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

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The Longbrake Letter*

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I. Onward to the Fiscal Cliff

Like September's report, November's employment report was better than expected, even though the unemployment rate increased from 7.8% to 7.9%. Other data reports, such as housing prices and consumer confidence, while nothing to get overly excited about, have been a little better.

Financial conditions have eased considerably in Europe since ECB President Draghi's August promise to do whatever it takes, although recession continues to deepen. While anxieties have abated for the time being, the euro zone's fundamental problems remain unresolved.

And, there is some evidence that China's growth slowdown may be ending and the possibility of a hard landing is not a near-term threat.

All-in-all, U.S. and global data point toward continued slow growth. There is still a long road ahead for the U.S. economy to return to full employment and eliminate the extremely high 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 as the Congressional Budget Office (CBO) has forecast, if Congress fails to address fiscal cliff issues on a timely basis.

In this month's letter, I begin by reviewing recent developments for U.S. GDP growth (Section II). This is followed by a discussion of U.S. personal income and consumption (Section III) and employment and housing (Sections IV and V). Section VI takes a look at the post-election prospects for

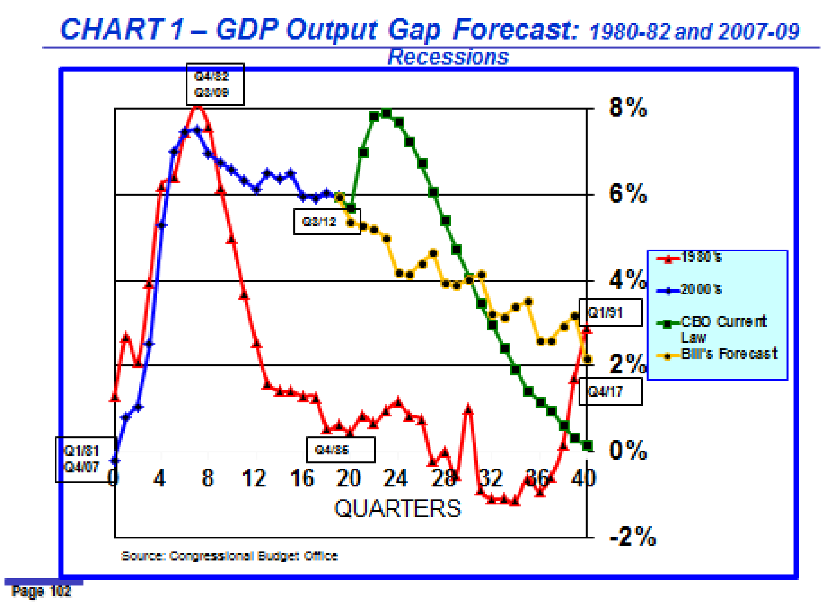
*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

financial policy, legislation and regulation. Section VII discusses possible options for avoiding going over the fiscal cliff. The final four sections provide updates on developments in Europe, China, India and Japan.

II. U.S. Real GDP Growth

Like a slow moving glacier, real GDP continues to grind higher, but virtually no progress has been made over the last year in reducing the very sizeable output gap. The advance annualized estimate of third quarter real GDP growth was 2.0% and the output gap was virtually unchanged at 5.93% compared to 5.96% in the fourth quarter of 2011. Based on recent data reports, third quarter real GDP growth could be revised up to 2.7%, which would reduce the output gap to 5.76% — moderate, but not meaningful progress.

Chart 1 compares the output gaps during and after the recession of



1981-82 and the Great Recession of 2007-09. The output gaps peaked during the seventh quarter of each recession — 8.1% in the 1981-82 recession and

7.5% in the Great Recession. Nineteen quarters have passed since the start of the Great Recession and the output gap is still 5.9% compared to 0.6% nineteen quarters following the onset of the 1981-82 recession.

The green line in **Chart 1** shows the ***Congressional Budget Office's "current law" scenario*** in which Congress takes no action to extend tax cuts and the spending reductions required by the Budget Control Act take effect in January — the U.S. economy falls off the "fiscal cliff". As a consequence, recession ensues during the first half of 2013. My scenario (***Bill's Forecast***), the yellow line, assumes that Congress addresses the fiscal cliff in time but tighter fiscal policy over the next several years results in only a very gradual reduction in the output gap, which is still estimated to be 2.0% of GDP at the end of 2016.

1. Continued Slow GDP Growth Likely

Initially, many did not appreciate the significant differences between the causes of the 1981-82 recession and the Great Recession and how those differences would affect the speed of recovery. However, after three years of recovery the stark differences in the rates of improvement in the output gap are obvious to all and that has forced a deeper examination of the reasons.

Most recessions over the last 70 years were corrections of overshoots in demand relative to supply. Key indicia prior to recessions were rising prices and interest rates. Recession resulted in rebalancing supply and demand and set the stage for rapid recovery followed by economic expansion. Usually interest-rate sensitive sectors, namely autos, housing and capital investment, led recovery. Recoveries were rapid and within a few quarters real GDP eclipsed the pre-recession high.

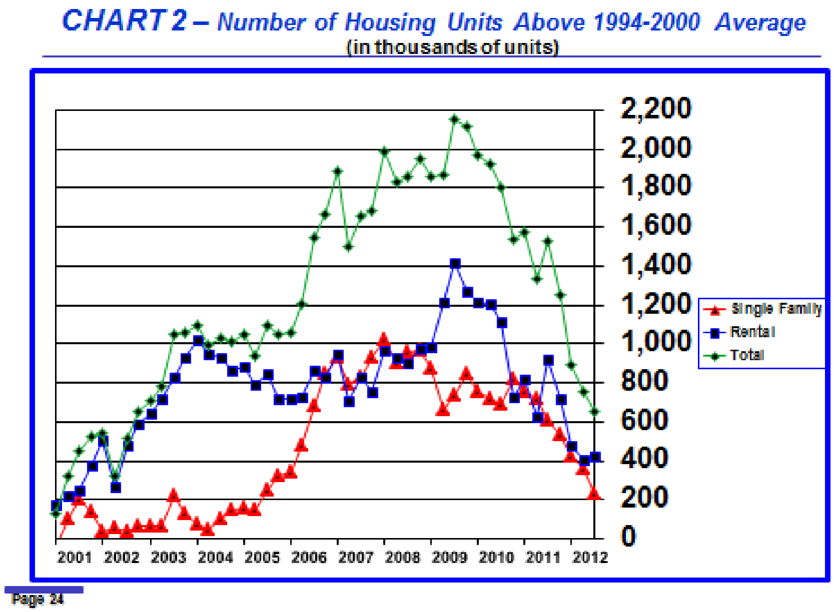
However, although there were definitely elements of significant demand-supply imbalances prior to the Great Recession, most notably in residential housing, the severity of the Great Recession was the result of excessive leverage in both the household and financial sectors. Economists now understand that excessive-leverage induced recessions, referred to as balance sheet recessions, have very different characteristics and consequences from more traditional excess demand recessions. These differences result in an extended period of balance sheet healing and very slow real GDP growth until the debt deleveraging process is largely completed. Carmen Reinhart and Kenneth Rogoff published a treatise that documented the aftermath of financial crises in many different countries over several centuries. The common attribute was that economic recovery was always painfully slow and it took upwards of ten years, not just a few quarters, to eliminate the output gap.

For the most part U.S. financial institutions have completed the deleveraging process and recapitalized. That is not true for European financial institutions. Thanks to aggressive monetary policy, financial conditions have eased substantially in the U.S.

However, credit conditions remain tight by historical standards and this is not likely to change materially for quite a while. There are three reasons. First, financial institutions, particularly the very largest ones, are required to phase in over the next several years much higher capital ratios. This constrains the ability of financial institutions to leverage their balance sheets and limits the availability of credit to businesses and households. Second, a plethora of laws and regulations discourages certain kinds of lending and raises costs. This, too, restricts the availability of credit and raises its cost. Third, financial institution executives are more risk averse. It will take time and probably a generational change before risk-taking rebounds to a less conservative historical norm.

