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PHILO CAPITAL ADVISERS

US DEFICITS & DEBT

THREE ROOSEVELTS, THREE TURNING POINTS AND THE CURRENT CRISIS

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Philo Capital Advisers

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Introduction

The US is critically important for investors globally. It has the largest economy and the largest financial markets in the world so what happens in the US greatly affects markets everywhere else. The US sub-prime debt crisis of 2008 triggered the most serious global economic and financial collapse since the 1930s depression. Now, five years later, the US is still grappling with huge budget deficits, an on-going government debt ceiling crisis, a mounting government debt pile that is getting worse with each trillion dollar deficit, a stagnant economy despite five years of extremely expansionary fiscal and monetary policies, and high unemployment levels.

There is a crippling and acrimonious stand-off between Democrats and Republicans over what is the right mix of solutions to these problems. Should the government impose strict "budget austerity" to "balance the budget" or to go even further and create budget surpluses to actually "pay off the debt"? Or is the solution even more "deficit spending", even more debt, and seemingly endless "money printing"? What is the greater threat – inflation or deflation? The US faces a debt crisis, a fiscal crisis, a monetary crisis and a political crisis.

News stories are full of headlines that are worrying investors:

- "What if the government hits the debt ceiling and has to stop paying wages or pensions?"
- "Will the government need to shut down?"
- "What if the government defaults on its debt?"
- "Will it ever get the economy growing again?"
- "What happens when the level of government debt is above 100% of GDP?",
- "Is the current level of debt too high / unsustainable?" and so on.

These types of headlines are being posed as if they are "the end of the world" (or at least America) as we know it.

In fact all of these things have happened before in the US. The US government has run out of money before, it has shut down the government before, it has failed to pay interest and principal on its debts before (even after being sued by US citizens in US Courts), and it has faced deeper economic contractions with higher unemployment rates, more bank failures and more debt than it has today.

Far from being the "end of the world", markets rebounded from these crises in the past, usually starting from the depths of the crises, into new booms and into new eras of growth and prosperity. In other cases markets have simply brushed it off and got back to business. Very often the impact of these crisis events on markets was the reverse of what most people might expect.

In this paper we look at when all of these events occurred before, how America got itself out of the crises, and what was the impact on investment markets. In light of these, we assess the likely impacts on markets of the current crisis.

We also consider some of the impacts and implications for Australia and Australian investors as we are inexorably bound to the US in a number of ways.

Current status

First, a quick snapshot of the current situation (as at March 2013).

The debt ceiling

The Federal government debt ceiling is nothing new to Americans. Congress has a legislated debt ceiling that is there to cap the total amount of Federal government debt outstanding. The debt ceiling has been raised by Congress more than 60 times over the past 50 years, and usually without incident. Most of the debt ceiling negotiations have gone relatively smoothly. Usually the two sides talk tough in public but when it comes down to the wire they roll up their sleeves behind closed doors and come up with a compromise deal. But occasionally things don't go smoothly and the negotiations erupt into crisis and chaos.

When the debt ceiling is hit, the government runs out of money and has to either stop paying its bills or stop paying interest and principal on its debts.

Since the middle of 2011 the Republicans (who were responsible for most of the existing debt pile, as we shall see) have put their foot down and said no. Republicans want cuts to welfare entitlements and no increases in taxes. Democrats want to raise taxes and want no cuts to welfare. Both sides have thus far shown very little signs of budging.

The sequester

As the crisis escalated last year Congress put in place a set of across-the-board budget cuts that would automatically start on 1st January 2013 if a compromise deal was not passed by the end of December 2012.

A past-midnight deal was done on 1 January which delayed the deadline, raised taxes (slightly) on the rich and let a previous payroll tax cut expire, but did nothing to cut government spending or welfare. The delayed deadline was reached at the end of February with no compromise deal agreed, so the automatic "sequester" spending cuts started to bite on 1 March. They will automatically cut spending by $85 billion in 2013 and $1 trillion over 10 years, including cuts across most areas of the budget. These spending cuts are expected to reduce national economic growth by at least 1% this year and raise unemployment levels.

The next deadline was set for 27 March. The sequester cuts will not reduce spending enough to avoid hitting the debt ceiling, as we shall see shortly. When the debt ceiling is reached the government must either stop spending money (ie stop paying staff, rent, suppliers, etc) – or stop paying interest on its debt and/or repay maturing principal – or a combination of both. It is already delaying payments to suppliers, delaying tax refunds and has "borrowed" $156b from the Federal employee pension fund in mid-January to make interest payments on debt and keep paying staff (borrowed from their own pension funds!).

On 24 Jan 2013 the Republican controlled House passed another bill, with the support of the Senate and President, allowing Treasury to effectively ignore the debt ceiling until 18 May, after which time so-called "extraordinary measures" will be taken to cut spending. The bill requires the Democrat controlled Senate to pass a budget bill by 15 April or Senators' pay will be docked.

All of this is very short term stuff and doesn't address the real problems, which are the sheer scale of the deficit and the scale of the debt.

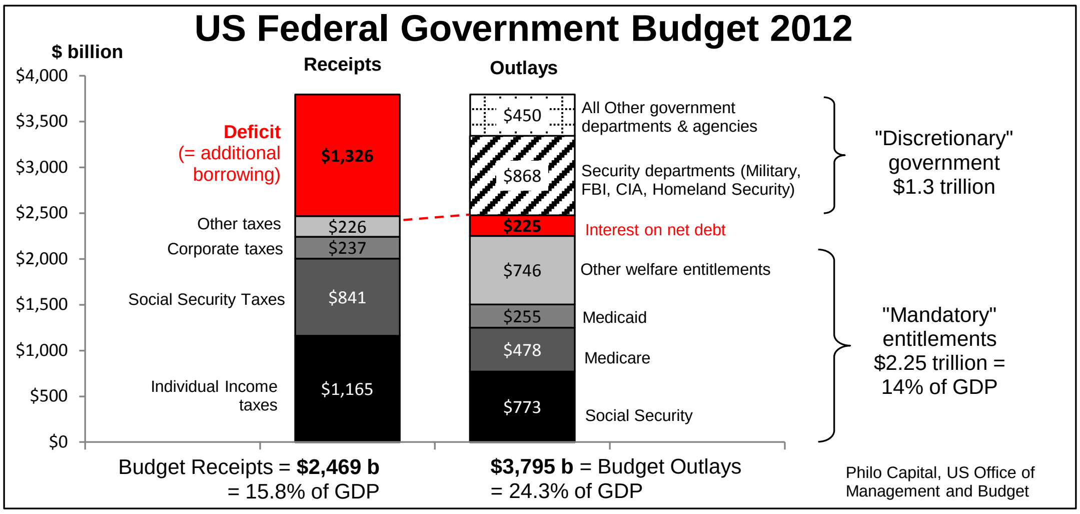
The deficit

The automatic sequester cuts are a drop in the ocean - $85 billion is only fiddling around at the margins. $85 billion is only 2% of the total budget of $3.8 trillion. Budget deficits have been more than $1 trillion in each of the past 4 years under President Obama, and look like being close to another $1 trillion in 2013.

But here is the problem: *even if the entire US government closed down today and stayed closed forever, it still would not balance the budget!* If every single government department, including the US Army, Navy, Air force, CIA, FBI, the Departments of Homeland Security, Defense, Agriculture, Commerce, Education, Energy, Health, Housing, Interior, Justice, Labour, Transportation, Treasury, Environmental Protection, the White House, Congress, and every other government department, agency, program and employee – were shut down completely and stayed closed forever – it STILL would not balance the budget.

Why? Because the amounts paid out in welfare plus interest paid on government debt *exceed* the total amount of tax revenues collected. Total tax collections ($2.47 trillion) don't even cover welfare payments ($2.25 trillion) and interest on debt ($0.23 trillion), so there is a deficit before even a single cent is spent on government departments and administration.

The following table shows the US budget outcome for 2012:

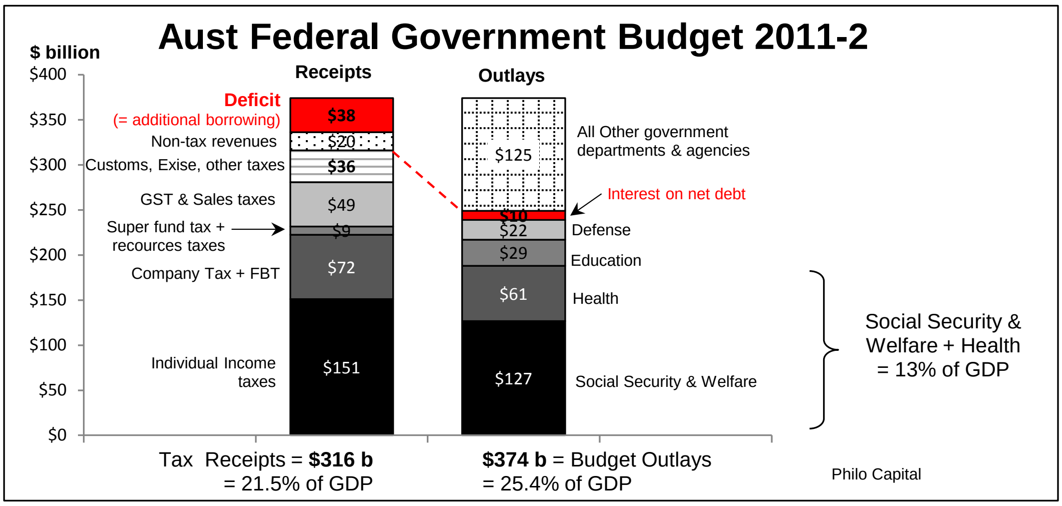


These numbers are from the official Congressional Budget Office - (http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/tables.pdf)

The government divides spending into two main groups – what they term "mandatory" welfare "entitlements" ($2.25 trillion), and "discretionary" spending ($1.31 trillion). Two thirds of the "discretionary" spending is for the military ($868b) and the other third ($450b) is for the civilian government. Interest on debt is $225b, bringing total spending to $3.8 trillion.

Of this spending budget, less than two thirds is paid for by taxes collected ($2.47 trillion), leaving a deficit of $1.3 trillion. This deficit hole is covered by borrowing more – adding to the debt pile, which is now more than $16 trillion.

How does this compare to Australia? Here is the same chart for the Australia's federal budget outcome for the 2011-12 year, which had a deficit of $38 billion:



Contrary to popular belief Australia and America are equally generous (or mean) with welfare spending - in both countries federal welfare spending is 13-14% of GDP.

The two big differences between the US and Australia are military spending and tax. In the US, military spending (called "security" in the US chart above) is 5% of GDP, but in Australia it is only 0.5%. America spends 10 times more per dollar of national income than Australia on the military. America won the cold war against the soviets, fought expensive wars in Korea in the 1950s, Vietnam in the 1960s to early 1970s, in Afghanistan and Iraq in the 2000s, and is now under pressure from a rapidly emerging military power - China. Republicans refuse to consider any cuts to the military and Democrats are reluctant to cut there as well.

The second big difference is tax. Total federal tax in Australia is 22% of GDP but in the US it is only 15%, which is very low compared to other developed countries. Americans expect first world services from government and a huge military force around the world, but they don't want to pay for it. (In the US, more taxes are collected by state and city governments than in Australia, but American states and cities also have trouble balancing their budgets, and many are on the edge of bankruptcy).

As a result of Australia's much higher taxes and much lower military spend than the US, our budget deficit is "only" 3% of GDP, but in the US it is 8%.

The debt pile

The automatic "sequester" spending cuts will only make a very small (2%) dent in the US budget and will go nowhere near balancing the budget. Even if the government shut down forever (retaining say one person and a big free computer to collect taxes and pay welfare), it will still run a deficit and would keep on borrowing and adding to the debt pile each year.

The total debt pile is now above 100% of Gross national output pa (both are a little above $16 trillion). This level is higher than the UK, France, Germany and Spain (and not far behind Italy, Ireland and Portugal).

On-going refinancing of existing debt as it matures

In addition to new debt required to fund the ongoing deficits, the government must refinance maturing existing debt every week. It must refinance around $3 trillion of treasuries due to mature over the course of 2013, and another $2 trillion in 2014.

Today the stand-off seems as intractable as ever, as each new delayed deadline comes and goes. Democrats are resisting cuts to “mandatory” welfare “entitlements”, and the Republicans are refusing to allow any more tax hikes, still smarting after their concession in the New Year’s Day deal under which they were pressured into allowing limited tax hikes on the rich.

The above facts and figures seem alarming and unprecedented, but in fact all of these “end of the world” threats have happened before – debt ceilings being hit, governments being shut down, and defaulting on debts. Several times in the past, Americans have suffered far worse depressions and financial crises, higher debt levels, and larger budget deficits than they face today. In fact these prior economic and financial collapses and fiscal, monetary and political crises often turned out to be great turning points and catalysts for the birth of new eras of growth and prosperity, right out of the middle of the crises when all hope seemed lost.

Let us now consider some of these crises and turning points and how they affected markets.

Which Roosevelt?

In 1976, in the middle of America’s celebrations of the 200^{th} anniversary of the Declaration of Independence, I graduated from Roosevelt High School, which was on Roosevelt Way in Roosevelt, Washington (and I lived at 8008 Roosevelt Way, Roosevelt). It was a very Roosevelt kind of place!

Whenever I mention this it inevitably sparks a debate – which Roosevelt? Was it Theodore Roosevelt, the Republican 26^{th} President, or was it Theodore’s fifth cousin Franklin Roosevelt, the Democrat 32^{nd} and longest serving US president?

This paper looks at the current crises of US debt, deficit, monetary policy and threat of default through the eyes of these two Roosevelt Presidents – one Republican and the other Democrat.

Just like in today’s crisis, both Roosevelts were at the centre of national debates over how best to stimulate the American economy from deep economic and financial crises that involved collapsing banks, deflating prices, declining incomes, mass bankruptcies, and high unemployment – Theodore in the 1890s depression and Franklin in the 1930s depression. They took opposite sides of the debate – Theodore a Republican and Franklin a Democrat. Each looked into the abyss in the depths of their respective crises, made critical decisions and, as a result, their presidencies marked two great turning points in the evolution of the American economy.

A third major turning point was at the end of the bicentennial 1970s.

Theodore Roosevelt's presidency marked the point at which America changed from being a predominantly agrarian economy with mainly rural and small town populations of the 19th century, into a predominantly urban, industrial powerhouse of the 20th century – from a capital importing emerging market in the 19th century, into a capital exporting developed market in the 20th – from the railway age to the motor car age – from the Victorian British 19th century in which the pound ruled the markets and the British Navy ruled the waves, into the American 20th century with the supremacy of the dollar and the US military.

Franklin Roosevelt's presidency marked another great turning point - from an era of small government and limited government involvement in the economy, to big government and heavy involvement, control and direction– from an era of extreme distribution of wealth and grinding poverty, to the growth of the welfare state and safety nets – from balanced budgets, to deficit spending - from unregulated markets and banks, to increasingly heavy regulation and bank deposit insurance – from caveat emptor, to consumer protection – from relatively volatile financial markets with frequent crashes, panics and recessions, to a period of relatively few financial collapses and panics.

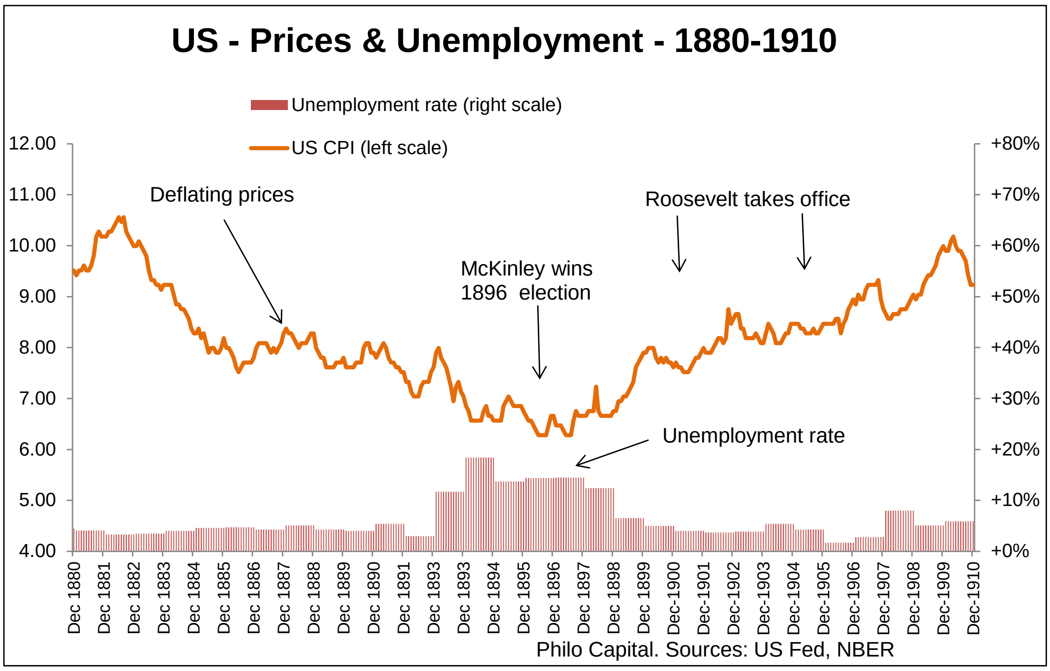
A third great turning point at the end of the 1970s marked a shift from the primacy of the goal of full employment, to one of inflation reduction – from big government and heavy state direction, back to small government – from nationalisation of industries, to privatisation – from regulation of markets, to deregulation – from government control of monetary policy, to the independence of the Federal Reserve - from the high inflation in the mid-1960s to late 1970s, to the low inflation 1980s, 1990s and 2000s – from sky high taxes in the 1970s, to seemingly never-ending tax cuts from Reagan on – from the demoralising political scandals of Nixon's Watergate and Carter's sense of hopelessness, to the return of national confidence under Reagan – from the humiliation of defeat in Vietnam, to victory over communism in winning the cold war. Reagan also started a new era of massive budget deficits and trade deficits and his election in 1980 marked the start of US going from being the biggest creditor nation in the world, to being the biggest debtor, and once again reliant on foreign lenders as it was prior to the 1890s turning point.

