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

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The Longbrake Letter*

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I. Dog Days of August — Marking Time

August is the holiday month in much of the developed world. With a few exceptions, such as in 2007 and 2011, markets tend to be as languid as August summer breezes. August 2012 appears to be following the traditional pattern.

In the U.S., Congress is in recess until after Labor Day, but before leaving it reached a bipartisan agreement to pass a continuing resolution to fund the government through March 31, 2013. This averts the possibility of a government shutdown during the presidential election campaign. The FOMC (Federal Open Market Committee) downgraded slightly its assessment of the U.S. economy and strengthened its easing policy bias, but took no specific actions.

In Europe the ECB found a way to provide cash indirectly to Greece sufficient to forestall default until September. ECB president, Mario Draghi, quieted market anxieties, particularly with respect to Spain, with bold words: "We will do whatever it takes to save the euro."

In China, the central bank announced it will prioritize stabilizing growth and Premier Wen Jiabao called for new efforts to improve the Chinese economy's growth and dynamism.

Soothing words and delaying actions can quell anxieties for a time, especially when there is incentive to believe and personal agendas are ascendant. But, history suggests that when August passes and people return from their

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holiday excursions, hard data, rather than soothing words, will drive markets once again. Historically, the months of September and October have often been difficult ones.

Downside risks to the U.S., European and global economies have not lessened. The U.S. economy continues to struggle to find traction and the looming fiscal cliff is amplifying unhealthy uncertainty. The European economy is in recession which is steadily worsening. China may achieve a soft landing but it no longer possesses the capability singlehandedly to reverse adverse trends in the rest of the world. Matters are going from bad to worse in India in the wake of power outages and a feeble monsoon, not to mention political paralysis.

These trends leave me with a very uneasy feeling about future prospects. Last month I discussed how policy intervention has had little apparent lasting positive effect. Thus, when the balance of risks is weighted to the down side, it is hard to be optimistic and easy to worry that Nouriel Roubini's forecast of the "Perfect Storm", which he expects will inundate the global economy in 2013, will prove prophetic. As a reminder, Dr. Roubini's forecast of the 2007-08 global financial and economic crash was not only solidly on the mark but also made years in advance.

In this month's letter, I begin by reviewing recent developments for U.S. and global GDP growth (Sections II and III). This is followed by a discussion of U.S. personal income, consumption and employment (Sections IV and V). Section VI explores how the U.S. economy can create more jobs. The final four sections provide updates on U.S. monetary policy and fiscal policy and developments in Europe, India and China.

II. U.S. GDP

Every July the Bureau of Economic Analysis (BEA) revises GDP data for at least the three prior years. At times these revisions can be substantial. This occurs because initial GDP data are based upon a mixture of actual data reports and estimates for parts of the economy where actual data reports are not readily available. As time passes initial estimates are replaced by hard data and GDP data become increasingly reliable. **Table 1** shows how substantial these changes can be.

Table 1
Progression of Real GDP Growth Estimates Over Time

Quarter	Advance Estimate	Final Estimate	First Revision	Second Revision	Third Revision	Fourth Revision	Fifth Revision
2008 Q1	0.88%	0.94%	0.80%	-0.73%	-0.73%	-1.77%	-1.78%
2008 Q2	3.42%	2.97%	1.46%	0.60%	1.32%	1.32%	
2008 Q3	-0.58%	-0.56%	-2.68%	-4.00%	-3.66%	-3.71%	
2008 Q4	-6.23%	-6.28%	-5.37%	-6.77%	-8.89%	-9.20%	
2009 Q1	-5.75%	-5.53%	-6.43%	-4.87%	-6.67%	-5.36%	
2009 Q2	-1.02%	-0.74%	-0.70%	-0.69%	-0.31%		
2009 Q3	2.78%	2.23%	1.60%	1.69%	1.44%		
2009 Q4	5.93%	5.56%	5.01%	3.80%	3.97%		
2010 Q1	3.04%	2.74%	3.73%	3.93%	2.31%		
2010 Q2	1.61%	1.72%	3.79%	2.22%			
2010 Q3	2.52%	2.56%	2.51%	2.58%			
2010 Q4	3.17%	3.11%	2.35%	2.37%			
2011 Q1	1.84%	1.91%	0.36%	0.08%			
2011 Q2	0.99%	1.33%	2.45%				
2011 Q3	2.00%	1.81%	1.27%				
2011 Q4	2.98%	2.95%	4.03%				
2012 Q1	1.86%	1.87%	1.95%				

The “Advance Estimate” is made in the month following the end of the quarter; the “Final Estimate” is made in the third month following the end of the quarter. The “Preliminary Estimate”, which is not shown, is made in the second month following the end of the quarter. Thereafter, quarterly GDP estimates are updated in July each year for at least the past three years and sometimes for an even longer period. **Table 1** shows revisions for up to five years following the initial “Final Estimate”.

Observe that initial GDP estimates in all four quarters of 2008 were revised downward substantially over time. GDP was revised downward by an average of 2.6% in each quarter of 2008. Thus, it has taken three years to find out how really ugly the “Great Recession” actually was.

Also observe that what initially appeared to be a strong recovery in the third and fourth quarters of 2009 and the first quarter of 2010 has turned out to be much weaker. GDP was revised down an average of 0.9% in each of these three quarters.

1. GDP Revisions

In the aggregate this year's revisions for 2008 through the first quarter of 2012 did not change the level of GDP; however, the Great Recession was somewhat less severe which was offset by a slower recovery in 2010. GDP growth for 2009 was revised upwards from -3.49% to -3.07%; 2010 was revised downwards from 3.02% to 2.40%. Original and revised GDP data for 2010 and 2011 are shown in **Table 2**.

Table 2
GDP Revisions for 2010 and 2011

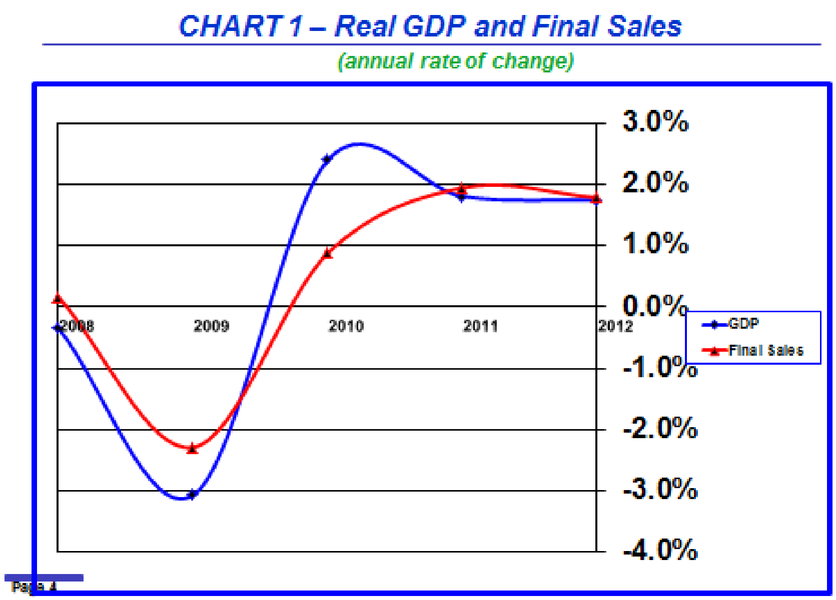
	Original 2010	Revised 2010	Original 2011	Revised 2011
Personal Consumption	1.44%	1.28%	1.53%	1.79%
Private Investment				
Nonresidential	.42%	.07%	.84%	.80%
Residential	-.11%	-.09%	-.03%	-.03%
Inventories	1.64%	1.52%	-.21%	-.14%
Net Exports	-.51%	-.52%	.05%	.07%
Government	.14%	.14%	-.44%	-.67%
Total	**3.02%**	**2.40%**	**1.74%**	**1.82%**
Final Sales	**1.38%**	**.88%**	**1.95%**	**1.96%**

Revisions in 2010 subtracted 0.62% from GDP and were concentrated in personal consumption (-0.16%), nonresidential investment (-0.35%) and inventories (-0.12%), all of which were revised downward. There was only a slight increase of 0.08% in 2011 GDP. However, an increase of 0.26% in personal consumption was offset by a -0.23% decrease in government spending. Government spending contributed to GDP growth in 2010 but decreased growth in 2011. State and local government spending declined sharply in both years with federal government spending adding 0.37% to growth in 2010 and subtracting -0.23% in 2011.

2. Final Sales Are Improving Slowly

Although the recovery has been very weak, the revised data indicate gradual improvement is taking place. Final sales, which deducts changes in inventory accumulation from GDP, is a better measure of underlying demand. Inventory accumulation tends to be procyclical, decreasing more rapidly than other components of GDP during a recession and rising more rapidly during recovery. Revised data in **Table 2** show that final sales grew just 0.88% in 2010 and accelerated to 1.96% in 2011. Final sales accelerated further to 2.35% in the first quarter of 2012 only to slip back to 1.22% in the second quarter of 2012 according to the "Advance Estimate". Many data revisions for 2012 GDP data are yet to come and final sales estimates could change substantially.

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



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

3. 2012 Q1 GDP Revised Estimate

The "Revised Estimate" of first quarter GDP growth was 1.96%, which was slightly higher than the "Final Estimate" of 1.88% reported in June. However, final sales, which nets out the impact of inventory accumulation, increased sharply from 1.78% to 2.35%. As mentioned above, real final sales growth is a better measure of how the economy is doing because inventory accumulation tends to be volatile from quarter to quarter.

Because the Congressional Budget Office (CBO) estimates that GDP growth potential currently is 1.7%, the GDP output gap declined only slightly from 5.39% in the fourth quarter of 2011 to 5.35% in the first quarter of 2012.

Positive adjustments occurred in nonresidential investment, which was much stronger, and government spending, which was less negative. These improvements in growth were largely offset by a substantial decline in inventory accumulation.

Table 3 provides details of the composition of GDP growth in the first quarter of 2012.

Table 3
2012 First Quarter GDP Growth

	Advance Estimate	Preliminary Estimate	Final Estimate	First Revision
Personal Consumption	2.04%	1.90%	1.74%	1.72%
Private Investment				
Nonresidential	-.22%	.20%	.32%	.74%
Residential	.40%	.41%	.42%	.43%
Inventories	.59%	.21%	.10%	-.39%
Net Exports	-.01%	-.08%	.10%	.06%
Government	-.60%	-.78%	-.80%	-.60%
Total	**2.20%**	**1.86%**	**1.88%**	**1.96%**
Final Sales	**1.61%**	**1.65%**	**1.78%**	**2.35%**

4. 2012 Q2 GDP Estimates

According to the "Advance Estimate", second quarter GDP growth of 1.5% was just a bit better than the 1.4% tracking estimate. Details of the "Advance Estimate" are shown in **Table 4**. The biggest disappointment was

Table 4
2012 Second Quarter GDP Growth

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

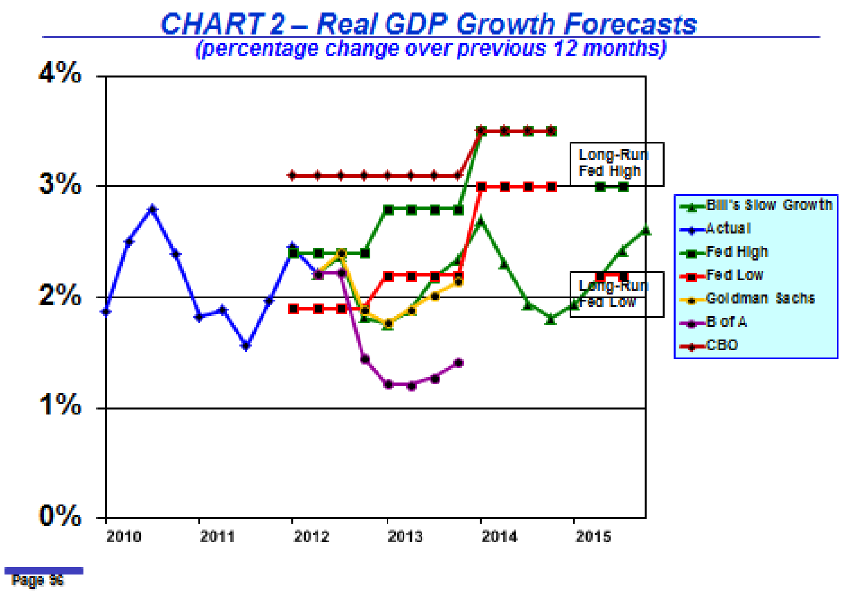
the sharp slowing in personal consumption growth. However, because consumption grew 3.97% during 2011 while disposable income grew only 2.88%, a pullback in consumer spending was inevitable.

