and nonresidential investment, which account for approximately 85% of GDP collectively, were much weaker, totaling 1.61% in the second quarter compared to 2.89% in the first quarter.

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. "Final Sales" grew a disappointing 1.71% in the second quarter compared to 2.35% in the first quarter. Unfortunately, this means that no progress has occurred this year in reducing the output gap.

3. 2012 Q3 and Q4 GDP Estimates

Goldman Sachs (GS) expects GDP to expand at a 2.0% annual rate in the third quarter and 2.0% in the fourth quarter, while Bank of America/Merrill Lynch (B of A) expects growth to be a weak 1.4% in the third quarter and decelerate to 1.0% in the fourth quarter. B of A's rationale for sharply lower GDP growth in the fourth quarter is based upon its view 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.

4. GDP Forecasts for 2013

B of A's forecast of 1.4% GDP growth in 2013 is one of the most pessimistic. The International Monetary Fund (IMF) recently reduced its forecast to 1.5% from 2.25%. GS's 2013 real GDP growth forecast is 2.1%, the Blue Chip consensus is 2.5% and the Federal Reserve has a central tendency range of 2.5% to 3.0%. "Bill's Slow Growth" scenario projects real GDP growth in 2013 of 2.6%.

5. Risks to the Outlook

Risks to the 2013 forecasts are numerous and collectively are tilted toward the downside. B of A's forecast includes a negative assessment of the risks while other forecasters mention the risks but do not necessarily embed them into their forecasts.

GS includes a positive bump for the effects of the Fed's quantitative easing program which it expects to raise GDP growth by 30 to 75 basis points. There is no explicit mention of such a favorable adjustment in the other forecasts.

Downside risks include slower global growth, tighter U.S. fiscal policy and increased uncertainty. On a more favorable note, housing prices and new construction could rebound more rapidly.

III. Global GDP Growth

Global growth continues to slow gradually. The IMF recently downgraded its global real GDP growth forecast for 2012 from 3.5% to 3.3% and its forecast for 2013 from 3.9% to 3.6%. The revised estimates include an 80% or greater chance of recession in Europe, 15% in the U.S. and 25% in Japan. The IMF lowered the 2013 growth estimate for emerging economies from 5.6% to 5.3% including reductions of 1.0% in the growth estimate for Brazil and 1.3% for India. The World Trade Organization (WTO) cut its trade growth estimate for 2012 from 3.7% to 2.5% and for 2013 from 5.6% to 4.5%.

Developed countries are plagued with high unemployment, contractionary fiscal policies, policy uncertainties and brewing political instability in some countries.

Emerging economies are also slowing, but the causes are different. Growth in many emerging economies over the last several years has been pushed up by investment and infrastructure spending. In classic fashion this has ignited the investment accelerator effect, which for a while can sustain a high rate of growth. But, also in classic fashion, investment booms lead to construction of too much capacity to supply goods and services relative to underlying demand. And, when the investment accelerator effect peaks and then rolls over the excess of supply over demand asserts itself in the form of declining prices, slowing economic activity and declining trade.

Increasingly, it appears that emerging economies collectively have reached a point at which the investment cycle has entered into the negative deceleration phase. Weakening demand in developed economies, unfortunately, will serve only to aggravate the downturn in the investment cycle.

What this means is that the risk of a much more severe deceleration in global growth than embodied in the reduced IMF forecast is a significant possibility. Forecasters generally don't have a good track record in anticipating re-enforcing feedbacks that tend to accentuate trends once those trends are underway. Moreover, there is faith that policymakers can take actions to modify or reverse trends. To a certain extent such faith is legitimate, but when the imbalances between supply and demand are extremely large, the effectiveness of policy is limited to moderating the painful consequences of adjustment. For proof of this observation consider the evolution of the U.S. economy in the aftermath of the bursting of the debt-fueled housing bubble.

Soaring prices of commodities over the last several years are indicative of the infrastructure and manufacturing investment booms that have stoked the economies of developing nations. Prices rose rapidly because demand initially exceeded supply. Rising prices attracted speculators, which boosted demand even more. Money simply was there for the taking by letting inventories pile up. But, when profits are easy investment also goes into the development of new productive capacity. And, with an inevitable time lag, that new capacity comes on line. As that occurs, the gap between supply and demand closes and eventually reverses. As this occurs, prices first stabilize and then turn downward. Price declines, then, are exacerbated both by inventory liquidation but also by decreases in primary demand as economic activity slows.

China is currently experiencing a cyclical inventory correction, which is part of the reason China's GDP growth rate is drifting lower. This correction is in an early stage. How deep the correction ends up being depends upon several factors. First, the greater is the excess of inventories and productive capacity relative to primary demand (excludes demand stemming from the investment accelerator effect), the deeper the correction will turn out to be. Because of fragmentary data in China, the extent of this problem is uncertain. But, it is cause for concern.

Second, slowing global growth and trade will exacerbate the correction by decreasing primary demand. Third, financial stress usually accompanies falling prices. Such financial stress can be papered over for a time by pursuing a policy of "pretend and extend" as Japan did in the 1990's after its bubble economy deflated.

Fourth, China needs to rebalance its economy and transition from an investment focused economy to one oriented more toward domestic consumption. But, it will take time to build this kind of demand. Because of the excesses that have built up, this transition will not be easy. There will be intense political pressure, particularly from the large state owned enterprises, to maintain the status quo. In the short run such political pressures may lead to policies which slow the pace of adjustment. In the long run adjustment is inevitable. The history of economies with large imbalances which engage in delaying tactics has not exactly affirmed the wisdom of such an approach. Frequently, delay makes the eventual adjustment more traumatic rather than less so.

In the longer term, returning to commodities as an example, the increase in supply relative to demand will exert intense downward pressure on prices for a very long period of time until demand grows to absorb excess supply or supply is reduced. For the next few years it looks like supply will increase while demand contracts. In other words, excess supply is likely to grow substantially.

