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Easy Money, Hard Truths

By DAVID EINHORN

Are you worried that we are passing our debt on to future generations? Well, you need not worry.

Before this recession it appeared that absent action, the government’s long-term commitments would become a problem in a few decades. I believe the government response to the recession has created budgetary stress sufficient to bring about the crisis much sooner. Our generation — not our grandchildren’s — will have to deal with the consequences.

According to the Bank for International Settlements, the United States’ structural deficit — the amount of our deficit adjusted for the economic cycle — has increased from 3.1 percent of gross domestic product in 2007 to 9.2 percent in 2010. This does not take into account the very large liabilities the government has taken on by socializing losses in the housing market. We have not seen the bills for bailing out Fannie Mae and Freddie Mac and even more so the Federal Housing Administration, which is issuing government-guaranteed loans to non-creditworthy borrowers on terms easier than anything offered during the housing bubble. Government accounting is done on a cash basis, so promises to pay in the future — whether Social Security benefits or loan guarantees — do not count in the budget until the money goes out the door.

A good percentage of the structural increase in the deficit is because last year’s “stimulus” was not stimulus in the traditional sense. Rather than a one-time injection of spending to replace a cyclical reduction in private demand, the vast majority of the stimulus has been a permanent increase in the base level of government spending — including spending on federal jobs. How different is the government today from what General Motors was a decade ago? Government employees are expensive and difficult to fire. Bloomberg News reported that from the last peak businesses have let go 8.5 million people, or 7.4 percent of the work force, while local

governments have cut only 141,000 workers, or less than 1 percent.

Public sector jobs used to offer greater job security but lower pay. Not anymore. In 2008, according to the Cato Institute, the average federal civilian salary with benefits was $119,982, compared with $59,909 for the average private sector worker; the disparity has grown enormously over the last decade.

The question we need to ask is this: If we don't change direction, how long can we travel down this path without having a crisis? The answer lies in two critical issues. First, how long will the capital markets continue to finance government borrowings that may be refinanced but never repaid on reasonable terms? And second, to what extent can obligations that are not financed through traditional fiscal means be satisfied through central bank monetization of debts — that is, by the printing of money?

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The recent United States credit crisis was attributable in large measure to capital requirements and risk models that incorrectly assumed AAA-rated securities were exempt from default risk. We learned the hard way that when the market ignores credit risk, the behavior of borrowers and lenders becomes distorted.

It was once unthinkable that "risk-free" institutions could fail — so unthinkable that the chief executives of the companies that recently did fail probably didn't realize when they crossed the line from highly creditworthy to eventually insolvent. Surely, had they seen the line, they would, to a man, have stopped on the solvent side.

Our government leaders are faced with the same risk today. At what level of government debt and future commitments does government default go from being unthinkable to inevitable, and how does our government think about that risk?

I recently posed this question to one of the president's senior economic advisers. He answered that the government is different from financial institutions because it can print money, and statistically the United States is not as bad off as some other countries. For an investor, these responses do not inspire confidence.

He went on to say that the government needs to focus on jobs now, because without an economic recovery, the rest does not matter. It's a valid point, but an insufficient excuse for

holding off on addressing the long-term structural deficit. If we are going to spend more now, it is imperative that we lay out a credible plan to avoid falling into a debt trap. Even using the administration's optimistic 10-year forecast, it is clear that we will have problematic deficits for the next decade, which ends just as our commitments to baby boomers accelerate.

Modern Keynesianism works great until it doesn't. No one really knows where the line is. One obvious lesson from the economic crisis is that we should get rid of the official credit ratings that inspire false confidence and, worse, are pro-cyclical, aggravating slowdowns and inflating booms. Congress has a rare opportunity in the current regulatory reform effort to eliminate the rating system. For now, it does not appear interested in taking sufficiently aggressive action. The big banks and bond buyers have told Congress they want to continue the current system.

As William Gross, the managing director of the bond management company Pimco, put it in his last newsletter, "Firms such as Pimco with large credit staffs of their own can bypass, anticipate and front run all three [rating agencies], benefiting from their timidity and lack of common sense."

Given how sophisticated bond buyers use the credit rating system to take advantage of more passive market participants, it is no wonder they stress the continued need to preserve the status quo.

It would be better to have each investor individually assess credit-seeking entities. Certainly, the creditworthiness of governments should not be determined by a couple of rating agency committees.

Consider this: When Treasury Secretary Timothy Geithner promises that the United States will never lose its AAA rating, he chooses to become dependent on the whims of the Standard & Poor's ratings committee rather than the diverse views of the many participants in the capital markets. It is not hard to imagine a crisis where just as the Treasury secretary seeks buyers of government debt in the face of deteriorating market confidence, a rating agency issues an untimely downgrade, setting off a rush of sales by existing bondholders. This has been the experience of many troubled corporations, where downgrades served as the coup de grâce.

The current upset in the European sovereign debt market is a prequel to what might happen here. Banks can hold government debt with a so-called zero-risk weighting, which means zero capital requirements. As a result, European banks stocked up on Greek debt, and sold sovereign

credit default swaps, and now need to be bailed out to avoid another banking crisis.

