Beyond Reinhart and Rogoff

By Robert Huebscher
January 24, 2012

My article two weeks ago, The Misreading of Reinhart and Rogoff, elicited a number of challenges, both from those who argued that excessive debt imperils the growth of the US economy and from those who claimed that my proposed solution was unworkable. Among those challengers was Lacy Hunt, a highly respected economist with Texas-based Hoisington Investment Management, who raised several valid concerns. I will explain why I disagree with Hunt and others, and I will show why a broader view of global trade imbalances, rooted in the dollar's position as the reserve currency, increases the United States' borrowing capacity.

But our ability to borrow cannot be a license to spend unwisely, and I will conclude by expanding on the policy choices the US must pursue.

Hunt is among those who have cited Reinhart and Rogoff's work as evidence that the growth of the US economy will slow, now that its debt exceeds 90% of GDP. When I spoke with him a week ago, he pointed to another study, The Real Effects of Debt, by Stephen Cecchetti, who is an economic adviser and the head of the monetary and economic department at the Bank for International Settlements (BIS), and two co-authors. That study expands on Reinhart and Rogoff's work, but I will explain why its message has little relevance for the US today.

In my article, I argued that the US should pursue a policy similar to that recommended by Woody Brock, consisting primarily of a large-scale investment in infrastructure. I will address Hunt's concerns with those policies, as well as the concerns cited in letters to the Editor last week and this week.

Cecchetti and the Real Effects of Debt

Cecchetti and his co-authors performed an econometric analysis of the debt levels and GDP growth of 18 OECD countries, using data from 1980 to 2010. Their study expanded on Reinhart's and Rogoff's work by considering government, corporate and household debt, whereas Reinhardt and Rogoff considered only government debt. It also used a panel of countries using a method that ensured they were isolating the impact of debt from other known influences on trend growth. Their sample data were also different: The data covered two countries fewer and it started from a later date than did Reinhart's and Rogoff's. Finally, Cecchetti et al used GDP per capita growth rather than GDP growth.

They looked first at the direct relationship between growth and debt, finding that they were uncorrelated. But they expanded their model, at which point they included a number of other variables (gross savings, population, education, demographics, trade barriers,

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inflation, financial market development and banking crises) to help explain the sources of growth. Using this model, they found that government debt improves growth until it reaches 85% of GDP, and beyond that point it is a drag on growth.

In an email exchange, I asked Cecchetti whether the US should benefit from its ability to borrow at real interest rates of less than 1%. He explained that while there should be a two-way relationship between growth and interest rates (i.e., the capital markets will reward a rapidly growing country with lower interest rates and vice versa), his studies didn't find one. But the fact that the studies didn't find one doesn't mean there isn't such a relationship. Hence, it doesn't say the US can't and shouldn't take advantage of the opportunity that appears to be presented by its low borrowing cost.

I also asked Cecchetti whether his study addressed the nature of a country's deficit spending – did those countries that invested in projects with high rates-of-return achieve higher growth? He said that "more research is needed to identify and measure the channels through which higher debt influences trend growth, perhaps using investment or other variables as the dependent variable in place of per capita GDP growth."

Cecchetti was not willing to comment on how his results might apply to a specific country, such as the US.

In fairness to Hunt, he said that research by Reinhart, Rogoff and Cecchetti merely serves to corroborate a great deal of other evidence that points to the dangers of excessive debt. Hunt said that the work of Irving Fischer in the early 20th century and, more recently, studies such as those by Harvard economist Robert Barro have shown the ineffectiveness of government spending. Among other things, that research has shown that the "multiplier" on government spending is negative or, at best, zero.

Cecchetti's study and those of Reinhart and Rogoff explain why many of the peripheral European countries face a sovereign debt crisis. But they have little relevance to conditions in the US. The data used by Cecchetti and his co-authors do not include the high-debt, high-growth era in the US following World War II, which is *prima facie* proof that a country can grow its way out of a high debt level. The UK had a similar experience; in 1815 it had public debt that was 260% of GDP, just before the industrial revolution.