But, household balance sheet deleveraging is having an even greater impact on the pace of economic recovery. Consumer spending accounts for 71% of real GDP. In the aftermath of a typical recession, lower interest rates and relatively easy access to credit induce households to finance the purchase of autos and houses through debt. Growth in these two sectors creates jobs and income. Most of the additional income is spent, which creates more jobs and more income. Thus, the virtuous circle of economic recovery is ignited and builds rapidly. Remember: when consumers spend it is someone else's income.

Two things have blocked the traditional role of housing in fostering the recovery process. First, because the housing bubble lead to an extreme excess in housing supply, it has taken a much longer time to reduce that excess through natural demographic growth in the number of households. **Chart 2** shows that there is still an excess of about 600,000 housing units but only 200,000 of these are single family homes. Importantly, excess vacancies are down from 2.2 million in 2009. Already housing starts are rising and housing



prices are firming. Thus, housing is finally ready to play its traditional role of fostering recovery.

However, the second reason has to do with the availability and cost of mortgage credit. Since 2007, the private mortgage market has ceased to exist. Over 90% of all new mortgage originations currently are guaranteed by Fannie Mae, Freddie Mac or FHA. In the interest of protecting mortgage borrowers from potential abusive treatment by lenders, the Dodd-Frank Act mandated strict regulation of all aspects of mortgage lending including disclosures, securitization and servicing. Penalties for non-compliance are often severe, including in some instances the right of individuals to bring class action suits against lenders. Many of the implementing regulations are not yet in place. Lack of clear standards of conduct has reduced credit availability except via government sponsored enterprises and more restrictive standards of conduct have increased the cost of lending.

In addition, in the wake of the housing bubble and Great Recession it is now evident that the risks inherent in residential lending are greater than were recognized both in terms of capital requirements and credit guarantee fees. Guarantee fees averaged 22 basis points at Fannie and 18 basis points at Freddie in 2006. During the first half of 2012 guarantee fees were 27 basis points at Fannie and 24 basis points at Freddie, little changed from the housing bubble era. Now, in an attempt to encourage the private sector to begin offering mortgage credit guarantees, Congress mandated a 10 basis point increase in April and the FHFA is requiring the GSEs to implement another 10 basis points increase this month. This will raise guarantee fees on new loans to nearly 50 basis points but analysis, which incorporates the experience of recent years, indicates the fee should be about 70 basis points provided that the government provides a catastrophic loss backstop. Whatever way one looks at it, the cost of borrowing is going to go up and the historical government subsidy is going down. Following the laws of demand, if the price rises, demand will fall. This means that the trend toward rental and away from ownership will continue. Under Basel III risk-based capital requirements for investing in residential loans will be much higher. This will also raise the cost of mortgages and depress demand.

2. Growth in Consumer Income Is Depressed

Because consumer spending is 71% of GDP a change in the growth of consumer income, which drives spending growth, is the most important determinant of GDP. Aggregate consumer personal income is composed of wages, salaries, employer contributions to pensions, social security and Medicare; proprietor's income; rental income; income on financial assets; government transfer payments; less payroll taxes. Disposable income is equal to personal income less personal taxes.

Table 1 compares the composition of consumer income prior to the Great Recession with the composition in September 2012. The composition has shifted significantly toward higher government transfer payments and lower payroll and personal taxes. These components account for 5.7% more of income currently. The offset is in reductions in wages, salaries and supplements and financial asset income.

Government transfer payments are already shrinking and payroll taxes are about to go up, if Congress eliminates the 2% temporary reduction. Depending upon how the fiscal cliff is resolved, personal taxes could also go up and decrease disposable income.

What all of this means is that growth in consumer spending in future

Table 1
Composition of Personal Income

	2007	2012	Change
Wages, Salaries, Supplements	65.8%	64.0%	-1.8%
Proprietors Income	9.0%	9.1%	+0.1%
Rental Income	1.2%	3.5%	+2.3%
Financial Asset Income	17.6%	12.7%	-4.9%
Government Transfer Payments	14.4%	17.7%	+3.3%
Less Payroll Taxes	-8.0%	-7.1%	+0.9%
Personal Income	100.0%	100.0%	
Personal Taxes 12.5%	11.0%	+1.5%	

quarters is going to have to come from growth in wages, salaries and supplements. Increases in financial asset income are not likely in the near term as long as the Federal Reserve keeps interest rates near zero.

Growth in wages and salaries depends upon the level of employment and the wage rate. Employment is increasing gradually but the unemployment rate remains stubbornly high. Worse, the hourly wage rate is stuck at a very low level and has grown only 1.6% over the last 12 months.

Employment needs to grow faster and the wage rate needs to accelerate to ignite a virtuous circle of growth. When income rises, spending rises. Increased spending creates more jobs and more income. And that, in turn, leads to more spending.

Ordinarily, increases in government transfer payments and reduced taxes are sufficient to ignite the virtuous circle. However, because of the depth of the recession and the significant impairment of household balance sheets overloaded with debt, much greater than normal government intervention has proved to be insufficient to kick off the virtuous circle.

Another way of understanding how different the recovery from the Great Recession is from the one following the 1981-82 recession is shown in **Table 2** which compares real growth rates for GDP, income, consumption and saving for the thirteen quarters following the two recessions. Annual real consumer

Table 2
Annual Real Rates of Growth in GDP, Disposable Income, Consumption and Saving Over the 13 Quarters Following the Great Recession and the 1981-82 Recession

	Real GDP	Real Disposable Income	Real Consumption	Real Saving
Great Recession	1.62%	1.63%	1.98%	-6.92%
1981-82 Recession	4.01%	4.64%	5.59%	-4.89%

disposable income growth has averaged just 1.63% since the end of the Great Recession compared to annual real growth of 4.64% over a comparable length of time following the end of the 1981-82 recession. Consequently, annual real GDP growth has averaged just 1.62% compared to 4.01% in the 1980s.

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 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.

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 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.

3. 2012 Q3 GDP — Advance Estimate

Third quarter's GDP growth estimate was 2.0%. Details of the "Advance Estimate" are shown in **Table 3**.

Table 3
2012 Third Quarter GDP Growth

	Advance Estimate	Preliminary Estimate	Second Quarter	First Quarter
Personal Consumption	1.42%		1.06%	1.72%
Private Investment				
Nonresidential	-.13%		.36%	.74%
Residential	.33%		.19%	.43%
Inventories	-.12%		-.46%	-.39%
Net Exports	-.18%		.23%	.06%
Government	.71%		-.14%	-.60%
Total	**2.03%**		**1.25%**	**1.96%**
Final Sales	**2.15%**		**1.71%**	**2.35%**

Consumption improved from the low level in the second quarter, but was still below the weak growth rate registered in the first quarter. The big story is in the swoon in nonresidential investment from a positive contribution of 0.74% in the first quarter to a negative contribution of -0.13% in the third quarter. Capital spending, which played a big role in driving real GDP growth in 2011, has now run out of gas. Some of this slowdown is probably related to the uncertainty surrounding the fiscal cliff and delays in making investments. But, a greater impact probably is coming from weak sales demand and lethargic revenue growth. An unusual aspect of third quarter GDP, which gave a false sense of improvement, was a sharp increase in government expenditures. This is most likely a temporary timing issue that will not repeat in coming quarters.

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 2.15% in the third quarter compared to 1.71% in the second quarter and 2.35% in the first quarter.

Recent data reports indicate that third quarter GDP could be boosted to as much as 2.7% in the "Preliminary" estimate that will be released at the end of November.

4. Q4 GDP Estimates and Impact of Hurricane Sandy

Goldman Sachs (GS) expects GDP to expand at a 1.9% annual rate in the fourth quarter, while Bank of America/Merrill Lynch (B of A) expects growth to be a very weak 1.0%. 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. As third quarter GDP data indicate, there is already evidence that investment spending is slowing. However, prior to the election there was no evidence that consumers were reacting negatively to the uncertainty posed by the approaching fiscal cliff.

