

Lacy Hunt on the Roadblock to Recovery

By Robert Huebscher

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I spoke with Hunt on January 26.

I would like to begin with your overall assessment of the state of the economy. You've [written](#) that the US will enter a recession in 2012. Has anything changed to alter that view?

I don't have any change in our view. We're still expecting a mild recession in the one-half to 1% range. Actually, that is a very significant development. It doesn't seem like one, but when you are operating at such a low levels of capacity – personal income less transfer payments is a half a trillion dollars below its cyclical peak and industrial production is substantially below its old high – a small decline is an extremely unwelcome development.

The main problem for us in this downturn is our export sector. Exports accounted for about 45% of the cumulative gain in GDP. Since the end of the recession in mid-2009, exports were growing at about 10% per annum. Consumer spending was only growing at 2% per annum. So it was a miserable recovery, but what recovery we had was due to exports.

The principal determinant of export growth is foreign income, or the level of economic activity overseas. The price considerations are another factor, but they are only one fourth or one fifth as powerful as the income effects.

By price considerations, do you mean the relative value of the currencies?

Yes, and that suggests our exports will erode this year. That process has already started, and there are a number of indicators that support that view.

Another problem is that last year we had a gain in GDP, but we didn't have an increase in prosperity. GDP measures spending. Prosperity is determined by income. Disposable income declined for 11 months in 2011, and in per capita terms there was an even larger decline. In addition, when you have an uptick in inflation, such as we did over the first three



quarters of 2011, the typical response of the American household is to maintain their standard of living, and hope that inflation goes away.

So what families did is they hit the credit cards particularly hard in the second half of the year. Over the course of the year they drew the saving rate down from close to 6% to 3.5%, which took us back to where we were when the recession started – a very unsalutary development. In addition, real consumer net worth, which is derived from the flow-of-funds account, was negative year-over-year. Every time that that's happened it's been consistent with a recession.

Another problematic area is capital spending. I know there is a lot of optimism, because capital spending had a very good year in 2011. But a lot of that strength was probably related to the 100% accelerated depreciation. This gimmick has been tried many times over the years. What firms do when there is a transitory tax cut like this, and what individuals do in response to any type of transitory stimulus is they look ahead and try to anticipate their future needs. They pull them forward, and then when the stimulus goes away, the spending drops. We've seen this happen with capital spending, cash for clunkers, and incentives for first-time homebuyers.

We will see a decline in capital spending this year, because this year you only get 50% accelerated depreciation.

If you were to focus on the goal of full employment, how long will that take given our current policy direction?

I don't really think that is achievable given the current policy mix.

Are we in an equilibrium that is going to keep us in the 8.5% range, or is it going to get worse?

It will deteriorate to some extent, but mainly we will have an extended period of severe unemployment. We just don't have the right types of policies. The country is extremely over-indebted. That is our main underlying problem. We are not going to cure our indebtedness problem by taking on more debt.

I don't see the right mix of fiscal policies. I don't see that monetary policy is constructive either. So there isn't any material way to achieve full employment with the current mix of policies.

The US faces an important choice with respect to fiscal policy: Whether to prioritize deficit reduction or to prioritize investment in initiatives such as new infrastructure which would entail increasing the deficit. Let's put entitlement reform aside for now and agree that there is significant reform that is necessary to correct those



programs. If we look at the non-entitlement portion of the budget, what is the proper way to frame the debate?

One of the reasons that we are in this difficulty is that we have always put aside entitlements. We knew it was a high-speed freight train. Now we are in the situation where 10,000 people a day for the next 10 years will reach full-eligibility age for Social Security and Medicare, and then it is going to go up. Of course the theory in the past was that we could always postpone confronting entitlements, because the situation had to get better. Something would come along and ameliorate the situation in with regard to the fiscal strains in the country.

We took the postponement route. We now have a situation where Federal outlays, which include expenditures for goods and services, and entitlements are 25% of GDP. The last three years have been the highest for any three-year period since 1943-1945 when we were in a world war.

There are calculations, including one done by the very esteemed economist Barry Eichengreen, a Yale PhD at the University of California, Berkeley, showing that in 25 years federal outlays are going to jump to 40% of GDP. Well, we are not going to be able to transfer another 15% of the economy into entitlements.

