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

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The Longbrake Letter*

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In recent days market sentiment has shifted from optimism and complacency to pessimism and fear.

Significant and troublesome imbalances have been building in the global economy for a long time but the threats they pose to global economic well-being have largely been ignored until now. That is not surprising because markets tend to focus on what is happening in the short run and discount longer-term possible developments, particularly when those possibilities seem remote and are decidedly negative. Such short-termism has been made all the easier by the elixir of abundant and cheap liquidity, which has fueled rising asset prices and damped volatility and risk.

But now the possibilities of much slower growth in China, failure of Abenomics in Japan, and deflation in Europe, not to mention the existential threat to the euro and the European Union, are being discussed more openly. Probabilities of such outcomes have been upgraded, but widespread hope remains that policymakers will be able to avoid worst case outcomes.

My own views are less sanguine, as I have discussed in previous letters and reiterate in this month's letter. Markets may yet stabilize and shrug often recent anxieties because market participants still want to believe in market-friendly outcomes. In other words, the climactic moment of capitulation and realization that the status quo is neither fixable nor sustainable is probably not yet at hand.

Unfavorable demographic trends, excess supply of goods and services relative to underlying demand, monetary profligacy, negative real rates of interest, and huge and rising debt-to-GDP ratios collectively are the hallmarks of a global ***deflationary bust***, which is described in ***Section IV*** below.

I. U.S. Economic Outlook

Economic activity in the U.S. continues to exhibit gradual improvement. A more detailed update is included in the **Appendix.**

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

Employment growth continues to be a bright spot. Payroll employment has grown 1.93 percent, household employment has grown 1.62 percent, and total hours worked is up 2.63 percent over the last 12 months. The U-3 unemployment rate has fallen to 5.9 percent and the U-6 rate has drifted down to 11.8 percent from 7.2 percent and 13.6 percent a year ago, respectively.

But other labor market indicators are less encouraging. The number of people eligible and willing to work has increased only 0.25 percent over the last 12 months. As a consequence the participation rate continues to edge lower. If the labor market is really tightening, as suggested by payroll and household employment gains, the hourly wage rate should be rising. But, it is not. Growth in hourly wages has been static at just shy of 2.1 percent for the last 12 months. The Federal Reserve updated its Labor Market Conditions Index (LMCI), which was first published in April. LMCI is a composite of 19 labor market indicators. The value of LMCI in September was 2.5, which means that labor markets are improving, but the index has declined from over 5 in 2011-12 and 4.5 in early 2014. Historically, wage growth has not accelerated appreciably until LMCI rises to a value of about 7. Wage growth should accelerate gradually in the neighborhood of 0.5 percent in the coming year as the labor market continues to tighten. Although rapid growth in hours worked should boost consumer spending, sluggish wage rate growth will retard the rate of improvement.

Recent retail sales and consumer spending data have fallen short of expectations and consumer sentiment improvement has stalled. This is not particularly worrisome yet.

Estimates of third quarter real GDP growth are edging lower. Merrill Lynch/Bank of America's current tracking estimate is 2.7 percent.

Recent financial market volatility could depress consumer confidence, but falling gas prices will have the opposite impact — oil prices have fallen more than 20 percent in the last few months. Also, the increasing value of the dollar will have small negative impacts on consumer spending for imported goods and manufacturing exports. While it is still too early to know with any degree of certainty how these developments will affect consumer spending and real GDP growth, the impact is likely to be modest because the U.S. is a relatively closed economy. The greatest impact may occur through a change in consumer confidence and that is likely to be tilted in the negative direction because of the fall in stock prices.

However, when it comes to inflation recent developments are likely to push it lower. The market expects inflation to average 1.6 percent over the next several years, but this projection has edged down as market turmoil has escalated.

II. Market Volatility Returns — Correction or Harbinger of Much More to Come Because of Deep-Seated Imbalances in the Global Economy?

Suddenly, market volatility has returned with a vengeance. Stock markets around the globe have taken a pummeling in recent days. Oil prices have collapsed and interest rates are tumbling.

Slowing global growth, particularly in Europe, but also in China and Japan is the principal culprit for the sea change in market sentiment. Worry about declining inflation and the possibility of outright deflation in Europe has also been a contributing factor. And, the markets appear to be losing confidence that the European Central Bank (ECB) will be able to deliver effective monetary stimulus.

Historically, October has often been a turbulent month in financial markets. This is once again proving to be the case. This oddity of the calendar may simply stem from market participants re-engaging in examining more critically what is going on in global economies and markets after the blissful inattention that seems to accompany the summer months.

1. Financial Market Corrections — Temporary or Symptomatic of Fundamental Problems in the Economy

Usually, an abrupt deterioration in market conditions follows a long period in which market participants' optimism steadily rose and risk taking was rewarded. Human nature, being what it is, when profits are easy to come by, feeds further increases in optimism and risk taking. Markets march upwards and volatility declines.

At some point, which often seems to occur in the month of October, an event or a series of data reports challenges the complacency of the optimistic widely-shared beliefs. That sets in motion a correction which can quickly gather momentum.

Sometimes the correction is violent and harsh but short-lived. The stock market crash of 1987 and the market seize-up in 1998 were of this sort. The real economy wobbled, but forward momentum continued. However, the savings and loans collapse in 1990, the dot-com bust of 2001, and the panic of 2008 were not just creatures of overextended financial markets. The real economy rolled over into severe recessions in each of those instances.

Differences in the severity of market corrections and the response of the real economy are linked to the degree to which fundamental imbalances between supply and demand have built in the real economy.

The 1990 recession was preceded by runaway investment and speculation in commercial and multi-family real estate; the 2001 recession by excessive investment in telecommunications and technology; and the 2007-09 Great Recession by the housing bubble in residential real estate.

In each case, supply grew much faster than fundamental demand. Once the prop of speculative demand, which had been driven by plentiful and cheap funding and the promise of quick profits, was removed, the excess supply relative to fundamental underlying demand was fully exposed. Prices collapsed in the most affected sectors of the economy and employment plummeted. Policymakers rushed to curtail potential contagion and to limit the damage through aggressive monetary and fiscal policy intervention. But, it still took a very long time for supply and demand to be brought back into balance. Indeed, economic recoveries following the last three recessions have been extended lethargic affairs.

2. Monetary and Fiscal Policy Intervention

Without question financing on an unprecedented global scale has been abundant and cheap in the aftermath of the Great Recession. Zero interest rates and quantitative easing have been intentional tools of monetary policy aimed at stimulating demand.

Low interest rates are supposed to raise demand by lowering the cost to consumers to buy interest-sensitive goods, such as cars and houses, by reducing the cost to firms to make new investments, and by inducing additional consumer spending out of accumulated wealth that grows more rapidly because of asset price inflation.

Stimulative monetary policy has had some positive effect but the impact has been less than hoped. Car sales have rebounded strongly and credit financing is abundant. However, even though excess housing supply has been eliminated and mortgage financing is exceptionally cheap, robust growth in housing investment has been held back by depressed household formation and tight mortgage underwriting standards.

Private business investment has been depressed by policy uncertainty and meager nominal sales growth stemming from low growth in consumer incomes. A more complex argument for slow investment growth is "secular stagnation," which occurs because monetary policy drives real rates of return below a firm's cost of capital. What incentive is there for a firm to invest when the expected rate of return could be, or is likely to be, negative?

Public investment spending historically has been a major driver of productivity and economic growth. However, local, state, and federal investment spending has fallen considerably in recent years relative to the overall size of the economy.

Consumption benefits of increased financial wealth have been restrained because only very wealthy consumers have participated in the wealth created by rising financial asset prices and this segment has a below average propensity to consume.

3. Global Monetary Policies

But, much of the ample liquidity monetary authorities has been pumping into global economies has gone into inflating the prices of existing financial assets and financing mergers and acquisitions and not into new productive investment. Indeed, while stock prices have sprinted to new highs, public and private investment activity and productivity have fallen considerably short of levels typical during an economic expansion.

But worse, the promise and provision of abundant liquidity can deflect attention from dealing with serious fundamental structural problems. Europe is a case in point. During 2011 and 2012 it looked very much as though the euro was about to implode. However, all Mario Draghi, president of the ECB, had to say was "we will do whatever it takes" and the market did an about face because it believed the ECB would eliminate any kind of sovereign country investment risk. Once market pressure disappeared policymakers no longer were forced to try to resolve structural governance problems inherent in a monetary union that did not have a robust banking, fiscal, and economic union. The imbalances from these policy failures continue to build as evidenced by stagnant growth and slowing developing political fragmentation.

Economic growth in Europe is once again slowing and recession appears to be at hand. Inflation is near zero and deflation is a credible threat. In recent days markets have come to doubt the credibility of Mario Draghi's promise. A clear understanding of the European Union treaties that established the governance structures and knowledge of German constitutional law have made it clear all along that Draghi's promise was tenuous at best. But, the market bet that the stakes were so high that policymakers would ultimately make good on the promise. Many market participants still expect such an outcome. But, it is hard to see how that can be accomplished as economic conditions worsen and the power of euro-skeptic parties waxes and that of established power elites wanes. Could it be that the ***emperor has no clothes***?

III. Global Economic Imbalances — The Emperor Has No Clothes

It is looking like the global economy may finally have arrived at an inflection point. Economic trends that have held sway for much of last five years appear to be giving way. The global equilibrium of sorts that developed in the wake of the global Great Recession was one engineered by massive public policy intervention. In China it was aggressive state stimulus of investment. In the U.S. it was a combination of Keynesian deficit spending initially and a flood of monetary policy driven liquidity. In Europe initial fiscal stimulus quickly led to sovereign solvency issues and a response to deal with these issues through a combination of austerity, bailouts and massive liquidity injections. The list of interventions goes on with Japan the most recent major economy to embrace significant government policy intervention in an attempt to revive a deeply troubled economy.

These interventions generally have had two effects — one good, but the other was not because it involved denial. The interventions did lead to a semblance of normality and not only calmed financial markets, but provided sufficient liquidity to unleash animal spirits. However, the policies pursued more often than not did not address deep-seated structural flaws and imbalances in the global economy. In effect, the policies that were implemented papered over problems rather than fixing them. Denial has had the consequence of letting serious problems become much worse.

1. European Union

Europe steadfastly refuses to address fundamental governance flaws in the makeup of the European Union and its common currency, the euro. As a consequence it is only a matter of time before the European Project endures a great cataclysm. Because the stakes are so high, ongoing attempts will be made to band-aid the beast. This will buy more time, but without fundamental governance changes, the European Union and euro cannot survive indefinitely. This is a risk that few see and fewer believe could happen.

Policy actions to bail out peripheral nations and establish bailout facilities, coupled with the ECB's stated intention "to do whatever it takes," eased financial conditions considerably. Thus, even though the German-inspired policy of sovereign budget austerity led to restrictive fiscal policies across the European Union, the EU eked out a few quarters of positive GDP growth. For a while easing financial conditions trumped the adverse effects of austerity. The damage from austerity has been cumulative in the form of higher unemployment and inflation approaching zero.

Now that financial conditions are tightening once again and global growth is slowing, a return to recession in the EU seems almost inevitable.

The rate of economic decline has exhausted itself in the European peripheral countries but their economies remain mired in depression with stunningly high rates of unemployment. The social contract in those countries is eroding and with it social stability. Political stability is also ebbing. For the time being the policy palliatives have created a sense that all is well. But, the cancer has not been cured and continues to spread. At some juncture a flash point will be reached when the palliatives no longer work. Although the moment of truth is probably not yet at hand, it is getting closer.

Centrist political parties still rule the roost but euro-skeptic parties on both the right and the left are gaining momentum. Inevitably, this puts pressure on ruling parties to avoid losing votes and perhaps power to embrace popular aspects of fringe party policy issues. Thus, the political trend is unambiguously evolving in the direction of nationalism and this will increasingly undermine the glue that holds the EU together.

2. China

In the early years of China's ascendancy, it bootstrapped its phenomenal growth by linking its currency to the dollar and pursuing trade-based mercantilist policies. While those policies were essential in the early going to galvanize China's economic breakout, an economic model driven primarily by investment by repressing consumption, which is what China did, leads in the long run to unsustainable imbalances.

When the global Great Recession hit, Chinese policy makers doubled down by cranking up the state-driven investment economic model. Growth surged and many countries, particularly those that were resource rich, benefited handsomely. But as Hyman Minsky described in his "financial instability hypothesis", overinvestment leads first to "speculative financing" which is often followed later on by "Ponzi financing". When cash flows from real economic activity are not sufficient to support servicing of interest and principal on the credit used to finance the investment, momentum and state support can sustain the situation at the cost of ever growing imbalances.

China pretty clearly has been in the Minsky "speculative financing" phase for a while. As China's investment focus matured, an ever increasing number of renminbi has been required to generate an additional renminbi of output. This is a telltale sign of the Minsky "Ponzi financing" phase. And that is exactly what has been happening in China.

China's leaders understand the need to transition the economy from one in which investment and exports have driven growth to one in which domestic consumption will eventually dominate. And that is what the Chinese market reform agenda is all about. Such a transition is typical in a developing economy as consumer incomes rise and a large middle class evolves. This transition is also necessary for sustaining social and political stability. However, the transition which is in its early stages already appears to be resulting in a slowing in the rate of GDP growth. While China has a stated goal of 7.5 percent annual real GDP growth, it is increasingly clear that this goal will not be met in 2014. It appears that China's leadership is determined to stay the course. This should result in a healthier, more-balanced economy in the long run, but it will also be one that grows much more slowly.

3. Resource-Based Economies

Growth in China's demand for raw materials has already slowed. At the same time substantial increases in capacity to supply commodities are coming on line in many resource-based economies. Not surprisingly, prices of most commodities are falling. This is not a short-term phenomenon. Until recently rising prices for commodities partially offset powerful deflationary forces; falling commodity prices will now reinforce deflationary forces. Commodity-driven economies such as Russia and Brazil are already in recession.

4. Japan

Japan has yet to come to grips with the challenges of an economy whose population and work force are shrinking. Its failure to understand this problem and develop effective policies assured 20 years of malaise and deeply embedded deflation.

Now nearly all the policy stops have been pulled out. Developing "third arrow" policies, which involve increasing competitiveness and growing the size of the labor force, are essential for dealing with the consequences of an aging and shrinking population. These policies are mostly conceptual at this juncture and will soon need to be turned into concrete programs. Unfortunately, increasing it looks like "third arrow" policies will be limited in scope and slow to be implemented. Aggressive fiscal and monetary policies had favorable impacts on growth and deflation initially, but their effectiveness is already diminishing and will shortly lose effectiveness altogether without "third arrow" programs. Already there are multiple signs that "Abenomics" could fizzle.