Both nonresidential and residential investment slowed sharply as did net exports. Offsetting these negative impacts was a substantial reversal in inventory accumulation, which undoubtedly occurred in part because of slower personal consumption growth. As the decline in final sales growth from 2.35% in the first quarter to 1.22% in the second quarter implies, GDP growth weakened considerably in the second quarter. About the only bright spot in the second quarter "Advance Estimate" was government spending, although most all of the improvement came from less negative defense spending growth.

The "Preliminary Estimate" is likely to be higher than the "Advance Estimate". Updated construction data indicate that both nonresidential and residential investment should be revised upwards. Also, a better than expected June trade report will boost GDP growth. The current tracking estimate for second quarter GDP is 2.0%.

5. GDP Forecasts for 2012 and Beyond

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



Bank of America/Merrill Lynch (B of A); Goldman Sachs (GS); the Congressional Budget Office (CBO); and "Bill's Slow Growth" scenario.

FOMC projections for real GDP growth were revised sharply lower in June to a range of 1.9% to 2.4% in 2012. The FOMC also lowered the GDP growth ranges for 2013 and 2014, and still expects steady improvement. CBO's projection was made early in 2012 and has not been revised.

Both GS and B of A forecasts remain on the pessimistic end of the spectrum. GS's forecast is similar to the FOMC's revised low forecast for 2012, but B of A's is substantially worse. Both forecasts, particularly B of A's, are below the Fed's revised low projection for 2013.

GDP growth averages 2.0% for the next six quarters in GS's forecast and

1.5% in B of A's forecast compared to the FOMC's median of approximately 2.3% and CBO's 3.1%. The consensus of 54 members of the National Association of Business Economists is that GDP growth will average 2.6% over 2012 and 2013 (2.4% in 2012 and 2.8% in 2013). The recently updated Blue Chip consensus forecast now expects growth to be just 2.0% in 2012. The International Monetary Fund (IMF) recently lowered its U.S. GDP growth forecasts to 2.0% in 2012 and 2.25% in 2013.

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

GS expects GDP to expand at a 2% annual rate in both the third and fourth quarters, while B of A expects growth to decelerate to 1.3% in the third quarter and 1.0% in the fourth quarter, primarily as a consequence of slowing employment and business investment due to the impending fiscal cliff. GS expects a slight pickup in consumer spending, slow improvement in residential housing construction, expansion of industrial production with an increase in the ISM manufacturing index from 49.8 to 52.0, somewhat better employment growth and slowing core inflation. While all of these factors are positive, their impact is likely to be very modest. Thus, the GS forecast is not one of accelerating recovery but rather one of sluggish growth which is insufficient to make any real dent in the sizable output gap. Thus, unemployment falls only modestly from 8.3% to 8.1% by the end of the year. However, it should be noted that GS's current activity index (CAI), which approximates the real GDP growth rate, was just 1.1% in July. This implies there is downside risk to the GS forecast. GS also notes the recent improvement in real disposable income growth and an improvement in financial conditions as causes for a little more optimism.

B of A's rationale for sharply lower GDP growth in the third and fourth quarters is based upon continued weak growth in services and negative impacts on business investment, consumer durables and exports of manufactured goods. B of A believes that uncertainty about future fiscal policy will prompt business to delay investment in equipment and software and consumers to postpone purchases of autos and homes. In addition, Europe's recession and slower global growth will reduce demand for U.S. exports.

6. Recession Possibility

My base case outlook is for sluggish growth, not recession. However, risks are skewed to the downside. Deepening recession in Europe, uncertainty about U.S. fiscal policy, and the failure of China to reverse the recent trend of slowing growth could lead to recession in the U.S. However, there are a few who expect recession.

Indices of economic conditions confirm the likelihood that sluggish growth continues. For example, the Chicago Fed activity index has been slightly negative for four months. The three-month average of this index improved from -.38 in May to -.20 in June. This index is scaled to trend growth which means that a negative reading signals below trend growth. It would have to be much more negative, generally -.75 or lower, over a three-month period to signal negative growth (recession).

The Economic Cycle Research Institute's (ECRI) leading index has been falling. ECRI expects the U.S. economy to enter a new recession and is on record that "... sometime at the end of the year or early next year the data will be revised and we'll start to get some clarity about when the recession actually started."

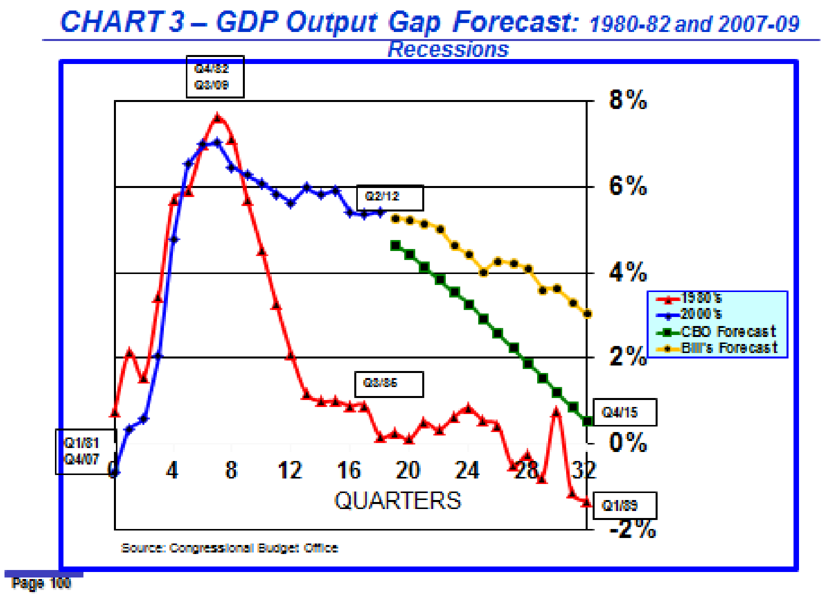
Capital IQ Markets Intelligence recently cut its GDP growth estimate for 2012 to 1.0% and raised its recession odds to 50%.

Nouriel Roubini expects GDP growth to slow to 1.5% by the end of 2012 and to average 1.0% in 2013. This is not a recession call, but it is one that would lead to higher unemployment and an increase in the output gap. It wouldn't take much of a negative shock to tip the economy into recession, given Dr. Roubini's baseline forecast.

7. GDP Output Gap and Potential GDP

Since the end of the Great Recession real GDP growth has averaged just 2.2% annually. The Federal Reserve believes the long-term potential real GDP growth rate lies between 2.25% and 3.0%; CBO estimates that the potential real GDP growth rate is currently about 1.7% and should rise gradually to 2.6% by 2017. Growth of GDP at 2.0% or less is insufficient to reduce unemployment; it fosters slow growth in consumer incomes and spending; it keeps downward pressure on inflation; and it slows the important process of debt deleveraging.

Chart 3 shows CBO's forecast for the GDP gap, which is simply the



difference between CBO's real GDP forecast and its estimate of potential GDP divided by potential GDP. The gap at the end of the second quarter was 5.41% and does not fully close until the end of 2015. CBO's estimate is consistent with the FOMC's monetary policy to maintain interest rates at exceptionally low levels until late 2014.

However, if the B of A, GS and Bill's GDP growth projections, which are lower than CBO's, turn out to be more accurate, the GDP gap will close more slowly, perhaps much more slowly, as shown in the "Bill's Forecast" in **Chart 3**. CBO's projections for potential and actual GDP were last updated in January 2012. Actual GDP growth over the first two quarters of 2012 has fallen short of CBO's projection, which explains the growing gap in the near term between Bill's and CBO's gap forecast.

Potential GDP growth depends on labor force growth and labor and capital productivity. If CBO's assumptions turn out to be optimistic, then its estimates of potential and actual GDP growth will be too high. My estimate of future productivity growth is about 1.5% compared to CBO's 2.1%. Over time this differential leads to much slower growth in potential and actual GDP. In addition, my forecast assumes slower employment growth, which is why the GDP output gap closes more slowly in my forecast than in CBO's forecast.

If my more pessimistic forecast for the closing of the GDP output gap turns out to be on the mark, there would be greater downward pressure on inflation for a longer period of time and the FOMC would maintain interest rates at an extremely low level well beyond the end of 2014.

III. Global GDP Growth

As we pass the mid-2012 point, after decelerating in the first half of 2012, B of A's measure of global economic conditions stabilized in July. Europe was weaker; the U.S. and U.K. were stable; Japan improved; and emerging economies also improved. B of A believes the low global growth point occurred in the second quarter and that global GDP growth will improve in coming months. B of A's current global GDP growth estimate is 3.4% for 2012 but the balance of risks points to lower rather than higher growth.

U.K. industrial production fell 2.5% in June and is now lower than the previous Great Recession low. Italy's industrial production decreased 1.4% in June and is nearing its Great Recession low. German factory orders were down 1.7% in June and have declined 7.8% over the last year. German retail sales fell in both May and June.

Steel production in China is on track to decline in 2012 for the first time in 31 years. Taiwanese exports are down 11.6% over the last year and imports are down 3.2%, which signals deteriorating domestic economic conditions. Manufacturing is contracting in Australia, Japan, Korea and Taiwan; just barely increasing in China; and increasing in India at a decelerating rate.

U.S. drought, which affects over half of the U.S., promises to reduce food production and drive prices much higher. A feeble monsoon in India is contributing to a global escalation in food prices. This food price shock is adding to downside risks to global growth. Upside risks to consumer prices are high in China (pork prices), Brazil, and India, where a poor monsoon season could raise inflation by 1.0% and decrease GDP growth by 0.4%.

Another telling signal of slowing global growth is the U.S. purchasing managers "new export orders" index. It has moved rapidly from expansion to contraction over the last four months — from 59.0 in April to 46.5 in July. Since this is a leading index it implies that there will be downward pressure on U.S. manufacturing in coming months.

