Debt, Growth, and the Austerity Debate

John Mauldin | April 30, 2013

Two weeks ago I wrote about the current debate over the 2010 paper by Ken Rogoff and Carmen Reinhart (hereinafter referred to as RR) on the correlation between debt and GDP growth. I said that the most important part of their work, which is the construction of an enormous database on debt and financial crises over the last few hundred years, was to be found in their book *This Time Is Different* and elsewhere. And their fundamental conclusion: debt is not a problem until it becomes one. And then it reaches a critical mass and you have what they called the ***Bang!*** moment.

They did make an unfortunate error in a few cells of a massive Excel spreadsheet, which subsequent analysis has shown to not be a huge deal, though some have made it out to be. And the more I read of the issue, the more I believe that the bulk of the negative response has political overtones. There are those who wish to find reasons to abandon any move toward balanced budgets and reasonable fiscal policies. They see austerity as a punishment, some type of masochistic conservative Calvinist plot foisted on poor unsuspecting citizens who should not be held responsible for the governments they elect.

As I wrote two weeks ago, austerity is a consequence, not a punishment.

Last Thursday RR published an op-ed in the *New York Times*. Some were uncharitably dismissive of it, but if you take a careful look at the detailed online version, which is this week's Outside the Box, I think you'll find their counterarguments thorough and reasonable.

An essay on Bloomberg notes:

> The biggest howler is the least consequential. By highlighting the wrong cells in an Excel spreadsheet, Reinhart and Rogoff actually took an average over 15 countries, rather than the full sample of 20. Embarrassing? Yes. Important? No. Of the five missing countries, only one – Belgium – had ever experienced very high debt**. Adding it barely changed the findings because Belgium's economic growth during its high-debt episode was roughly similar to that in other highly indebted nations.**
> [emphasis mine]

While the media loves to focus on the simple (and regrettable) coding error (which RR acknowledge), the main body of their analysis still points strongly in the same direction, and that direction has been noted by other, independent researchers:

> Researchers at the Bank of International Settlements and the International Monetary Fund have weighed in with their own independent work. The World Economic Outlook published last October by the International Monetary Fund devoted an entire chapter to debt and growth. The most recent update to that outlook, released in April, states: "Much of the empirical work on debt overhangs seeks to identify the 'overhang threshold' beyond which the correlation between debt and growth becomes negative. The results are broadly similar: above a threshold of about 95 percent of G.D.P., a 10 percent increase in the ratio of debt to G.D.P. is identified with a decline in annual growth of about 0.15 to 0.20 percent per year." (NYT)

In fact, when you examine the paper and underlying research of the University of Massachusetts trio who discovered and wrote about the error, you find that there is not all that much difference in outcomes if you use their assumptions. The best analysis I have read is in this piece by F. F. Wiley (even if he misspells my name in his links <g>). For those wanting even more detail on this issue, I suggest you read the Wiley piece *after* you read RR's response below.

Economics, at least in its predictive and prescriptive forms, is not a physical science, notwithstanding the physics envy of many economists. To try and suggest that major policy differences should be formed on the basis of numbers to the right of the decimal point is folly. It is enough at times to get the direction right. North rather than south. With regard to the present debate, it is clear that a point can be reached at which too much debt is a problem. Is there a bright, unchanging line? This far and no farther? There is not.

Water transmutes from solid to liquid to gas. In physics and mathematics, limits, and indeed singularities, occur; and we can measure and even predict them. With debt-to-GDP ratios, all we know for now is that the ***Bang!*** moment exists, but the precise point for any one given country is not something we can calculate. But wherever that line happens to fall, once it is crossed, ***Bang!*** Everything changes. And dear gods, that is a fate to be avoided.

This is far more than an academic tempest in a teapot. Understanding the relationship between debt and systemic financial problems is critical to how you construct your long-term portfolio positions. If there is not a relationship between debt and growth, then quantitative easing will have an entirely different effect on markets than if there is. It is really that simple. Can we point to exact figures and immutable relationships? Of course not. Nothing in life is that simple, and RR don't even attempt to do so, although some of their critics (and to be fair, some of their supporters) try to see bright red lines around the 90% debt-to-GDP number.

I write this note from La Jolla, looking over the Pacific Ocean. I will have dinner with Jon Sundt and the partners at Altegris at George's later this evening and then move on to Carlsbad, where I will meet tomorrow with my partners and team at Mauldin Economics. The bulk of the team will be in this week for a two-day planning fest before we celebrate our 10th annual Strategic Investment Conference, starting Wednesday evening. I also have writing and reading and a brand-new speech to attend to. And I want to be there for all the speaking sessions. There will also be lots of late-night conversations with great friends on a very wide range of topics, from QE to biotech to geopolitics and all sorts of politically incorrect notions. Can it get any better?

It is about time to get to that next meeting. I hope your week is going well.

Your about as excited as I can get when I think about this week analyst,

John Mauldin, Editor
Outside the Box

Debt, Growth, and the Austerity Debate

By CARMEN M. REINHART and KENNETH S. ROGOFF
The New York Times, April 25, 2013

In May 2010, we published an academic paper, "Growth in a Time of Debt." Its main finding, drawing on data from 44 countries over 200 years, was that in both rich and developing countries, high levels of government debt – specifically, gross public debt equaling 90 percent or more of the nation's annual economic output – was associated with notably lower rates of growth.