5. Other Countries

The list of global imbalances could go on. For example, the recent rapid growth of the Indian and Indonesian economies may turn out to be the product of liquidity-driven financial flows seeking yield, rather than to deliberate enabling economic policies.

IV. Deflationary Bust

In the ***August 2013 Longbrake Letter*** I discussed two economic scenarios that are alternatives to the baseline scenario of slow growth and gradual elimination of the output gap and return to full employment — ***deflationary bust*** and ***severe inflation***.

Each scenario is a possible extreme outcome of the extraordinary monetary and fiscal policy interventions that have occurred in the U.S. and other global economies in recent years. The consequences of these extreme outcomes are very negative and, thus, we should all hope that neither materializes.

Over the last year the baseline scenario of slow growth has continued to hold sway, but recent developments, including falling commodity prices, plummeting interest rates, and slowing growth, have renewed discussion of the ***deflationary bust*** scenario. Indeed, while this scenario seemed to be a remote possibility a year ago, as global imbalances continue to build and policy continues to be largely ineffective or even counterproductive, recent global developments strongly suggest that the probability of a ***deflationary bust*** is rising.

Thus, it is important to recap the economic conditions that spawn a ***deflationary bust*** and also to summarize the consequences for the real economy should it materialize.

1. Deflationary Bust

Market economies are naturally deflationary because participants strive to maximize profits. This is accomplished by increasing revenues and decreasing costs. Thus, over the entirety of the economic cycle, market-driven economies will tend to have an excess of supply relative to demand which fosters downward pressure on prices.

This fundamental trait of market economies has been masked in our lifetimes by persistent and sometimes virulent inflation. Because that has been our experience, we have come to think of inflation as a normal condition. But, it is not. However, because that has been our experience and because too much inflation is troublesome, policy has focused on containing inflation. Now that the natural deflationary tendencies of market-based economies are returning to the fore, policies designed to deal with inflation are ineffective in dealing with the opposite problem of deflation. In addition, traditional policies designed to stimulate demand, which arguably should counterbalance deflationary forces, don't appear to be working very well and may actually be feeding deflationary forces.

There are several reasons that the deflationary characteristics of economic activity were replaced by inflationary characteristics during our lifetimes. Prominent among these were rapid population growth including lifespan extension, systematic construction of social welfare institutions, and active policy intervention to dampen economic cycles. Aggregate demand stemming from population growth outpaced development of aggregate supply. Social welfare institutions and active monetary and fiscal policies moderated the consequences of economic recessions, but at the cost of limiting the corrective impact of creative destructive; in other words, some economic inefficiencies were not purged during recessions. Collectively, these developments imparted an inflationary bias to market-based economies.

Recent global developments are pushing the performance of many market-based economies back in the direction of their historical deflationary bias. Population growth is slowing in many developed economies and is actually negative in Japan and many European countries, and soon will be in China as well. This development automatically decreases aggregate demand. In addition, over the last 25 years, the portion of the global population living in countries with market-based economies has more than doubled. This has unleashed huge increases in aggregate supply. When supply increases faster than demand, which is what has been happening over the past few years and which will most certainly continue, prices must inevitably fall.

Deflation is not necessarily bad if it is accompanied by economic expansion, an outcome that is called ***deflationary boom.*** A deflationary boom occurs when the volume of output rises more quickly than prices fall — the nominal value of output rises. This clearly occurs when population grows rapidly.

But, a ***deflationary bust*** occurs when prices fall faster than output rises — the nominal value of output falls. This has been Japan's problem for over 20 years and is fast becoming Europe's and Russia's problem currently and will become China's problem in a few years. While the U.S. is not likely to suffer from depopulation in coming years, the rate of population growth is slowing and the Congressional Budget Office estimates that the annual rate of growth in total hours worked will fall steadily in coming years to 0.5 percent.

Downward pressure on nominal sales growth in firms makes it more difficult for those firms to service their indebtedness and increases the potential for bankruptcy. The same is true for governments. Slower growth in tax revenues makes it harder to service public debt.

If a ***deflationary boom*** holds sway, equity returns should exceed the cost of capital. If the relationship is reversed, then a ***deflationary bust*** is at work.

Charles Gave of GavekalDragonomics has constructed a simple index to measure whether a deflationary boom or a deflationary bust prevails.[1] Gave measures equity returns as the total return (includes reinvestment of dividends) on a local country's MSCI stock market index in U.S. dollar terms. He measures the cost of capital as the total return on a U.S. 20-year constant duration Treasury zero coupon bond. Over the last 12 months the cost of capital has exceeded equity returns in 14 countries. In only one, the U.S., has the reverse been true. Gave concludes that this is powerful evidence the global economy is mired in a ***deflationary bust***.

[1] Charles Gave. "Plodding Towards Deflation," GavekalDragonomics Global Research, October 13, 2014. This commentary is proprietary and is not available for distribution without permission by GavekalDragonomics.

2. Negative Real Interest Rates

When aggregate demand is insufficient, which is the case when ***deflationary bust*** conditions hold sway, policy makers structure traditional monetary policy to drive down nominal interest rates.

However, when nominal interest rates fall below the rate of inflation, real rates of return become negative and saving is discouraged. But realized investment must equal saving. If saving is discouraged, realized investment must also fall. In the long run, declining investment depresses productivity growth and leads to lower potential real GDP growth. Unfortunately, this is exactly what has been happening in the U.S.

Private investment depends upon the availability of credit. The Federal Reserve can create liquidity through asset purchases but it cannot create credit. Creation of credit depends on the willingness of financial intermediaries to lend — to supply credit. Willingness to lend, while improving slowly, is still being held back by tight underwriting standards and conservative regulatory policies and supervisory standards and practices, as well as by increased capital and liquidity requirements for financial institutions.

Demand for credit also depends upon the extent to which returns on investment are expected to exceed the cost of financing it. Demand for credit has been slack because of uncertainty about future growth. In other words, very low borrowing interest rates appear to be insufficient to prompt investment in the face of enormous uncertainty about sales and revenue growth. In short, investors prefer safe assets, even though they have had low or even negative real rates of return, rather than capital investments with uncertain returns, which could turn out to be even more negative.

Negative or below normal real interest rates pump up the value of financial assets and create the illusion of greater wealth. And for a while this feels good. But, artificially induced financial wealth must eventually be ratified by an increase in real wealth. ***This is a very important point and the condition does not appear to be met currently.*** If real wealth falls short of financial wealth, a financial bubble builds. Hyman Minsky's "financial instability hypothesis" states that financial bubbles occur when speculative forces predominate and "Ponzi financing" emerges. Ponzi financing drives up financial valuations to levels that greatly exceed those justified by likely cash flows from real economic activity. Ponzi financing activity can persist for a very long time due to animal spirits. The risk has been that the Federal Reserve has fed the beast with its large scale asset purchase policy. But, eventually bubbles burst and when that occurs, a ***deflationary bust*** follows.

An economy whose real rate of growth is declining has a profound structural problem which over time could lead to an insufficient amount of real wealth creation to ratify the artificially inflated financial wealth. If that is the pathway the U.S. economy is on, then the market will eventually realize that financial valuations are not supported by real economic growth. When, and if, this realization takes hold, a ***deflationary bust*** will unfold with a vengeance. This risk applies to other global economies, which means that the U.S. need not be the country that triggers the ***deflationary bust***. Europe is the prime suspect. Once underway, financial asset prices will decline precipitously as real rates of interest return to positive levels that are consistent with actual potential economic growth. Indeed, stock prices are plummeting in Europe in parallel with falling inflation and interest rates. Clearly, Europe is already in the throes of a powerful ***deflationary bust***. And, there is little, or perhaps nothing, in the policy mix that will arrest downward momentum.

3. Ruminations — Charles Gave[2]

Charles Gave opines that "*The current financial situation reminds me of a Greek tragedy. Every step toward an international liquidity crisis is being followed on cue...*" There are two steps in the developing global liquidity crisis.

Step one — the U.S. trade and current account deficits are shrinking. This means that there are fewer dollars available globally. (When the world was on the gold standard, too little gold led inexorably to sustained deflation. To avoid such an outcome growth in global monetary reserves need to keep pace with growth in nominal economic activity.)

Step two — collectively foreign central bank reserves held at the Federal Reserve are declining. This is an indication that central banks are liquidating dollar reserves to finance current account deficits. India is already feeling the full brunt of an acute liquidity squeeze. India has been forced to raise short-term interest rates in an attempt to stop capital outflows so that it can continue to finance its current account deficit. However, higher interest rates, if sustained, will depress growth in India and could even lead to recession.

What Charles Gave is saying is that growth in global financial flows has not been matched by real wealth creation. Rates of return on real, as opposed to financial, investment are inadequate or even negative. As investors begin to realize this, speculative finance is withdrawn and a liquidity crisis ensues. The Minsky financial instability hypothesis is at work.

This is heavy and frightening stuff. We will know in time whether the analysis is on the mark.

4. Nouriel Roubini's "New Abnormal"

Nouriel Roubini, the economist who correctly foresaw the consequences of the U.S. housing bubble and the global speculative frenzy it spawned, recently penned an article titled the "*New Abnormal*". [3]

Roubini notes that the theme of the "***New Normal***" has been embraced by many. The "New Normal" involves the presumption that economic progress will be slow but steady and will be supported by an abundance of central bank provided liquidity. But this "New Normal" involves papering over significant structural imbalances. Policy intervention has sedated the disease but it has not cured it. But in the absence of crises policymakers have lost fear; complacency has taken over. Ignoring serious issues does not make them go away. In fact, history suggests that problems tend to get much worse by virtue of neglect.

Roubini puts it this way: *"... this situation is one that is not a stable equilibrium, is not even a stable disequilibrium. It's an unstable disequilibrium. Take for example the Eurozone. You cannot have just a monetary union without banking, political, economic, fiscal union. Either you move towards more integration or you're going to have more fragmentation and disintegration. So the situation we face right now in the global economy, same in the Eurozone, is of an unstable disequilibrium, therefore a new abnormal, that cannot be sustained. ... liquidity has been like a drug, a palliative, it doesn't resolve the disease, you have to do fundamental, structural changes that's going to increase the productivity."*

Roubini concludes that: *"The deeper questions that created the recent convulsions have not been an-*

[2] Charles Gave. "Greek Tragedies Always End the Same." GavekalDragonomics Global Research, August 8, 2013. This commentary is proprietary and is not available for distribution without permission by GavekalDragonomics.

[3] Nouriel Roubini. "Roubini and Bremmer on Charlie Rose: Unveiling New Abnormal," EconoMonitor, June 27, 2013.

swered, and the easing of so much useful fear will make them much more difficult to address. That's why ***the uncertainty and volatility of the past half-decade is far from finished — and is almost sure to trigger new crises****. We have entered the* ***New Abnormal****, a period in which every market assumption must be questioned and the wise investor is prepared to be surprised."* [I have supplied the bold type to emphasize Roubini's key conclusion.]

There is substantial congruity between the analyses of the Charles Gave and Nouriel Roubini. Recent market developments suggest that the blinders may now be coming off.

In the sections that follow about Europe, China and Japan some background material from previous Longbrake Letters is provided.

V. Europe

Excerpts from *December 2012 Longbrake Letter*

Calm has returned to European financial markets thanks to Mario Draghi's commitment to do "whatever it takes". But, economic conditions continue to worsen and Europe's recession is spreading to the stronger countries and deepening in the weaker ones. The markets are calm because Draghi's "whatever it takes" is understood to mean that the ECB and European Stability Mechanism (ESM) will purchase sovereign debt of troubled Eurozone (EZ) countries. As long as there is a committed "lender of last resort" there is no need for investors to unload toxic sovereign debt.

Thus, the financial crisis has abated. But, virtually nothing has been done to address the underlying structural flaws that plague the European Union and the euro area. There needs to be a fiscal and transfer union — this is not even receiving serious discussion. There needs to be economic policy integration — again no serious discussion is occurring. And, there needs to be a banking union — an agreement was announced recently with great fanfare but it is woefully inadequate.

As a consequence severe competitive imbalances among the economies of euro area members remain largely unaddressed except for the peripheral countries of Greece, Ireland, Portugal, Spain and Italy. And, in those countries some progress has occurred largely by crushing economic growth and forcing down wages and benefits. Austerity policies are an exceedingly painful way of pursuing improved competitiveness.

(Note: nearly two years later this critique remains as valid as when it was first written.)

1. Economist Magazine — France "The Time Bomb at the Heart of Europe"

According to the *Economist Magazine*, France's principal problem is that it is steadily becoming less competitive relative to Germany. The public-debt-to-GDP ratio exceeds 90% and is climbing. Businesses are burdened by high taxes. Few new companies have been formed in recent years and little innovation is occurring. France's banks are heavily exposed to the debt of struggling peripheral countries. The magazine speculates that crisis could hit France during 2013 and suggests that France, not Spain or Italy, may be where the fate of the euro is determined.

Moody's seems to agree as it recently downgraded French sovereign debt, citing the country's chronic structural impediments to growth.

(Note: Both Fitch and Standard & Poor's placed France's AA+ rating on negative outlook on October 15, 2014 and October 11, 2014, respectively.)

2. EU's Much Ballyhooed Banking Union Is Woefully Inadequate

Europe's banking union is woefully deficient yet its announcement on December 13, 2012 elicited great optimism. Bank customers can freely move euro deposits to any euro area financial institution. If there is concern about the solvency of a bank, deposits can simply be transferred. At the height of the Spanish banking crisis billions of euros left Spain. Through the Target2 clearing system and ECB liquidity facility potential liquidity problems were avoided.

Properly designed, the EU banking union should look like the U.S. banking system. There are three components to a well-structured banking union: supervision of all banks by the same supervisor (the U.S. has multiple supervisors — Federal Reserve, Comptroller of the Currency, Credit Union Administration and states — but coordination is reasonably effective, but not perfect); deposit insurance; and resolution of failed banks.

For starters the EU banking union has no deposit insurance and no failure resolution mechanism. This means that if the ECB decides to close a supervised bank, it will have to work with the country in which the bank is chartered to implement closure. To say the least, it promises to be a messy affair. The reason deposit insurance and failure resolution is missing is that its existence would make all EU countries jointly liable for the costs of closing a bank. Obviously, since it is absent, the EU collectively is not yet ready to assume responsibility for the problems of individual banks. Deposit insurance has the same effect as debt mutualization, which Germany, in particular, has resisted. However, an effective fiscal and transfer union would have both features.