For example, according to analysis compiled by Michael Pettis, the annual increase in global copper production capacity in each of the next seven years will equal the total amount of capacity added between 2004 and 2011.[1] The same pattern will occur for other commodities such as iron ore.

In the wake of the 2007-09 global financial meltdown, most all governments pursued aggressive monetary and fiscal policies. In many emerging economies these policies provided fuel to reinvigorate and accelerate an investment boom that had been temporarily interrupted by the global financial crisis. China was the most obvious case in point. For a time these policies resulted in high rates of growth. But the extended slow healing of a fragile U.S. economy, the financial crisis in Europe, and increasing inability of emerging economies such as China and India to sustain the investment accelerator effect inevitably have collectively 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 take time to rebalance and rebalancing will be accompanied by much slower global growth in

[1] Michael Pettis. "By 2015 hard Commodity Prices Will Have Collapsed," EconoMonitor Blog, September 17, 2012.

coming quarters. A really bad outcome, which is by no means certain, but which is possible, could occur if negative feedbacks build and reinforce each other.

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

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

	Nominal 2011*	**Pct. Change**	**Nominal 2012 Jan.-August****	**Annual Pct. Jan.-August Change**	**Annual Pct. Apr.-August Change**
Personal Income	**$458.1**	**3.64%**	**$398.2**	**4.58%**	**2.38%**
Compensation	269.2	3.34%	270.1	4.86%	1.74%
Proprietors' Income	21.0	1.83%	40.0	5.13%	3.91%
Rental Income	70.7	19.50%	31.2	10.80%	7.02%
Asset Income	25.9	1.56%	36.2	3.22%	2.93%
Government Transfers	4.3	0.19%	51.4	3.31%	2.20%
Less: ***Personal Taxes***	-112.7	5.05%	-90.9	5.82%	2.75%
Disposable Income	**278.5**	**2.46%**	**337.9**	**4.37%**	**2.22%**
Less: ***Consumption***	**435.8**	**4.04%**	**285.6**	**3.82%**	**2.14%**
Personal Saving	**-157.4**	**-28.63%**	**52.6**	**20.07%**	**4.40%**
Personal Saving Rate	**4.24%**		**3.86%**		**3.99%**

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

accelerated from 2.46% in 2011 to an annual rate of 4.37% over the first eight months of 2012. However, the annualized rate of growth over the last five months has been 2.22%, which is in line with 2011's weakness. It is increasingly apparent that there was a one-time boost in reported income during the first quarter for bonus and deferred income. This adjustment conveyed the impression that income growth was improving; however, it is now clear that the underlying weak trend is still in place and that there has been no actual improvement in the rate of income growth.

Moreover, consumption growth has decelerated and has converged downward to match weak income growth. Although the saving rate has declined further so far in 2012, as spending and income growth have converged, the saving rate is in the process of stabilizing, but at a somewhat lower level.

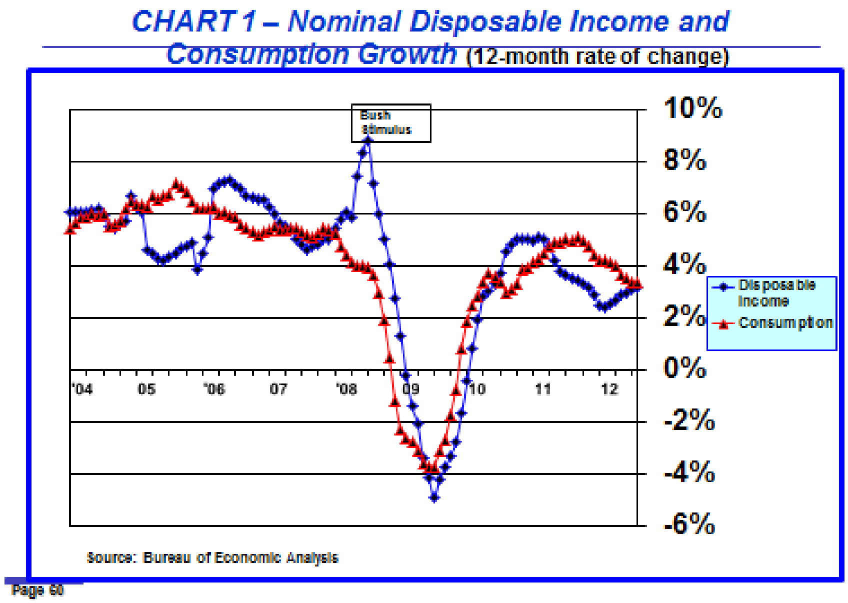
Personal taxes continue to rise more rapidly than disposable income, not an encouraging development as we approach the fiscal cliff at year end. Government transfers, which had a negative impact on disposable income growth in 2011, have had a neutral effect in recent months.

All-in-all, income growth is extremely weak and will not improve in any meaningful way until employment growth accelerates to a greater extent.

2. Disposable Income and Spending — Long-Term Relationship

Chart 1 shows the nominal rate of growth in disposable income and consumer spending from 2006 to the present. The annual rate of growth in 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 has risen since then to 3.2% in August 2012. As mentioned above, the rebound in the growth rate since February appears to be due entirely to a one-time boost in bonus and deferred income during the first quarter. It will take several more months for this one-time pop in income to work its way through the 12-month moving average of income growth. This means that the percentage rate will probably rise above 3.2% in coming months. While I generally prefer to look at 12-month rates of change, this is one of those times when this method of analysis may convey a false sense of an improving trend.

Growth in consumer spending peaked later than income growth at 5.1% in September 2011, but now is declining and reached 3.4% in August 2012.



