

# Hoisington

INVESTMENT MANAGEMENT COMPANY

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## Quarterly Review and Outlook

First Quarter 2010

### Contradictory Fiscal Policy

The federal government cannot create prosperity by spending funds that it does not have. It can, however, spend us into poverty by taking dollar balances from highly productive individuals and their business entities, through borrowing or taxing. This process of transferring these assets from income and wealth generators to other government applications has profound economic consequences.

Economists from David Ricardo (1772-1823) to John Maynard Keynes (1883 to 1946) to present day scholars have theorized about what this massive transfer of resources from the private to public sector does to overall economic conditions. Our read of history, economic theory, and mathematics leads us to one clear conclusion. The “taking” of funds by central governments to be redistributed to other priorities is, in the end, contractionary.

Viscerally, the normal reaction to a massive increase in government spending is to assume it is an inflationary event, particularly in the U.S. where amounts have been so large over the past ten years

(Chart 1). Has this huge spending shift from 18.4% of GDP in 2000 to 24.7% today made the U.S. more prosperous? The results are unequivocal. Inflation today is 1.3% versus 1.7% ten years ago (core PCE deflator.) The percent of the population working today is 58.6% while prior to the large budget deficit spending of the last ten years it was 64.6%. Our GDP was growing at 4.8% ten years ago, and today we are staggering out of recession.

History displays the same pattern in other countries where excessive government deficits have been implemented. The modern example is Japan. Its government debt soared from 52% of GDP in 1989 to 184% today (Chart 2). The economic results: GDP in that country is no higher than it was 18 years ago; its employment is no higher than it was 19 years ago, and there is no inflation since consumer prices are at 1993 levels.

Thus, contrary to conventional wisdom, monumental government spending produced less growth, and lowered both standards of living and inflation. Why does this occur, and will the prospective budget deficits change that history? The

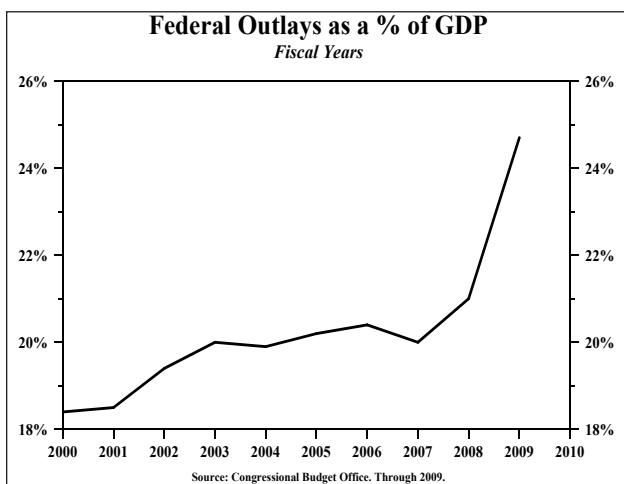


Chart 1

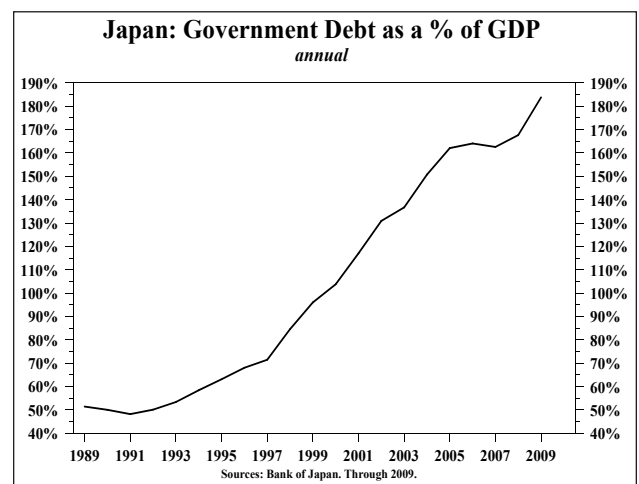


Chart 2

answer boils down to the application of mathematics to economic theory.

Ricardo initially spelled out the role of fiscal policy influences on economic activity in what is termed “Ricardian equivalence.” He was a seminal thinker who also originated the concepts of “comparative advantage” and “diminishing returns.” The point of Ricardian equivalence is that it doesn’t matter whether governments fund expenditures by taxing or borrowing. Either way resources are shifted from the private sector to the government sector. Thus, an increase in government spending does not increase the economic pie (real GDP); it merely shifts the distribution of the pie, with the government taking more and the private sector having less.

In his book, General Theory of Employment, Interest and Money, published in 1936, Keynes rejected Ricardo, arguing that deficit spending could increase economic activity. Keynes views have been taught to economics students for most of the past five decades. Importantly, neither Ricardo nor Keynes could know whether their views were right or wrong given the mathematical and statistical technology and data availability of the day.