Thus all that is left in the banking union is supervision. There are about 6,000 banks in the EU which could be supervised by the ECB. Germany strongly objected to including all banks and eventually prevailed. Only about 150 to 200 of the largest banks with assets above euro30 billion will be part of the banking union.

Large banks in the 18 euro area countries are automatically covered. The other 10 EU countries which have not adopted the euro may at their discretion chose to include their large banks. The banking union will be called the "Single Supervisory Mechanism". The European Banking Authority, which is based in London, will continue to be in charge of establishing common banking rules for banks in the 27 EU member countries.

So, the ECB will be the supervisor for most, but not necessarily all large EU banks. But, it will not have authority to write rules. Also, the ECB's enforcement powers as supervisor have yet to be spelled out.

All I can say is that as convoluted as the U.S. bank regulatory and supervisory system is, it seems to be relatively uncomplicated compared to what the Europeans have dreamed up. It will be interesting to see how Europe's banking union works in practice and whether it will have any practical impact in addressing Europe's financial system problems.

(Note: the first ECB stress tests of European banks will be reported in October 2014; some issues with a few banks are anticipated.)

Excerpts from the *March 2013 Longbrake Letter*

Europe's recession continues, although most forecasters expect a return to growth by the second half of 2013. I think this may well turn out to be optimistic. As I have mentioned repeatedly, European policy makers have been effective in stabilizing financial markets through a variety of initiatives, but none of these has addressed effectively fundamental political and economic reforms which are necessary in the long run to assure the viability of the EU and the common currency. And, as feared, stabilization of financial markets since last August has reduced the sense of urgency on the part of policymakers to pursue essential reforms.

Political risks are rising. The outcome of the recent Italian election in which the populist Five Stars party garnered 25% of the vote made that risk abundantly clear. As of yet, a new Italian government has not been formed. When one is formed it is expected to be weak and new elections are expected within a year.

Euro-skeptic parties on the right, while still far distant from obtaining real political power, are growing. Reductions in the recently approved seven-year EU budget will result in large wealthy members providing smaller subsidies to less well-off members. Thus, the budget marks a move away from integration as countries with stronger economies seek to limit transfer of resources to less well-endowed countries. The slow unraveling of the European Project is continuing.

There is a presumption that the banking and sovereign debt crises are slowly being resolved. This presumption is not soundly based. Abatement of turmoil in financial markets is not an indicator that the underlying problems have been addressed and resolved. Provision of unlimited amounts of liquidity, which is what the principal remedy has been to date, can treat the symptoms but cannot cure the disease. The disease is deeply rooted in balance of payments mismatches among members of the EU and euro area, differences in competitiveness among countries and the absence of effective economic and political governance mechanisms. Can Europe emerge from recession when these fundamental problems remain unresolved? Perhaps, but a return to normal growth seems to be a real stretch of the imagination. The European financial system remains deeply dysfunctional and like the Japanese financial system of the 1990's will not be in a position anytime soon to facilitate the kind of credit creation essential to promote economic growth. Stay tuned — Europe remains a large downside risk that is significantly underappreciated.

Excerpts from the *April 2013 Longbrake Letter*

1. Reasons Why the European Project As Currently Structured Is Fatally Flawed

There are many reasons why it is likely that the European Project will eventually fail. In my opinion the two most important reasons are crippling design flaws in the governance structure of the EU and Germany's economic policies.

Incomplete Political and Economic Integration. The U.S. federal/state system and constitution, which have been the foundation of U.S. economic success and ascendancy for over two centuries, rightly provide a model of the governance structures required for a successful and durable union. The European Union has some of the necessary governance structures, but lacks others.

Essential governance components include political union, economic integration, fiscal consolidation and a common currency. The euro area has a common currency, but the remainder of the governance structures, which extend to all EU countries, do not strike the necessary balance for long-term success between central authority and individual country sovereign prerogatives.

For example, all EU member countries must agree to a treaty change before it becomes effective. The U.S. constitution only requires of the states to ratify amendments.

There is no ability for the EU to tax citizens of member countries directly and there is no provision for fiscal transfers from countries with strong economies to countries with weak economies except through onerous bail-out agreements complete with intrusive, and often counterproductive, conditions. Fiscal transfers are essential to address differentials in economic performance. Such transfers occur automatically in the U.S. with virtually no notice.

While there is ample tension between the federal and state governments in the U.S., the ability of the federal government to forge national policies and to enforce them is clear. The EU does have a limited ability to forge common policies and to enforce them. However, the EU's sway does not extend to any significant degree to matters of finance and commerce, which is partly why the financial and economic situations spun out of control in Ireland and Cyprus.

The European Project will remain fundamentally flawed until its governance structures are modified to align to a greater extent with those that have made the American union successful. It is not mysterious as to what needs to be done. Doing it, however, given the strong allegiance to individual country sovereignty, has a probability close to zero. At best one can hope for a few modifications, such as forging a banking union or agreeing to mutualization of sovereign debt, which might be sufficient. But important as these modifications are, there is no assurance, even if enacted, that they would be sufficient in the long run.

Germany's Economic Model. While the rest of Europe struggles economically, Germany is enjoying low unemployment. Germany's success is rooted in reforms it undertook in the 1990s following the union of East and West Germany which improved competitiveness tremendously. But, success is also the result of Germany's intentional policy to emphasis manufacturing and exports. Its competitiveness and prowess in manufacturing have resulted in the creation of jobs and large trade surpluses. Germany's economic strategy and success are a cause of economic problems in other members of the euro area.

Suffice it to say that because Germany is a net exporter, other euro area countries are forced to be net importers. This shifts jobs from those countries to Germany. Were it not for the common currency, such imbalances would melt away over time through adjustment in currency exchange rates. This is not possible in the euro area. Thus, adjustment can only occur through internal devaluation which entails eliminating competitive disadvantages with Germany by driving down labor costs, among other things. Germany could assist the adjustment process by permitting its labor costs to rise, but, of course, this is not part of Germany's policy agenda because it would unleash the inflation boogeyman, which is anathema to the German public.

Germany has forced internal devaluation in euro area members by mandating fiscal austerity. This is enforced directly through bailout agreements but also indirectly through the Fiscal Pact which establishes budget deficit targets with enforcement to be carried out through the European Commission. Unfortunately, as well intentioned and as fiscally prudent as these policies might appear to be, in practice they have been a disaster. That is because fiscal multipliers in weak economies have turned out to be greater than one. What that means is that tax increases and spending cuts intended to reduce the public-debt-to-GDP ratio actually end up raising it because economic activity falls too much.

(Note: German growth slowed to near zero during the second quarter of 2014 and may be negative in the current quarter. Since a large share of German exports go to other EU

nations, weakening economic activity in those countries necessarily hurts German growth as well.)

Bank Solvency and Inability to Forge a Banking Union. One of the features of the EU is free and uninhibited capital flows. This is an essential governance component for successful union, but unfortunately its operation is deeply flawed because of the absence of a banking union.

An effective banking union has three components. First it has a common set of rules and a single supervisor. Second, it has a universal deposit insurance system. Third, it has a centralized resolution facility to manage failures of individual financial institutions. All three components exist in the U.S. The only component that exists in the EU today is a common set of rules and even that is limited primarily to capital and liquidity requirements. Other rules, for example those governing the granting of credit, are left to the determination of individual countries. This absence of unified rules and oversight contributed to the unsustainable financial imbalances that built up in Ireland and Cyprus.

Reluctantly, EU members agreed to a common bank supervisor, which is to be the ECB. But, the scope of this decision was limited in two ways by Germany. First, Germany gained acceptance of EU members to limit unified supervision to the 150 largest financial institutions. Second, more recently Germany convinced EU members that the next time treaty revisions are considered, one of the revisions should be a clear separation of the ECB's monetary and supervisory responsibilities. While such a clarification appears to be reasonable, many view this development as a German tactic for delaying implementation.

Importantly, integration of bank supervision remains a concept and implementation is still sometime in the future. Deposit insurance and resolution remain totally unaddressed.

There is implied deposit insurance for the first euro100,000 of bank deposits. This implied guarantee was violated in the initial Cyprus bailout proposal. The subsequent proposal restored the implicit guarantee but also forced conversion of "uninsured" deposits into equity which is estimated will result in at least a 50% to 60% loss.

Now ponder this. If you can move euros freely to any financial institution in any EU member country and there is doubt that your deposits are guaranteed, why would you keep them in financial institutions that are perceived as weak or that are located in EU countries that are potential candidates for bailouts replete with conditionality. The Cyprus solution is extremely dangerous because knowledgeable depositors will move their funds to safer places at the first hint of trouble. This is the stuff of contagion. The potential for contagion can only be stopped through a banking union that covers all financial institutions and provides for deposit insurance and resolution.

So, since the risk of contagion is so obvious, why hasn't a banking union been embraced? It is because significant unrealized banking losses already exist and these losses are likely to get worse as recessions progress in many EU countries. Losses eventually will have to be realized. The question is one of who will bear the burden — individuals, sovereign nations, or the EU collectively? Germany has made its view clear that the burden should not fall on the union collectively. That is because a large portion of the losses would ultimately end up being borne by German taxpayers. Again, such an outcome is unacceptable politically.

Unwillingness to Forge a Fiscal Union and Mutualize Sovereign Debt. As just mentioned, losses must be borne by someone. When individual institutions fail, the losses are borne by the creditors. But, because this usually triggers panic and a meltdown in the financial system, nations generally step in and bailout creditors. This solution works only as long as the nation itself remains solvent. If the obligations of bailing out creditors become too great as it has in Greece, Ireland, Portugal and Cyprus, either the nation must declare bankruptcy or it must be bailed out by others.

As we know, the solution to date to avert bankruptcy of individual EU members has been to provide bailout loans with conditions that ostensibly are intended to return those nations to solvency over time. We also know that these policies not only are not working but they are making matters worse and spreading economic decline to other EU nations.

Issuance of euro bonds would spread losses to all EU member countries, which collectively are in a position to backstop individual country insolvencies. But this means that strong EU countries would end up paying for the sins of weak countries. To date this solution has been unacceptable but may be required nonetheless in time to preserve or extend the life of the EU and euro area.

Cultural and Language Differences and Limitations on Population Mobility. Although the Schengen Agreement among EU members mandates the free movement of people with EU citizenship, cultural and language differences limit population mobility. In the U.S. when a particular geographic area is afflicted by an economic downturn many people leave the area to seek employment opportunities in regions with stronger economies. Language and cultural differences make labor mobility stickier in the EU. As a result, it takes longer for depressed areas to recover.

Aging and Declining Population Growth and Low Potential GDP Growth. Most EU countries either have low population growth or negative population growth Population growth is a critical component of potential GDP growth. When population growth is negligible, potential GDP growth depends entirely on productivity gains. But, productivity growth has collapsed in EU countries since the onset of the Great Recession.

Potential GDP growth is important because the higher it is the easier it is to grow out of a sovereign debt problem.

In addition to the low potential GDP growth posed by limited or negative population growth, an aging population stresses social welfare pension and health systems. EU nations collectively have extensive social safety nets which will result over time in increasing amounts of government expenditures. At the same time, as work forces shrink, revenues will also shrink. Declining and aging populations inherently create potential budget deficits in nations with extensive social welfare programs.

This problem is one that is gathering momentum gradually. While not an immediate consideration, it will make policy resolution more difficult.

High Levels of Sovereign Debt. While I have argued that sovereign debt is not bad in and of itself, too much of it relative to the size of a nation's economy creates enormous risks. The EU has established a 60 percent target maximum for the sovereign-debt-to-GDP ratio. This appears to be a reasonable upper bound to avoid the potential for insolvency risks to become significant. Unfortunately, most EU members have higher ratios. And, even when they have lower ratios, as was the case for Ireland and Cyprus, the need to backstop the financial system resulted in an immediate and substantial escalation in their debt ratios to levels greatly in excess of 60 percent.

It would seem that the solution to high debt ratios is fiscal austerity and that is the policy that the EU is pursuing. But, when economies are already weak, we have seen that austerity depresses economies and results in rising rather than falling debt ratios. The alternative solution of growing out of the problem is limited by population dynamics and poor productivity.

Unfortunately, the more probable solution longer term is restructuring of sovereign debt through bankruptcy or other means. This requires forcing creditors to absorb losses. Since Germany is the largest creditor in the EU, it would be the largest loser.

Write down of sovereign debt either directly or through the issuance of euro bonds appears to be inevitable. Write down has already occurred in the case of Greece, but in a way that permitted Greece to remain a member of the EU. However, the consequences for Greece of this particular solution have been disastrous. If write downs in the value of sovereign debt occur for other nations, such as Cyprus, it seems probable that they will be accompanied by exit of that country from the EU.

2. Where Are the EU and Euro Area headed?

When I review the fundamental flaws inherent in the EU and euro area governance structures and consider demographic trends and political constraints, I am hard pressed to see an outcome that preserves the EU and euro area in their current forms. But European political elites are committed to the European Project and will continue to struggle to preserve it. This means that the unraveling process is likely to be an extended affair. However, deterioration is proceeding and damage is accumulating. Social unrest is building and legitimacy of the ruling political elite is slowly eroding. In short, the crisis is far from over. Indeed, more and worse episodes are ahead.

Matters are worsening rapidly in France. Within the next two years France is likely to hit the wall and will require some kind of financial assistance. Because France and Germany are the heart of the EU and their alliance has been critical to avoiding a repeat of the European disasters that transpired between 1870 and 1945, a way will be found to deal with the coming French crisis, but the rest of the EU may not survive this climactic event.

Excerpts from the *May 2013 Longbrake Letter*

France's Economy is Deteriorating Rapidly

France is headed into recession. Once recession is underway feedback loops will cause matters to worsen, perhaps rapidly. In the following paragraphs I describe the kinds of impacts that can be expected to occur over the next few months.

France's manufacturing index has been substantially below 50 for many months signaling that manufacturing output is declining. Unemployment has been increasing. GDP growth is nonexistent and is likely to be declining at a rate of 1% or greater within a few months. The INSEE Business Climate Survey has fallen two standard deviations below the long-term average, which indicates that recession is at hand.

France's problem is that government accounts for 57 percent of GDP. Its debt-to-GDP ratio is near 90 percent. As recession unfolds, it will be the private sector that bears the brunt of the decline and the private sector in France is very small. As the private sector declines unemployment will rise, tax revenues will fall and tax expenditures will rise. The budget deficit will increase rapidly, perhaps in the vicinity of 4 to 6 percentage points. If that occurs, the debt-to-GDP ratio will ratchet up sharply. The extra two years France has been granted by the EC to reach a 3 percent of GDP deficit target will turn out to be meaningless.