Even with the recent improvement in income growth, the growth rate in consumption still exceeds the growth rate in disposable income. This relationship will probably reverse in the next few months for the reasons stated above. What will be important to watch in the interim to have a clearer sense of trend will be whether the saving rate continues to edge down on a short-term basis or whether it stabilizes. If it continues to edge down, consumption growth would probably strengthen.

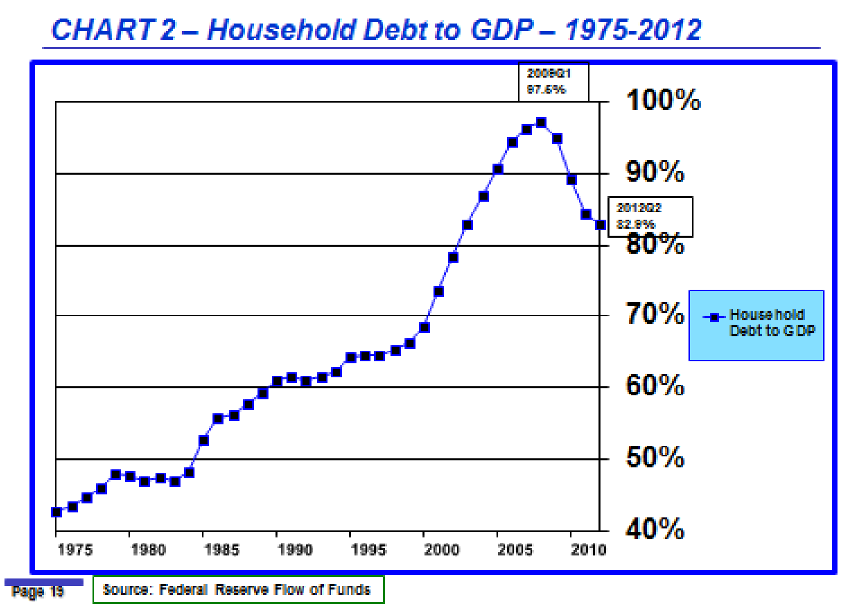
3. Other Factors Influencing the Willingness of Consumers to Spend

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 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 14.5 million in August to 14.9 million in September, which was a new monthly high since the onset of the Great Recession.

While consumer confidence measures remain mired at recession levels, they have improved modestly over the last month. Thus, there is no strong evidence yet that uncertainty is dampening consumer spending. The prevailing weakness is a function of slow employment and income growth rather than acute anxiety about economic prospects.

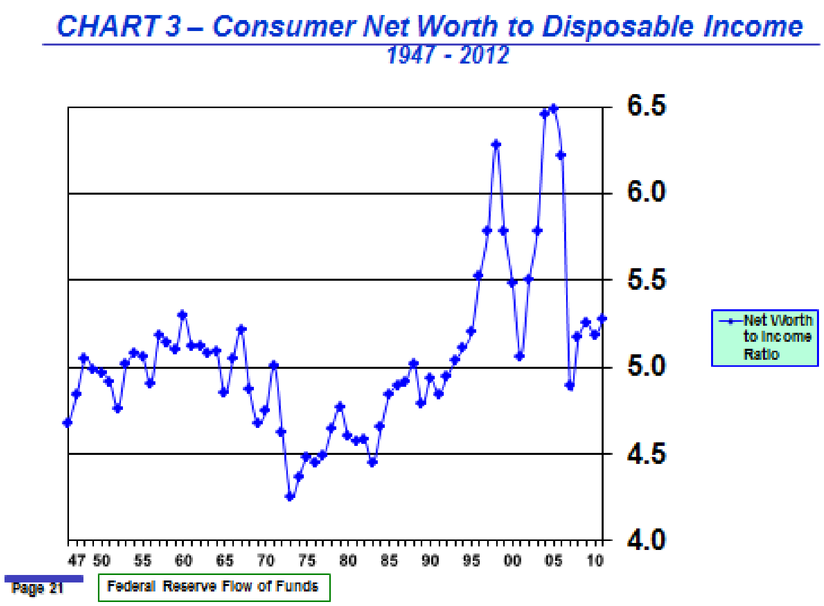
Consumer Credit. Revolving credit, mostly credit card debt, rose $4.2 billion in August and non-revolving credit increased $13.9 billion. Growth in student loans continues to account for most of the increase in non-revolving credit. Student loans are a problem in the making. I will have more to say about this in a future letter.

By far the largest component of consumer debt is mortgage debt which has shrunk $1.05 trillion since the first quarter of 2008 to $9.6 trillion in the second quarter of 2012. Much of this decline has occurred through defaults and foreclosures. But, as can be seen in **Chart 2** the household



debt to GDP ratio probably needs to fall further to restore healthy household balance sheets. Because interest rates are very low and should remain so for a while, household debt servicing capacity can probably handle a debt to GDP ratio somewhat higher than the 60 to 70% level that prevailed prior to the housing bubble. This suggests that a ratio somewhere between 70 and 80% might be consistent with restoring reasonable household balance sheet health. Debt reduction, too, is part of the slow economic healing process. It is well underway but there is still further progress that needs to occur.

Household Net Worth. Net worth rose 2.5% in the 12 months ending June 2012. The ratio of consumer net worth to disposable income, shown in **Chart 3**, was 5.27 compared to 5.30 a year earlier. This ratio has been



relatively stable since 2009 and is only slightly above the 65-year average of 5.05. Housing and stock prices, two of the primary drivers of changes in net worth, were relatively stable during the second quarter, but both moved up during the third quarter. Thus the net worth to disposable income ratio should improve in the third quarter. This should have a modest positive effect on consumer spending.

V. Employment

September's employment report exceeded 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 114,000 in August in line with the consensus expectation of 115,000. However, the prior two months were revised upward by a combined 86,000. But, all of the July and August improvement came from upward revisions in government employment. The improvement in labor growth looks a little less rosy in terms of private sector jobs, which rose 104,000 in September and 97,000 in August. Monthly payroll growth has averaged 142,000 so far this year, which is marginally above the 100,000 to 125,000 jobs that need to be added each month to absorb new entrants.

