What Happens Next – Sunday January 31, 2021
COVID, Vaccines, Homebuilding, Success Academy, and Budget Deficits

Alan Auerbach QA

Larry Bernstein:

Thanks Alan, your focus with interest rates right at the center, ironically, this interest rate is really a function of the fed policy. And we heard Steve earlier speak about how low interest rates has turned the residential, single family home market into a frenzy. We also have it turning the stock market, our equity markets and our bond markets into a frenzy. And those have propped up assets values, which we can tax with capital gains, et cetera. But I don't know if this is sustainable. I don't remember in your class saying, we can have the fed keep long-term interest rates to incredibly low levels. And therefore we can pay for all our entitlements and have a booming stock market go up every year. I think you would have said, there's a problem to doing that. And it would have to pay the piper for that. So what is the problem with keeping interest rates abnormally low?

Alan Auerbach:

Well, you've mentioned one potential problem, which is bubbles, asset bubbles. And this also happened during the financial crisis. There was concern when the Fed embarked on its very low interest rate policy, some of the critics said you're creating dangers in the form of asset bubbles. And the Fed is generally taking the position, they took the position and it's taken the position now, that's not their problem. Their job is the real economy and we have to deal with potential asset bubbles, some other way. One of the things that's different now than say 10 years ago is it's not just short-term interest rates that are low. You can go all the way out of the yield curve to 30 years and you still got extremely low interest rates. And that says, we normally think about the fed is controlling short-term interest rates, primarily.

It's true that with their balance sheet expansions in the last decade, they've engaged in quantitative easing and buying assets at the longer end of the yield curve. But I think economists still think that what the fed is mostly controlling is short-term interest rates. And it's more fundamental factors that are affecting long-term interest rates. And the fact that long-term interest rates are so low right now, seems to be sending a signal that market participants believe short-term interest rates are going to be low for a very long time. Whether that is a realistic or rational perspective, I don't know, but it's certainly one that's commonly shared.

Larry Bernstein:

I've told you before that, I've always viewed you as the grown up in the room, that Democrats have a desire to spend money and Republicans have a desire to cut taxes and you always said, "Look, you got to lead a more balanced life." If I had told you a year ago, we were going to have a $3.1 trillion deficit, and what were the long-term consequences? You would have told me, I would have thought, that this is going to have extreme negative consequences on our ability to meet our entitlement requirements in 30 to 50 years. We had some powder and that powder just got blown. How do you think about, in context to, what are we going to be forced to do with entitlements, sooner rather than later, given this 2020, 15% a year and 10%, we'll call it a generic, two year period of 25% of GDP budget deficit?

Alan Auerbach:

The answer, I'm sure if you ask Janet Yellen, and if you asked the government officials in 2010, what their answer was, their answer would have been, "We should deal with that as soon as this crisis is over, but the crisis should take precedence." And I would give you the same answer. Except that I don't really believe that's what's going to happen. And whatever hope I would have had would have been dashed the last time around. In fact, I think it's going to be harder for us to deal with the long-term budget problems, as a result of the pandemic, because to the extent that programs like social security and Medicare are popular, they have to have become more popular because of the pandemic. It's true, the elderly have certainly suffered in terms of mortality rates from disease, but otherwise they haven't suffered economically.

Those of them that have money in the stock market have benefit and that even those of them who don't, have guaranteed income and medical care through social security and Medicare, so that group has done okay. But other groups in the population, looking ahead are thinking, "These are about the only certainties left in my life, and I don't want the government to take them away." So I think it's going to be very difficult, leaving aside polarized and dysfunctional government, I think it's going to be very difficult for government to come up with any solution, which means that I think the solution will end up being solutioned by crisis. That is whenever it is that the social security trust fund runs out of money, or one of the Medicare trust funds runs out of money. Then they'll have to scramble to do something about it, but it'll be ad hoc, it won't be as well thought out as a planned restructuring of the programs. But I think given our both public demands, as well as the political problems we have, I think that's what we're likely to see.

Larry Bernstein:

In that Herbert Stein famous quote, "What can't go on forever won't." And I might be misquoting it slightly, but that was the essence of it. And so as we have this ever expanding entitlement program, I think we're going to be making demands on children, even unborn, to pay for some of these things.