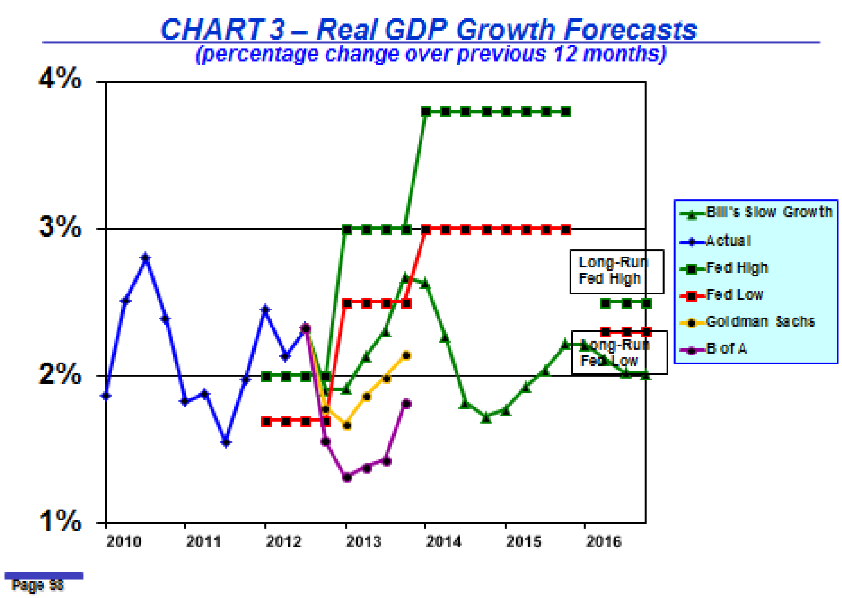
However, the impact of hurricane Sandy was significant and is likely to throw all forecasts of fourth quarter GDP off. Typically, severe natural disasters depress spending initially. However, as rebuilding gets underway, there is a surge in growth. Over the longer run, the structural rate of growth in real GDP remains the same. However, in the short run the impacts of the hurricane will introduce volatility into many economic indicators and make it more difficult to ascertain underlying trends.

Data from MasterCard Advisors indicates that during the week that the hurricane struck retail sales were 63% of normal in New Jersey; and 79% in New York and Connecticut. These three states account for approximately 13% to 14% of national retail sales. ISI's retail sales diffusion index fell by 7 points. Airlines, truckers, auto dealers and home builders were also adversely impacted. Interestingly, there was a surge in sales of tennis shoes and carpeting.

Goldman Sachs expects Sandy to reduce fourth quarter GDP by 0.25% to 0.50% but this decline will be more than offset by a somewhat larger increase in the first quarter of 2013.

5. GDP Forecasts for 2013

B of A's forecast of 1.8% GDP growth in 2013 is one of the more 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 2.0% 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 2.7%. (See **Chart 1**.)



Of course, resolution of tax and spending issues will have a significant impact on 2013 in ways that are not fully knowable yet. Most forecasts factor in a 1.0% to 2.0% drag on GDP growth in 2013 from tighter fiscal policy.

6. 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 based on uncertainty while other forecasters incorporate some negative impact from tighter fiscal policy.

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. And, if Congress agrees to a grand bargain approach to tax and spending issues and phases in the impacts over time, this could decrease the extent of the short-term negative impacts and boost business and consumer confidence. In recent days there has been some talk in political circles about phasing out the payroll tax cut over two years rather than going "cold turkey" on January 1, 2013. This would surely reduce the extent of fiscal drag in early 2013.

III. 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 4**, indicate that disposable income growth accelerated from 2.46% in 2011 to an annual rate of 4.45% over the first nine months of 2012. However, the annualized rate of growth over the last

Table 4
Change in 2011 and 2012 Personal Income and Its Disposition
(in billions of dollars)

	Nominal 2011*	Pct. Change	Nominal 2012 Jan.-Sept.**	Annual Pct. Jan.-Sept. Change	Annual Pct. Apr.-Sept. Change
Personal Income	**$458.1**	**3.64%**	**$452.5**	**4.63%**	**2.80%**
Compensation	269.2	3.34%	300.2	4.82%	2.16%
Proprietors' Income	21.0	1.83%	54.8	6.25%	5.75%
Rental Income	70.7	19.50%	35.5	10.92%	7.76%
Asset Income	25.9	1.56%	31.2	2.46%	1.86%
Government Transfers	4.3	0.19%	64.3	3.69%	2.93%
Less: ***Personal Taxes***	-112.7	5.05%	-99.0	5.63%	2.97%
Disposable Income	**278.5**	**2.46%**	**387.1**	**4.45%**	**2.68%**
Less: ***Consumption***	**435.8**	**4.04%**	**384.5**	**4.57%**	**3.52%**
Personal Saving	**-157.4**	**-28.63%**	**2.7**	**0.92%**	**-19.14%**
Personal Saving Rate	**4.24%**		**3.80%**		**3.88%**

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

six months has been 2.68%, 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.

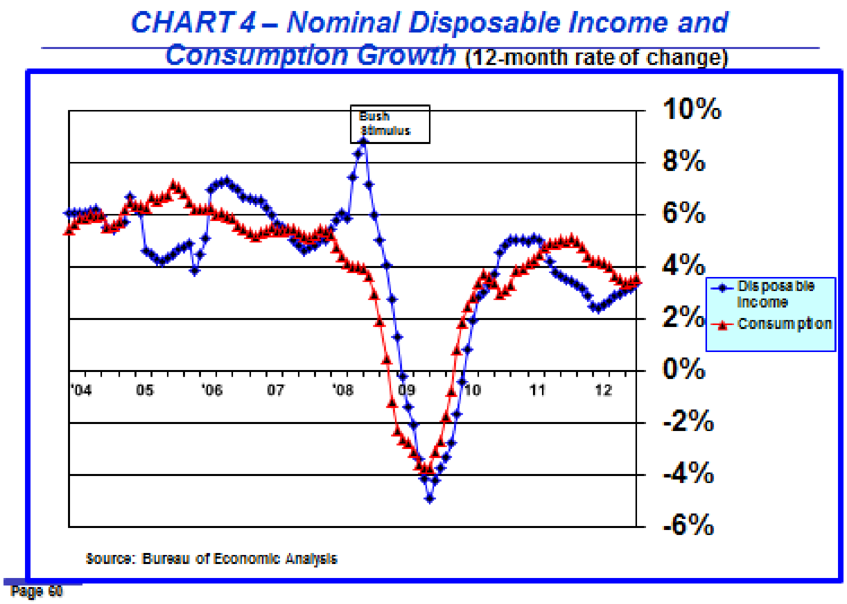
The saving rate has declined farther so far in 2012, but may be in the process of stabilizing, but at a somewhat lower level.