Jobs surged in the household employment survey with 874,000 new jobs created. However, this survey indicated that 313,000 jobs were lost in July and August. This means that the average monthly gain over the last three months was 187,000. The monthly gain over the last 12 months has averaged 239,000. The household survey is very volatile from month to month and has a large sampling error. Faulty seasonal adjustment factors might also have had an impact.

Involuntary part-time jobs surged 582,000 in September. What this means is many of the 456,000 workers who were no longer unemployed in September probably found only part time work.

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 from March 2011 through March 2012. Based on preliminary data through March 2012, the current benchmark revision estimate would raise the total number of jobs by 386,000 or an increase of about 32,000 per month. This would raise the monthly average from 142,000 over the last 12 months to about 174,000 which is closer to, but still less than the 239,000 average in the household survey, which is never revised.

But, when all is said and done, payroll employment is still 4.5 million less currently then it was in December 2007. This coupled with sluggish wage growth has restricted growth in consumer spending power. When this is understood it is not surprising that both nominal and real GDP growth have been extremely weak.

2. Unemployment Rate

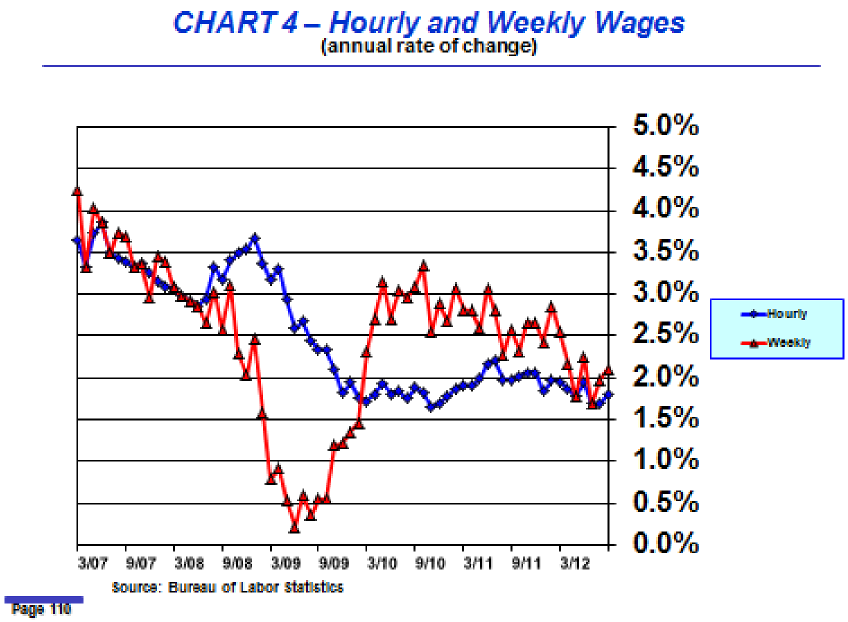
Unemployment fell 456,000 in September after falling 250,000 in August. As a result the unemployment rate improved to 7.8% in September from 8.3% in July. To reiterate, this apparently good news may be overstated because of a larger than typical survey sampling error. Whether this is so will become clearer in coming months.

Notably, the U-6 unemployment rate, which includes part-time workers who would prefer to work full time and other "marginally attached" workers was 14.7% in both August and September.

3. Growth in Wages

If the labor market really is tightening, wage rates should begin to rise and that development would threaten subsequent increases in inflation. However, increases in both hourly and weekly wage rates appear to be stuck at a very low level.

Chart 4 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. 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.



VI. U.S. Presidential and Congressional Elections

After passing a continuing resolution to fund the government through March 31, 2013, Congress adjourned and will not return until after the November 6 elections. When Congress returns it will need to deal with various aspects of the looming fiscal cliff.

Both political parties have elected to take their policy views to the people. The Republican nominee, Mitt Romney, sharpened the focus of the 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 50% or less for many months (see **Table 3**).

Table 3
Obama Job Approval Rating and Presidential Election Lead

Date	Obama Job Approval	Obama Election Lead*
September 12	49.6%	+3.6%
September 18	49.3%	+3.0%
September 25	50.0%	+3.7%
October 3	49.8%	+2.8%
October 9	49.7%	+0.5%

*Average of Polls

Subsequent to the first presidential debate on October 3, Obama's lead over Romney melted away. The Gallup and Rasmussen polls taken subsequent to the debate indicate a tie and the Pew Center poll showed a 4-point Romney lead, but there is evidence that this poll over-sampled Republicans. Gallup polls registered voters daily and publishes both daily and 7-day moving average results. Sampling error is much larger for the daily poll. Prior to the debate, Obama led Romney by 5 points; in the three days following the debate, Obama and Romney were tied; but, the debate bounce evaporated quickly and Obama's 5 point lead re-emerged. However, Gallup's "first likely voter poll", released on October 9, showed Romney ahead of Obama by 49-47%.

It is too soon to know whether Romney's debate bump will hold. But, Romney did succeed in projecting presidential qualities and neutralized the impact of negative ads. The economy's weak recovery and high unemployment continue to make Obama vulnerable, although September's stronger than expected employment report could help Obama.

2. Obama's Polling Margin in Key States

At this juncture Obama still has an edge over Romney in key battleground states. But polls in many of these states do not yet reflect the impact of the October 3 presidential debate. Table 4 shows Obama's lead over Romney in key states as of October 8, 2012. Compared to September, state-by-state changes have been mixed. Updated polls in coming days could show shrinking Obama margins in most of these states and in any event polling results shown in **Table 4** are within the margin of statistical error. For

Table 5
Presidential Election — State Matchups

State	Obama Lead	Obama Lead
	Sept. 12, 2012	Oct. 9, 2012
Colorado	+3.4%	+0.2%
Florida	+2.0%	Tie
Iowa	+0.2%	+3.2%
Nevada		+4.6%
North Carolina	-3.5%	-0.8%
Ohio	+3.0%	+3.0%
Virginia	-0.8%	+0.3%
Wisconsin	+1.4%	+6.6%

example, polls that became available on October 9 indicated that Romney had small leads in Colorado and Florida and Obama's lead in Ohio was less than +1.0%. 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.

