

## A Historical Perspective on the Slight Depression

By Robert Huebscher

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Armed with textbooks and formulas, economists attack a problem by drawing lines, forming equations and trying to fit data to the real world. Niall Ferguson, a historian by training, thinks you can learn more simply by analyzing what has already happened. So what's a historian's take on the current crisis? Ferguson says it has yet to run its course.



"They always last much longer than you want them to last," Ferguson told investors last month.

Naming the crisis "the Great Recession," as others have, understates its severity, according to Ferguson. A more appropriate name is the Slight Depression, one which, at least so far, has not reached the proportions its "Great" predecessor.

Ferguson is a British-born professor at the Harvard Business School and author of *The Ascent of Money*, a best-selling book that was turned into a television series. He spoke on April 24 at the Strategic Investment Conference in San Diego. That conference was sponsored by Altegris Investments and Millennium Wave Investments.

"US fiscal policy is on a completely unsustainable course, putting us on a path where we will never have a balanced budget," he said. "That cannot happen."

What will happen? Ferguson said he is optimistic about the US in the long run, particularly about what brought him here from his native Britain – our entrepreneurship, our capacity for technological innovation, and the character of Americans in general.

But we can head in the wrong direction, he said – and that was the focus of his talk.

### Fiscal follies

Misguided fiscal policy has been a constant theme in Ferguson's work, and he used data from the Congressional Budget Office (CBO) to underscore the dangers of deficit spending. The CBO has published two projections – its baseline scenario, where the debt-to-GDP ratio goes to 300% over the next 50 years, and its more conservative-growth scenario, where that ratio rises to 700% over the same period.

"Neither can happen," Ferguson said, calling such outcomes "historical impossibilities."

Either scenario would imply unending trillion-dollar deficits, he said – and never again a balanced budget. "That just can't be right," he said. By 2040, he explained, all tax



revenue would go to pay interest on the national debt, and half of that will be paid to foreigners.

The administration projects a temporary reduction in the deficit over the next several years, but expects it to rise starting in 2013. The problem, which constitutes Ferguson's primary criticism of policy-makers, is that there is "never any plan for fiscal stabilization," and that troubles bond investors.

Ferguson has been critical of economist Paul Krugman on this topic, and the two debated in a highly publicized forum sponsored by the New York Review in April of 2009. Krugman has been a vocal proponent of fiscal stimulus measures to counteract the weak economy. "Only Paul Krugman," Ferguson said, "believes there should be no end to deficits."

The US is becoming a "welfare state," Ferguson said, following a policy experiment that failed the last time it was tried – in Europe. We are headed toward permanently high unemployment, with a generation that will never work. "That is the ultimate destination of a two-term Obama administration," he said.

### **Is there an answer?**

Ferguson offered an alternative plan for generating growth: slash entitlements, reduce marginal tax rates, raise taxes on consumption, and commit to free trade. Only once have such policies been followed, he said – by the United Kingdom after the Napoleonic Wars – and few political leaders today have the guts to suggest such a path, he said. Of course, the UK was helped in its case by the fact it was the world's biggest economy in the midst of an industrial revolution at the time.

And, despite his apprehensions, Ferguson credited current US policies with avoiding an even deeper crisis.

"Why are there no shanty towns in Central Park?" Ferguson asked. During the Great Depression, encampments of the disposed appeared in the center of New York, but Ferguson said he had been there a week before and was confident that none have been built during the current crisis.

He offered two explanations of why we are not in deeper trouble. First, Fed Chairman Ben Bernanke followed the principles of Milton Friedman, undertaking an unprecedented level of quantitative easing. Second, the Obama administration, following the principles of John Maynard Keynes, has turned to fiscal stimuli large enough to create deficits of 10% or more of GDP for two years in a row.

Yet, Ferguson noted, we are still in a monetary contraction with sparse lending. Proposed financial regulatory reform threatens to make matters worse, he said, by requiring banks to have more capital.



The troubles in the US are symptoms of the broader global crisis, and Ferguson presented data from the International Monetary Fund (IMF) showing that, based on debt-to-GDP ratios, the US projects to be among the most indebted countries in the world a decade from now. The IMF ranked countries based on the degree to which they must tighten their budgets in order to stabilize their fiscal position. Heading the list was Japan, which needs to tighten by 13.4%, followed by the UK at 12.8%. Next came three of the “PIIGS,” – Ireland, Portugal and Greece. Ominously close behind, though, was the US at 8.8%.

Ferguson presented data from the Bank for International Settlements (BIS), which reached the same conclusion. That data has been the topic of two recent commentaries by John Mauldin of Millennium Wave Advisors (see [here](#) and [here](#)).

“We sometimes take too parochial a view,” Ferguson said, emphasizing that the crisis has not affected only the US. The position of US, however, is so dire that he said he wanted to title a recent article in the Financial Times “PIIGS-R-US.”

His editors rejected the idea.

### **A bleak outlook**

History shows that nations that become over-indebted follow a predictable course, Ferguson said. They coerce other nations to hold their debt, restrict overseas investments by their citizens, default on commitments to politically weaker countries, and ultimately condemn investors to negative real returns.

All this is a prelude to inflation, and he said the inflation-deflation debate is the “heart of the matter” for investors today. In the short-term, he expects deflation and is fearful of a rise in real (i.e., TIPS) rates, which he said would slow economic growth. Only two extraordinary measures – the purchase of mortgage-backed securities by the Fed and Chinese investments in Treasury bonds – have kept interest rates low, he said.

Both of those restraints on interest rates are now gone. China has explicitly said it does not want to accumulate more dollar-denominated bonds, Ferguson noted, and the Chinese have not bought any directly since October, although they may have bought some indirectly.

“The game ends in a sudden way with a rise on risk premia in US debt, and this is the big problem for Keynesians,” Ferguson said. “Just because it hasn’t happened yet doesn’t mean it won’t happen.”

Therefore, nominal yields should go up, and he endorsed a forecast by Morgan Stanley that the benchmark 10-year rate would be 5.4% at the end of this year. This will be



followed by inflation, consistent with historical patterns, he said, but he did not give a specific timetable.

Don't count on the status of the dollar as the reserve currency to provide protection. All prior countries with reserve currencies – from Spain in the 15<sup>th</sup> century and Denmark in the 16<sup>th</sup> century to the UK, France and Germany more recently – eventually lost that status. "The US is in precisely that position," Ferguson said, adding that China is now positioned as the new hegemon, ready to step up and supply the reserve currency.

Ferguson offered a final historical lesson, based on an [article](#) he recently published in *Foreign Affairs*. As the debts of global leaders grow, one of the first consequences is that discretionary military spending suffers. In the US, defense spending as a percentage of federal revenues has gone down steadily over the last 60 years, and he said we will soon be paying more in interest payments than we do on defense. George Friedman, he noted, had just given a [talk](#) at the conference, where he argued that the US was already in a weak position.

"This is just the beginning of that weakness," Ferguson said.

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