Each of these three great turning points occurred in the midst of, and were triggered by, deep financial, monetary and fiscal crises involving similar issues that are at stake in today's crisis.

Theodore Roosevelt and the 1890s depression

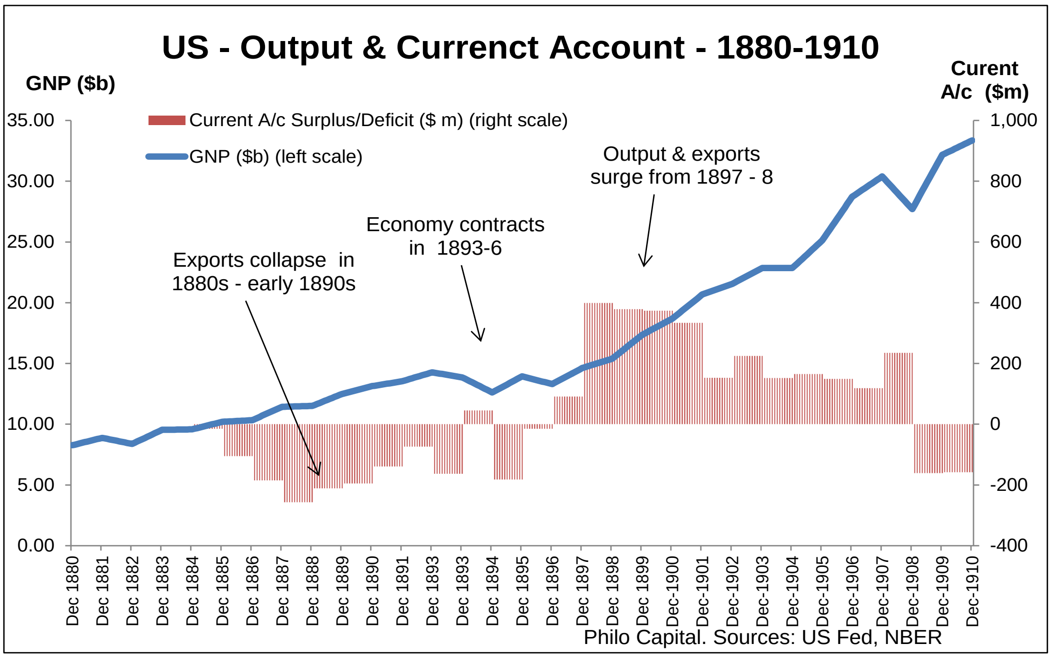
Theodore Roosevelt had been Vice President under Republican President William McKinley and became president in September 1901 after McKinley's assassination. The 1890s depression was a global phenomenon that affected many countries including the US, Britain, Western Europe, South America and Australia. In the US, commodities prices had collapsed, US exports had fallen by more than 20%, including agricultural exports down by 40%, unemployment rates had been in double digits since 1893 and hit 20% by 1896. Deflation had seen prices across the US collapse by 40%, and this dramatically increased the real value of debts, resulting in widespread business and household bankruptcies and poverty.

The first chart below shows consumer prices and unemployment rates from 1880 to 1910, indicating the depth of the crisis in the mid-1890s:

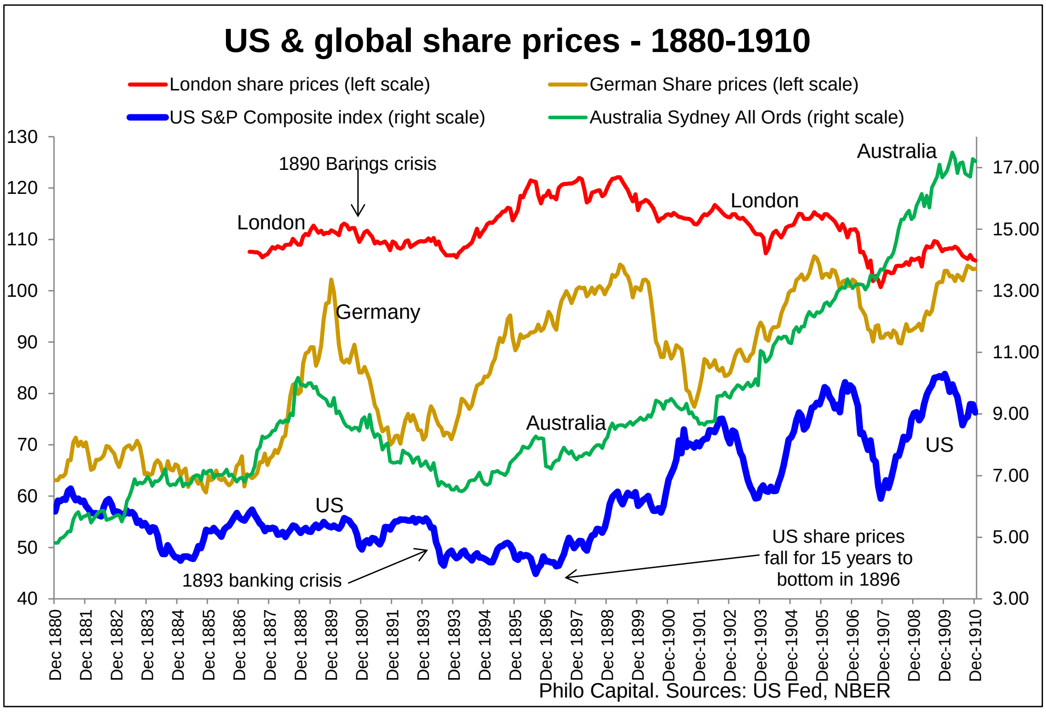


Wholesale and consumer prices had been falling since the early 1880s and bottomed in 1896, when unemployment rates soared from 3% in the 1880s and early 1890s up to 20% by 1894.

The next chart of Gross National Product and the current account for the same period shows the dramatic decline of exports from the late 1880s and economic contractions in the mid-1890s:



Share prices in the US had been falling since 1881 in a succession of panics and had collapsed by more than 40% by 1896. A collapse in 1890 was triggered by the sudden withdrawal of foreign capital from the “emerging” markets (including America and Australia) following the failure of Barings Bank in London due to collapses in Argentina (Argentina is still defaulting on debt and struggling to “emerge” more than a century later). London was still the capital market of the world at that stage and the sudden withdrawal of British and European money from the emerging markets caused prices to collapse, triggering bank runs and banking collapses.



In 1893 the failure of the Cordage Trust triggered the “panic of 1893” in which 640 banks collapsed, together with hundreds of railroad stocks which were the speculative “hot stocks” of the era. The widening current account deficit caused by the collapse of exports and the flight of foreign capital almost exhausted America’s gold reserves. The US economy, banking system and government were in crisis.

Fiscal policy was not available as a policy tool because governments were only very small back then - the entire US government budget was less than 3% of national output at that time, not 30% as it is today. With no fiscal policy available, the Republicans turned to trade protection and instigated the McKinley tariff in 1891 and the Dingley tariff in 1897 to try to assist local producers. The populist urge to raise trade protection barriers was a mistake in the 1890s, and the mistake was repeated in the 1930s.

In today’s crisis, trade protection wars have largely been avoided, but populist pressure is mounting – particularly between China and Japan, and between the US and China, evidenced by the escalating “currency manipulator” allegations and the more recent cyber-hacking disputes.

Gold –v- silver: "hard money" -v- inflation

The great partisan debate in the US in the 1890s was over monetary policy. In particular it was a national debate between the "hard money" Republicans versus the "inflationist" Democrats – echoing the similar partisan debate between the "hard money" north and the "profligate" south of Europe; and between the Republicans and Democrats today in the US.

The "hard money" lobby in the 1890s wanted to stick with the tight monetary policy of the gold standard, in which the supply of money in the banking system and the economy was limited to the amount of gold held. "Hard money" stood for fiscal rectitude, balanced budgets, tight control of money and credit. The gold standard prevented banks and governments from printing money indiscriminately, and forced them to tightly control spending and lending.

Britain was the first country to adopt the gold standard in 1717 (introduced by Sir Isaac Newton), but had suspended the gold standard briefly to urgently print more money to finance wars – mainly against the US and France. Governments of all complexions throughout history have resorted to abandoning fixed monetary constraints and printing extra money as a way of quickly creating money with which to buy supplies for wars. Printing excess money like this is almost always inflationary as it increases the amount of money chasing the same fixed supply of goods and services. But in urgent emergencies like wars it is seen as a necessary evil.

The US had been on the gold standard since Independence, but had also departed from it temporarily in order to raise money quickly to finance major wars – the 1812 War against Britain, the 1846-48 war against Mexico and the Civil War. Even the great Abraham Lincoln, first Republican president, abandoned the gold standard in February 1862, to print paper money to finance the Civil War. The newly printed paper notes were called "greenbacks" because they were not backed by gold.

The greenbacks immediately traded at a discount to gold because people knew they were not "real money". With greenbacks on the loose in the system, the war-time inflation continued after the war until the greenbacks were progressively taken out of circulation by Republican presidents Grant, Garfield and Arthur, and the fixed gold standard was re-introduced with the Gold Resumption Act of 1879. This was deflationary as it reduced the supply of money and it contributed to the deflationary forces that culminated in the 1890s depression.

In the 1890s depression the champion for the inflationists was Democrat candidate William Jennings Bryan from Nebraska who ran for the 1896 and 1900 presidential elections lobbying for money printing as a solution to deflation and depression. The inflationists, were known as the "silver lobby" because they advocated creating new money by minting silver coins in order to expand the money supply from the tight constraints of the gold standard. Minting a flood of new silver coins would help inflate farm commodity prices and inflate away the real value of debts owed by farmers and urban workers. In the 1890s the American economy was still largely rural and the silver lobby was a powerful, primarily rural-based populist force.

The rise of the silver lobby in rural and small town America fuelled a global silver price boom that led to the exploration and discovery of silver around Broken Hill. Thus was born the greatest new silver miner of the 1880s silver boom, The Broken Hill Proprietary Company - BHP.

On the other side of the debate, the “hard money” men were pro- gold standard, pro-bank, pro-business, and in favour of tight central control, led by McKinley and Roosevelt. To them, minting new money for debtors to pay off their debts with devalued currency destroyed returns for lenders and creditors. Inflation, after all, is just a transfer of wealth from creditors to borrowers. Creditors get repaid with devalued money that is worth less than the original amount they had lent out. Inflation penalises the prudent savers, investors and lenders, and it rewards the profligate borrowers and spenders.

Today’s crisis

In today’s global debate about stimulating the economy and paying off debt, the inflationists are led by Federal Reserve Chairman Ben Bernanke, ECB President Mario Draghi, the IMF’s Christine Largarde (the IMF is known by some in the “hard money” camp as “*Inflation Maximisation* Fund”), France’s new PM Francois Hollande, Japan’s new (old) PM Shinzo Abe and Finance Minister (and also former PM) Taro Aso.

On the side of “hard money” are the savers and lenders. In Europe it is the Germans, led by Chancellor Angela Merkel, Finance Minister Wolfgang Schäuble, Bundesbank President Jens Weidmann. Standing with the Germans are the “north” of Europe – including Austria, Benlux, and the Nordic and Baltic countries. In the US it is the right wing of the Republicans in Congress, and in particular the Tea Party movement.

The inflationists are on the side of the debtors – who want to expand the money supply to stimulate spending and to inflate away the real size of debts by allowing debts to be paid off with devalued money. The “hard money” lobby reject the notion of people paying off their debts with newly minted devalued money that is worth less in real terms after inflation. They favour tight money, fiscal discipline and balanced budgets – even at a cost to jobs in the meantime.

Japan – sudden converts

Japan is an interesting case study. The Japanese people stoically rebuilt their country from rubble after the Second World War to be the one of the richest countries in the world in a single generation. Like the Germans, their success was due to a national policy of hard work, low consumer spending, high savings rates and trade surpluses.

In the 1980s Japan overtook the US to become the biggest creditor nation and chief banker to the US, which had rapidly became the biggest debtor under Reagan. Japan’s Nakasone was the chief admonisher of profligate big spending, big borrowing America and Nakasone’s often inflammatory and racist remarks degenerated into a trade protection war and currency war with the US. The LDP’s anti-inflation stance, slowness to deal with the Japanese banking crisis in the early 1990s, and two decades of ill-directed and expensive government stimulus borrowing and spending, resulted in deflation, a high yen and a stagnant economy for the past 20 years, plus a huge debt pile.

After briefly flirting with three alternative governments, the old LDP is now back in power, led by two former LDP Prime Ministers, Shinzo Abe (PM again) and Taro Aso (now Finance Minister). But this time they have “seen the light”. They are now fresh converts to the inflationist cause. They finally realise that the sheer size of the government debt means the only way of containing and reducing the debt is to inflate it away. Inflation reduces the real size of debt and depresses the currency to help exporters and local businesses. So far the new pro-inflation policies are showing early signs of working. The yen is finally falling, exports are growing, share prices are surging, and consumer confidence is returning. So far they are winning the currency war with the US and we will see why a little later.

Germany, led by Chancellor Angela Merkel, is still very much in the hard money, anti-inflation camp. Their debt levels are a third of Japan's, and still manageable. Thus far she is holding the hard line, despite increasing pressure from both the left and extreme right, and she will need to face the electorate in September.

Low unemployment or low inflation?

Reduced to a simple stark contrast, the inflationists put the goal of reducing unemployment at a higher priority over the goal of reducing inflation, and they regard inflation as an acceptable cost of bringing about full employment. The hard money side put the goal of reducing inflation at a higher priority over the goal of reducing unemployment, and regard high unemployment as a necessary cost of bringing down inflation. We see this contrast in the policy changes that occurred in the three great turning points covered in this paper, and it is the crux of the debate in today's crisis.

Ben Bernanke at the Fed has specifically put reducing unemployment as a higher goal than reducing inflation, saying he will keep the Fed Funds rate at or near zero, and keep buying bonds to keep interest rates artificially low until the unemployment rate falls back below 6.5%.

The contrast is just as stark when it comes to the US budget stand-off. President Obama and the Democrats want any deficit reduction to come from tax rises while maintaining current welfare "entitlements", and supports Bernanke in endless money printing to create inflation to inflate away the government debt. The Republicans want deficit reduction to come from welfare cuts, while resisting any tax rises. It was a Republican controlled Congress that put in place the automatic sequester provisions that were set to come into force automatically if no compromise deal was done on time. The Republicans want money printing constrained or stopped, and the far right wing, the Tea Party lobby advocate a return to the gold standard.

The gold price is being kept relatively high since the 2008 crash by two opposing factors. On one side is the fear of hyper-inflation as a result of endless money printing under a future scenario controlled by the Democrats and Bernanke (and his likely successor, pro-inflation Janet Yellen). On the opposite side, gold is also being kept high by the possibility of a return to the gold standard in a future scenario controlled by the far right wing of the Republicans. Both of these fears are long-shot possibilities. The more likely outcome would see the gold price collapse as it did in the 1980s after the 1979 turning point, as we shall see below.

Recovery from the 1890s depression

In the 1890s it was the "hard money" lobby that won the day, despite the deep economic depression, 20%+ unemployment levels and debilitating deflation. Keeping control of money and credit growth won the day over creating inflation raise prices and stimulate jobs growth.

The Republicans won in both the 1896 and 1900 elections and put an end to the inflationists plans. The 1900 Gold Standard Act established gold as the sole metallic standard in America, at a fixed price of $20.67 per ounce. It stayed at that level until Theodore's 5th cousin Franklin devalued the dollar against gold in Jan 1934.

Despite the defeat of the inflationists by the deflationary "hard money" movement in the 1890s, the American and global economies did recover strongly and the unemployment rate did came down, starting from the late 1890s. The US rebound can be seen on the above charts.

The supply of money received a boost from new discoveries of gold in Coolgardie/Kalgoorlie in June 1892, in Witwatersrand in South Africa in March 1896 and in the Klondike region of Canada in August 1896. These new gold rushes, together with the increased spending and employment in mining, transport and infrastructure, kick-started economic growth globally (just as the Californian and Bendigo/Ballarat gold rushes in the late 1840s and early 1850s increased the global money supply, and the resultant surges in employment, transport and infrastructure helped end the 1840s global depression).

Turning point to a new era of prosperity

In the depths of the 1890s depression and financial crisis the "green shoots" of a brand new era were appearing. 1893 was the year of Henry Ford's first petrol car engine and also America's first "sky scraper" – the Manhattan Life building. Then Marconi's first wireless telegraph appeared in 1896. 1901, the year Roosevelt ascended from Vice-President to President, saw the world's first $1 billion company – US Steel. 1901 was also the end of Britain's Victorian age, with the death of Queen Victoria. After the 1890s depression, America shifted from being a capital importing emerging market to a capital exporting developed market, and Wall Street began to replace London as the capital market of the world.

The year 1908, the final year of Theodore Roosevelt's reign, saw the launch of the first mass produced car – Ford's "Model T". 1908 was also marked by the discovery in Persia of oil – the dominant fuel for the next century (by William Knox D'Arcy – Townsville lawyer and Queensland gold mine speculator who made one of Australia's greatest ever fortunes with his Mount Morgan Gold mine. He then spent the rest of his life and his fortune searching for oil in the Middle East. With his discovery of oil in Persia he built what we know today as British Petroleum - BP). It was the end of the era dominated by railway booms, horses and small towns, and the start of the era of cities and cars. The ensuing boom from the late 1890s triggered recoveries in stock markets that continued for a generation until the 1929 crash and early 1930s depression.