There has been no change over the last month in the electoral vote count. 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. It takes 270 electoral votes to win. Ohio, Florida, Virginia and North Carolina have a combined 75 electoral votes. If Romney can carry these four states, he would win the election.

3. U.S. Senate

Democrats hold a 53-47 edge in the current Senate, so it would take only the loss of four seats to switch control or three, if Romney is elected president. Because a preponderance of Senate seats up for election this year are Democratic seats this provides a theoretical advantage to Republicans. However, Democratic candidates appear to be gaining on Republicans in hotly contested states in Florida, Ohio, Massachusetts, Virginia, Missouri, North Dakota and Arizona. The New York Times FiveThirtyEight political forecast model currently gives Democrats 84% odds of retaining control of the Senate.

VII. The Fiscal Cliff Is Less Than Three Months Away

There is little new that can be said about the impending fiscal cliff. Details of the issues in play are well known. Nonetheless, enormous uncertainty is building because there appears to be little common ground between Democrats and Republicans and the outcome of the elections is anyone's guess. We are in a waiting game until after the November 6 elections.

1. Continuing Resolution

Prior to adjourning for the elections Congress passed a continuing resolution to fund the government for six months through March 31, 2013. Spending levels will be maintained at fiscal year 2012 levels plus 0.612% increase across the board. This will maintain spending within the discretionary budget caps established by the Budget Control Act of 2011. The continuing resolution does not affect the automatic spending cuts, called the sequester, that automatically go into effect on January 2, 2013.

2. 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 2, 2013, unless Congress acts to eliminate it or defer the effective date, it could 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.

Beginning January 2, 2013 federal expenditures will be reduced at an annual rate of approximately $109 billion, evenly split between discretionary defense (95%)/homeland security (5%) programs and other discretionary domestic programs. Certain spending programs benefiting low-income households are exempted. Approximately $12 billion of the $55 billion reduction in discretionary spending will come from a 2% reduction in Medicare reimbursement rates; $38 billion comes out of other discretionary domestic spending; and $6 billion from certain domestic mandatory programs. These cuts amount to a 9.4% reduction in the discretionary 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 permitted 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.

3. Impact of the Fiscal Cliff on Taxpayers

If Congress does nothing, approximately 90% of taxpayers will experience tax increases averaging $3,500 or about a 5% increase in tax rates. There would be modest progressivity to the tax rate increases with the lowest 20% of income earners experiencing a 3.7% tax rate increase and the top 20% a 5.8% increase. The tax rate for the highest 1% would rise 7.2%.

Disposable income would fall 4% on average. However, the lowest 20% of income earners would be hit by a 9% decline, primarily because of the loss of unemployment benefits.

4. Impact of the Fiscal Cliff on the Economy

Fiscal policy has had a modest contractionary impact on real GDP growth during 2012 — less than 1%. If we fall off the fiscal cliff, the contractionary impact will be about 3.5% in the first quarter of 2013. The impact will continue to be between 2.5 and 3.0% in the second and third quarters before falling to less than 1.0% in the fourth quarter. The Congressional Budget Office prepared a detailed analysis of the macroeconomic effects of the fiscal cliff in August which was summarized in the ***September Longbrake Letter***.

5. Possible Pathway To Avert the Fiscal Cliff

Press reports indicate that a bipartisan group of senators is discussing a process to deal with the fiscal cliff. The first step would be to agree on a ten-year deficit reduction target. $4 trillion has been mentioned, but the number could differ somewhat from that level. There would be an understanding that the deficit reduction target would be reached through a combination of spending cuts, an overhaul of the tax code, which would have a net revenue impact, and adjustments to Medicare and Social Security. The second step would be to pass legislation that instructs relevant committees of Congress to draft specific legislation within six months. Importantly, if the second step failed to pass Congress, the alternative would be to adopt a plan similar to the Simpson-Bowles Fiscal Commission's proposal. It is unclear at this juncture exactly what mechanics would be specified in legislation to assure action rather than prolonged stalemate.

Assuming that steps one and two are achieved, Congress would repeal the automatic spending cuts and delay implementation of the tax rate increases, but would probably also take some kind of interim step to make a down payment on deficit reduction.

Of course this is the stuff of compromise and as reasonable as it might seem, cutting through strongly held ideological positions will be very difficult. Democrats continue to insist that they will agree to nothing unless there is an immediate tax increase for wealthy individuals. Speaker John Boehner has been just as emphatic stating that Republicans will not agree to an approach that extends some of the Bush tax cuts but allows others to expire.

Of course, we expect posturing and rhetoric prior to the election. But, the hollowing out of the moderate center in Congress and the increasing dearth of respected statesmen in Congress strongly implies that it will be very difficult to forge a compromise after the election results are in.

If all else fails during the lame duck session of Congress, a six-month extension of most of the fiscal cliff issues is a possibility. This would include a delay in the implementation of the sequester. However, many believe that the payroll tax reduction would be allowed to expire as scheduled; extended unemployment benefits would be phased out; and the 0.9% surtax on individuals' earnings over $250,000 and the 3.8% tax on passive income mandated by the Affordable Care Act would be allowed to take effect as scheduled.

6. Lame Duck Congress

Congress will return during the week of November 12th. The only issue of consequence will be dealing with the fiscal cliff. Action is unlikely to occur until mid-December. In 2011, Congress did not agree to extend the payroll tax cut until December 23.

