The Direction of the Compromise

By John Mauldin | September 15, 2012

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> "How did you go bankrupt?"
> "Two ways. Gradually, then suddenly."
> – Ernest Hemingway, *The Sun Also Rises*

We are often told that the current election is the most important in recent history. I think I have heard that in about ten presidential cycles, ever since I first voted, for McGovern, as a young man. And looking back, only about one of those elections actually qualified on that score. I think this election does have the potential to be one of those rare times, at least in terms of economic outcomes. In Thoughts from the Frontline we cover economics and investments, money and finance. We only rarely stray into the political world, and then only glancingly. Today, we cross that gray line, but at a somewhat different angle, as we look at the economic consequences of the political decision that will come with the choices we make in November in the US.

But it is not as simple as suggesting that choosing one party over the other will solve the nation's economic ills. If that were the case, we would not be facing the momentous challenge we now do, because both parties have had firm control of the levers of power in recent years, and both have failed to deal with what has become, at least for this economic analyst, the burning issue of the day. Indeed, both have made it worse. Today we look at what the choices are and the impacts of those choices.

The Economic Consequences of a Political Decision

The preview of economic consequences depends on your view of what the most important issues are that need to be decided (in terms of economics). Let me list my top ten.

1. The Deficit
2. The Deficit
3. The Deficit
4. The Deficit
5. The Deficit

6-10. Everything Else

I am only being mildly flippant. How we deal with the deficit affects everything else. And not dealing with the deficit leads to a disaster of biblical proportions, the equivalent of all eight of the first eight plagues. Ask Greece or Spain.

It is easy to dismiss the deficit as something that has always been there. Haven't Chicken Littles been telling us the deficit sky is falling for decades? Japan seems to be capable of running large deficits, and we are nowhere near their level of debt. Isn't "Japanese Disease" the worst outcome we are looking at – a slow-growth world that, while frustrating, is not cataclysmic? And some have been calling for even larger deficits in the name of spurring economic growth and jobs, harking back to periods when the government did indeed run deficits and the economy seemed to respond and once again grew.

It is easy to dismiss deficits as something we can deal with later. Like Hemingway's character, who when asked "How did you go bankrupt?" replied, "Two Ways. Gradually, then suddenly."

For most times, deficits are indeed not a problem. Many families and companies and governments run losses and borrow money to keep from having to curb their lifestyles and programs. It is not actually the immediate deficit that is the issue, but the total debt. If debt is low and cash flow is good, then deficits can be a good thing. Debt that is invested in income-producing assets or infrastructure that makes a family or business or nation work more efficiently can be beneficial.

It is when the total debt becomes too large that servicing that debt becomes an issue. And that is when the lenders first ask for more collateral or higher interest and then, if the debt is not brought under control, they stop lending. For a nation, its bond market simply collapses.

In a book that we have looked to many times, ***This Time Is Different***, Ken Rogoff and Carmen Reinhart detail over 200 instances where nations had a credit crisis. One of their main points is that nations seem to be able to borrow money right up until what they call the "Bang Moment" happens, and the bond market no longer functions. Right up until that moment, proponents of ever more debt argue that "this time is different," but it never is.

In the opening line of *Anna Karenina* Leo *Tolstoy* says, "Happy families are all alike; every unhappy family is unhappy in *its own way*." And governments and nations that get into debt problems get into them in their own way, as well. Spain, we are told, is not Greece. And it certainly is not. Spain created a completely different route to its own debt crisis than did Greece . And France, which will argue that it is neither Greece nor Spain (nor Italy nor Portugal, etc.), will find that if it does not quickly adjust its finances (and it certainly appears to be in massive denial), it will devise yet another way to have a full-blown debt crisis, with the bond vigilantes at her door.

It is a process I describe in *Endgame.* Much of Europe faces a debt crisis. It will not end happily. Spain and Greece have falleninto what can only be described as a depression. Much of the rest of Europe is either in recession or at the tipping point, and a slip into a full-blown, continent-wide depression is quite possible, for reasons we have explored in previous letters. Simply,

Southern Europe (along with Ireland) borrowed too much money (for different reasons), all European banks leveraged themselves too much (with the blessings of the regulators), and the Europeans created massive internal trade imbalances.

It is impossible to balance out a fiscal deficit while running a massive trade deficit, especially if there is capital flight. And a fall in currency prices, which is the normal balancing mechanism for a trade deficit, is not available to Greece, Spain et al. as long as they remain in the eurozone. This leaves a very large shift in labor costs as the only way to rebalance, and that solution cannot come quickly in the peripheral countries, without politically impossible structural reforms. The eurozone has no good choices. No matter what they (as a collective Europe and as individual countries) choose, it will mean years of extreme economic hardship.