Personal taxes continue to rise somewhat faster 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 4 shows the nominal rate of growth in disposable income and con-

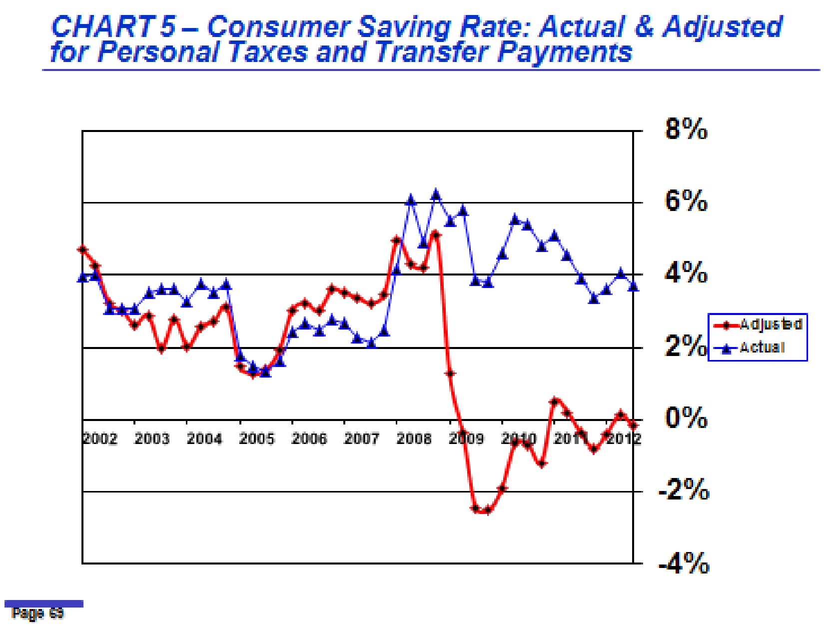


sumer spending from 2006 to the present. The annual rate of growth in disposable income began slowing in late 2010 and declined from its recent high of 5.1% in February 2011 to 2.4% in February 2012, but has risen since then to 3.4% in September 2012. As mentioned above, the rebound in the growth rate 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 3.4% in coming months. My model suggests it will peak at 4.3% in January 2013. 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, but rebounded to 3.6% in September. Even with the recent improvement in income growth, the growth rate in consumption still exceeds the growth rate in disposable income. This relationship may 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. Consumer Saving Rate

Chart 5 shows the actual reported saving rate (blue line) and an adjusted



saving rate that adjusts for changes in government transfer payments and personal taxes (red line). The impact of the Great Recession is very evident. After the initial plunge in spending in 2008 boosted the saving rate, **Chart 5** shows that the collapse in consumer income would have driven the saving rate negative were it not for the injection of government transfer payments and tax reductions. As government stimulus has been withdrawn slowly over the last few quarters, the adjusted saving rate has edged up while at the same time the actual saving rate is edging down. This evolving pattern suggests that the reported saving rate may actually continue to decline rather than stabilizing or rising as many forecasters expect. Were this to occur it would mean two things. First, spending growth would be a bit stronger and that would have a positive impact on economic activity. Second, a lower savin rate means that slower progress would occur in healing stressed household balance sheets. My sense of the combined effects is that recovery will continue at a relatively slow pace and will stretch out over a longer time period than generally anticipated.

IV. Employment

October'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 171,000 in October and August and September were increased by a combined 84,000. Monthly payroll growth has averaged 149,000 so far this year, which is marginally above the 125,000 jobs that need to be added each month to absorb new entrants into the labor force.[1] Thus, the unemployment rate has edged down from 8.3% in January to 7.9% in October.

Jobs surged yet again in the household employment survey in October, bringing the two month gain to 1.3 million. However, this survey indicated that 313,000 jobs were lost in July and August. This means that the average monthly gain over the last four months was 242,250. The monthly gain over the last 12 months has averaged 257,000. This compares to an average increase of 162,400 in the payroll survey.

[1] The population eligible for employment has grown about 1.047% annually since the end of the Great Recession, which adds about 213,000 monthly to the eligible work force population. The employment to population ratio measures the percentage of those eligible to work who are actually working. This ratio has averaged about .5852 since the end of the Great Recession and was .5877 in October. This implies that about 125,000 people eligible to work join the labor force each month.

The household and payroll surveys generally track each other fairly closely over time so this persistent and large divergence is puzzling. 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 162,400 over the last 12 months to about 194,400 which is closer to, but still less than the 257,000 average in the household survey, which is never revised.

But, when all is said and done, payroll employment is still 4.3 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.

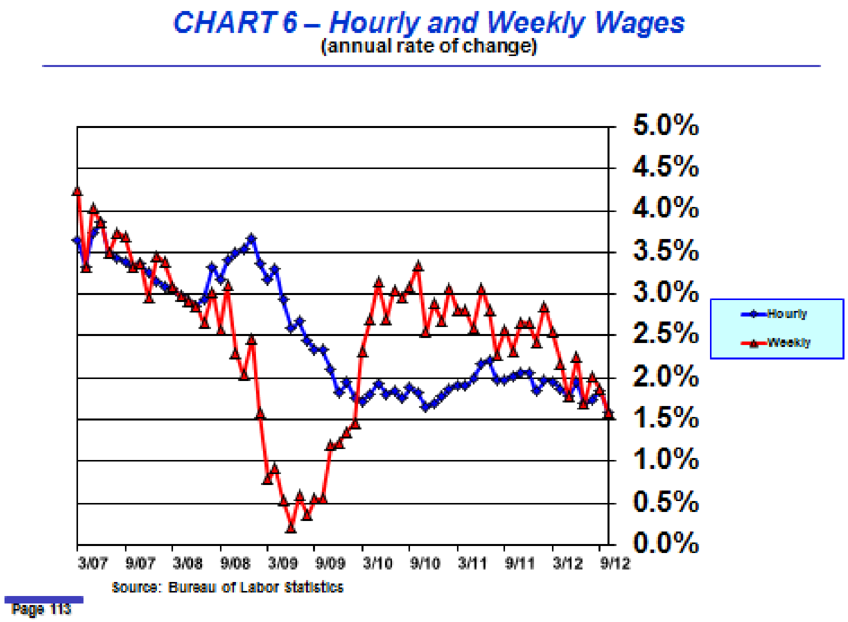
2. Unemployment Rate

Unemployed workers increased 170,000 in October after falling 456,000 in September. As a result the unemployment rate inched up to 7.9% in October from 7.8% in 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 and actually appear to be edging lower.

Chart 6 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 edging down slowly since then rather than stabilizing. 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.

Perhaps even more troublesome is the convergence of the growth rate in weekly wages to the growth rate in hourly wages. The workweek peeked at 34.6 hours in February and has been 34.4 hours for the last four months. This means growth in take home pay is slowing significantly. Real hourly and weekly wages are also declining modestly. This is not the stuff of an improving labor market.

V. Housing

There has been great excitement recently about increasing house prices and a nascent recovery in housing starts. Could it be that at long last housing is poised to play its historical role of catalyzing economic recovery?

I would say this about housing. Yes, it will lift GDP in coming quarters, but the impact will be small. Housing cannot and will not by itself lift the economy to a much higher rate of growth. Right now residential investment accounts for 2.73% of real GDP. The growth rate in residential investment over the last year has been 13.78%. This translates into a .17% add to GDP over the last year, although the four quarter average contribution has been a higher .30%. In any event, suppose housing growth accelerates to 25% over the next year. This would lift housing's contribution to GDP to .30%, which is about what B of A expects. Of course, there are the multiplier effects of construction for other components of GDP. However, even if housing construction is higher, this won't make a big difference in overall GDP growth.

There are still significant headwinds which will prevent a housing boom. Excess inventories have been reduced substantially, but they remain above long-term norms. Credit conditions remain tight and the percentage of first time buyers to total buyers is low and will remain low by historical standards. The troubled loan inventory is shrinking gradually but 9% of loans outstanding remain seriously delinquent or in foreclosure. Thus liquidation activity will remain a drag on supply and housing prices.

Housing prices are being bolstered by significant investment activity. With low prices and low interest rates, it pays investors to buy homes and rent them. I am invested in such a fund and the returns are in the mid-teens. This buying pressure is supporting the rise in prices. But, if prices rise far enough, the returns to a rental strategy will decline, so this phenomenon is self-limiting.

In the longer run, the dynamics of household formation are favorable to new construction and as employment improves there will be some catch up for a while. Falling unemployment and increasing household formation will both support increased residential construction. However, more construction will tilt toward rental, much of which will be in multi-family but some in single family. And, average unit size will probably decline — fewer McMansions. Also, there is the longer term effect on the composition of housing demand that is being driven by the aging of the baby boomers and downsizing. All in all, the housing market is no longer a negative for GDP growth. It is a modest positive, but no housing boom seems likely in the next couple of years.

VI. Election Aftermath: Financial Policy, Legislation and Regulation

Congress will focus on tax and spending issues over much of the coming year. This will crowd out consideration of most other legislative issues. However, there is unfinished business in dealing with mortgage finance issues and the future of the housing government sponsored enterprises — Fannie Mae and Freddie Mac.

