The Idle Speculator™

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Is the Federal Government *Too Tight*?

With the financial punditry and markets opining on a still-easy Federal Reserve, we're taking this opportunity to put forth a rather unusual assertion in today's political climate. Despite widespread perceptions of out-of-control public profligacy, and legitimate concerns about government expenditures and agency risk, there's a meaningful risk that the federal government becomes overly tight in the coming quarters and years.

Thank You Sirs and Madams, May We Have Another?

The latest evidence that the federal government could become 'too tight' is a bill signed by President Obama last week that extended unemployment benefits and other counter-cyclical measures.[1] While it included some important 'stabilizers', it was a rather skimpy measure for an economy as large as ours, with an expected cost of $20B, or only 0.14% of our $14T economy. Worse, it was allegedly "paid for" by extending a payroll tax on employers, and by dropping a provision that would have allowed multinational corporations domiciled in the U.S. to repatriate foreign profits at a reduced tax rate. As one commentator put it:

> The unemployment extension is actually fully paid for by extending an existing payroll tax on employers. The rest is covered by delaying a tax break that big multinational corporations were expecting to get on international interest payments. The U.S. Chamber of Commerce doesn't like that part of it, and says it'll fight any more corporate tax increases.[2]

So the federal government is determined to stimulate with one hand while it slaps with the other? That's great! Leaving bad S&M jokes aside, what could possibly be the logic behind extending public benefits for unemployment, while maintaining or slightly raising the burden of taxation on private employers, especially as empirical evidence for reforming the corporate tax code continues to pile up? In a 2004 paper paper on the subject, and one especially relevant to the repatriation of overseas profits, economists Mihir Desai and James Hines wrote (emphasis added):

> Reinventing corporate tax policy requires that international considerations be placed front and center in the debate on how to tax corporate income. A simple framework for assessing current rules suggests a U.S. tax burden on foreign income in the neighborhood of $50 billion a year. **This sizeable U.S.**

1 http://news.yahoo.com/s/ap/20091106/ap_on_bi_ge/us_jobless_benefits_homebuyers

2 http://marketplace.publicradio.org/display/web/2009/11/05/am-senate/

> **taxation of foreign investment income is inconsistent with promoting efficient ownership of capital assets, either from a national or a global perspective. Consequently, there are large potential welfare gains available from reducing the U.S. taxation of foreign income**, a direction of reform that requires abandoning the comfortable, if misleading, logic of using similar systems to tax foreign and domestic income.[3]

Lest anyone think that either major party has a monopoly on sound tax policy, we'd note that the Republicans' 2004 tax break on foreign profits only allowed for a temporary reprieve, versus the "large potential welfare gains" that the authors say would result from a *permanently* lower rate. The GOP was clearly willing to trade the most economically sound policy ideas for the most politically expedient, such as lower capital gains, top marginal rates on income, and the federal estate tax (even those are subject to distorting 'sunset' provisions that raise uncertainty and enrich the estate planning industry).

PAYGO Rears Its Ugly Head

Beyond partisanship, the logic of this latest law includes, of course, PAYGO, the noble but misguided idea that any budget expenditure should be paid for by an offsetting spending cut or tax hike.[4] We expect that PAYGO will be a stubborn obstacle to desirable public policies in the years ahead. While it may sound reasonable in theory, there are bound to be times when it's counterproductive. PAYGO has also been utterly abused in the political process, becoming the equivalent of a veto pen for both parties, especially whichever one happens to be in power.[5] Unfortunately, because of the massive dollar figures involved in the financial bailouts, most policymakers, pundits, and even voters seem to believe that budget discipline should now be our highest priority. That seems rather premature to us.

New political competitors don't seem to have a better grasp of the issue. For example, one of Carly Fiorina's first public utterances last week, as a new candidate for the U.S. Senate, was that the federal government needed to learn to "live within its means". If only her party had applied that principle in a more timely fashion, when the private sector went on a five year spending and leveraging binge! Had they done so, the federal government would be in a position to do more to ameliorate the economic pain that a lot of people are feeling.[6]

Unfortunately, the raw numbers in the federal budget (and the limited understanding of public finance among opinion makers and voters) increase the probability of fiscal tightening in the years ahead. If the federal government's role is subsumed to budget hawkishness, there's a probability that we'll see the kind of retrenchment that occurred in

3 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=606222
4 http://en.wikipedia.org/wiki/PAYGO
5 http://budget.senate.gov/republican/pressarchive/pay-go/SwissCheeseSideBySide.pdf
6 To be fair, as societies become wealthier, the idea of "pain" becomes increasingly relative. For example, hobo numbers are still low, and as far as we know, no one is selling their children. But that doesn't change the ethical and policymaking dimensions, and the fact that there is still a great deal more that the federal government can and should do.

