



The Longbrake Letter\*  
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October, 2011

**I. Was The Worry About Recession in the U.S. and Financial Meltdown in Europe Just Another Momentary Anxiety Attack?**

**1. United States**

Prices of stocks in the U.S., according to the S&P 500 index, peaked at 1364 on April 29, 2011 and again at 1353 on July 7, 2011. Then, after sharp downward revisions in reported GDP growth, the dramatically dysfunctional resolution of the U.S. federal debt ceiling dispute in early August and Standard & Poor's downgrade of U.S. Treasury debt, stock prices plummeted as recession fears mushroomed and renewed problems with Greek sovereign debt surfaced. The index bottomed, at least for the time being at 1099 on October 3, 2011, down 19.4% and was actually down more than 20% the next day, which marks the "official" definition of a bear market, before rallying hard at the end of the day on rumors that European authorities were putting together plans to recapitalize European banks.

Since October 3, 2011 stocks have rallied 11%, closing at 1225 on October 14, 2011. Part of the rally stems from reaction to a technically oversold condition, but the rally has also been supported by somewhat better economic news, which suggests that the U.S. economy is muddling along and that recession is not imminent. But muddling through is not really a good outcome in the long run because it means that unemployment will remain stuck at a very high level and GDP growth will be insufficient to reduce the enormous output gap that exists.

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## 2. Europe

In addition, the Europeans have stitched together policy actions that buy some more time with the result that hope, rather than fear, is driving financial markets, at least for the moment. Greece will probably now receive the next installment of 8 billion euros in early November and that will prevent Greece from running out of cash and defaulting on its debt. However, this is a “buy time” development because nothing has been done to reverse the dismal downward trajectory of the Greek economy. Thus, Greece’s ability to service its ever growing sovereign debt will continue to diminish. However, there is open discussion, though no plan has been formulated yet, to write-down the value of Greek debt by as much as 50% to 60%. This, of course, would threaten the solvency of some creditors.

In response to the threat that sovereign debt write-downs pose for the solvency of banks, various European nations, most notably France but Germany seems likely to follow suit, have made public promises to require banks to raise additional capital, at least on a temporary basis. This is to be accomplished by raising Tier I capital ratios from 7% to 9% by 2013. One option under consideration is to require a recapitalization plan within the next three months and completion of recapitalization within six months. Banks could meet higher capital requirements by bolstering reserves or issuing additional equity capital. But, the key to the market’s favorable response is the stated promise that the French government would provide capital, but only as a last resort, if it were needed and the banks had not been able to raise a sufficient amount of capital. This amounts to a relatively concrete “bail out” promise. While it does not prevent the potential for further equity dilution, it diminishes the extent of potential dilution and eliminates the likelihood of insolvency. From the market’s perspective, the real importance is that European authorities are promising not to let a potential future financial crisis spin out of control.

Finally, Slovakia became the 17<sup>th</sup> and final nation to approve expansion of the European Financial Stability Facility (EFSF), which provides increased capacity to manage the sovereign debt problems of the 17-member European Monetary Union. Furthermore, there is preliminary discussion about additional changes to the EFSF which would expand both its powers and size. Given the three-month time period that it took the 17 member nations to approve changes in the EFSF, substantial expansion of the EFSF,

if it occurs at all, is likely to take a long time to achieve.

So, for now hope, once again, appears to be transcendent. But, let me emphasize that the European policy responses that have helped restore hope have focused on protecting creditors. The underlying problems remain unresolved. And, like a slow developing cancer, the strength of the European economic and financial systems continues to erode. The European economy almost certainly will experience recession in coming months because of the breadth of fiscal austerity programs and the severe tightening of financial conditions. The United Kingdom already appears to be in recession. Recession will exacerbate financial stress for banks and countries.

Similar to the financial meltdown that developed in fits and starts from early 2007 to the climatic blow off in the fall of 2008, complete with its alternating periods of hope and fear, the latest return to hope will not last. More episodes of fear are ahead.

## II. The Gathering Storm ???

*“The Gathering Storm”* was the title of Winston Churchill’s first book in his multi-volume memoirs of World War II. This title may or may not be an apt analogy to the events of our time. Certainly global war is not even a remote possibility. But Churchill’s account in his first volume was about the unraveling of the old political order, beginning with a flawed peace following World War I, a financial collapse, depression and the rise of fascism. Over the last four years we have experienced extreme financial distress in both the United States and Europe. While we have avoided depression, the fallout of financial distress continues to undermine the foundations of the established political order.

It is simply too soon to know where the world order might be heading. What we do know is that established institutional and governance structures in the U.S. and Europe are under enormous stress and the financial underpinnings of these structures are fragile and precarious. The “???” in the title is intentional. Will we continue to experience a few thunder showers followed by sunnier days? Or, are the thunder showers a precursor to a more violent storm yet to come.

In Churchill's time, events unfolded over many years. With the benefit of hindsight we know that policymakers made many bad choices along the way which eventually led to the violent tempest of World War II. The choices could have been different and that would have changed outcomes. The choices today's policymakers make will determine in the long run whether the gathering storm dissipates with minor impacts on the world order or whether those choices precipitate a full-fledged storm. My hope is that policymakers make decisions and take actions that effectively address fundamental issues and economic imbalances. However, the record so far, as was the case in Churchill's time, has not been encouraging.

### III. Recapitulation of the Forces That Are Driving and Reshaping the Global Economic and Political Systems

Over the last several months I have discussed in various letters the global economic and political developments which are fundamentally altering the world order. If established systems of governance adapt to externally driven change, then the transition, though not entirely free from a few bumps, generally is orderly. However, orderly adaptation is usually the exception rather than the rule. History tells us that adaptation rarely occurs intentionally. Stresses build because existing governance structures are designed to regulate economic and financial activity within the context of the established order. Thus, existing governance structures are either ineffective in dealing with significant changes or, worse, they intentionally attempt to block adaptive changes. As Mark Bittman commented in a *New York Times* opinion on October 11, 2011, "Historically, the route to fixing broken systems goes through struggle, confrontation and even revolution."<sup>1</sup>

Deeply embedded long-term trends that lead to significant restructuring of how the economy functions over time dominate all other economic variables. What I mean by this is that such trends anchor the performance of the economy for an extended period of time. The economy's performance can vary considerably over the short run, but like a magnet, the economy's performance over longer periods keeps getting pulled back to the outcomes

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<sup>1</sup>Mark Bittman. "Finally Making Sense on Wall Street" *New York Times*. October 11, 2011.

that are fundamental to these deeply entrenched trends.

These trends guide key economic variables such as employment, inflation, interest rates, productivity and so forth. Generally, they wax and wane over a time period that typically covers several years and eventually are replaced by new trends that in turn become deeply embedded and anchor much of economic phenomena.

In today's world economy there are four major structural forces that are reshaping the functioning of the global and U.S. economies. These are the forces of *globalization*, *technical progress* (productivity), *debt leverage* and growing divergences in the *distribution of income and wealth*.

## 1. Globalization

*Globalization* is not a new phenomenon. It has been going on for several centuries. However, the scope and impact in this latest round is much greater than anything the world has previously experienced. Globalization breaks down communication and transportation barriers and in so doing stimulates economic efficiency. It takes frictions out of the system. But, to the extent that the global economy increasingly becomes an open system it simultaneously becomes more difficult to govern in the extant nation-state structure.

The development of wireless communications technology and the global establishment of the internet have substantially undermined the effectiveness of governance and regulatory regimes of traditional geographically limited political entities. One has to look no further than observe how the implosion of the U.S. subprime mortgage market rippled through the entire global financial system at lightning speed and was transmitted just as quickly from the financial sector to the real sector, again on a global basis. It is the nature a humans individually to seek enrichment and personal success. Governments exist to ensure that the actions of individuals are regulated in ways that serve the best interests of society collectively.

What has happened at an accelerating pace in the span of just of few years is that the natural human tendency to find ways to avoid restrictions and rules has now spread on a global basis. While such behavior curtails the impact of outdated restrictions and accelerates economic growth, it also

has contributed to a decline in the ability of governments to assure that common welfare of society is served. This has made it increasingly difficult to contain bubbles and to reverse the buildup in imbalances in a timely way, thus further accelerating growth in global economic system instabilities.

## **2. Technical Progress (Productivity)**

*Technical progress* simply involves the ability to produce an increasing amount of goods and services relative to the amount of inputs. Such a phenomenon is necessary to produce an increase in the standard of living. However, what changed in recent times, and I mark the critical transition point in the United States to 1997, were two very significant developments both of which greatly accelerated growth in productivity. In the U.S. productivity grew 1.4% annually from 1973 to 1997 but accelerated to 3.4% annually between the middle of 1997 and the middle of 2004.

While there were many causes of the significant upward shift in productivity between 1997 and 2004, the primary one was technological advances in information management, such as fiber optics and desk-top computing, which are reshaping literally every kind of business process. And this was not limited simply to the production of goods; it fundamentally changed how financial transactions are structured and how they are conducted.