In spite of calls from several quarters to revamp provisions of the Dodd-Frank Act, the most Congress is likely to do in the coming year is hold hearings. It will leave it to regulators to continue the slow tedious process of writing and adopting implementing regulations, although hearings will be used to try to exert some influence on the direction and content of certain regulations.

Increased bank size and complexity and greater concentration of financial resources in fewer institutions have lead to concern about "too big to fail" and adverse competitive impacts on smaller banking organizations. This is a bipartisan issue. Both Democrats and Republicans are troubled. Hearings will be held and legislation will be introduced, although passage of anything in the coming year appears to be unlikely.

Implementation of Basel III capital and liquidity rules was supposed to occur in 2013. However, the final rules have not yet been adopted. There has been a firestorm of protest, especially from smaller financial institutions, that implementation could have extremely harmful effects. Banks have lobbied for implementation to be delayed until a thorough economic impact analysis is completed. Congress appears to be sympathetic to this complaint. Regulators recently announced a delay in implementation but did not indicate they would conduct the requested economic impact analysis.

1. Congressional Leadership

Senate. Democrats increased their majority in the Senate by two seats and, assuming the two independent Senators caucus with the Democrats, will hold a 55-45 edge in the Senate. The overall composition of the Senate will be somewhat more liberal. Tim Johnson (D-SD) will continue to chair the Senate Banking Committee.

House of Representatives. Republicans lost a few seats in the House, but still have a comfortable majority which will enable them to control the legislative agenda in the House. Jeb Hensarling (R-TX) will chair the House Financial Services Committee as Spencer Bachus is term-limited by Republican Caucus rules. Jeb is known as a "free market conservative". What this means for housing policy is that he favors privatization of mortgage finance. Maxine Waters (D-CA) succeeds Barney Frank, who retired, as ranking member.

2. Regulatory Leadership

Because the presidency will not change hands, there will be few significant changes among regulators of financial institutions and financial services.

FDIC. Martin Gruenberg (D), who has been Acting Chairman of the FDIC, will likely quickly be confirmed as chairman. Thomas Hoenig (R), who was nominated to be Vice Chairman, but was confirmed as a director of the FDIC, will likely be confirmed as Vice Chairman at the same time Martin Gruenberg is confirmed as Chairman.

CFPB. Richard Cordray has a recess appointment as the Director of the Consumer Financial Protection Bureau (CFPB). That appointment expires in December 2013 unless he is nominated by the president and confirmed by the Senate to serve a full term. Nothing is likely to happen in the opening months of 2013, but the expiration of the recess appointment at the end of the year will force the situation. Republicans have blocked appointment of a permanent director because they believe the CFPB should be governed by a board rather than a director. The outcome of the election assures the status quo since the Senate will not agree to such a governance change. It remains to be seen whether Republicans will continue to block a permanent appointment.

FHFA. One regulatory change that seems highly probably before the end of the year is replacement of Ed DeMarco, Acting Director of the Federal Housing Finance Agency (FHFA). There have been repeated calls from Democrats in Congress to fire DeMarco. This cannot be done under the terms of the FHFA's statutory governance structure. However, the president can appoint a director using his recess appointment authority. This is very likely to happen following the end of the 112th Congress and prior to the convening of the new 113th Congress on January 3, 2013.

Treasury Secretary. Tim Geithner has made it clear that he will not continue as Treasury Secretary. Needless to say, speculation on successors has begun. Names that have been mentioned include Erskine Bowles (former Senator and co-chair of the Simpson-Bowles Commission on tax reform), Roger Altman (Clinton Administration Treasury official), Larry Fink (BlackRock), Gene Sperling (Director of the National Economic Council), Neal Wolin (current Deputy Secretary of the Treasury), Lael Brainard (Under Secretary of the Treasury for International Affairs), Jacob Lew (White House Chief of Staff), and Daniel Doctoroff (CEO of Bloomberg).

Federal Reserve Board. Elizabeth Duke's term expired on January 31, 2012 but she is continuing to serve until the president appoints and the Senate confirms a successor. Chairman Bernanke's term as chairman expires on January 31, 2014. It is widely believed that he plans to step down at that time. What this means is that by about the middle of 2013 speculation will crescendo about who the future chairman is likely to be. Republicans have been unhappy about the Fed's quantitative easing monetary policy. However, because the composition of the Federal Open Market Committee is unlikely to change appreciably it is unlikely that there will be any material change in monetary policy in coming months.

3. Dodd-Frank Act

No legislative tinkering with the Dodd-Frank Act seems likely in the coming year. Congress will hold oversight hearings. Democrats will focus on defending past achievements. Representative Brad Miller (D-NC) recently said, "I can't imagine an ambitious agenda coming out of Democrats in Congress." The House Financial Services Committee passed many bills in the current Congress, nearly all of which never were considered by the Senate. The same is likely to happen in the next Congress.

Regulators will continue the tortuous task of writing and implementing regulations covering:

- Asset-backed securities offerings

- Banking regulations
- Consumer protection
- Credit rating agencies
- Derivatives
- Executive compensation and corporate governance
- Mortgage reforms
- Orderly liquidation authority (living wills)
- Investors: advisers/private funds
- Investor protection/securitizations
- Systemic risk (SIFIs — systemically important financial institutions)
- Volcker Rule (proprietary trading)

Davis Polk puts out a monthly status report on Dodd-Frank rulemaking. The report makes it clear that regulators have a long road ahead. For example, banking regulators have finalized only 34 of 135 rules; the SEC has completed 32 of 95 and other regulators have finalized 27 of 108. The CFTC is the farthest along, having completed 43 of 60. This means that only about one-third of the 398 required regulations have been implemented.

Recently the Bipartisan Policy Center announced a "Financial Regulatory Reform Initiative" which will focus on the Dodd-Frank Act. A report is targeted for fall 2013.

4. GSE (Fannie Mae and Freddie Mac) Reform Legislation

GSE legislation is needed to enable and encourage the private sector to provide mortgage finance solutions. It is also needed to define the future role of the government in providing mortgage finance and specifically what, if any, role Fannie Mae and Freddie Mac will have.

While legislation is a pressing need, Congress' preoccupation with tax and spending issues is likely to leave little time for consideration of this issue.

Moreover, a deep ideological divide exists, mostly among Republicans, over the role of the private sector versus the government in providing mortgage credit guarantees. According to Gary Miller (R-CA), "The untold story is how much division there is among Republicans on exactly what to do."

There are three sets of issues that need to be addressed:

- Consumer protection
- Securitization and secondary market
- Credit guarantees

Consumer Protection. Consumer protection issues are being addressed by the CFPB. The most difficult issue is defining what constitutes a "qualified mortgage" in terms of unfair, deceptive and abusive practices (UDAAP). The principal issue is whether and how to define a safe harbor or whether to rely on a "rebuttable presumption". The stakes are high because aggrieved mortgagees have the right to bring private legal action for redress of any harm they believe they may have suffered. A safe harbor would preclude the right of private action. However, too narrow a definition of safe harbor could limit the availability of mortgage credit, particularly to low-income households. Adoption of a rebuttable presumption standard would permit more flexibility in mortgage instrument design but would entail potential legal ambiguity that could cause increased litigation risk. The CFPB has promised to issue a final regulation by January 21, 2013. Whatever the outcome, the availability and cost of mortgage credit is likely to be affected adversely.

Securitization and Secondary Market. Many of the reforms necessary to attract investors back to purchasing private mortgage securities can be implemented without legislation. The FHFA has already taken steps to initiate the process of standardizing many aspects of mortgage origination, securitization and servicing. A standard for providing representations and warranties has been adopted jointly by Fannie Mae and Freddie Mac. This covers securities issued by these two GSEs. This could also become the standard for privately issued mortgage securities.