Given debates occurring across the industrialized world, from Washington to London to Brussels to Tokyo, about the best way to recover from the Great Recession, that paper, along with other research we have published, has frequently been cited – and, often, exaggerated or misrepresented – by politicians, commentators and activists across the political spectrum.

Last week, three economists at the University of Massachusetts, Amherst, released a paper criticizing our findings. They correctly identified a spreadsheet coding error that led us to miscalculate the growth rates of highly indebted countries since World War II. But they also accused us of "serious errors" stemming from "selective exclusion" of relevant data and "unconventional weighting" of statistics – charges that we vehemently dispute. (In an online-only appendix accompanying this essay, we explain the methodological and technical issues that are in dispute.)

Our research, and even our credentials and integrity, have been furiously attacked in newspapers and on television. Each of us has received hate-filled, even threatening, e-mail messages, some of them blaming us for layoffs of public employees, cutbacks in government services and tax increases. As career academic economists (our only senior public service has been in the research department at the International Monetary Fund) we find these attacks a sad commentary on the politicization of social science research. But our feelings are not what's important here.

The authors of the paper released last week – Thomas Herndon, Michael Ash and Robert Pollin – say our "findings have served as an intellectual bulwark in support of austerity politics" and urge policy makers to "reassess the austerity agenda itself in both Europe and the United States."

A sober reassessment of austerity is the responsible course for policy makers, but not for the reasons these authors suggest. Their conclusions are less dramatic than they would have you believe. Our 2010 paper found that, over the long term, growth is about 1 percentage point lower when debt is 90 percent or more of gross domestic product. The University of Massachusetts researchers do not overturn this fundamental finding, which several researchers have elaborated upon.

The academic literature on debt and growth has for some time been focused on identifying causality. Does high debt merely reflect weaker tax revenues and slower growth? Or does high debt undermine growth?

Our view has always been that causality runs in both directions, and that there is no rule that applies across all times and places. In a paper published last year with Vincent R. Reinhart, we looked at virtually all episodes of sustained high debt in the advanced economies since 1800. Nowhere did we assert that 90 percent was a magic threshold that transforms outcomes, as conservative politicians have suggested.

We did find that episodes of high debt (90 percent or more) were rare, long and costly. There were just 26 cases where the ratio of debt to G.D.P. exceeded 90 percent for five years or more; the average high-debt spell was 23 years. In 23 of the 26 cases, average growth was slower during the high-debt period than in periods of lower debt levels. Indeed, economies grew at an average annual rate of roughly 3.5 percent, when the ratio was under 90 percent, but at only a 2.3 percent rate, on average, at higher relative debt levels.

(In 2012, the ratio of debt to gross domestic product was 106 percent in the United States, 82 percent in Germany and 90 percent in Britain – in Japan, the figure is 238 percent, but Japan is somewhat exceptional because its debt is held almost entirely by domestic residents and it is a creditor to the rest of the world.)

The fact that high-debt episodes last so long suggests that they are not, as some liberal economists contend, simply a matter of downturns in the business cycle.

In “This Time Is Different,” our 2009 history of financial crises over eight centuries, we found that when sovereign debt reached unsustainable levels, so did the cost of borrowing, if it was even possible at all. The current situation confronting Italy and Greece, whose debts date from the early 1990s, long before the 2007-8 global financial crisis, support this view.

The politically charged discussion, especially sharp in the past week or so, has falsely equated our finding of a negative association between debt and growth with an unambiguous call for austerity.

We agree that growth is an elusive goal at times of high debt. We know that cutting spending and raising taxes is tough in a slow-growth economy with persistent unemployment. Austerity seldom works without structural reforms – for example, changes in taxes, regulations and labor market policies – and if poorly designed, can disproportionately hit the poor and middle class. Our consistent advice has been to avoid withdrawing fiscal stimulus too quickly, a position identical to that of most mainstream economists.

In some cases, we have favored more radical proposals, including debt restructuring (a polite term for partial default) of public and private debts. Such restructurings helped deal with the debt buildup during World War I and the Depression. We have long favored write-downs of sovereign debt and senior bank debt in the European periphery (Greece, Portugal, Ireland, Spain) to unlock growth.

In the United States, we support reducing mortgage principal on homes that are underwater (where the mortgage is higher than the value of the home). We have also written about plausible solutions that involve moderately higher inflation and “financial repression” – pushing down inflation-adjusted interest rates, which effectively amounts to a tax on bondholders. This strategy contributed to the significant debt reductions that followed World War II.

In short: many countries around the world have extraordinarily high public debts by historical standards, especially when medical and old-age support programs are taken into account. Resolving these debt burdens usually involves a transfer, often painful, from savers to borrowers. This time is no different, and the latest academic kerfuffle should not divert our attention from that fact.

Carmen M. Reinhart is a professor of the international financial system, and Kenneth S. Rogoff is a professor of public policy and economics, both at Harvard.

In an appendix to this op-ed essay, the authors further defend their findings that high public debt is associated with lower economic growth.

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