

## CAN WE RECOVER FROM THE PUBLIC DEBT CRISIS? OF COURSE WE CAN

Laurence B. Siegel  
June 9, 2015

“If something cannot go on forever, it will stop.” — attributed to Herbert Stein

Is the world facing a public-debt crisis, or is too much debt just another headache we will muddle through? How can investors distinguish between countries that are likely to default or otherwise injure debtholders, such as through high inflation, and those that will resolve their debt problems and emerge stronger? How can *countries* deal with high and rising levels of debt and return their finances to a sound footing?

In a recent article, “Dealing with Debt,”<sup>1</sup> the husband-and-wife economic team of Carmen and Vincent Reinhart, along with Kenneth Rogoff, carefully studied the dynamics of high levels of public debt, and how governments have acted to reduce it. (Rogoff and Carmen Reinhart, who wrote the controversial and tremendously valuable book *This Time is Different*, are Harvard professors, and Vincent Reinhart works at the American Enterprise Institute.<sup>2</sup>)

Earlier, Stephen Sexauer, then at Allianz Global Investors, and Bart Van Ark of the Conference Board studied strategies by which countries can reduce their debt levels through economic growth.<sup>3</sup>

This article summarizes the findings of both of these teams and concludes with suggestions for investors.

### DON'T WE OWE THE DEBT TO OURSELVES?

First, a word of caution: debt is not harmless, even if it's all domestic (“we owe it to ourselves”). The U.S. has a lot of domestic debt, meaning that some Americans owe a lot of money to other Americans. The first group is taxpayers and the second group is bondholders — savers, pension beneficiaries, and so forth. Some people are in both groups but almost all are either net creditors (they are owed money) or net debtors (they have to pay). If there is a debt default or a burst of inflation that amounts to a default, the creditors become losers and the debtors become winners.

---

<sup>1</sup> [http://scholar.harvard.edu/files/rogoff/files/dealing\\_with\\_debt\\_postprint.pdf](http://scholar.harvard.edu/files/rogoff/files/dealing_with_debt_postprint.pdf)

<sup>2</sup> Reinhart, Carmen, and Kenneth Rogoff. 2009. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, NJ: Princeton University Press. The book made the case that beyond a public-debt-to-GDP ratio around 90%, economic growth is significantly impacted, making it difficult to reduce the debt level. Not long after, three authors (Herndon, Ash, and Pollin [2013]) gleefully reported that Reinhart and Rogoff had made a math error, and the “debt hogs” — my name for people who believe that governments can borrow indefinitely without consequence — took the error as evidence for their cause. It's not, and wherever you draw the tipping point, beyond which debt becomes significantly harder to repay, high levels of debt are not good. Debt service crowds out other uses of funds, high taxes discourage growth and investment, and savers suffer from negative real interest rates.

<sup>3</sup> Sexauer, Stephen C., and Bart Van Ark. 2010. “Escaping the Sovereign-Debt Crisis: Productivity-Driven Growth and Moderate Spending May Offer a Way Out.” *Executive Action Series*, Conference Board, New York.

These wins and losses affect wealth, spending, and investment in ways that slow growth and often lead to a worse crisis.

You cannot ignore domestic debt!

If some of the debt is owed to foreign lenders (bondholders), the situation is made a little more complicated, but not much. A default would increase domestic spending and decrease foreign spending, at least in the immediate run; longer-run consequences are harder to assess. But debt owed to foreigners is not economically all that different from debt owed to domestic bondholders.

Private debt is not harmless either. I worry less about private debt than about public debt because private agents — households and corporations — are subject to market discipline and have to weigh the cost of taking on debt against the benefit of holding the assets they use the debt to buy. (The 2008 mortgage fiasco shows that this mechanism does not work perfectly, to say the least.)

Governments, in contrast, can use debt proceeds to buy votes, a process that does not instill confidence in the quality of the decision to take on another unit of debt. But households have to service both piles of debt! They have to pay their taxes and their private debts. So one must add private to public debt when calculating the overall burden of debt in the economy.