It now appears that the burst in U.S. productivity ended in mid-2004. In the past seven years productivity has averaged 1.8%, only slightly better than the period prior to 1997. The downshift in productivity growth occurred at about the time the housing bubble entered the hyperbolic phase. This suggests that resources increasingly were diverted into less productive economic sectors that benefited from the debt leverage bubble. Since the bursting of the bubble, weak demand for goods and services has resulted in considerable excess capacity and depressed revenue growth, factors that generally retard investment.

The second development responsible for an acceleration in productivity involved entry of nearly half of the globe's population into market-based economic systems. These emerging nations are able to grow at astonishing rates, such as China's 9% real rate of growth, because they can apply existing technology to enormously underutilized resource bases. In short, they are catching up with developed nations. That has happened before as it did

for Japan. But what makes this episode much more significant is the sheer volume of people now involved in the catch-up process.

There is a systematic pattern to emerging nations' growth. Emerging nations benefit from an abundance of cheap labor and emphasize manufacturing of low-cost goods for export to more developed countries. This mercantilist economic paradigm can and is in certain instances, most notably currently in China, amplified through currency exchange rate management.

What is important to understand is that while the productivity impulse in the U.S. has diminished, the global impulse from emerging nations has not and is far from spent. It remains extremely powerful and will continue to shape economic events for years to come. Also, these forces not only have increased supply relative to demand dramatically they are also contributing to a rapid reshaping of all global economies. The speed of restructuring has been so great that adjustment of inevitable imbalances has lagged. These imbalances have been amplified by intentional policies by individual countries intended to convey advantage and address local political imperatives. But, unfortunately, imbalances lead to economic instabilities and it follows that that the greater the imbalances are the greater are the instabilities.

Economic imbalances are unsustainable and must eventually correct. As we have experienced in recent years, large imbalances have often fed on themselves — the bubble phenomenon — and then when they eventually and inevitably tip over the policy response must be massive to contain the damage created by the reversal. And, increasingly we are also discovering that the policy response is not always adequate and perversely the response may also contribute to new imbalances. In short, while productivity has lifted the standard of living of billions of people rapidly, and that is a good thing, it has contributed to a dangerous destabilization of global economies.

Globalization and technical progress collectively have increased supply and while they are stimulants for world-wide economic growth, they simultaneously are powerful engines of deflation. This is an extremely important embedded trend that will continue to shape the global economy for an extended time. Simply put, the global capacity to produce vastly exceeds demand. And when supply exceeds demand price falls — disinflation or deflation occurs. This has led governments to pursue demand stimulus through policies such as tax cuts and deficit spending. But, as we increasingly understand, such policies created debt that accumulates over time. And when

debt increases at a faster rate than the natural underlying growth rate in the economy, financial imbalances build that foster asset price bubbles and undermine the ability of the financial system to absorb shocks.

### 3. Debt Leverage

That brings me to the third major embedded trend and that is the increase in *debt leverage*. Since the dawn of human civilization we have understood that a dependable currency and an organized financial system facilitate commerce and contribute to higher rates of economic growth. Along the way we learned that the savings of some could be deployed effectively as loans to others thereby accelerating economic growth. But we also learned that reliance on debt risks default and bankruptcy if revenues are insufficient to service the debt. And, as debt leverage increases relative to income the ability of the borrower to service the debt across all economic situations declines.

In the U.S. debt leverage has risen steadily due to cultural considerations, social policy, more abundant information and financial instrument innovation. The historic stigma attached to debt and bankruptcy diminished substantially over the last 40 years. Fair lending and equal access to credit laws expanded access to credit and safety net programs, such as unemployment insurance and social security, have mitigated the historic consequences of unemployment and retirement. The ability to collect and analyze vast quantities of information fostered new enterprises and encouraged established ones to expand the risk spectrum of clientele that they serve. And, financial innovations, such as adjustable-rate loans, longer-term amortizing loans, collateralized mortgage obligations and an assortment of derivatives, facilitated the management and transference of risk.

Unlike globalization and technical progress, debt leverage stimulates demand rather than supply. In other words, liberal use of debt can accelerate economic growth. Up to a point, greater leverage is a positive trend when coupled with more efficient credit risk management capability and if the amplitude of business cycles can be moderated. For a long time we thought both of these conditions were true and thus we were complacent in dismissing the theoretical risks of ever increasing use of debt leverage. However, the financial meltdown of 2007-09 brutally swept that illusion aside.



There really is a limit to how much debt leverage an economy can handle before it becomes dangerously unstable. And, we now know that aggressive use of debt leverage fuels asset bubbles and can for a very long time sustain a seemingly benign environment. But there is also a simple truism. People, businesses and nations must be able to service debt based on income. If debt service takes an increasing portion of income, by definition resiliency declines and risk of default rises. The asset price bubbles created a myth that debt can be serviced through asset appreciation. But, this myth turned out to be nothing more than a much more broadly-based version of the traditional Ponzi scheme with the exception that it was legitimized as national policy. Careful study of economic history indicates that appreciation in asset values is tightly linked to the real rate of growth in the economy over time. Whenever the two growth rates diverge significantly from the historic relationship an imbalance is created which inevitably will correct or revert to the mean.

The recent global financial system catastrophe has reminded us of the truth of the enormous risks embedded in debt leverage. But in response to the Great Recession instead of beginning the painful process of shrinking debt leverage to a level that would over time support a healthy and stable economy policymakers chose to shift debt leverage from private entities to governments. This has been done in the name of stabilization policy. But governments are no different than individuals and businesses when it comes to the matter of capacity to service debt. There is a limit linked to the real rate of growth in the economy and when government debt grows faster than the economy as measured by a rising public debt-to-GDP ratio, debt service capacity, by definition, declines and the risk of default escalates

#### **4. Income and Wealth Inequality**

Stagnation in inflation-adjusted income growth and spending power and escalating levels of financial distress began well before the onset of the Great Recession. *Income inequality* has grown steadily since 1980. Real household income grew 42% for the highest 5% from 1980 to 2010, while real household income grew just 5% for the lowest 10% from 1980 to 2010.

For a while easy access to credit and the bubble economy masked this developing problem, but the credit bust and persistent high unemployment and underemployment have blown this false faade away. The vast bulk of

American society is bewildered by what has happened in their lives. What they know is that they are hurting and that government intervention appears to have done little, if anything at all, to improve their situations or provide hope for a better future.

Since the onset of the Great Recession all households have experienced declines in real income. However, the decline for the bottom 10% was 6.9% compared to 2.9% for the top 5%.

There are many other forces that are contributing to systematically restructuring the economy. Each by itself does not have the kind of pervasive impact that globalization, technical progress, debt leverage and growing income inequality are having. But, collectively they are important. An example is demographic trends like the aging of the baby boomers and changes in the labor force participation rate.

## IV. U.S. Economy is Struggling

Following the early August debt ceiling political fiasco, the downgrading of U.S. Treasury debt, barely positive U.S. GDP real growth during the first half of 2011, stock market turmoil and plunging consumer confidence, to many it seemed that it was just a matter of time before the U.S. economy experienced another recession. Since then, while the data haven't been exactly robust, they aren't signaling recession. In fact, early forecasts of third quarter GDP growth range around a median of 2.5%. And, September data reports have been a little better than expected.

### 1. Threat of Recession

Threats to economic growth greatly outweigh opportunities, the mood in the country is sour and anxiety remains high. In other words, while recession is not at hand, the threat of one is both real and significant.

Recessions typically occur when substantial excesses have built up in an economy. The 2001 recession corrected the excesses of the dot com and telecommunications investment overshoot. The 2007-09 recession was triggered by huge imbalances spawned by the housing bubble. Today there are

no obvious imbalances in the economy. Does that mean that recession is unlikely? The answer to this question is “No.” But, if recession does occur, it likely would be a mild one from a statistical standpoint. This is small solace, when unemployment is already at 9.1% and the GDP output gap remains at a recession-high level of 6.8%.

Thus, while a new recession is not inevitable, the risks of one are relatively high. Most forecasters place recession odds at 30% to 40% over the next twelve months.

While fiscal consolidation must occur in the U.S. to restore the economy to a healthy condition, too much fiscal austerity too quickly could unleash a negative circle of consequences which could end up pushing the U.S. economy into recession. Given recent congressional obsession with the federal deficit and cutting spending, this is not an idle concern.

And, even if a new recession is avoided, the reality, which markets have come to understand better over the last three months, is that economic growth will be subdued for a long time to come and unemployment will remain at stubbornly high levels.

This reassessment has resulted in a significant reduction in long-term growth expectations. It has also stoked fears of solvency risks in the financial system and the potential for contagion. Thus, the market is telling us that the financial crisis that began in 2007 is not over; rather it has entered the next stage. Market sentiment is oscillating between deep anxiety about whether tepid economic growth and potential policy mistakes might morph into recession versus hope that policymakers will be able to contain the accumulating negative momentum as they were able to do so in 2008-2009.