1936-37, which brought a period of fairly robust growth to a quick end. Unfortunately, the budget hawks continue to circle, with arguments long on catch phrases but short on logic and evidence (see our observations on Steve Wynn's recent comments, for example)[7].

Philosophically, there's a timeless and underlying debate at work about whether resources should be controlled by the public or private sector. That's fine, and vitally important. But well reasoned analysis should leave room for plenty of both, *and for tipping the balance in either direction when appropriate*. Today, that debate can't be resolved without determining just how much "slack" there is in the U.S. economy, and how long it is likely to persist. While there are indicators aplenty that say things are picking up, it's not entirely clear how much of this is driven by public demand versus private.

Demographic composition may be playing a key role too, meaning we should be alert for potential structural shifts affecting resource utilization now and in the years ahead. All in all, there may very well be a role for the federal government to play in increasing domestic demand and investment (which is not an easy thing for someone with libertarian leanings to admit). If so, there's little risk of financial "crowding out", as long as the expenditures and their financing terms are sensible. Unfortunately, this assertion runs contrary to much of the prevailing orthodoxy on both the political right and left.[8]

Debating Japan and 'Japanese Disease'

In a recent missive that we cited for its harsh criticism of proposed systemic financial regulations[9], financial scribe John Mauldin also asserted that the U.S. is in for a bout of what he calls 'Japanese Disease'. His arguments provide an opportunity to reflect on some of the concerns we've raised above.

In his riff on public spending and government debt, Mauldin admits that "Japan is a very clear demonstration that things that don't make sense can go on longer than we think." Based on our research, we think Japan's experience might actually make some sense, and that its future might not be as bleak as so many are betting; we also think that many of the concerns about federal deficits and our national debt could be misguided. Quotes from John's piece are interspersed with our comments below.[10]

Debt and Demographics

Mauldin opens with the widely shared view that Japan's demographics and debt levels pose serious problems:

> I have written a lot over the past year about the problems facing Japan. Their population is shrinking, as is their work force. They are running massive fiscal deficits and have done so for almost 20 years. Government debt-to-

7 http://symmetrycapital.net/index.php/blog/2009/10/strange-comments-from-steve-wynn/

8 Judging by the attacks on Bob Rubin, the orthodoxy is at greater risk on the left (see http://symmetrycapital.net/index.php/blog/2007/04/american-prospect-beware-rubinomics/)

9 http://symmetrycapital.net/index.php/blog/2009/11/an-outraged-john-mauldin/

10 The Mauldin piece is available here: http://www.2000wave.com/gateway.asp (email subscription required).

> GDP is now up to 178% and projected to rise to over 200% within a few years.

As we pointed out recently, such "leverage" pales in comparison to many private sector companies, while national governments tend to have better credit ratings and the lowest cost of capital in financial markets.[11] Additionally, to the extent that public spending is composed primarily of productive investments, the economic effects can be positive and quite powerful. According to the authors of a recent analysis of fiscal multipliers:

> In practice, a sizable component of President Obama's package consists of government investment, as opposed to government consumption. The multipliers [for investment] are 2.31 on impact and 1.83 in the long run. While the precision of the estimates falls as the horizon lengthens, we can see that the cumulative multiplier is significantly different from zero for around 14 quarters. In sharp contrast - and as already noted - the post-1980 multipliers for government consumption are not significantly different from zero at any horizon. Differentiating between government consumption and investment is thus a critical consideration.[12]

Clearly, we can't draw any inferences from current or expected federal budget deficits *without assessing the makeup of the underlying expenditures*. If they consist primarily of temporary counter-cyclical stabilizers like unemployment benefits, and longer term productive public investments, then we shouldn't gnash our teeth so loudly about government profligacy.

Saving, Investment, and 'Age Structure'

Mauldin continues:

> [Japan] started [its] "lost decades" with a savings rate of almost 16%, and are now down to 2% as their aging population spends its savings in retirement.

This may indeed be due to dissaving by the elderly, but that explanation is far from settled, and except for France and Germany, personal savings in G-7 countries have all declined in tandem over this period.[13,14] There are several competing explanations for changes in savings rates. Some correlate them with changes in disposable personal income, others with private sector productivity.[15] If Japan's domestic service economy is encouraged to pursue productivity enhancing investments, it would have a considerable impact on domestic incomes. So there's a possibility, however remote, that Japan's fallen saving rate is due to favorable economic trends, or at least improving expectations.

