

The Economy and You Report

ESSENTIAL FACTS • OBJECTIVE ANALYSIS • CRITICAL THINKING • THOUGHTFUL COMMENTARY

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What's Fundamentally Wrong with Our Economy?

What do we have to do to rebuild our economy? To answer this question, we first need to know what's wrong with it.

At the core of our current recession lies the most basic principle underlying any economy. This principle can be identified by conducting the following thought experiment.

1. Draw an imaginary circle around yourself.
2. Ask yourself how much money you can spend over the next ten years assuming you will owe nothing or are owed nothing at the end of that period. The correct answer is how much you earn – nothing more.
3. Now extend the circle around your family and ask yourself how much your family will be able to spend over the next ten years. It seems to me you will reach the same conclusion: what your family earns.
4. Finally, extend the circle to encompass the whole country and ask how much money all consumers will be able to spend. I'll bet you get the same answer: what we collectively earn. And what will determine how much we earn? The answer to this question is also quite simple. How much we earn will be the same as the value of the goods and services we produce.

The next critical question is, "How much will our government be able to spend over that same ten-year period?" The answer is only what it collects in taxes from individuals and businesses - and those taxes will reduce what people and businesses have to spend.

Now let's say we want to spend more than we earned this year so we can consume more than we produced. How can we do that? There is only one way - borrow from parties who have saved some money by spending less than they earned, which means they consumed less than they produced.

Of course, the same principle applies to our government. If it doesn't collect enough taxes from private individuals and businesses to cover its spending, it has to borrow to fill the gap. And when our government borrows, it gives everyone more money to spend by not taking the taxes it needs out of their wallets.

In effect, when our government borrows instead of funding its spending with taxes, it is the same as if you and I and everyone else went to the bank, got a loan to pay our taxes and spent the money that wasn't removed from our wallets on whatever we wanted.

Of course, we would be directly indebted to the bank for what we borrowed, just as we are indirectly indebted to the parties that loaned our government money so we could pay fewer taxes and have more money to spend. The only difference is that we don't get a monthly

statement from our government showing how much we owe. If we did, we might feel differently about budget deficits, government spending, and tax cuts.

What conclusions can be drawn from this mental exercise?

The first conclusion is that whenever our government borrows, it borrows on our behalf because we are the ones who benefit from not paying taxes and we (or future generations) are also stuck with the debt.

The second is that whenever we borrow - or our government borrows for us - it indicates we are spending more than we are earning because we are consuming more than we're producing. In other words, we are living beyond our means. There is nothing wrong with this, providing we will be able to produce more than we consume at some point in the future so we can pay off our debt.

However, **the most important point is that our standard of living ultimately depends on what we produce and earn as individuals and as a country.** We can consume more than we produce for many years, but in the long term, the proposition is very simple: **If we want more goods and services, we must produce more goods and services, not just borrow more money.**

The following table shows how the total of consumer credit, residential and commercial mortgages, and federal government Public Debt has grown since 1981. There are other categories of debt, but these are the most important right now because so much of our economy's recent growth was fueled by the housing and construction boom, consumer spending, and government spending, which has led to a debt bulge throughout our economy.

Period	Average Annual Growth Rate - % GDP
1981 - 1990	10.5
1991 - 2000	6.3
2001 - 2008	11.3

Growth Rate of Total Consumer, Mortgage and Government Debt

Note that these figures do not include any of the money our government owes to Social Security or other government trust funds. Our government has already spent every penny of the taxes it collected to deposit in those trusts so funds will be available to cover future tax revenue shortfalls. The figures also don't include business debt, financial sector debt or state and local government debt, all of which have grown significantly since 1980. Considerable relevant detail about government and private debt is available at <http://mwhodges.home.att.net/nat-debt/debt-nat-a.htm#summary>.

The numbers show the prosperity of the '80s was fueled by increased government debt and a large increase in private debt that resulted in the savings and loan crisis of the late '80s.

The '90s saw reduced government borrowing, but the growth rate of consumer and mortgage debt steadily increased after 1992, reaching a high point of 12.5% in 2005. This was supplemented by a rapid increase in government budget deficits that started in 2000. From 2002 through 2007 the average growth rate of total consumer, mortgage and government debt was 13.2% compared to a 5.4% growth rate for GDP! Try doing this with your own finances and see how long you last.