IV. Consumers

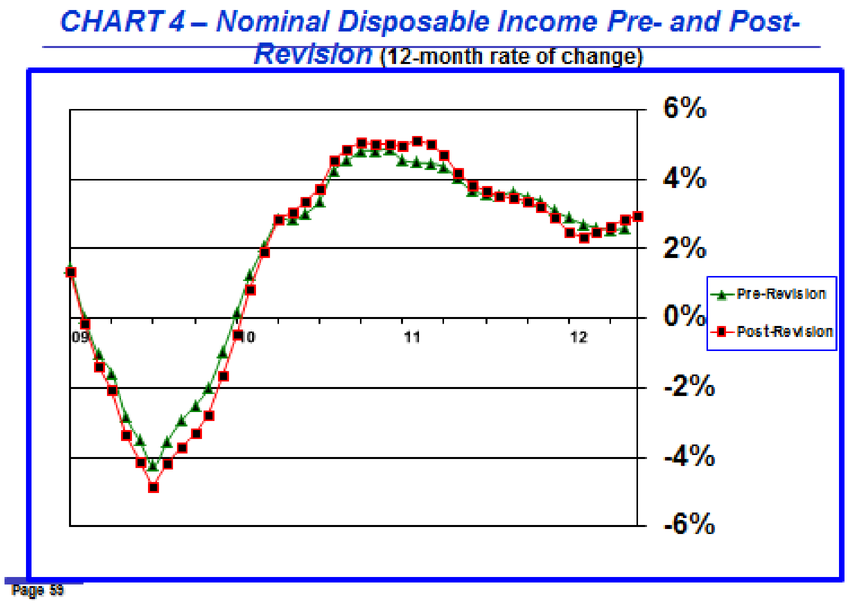
1. Personal Income, Disposable Income and Spending — Data Revisions

Consumer personal income and disposable income data are reported on a monthly basis but are revised several times over subsequent months. Thus, one can never be sure whether the story recently released data tells will be the same story several months hence. For example, in July the Bureau of Economic Analysis (BEA) revised personal income data from January 2009 through June 2012. The revisions were substantial and negative during and immediately following the Great Recession; somewhat better from mid-2010 to mid-2011; worse thereafter until the most recent four months. **Chart 4** shows a comparison of the pre- and post-revision nominal rates of growth in disposable income. **Table 5** shows the pre- and post-revision changes in the dollar amount and percentage change for 2009, 2010 and 2011.

It is evident in **Table 5** that the American consumer is worse off than

Table 5
Change in Nominal Disposable Income Pre- and Post-Revision

Year	Original $ Increase (billions)	Original % Increase	Revised $ Increase (billions)	Revised % Increase
2009	$60.5	0.56%	-$12.5	-0.12%
2010	$501.4	4.61%	$527.7	4.88%
2011	$327.4	2.88%	$278.5	2.46%
Total	$889.3	8.22%	$793.7	7.34%

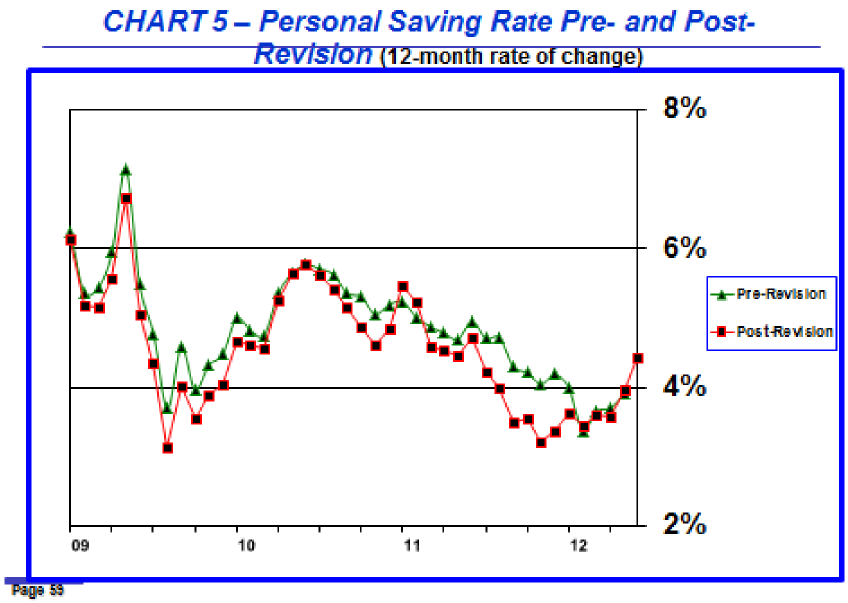


previously reported over the entire three-year period. Importantly, disposable income growth slowed more rapidly in 2011 than originally reported. What provides some hope going forward is the acceleration in disposable income growth in 2012 to an annual rate of increase of 5.52% (see **Table 7** below). But, as a word of caution, many revisions will be made to 2012 data in the future and after those revisions the story could be quite different.

Very minor revisions were made in personal consumption expenditures. As a consequence, as can be seen in **Chart 5**, virtually the entire decline in disposable income translated into reduced saving.

2. 2011 Personal Income, Disposable Income and Spending

Table 6 shows how the revision affected components of personal income during 2011. Wage and salary compensation, proprietors' income, and rental income decreased by a combined $76.4 billion. This decline was a staggering 17.5% of the pre-revision total. Asset income and government transfers increased and personal taxes decreased by a combined $27.5 billion. The



net decline in disposable income was $48.9 billion.

Consumption rose $8.0 billion, which means that revised saving was $56.9 billion less than originally reported. Thus the revised personal saving rate declined from 4.64% to 4.24%.

Revised disposable income grew 2.46% in 2011 and revised consumption grew 4.04%, a gap of 1.58%. This means that consumers dipped into savings and increased borrowing to support consumption. This is not sustainable. Either disposable income must rise or consumption must fall. Given the current fragile state of the economic recovery, a slowdown in consumer spending would be very damaging.

3. 2012 Personal Income, Disposable Income and Spending

On a brighter note, revised data for 2012, shown in **Table 7**, indicate that disposable income growth has accelerated significantly from 2.46% in 2011 to an annual rate of 5.52% over the first six months of 2010. This improve-

Table 6
Change in 2011 Personal Income and Its Disposition (Original and Revised)
(in billions of dollars)

	Orig. Nominal 2011*	Pct. Change	Rev. Nominal 2011*	Annual Change
Personal Income	**$503.9**	3.99%	**$458.1**	3.64%
Compensation	321.1	3.99%	269.2	3.34%
Proprietors' Income	36.0	3.32%	21.0	1.83%
Rental Income	80.2	22.61%	70.7	19.50%
Asset Income	22.0	1.25%	25.9	1.56%
Government Transfers	- 13.6	-0.58%	4.3	0.19%
Less: ***Personal Taxes***	-118.4	5.28%	-112.7	5.05%
Disposable Income	**327.4**	2.88%	**278.5**	2.46%
Less: *Consumption*	**427.8**	3.97%	**435.8**	4.04%
Personal Saving	**-100.5**	-17.01%	**-157.4**	-28.63%
Personal Saving Rate	**4.64%**		**4.24%**	

*Measured from December 2010 to December 2011

ment is almost too great to be credible as it does not reconcile with slow employment growth and stable to declining growth in hourly and weekly wages. This good news could well disappear in time as data are revised.

It seems likely that disposable income growth will slow during the remainder of 2012. The surge in income growth is limited to the first quarter of 2012. Disposable income grew at an annual rate of 7.53% in the first quarter compared to 3.44% in the second quarter, for a blended first half growth rate of 5.52%. There is reason to believe that the BEA revised first quarter salary data to include higher bonus and deferred income. Assuming that this revision was not seasonally adjusted, it could account for what appears to be a temporary one-quarter boost in disposable income growth.

Also perplexing is the improvement in government transfer payments. No new tax legislation has taken effect in 2012. Some of the increase was in social security payments but most was in Medicaid, which flipped from a decline of $24.4 billion in 2011 to an increase of $14.3 billion over the first six months of 2012.

Table 7
Change in 2011 and 2012 Personal Income and Its Disposition
(in billions of dollars)

	Rev. Nominal 2011*	Pct. Change	Nominal 2012 Jan.-Jun.**	Annual Pct. Change
Personal Income	**$458.1**	3.64%	**$379.8**	5.83%
Compensation	269.2	3.34%	244.7	5.87%
Proprietors' Income	21.0	1.83%	33.4	5.71%
Rental Income	70.7	19.50%	24.6	11.35%
Asset Income	25.9	1.56%	73.3	8.69%
Government Transfers	4.3	0.19%	32.1	2.76%
Less: ***Personal Taxes***	-112.7	5.05%	-87.8	7.49%
Disposable Income	**278.5**	2.46%	**320.2**	5.52%
Less: *Consumption*	**435.8**	4.04%	**183.1**	3.26%
Personal Saving	**-157.4**	-28.63%	**137.2**	69.95%
Personal Saving Rate	**4.24%**		**3.78%**	

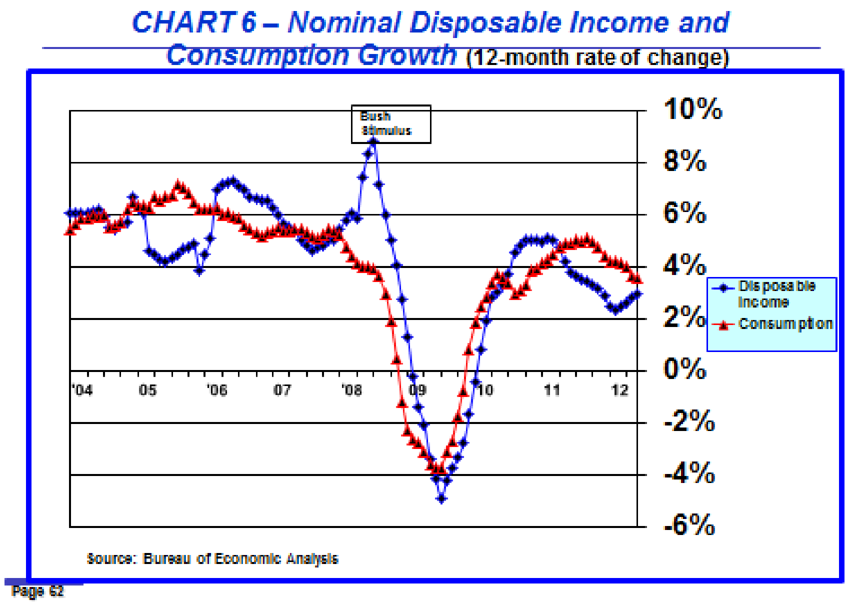
*Measured from December 2010 to December 2011
**Measured from December 2011 to June 2012

Personal taxes are up sharply in 2012, but much of this increase is linked to higher growth in the components of personal income. However, the 7.49% annual rate of increase is considerably higher than the 5.83% rate of increase in personal income.

Taken at face value the acceleration in disposable income growth so far in 2012 supports GS's optimistic outlook for increased consumer spending growth in the second half of 2012. But notice in **Table 7** that the personal saving rate over the first six months of 2012 is 3.78%, which means that consumer spending growth needs to remain slower than disposable income growth, if the 2012 saving rate is to equal 2011's saving rate of 4.24% by the end of 2012. Possible downward revisions in disposable income growth and the low saving rate do not bode well for stronger consumer spending growth over the remainder of 2012.

4. Disposable Income and Spending — Long-Term Relationship

Chart 6 shows the nominal rate of growth in disposable income and consumer spending from 2006 to the present. The annual rate of growth in disposable income began slowing in late 2010 and has declined from its recent high of 5.1% in February 2011 to 2.4% in February 2012, but rose to 3.0% in June 2012. Growth in consumer spending peaked later at 5.1% in September 2011, but now is declining and reached 3.6% in June 2012. Even with the recent improvement in income growth, the growth rate in consumption still exceeds the growth rate in disposable income.