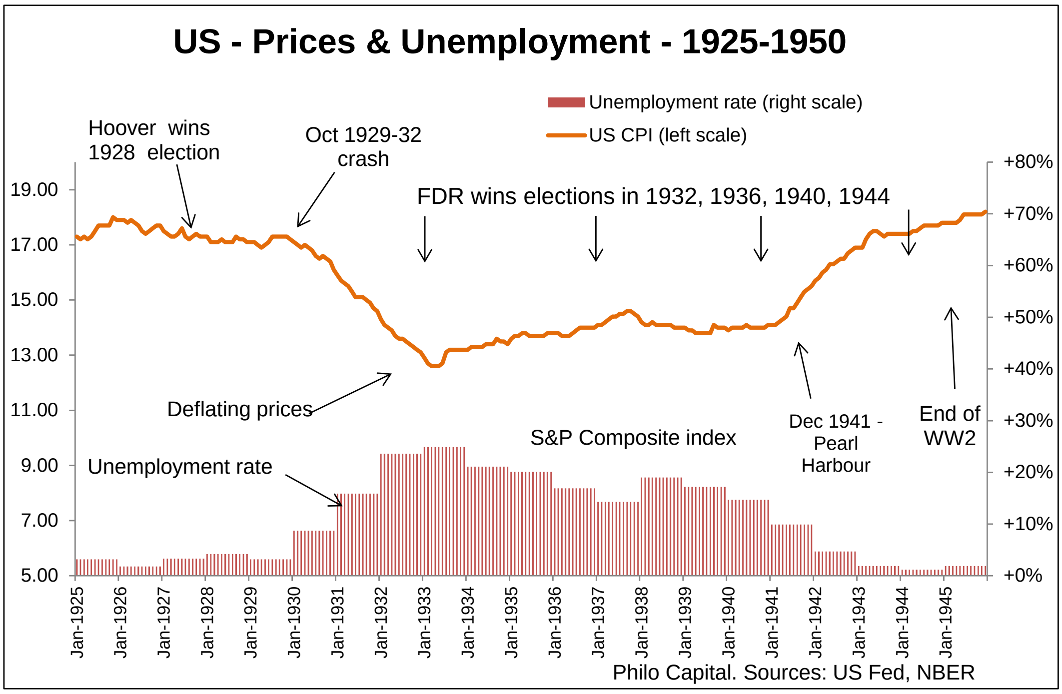
In the 1908 elections at end of Roosevelt's second term, William Taft continued the Republican line of Presidents. He defeated William Jennings Bryan who ran yet again (for a third and last time), this time on a platform of nationalisation of industry, national deposit insurance and more government intervention. Bryan's radical policies – money printing, inflation, nationalisation, national deposit insurance and greater government intervention – were rejected by the voters in the 1890s and early 1900s, but their time would come a generation later – as integral parts of the other Roosevelt's solution to the 1930s depression.

With the failure of the inflationists in the 1896 and 1900 elections, and the new surge in gold production that enabled many other countries to shift from their silver monetary standards to the gold standard, the price of silver collapsed globally. The impact on Australian mining was dramatic. The collapse in the silver price ended the silver mining boom in Broken Hill and around the world. The big silver/lead miners, led by BHP, were forced to scale back operations and switch from mining to smelting. In 1896 BHP bought land near Newcastle to supply coking coal for its new iron & steel smelters and then later started mining coal in the Hunter. In 1897 BHP shifted smelting in Port Pirie and then later started mining iron ore in nearby mountains around the Spencer Gulf. Zinc and then iron and steel replaced silver as BHP's primary products, and BHP became primarily a smelter, refiner and metal products manufacturer for the next 70 years. We will return to BHP and zinc in a moment.

Franklin Roosevelt and the 1930s depression

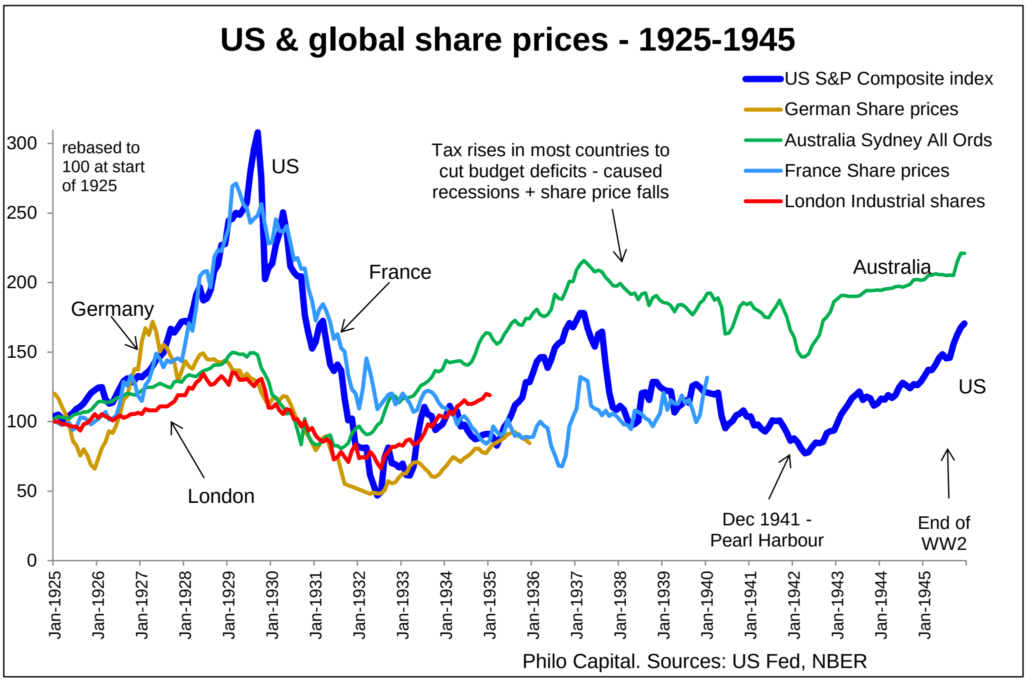
The long economic boom and stock market rally that started from the depths of the 1890s depression and crisis, ended with the 1929 crash. The world was again plunged into a deep depression. Falling commodities prices, contracting global trade, collapsing banks, deflating prices and wages, high unemployment, widespread poverty and starvation were all there once again. The depression was preceded by a bursting of speculative debt-fuelled excesses on stock markets, but this time the speculative bubble was in automobiles, telephone and radio stocks (which were born in the midst of the 1890s depression) instead of railroad stocks in the 1890s crash.

The first chart below shows consumer prices and unemployment rates from 1925 to 1950. It is virtually the same as the previous chart for the 1890s depression.

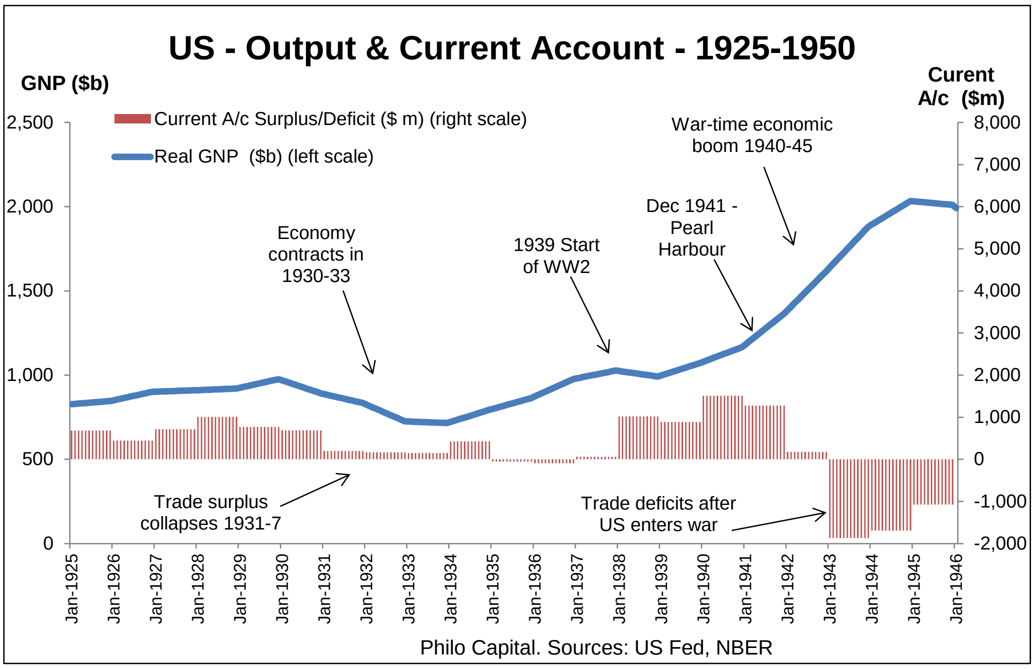


Prices of farm produce, commodities and consumer goods had been falling since the mid-1920s and bottomed in 1933 when unemployment rates peaked.

The 1920s stock market boom collapsed – with the Dow Jones Industrials index down by 89% and the S&P composite down by 85%. Share prices in the US trebled in 1925 to 1929 (as they had in France, but rose only 50% in Britain, Germany and Australia), but all these of gains and more were lost in the 1929-32 crash.



The next chart shows US Gross National Product and the current account balance for the same period:



Exports collapsed, America's trade surplus disappeared and total output fell by more than 25% between 1919 and 1933.

Republicans had been in the White House from McKinley after the 1896 election all the way up to the end of the 1920s boom – with the sole exception of Democrat Woodrow Wilson during WW1. The president at the height of the boom was Republican Herbert Hoover, the champion of tight money, fiscal rectitude, balanced budgets, free markets and a small hands-off government. He also knew a thing or two about gold, mining, business and Australia. He was at the heart of building two iconic Australian companies - one famous and one now infamous.

Hoover, BHP, gold, silver and zinc

Hoover was a talented and enterprising American mining engineer who came to Western Australia in 1897 in the great Coolgardie/Kalgoorlie gold mining boom. He managed the Sons of Gwalia gold mine north of Kalgoorlie and at one stage his mining companies produced up to half of WA's gold output. He also pioneered the importation of foreign labour (mainly Italians) to compete with unionised Australian workers (long before the controversial "457" visas of today).

He then went on to develop and manage several mines in China, but returned to Australia and headed to Broken Hill where he co-founded the Zinc Corporation in Sep 1905 to extract zinc from the Broken Hill mine tailings after the silver price had collapsed. He pioneered a variety of new extraction techniques on a number of deposits and the company prospered. After Hoover returned to the US, Zinc Corp continued to grow. It received a major injection of British capital from Rio Tinto (UK) to form Conzinc Riotinto Australia in 1962, which was renamed CRA in 1980, and then Rio Tinto Ltd (RIO) in 1997.

(Hoover's other company in Australia, Sons of Gwalia, suffered a very different fate. After the very profitable gold mines were depleted and closed in 1963, the company was mismanaged for much of the next 40 years and finally ended ignominiously in 2004 in one of Australia's most famous and controversial court cases on corporations law. The mere mention of the name "Sons of Gwalia" today can strike fear in the minds of public company directors across Australia.)

Hoover made many millions out of his major shareholdings in Sons of Gwalia, Zinc Corp and his many other mining ventures around the world after leaving Australia. Back in the US he served as Secretary of Commerce under Republican Presidents Harding and Coolidge during the great 1920s boom and then won the 1928 US Presidential election. He took office as President in March 1929 – right at the top of the long 1920s boom and just before the 1929 crash.

Faced with a severely contracting economy, collapsing prices and soaring unemployment, Hoover's "hard money" approach was in many ways like Germany's approach to the European debt crisis – countries should cut spending to balance their budgets and pay off their debts, and businesses should cut wages and/or cut staff to reduce costs to meet lower demand and lower prices.

With this deflationary austerity program, unemployment rates need to rise and wages need to fall to a level at which companies are encouraged to start hiring again. As Britain and the PIIGS have found in the current crisis, the short term deflationary effects are very painful and politically unpopular. Britain has been in and out of recession for the past three years as the coalition government goes in and out of austerity mode. In Italy, stand-in PM Mario Monti was making good progress with labour market reforms, pension reforms and cost cutting while he was in power during 2012, but the Italians quickly lost faith, booted him out and voted instead for a populist party run by stand-up comedian Beppe Grillo in the February 2013 elections.

Hoover also allowed the Smoot-Hawley tariffs to become law in 1930 (Smoot and Hawley were Republican Congressmen), just as the Republicans had gone for trade protection in the 1890s. This triggered a devastating global trade protection war that resulted in severe contractions in world trade and consequent contractions in production and employment around the world.

Franklin Roosevelt

By the time of the Presidential elections in November 1932, the US economy was still contracting and the unemployment rate had soared to more than 30%. With very little in the way of government services or welfare, there was widespread poverty across the US. There were severe runs on banks as people rushed to get their savings out in gold. In these panic conditions, the Democratic candidate Franklin Roosevelt swept to power in a landslide victory for the Democrats.

One of Roosevelt's immediate concerns was how to create new money to halt the price deflation and to finance programs designed to create jobs to relieve unemployment. This couldn't be done under the gold standard where the supply of money was restricted to the amount of gold reserves, and the gold reserves were running down.

The main influence on Roosevelt's policies was British economist John Maynard Keynes. Keynes argued for the gold standard to be abandoned so the US dollar could depreciate. This would assist exporters by making exports cheaper and imports dearer, stemming the outflow of money and gold from America. Keynes' writings and speeches railing against the gold standard echoed William Jennings Bryan's rousing "cross of gold" speeches in the 1890s. Keynes was largely ignored in his native Britain, just as Bryan was defeated in the US in the last depression, but Keynes found an audience in the US.

Roosevelt was inaugurated on 4 March 1933 in the middle of a full scale nationwide banking crisis. Two days later he ordered all banks to close to prevent people withdrawing their money. He banned US citizens from owning gold (the ban stood until 1975), ordered all gold to be handed in to the government at the fixed price of $21.67 per ounce (cousin Theodore Roosevelt's price), banned gold as legal tender and ceased the production of gold coins. Several thousand banks closed forever, but when the surviving banks re-opened a week later the people were not allowed to withdraw their money in gold but had to settle for paper instead. Paper dollars immediately traded at a discount to gold (just as the funny-money "greenbacks" had done in the Civil War) because everybody knew paper money was worth less than gold.

On 1 January 1934 the Gold Reserve Act devalued the US dollar by 41% by lifting the set price of gold to from $21.67 to $35. This devaluation effectively amounted to a 41% default on all US dollar debt because people who lent money to the government before the January 1934 were repaid in paper money that bought 41% less after the devaluation.

Default by inflation instead of outright default or restructure

Governments usually don't default outright on, or restructure, their domestic debt (owned by their own citizens) because they generally don't need to. A more subtle and surreptitious way of achieving a similar outcome is to create inflation and/or unilaterally declare a new arbitrary value of their paper money and then repay their debts with the new devalued paper.

In today's sovereign debt crisis, with debts at crippling levels in many countries, the easiest way out of debt is inflation – repaying debts with paper money that is less valuable in real purchasing power. (Australia was an exception in the 1930s depression. Crippled by deflation and unable to create inflation despite abandoning gold and devaluing the Australian pound through 1930 and 1931, in January 1932 the Commonwealth legislated to mandate a Greek-style debt restructure deal in which domestic holders of Commonwealth debt took a "haircut" - interest was reduced by 22.5% and repayment of principal was delayed for up to 30 years - in order that foreign creditors could be paid in full. It was done after a national referendum in which 97% of domestic bond holders agreed to take a loss so that foreign creditors wouldn't suffer losses – for the good of the country and its international reputation. Usually countries choose to repay their own citizens in full and let foreign creditors take a loss.)

Recovery from the 1930s depression

Franklin Roosevelt followed Keynes' advice and embarked on a massive experiment in deficit spending, funded by a build-up of government debt, and also a far reaching program of government regulation, welfare safety-nets and deposit insurance for bank deposits. Despite these measures to increase aggregate demand the US economy was slow to recover.

After tentative recoveries in 1934-5 the government then raised taxes in 1936-7 to start paying for the spending, but this caused output to fall, prices to fall and unemployment to rise in 1938. Only when World War Two started did demand, production and employment get a sudden boost, ending the depression.

This is what we are seeing in UK and Europe in today's crisis. Every time governments try to reduce the budget deficit by raising taxes and/or cutting spending, it reduces employment and tax revenues and raises welfare payouts, resulting in higher deficits. What is needed to cut this self-defeating spiral is radical surgery, and we show examples later in this paper.

One reason is that the US was slow to recover from the depths of the depression in the early 1930s was that it was slow to devalue the dollar. The US dollar effectively rose in value as other currencies devalued more quickly than the US. The US had become the global reserve currency since the British Pound lost that title in the First World War and Franklin Roosevelt devalued the dollar against gold relatively late in the piece in January 1934. On the other hand, Britain started to depreciate the pound sterling much earlier, abandoning the gold standard in September 1931, after which sterling fell 30% against the US dollar (from $4.80 to

$3.40 per pound) – taking the Australian pound with it because our pound was still linked to sterling.

Australia abandoned the gold standard even earlier still - in January 1930. It had no other choice. It couldn't borrow any more money to fund its deficits because foreign credit markets had already refused to lend any more to Australian governments, and the capital flight from Australia had almost completely depleted our gold reserves. The government broke the gold link in January 1930, compulsorily acquired all gold and exchanged it for paper, and sent the gold to London to repay foreign creditors. The value of the paper Australian pound started to fall immediately and by the end of 1931 had fallen 16% against Sterling and 42% against the US dollar. As a result our stock market bottomed and started to recover from September 1931, a year earlier than the US market.