We have always lacked the political will to deal with entitlements, because promises have been made that cannot be kept. We shouldn't put it off.

I agree. What is the appropriate fiscal policy today?

It is clear that higher levels of debt, whether it is public or private, debilitate us. It does not increase our options. It does not make us stronger; it makes us weaker.

The problem for fiscal policy is, number one, that we are too heavily indebted. Our gross debt is about 100% of our GDP – and by the way, gross debt is an understatement of the commitments that we've made. The present value of the unfunded liabilities in Social Security and Medicare are \$59 trillion. The other unfunded liabilities are four times our GDP. We have too much debt, an economy that is under-performing, and our standard of living has fallen back to where it was in the mid- to the late-1990s.

Clearly, the stresses and strains of this policy are evident.

To get ourselves out of the problem, we have to address the debt level. We don't have the situation that John Kennedy faced in the early 1960s, or Ronald Reagan faced in the early 1980s, where there was just a problem of insufficient growth, and you could cut the marginal tax rates and take on some additional debt, and the economy would respond to it. We don't have that option, because the debt level is too high.



What do we know about the three fiscal policy spheres of action? We have to think about them separately. One is the level of government expenditures. The second is the so-called tax expenditures, which is the technical term for the “loopholes.” The third component is the marginal tax rates.

We need to cut government spending. But we are not going to be able to do that by itself, because the country is generally of the view that there has to be shared sacrifice. In other words, you cannot simply expect the current recipients of government spending to shoulder all the blame. There will have to be a shared sacrifice with the taxpayers.

In this regard, we have two options. One is the tax expenditures; the other the marginal tax rates.

We know that from some very substantial econometric research that when marginal tax rates are changed they have a multiplier between -2 and -3. In other words, if you raise the marginal tax rate by a dollar, after about three years you will lower the GDP between two and three dollars.

We don't have econometric estimates on the tax-expenditure multiplier. But we do know that in 1986 when a revenue-neutral tax bill was pushed through Congress with bipartisan support – Bill Bradley leading for the Democrats and Ronald Ragan in the White House at the time – we eliminated a lot of loopholes and cut the marginal tax rates. Over the next five- to 10-year period the economy accelerated. Clearly, the tax rate multipliers are stronger than the tax expenditure multiplier.

The government expenditure multiplier is at best zero and more probably slightly negative. If you reduce government spending over time, although you will impair economic activity over the short run, at the end of three years you will actually raise the level of economic activity. You will reduce the government's share and you will increase private share.

If you eliminate tax loopholes there will be some drag on economic activity, but if at the same time you cut the marginal tax rates, you can adopt a policy that will be pro-growth and addresses the budget deficit.

You can do this by instituting a value-added tax of 5% or 6% which is absolutely necessary in my opinion, so that we can start reducing the debt and preparing for the avalanche of expenditures that are going to occur from the demographic tidal wave that faces us.

The key policy options that you would prioritize are closing loopholes, implementing a value-added tax, and reducing government spending by cutting marginal tax rates.

Yes. You've got to reduce marginal rates a little bit. That is the key.



Reductions in the loopholes should be very extensive. Let the private sector decide how it wants to allocate the capital, not the federal government. We want a policy in which everybody has skin in the game. That is why we need a value-added tax.

We are not going to be able to meet the Social Security and Medicare obligations without it. But you want to encourage incentive and hard work. Tax the things that have hurt us, like overspending, and leave our income untaxed.

Encourage that which contributes to society, and discourage that which hurts society.

Can't the entitlement programs be addressed in other ways, for example, by extending the retirement age for Social Security, or by changing the way that benefits are indexed, or in the case of Medicare, by means-testing the benefits?

Absolutely, they can. There will be law changes, and Barry Eichengreen agrees with me. The problem is that there is a lack of political will to address those issues. For example, taking away benefits, whether you call it means-testing or taxation of those earning more than \$200,000, doesn't produce a lot of saving. We don't have that many retired people that are earning \$200,000 or more.