If Congress fails to act before year end, the new Congress is sworn in on January 3, 2013. Presumably, dealing with the fiscal cliff would be the new Congress's first order of business. This could become more complicated if Governor Romney is elected president as he would not take office until January 20.

7. Possible Scenarios

GS has suggested four scenarios and attached probabilities to each:

Short-Term Extension of Most Current Policies (40%). This is the most likely outcome because it is one that would provide about six months for the New Congress to work through difficult issues. Certain matters such as the payroll tax cut would probably be allowed to lapse rather than receiving a temporary extension. The Republicans will insist on extending all of the Bush tax cuts while the Democrats will insist on letting the tax rate cuts expire for high income earners. For this option to occur either the Democrats or the Republicans will have accept the position of the other party on a temporary basis.

Fiscal Cliff Occurs (35%). As mentioned above, both Democratic and Republican leaders have articulated conditions that are unacceptable to the other party. Unfortunately, this increases the possibility that it will be impossible to reach compromise quickly. If neither of the parties emerges from the election with a clear mandate, the probability of this outcome will rise.

One-Year of Longer Extension of Current Policies (20%). This is the proverbial "kick the can down the road" option and would create a high likelihood that one or more of the rating agencies would downgrade U.S. debt.

Grand Bargain (5%). President Obama and Speaker Boehner almost agreed to a "Grand Bargain" in August 2011. In the aftermath of failure the recriminations were visceral. While this would be the optimal outcome for the American people and a version of it is what the bipartisan group of senators appears to be working on, it is probably the least likely outcome if government remains divided after the election as seems probable.

8. Debt Ceiling

Unfortunately, the debt ceiling will be reached sometime between December and February. There hasn't been much commentary yet about the exact timing. Because of the enormous negatives that accompanied the August 2011 debt ceiling fight, Congress is likely to confine its work to deficit reduction and to enact temporary increases in the debt ceiling until there is a full-fledged deficit reduction agreement.

VIII. Recent Developments in Europe

Recession continues to deepen. GDP contracted at a -0.7% annual rate in the second quarter and the annual rate of decline is expected to worsen to -1.5%

in the third quarter. The purchasing managers index remains in contraction territory and worsened slightly from 46.3 in August to 45.9 in September. Unemployment was 11.4% in August. Importantly, bank lending is now shrinking, which is not a good sign for future economic activity. Lending decreased year-over-year by -0.6% in August.

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 mechanism and one that takes a long time to work. But, that is the course that the EZ has chosen. 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) through its promise to purchase sovereign debt of EZ member countries in the secondary market through the Outright Monetary Transactions (OMT) program. Only time will tell us whether the policies being put in place will work as intended.

These policies have reduced near-term financial risks and have contained the potential for speculative attacks. But they do not address the deteriorating economic situations in Greece and Spain or worsening recession in many other European countries. And, they won't help arrest the gathering centrifugal politics forces of nationalism and populism. Thus, I remain extremely skeptical, unlike ECB President Mario Draghi, that recent European policies have provided a platform for eventual resolution of the European financial crisis. But, what is clearer now is that we won't have an answer to whether and in what form the EZ survives for a much longer period of time than I previously thought.

Muddling through remains the policy path of choice. There are three major issues that are front and center currently, but others will move to center stage next year. First, as discussed below, Spain will require a bailout over and beyond the one already agreed to involving recapitalizing its banks. Spain will have to sign a memorandum of understanding (MOU) which will specify deficit targets and numerous other conditions for economic reforms. Until the MOU is signed Spain will not be able to borrow directly from the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM) and the ECB will not buy Spanish debt on the secondary market through OMT.

Second, the next tranche of troika (ECB/IMF/EC) funding must be agreed to and released by sometime in November and an alternative approach, possibly involving exit of Greece from the EZ and default, will have to be crafted.

Third, details of the European banking union and ECB supervision of European banks will need to be worked out. While the target to put these changes in place initially was January 2013, ECB President Mario Draghi recently announced that it would take another year to implement banking system reforms. There are difficult issues of national sovereignty yet to be worked through. And, importantly, central deposit insurance for European banks is not yet an element of the banking union agenda. Getting all the details resolved will be challenging because the banking union applies to all 27 members of the EU and not just to the 17 members of the EZ. It remains to be seen whether the U.K. will accede to a banking union which results in the ECB supervising British banks. It seems likely that the banking union project will proceed, but without U.K. involvement.

1. Greece

Greece's depression continues to plumb new depths. GDP has collapsed by 25% since 2008 including an expected 7% decline during 2012. And, it's not over. GDP is projected to decline a further 3.8% in 2013. Unemployment climbed to 25.1% in July 2012 compared to 17.8% in July 2011. Youth unemployment continues to climb and has reached 55%. These are numbers that presage social unrest. The prospect for political instability is growing.

To secure the next tranche of the troika (IMF/ECB/EC) bailout funds, Greece must cut its budget deficit by €11.5 billion in 2013 and 2014, which amounts to about 5.5% of GDP. The fiscal year 2012 budget deficit is expected to be €20 billion. However, as GDP continues to decline, the bar for deficit cutting continues to move ever higher. There is absolutely no question that the austerity medicine is killing the patient. One has to wonder when the breaking point will be reached and Greece will descend into social and political anarchy.

No decision is expected on release of the next bailout tranche until after the U.S. presidential elections on November 6. The Greek parliament has yet to take action on additional tax increases and spending cuts. While there has been some talk in the media about extending the timeframe for Greece to meet bailout conditions, these same reports emphasize that the troika is unwilling to consider increasing the amount of bailout funds.

Starkly put, the math doesn't work. Either bailout funds will have to be increased or a debt restructuring, which greatly reduces Greece's obligations to the IMF and ECB, will have to be negotiated. Of course, Greece could be kicked out of the EZ, but that, too, would entail default and massive losses to creditors. This option continues to be emphatically rejected. But, if Greece descends into social discord and political anarchy, it may become the default (no pun intended) option.