French banks are already contributing to the strangulation of the French economy because of their inability to extend credit to businesses. This situation will worsen and contribute to an ever deepening vicious circle.

As consumer incomes decline, French imports will shrink and that will have especially adverse effects on Italian and Spanish exports. Both of those economies are already deeply mired in recession. France's economic difficulties will serve to worsen the recessions in both countries.

France's economy has lost enormous competitiveness. Entrepreneurs are a nearly extinct species.

Significant divergence in the performance of the French and Germany economies will place enormous stress on the political relationship between the two countries, which is key to holding together the EU and euro area. If the Germans are lucky, the extent of France's evolving economic challenges will not hit with full force until after the German elections in September.

Add to this grim outlook the stunning unpopularity of Francois Hollande barely a year after he ousted Nicolas Sarkozy from the French presidency.

Stay tuned for further developments. Perhaps France can muddle through just as the euro area has been able to do for the last three years. Given the rigidities and lack of competitiveness which have built up in the French economy, it is difficult to see how France can contain the damage that recession in many euro area economies and its crippled banks are inflicting upon its own economy.

Excerpts from *December 2013 Longbrake Letter*

The disparities in economic performance among the EU member countries are substantial. For long-term survival of the EU, such disparities must diminish. That requires creating governance and fiscal structures that provide for greater integration. It also would require the strongest economy — Germany — to modify its current export-driven economic model. While there has been a lot of talk about what is needed, little of substance has taken place and there is little reason to expect further action of consequence to occur.

The absence of a fiscal transfer mechanism along with the common currency means that the only available economic adjustment mechanism is fiscal austerity and repression of wages. But these mechanisms depress economic activity and eventually breed social unrest and fuel political instability.

Europe may well muddle through 2014 with modest growth. But, the risks of setbacks remain high. Fragmentation of the EU is still in process and promises to worsen.

1. Germany

Germany's economic policies are self-serving and in the context of the euro currency union are contributing to the deep depressions gripping many peripheral European Union members. Germany continues to enjoy huge trade surpluses. This provides jobs and keeps unemployment low. But, Germany's good fortune and so-called prudence is the source of difficulties in other European countries.

Germany enacted significant economic reforms between 2003 and 2005 based on Gerhard Schroeder's Agenda 2010. At the time Germany's economy was sputtering and Germany was sometimes referred to as "the sick man of Europe."

Agenda 2010 entailed large cuts in corporate income tax rates; reductions in public medical insurance, pensions, and unemployment insurance; and significant labor market reforms, which prioritized employment over high wage rates.

Nearly ten years later Germany is an economic powerhouse with low unemployment and reasonable growth, given the extensive difficulties in the rest of the Eurozone. Germany also has transformed its balance of payments from chronic deficits to enormous surpluses. This development stemmed directly from the Agenda 2010 reforms which embedded a substantial competitive advantage in the German economy which was amplified by its participation in the Eurozone and the shared common currency.

Unfortunately, Germany's success has contributed to weakness in some other European countries. Ordinarily, a growing competitive advantage would cause the value of the country's currency to rise and that would increase the price of its exports offsetting the competitive advantage. But this cannot occur completely when the currency is shared with countries with less competitive economies. Consequently, Germany's trade surplus not only was large but it grew over time.

One country's trade surplus must be offset by trade deficits in other countries. By running a consistent trade surplus, Germany transfers production and jobs from deficit countries to Germany. That was good for German growth and German employment but hurt growth and employment in deficit countries.

Germany could have reduced its competitive advantage by using fiscal policy to stimulate consumer spending. This would have resulted in moderate increases in inflation and somewhat higher wage increases, which would have lowered Germany's competitive advantage.

But, Germany did the opposite. Having engaged in belt tightening to become more competitive and then benefiting, the German public felt that austerity was not just a matter for German workers to endure but that the government should live within its means as well. This meant that German fiscal policy was tight when it should have been easy. This, unfortunately, fed the beast and the competitiveness gap grew larger.

In a recent U.S. Treasury Department report on foreign economic and currency policies, Germany was sharply criticized for its huge balance of payments surplus which the report cited as creating "...a deflationary bias for the euro area, as well as for the world economy."

It has been German policy to demand that members of the Eurozone reduce budget deficits. In Germany austerity policy works because of its economic model and its competitiveness. However, in less competitive countries austerity depresses economic activity, engenders recession and, in the case of Greece, an ugly depression.

Germany could transfer some of its accumulated wealth to other Eurozone countries through fiscal transfer or by agreeing to replace sovereign country debt with Eurobonds. But Germany has adamantly opposed such proposals.

Unfortunately, rebalancing of the Eurozone economies cannot occur until Germany adjusts its economic model. It looks like the new German coalition government will take some steps to stimulate the German economy, including raising the minimum wage, cutting the retirement age for certain workers to receive pension benefits, increased infrastructure spending, and some other initiatives. The total package amounts to euro23 billion of additional spending through 2017, or about 0.2 percent of GDP per year for four years. While these fiscal initiatives will have a modest impact on reducing Germany's competitiveness, much more significant change is necessary and this Germany refuses to do. Thus, the integrity of the EU will probably continue to erode slowly and its long-term survival is in doubt.

What we have learned over the last two years is that the promise of liquidity by the ECB has taken investor risk off the table. This means that financial markets will probably not be the catalyst for forcing rebalancing. Rebalancing will eventually occur, but it may take a very long time to unfold. The catalyst most likely will be slowly escalating social unrest in economies with high unemployment rates and the gravitation over time of voters to political parties on the right and the left that do not have a stake in the preservation of the EU.

2. France

France has emerged, just barely, from recession, but the IMF projects only 1.0 percent real GDP growth in 2014 with gradual improvement in following years. France's public-debt-to-GDP ratio will rise to 95 percent in 2014 and then will gradually fall. This is the Goldilocks scenario. Slower real GDP growth or higher interest rates would quickly derail this scenario. The debt situation is fragile because about two-thirds of France's public debt is held by non-resident investors. For the time being the IMF's projections appear to be reasonable.

On November 12, 2013, the Organization for Economic Cooperation and Development (OECD) issued a report in which it concluded that France lags other European countries in adopting reforms to improve its competitiveness. In fact, the competitiveness gap between France and Germany continues to widen. This is not a sustainable situation and will lead to trouble if not reversed.

Although France may muddle through its economic and financial challenges, the political situation is changing with Marie Le Pen's National Front gaining ground. The latest national polls show President Hollande's Socialist party in third place with 19 percent, the center-right UMP party with 22 percent, and the National Front party leading with 24 percent. If the National Front party continues to gain momentum, it could do very well in the May 2013 European parliament elections. The National Front has carved out messages that are resonating. It is highly critical of France's banks and global capitalism. It espouses strong French nationalism and is highly critical of the European Commission (EC). It defends France's expansive social welfare system and rejects austerity. The National Front wants to hold a referendum on EU membership and has proposed exiting the EU in tandem with Italy and Spain. This probably would be very attractive to Italian and Spanish voters, given the condition of their economies, but French voter receptivity is another matter. Obviously, such a development would not be in Germany's interests.

3. Italy

While much of the rest of Europe has emerged from recession, Italy has not. Italy's unemployment rate rose to 12.5 percent in September 2013 and is expected to rise to 13.0 percent before topping out. Even though interest rates have fallen on Italian sovereign debt, negligible growth in nominal Italian GDP means that its ratio of public-debt-to-GDP continues to rise. This relationship is not likely to reverse any time soon. The implication is that either recession will continue or there will be almost negligible positive growth and the unemployment rate will remain stuck at a very high level and could increase more than expected.

Italy's political coalition is fragile and social unrest continues to build. To add to the Five Star Movement's unexpectedly strong showing in the last election, a new popular movement, the Pitchforks Movement, has evolved quickly from a protest group in Sicily to one that was able to stage significant anti-austerity protest rallies of farmers and truck drives in Rome, Venice, and Turin on December 14. The Pitchforks Movement is critical of Italian politicians, austerity, and the European Union. It is also opposed to taxes. Its goal is resignation of the current national government and new elections.

What is happening in Italy is indicative of what is happening elsewhere in Europe. Support for mainstream governing parties is eroding. High unemployment is fostering increasing social unrest which traditional institutions, including political parties and trade unions, have been unable to channel. While the Pitchforks Movement may flame out as quickly as it came to prominence, its rapid rise is indicative of growing discontent.

4. Spain

Spain's GDP grew 0.1 percent in the third quarter of 2013 after contracting by a similar amount in the second quarter. Some might argue that the worst is past, but favorable net exports, primarily the consequence of plummeting imports, more than offset continued deterioration in domestic demand. The official European Union forecast is that Spain's GDP will expand 0.5 percent in 2014. Risks are heavily weighted to the downside, however. Small and mid-sized businesses in Spain are suffering severely from unrelenting tightening of credit.

Domestic inflation eked out a year over year gain of just 0.1 percent in the third quarter and was 0.0 percent in October 2013. Deflation is a strong possibility in coming months. The unemployment rate has risen to 26.6 percent.

As is the case in Italy, interest rates have fallen but the public-debt-to-GDP ratio continues to rise.

In spite of the recapitalization of many Spanish banks, a practice of pretend and extend by refinancing housing loans has hidden embedded losses. Recapitalization was accompanied by stricter valuation standards. As a result mortgage delinquencies have been rising rapidly. According to a recent report, Spain's six largest banks have refinanced euro50.8 billion in home mortgages since December 2012. Over the same period doubtful loans have risen from 36 percent to 46 percent of refinanced loans.

As in Italy, support of two centrist political parties is eroding. Polls indicate that they command support from 57 percent of the Spanish electorate compared to 73 percent in 2011 when the last election was held.

5. Greece

Greece's unemployment rate was 27.4 percent in September. Industrial production has collapsed 33 percent since 2007. Wages have declined about 10 percent over the last two years. Consumer prices in November were 2.9 percent below a year earlier as deep deflation has taken hold. Another small decline in Greece's real GDP is forecast for 2014.

While Greece's borrowing rate is down to 8.5 percent, rapidly declining nominal GDP, courtesy of ongoing recession and deflation, is causing the public-debt-to-GDP ratio to explode. This is a disaster scenario.

Greece has a financing gap of euro10.9 billion in 2014 and 2015. While this gap can be funded through further austerity measures, it would merely exacerbate the vicious debt-deflation circle that is slowly destroying the Greek economy. Ultimately, the ECB and EU will likely be forced to write down the value of their holdings of Greek sovereign debt, which is something that in previous bailouts was restricted to private sector investors, but there are few private sector investors remaining. B of A estimates that Greece eventually will need euro100 billion in debt relief.

Greece's current coalition government holds only a three-seat majority. New elections are not in the offing soon unless the coalition falls apart. However, the European parliamentary elections in May 2014 could lead to an overwhelming defeat of the two coalition parties and catalyze a collapse of the government. There is a reasonable chance that if new elections were held, Syriza would win. It has called for Greece's exit from the EU.

6. Summary

So, if you thought all is well in Europe and things are getting better, that is hardly the case in several key countries. Europe may well limp through 2014 with feeble economic growth and it may avoid political turmoil. However, the fundamental problems that are tearing the EU apart have not been addressed. Unlimited liquidity from the ECB can hold things together for a while longer, but it is not a lasting solution.

VI. China

Excerpts from ***December 2012 Longbrake Letter***

President Xi Jinping and Premier Li Keqiang, the new Chinese leadership, have begun their terms, but no significant policy changes appear to be in store in the short run for dealing with the economic situation.

In a memo and speeches to lower-level officials at the recent annual Central Economic Work Week Conference, the official growth goal for 2013 was cast in somewhat more moderate language — "sustained and healthy" compared to "stable and relatively fast". Specific reference was made to avoiding redundant investment in public infrastructure. China watchers interpret this change in nuance as meaning no significant additional infrastructure spending is in the works and a somewhat slower growth rate in GDP is expected and acceptable. Although the language was oblique, the leadership message appears to be one of setting the stage for eventual identification and implementation of economic reforms that transition the economy from reliance on exports and high infrastructure spending to a greater focus on domestic consumption and innovation. For example, the memo states that one of the goals in 2013 will be to "propose a clear overall plan, roadmap and timetable" for economic reform.

Most likely it will take several months to develop plans for specific economic reforms. But, there are some obvious areas for inclusion.

First, financial markets need to be developed to improve the efficient pricing of capital and place competitive pressure on banks. This needs to include ways of encouraging banks to make reasonably priced loans available to smaller private businesses which currently rely on family members for financing or must go to high-cost money lenders.

Second, the financial and economic power of state owned enterprises needs to be reduced.

Third, the cozy relationship between local governments and local businesses, which tends to curtail competition, needs to change.

Fourth, the propensity of local governments to encourage excessive construction of manufacturing capacity and high-priced real estate needs to be curtailed.

Fifth, an array of prices needs to be determined by market forces rather than be established through administrative processes to assure more efficient allocation of resources. Administered prices have subsidized capital-intensive infrastructure projects and provided unreasonably cheap funding.

Deeply entrenched interests and embedded corruption within the Communist Party will be powerful obstacles to successful implementation of these economic reforms. There has been much debate about whether Chinese leaders can orchestrate the necessary reforms in a timely manner. If they cannot, then the Chinese economy will eventually stagnate just as the Japanese economy has. But, it is far too early to assume that such an outcome is inevitable. Market forces are powerful directors of behavior and once unleashed they will take on a life of their own. Thus, the key to whether the transformation of the Chinese economy occurs will depend upon the extent to which the new leadership can implement some significant economic reforms in coming months.

Excerpts from *May 2013 Longbrake Letter*

It is well understood that China cannot sustain rapid growth through an economic model which relies on massive infrastructure investment and export of manufactured goods. It is also well understood that China needs to develop a robust consumer-driven economic model. The challenge is how to manage the transition. Vested interests within the Communist Party and state-owned enterprises are likely to resist reforms which they perceive will diminish their spheres of influence. But, the emerging middle class, which is beginning to accumulate wealth and discretionary purchasing power, is demanding reforms. The new leadership's challenge is to steer China through both an economic and political transition without creating either an economic or political crisis. Economic transformation is essential to sustaining China's growth, but maintaining the Communist Party's primacy is also an imperative.