Other explanations invoke age structure, which argues that the ratio of young or elderly

11 http://symmetrycapital.net/index.php/blog/2009/10/strange-comments-from-steve-wynn/
12 http://www.cepr.org/pubs/PolicyInsights/PolicyInsight39.pdf
13 http://www.mckinseyquarterly.com/Economic_Studies/Productivity_Performance/The_economic_impact_of_an_aging_Japan_1614?gp=1
14 http://research.stlouisfed.org/publications/review/07/11/Guidolin.pdf
15 http://www.mckinsey.com/aboutus/mckinseynews/pressarchive/pdf/FnD0306_Baily.pdf

adults to middle aged adults has a significant impact on some economic and financial outcomes.[16] One study of age structure found that a low middle aged ratio has a negative impact on personal savings rates.[17] While Japan's overall population may be aging, its age structure is going to improve considerably in the coming decade, which would argue for a rising personal saving rate in the years ahead, which could allow private domestic savings to support 'repair' of the public sector's balance sheet.

> They have had no new job creation for 20 years, and nominal GDP is where it was 17 years ago.

True, but why? Was it solely the result of a 'balance sheet bubble'? It was certainly a, if not the, primary contributor. But the "demographic dividend" of age structure theory that occurs when middle aged adults are the predominant cohort in a society may have had a powerful negative effect starting around 1989-1990, when the ratio of middle aged adults began to decline precipitously. Again, if so, the next decade or two actually look promising for Japan.[18]

Post Bubble Muddling

Mauldin reminds readers of the breathtaking leverage that Japan's private sector carried into the post-1989 crisis:

> As bad as our problems are here in the US, their bubble was far more massive. Values of commercial property fell 87%! Their stock market is still down 70%. They had **twice as much bank leverage** to GDP as the US. (Think about how bad off we would be if bank lending was twice as large and had even worse defaults and capital shortfalls!)
>
> And yet, they Muddle Through. Productivity has kept their standard of living reasonable.

We agree with John that "muddling through" is the most likely scenario for the U.S., despite all the prevailing anxieties. In fact, if government expenditures and fiscal measures push and pull in favorable directions, we would be fairly optimistic about the impending muddle. That said, it's still going to be something of a muddle compared to the last six decades.

Interest Rates, Balance Sheets, and Financial Assets

Mauldin's next target is interest rates and Japanese government bonds:

> The trading floors of the world are littered with the bodies of traders who have shorted Japanese government debt in the belief that it simply must implode. While I believe that it eventually will, if they stay on the path they

16 http://www.entrepreneur.com/tradejournals/article/77498534.html; see also http://www.nber.org/papers/w8685
17 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=77911
18 http://investments.miraeasset.us/en/ourMarkets/outlookView.do?board_id=1125&group_id=1&pageNo=1

> are on, Japan is a very clear demonstration that things that don't make sense can go on longer than we think.

There are several things to think about here. It's true that some speculators have been waiting for years for JGBs to take a beating, to no avail. Their mistakes are due in large part, we think, to conventional thinking that is heavy on theory but short of sufficient data. To paraphrase a quote attributed to Keynes, Japan's experience presents us with new facts that call for existing models to be reconfigured or replaced. I too agree with Mauldin that interest rates in Japan are more likely to rise than fall in coming years, but if they do, it's more likely to be the result of improving prospects in Japan's real economy than some sort of 'crack up boom'[19] – barring any severe policy errors, of course. As such, the decline in JGB prices could be fairly orderly, if it's accompanied by improving economic expectations and a growing appetite for riskier assets in the private sector.

Back to Mauldin:

> Richard Koo (chief economist of Nomura Securities, in Tokyo) argues passionately that Japan had a balance-sheet recession, and that the only way for Japan to fight it was to run massive deficits. Banks were not lending and businesses were not borrowing, as both groups were trying to repair their balance sheets, which were savaged by the bursting of the bubble. It is said that at one time the value of the land on which the Emperor's Palace sits in Tokyo was worth more than all of California. Clearly this was a bubble that puts our housing bubble to shame.

FYI, Richard Koo's book[20] is a fantastic read if you're interested in Japan's longstanding recession and the notion of a "balance sheet recession".

