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US Economy: Rudderless and Reeling From Direct Hits

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"A country that had intelligent leaders would recognize its dire straits, stop its gratuitous wars, and slash its massive military budget, which exceeds that of the rest of the world combined. But a country whose foreign policy goal is world hegemony will continue on the path to destruction until the rest of the world ceases to finance its existence."

Such is the conviction of Paul Craig Roberts, former President Reagan's Assistant Secretary of the Treasury.

We were promised a "New Economy" of high-tech tradable services to take the place of the offshored manufacturing economy. Wondering what had become of the "New Economy," Duke University's Offshoring Research Network searched for it and located it offshore. Yes, the activities of the "New Economy" are also outsourced offshore.

Call centers, IT operations, back-office operations, and manufacturing have long been moved offshore. Now high-value-added proprietary activities such as research and development, engineering, product development, and analytical services are being sent offshore. All that's left is finance, and it is crumbling before our eyes.

Independent broker-dealers are disappearing: Merrill Lynch, Bear Stearns, Lehman Brothers. These venerable institutions were too thinly capitalized for the risks that they took. Merrill Lynch is now part of the Bank of America, and Lehman Brothers is history.

Ill-advised financial deregulation led to financial concentration and not to more efficient markets. Independent local banks, which focused on financing local businesses, and Saving and Loan Associations, which knew the local housing market, have been replaced with large institutions that package unanalyzed risks and sell them worldwide.

Regulation over-reached. The pendulum swung. Deregulation became an ideology and a facilitator of greed.

Deregulating electric power gave us Enron.

Deregulating the airlines destroyed famous American brand names such as Pan Am, shrank the number of companies, and caused a decline in service. When airlines were regulated, they could afford standby equipment, and cancelled flights were rare. Today, the bottom line prohibits standby equipment, and mechanical problems result in cancelled flights. When economists calculated the benefits of deregulation, they left out many of its costs.

There are no longer any blue chip companies, which means that investing for retirement has become a crapshoot. People realize this; thus, the privatization of Social Security has no support.

If we look realistically at the US economy, we see that what is not moved offshore is being bailed out. Last year, the US Department of Energy was authorized to make $25 billion in loans to auto manufacturing firms and suppliers of automotive parts. Last week the Secretary of the Treasury took $5 trillion dollars in Fannie Mae and Freddie Mac home mortgages under its wing.

The Congressional Budget Office says this action by the Treasury means "that the operations of Fannie Mae and Freddie Mac should be directly incorporated into the federal budget." Their revenues would be treated as federal revenues, and their expenditures as federal expenditures. If the former were greater than the latter, there would be no reason for the takeover.

The open question is: what do these new liabilities do to the Treasury's own credit standing?

For now, this question is submerged. The traditional practice of fleeing to the US dollar and US Treasury bonds during periods of financial stress and uncertainty has boosted the dollar and kept interest rates low. But sooner or later the large US budget deficit, worsened by recession and bailouts, and the large trade deficit, which requires constant recycling of dollars held by foreigners into US financial and real assets, will result in renewed effort on the part of foreigners to lighten their dollar holdings.

When this time arrives, US interest rates will have to rise in order for the government to be able to continue to rely on foreigners to recycle the dollars acquired in trade to finance the US government's annual budget deficit.

The current financial problems have pushed into the background the larger problems of the US budget and trade deficits. Goods and services for American markets that US corporations outsource offshore return as imports, which widen the US trade deficit. Moving production offshore reduces US GDP and employment and increases foreign GDP and employment. Moving production offshore reduces the export capacity of the US economy while raising the import bill.

Therefore, how is the trade deficit to be closed? One way is through the dollar's loss in exchange value, which would reduce American consumers' real incomes and leave them too poor to purchase the offshored goods and services.

How is the budget deficit to be closed when jobs are disappearing and GDP (tax base) is being relocated offshore?

Not by higher taxes. Higher taxes are problematic for a recessionary economy in which unemployment, properly measured, is already in double digits (www.shadowstats.com).

Some people have speculated that the budget deficit will be closed by dismantling entitlement programs such as Medicare. However, considering the cost of medical insurance, this would be catastrophic for tens of millions of older Americans.

The more likely avenue will be a raid on private pensions. The Clinton administration's appointee, Alicia Munnell, as Assistant Secretary of the Treasury for Economic Policy argued that private pensions should face a capital levy to make up for the fact that their accumulation was tax free. I expect that the federal government, faced with its own bankruptcy, will resurrect this argument, as it will be preferable to printing money like a banana republic or Weimar Germany.

In the 21st century, the US economy has been kept going by debt expansion, not by real income growth. Economists have hyped US productivity growth, but there is no sign that increased productivity has raised family incomes, an indication that there is a problem with the productivity statistics. With consumers overloaded with debt and the value of their most important assetâ€”housingâ€”falling, the American consumer will not be leading a recovery.

A country that had intelligent leaders would recognize its dire straits, stop its gratuitous wars, and slash its massive military budget, which exceeds that of the rest of the world combined. But a country whose foreign policy goal is world hegemony will continue on the path to destruction until the rest of the world ceases to finance its existence.

Most Americans, including the presidential candidates and the media, are unaware that the US government today, now at this minute, is unable to finance its day to day operations and must rely on foreigners to purchase its bonds. The government pays the interest to foreigners by selling more bonds, and when the bonds come due, the government redeems the bonds by selling new bonds. The day the foreigners do not buy is the day the American people and their government are brought to reality.

This is not the financial position of a superpower.

Will what happened to Lehman Brothers today be America's fate tomorrow?

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Paul Craig Roberts was Assistant Secretary of the Treasury during President Reagan's first term. He was Associate Editor of the Wall Street Journal. He has held numerous academic appointments, including the William E. Simon Chair, Center for Strategic and International Studies, Georgetown University, and Senior Research Fellow, Hoover Institution, Stanford University. He was awarded the Legion of Honor by French President Francois Mitterrand. He is the author of *Supply-Side Revolution : An Insider's Account of Policymaking in Washington*; *Alienation and the Soviet Economy and Meltdown: Inside the Soviet Economy*, and is the co-author with Lawrence M. Stratton of *The Tyranny of Good Intentions : How Prosecutors and Bureaucrats Are Trampling the Constitution in the Name of Justice* . Click here for Peter Brimelow's *Forbes Magazine* interview with Roberts about the recent epidemic of prosecutorial misconduct.