One the thing that you could do, and we should do, but will create all kinds of political repercussions, is to eliminate the early retirement for Social Security, which is at age 62. Full eligibility age is four years later. That solves some significant near-term problems, because if people stay in the work force then they contribute to Social Security for four more years and then they don't get the benefit. But even that won't solve the problem.

Your question is well put. We have to increase the full eligibility age, and we have to eliminate the cost-of-living escalator. It is just not conceivable that we are going to try to extract a huge tax on our working-age generation and transfer those resources to retired people.

It is already happening. We gave Social Security recipients a 3.6% cost-of-living increase. But only a small percent of our working age population has a cost-of-living escalator. The average wage earner last year had a 1.8% increase in earnings, but we gave Social Security recipients twice that much.

That it's not a situation that is justifiable or that can continue.

Especially since the expenditure basket for retired people is different from what is used to calculate the CPI.

Yes. We want to energize and not overburden our working-age generation, because it is they on whom we are counting to lead the economy forward.



Let me add one more point regarding the so-called discretionary components of the budget. We are going to find out that defense spending is discretionary, and that trend has already started. Defense is going to be cut more than people believe, and I for one suspect that we have probably fought our last discretionary war. The country is too poor to be engaged in another discretionary war. Defense spending will be cut along with everything else.

Discretionary items have already been cut down from 14% of GDP in the 1970s to 10% today. There could be further cuts. But that is not going to be very much, and in that 10% are a lot of programs that are necessary – for example, our highways, and bridges, and our infrastructure – and some of the things that could be contributive to growth longer term.

Another element that is in the budget picture – one which no one really wants to address – is what could happen to the interest expense. Right now, it is 10% of our revenues. If market interest rates – a quarter of a percent for the two-year, and then less than 2% for the 10-year, and so forth – hold at these levels through 2030, which is a formidable assumption, the interest expense will reach 20% of revenues by the end of this decade. It will be 35% of revenues in 2030.

The wild card is that could exacerbate. I don't expect a rise in interest rates over the near term, but knowing where interest rates are going to go is a difficult business, as we all know. You've got a Damocles' sword hanging out there in addition to very negative demographic factors.

You have cited Irving Fisher in your quarterly letter. Fisher wrote in 1932 that “balancing the budget by reducing expenditures for many useful services, and by extracting larger revenue from reduced income, is deflationary.” That assessment is reminiscent of the policy that you've described. Fisher also said that spending money on public works would be “least beneficial way to cure the depression.” He went on to say that he thought that balancing the budget would be impossible for Franklin Roosevelt during the Depression, and that “the effort to do so has defeated itself by being deflationary.” How are those writings relevant today?

From 1933 onward, especially 1935 to 1937 and toward the end of the decade, Fisher changed his mind about fiscal policies a great deal. In the 1933 article on debt-deflation he held out the hope that deficit spending might help to deal with an extremely over-indebted situation. But in a series of letters to FDR it became clear that Fisher had reversed that view. He felt that the deficit spending was counterproductive.

He also made it very clear in those writings that one of the most destructive elements of FDR's fiscal program was the substantial increases in the marginal tax rates and the corporate tax rates. Fisher was operating under the assumption that there was a fairly negative multiplier on marginal tax rates. He viewed them as a very destructive to the level of prosperity and very harmful to wealth creation.



I think that Fisher's views apply today.

We want to cut the government spending; something Fisher felt was not productive. He didn't address the issue of the tax expenditures, which were not an issue at that time, but we want to try to keep the marginal tax rates down. Fisher, by the way, was in favor of the taxation of sales. He was totally opposed to corporate taxation.

We want sales rather than income taxes. We want the lowest marginal tax rates that we possibly can. We want the least amount of taxes on our corporate sector, which is the key to job creation.

Let's turn to Woody Brock's approach. He has argued for infrastructure spending funded through an infrastructure bank operated independently without political influence. How do you view the trade-off between deficits and investing in things such as infrastructure? What is your critique of that approach?

First of all, that proposal is flying in the face of a lot of econometric evidence that indicates that government's expenditure multiplier is zero to slightly negative. We have those findings in the United States and overseas. The Italian economist, Roberto Perotti, did work at the European Central Bank and found that the government expenditure multiplier was close to zero not only in the United States, but in the UK, Germany, Australia, Canada, and Japan.