## **2. Potential GDP Growth Depends on Population Growth and Productivity**

Potential noninflationary GDP growth in an economy benefitting from full employment is equal to the population growth rate plus the rate of productivity improvement. The Congressional Budget Office estimates that potential GDP growth is likely over the next few years to be in a range of 2.3% to 2.4%. My own estimate is a marginally higher 2.5%.

When there is substantial slack in the economy, as is currently the case, real GDP growth equal to the potential rate becomes the “stall speed” rate of growth. That is because growth at the potential rate is not fast enough to reduce the amount of slack — it is just sufficient to maintain the output gap at the same high level. Over the last two quarters real GDP grew less than stall speed at an annual rate of 0.8% and the output gap increased from 6.34% to 6.84%.

### 3. Final Estimate of 2011 Q2 GDP

The “Final Estimate” of second quarter GDP growth was 1.34%. **Table 1** provides details. Improvements in consumer spending and nonresidential construction were offset by declines in inventories and net exports. Even with a small increase, consumer spending growth, which accounts for approximately 70% of GDP, was far below potential of about 1.7% (70% of 2.4% potential growth rate).

**Table 2**  
**2011 Second Quarter GDP Estimates**

	Advance	Second	Final
	Estimate	Estimate	Estimate
Personal Consumption	.07%	.30%	.49%
Private Investment			
Nonresidential	.61%	.94%	.98%
Residential	.08%	.08%	.09%
Inventories	.18%	-.23%	-.28%
Net Exports	-.58%	.09%	.24%
Government	-.23%	-.18%	-.18%
<b>Total</b>	<b>1.29%</b>	<b>1.00%</b>	<b>1.34%</b>

#### **4. Initial Estimates of GDP Growth Probably Biased Upward**

GDP statistics go through a lengthy series of revisions. Initial estimates are based on readily available information, which reflect only a fraction of total economic activity. Missing information is estimated based on past experience and historical relationships between the available and missing information. Over time GDP statistics are revised as missing source data become available and replace the initial estimates.

In recent years, the periodic benchmarking process conducted by the Bureau of Economic Analysis has resulted systematically in significant downward adjustments to originally reported GDP estimates. For example, the most recent GDP benchmark revision, released in July resulted in a decrease of 0.34% in GDP growth in 2008 and a decrease of 0.86% in 2009. Growth in 2010 was revised upward 0.18%, but growth in the first quarter of 2011 was reduced from 1.9% to 0.4%.

In a recent analysis Goldman Sachs (GS) noted that substantial downward revisions to GDP growth occur when small business sentiment is weak. The National Federation of Independent Businesses sentiment index remains very weak. Recent values of this index are in the seventh percentile of the historical distribution. However, other measures of business activity, such as Institute of Supply Management diffusion indices and growth in S&P corporate earnings, which primarily reflect large businesses, have been relatively strong. Source data for small business, which represent approximately 40% of business activity, become available well after initial GDP estimates are released. Based on the sharp divergence between small and large business sentiment and historical correlations of these measures with revised GDP growth estimates, GS believes the 2011 Q2 GDP estimate will eventually be revised downward by 1.2%, which would mean that growth was essentially zero rather than the “final” estimate of 1.3%.

#### **5. Flawed Econometric Forecasting Models**

Did you ever wonder why econometric models often do a poor job of forecasting? For example, the Federal Reserve has one of the more sophisticated models, but it has been routinely forecasting a much stronger economic recovery than has occurred. Quarter after quarter the Fed has been forced to

downscale its forecast. It will do so once again at its upcoming November Federal Open Market Committee meeting.

Most econometric models have a common underlying architecture based on a dynamic stochastic equilibrium methodology. The model is stochastic in the sense that it is based on hundreds of equations whose parameters are estimated from historical time series data. Simplistically, this means that because forecasts are based on historical relationships among variables, accuracy of the forecasts will depend upon whether those relationships are stable. If there are fundamental structural changes taking place in the economy which alter the relationships among economic variables, the quality of the forecasts will deteriorate.

These models also presume that whenever there is a major economic shock, the shock will ripple through the model for several time periods, but eventually the forecast will converge to the long-term equilibrium level. This is called “mean-reverting” behavior.

Concepts, such as the liquidity trap, imply that an economy can get stuck in an equilibrium that is not mean-reverting. The models don’t do a good job of capturing this kind of possible outcome.

As is very evident, the models haven’t performed at all well since the end of the Great Recession. The expected outcomes of policy actions that the models have forecast have not occurred. The case histories of what has happened to the economies of countries in the aftermath of severe financial crises, which have been chronicled by Carmen Reinhart and Kenneth Rogoff, have been far more accurate and informative than any econometric model.<sup>2</sup>

One of the more significant weaknesses in econometric models is modeling of the interaction between the real and financial sectors of the economy. Recent experience has provided ample data to assess the impact of financial conditions on the performance of the real economy. Not surprisingly, it turns out that financial conditions have a very powerful impact on real economic activity. And, the impact appears to be asymmetric in this sense. Most of the time there is little variation in financial conditions which makes it appear that fluctuations in the real economy are relatively independent of financial conditions. However, during times of acute financial distress, the

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<sup>2</sup>Carmen M. Reinhart and Kenneth Rogoff. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press, 2009.

financial payments and credit mechanisms cease to function fluidly. This disrupts real economic activity and has a material adverse impact that is not captured well by forecasting models.

Financial stress has been rising again in recent months and spiked up sharply during the summer. The increase in stress has been greater in Europe, but the U.S. has also been impacted, albeit to a lesser degree. This is why the European situation is more dangerous than supposed. Financial stress is already doing significant damage to the European economy which will become evident over time as data becomes available. Financial stress when coupled with fiscal consolidation and austerity becomes a toxic and extremely dangerous combination.

## **6. GDP Forecasts**

With recession-level consumer confidence and stock market turmoil it will be very difficult for consumer spending to reach potential level. I estimate two forecast scenarios — “Slow Growth” and “Stall Speed.” In the “Slow Growth” scenario employment grows about 140,000 per month through the end of 2013; the unemployment rate falls from 9.1% to 8.7%; GDP growth averages 2.2% and the output gap shrinks from 6.8% to 6.0%. In the “Stall Speed” scenario employment grows about 90,000 per month; the unemployment rate edges up to 9.2%; GDP growth averages 1.9% and the output gap remains stuck at 6.8%.

By comparison, Bank of America/Merrill Lynch (B of A) is forecasting employment to grow 90,000 per month through the end of 2013; the unemployment rate rises to 9.3%; GDP growth averages 1.6% and the output gap rises to 7.8%. In addition, B of A places a 40% probability of recession in the next twelve months. If that were to happen, B of A’s dismal forecast would turn out to be quite optimistic.

In both my “Slow Growth” and “Stall Speed” scenarios, real consumer spending growth slows over the next two to three quarters. Annual growth bottoms at 1.2% in the “Slow Growth” scenario in the fourth quarter of 2011 and averages 2.0% through the end of 2013. Consumer spending growth slows to 1.0% in the “Stall Speed” scenario in the first quarter of 2012 and averages 1.6% through the end of 2013. By comparison, B of A expects real consumer spending to grow 1.7% through the end of 2013. The slowdown

in consumer spending growth reflects the lagged effects of weak employment and income growth which occurred during the first half of 2011. If a recession takes hold, growth in consumer spending would slow to an even greater extent.

In summary, as events are unfolding in financial markets, experience tells me that risks to forecasts of GDP growth are decidedly to the downside. The possibility of recession has increased. If recession were to occur the most likely causes would be reduced consumer and business spending. Extremely low consumer confidence suggests that such an outcome is a very real possibility. Limited evidence for the months of August and September suggests that consumer spending is weak but not consistent with the onset of recession. Thus, it would seem that the early August confidence shock has yet to translate into significant spending curtailment. However, lest we celebrate too quickly, lethargic employment growth will take its toll in coming months. It is premature to declare that recession has been avoided.

## 7. Monetary Policy

As expected, the Federal Open Market Committee (FOMC) implemented “Operation Twist” at its September meeting. While this monetary policy action is a form of quantitative easing, since it does not involve expansion of the Federal Reserve’s balance sheet, it is not being referred to as QE III. What the FOMC announced it intends to do by mid-2012 is to sell \$400 billion of Treasury securities with maturities of 3 years or less and use the proceeds to purchase a like amount of Treasury securities with maturities of 6 to 30 years. In addition, the FOMC said it plans to reinvest principal repayments on its mortgage backed securities portfolio back into mortgage backed securities, thus maintaining a constant amount of such securities on the Federal Reserve’s balance sheet.

The FOMC expects “Operation Twist” to “... put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative.” Analysts expect longer-term interest rates to decline by approximately 20 to 25 basis points.

**Effectiveness of Monetary Policy Appears To Be Limited In An Economy Recovering from a Severe Financial Crisis. The U.S. economy is caught in a classic liquidity trap.** A liquidity trap ex-



ists when monetary policy easing has limited to no impact in stimulating expansion in aggregate demand. It is characterized by zero short-term interest rates, low inflation rates or even deflation, limited attractive investment opportunities and a broken credit creation mechanism.

