“Everyone” is upset with the level of fiscal deficits being run by nearly every developed country. And with much justification. The levels of fiscal deficits are unsustainable and threaten to bring many countries to the desperate situation that Greece now finds itself in. We must balance the budget is the cry of fiscal conservatives. But there are unseen consequences in moving both too fast or too slow in the effort to get the deficits under control. Today we look at them as we explore what a fine mess we have gotten ourselves into. (I am working without internet today so the letter will be shorter with fewer references than normal.)

\[ \text{GDP} = \text{C} + \text{I} + \text{G} + (\text{X} - \text{M}) \]

We have discussed the above equation before, but let’s look at it again from a different angle. Basically, the equation is another accounting identity. GDP (Gross Domestic Product) for a given country is the total of Consumption (personal and business) plus Investments plus Government spending plus exports minus imports.

The Keynesians argue that when there is a drop in C due to a recession that the G must rise to offset the drop. That was at the heart of the argument for stimulus packages in so many countries. And there is no doubt that stimulus did help keep a very deep recession from turning into an even deeper depression. One can legitimately argue about the size of the stimulus, or about the nature of the spending, but it is difficult to argue that it did not have an effect.

Now, of course, the hope is that a recovery will allow C to begin to rise so that there is no more need for government deficits. Keynes argued that governments should run surpluses in good times, which is conveniently forgotten by most government spending types. The problem is that we are still running massive deficits. Tax receipts are way down (10% unemployment will do that to you!) and show no sign of turning back up soon all over the developed world.

If you reduce government spending, that also has a negative effect on GDP in the short run. But in past recoveries the growth of the private sector has overcome that negative effect. Normally at this time in a recovery growth is in the 7% range. This is a very tepid recovery in the US and the developed world.

There are loud calls in the US and elsewhere for more fiscal constraints. I am part of that call. Fiscal deficits of 10% of GDP is a prescription for disaster. As we have discussed in previous letters, the book by Rogoff and Reinhart (This Time is Different) clearly shows that at some point, bond investors start to ask for higher rates and then the interest rate becomes a spiral.
Think of Greece. So, not dealing with the deficit is simply creating a future crisis even worse than the one we just had.

But cutting the deficit too fast could also throw the country back in a recession. There has to be a balance.

Greece has promised to cut its deficit by around 4% a year for 3 years. Spain is also making deep cuts. But the danger is that you could create a nasty spiral.

That deficit reduction will also reduce GDP. That means you collect less taxes which makes the deficits worse which means you have to make more cuts than planned which means lower tax receipts which means etc. Ireland is working hard to reduce its deficits but their GDP has dropped by almost 20%! Latvia and Estonia have seen their nominal GDP drop by almost 30%! That can only be characterized as a depression for them.

If you are in a country which cannot print its own currency as Greece or Ireland, the only way you can get back to competitiveness is to increase your competitiveness by decreasing your costs of production. And that is not just goods. It is a lot of labor cost. But if you reduce labor costs, you get less tax receipts. It is a very painful path, but once you get to the end game, the only choices you have are painful.

Britain is now running about 5% inflation. Let’s say real (after inflation) growth could be 3% for a total of nominal growth of 8%. If Britain can get their deficit to GDP down to 6%, then they would actually be seeing the relative size of their debt being reduced. Debt is not adjusted for inflation (what that does to bond investors is another story) and so a country can run a deficit that is less than nominal GDP essentially forever. That may not be wise, but it is not a course for disaster.

But countries like Greece which cannot print their own currency don’t have the inflation option. They are stuck with the low inflation of Europe. So if their economy is shrinking by 3% that means their debt to GDP level is rising even if they were not borrowing any more money. And trying to reduce “G” by large amounts insures that their GDP will shrink even more. Essentially they have to deflate their economy to make themselves more competitive. It is not going to be easy.

Those calling for countries to quickly cut their deficits are essentially telling them they must enter into a serious recession for some time in order to get the ECB to buy their bonds. And what choice do they have? If they do not make the cuts, the bond market will simply dry up and their interest rates will sky-rocket, which will force more cuts that will be deeper and sooner. There are not good options, only painful ones.

By the way, as countries go into recession, they will buy fewer goods. That cannot be good for exporting countries like Germany and China.
Be Careful for What You Wish

In the US, we must start to get our fiscal house in order. But if we cut the deficit by 2% of GDP a year, that is going to be a drag on growth in what I think is going to be a slow growth environment to begin with. If you raise taxes by 1% combined with 1% cuts (of GDP) that will have a minimum effect of reducing GDP by around 2% initially. And when you combine those cuts at the national level with tax increases and spending cuts of more than 1% of GDP at state and local levels you have even further drags on growth.

We need to cut our fiscal deficits. We need to reduce the size of governments. But let’s make no mistake that it will be painless. It is necessary that we begin as soon as possible so that we can do it at a reasonable pace before the bond markets force us to move at a pace which will be even more painful. Be careful what you wish for.

I still maintain that we have better than a 50% chance of a recession in 2011. I wish it were otherwise.

The View From Europe

A few observations from my European trip (I am now in Paris). There seems to be a sense that Europe will fall into a recession later this year from those I talk with and read. That will be a drag on growth everywhere, and only make their situation worse.

No one seems too worried about the recent fall in the euro. Calls for the euro to go to parity with the dollar are everywhere. That echoes Martin Wolf’s call a few weeks ago that Britain should allow the pound to fall further.

One of our guides in Italy, a very educated and sophisticated young lady of 40, said she plans to work and save for another ten years then move to Brazil or Chile and open a gelateria. “The government will never be able to pay my pension or health care. I must take care of myself.”

Everyone wants to run a trade surplus, but everyone can’t. Someone has to buy.

The feeling seems to be that the euro will survive. As one bond trader told me, the euro is not an economic currency. It is a political currency, and there is political will for it to survive.

When the euro was created, the Germans got a Mediterranean currency and the Mediterranean countries got German interest rates.

Under the Tuscan Sun

Last week I wrote that life could be better, but I am not certain how, as Venice was so wonderful. I now know how it can get better. You can go to Tuscany. While all things are subjective, the view from our mountain top villa in the little village of Trequanda is one of the
most beautiful that I have ever seen anywhere. The wines are very good and inexpensive (the local chardonnays are superb!). The tomatoes and mozzarella are so fresh.

The kids (except for Tiffani and Ryan) went back yesterday and I am going back to Tuscany for a few days before I go on to Milan for a speech on Tuesday and then home the next day.

“Dad. I don’t think Tiffani knows how to spell guide.” Trey would love to find a mistake by Tiffani. It’s a younger sibling thing. “Why do you say that Trey?” (My youngest son at 16.) “Well,” he said, “she spells it guido everywhere in the papers she gave us.”

“That’s the name of the guide, son. He is called Guido.” “Oh.”

I am off to the hotel lobby where I can send this and then out to see some of Paris. Have a great week.

Your wishing he could speak French analyst,

John Mauldin