2. Spain

Spain's unemployment rate is 25.1% and is 53% for young people. As in Greece, high unemployment, especially of young people, will fuel demonstrations and could lead to substantial social unrest in coming months. Spanish GDP is likely to decrease at least 1.5% in 2012 according to the government's own forecast and recession will continue on into 2013. ISI expects Spain's economy to contract 2.5% in 2012. The cessation of bank lending will only serve to exacerbate the downturn in economic activity.

Spain's budget deficit, which was expected to be 6.3% of GDP in 2012 is headed toward 7.5%. This will require even more government budget cutting to meet Fiscal Stability Pact targets. Mariano Rajoy's Popular Party, which has solid control of the Spanish parliament, has proposed spending cuts and tax increases amounting to €65 billion through 2014. Budget cuts amount to about 9% of current expenditures.

These budget measures are intended to cut Spain's budget deficit to 4.5% in 2013 and 3.0% in 2014. But, as has occurred in every other country pursuing austerity policies and in Spain itself during 2012, further budget cutting will depress growth to an even greater extent and require even more budget cutting to meet these budget deficit targets. While the Spanish government currently retains a degree of discretion, presumably that discretion would go away once it signs an MOU.

Debt refinancing requirements in 2013 have risen to €39 billion. Since the announcement of the ECB's OMT program, yields on Spanish sovereign debt have declined. Importantly, Spain was able to sell €8.6 billion in short-term debt to private investors during September. However, as Spain's economy deteriorates, the willingness of private investors to continue buying Spanish debt at reasonable rates is doubtful. Presaging such and outcome, S&P reduced Spain's debt rating to BBB-, one notch above junk status, on October 11th. Thus, the need for Spain eventually to sign an MOU so that it can borrow from the EFSF/ESM appears to be inevitable.

Spain's public debt to GDP ratio has risen to 75.9% of GDP. Outstanding public debt amounts to €804 billion. If the debt of regional governments is included, the ratio would be considerable higher. Despite Prime Minister Rajoy's attempts, funds to recapitalize Spanish banks will be lent to the Spanish government and therefore will be added to the public-debt-to-GDP ratio.

With the easing of anxiety following the ECB's announcement of the OMT program, capital flight out of Spanish banks has virtually ceased for the time being. The audit report which indicated that Spanish banks need €53.7 billion (€59.3 billion if proposed mergers fall through) to recapitalize their balance sheets has also had a favorable impact on creditor sentiment. Nonetheless, Spanish banks collectively are saddled with €170 billion in troubled loans, equaling nearly 10% of total loans outstanding, whose repayment is doubtful. Credit conditions remain extremely tight. No net new lending is occurring, which is a negative for future economic growth.

If all of these negatives were not enough, several of Spain's regional governments are in financial difficulty. The central government set up an €18 billion emergency loan fund. Six of Spain's 17 regional governments have formally requested €16 billion. Moreover, political leaders of Catalonia, which accounts for 20% of Spain's GDP and transfers 9% of its GDP to the central government for redistribution to other regional governments, is threatening to seek greater autonomy. On October 10, the Spanish parliament denied a motion to permit Catalonia to conduct an independence referendum. Catalonia is one of the regional governments which has requested funding from the emergency fund, but its leaders argue that request would not have been necessary were it not for the fact that Catalonia is financing other regional governments.

Social unrest is escalating rapidly. A reported 500,000 people marched protesting austerity on September 15. On September 22, youth riots occurred in Madrid. And, on October 9, demonstrations against austerity occurred in Madrid and 56 other Spanish cities.

In summary, although Prime Minister Rajoy is emphatic that Spain will not need a bailout, Spain's multiple financial difficulties and the deteriorating economy make bailout inevitable. But, perhaps even more troublesome is the growth extent of social unrest and developing political instability. An understanding of the depths of Spain's problems and the likelihood that much worse is in store should put an emphatic damper on optimism about a turnaround in the European financial crisis.

3. Portugal

Portugal has complied to the letter with budget and economic reform conditions imposed by the ECB/IMF/EU troika. As is the case for all countries that have instituted extensive austerity, the Portuguese economy has been in deep recession. GDP is expected to fall 3% in 2012 and decline further in 2013. Unemployment has climbed to 15%.

Increasingly, the depth of the recession is fostering political and social instability. Further budget cuts will be necessary to win approval by the troika of the next bailout funding tranche. The government's last two attempts at reform have been abandoned. One was annulled by the Portuguese Constitutional Court and the other was dropped in response to intense political and social protests. The government has prepared a budget which complies with bailout requirements. The budget will go to parliament for action on October 15.

Political instability is increasing as opposition parties strengthen in terms of polling results. Social unrest is escalating. The General Confederation of Portuguese Workers held demonstrations on September 29. More demonstrations are planned.

Portugal is not yet at an inflection point but austerity fatigue is fueling political and social instability. Unfortunately, the economy is likely to get worse. It remains to be seen whether Portugal will be able to weather austerity without a severe eruption of social and political discord.

4. Italy

Italy's primary problem is not the size of its budget deficit but its uncompetitive economy. Italy is in recession and there is little prospect of improvement at least for the next year. Substantial labor market reforms are required to restore competitiveness but political resistance is overwhelming. Prime Minister Monti has had some success in forcing parliament to enact reforms.

However, parliamentary elections are required in the spring of 2013. Most of the major parties are promising to roll back some of Monti's reforms. Reflecting the drift of the electorate toward nationalism and populism, the Five Star Movement, with opposes the austerity program, continues to garner support and could receive as much as 10-15% of the vote in the upcoming parliamentary elections. Recent violent student protests in Rome do not bode well.