When a liquidity trap exists the ability of monetary policy to have a material favorable effect on economic activity is quite limited. Monetary policy works primarily through governing the price and availability of money and credit, which facilitate the financing of economic activity. The Fed can reduce interest rates by buying securities which increases the amount of liquidity available to consumers and businesses. In the case of consumers, lower rates make it cheaper and easier to access credit to buy things like cars and houses. For businesses, lower interest rates reduce the cost of capital hurdle rate and make investment more attractive.

When the credit system is functioning normally monetary policy is effective, but after fairly long lag times. Since the onset of the financial crisis in 2007, the credit system has not functioned normally. This has been particularly evident for home mortgages and small business borrowing. In both sectors underwriting standards remain more restrictive than in normal times and this limits access to credit for all but the most creditworthy and raises the cost of credit even for those who are qualified. In the case of home mortgages no private market exists as Fannie, Freddie and the Federal Housing Administration now account for 97% of all new mortgage loan originations. Thus, lowering rates in an impaired credit market is likely to be of very limited help.

Once in the liquidity trap, no matter how much liquidity the Fed provides, rates cannot go any lower than zero. Of course, long-term rates are still positive, which means that the Fed can drive down longer-term rates through monetary policy actions. This is what quantitative easing and “Operation Twist” are intended to accomplish. Yet, the impact will still be limited when the credit system is impaired.

Quantitative easing has another impact and one about which there is considerable debate whether that impact is helpful or harmful. By lowering longer-term interest rates, quantitative easing raises the value of long-dated assets, particularly stock prices. When Federal Reserve Chairman Bernanke announced the Fed’s large scale asset purchase program in December 2010, raising the prices of risk assets was an explicitly stated objective. To the

extent that stock prices rise, and they most certainly did rise until the recent market reversal, it creates additional financial wealth. We know that consumer spending is correlated with stock prices and economic theory posits that a certain portion of wealth will filter into current spending patterns provided that the increase in wealth is considered to be permanent.

But the dark side of rising stock prices is that it unleashes animal spirits, that is, speculation. And, speculation in this modern era of commodity trading and exchange traded funds, spreads far beyond equities. Earlier this year we experienced a conjunction of speculation with an insatiable demand for commodities by emerging economies. Unfortunately, the two phenomena reinforced each other and drove prices, particularly the price of oil, up sharply. American consumers are very sensitive to the price of gasoline and the sharp rise in its price depressed sentiment and crushed spending, as the second quarter GDP report confirmed.

**Potential GDP Impact of “Operation Twist.”** Empirical research suggests that QE I may have boosted real GDP by as much as 2.0% over two years, while QE II should boost real GDP by about 0.6%. The smaller impact of QE II is the result of a smaller amount of purchases — \$600 billion versus \$1.75 trillion — and a diminished impact due to increasingly impaired credit markets. Arguably, the impact of “Operation Twist” would diminish further. For example, GS suggests that the first-year GDP impact of \$400 billion in duration extension of the Fed’s balance sheet would be about a 0.2% boost in real GDP growth. This is tantamount to a rounding error. It is easy to see why monetary policy in current circumstances is virtually irrelevant. This shifts the burden of policy stimulus to fiscal policy almost entirely and the politics of fiscal policy currently is problematic and appears to be on a track that could increase recession risks.

## **8. Fiscal Policy**

If existing temporary tax benefits, such as the 2% payroll tax cut, are permitted to expire and spending cuts are implemented pursuant to the Budget Control Act, fiscal policy would subtract more than \$270 billion or about 1.7% from GDP in 2012. Unquestionably this would have a substantial adverse impact on the U.S. economy in an election year.

**Fiscal Consolidation Speed Limit.** Most agree that policies need to

be crafted to limit further increases in the public-debt-to-GDP ratio with the longer run objective of eventually reducing that ratio. However, at a time when the economy remains incredibly weak and fragile, the extent of fiscal consolidation and the speed of implementation are of considerable importance. Substantial fiscal stimulus in the short run would help economic recovery but could exacerbate economic problems over the long run. Alternatively, substantial fiscal consolidation in the short run could lead to recession, higher unemployment and a higher, rather than lower, public debt-to-GDP ratio. The challenge for policymakers is to find the balance point between the two extremes so that the economic growth does not deteriorate but the problem of excessive debt is not deferred to another day and actually made worse. This challenge of finding the balance point is sometimes referred to as the “**speed limit**” for fiscal policy.

GS estimates that the fiscal consolidation **speed limit** for large, relatively closed economies at the zero-interest-rate monetary policy boundary, such as the U.S., is quite low — less than 2% of GDP. Thus, a 1.7% negative GDP impact in 2012 very well could exceed the speed limit with counterproductive consequences. GS projects a 1.25% fiscal contraction in 2012 which means it is assuming that Congress will provide some kind of limited fiscal stimulus in 2012, such as extending the 2% payroll tax cut for another year, which would continue the current stimulus of about \$112 billion.

**Bernanke’s Advice to Congress.** In recent congressional testimony, Federal Reserve Chairman Bernanke in an appropriately diplomatic manner stated the tenets of “good” fiscal policy. He began by observing that fiscal policy is exerting an increasing “drag” on the U.S. economic recovery. He outlined four objectives for good fiscal policy:

- The federal budget needs to be put on a sustainable path. This will require changes that reduce the size of future deficits and assure that the debt-to-GDP ratio is consistent with long-term fiscal stability.
- Implementation of the long-run program must be designed in a way that avoids the threat to economic recovery that overly aggressive near-term fiscal austerity could cause. The first and second objectives embody the notion of the “speed limit.”
- The long-run program needs to establish fiscal priorities that nurture and improve long-term economic growth prospects.

- Finally, and in Bernanke's own words, "... there is evident need to improve the process for making long-term budget decisions."

**Congressional Super Committee (Joint Committee on Deficit Reduction)**. The Budget Control Act (BCA) created a 12-member select committee of Congress which is required to present proposals for budget deficit reduction to the Congress by November 23, 2011. BCA specifies the following:

- The joint committee is directed to agree on \$1.5 trillion in deficit reduction over ten years and is required to forward its recommendation to both houses of Congress by November 23, 2011.
- Provided that the joint committee recommends at least \$1.2 trillion in deficit reduction to Congress, Congress may adopt the recommendations by simple majority without amendments and must take action by December 23, 2011. In other words, Congress must vote the recommendations up or down by simple majority. If both houses of Congress adopt the joint committee's recommendations, the president must still sign the legislation for the recommendations to become law.
- If the joint committee fails to agree on at least \$1.2 trillion in deficit reduction, whatever recommendations the committee does reach agreement on will be forwarded to Congress for action. However, the difference between the amount of the recommendations and the minimum \$1.2 trillion would result in automatic across-the-board spending cuts beginning on January 1, 2013. The automatic cuts would be divided equally between security and non-security spending, but Social Security and certain low-income programs would be exempted and cuts in Medicare would be limited to a maximum of 2%.
- If both houses of Congress pass a balanced budget amendment, the automatic spending cuts feature of BCA would not take effect.

As numerous analysts and think tanks have pointed out, the ten-year \$1.5 trillion deficit reduction target does not meet Chairman Bernanke's first "good" fiscal policy objective of putting U.S. fiscal policy on a long-run sustainable path. It is simply not a large enough target. The \$1.5 trillion target was an inadequate political compromise because it has been

impossible to date for Republicans and Democrats to agree that the only way to achieve long-term fiscal sustainability requires restructuring entitlement programs **and** restructuring the tax base, tax deductions and tax rates. Democrats steadfastly have resisted serious consideration of entitlement reform and Republicans are locked into a narrow philosophy of cutting spending and tax rates.

Perhaps the Super Committee will seize the moment and craft the “Grand Bargain” which would include a much higher long-term deficit reduction target, would address entitlement reform and would set out a process to restructure and increase tax revenues. But given the strong political rhetoric and the looming 2012 presidential campaign, few hold serious hope that the Super Committee will recommend the “Grand Bargain.” Indeed, most think the committee won’t come close to the \$1.5 trillion target.

### **President Obama’s American Jobs Act**

In an address to a joint session of Congress on September 8, 2011, President Obama proposed a \$447 billion fiscal stimulus program designed to create jobs. The jobs program, which the President lectured the Congress “You should pass this bill now,” consists of the following:

- Renewal of existing programs (no new stimulus)
 

✓ 2% employee payroll tax cut	\$112 billion
✓ Unemployment benefits	49 billion
✓ Full expensing of investments	5 billion
	\$166 billion
  
- New programs
 

✓ Increase employee payroll tax cut to 3.1%	\$ 63 billion
✓ Employer payroll tax cut	65 billion
✓ \$4,000 employer tax credit for hiring unemployed	8 billion
✓ Various job and training initiatives	5 billion
✓ Infrastructure investment	60 billion
✓ Aid to states for teachers and firefighters	35 billion
✓ Rehabilitate vacant and foreclosed homes	15 billion

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✓ School and community college infrastructure	30 billion
	\$281 billion

Although the math is a little complicated, if the American Jobs Act were enacted exactly as proposed, which is highly unlikely (the Senate already voted not to approve the proposed legislation), the effect in 2012 on real GDP growth would move fiscal policy from having a negative to a neutral impact.