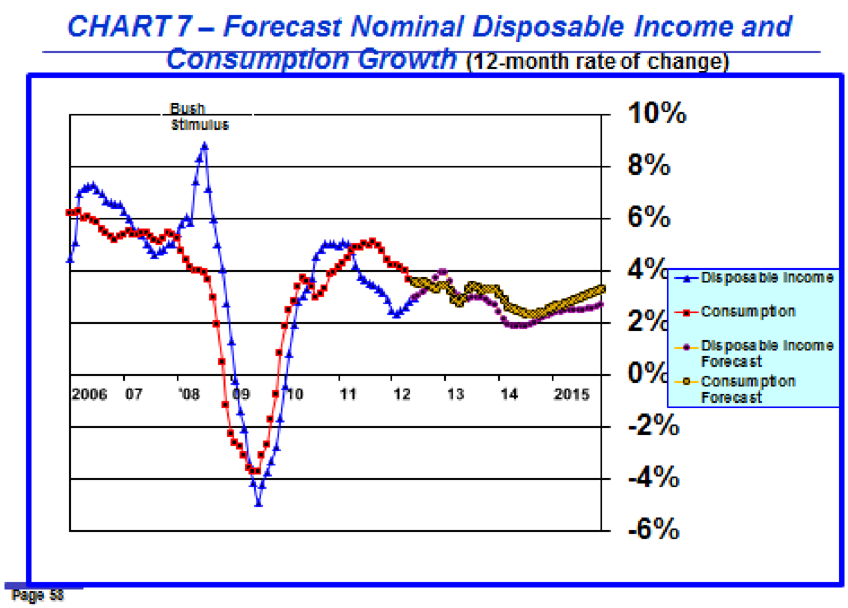
Notice in **Chart 6** that spending growth tends to lead income growth. This relationship is consistent with changes in consumer confidence. When confidence declines consumers reduce spending in anticipation of harder times ahead. To a certain extent such anticipation can be self-fulfilling.

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

In summary, the preponderance of the data suggest that consumer spending growth will probably continue to edge lower in coming months.

5. Disposable Income and Spending — Forecast

Chart 7 shows the forecast growth rate for nominal disposable income and



consumption through 2015 based on "Bill's Slow Growth" forecast. The forecast projects a decline in nominal spending growth and an increase in nominal disposable income with convergence occurring by late 2012. Thereafter, both growth rates remain mired at low nominal levels ranging between 1.9% and 3.6%. This is considerably below the average growth rate of approximately 6% between 1985 and 2007. This significant decrease is due in part to a fall in the inflation rate, in part to slower population growth, and in part to lower productivity growth. Of these three factors lower productivity growth is the most important because it signals slower improvement in the standard of living.

V. Employment

Without a doubt the stock market liked the July employment report. Stock prices rose 1.9% on the day of announcement and added another 0.85% gain in the next four trading days. Apparently what was important to market participants was the 163,000 payroll increase compared to an expected 100,000 and following three months averaging just 73,000 each month. No apparent attention was paid to other aspects of the report which were less than stellar. Overall, the report was consistent with sluggish growth and a fragile labor market.

1. Payroll and Household Reports

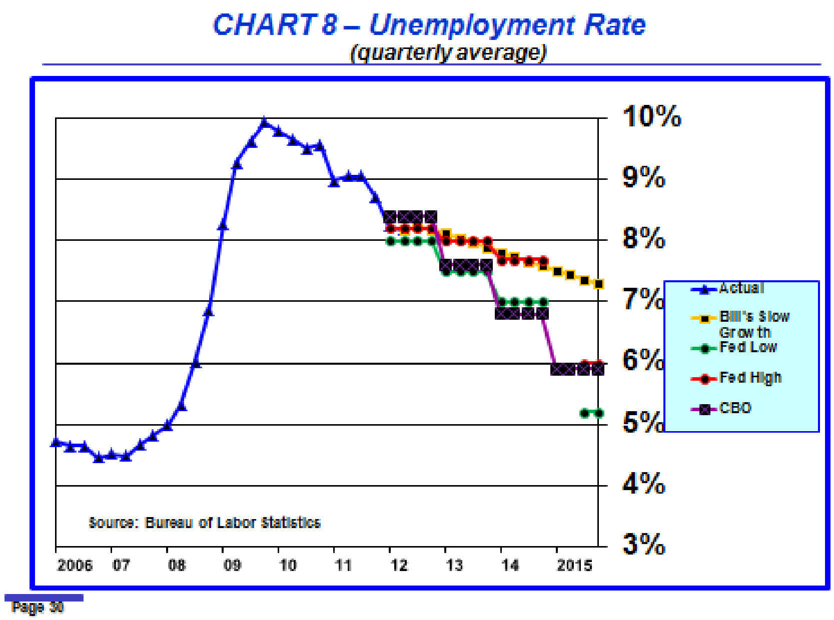
While payrolls grew 163,000 in July, the prior two months were revised down by a combined 6,000. The household employment survey revealed that 195,000 jobs were lost in July. Since February household employment has increased an average of 31,000 monthly while payroll employment has increased an average of 107,000 monthly. These data don't reflect a robust labor market.

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

2. Unemployment Rate

Unemployment rose 45,000 in July while the labor force shrank by 150,000. The unemployment rate is calculated from the household employment survey and is computed as the total unemployed divided by the labor force. The unemployment rate rose to 8.3% in July and is the same as it was in January and February.

There is little optimism among forecasters about the potential for significant reductions in the unemployment rate over the next two years. **Chart 8** shows projections for the unemployment rate for "Bill's Slow Growth"



scenario, the FOMC's high and low projections and CBO. The high and low FOMC unemployment numbers for 2015 are not forecasts; rather they are the FOMC's upper (6.0%) and lower (5.2%) bounds for the long-run non-accelerating inflation rate of unemployment (NAIRU), often referred to as the natural rate of unemployment.

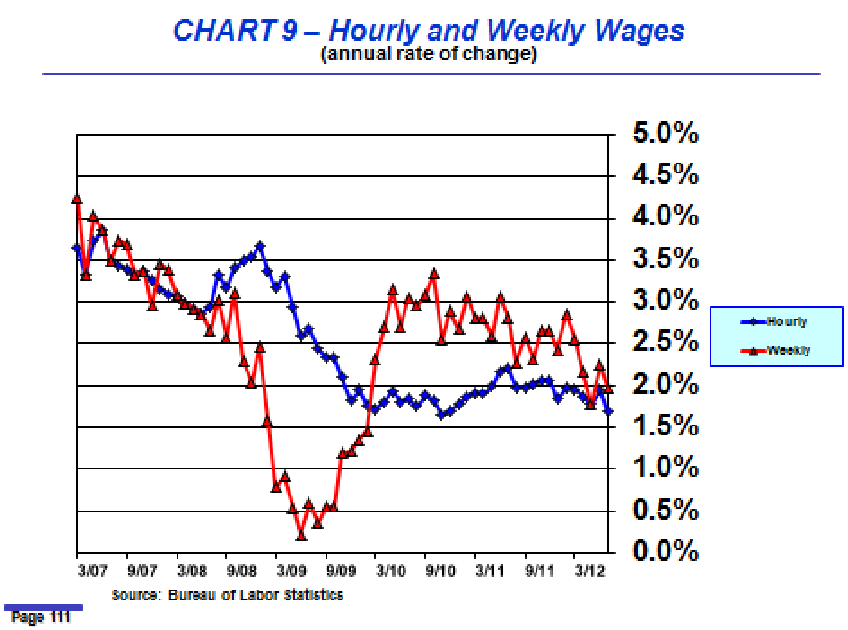
At its June meeting the FOMC raised its 2012 unemployment rate forecast range from 7.8% to 8.0% to 8.0% to 8.2% and also raised its projected unemployment rates for 2013 and 2014. While not shown, GS forecasts that unemployment will fall only to 8.0% by the end of 2013 and B of A forecasts that unemployment will remain relatively stable and will be 8.2% at the end of 2013.

"Bill's Slow Growth" scenario projects a decline in unemployment to 7.9% by the end of 2013.

3. Growth in Wages

If the labor market really is tightening wage rates would begin to rise and that development would threaten subsequent increases in inflation. However, wage rate increases are at a very low level. Indeed, preliminary data for July suggest hourly and weekly wage rates are heading lower. This incipient trend may be revised away in future reports, but it is indicative of the absence of any bargaining power on the part of labor.

Chart 9 shows that from 2007 to the end of 2009 the annual rate of



growth in hourly wages decelerated from about 3.5% to less than 2.0% and has been relatively stable since then, although the latest data point shows only 1.7% growth over the last 12 months. As long as the unemployment rate remains unusually high, labor will have very little bargaining power and this is likely to limit increases in hourly wages for the foreseeable future.

Weekly wage growth is more volatile than hourly wage growth because it incorporates the length of the workweek. When the length of the workweek is stable, the two measures will track each other closely, which is currently the case. Divergences occur during and following recessions. During recessions employers tend to cut the length of the workweek before shedding workers. The opposite happens in recoveries — employers increase hours before adding workers. The recent convergence of the two measures means that the length of the workweek has stabilized. Indeed, the length of the workweek peaked at 34.6 hours in February and has since declined to 34.5 hours in July. This is not a good news story because it means that the rate of growth in take home pay has fallen from approximately 2.8% a year ago to 2.0% currently. This weakening trend in weekly wage increases is an important reason why the recent acceleration in aggregate personal and disposable income growth is suspect. Weekly wages have increased at an annual rate of 2.0% so far in 2012, but wage and salary disbursements, according to the national income accounts data, have increased at an annual rate of 6.3%. This is not a credible difference. My sense is that the BLS's weekly wage data are more reliable than the BEA's national income account data.

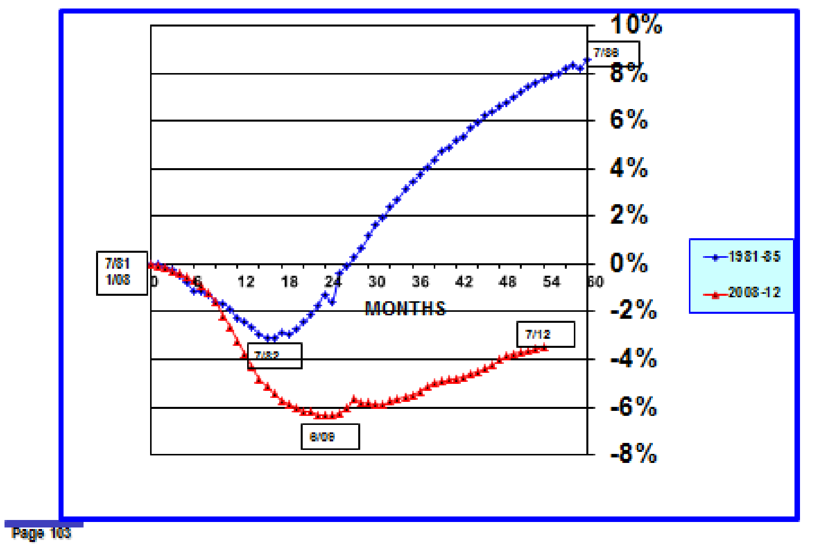
VI. How the Economy Can Create More Jobs

As is evident in **Chart 10**, it is painfully clear that unlike past recoveries, job creation has been abysmally low. Fully 54 months after the start of the Great Recession there are 3.5% fewer jobs. 54 months following the onset in July 1981 of the worst recession preceding the Great Recession jobs were 7.8% greater. This is an enormous divergence — more than 15 million jobs based on today's employment level.

1. Consumer Debt Deleveraging and Deeply Impaired Economic Sectors That Typically Lead Recovery

While there are several theories, the fundamental cause is consumer debt deleveraging. Typically, consumer durable purchases of autos and homes along with business investment have lead recovery. These sectors of the economy create jobs in the early stages of recovery and initiate a virtuous

CHART 10 – *Monthly Employment Growth Following 1981-82 and 2008-09 Recessions* *(Measured from: January 2008 and July 1981)*



circle that leads to job creation in other sectors. As that occurs the recovery gathers momentum and the unemployment rate falls.

Housing. Housing is only now beginning a slow, painful recovery. And, even though housing starts have risen 36% since bottoming in the fourth quarter of 2010, the level of housing starts in the most recent quarter has only recovered to the level of the first quarter of 1975, which was worst quarter prior to the onset of the Great Recession. But the number of households today is 70% greater than in the first quarter of 1975. Or, looked at in another way, housing starts are currently only about half the expected average rate of 1.5 new units annually given replacement needs and population growth. Clearly, the housing debacle has severely retarded recovery and although recovering slowly housing continues to hold back recovery and job growth.

