Public Sector Debt Bubble Could Yet Rupture

The decline in the GDP of the United States in the first quarter of this year has been officially treated as almost as much a ho-hum as the fall of Ramadi to ISIS, but at least the Federal Reserve is not relying on America’s new Iranian allies to rectify the economic-growth problem, too.

The official version of events is that a strong dollar, a severe winter, a reduced oil price and slackened activity in that industry, and a dock strike on the West Coast are to blame. These are the feeblest excuses imaginable, and if the acumen of the country’s monetary managers is no more acute than their powers of improvisation in this case, the country could be in for a rougher sleigh-ride than has been foreseen.

It wasn’t a severe winter, a reduction in the country’s oil and fuel prices compensates for the sluggish impact on the energy sector, and none of these factors, such as they were, were unknown when official predictions were still for growth at about one-fifth of a percentage point – hardly a neck-snapping great leap forward but almost a full point above where the economy stumbled in at the end of March.

This was the third time in this syncopated and feeble recovery that the U.S. economy has paused for a decline, a brief 180-degree turn, and this time it came after generating a couple of relatively peppy quarters, and as the U.S. national debt, which stood at $9 trillion seven years ago, topped out at $18 trillion.

An inundation of red ink on such a scale as to cause wise people to start building an ark could have been and was expected to produce a much faster and less vulnerable level of economic growth. There appear to be three takeaway messages in these results: This is not a normal turn in the economic cycle and there are more fundamental problems in the economy than there were during the Carter or Eisenhower recessions; the policies adapted for dealing with it have not been the best available; and the whole debt issue is situated in a worldwide context that is very worrisome and in some respects unprecedented.

General expectations are for a revival of consumer activity to stoke up economic growth and get the tide that lifts all boats to rise. But consumer debt is high, the middle class is squeezed, and the experiences of the last seven years have not imbued the public with a relaxed attitude to carefree spending (and if it were otherwise the consequences would be disastrous).

The consumer boom of the late 1940s and the subsequent three decades replaced the nearly 20 preceding years of depression and wartime controls, and gradually became more and more a boost to the luxury-goods industries of France and Italy and the engineered-products industries of Germany and Japan than to U.S. manufacturing, which declined with the slippage of less-sophisticated manufacturing to developing markets.

The increasing prosperity of all these countries benefited the United States to some extent, and created a healthier world economy — one that was more broadly based than it had been when, at the end of World War II, half of the world's GDP was in the U.S. But to an ever-increasing degree, the United States was carrying the world on its back. This could not go on forever and it didn't.

If there were less tinkering and fewer half-measures and 'stimulus' boondoggles, and if those who govern would let America be America, the economy would respond quickly and effectively.

The Reagan experience of over 40 million jobs being lost but about 60 million being created would be replicated, and so also might be the Reagan era’s high rates of productivity increases, as, contrary to the yelps of organized labor, the new jobs were not hamburger flipping and pizza delivery (not that there is anything wrong with these), but largely high-tech. The United States is suffering from overreliance on service industries that generally do not add value as those who harvest agricultural products, extract natural resources, or fabricate or finish manufactured goods from components do.

The United States has a large and uniquely talented and motivated work force, and capitalism, eased and succoured by official fiscal emollients as required, will make the necessary adjustments if the economy is not straitjacketed by official pandering to apologists for aggrieved industries (even if some of them have legitimate public-policy complaints).

The debt-ridden state of almost the whole world is worrying; in the eight years since just before the 2008 problems, debt in the world has grown by $57 trillion, raising the ratio of debt to GDP in the world by 17 percent, and the greatest national risk-taker has been China, whose debt has skyrocketed in that time from $7 trillion to $28 trillion, and represents 282 percent of Chinese GDP, almost three times the percentage of GDP of the national debt of the United States. Half of all the Chinese loans are connected to the country’s inflated real-estate sector.

Shadow banking, which is unregulated and imprecisely monitored, accounts for almost half of new lending, and many local governments have borrowed beyond their capacity to carry and service their debt. China can probably manage this debt if the ratios and loan quality do not continue to deteriorate, but maintaining the country’s fiscal viability and reversing the trend to ballooning debt will be a severe challenge without inducing potentially serious deflation.