Pooling and servicing agreements (PSAs), purchase and sale agreements and trust agreements also need to be standardized. Pooling and servicing agreements are especially important because they define the responsibilities of servicers and investors. In the aftermath of burst housing bubble lack of standardization and ambiguity in PSAs lead to disputes between investors and servicers over liability for loss mitigation costs. These disputes have contributed to the slow pace in resolving troubled mortgages.

Another reform that is needed, which requires legislation, is preventing holders of second mortgages from interfering with loss mitigation solutions for first mortgages.

In addition, transparent data on individual mortgages which provide detailed information about pricing, credit and payment history, while simultaneously protecting borrower privacy, must be readily available and updated regularly. The CFPB and FHFA recently announced a joint approach to creating such a database. The Office of Financial Research will also need to be involved as it has responsibility for establishing data protocols including requiring a loan specific permanent tracking identification number.

Mortgage Credit Guarantees. Who provides credit guarantees is at the heart of the debate about the role of government versus the private sector in mortgage finance. Historically, Fannie and Freddie provided mortgage credit guarantees for "conforming" loans which had a maximum size limit with some higher limits for "high cost" markets.

Guarantee fees averaged 22 basis points at Fannie and 18 basis points at Freddie in 2006. During the first half of 2012 guarantee fees were 27 basis points at Fannie and 24 basis points at Freddie, little changed from the housing bubble era. Recently, in an attempt to encourage the private sector to begin offering mortgage credit guarantees, Congress mandated a 10 basis point increase in April and the FHFA is requiring the GSEs to implement another 10 basis points increase this month.

Even though these increases would take credit guarantee fees to nearly 50 basis points, an analysis prepared for the Housing Policy Council indicates that if there is no government role in providing credit guarantees or backstopping private mortgage credit guarantees, the private sector would require a fee of 130 basis points. However, if there is a provision for the government to provide a catastrophic backstop, similar to how deposit insurance works through the FDIC for banks, the required private sector guarantee fee would drop to 71 basis points. The catastrophic backstop would only be activated if two lines of defense fail. The first line of defense would be the private insurer's loss reserves and capital. If that were exhausted, the second line of defense would be assessments levied on other private insurers. Only in the event that both lines of defense were exhausted would the government's loss reserves be tapped. The analysis indicates that 62 basis points of the credit guarantee fee would go to the private insurer and 9 basis points would go to the government's catastrophic loss fund.

It should be noted that although many Republicans prefer eliminating the government completely from the mortgage guarantee business, financial institutions engaged in mortgage finance strongly prefer the catastrophic government backstop approach.

I should add that it has been the federal government's policy for decades to provide housing subsidies of various sorts, all of which are intended to reduce the cost of owning a home. Subsidies are also intended to increase the number of lower income households who can afford to buy a home and qualify for a mortgage. There is a powerful lobby of realtors, builders, consumer advocacy groups and even financial institutions which want to continue some kind of government involvement in the mortgage market.

VII. The Fiscal Cliff Is At Hand

In days to come talk of the fiscal cliff, political posturing, and speculation about deals to avoid going over the cliff will dominate the headlines. The outcome of the election strengthened the president's hand. Republicans in the House are in a more defensive position but that does not mean they are ready to cave into President Obama's demands. The president was careful in a recent statement in speaking about the imperative of increasing tax revenues. He did not talk about tax rates. This leaves open the possibility that the Bush tax cuts could be retained if revenues are found elsewhere, such as limiting the amount of deductions wealthy taxpayers can take.

1. Possible Pathway To Avert the Fiscal Cliff

Prior to the election press reports indicated that a bipartisan group of senators was 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. This plan is a version of the so-called "Grand Bargain".

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. The flaw in this plan is that President Obama continues to insist on an immediate tax increase for the wealthy.

Of course this is the stuff of compromise and as reasonable as this proposal 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 — those earning $250,000 or more. 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.

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 spending cuts mandated by the Budget Control Act. 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.

2. Possible Scenarios — Goldman Sachs

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 to 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.

3. Possible Scenarios — ISI

Among investors the consensus view is that Congress will pass a short-term extension — Goldman Sach's highest probability scenario. Investors put lower odds of going over the cliff than the Goldman Sach's 35% and believe a grand bargain is highly unlikely. ISI believes that the odds of either going over the cliff or arriving at a grand bargain are much higher than investors believe.

There is reason for some optimism because both President Obama and the Republicans have something to gain by reaching a compromise. By reaching an acceptable compromise quickly, President Obama can take credit for eliminating uncertainty and setting the stage for better economic growth in 2013. He would also have the space to move onto other policy priorities. Republicans can't afford to back off their commitment not to raise tax rates, but they understand that intransigence on this issue will crush the Republican brand. The best way out of this would be to embrace the grand bargain, which would shift attention from the narrow issue of not raising tax rates to the broader issue of tax and spending reform and a long-term commitment to measured deficit reduction.

4. 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.

5. 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***.

6. 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

Recently, a reader of this letter, after hearing Michael Spence (from Stanford and a Nobel Laureate in Economics) speak, shared the following: "*He said that Europe had essentially stopped the European debt crises from going over the brink, and that yields would be lowering soon — he was pretty confident in this statement, saying Mr. Draghi has been saying and doing the right things.*"

I responded as follows: "*When analyzing what is likely to happen in Europe it is important to understand that Mario Draghi can only influence monetary and financial market conditions. His "we will do whatever it takes" statement means that the ECB stands ready to buy, without limit, the sovereign debt of troubled countries, most notably Spain. The Germans parried this by requiring that Spain sign an MOU first. However, the mere threat of buying bonds and driving down interest rates is sufficient, for now, to stop speculative short selling of Spanish debt. This is the reason that markets have calmed down and interest rates have fallen. I have been saying all along that a long-term solution to the flaws in the euro zone (EZ) will involve fiscal transfers from strong to weak areas — from Germany to Spain, etc. There is no agreement to do this yet. However, if the ECB buys Spanish debt without limit, this is a backdoor way of accomplishing the same thing because it involves, in effect, all EZ member nations assuming responsibility for Spanish debt. In that sense it is similar to issuing Eurobonds or providing deposit insurance on an EZ-wide basis. This action spreads the Spanish problem to all EZ nations. The intent of the monetary policy is to stabilize financial market conditions and give countries like Spain time to resolve fiscal issues and restore competitiveness to their economies.*

However, nothing, let me emphasize, nothing, has been done to ease macroeconomic conditions in Europe. All that has been accomplished so far has been to ease financial conditions. Recession in the European macroeconomy is still gathering momentum. Severe competitive imbalances among members of the EZ have to diminish considerably. The chosen policy to accomplish this is austerity — cutting government spending and raising taxes. This policy crushes economic activity in the nations pursuing such policies, but ripples out to other EZ nations through trade relationships. The intent of austerity is not just to reduce fiscal deficits but also to force down wages and improve trade competitiveness. Actually over the last three years the competitiveness gap between Spain and Germany has already narrowed by about 10% as Spanish unit labor costs have declined 6% while Germany's have risen 3%. However, compared to 1999, Spanish unit labor costs are still about 20% higher than Germany's. Thus, there has been progress, but more is required. The problem, however, is that Spain's unemployment rate now exceeds 25% and is rising. How much more pain will the populace tolerate before the social fabric frays to the point of significant social unrest and political upheaval? The situation is deteriorating — gradually for the time being. And, even if austerity eventually is successful in restoring competitiveness without unleashing social and political fragmentation, this will not validate the current governance structure of the EZ, although it would end the financial crisis. In the long run, a successful monetary union can only persist if there is substantial integration of economic, fiscal and political governance structures. In the interests of individual country sovereignty, this looks to be a daunting and probably impossible task to accomplish.

So, in response to Michael Spence, he gave a very oversimplified response to a complex set of problems. Aspirin can cut a fever and monetary policy can stabilize financial markets, but aspirin does not cure the disease and the same is true for monetary policy in the EZ."