President Xi Jinping's and Premier Li Keqiang's list of needed reforms is long. To enable realization of the necessary economic transformation, the overall thrust of reforms must be to increase the efficiency of investment by decreasing the public sector's role and increasing the private sector's role. Needed reforms include:

- ***Political reforms*** that corral entrenched interests of Communist Party elite, which foster corruption, without threatening the Party's overall political power.
- ***Structural reforms*** that boost private-sector growth — deregulating administrative approvals, limiting the preferred competitive position of state-owned enterprises.
- ***Financial reforms*** that enable capital to flow freely to high-return initiatives in the private sector.
- ***Governance reforms*** that ensure that public-sector investments, such as low-income housing, are efficiently designed and implemented.

Up to this point in time it has been relatively easy to manage high rates of growth through policies that allocate cheap credit to state-owned enterprises which engage in infrastructure investment and export manufacturing. However, pursuit of these policies has occurred not without consequences. Growth has relied on extensive debt financing. But, many of the debt-financed projects are relatively inefficient. Opening up competition and eliminating administrative processes that steer credit to preferred entities will lessen the extent of inefficient investments in the future. However, deregulating financial markets too quickly, which means letting interest rates rise and opening up access to credit, will put many of the existing inefficient investments at risk of default. That is the potential stuff of a hard landing, which authorities are committed to avoid at all possible costs. However, if reform moves too slowly, inefficient investments that are over-leveraged with cheap financing will continue to pile up and increase the risks of an eventual hard landing.

Thus, China's policymakers must walk a tightrope. GKDragonomics uses a different metaphor to describe the situation. It likens the task of the Chinese leadership to that of guiding a sailboat. In the face of opposition and resistance leaders must constantly change course to move forward. Sailing directly into the wind will preclude reaching the intended destination. Tacking back and forth will take longer but the destination eventually will be reached.

As an example of how tenuous the situation is, consider the property market. There is no question that China needs substantial amounts of housing to accommodate the rapid migration from rural to urban areas. However, housing programs have led to speculative activity in "high-end" properties. In early 2012 policymakers tightened credit and imposed property controls. This was followed quickly by declining property values and slowing investment in real estate. GDP growth also slowed. At the same time downward adjustments in inventories exacerbated matters. In reaction to the greater than expected slowing, policymakers relaxed credit and property controls toward the end of 2012. Almost immediately property prices took off, which was facilitated by rapid credit expansion enabled by "wealth management" financial products. While GDP growth reaccelerated and investor anxieties diminished, these developments ran in opposition to needed longer-term reforms and demonstrated just how dependent the Chinese economy has become on speculative investments and cheap and abundant funding.

In response to the surge in property prices, the State Council recently announced five property control measures. While none of these measures is particularly substantive, the intent is to limit the reemergence of speculative excesses in the property market. In addition, China's banking regulator announced controls on shadow finance which cover wealth management products. As mentioned above, this type of financing, which promises high rates of return, has fueled property speculation. All of these measures appear to be aimed at curtailing the reliance of local governments on revenue from land sales. Perhaps in response new housing starts have stagnated — they have actually fallen 3% over the last year.

These developments have made China watchers and investors more wary. That is because credit drives growth in China and, if the credit cycle is peaking, then so is GDP growth.

In the long-run a stable and sustainable consumer-driven economy will grow more slowly than the investment driven economy of recent years. That would be a good outcome because such an economy would be more stable and less subject to the kinds of excesses and imbalances that end in hard landings. Nonetheless, the prospect of near-term slowing in China's growth, which is once again on the minds of investors, will be treated as a negative development in the short run.

If growth slows during 2013, as looks increasingly possible, it will be a test of the new leadership. A reversal in policy, such as occurred in late-2012, might ease market and internal political pressures but would delay implementation of necessary reforms. Clearly the road ahead for the new leadership team will be very challenging. We should all hope that they are successful at walking the tightrope.

Excerpts from *December 2013 Longbrake Letter*

China's new leadership is moving forcefully in many ways — corruption, economic reforms, housing policy, and foreign policy.

1. Economic Reforms

It is generally agreed that the program of economic reforms approved by the third plenum in November 2013 is bold and far reaching. Generally, the policy focus will shift from demand management of recent years to supply-side reforms.

Three general strategies are already emerging. The first strategy is reform of Chinese governance, such as shifting the activities of government agencies from direct intervention in markets to guiding macroeconomic policy, regulating market activity, and delivering public services. These are customary government functions in market-based economies. In time this should reduce local government direct management of investment spending, which has frequently resulted in inefficient projects, excess capacity, and bad loans.

Second, the reforms emphasize the importance of market forces and reduce the role of government intervention. Market forces henceforward are to play a "decisive" role. What this means is that governments' ability to manage prices and allocate resources will diminish. Bureaucratic impediments to establishing new businesses will be reduced or eliminated. Restrictions on private investment will be eased. Limitations on the movement of goods between provinces will be removed.

Third, President Xi Jinping is centralizing power to remove obstacles to implementation of reforms (see discussion in section on "Corruption" below). Two new organizations have been created to resolve intragovernmental disputes which in the past have impeded implementation of reforms. One is a national security agency, patterned after the U.S. National Security Council, which will coordinate the activities of various government agencies covering intelligence and military and foreign affairs. The other new organization is a "leading group" on reform. Both organizations will report directly to Xi. The purpose of these two organizations is to cut through bureaucratic obstacles and expedite implementation of reforms.

The broad plan of reform is referred to as the 3-8-3 plan.

There are three sets of reform objectives covering opening up market competition, transforming the role of government, and improving the management of companies with the overarching goal of reducing the government's role in directing economic activity.

These objectives are to be achieved through eight policy initiatives — cutting administrative red tape; promoting competition; reforming land tenure and residence laws; restructuring finance by gradually liberalizing interest rates and exchange rates; strengthening the fiscal and taxation system; reforming state owned enterprises; promoting innovation; and developing the service sector.

There are three expected outcomes: directing more benefits of economic growth to rural communities and farmers; increasing efficiency and the quality of investment by expanding market mechanisms and competition; and creating a basic social safety net, increasing consumption, and helping rebalance the economy through fiscal reforms.

State owned enterprises will come under increased pressure to operate efficiently and to achieve acceptable rates of return on investment. They will be subjected to tighter regulation and forced to compete with private firms. Increased competition will be achieved by putting state owned enterprises and privately owned companies on an equal footing and by increasing private and foreign investment in industries and sectors of the economy previously reserved for state owned enterprises.

Indeed — the reform program is bold. But it is not a capitulation to the west's version of a market economy. China believes that economic success is not dependent upon private ownership but effective competition.

In the long run success of the reforms will depend upon effective implementation. First, China will have to figure out how to restructure its economy to reduce its dependence on manufacturing, infrastructure investment, and exports. Second, China needs to get runaway credit growth under control and avert speculative bubbles. Third, China will have to manage an orderly transition to a lower rate of economic growth.

2. Corruption

In October President Xi Jinping established an organization reporting directly to himself to investigate corruption among highly place government officials. Recently Xi authorized an investigation of Zhou Yougkang, a former Politburo Standing Committee member who served as China's chief of security under President Hu Jintao. Zhou presides over a large patronage network linked to the oil industry. Many of Zhou's colleagues are also under investigation.

While there is probably a genuine focus on rooting out corruption which will be popular with the Chinese populace, it also enables Xi to consolidate his own power and remove opposition to implementation or economic reforms that will reduce the sway of state owned enterprises and other state institutions.

3. Social Stability

It is axiomatic that as a nation develops economically and as more of its population accumulates discretionary spending power, individuals increasingly demand freedoms.

China's rapid economic progress has lifted millions out of poverty. Millions more are being added to a rapidly growing middle class. OECD data document that income inequality has declined as China's wealth has grown. Household income growth is an essential development to facilitate China's transformation from economic growth dependent upon capital investment and trade to one that is driven primarily by domestic consumption.

While most would view the decrease in income inequality as a welcome and positive development, it does necessarily mean it will lessen the tensions in Chinese society that threaten political stability. That is because improved economic equality does not translate to improved political equality. The key to political power is membership in the Communist Party. Without that, education, income, and wealth count for little.

China's decline in income inequality actually is not what typically happens as a country develops economically. A deeper look at what is happening in China's labor market provides an explanation for China's divergence from the customary pattern of increasing income inequality as a nation develops economically. China's education policy in recent years has pushed millions into obtaining university educations. The number of college graduates has grown from 1 million in 2000 to 6 million in 2012. The data show that this has resulted in a shortage of blue collar workers and a surplus of educated white collar workers. In response, wages of blue collar workers are rising rapidly while those for white collar workers are rising less rapidly. In the aggregate, this phenomenon is causing the decline in income inequality.

But, we also know from history that unemployed college graduates in abundance can be the source of potentially significant social agitation. If China can develop more white-collar jobs quickly to absorb the excess supply, it will be a source of substantial strength in propelling rapid economic growth. But, if the job gap remains large, the risks of significant social unrest will escalate.

Excerpts from *March 2014 Longbrake Letter*

Serious imbalances in the Chinese economy have been building for years and, if the policies that have been responsible are not adjusted, the imbalances will continue to build and could lead eventually to a severe financial crisis. That is because resources are being allocated increasingly to investment activities that have low or negative rates of return. The investments are being financed by credit that ultimately cannot be repaid in full because the investments are not earning sufficient returns to service both interest costs and repay principal. Put differently, the rate of return on investment is less than the cost of capital. This state of affairs can be sustained for a while through refinancing loans and capitalizing interest expenses, but eventually losses will have to be realized and bankruptcies will occur. Thus, sometime in China's future a financial cataclysm — a Minsky moment — lurks unless policies are pursued that reverse the persistent misallocation of resources in non-economic activities.

As a reminder, Minsky moments occur when markets realize that significant amounts of credit cannot be repaid through cash flows naturally flowing from the business activities they finance. Credit extension increasing covers losses in addition to new investment initiatives. This is a pattern consistent with financial speculative bubbles. When markets realize that loans will never be repaid in full, credit access is abruptly withdrawn and the Minsky moment is underway. Governments then are forced to intervene and absorb the losses to prevent economic collapse. This is what happened in the U.S., Europe, and elsewhere in the world during the financial panic of 2007-08. But, while governments can stop panic, the harm done to economies is severe and, as we have seen, recoveries are slow and extended. And, there is also a limit to how much bad debt a government can absorb before it has its own Minsky moment. Greece is a recent case in point but there are many other examples throughout history.

There are two data points that underline the evolving credit speculative bubble. The first has to do with deteriorating return on assets (ROA) and return on equity (ROE) in state-owned enterprises (SOEs). According to data from the Ministry of Finance, ROA for nonfinancial SOEs declined from a peak of 5.0 percent in 2007 to 3.25 percent in 2011. The decline was broad-based across a variety of industries. Other data indicate that the ROA for non-state companies was approximately 8.0 percent in 2007 and 9.0 percent recently.[4]

The second set of data has to do with the rate of growth in credit compared to the rate of growth in nominal GDP. When credit grows faster than GDP, which is what has been happening in China, this indicates that a portion of credit is going to support price increases in existing assets, to refinance existing debt and capitalize interest, or to finance unproductive investments. This is reflective of speculation or, in Minsky terminology, Ponzi finance. But the situation is deteriorating because the gap between the rates at which credit and nominal GDP have been growing has been widening. This means that an increasing portion of credit growth is going in speculative ventures and nonproductive investments. These are the indicia of inflating bubbles.

There is hope that China's new leadership and the reforms announced at the culmination of the Third Plenum last November will diminish the extent of existing imbalances and set China on a course of sustainable growth. However, to date many of the reforms are couched as goals and have yet to be articulated through specific implementation plans. The absence of specifics for dealing with misallocation of resources and underperformance of SOEs is especially troublesome. Also, the leadership is clinging to a real GDP growth goal of 7.5 percent for the next several years, which can only be met in the short run by continuing to pursue the policies that are contributing to growing, but ultimately unsustainable, imbalances.

[4]Data provided by Gavekal Dragonomics. Data provided by Gavekal Dragonomics.

To avoid a potentially painful and stressful future, China needs to implement reforms with teeth and accept the reality that a healthy and stable economy will be one that grows more slowly than 7.5 percent.

1. Michael Pettis' Commentary on Typical Progression of Economic Miracles and Transition Challenges[5]

In a series of blog posts, Michael Pettis explains cogently why China's growth rate must slow if it is to achieve sustainable and stable growth and why the alternative course, which China is currently pursuing, will probably not end well. The challenge China is facing is not unique. It is the same challenge that other "growth miracle" emerging economies have faced historically, most notably Japan in the 1980s.

Pettis opines that "The most difficult part of growth miracles has not been the growth miracle itself but rather the subsequent adjustment." China now finds itself at the point of adjustment. What needs to be done is no mystery but the obstacles are formidable.

Growth miracles have common features. They typically involve aggressive state-directed investment in infrastructure and export-based industries. This is accomplished by subsidizing investment and suppressing consumption, which forces up saving to support the outsized investment activity. This is an intentional resource reallocation strategy. It works for a while because the stock of capital is "lower than the country's social and institutional ability to absorb investment efficiently." Such a strategy initially enables a country's infrastructure to catch up with other more developed economies. It has the benefit of producing rapid GDP and productivity growth. This is a good result.

But once the infrastructure deficit has been largely eliminated, this strategy begins to create negative outcomes. That is because high return projects are no longer available. Indeed, the infrastructure investments now available have expected returns that are insufficient to cover debt servicing requirements. In other words, the debt can never be repaid in full and can only be sustained as long as lenders are willing to refinance the debt plus accumulated interest. Once the infrastructure deficit has been closed, the strategy of shifting resources from consumption to investment no longer results in wealth creation. In fact, it leads to wealth destruction.

An indicator of when the gap has been closed is how many dollars of credit it takes to create a dollar of GDP. When the ratio begins to rise rapidly, as it has in recent years in China, it is a clear signal that much of the increased credit is going into inferior investments or is simply refinancing unrecognized bad debts.

Michael Pettis' first observation is that "when a country's growth has been driven by wasteful investment, GDP growth will exceed economic wealth creation, productivity will be overstated, and debt will rise faster than debt servicing capacity." The final phase of an investment-driven growth miracle is always characterized by debt growing at an unsustainable pace. Emergence of wealth management products over the last two years provides ample evidence that China is in the final phase.

Just as was the case with the housing bubble in the U.S. market participants typically don't see trouble coming and generally expect the growth miracle in China to continue. Even skeptics tend to underestimate the difficulty and severity of the adjustment period that inevitably follows the extreme accumulation of debt leverage that accompanies the final phase of the economic miracle.

[5]Michael Pettis. "China: The Politics of Adjustment," blog post on EconoMonitor, December 9, 2013; "Will Reforms Speed Growth in China," blog post on EconoMonitor, January 6, 2014; "China: The Impact of Reform on Growth," blog post on EconoMonitor, February 3, 2014.

