Five Mainstream Economists Sound a Warning

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Recently by Gary North: Digital Technologies vs. Truth Suppression

The *Wall Street Journal* ran an article the likes of which I have never seen. "The Magnitude of the Mess We're In." It was written by five well-known economists. It warns readers about a series of highly destructive outcomes of the federal government's present fiscal policies. The article says that these problems are close to being unmanageable.

The first economist involved is George Shultz. He taught at the University of Chicago and MIT. He served as the Secretary of the Treasury under Nixon and Secretary of State under Reagan. He served as the Head of the Office of Management and Budget under Nixon, and also Secretary of Labor under Nixon. I can think of no other economist with comparable experience at the highest level. He is an insider's insider. He is 92 years old – a true elder statesman.

The second economist is Michael Boskin. He teaches at the Hoover Institution. He used to teach at Stanford. He was the head of the Council of Economic Advisers under the first Bush. Then there was John F. Cogan of Hoover and Stanford. Then there was Allan Meltzer, who is the most respected historian of the Federal Reserve System. Finally, there was Stanford's John Taylor, of "Taylor rule" fame, one of the most respected academic economists in the USA.

A NAÏVE ARTICLE

The problem with this article is it is naive. **It is Pollyanna to the core**. It begins with the on-budget deficit: a mere $1.2 trillion a year. The on-budget deficit is peripheral to the real federal deficit, which reflects the unfunded liabilities of the federal government, primarily in Social Security, Medicare, and Medicaid. This deficit dwarfs the on-budget deficit. It is rising at $11 trillion a year.

This deficit has a present value of $222 trillion. This means that the federal government, today, must invest $222 trillion in market investments that will return about 5% per year for the next 75 years. No such investments exist, and the federal government does not have $222 trillion in reserve. The Federal Reserve system could print that, of course, but then that would only lead to hyperinflation.

In other words, by starting with the on-budget deficit, the five economists low-balled the problem. **This makes look as though the problem can be dealt with by Congress. It cannot,**

except by one technique, namely, default. They mention unfunded liabilities only briefly, and they offer no numbers.

Nevertheless, in a naive sort of way, the five economists do point out that present politics makes it virtually impossible for the on-budget deficit not to escalate, and if it does, it is going to lead to a series of inevitable disasters. The five economists go into the details about these disasters, and it is a good thing that somebody bothered to do this.

The article began with a good question: "Where are we now?" Answer: a lot worse off than the article says.

It asks this question: "Did you know that annual spending by the federal government now exceeds the 2007 level by about $1 trillion?" I do. You do. Who doesn't?

They list the deficits: $1.4 trillion in 2009, $1.3 trillion in 2010, $1.3 trillion in 2011, and another $1.2 in 2012. "The four-year increase in borrowing amounts to $55,000 per U.S. household."

Recall that the unfunded liability's present value grew by $11 trillion over the past 12 months. So, the article low-balls the magnitude of the mess we are in.

The Treasury must raise $4 trillion this year to pay the interest on the on-budget debt. They warn: ". . . the debt burden will explode when interest rates go up." Quite true.

The government cannot tax upper-income people. The top 1% pay 37% of the incomes taxes. **(That is because they make most of the income, which the authors do not mention.)**

Did you know that, during the last fiscal year, around three-quarters of the deficit was financed by the Federal Reserve? Foreign governments accounted for most of the rest, as American citizens' and institutions' purchases and sales netted to about zero. The Fed now owns one in six dollars of the national debt, the largest percentage of GDP in history, larger than even at the end of World War II.

This is true. But this means that the Treasury will get back most of the $4 trillion it pays as interest. The FED repays most of this at the end of the year. **This is an accounting device.**

Conclusion: "**By replacing large decentralized markets with centralized control by a few government officials, the Fed is <u>distorting</u> incentives and interfering with price discovery with unintended economic consequences."** This is true. It lies at the <u>heart of the mess</u> we are in.

The Fed's policy of keeping interest rates so low for so long means that the real rate (after accounting for inflation) is negative, **thereby cutting significantly the real income of those who have saved for retirement over their lifetime.**

Bernanke's FOMC says this will continue until at least 2015.

They say that the FED is replacing the Treasury as the source of government debt management. They are correct.

