L. R. Levin Consulting, L.L.C.
Newsletter
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Is China Hurting The U.S. Recovery?

During the last month it has become increasingly clear to consensus economists that the U.S. economic recovery is slowing in spite of an enormous deficit financed stimulus program. ***What role has China played in blunting our recovery?***

The economies of many countries have been recovering nicely over the past several months. China has seen strong growth during the last 3 quarters, helping Asia's growth. Brazil has experienced a solid turn around as China increased its investment in and imports from Brazil.

Germany has seen GDP grow by 9%, fueled by manufacturing and increasing exports to China. Germany in the G-20 meeting stressed reduction in government spending to promote economic recovery. ***Why is the U.S. lagging behind?***

One answer may be China's policy toward the U.S.. China tightly controls importation of U.S. goods and services. China has restricted buying of U.S. goods such as food items and cars. China has placed strong tariffs on items such as chicken, reducing U.S. sales of food products. West Coast ports are crowded with super sized container ships bring Chinese imports. Yet, the super container ships leave empty for their return voyage.

The commerce department revise downward U.S. GDP numbers that had been thought to show our recovery was strengthening. The reason for the revision was that the Commerce Department substantially under estimated U.S. imports.

This reflected the fact that China's exports of manufactured goods to the U.S. have increased with our recovery, while our exports to China have not kept pace. A substantial portion of our stimulus has gone to buy Chinese manufactured goods.

Items like T-shirts and hats for census promotions to windmill components have come from China. While we often buy parts from China

803 Sheridan Road, Glencoe IL 60022 ■ (847) 242-1000 ■ Web: www.LRLevin.com ■ LLevin@LRLevin.com

for assembly here, China does not allow us to sell the finished products in China, such as cars.

China has continued under valuing the Yuan against the dollar and dumped cheap goods in the U.S. market. These include such items as tires for vehicles and aluminum products. Through its stimulus program, China has subsidized manufacturing for export.

In August alone, the Commerce Department found that China unfairly subsidized more than $514 million of aluminum exports to the U.S. in 2009. Duties from 6% to 137.7% were recommended to equalize pricing!

China's actions have resulted in driving manufacturing out of the U.S. to China. This causes investment dollars to flee the U.S. to China in hopes of achieving a greater return. China's actions distorts the economic free market pricing of where to buy and invest. The result is a reduction of liquidity and investment in U.S. businesses, especially manufacturing.

This translates to fewer jobs in the U.S. It is clear that U.S. policy makers need to take into account China's role in international trade, if our economy is to come back on track.

China has announced that it will now allow the use of the Yuan for cross-border investments. This is China's next step in replacing the U.S. dollar as the medium of international trade.

To make it more attractive for central banks to hold Yuan, rather than dollars, China now allows central banks holding Yuan to invest them in its interbank bond fund to earn interest in Yuan, further strengthening its economy. In the long run this will make it harder to finance the growing U.S. debt.

It should be no surprise that Chinese manufacturing expanded for the 18th month in a row in August and accelerated from July. At the same time our recovery was seeing its growth rate decrease.

Over the last seven months, , the Yuan strengthened 3.6% against a basket of trading partners' currencies. Yet, China only recently allowed a 1.3% rise in the Yuan against the dollar.

Chinese manufacturing has become the greatest cause of water and air pollution in the world. Between 35% and 40% of the cost of manufacturing in U.S. is attributable to the cost of governmental regulations including meeting U.S. pollution control standards, OSHA requirements and labor laws.

Perhaps the single most effective step the U.S. could take to control pollution and help domestic manufacturing would be to place a 35% to 40% tariff on all Chinese goods until they meet our standards. If the U.S. had had such a tariff during the past several years, this might not have been a jobless recovery.

Are The Unemployment Numbers Good News?

With an election just around the corner, many pundits have heralded the latest unemployment numbers as "good news" even as the official rate climbed from 9.5% to 9.6%. The actual unemployment number counting those unemployed and underemployed reached at least 26.2 million Americans for a real unemployment rate of 16.8%.

41.6% of those are long term unemployed who are exhausting their resources and compounding the loss of buying power in the economy. Of the 67,000 new jobs in the private sector in August, 26% were temporary help services jobs and another 19,000 were workers returning after a strike.

Thus, in August, 53% of all the new employment was temporary workers and returning strikers. The unemployment and jobs figures reflect an economy that is only improving marginally and very slowly. That is not good news for businesses trying to increase their sales.