What needs to happen when the economic miracle has run its course, as is now the case in China, is to end the suppression of consumption, redirect investment into productive activities, and rely to a much greater extent on market forces to allocate resources efficiently. The reforms announced at the culmination of the Third Plenum in November recognize what needs to happen. It this sense denial is not at issue. But, what is at issue is whether the articulated reforms will be implemented and whether the inevitable dislocations that accompany implementation will be managed effectively.

Continuation of real annual GDP growth of 7.5 percent is mathematically impossible as the economy shifts resources from investment to consumption. That is because, as Pettis observes, "…deleveraging, writing down unrecognized investment losses, and reversing policies that goosed growth rates — must lead to much slower growth." While observers generally acknowledge the legitimacy of these three conditions, they uncritically believe that reforms will unleash sufficient productivity gains to maintain a high level of growth. Pettis explains that for this to occur, productivity would have be "implausibly, even extraordinarily, high" and would need to occur "almost immediately." Moreover, the kinds of necessary reforms involve education, land, SOEs, the hukou registration system, the one-child policy, and others, all of which will take significant time to unfold and take hold.

Lower real GDP growth that accompanies successful implementation of reforms would be a good and healthy result. Sticking with the 7.5 percent real GDP growth goal can only be accomplished by continuing to rely on the investment-driven economic model and would serve to worsen imbalances and create even greater financial instability.

Managed transition and adjustment to a more consumer-based economy is particularly difficult in emerging economies in which the growth miracle has been driven by the state. During the rapid growth phase of the economic miracle the political power structure and the system of incentives are aligned. Party members benefited personally and disproportionately relative to the general population from rapid economic growth. But the country as a whole also benefited. However, as the growth miracle matures, unproductive investment escalates and along with it party-member corruption.

Adjustment to a consumer-focused economy, driven to a much greater extent by market forces, necessarily will diminish benefits to party members as they will no longer be able to direct the deployment of funds to the same extent or extract financial benefits in the process. Generally speaking, it is not within human nature to voluntarily engage in behaviors that forego personal benefit unless the culture, reinforced by severe penalties, mandates selfless decision making. Thus, it is not accidental that part of the new Chinese leadership's response has been a campaign to root out high-level corruption. Also, the art of politics mandates that power be tightly centralized when policy changes are not aligned with the incentives of the old decision-making structure. Centralization of power is already underway.

There is yet another political tactic that typically is helpful during periods of significant policy change and political power realignment. That involves stirring up patriotic fervor and deflecting focus from internal problems to external "enemies." This, too, is exactly what the new Chinese leadership is doing with all its saber-rattling with Japan, the Philippines, and other Asian countries.

So, having stated how formidable the obstacles to fundamental change are and how little market participants understand about the difficulties and challenges that lie ahead, one must not sell the new leadership short, at least with respect to their understanding of what needs to be done and some of the necessary political tactics that are required. Nevertheless, there is a gaping hole in reform plans that, unless filled, will, as Derek Scissors writes, lead to the failure.[6] That hole involves the absence of definitive plans to attack the underperformance of SOEs and impose market discipline.

[6]Derek Scissors. "China's Economic Reform Plan Will Probably Fail," American Enterprise Institute, February, 2014.

2. State Owned Enterprises — Exit Policies Are Needed

In 1997 China implemented policies intended to force SOEs to improve profitability and productivity. The policy was adopted in conjunction with China joining the World Trade Organization with the intent of making SOE's more competitive on a global footing. This policy was enforced by withdrawing direct government subsidies and forcing underperforming SOEs to cease operations or merge with successful SOEs. This policy was quietly abandoned in 2003. Then in 2008 SOEs became the means through which the Chinese leadership stimulated the Chinese economy and parried the consequences of the global recession that followed the financial panic of 2007-08.

In 1997 there were 262,000 SOEs most of which were controlled by local governments. By 2003 that number had fallen to 146,000. ROA rose from a paltry 0.2 percent in 1997 to a peak of 5.0 percent in 2007; ROE rose from 0.4 percent to 12.4 percent over the same time period. SOE profits soared from 0.3 percent of GDP in 1998 to 6.6 percent in 2007. By 2011, with the abandonment of the policy of forcing exit of underperforming SOEs, ROE fell to 3.25 percent. The decline in performance has been broad-based across a variety of industries.

Third Plenum reforms highlight the need to rely to a greater extent on market forces. However, unlike the SOE policy pursued from 1997 to 2003, no specific policy has yet been articulated that establishes clear performance goals for SOEs and requires exit of those that do not meet those goals. Without such a policy rigorously enforced, it is hard to see how significant transformation of the Chinese economy can occur.

3. Concluding Comment

Two essential policies for restoring financial stability and transitioning China's economy from investment-driven to consumer-focused and thereby achieving stable long-term growth are missing. One is outright acknowledgement that the 7.5 percent real GDP growth goal is inconsistent with economic transformation. The other is absence of performance goals for SOEs and disciplinary action for SOEs that do not meet the goals.

Even if policies were specified precisely and clear cut rationale provided, successful implementation would still be at great risk because of formidable obstacles. Fundamental reforms are necessary but will be fraught with social and political consequences. The demographics of China's long-standing one-child policy stand in the way of achieving high rates of growth over the longer run.

All of this said, disaster is not necessarily imminent. Imbalances could continue to build and can be papered over for a period of time that could run to years. But, there is no country in recorded history that has been able to sustain rapid growth indefinitely once the final phase of excessive leveraging and Ponzi finance has been reached as is now the case with China.

Managing transition itself is fraught with risk and simply getting on with the process, as necessary as it is for avoiding the alternative of a major financial and economic crisis, could be mishandled in ways that lead to social and political instability.

It is far too soon to attempt to predict how China's leadership will handle the challenges. Suffice it to say that it will not be easy and the risk of bad things happening is great.

VII. Japan

Excerpts from *April 2013 Longbrake Letter*

Japan's recent change in government has resulted in the adoption of an aggressive policy agenda intended to end Japan's two-decade long deflation. Financial markets have responded enthusiastically. But some are worrying about potential consequences of Japan's policies for other countries.

1. Global Economic Linkages

To put this combination of enthusiasm and worry into context requires an understanding of how the application of monetary and fiscal policies in a country impacts economic activity in other countries. Usually, we don't pay much attention to the global consequences of an individual country's policy mix. This is an oversimplification, of course, because there are significant cross border trading and financial relationships.

In addition to trade in goods and services, flows of financial assets cross borders, and these flows link global financial markets. This means that policy impacts on financial markets in one country will be transmitted to financial markets in other countries.

2. It's A Zero-Sum Game

In a global setting, if one country exports more than it imports, one or more other countries must import more than it exports. The total of all imports and exports across all countries must sum to zero. As a matter of policy, countries prefer to be net exporters because it creates jobs in the country that otherwise wouldn't exist if its exports equaled its imports. And, woe to the country that is a net importer because it is saddled with the burden of exporting jobs to other countries.

3. Role of A Country's Currency

Within a country its currency facilitates economic activity. But, in an open global economy involving trading among countries, the exchange rate at which one currency is converted into another is a pricing mechanism which will, if unimpeded, lead to rectification over time of trade imbalances. The currency of a country that is a net importer, such as the U.S., will decline in value over time relative to the value of the currencies of other countries. As the currency declines in value, exports become relatively cheaper to other countries and imports become more expensive to U.S. consumers. The result is that the net import trade imbalance shrinks and might disappear altogether. Conversely, the currencies of net exporter nations will tend to appreciate over time and the trade surpluses in those countries will shrink.

One might wonder why, given all of Europe's problems, the euro's value has held up so well and has been rising recently. The anchor country of the euro area is Germany and its economy is intentionally structured to be a net exporter. German government policy vigorously supports a net export balance of trade because it creates jobs, helps keep the unemployment rate low and underpins social and political stability. The flaw, however, is that the euro area is full of net importing countries which need a weaker euro to help them balance their economies. But Germany dominates and thus the euro appreciates.

I have said it before and will say it again. Much of the euro area's economic tribulations can be traced directly to two German inspired policies, which, of course, are beneficial to Germany. The first is Germany's reliance on a net export economy and its unwillingness to modify it. If Germany had its own currency, it would appreciate in value relative to the currencies of other euro area countries. But, the common currency makes this impossible. The second policy is Germany's insistence of fiscal prudence on the part of all EU member countries which means adhering to arbitrary government deficit targets and forcing fiscal austerity in an attempt to comply with those targets. As I explain further below, fiscal austerity eliminates a vital tool for helping stabilize and rekindle aggregate demand in member countries with weak economies.

4. Governments Use Policy Levers to Counter Economic Slack

Since 2008 most developed economies have experienced a collapse in aggregate demand and an increase in unemployment. Each has been struggling to boost aggregate demand and close its output gap by pursuing easy monetary and fiscal policies intended to increase aggregate demand.

Monetary Policy. Easy monetary policy reduces interest rates and stimulates investment by lowering the cost of capital and boosts spending on interest-sensitive consumer durables, such as homes and cars, by lowering the cost of financing. Normally, easy monetary policy is implemented by reducing the short-term rate of interest. But when the short-term rate hits zero, as it has in most developed economies, the pursuit of easy monetary policy moves on to central bank purchase of longer-term debt with the intent to reduce long-term interest rates and encourage greater risk taking.

Fiscal Policy. Easy fiscal policy involves a combination of lower taxes and higher government spending. This depresses government revenues, which have already fallen due to a decline in economic activity. It also raises expenditures. The result is a large budget deficit.

If aggregate demand is slow in responding and easy fiscal policy continues to be pursued aggressively, it can result in a substantial increase in the public-debt-to-GDP ratio. At some level the public-debt-to-GDP ratio becomes large enough to trigger market worries about the potential for a government to service the cumulating debt and prompts fears about potential default. When this occurs, interest rates on government debt rise and this contributes to an even more rapid increase in the public-debt-to-GDP ratio.

What we have experienced in some countries when government debt becomes outsized are political pressures to rein in government deficits. This results in transforming fiscal policy from stimulus to austerity. Austerity has appeal in the sense that it seems to be the responsible thing to do to live within one's means. When austerity is imposed, as it has been in the U.K. and Europe, it leaves the entirety of the job of stimulating aggregate demand to monetary policy. While it was understood that the withdrawal of fiscal stimulus would slow the progress in reducing the output gap, it was believed by many that the greater evil was the threat of default and toleration of a slower and longer period of healing was required to avoid such a dire outcome.

Unfortunately, what we are learning is that when austerity is substantial and considerable slack exists in an economy the fiscal multipliers are much greater than when little slack exists in the economy. This results in depressing economic activity further and reducing tax revenues with the outcome that the public-debt-to-GDP ratio rises further. This is the worst possible outcome. Unemployment climbs, government finances become more, rather than less, precarious, social unrest builds and political instability emerges. One only has to look at events in Europe to see how a policy of rigid austerity and limited monetary easing — Europe has not yet engaged in quantitative easing as has the U.K., the U.S. and now Japan — can end up creating additional problems and fostering a worsening economic outlook.

5. Japan's Reflation Strategy

Current Situation. The rate of growth peaked in Japan more than two decades ago. As growth slowed deflation took hold in 1994 and since then has become deeply entrenched. Consumer prices have declined 20% over the last 20 years.

The direct cause of the deflation is not flawed policy but rather an aging and declining population. We are used to thinking about economic issues in the context of a growing population, not a declining population. It is time that we do so, because fertility rates are dropping in all developed nations and declining populations are just around the corner in many countries and already exist in a few countries such as Germany and Russia. In this context Japan is the canary in the coal mine because it is the first developed economy to experience the consequences of negative population growth. But, Germany is close behind.

When population ages and declines so, too, does aggregate demand. Internal investment opportunities diminish which forces savings to seek investments in other countries with growth potential. An external investment focus and internal price deflation have led to a steady appreciation of the yen.

As internal demand shrinks, growth can be maintained only by adopting an export strategy. Of course, such a strategy was Japan's way of promoting rapid development in the 1960s, 1970s and 1980s. And it is China's strategy today. But, the steady appreciation of the yen has eroded Japan's trade competiveness. In fact, over the last several months Japan has experienced a trade deficit. This occurred, in part, because of the appreciation in the yen but has been exacerbated in recent months by the need to import expensive energy supplies after nuclear facilities were shutdown. Overall Japan's balance of payments is still positive because net capital flows exceed the trade deficit.

But to increase aggregate demand, Japan now needs to reinvigorate its historic export strategy. For similar reasons Germany is pursuing a nearly identical strategy.

Remember that it is a zero-sum game. Japan can pursue an export strategy only so long as other countries tacitly accept a net import balance of trade. The 20 percent depreciation in the yen since November and potential further depreciation will put passivity to the test, particularly in China and Germany, both of which stand to lose substantial export market share to Japan in coming months.

Policy Response. Shinzo Abe determined that letting Japan grow old and accepting low to negligible growth rates and a constantly appreciating yen was not acceptable. Also, based on the limited and relatively ineffective reflation policies over the last 20 years, he realized that any attempt to boost aggregate demand and end deflation would require massive policy intervention. And, that is exactly what he has initiated. There are three policy initiatives involving enormous fiscal and monetary stimulus and a moral suasion campaign to encourage the private sector to boost wages and investment.

It was expected that monetary policy under the leadership of recently appointed Bank of Japan (BOJ) president Haruhiko Kuroda would be aggressive but when the new policies were announced they exceeded expectations.

First and foremost the BOJ adopted two targets. The first is to abandon targeting the overnight rate of interest and to increase the monetary base by purchasing large quantities of securities, estimated to be 60 to 70 trillion yen annually, which at current exchange rates is equivalent to about \$600 to \$700 billion. While this is smaller than the Fed's \$1 trillion large scale asset purchase program on an annualized basis, it is much larger relative to the size of Japan's nominal GDP — 16 percent of GDP compared to about 6.5 percent in the U.S.

Second, the BOJ committed to achieve a 2 percent inflation rate within two years. Asset purchases will continue until this objective is achieved.

In the aftermath of the announcement asset yields plunged. It remains to be seen whether the expansion of the monetary base results in any significant increase in credit extension by Japanese banks. But, this may not be an essential component of the strategy which appears to depend to a greater extent on inflation in the values of financial assets and the depreciation of the yen.

Reasons for Policy Change. The obvious reason for pursuing an aggressive reflation policy appears to be driven by economic considerations, namely to increase aggregate demand and end deflation. An increase in aggregate demand is intended to be driven both internally and externally. From an internal standpoint, there are two considerations. First, an acceleration in aggregate demand should occur as expectations shift from deflation to inflation. Second, aggregate demand should be boosted by the wealth effect as the values of financial assets appreciate. From an external standpoint, a more attractively priced yen will stimulate demand for Japanese exports. Certainly, those are the officially stated objectives.

