

Lacy Hunt on Debt, Austerity and Recovery

By Robert Huebscher

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Global economies are experiencing unsustainable debt disequilibrium, according to Lacy Hunt. Economic textbooks preach that equilibrium, rather than transition, should be the predominant condition. But our attempts to reduce our indebtedness by taking on more – and less productive – debt are weakening our economy and creating unstable conditions.

Hunt is executive vice president of Texas-based Hoisington Investment Management. He spoke on May 3 at the Strategic Investment Conference in San Diego, hosted by John Mauldin and Altegris Investments.

“If we take on debt, either in the private sector or indirectly in the government sector, to finance current consumption, the net result is that we will make the economy weaker and weaker,” Hunt said. “That is basically the path that we are on.”

Hunt cited several econometric studies to illustrate the pernicious effect of debt on economic growth, and he argued that, historically, austerity has been the most common path to recovery.

Hunt provided articulate and thorough support to those who call for deficit reduction through aggressive cuts in government spending. I’ll present an alternative path to economic growth – one which is at odds with some aspects of Hunt’s. But, first, let’s look at what Hunt said.

The enemy of growth

Our debt is historically high, and it’s impairing our growth, according to Hunt.

US private and public debt – excluding entitlements – is now 360% of GDP, Hunt said. High debt levels were reached three times before and, he said, in all cases the economy suffered as a result.

The first was in the 1820s, when we were building roads and canals beyond the Alleghenies. But we paid a price, according to Hunt – a panic in 1838, followed by slow growth until the Civil War.

The second episode was in the 1860s, when we built the transcontinental railways. Hunt said that most of the government-financed railroads subsequently failed, and four decades of slow economic growth ensued.



Hunt's third example was the debt buildup that began in the 1910s and grew until the debt-to-GDP ratio peaked in 1933. It wasn't until 2003 that the debt-to-GDP ratio exceeded its 1933 peak.

Hunt faulted the Fed to providing excess liquidity to the market in 1920s and again from the late 1990s through 2006. Since 1998, "We have added 100 points to the total debt-to-GDP ratio and yet our typical family is no better off," he said. And how are we trying to solve the problem? By either encouraging the household sector to take on more debt mainly for consumption, or having the government sector take it on and subsidize the private sector."

The eurozone and the United Kingdom have similar challenges, with overall debt-to-GDP ratios of 450% and 470%, respectively, Hunt said.

Japan is the cautionary tale for the US, according to Hunt. In 1989, its debt-to-GDP ratio reached what the US experienced in 2008. Hunt said that, even though the Japanese did everything that Keynes and Friedman would have advised, all that resulted were two lost decades and an increasing level of debt.

Hunt dismissed the possibility that Chinese consumption and economic growth would rescue the global economy. China, in his view, is too is burdened with excess debt, which it has used to fuel investment and consumer spending. But now, Hunt said, "big government loan banks are almost in an insolvent situation."

After the Fed encouraged the massive buildup of debt from 1998 to 2006, "the monetary or fiscal responses mattered only to a very marginal degree. We had to prevent the problem before it occurred."

"At that point in time, we had to suffer the consequences," Hunt said.

The supporting research

Hunt discussed several studies that illustrated the effect of debt on economic growth and the ways in which countries have historically deleveraged.

The first was a [paper](#) by Atif Mian of the University of California Berkeley and Amir Sufi of the University of Chicago. By studying the relationship between household debt and economic growth on a county-by-county basis, they concluded weaknesses in household balance sheets and declining housing prices were the "primary culprit of weak economic recovery."

Hunt cited Reinhart and Rogoff's 2010 paper, [Growth in a Time of Debt](#), which argued that a country's median growth rate falls by 1% once its debt surpasses 90% of its GDP. Along the same lines, he noted a 2011 paper by Stephen G. Cecchetti and two co-authors, [The](#)



[Real Effects of Debt](#), in which they argued that an excess of debt can lead to a “disaster,” impairing a country’s ability to deliver essential services to its citizens.

To understand how countries extract themselves from overleveraged situations, Hunt discussed 2010 [research](#) from the McKinsey Global Institute. That study examined 32 highly indebted countries that faced a financial crisis. In half the cases, those countries underwent austerity programs to reduce their debt.

In the remaining cases, the countries got out of debt through high inflation, default, expanding oil production, or a postwar boom. But those incidents were “relatively rare and occurred in conditions that do not occur today in mature economies,” he said. Moreover, Hunt said that high inflation is tantamount to austerity, in that it penalizes those on fixed incomes.

Hunt said the US recovery from the Great Depression was not the result of deficit spending; he credited a surge in demand for exports of our manufacturing and agricultural products. The savings rate rose for Americans, he said, permitting them to pay off debt and propelling economic recovery.