Autos. While domestic auto sales have risen to an annual rate of about 14.1 million in recent months, they are still more than 25% below pre-Great Recession sales levels. People are keeping vehicles for a longer time before replacing them and the number of vehicles per household is declining. So, even though auto sales have increased nicely in recent months, total unit sales are unlikely to approach the pre-Great Recession level any time soon.

Business Investment. And, as for business investment, it has risen but not robustly. Lack of consumer demand and ongoing policy uncertainty has put a damper on investment growth.

2. Other Factors Inhibiting Job Creation

Other factors may be contributing to slower job creation than typical of previous recoveries. Michael Spence (NYU Stern School of Business) and David Autor (MIT) argue that the disappearance of mid-level jobs is being driven by globalization and acceleration in technological progress. Neither of these factors are recent phenomena. Both were well underway long before the onset of the Great Recession. Globalization involves loss of jobs to less costly venues. There is clearly merit to this concern based simply upon the persistent U.S. trade deficit.

However, accusing accelerated technological progress of limiting job growth is much more controversial. While new technologies displace jobs in old technologies, the historical record is clear that net new jobs are created and the accompanying increases in productivity raise real wages and the standard of living. However, there can be timing discontinuities which is to say that net total jobs might decline initially but rise as the new technologies mature.

3. Impact of the Large Output Gap

When the output gap is large as it is currently there are two responses which impact job creation. First, because demand is weak and sales revenue growth is slow, businesses are pressured to grow profits through cost cutting and implementation of cost-saving technologies. This results in fewer jobs. Second, the lack of strong demand causes some businesses to defer investment in new costly technologies, particularly if the payback is uncertain or will take a long time to materialize. This could result in retaining jobs in the short run which might otherwise no longer be needed if the new technologies were deployed. But, it could also hold back job creation in the longer run which might otherwise be stimulated by the spinoffs from deployment of the new technologies.

Based on my statistical analysis it appears that investment in new technologies and increases in productivity are delayed when the output gap is large. Statistical analysis indicates that productivity growth slows as the output gap rises. Productivity drops 21 basis points for each 1% increase in the output gap. Since the second quarter output gap, as measured by CBO, was 5.41%, this implies that the rate of productivity increase is 1.14% below the full employment level. If the level of output were unchanged, this would imply that there are more jobs currently than there would be if the rate of productivity improvement was at a higher level. This is not necessarily the right interpretation, however. Higher productivity would result from investment in new technologies and that activity itself would create jobs. And, more importantly, we know that once investment gets underway the accelerator effect kicks in and amplifies job creation. In other words, low productivity is really not a desirable outcome. It may save a few jobs in the short run but it leads to economic stagnation, slower job creation over time and reduced improvements in the standard of living.

There is survey evidence that acceleration in technological innovation can lead to labor shortages in impacted sectors of the economy. To the extent this has validity it argues for more targeted jobs training programs.

4. Proposals to Stimulate Job Creation

Rather than try to create jobs indirectly by using fiscal policy to stimulate demand, more effective ways of promoting job creation include:

- Strengthening incentives and reducing disincentives for individuals to work, especially for women, those near retirement, and those with low skill levels
- Creating tougher job search requirements to receive unemployment benefits
- Expanding job assistance and training programs
- Creating a means to better match unemployed workers with job vacancies

- Eliminating pension system benefits which encourage early retirement

5. Government Spending on Investment Initiatives — the Overlooked Option

Finally and importantly, fiscal policy could be directed toward investment rather than to transfer payments to support income. There is ample statistical evidence that economic activity multipliers are much higher for a dollar the government spends on investment initiatives than those for a dollar transferred to an individual to support income. Dollars spent on investment have a short-term impact of creating new jobs, whether it is for infrastructure construction, research or some other investment initiative. But, this kind of spending also has a longer-term benefit as other new jobs are also created as a consequence of investment activity. This is the multiplier effect.

It is unfortunate that fiscal stimulus has focused almost entirely on transfer payments. That approach worked to ignite previous recoveries where a deficiency of demand was clearly a problem and sectors, such as housing, autos and business investment, were responsive to the stimulus. But, while there is a deficiency of demand today, consumer debt deleveraging and impaired housing and auto sectors, and to a lesser extent the business investment sector, are nullifying the effectiveness of traditional fiscal stimulus.

Unfortunately, while there is discussion about deteriorating infrastructure in the U.S. and long-term deleterious consequences this poses for the U.S. economy, there is no groundswell to do anything about it. Furthermore, the budget deficit has burgeoned to dangerous levels and political debate now centers around how to get the deficit under control rather than how to get the economy firing once again on all cylinders. Simple math indicates that the burden of debt will shrink if growth accelerates. Unfortunately, the opposite is also true — the burden of debt rises if growth slows or declines. Reducing government spending can produce the latter unfavorable result as we are witnessing in Europe. Austerity is a negative solution that comes with high risks. Government spending would not need to be reduced if it were redeployed into high multiplier investment initiatives which would translate within a reasonable period of time into a higher rate of growth in the economy. Such an outcome would lead to a lessening of the debt burden without reducing government spending.[1]

Some, perhaps many, would argue that government administration of investment spending would result in waste and inefficiency. Woody Brock argues persuasively that during times when the output gap is enormous, the risk-adjusted return to government investment spending for many projects exceeds the risk-adjusted return to the private sector. What this means is that the private sector is unlikely to make such investments and if the government doesn't do so, then the output gap will remain higher for longer.

As to the concern about government waste and inefficiency there are mechanisms for the government to partner with the private sector and marshal the private sector's profit incentive to drive down waste and inefficiency and accelerate timely implementation. Partnering with non-governmental not-for-profit organizations, such as community loan development funds, has also proven to be an effective means for administering government investment spending.

President Obama has proposed legislation to create a national infrastructure bank to be capitalized with $10 billion in federal funds. Through partnering with private sector entities, this sum could be leveraged many times over. But, it still is a very small amount relative to 2012's expected fiscal deficit of $1.2 trillion. Much more than $10 billion will be required for a government investment program to have a meaningful impact. While hearings have been held on the president's proposal, there appears to be little congressional interest in seriously pursuing creation of a national infrastructure bank.

VII. Monetary Policy

At the conclusion of each meeting the Federal Open Market Committee (FOMC) releases a short statement that includes its assessment of the outlook for economic growth, the outlook for inflation, its policy stance and policy initiatives. At each quarter-end meeting, on a quarterly basis, the FOMC publishes its projections for the next three years for real GDP growth, the

[1]For a logical proof of the validity of the points made in this paragraph, see Chapter 2 of American Gridlock: Why the Right and Left Are Both Wrong by H. Woody Brock, published by John Wiley & Sons, Inc.

PCE (personal consumption expenditures) price index, the core PCE price index, which excludes food and energy prices, the unemployment rate and the expected federal funds rate. Also, the Chairman of the Federal Reserve holds a press conference quarterly in conjunction with publication of updated economic projections.

1. August FOMC Meeting

The most recent meeting did not include an updating of economic projections or a press conference. It was pretty much a non-event as there were only minor wording changes to the statement and no monetary policy changes were announced.

Although a few were disappointed that the FOMC did not extend to a later date its guidance for "exceptionally low levels for the federal funds rate", financial markets did not react. This lack of reaction might have occurred because the tone of the statement strengthened expectations of a policy easing bias. In other words, unless the economy strengthens appreciably in the next few weeks, markets expect the FOMC to initiate additional policy easing. That decision may come at the September meeting or the October meeting. It will certainly come at the September meeting if incoming economic data continue to be weak. The September payroll report will be especially important. There is also an argument that the September meeting is a more likely time than October for two reasons. First, the FOMC will update economic projections at the September meeting and Chairman Bernanke will hold a press conference following the meeting. Second, the September meeting is scheduled for September 12th and 13th, which comes well before the date of the presidential election. The next FOMC meeting after that is scheduled for October 23 and 24, which is barely two weeks before the election.

Growth Outlook. The FOMC's outlook for growth was less optimistic than in the June statement. It noted that "economic activity decelerated somewhat over the first half of this year." The language in the June statement about employment, "growth in employment has slowed in recent months," was changed to "growth in employment has been slow in recent months." This small wording change indicates that the FOMC believes that sluggish employment growth has become a more persistent problem. The language in the June statement about consumer spending, "household spending seems to be rising at a somewhat slower pace than earlier in the year," was changed to "household spending has been rising at a somewhat slower pace than earlier in the year." Only the verb was changed from "seems" to "has been", but again reinforces a sense that the FOMC is persuaded that the slowdown is not a transitory matter. The FOMC's conclusion that economic growth will remain moderate in coming quarters and then pick up "very gradually" and that the unemployment rate will decline "only slowly" was identical word-for-word in both the June and August statements.

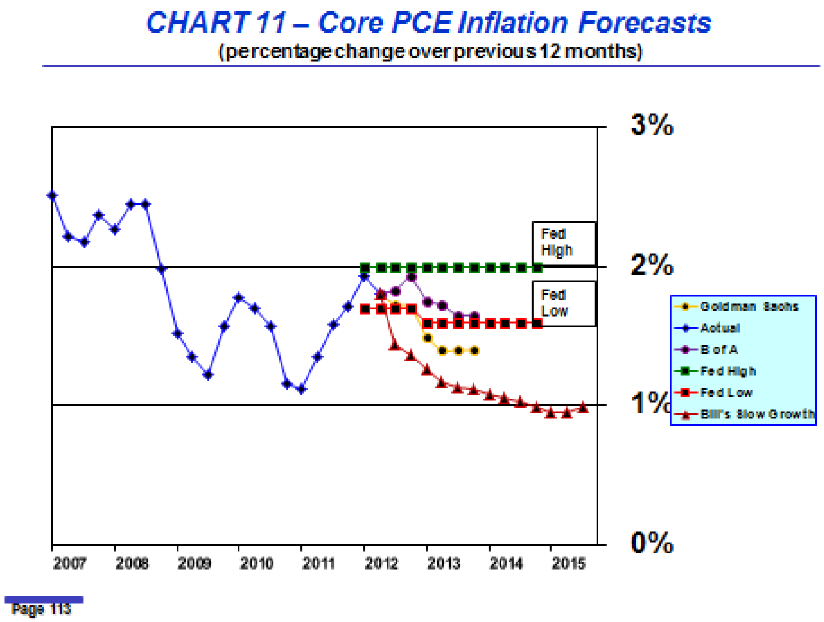
Inflation Outlook. Inflation has declined reflecting lower oil prices and longer-term inflation expectations remain stable. The words "since earlier this year" were added in the August statement. The conclusion that inflation will be at or below the level consistent with the Federal Reserve's mandate of full employment and price stability was worded identically in both the June and August statements.

Risks to the Outlook. Concerns about downside risks to the growth outlook were unchanged: "...strains in global financial markets continue to pose significant downside risk to the economic outlook." When the meeting minutes are released on August 22 there will an opportunity to review more details about the discussion of risks.

Policy Stance. There were no changes in the FOMC's policy stance. It "expects to maintain a highly accommodative stance for monetary policy" and retains its commitment to maintain "exceptionally low levels for the federal funds rate at least through late 2014". However, it did change the language in the June statement that it is "prepared to take further action as appropriate ..." to it "will closely monitor incoming information on economic and financial developments and will provide additional accommodation as needed ..." In the past the language "closely monitor" has usually signaled an intent to ease policy at the next FOMC meeting.