Unfortunately, the preponderance of the proposals are more of the same kinds of programs which have had limited impact on job creation to date. A measure that economists use to evaluate the effectiveness of a fiscal policy initiative is the multiplier. The multiplier measures the extent to which a dollar of government spending multiplies into additional spending by the private sector. Investment in infrastructure has a very high multiplier, but such investment also takes considerable time to get underway. But, in the long run this kind of fiscal expenditure will end up creating significantly more jobs dollar for dollar than a reduction in the employee payroll tax. The multiplier on payroll taxes reductions is very low. In the current environment much of that stimulus is either going into savings or being used to pay down debt. The multiplier on unemployment benefits is somewhat higher but the money gets spent on necessities which generally have smaller multiplier impacts than money that is spent on infrastructure.

Obama proposed \$447 billion in tax increases to pay for the American Jobs Act. Most would come from enacting the so-called “Buffet Plan” by limiting itemized deductions for individuals earning more than \$200,000 annually and couples earning more than \$250,000 annually. Republicans are likely to oppose the revenue proposals.

**Summary.** Ultimately, Congress is likely to extend the payroll tax cut for another year, but enactment of additional spending proposals is doubtful. Thus, it appears highly likely that fiscal policy will impart a negative impulse to the U.S. economy in 2012. The real question seems to be one of how large that negative impulse will be. Prospects for 2013 are much worse as the Bush tax cuts expire and the automatic spending cut triggers in the Budget Control Act take effect.

## V. Can the Euro Survive the European Sovereign Debt Crisis?

### 1. Changes in Currency Exchange Rates Balance Competitive Differences

Changes in currency exchange rates enable countries to remain competitive with each other. If inflation rises faster in one country than another, competitiveness can be maintained between the two countries by letting the value of the currency of the country with the higher rate of inflation fall relative to the value of the currency in the country with lower inflation.

Generally, differences in inflation rates arise because of differences in labor wage inflation (cost-push inflation) or differences in monetary policy stimulus (demand pull) inflation.

Systematic differences in the real rate of growth of GDP also affect competitiveness over long periods of time and can be offset by letting the currency of the country with a higher growth rate rise in value relative to the currency of the country with a lower real rate of growth.

Over shorter time periods, differences in interest rates between two countries can lead to capital flows from the country with lower rates to the country with higher rates. As long as such a rate differential exists this phenomenon tends to boost the value of the currency of the country with higher interest rates.

When a currency union is formed, as it was for the 17-member European Monetary Union, all members of the monetary union have a single currency. This means that competitive differences among the 17 countries can no longer be resolved through the exchange rate mechanism.

### 2. Benefits of Monetary Unions

Given this loss of flexibility to manage its economy why would a country want to be a member of a currency union? There are a variety of reasons. In the case of Europe with its history of horrific wars a currency union is a form of political union which creates interdependencies that reduce or even

eliminate the potential for military hostilities.

From an economic standpoint having a single currency eliminates frictions, facilitates trade and just generally increases the efficient functioning of all the economies of the members of the monetary union.

In the case of specific countries, like Greece, becoming a member of the monetary union enabled it to expand the market for its sovereign debt at much lower interest rates. While this benefitted economic growth in such countries, it also sowed the seeds of the financial and economic disaster that is currently unfolding in Europe.

### **3. Flawed Implementation of the European Monetary Union**

As the European Monetary Union was implemented two things happened both of which set in motion creation of today's sovereign debt problems.

First, smaller countries like Greece and Portugal took advantage of easy access to cheap credit to stimulate economic growth.

Second, access to cheap credit was facilitated by bank capital regulation and the European Central Bank (ECB). Sovereign debt was assigned a zero risk weight because it was believed that sovereign debt could never default. This meant that a bank could acquire any amount of sovereign debt it wanted to without being constrained by capital limitations. Leverage, in effect, was infinite. The ECB facilitated member bank acquisition of sovereign debt by accepting the debt as collateral with small value discounts. This set up a lucrative arbitrage opportunity for banks which could earn a handsome interest rate differential between the return on sovereign debt and the cost of loans from the ECB. Everyone believed this was a riskless way of making money. Thus, the banks exercised no discipline over fiscal policy management in individual countries. In fact, the banks were eager to take advantage of small differentials in sovereign debt rates and were willing suppliers of credit with the help of unlimited lending from the ECB.

These two processes combined to stimulate growth. The absence of effective discipline led to growing competitive gaps among countries as some aggressively pursued deficit financing which resulted in higher wage inflation rates.



Also, just as occurred in the U.S., access to cheap credit fueled property price bubbles in many countries. Again, for a while this seemed to banks to be a lucrative, relatively riskless form of lending. But, when the property boom burst and prices began to decline banks in countries like Ireland were confronted with enormous losses. Ireland chose to bail out the banks, but the enormity of the bailout, which initially was grossly underestimated, created an instantaneous sovereign debt problem for Ireland.

#### **4. Processes for Adjusting for Competitive Differences Among Members of a Monetary Union**

There are two other ways to restore competitive balance among the economies of currency union members absent the ability to adjust currency exchange rates.

First, as has been the case in the U. S. since its creation, all members of the union can agree to be bound by a common fiscal policy. Typically that involves having a single issuer of sovereign debt. This is not entirely true for the U.S., but the requirement is closely achieved anyways by virtue of the practice of all but one state in balancing the state's budget each year. Thus, the only entity that engages in deficit financing is the federal government. In contrast, each member of the European Monetary Union can issue its own sovereign debt and can engage in deficit financing. Ideally, but of lesser importance, there should be common tax policies among members of the monetary union. This is not the case in the U.S. but this shortcoming is offset by the second adjustment process.

Second, competitive differences can be rebalanced by permitting free movement of business activity and labor from an expensive country or location to a less expensive country or location. This kind of fluidity of resource redeployment has long been a feature of the U.S. and works relatively well. However, mobility of resources is very limited in Europe due to ethnic, language and cultural differences and differences in governance.

Two of the three adjustment mechanisms — exchange rates and resource mobility — are not feasible in the European Monetary Union. That places the entire adjustment burden on fiscal policy coordination, which currently does not exist in any effective structured fashion.

## 5. Greece

Greece is the weak link. But it is the “canary in the coal mine” rather than the cause of all ills. It exploited the flaws in the monetary union to stimulate growth. It did nothing to manage labor costs or labor productivity with the consequence that its exports became increasingly uncompetitive. This deterioration in competitiveness was masked for a long time because it was easy to borrow — no one was worrying about the amount of sovereign debt Greece was accumulating. Also, Greece either intentionally lied about the size of its sovereign debt or it simply didn’t really know because of poor data collection and reporting methods.

When the market finally focused on the severity of Greece’s sovereign debt problem in the Spring of 2010, the textbook remedy was to force Greece to reduce the size of its annual budget deficit with the expectation that the public debt-to-GDP ratio would eventually fall. The flaw in the textbook solution was that the size of Greece’s debt-to-GDP ratio had already exceeded the fiscal speed limit.

In return for short-term loans to enable Greece to meet its immediate payment requirements, policymakers required Greece to raise taxes and cut government spending. It was expected that those actions would eventually reduce the numerator of the public debt-to-GDP ratio. It was assumed that after an initial modest decline in GDP, GDP growth would resume and the denominator of the ratio would rise. As a result, through growth and austerity Greece’s finances would correct.

This policy remedy was not realistic, as many pointed out at the time. Austerity depressed economic growth much more than expected with the result that tax collections fell short of expectations. Thus the numerator rose while the denominator of the ratio fell and Greece’s public debt-to-GDP ratio exploded. The response perversely has been to require even greater austerity, which simply will only serve to make matters worse.

***The only way to resolve Greece’s sovereign debt problem is to restructure its debt. This means that creditors will have to incur substantial losses.***

And, while debt restructuring will resolve Greece’s sovereign debt problems, it will do nothing to improve its competitiveness. In the absence of the

ability to adjust exchange rates, Greece is faced with years of low economic growth and deflation until its cost of producing goods and services is once again competitive. Whether Greece socially and politically can endure such a lengthy adjustment process remains to be seen. But there is already accumulating evidence that austerity fatigue is beginning to take hold. What this portends is that Greece's willingness to stay the course and remain a member of the European Monetary Union is very much in jeopardy.

## 6. Liquidity Versus Solvency

As market participants have reached the inevitable conclusion that default and restructuring of Greek sovereign debt is inevitable they naturally have focused on the ability of holders of Greek debt to absorb the losses and whether European authorities will bail out those banks that are unable to absorb losses and remain solvent.

There is increasing anxiety that the sovereign debt of other countries may ultimately need to be restructured, most notably Ireland and Portugal.

