

A Winning Endgame

By Robert Huebscher

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Reducing our nation's debt burden is no longer only the rallying cry of Tea Partiers and fiscal conservatives. As the debate over the debt ceiling proved, it is now the goal of the president and many fellow Democrats. John Mauldin and Jonathan Tepper's book, *Endgame*, published earlier this year, makes a compelling argument as to why reducing the deficit is so critical and why we face a long, slow and ultimately painful period of deleveraging. I will explain their thesis and then provide the counterargument.

Mauldin writes the weekly newsletter "Thoughts from the Frontline," which claims over a million readers. Tepper is the founder of Variant Perception, a macroeconomic consulting firm.

The next phase of the debt super-cycle

Mauldin's regular readers (of which I am one) will be very familiar with this book's presentation. Its nearly 300 pages can be summed up as follows: Global economic growth benefited from a number of bad choices by policymakers — excessive leverage, financial engineering and, to some degree, lax regulation. But in the 2008 financial crisis, government leveraging replaced consumer leveraging as the most imminent danger. The financial crisis did not trigger a normal business-cycle recession. Instead, we are experiencing a balance-sheet recession, which can be conquered only when governments reduce their debt burdens.

This era of deleveraging will be the next and final phase in a long-term debt supercycle, according to Mauldin and Tepper. The endgame the authors foresee is the crisis of excessive public debt.

The book draws heavily on the work of Carmen Reinhart and Ken Rogoff, authors of *This Time is Different*. They argue that financial crises such as we experienced in 2008 are fairly common and are typically followed by a seven-year-or-longer period of deleveraging and recovery. Reinhart and Rogoff point to the debt-to-GDP ratio as the key metric in assessing the fiscal health of a country and identifying when its debts will become unserviceable.

The debt-to-GDP ratio for the US is nearing 100% – a level Reinhart and Rogoff consider dangerous. Once a country reaches this debt "tipping point" – which has already happened, for example, to Iceland – the capital markets recognize that it can no longer





service its debts. Countries are forced to issue debt at higher interest rates and eventually default.

Greece faces this dilemma now, and its default has been forestalled with additional funding from the European Union. Spain, Portugal and Italy may soon face similar crises.

Mauldin and Tepper state that *This Time is Different* supports one of their main points: “that we have a lot of pain to experience because of the bad choices we have made.”

Default is not the only option for a country facing excessive debt. Mauldin and Tepper offer one other choice, which is inflation. Through currency devaluation or monetary policy (such as quantitative easing), a country can inflate its way out of debt.

Nobody (including the authors) expects the US to default on its debt obligations. But Mauldin and Tepper fear that loose monetary policy will inflict higher inflation, which will burden those with fixed incomes, such as seniors.

“We are left with no good choices,” they write, “only difficult or bad ones. We have created a situation that is going to cause a lot of pain.”

Is there another choice?

Aside from default and inflation, the third option for a government is to grow its way out its debt burden. But Mauldin and Tepper dismiss this possibility. “Real economic growth solves most problems and is the best antidote to high deficits,” they write, “but the problems that we have now won’t be solved by growth. They’re simply too big.”

They write that the US needs the equivalent of the Industrial Revolution to conquer its debt problems, yet they offer no quantitative analysis to support this claim.

Instead, they write that we are “fast approaching” the end of the debt super-cycle, and government spending must be not only brought under control but reduced.

Let’s pause for a moment and consider whether the fear of rising debt-to-GDP ratios is well-justified and whether the US might have the option to grow its way out of its debt burden.

Yale economist Robert Shiller recently [wrote](#) that the debt-to-GDP ratio should not be the key metric in determining a country’s fiscal health. For starters, the ratio does not make mathematical sense. It uses two different units of measurement: debt, which is measured in currency units, and GDP, which is measured in currency per units of time. Depending on how you correct for that mathematical incongruence, countries like Greece can appear downright solvent.



“The fundamental problem that much of the world faces today is that investors are overreacting to debt-to-GDP ratios, fearful of some magic threshold, and demanding fiscal-austerity programs too soon,” Shiller writes.

Moreover, Reinhart and Rogoff present a largely quantitative framework and do not consider important qualitative aspects necessary to recover from a recession triggered by a financial crisis. As Columbia professor Bruce Greenwald pointed out in a 2009 [interview](#), it was not World War II that ended the Great Depression. It was the industrial policy associated with the war effort, which urbanized our population and built our manufacturing sector.

The US (and the rest of the world) faces a problem whose solution has the potential to stimulate growth on par with that seen during the Industrial Revolution and the 1940s. The challenge is to develop an energy policy that will decrease our reliance on fossil fuels. Energy is the greatest challenge we will face in this century, and it is clear that fossil-fuel supplies are limited. Indeed, increased energy costs pose a greater challenge to economic growth than do rising debt-to-GDP ratios.

If you're not convinced that the energy-driven industrial policy can be large enough to drive meaningful economic growth, consider that \$252 billion of the \$498 billion US trade deficit last year came from importing petroleum-related products.

In fairness, Mauldin and Tepper touch on this subject and call for a gas tax as one way to decrease our reliance on foreign oil. But that solution only addresses one use of fossil fuels – gas for automobiles. A more comprehensive approach is needed, such as a cap-and-trade carbon-emission tax that would cover all fossil fuel uses.

Uncertainty over fuel prices is holding back the development of alternative energy sources. A cap-and-trade system would force fossil fuel users to pay the true cost of this energy source. Oil prices would rise, but the system would provide the certainty needed to invest in wind, solar, nuclear and other energy sources. Oil prices are going to rise regardless. The question is whether we continue to put ourselves at the mercy of OPEC or administer those price increases at a time and pace of our choosing.

Had President Obama chosen to make cap-and-trade a priority instead of health care, he might have passed this legislation and laid the framework for an energy-driven industrial revolution. Instead, he is signing off on \$2 trillion in budget cuts as part of the debt-ceiling resolution – a move toward austerity that will stifle economic growth.

We cannot ignore our duty to be fiscally responsible. There is a limit to the debt our nation can service, but it's not at all clear that we are approaching that limit. After all, Japan's debt-to-GDP ratio is over 200%, and it enjoys some of the lowest interest rates of any developed economy. We should not resign ourselves to the long and painful deleveraging endgame that Mauldin and Tepper advocate. Growth is a far better option.



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