In 2009 government borrowing was used to replace much of the decrease in consumer borrowing in order to avoid an economic crisis. Although this provides temporary relief, all it really does is swap one problem (private spending) for another (more government debt).

The only logical conclusion that can be reached from these numbers is that our economy's growth for the past thirty years - especially during the '80s and the '00s – was largely built on a foundation of government and private debt. Of course, our political leaders don't want you to know this, so they never talk about these figures.

How could we keep increasing borrowing like we did after 2000 to buy consumer goods and houses that a great many people couldn't afford? We couldn't, but we did it anyway.

There is no doubt our key fiscal policy-makers were well aware of what was happening and they should have been taken steps to curtail easy credit before 2005. However, too many people had too much to gain politically and personally by keeping alive the myths of strong economic growth and money falling from the sky.

Much of the borrowing was affordable, but an awful lot of it was not and we still don't know how much garbage the banks, insurance companies and other investors have buried in their vaults. They may not know themselves until all the shaky residential mortgage, commercial mortgage, consumer credit, and business loans finally play out over the next few years.

Although our politicians in Washington love to avoid accountability by pointing fingers at each other, economic data like declining real wages, our trade deficit, current account deficit, financial obligation ratios and our growing national debt all point to the same conclusion: **The current severe recession didn't develop in just the past 5-10 years; it is the result of living beyond our means for most of the past thirty years.**

Its roots go back to the early '80s and its development cuts across control of the White House and Congress by both political parties. The Democrats and Republicans love to point fingers at each other to avoid accountability, but in this case they are both right about their failure to recognize or admit what was happening to our economy and to do something about it.

Although there were a few minor attempts to deal with economic and fiscal reality, neither the Republicans nor the Democrats made any serious attempts to fix what has been fundamentally wrong with our economy since at least the late 70's. Instead of recognizing and dealing with the problems, our government officials took the easy way out by covering up our economy's fundamental problems with borrowed money and proclaiming prosperity.

But our government had the willing support of the business sector and the public because many people had much to gain, the future pain couldn't be felt, and most people don't believe what they hear and see; they hear and see what they believe or want to believe.

So what's the solution? **There is only one way out of debt and spending more than you're earning: some combination of consuming less and producing more to reduce spending, increase income, reduce debt and increase investment that will make it possible for you to consume more in the future.**

Does it make sense for us to borrow more money so we can continue to live beyond our means? No more than it would make sense for you to borrow money to take a grand vacation when the repo man was hitching up his tow truck to your car.

Maybe our government had to rescue the financial system and a case can be made for temporarily "stimulating" our economy to prevent a psychological meltdown, but continuing to

prop up consumer spending with borrowed money is a recipe for disaster. All we will get for that is more debt, a short postponement of the inevitable day of reckoning and a stronger dose of pain when the correction eventually occurs.

It does make sense to borrow for investing in things that will produce a net return, but rebuilding our economy will have to be accomplished almost exclusively by the private sector, just as the private sector built our economy in the first place. Government policies can help or hinder business development, but as history clearly shows, the private sector will have to do the work.

The bad news is that rebuilding our economy will take a few years just to get well underway. The good news is that we can rebuild it if we are willing to make some sacrifices and do the necessary work. I have no doubt the American people can do what must be done, but the critical question is, **“Can our political leaders muster the courage and will to face reality and make some unpopular decisions?”** Possibly, but their behavior over the past thirty years says otherwise.

Repeating the mistakes of the past isn't going to fix the future, but this is what we are doing right now and we will undoubtedly get the same results. However, despite a long list of undeniable facts that says pumping up consumer spending with borrowed money is no way to build a strong economy, some politicians and economists are calling for more of the same.

The fundamental problem with our economy is that we have been consuming more than we were producing and spending more than we were earning for most of the past thirty years. Until we recognize this basic problem and decide to deal with it, our economy will continue its meltdown, causing terrible future consequences for a great many people.

From establishing the first settlements and clearing the land to the industrial, agricultural, and technological revolutions, our country has prospered by increasing its production of goods and services. It is about time we recognize this is the only course to real economic recovery and start to aggressively do something about it.

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and remember to count the day lost that you don't learn something new!***

Regards,
Will Kaydos

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