But anxiety has also spread to Italy and Spain as well. Italy has a very high public debt-to-GDP ratio but a low budget deficit. Were it not for Italy's lagging economic growth and low productivity the high public debt-to-GDP ratio might not be cause for concern. In the case of Spain, the public debt-to-GDP ratio is not particularly high, but the solvency of the savings banks which financed Spain's housing bubble is in question. If Spain eventually is forced to bail out its banks then it could well suffer the same fate as Ireland. There is uncertainty about the outcome, but markets do not thrive on uncertainty with the consequence that the cost of Spanish sovereign debt has risen considerably.

Investor anxieties have greatly increased the cost of sovereign debt financing for the weaker countries and diminished access to funding. At first blush this appears to be a liquidity problem which has been parried through ECB purchases of sovereign debt. But at the heart of the matter are sovereign debt insolvency concerns.

Unfortunately, liquidity difficulties contribute to the potential for insolvency in two ways. First, the higher cost of borrowing increases the size of budget deficits. Second, attempts to reduce budget deficits through fiscal

austerity slow economic growth. Again, the operation of a fiscal speed limit comes into play. Fiscal austerity can work if applied in moderation and if the public debt-to-GDP ratio is not too high. It is doubtful that these conditions are met in either Italy or Spain which is why their sovereign debt is under pressure.

## **7. Europe Headed Into Recession**

Economic developments are headed in a direction that is increasing insolvency risks. Europe's reaction generally has been to pursue policies of fiscal consolidation, which in the short run depresses economic growth. Severe escalation in financial stress among European banks, as we have come to understand, also is depressing growth.

Unnecessarily compounding matters, the ECB perversely has raised interest rates to fight a surge in inflation induced by the boom in commodity prices. This temporarily has boosted the value of the euro relative to other currencies and depressed European exports. The U.S., by contrast, which has experienced exactly the same rise in inflation, has had the good sense to stay the course and actually has eased, rather than tightened, monetary policy. The ECB's only policy mandate for the conduct of monetary policy is to contain inflation; whereas, the Federal Reserve has a dual mandate of containing inflation and promoting full employment. So, one can blame the ECB's myopia on its narrowly constructed policy mandate. But even given that excuse, a more complete appreciation for the consequences of raising interest rates in the midst of a sovereign debt crisis should have led the ECB to avoid raising rates.

And, if this were not enough, a slowing U.S. economy, global excess supply courtesy of emerging economies and weak European demographics, will reinforce downward pressure on European GDP growth. What this means is that with the passage of time Europe's sovereign debt and banking problems are likely to worsen rather than improve.

## **8. How To Save the Euro**

In the September 17<sup>th</sup>-23<sup>rd</sup> 2011 edition of The Economist, that news magazine spelled out what it believes is necessary to save the euro:

- *“First, make clear which of Europe’s governments are deemed illiquid and which are insolvent, giving unlimited backing to the solvent governments but restructuring the debt of those that can never repay it.*
- *Second, it [European governments] has to shore up Europe’s banks to ensure they can withstand a sovereign default.*
- *Third, it [European governments] needs to shift the euro zone’s macroeconomic policy from its obsession with budget-cutting towards an agenda for growth.*
- *And, finally, it [European governments] must start the process of designing a new system to stop such a mess ever being created again.”*<sup>3</sup>

These recommendations are quite logical. While they sound straightforward and appear to be relatively simple, they are anything but. It took from July 21, 2011 to October 13, 2011 for the governments of the 17 members of the European Monetary Union to ratify the modest expansion of the European Financial Stability Facility (EFSF). Ratification could have been blocked by a single country and almost was by Slovakia.

It is estimated that the EFSF will need 2 trillion euros to accomplish the policy agenda set forth by *The Economist*. As it stands the EFSF has access only to 440 billion euros and it is actually less than that because member countries receiving EFSF bailouts cannot simultaneously be contributors to the EFSF.

## **9. Ring-Fencing the Banks for Inevitable Greek Sovereign Debt Default**

While little discussed in public, European policymakers now appear to accept the inevitable need to restructure Greek debt at a substantial discount, perhaps as much as 50% to 60%, rather than the 21% present value haircut crafted in the July debt extension plan. Because this means that many European banks would incur substantial financial losses and elevate solvency concerns, policymakers are stitching together a plan to ring-fence the most

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<sup>3</sup>“How to Save the Euro.” *The Economist*, September 17<sup>th</sup>-23<sup>rd</sup>, 2011, p. 11.

exposed banks and prevent contagion and potential financial system melt-down.

To date, as I mentioned at the beginning of this letter, the policy response is to require banks to raise capital levels with the promise that governments will provide capital as a last resort, if all else fails. For the moment the markets appear to be cautiously optimistic that this will work. However, in my view the gradually deteriorating situation, which will be exacerbated by European recession, will eventually require more direct bank recapitalization by governments.

If or when that occurs, there is the question of which countries have the capacity to rescue the banks and the euro. All eyes point toward Germany, which is Europe's largest and strongest economy. But it is not at all clear that Germany, when the chips are really down, will be willing to make this kind of sacrifice to save the euro.

## **10. Will Germany Step Up and Save the Euro?**

George Friedman believes that cultural differences between Germany and most of the other members of the European Union put an affirmative response to this question very much in doubt, although he does not rule out the possibility that the evolving financial solution could work, if there is adequate compliance. He argues that the fundamental European dilemma is political and geopolitical, not financial, and is deeply rooted in Europe's history.

*“The political and geopolitical problem is simply this: Germany is unique in Europe in terms of both size and values. It tried to create a free trade zone based on German values allied with France that looked at the world in a much more complex way. The crisis we are seeing, which Germany is trying to solve with extraordinary complexity and precision, rests on a highly unstable base. First, the European banking system, like the American banking system, does not understand its status. Second, the entire mathematics of national statistics is inherently imprecise. Third, the peripheral countries of the European Union have economies that cannot be measured at all because their informal economies are massive. The fundamental principles and self-conception of Germany and Central Europe diverge massively. The elites of these countries might like to think of themselves as Europeans first — by the*

*German definition — but the publics know they are not, and they don't want to be.*

*The precision of the bailout schemes reveals the underlying misunderstanding of reality by Europe's elites, and specifically by the Germans. To be more precise, this is willful misunderstanding. They all know that their precision rests on a foundation of uncertainty. They are buying time hoping that prosperity will return, mooting all of these problems. But the problem is that a precise solution to a vastly uncertain problem is unlikely to return Europe to its happy past. Reality — or rather the fundamental unreality of Europe — has returned.”<sup>4</sup>*

I might add that the reality of global economic restructuring is unlikely to permit realization of the European hope that somehow, some way prosperity returns. In fact, the policy responses Europe has pursued to date, while buying time and kicking the can down the road, appear to be making matters worse with the passage of time rather than better. While the euro and the European Union may yet survive, the road ahead is a rocky one and a favorable denouement is far from assured.

## VI. Global Growth — Emerging Economies — China

As the U.S. and European economies slow and flirt with recession, little attention has been paid to global growth trends, particularly for the major emerging economies of Brazil, China and India. At least on the surface momentum seems to be intact. However, emerging economies are heavily export dependent. This means that slowing demand in Europe and the U.S. will depress trade.

There were some hints in the August trade data that China is beginning to experience some pressure. The aggregate U.S. trade deficit was \$45.6 billion in August. This is far below the peak deficit month of \$65.7 billion in July 2008 shortly before the crash in global trade that followed hard on the heels of the Lehman Brothers failure. However, the U.S. trade deficit with China reached an all-time high of \$29.0 billion in August. This was all the more significant because China's aggregate trade surplus has been

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<sup>4</sup>George Friedman. “European Crisis: Precise Solutions in an Imprecise Reality.” *STRATFOR*. October 4, 2011.

shrinking and was down to \$14.5 billion in September from \$17.8 billion in August. Slowing global growth and the appreciation in the renminbi are collectively contributing to the reduction in China's trade surplus.

U.S. imports from China are approximately four times as large as exports to China. During the first eight months of 2011 the U.S. trade deficit with China was \$225.2 billion which was 60% of the U.S. aggregate trade deficit. Over the first eight months of 2010 the U.S. trade deficit was \$173.5 billion, or 51% of the U.S. aggregate trade deficit. This is not a healthy trend for either country.

On October 11, 2011, the U.S. Senate voted 63-35 to pass the Currency Exchange Rate Oversight Reform Act. The bill is specifically targeted at China and would impose duties on imports from countries with misaligned currencies. While this legislation is not expected to become law, it is significant that the Senate passed it with substantial bipartisan support.

While most simply assume that the Chinese growth machine will march onward uninterrupted, imbalances are building. China's economy steadily has become increasingly export dependent which makes it more vulnerable than in the past to a slowdown in global growth. Moreover, much of the Chinese miracle stems from enormous infrastructure investment financed by Chinese banks and municipal debt. One need only look at the U.S. housing market to understand the risks of overinvestment in infrastructure. Infrastructure investment is a powerful economic accelerant. It creates jobs and wealth, but unfortunately it also fosters financial bubbles. China is experiencing an enormous property bubble.

