# The euthanasia of pensioners in Peoria

Charles Gave | GaveKal | 01 April 2014

I read everywhere that the US budget deficit is contracting because government consumption is falling as a percentage of GDP, now that the worst of the crisis has passed. This would be very good news indeed - however, I am not so sure that this decline is for real. In fact, I believe it is an accounting illusion.

Over a period of time long rates, if left to their own devices, always converge to the nominal GDP growth rate (this was called the "golden rule" by Economics Nobel laureate Maurice Allais, and is the core belief in Knut Wicksell's theory). However, a central bank can fight against this natural tendency by maintaining short rates at abnormally low levels, as the Federal Reserve did from the early 1970s until 1980 and again since 2002. During these two periods, long rates were conspicuously lower than growth rates, violating the golden rule.

If negative, the difference between long bond rates and the economic growth rate is effectively a subsidy paid by the saver to the government. In short, this difference measures the amount of financial repression taking place in an economy. The fact that it is not paid to the Treasury does not mean it doesn't exist. It is a tax paid by a nation's savers - e.g. pensioners in Peoria.

I can measure the size of this tax by looking at the difference between the seven-year government bond yield (the average duration of US debt) and the seven-year moving average growth rate of nominal GDP. This spread measures the difference between what the government should have paid and what the government really paid. Multiplying this difference by the US debt as a percentage of GDP gives us an idea of the amount of the implicit tax paid by the saver to the US government as a percentage of the US GDP. A positive reading implies that the rentier is suffering from financial repression, a negative reading that the government is paying what it should and some more. Figure 1 shows the results.

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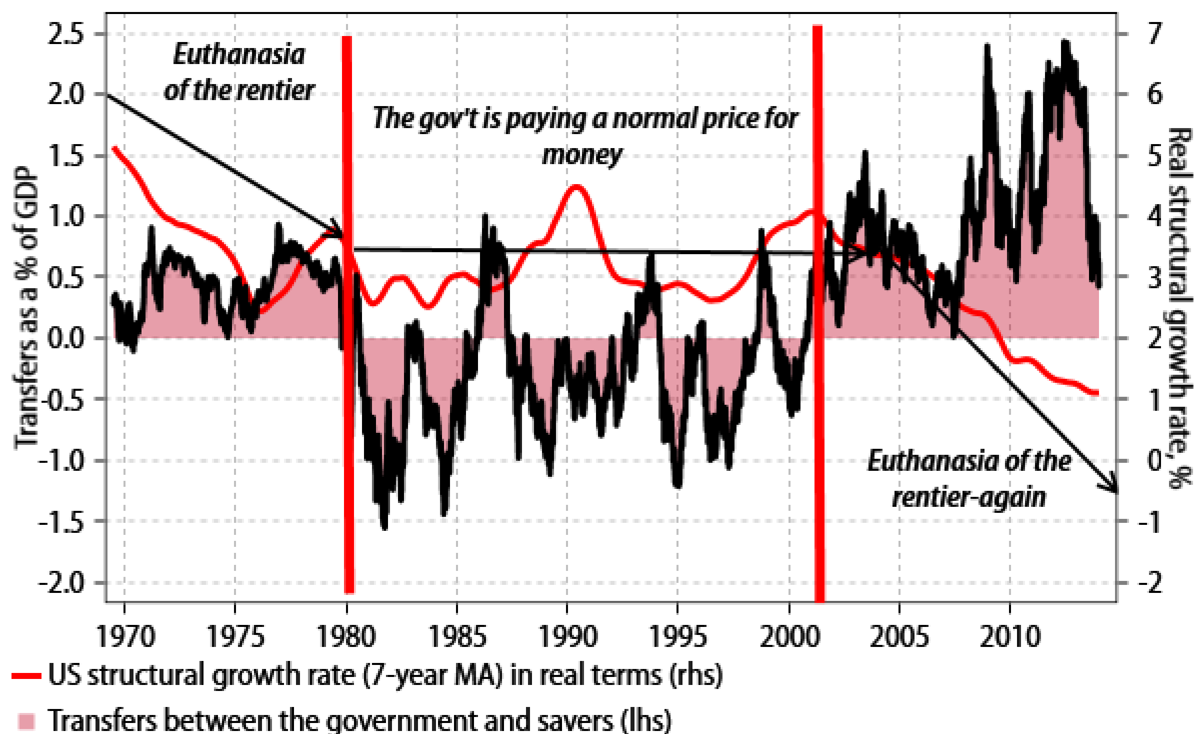
Figure 1: The great transfer robbery




Sources: Gavekal Data/Macrobond

Figure 1 shows us that US savers have been paying a virtual tax equivalent to between 1% and 2% of GDP almost every year since 2002 – a sign of the "euthanasia of the rentier" central to every Keynesian analysis. The problem is that subsidising government spending ultimately leads to lower productivity, slower structural growth and higher financial-crisis risk (see The High Cost Of Free Money[1]). We saw a similar euthanasia from 1966 to 1980, when the real structural growth rate of the economy was also in collapse (red line, right scale). The re-imposition of that dreadful tax by Alan Greenspan in 2002, only to be further aggravated by his successor Ben Bernanke, is a key factor behind the falling structural growth rate, the financial crisis and the subsequent slow recovery.

Unnaturally low funding costs undermines the structural growth rate of the US economy, because of capital misallocation. The losers in this deal are usually ordinary folk. Pensioners get no interest on their savings, while rich investors use cheap capital to chase up the cost of property, oil, etc. The gini coefficient rises as the poor are seldom asset rich, and real disposable incomes take a hit as prices rise. Sometimes banks are pressured to make up the shortfall with consumer loans to the struggling classes – adding to the bonfire when the inevitable financial crisis comes.

At the end of the day, it is simple. Savings equal investments – so any tax on savings leads to lower economic growth over time. We may be seeing declining ratios in government

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spending as a percentage of GDP, but this is really an accounting decline. Financial repression means the government is still taxing the savers, leaving less aside for meaningful investment in the future.

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