Let's say you start with a \$15 trillion economy, with 20% from government and 80% from the private sector, and you shock it with defense spending. You get a transitory lift to GDP. But, depending upon the initial conditions, that transitory lift only lasts for three to five quarters. At the end of that lift, within 12 quarters you revert to where you were. So if you start with \$15 trillion, you end up with \$15 trillion except you increase the government's share of GDP. You reduce the private share, and you have a higher level of debt. The private sector – not the government sector – has to generate the resources for the higher level of debt.

You have another problem, which is the point at which the markets say to a government, "I'm not going to lend to you at all." We don't have that problem in the United States today. We borrowed about 40% of what we spent last year, and we had tax revenues for the other 60%. But there is a lot of evidence, what's going on in currently in some cases in Europe, that over the long sweep of history that when governments start to borrow 50% or more, sometimes a little bit less than 50%, you get to the point at which the source of additional borrowing is denied.

You hit Reinhart and Rogoff's "bang point."



But Brock is advocating something that is very different from anything that has been tried in any of the countries that Perotti studied. Brock is advocating a venture capital fund to finance projects that would be transitioned to the private sector and that would generate market-competitive rates-of-return. Does that change the analysis when you look at it in terms of multipliers?

Well, all I can tell you is what work has been done. Robert Barro at Harvard calculated the government expenditure multipliers by year. He found that the highest year was in 1942, and the multiplier was 0.6. The second highest multiplier year was in 1943, and it fell to 0.4. Those were the two years in which we had the largest increase in government spending – and of course it was defense spending – in our history. Even in those two years the multiplier remained less than one.

If Woody's view is correct, then he should produce evidence that indicates that the multiplier would be different than what we know it to be. Also, there is the issue of where the funds come from, and what in the private sector is displaced by the activity.

There is another point, which I intend as a well-meaning suggestion, since we are obviously all struggling for suggestions in the current environment. We have to recognize that the fundamental key to prosperity is not governmental financial transactions, or even private sector financial transactions. The key to prosperity is the hard work and creativity of our individuals in businesses. That is how we are going to produce prosperity.

That will be achieved by the broad set of priorities I outlined earlier. You want to tax what you don't want – spending. You want to keep it simple; sales taxes are simple. You want to tax income, but keep it relatively limited, with no deductions. Let the private sector allocate, and you want to do it in the context of not further increasing governmental indebtedness.

If Woody's project entails a further buildup of indebtedness, it would be counterproductive.

I want to come back to the reasons why our growth slows as our deficit increases. That is something I have [written](#) about, as you know. With real interest rates below 1%, will our ability to meet our interest payment obligations be called into question? Or is it really the threat of public borrowing that will crowd out the private sector?

It's really not possible to look at conditions at any one time. You've got to undertake statistical tests, and you've got to try to examine the world *ceteris paribus* [all else being equal]. Current market rates of interest are very low, and we assume there is no crowding out. But we don't really know that, because we are operating in the world described by the Latin phrase *mutatis mutandis* [the necessary changes have been made]. The econometric studies have shown that when there is deficit spending, it raises the specter of future tax increases, and it causes a displacement of the available credit from the government sector to the private sector.



No one can say for sure what was displaced or how the specter of higher tax increases affects the current level of economic activity. But the evidence is quite clear that we have not benefited from deficit spending.

There was a letter from Fisher to FDR in which he made it very, very clear that the deficit spending had been counterproductive. I am afraid that is true in the current situation as well.

I want to touch on monetary policy. The Fed announced that it will keep rates low for another three years. Going back to Fisher, he is reported to have urged FDR to suspend the gold standard in 1933 and to expand monetary supply. Does that same advice to apply today, or have we exhausted all monetary policy options, and are therefore left with only fiscal policy tools to reinvigorate the economy?

You are absolutely correct. Fisher did advocate to FDR to suspend the gold standard, and in fact, FDR took that recommendation. But we have to keep that in context. There had been a series of devaluations dating back to the late 1920s, starting with the Dutch East Indies, and then Australia, and then the British devalued. In the early 1930s, when the British devalued, virtually everybody who had previously devalued did so again.