2. Inflation

Chart 11 shows the FOMC's high and low projections for inflation. Both B of A's and GS's forecasts track the lower FOMC projection and both edge down over time. While these forecasts do not reflect serious concern about potential deflation, all of them project a lower rate of inflation than the

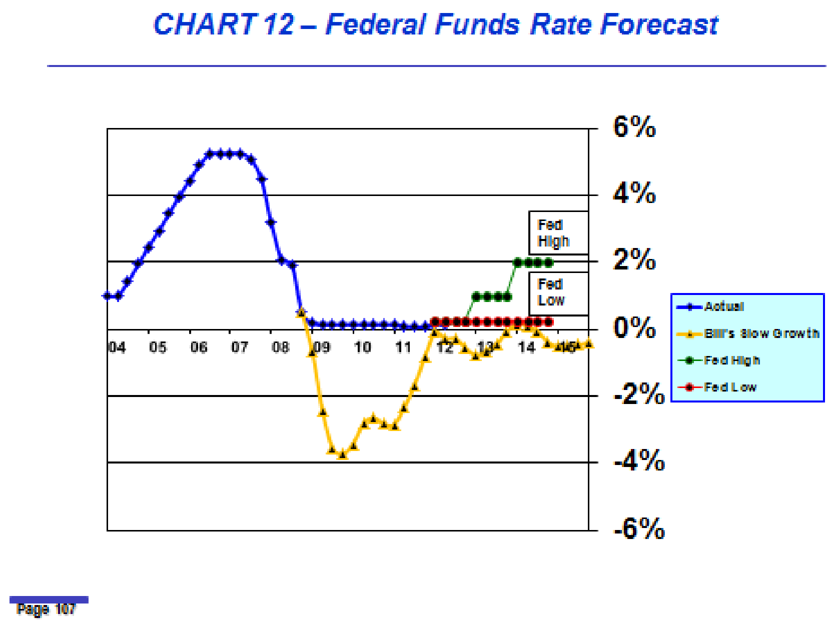


FOMC believes is desirable. "Bill's Slow Growth" scenario projects an even greater downward trajectory for inflation. This more pessimistic projection indicates the direction of risks to inflation but probably overstates the extent of that risk. Because wages are sticky in the downward direction, downward pressures on inflation, notwithstanding the very large output gap, is likely to be contained.

3. Federal Funds Rate

The FOMC's high and low range for its federal funds rate projections is shown in **Chart 12**. The FOMC does not report its projections in this way. I derived the high and low boundaries of the central tendency range by eliminating the three highest and three lowest projections. This is the same methodology the FOMC uses for projections of other economic variables.

The only alternative federal funds rate forecast shown in **Chart 12** is "Bill's Slow Growth" scenario. It implies that the FOMC will eventually extend its guidance for maintaining exceptionally low levels for the federal



funds rate beyond late 2014. It should be noted that both GS and B of A expect the guidance to be extended to mid-2015. "Bill's Slow Growth" scenario suggests that the first increase in the federal funds rate would not occur until mid-2016 or later.

4. Future Monetary Policy Options

Many, including myself, believe that another round of quantitative easing is inevitable. While Chairman Bernanke has not signaled that such a decision is imminent, he and others, such as Vice Chairman Janet Yellen and New York Federal Reserve President William Dudley, have stated that the Fed is prepared to act if the U.S. economy bogs down. More recently San Francisco Federal Reserve Bank President John Williams and Boston Federal Reserve Bank President Eric Rosengren have both been outspoken about the need for additional quantitative easing. Given the FOMC's policy stance, additional easing seems probable before year end and is likely to occur at the September meeting if incoming data reports remain weak.

The three most likely monetary policy actions the FOMC could take include: (1) extension of forward guidance to sometime in 2015 or beyond; (2) expansion of the Federal Reserve's balance sheet through purchase of additional long-term Treasury securities; or (3) expansion of the balance sheet through purchase of mortgage backed securities. It is entirely possible that when action is taken it will involve a combination of all three.

Extend Forward Guidance. The new time frame would have to be extended at least one year to be meaningful and even that would merely maintain approximately the same forward time period as when the "late 2014" guidance was provided in January. There is also risk that the quarterly federal funds rate projections made by the 19 members of the FOMC would be inconsistent — only 6 of 19 members currently expect the first federal funds rate increase to be delayed until 2015. GS estimates that the 10-year Treasury note rate would decline between 5 and 20 basis points, if guidance is extended. It could be more than that if the backup in rates that has occurred in recent days is sustained.

Purchase Additional Long-Term Treasuries. The law of diminishing returns may be at hand. Long-term rates are already very low. Additional purchases might not reduce rates enough to make much of a difference. Many will fret also about the increased size of the Federal Reserve's balance sheet and the increased difficulty that will pose when the time comes for the Fed to shrink its balance sheet. Another potential negative consequence could be to disrupt the market for long-term Treasuries by reducing the availability of these securities to other investors. If purchases were in the range of $400 billion to $500 billion, GS estimates that the 10-year Treasury note rate would decline 15 to 20 basis points.

Eric Rosengren recently proposed an open-ended commitment to continue large scale asset purchases until the FOMC is satisfied with the state of the economy. For such a policy to be credible the FOMC would need to define more precisely than it has to date what would constitute a satisfactory condition of the economy. There are several possible guidelines the FOMC might specify: 1) a return of inflation to its target of 2%; 2) a combination of an inflation and unemployment target; or 3) a specific target for nominal GDP growth. Chairman Bernanke has been unsympathetic to nominal GDP growth targeting. The volatility of inflation over the short term would pose challenges for setting a measurable inflation number, but a possible alternative would be to rely instead on FOMC inflation projections as a guide. To date the FOMC has not ventured into considering an unemployment rate target. Such a debate would have to contend with differing views on the level of the natural rate of unemployment. The CBO provides projections currently for that rate, but CBO's view is not necessarily widely accepted.

Purchase Additional Mortgage Backed Securities. Purchasing mortgage backed securities would avoid disrupting the Treasury securities market and would have the advantage of shrinking the yield spread between mortgages and Treasury securities. A recent Federal Reserve study indicated that purchase of $200 billion in mortgage backed securities would lower long-term Treasury rates by 10 to 15 basis points and analysis conducted by GS indicates that it would also reduce the yield spread on mortgages by 10 basis points.

Combination. These options could be combined which would amplify the overall impact. For example, GS estimates that extending guidance, purchasing $400 billion in Treasuries and $200 billion in mortgage backed securities could lower the 10-year Treasury rate by 30 to 50 basis points and the mortgage backed securities rate by 40 to 60 basis points.

5. Will Further Monetary Policy Easing Make Any Difference?

I discussed this issue in detail in the ***July Longbrake Letter*** and so won't repeat that commentary again other than to summarize.

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

Further easing in the form of guidance, asset purchases or a combination will be positive for stock prices for two reasons. First, we know from experience that these policies have lowered long-term rates and flattened the yield curve. Depressing long-term bond yields makes dividend yields on stocks more attractive and provides price support for stocks. But, given low long-term interest rates and the guarantee that they will remain low for an extended period, stock prices have not risen as much as would be expected. This is probably because of the enormous uncertainties posed by the European sovereign debt crisis and the U.S. fiscal cliff. The equity risk premium is more than 200 basis points above its long-term norm of approximately 6%. This suggests that if these policy uncertainties could be resolved favorably, stock prices would rise and perhaps to a considerable degree.

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

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

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

VIII. Fiscal Policy

1. Recent Congressional Action

Before recessing for the Republican and Democratic presidential selection conventions, Congress took several actions or reached agreement to take action:

- The House voted to defer to a later date most of the $109 million in automatic spending cuts mandated by the Budget Control Act. The Senate took no action.
- The Senate voted to extend the Bush tax cuts for all taxpayers earning less than $250,000; it rejected legislation to extend all the Bush tax cuts.
- The House voted to extend all the Bush tax cuts and rejected legislation to extend the tax cuts only to those earning less than $250,000.
- With broad bipartisan support, the Senate Finance Committee approved legislation to extend 49 of 73 expiring tax benefits, called extenders, and alternative minimum tax (AMT) relief for two years. The

full Senate has not yet acted and it is uncertain what the House might do. The total cost would be $152 billion over two years, of which $92 billion is for AMT relief. The 24 extenders not included in the bill would expire and save $32 billion over two years.

- The House and Senate passed legislation requiring the president to provide detail about the automatic spending cuts required by the Budget Control Act.

- The leadership of the House and Senate reached agreement to pass a $1.047 trillion continuing resolution to fund the government for the first six months of the 2013 fiscal year at the fiscal year 2012 level of funding. This resolution is expected to pass when Congress returns in September. This will avoid the threat of a government shutdown at least until March 31, 2013.

As is evident there was no progress in reaching compromises on any of the components of the fiscal cliff shown in **Table 8** below. It is unlikely that

Table 8
Components of the Impending Year End Fiscal Cliff

2013 Fiscal Policy Shock

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

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

Page 142 Source: Congressional Budget Office

any action will be taken prior to the presidential election on November 6.

Uncertainty is already building and could have a significant negative effect on economic activity during the remainder of this year. Attention will increasingly focus on what Congress might do after the election and market participants will watch closely political positions on each issue and polls of possible election results.

2. Enormous Fiscal Cliff Ahead

Table 8 shows the components of the fiscal cliff and the values of each based on analysis conducted by CBO. The first column in **Table 8** is for fiscal year 2013, but since the fiscal year begins on October 1 and all of the fiscal cliff items are effective January 1, the numbers in this column cover only nine months. The next column extrapolates some of the items to a full 2013 calendar impact. Collectively, if Congress does nothing, there could be a negative shock equal to as much as 4.5% of GDP.

Most assume Congress will reach some kind of compromise that avoids the full impact of the fiscal cliff. But, ideological differences between Republicans and Democrats are significant.

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

Payroll Taxes. Neither party appears to have a great deal of enthusiasm about extending the 2% payroll tax cut.

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

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

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

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

Medicare Physicians "Doc Fix". This has always been extended in the past and is likely to be extended again.

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

3. Potential Economic Consequences of the Fiscal Cliff

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

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

B of A has put together consensus and severe cliff forecasts for 2013 in addition to its own forecast. Consensus GDP growth for 2013 is 2.2%, GS's forecast is 2.1%, B of A's forecast is 1.4% and the severe cliff forecast is 0.5%. The severe cliff forecast includes a quarter or two of zero or slightly negative growth at the beginning of 2013.

IX. Recent Developments in Europe

Markets have been relatively calm in the weeks following the European Union (EU) summit meeting on June 28 and 29. But, like previous policy initiatives, the new ones announced at the conclusion of the summit, which are focused on recapitalizing banks, buying sovereign debt to stabilize yields and extending compliance timeframes for achieving budget deficit targets, will have limited effect in dealing with the real problems bedeviling the EU and the Eurozone (EZ). In essence, this summit, like its predecessors, embraced policies which buy time but which will do little to correct fundamental economic imbalances that are inexorably worsening. In addition, they do little to address severe structural flaws in the EU and the monetary union.

1. Crisis Recap[2]

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

Bank Solvency and Tight Financial Conditions. Many European banks have high levels of troubled loans and sovereign debt whose market value is considerably less than book value. Many troubled loans are carry overs from aggressive lending prior to the global recession in 2008 and 2009.

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

But, increasingly, recession is adversely impacting the quality of many other loans.

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

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

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

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

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

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

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

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

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

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

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

Agreeing to policy changes, particularly if they involve treaty changes takes a very long time. Time is working against elected governments. Fringe parties are gaining traction and are feeding off of discontent. ***Nationalism*** is a natural response to economic crisis as political leaders give primacy, not to the union, but to their own nation's well-being. Similarly, ***populism*** naturally gains strength as economic hardship afflicts a country's citizens with the loss of social benefits and perceived competitive threats from immigrants. Unlike the United States where citizens think of themselves as Americans first and citizens of individual states second, the exact reverse is true in Europe. Other than among the political elite there is no emotional allegiance to the importance of the EU.