More Demographics

> So, I understand the point that there are differences between Japan and the US. But there are also similarities. We too have had a balance sheet recession, although here it was mostly individuals and financial institutions that have had to retrench and repair their balance sheets.

That's not the only similarity. The age structure in the U.S. is similar, except that it trails Japan's by about a decade. Doing the math, that means *our financial markets should have seen a peak circa 1999-2000* (coincidence?), and that overall economic output could remain subpar in the coming decade or so. At the same time, it argues for improving fortunes in the Japanese economy in the near term.[21]

Public Debt – Boon or Bugaboo?

Mauldin continues:

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19 http://mises.org/humanaction/chap20sec6.asp

20 http://www.amazon.com/gp/product/0470824948?ie=UTF8&tag=symmetrycapit-20&linkCode=as2&camp=1789&creative=390957&creativeASIN=0470824948

21 http://cowles.econ.yale.edu/~gean/art/p1099.pdf

> Japan elected to run large deficits and raise taxes...government stimulus and deficits have no long-run positive effect on GDP. In fact, the work done by Christina Romer, Obama's chairman of the Council of Economic Advisors, shows that tax cuts have a three-times-greater positive effect on GDP, and tax increases have the same level of negative effect.

He's on the right track here, echoing the ongoing debate over 'fiscal multipliers'.[22] If we're going to rely on public spending to stimulate economic output, it's critical that we address these kinds of questions. Tax cuts would be our first choice too, and the main point we're trying to put forth here is that when fiscal stimulus is appropriate, neither tax cuts nor public expenditures should be financed through higher taxes.

However, tax cuts have an uphill battle in any political forum these days. As noted above, the tax cuts passed by the GOP in the past decade were pretty lame overall, with questionable long term effects on investment and productivity, and little to rectify longstanding distortions in the tax code other than closing the gap between dividend and capital gains rates. Perhaps most importantly, they were perceived by a large proportion of the electorate to be lacking in fairness, which has resulted in a likely return to more punitive tax rates on high incomes, dividends, and capital gains.[23]

Slack or No Slack?

Mauldin continues:

> [An] increase in [government expenditures] must be made up by savings from consumers and businesses and foreigners.

In a period of typical economic growth – or at least the type we've become accustomed too since the end of World War II – this is true. But what if there are indeed periods when private sector consumption and investment fall short of potential for sound structural reasons, whether demographics or something else? The Great Depression, to a significant extent, resulted from errors in monetary, trade, and tax policies. *But it also coincided with*

22 http://www.cepr.org/pubs/PolicyInsights/PolicyInsight39.pdf

23 In fact, the meme of 'tax cuts' seems to have lost a lot of the power it held in the late 1970s, early 1980s, and mid-1990s. This too could be due in part to demographics, but we think it also has a contextual element. Under the extraordinarily high marginal rates of the 1960s and 1970s, “cutting” wasn't a bad way to approach the problem – just pull out the tax machete and hack away. However, with more normal rates in place, the tax debate calls for greater nuance. Instead, representatives of traditional 'tax cut' constituencies often reflexively advocate policies that may no longer be as aligned with the greater economic good as they were in past decades. They conveniently and consistently overlook things like: (1) “all in” tax burdens, e.g., including payroll and consumption taxes, and the disproportionate impact of a persistent inflation tax on lower income households; (2) differential tax treatment that distorts business formation and expansion decisions; (3) differential treatment of labor and capital income and different forms of capital income; and (4) the compound disincentives created by the intersection of corporate taxes with various regulations. They do give needed attention to the realities of tax competition, and the risks of using the tax code for social engineering. But these arguments are usually subsumed to calls for lower marginal rates on high incomes, lower tax rates on investors, etc. In a back-to-the-future way (e.g., the late 1980s), perhaps tax 'reform' is a more appropriate moniker for the pursuit of sound tax policy nowadays. Or riffing on the Desai-Hines paper, perhaps we should call it tax 'reinvention'.

a reversal of the demographic dividend that had been at work in the 1920s. Whatever the causes of such periods, once we accept that they can and occasionally do occur, some of Keynes' objections and alternatives to the assumptions of classical economics seem quite logical. In fact, most modern economic theory allows for a variety of states, conditions, and agents to exist in markets and economies. But unfortunately, economics too often get split into ideological camps, each with its unique intellectual straitjacket, especially in discussions over public policy.

Can Government Expenditures Enhance Productivity?

Mauldin continues his attack on government expenditures:

> But [government spending] does not enhance overall productivity. Government spending may be necessary but it is not especially productive. You increase productivity when private businesses invest and create jobs and products. But if government soaks up the investment capital, there is less for private business.