They warn of price inflation. The reserves of QE3 could do this. But if the FED unwinds too fast – sells assets, abandoning QE – "banks may find it hard to adjust and pull back on loans. Unwinding would be hard to manage now, but will become ever harder the more the balance sheet rises."

The FED tried to unwind over the last 12 months. They do not mention this. The result: the FED's panic return to QE3. There will be no unwinding.

Then they summarize some highlights, though peripheral. "Did you know that the federal government had 46 separate job-training programs? Yet a 47th for green jobs was added, and the success rate was so poor that the Department of Labor inspector general said it should be shut down. We need to get much better results from current programs, serving a more carefully targeted set of people with more effective programs that increase their opportunities." In short, blah, blah, blah. If we have 46, one more program is marginal, and there will not be the elimination of (say) 45 of them.

They go on and on, telling us of boondoggles. This is just noise. **Nothing is going to change.**

Then they get to Obama's budget. That budget will "raise the federal debt-to-GDP ratio to 80.4% in two years, about double its level at the end of 2008, and a larger percentage point increase than Greece from the end of 2008 to the beginning of this year." Quite true. But this budget was passed by Congress. **All budgets are passed by Congress.**

We are headed toward $18.8 trillion in debt. That will take $743 billion in interest payments. But, as they fail to mention, most of this will go to the FED, and will be returned. The problem is this: **there is no negative feedback for Congress. Rates are close to zero.**

Then they get to the really tough nut to crack: **the unfunded liabilities**. But they offer no specifics.

Worse, the unfunded long-run liabilities of Social Security, Medicare and Medicaid add tens of trillions of dollars to the debt, mostly due to rising real benefits per beneficiary. Before long, all the government will be able to do is finance the debt and pay pension and medical benefits. This spending will crowd out all other necessary government functions.

No, it won't. Why not? **Because there will be a default on these programs.** Younger voters will mandate this. Granny is going to get her checks cut off. The following will not happen: "One result will be ever-higher income and payroll taxes on all taxpayers that will reach over 80% at the top and 70% for many middle-income working couples."

QE3 creates uncertainty, they say. Quite true. "Traders speculate whether and when the Fed will intervene next. The Fed can intervene without limit in any credit market. . . ." Quite true.

Then they mention what was never mentioned before Ron Paul's run in 2007: **"This raises questions about why an independent agency of government should have this power."**

Then they ask: "What's at stake?" It's the right question.

Treasury debt is not a safe haven forever, they say. Good point.

"In short, we risk passing an economic, fiscal and financial point of no return." There. Someone said it. Of course, we are far beyond the point of no return. The $222 trillion in the present value of the unfunded liabilities guarantees this.

The USA could lose its full faith and credit status.

They see this as a great danger. **I see it as liberation.** They quote Alexander Hamilton on the benefits of the federal debt. I much prefer Thomas Jefferson's assessment. The full faith and credit of the U.S. government allowed the government to finance the Civil War and World War II. Quite true, and that is why its loss would be a great thing.

Then comes the bottom line.

The problems are close to being unmanageable now. If we stay on the current path, they will wind up being completely unmanageable, culminating in an unwelcome explosion and crisis.

We are going to stay on the present path. The problems will become unmanageable.

The U.S. government is going to default. The five do not use the D-word, but what they say points to it.

Then they push to full Polyanna mode.

The fixes are blindingly obvious. Economic theory, empirical studies and historical experience teach that the solutions are the lowest possible tax rates on the broadest base, sufficient to fund the necessary functions of government on balance over the business cycle; sound monetary policy; trade liberalization; spending control and entitlement reform; and regulatory, litigation and education reform. The need is clear. Why wait for disaster? The future is now.

They are correct. The future is now. And it is not going to change. Politics guarantees this.

CONCLUSION

I was happy to see an article from mainstream economists on the mess we are in. Of course, **the mess is vastly worse than they indicate.** The on-budget debt of $15 trillion is peanuts compared to the

$222 trillion of present-value net unfunded liabilities. But the mess is bad enough to warrant this article.

Nothing will change Congress. Nothing will change the executive. There will be no cutback in spending until the numbers force the Great Default.

Americans will not be ready. State and local governments will not be ready.

Will you be ready?