### WHEN DO GOVERNMENTS INCREASE THEIR INDEBTEDNESS? WHEN DO THEY REDUCE IT, AND HOW?

Reinhart, Reinhart, and Rogoff (henceforth “R<sup>3</sup>”) begin by observing that governments, at least in advanced countries, do not typically tolerate high levels of debt (more than 90% or 100% of GDP) for long.<sup>4</sup> They run up debts during a war or depression and take steps to reduce the debt burden once the crisis is resolved. The R<sup>3</sup> data are extensive and meticulously assembled, but the authors offer no economic theory as to why 90% or 100% is the cutoff. These levels have been suggested as a rule of thumb indicating the debt burden is so high that steps need to be taken, sometimes rapidly, to avoid a collapse and some form of default, but the real danger point depends on the specifics of each case.

R<sup>3</sup> classify the steps taken to reduce debt into “orthodox” and “heterodox” categories. Orthodox steps include the “Boy Scout” method of raising economic growth rates above nominal interest rates, so that the debt burden reduces on its own. Of course, governments don’t fully control the growth rate, or we would all be rich. Limits to growth are set by the speed of innovation, the cost of inputs, and competition from other countries. Governments can, however, maintain control of their own outlays such that the nominal growth rates are positive but below those of GDP and tax revenue. Sexauer and Van Ark show that this *always* works, mathematically, to decrease the debt-to-GDP ratio. Other orthodox methods are

---

<sup>4</sup> Emerging countries typically have less debt, at least partly because they “run into problems at lower public debt levels than do advanced economies” (R<sup>3</sup>, footnote 4 on page 8). But emerging countries also differ more from each other in their debt levels — Argentina is a case in point.

“austerity” (reductions in government spending) and selling government assets; this approach has a mixed track record (think Greece).<sup>5</sup>

#### “HETERODOX” WAYS OF REDUCING DEBT

Heterodox methods include defaulting on or restructuring the debt, creating unexpected inflation, taxing wealth, and “financial repression” (negative real interest rates, amounting to a tax on savers). R<sup>3</sup> find that, in past recoveries from high debt levels, governments have used these unpleasant methods more often than one might think.

For example, the massive World War II debt of the U.S. and U.K. was paid off in dollars and pounds that were radically devalued (through inflation), to the point that U.S. Treasury bonds, so beloved by investors today, were called “certificates of confiscation” not that long ago. The wealth destruction in the U.K. in the 1970s, caused by unexpected inflation, negative real interest rates, and collapsing stock prices, was worse in that country than in the Great Depression. While the 1970s are quite a while after the war, many economists trace the Great Inflation of that era to the U.S. and U.K. governments’ need to pay back the war debts of a generation earlier in cheaper dollars and pounds.

#### FINANCIAL REPRESSION: TODAY’S PREFERRED DEBT REDUCTION APPROACH

Bondholders (savers) don’t like their wealth decimated by inflation, and they vote.<sup>6</sup> Moreover, inflation hurts a lot of people, not just savers. So governments recently have sought another, more palatable solution. If you can’t get away with not paying principal (in real terms), don’t pay interest!

Today’s rock-bottom interest rates are a wealth transfer from U.S. saving depositors to debtors at the rate of hundreds of billions of dollars every year. These low rates are tolerated partly because inflation is low, but savers who are invested in money-market funds and other cash instruments are losing between 1% and 3% of their real wealth every year. That’s quite a wealth tax. Economists, following McKinnon (1973) and Shaw (1973), call a policy of persistently and intentionally negative real interest rates “financial repression,” and that feels right.<sup>7</sup>

Principal and interest are, at least conceptually, interchangeable. A perpetual bond that never pays any interest is just as worthless as one that defaults (fails to pay principal). This is, of course, just an illustrative example. Today’s long-term bonds do pay a little interest. But it’s still financial repression.

---

<sup>5</sup> I put the word “austerity” in scare quotes because it has become politically charged and has thus lost much of its meaning. See my comment on p. 1 of “The Tooth Fairy Economics of Jeff Madrick,” *Advisor Perspectives*, December 2, 2014.

<sup>6</sup> The governments blamed for the peak inflation rates of the 1970s — those of President Carter and James Callaghan in the U.S. and U.K. respectively — were unceremoniously booted out by the voters in landslide elections, despite having been voted in only a few years earlier.

<sup>7</sup> McKinnon, Ronald I. 1973. *Money and Capital in Economic Development*, Washington, DC: Brookings Institution. Shaw, Edward. 1973. *Financial Deepening in Economic Development*, New York: Oxford University Press.