When a country devalued, it generally went back on the gold standard. The US was holding the gold peg, which meant that those repeated rounds of devaluation were, in conjunction with falling income, destroying our export base. Fisher was aware that this process of repeated rounds of devaluation against gold, which meant the dollar, had been harmful to us, and had been a cause of the Great Depression.

But Fisher's recommendation was given in the context of the gold standard. We devalued the dollar by about 60% between April of 1933 and January of 1934. That helped us to recover some of our export markets. We were fortunate because the mentality of the gold exchange standard – although wobbly – was still intact, and even though other countries immediately started losing markets to us, they tried to defend their pegs because they felt it was their obligation to do so. The US benefited from that until France and the gold-block countries devalued in 1937 and 1938. Then we lost those benefits and the economy relapsed.

Fisher's recommendation of going off the gold standard was appropriate given the fact that others had done that to us. Today, we have floating exchange rates, so that is really not an option.

With regard to the money supply, you have to remember the situation with which Fisher was dealing. When he was making those recommendations, the money supply was declining very sharply. From the 1929 high to the 1933 low, the money supply fell by a third. I'm not talking about a 30% rate-of-decline. I'm talking about an absolute fall from \$100 billion to \$65 billion or so.



What Fisher said – and he was very explicit on this point, especially in his book *100% Money* – was that he didn't want the money supply to fluctuate. He didn't want it in the hands of the bankers. He felt that the deposit-taking function should be segregated from the lending function. He did not want inflation or deflation. He did not want accelerating or falling money supply.

Fisher would not be supportive of what is going on today, because that is not consistent with his view expressed in *100% Money*.

Fisher was a very caring individual, which is hard to understand, because he didn't see the Great Depression coming and he took a lot of heat for that. But he wanted to prevent that from happening again and that is why he wrote the book in 1935. He worked very hard to promote the idea, but there were objections to it.

Minsky and Kindleberger agreed with Fisher, in that we would again have an excessive buildup of debt. They tweaked Fisher's recommendations. Minsky said that what we've got to keep the banks small. He was aware that Fisher couldn't achieve 100% Money. Fisher made that recommendation in the context of trying to prevent a one-third decline in the total stock of money in a three- to four-year period.

I want to ask about the special position of the dollar as the reserve currency. One view is that the dollar's position as the reserve country naturally leads to a strong currency, as the demand for dollars by the countries that are running surpluses grows over time. But, as a consequence, it keeps our economy on a deflationary path. Is that consistent with your own view? And if so, what are the policies that can counteract that dynamic?

The fact that we have been a reserve currency has, over time, produced a lower level of interest rates than we would have otherwise, if we had not been a reserve currency.

We will lose the reserve currency status as we approach the "bang point" – the point at which the market says that we are trying to borrow too large of a percentage of our federal budget deficit. But I don't think that that's at hand.

John Cochrane at the University of Chicago has done some very interesting and significant work on this matter. Cochrane says if you can look at any sort of income-producing asset and ask, "What is it worth?" Well, the market value of an income-producing asset has to equal the future stream of revenues discounted by some appropriate interest rate. The present value of the stream of future earnings must equal the market value of that asset.

Let's take that analysis and ask, "What is going to determine the current value of our bonds?" It's got to be equal to the discounted present value of our stream of future surpluses – the difference between federal revenues and federal taxes.



By the way, Cochrane includes not only the bonds outstanding, but also the bonds being held by the Federal Reserve, because that is an additional governmental entity.

At the point in time that the marketplace loses confidence that there will be a stream of future surpluses, our country will lose control of the discount rate. It will not matter what fiscal policy does, or what monetary policy does; the discount rate will escalate very dramatically.

We are seeing that happen in Europe. That will happen in the United States. That is why our ultimate priority at the present time is to begin bringing down the deficit and the debt levels. If we cannot do that, then the United States is on a path toward instability. I don't think instability occurs now or even in the next two or three years, but timing on these matters is always difficult to pinpoint.

But it is clearly our future if we cannot contain the federal deficits.

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