While the spotlight is not currently focused on Italy, it could become a serious problem during 2013 as recession takes its toll and elections disrupt the momentary political stability of the Monti government. There is some talk that Monti might stay on as prime minister after the elections, which, if that occurs, could keep the lid on matters.

5. France

French bond spreads relative to German bonds have tightened from 200 basis points in November 2011 to 50-70 basis points recently. This development is somewhat surprising given that France has its own competitiveness issues and its banks are massively exposed to weak peripheral European countries.

Either the bond market is ignoring the risks or believes that President Hollande's government is moving in a bond-friendly direction by emphasizing growth policies over austerity policies.

In fact, the Hollande government appears to be quite serious about reducing labor costs and creating jobs by enacting reforms that would increase the competitiveness of the French economy over time.

France's deficit is forecast to be about 4.5% in 2012. The government plans to reduce the deficit to 3% in 2013. The 2013 budget, which parliament will pass in spite of considerable controversy, cuts spending and raises taxes by a combined €30 billion. However, the government's underlying assumption that GDP will grow 0.8% in 2013 is optimistic. If growth actually declines in 2013, as most forecasters expect, France will not meet its 3% budget deficit target.

France historically has had concern about preservation of its national sovereignty within the EU. However, President Hollande has signaled France's willingness to proceed with a European banking union and supervision under the aegis of the ECB. This is an important sovereignty concession and signals France's commitment to the European project. However, stickier sovereignty issues lie ahead in the form of further political and economic integration.

6. Germany

GDP growth in Germany is expected to be close to zero in 2012 and then be moderately positive, but less than 1%, in 2013. Thus, while Germany is weathering the severe economic turndowns in other European nations, its economy is slowing down. Unemployment has risen for six consecutive months. The IFO and ZEW business climate indices continue to fall. Factory orders continue to decline and are 4.8% below a year earlier.

German elections are scheduled for the fall of 2013. Chancellor Merkel is widely expected to lead the next government, although the composition of the coalition may change. As elsewhere in Europe, fringe parties which espouse nationalism and populism are gaining some traction, but are not expected to impact the election outcome in any material way.

Germany continues to be in a delicate position. Its economy and financial institutions will be damaged substantially if the EZ breaks up. For example, the German Bundesbank has a total exposure of €750 billion to peripheral EZ countries through the ECB's Target2 clearing system. However, to avoid an EZ breakup, Germany will have to commit substantial financial resources and hope that by so doing the severe economic imbalances currently threatening the survival of the EZ will in time lessen. If rebalancing occurs, a policy of support rather than breakup will prove less costly. But, if that strategy fails, the cost of restructuring the EZ will grow, not lessen, with the passage of time. The evolving consequences of the austerity solution in Greece, Portugal and Spain do not auger well. Also, Italy remains a potential severe problem.

In the longer run Germany's pending population decline will have severe negative implications for Germany's economy. Germany's population is expected to decline from a current level of 82 million to 65 million in 2060. This is not an immediate problem, but one whose importance will grow.

IX. China — Slowing Growth Continues

On November 8, 2012, Chinese leaders will hold the 18th National Congress of the Communist Party. China's leadership change will take effect at this time. In the run up to the leadership change policy appears to be drifting.

Recent economic reports tell a story of a weakening economy. Profits of industrial companies have fallen 6.2% over the last year. The purchasing managers manufacturing index improved slightly in September but is still signaling contraction. There is reason to believe that production is stronger than underlying demand with the consequence that unsold inventories are building. The purchasing managers non-manufacturing index is still indicating expansion but it shrank from 56.3 in August to 53.7 in September. ISI's index of China sales is solidly in contraction territory and at 39.6 in the week of October 8 is closing in on the lows experienced in the immediate aftermath of the 2008 global financial and trade crisis.

There are a number of problems in the Chinese economy that are contributing to the slowdown in growth. First, there is the problem of slowing global growth which is negatively impacting Chinese exports. This has been made worse by Chinese wage escalation which has reduced price competitiveness of Chinese exports in global markets. Growth in exports year-over-year in September was 9.9% — mainly driven by other Asian countries. Exports to Europe contracted 10.7%. Imports rose 2.4% after declining in August. Thus, China's trade data in September were stronger, which was welcome news for soft-landing believers. But the weakening trend remains intact.

Second, China has imported large quantities of commodities in recent years, much larger than needed for current production. Rising prices and low-cost financing made inventory accumulation profitable. Now that prices of commodities are falling and growth in demand for manufactured goods is slowing, China finds itself in the early stages of what could turn out to be a massive inventory correction. China's trade data indicate that such a correction is already underway. China accounts for 40% of global copper consumption and 65% of cross-border iron ore demand.

Third, there is evidence of overproduction in many areas. This is reflected in rising inventories of finished products. For example, China has become a powerhouse in recent years in renewable energy, dominating the production of solar panels and wind turbines. But, production capacity has far outstripped rising global demand with the result that excess inventories are piling up and prices are crashing. Prices for solar panels have fallen 75% since 2008. A number of Chinese companies are on the brink of bankruptcy which means that banks will be saddled with a plethora of bad loans. Municipal and provincial governments, which provided loan guarantees, will also face losses.

Fourth, while China has invested in world class ports, highways and other kinds of infrastructure to support trade, internal distribution systems have been woefully neglected. The cost of moving goods within China is approximately 18% of GDP, which is about twice the cost in developed economies. These inefficiencies will impede the development of a consumer-based economy. On a brighter note, however, there is ample opportunity to invest in internal distribution infrastructure which would result in significant productivity improvements. But, this will require overcoming deeply entrenched domestic protection of markets.

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.

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 spending.

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. 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. For example, the People's Bank of China announced a financial reform program that will reduce government intervention in small-scale financial activity and encourage more private capital to be invested in the financial sector. Such policies are internally directed and 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 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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