Japan, as I am wont to say, is a bug in search of a windshield. They have transmuted the savings of two generations into the largest debt ever for a country that I am aware of (in terms of GDP). It is now approaching 220% and rising at a prodigious pace, about 10% in 2011. They have gone from a savings rate of 16% to around 1%, largely due to an aging population that is now living off its savings.

When that savings rates goes negative, and it is a demographic certainty that it will, Japan will either be forced to pay higher interest rates or print massive amounts of yen or cut government spending by equally massive amounts. All of those options are ugly in the short term. If interest rates rose by a mere 2% for Japan, they would be spending more than 70% of their budget on just interest expense within a few years. That is *not* a workable business model. Today, we can't get into the election later this month in Japan, but it will be an important one.

American Exceptionalism

The US deficit (held by the public) is now over 72% of GDP and rising.

> "Egan-Jones Ratings Co. said Friday [September 14] it downgraded its U.S. sovereign rating to AA- from AA on concerns that the Fed's new round of quantitative easing, or QE3, will hurt the U.S. economy. The ratings agency said the Fed's plan of buying $40 billion in mortgage-backed securities a month and keeping interest rates near zero does little to raise GDP, reduces the value of the dollar, and raises the price of commodities. 'From 2006 to present, the US's debt to GDP rose from 66% to 104% and will probably rise to 110% a year from today under current circumstances; the annual budget deficit is 8%,' Egan-Jones said in a note. 'In comparison, Spain has a debt to GDP of 68.5% and an annual budget deficit of 8.5%.'" (MarketWatch)

(For what it's worth, I don't count the "Social Security Trust Fund" as debt, as it is an accounting fiction. It does not exist except on a fictional balance sheet, thus I see the debt as less than Egan-Jones does, but they are correct about the deficit.)

There is no set debt-to-GDP ratio at which point a nation loses its ability to borrow money at reasonable rates. For Russia it was 12% in 1998. Japan, as noted above, is at 220% (the exact figure is somewhat up for debate, but this is close enough). Spain lost access without major ECB

intervention at less than 68%. Italy is at 120% and has seen its rates rise to levels that cannot be sustained.

At some point, if a nation does not get its debt and deficit under control, it will lose access to the bond market at reasonable rates. There have been no exceptions. There is a point at which the bond market begins to worry about the ability of a nation to repay its debt with a currency that is now worth less than when the money was lent, and then interest rates begin to climb.

There is no reason to think the US will be an exception to that rule. That is not what is meant by American exceptionalism.

Why do I think the deficit is such an issue? What makes me concerned that we can't wait another four years until the US loses access to a low-interest bond market? Would that really be a disaster?

First, in a world without Europe or Japan, the US could probably go out to the latter part of this decade running large deficits. We have the world's reserve currency, we are the major superpower, the engine of free markets, etc.

But I think Europe is likely to hit a real wall by the end of 2013 or the middle of 2014, if not sooner. Ditto for Japan. I am afraid that the bond marketeers will look at their losses in Europe and Japan and tell the US government something like this:

"We have already watched the movies about European and Japanese debt. Those did not have happy endings. The US debt movie seems to be based on the same script; so if you don't mind, since we know how this ends, we are going to slip out during intermission."

In my opinion, the deficit needs to be dealt with in 2013. If we wait until 2014, we will be in the middle of another election. As we will discuss below, solving the deficit is going to involve politically unpopular compromises for either or both parties. While I am optimistic that something can be done in 2013, I am cynical enough to think that 2014 is much more politically problematic.

By 2015 the debt will be well above 90% of GDP. As outlined in previous letters, there is increasing evidence that when the debt of a country grows to 90%, GDP slows by about 1%, which of course makes it harder to grow your way out of debt.

Interest rates start to rise as a result, and that makes it harder to balance the budget. Yes, I know, the Fed can hold rates down and print money; but printing money in quantity is not a strategy designed to bolster bond market confidence in the value of the dollar.

Not only the research of Rogoff and Reinhart, but numerous other studies also point out that when confidence goes, it is a fairly quick process. It is indeed the ***Bang!*** moment.

If rates start to creep up, perhaps Congress will be forced to do something. But at that point, it will be time for higher taxes and deeper cuts than any of us can now imagine. The longer things go on as they are, the worse the final result and restructuring will be.

We have often been told that borrowing money creates a problem for our children. And that is true. But it is also creating a problem for this generation in the here and now.

Much of Europe and Japan are going to fall into a depression as a result of their unwillingness to deal with the deficits and the structural issues they face. 25% unemployment is an ugly, ugly reality that is spreading across Southern Europe. Japan will face its own version of a debt crisis, and I think the result will be significant inflation in its import prices and a drop in the living standards of its elderly.