Devaluing the US dollar today

The US, UK, Europe and Japan are all trying their hardest to devalue their currencies against each other to assist their exporters, penalise imports and boost local employment, but it is a zero sum game. In 2010 we wrote extensively about an impending "currency war" and it is now hotting up. Japan is having the most success to date. In the December 2012 elections and the return of the LDP, Japan switched from its deflationary stance to in favour of deliberate targeting inflation, more bond buying and more deficit spending.

In the current debt crisis, the US is once again having a hard time depressing its dollar to help exporters and slow imports – despite the trebling of the money supply by the Fed - because the US dollar is still the main "safe haven" global currency, as it was in the 1930s.

With the Fed unable to engineer inflation – despite more than four years of extremely expansionary fiscal and monetary policies - to bring down the value of the dollar, investors everywhere still rush to buy US dollars and US treasuries in a crisis. The US dollar and US debt are seen as "safe havens" - even when the US itself is the cause of the problem.

For example in the US sub-prime crisis the US dollar didn't fall, it soared instead. The US dollar actually jumped by 2% in the first 2 days immediately after the Bear Stearns fire-sale in March 2008, then rose another 7% from July to the middle of September, and then rose by another 7% in four weeks of chaos following the Lehman bankruptcy. All up, from the time of the Bear Sterns collapse in March 2008 to the bottom of the market in March 2009, the US dollar index (which is the trade-weighted basket of currencies against the US dollar) rose 25%. (including rising 47% against the pound).

That's the downside of having a "safe haven" currency. As the main "safe haven" currency, the US dollar rises in crises, just when the US needs a lower currency to stimulate growth. On the other hand, the dollar also rises as the US economy recovers, which dampens growth as well.

The US Treasury and Federal Reserve have clearly followed the Keynesian model of placing reducing unemployment as a higher goal than containing inflation. Central bankers and governments now dream of creating inflation to devalue the real size of government (and private) debts; to stimulate exports and employment and reduce imports.

There is a precedent for this – it's called the 1970s - and is it not the answer .We consider the deficit crisis at the end of the 1970s shortly.

Impact of the 1930s devaluations on Australia – the new gold rush

The combined effects of the Australian pound devaluations in 1931 and the USD devaluation in 1934, were that the Australian pound price of gold more than doubled from £4 per ounce to £8/15/-. This caused the share prices of Australian gold stocks to surge. For example Anglo Australian Gold shares doubled to 10/- in London trading. It also caused a flood of new gold mining floats – including North Kalgurli United, Southern Cross Gold Development, Commonwealth Mining & Finance, Murchison Gold, Anglo Australian Gold, Yellowdine Gold, Ora Banka Gold, Meekathara Gold Mines, Great Bounder Mining & Finance. Since Australians were strapped for cash, almost all the new money for the gold floats was raised in London which was still the banker to Australia.

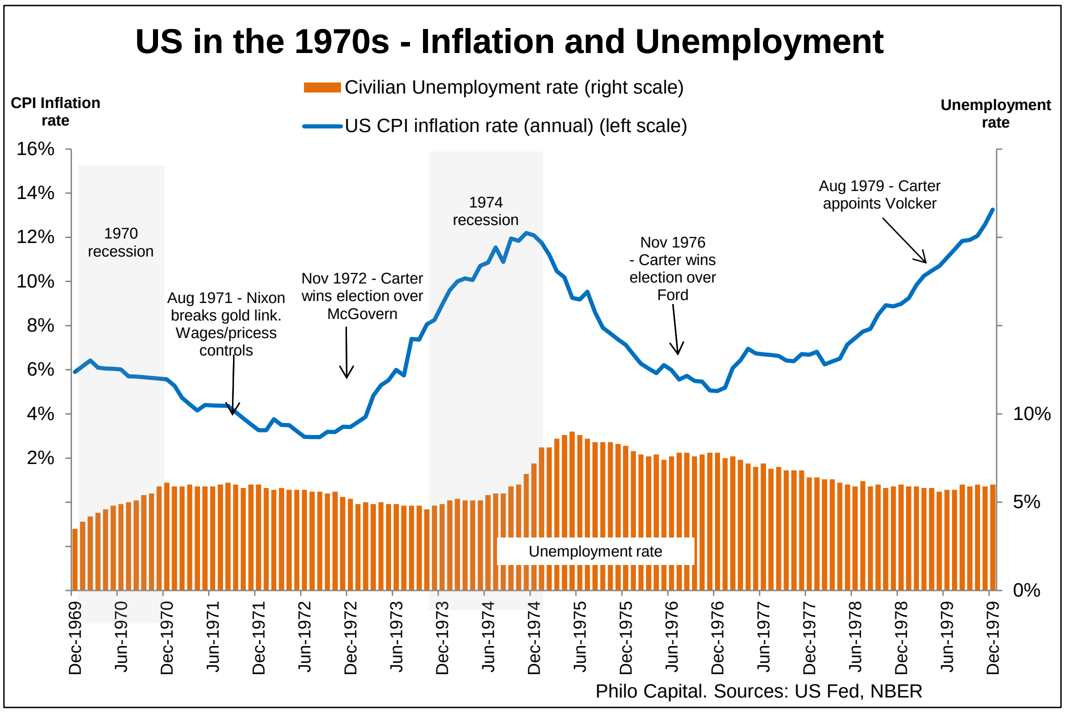
The new gold mining boom reached a peak at the end of 1937. Even BHP had done well in the mining boom – up from 12 shillings in 1931 to 85 shillings. It was by then primarily a steel producer operating behind high protection barriers, but continued small mining operations in Broken Hill until 1939. The 1931 to 1937 stock market boom in Australia was the second biggest boom in terms of real prices (thanks to negative inflation) secondly only to the tremendous 1982-7 stock market boom here, as can be seen in the above chart of share prices from 1925-50.

1979 – debt ceiling/default & inflation crisis

Failing to make repayments on government debt is not new for the US government. The US treasury defaulted three times on US treasury bills in 1979, when Congress didn't legislate in time to raise the debt ceiling because negotiations went to the last minute – like in early August 2011 and again at the end of December 2012. They were "temporary" defaults, and were rectified within a month, but they did shock people who believed that the mighty US would always pay its debts on time.

1979 capped off a long dark decade for America in which one of the very few highlights was the 200 year anniversary celebrations in 1976. Forty years of Keynesian policies were taking a heavy toll.

The first chart below shows the CPI inflation rate and unemployment rate during the 1970s:

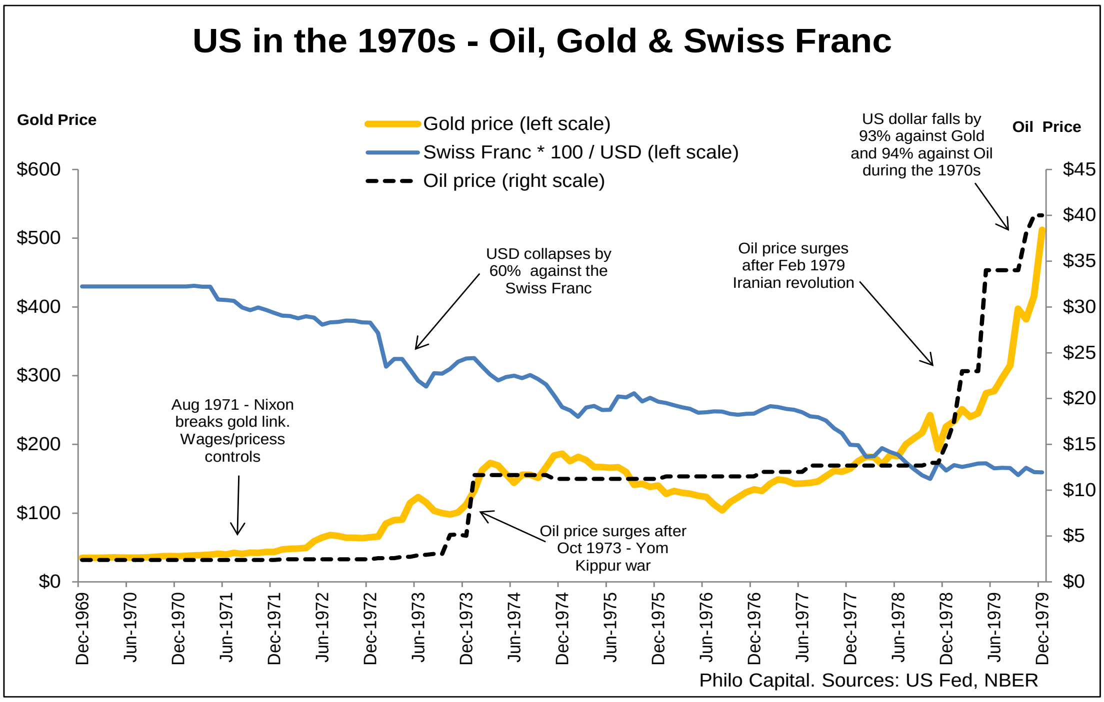


Inflation had started rising in the mid-1960s but it was only recognized as a problem in the early 1970s. CPI inflation peaked at more than 12% pa in Nov 1974, fell to 5% by end 1976, but then accelerated rapidly in 1978, and kept rising above 10% by March 1979.

The unemployment rate rose above 6% in 1971, peaked at 9% in 1975, but was still 6% in 1979 and rising again. This ran against one of the core tenets of Keynesianism, which held that high unemployment should bring down inflation. The 1970s stagflation – stagnant growth together with high inflation – plus high unemployment levels, showed that the Keynesian model was not working. In the 1970 recession unemployment rose but inflation remained high, prompting Nixon to break the gold standard in August 1971 and institute his “New Economic Policy” involving prices and wages controls (supported by Paul Volcker, then under-Secretary of the Treasury).

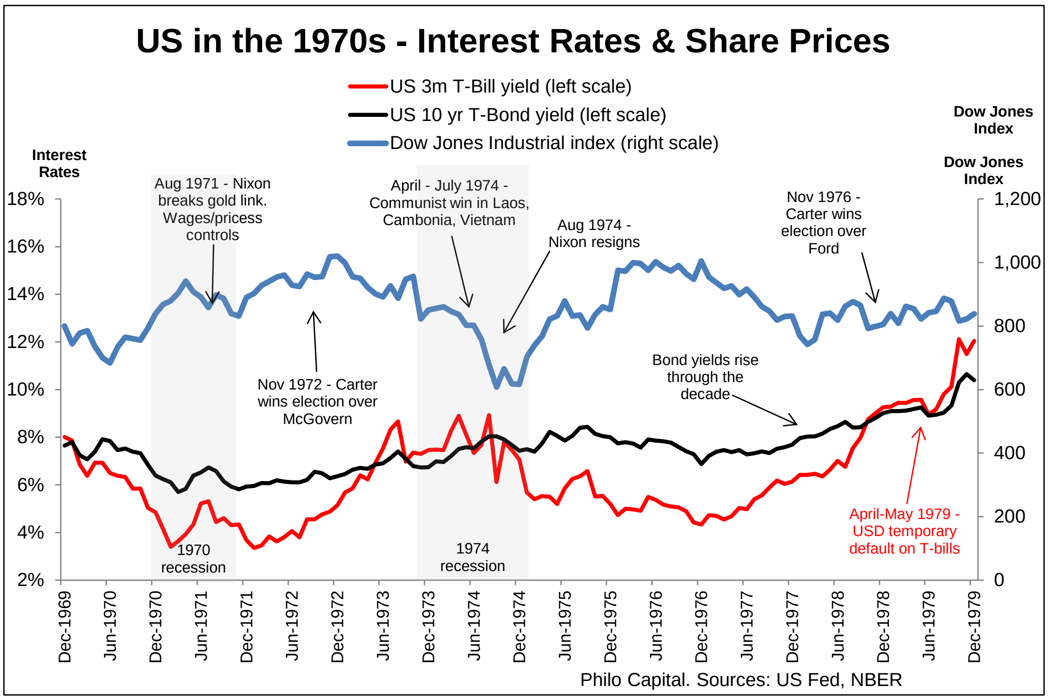
The peak of Keynesianism in America was October 1978 when Congress passed the Humphrey-Hawkins Full Employment Law – specifically stating that fighting inflation was NOT to take priority over reducing unemployment, even though inflation was already in double digits. It was championed by Nobel Prize winner and leading Keynesian James Tobin. Tobin had been the architect of Kennedy’s 1963 tax cut plan which marked the start of the inflationary era. Tobin championed the Keynesian cause and fought against every attempt to fight inflation, even into the 1980s.

Another feature of the 1970s was oil. Oil prices had gone from $3 per barrel at the start of the 1970s, but prices trebled after the Yom Kippur war in October 1973 and then nearly doubled again from late 1978 to early 1979 following the Iranian revolution.



The once mighty US dollar – the symbol of American dominance in the world – collapsed during the 1970s. By 1979 the dollar had lost half its value against the Deutsche Mark, lost two thirds of its value against the Swiss Franc, and a third against the yen. The problem was that the lower US dollar was not helping US manufacturers and exporters as it should in theory. The economy was stagnant and the US was starting to lose out to Japan and Germany in quality and efficiency. The Japanese had taken the lead in small cost-effective fuel-efficient cars while Americans were still making giant gas-guzzlers that Americans couldn't afford to run. Factories were closing down in America's "rust belt" and new ones were opening up in the new southern "sun belt" – financed by Japanese money and run by Japanese management. This came as a rude shock to many Americans troubled by what they saw as the rise of Japan and the loss of American economic dominance and sovereignty.

Interest rates were also at crippling levels. By 1979 yields on 10 year Treasury bonds had risen to above 9% for the first time ever in US history, and short term interest rates were back up above their 1974 peaks and heading for 10%.



Shareholders suffered badly in the 1970s. Share prices were no higher in 1979 than they had been 10 years earlier, but in real terms after inflation, prices had fallen by an average of 50% over the decade.

Domestic politics plunged to new depths with the Watergate scandal and Nixon's impeachment and forced resignation in 1974. In foreign affairs it was also the peak of a bad decade for America. They had lost the enormously expensive and unpopular Vietnam War to the Communists, and in February 1979 the US were also kicked out of Iran when the US-backed Shah of Iran was overthrown by the Ayatollah Khomeini's Islamists.

Then in February China was on the march, invading Vietnam over Vietnam's occupation of the Spratley Islands and its invasion of Cambodia. Meanwhile, with America out of the Middle East, the Soviets were gearing up to march into Afghanistan.

To cap it off on 28th March 1979 there was a nuclear leak at Three Mile Island in Pennsylvania, which put the fear of nuclear fallout into Americans on the densely populated East Coast.

Federal Reserve Chairman Arthur Burns had let inflation run out of control during his eight year reign, so Jimmy Carter replaced him with Bill Miller in 1978, but Miller just made the situation worse. As a committed Keynesian he opposed interest rate rises, increased money supply to increase inflation and devalue the dollar in an effort to assist US exporters. The US dollar collapsed in 1978 and the US government was forced to borrow from the IMF and start issuing US Treasuries in foreign currencies for the first time. This humiliation caused a crisis in the Carter administration and Carter himself descended into despair and self-doubt.

It seemed that everything that could go wrong for America had gone wrong. This then was the environment in which the 1979 defaults occurred.

The debt ceiling - again

In April of 1979, Congress failed to legislate to reach a deal in time, and the government hit the debt ceiling. Without the ability to borrow more it had to decide who not to pay. It could "close down the government" and stop paying government employees or suppliers, or it could stop paying interest and maturing principal on its debts – Treasury bills, notes and bonds. It chose the latter.

In the 1979 defaults, the US government didn't treat all its creditors equally. Most treasury bills, notes and bonds are held by banks and other financial institutions like insurance companies and pension funds, with a small minority held by individuals. In 1979 the government chose to repay the main institutional creditors in full, but chose to default only on individual investors, about 6,000 investors in total.

On 26 April 1979 the US Treasury defaulted on $41m of maturing T-bills. They were paid 20 days late on Thursday 17 May after the government had found some money. Then again on 3 May Treasury defaulted on another $40m of maturing T-bills. These were also paid 14 days late. Then again on 10 May Treasury defaulted on yet another $40m of maturing T-bills. These were also paid on 17 May.

Treasury refused investors' demands to reimburse the $325,000 in lost interest on the late days and so investors were forced to sue the US government in a class action. (*Claire G. Burton v. United States, US District Court, Central District, California, D 79, 1818LTL (Gx)*). Unfortunately the Court threw out the investors' claim by relying on a 1937 Supreme Court ruling that "*interest does not run upon claims against the Government even though there has been a default in the payment of principal*" (*Smyth v. United States, 302 U.S. 329, 1937*). It came as a shock for Americans to discover that not only had the government defaulted on its debts, but there was a decades old judicial precedent establishing that it didn't legally owe interest when it failed to pay on time!

When the money market opened on Friday 27 April 1979, the day after the first default, T-bill yields spiked up by 50 basis points and this default premium on US T-Bills remained even after the default was rectified the next month. This demonstrates that the US government has indeed defaulted on its debt (at least temporarily), and that US T-bills are not "risk-free", but are prone to a credit default premium in their pricing.

This was the end for the Carter administration. Carter threw in the towel in his televised "malaise" speech on 15 July 1979, in which he succumbed to the national sense of hopelessness:

> *"… I realize more than ever that as president I need your help… We are confronted with a moral and a spiritual crisis…..It is a crisis of confidence. It is a crisis that strikes at the very heart and soul and spirit of our national will. We can see this crisis in the growing doubt about the meaning of our own lives and in the loss of a unity of purpose for our nation. The erosion of our confidence in the future is threatening to destroy the social and the political fabric of America*". (http://www.youtube.com/watch?v=KCOd-qWZB_g)

Carter's admission of defeat and despair marked the nadir for the American post-war prosperity and the end of the grand Keynesian dream that had dominated political and economic thought since Franklin Roosevelt's election in the depths of the 1930s depression.