As with the work of Reinhart and Rogoff, the proposition that the US faces a period of slow growth because it its government debt exceeds 85% of its GDP is not supported by Cecchetti's and his co-author's research.

Moreover, Cecchetti, Reinhart and Rogoff do not consider the position of the US as the reserve currency, to which I turn next.

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Beyond Reinhart and Rogoff

To understand the importance of reserve currency status, we must consider the role of the US economy in global trade. An excellent source for this topic is Globalization: The Irrational Fear that Someone in China will Take Your Job, by Bruce Greenwald and Judd Kahn. Martin Wolf has also written about this in *The Financial Times.*

As Greenwald and Kahn explain, the situation the US faces now parallels that of the UK in the 1920s, when the British pound was the reserve currency. Debt issued by other countries was in British pounds, and countries needed to maintain reserves in pounds in order to purchase their own currencies so as to stabilize exchange rates. This was possible because of widespread faith that the British government would issue pounds in reasonable amounts.

As the global economy grew, countries had to hold increasing amounts of British currency to address trade imbalances and to keep their own currencies from fluctuating too widely. The only way for a country to do this was to export more to Britain than it imported, and thus to run a growing trade surplus.

As the US does today, Britain had a trade deficit to the rest of the world and, because the pound was the generally accepted currency, its chronic trade deficit was sustainable. While having the reserve currency had its benefits, it also created a problem. Because it ran a trade deficit, British domestic income was increasingly spent on foreign-produced products. This created a situation where Britain had to produce more goods than it consumed domestically. These deflationary conditions reduced domestic prices, slowing growth and creating unemployment. The US faced an analogous situation, as the automotive industry lost market share to foreign producers. This created a downward pressure on car prices and led to bankruptcies in the industry. Indeed, as Greenwald and Kahn explain, Britain experienced mass unemployment in the late 1920s, well before the Great Depression.

While there are significant differences, Britain's situation then mirrors that of the US today – we have a growing current account deficit, slow growth, high unemployment and the threat of deflation.

Britain could not devalue the pound, because its trading partners – the surplus countries – had the upper hand. Surplus countries could create as much of their local currencies as necessary, in order to purchase pounds and devalue their own currencies. Then as now, the surplus countries were in the driver's seat, which explains why the value of China's currency is 47% lower than it was in 1990. Its currency should have appreciated, given its trade surplus. Japan, the Asian "tigers," Germany and the oil-exporting countries in the Middle East have all devalued their respective currencies, to varying degrees, over time.

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Today, the surplus countries have few choices other than investing their dollars in low-yielding US Treasury securities. A country like China cannot reduce its trade surplus by reducing exports without incurring a severe recession; its domestic consumption cannot pick up the slack. Nor can it purchase assets in another currency, such as the euro, instead of dollars. Doing so would increase the value of the euro, which would be unacceptable to the EU, especially Germany. The ECB would move to lower the value of the euro, bringing it back in line with the renminbi and the dollar.

As Greenwald and Kahn observe, the surplus countries must “accumulate growing amounts of low-yielding dollar-denominated assets, or do an about-face on their international trade policy, stop protecting their domestic producers, become net importers, and suffer the economic and political consequences they have been working so hard to avoid.”

The US cannot devalue the dollar to eliminate its deficit, because those efforts would be offset by competitive devaluations by the surplus countries. This is why the trade-weighted exchange rate of the dollar has not changed appreciably since the financial crisis, despite two rounds of quantitative easing. Likewise, any attempt by the US to impose trade barriers would be met by offsetting measures in the surplus countries.

Greenwald and Kahn point out that the US faces no danger of failing to meet interest payments on its foreign debt. Using their reasoning with today’s numbers (their book was written in 2008), the US has a current account deficit of approximately $500 billion, which is at most the amount that is added annually to our overseas debt. That is about 3.5% of our GDP. Generously assuming we borrow at a real interest rate of 1%, the cost of financing a year’s current account deficit is 1% of 3.5% – or 0.035% – of GDP. But productivity growth of 3% to 4% per year, not to mention population growth, adds more than 25 times those interest costs to our GDP, in perpetuity.