Perhaps I am wrong and the US can go on for another four years before we reach our own ***Bang!*** moment. Things can sometimes go on for longer than we think, for reasons we (or at least I) do not understand. But waiting longer certainly will not make it any easier. Entitlement programs are steadily getting into worse shape, and interest costs will be another $80 billion a year for the additional debt we will take on (my back-of-the-napkin estimate – you can make your own). Trying to solve the problem four years from now will require decisions even more difficult than those we have to make now.

The Cost of Dealing with the Deficit

Let's be clear. For reasons I have written about at length, there is a significant cost to cutting the deficit. It will impact current-year GDP. I certainly would not advocate balancing the budget all at once or even in a few years. I would suggest cutting by no more than 1% of GDP per year, or about $150 billion a year. Even that little will produce growth headwinds.

Tax cuts or increases have an impact on the economy. Quoting from *Forbes:*

"A powerful analysis by President Barack Obama's first Chair of his Council of Economic Advisers (CEA) indicates the President's proposed tax increases would kill the economic recovery and throw nearly 1 million Americans out of work. Those are the extraordinary implications of academic research by Christina D. Romer, who chaired the CEA from January 28, 2009 – September 3, 2010. In a paper entitled "The Macrcoeconomic Effects of Tax Changes," published by the prestigious *American Economic Review* in June 2010 (*during her tenure at the White House*), she stated: 'In short, tax increases appear to have a very large, sustained, and highly significant negative impact on output.'

"The AER paper, co-authored with her husband and fellow UC Berkeley Professor, David H. Romer, examines the impact of tax increases and reductions on U.S. economic growth for the period 1945 to 2007. One of the innovations in the paper is its focus on 'exogenous' changes in taxes, that is changes in taxes that were meant to either increase the rate of economic growth (not simply offset a recession), such as the Kennedy, Reagan and Bush tax cuts, or to reduce the budget deficit, such as the Clinton tax increase. Excluded were 'endogenous' tax changes that were purely countercyclical, such as the 1975 tax rebates, or were used to 'offset another factor that would tend to move output growth away from normal', such as the tax increases to finance the Korean war and the introduction of the payroll tax to finance Medicare.

"The Romers' baseline estimate suggests that a tax increase of 1% of GDP (about $160 billion in today's economy) reduces real GDP by 3% over the next 10 quarters. In addition, the Romers used a variety of statistical tests to take into account other factors that could influence economic growth at the time of the tax changes, including government spending, monetary policy, the relative price of oil, and even whether the President was a Democrat or Republican (it doesn't matter much). A summary of the statistical work estimates that a tax increase of 1% of GDP would lead to a fall in output of 2.2% to 3.6% over the next 10 quarters.

"'In all cases, the effect of tax changes on output remains large and highly statistically significant,' they write.

"'Thus the finding that tax changes have substantial impacts on output appears to be very durable. That including controls for known output shocks has little effect on the estimated impact of tax changes is important indirect evidence that our new measure of fiscal shocks is not correlated with other factors affecting output.'

"'The behavior of output following these more exogenous changes indicates that tax increases are highly contractionary. The effects are strongly significant, highly robust, and much larger than those obtained using broader measures of tax changes.'"

Forbes *goes on to say that "*In his 2013 budget, President Obama proposes $103 billion in 2013 tax increases, including $83 billion of higher income taxes on those who make more than $250,000 a year, or about 0.65% of GDP. Using the Romer baseline estimate, that would reduce real GDP by 2 percentage points over the next 10 quarters. Based on the general relationship between economic growth and unemployment, such a fall in output implies a loss of more than 800,000 jobs."

(Note: There are those who disagree, often vigorously, with the conclusions of the paper, but offer no counter-data that I am aware of. Romer resigned less than two months after publishing the paper.)

Basic economic accounting and academic research suggest that cutting spending will also have a contractionary effect on GDP for about 4-5 quarters. But if you cut 1% a year for 5 years, then you have reduced potential GDP by 1% year for those 5 years, which does *not* help job growth.

Of course, if the US loses access to low-cost bonds, that will be a disaster that even worse for jobs. We face either a difficult situation or a disastrous one. That is the nature of the Endgame, when the Debt Supercycle is in its final throes. There are no easy choices. Right now the US merely has some very difficult choices. If we put those off much longer, we will be faced with the disastrous choices of Europe.

Which Candidate's Plan Solves the Deficit?

I am not going to go into detail about how to balance the budget over time in this letter. There are numerous ways to get there. Simpson-Bowles (the presidential debt commission) is one

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path. It gets rid of many of the so-called tax expenditures and actually reduces the top rate by 24% and raises more taxes.

