



The Enemy Within

The U.S. is suffering a government-spending and debt crisis, compounded by an investment exodus caused by Washington's weak-dollar policy. These risk a tipping point where financial markets and the dollar collapse. Heavy daily flows into gold, silver and foreign markets show the path of capital flight.

As a nation we're spending a lot of time and energy worrying about tipping points. The current path is unacceptable—a grinding decline in wealth, living standards and global stature as the dollar withers. Nor will grand political compromises make us safe and strong.

First-order U.S. growth solutions rest on clear decisions by the President to end the weak-dollar policy and substantially reduce current and projected federal spending. Proponents of Washington's devastating weak-dollar policy have promised for years that devaluations would make us more competitive, yet jobs, capital spending and innovation keep moving abroad to avoid the shrinking dollar. Near-zero interest rates tag the dollar as the flight currency of choice for world markets.

Big-government advocates argue that aggressive deficit spending will add jobs, yet the federal blowout mostly benefits big government and well-connected borrowers, not jobs or savers.

We wait almost hopefully for a warning shot from bond market vigilantes that might scare Washington into downsizing. But S&P's negative April report on U.S. spending and debt was a one-day story, which the Administration deflected into a call for an increase in the debt ceiling.

TIPPING POINTS

Tipping points are clearest when bond yields rise sharply, as they have in Greece, Ireland and Portugal, making their debt too expensive to keep rolling over. Greece's two-year bonds now pay 25% interest, but there's little hope that the principal will be fully repaid.

In late 2009 Greece triggered the tipping point by announcing that its gross debt—127% of GDP—was much greater than previous disclosures, which had benefited from “financial engineering.” Many countries, including the U.S., understate debt, but Greece was worse than most, and its growth and revenue prospects were more limited, hence the collapse.

Ireland's case is tougher. Its government entered the crisis with budget surpluses in 2006 and 2007 and an unusually low level of debt, 38% of GDP, in 2009. However, Ireland's banks had taken deposits from foreigners and lent the money unwisely, often for politically popular mortgages. When the 2008–09 global economic crisis disclosed the weakness of many Irish bank loans—what Warren Buffett calls swimming naked when the tide goes out—the Irish government decided to guarantee all bank depositors and pay withdrawals from new debt. The national debt has risen to 95% in 2011, pushing short-term bond yields over 12% and, sadly, triggering emigration.

Devaluations are another signpost of traumatic collapse, as Mexico showed in 1994 and Russia showed under Boris Yeltsin. Currency devaluations plagued Asia during the debt crisis of 1997–98. The common tipping point was an accumulation of foreign-currency debt combined with devaluation.

Economists have posited a 90% debt-to-GDP ratio as a tipping point, but in practice there's a wide range of experiences. Portugal started its collapse from a 79% debt-to-GDP ratio in 2010, yet Japan is still easily rolling over a net debt burden of 128% of GDP (latest IMF data).

Several factors help explain Japan's survival with high debt. Through years of hard work and saving, Japan built up national assets that were much larger than its debt, a cushion also available to the U.S. Japan has a strong-currency policy, causing much of Japan's savings to stay home. And Japan issues more long-term debt, making it less susceptible to swings in market confidence.

The IMF puts net U.S. debt at 72% of GDP, but it's on its way to a red flag 86% as early as 2016. Two sources of growth can stop this. A new check-and-balance procedure to reduce federal spending would energize business investment. One technique would be to replace the current statutory debt limit with a glide path to a 50% ceiling on the debt-to-GDP ratio and empower the President to cut spending when we exceed the debt ceiling. Second, a presidential decision to provide a strong and stable dollar would stop the hemorrhaging of American capital and jobs, restoring a cornerstone of President Reagan's vision of middle-class prosperity.

There's time. Interest rates are low, and national assets are still a multiple of debt, arguing against a near-term tipping point. Still, Washington grows ever stronger, reinforcing current policy weakness. So it makes sense to keep investing elsewhere, preserving capital while the dollar slides and getting ready to rebuild the U.S. once a President calls for a stronger dollar and less spending. 