Check my numbers. I am certain that there is a team of analysts at the People’s Bank of China who did so, as a prerequisite to lending us as much money as they have.

At some point, our debt level will be intolerable. For now, though, the bond markets are telling us (as Martin Wolf argued in his column on September 6 of last year) that we can and should borrow. This analysis has several policy implications, which I turn to now.

Policy implications

In my previous article, I argued that the US should follow the advice of Woody Brock, who has called for bold stimulus measures directed to infrastructure improvements. Brock has argued for “good-deficit” spending limited to projects that would generate market-competitive rates-of-return; he does not support deficit spending on low-return “bridges to nowhere.”

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Hunt told me that Brock's plan isn't feasible, since there aren't enough opportunities for good-deficit spending. As entitlement spending has risen, the portion of our budget directed to discretionary spending has shrunk, according to Hunt, and is now at its lowest percent since the 1970s.

"There is nothing in the good category left," Hunt said.

Of the $3.6 trillion the government spends annually, Hunt said approximately 60% comes from taxes and the remaining amount from borrowing. In Europe, those percentages are reversed, and he said that is where we are heading.

But Brock's plan should not be viewed as a way to reallocate our existing discretionary expenses. Instead, it should be new expenditures, of necessity funded through borrowing. The program must be sufficiently bold to stimulate the economy. A $1 trillion initiative could add as much as 7% to our $14.5 trillion GDP, and because our economy requires 3.5% growth just to maintain full employment, a response of that magnitude is needed. Our economic growth was less than 2% in 2011, and it will be even less this year if Europe goes into recession. Unemployment will grow as a result.

Brock has called for a "Marshall Plan" of stimulus measures, similar to what helped Western Europe and Japan rebuild after World War II. Brock is correct to call for a measure this bold, but the Marshall Plan is a poor example. It turns out that there was little correlation between the amount of Marshall Plan money spent by individual countries and their respective growth rates after World War II.

To ensure that money is spent effectively, Brock has called for an independent board, staffed by highly-paid non-government analysts, free from political influence. The board's role would be to objectively evaluate proposed projects on a risk-adjusted basis, and to rank them based on their present value contribution to the economy. Those with the greatest present value would be funded, and those below a certain threshold would not.

Like Hunt, I am skeptical that there are sufficient opportunities for investment on the scale that Brock advocates, which is why I propose that we target the energy sector. Approximately half of our trade deficit is attributable to oil imports, so energy is clearly a big enough candidate. Alternative energy sources, such as wind and solar, are currently economically impractical because of the uncertainty of oil prices. Our government's efforts thus far, through Solyndra-like loan guarantees and ethanol-like subsides, have merely resulted in a misallocation of billions of dollars.

The economically correct way to compare alternative energy generation to carbon-based fuel consumption is through a cap-and-trade policy, a proposal that drew criticism in the letters to the editor. Cap-and-trade is a system whereby producers of carbon-based fuel pay market-based fees to compensate for the cost of what economists call "externalities." Those externalities include pollution and the potential for global warming. One does not

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need to accept the inevitability of global warming in order to justify its cost as an externality; you only need to accept that it is a possibility and that we have only one opportunity to take reasonable steps to deal with it.

Cap-and-trade has been supported, at times, by both political parties. It can be implemented gradually to avoid sudden price increases. The end result will be more certainty and less volatility in oil prices, and an environment that will foster the development of economically justified alternative energy sources.

If you don't believe that Brock's recommendations are correct, consider the alternative, which is retrenchment and austerity. That is a path to failure. The problem now is that our discourse does not in any way reflect on the debate between good and bad deficits. Brock has just come out with a book on this topic, *American Gridlock,* which I will review in an upcoming issue.

Don't believe the misguided but all-too-familiar rhetoric that says the US missed its opportunity to grow out of its debt problem and now faces only a series of bad choices. The bad choice is to continue on the path we are on, which will result in a decade or more of high unemployment. As Martin Wolf has written, we should do what the bond market is telling us: borrow and spend, but spend wisely.

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