### Contemporary Econometric Research

Now there is credible research employing sophisticated econometric techniques that confirms that Ricardo, not Keynes, is correct. The Harvard economist Robert Barro, from whom the term “Barro Ricardian Equivalence” has risen, as well as the Italian econometrician Roberto Perotti have found that the government expenditure multiplier is very close to zero. A zero government expenditure multiplier means that deficit spending only provides a transitory boost to the economy. Deficit spending initially raises GDP, but then the effect dissipates and later is reversed as the financial resources available to the private sector are reduced. The econometric calculations indicate that each \$1 increase in government expenditure will, over time, reduce private expenditures by \$1. The distribution of the pie is impacted, i.e., government is larger and the private sector is smaller, but its overall size is not affected, just as stated in Ricardo’s equivalence theorem.

### Spending Multipliers

While there is credible evidence that during the post-Korean War era the expenditure multiplier was zero, other research has produced slightly different results. For instance, during the extraordinary conditions of World War II and the Korean War the multiplier has been calculated as .6, meaning that a \$1 rise in government spending would lift the economy as a whole by 60 cents while reducing private spending by 40 cents.

Valerie A Ramey, Professor of Economics at the University of California at Berkeley has found that the expenditure multiplier is in a range of 0.6 to 1.1, or an average of .85. Once again this suggests some boost to overall economic activity from government spending at the expense of the private sector. The estimates of the multipliers vary due to different sample periods and other technical considerations. The objective is to identify the effects of government spending on economic activity while over time a host of other influences are also at work. The center of the estimates of the spending multiplier, however, is less than one, while the center of estimates for the tax multiplier, our next topic, is greater than one. Consequently, economic conditions will ultimately deteriorate in response to the current fiscal policy mix.

### Tax Multipliers

There is no free lunch when the government is spending. Taxes have to rise. Beginning January 1, 2011 the sizeable tax reductions enacted in 2001 and 2002 will expire. The administration projects that household taxes will rise by a cumulative \$1.1 trillion over the ensuing ten year period, while business taxes will rise by \$400 billion. This calculation was prior to any taxes enacted in the healthcare bill, and does not account for other taxes such as the recently mentioned value added tax suggested by administration policy advisors. Dr. Barro estimates that the tax multiplier is minus 1.1, meaning that a \$1 increase in taxes will reduce GDP by \$1.10. However, Christina Romer, Chair of the Council of Economic Advisors and her husband David in an exhaustive study published in March 2007 found the tax multiplier to be -3.

If we apply these two multiplier estimates to the repeal of the 2001 and 2003 tax cuts, the drag on economic activity will be between \$1.65 trillion and \$4.5 trillion. Bottom line, if the spending multiplier is .6 and the tax multiplier is at least 1.1 or higher, then mathematically this country cannot spend its way to prosperity.

## History

The multiplier analysis is also confirmed by numerous experiences in U.S. economic history. On the positive side, the major tax reductions initiated by President Kennedy in the early 1960s gave economic activity a major boost, just as did the similar reductions by President Reagan in the 1980s. To deal with the depression that arose after World War I, President Harding cut taxes and government spending, keeping the federal budget in balance. The 1920 depression ended quickly and prosperity returned. Tax increases by Presidents Hoover and Roosevelt in the 1930s had a negative impact on growth.

## Fiscal Policy: The Net Effect

History therefore suggests that cutting taxes tends to boost GDP while raising taxes has the opposite effect. Economic theory suggests that increased government spending can boost economic activity for a time, but the additional borrowing and subsequent tax increases reverse that short-term boost, resulting in lower total output for the economy. The mathematics of these two variables, spending and taxes, suggest the inevitability of a contractionary outcome if there is a massive shift in funds from the private to the public sector.

## Monetary Conditions and the Economy

Milton Friedman gave us a modern theory of interest rate determination that has stood the test of time. This theory was first outlined in his December 1967 Presidential address to the American Economic Association and published in the *American Economic Review* of March 1968.

The essence of this theory is that monetary accelerations lead to higher interest rates while

monetary decelerations lead to lower interest rates. This startled those who held the opposing view. Friedman is taking into consideration the second, third and ultimate round effects, necessary in evaluating both monetary and fiscal actions.

Friedman's breakthrough was a synthesis of previous scholarly work by earlier economists, most notably the Swedish economist Knut Wicksell, the Austrian Eugen von Bohm Bawerk and Irving Fisher. Friedman conceptualized interest rates as being linked to monetary growth over the course of time through what he termed the liquidity, income and price (or Fisher) effects. Friedman's "liquidity effect" was consistent with mainstream economics, but his "income and Fisher effects" extended the liquidity effect to its ultimate conclusion.