Assertions like these assume away significant frictions, market imperfections, and factors such as demographics; those assumptions seem safe at times, but are way off base at others. And the question we're faced with is where the pendulum of structural economic conditions stands today. Some key tenets of classical economic theory were displaced by Keynes' General Theory due to the economic conditions that prevailed in the early 1930s. Some key tenets of Keynesian economics were displaced in later decades, again, due to conditions that prevailed in the recovery from World War II. Some of those same ideas are now under attack as a result of the global financial crisis and recession of 2007-2009. We're familiar with the major catechisms; we're just not sure that the evidence supports any one of them over another. Structural economic conditions can and do change – age structure is just one example of how this can come about – and different conditions may call for for different approaches.

If private investment and consumption were running at optimal levels today, Mauldin's objections would be sound (for the most part). But no one has been able to prove that economies are immune to periodic surfeits of idle capital, be it financial, physical, human, or otherwise (though Nobel Prizes have been awarded to those who tried). It's also far from heretical to assert that markets are imperfect and do not always clear efficiently. And though this may not be something that empirical economists would want to admit, the history of modern economies makes for rather small sample sizes, especially when examining long cycle phenomena like demographics, which the economics profession (outside of the Ehrlich-Simon debate[24]) largely ignores.[25]

In addition, and this is more relevant to John's argument, fiscal multipliers for government investment are actually pretty robust judging by the evidence, as pointed out previously. The belief that the public sector cannot enhance economic productivity is a

24 http://en.wikipedia.org/wiki/Simon-Ehrlich_wager

25 We'll candidly admit that the research upon which our views of age structure are based is limited to only a handful of major demographic cycles, and thus could be completely spurious.

common one in our industry; it's also one that available evidence argues strongly against. And a quick thought exercise should convince even arch-libertarians that it is at least possible: delegating national defense and the administration of legal systems to the public sector frees up considerable resources for productive investment elsewhere, thereby increasing overall productivity. It also creates the potential for second and third order benefits to the private economy, e.g., the development of military technologies that are transferable to the civilian economy, advances in legal theory and practice, human capital development, etc.

All public sector activity is fraught with agency risk, of course. But it's a mistake to argue that public sector activity can never improve employment or enhance productivity – and it's just plain silly to believe that agency risk doesn't exist in equal measure in the private sector. Insert Bernard Madoff mug shot here!

Thus, if we're correct that the demographic dividend in the U.S. will remain negative for the time being, and that the U.S. economy will suffer a period of subpar growth as a result, then a considerable expansion of the federal government's balance sheet into *sound* public investments might constitute the best approach to economic policy in the years ahead. *That's why we think that budget tightening at the federal level poses some notable risks if it is pursued too early and with too much vigor.*

The Japanese Disease – Sucking Air, or Sucking Wind?

More Mauldin:

> And that is Japanese disease. You run large deficits, sucking the air out of the room, and you raise taxes, taking the money from productive businesses and reducing the ability of consumers to save. Then you go for 20 years with little or no economic or job growth.

Again, "sucking the air out of the room" assumes there was little or no slack in the Japanese economy post-1989. Japan's policy responses have been rather poor at times, and have lacked effective coordination between monetary and fiscal authorities (hence the coincidence of fiscal tightening and public spending). But it's a leap to assert that large deficits themselves were the direct cause of 20 years of no growth, without assessing whether they were instead a symptom of something deeper.

> This is the path we currently seem to be on. The Japanese experience says that it could last a lot longer than people think before we hit the wall; because if savings rise in the US, and if banks, instead of lending, put that money on deposit with the Fed, as they are now doing (in order to repair their balance sheets), the US could run large deficits for longer than most observers currently believe.

That balance sheet repair process is necessary. Furthermore, if the federal government is going to be the marginal actor in the U.S. economy, then it absolutely makes sense for the financial sector to keep reserves on account with the Fed and to lend capital to the U.S. Treasury. At the moment, there are no indications of substantial crowding out of the private sector.

Whether the Japanese conundrum is likely to have any meaningful long term consequences is still up in the air. Will Japan eventually prove to be a historical outlier? Or will it turn out to be fairly typical of what can happen when a negative demographic dividend coincides with a massive investment bubble in a wealthy, productive, and advanced economy? Again, the sample space is far too small to make highly confident assertions (after all, how long have wealthy, productive, advanced economies existed?). So "hitting the wall" might simply mean that the demographic dividend turns positive again, allowing the public sector balance sheet to be shored up in due course. Japan will be an important test case of this hypothesis in the coming years.