Recovery from 1979 crisis

But all was not lost. The dark days of 1979 turned out to be just before the dawn of a new era for America. Jimmy Carter removed Bill Miller after just 18 months as Fed Chairman and installed Paul Volker in his place. Following Volcker's confirmation on 6 August, he set about immediately to switch Fed policy from Keynesianism to Monetarism – advocated by Friedrich Hayek, Keynes' arch rival, and Milton Friedman. Volcker instituted a new policy that clearly elevated the low inflation goal above the low unemployment goal, and focused the policy tools on tight control of the money supply to bring down inflation.

Meanwhile across the Atlantic, the UK had suffered a similarly debilitating and demoralising 1970s – with stagnant growth, high inflation, high unemployment, high interest rates, high tax rates and negative stock market returns and a humiliating IMF bailout. Following the "winter of discontent", a series of bitter industrial disputes and strikes under Labour, British voters elected Margaret Thatcher's Tories in the 3 May 1979 elections in the largest electoral swing seen in Britain since 1945.

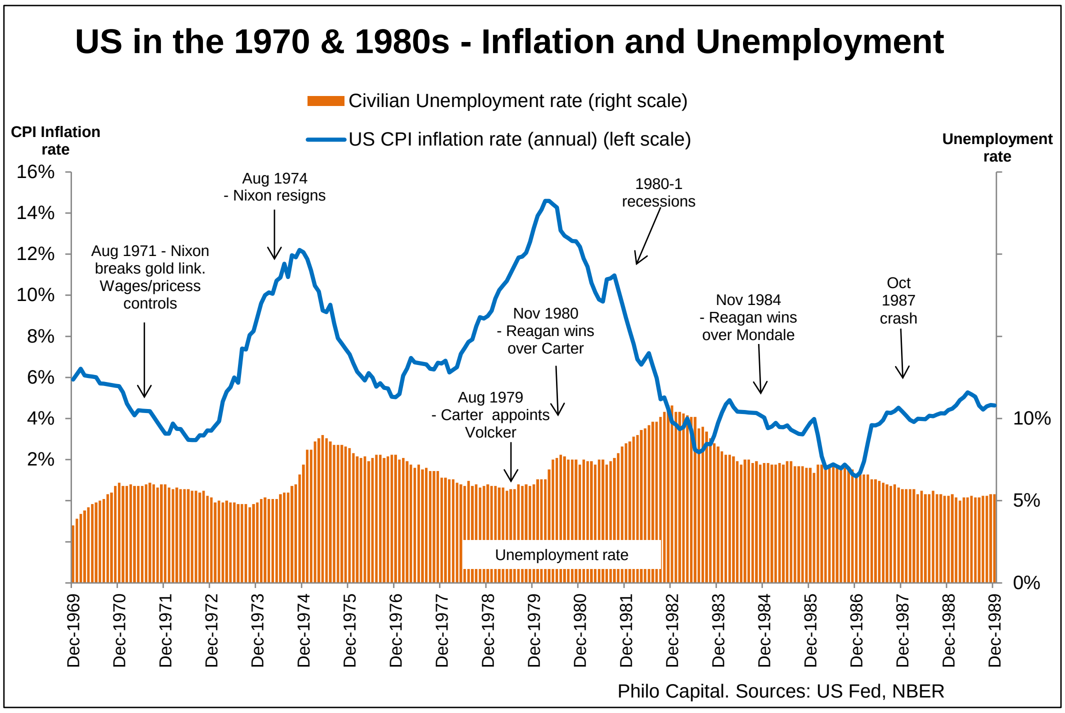
To Carter's credit, he honoured his promise to let Volcker increase interest rates until he brought down inflation, even though it triggered a deep double-dip recession in that began in 1980. The Fed discount rate peaked at 13% in Feb 1980 and T-bill yields peaked at 16% in March when inflation peaked at 14.6%, as the economy dived into recession and the unemployment shot up to double digits.

In conditions like these it is hardly surprising that the November 1980 Presidential election was won by Ronald Reagan in a landslide victory. Volcker, Reagan and Thatcher led the macroeconomic revolution in the 1980s – back toward smaller government, lower tax rates, privatisation of industries, deregulation of markets – which resulted in lower inflation, lower interest rates, lower unemployment rates, a return to economic growth, and ultimately victory over communism.

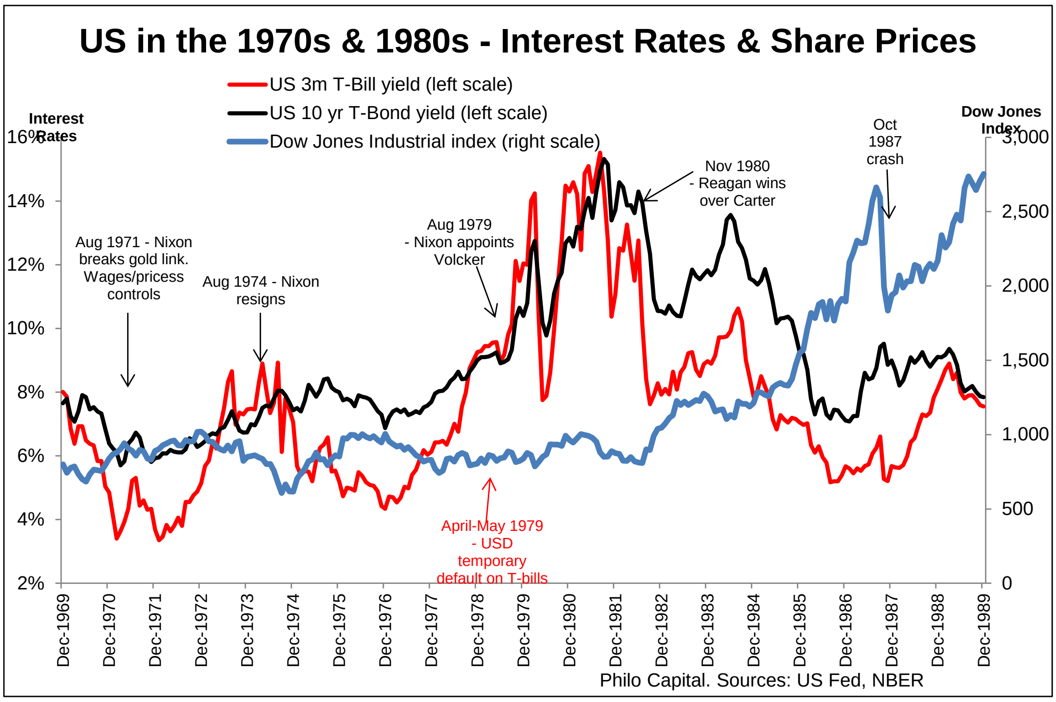
1979 was the turning point and the start of the 1980s which saw the victory of monetarism and market capitalism over state-directed Keynesian, socialism and communism. In China, Deng Xiao Ping turned his back on communism as an economic system and started down the capitalist road, and within a decade the Soviet system and communist eastern bloc had completely collapsed.

The following charts are the same as the previous three except they show the 1980s as well as the 1970s, illustrating how each of the measures turned the corner from the 1970s to the 1980s.

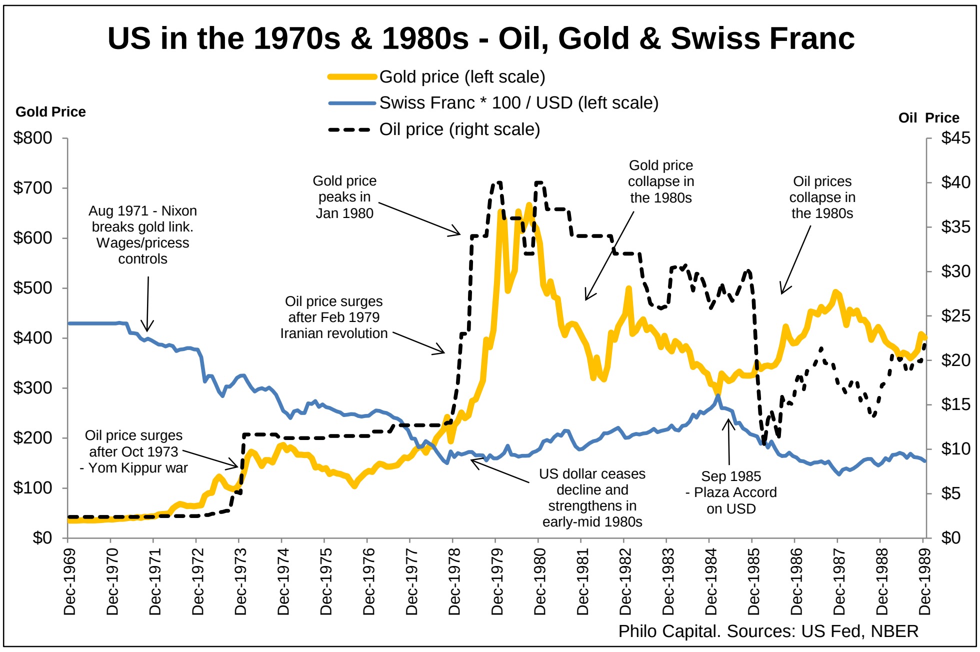
The first chart shows inflation and unemployment rising in the 1970s but both then falling in the 1980s following the 1979-1980 turning point.



The next chart shows short and long term interest rates rising in the 1970s but then falling in the 1980s. It also shows the stock market shifting from the stagnant 1970s into the booming 1980s.



The final chart shows oil and gold prices rising in the 1970s, but then collapsing in the 1980s. It also shows how the US dollar ceased its 1970s decline, turning into strength in the 1980s. The dollar returned to such strength in the early 1980s that the US had to engineer a major international intervention, the 1985 Plaza Accord, to prevent its further rise.

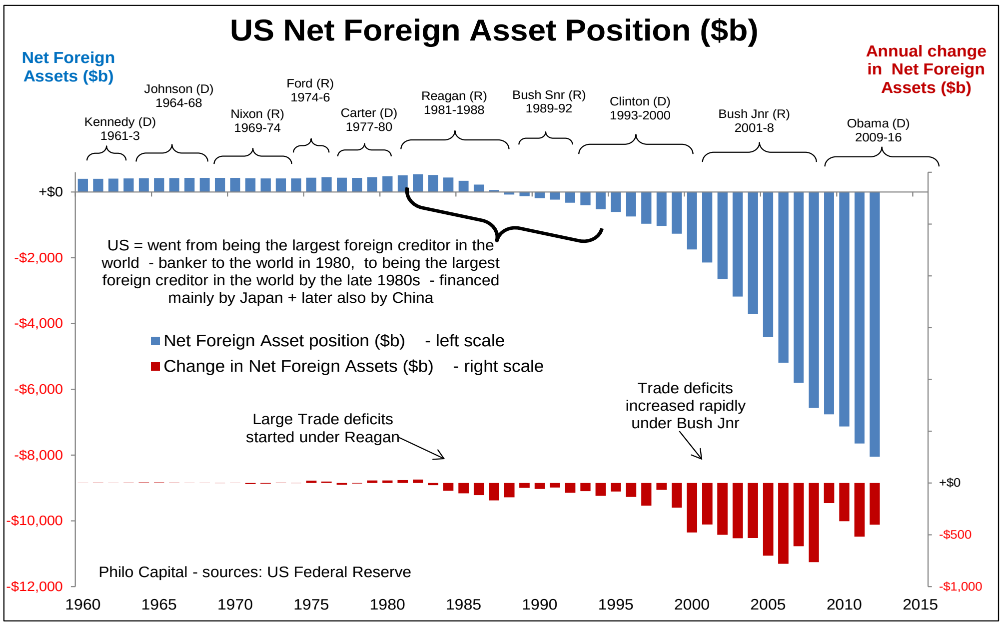


Thus the deep financial, economic and political crises that came to a head at the end of the 1970s became the dawn of a brand new era of growth and prosperity for Americans.

Or so it seemed.

The US economy may have grown strongly in the 1980s, 1990s and 2000s after the stagflation of the 1970s, but the boom was financed by debt.

When Reagan came to office in 1981 the US was the biggest creditor nation – it was the banker to the world. By the end of Reagan's first term it had become a net debtor. By the end of his second term the US had become the world's biggest net debtor and Japan had become the biggest creditor and main banker to America. This is shown in the following chart of the net foreign asset position.



Trade deficits increased rapidly under Reagan, were lower under Bush Snr and Clinton, but then blew out to record deficits again under Bush Jnr.

The trade deficits were financed by foreign investors, including a rapid build-up of foreign debt – firstly to the Japanese, and during the 2000s to the Chinese.

Fifteen years of spending and borrowing led to the next crisis – the 1995-6 government shut-downs.

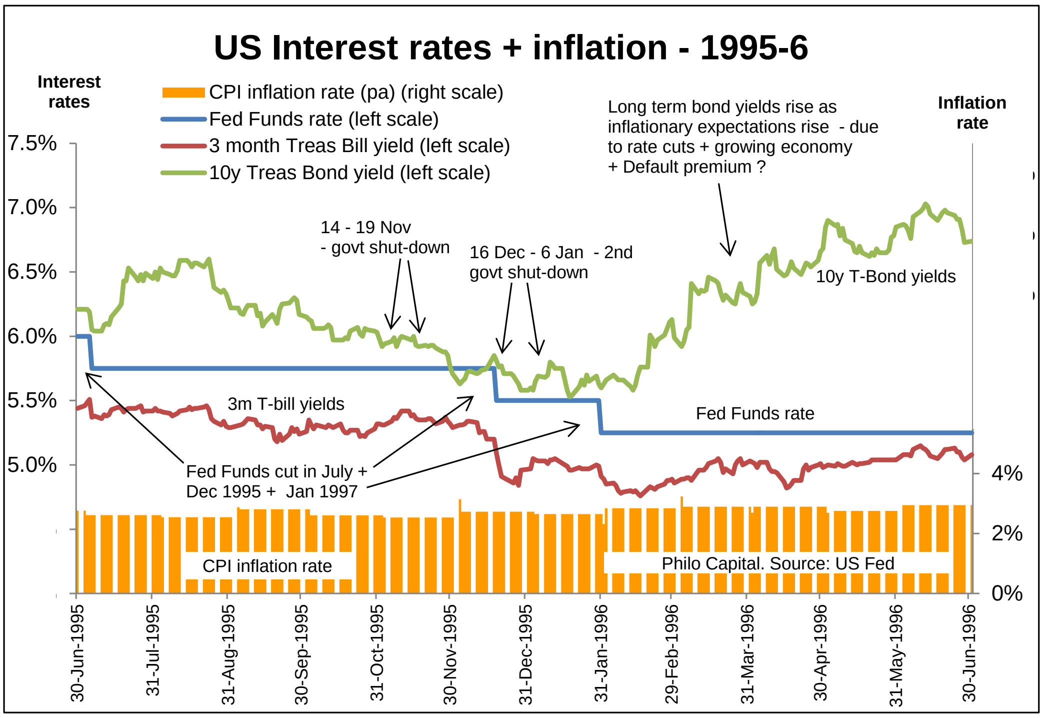
1995-6 deficit crisis & government shutdown

Now is not the first time the US Federal government has been forced to consider shutting down the government because it had run out of money and was unable to borrow more to keep paying its bills. It has happened before - most recently in 1995 and 1996. The stand-off forced temporary shut-downs of non-essential government services for 28 days across two periods: 14 to 19 November 1995, and again from 16 December 1995 to 6 January 1996.

The crisis was a culmination of the stand-off in the 1990s between the Republican controlled Congress (led by Newt Gingrich) and Democrat President Clinton. Clinton's 1993 Deficit Reduction Act was opposed by Republicans in Congress, who wanted more cuts to welfare, mainly Medicare.

By pushing the President all the way down to the wire in 1995 and forcing a shut-down of the government, Gingrich was seen by the public as going too far in putting political point-scoring ahead of America's credit standing in the world. Gingrich's loss of public support effectively ended his political career.

The first chart shows US interest rates and inflation during the 12 months from July 1995 to June 1996.

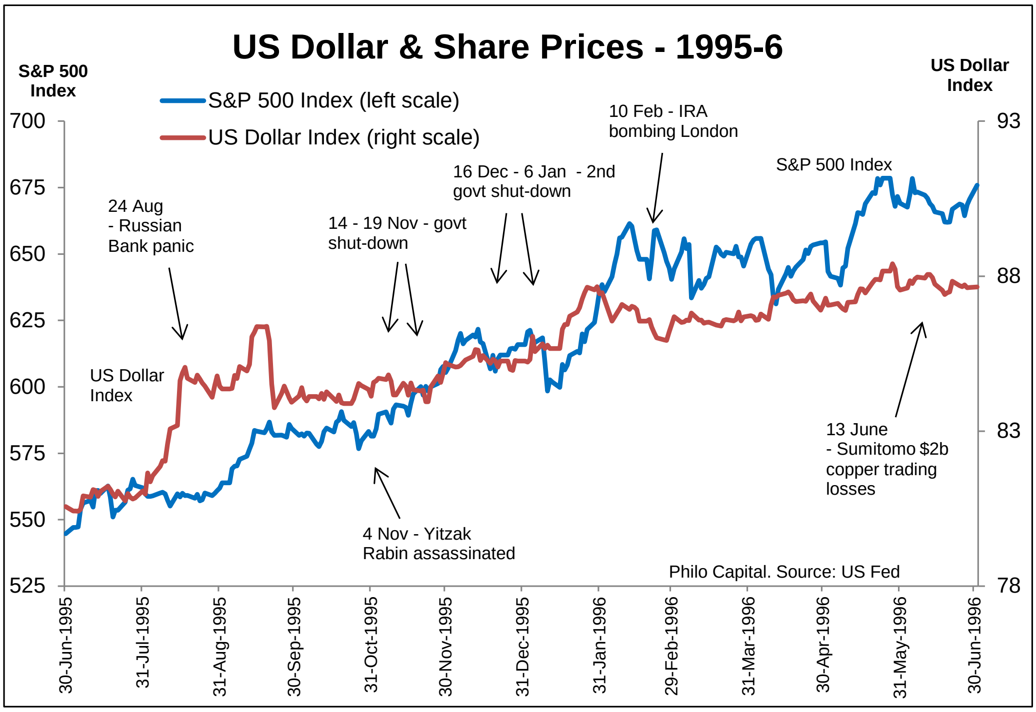


The Fed reduced the Fed Funds target rate 3 times from July 1995 and January 1996, following the seven rate hikes between February 1994 (which had triggered the 1994 bond market crisis) and February 1995. Short term rates were drifting down during the second half of 1995 and did not spike upward when the government shut-downs occurred, as might be expected in the event of a cash shortage. Rates stabilised at around 4% during 1996, and the Fed did not cut rates again in that cycle.