Since 2008, the world has struggled to absorb the shocks of that year's crisis, radiating out from the implosion of the U.S. housing bubble, by piling on debt and vastly increasing the money supply. The consequences of that effort are that government debt, which in 2008 was smaller than corporate, household, or financial debt, has outstripped those other categories.

Interest rates on government debt have been maintained at minimal rates and the United States has notoriously issued trillions of dollars of debt to the Federal Reserve rather than face the interest music of an arm's-length debt auction to free-market buyers. The world is now afflicted by a public-sector debt bubble that could rupture in any of a number of countries with instant knock-on effects.

The residual confidence in the ability of the world's central bankers and treasury officials to be successful stewards of the whole, vast, interconnected world debt structure could be very suddenly and unanswerably challenged. The stock-market rise, especially where newly hatched Internet companies that are not even profitable are valued at astronomical multiples of envisioned earnings — so-called unicorns, a phenomenon that has flourished in this time of artificially low interest rates — could come under severe pressure without (further) warning.

Companies that are brilliant concepts but thin on cash generation, such as taxi-competitor Uber ($50 billion capitalization), and social-site Pinterest ($11 billion capitalization), and many others — and I do not impugn the ingenuity of their organizing principles — could be vulnerable to sharp corrective forces.

Apart from these innovative companies that have levitated beyond traditionally justifiable multiples of any value measurement, there are beleaguered companies that have established businesses that have sold themselves as opportunistic turnarounds, such as retailer J. C. Penney, whose stock price has declined in three years from $42 to $9 but whose actual financial deterioration would, by traditional criteria, have reduced the stock price almost to zero. The turnaround may be imminent, but that is based on optimistic extrapolations of trends and continued confidence in the strength of consumer demand that may be fragile.

For the United States, which, despite the remarkable rise of China, is effectively unchallenged as the world's leading economy (and almost all the oppressive conventional social wisdom of the imminent rise to preeminence of China has mercifully abated), the challenge is to pull the present stumbling and tentative recovery up to the standard of previous rebounds, such as that achieved by the Reagan administration's tax cuts and encouragements of economic rationalization and employment and productivity increases.

U.S. economic growth over these six years of endlessly vaunted recovery has been at a rate of about 2.3 percent, where the long-term economic performance of the country has been at an annual growth rate of about 3.4 percent. To get this period of ostensible recovery into line with past performance and lift the burden of possible secular decline in the sustainable growth rate of the American economy, the country will have to rack up growth numbers of about 5 percent for the next decade.

The national GDP is about $2 trillion and 15 million jobs short of that now, and each 1 percent increase in real economic growth lowers the deficit by about $3 trillion over ten years. This is the proof of the politicians' ancient ambition to "grow" out of problems, rather than tighten belts or do other stringent and politically difficult acts that imply self-discipline and arithmetical rigor.

The way to encourage such growth and facilitate whatever adjustments are needed for the recalibration of the American economy to optimal sectoral distribution of job creation and productivity lies in the tax system, and obviously not in the dirigiste public-sector payroll and spending increases favored by the quaint social-democratic time-warp notions of the Obama administration.

For a reason that escapes my comprehension, the obvious and proven answers have not been attempted. These lie in cutting personal and corporate income taxes, simplifying taxes, reducing cronyist rebates and allowances, and – where revenue increases are necessary beyond what resulting growth will provide – raising consumption and transaction taxes that will affect only elective spending by relatively well-off people and corporations.

It is not beyond the wit of even the current set of administration and congressional policymakers to alight upon a workable formula in this policy zone. The Christie and Rubio proposals, and some of the other candidates' suggestions, are a good start. But it is almost certainly beyond the ability of the present bipartisan leadership to agree on anything sensible and adopt it before another grueling and expensive election in which the waters will be muddied by a lot of demeaning wedge issues about one or the other party's "war" against vast sections of the population.

The best we can realistically hope for is that the next president and the incoming senior policy entourage will combine a little original thinking with the requirements of the moment and the new-administration honeymoon spirit to innovate and change course, as Franklin D. Roosevelt did in 1933 (though with different policies for different times), Lyndon Johnson did in 1964 with his income-tax cuts, and Ronald Reagan did in the golden window of 1981 when he cut taxes and relaunched the U.S. economy. It requires optimism to credit the Obama administration with anything more than the ability to survive to the inauguration of the succeeding regime without the economic sky falling down. And even that, as the sports announcers say, could be touch and go.

From the