Seriously Off Track

AT THE CORE OF OUR CULTURE IS A CAN-DO SPIRIT THAT WELcomes challenge. This is also built into free-market economics. Assuming price stability and limited government, we expect growth to rebound after a recession, recouping at least part of the lost output. Pent-up demand should kick in and inventories be rebuilt. Many companies stay profitable even through a recession, and those can start hiring. We rationalize the bad times with the belief that the contractions provide an opportunity for renovation.

This native optimism will be sorely tested in 2010 as Washington grows fast while national unemployment remains stuck in double digits. Living standards are sinking, squeezed by Washington's expansion and the falling value of the dollar. The dollar downtrend pushes capital away, lifts the price of oil and makes foreign earnings and assets (and the related jobs) more valuable than those in the U.S.

Washington is taking over wide swaths of the for-profit economy, including major portions of the mortgage, automotive and energy industries, the health care field and the banking and insurance sectors. The question is whether the balance between the private sector (profitable by nature) and the government (unprofitable by nature) has shifted so much that there won't be enough rebound to cover the overhead, to pay the economy's fixed costs while it digs out from recession. There's no room in the private sector to boost Washington's already insatiable tax extraction—Secretary Hillary Clinton is right when she says that "we tax everything that moves and doesn't move"—yet there's no will to shrink government.

Federal, state and local governments employ 25 million Americans, heavily unionized outside the military, with no political dynamic that allows much downsizing. An additional 9 million Americans are collecting weekly unemployment insurance checks (now available for a record 99 weeks). Every month this year more than 2 million people filed an initial claim for benefits, reflecting a staggering downward spiral in private-sector employment to only 108 million, 7.5 million off the peak.

The national debt consequences are just as unnerving. In projecting the stabilization of government finances years hence, the Administration is depending on a traditional private-sector rebound to rebuild some of the lost output and tax receipts. It's counting on an odd couple: low interest rates and low inflation, despite the dollar's crash. Just as crucial for rosy growth and tax-receipt projections, Obamanomics assumes that top marginal tax rates will rise—hammering one of the most sensitive drivers of the private-sector incentive structure—but with no subsequent decline in work effort, innovation or growth rates.

Even under this unlikely modeling the Administration's projections show marketable national debt growing to $17 trillion by 2019 (versus $5.8 trillion at the end of the Bush Administration and $7 trillion now). Under more realistic assumptions—slower growth, rising interest rates and moderate growth in government spending—debt would surge to $21 trillion by 2019. Neither total includes the government's promises for Social Security and Medicare (unfunded present value liability is $100 trillion per their trustees) nor guarantees of debt issued by Washington's mortgage megaagencies (roughly $13 trillion), the World Bank and a host of others.

The short maturity of the debt is as challenging as the amount. The average maturity of privately held Treasurys is only 49 months. The consolidated government balance sheet now includes an extra $1 trillion in short-term Federal Reserve debt used to buy long-term mortgage and Treasury securities. This leverage works fine when interest rates are low but rapidly compounds the debt when interest rates are rising. By letting the debt maturity shorten, Washington has trapped itself in a lose-lose outcome: If the economy does poorly, the debt-service costs stay low, but so do tax receipts; if growth rebounds, tax receipts jump, but so do interest costs.

Antidepressants

Reconciling this grim picture with innate optimism is hard. To make the current path work small businesses would have to invest and hire, despite high tax rates and a Washington-imposed credit crunch. Unions would need to accept pay cuts and reduced benefits in order to gain jobs in this slow-growth environment. The voting public would have to accept lower domestic living standards in order to absorb dollar weakness into their real wages. Washington would have to cut spending enough to give investors hope that the debt and dollar are sustainable. Far-fetched.

More plausible is that democracy will weigh in, with the Administration altering course in order to avoid a 2010 election disaster. These necessary changes are relatively clear: Offer Americans pro-growth policies that would build up the for-profit sector more than Washington. Reverse the weak-dollar policy to draw capital back to the U.S. Instruct bank regulators to change policies so that small-business lending resumes. Extend current tax rates beyond their 2010 expiration. End the Fed's purchases of high-priced long-term bonds—let the private sector make those bets. Treasury should sell many more long-term bonds while yields are still low (prices high). All these steps could have been taken many months ago but would still work even today to restart private-sector growth. F

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