The difficulty with infrastructure investment driven economic growth is that it results in enormous amounts a productive capacity. If that capacity cannot be put to effective use through growth in domestic demand, it puts tremendous pressure on exports. In the long run this kind of economic growth is not sustainable and will have significant deflationary impacts.

China has probably not yet reached the point where the imbalances it is creating in its economy will result in a painful correction. However, China's ability to apply massive stimulus to its economy and jump start the global economy, as it did in late 2008 and early 2009, is much more limited today. Thus, if the global economy slows significantly, China's economy could be at considerable risk.



## VII. Occupy Wall Street

In the last month a new spontaneous movement has begun to take hold. Unlike many demonstrations which quickly come and go, this one has struck a sensitive nerve and appears to be gaining momentum. It is too early yet to know whether it will have a lasting impact on American politics as has the “Tea Party” movement, which initially was also spontaneous, and was prompted by some of the same grievances, but has evolved into a political movement connected with the more conservative anti-government, anti-spending wing of the Republican Party.

Occupy Wall Street lookalikes have sprung up all across the country. They have some resemblance to the civil rights and Vietnam War protests of the 1960’s. The emerging movement has no clear leadership and appears to be aligned to a certain extent with the liberal wing of the Democratic Party. However, participants share a key core grievance — anger with the Wall Street fat cats and big banks — with the Tea Party movement.

I have been wondering for some time why no voice had been given to the simmering anger that has been building in America. High unemployment, particularly among younger people, falling real spending power and the steadily growing income and wealth gaps provide ample reason for protests. All is not well in America and many are sensing that the system has been captured by the economic elite and is serving their narrow interests rather than the interests of the broader population. Thus, it is hardly surprising that rail about the 1% — “We are the 99%.”

In light of this emerging movement, I think it is important to repeat the discussion of George Friedman’s essay, which I initially covered in the August Longbrake Letter.

### **1. George Friedman’s Essay: “Global Economic Downturn: A Crisis in Political Economy”**

In August I summarized George Friedman’s essay. He wrote it before the “Occupy Wall Street” movement got underway. But, in very large measure this essay described the series of economic and political developments that have laid the foundation for this to be a substantive movement with lasting

and, as yet unknown, potentially far reaching political consequences.

For a long time I have puzzled about the lack of organized popular response to the ever escalating wealth and income inequality that has been underway for 30 years. Income and wealth inequality in America is now greater than many third world developing nations. As Friedman described in his essay, the political elite bailed out the financial elite that had caused the financial meltdown. This might have turned out all right, but the policy intervention is now widely viewed as having failed to accomplish what it was expected. The economy continues to flounder. GDP growth, while positive, is barely at stall speed — the output gap was 6.8% in the second quarter according to the Congressional Budget Office and growing rather than shrinking. Unemployment remains stuck at extremely high levels. Real wages are falling for most Americans. Hopes for improvement in economic prospects are fading. And, governmental bodies are increasingly dysfunctional and apparently incapable of crafting credible long-term strategies to restore economic growth and opportunity for all Americans. But the financial elite are doing well and as recent Census Bureau statistics show the gap between rich and poor continues to grow.

Economic and financial crises have their genesis in government policies and regulation. Government policy and regulation, either by design or through operation of the law of unintended consequences, determine who makes or loses money and how much. Of course, government policy and regulation only serve to define the boundaries. What actually transpires depends on the decisions of the financial elite. In the case of the recent ill-fated housing bubble, the financial elite ran amok, while financial regulation was largely ineffective. In the end the financial system in the U.S. failed because of the misguided decisions of the financial elite. This failure, in the words of George Friedman “. . . created a massive political problem centered not so much on confidence in any particular financial instrument but on the competence and honesty of the financial elite itself.”<sup>5</sup>

Friedman goes on to say that the financial crisis created a political crisis in which “The question was whether the political system was capable not merely of fixing the crisis but also of holding the perpetrators responsible.” Unfortunately, based on recent events, the answer to both parts of the question appears to be “No” — the system has not been fixed and no one of any

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<sup>5</sup>George Friedman. “Global Economic Downturn: A Crisis of Political Economy.” *STRATFOR*. August 9, 2011.

prominence has gone to jail. Friedman concludes that "... the perception is that having spent large sums of money to stabilize the financial system, the political elite allowed the financial elite to manage the system to its benefit." This in turn led to a second crisis involving the political elite. In the U.S. the direct response was the rise of the Tea Party movement, which took on the direct role of criticizing the political elite by arguing "... that the political elite had solved the financial problem both by generating massive debt and by accumulating excessive state power."

Friedman's essay is worth a careful reading because he documents the failures of the financial elite followed by the failures of the political elite, not just in the U.S., but also in Europe and China. These three powers account for the preponderance of global economic wealth and military power. Failures of the financial and political elites set the stage for the potential emergence of a third crisis — one in which the elites themselves "... become delegitimized and all that there is to replace them is a deeply divided and hostile force, united in hostility to the elites but without any coherent ideology of its own. (This does sound a bit like the Occupy Wall Street movement.) In the United States this would lead to paralysis. In Europe it would lead to a devolution to the nation-state. In China it would lead to regional fragmentation and conflict." These are not forecasts of what will happen but of what could happen. What is clear is that what started as an economic problem led to a political problem, which is now exacerbating the economic problem.

In summary, policymakers (political elite) did not successfully resolve the economic problems stemming from the great bubble of excessive debt leverage. In fact, the solutions exacerbated the problem of excessive debt leverage and along with it created a political crisis that threatens the legitimacy of the political elite. As we enter the second phase of the financial crisis, our flexibility to respond is far more limited and the political risks are enormous.

When one considers all of this, the market crash of early August becomes less mysterious. Markets have a history of myopia, of engaging in the pursuit of hope and persisting in optimism in spite of evidence to the contrary until the relentless march of contrary information ultimately becomes too great to ignore any longer. Thus, while nothing of a dramatic nature set off the stampede, a series of events slowly undercut the foundation of optimism. In the U.S., the June employment report and rise in the unemployment rate

was clear evidence that stimulus was not working and the economy was not turning around. Then second quarter GDP came in at a tepid 1.3% annual rate and first quarter GDP was revised down to 0.4% — neither figure was remotely close to the 3% to 4% GDP growth rate that had been forecast by many, including the Federal Reserve, at the beginning of 2011. This was quickly followed by the absurdity of the debt ceiling debate and failure of the politicians to agree on a substantive fiscal consolidation process. It appears that S&P's downgrade of U.S. public debt, although amply telegraphed in advance, was the final nail in the coffin. To this should be added the destabilization of the European financial system in the wake of the failure of the European Union to deal incisively and effectively with sovereign debt issues. And, China with its declining competitiveness and rising inflation increasingly looks like it is becoming part of the problem rather than part of the solution. And, to the extent that that is the case, China and other emerging economies will not have an ability to come to the rescue of developed economies to nearly the extent that they did after the economic collapse in 2008.

## **2. Will “Occupy Wall Street” Evolve Into a Movement That Has the Potential to Impact Political and Policy Making Processes?**

The answer to this question is not yet clear. But, in a very short time two things have happened. First, the protests so far have had durability and have spread to many other geographical locales from the initial venue of Zuccotti Park in New York City near Wall Street. Second, media coverage has mushroomed and is at about the same level of intensity that prevailed during the early stages of the Tea Party movement.

Polling done in the first week of October by the Pew Charitable Trusts Project for Excellence in Journalism found that the protests accounted for 7% of the collective news media coverage. Increased news media coverage is important in sustaining protests and in helping to create the potential to transform those protests into a movement. In another Pew poll, 42% said they were either following the news coverage “very closely” or “fairly closely.” A poll conducted by Rasmussen indicated that 33% had a favorable opinion of the protests; 27% had an unfavorable reaction; and 40% had no knowledge about “Occupy Wall Street.”

**Drivers of “Occupy Wall Street” Protests.** Anne-Marie Slaughter

recently wrote in the New York Times that “. . . the twin drivers of America’s nascent protest movement against the financial sector are *injustice* and *invisibility*, the very grievances that drove the Arab Spring.”<sup>6</sup>

*Injustice* is about economic inequality and the capture of the political and economic systems in America by the financial elite to serve their interests to the detriment of the other 99%. The core grievance is that the economic hardships millions of Americans are enduring have been caused by the practices of big financial institutions and the enormous political power Wall Street wields over the U.S. government.

*Invisibility* is about a dysfunctional political system dominated by narrowly-based partisan political agendas which are unresponsive to the grievances of millions of Americans. Simply put, millions of Americans are hurting because America’s economic system is not working for them and they don’t feel the government is listening to them or responding to their grievances. As Ms. Slaughter wrote, “*In the words of one protester interviewed in San Francisco, ‘We don’t have a government for “we the people” anymore.’*”

Thus, the drivers of “Occupy Wall Street” are broken economic and political systems.