Long term bond yields were on the way down following the 1994 rate hikes, but started to rise again from the January 1996 following the shut-down crisis. There are several likely reasons for the rises in bond yields. The first is that inflationary expectations were rising – with inflation still running at 3% while the Fed was cutting rates and the economy was also growing relatively strongly.

It is possible that the increase in bond yields also started to factor in a credit default premium since clearly shutting down the government was not a long term solution to the deficit/debt crisis. However a stronger argument is that it reflected higher inflationary expectations as a result of Clinton's perceived victory over Gingrich in the PR war, meaning there was likely to be less pressure to balance budgets in future and more latitude to keep running expansionary deficits.

The next chart shows the US Dollar index (trade weighted basket) and the S&P 500 index over the same period.



The US dollar surged during the Russian bank crisis in August 1995 and then kept strengthening during the budget stand-off and even during the government shutdowns. Far from panicking in the crisis, investors kept buying US dollars and US shares. Over the 12 month period the US dollar gained 10% and the S&P 500 index put on a decidedly bullish 20%.

President Obama and the Republicans in Congress today are keen to not repeat the errors of gamesmanship in the 1995-6 shut-down crisis. Painful as the shut-downs were at the time for staff and suppliers, markets ignored it and kept on booming. The crisis did act as shock therapy for the President and Congress and it stunned both sides into constructive action.

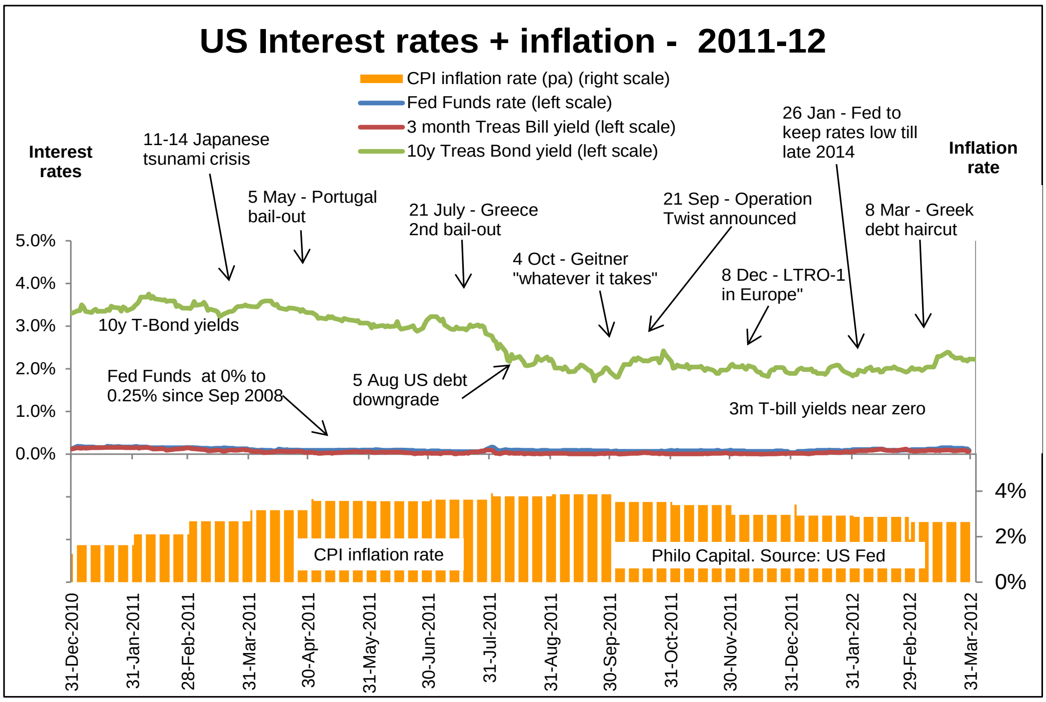
A compromise balanced budget bill was passed in August 1997, aimed at balancing the budget by 2002. In fact the goal was achieved earlier than expected, thanks to the booming dot-com economy that delivered better than expected tax revenues and lower than expected welfare costs.

To this day, Republicans and Democrats both claim credit for the surpluses, and they are both partially correct – it was the bi-partisan co-operation that was forged by the shock therapy of the crisis that produced the result. Clinton is the only President since Nixon (Republican) in 1973 to achieve a budget surplus. Not only that, there were three surplus years in a row – 1998, 1999 and 2000 - a feat not seen since the Kennedy/Johnson (Democrat) surpluses of the early-mid 1960s.

2011 deficit crisis & credit downgrade

Following the 2008 sub-prime crash and 2008-9 recession, the deficit talks broke down seriously again in mid-2011 and culminated in an historic downgrading of US debt from Standard & Poor's in August – the first credit downgrade ever for the US.

The first chart shows US interest rates and inflation during the 12 months from January 2011 to March 2012.

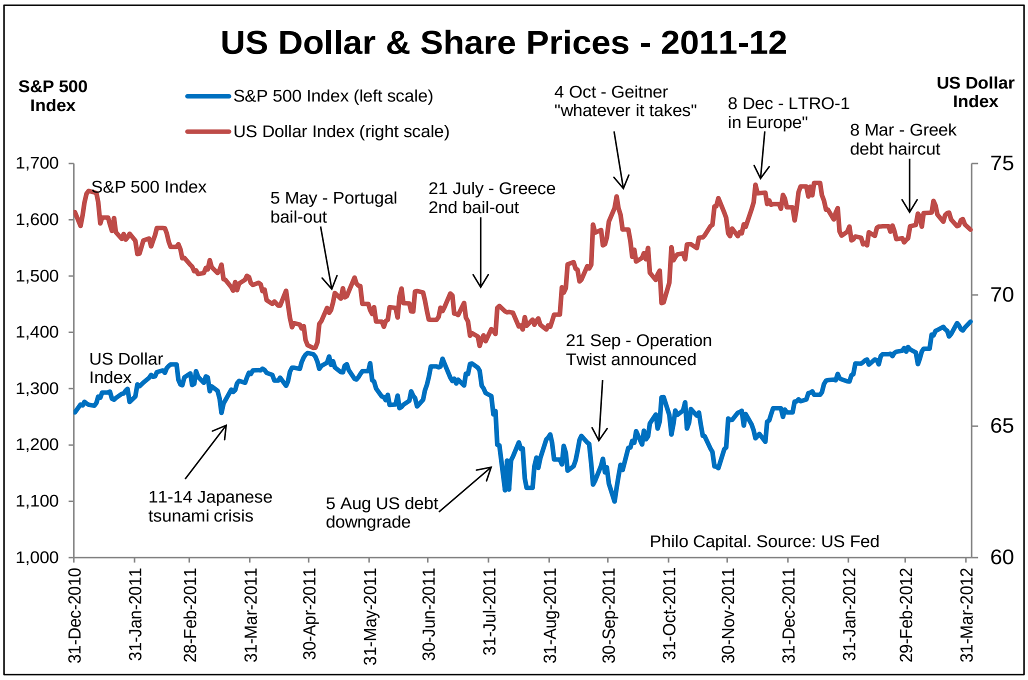


Short term rates had been kept near zero since the Lehman collapse in September 2008 and bond yields had been falling since the recovery from the Japanese tsunami crisis in March.

Yields kept falling, supported by "QE-2" and also due to the growing storm in the European debt crisis with the Portuguese bailout in May and the 2nd Greek bailout in July.

When the debt ceiling talks went down to the wire in the first few days of August and S&P issued their historic credit rating downgrade on Friday 5th August, investors did not dump US debt as was feared. Instead, short term rates remained at almost zero and bond yields actually fell as investors rushed into buy more. In the immediate aftermath of the downgrade, yields fell below 2.4% and have remained below that level ever since as the debt pile continues to mount.

Clearly there is no credit default premium nor inflation premium built into US bond yields, at the time of the downgrade or ever since, with yields still now around 2%. The next chart shows the US Dollar index (trade weighted basket) and the S&P 500 index over the same period showing the impact of the downgrade on the currency and stock markets.

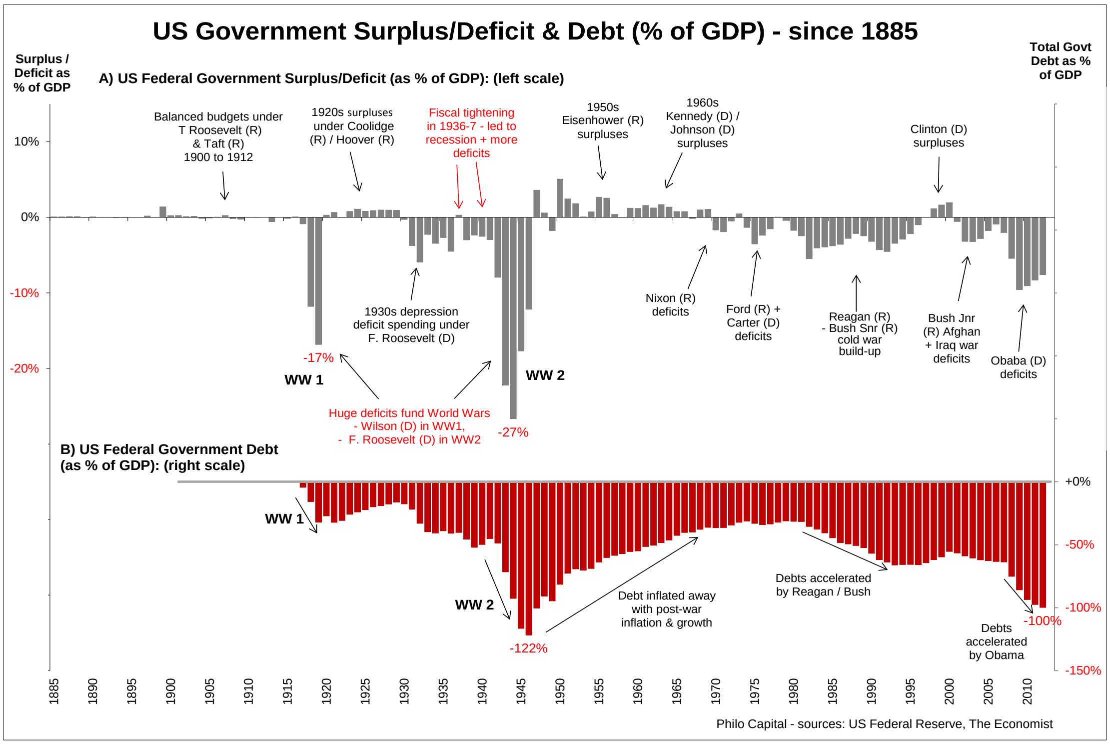


The US dollar and share prices had been falling during June and July as the European and US crises escalated. Did investors panic and dump the dollar and/or US shares when the US debt was downgraded? No. They did the reverse, just as they had done after the 1995-6 government shut-down crisis. Both the dollar and US stock markets recovered strongly immediately following the downgrade, supported by more monetary easing and Bernanke's promises to keep interest rates near zero for at least the next two years.

But they did buy gold, just as they had done after the 1979 defaults. The gold price spiked up to $1,900 per ounce in the aftermath of the crisis, but has since fallen back to around $1,600.

History of US deficits and debt

Having described the main events and turning points of the past hundred years or so, the following chart shows US government deficit and debt positions each year since 1885. The top section shows the annual budget surplus or deficit as a per cent of annual GDP, and the bottom section shows the cumulative Federal government debt balance, also as a per cent of GDP.



World Wars

Clearly the largest deficits and debt build-ups were in in the First and Second World Wars. Both of these were under Democrat presidents – Woodrow Wilson in WW1 and Franklin Roosevelt in WW2. However, the debts would probably have been even higher in each of the World Wars had Republicans been in power. In both cases the US profited enormously from selling to both sides before it entered the wars, but once it entered the wars it had to run up massive debts to finance the war efforts.

Democrat Woodrow Wilson was extremely reluctant to enter the war, and won his second term in the 1916 election on a platform of staying neutral. Theodore Roosevelt, who had split the Republican vote and by that time headed the Progressive Party, wanted the US to enter the war. The US economy boomed during the war and the deficit blow-out only began in 1918 after the US entered the war.

Likewise, in WW2, the budget deficit and debt only blew out from 1942 when US was drawn into the war by Pearl Harbour in December 1941. Franklin Roosevelt won the 1940 election on a platform of isolationism over the pro-war Republicans, despite Germany gaining the ascendancy over France during 1940. Had Republican candidate Wendell Wilkie won the 1940 election, the US war effort (and the increase in debt) would probably have started a year earlier than it did under Roosevelt.

Reagan / Bush / Bush war build-ups

Aside from the two World Wars, the largest debt build-up period was the 12 years from 1981 to 1992 under Ronald Reagan and George Bush Snr – a combination of tax cuts and cold war military spending.

Then Democrat Bill Clinton (1993 to 2000) produced progressively lower deficits in 1993 to 1996, a balanced budget outcome in 1997 and then three years of surpluses – 1998, 1999 and 2000.

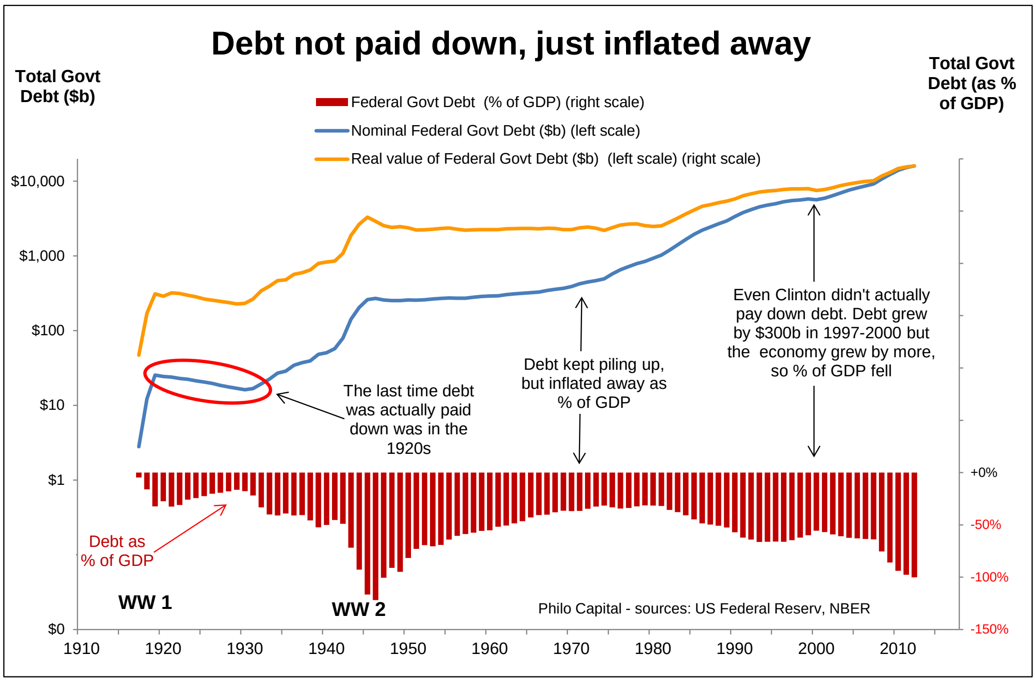
George Bush Jnr (2001 to 2008) ran deficits and ran up debts with his massive war-time spending and tax cuts on a scale similar scale to the Reagan / Bush Snr years.

At the very right of the chart we see that President Obama's deficits have been larger than all other deficits outside of the two World Wars. The Obama deficits dwarf even the Reagan / Bush / Bush deficits and also dwarf Franklin Roosevelt's 1930s depression deficits. The Obama deficits have been the result of a continuation of the Bush Jnr tax cuts, continued wartime spending, GFC stimulus programs and extensions to welfare. (The bailout funds for banks, AIG, General Motors, Chrysler, etc have actually returned profits to Treasury rather than being costs to the budget).

Paying off the debt?

Like companies, countries do not need to pay off debt. They are very different to individuals, and so comparing maxims on fiscal rectitude to that apply to individuals and the households is not appropriate in the context of companies or countries. Individuals earn money during their working years but then hope to retire one day, when income ceases and spending keeps going for decades in retirement, so they need to pay off debt before their income ceases in retirement. On the other hand, countries and companies are perpetual. Income doesn't suddenly cease one day, and so carrying an appropriate amount of debt is healthy – provide the debt is used to invest in productive assets that generate future tax revenues (or future budget savings) that exceed the interest rate on the debt.

The next chart shows the cumulative debt pile in nominal (pre-inflation) terms and in real (after-inflation) terms, together with the debt to GDP ratio at the bottom.



Here we see that even Bill Clinton's surpluses didn't actually pay down debt. Federal government debt grew by $300b during 1997 to 2000 but the economy grew by more, so the level of debt to GDP fell.

The last President to actually reduce total debts was our friend Herbert Hoover in the 1920s boom, when debt was reduced in both nominal and real terms, and also reduced relative to GDP.