## THE BOY SCOUT WAY: WORK OFF THE DEBT

Borrowing money and not paying it back, explicitly or through a subterfuge, is a neat trick if you only care about enriching the government. But governments are supposed to serve the people, meaning taxpayers and savers as well as the beneficiaries of government spending. (Often, they're the same people; everyone benefits in some way from government spending, while almost everyone becomes a saver at some point in his or her life.)

Taking this view as a starting point, Sexauer and Van Ark show how governments can "work off" their debts, paying them down without relying on the heterodox strategies documented by R<sup>3</sup>. This Boy Scout, good guy approach preserves the government's legitimacy and its ability to borrow again at favorable rates in case of another crisis.

The authors recognize the basic math of public finance: Public debt as a percentage of GDP will not grow if nominal GDP growth in dollars exceeds interest payments on government debt plus any budget deficit. When these conditions are violated, debt-to-GDP and interest rates can increase rapidly.

They offer three key insights for resolving the unfolding crisis: (1) What matters most is the power of the compounding relative growth rates where government still grows, but grows less than GDP (and tax revenues); (2) a powerful policy rule is to increase government spending at the growth rate of population plus inflation — a "no one worse off" policy; and (3), of all the policies a government can pursue — from default to austerity to inflation — it is productivity-enhancing policies that have the biggest payoff. These policies will take time to work, but the evidence is that once the market sees productivity-led growth accelerate and government spending increase less than revenues, the bond markets will continue to offer low rates and the crisis will gradually disappear.

Sexauer and Van Ark note that, once the difficult first steps are undertaken, debt repayment tends to accelerate, like a mortgage that is hard to pay down at first but later becomes easy as one's income rises and principal becomes an ever-increasing part of the mortgage payment. They write:

[O]n average, no absolute cuts in government spending per person are required, although reallocations and redistributions remain important policy choices. The annual flow of productivity-driven GDP above the combined growth of population and inflation can be allocated to debt and tax reduction or more investment in productivity-enhancing measures that strengthen a "virtuous" feedback loop. The bond markets will see this and will stay open at reasonable interest rates.

The authors make the case that, to reduce the debt-to-GDP ratio, nominal government spending does not have to be cut; it just has to grow more slowly than the economy grows in nominal terms. This is good news because cutting nominal government spending is almost impossible, but cuts in its rate of growth have been achieved in many different countries and circumstances. Still, some government

spending is frankly wasteful or creates disincentives to produce.<sup>8</sup> These kinds of spending can be cut, and may only be able to be cut in a crisis. "Don't let a good crisis go to waste."<sup>9</sup>

During long periods of fiscal adjustment, it is also good news that much of productivity growth comes from policies that change incentives and do not require large government outlays. For example, in 1980, the Staggers Act deregulated U.S. air, rail and ground transportation and unleashed a 35-year run of productivity-led growth and environmental improvements. U.S. freight railroads are now the most productive in the world and have attracted such astute investors as Warren Buffett (Burlington Northern Santa Fe). The gain in efficiency has also been very green: energy use per freight mile is down 65%, saving 6 billion gallons of fuel per year.<sup>10</sup>

### **A LESSON LEARNED FROM CANADA AND SWEDEN**

A scheme for paying off the public debt without cutting spending, then, is attractive indeed — but is it realistic?

Sexauer and Van Ark argue that it is, with Canada and Sweden having achieved just that in the recent past and the U.S. and the U.K. in the more distant past. Exhibit 1 shows the Canadian example. In the mid-1990s, Canadian public debt reached 70% of GDP, a shocking number for a prosperous peacetime economy with no financial crisis. The first crisis management step was the most important one: The Canadian government resolved to first get its fiscal house in order. There was a two-year pause in the growth of nominal government spending, something that has also been achieved in the U.S. recently (over 2011-2015). The second step was a determination to grow government spending at or below the growth rate of population plus inflation (that is, to keep real *per capita* spending flat or declining), and to do so with the goal of fairness.