Ultimately, political forces, more than economic forces, will define the future of the EU and the EZ. Many seem to think that the twin economic and political crises will create pressure sufficient to correct a fundamental flaw in the EZ by compelling members to accept some form of fiscal and political union to complement the monetary union. The political forces which are in the process of being unleashed are strongly pushing in the opposite direction — not toward greater integration but toward the reclaiming of national sovereignty. The political elite who fervently believe in the importance of a united Europe are losing ground to fringe political movements on both the right and the left which do not share the goal of union.

Summary. In coming months the EZ and EU will undergo significant change. The political elite are committed to the European Project of integration. Indeed, there is emerging agreement that the time has come to move in the direction of greater economic and fiscal integration to complement the monetary union. However, the sheer complexity of reaching agreement and the cumbersome process of ratification of governance changes greatly limit the odds of success. As recession spreads and deepens, political centrifugal forces will build and will increasingly diminish the chances for broad-based acceptance of significant reforms. In this regard, the recent EU summit was disappointing because other than bank supervision no other integration issues were mentioned.

There is practically nothing in the reforms under discussion which would address in any material way the severe lack of competitiveness in the weaker countries. With recession deepening and sovereign debt and banking problems worsening, already committed bailout financial resources are inadequate. The important question is whether there is capacity among the strong countries to provide additional financial resources in the quantity that might eventually be needed to avoid sovereign defaults.

I continue to believe that the complexity of the problems and the enormity of the obstacles to effecting meaningful and timely reform argue against survival of the EZ and EU in their present forms. I do believe that some kind of union will survive, but it will involve fewer countries. Assuming that this comes to pass, the resulting union is likely to involve a much greater degree of fiscal, economic, funds transfer and political integration alongside the established monetary union.

2. Recent Developments in Individual European Countries

The following litany of recent developments in various European countries for the most part describes worsening economic conditions and the difficulty of coordinating policy responses to the crisis.

Greece.

- July 20 — the ECB announced that Greek bonds would be ineligible for collateral pending EC and IMF review of progress with bailout conditions.
- July 24 — GDP is expected to decline more than 7% in 2012 and not turn positive until 2014. The Greek economy has already contracted -16% over the last three years.
- July 29 — German Finance Minister Wolfgang Schaeuble said there is no room for additional concessions — Greece must implement extensive reforms and reduce its budget deficit.
- August 2 — the government coalition agreed to €11.7 billion in cuts and taxes and will defer renegotiating the bailout agreement until a later date.
- August 4 — the ECB agreed to guarantee €4 billion in loans to the Greek central bank so that it can buy government treasury bills. This action prevents a Greek default and provides sufficient cash until the EC/ECB/IMF review of implementation of the bailout agreement in September.
- August 8 — S&P cut the government's bond rating from CCC to CCC with a negative outlook.

- August 9 — the unemployment rate rose to 23.1% in May from 22.6% in April.

Portugal.

- August 9 — GDP growth was -1.5% in 2011 and is expected to be negative in 2012 and 2013.
- August 9 — the budget deficit was reduced from 9.8% in 2010 to 4.2% in 2011.
- August 9 — the unemployment rate was 15.0% in July.
- August 9 — countries with historical relationships with Portugal, such as Brazil, Angola and Mozambique, are participating in purchasing state-owned enterprises at favorable prices.

Ireland.

- July 26 — bonds were sold to the public for the first time in two years: the 5-year bond yield was 5.5% and 8-year bond yield was 5.0%.
- August 1 — unit labor costs have declined -6.3% since 2008 which is improving export competitiveness.
- August 10 — banks' reliance on emergency funds fell in July to €122 billion from €127 billion in June; loans from the ECB decline to €80 billion in July from €84.6 billion in June.

Spain.

- July 16 — Spanish banks borrowed €365 billion from the ECB in June.
- July 17 — Finland required Spain to provide collateral for Finland's share of the €100 bank bailout funds from the ESFS.
- July 19 — the government agreed to cut spending and raise taxes by €65 billion by 2015. This sparked anti-austerity protests nationwide.
- July 19 — the government created an €18 billion fund to assist Spanish regions.

- July 20-24 — the regional government of Valencia, shortly thereafter followed by the regional governments of Murcia and Catalonia, formally applied to the central government for financial assistance.
- July 20 — the government forecast GDP would decline -1.5% in 2012 and -0.5% in 2013 before rising 1.2% in 2014 and 1.9% in 2015.
- July 24 — second quarter GDP declined -0.4%.
- July 27 — unemployment rose to 24.5% in the second quarter compared to 23.7% in the first quarter.
- July 27 — Spain's economy minister discussed the prospect that €300 billion in bailout funds may be required if borrowing costs don't come down. Others estimate that the cost of a bailout would be €385 through the end of 2014.
- July 31 — the budget deficit goal for 2012 of 4.0% was on target at the end of June.
- August 1 — S&P affirmed the government's bond rating as BBB with a negative outlook.
- August 1 — youth unemployment in June was 52.7%
- August 1 — financial institutions suffered outflows of €9.6 billion in April and €41.3 billion in May.
- August 3 — the government will need to issue €900 billion in debt in 2013.
- August 9 — the 10-year bond rate remains at a very high level of 6.82%.

Italy.

- July 12 — Moody's downgraded the debt rating from A3 to Baa2
- July 17 — Prime Minister Mario Monti expressed concern about the eventual default by the region of Sicily.
- July 31 — the unemployment rate rose from 10.5% in May to 10.8% in June.

- August 6 — S&P affirmed the ratings for 15 banks, but downgraded the ratings for 15 others.
- August 7 — €4 billion in spending cuts were approved by parliament and Primer Minister Mario Monti won a vote of confidence.
- August 7 — industrial production declined -1.4% in June.
- August 9 — second quarter GDP declined -0.7% after a -0.8% decline in the first quarter. GDP is expected to fall -2.5% in 2012.

United Kingdom.

- July 25 — second quarter GDP declined -0.7% following a -0.3% decrease in the first quarter.
- August 7 — industrial production declined -2.5% in June.
- August 8 — the Bank of England expects GDP growth to be 0.0% in 2012.

France.

- July 20 — President Hollande's budget will raise taxes by €7.2 billion.
- July 26 — the jobless rate rose 0.8% in June which was the 14th consecutive month that unemployment rose.
- August 8 — the French central bank expects France to enter recession in the third quarter with a fall in GDP of -0.1%.
- August 9 — business confidence is at a three-year low.

Germany.

- July 17 — the German Constitutional Court will rule on the constitutionality of the ESM (European Stability Mechanism) by September 12th. This means that the ESM is unlikely to be fully operative until toward the end of 2012.

- July 17 — the regional government of Bavaria announced its intention to question the legality of Germany's regional financial redistribution system.
- July 18 — €4.17 billion in 2-year notes were sold with a negative yield of -0.06%.
- July 24 — Moody's cut the government debt rating from AAA; it also cut the AAA debt ratings of the Netherlands and Luxembourg.
- July 24 — GDP grew 1.2% for the 12 months ending in March 2012.
- July 25 — business confidence in July was the lowest since March 2010.
- July 26 — Moody's downgraded ratings for 17 German banks.
- July 31 — the unemployment rate rose from 6.6% in June to 6.8% in July.
- July 31 — German bank lending to businesses in periphery EU countries has declined -20% over the last seven months.
- August 1 — machine tool orders declined 1% over the previous 12 months.
- August 1 — the purchasing managers was 43.0 in July, indicating rapid contraction in manufacturing.
- August 2 — the government rejected giving the ESM a banking license. This means that the ESM will be unable to leverage its size through borrowing. Thus, the maximum size of the ESM will be limited to €500 billion.
- August 7 — the opposition party — Social Democrats — backs a fiscal union for EZ members to pave the way for Eurobonds.
- August 9 — a recent poll indicated that 45% of Germans oppose "joint and several guarantees" of euro debt; 44% support debt mutualization, but only with strict rules.
- August 9 — exports fell -1.5% in June.
- August 9 — industrial production declined -0.9% in June.

Estonia.

- August 8 — the government is considering whether a public referendum is required to ratify participation in the ESM.

Finland.

- August 10 — the prime minister proposed creating a banking-sector funded European crisis fund to recapitalize struggling banks and should move forward to implement decisions to tighten a fiscal union.

Europe in General.

- July 24 — Moody's cut the European Financial Stability Facility's (EFSF) AAA debt rating.
- July 26 — ECB President Mario Draghi pledges: "We will do whatever is needed to save the euro. This has been widely interpreted as a pledge to buy member country sovereign debt. Draghi subsequently clarified his remarks to make it clear that a country would have to make a formal request to the ECB to purchase its debt and that a memorandum of understanding containing conditions would be negotiated and signed before the ECB would purchase that country's sovereign debt.
- July 27 — Chancellor Merkel of Germany and President Hollande of France declare their commitment to do everything to protect the integrity of the EZ.

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

In a speech on July 26 that electrified and calmed financial markets ECB President Mario Draghi said, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

Draghi's remarks were immediately interpreted to mean that the ECB would do two things. First, the ECB would lower interest rates and perhaps engage in quantitative easing and second the ECB would resume direct purchase of sovereign debt in the secondary markets.

However, the ECB met on August 2 and did not cut interest rates as anticipated. It also clarified that before the ECB would engage in secondary market purchases of sovereign debt, the country in question would have to request such assistance. Implementation would require the country to enter into a memorandum of understanding (MOU) stipulating fiscal and structural economic policy commitments. This requirement is essentially the same as the bailout requirements imposed on Greece, Ireland and Portugal.

It is generally assumed that once a request has been made and an MOU has been agreed to and ratified, the ESFS and later, once it becomes operational, the ESM would purchase new issue sovereign debt and the ECB would purchase existing sovereign debt on the secondary markets.

The intent, of course, would be to drive down sovereign borrowing rates but also encourage continued private purchase of sovereign debt. Whether this latter objective can be achieved is questionable. If it cannot, then the request for assistance from the ECB will quickly expand to a broad-based bailout similar to those in force in Greece, Ireland and Portugal. That, then, would raise the question of adequacy of ESFS/ESM resources. Currently, the combined resources of the EFSF/ESM are limited to €500 billion. Proposals to provide the ESM with a banking license so that it could leverage the €500 billion to a much larger amount to date have been rejected by Germany. If Spain is entirely shut out of the financial markets, its net funding requirements through 2014 are estimated to be €385 billion, which leaves no room for help for Italy. In fact, the €100 billion in EFSF funds to help recapitalize Spanish banks will be transferred to the ESM once the ESM becomes operational. This means that there will be no room to help any other nation. Thus, it seems likely based on experience to date that at some juncture a way will be found to increase the resources of the ESM. Nevertheless, because of all these uncertainties Spanish and Italian sovereign debt yields remain at prohibitively high levels.

Also, the ECB said that once an MOU is in place it will "define the framework for bond purchases", which will include the amount of bonds to be purchased and clarification of ECB's seniority status. When the ECB purchased Greek debt on the secondary market, it imposed a senior priority claim. However, this is not a mandatory requirement as the ECB has discretion to determine on a case-by-case basis whether and in what form to impose seniority status.

Because the MOU would require concurrence from EZ member nations and probably parliamentary approval at a minimum from Germany and Finland it could take several weeks from the time a country requests ECB assistance to the time when bond purchases actually commence.

While the ECB did not lower interest rates at the August 2 meeting, market participants expect this to occur at its September 6 meeting. There are additional actions the ECB could take including lowering collateral requirements, imposing a negative deposit interest rate, and perhaps engage in a program of deliberate quantitative easing over and beyond purchase of trouble countries' sovereign debt. No commitments have been made, but the market understands that the ECB has moved to a more flexible policy posture, which means that innovative and aggressive policy actions are possible.