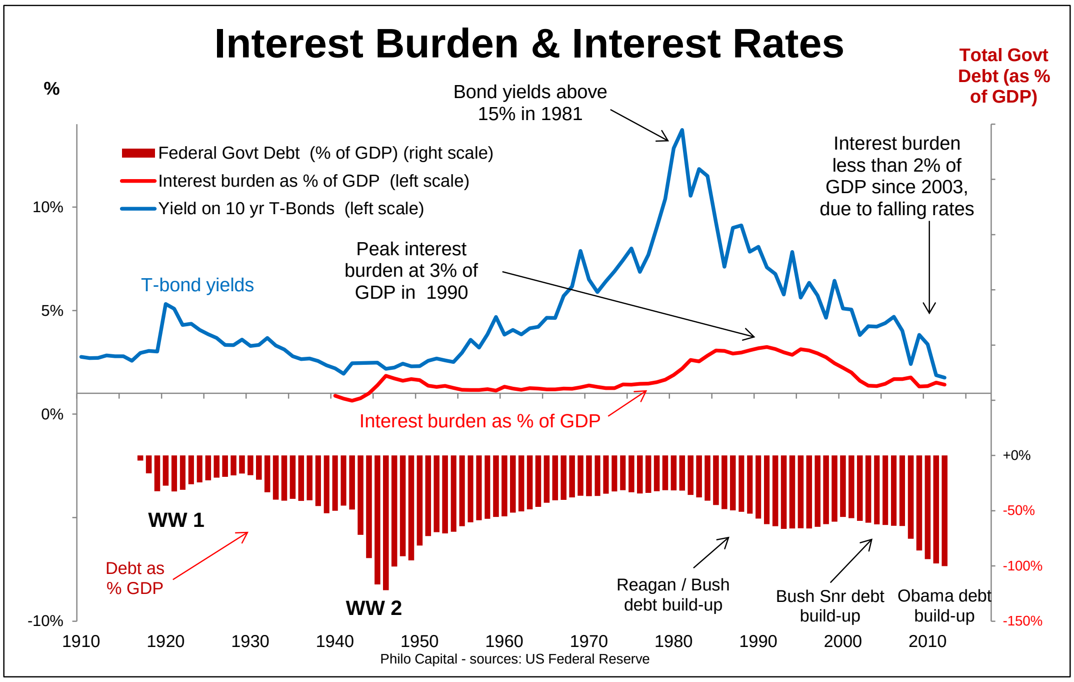
So the challenge is to make sure deficits and debt are used to build productive assets that generate returns that are higher than the interest rate on the debt.

Even if governments don't need to actually pay of government debt, the challenge is to get the economy growing. The goal is inflation. Inflation brings three benefits. First, it depresses the currency which in turn can (but not always) assist domestic business that compete with imports, both of which help stimulate production and jobs at home. Second, inflation decreases the real size of the debts owed by households, companies and government, so people feel confident to start spending again and companies feel confident to start investing and hiring again. Third, inflation encourages people to spend money today because they fear prices will rise in future.

Is the current level of debt too high?

The interest burden on government debt is actually quite moderate and manageable, and similar to what it was in the 1950s and 1960s.

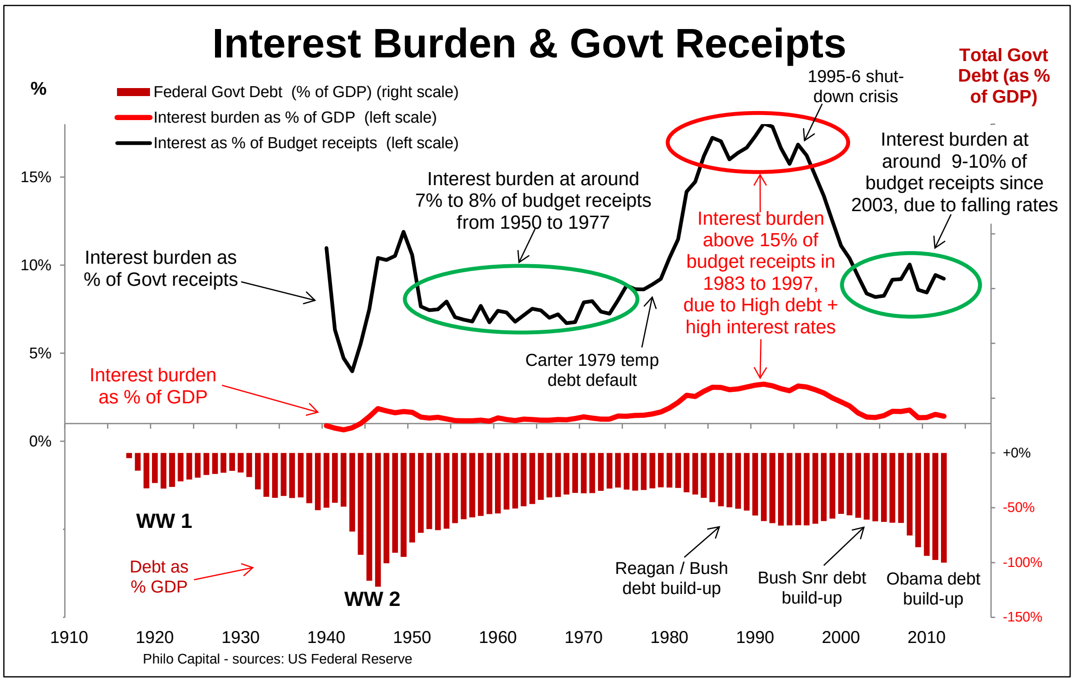
Interest costs have been running at around 1.5% to 2% of national output since 2002, as it had been since the 1940s.



It rose to more than 3% of GDP from 1986 to 1996 due to the Reagan/Bush Snr debt build-up, even though interest rates fell dramatically during the period. Interest costs as a % of GDP then fell rapidly in the Clinton surplus years following the 1995-6 government shut-down crisis.

The interest costs have remained flat in recent years even though the nominal amount of debt has grown because the economy and tax revenues have also grown. If the overall economy keeps growing even modestly, the interest burden is manageable.

Interest costs have been running at around 9-10% of budget receipts since 2003, despite the rising debt level. This is around the same interest burden from 1950 to the late 1970s, and so is entirely manageable.



Interest costs were running at more than 15% of budget receipts in the 15 years from 1983 and 1997, as a result of the massive debt build-up under Reagan and Bush Snr, despite declining interest rates.

Notice that the 1979 temporary default crisis occurred when the interest burden was at a low level before the rapid rise in debt burden in the 1980s. The default crisis in 1979 and capitulation of Carter was enough to trigger a change in government and a whole new economic paradigm but the debt problem just got a whole lot worse under Reagan.

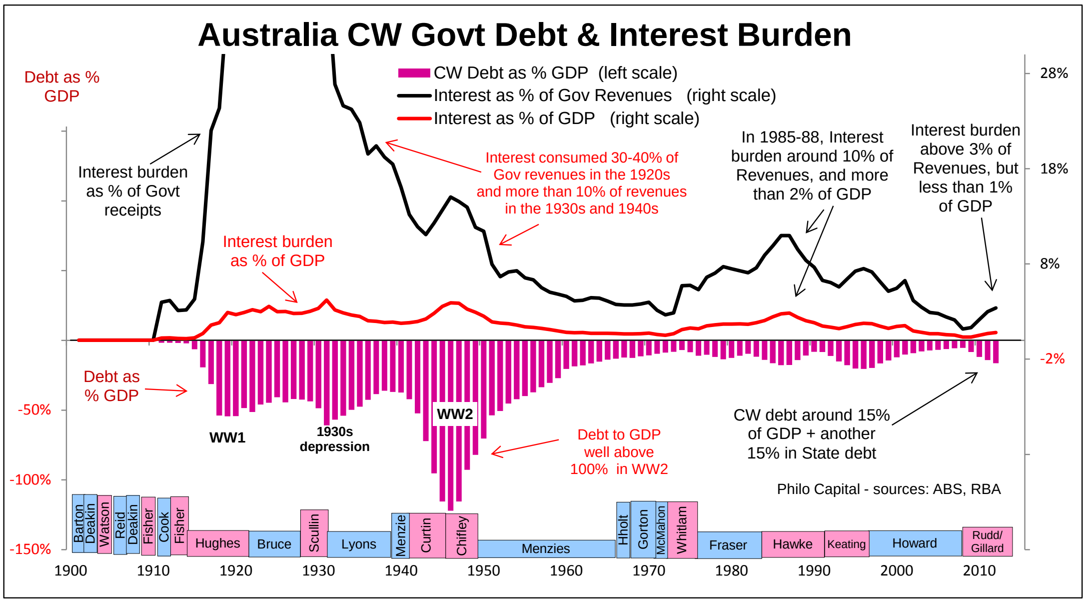
Interest costs as a share of budget receipts have remained flat over the past 10 years despite rising debt levels because national output and tax revenues have also been rising, and interest rates have been very low. Even four years of trillion dollar deficits in 2009-12 have not raised the interest burden thanks to declining interest rates, and a growing economy.

All of this means that the current deficits are moderate and manageable. The trigger for the recent crises has been the debt ceiling issue, and inability to agree on the mix of spending and taxes – and those are all about politics. If the politics can be sorted out, the economic and financial situation is far from dire, and so there is time to come up with real solutions.

There is time, but not a lot of time, because interest rates could start to rise as the economy improves further and as the Fed winds back its bond-buying program.

How does Australia compare?

Here are the same debt burden measures for Australia since Federation.



In the mid-late 1980s (epitomised by Keating's "banana republic" panic in May 1986), interest costs on government debt were running at around 10% of revenues and more than 2% of GDP, and debt to GDP was above 15%. This was significantly better than the US from the mid-1980s to the late 1990s under Reagan and Bush Snr, where interest was running at more than 15% of revenues, more than 3% of GDP, and debt to GDP was above 50%.

Australia was in a similar position to the US in the Second World War in terms of debt levels (both well above 100% of GDP), but Australia was a very different proposition in the 1920s and 1930s. Australia (mostly NSW) spent up big time in the 1920s, defaulted on debts in the 1930s and adhered to a strict program of deflation and balanced budgets in the depression – simply because it was unable to borrow following the NSW and Commonwealth defaults.

Today Australia's debt is relatively low – running at around 15% of GDP (plus another 15% in State debt), and interest costs are consuming around of 3% of government revenues, compared to around 10% in the US. Australia's interest cost per dollar of debt is about double that of the US because of our higher interest rates, due to higher structural inflation.

Ways out for America

The government defaults and shut-downs in recent years were only temporary and were rectified quickly. A full default or debt restructure could be many years away yet. America is still the wealthiest country in the world and has plenty of ways to find cash here and there to postpone the debt ceiling crisis, as it has done in the past – perhaps for many years to come. Markets have brushed off these mini-crises in the past and will probably do so again in the future.

But this doesn't solve the problem. Every year that passes without balancing the budget just makes the problem even larger when the eventual day of reckoning arrives.

There is no sign of any credit default premium in bond yields yet. Yields would need to be above about 5.5% to reflect a default premium, but they are currently around 2% still. (Nominal yields without any default premium would be around 5% to 5.5%, consisting of: the expected long term real GDP growth rate of around 2.5% given the likely outlooks for population and productivity growth, plus the long term expected inflation rate of around 2%, plus a maturity premium of around 0.5% to 1%).

The debt is large, and only a major external jump in demand or a major radical overhaul will fix it. The Second World War provided a sudden external boost to demand, production and employment that ended the 1930s depression, but there is no major war in sight today. In any event, the US went into the war as the largest net creditor, but is now the largest net debtor.

Another war-time debt build up is not the answer from the current position. The First and Second World Wars were short and sharp. The cold war build-up, and the wars in Vietnam, Iran and Afghanistan were long, drawn out and expensive, and they are half the cause of the current debt pile. America doesn't need another expensive war.

Radical surgery will be needed to solve the problem – eventually.

The automatic sequester will only cut 2% from the budget, so the debt will keep on piling up. We have also seen that even if the entire US government closed down completely and forever it would not even balance the budget. Even if the entire US government were eliminated completely, taxes are still far too low and/or welfare costs are far too high. Balancing the budget would require an immediate and permanent 35% across-the-board cut to all spending, including welfare, the military and everything else, or an immediate 54% rise in taxes, or a combination of the two.

Cutting the military?

The largest single area of spending is the military – and any tampering with the budget there is highly political. Many millions of Americans, and perhaps a majority of Republican supporters, may not see a need for much of what the government does, but what they do see as a core non-negotiable role of the Federal government is national defence. Any cuts to defence are a sure vote loser in an era of rising perceived threats from China, Russia, Islam, terrorism, and a host of other fears that can be whipped up easily in an election campaign.

However, large cuts to the military budget should be possible. With the Iraq and Afghanistan wars winding down, Japan now wanting to build its own defence capability, the Soviet threat gone, and the rise of shale gas reducing America's reliance on oil and the middle east, a saving of 50% of the current military spend would cut 11% from the total budget. Not a bad start, without even touching the civilian government, welfare or taxes yet.

Only another major crisis will bring a mandate for change

It is clear that fiddling around at the edges with minor cuts here and there and minor tax rises is not working. All it does is delay and escalate the real problem. As the UK and the PIIGS have found (and all developed countries found in 1936-8, including the US and Australia), tackling the deficit by cutting spending and/or raising taxes just increases the deficit because in the resultant slowdown tax revenues fall and welfare bills rise. In the absence of a deep crisis that gives rise to clear voter mandates for radical change, austerity is political suicide and very hard to maintain in the face of voter backlashes.

A radical cutting of say "even" 20% or 30% from the budget (or equivalent tax rises) would probably plunge the US and the rest of the world into a deep depression on the scale of the 1890s or 1930s. The problem is that in all likelihood it will probably require a severe crisis to bring about the radical policy changes that will be needed to break out of the deficit cycle and give birth to the next era of growth and prosperity.

Franklin Roosevelt obtained such a voter mandate for radical and unprecedented policy changes. He even broke the 2-term limit for US Presidents by standing for, and winning, four elections - a feat never achieved before or since. Americans respond to strong leadership and will do whatever it takes when the see the need is great enough.

Hurdles for American recovery

There are three main hurdles to the US recovering and balancing the budget.

Hurdle 1: the US dollar

The first is the dollar. It is very hard for the US to depress the US dollar as it is still the main "safe haven" currency. The dollar rises in any crisis, even if the cause of the crisis is the US itself. Another international agreement like the 1985 "Plaza Accord" would probably not work in today's world. Markets are now larger and more powerful than governments – as Britain discovered in the 1992 sterling crisis.

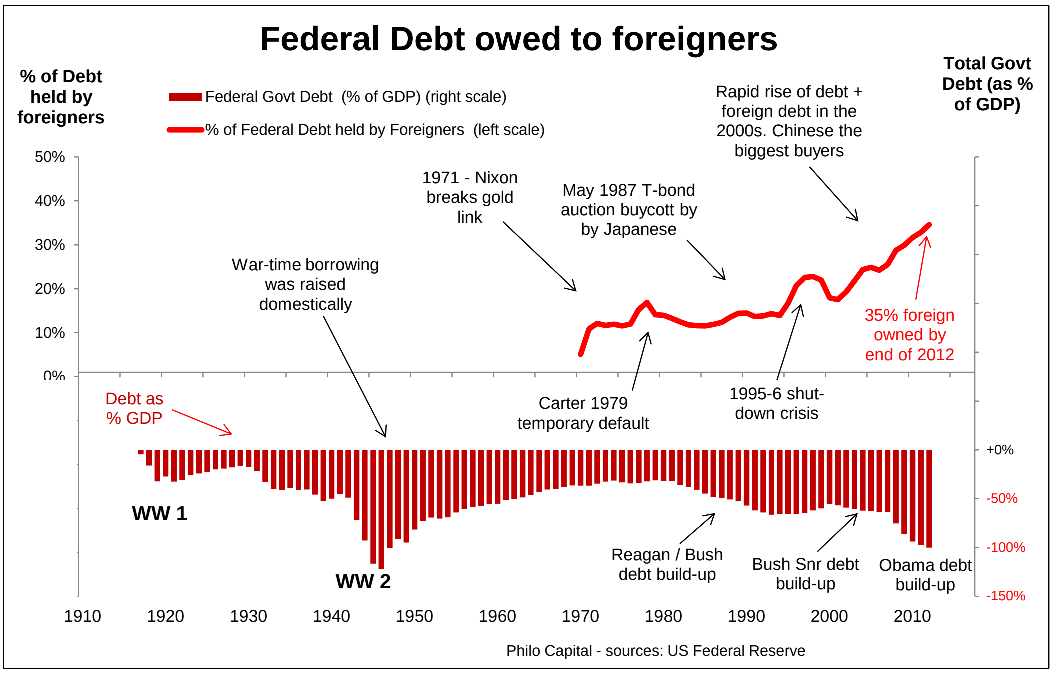
Japan is having some success with its pro-inflation policy, but the Japanese debt to GDP ratio is more than double that of the US. Perhaps after several more years of trillion dollar debts the US debt will be the size of Japan's (relative to its output), but that could be years away yet.

The US dollar will probably strengthen, not fall, as the US economy continues to recover. This is the most likely scenario – more short term quick fixes for the regular budget ceiling crises while the economy keeps recovering tentatively, and a steadily strengthening dollar.

Not being able to depress one's exchange rate is a hurdle to stimulating growth but it is not fatal, as we shall see.

Hurdle 2: Current debt position and ownership by foreigners

More than a third of government debt is now owned by foreigners. The share of foreign ownership of US debt has been rising rapidly since the Reagan debt build-up – bought mainly by the Japanese, and the foreign share accelerated in the 2000s as the Chinese became the main lenders.



Americans have not been in this position for more than a century. America shifted from being a net debtor and heavily reliant on British and European capital for its first 100 years of Independence. It made the great turn-around from reliance on foreigners to self-sufficiency and self-determination after the 1890s depression.

