

Forbes

Tough Truths About The Dollar, The Debt and The Economy

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May 23, 2011

Someone recently asked me whether I thought the taxpayers would be willing to pay to clean up our fiscal mess.

From a political perspective, I doubt that they will be willing to pay enough to convert the fiscal deficits into surpluses, which is necessary to reduce the level of debt. Since public awareness is probably at an all time high, they probably will tolerate a reduction in the deficit, perhaps enough to avert a financial panic if we have enough time for that. Hopefully, it would be sufficient to reduce the ratio of the deficit and the debt to the economy. That probably could take place over time, but an early start and a credible plan is crucial.

One political problem is that we've had warnings about the dangers of deficits and debt for decades without the sky falling and we will be hard to convince that it will fall this time. We must realize that the magnitude of the problem now is sufficiently larger than in the past to constitute a difference in kind rather than merely a difference in degree. Another political problem is that our politicians are addicted to making promises today that someone else will have to keep tomorrow.

From an economic perspective, taxpayers, qua taxpayers, may refuse to pay, but citizens, including taxpayers, have no choice but to pay one way or another. Those ways may include higher taxes, but would also likely include slower growth, higher inflation, etc. In short, we can't continue forever to consume, broadly speaking, more than we produce. We are like a family that maxed out on our credit cards. While the balances were growing, we could live beyond our means, beyond our current income level. To reduce those balances we must reverse that and live beneath our means, but the higher the balances the more difficult it will be to make much progress beyond servicing the debt.

The post WWII status of the dollar as a reserve currency had its advantages, especially in the 1950s and the 1960s but also since then to a lesser degree. We were able as a nation to consume more than we produced by running deficits in our trade balance that the world was willing to finance by lending to us through the balancing capital accounts. As I recall, we made the transition from a net creditor country to a net debtor country in 1985. That means that we have covered our excess of imports over exports in value terms by increasing our foreign debt, broadly defined to include equity ownership as well as traditional debt in the form of bonds, bank

balances, and the like. In short, we've been living on debt and were able to do so more than most countries because of the special status of the dollar.

The problem with running up your credit card balances is that it can't go on forever. When the time comes to reverse that process, your favorable credit rating in the past looks more like a curse than an advantage. More discipline all along would have made the day of reckoning less traumatic. We should have recognized that there was something perverse about the richest, most productive country in the world borrowing year after year from poorer countries.

Some readers may think that I slipped a gear by starting out to discuss our fiscal mess—our outsized budget deficits and the resulting level of debt outstanding—and ended up discussing our external deficit and debt. However, the two are part of the same problem. Our national investment spending must be financed by saving. Our national saving, consisting of personal saving, business saving, and government saving, has been inadequate, in part because the government saving component, measured by the budget balance, has been negative rather than positive. That has required us to make up the difference between our national investment and national saving by borrowing abroad in the form of the capital inflow that finances our trade deficit. A move toward budget balance, other things equal, would also improve our external balance. They are part of the same problem.

Since our internal and external deficits are part of the same problem, failure to deal with the internal deficit will have external repercussions. A continued, accelerated decline in the dollar would worsen the terms of our international trade and reduce our standard of living. The only alternative is to get our fiscal house in order.