How do you think ... you just mentioned that the trust funds will have to go bankrupt first. I think there's already one of the trust funds that deals with disabilities, it went bust, but it was quickly paid out through general public funds. Don't you suspect that maybe the problem won't come from the trust fund itself being unable to pay, but maybe more from the bond market and demands, of very high credit yields for the government or near default, that will be the primary factor?

Alan Auerbach:

That's possible. I guess my perspective was a hopeful one, which is that I'm hoping that the social security trust fund, the main retirement trust fund, runs out of money before we have a general fiscal crisis. And so we start dealing with it, then. You're right, we could end up papering things over, the social security trust fund could run out of money and we could opt for general revenue funding, which would solve the social security specific problem, not the overall problem, and then just wait for the financial crisis to happen. Of course, one of the ironic things is whenever the world has a financial crisis, that becomes easier for the US government to borrow because we're a relative safe haven, even if we're having problems, other countries are having problems that are worse.

Larry Bernstein:

And so, as you think about what's happened here with regards to massive budget deficits and imbalances, what are the lessons that have been learned, is the lesson been learned that our next

recession, we're going to just have a Cares Act, a trillion, 2 trillion, 3 trillion? And if so, will that reckoning be even sooner? In 2008 we had a playbook, in 2020 we had a playbook. Is this new playbook, just so problematic it's going to be catastrophic?

Alan Auerbach:

I don't think so. I think we have to think back to March, 2020, on an annual basis, GDP in the second quarter of 2020 fell by over 30%. And it had already fallen by 5% in the first quarter, this was unprecedented. It didn't happen during the Depression that fast, and it's not happened any other time. And so I think we were just frantic at that point, and everybody was willing to throw money at the problem.

And there was just consensus about that. That's not the way normal recessions happen, even the financial crisis, which was a terrible recession. The worst one, since the Depression, unfolded slowly. It really took all of the year 2008 for us to get into a point where we realized how bad it was going to be. So, no, I don't think this is a new playbook, I think, unless we're going to have another pandemic, which I guess we might, but unless we have an experience similar to this, in terms of the sharpness of the drop in GDP, I think the responses will be more measured in the future.

Larry Bernstein:

Well, you spoke about what we did in March and April, but now we're talking about a proposed $1.9 trillion package, which is even bigger when we have, maybe not certainty, but we have four vaccines in the pipeline. Do you think that package doesn't make sense? Is that imprudent?

Alan Auerbach:

I think it doesn't make sense. I think having a package now makes sense, as I mentioned in my comments, I think states and including through public health provision, but in other respects as well, I think states could use more funding. I think there's no doubt that extension of unemployment benefits, we have a lot of people who however, not traditionally unemployed, but underemployed and finding it difficult to earn income. I think more targeted assistance to businesses, as well. I think all of this makes sense. I think unconditional transfers to a large fraction of the household population, makes very little sense. And I think frankly, from what I've seen among economists, I think there's a lot of consensus about that. I think this was an aspirational proposal, coming at the beginning of an administration. My guess is we are going to have something and I think it's going to be done by consensus and it's going to be smaller and more targeted.

Larry Bernstein:

We had Charles Goodhart on the program a couple of weeks ago, and he was commenting on the Chinese productivity, creating a deflationary environment and these low interest rates. But he also said that he thought that the Chinese growth was a one-time phenomenon and that it would not lasts forever and won't last for very long, in fact.

Do you think that the reason we're at the strange interest rate levels, both domestically and globally, is a function of that Chinese deflationary phenomena? And do you believe it's temporary and once that disappears and we return to, I'll call it, a more historically normal interest rate that, that's going to really blow up these budgets and undermine all the valuations in equities, bonds, and real estate?

Alan Auerbach:

There's been a discussion about the explanation for low interest rates that predates the pandemic because interest rates were very low before that. And whether it's productivity related, whether it's due to a savings' squat, there are all kinds of variants of the story. And I don't really have a good answer. Except again, to point to long-term interest rates. If we think that long-term interest rates are telling us about expectations of future short-term rates, there's a strong consensus built into the market. And there are a lot of people out there willing to lend at microscopic interest rates for 30 years. Would suggest that people aren't expecting this to turn around soon.

Now, of course, that doesn't mean it won't turn around soon. And it also doesn't mean that our federal government should be taking that mean expectation and ignoring the possible tail risks, that could accompany it. So I don't have a crystal ball on this. I think prudence suggests that we should expect at least a possibility that interest rates will rise sharply in the not too distant future. And we should be planning with that contingency in mind. But I don't know when that would happen.