Recession continues to deepen in Europe and the EZ. 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 and -2.0% in the fourth quarter. The purchasing managers index remained in contraction territory at 45.8 in October. Importantly, bank lending is 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 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, Spain will eventually require a bailout over and beyond the one already agreed to that recapitalizes its banks. When that time comes 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 the Outright Monetary Transactions program. Part of the reason Spain has not been forced to sign an MOU yet is that some deposits have returned to Spanish banks as financial conditions have eased. Nonetheless, the implosion of the Spanish economy continues relentlessly. In September industrial production had retreated to a level last experienced 20 years ago in the early 1990s. Unemployment reached 25.6% and youth unemployment is 54.2%. Bad loans in Spanish banks now amount to 10.51% of loans outstanding. And, to cap it all off, social discontent is growing. So, while financial markets are calmer and rates on 10-year Spanish sovereign debt have dropped thanks to gobs of liquidity and promises from Mario Draghi, the Spanish economy is in deep depression with no visible light at the end of the tunnel. Macro fundamentals will eventually prevail, so it is prudent to be prepared for a return to crisis in Spain sometime in the future.

Second, the Greek parliament approved by a slim margin of three votes the conditions laid out by the troika (ECB/IMF/EC) to provide the next round of bailout funding. Parliament must also pass a budget before the funds are disbursed. Someone aptly observed that Greece's parliament chose to drink the hemlock. By the end of this year Greece's GDP will have contracted 25% since 2007. The end of the decline is not yet in sight. One has to wonder how long it will be before social unrest destroys the current fragile political stability.

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.

There is yet another looming issue and that is the U.K.'s threat to veto the EU budget. A Polish spokesman suggested that one or more countries might veto the budget. The significance of this threat is that by constricting the EU budget it will be more difficult to pursue the kinds of integration that are necessary if the monetary union is to survive in its present form.

IX. China

The same reader of this letter reported to me that Michael Spence (from Stanford and a Nobel Laureate in Economics) also said: "*. . . all leadership changeovers in China are extremely difficult and risky but they usually work, and that the Chinese economists and the economic leaders really know what they're doing, at least in knowing what policies to implement.*"

I responded as follows: "*I would say that Michael Spence is engaging in an exercise in faith rather than in disciplined economic analysis. It is the common narrative these days that China's leaders are smart, that they know what they are doing and they will apply a set of policies that helps China through its economic transition in a way that avoids economic collapse or stagnation. Remember that the same narrative existed for Japan in the 1980s.*

When one dissects the details of China's situation it is clear that the rapid growth based upon investment in infrastructure and trade is not sustainable. China must rebalance its economy to increase internal consumption. I believe that the leaders understand this quite well. However, understanding the problem does not necessarily mean that they will be able to resolve it. Economists tend to underappreciate the influence of institutional structures, culture and social systems on the ability to manage and direct economic activity. This naivety is a casualty of the separation of the disciplines of economics, sociology and political science. It would be better if the all-encompassing discipline of political economy still held sway, but it does not.

China's problem is not in knowing what it needs to do but it is rather in being able to accomplish it given significant resistance from maintenance of the status quo. Timing is also an issue. Delay in implementing the transition will make it harder to pull off without triggering severe repercussions. Yet, the path of least resistance, as we are seeing in Europe, is a tendency to *delay — to hope that matters will resolve themselves over time.*

So, a much greater slowing in China's growth rate than the consensus assumes seems likely. This would not be a bad thing as it would reflect an intentional policy to rebalance the Chinese economy and put the economy onto a sustainable path. If the growth rates approximate recent levels of 7.5%, I would interpret this not as a good thing but as a delaying strategy that actually makes the rebalancing task much harder later on."

1. Green Shoots

Market analysts have been quick to pounce on slightly better recent Chinese data reports to declare an end to the slowdown in real GDP growth. Indeed, forecasts are now being marked up. For example, Bank of America/Merrill Lynch (B of A) recently upgraded its year-over-year real GDP growth forecast from 7.5% to 7.8% for the fourth quarter of 2012. (Part of this increase was due to revisions in China's national income accounts, which decreased GDP slightly in 2011.) It also marked up its 2013 forecast from 7.6% to 8.1% with a progression over four quarters of 8.3%, 8.3%, 8.0% and 8.0%. B of A asserts that a hard landing has been averted.

Third quarter data reports indicated that housing and infrastructure spending is improving. However, heavy industry revenue growth remains weak, but profits were up 7.8% year over year. Consumption growth is slowing a bit reflecting pressure on wages and incomes from a somewhat softer labor market, although data for job openings suggest the labor market is actually tight. Other data reports indicate that supply excesses have diminished, which would be consistent with an inventory cycle correction running its course. But, there isn't much evidence of increasing demand.

However, International Strategy and Investment (ISI) believes that China is in the throes of a hard landing currently. ISI bases its conclusion on a weekly survey it conducts of China sales. The survey collects data from 21 U.S. multi-national companies. The survey covers sales of goods and services produced and sold in China and goods exported to China. The survey is a diffusion index. A value greater than 50 means that activity is expanding, while a value below 50 means activity is contracting. The index value has been below 50 since the beginning of 2012 and has steadily worsened. The index in the week ending November 9, 2012 was 39.2 year.

The index is closing in on the record low of about 35.0 briefly reached in early 2009 before China's massive infrastructure investment program had kicked into high gear. ***There are no green shoots in ISI's report***.

When contrary data surface and widely divergent differences of opinion about the future develop it is useful to examine details closely.

2. Challenges Facing China's Economy

There are a number of challenges facing the Chinese economy.

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 an inventory correction. In particular the inventory correction is impacting commodities, as 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.

Fifth, non-financial debt to GDP, while not at the lofty levels many developed economies sport, has risen since the aggressive stimulus of 2009 to over 200%. The troublesome sector, however, is the corporate sector. The debt-to-GDP ratio for that sector has reached 122% of GDP, which compares unfavorably with the 77% corporate debt ratio in the U.S. High debt leverage in the corporate sector increases individual company fragility to revenue and profit shortfalls.

3. China's Two Economies — Capital Formation and Consumption

There is a reasonably straightforward answer to the "green shoots" view and ISI's "hard landing" view. It has to do with China's two economies — capital formation and consumption, which are currently approximately equal in size according to data compiled by GK Dragonomics.

ISI's survey primarily captures the capital formation sector of China's economy which includes manufacturing and infrastructure. The trend in ISI's index almost exactly matches the trend in revenue growth for industrial firms. As can be seen in **Table 5**, the contribution to GDP of this sector has declined more than 20% from 2011 to the first half of 2012. Growth of the consumption sector has slowed by about 5%. However, its contribution to GDP is now larger than that of the capital formation sector.

Table 6 shows the annual rates of growth for the two sectors. Capital formation has slowed from an annual growth rate of 10.2% in 2011 to 7.9% in the first half of 2012; consumption growth has slowed from 9.8% to 9.3%. The substantial decline in net exports reflects a greater decline in imports than exports as the capital formation sector slows.

Table 5
China's GDP Growth — 2011 and 1H 2012

	Share of GDP	Contributions to Growth	
	2011	2011	H1 2012
Capital Formation	49%	4.9%	3.9%
Consumption	48%	4.7%	4.5%
Net Exports	3%	-0.4%	-0.6%
GDP Growth	100%	9.2%	7.8%

Source: GK Dragonomics

Table 6
China's GDP Growth — 2011 and 1H 2012

	Share of GDP	Growth Rates	
	2011	2011	H1 2012
Capital Formation	49%	10.2%	7.8%
Consumption	48%	9.8%	9.3%
Net Exports	3%	-10.8%	-23.1%
GDP Growth	100%	9.2%	7.8%

Source: GK Dragonomics

Further slowing in the capital formation sector is likely, but the overall rate of growth will be held up in the next few quarters by consumption growth and a reduced drag from net exports. Thus, B of A's GDP forecast for 2013 may well be reasonable.