I would prefer to get rid of almost all tax deductions, except the earned-income tax credit, and end up with a lower top rate. The large majority of tax deductions favor those with higher income, anyway. If I really got my wish, there would be some type of consumption tax (like a VAT) and much lower income taxes across the board, and perhaps we'd even get rid of the Social Security tax as part of the deal, which would clearly help lower-income citizens. For what it's worth, consumption taxes have less of a negative impact on the economy than income taxes.

Neither the Romney proposed budget nor the budget Obama submitted to Congress (and that did not get even one positive vote from his own party) is politically doable, and both have serious problems in dealing with the deficit.

To get to a real budget solution is going to take a compromise, which means some combination of spending cuts and tax increases. It must deal with entitlements and health care. In one sense, the election is about how much health care we want and how we want to pay for it. Everything else is "easy" after that.

I have talked with lots of Congressmen, Senators, and their staffers in the past few years, from both parties. They all get that something must be done, and my sense is that they will do something after this election. The consequences of doing nothing would be disastrous, especially given the "fiscal cliff." Facing such a scenario, I think Congress will act.

The question then becomes, what is the nature of this compromise? And that, gentle reader, will be the real economic effect of this election.

We are voting about the direction of the compromise. Pure and simple.

One path will mean a larger government and budget, and the other a (relatively) smaller government, although I can see no path to a truly smaller government in terms of tax burden, unless we decide we want a lot less health care, which I do not see anyone predicting or advocating.

A "sweep" by either party would be a game changer, but that does not seem likely, according to any poll I am looking at today.

As we saw last week, in research I cited from Europe, there is a correlation between government size and GDP growth. Which makes sense, in that jobs really come from the private sector. Government jobs depend on taxes, which come from the private sector. Please note that this is not the same as saying that we should get rid of all government costs to increase economic efficiency – that is clearly not true. But we should recognize the costs of government spending and taxing of the private sector.

It will come as no surprise that I favor the smaller-government version. But I hope that while we are on the way to compromise we will completely overhaul the tax code, simplifying the

process and lowering overall rates while eliminating most tax deductions. And perhaps getting rid of *all* special corporate tax deductions, while lowering the rate to 15% on US income and 10% on foreign income. That would mean the very large corporations that shelter income by various means and domiciles would pay taxes just like local businesses. We could drop the rates that low and still collect more taxes and really boost our economic competitiveness.

If we balance the budget over time (say 5-6 years) and lower tax rates, while eliminating special deductions and tax expenditures (and I say, get rid of almost everything!), and drill more oil and gas so we can start exporting energy, I will become a raging bull, and not too far in the future. In such a scenario, the future of the United States would be better and brighter than ever. It is the one I want for my kids.

And if we don't act responsibly? Then we need to get ready to batten down the hatches, because if it going to be an exceedingly rough storm. I think we'll know by the middle of next year. And yes, I know our choices will mean radically different investment environments ahead, but that is why this election makes such a difference. It really is about avoiding a depression.

In the very near future, I am going to post for the public two interviews I did along these lines, one with Newt Gingrich and the other with Erskine Bowles. I think you will find both very interesting.

If you feel the way I do about the need to balance the budget, you might want to sign the "Citizen's Petition To Fix The Debt" The petition can be found at www.fixthedebt.org.

While I prefer the smaller-government path, the more important thing is to balance the budget. As businessmen, we can deal with reality. I prefer one where I have more left over to save and invest in growing my business, but I will cope. To not get serious about the budget and the debt is a sure path to disaster. Let's all tell our Congressmen and Senators to work together to get the job done.

Chicago, Atlanta, New York, and Scandinavia

I am off to Chicago on September 19, presenting at the RDA Financial Network Investor Forum, from 6:00 to 7:30 PM. The Forum will be held at the Chicago Marriott Oak Brook. This event is sponsored by Steve Blumenthal and my friends at CMG. If you would like to attend, please email Linda Cianci at Linda@cmgwealth.com.

And I'm speaking October 1 in New York at the 8th Annual Value Investing Congress. I'll be joined by many really smart speakers, including Bill Ackman and David Einhorn. I've been able to secure a "friends and family" discount, if you'd like to join me there: $1,500 off the regular price to attend. To take advantage of these savings, ***register by September 7th*** at www.ValueInvestingCongress.com/Mauldin with discount code **N12JM.**

And what fun, I get to go to Scandinavia for three days next January.

It is time to hit the send button. Next week I will report on the Casey conference and come

bodacious people I met in Palo Alto.

Have a great week. And think about your choices. Especially if you are one of the 97 people in Florida that have not made up your minds. They are spending something like $150,000 a vote on you. Sigh.

Your never gonna run again for anything analyst,

John Mauldin

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