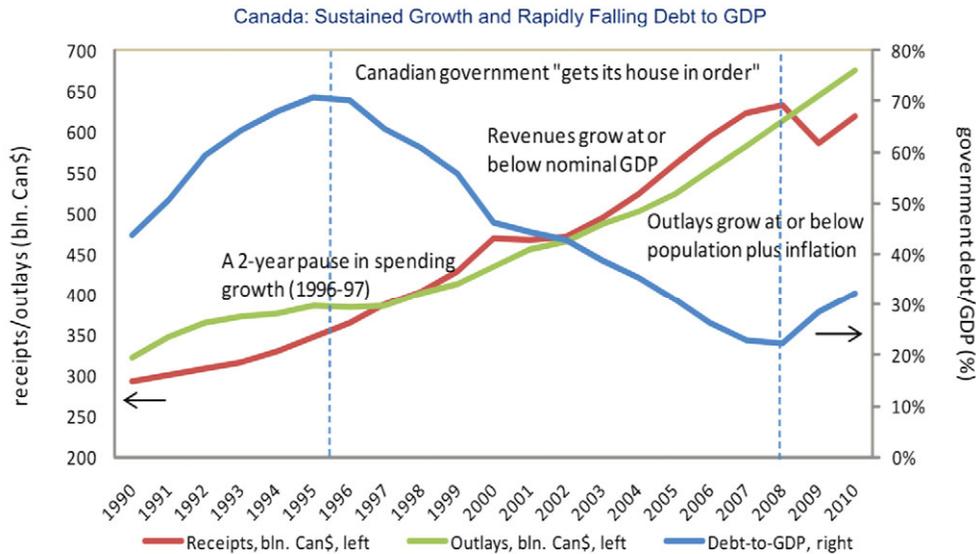
---

<sup>8</sup> See the work of the University of Chicago economics professor Casey Mulligan, who argues that current U.S. policies have already created strong disincentives to work and that these policies are at least partly to blame for the low growth rate since the 2008 crash: <http://caseymulligan.blogspot.com> and <http://www.caseymulligan.com>.

<sup>9</sup> No one knows the exact origin of this quote, but it is frequently used by Chicago Mayor Rahm Emanuel.

<sup>10</sup> Becker, Gary, and Kevin Murphy, "Escaping the Sovereign Debt Crisis," page 14. Conference Board webcast, May 25, 2011.

## EXHIBIT 1



The Canadian results were spectacular. The debt-to-GDP ratio fell from 70% to just over 20% in 13 years! Such is the power of compounding small differentials in growth rates. As a result, when the 2008 recession hit, there was more than enough borrowing capacity. Debt-to-GDP falls quickly under these circumstances because GDP is rising while debt is falling; the ratio is hammered from both ends.

### APPLYING THE CANADIAN LESSON TO THE U.S.

OK, why not here? Some readers may argue that Canada is a special case, a small country with not much of an underclass to support and with mammoth energy reserves. But the U.S. has some advantages that Canada does not: a diversified economy with particular strength in technology, a reserve currency and a higher education system that attracts the world's young elite (if we can keep them). Moreover, the U.S. debt-to-GDP ratio also fell during the late 1990s boom years, although less dramatically than Canada; the U.S. trimmed its ratio by about 10 percentage points.

In fact, this trend is underway in the U.S. We have already experienced a sequestration-driven pause in the growth of (not cuts in) government outlays, and tax revenues are growing faster than expenditures.

The lesson of the Sexauer-Van Ark study is that economic growth covers a lot of sins. We do not know, for certain, how to stimulate rapid growth through policy. The best policies create incentives to invest and innovate, increase our working population (this includes our long history of accepting immigrants of all talents) and grow the money supply at a relatively constant rate. In addition, it's important to keep taxes simple and at a practical minimum, and to encourage free trade.<sup>11</sup>

<sup>11</sup> I am going to stay out of the infrastructure debate. Economic growth would benefit from better infrastructure, but it's not clear how to get that infrastructure without massively overpaying for it and without having infrastructure funds directed mainly on a political rather than an economic basis.

## IMPLICATIONS FOR INVESTORS

This, too, shall pass. The resolution of the current public-debt crisis will in all likelihood be just like the prior crises. There will be various forms of restructuring with big winners, big losers and many muddle-through companies. Then growth will return. All the rules of smart investing will still hold: indexing, value investing, buying and holding for the long run. This time is not different.

Will there be a prolonged 25-year Japan-like stupor? Japan's lost decades occurred because it never got its fiscal house in order and its productivity growth fell to an anemic 1% per year. The odds of this kind of stupor unfolding globally are low, especially in the U.S., much of the rest of the West, and many of the emerging markets. The evidence is that the future will bring, not stagnation, but more reform and more growth (see my *Advisor Perspectives* article, "Two Top Experts Debate the Outlook for Growth"). Billions of smartphone users can now see how others live. They will not stay idle or docile.