A Double Rub

Mauldin looks backwards to assess the economic climb ahead:

> We will need 15-18 million new jobs in the next five years, just to get back to where we were only a few years ago. Without the creation of whole new industries, that is not going to happen.

And there you have the rub -- two of them, actually. First, "where we were only a few years ago" was enabled by the run up in financial sector leverage that John rails against in the same missive. Thus, true equilibrium probably lies below 15M+ new jobs, all else equal.[26] Second, history indicates that innovations that spark the creation of new industries can arise from public or public-private initiatives as well as purely private ones. And at a point where the demographic dividend will continue to be negative for some years, we should be skeptical of calling for the public sector to be banned from involvement.[27]

Deficits, Taxes, and the USD

Mauldin wraps up with the following:

> Nearly 20% of Americans are not paying anywhere close to the amount of taxes they paid a few years ago, and at least ten million are now collecting some kind of unemployment benefits or welfare.
>
> Choosing large deficits does not reduce the amount of pain we will experience, it just seemingly reduces it in the short term and creates the potential for a serious economic upheaval when the bond market finally decides to opt for higher rates. This path is a bad choice, but sadly, in reality it is one we could take.

Large deficits, *done correctly*, <u>do</u> have the potential to reduce the amount of economic

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26 This assertion relies on a rather shaky assumption that there was not underemployment in the U.S. economy prior to 2004-2005. Assuming there was, this would argue for an even greater role for fiscal policy.

27 Mauldin does not explicitly advocate keeping the public sector out of the innovation process, but based on the rest of his piece, we've assumed that's what he would advocate.

pain experienced, as long as economic circumstances are appropriate to such measures. It's a matter of removing intellectual blinders or straitjackets and assessing what might work and when.

And in a period of widespread unemployment and rising private sector saving, it's hard to imagine U.S. government bond rates heading sharply higher. Of course, there's a critically important caveat that we've noted many times, which is the centrality of the USD in global finance. This situation does increase the risk of higher inflation and nominal interest rates in the U.S., and this is especially true in weak financial regulatory environments. If systemic leverage is not capped at an optimal or at least pre-2004 level, then low U.S. interest rates will ignite another round of wildly leveraged speculation and 'hot' capital flows (the G-20's discussion of a Tobin tax on speculative financial flows this weekend indicates rising concerns about this risk[28]) and the inevitable financial crises to follow. But with the twin overhangs of a burst financial bubble and a negative demographic dividend in the U.S., real economic conditions at home are *not* likely to push interest rates substantially higher for several years. If and when it finally happens, we hope it's due primarily to the demographic dividend turning positive once again.

Lend the Fed a Hand!

Finally, we'll jump into the monetary side of things from the fiscal perspective developed above. The Federal Reserve's dovish stance on interest rates is clearly having negative consequences for dollar holders abroad and other parts of the world. If the U.S. were not in the midst of a historic balance sheet recession, the Fed would be able to raise its target rate to a level closer to equilibrium with the global economy. Unfortunately, the realities of the private sector paint the Fed into a corner, imposing a painful choice between USD credibility and marginal U.S. debtors.

The safest and surest way to ease this burden is through solid economic performance in the U.S., and the federal government is a key player in this regard. To the extent that the federal government pursues sound policies that enhance economic performance in the years ahead, it will make the Federal Reserve's job much easier.

Fiscal Health and Disease

One final note – in his description of 'Japanese Disease', Mauldin frequently describes two symptoms, rising deficits and *rising taxes*. When those symptoms coincide, it truly does imply a 'diseased' political economy. Our argument is definitely *not* for higher taxes. Rather, it can be summed up as follows:

- Pundits and analysts shouldn't blindly discard *any* potential fiscal strategies on the basis of ideology alone.
- Ideology should not be the driving force behind policy development. The main ideological approaches are:
    - Lower Taxes + Lower Spending = Conservative

28 http://www.bloomberg.com/apps/news?pid=20601080&sid=aEbwLvzaLk04

    - Higher Spending + Higher Taxes = Progressive

  Neither one is appropriate when fiscal stimulus is desired!

- Fiscal and monetary policies must be better coordinated than they were during Japan's long recession.

The next few years will be interesting, for both Japan and the U.S. They should provide us with important (though limited) evidence on the effects of both demographics and pubic policies on economic and financial market outcomes.

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