As we saw first in Dubai and now in Greece, it appears that governments' response to the failure of Lehman Brothers is to use any means necessary to avoid another Lehman-like event. This policy transfers risk from the weak to the strong — or at least the less weak — setting up the possibility of the crisis ultimately spreading from the "too small to fails," like Greece, to "too big to bails," like members of the Group of 7 industrialized nations.

We should have learned by now that each credit — no matter how unthinkable its failure would be — has risk and requires capital. Just as trivial capital charges encouraged lenders and borrowers to overdo it with AAA-rated collateral debt obligations, the same flawed structure in the government debt market encourages and therefore practically ensures a repeat of this behavior — leading to an even larger crisis.

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I don't believe a United States debt default is inevitable. On the other hand, I don't see the political will to steer the country away from crisis. If we wait until the markets force action, as they have in Greece, we might find ourselves negotiating austerity programs with foreign creditors.

Some believe this could be avoided by printing money. Despite the promises by the Federal Reserve chairman, Ben Bernanke, not to print money or "monetize" the debt, when push comes to shove, there is a good chance the Fed will do so, at least to the point where significant inflation shows up even in government statistics.

That the recent round of money printing has not led to headline inflation may give central bankers the confidence that they can pursue this course without inflationary consequences. However, printing money can go only so far without creating inflation.

Government statistics are about the last place one should look to find inflation, as they are designed to not show much. Over the last 35 years the government has changed the way it calculates inflation several times. According to the Web site Shadow Government Statistics, using the pre-1980 method, the Consumer Price Index would be over 9 percent, compared with about 2 percent in the official statistics today.

While the truth probably lies somewhere in the middle, this doesn't even take into account

inflation we ignore by using a basket of goods that don't match the real-world cost of living. (For example, health care costs are one-sixth of G.D.P. but only one-sixteenth of the price index, and rising income and payroll taxes do not count as inflation at all.)

Why does the government understate rising costs? Low official inflation benefits the government by reducing inflation-indexed payments, including Social Security. Lower official inflation means higher reported real G.D.P., higher reported real income and higher reported productivity.

Subdued reported inflation also enables the Fed to rationalize easy money. The Fed wants to have low interest rates to fight unemployment, which, in a new version of the trickle-down theory, it believes can be addressed through higher stock prices. The Fed hopes that by denying savers an adequate return in risk-free assets like savings deposits, it will force them to speculate in stocks and other "risky assets." This speculation drives stock prices higher, which creates a "wealth effect" when the lucky speculators spend some of their gains on goods and services. The purchases increase aggregate demand and lead to job creation.

Easy money also aids the banks, helping them earn back their still unacknowledged losses. This has the perverse effect of discouraging banks from making new loans. If banks can lend to the government, with no capital charge and no perceived risk and earn an adequate spread, then they have little incentive to lend to small businesses or consumers. (For this reason, higher short-term rates could very well stimulate additional lending to the private sector.)

Easy money also helps the fiscal position of the government. Lower borrowing costs mean lower deficits. In effect, negative real interest rates are indirect debt monetization. Allowing borrowers, including the government, to get addicted to unsustainably low rates creates enormous solvency risks when rates eventually rise.

While one can debate where we are in the recovery, one thing is clear — the worst of the last crisis has passed. Nominal G.D.P. growth is running in the mid-single digits. The emergency has passed and yet the Fed continues with an emergency zero-interest rate policy. Perhaps easy money is still appropriate — but a zero-rate policy creates enormous distortions in incentives and increases the likelihood of a significant crisis later. It was not lost on the market that during this month's sell-off, with rates around zero, there is no room for further cuts should the economy roll over.

EASY money has negative consequences in addition to the risk of inflation and devaluing the dollar. It can also feed asset bubbles. In recent years, we have gone from one bubble and bailout to the next. Each bailout has rewarded those who acted imprudently. This has encouraged additional risky behavior, feeding the creation of new, larger bubbles.

The Fed bailed out the equity markets after the crash of 1987, which fed a boom ending with the Mexican crisis and bailout. That Treasury-financed bailout started a bubble in emerging market debt, which ended with the Asian currency crisis and Russian default. The resulting organized rescue of Long-Term Capital Management's counterparties spurred the Internet bubble. After that popped, the rescue led to the housing and credit bubble. The deflationary aspects of that bubble popping created a bubble in sovereign debt, despite the fiscal strains created by the bailouts. The Greek crisis may be the first sign of the sovereign debt bubble bursting.

Though we don't know what's going to happen next, the good news for our grandchildren is that we will have to face our own debts. If we realize that our own future is at risk, we might be more serious about changing course. If we don't, Mr. Geithner and others might regret having never said never about America's rating.

David Einhorn is the president of Greenlight Capital, a hedge fund, and the author of "Fooling Some of the People All of the Time." Investment accounts managed by Greenlight may have a position (long or short) in the securities discussed in this article.