Friedman wrote, "The initial impact of increasing the quantity of money at a faster rate than it has been increasing is to make interest rates lower for a time than they would otherwise have been. But this is only the beginning of the process, not the end."

This first round impact is referred to as the "liquidity effect." The more rapid rate of monetary growth will stimulate income and spending, which will serve to reverse the initial downward pressure on interest rates. To quote Friedman, "Rising income will raise the liquidity preference schedule and the demand for loans; it may also raise prices, which would reduce the real quantity of money." These effects serve to reduce the downward pressure on interest rates. After a longer interval, interest rates return to the level they otherwise would have been. This may be termed the "income effect."

The final step in this process is termed the "Fisher effect." To quote Friedman "Let the higher rate of monetary growth produce rising prices, and let the public come to expect that prices will continue to rise. Borrowers will then be willing to pay and lenders will then demand higher interest rates—as Irving Fisher pointed out decades ago."

## Applying Friedman's Theory

Using this theory, what is happening in the U.S., and what does it mean for long-term interest rates?

Money growth is decelerating sharply. Thus, the line sequence runs in the opposite direction, or in Friedman’s own words: “Paradoxically, the monetary authority could assure low nominal rates of interest. However, to do so it would have to start out in what seems the opposite direction by engaging in a deflationary monetary policy.” Friedman states that a deflationary monetary policy is one where the rate of growth in the quantity of money is decreasing, which is the situation at hand (Chart 3). The current 1.4% annual growth rate in M2 is miniscule compared with the 6.6% annual average growth rate since 1900. Similar slowdowns have occurred in MZM and the Austrian money supply.

Friedman’s interest rate theory strongly indicates that the growth in GDP experienced since the third quarter of 2009 is transitory. In other words, the reduction in money growth will reduce spending, income, and the price level. If this monetary deceleration is sustained it will give rise to deflationary expectations. Such developments will produce lower Treasury bond yields.

**Decelerating Monetary Growth**

While counterintuitive, the deceleration in the money supply measures should not be surprising. As we have discussed previously, Fisher outlined the rationale almost 80 years ago. In extremely overleveraged economies, monetary policy doesn’t work. Potential borrowers do not have the balance sheet capacity to take on more debt.

Currently, borrowers are loaded with excess houses, office buildings, retail space, and plant capacity. No need exists to get even deeper in debt. Moreover, due to rising foreclosures and delinquencies, bank capital has been badly eroded and banks are not in a position to put more risk onto their balance sheets by lending to already over committed borrowers.

Also, to the extent that borrowers and lenders manage to increase leverage further, the benefits to the economy are fleeting, only serving to make the economy more vulnerable to economic deterioration and possibly systemic risk in the future.

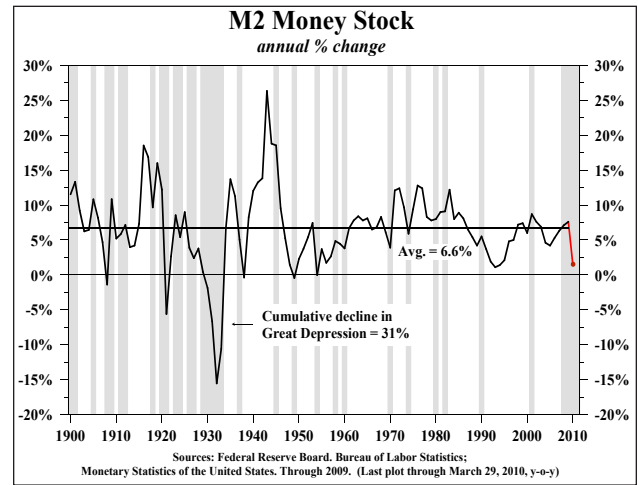


Chart 3

**Behavioral Economics**

Another major development in interest rate theory was the cofounding of behavioral economics in the late 1970s by Richard Thaler and Daniel Kahneman. Kahneman won the Nobel Prize in economics in 2002. In the compelling analysis of behavioral economics, markets are determined over the short-run by a host of psychological and transitory conditions, including but not limited to, heuristics, or various rules of thumb, to guide trading practices. However, in behavioral economics, the fundamentals apply over time to market prices. This confirms the analysis of both Fisher and Friedman, at the end of the day. That is, lower inflation leads to lower interest rates.

**Treasury Bonds**

With excessive levels of debt and contractionary monetary and fiscal policies in place, inflation will continue to moderate, thereby driving long term treasury yields lower. The path to lower rates will not be smooth as volatility will arise from heavy sales of U.S. government debt and occasional transitory improvements in economic activity. However, patient investors will be significantly rewarded.

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