As Japanese bought up most of the American foreign debt to finance the 1980s Reagan budget deficits and trade deficits, the thought of America surrendering some financial sovereignty to the Japanese resulted in a rise in American xenophobia against the Japanese and a series of acrimonious trade protection and currency disputes all the way thought the 1980s.

Japan itself has more than twice the level of government debt than the US, but Japan is not beholden to foreigners, as more than 90% of Japanese government debt is owed by Japanese investors, and half of that is owned by government pension funds and government departments themselves. Since the mid-1980s, the US has been beholden to foreign creditors – first the Japanese and now the Chinese. Unlike Japan, America cannot make its own rules and set its own agenda. Japan first flexed its fiscal muscles in the US bond auction crises in May 1986 and May 1987, just to show that it could.

In the 2000s China has taken over as the main lender to the US government and we have seen a rise in US-China trade protection and currency disputes, and recently the cyber-hacking allegations. Disputes like these are likely to increase in intensity over time as China's role on the world stage expands.

On the other hand there are some positives in this situation of significant foreign ownership of American debt. The first is that foreign bond holders are terrified of the potential losses on their bond holdings if yields were allowed to rise, and so they have powerful incentives to keep lending to the debt addict to keep yields low. The Japanese in particular are enjoying double-digit returns from their holdings of 2% US bonds as the yen falls. Japanese pension funds could keep selling yen bonds and buying US treasures (which depresses the yen and keeps the dollar high) for years and make handsome returns.

Hurdle 3: Politics

This brings us to the third major hurdle. Politics in Washington is still very partisan and divisive following the November 2012 elections and is deteriorating. The Democrats lost their super-majority in January 2010 after Ted Kennedy died, after Obama had only been in office for a year. The balance seemed to be swinging further the Republican's way during 2011 and 2012, highlighted by the extremely divisive August budget ceiling and downgrade crisis. Now the pendulum has now swung back a little toward the President after the November 2012 elections, but relations have become increasingly caustic between Republicans and Democrats.

The other big risk for the Republicans, or opportunity for the Democrats, is a split in the Republican vote, just as Theodore Roosevelt split the Republican vote in 1912, allowing Democrat Woodrow Wilson into the White House. Today the Republicans are showing internal frictions on two fronts. The first is the Tea Party movement, which still wields significant influence. The second is a potential split between the old guard with their predominantly white, xenophobic, working class supporters, and a new guard that recognizes and embraces the growing Hispanic vote. As the economy improves slowly the Tea Party influence should wane, but the Hispanic influence may keep rising.

These internal divisions within the Republicans, in particular the Tea Party faction, are centred around fiscal and monetary policy differences, and may make getting Republican agreement on any solution very difficult.

Positives for America

Despite these hurdles, there are many positives for America.

As we have seen, the interest burden on the debt is entirely manageable as is on a par with the low debt and low interest rate era of the 1950s and 1960s. The problem is politics – in dealing with the debt ceiling and with the budget mix of spending and taxes.

US yields are still at ultra-low levels. That buys time. It has time to get its budget house in order and come up with a real plan for the future.

Another positive is that the current low interest rates and low debt burden mean that the US has the opportunity to use these very low yields to borrow at locked-in ultra-low fixed rates to invest in productive long term assets that will generate tax revenues well in excess of the interest cost – eg in long term productive infrastructure like education, energy and transport.

The Fed's bond buying program will have to end and even unwind one day and that will cause yields to rise. The sooner the US economy recovers the sooner that day will come. So far it looks like another half year or so away, or perhaps longer. The President and Congress should be using that window to come up with real long term solutions, not endless short term quick-fixes and political point-scoring.

The US is a relatively good place to do business – it has flexible labour laws (particularly relative to Europe, Japan and Australia), declining energy costs (with the shale revolution), strong rule of law, protection of property rights and independent judiciary (relative to emerging markets), a relatively hands-off government (compared to just about everywhere else), labour mobility and incentives for work due to limited entrenched welfare.

It also has a relatively good outlook for its domestic economy – a relatively young population (unlike Europe, Japan, soon China), and a growing population (unlike Japan, Russia, much of Europe, and soon China).

The US also continues to be the mecca for the creative and enterprising people of the world – inventors, designers, artists, writers, poets, engineers, architects, mathematicians, scientists, etc - all flock to America to make their mark on the world. These are the creators of knowledge, wealth and progress.

As a result of these advantages, the US is home to hundreds of major companies and countless thousands of small companies that are capitalising on the rapid growth of the "emerging markets".

Precedents for radical change

Fortunately there are some recent and current precedents for radical fiscal surgery, even in countries that also lacked the ability of depress their currencies.

Ireland

While at the eastern end of Europe, the often violent reactions to austerity in Greece have dominated the world's headlines, at the western end of Europe Ireland has been reforming relatively quietly and peacefully. Ireland's debt problem was created not by big budget deficits but by the government's bail-out of its banking system after the speculative property boom crashed. It couldn't depreciate its currency, as it was stuck with the Euro, so had to embark on a savage program of "internal devaluation" - wages & prices fell by around half, labour markets and business regulations were reformed radically. Ireland is now growing again, and is set to be the fastest growing economy in the Eurozone this year.

The Baltics – Estonia, Latvia, Lithuania

Estonia also suffered from a property lending crash and is leading Latvia and Lithuania out of the crisis. A similar savage "internal devaluation" involved deep budget cuts, reductions in wages and increases in labour market flexibility. Exports and production are now growing strongly, unemployment rates have been reduced from 19% to 13% and still falling quickly. Having taken the painful austerity medicine and come out the other side in much better shape they are now on the side of "hard money" standing beside Germany and the rest of the north of Europe.

California

California was until recently a national laughing stock – considered an economic basket case often likened to Greece. Starting in 2009, there was a full scale debt crisis under then Governor Arnold Schwarzenegger. The government had to sack staff and reduce pay, there were several government shut-downs, departments went onto 4 day weeks, the State debt suffered credit ratings downgrades to BBB, Obama refused to give a Federal guarantee to State debt, the major banking groups refused to accept $2 billion of State debt notes, and the government delayed and deferred making payments to suppliers and creditors.

But all that has now changed. A currency devaluation was not available of course, being stuck with the high the US dollar, so they had to tackle the budget directly. A $40b deficit in 2009 has now been turned into a surplus this year. Aged pensions and healthcare entitlements are still far too generous, but at least the state will have a surplus with which to tackle the problem as the next step. The government raises taxes on individuals and companies – "Proposition 30" raised income taxes on the wealthy and also increased sales taxes, while "Proposition 39" closed several corporate tax loopholes. It has even managed to increase spending on education again after the savage cuts in 2009-2010.

Who achieved this?
The other high school I went to before Roosevelt High was John Muir High in Pasadena, California. When I was there in the mid-1970s the Californian State Governor at the time was a young Democrat named Jerry Brown, fighting against the death penalty and fighting for balanced budgets. He left office in 1983, but he was so enraged with the current level of debt and decay in California that ran for the Governorship at the end of 2010 and won. Since taking office again in January 2011 he has led the state out of deficit and back into surplus in just 2 years.

California is the most populous American State (with 38 million people), it has the largest economy, and would be the ninth largest economy in the world if it were a separate country. If Jerry Brown can turn a $40b deficit into a surplus by taking quick, decisive action, and still have plenty of scope to increase the surplus further and reduce the debt, then it is indeed possible for the rest of the US.

Texas, the second most populous state with the second largest state economy, is also going through a radical fiscal turn-around - led by Republican governor Rick Perry. Texas is one of the lowest taxing states and has no personal income taxes, relying mainly on sales taxes for revenues, but radical budget cuts have turned a $20b deficit into a surplus.

A significant factor in the turn-around in Texas has been the shale revolution, which is not only helping transform government finances in the oil states but is also fuelling a manufacturing revival in many of the old “rust belt” regions across the nation. America is on the way back!

Some conclusions

The US is facing a serious government deficit and debt crisis. Republicans and Democrats are fiddling at the margins while the debt pile grows progressively larger with each delay and short term quick fix. America has faced worse economic, financial and political crises in the past – in the 1890s, 1930s and even in the 1970s. Each of these crises brought about radical changes in policy and proved to be major turning points in America’s economic and financial history, and in each case the US economy and markets survived and prospered.

Our focus is on markets, not just economies, and in each crisis markets recovered, starting right from the middle of the crises when all hope seemed lost and pessimism was greatest.

Let us close by offering some comments on the questions posed at the outset:

Should the government impose strict “budget austerity” to “balance the budget”? Or is the solution even more “deficit spending”, even more debt, and seemingly endless “money printing”?

- There is no one right or wrong set of policies that work at all times and in all situations. Inflationist full employment targeting, deficit spending and government intervention sounded like a good idea in the 1930s depression but economies collapsed in a mire of high inflation, high unemployment and stagnation in the 1970s (although it is probably unfair to sheet home the malaise of the 1970s to Keynes)
- Hard money policies of money supply targeting, deregulation and freer markets sounded like a good idea after the 1970s. Inflation was brought down and the economy and stock market boomed, but it trade deficits and foreign debt soared. Low interest rates and deregulation produced a string of asset bubbles and collapses culminating in the sub-prime crash and sovereign debt crisis. (Likewise it is probably unfair to blame the current crisis on Hayek and Friedman).
- Severe economic, financial and political crises provide the catalyst for radical policy changes and, even when they are successful, often contain the seeds of the next crisis.
- Trying to balance the budget through piecemeal budget cuts and/or tax hikes generally just makes the deficit and debt worse, as tax revenues fall and welfare spending rise in the resultant slowdown – as was the case in 1936-8 globally and more recently in the UK and the PIIGS. It is also politically unpopular and hard to sustain in the face of popular backlashes.

- Generally it requires a very serious crisis in order to provide the catalyst and the political mandate for radical change. It generally requires either a deep external devaluation (large-scale currency depreciation, which is not possible with a fixed currency like the Euro or a strong currency like the US dollar) or deep internal devaluation (savage cuts to spending, wages and working conditions).
- There are precedents for successful turnarounds – in the Eurozone and in US States (including large states like California and Texas)

"Should the government go even further and create budget surpluses to actually 'pay off the debt'?"

- Governments are not like individuals who need to pay off debt and create a surplus to fund retirement after income has ceased. On the contrary, governments, like companies, are perpetual and can carry a level of debt forever as long as the debt is used to finance proactive assets that will generate tax revenues that exceed the cost of the debt. Great nation-building projects like transport and energy infrastructure would qualify, but borrowing to pay welfare, government administration or the military would generally not.
- Even the Clinton budget surpluses in 1998-2000 did not actually reduce the level of government debt. The last President to actually reduce the level of Federal government debt was Herbert Hoover in the 1920s boom.
- There is plenty of money in the US and plenty of scope for governments to collect more of it in tax revenues. The Clinton surpluses were achieved thanks to the 1990s dot com boom, but the dot com boom was a relatively profitless boom. US companies today are many times more profitable and today's profits are cash profits, not the largely artificial cashless profits of the late 1990s.
- Trying for surpluses without radical reform will probably only lead to larger surpluses and more debt in the short term. Surpluses are generally only achieved from recessions after a deep crisis and radical reform.

"What is the greater threat: inflation or deflation?"

- Deflation is the greater of the two evils when unemployment rates are high and economic growth rates are low. Governments can use monetary policy by rapidly increasing the supply of money to create inflation - to inflate away the real size of debts (for consumers, companies and governments), and also to provide incentive for people to spend rather than wait for prices to fall. But it does not always work out as planned.
- In the 1890s depression the government retained tight money supply but the economy rebounded strongly from 20%+ unemployment levels and 40% price deflation, while in the 1930s New Deal expansionary program the economy remained weak until the Second World War.
- So far in the current crisis the Fed has trebled the size of the money supply with its bond-buying programs to keep interest rates extremely low. But banks so far don't want to lend the extra money out, and borrowers so far don't want to borrow it, so the economy remains slow and the expanded money supply has not resulted in price inflation.

- The Fed's extremely loose monetary policy has so far been successful in limiting price deflation, but has allowed significant wage deflation, so jobs are returning and consumer spending has been moderately strong.

"What if the government hits the debt ceiling and has to stop paying wages or pensions?" and "Will the government need to shut down?"

- This has happened in the recent past and has been brushed off by markets – both the US dollar and US stock market kept rising strongly after the crisis.
- It will probably happen again in the current crisis. Already payments to suppliers and tax refunds have been delayed. If this escalates further it may become serious enough to create a public backlash that could provide the catalyst for real action, like it was in the 1995-6 federal government shutdown crisis.

"What if the government defaults on its debt?"

- The Federal government has also missed payments on interest and maturing debt in the recent past, and this is another likely outcome in the current crisis. If it is selective and temporary it is likely to be brushed off by markets as it has been in the past. The government has plenty of ways to come up with cash to keep the current process of short term delays and quick fixes going for some time yet.
- The sooner it escalates into a major crisis the sooner radical action will be need to be taken, and the sooner the real problem can be tackled and solved.

"What happens when the level of government debt is above 100% of GDP?"

- This threshold was passed in 2012, but the US has been there before – in the mid-1940s.
- There are two key differences this time. The first is that the debt is now increasingly owned by foreigners, and so the US government is at the mercy of foreign lenders – mainly China and Japan. (Japan has a large foreign debt – more than twice as large as the US debt as a % of its GDP, but almost all of it is owned by the Japanese themselves, so it is an internal problem not an external problem with foreign lenders in control)
- The second difference is that the US has been running huge trade deficits since the 1980s after the 1970s decline in the US dollar was halted. However not even the decline in the dollar in the 2000s was enough to engineer a trade surplus.
- There is hope for American exporters even with a relatively strong dollar – with declining wages, declining energy costs, declining commodity input costs, low debt levels and low interest rates, and explosive growth in emerging market middle classes who clamour for American brands and technology, the future is looking relatively bright for American exporters.

"Will it ever get the economy growing again?"

- Yes, the US has suffered far more severe economic contractions and financial crises in the past. Markets rebound out of the depths of the crises when pessimism is greatest and all hope seems lost.

- But radical policy changes generally require a severe crisis to provide the catalyst and the mandate for action.
- The fact that the current debt situation is only moderate and manageable means that, if the politicians can grow up and co-operate, there is time for the flood of cheap and plentiful money to translate into growth in confidence, spending, production and jobs.

"Is the current level of debt too high / unsustainable?"

- No. The interest burden on the government debt is only moderate. Interest costs have been running at around 9-10% of budget outlays since 2003, despite the rising debt level. This is around the same interest burden from 1950 to the late 1970s, and so should be entirely manageable. The share of budget outlays has remained flat despite rising debt levels because national output and tax revenues have also been rising.
- Likewise, interest cost as a percentage of GDP is between 1.5% and 2%, similar to what it was in the 1950s to the late 1970s.
- In real terms after inflation, the interest paid on government debt ($230b) is lower than it has been since 1984, and is 35% lower than it was at its peak in 1996.
- Even four years of trillion dollar deficits since 2009 did not increase these debt servicing ratios, because interest rates remained low and the economy grew.
- However, as the economy improves and the Fed winds back and even reverses the bond-buying programs, yields will rise and the cost of refinancing treasuries will rise, so the clock is ticking on solving the problem.

In summary, the US government deficit / debt problem is large but not insurmountable and is it mainly a political problem. The acrimonious point-scoring in Washington may well continue to flare up into occasional crises that are likely to include temporary defaults on interest and maturing principal, government shut-downs, selective late payments to creditors, and more credit ratings downgrades, as they have in the recent past. Most are unlikely to rattle markets seriously, and have been brushed off by markets in the recent past.

Only radical change would make sizeable inroads to the budget – on the tax side and on spending. Generally only a cataclysmic crisis is enough to provide the catalyst and the political mandate for wholesale and radical changes to spending patterns and tax structures.

Given the moderate interest burden of the current level of debt, even after the past four years of trillion dollar deficits, the most likely outlook is that a game-changing cataclysmic event may be many months or years away.

The most serious threat to markets will be the fallout from interest rates rising. Rising interest rates are unlikely be caused by credit spreads and default fears if the deficit/debt situation were to deteriorate further. (Japan has more than double the debt levels and interest burden but interest rates are less than half those in the US).

Rising interest rates are more likely to be caused by a return to inflationary expectations as the economy improves, and this will most likely improve the deficit position significantly as tax receipts rise and welfare spending falls.

The US is far better placed than the UK, Europe or Japan – in regard to both the current deficit and debt situations and also the longer term outlooks for growth and market performance.

America has experienced three great turning points in fiscal and monetary policy over the past 140 years and each arose out of the depths of a cataclysmic crisis - the 1890s depression, the 1930s depression and the end of the 1970s. Out of each crisis was born a brand new era of growth and prosperity for Americans and for investors.

But the policies and ideas that gave rise to the recovery from the 1970s crisis and drove the economy and markets for the past 30 years came crashing down in the current crisis. It is likely that America is now standing at the edge of another great turning point, as many of the underlying assumptions, conditions and policies of the past 30 years are unwinding and reversing.

De-regulation is returning to re-regulation – the idea of small hands-off government is returning to more government influence – central bank independence is returning to influence and control by governments and politicians – the focus on defeating inflation is returning to deliberate positive inflation targeting – free capital movement is returning to capital controls – the primacy of low inflation over jobs growth is returning to jobs growth at a cost of inflation – tax cuts are returning to tax hikes – free and open access to open-ended un-funded pensions and welfare “entitlements” are returning to the ideas of user-pays and contribution.

It is not our role to opine on what is right or wrong. No set of policies or ideas works forever in every set of conditions, as we have seen. It is our role to study the actions and reactions of policy makers and participants that affect markets, to understand and assess likely implications and consequences, and to adjust investment portfolios to ensure preservation of capital and sustainable real growth.

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