**Movement Criteria.** Many have been quick to point out that a few protests and some news media coverage do not guarantee that significant change will follow. For that to happen, the protests need to evolve into a movement. Movements generally develop from a crisply defined grievance and explicitly stated solutions. This was the case for the civil rights movement and the Viet Nam War protests.

Economic injustice and governmental dysfunction are much more broadly-based grievances and lack the kind of focus that spawn and propel movements. Also, there is not yet a well-defined list of solutions. However, perhaps that is the relevancy of the Arab Spring for “Occupy Wall Street.” The Arab Spring was about challenging governments which catered to narrow elites and which had become unresponsive to the people. Perhaps that grievance is also deep-seated in America and that will be sufficient to perpetuate and expand the protests to the point where they transform into a

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<sup>6</sup>Anne-Marie Slaughter. “Occupied Wall Street, Seen From Abroad.” *The New York Times*. October 6, 2011.

movement which then might have the potential to force fundamental political and economic change.

Movements which have impact typically have the following attributes:

- **Single identifiable or charismatic leader.** “Occupy Wall Street” has no identifiable leader, although that was also the case for the Tea Party movement in the early days.
- **Creation of an institution which can influence and martial public opinion.** “Occupy Wall Street” has yet to evolve into an institutional framework.
- **Define an action agenda; develop a program.** There are many grievances but no action agenda or program yet exists.
- **Engage in the political process.** This poses a challenge because many “Occupy Wall Street” protesters believe that both political parties have been captured by Wall Street. But, politicians aren’t likely to respond unless they believe that the movement has become powerful enough to change election outcomes.

In the words of Stephen Zunes, professor of politics at the University of San Francisco, “*Successful movements focus on developing a well-thought-out strategy, clearly articulated political demands, a logical sequencing of tactics, well-trained and disciplined activists, and a recognition that colorful protests are no substitute for door-to-door organizing among real people.*”<sup>7</sup>

We will know in time whether “Occupy Wall Street” becomes the catalytic agent that spurs political change and economic revival. One can hope that it does have impact because the course we have been on appears to be one that is contributing to America’s slow decline as a global power.

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<sup>7</sup>Stephen Zunes. “Protests Are Not a Movement.” *The New York Times*. October 7, 2011.

## VIII. “The Way Forward”

### 1. David Brooks

America’s economic system is not working for most Americans and its political system is focused on partisan bickering over narrowly-based agendas. In the meantime development of bi-partisan solutions to fundamental issues, which in time could rebuild America’s economic vitality, aren’t getting serious consideration. David Brooks articulates it extremely well:

*“The U.S. economy is probably going to stink for a few more years. It is beset by short-term problems (low consumer demand, uncertain housing prices, too much debt) and long-term problems (wage stagnation, rising health care costs, eroding human capital).*

*Realistically, not much is going to be done to address the short-term problems, but we can at least use this winter of recuperation to address the country’s underlying structural ones. Do tax reform, fiscal reform, education reform and political reform so that when the economy finally does recover the prosperity is deep, broad and strong.*

*Don’t be fooled by the clichs of protest movements past. The most radical people today are the ones that look the most boring. It’s not about declaring war on some nefarious elite. It’s about changing behavior from top to bottom. Let’s occupy ourselves.”<sup>8</sup>*

### 2. “The Way Forward” — Daniel Alpert, Robert Hockett, Nouriel Roubini

The New American Foundation recently released a white paper titled “The Way Forward: Moving From the Post-Bubble, Post-Bust Economy to Renewed Growth and Competitiveness.”<sup>9</sup>

<sup>8</sup>David Brooks. “The Milquetoast Radicals.” *The New York Times*. October 10, 2011.

<sup>9</sup>Daniel Alpert, Managing Partner of Westwood Capital; Robert Hockett, Professor of Financial Law, Cornell University; and Nouriel Roubini, Professor of Economics, New York University. “The Way Forward: Moving From the Post-Bubble, Post-Bust Economy to Renewed Growth and Competitiveness.” The New American Foundation. October 10,

This white paper pulls no punches. America's economic problems are severe; its political processes are dysfunctional and policy initiatives to date have been inadequate and based on a misunderstanding of what the problems really are.

The authors state bluntly that unless a new course is charted there is “... *real and present danger that Europe and the United States alike fall into an indefinitely lengthy period of negligible growth, high unemployment and deflation, much as Japan has experienced over the past 20 years following its own stock-and-real estate bubble and burst of the early 1990s. Protracted stagnation on this order of magnitude would undermine the living standards of an entire generation of Americans and Europeans, and would of course jeopardize America's position in the world.*”

The authors — Daniel Alpert, Robert Hockett and Nouriel Roubini — state the obvious that policy initiatives over the last three years served to stabilize the economy temporarily but have been ineffective in fostering a sustainable recovery. They are openly skeptical that President Obama's American Jobs Act or recent Federal Reserve monetary policy actions will make any real difference.

In the remainder of the white paper the authors first discuss why policies have been inadequate and then propose three initiatives, which they believe, if pursued, will promote recovery and eventually restore America's economic strength.

**Reasons Why Policy Intervention Has Fallen Short.** First, as I have pointed out in my letters, the Great Recession was caused by a credit and asset-price bubble, which when the bust inevitably arrived did grievous balance sheet damage. Balance sheet driven recessions unleash deflationary consequences because the burden of debt built up in the preceding bubble escalates as incomes and prices fall. This can evolve into a vicious downward debt-deflation spiral. Ongoing declines in home prices are stark evidence of this phenomenon. Not only do declining home values put stress on homeowner balance sheets, declining prices also create ongoing solvency uncertainties for holders (and given extensive mortgage securities litigation — for originators as well) of home mortgages. Policies to date have focused on stimulating demand rather than dealing with corrosive effects of too much

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2011.



debt.

Second, the authors discuss the importance of two global structural developments that have been building over the last several decades. The first involves the entry of large export-oriented countries with 2 billion workers into the global market economy. This has resulted in an enormous expansion in the supply of labor, capital and productive capacity which has outstripped growth in demand. The significance of this development is that the alternative policy antidote for America of promoting business investment and exports, when stimulating consumer demand is ineffective in a debt-deflation balance-sheet downturn, no longer works.

Globalization has also shifted the balance of power between capital and labor. This has been manifested by stagnation in wages, strength in corporate profits and growing income inequality.

The housing and credit bubbles masked the impacts of these global structural changes for several years, but in the end when the bust occurred, the consequences became apparent and unfortunately were greatly exacerbated by bubble-driven debt accumulation.

**Recovery Plan.** Not all is gloom and doom. The authors conclude the white paper with three specific recommendations which they believe, if adopted, will foster economic recovery.

First, implement a five to seven year \$1.2 trillion public infrastructure investment program. Infrastructure investment is about building roads and the like but it is also about investing in education and research. Not all of the funding would have to come from government but government would oversee and drive the program. Such a program would have both short-term and long-term benefits. In the short-run it would provide jobs both directly and indirectly through high-powered multiplier effects. The authors estimate that the program would create 5.2 million jobs. Second, by rebuilding the nation's infrastructure, the program would lay the foundation for a cost-effective competitive economy which could more than hold its own in competitive global markets.

Second, existing debt burdens must be restructured. The existing policy of benign neglect aimed at protecting creditors has had and will continue to have pernicious impacts. Until the overhang of debt is addressed, the debt-deflation spiral, with all of its consequences, will continue unabated.

The authors propose specific debt restructuring programs. To date there has been no serious willingness to consider such programs. Accounting conventions, contractual law and the political power of creditors stand in the way. Effective debt restructuring programs will require coming up with ways of handling the insolvency risks that debt forgiveness will impose on creditors. Remember that it is all about who bears the loss. Losses will not magically disappear of their own accord.

Third, balance must be restored to the global economy. The authors believe that this must involve transforming emerging economies from an export orientation to domestic consumption. They also argue that there is need to establish an “emergency global demand-stabilization fund” which would be used to recycle foreign exchange reserves from surplus nations to deficit nations in a way that boosts employment in deficit nations. This is a fancy way of describing foreign aid. This is an elegant and straightforward solution to global economic imbalances but it begs the question of national interests. In other words . . . easier said than done.

### **3. Concluding Comment**

Unfortunately, I feel compelled to voice my personal sense of cynicism. As matters now stand, as thoughtful and logical as the solutions described in “The Way Forward” are in theory, they are probably dead on arrival. We are caught up in a governance paradigm which will not enable development of these kinds of programs and responses. And, no one really knows how to change the existing governance paradigm. Perhaps “Occupy Wall Street” will become a movement that provides the impetus for the necessary paradigm shift. Of that we can be hopeful. But, if you need a sobering reality check, I recommend that you read Collapse: How Societies Choose to Fail or Succeed by Jared Diamond.<sup>10</sup>

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<sup>10</sup>Jared Diamond. Collapse: How Societies Choose to Fail or Succeed. Viking Penguin, 2005.