## WHAT GOOD ARE LOW INTEREST RATES?

Managed interest rates, or financial repression, create winners and losers on a global scale. They also increase the chances for the next crisis as the imbalances grow year after year.

Investors should be wary of any central-bank strategy that depends on a Phillips curve, the purported relation between inflation and unemployment. The Phillips curve holds that an increase in inflation is stimulative. If this relation works at all, it is only in the short run; in the longer run, the extra inflation causes lenders to demand higher interest rates, restraining economic activity instead of stimulating it. In "The Tooth Fairy Economics of Jeff Madrick," I showed that the Phillips curve is radically unstable over time; policymakers cannot possibly rely on it.

Yet that is what central banks seem to be doing — although they won't acknowledge it. The regime of rock-bottom interest rates is said to be good for us because low lending rates stimulate the economy, although it's hard to see how they do so unless (1) the low rates lead to unexpected inflation and (2) the inflation is stimulative through the agency of a Phillips curve, an unlikely outcome.<sup>12</sup>

---

<sup>12</sup> Without a working Phillips curve, low rates could be stimulative if they allow what business school professors call "positive NPV projects" — profitable business opportunities — to be funded when they would otherwise go unfunded. That is what is meant by easy money, although market monetarists, an increasingly influential group of economists, think we have tight money — that is, tough credit conditions — despite low rates. (For a summary of the market monetarist view, see Scott Sumner's economics blog, <http://www.themoneyillusion.com>; Sumner is a professor at Bentley University in Waltham, MA.) But there is little evidence of such a capital shortage or of unfunded profit opportunities. In fact, there's some evidence of the opposite, a capital glut, too much money chasing too few opportunities in the real economy. A shortage of opportunities can only be fixed through innovation, not through monetary policy.

Meanwhile, low interest rates hurt the economy by lowering the income of savers. It is as though the lost income and spending of savers doesn't count. It's not clear which is stronger, the stimulating effect of low borrowing costs or the chilling effect of a large and covert tax on savers. Beyond a point that we have almost certainly passed, the stimulating effect of low borrowing costs will peter out (as all profitable projects become funded) and the chilling effect becomes dominant.

So, low rates are mostly helpful to governments, by minimizing their borrowing and debt-refinancing costs through a savings tax. Investors should favor countries where low rates are actually being used to reduce debt, rather than to take on more of it. Someday there will be another crisis, and countries with low debt will be tremendously advantaged.

## BONDS

In normal times, investors seek out bond markets where interest rates are expected to move from high to low, producing capital gains; if the rates don't decline, at least you get a high current yield. Countries that are getting out of debt are favored in this strategy. In today's world, however, we have extremely low rates even in highly indebted countries, unless the country is really a basket case (Greece, Argentina); even Spanish and Italian interest rates are below those of the U.S., despite having more public debt.<sup>13</sup> In this environment it probably pays to wait until rates normalize somewhat,<sup>14</sup> and then to invest in countries with *less* debt, because the bonds are safer and the economies have more headroom for growth; the U.S. is the best example.

## STOCKS

There isn't much of a correlation between the finances of a country's government and the performance of the stocks headquartered in that country. As a general rule (with many exceptions), companies are already domiciled where they think they'll be regulated and taxed fairly, and where their target markets are located. A sovereign debt restructuring, including default, distributes the losses between the government, its lenders and the bailout agent. Such an action is typically followed by higher growth, so except for companies tightly linked to domestic spending, look for companies with strong global growth prospects and attractive valuations, even if they're located in countries with stressed public finances. Governments know they are competing for corporate tax dollars, so taxation of mobile, shareholder-focused companies tends not to get out of hand.

To sum up, most countries have not passed any sort of tipping point where an ever-increasing debt-to-GDP ratio becomes a self-fulfilling prophecy. A high level of public debt can be reduced through fiscal prudence and pro-growth economic policies.

---

<sup>13</sup> Spain recently floated a short-term (6-month) bond issue at *negative* rates (-0.002%).

<sup>14</sup> See Leibowitz, Martin L., Anthony Bova, and Stanley Kogelman, "Long-Term Bond Returns under Duration Targeting," *Financial Analysts Journal*, January/February 2014, who argue that the long-run return of a bond portfolio is more heavily influenced by the initial yield than one might think.