Hunt said that econometric studies have confirmed that the multiplier on government expenditures is “very close to zero, and in fact might be slightly negative.” He said that is true for the US and for the next five largest economies in the world. Increased government spending might generate short-lived growth lasting a year or so, he said, but it also increases the size of the government sector relative to the private sector, making the economy fundamentally weaker.

Hunt concluded his talk with a quote from the 18th century philosopher David Hume, whose work, he said, sparked the Enlightenment and was studied by scholars including Adam Smith, Emanuel Kant and Albert Einstein. In a 1752 paper, Hume wrote, “When a country has mortgaged all of its future revenues, the state by necessity lapses into tranquility, languor, and impotency.”

An alternative view

Hunt and I agree that reducing our nation’s debt is its greatest challenge, but we disagree as to how that can be achieved.

I am unwilling to dismiss the possibility that the US can grow its way out of its debt, and I am not persuaded by studies such as those by Reinhart and Rogoff, Cecchetti and the McKinsey Global Institute. Those studies use data from a broad cross-section of developed and emerging economies. But it is unwise to infer any implications for a specific country, as Ken Rogoff told me in a conversation I related in a previous [article](#) on this topic.



And it is particularly problematic to apply those studies to the US. Our position is unique because of the dollar's status as the reserve currency. Because all international trade is conducted in dollars, there is an ongoing structural demand for our currency. Indeed, the value of the dollar against a trade-weighted basket of other currencies has strengthened since the onset of the financial crisis. As Europe, Japan and potentially China deal with weakness in their economies, US assets will be the investment of choice, ensuring a strong dollar and low interest rates.

That dynamic cannot continue indefinitely, and we must reduce our debt. But we have time to do so, provided we act wisely. Our government must invest in high-return expenditures, such as those related to infrastructure. That approach has been championed by [Woody Brock](#), who also spoke at the Strategic Investment Conference.

The econometric studies cited by Hunt that have sought to quantify the multiplier on government expenditures have not considered how that money is spent – whether it goes to low-multiplier transfer payments or to high return-on-capital infrastructure improvements. Indeed, Hunt partially acknowledged as much in his talk: “The composition of bank lending is extremely critical, because the composition determines whether or not the additional borrowing is going to generate an income stream,” he said. “We need the loans to be productive.”

I spoke with Hunt after the conference, and we discussed a new paper by Carmen Reinhart, Vincent Reinhart and Ken Rogoff, [Debt Overhangs: Past and Present](#).

Those authors studied 26 episodes, mostly among advanced economies, since the early 1800s where public debt-to-GDP exceeded 90%, and found that the average duration that the debt exceeded that level was approximately 23 years, implying a “massive cumulative output loss.” During those episodes, they found that real interest rates were lower or about the same as compared to lower debt periods. “Those waiting for financial markets to send the warning signal through higher interest rates that government policy will be detrimental to economic performance may be waiting a long time,” they wrote.

Hunt said that this study provides a compelling counterargument to Brock's thesis. But I am less certain of that. Of the 26 episodes the co-authors examined, only two involved countries with the reserve currency (the UK prior to the Industrial Revolution and the US following World War II). In both cases, it was growth – not austerity – that reduced debt levels while real interest rates remained low. The co-authors addressed this issue directly: “Our analysis, based on these cases [the two I noted plus the UK after World War II] and the 23 others we identify, suggests that the long-term risks of high debt are real.” I agree with that conclusion, but it does not imply that Brock's approach is infeasible.

Hunt and I agree that Social Security and Medicare must be reformed as part of our efforts to deleverage. But I disagree with those (not necessarily Hunt) who include the unfunded liabilities from those programs as part of overall US debt, on a par with our Treasury obligations. We can and will default on our entitlement obligations, either through modest



measures such as extending the Social Security retirement age or by more aggressive measures, such as restricting the medical procedures eligible for Medicare coverage (as Paul Krugman advocates). We will not, however, default on our Treasury obligations.

Understanding how the US emerged from the Great Depression is critical, since that is a historical example of how a country with the reserve currency deleveraged. US exports grew, as Hunt said, but there was a much more important structural shift in the economy at work. As Columbia economist Bruce Greenwald has [explained](#), the Great Depression ended because the US work force transitioned from agriculture to manufacturing. Productivity in the agricultural sector had grown much faster than demand, driving the unemployment that prevailed during the Depression. The war effort created manufacturing jobs in the cities, and that shift ended the high unemployment.

We face a similar situation today. Productivity in the manufacturing sector has increased relative to demand, and those jobs are going away. Ultimately, we need infrastructure spending and policies that will create jobs in the faster-growing service-oriented sectors of the economy.

The alternative, which Hunt said has been the historical road to recovery, is austerity. That is a sure path to tranquility, languor, and impotency. The Germans are attempting to impose those measures on Europe, but the US has a better alternative.

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