However, there is another possible set of reasons which has to do with the ascendency of China as an economic power. China's growing economic clout threatens Japan's political sway, particularly in Asia, and could evolve into Japan becoming dependent upon Chinese policy decisions. Given the historical enmity between the two countries, this is hardly an acceptable outcome for Japan to accept.

Recent developments and Longer-Term Consequences. In addition to the 20 percent decline in the value of the yen, prices of Japanese financial assets are surging. Bank stock prices are up 70 percent and real estate stock prices are up 90 percent. The index of leading indicators is also rising.

B of A expects the 20 percent devaluation of the yen to lead to zero or slightly positive inflation during 2014. This expectation is based upon trade only and does not include any estimate about the effect on inflation from increased internal aggregate demand stemming from changed expectations or substantial government spending on infrastructure.

Longer run there is uncertainty and disagreement as to how much additional depreciation in the value of the yen the Japanese government will accept. Obviously, further yen depreciation would improve Japan's competitive trade position to an even greater extent. However, at some juncture, the shift in market share from other countries will become sufficiently painful to those countries that retaliation will occur. To date rhetoric has been subdued, which suggests there may be further room for yen depreciation.

In summary, Japan's reflation policy should boost aggregate demand and result in a small amount of inflation. But that policy will not and, in fact, cannot create a higher rate of growth on a sustained basis. The aging and declining Japanese population will prevent this kind of outcome. And since Japan is fundamentally a xenophobic society, it will never embrace an open immigration policy that could counter the economics of population decline. A significant negative consequence of Japan's current policies is a rapid increase in debt. In conjunction with a shrinking population, an eventual return to deflation would likely prove to be disastrous.

Close study and monitoring of developments in Japan will be important because the economics of an aging population and slowing population growth will become increasingly important in the U.S. in coming years. It will also be important to study the global political ramifications of slowing population growth and aging. Demographics is already a significant driver of Europe's current economic and political challenges. And, in spite of China's rapid growth currently, its one-child policy will result in similar demographic challenges in the not too distant future.

Excerpts from *May 2013 Longbrake Letter*

Four months have elapsed since Shinzo Abe became Japan's prime minister and three months have passed since he announced Japan's aggressive reflation program. One month ago Haruhiko Kuroda, Governor of the Bank of Japan's policy board, announced far-reaching changes in monetary policy intended to end Japan's two-decade long deflation.

1. Current Situation

Abe's and Kuroda's shock and awe treatment was intended to be dramatic and to change expectations which would result in accelerating spending thereby killing deflation. Early returns indicate that these policies are having exactly the intended effects. Consumer confidence has surged. Retail and car sales are up. Industrial production is rising rapidly as is the manufacturing purchasing managers' index. ISI's economic diffusion index has surged to the highest positive level in over 20 years. Another survey of current economic conditions is at its highest positive level in years.

Stock prices continue a steady upward march. The Nikkei average has skyrocketed 55 percent from 9500 when Abe was elected to 14800 on May 13. Many companies have announced expectations for huge profit gains ranging from 20 percent to 70 percent or more. Many of these companies have international operations which will benefit significantly from the depreciation of the yen.

The yen is plummeting in value. It is down 24 percent against the dollar, 25 percent against the Korean won, and 26 percent against the Chinese renminbi. If this sizable devaluation sticks for any length of time, it will result in an enormous surge in Japanese exports. ***(Note: exports have not surged and this has contributed lower than expected increases in real GDP growth; energy imports surged following the earthquake and tidal wave disaster at the Daiichi nuclear facility, which led to the shutdown of all nuclear generators in Japan; this contributed to higher inflation but penalized growth.)***

On the home front Abe is "encouraging" companies to increase wages. After the summer elections for the upper house of the diet, it is expected that Abe will push through legislative measures intended to improve Japanese productivity and global competitiveness. Another "encouragement" initiative is to entice women to enter the labor force and encourage companies to offer them jobs. This is an especially important initiative in as much as one of Japan's most intransigent problems is a declining population and a shrinking labor force. ***(Note: the moral suasion campaign to raise wages has had some success; however, the labor force continues to shrink.)***

2. Significant Challenges Lie Ahead

There is little doubt that Japan's policy initiatives will boost output and inflation in coming quarters. However, the important question is whether these policies will lead to a permanent transformation of the Japanese economy or whether Japan will eventually slide back into a low growth, deflation-plagued pattern.

There are two enormous challenges to sustaining growth and inflation over a longer period of time. First, Japan is unambiguously pursuing a "beggar-thy-neighbor" policy. It is hard to imagine that Korea, China, Germany, and other countries will do nothing to counteract the appreciation of the yen against their currencies. If they do nothing, trade and other kinds of business will flow to Japan. Remember! It is a zero sum world. Japan's gain will be another country's loss. Changes in currency valuations take a long time to impact the real economy. This means that the pain for other countries is ahead. But it will build over time and as it does political pressures to respond will also build.

Second, the policies Japan has adopted are classic Keynesian policies to jump start an economy that has inadequate aggregate demand and is mired in a liquidity trap. This is clearly the problem currently facing the U.S. economy. But, it doesn't appear to be Japan's problem. Japan's problem is that its population has been declining for more than two decades. It's insufficiency of aggregate demand is not due to underutilization of available resources, it is due to a declining population. There is a big difference between the two causes. If there were truly an insufficiency of demand in the classic Keynesian sense, why would the unemployment rate be at a barely visible level of 4% and why would per capita real growth in GDP be as strong as it has been in recent years. Declining nominal GDP can turn into strongly rising real per capita GDP when adjusted for deflation and a declining population.

The direct cause of the deflation has not been flawed policy but rather an aging and declining population. We are used to thinking about economic issues in the context of a growing population, not a declining population. It is time that we do so, because fertility rates are dropping in all developed nations and declining populations are just around the corner in many countries and already exist in a few countries such as Germany and Russia. In this context Japan is the canary in the coal mine because it is the first developed economy to experience the consequences of negative population growth. But, Germany is close behind. And, China is headed in that direction.

When population ages and declines so, too, does aggregate demand. Internal investment opportunities diminish which forces savings to seek investments in other countries with growth potential. An external investment focus and internal price deflation led to a steady appreciation of the yen until the recent reflation policies were unleashed. This is the natural state in an economy with a declining population. Japan's current policies are trying to overcome this natural tendency.

As internal demand shrinks, growth can be maintained only by adopting an export strategy. Of course, such a strategy was Japan's way of promoting rapid development in the 1960s, 1970s and 1980s. And it is China's strategy today. But, the steady appreciation of the yen eroded Japan's trade competiveness. In fact, over the last several months Japan has experienced a trade deficit. This occurred, in part, because of the appreciation in the yen but has been exacerbated in recent months by the need to import expensive energy supplies after nuclear facilities were shutdown. Overall Japan's balance of payments is still positive because net capital flows exceed the trade deficit. Japan's new policies will lead to a dramatic and favorable surge in Japan's trade balance.

Excerpts from *December 2013 Longbrake Letter*

Japan has embarked upon a bold experiment to defeat embedded deflation, lift the real rate of economic growth, and maintain Japan's economic and political power in the face of the growing challenge that China's rise poses.

1. Three Arrows Policy

To accomplish these goals, Prime Minister Shinzo Abe established his three arrows policy. The first arrow involves massive monetary policy easing, the second arrow entails infrastructure investment spending, and the third, and most critical arrow, includes significant economic reforms intended to increase labor force participation and boost productivity and competitiveness. Collectively, the policy was intended not only to change economic dynamics it was also intended to change expectations about demand and inflation so that Japanese consumers and companies would act in anticipation of greater demand and higher inflation and in so doing help to achieve the desired outcomes.

2. Abenomics' Three Arrows

Shinzo Abe determined that letting Japan grow old and accepting low to negligible growth rates and a constantly appreciating yen was not acceptable. Also, based on the limited and relatively ineffective reflation policies over the last 20 years, he realized that any attempt to boost aggregate demand and end deflation would require massive policy intervention. That is what the three arrows policy is all about.

First Arrow — Monetary Policy. The Bank of Japan (BOJ) adopted two monetary policy targets. The first involved abandoning targeting the overnight rate of interest and engaging in massive expansion of the monetary base by purchasing large quantities of securities equal to approximately 16 percent of GDP. By comparison, the FOMC's quantitative easing, large as it is, is less than half the size.

Second, the BOJ committed to achieve a 2 percent inflation rate within two years. Asset purchases will continue until this objective is achieved.

Almost immediately the value of the yen plunged 20 percent. This had an immediate short-run benefit of boosting the profits of many Japanese companies substantially. Higher profits should make it easier to implement one of the policy initiatives of the third arrow involving raising worker wages. Higher company profits also led to a surge in stock prices which directly resulted in greater optimism as well as creating spendable increases in wealth.

So far so good . . . Another objective of the first arrow was to raise the inflation rate. Measured inflation rose to an annual rate of 0.9 percent in October. This would appear to be progress in the right direction excect that the inflation rate was 0.3 percent without the impact of higher energy prices, which are almost entirely the result of the shutdown in nuclear reactors and the huge increase in expensive imported oil. Knowledgeable observers agree that inflation will not rise appreciably until wages do, which is one of the elements of the third arrow.

Second Arrow — Fiscal Policy Infrastructure Investment. Government investment expenditures are not expected to have a large impact, but are believed essential to offset the contractionary impact of the increase in the consumption tax scheduled for April 2014. The tax will raise 8 trillion yen and the stimulus will recycle 5 trillion yen back into the economy. In addition, corporate taxes will be reduced by 1 trillion yen. In the longer run, however, the intent of the tax increase is to reduce the budget deficit. The intent of increasing nominal growth and inflation is to reduce the ratio of public-debt-to-GDP over time. That ratio is one of the highest in the world and is a ticking time bomb. The time bomb has not been triggered because almost all of Japanese debt is held by domestic investors. This strategy is a race against time and depends upon interest rates on the debt remaining very low even as inflation rises. This is a big bet and it is unclear from an economic theory standpoint that the objective is achievable.

Third Arrow — Economic Reforms. There are three elements to the third arrow. The first involves raising worker wages. The object is to boost spending and inflation. The government has established tax breaks for companies that raise wages by 5 percent. Bountiful profits should enable companies to boost wages, but few have done so. Between January and October, base salaries declined -0.6 percent. This result has had a lot to do with hiring more part-time workers at lower wage rates. But, wage rates for full-time workers have been flat. Anecdotal commentary from Japan indicates that many large Japanese companies will pay bonuses but very few are willing to increase base pay rates. This reticence must change or the 2 percent inflation target will never be achieved. Abe's strategy of moral suasion appears to falling on deaf ears.

The second and third elements of the third arrow involve boosting productivity to at least 2.0 percent annually from the recent level of 0.8 percent and stabilizing employment by increasing participation enough to offset the -0.6 percent annual demographic decline. If third arrow policies are successful, nominal GDP would grow 4 percent annually and real GDP would grow 2.0 percent annually.

Productivity could be increased by increasing investment in capital, although Japan's past track record in utilizing capital efficiently is disappointingly poor. Productivity could also be raised by implementing various labor market and production reforms to increase competitive incentives and boost worker productivity. Japan's culture of employment for life is an inhibitor.

Labor force participation could be increased through immigration, which is antithetical to Japanese culture, or encouraging greater involvement of women. The government is attempting to create policy incentives that accomplish the latter.

What Japan needs to do for the third arrow to be effective is to follow Gerhard Schroeder's 2003-2005 supply side economic reform "Agenda" 2010 plan that transformed Germany's competitiveness so effectively that its current success threatens the survival of the Eurozone. After all, the two nations are very similarly situated. Both suffer from a declining labor force. Both have a long tradition and competency in manufacturing to export. Germany's labor markets lacked flexibility then as Japan's do today. The Schroeder plan involved large cuts in corporate tax rates, pensions, medical insurance, unemployment insurance and extensive labor market reforms with the objective of boosting competitiveness and maintaining low unemployment rather than raising wage rates.

3. Prospects

Abenomics has placed a big bet on turning the Japanese economy around. Elements of the policy make sense. For this reason and based on events of the last few months most are very optimistic that Abenomics will be successful.

However, the odds of success are very low. Depopulation is accelerating and labor force shrinkage will reach an annual rate of decline of -0.8 percent by 2021. The eligible labor force will decline by 40 percent by 2050. By 2050 the proportion of the population over 65 will be 38 percent compared to 24 percent currently. Think about the cost burden of supporting such a large elderly population on a shrinking employment base.

Japan's third arrow policy lacks coherency. As demonstrated by Germany's experience, cohesive and far-reaching supply side reforms can be effective if there is agreement by all constituencies to commit to implementing the reforms and enduring the pain during the time it takes for the reforms to have effect. In addition to there being no coherent overarching plan for supply side reforms in Japan, there is no apparent consensus to support the policies that have been proposed.

If, or when, faith succumbs to reality, the yen will appreciate in value, stock prices will decline and an ugly mood of despair will descend upon Japan. Interest rates could well rise more than offsetting the intended combined benefits of higher inflation, which may be realized, and higher real growth, which likely will not be realized. The extraordinarily large public-debt-to-GDP ratio coupled with an aging population would become very toxic and probably would be unsustainable.

The moment of truth probably is many months in the future. However, perhaps an early warning signal of developing uncertainty is the 9 percentage point decline in Abe's approval rating in December. The fall session of the Japanese legislature ended on December 6, 2013 without enacting any significant third arrow programs. Consumer confidence is also down a bit. This may be transitory or it may be the start of loss of confidence in Abenomics.

VIII. APPENDIX: Outlook — 2014 and Beyond — Forecast Summary for the U.S. and the Rest of the World, Highlights of Key Issues, and Identification of Risks

Observations about the 2014 U.S. and global economic outlook and risks to the outlook were contained in the ***December Longbrake Letter; 2013 Forecast Assessment and 2014 Outlook*** and are included below without any changes. As events unfold during 2014, this will enable the reader to track my analytical prowess. Current assessments follow each item with the following identifiers: "+" tracking forecast; "-" not tracking forecast; "?" too soon to know.

1. **U.S.**

- ***2014 real GDP Q4/Q4*** growth projections range from 2.9% to 3.4%; the FOMC's projection range is 2.9% to 3.1%. ***2014 real GDP Y/Y*** growth projections range from 2.5% to 3.1%. (Q4/Q4 projections are highly dependent upon potential anomalies in Q4 data; therefore, Y/Y estimates, which average all four quarters, are more stable estimates.) Growth should improve gradually over the course of the year. I expect real GDP growth to track the lower end of the Y/Y range in 2014.