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

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

Also key is the capacity of the ESM to purchase sovereign debt to provide time for reform policies to become effective. As mentioned above, ESM's resources as currently configured are inadequate. When measured against the size of the ESM, the outstanding amount of Spanish and Italian sovereign debt dwarves by many times over the capacity of the ESM. The conclusion is straightforward. The ESM with the assistance of the ECB should be able to fend off speculative attacks on Spanish and Italian sovereign debt for a period of time. If the size of the ESM is increased, the time period for fending off speculative attacks could be extended. All of this is not likely to be successful in the long run because many of the necessary reforms discussed in the "**Crisis Recap**" section above are not under serious consideration.

X. China and India — Slowing Growth Continues

1. Recent Chinese Data Reports Confirm Significant Slowing in Growth

Recent Chinese data releases have conveyed a whiff of a hard landing in the making. Nonetheless, most market participants continue to have faith that Chinese policymakers will engineer a soft landing by easing monetary policy, encouraging bank lending and implementing more aggressive infrastructure spending.

Rapidly slowing inflation in China to 1.8% is prompting investor anxiety that the Chinese economy may be cooling more rapidly than expected. Corroborating evidence gives credence to this anxiety. Industrial production has slowed dramatically to a 6.1% rate over the last twelve months from an average of 20% over 2010 and 2011. This is the lowest growth rate since early 2009 during the Great Recession when industrial production growth fell nearly to zero. Second quarter 2012 GDP growth, measured as the change over the previous 12 months, declined to 7.6% from 8.1% in the first quarter and 9.2% in 2011. This means that the second quarter annualized rate of growth was less than 7.6%. It increasingly looks like China may grow less than 7.5% during 2012. Premier Wen Jiabao forecast at least 7.5% 2012 GDP growth in March. However, the IMF still expects China to grow 8.0% during 2012, down 0.2% from its previous forecast. To attain that would require a significant reacceleration in Chinese growth during the second half of 2012.

Other recent reports generally reveal weaker economic activity:

- Retail sales slowed in July to a five-year low growth of 13.1% over the preceding 12 months.
- Outbound investment flows in the first half of 2012 were $35.4 billion, up 48.2% over 2011, while inbound investment flows were $59.1 billion, down 3%, suggesting that attractive investment opportunities within China are diminishing.
- The official purchasing managers index of manufacturing activity declined to 50.1 in July from 50.2 in June, implying negligible growth.
- The MNI flash report on business conditions declined to 49.6 in July from 53.2 in June.
- China aluminum supply is 1.6 million tons, growing 20% annually; demand is 1.3 million tons, growing 4% annually.
- Crude steel production is likely to decline in 2012 for the first time in 31 years.
- Home prices rose 0.02% year over year in June, up in 25 cities and down in 21.
- 60% of businesses in Wenzhou have slowed or stopped production since June.
- Power consumption was up 5.2% year over year in May compared to 3.7% in April and 11.7% in May 2011; Hunan power plant utilization is 25% due to weak demand from steel and cement production.
- Home appliance sales were up 0.5% year over year in May compared to 7.7% in April.
- ISI's diffusion index of export sales to China and sales in China of U.S. companies continues to decline well below 50 to 42.3 as of August 3, 2012; any number below 50 means that sales are contracting and the decline in the index means that the contraction is accelerating.

- The Shanghai stock composite index has declined over 30% from its post-Great Recession high and has continued to edge down slowly during 2012.

Chinese policymakers are responding in both words and actions, but it remains to be seen whether their responses will be sufficient to reverse the current downward slide:

- China's central bank announced in early August that it will prioritize stabilizing growth; this means cutting both interest rates and reserve requirements.
- In mid-July Premier Wen Jiabao called for new efforts to improve the economy's growth and dynamism.
- In late July a 14% increase in spending, amounting to 570 billion yuan, on railroads and bridges was announced.
- But tellingly, Premier Wen Jiabao warned that the employment situation will become more complex and severe.

It is important to understand that China's current slowdown is due primarily to correction of internal imbalances. The dramatic slowdown in late 2008 was due to a sudden collapse in global trade in the wake of the Lehman failure. As I discussed in detail in the ***May Longbrake Letter***, China has less room to stimulate its economy aggressively than it did in late 2008 when it implemented massive government stimulus. If China elects to pursue a new aggressive stimulus program by boosting investment and bank lending, it risks exacerbating already significant and troublesome imbalances. China needs to develop its consumer economy and reduce reliance on infrastructure investment and exports to propel GDP growth. This will entail a somewhat reduced rate of growth during a transition period. If handled correctly, China can avoid a hard landing, but it is also not the policy approach that leads to the kind of soft landing most market participants are anticipating. It is commonly assumed that a soft landing would entail vigorous stimulus similar to what occurred in 2008 and 2009 which would boost global trade. As I mentioned above, this would exacerbate China's economic imbalances and increase the likelihood and depth of a hard landing sometime in the future. If China takes the alternative route of pursuing policies to rebalance its economy, it will not provide a significant boost to global trade as market participants generally currently expect.

Chinese Premier Wen Jiabao recently stated that the key to stabilizing China's economic growth is promoting investment growth which is of the right type, in the right location, high quality and cost effective. He added that stabilization policies must include boosting consumption, diversifying exports, supporting emerging industries and developing new technologies. All of this sounds good and is consistent with a rebalancing theme, but the devil will be in actual policy initiatives and whether state owned enterprises will cooperate.

What seems clear at this juncture is that China will not be able to counter a global growth slowdown as it did in 2009. What is less clear is whether China's own growth will slacken a bit or take a nose dive. Slowing growth in the U.S., recession in Europe and slowing growth in major emerging economies such as Brazil, Korea, Taiwan and India, will put Chinese policy makers to the test. Hopefully, they will find the middle road which avoids a sharp slowdown but also avoids reigniting speculative growth based on overinvestment in real estate and infrastructure.

2. Is China's Real Estate Bubble Expanding Again?

Notwithstanding official policy there is some evidence that real estate activity may be rebounding. If that is so, it would lead to better reported economic data in the second half of 2012 but would exacerbate the already considerable overinvestment in real estate.

Patrick Chovanec has been writing a series of articles which have been posted on EconoMonitor entitled: "*What's Driving China's Real Estate Rally?*"[3]

These articles explore in depth five basic theories that may explain the apparent turnaround in the property sector of China's economy:

[3] Patrick Chovanec. Whats Driving Chinas Real Estate Rally? Posted on EconoMonitor: Part 1 on July 23, 2012; Part 2 on July 24, 2012; Part 3 on July 31, 2012. Parts 4 and 5 are forthcoming. These articles were originally posted at *An American Perspective from China* and were reposted on EconoMonitor with permission.

1. Lower prices are bring buyers back
2. Looser restrictions are unleashing pent-up demand
3. Optimistic buyers are misreading the market
4. Government intervention is boosting the numbers
5. Developers are fudging the numbers to stay afloat

As mentioned in the footnote, Chovanec has written detailed commentaries on the first three theories and the latter two are forthcoming.

Chovanec cites a plethora of data from China's National Bureau of Statistics and other sources:

- Home prices were up year over year in 25 cities and down in 21; overall prices edged up 0.02%.
- Total floor space sold was down 9.3% year over year in May and down 3.3% in June.
- Total unit sales increased year over year for the first time in June by 6.9% but units available for sale increased 33% over the same time period.
- Land sales were down 22.4% year over year in June.
- New starts were down 16.3% year over year in June.
- Growth in total floor space under construction was 17.2% in June year over year compared to 35.5% at the beginning of 2012.
- Completions grew 0.3% year over year in June compared to 45.2% in January.
- Growth in real estate investment overall has fallen from 27.9% in 2011 to 11.8% year over year in June.

Chovenac adds that China's property developers are under severe financial pressure. In short, the official data paint a picture of a bursting bubble. Thus, recent commentary about a real estate rally is something of a conundrum. Chovenac's articles explore five theories. The first three are summarized below.

Theory 1: Lower Prices are Bringing Buyers Back. The theory is that falling prices and rising consumer incomes lead to increased sales. While there may be some merit to this theory, falling prices are indicative of excess supply. And, if falling prices is what is required to clear the market, then prices probably would continue to fall as long as supply exceeds demand. This squeezes developer profits and exacerbates developers' financial stress.

Theory 2: Looser Restrictions are Unleashing Pent-Up Demand. The argument driving this theory is that government-imposed restrictions suppressed demand. Thus, demand would reemerge once restrictions are lifted. This would result in both an increase in sales and prices. As it turns out the restrictions were almost totally ineffective and served only to redirect development to unrestricted areas.

Chovenac notes that most of the government's restrictions intended to "cool off" the property market were adopted in April 2010 and were aimed primarily at high-end units in key urban markets. But, aggregate nationwide property sales actually accelerated, indicating that the restrictions were relatively ineffective. There were a number of reasons for that outcome. First, the restrictions were not uniformly enforced. Second, development shifted to secondary cities. Third, as restrictions were extended to additional cities, development shifted to areas outside of the restricted zones. In reality while sales grew by 20% property development grew at 30%, resulting in an ever increasing overhang of excess supply.

Chovenac argues that while pent-up demand might have developed in first-tier cities and undoing the restrictions would help sales in those cities, on a nationwide basis there would be no net impact from pent-up demand. In other words, prices could rise in some cities and fall in others. Overall, the aggregate effect is the same — supply exceeds demand, prices are too high and developers' finances are stretched to or beyond the breaking point. China's property bubble is no different from any other property bubble in that sense. One has only to look at what has happened to the U.S. property market since prices peaked in 2006 as to what might be in store in China.

Theory 3: Optimistic Buyers are Misreading the Market. This theory is based on buyer expectations. If buyers expect prices to rise they are more likely to buy. This can become self-sustaining if prices actually rise. But, if they do not, optimism will quickly turn to pessimism and the real estate rally will burn itself out. The odds favor a "dead cat bounce" — a short-lived rally. This is because inventories are excessive. Rising prices are supported by shortages, not excesses, in supply. Price speculation acts to drive up demand and prices but it is more likely to be sustainable when demand consistently exceeds supply and that is hard to accomplish when there are large inventories of unsold properties. Chovenac notes that inventories of properties for sale peaked in many cities in January or February and have declined since then, suggesting that excess inventories are diminishing. He adds that he doubts the credibility of the data because the for-sale inventory number is easy to manipulate — developers and local governments can determine what is for sale. Based on his analysis, Chovenac believes there is one year of excess housing inventory, five years of excess office inventory and four years of excess retail space. And, he adds that those numbers are growing, not shrinking.

What tipped over the U.S. housing bubble was that prices rose to an unaffordable level that destroyed demand. The price-to-income ratio in China is 7.4 and much higher in key urban areas. This is an extraordinarily high ratio. It would appear that a good deal of housing demand is speculative for investment purposes with the expectation that prices will rise rather than for owner occupancy. Again, this is the stuff that expands bubbles. Then, when expectations are not met and finances are stretched, the bubble bursts with a bang. While demand and buying power is undoubtedly rising over time, there is plenty of evidence that developers and investors are way out in front of market demand.

3. Recent India Data Reports Confirm Significant Slowing in Growth

Unlike China, there is limited news coverage of economic developments in India. However, what little has been published is very troubling.

India's industrial production rate is also plunging, reaching 7.4% over the previous 12 months in June. Growth was well over 15% during most of 2010 and 2011. Consumer spending for autos is also declining rapidly, more than 15% since sales peaked in early 2012.

In addition, a weak monsoon and soaring global food prices will put a significant damper on consumption growth. Food is a large portion of an Indian household's budget.

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