Unemployment is only down 0.5% from its 10.1% peak last October. At this rate it will take 5 to 7 years or more for unemployment to return to a "normal 5-7%" level. Basic unemployment has been above 9.0% for 16 months, the longest period in more than 25 years.

Restoring consumer liquidity and purchasing power are a key to private sector employment. Until the conditions for private sector employment are restored the economy will not return to meaningful growth.

Is The Impact Of Government Policy On Banks & Of Tax Increases, Hurting

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Job Creation And Economic Liquidity?

Reality based economics teaches that for the economy to digest a financial dislocation and resume growth, government policy must facilitate a return of liquidity within the economy including consumer buying power.

Many economists recognize today that restoring stability and growth to retail sales and the real estate markets is a key component to revitalizing our economy and resuming meaningful job growth. To achieve this we need to promote private sector business growth.

One important element of restoring business growth is creating the right environment for mid-sized and small businesses. Currently, government policies have focused on large enterprises that obtain their financing primarily from large banks and the bond market.

For mid-sized and small businesses the health of smaller regional banks, where they obtain the majority of their financing, is critical. More than 118 of these have failed so far this year.

Recently, the FDIC said 829 of the nation's 7,800 banks are on the government's watch list. This is up 6% from 775 at the end of the first quarter. Smaller regional banks have experienced a substantial increase in non-performing loans as commercial, office, and industrial real estate continue to decline.

While government programs have infused capital into larger banks, even buying troubled assets, no similar programs have helped the smaller regional banks. In fact, the government has substantially tightened lending requirements for these banks, making it extremely hard for them to restructure problem loans or to continue funding mid-sized or small businesses.

With reduced liquidity and stricter lending standards, these regional banks have reduced the funding of working capital loans to mid-sized and small businesses. Loans and lease financing by banks fell by more than 1.3% in the second quarter alone.

Rising exports have primarily helped farmers and larger businesses, especially those with developed international operations. Continuing high unemployment and soft retail sales

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have hurt mid-sized and small domestic business especially in the manufacturing sector.

Many mid-size and small domestic businesses are pass through entities for tax purposes that must rely on internally generated after tax profits to finance operations and qualify for bank financing. Any government policy that reduces their current after tax profitability will hurt the economy.

One reason that the current recovery has not had the benefit of these companies adding jobs and liquidity to the economy relates to the failure to create the right environment in the banking sector.

These types of businesses employ more than 50,000,000 Americans. If after tax profitability is reduced, their ability to obtain necessary bank financing will be hurt.

If the Bush tax structure is allowed to expire for individuals making over $250,000 that tax increase will have a meaningful impact on these businesses. These companies have their profits reported on the returns of the various owners.

Government statistics indicate that individuals reporting more than $250,000 who own pass through entities, report more than 44 percent of all the business income included in individual returns, and employ approximately 50% of the work force.

A half million top-bracket filers will report net positive business income averaging more than $700,000 on their returns.

This is not generally income that is available for these individual taxpayers to spend as they please. A high percentage of it is retained and used in the business.

If now subject to a tax increase, the tax portion would have to be withdrawn quarterly from the business and paid to the government. That will reduce the business' liquidity. That liquidity will no longer be available to support bank financing, new employee hiring, marketing, or plant expansion, to name but a few uses. It will also withdraw substantial buying power from consumers.

To pursue policies that weaken regional banks or reduce the liquidity of mid-sized and small businesses at this time is not what reality based economics dictates. Targeted tax cuts are no substitute. They are too narrow in their focus. Businesses, not the government, need to decide how best to allocate their resources.

Recent Cartoon

THE WISE OLD OWL

There is very little consistency between the various economic sectors. Construction, whether home, office building, warehousing, or commercial is still in decline. Even within construction, educational, power plant and home construction are each behaving differently. Manufacturing related to exports is behaving differently from general manufacturing. The entire economy differs by sectors.

Consumers and businesses have been slow to spend because they fear tax increases are coming. Any reduction in consumer retained income will reduce spending, hurt employment and the strength of the recovery.

Thus, economic analysis of where we will go over the next 12 months is very much dependant on the sector involved. More than at any time in this economic cycle, which one or more of the five possible scenarios will occur and how they will impact the various sectors of the economy is dependent on a variety of factors that are currently unpredictable. Click Here to read the Managing for Success article on **5 Scenario Planning**. You need to plan for how you will handle any of the five scenarios as they impact your sector to remain profitable. Our clients have started their planning for the next 18 months early, so they can more effectively identify the break points and have alternative scenarios ready to put into action. Click Here **For More Information On Action Steps Workshops**

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