  ✓ *+ Y/Y forecast range has been reduced to 2.1% to 2.3%; the FOMC lowered its projection range to 2.0% to 2.2% at the September meeting*

- ***Real GDP output gap*** will remain very high, but will close a little faster during 2014.

  ✓ *- CBO updated its output gap analysis in August 2014; 2013 Q4 gap was 3.72%; CBO's projected 2014 Q4 gap is 3.52%; I expect the year-end output gap to be between 3.37% and 3.52%; the gap is closing, but not as rapidly as expected*

- ***Potential structural rate of real GDP growth*** has declined significantly in recent years. I expect potential growth to be about 1.5% in 2014, which means the output gap could close by approximately 1.0%. Potential GDP growth is likely to rise slowly in coming years to between 2.1% and 2.4%.

  ✓ *- CBO expects 2014 potential growth to be 1.6%; my estimate has risen to 1.8%*

  ✓ *+ My future potential growth range remains between 2.0% and 2.3% and most other forecasts now fall within this range*

- ***Productivity*** should rise as growth improves and investment increases, but should still fall well short of the historical 2.1% average.

  ✓ *+ Nonfarm productivity is up 1.1% over the last 12 months*

- ***Employment*** should grow about 190,000 per month in 2014, about the same as in 2013.

  ✓ *- payroll employment averaged 227,000 monthly over the first nine months of 2014, which is stronger than expected; household employment averaged 224,000 over the first nine months of 2014*

- ***Employment participation*** will not rebound in 2014, which will contribute to a more rapid decline in the unemployment rate; the secular demographic decline will be offset by a small reduction in discouraged workers.

  ✓ *+ the participation rate in September was 62.73%, slightly lower than 62.79% in December 2013*

- ***Unemployment rate*** should edge down to about 6.5%. A lower rate is not very likely unless discouraged workers do not re-enter the labor force or more exit the labor force.

✓ *- the unemployment rate was 5.94% in September and will probably be about 5.9% by the end of the year*

- ***Nominal consumer disposable income,*** measured on a Y/Y basis will rise about 2.0% with employment growth and a small increase in the nominal wage rate. Because of the depressing effect of increased taxes in 2013 on disposable income growth, the Q4/Q4 growth rate should be a much higher 2.9%.

  ✓ *- the 12-month moving average was 2.55% in August and I project it to be 3.8% by the end of the year (note that income and consumption data were revised substantially in July)*

- ***Nominal consumer spending growth*** on the Y/Y basis will grow at a faster rate of approximately 3.3% (Q4/Q4 growth rate would also be about 3.3%, as spending was not affected materially by increased tax rates in 2013).

  ✓ *+ the 12-month moving average was 3.7% in August and I project it to be 3.7% by the end of the year*

- ***Household personal saving rate*** will decline slightly as growth in spending exceeds growth in disposable income.

  ✓ *- the average saving rate was 5.22% through the first eight months of 2014 compared to 4.86% for all of 2013*

- ***Stock prices***, as measured by the S&P 500 average, should rise about 5%.

  ✓ *+ through October 17, S&P 500 average is up 2.1% year to date*

- ***Manufacturing*** growth will continue to be relatively strong and the PMI index will exceed 50.

  ✓ *+ August ISM index fell to 56.6 in September from 59.0 in August, but has been above 50 the entire year*

- ***Business investment*** spending growth should improve to about 5 to 6% as employment and consumer spending growth gathers momentum.

  ✓ *+ business investment spending is on track to grow 6.3% to 6.5% in 2014*

- ***Residential housing investment*** should rise about 10% and contribute 30 to 40 basis points to real 2014 GDP growth; residential housing starts should rise 20 to 25%.

  ✓ *- residential investment spending decreased 5.3% in the first quarter and increased 8.8% in the second quarter and is now projected to increase 4% or less in 2014*

  ✓ *- total housing starts are up 5.2% over the first nine months of 2014 from the 2013 average; residential housing starts are up 0.5%*

- ***Residential housing prices*** should rise about 5% in 2014, more slowly than 2013's 10% increase.

  ✓ *+ Housing prices were up at an annual rate of 4.2% in the first half of 2014 according to data compiled by the Federal Housing Finance Agency (5.6% per S&P/Case-Shiller index); S&P/Case-Shiller index forecast to fall below 4% year over year by the end of 2014*

- ***Trade deficit*** should rise slightly as economic growth improves because imports should grow more quickly than exports. The ***dollar's value*** should decline modestly on a trade-weighted basis.

  ✓ *+ trade deficit was 2.79% in August compared to the 2013 trade deficit of 2.79%, but should rise slightly later in 2014 as consumer spending strengthens*

  ✓ *- the value of the dollar has risen 4.4% so far in 2014*

- ***Monetary policy*** — the Federal Reserve will end quantitative easing by mid-year and will clarify forward guidance.

- ✓ *- the FOMC is on a course to end quantitative easing in October*
- ✓ *+ the FOMC eliminated the 6.5% unemployment threshold and clarified forward guidance to embrace a broader set of labor market indicators and to emphasize that rate increases will be data dependent and will occur slowly after the initial increase takes place*

- ***Inflation*** will rise slightly in 2014 but will remain well below the FOMC's 2% objective at least through 2016.
  - ✓ *+ core PCE inflation was 1.47% in August compared to 1.34% in December;*
  - ✓ *+ total PCE inflation was 1.46% in August compared to 1.24% in December*
- ***Federal funds rate*** is not likely to increase before mid-2015 and might not increase until late 2016 or early 2017. The 10-year Treasury rate is likely to fluctuate in a range between 2.5% and 3.5% in 2014.
  - ✓ *+ federal funds rate is likely to increase in mid-2015, but the balance of risks suggests a later start date is possible*
  - ✓ *- the 10-year Treasury rate was 2.22% on October 17, which is below the lower end of the expected range*
- ***Fiscal policy*** will be significantly less contractionary in 2014, decreasing real GDP growth by about -0.4%; the ***federal budget deficit*** will decline to 3.0% by the end of 2014.
  - ✓ *+ federal budget deficit was 2.76% in fiscal year 2014*

2. **Rest of the World**

- ***Global growth*** is likely to improve to 3.5% in 2014 from 2.9% in 2013.
  - ✓ *- growth is on track to reach 3.1% in 2014; risks are tilted to the downside (China and Europe are falling short of expectations; Russia and Brazil are in recession)*
- ***European growth*** will be positive but will fall short of the ECB's forecast of 1.1%.
  - ✓ *- euro area growth is on track to reach only 0.7% in 2014, much slower than originally expected; growth in the euro area was 0.9% in the first quarter and 0.1% the second quarter, with negative second quarter growth in both France and Germany; risks are tilted to the downside over the remainder of 2014*
  - ✓ *- euro area inflation was 0.3% year over year in September and is expected to fall to 0.2% in October; core inflation was 0.8%; inflation expectations have fallen to 0.4%*
- ***European financial markets*** are likely to remain relatively calm thanks to the activist role of the European Central Bank; the May European parliamentary elections could lead to a new round of turmoil.
  - ✓ *- until the last few weeks all was quiet; however, volatility is rising and stocks are down sharply*
- ***European banking union*** will do little to solve deep-seated European and Eurozone structural problems; ECB stress tests will contribute to slow credit expansion.
  - ✓ *+ institutional structures to implement the banking union have been put in place; however, critics say the plan is fraught with uncertainties and weaknesses*
  - ✓ *+ results of stress tests will be released in late October and are not expected to be favorable*
  - ✓ *+ private bank loans have contracted 2.2% over the last year*
- ***European political dysfunction, populism and nationalism*** will continue to worsen gradually.
  - ✓ *+ Italy recently replaced its prime minister without triggering new elections; established parties seem intent on postponing new elections for as long as possible*

- ✓ *+ Eurosceptic parties are gaining momentum*

- ***U.K. growth*** will continue to be robust as the housing and debt bubble continue to build.
  - ✓ *+ GDP growth is on track to reach 3.0% in 2014*

- ***China's GDP growth*** will slow below 7% as economic reforms are implemented.
  - ✓ *? forecasters expect full year growth to come in at 7.2%; however, economic data was very disappointing in August*

- ***China's leadership*** will focus on implementing ***economic reforms*** and will overcome resistance and maintain stability.
  - ✓ *? it's really too early to make a call; however, investor anxiety is increasing in the wake of weaker than expected data reports*

- ***Japan's*** economic resurgence is likely to falter by the end of 2014, as Abenomics' third arrow of economic reforms fails to raise the level of potential growth sufficiently to overcome negative population growth.
  - ✓ *+ market skepticism has increased; third arrow market reforms have yet to have significant impact*
  - ✓ *+ 2014 GDP growth expectations have been downgraded to 1.2%*
  - ✓ *+ inflation is running at 2.7%, which is above the 2.0% target, but when the effect of higher taxes is stripped out, inflation is only about 1.0%*

- ***Emerging market countries*** on balance will experience greater growth, as long as the U.S. and European economies do better in 2014; countries heavily dependent upon commodities exports for growth will do less well as will also be the case for countries with large balance of payments deficits.
  - ✓ *- growth in emerging market countries has fallen short of expectations*
  - ✓ *+ falling commodity prices have exacerbated growth shortfalls in export-oriented emerging economies, such as Brazil and Russia*

3. **Risks** — stated in the negative, but each risk could go in a positive direction. "+" means risk not realized; "?" means risk may be developing; "-" means risk realized
   Note: ***Risks generally have remained subdued in the U.S., but have escalated considerably in the rest of the globe in recent weeks.***

   - ***U.S. potential real GDP growth*** falls short of expectations
     - ✓ *- full year growth estimates have been revised sharply lower, however, an improving trend in growth is likely*
   - ***U.S. employment growth*** is slower than expected; the ***participation rate*** continues to decline
     - ✓ *+ participation rate remains unchanged over the first nine months of 2014*
     - ✓ *+ employment growth is slightly higher than expected*
   - ***US. Unemployment rate*** falls less than expected
     - ✓ *+ unemployment rate has fallen more than expected*
   - ***U.S. productivity*** does not improve
     - ✓ *- productivity is rising at a 1.1% annual rate over the last 12 months, but has declined since the beginning of 2014*
   - ***Real U.S. consumer income and spending*** increase less than expected

- ✓ *+ consumer income and spending are increasing at a slightly faster rate than expected; however, retail slows growth has weakened over the last two months*

- ***U.S. financial asset prices*** rise more than expected posing increased bubble risks
  - ✓ *+ stock prices are up slightly and valuations appear reasonable*
- ***Growth in U.S. residential housing investment and housing starts*** is less than expected
  - ✓ *- housing formation hit a new low in last year's fourth quarter; starts have been disappointing and are only 5.2% above 2013's average; full year residential investment forecasts have been revised lower*
- ***U.S. residential housing price increases*** slow more than expected
  - ✓ *+ prices are rising at about a 4% annual rate*
- ***U.S. private business investment*** does not improve as much as expected
  - ✓ *+ business investment is on track to rise about 6.3% to 6.5% in 2014*
- ***U.S. manufacturing growth*** slows
  - ✓ *+ manufacturing activity has remained strong, but slowing global growth and the rising value of the dollar are threats*
- ***U.S. trade deficit*** widens and the ***value of the dollar*** falls
  - ✓ *+ the trade deficit has been stable*
  - ✓ *- the value of the dollar has increased 4%*
- ***U.S. monetary policy*** spawns financial market uncertainty and contributes to financial instability
  - ✓ *? financial conditions have been relatively easy for much of the year, but have tightened over the past few weeks*
- ***U.S. inflation*** *falls, rather than rising, and threatens deflation*
  - ✓ *+ Inflation has risen slightly but remains well below the 2.0% target*
- ***U.S. interest rates*** rise more than expected
  - ✓ *+ long-term rates have fallen approximately 75 basis points so far in 2014; (Note: if rates continue to fall from recent levels, this would be a negative, not a positive, development as it would foreshadow concerns about potential deflation)*
- ***U.S. fiscal policy*** is more restrictive than expected and the ***budget deficit*** falls more than expected
  - ✓ *- the budget deficit as 2.76% fiscal year 2014 — slightly lower than expected; although fiscal policy has been slightly more restrictive than expected, the lower deficit was driven by higher revenues, rather than lower spending, reflecting a somewhat stronger economy*
- ***U.S. state and local spending*** does not rise as fast as expected
  - ✓ *+ state and local spending is rising slowly*
- ***Global GDP growth*** does not rise as fast as expected
  - ✓ *- 2014 growth is now forecast to be 3.1% compared to the forecast of 3.5%; the balance of risks tilts toward even slower growth*
- ***Europe*** slips back into recession
  - ✓ *- second quarter GDP growth was near zero*
  - ✓ *- German growth is deteriorating*
- ***Europe*** — financial market turmoil reemerges

✓ *- financial conditions have deteriorated in recent weeks*

- ***Europe*** — political instability and social unrest rises more than expected threatening survival of the Eurozone and the European Union

  ✓ *- Euro-skeptic parties continue to gain strength*

- ***U.K. growth*** falters as housing bubble collapses

  ✓ *+ 2014 GDP growth is on track to reach 3.0%; Scotland voted against independence*

- ***Chinese*** leaders have difficulty implementing ***economic reforms***

  ✓ *? implementation is proceeding slowly*

- ***China's growth*** slows more than expected

  ✓ *- full year GDP growth is likely to slow to 7.2%; risks are tilted toward even slower growth*

  ✓ *- housing prices are declining, the housing market price correction has been more severe than expected*

- ***Japan*** — markets lose faith in Abenomics

  ✓ *- GDP growth has weakened to an expected 1.2% in 2014; the Japanese economy has not recovered as strongly as expected following last Spring's tax increase; implementation of supply-side reforms is lagging; stock prices are down 10% in recent weeks*

- Severe and, of course, unexpected ***natural disasters*** occur, which negatively impact global growth

  ✓ *+ nothing of consequence has happened*

- ***Middle East oil supply*** is disrupted and oil prices rise sharply

  ✓ *+ oil prices have declined nearly 20% over the last year; note that this is a favorable result for net consuming nations, but an unfavorable development for exporting nations, particularly Russia*

- **New — Russia's annexation of the Crimea and Civil Unrest in Ukraine**

  ✓ *- political tensions between Russia and member nations of NATO have risen; Russia's economy has slowed and probably is in recession; sanctions are contributing to recession risk in European economies*

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