GK Dragonomics summed up the current economic situation in China in its quarterly chartbook as follows:

- The worst of the slowdown is over, as most growth indicators have steadied.
- Given the structural constraints on debt-driven stimulus, aggressive measures to support growth are unlikely unless there is another sharp deterioration.
- Yet conditions for a strong rebound are not yet in place, given the

continued overhang of inventories domestically and sluggish demand globally.

- Housing sales are rising, but this will not immediately translate into a boost to new construction.
- The trade surplus is expanding again, as import demand weakens and the terms of trade improve.
- Inflation has bottomed but is not an immediate threat.

4. Rebalancing China's Economy and Potential Long-Term Growth

However, over a longer time horizon it is clear that China's structural rate of GDP growth will slow. Outgoing Chinese President Hu Jintao on November 8, 2012 at the commencement of the Communist Party Congress set a goal of doubling GDP between 2012 and 2022. This forecast works out to a 7.2% annual rate of growth.

As I have commented in previous letters, China could maintain or increase its growth rate by repeating its 2009 stimulus policy of massive investment in infrastructure. But, that would result in exacerbating further substantial imbalances that already exist. It is reasonably clear that Chinese policymakers understand the risks such a policy would create and have chosen a path of gradually rebalancing the economy toward domestic consumption.

Given the evolving policy stance, the question, then, is one of whether an average 7.2% rate of growth over the next ten years is achievable.

There are two credible arguments that tilt in the direction of a sustained real growth rate of at least 7% for the next few years. One is that China is intentionally transitioning its investment policy from one of constructing infrastructure to one that focuses on investments that increase efficiency. However, the shift in strategy will not automatically be successful unless it is accompanied by significant enabling reforms covering financial, fiscal, regulatory and competitive matters. This need appears to be understood by the incoming new leadership, based on comments made on November 9, 2012, by Wang Jingqing, deputy head of the Organization Department of the Communist Party's Central Committee. But vested interests and status quo inertia, particularly involving state owned enterprises, stand in the way of significant reforms. A second argument is that as growth slows in the coastal regions, it will accelerate in inland areas, resulting in a relatively stable growth rate of at least 7%.

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 slower 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.

Those who study the internal dynamics of China's economy and demographic trends believe that the structural growth rate in China's economy over the next ten years is likely to be about 6.0% with a gradual downward trend to as low as 5.0% by 2022. Key to this analysis is the fact that there will be no growth in China's eligible working age population over the next ten years. Thereafter, the working age population will actually begin to shrink as China's one-child policy takes full effect.

X. India

Economic growth has slowed in India from 8.4% in fiscal 2011 to about 5.0% in the second half of calendar year 2012. However, market analysts, just is the case for China, are optimistic that India's real GDP growth will rebound in coming quarters. For example, Bank of America/Merrill Lynch economists expect India's real GDP growth to reaccelerate to 6.5% by the first quarter of 2013 and to be 6.9% during fiscal year 2014.

Just what is behind this optimism? Answering that question is particularly vexing because of the substantial inefficiencies that plague India's economy. These include government corruption (nearly one-third of the members of parliament had criminal charges filed against them at the time the current parliament convened in 2009); an overburdened but honest judicial system (justice delayed is justice denied); stifling government bureaucracy (debilitating intervention, financial repression and crony capitalism); extremely rigid labor markets; an antiquated and essentially bankrupt power sector; a nearly nonexistent internal supply chain infrastructure; and a weakening financial system, as loan asset quality declines. Add to this list of sorry litanies ongoing weak growth in the U.S. and recession in Europe. Also worrisome is the decline of India's two-party system and an increasing number of small parties, which, if this trend is sustained, will result in weaker coalition governments in the future.

Either analysts have been captured by the mystique of the emerging economies economic miracle and are simply extrapolating uncritically past growth trends, or foreign investors continue to pour oodles of cash into the Indian economy irrespective of the risks and prospects for return on, or return of, their capital. The answer is probably a combination of both.

Bubbles can build and persist for long periods of time as we well know from America's recent disastrous experience with its housing bubble. But if the foundations of the bubble are rotten, it is only a matter of time before the imbalances bubbles create become so massive that the driving fuel of copious amounts of investor financing and speculative optimism becomes insufficient to sustain the bubble. Then it bursts, panic takes hold . . . Well, you know the rest of the story.

All we know about India's significant structural and cultural weaknesses resoundingly do not support a real rate of GDP anywhere near recent or projected levels. For now the narrative of the magic of growth in emerging economies continues to hold sway and the bubble in India continues to grow.

XI. Japan

Japan appears to be headed back into recession. Until recently Japan counted on exports of high quality manufactured goods to support industrial production and economic growth and run a favorable balance of trade. Industrial production declined 4.1% in September compared to August and exports have fallen 10% over the last year.

There are two sets of converging forces that account for this negative development. They are being exacerbated by the ongoing repercussions of the Fukishima nuclear disaster and weak political leadership — elections are to be held in April 2013 and the current expectation is that the ruling party will be defeated and Liberal Democratic Party leader Shinzo Abe will become prime minister once again, although a coalition government is also a possibility. The Fukishima disaster has contributed to the deteriorating balance of trade by forcing Japan to import substantial amounts of costly energy supplies.

Japan at one time had a strong competitive advantage in the manufacture of electronics and other high value, high quality goods such as autos and infrastructure equipment. That advantage has steadily diminished as other Asian countries, such as South Korea and now China, have become increasingly effective competitors.

Diminishing export competitive advantage has been worsened by the persistent increase in the value of the yen relative to other currencies. Yen appreciation makes Japanese exports more expensive and shifts demand to other countries with cheaper currencies. The yen has appreciated approximately 65% against the Korean won since 2008.

Persistent deflation and until recently persistent large balance of payment surpluses were behind the steady increase in the value of the yen. The balance of payments includes the trade balance and the capital transfers balance. The trade balance is now negative and worsening. However, up until September Japan's current account balance had been positive as capital inflows more than offset the trade deficit. But that has now changed. For the first time, ever Japan's trade deficit of -$16.2 billion exceeded capital inflows of $15.4 billion, which resulted in a balance of payments deficit of -$0.8 billion in September.

During Japan's ascent during the 1970s and 1980s it ran substantial trade surpluses. As a result, over time Japan became a substantial net creditor nation by redeploying its surpluses into financial and real assets on a global basis. These assets, like any earning asset, earn returns which come back to Japan through the capital transfers segment of the balance of payments.

In the early 2000's, Japan's venture into quantitative easing in an attempt to stimulate demand and quash deflation led to substantial capital outflows which were invested in financial and real assets in other countries. This did weaken the value of the yen at the time and supported exports. However, more recently repatriation of some of these investments has increased capital inflows and contributed to the strengthening of the yen.

Japan's current problems are an illustration of how what appears at one time to be a key economic strength — robust growth driven by large trade surpluses — leads progressively to larger and larger imbalances which eventually have real consequences. The same observation applies to Japan's massive quantitative easing in the early 2000's.

Recent Japanese monetary policy has made matters worse. In the aftermath of the Great Recession, the U.S., the U.K., and more recently Europe have engaged in monetary policies intended to debase the dollar, pound and euro with the intent to price exports more attractively in global markets. Japan, too, has pursued a similar monetary policy but not nearly of sufficient magnitude to hold back yen appreciation. Thus, the yen has continued to rise against other currencies and Japanese exports continue to decline.

Japan's recent announcement of additional quantitative easing recognizes the problem, but appears to be too small in size to arrest the ongoing decline in Japanese exports. It should be added that as the trade balance worsens, the yen is likely to depreciate and monetary policy will reinforce that trend. So, the issue is no longer about an appreciating yen but rather one of whether the impending depreciation of the yen will be sufficient to reverse Japan's deteriorating economy.

Longer-term prospects are even less encouraging. Japan's public government debt-to-GDP ratio exceeds 200%. Its population is shrinking. This means that the ratio of the working age population to the population under 15 and over 64 will continue to decline from its current low level of 1.5 to 1.0 by 2050. Declining population virtually assures a deflationary trend in prices and makes it hard to sustain positive real GDP growth.

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