

US economy needs to rid itself of debt addiction

The US can solve its debt crisis but sustainable prosperity lies in improved productivity and real wage growth not asset bubbles

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US policymakers need to recognise high levels of public borrowing are symptomatic of a problem of private-sector debt addiction. Photograph: Michael Reynolds/EPA

A country where a plutocracy is firmly in control. A country that has racked up whopping trade and budget deficits over the past quarter century. A country where the tax system is biased towards the rich and spending is lavished on the military rather than the poor. This country – where the politics are dysfunctional and the economy a train wreck – is not some tinpot Latin American dictatorship circa 1980 but the United States in 2011.

If the US were any other country it would be seeking help from the International Monetary Fund (IMF). It is considered a blessing that the dollar's role as the global reserve currency of choice means that Washington does not have to suffer this indignity, but in reality the blessing has turned out to be a curse. The security blanket provided by the dollar has allowed Americans to believe that if they close their eyes all their problems will go away.

Policymakers have fostered this belief. They have assumed that the normal rules of economics do not apply to the US and have always looked for the easy way out of any problem. Under Alan Greenspan,

an excess of private-sector debt and speculation created the dotcom boom of the late 1990s. When the bubble burst, Greenspan's response was to create an even bigger bubble, this time in the housing market.

At the same time, George W Bush took what had been a solid fiscal position inherited from Bill Clinton and trashed it. Two expensive wars and tax cuts for the well off meant that by the time the subprime mortgage crisis broke the US was saturated in private-sector debt and the public sector balance sheet was in poor shape.

Interest rates were slashed in the hope that individuals would borrow even more money to fund their consumption patterns, but as last Friday's growth figures show, they have been reluctant to do so. Washington stepped in and sought to prevent a Great Depression-style fall in demand by cutting taxes and increasing spending. But the enfeebled state of America's public finances going into the slump meant that this counter-cyclical boost was more modest than it otherwise would have been.

George Osborne's aides took pleasure in pointing out that the revisions to US growth data mean that the profile of America's recessions now looks quite like Britain's. The peak to trough fall in output in the US was just over 5%, while in Britain it was a little more than 6%. Neither country has yet made up the ground lost during the global downturn of 2007-09. From the chancellor's perspective, loose fiscal policy in the US has done little but push the national debt to levels that will lead to a debt downgrade from the credit rating agencies even if the politicians in Washington cobble together a deal over raising the debt ceiling.

Even now there are Americans still in denial about how big a hole

they are in. Some take comfort in the fact that the United States is not Greece. But as Nick Parsons, of National Australia Bank, points out, many individual US states – California, for example – are exactly like Greece in that they have high levels of personal indebtedness, public spending that exceeds income by a considerable margin, lots of people out of work and are locked into a monetary union with no exchange rate flexibility and where decisions are taken thousands of miles away.

"A similar picture can be done for many of the States and literally thousands of municipalities and cities across the country," Parsons said. "In this respect, the debt concerns in peripheral Europe are set to be replayed right across America; the significant difference being that instead of relying on the generosity of Germans to bail them out, the US is dependent on Chinese goodwill."

Both Democrats and Republicans are partly right in their analysis of the crisis. The Democrats are right when they say that Bush's tax cuts and military spending were the fundamental reason for the deterioration in the public finances. By the time Obama arrived at the White House in early 2009, he was faced with a budget deficit projected to climb to \$1.2tn based on the cost of the recession and of Bush's policies continuing. Obama's stimulus measures have added to the deficit, although the assumption has been that the effect would be temporary rather than permanent.

The Democrats are also right when they say that trying to slash the deficit now would further weaken the economy. There has been much debate among economists recently about whether austerity can be good for growth, with one school of thought arguing that getting tough with tax and spending adds to a government's

credibility in the financial markets. Governments can then borrow more cheaply, and this feeds down into lower interest rates for businesses and individuals.

This is what policymakers mean by "expansionary contraction". According to the IMF, though, it is hard to find examples of it happening. IMF economists looked at more than 170 examples of fiscal policy stretching back to the 1930s and concluded: "Our estimates suggest fiscal consolidation has contractionary effects on private domestic demand and GDP." More specifically, the Fund found that a fiscal consolidation amounting to 1% of GDP reduced private consumption by 0.75% over the next two years, while GDP dropped by 0.62%.

This finding is consistent with Keynes's assertion that the right time for austerity is the boom not the slump, because putting up taxes and cutting spending at the wrong time simply sucks demand out of an already feeble economy, leading to a deeper recession and even bigger deficits. The breakdown of last week's US GDP figures showed that government consumption and investment has been falling sharply as the fiscal stimulus winds down.

Fiscal conservatives have a point, though, when they express doubts about whether the "right time" for budgetary restraint will ever present itself. Historically, policymakers have been far more willing to borrow money in a downturn than they have been to pay it back when growth is strong. It is hard to explain to voters why taxes should be going up and spending pared back when the economy is doing well. That was the case not just in America in the past decade but in Ireland and Britain as well.

So is there a way out of this mess? Yes, but only if there is

recognition that high levels of public borrowing are symptomatic of a deeper problem of private-sector debt addiction. The real way to sustainable prosperity is through genuine improvements in productivity and real wage growth not asset-price bubbles.

In the short term macroeconomic policy should be designed to get the economy moving, with a bias towards policies that boost employment and the productive capacity of the economy.

Running alongside that, there needs to be a long-term and credible plan for deficit reduction that sticks. Financial markets will take some convincing of this because there is a tendency for policymakers to behave like alcoholics who pledge to give up the booze but who fall off the wagon within a couple of days.

Christine Lagarde, the new managing director of the IMF, gave the US some useful advice last week. She said Washington should announce the details of a plan that would be implemented once the economy is fully back on its feet. That, though, assumes that the US can rid itself of its debt addiction before it becomes the new Japan. And, perhaps more importantly, that it wants to.