The
NATIONAL STRATEGY FORUM REVIEW
An Online National Security Journal Published by the National Strategy Forum

Dire Straits: Will We Take Them Seriously?

By Frank Schell

In November, we heard from the President's Deficit Commission, and then in January from President Obama in the State of the Union Address. In the aftermath of the worst recession since the Great Depression and the collapse of much of Wall Street, America continues on an unsustainable course of trade and treasury deficits, with a culture of entitlements. We are left with the view that if unchecked, they will imperil the nation's competitiveness and economic leadership in the 21st century.

That is a draconian assessment – dire straits – but the question is as a nation, are we going to take them seriously? The endgame of not doing so is not clear, but 9%+ unemployment could be mild for a U.S. without globally competitive industries, and a continuing shift of wealth to China and others having massive trade surpluses. The guarantor of much of the world order since World War II, a U.S. with diminished moral and practical influence and a parsimonious defense budget is not a happy sight in view of asymmetric threats and the military ascent of China. Presently defined as neither friend nor foe, China aims for a blue water navy, stealth air superiority aircraft, cruise missile technology to threaten Carrier Strike Groups, with a robust cyberwarfare capability.

Momentous legislation known as Dodd-Frank was enacted in July 2010 to stabilize and regulate the financial system. While it strengthened diagnostics with a Financial Stability Oversight Council to address system risk, and enabled government control and intervention beyond the commercial banking industry to encompass financial services, the fundamental drivers of the catastrophe remain alive and well. Intertwined trade and treasury deficits of massive proportions continue, with dollar claims on the U.S. converted into holdings of U.S. treasury securities, fostering a low interest rate environment with the same moral hazard of easy money, use of cheap debt, and outsized financial appetites and lifestyles. Junk bonds (high yield debt) are back at record levels. The national debt now approximates about $14 trillion or one year's GDP. Fannie Mae and Freddie Mac, wards of the state that have cost the U.S. taxpayer at least $160 billion and still counting, have not even been addressed by Dodd-Frank.

The U.S. is fortunate to have the dollar, its store of value, as a reserve currency so that there is strong demand for U.S. Treasury securities, but it must no longer expect more fiscal discipline of others than it does of itself. To avert a day of reckoning, which would probably not come in the form of a day but as a series of events in currency, capital and credit markets, the U.S. must moderate its commitment to entitlements such as Medicare, Medicaid, the defense budget, and Social Security. (The State of the Union Address did not name the latter in terms of austerity, but instead spoke of strengthening it, unlike pension and retirement age changes already announced by France and Britain).

The net deficit in petroleum products of about $200 billion for 2009[1] was nearly as much as the trade deficit with China. This deficit not only increases foreign holdings of U.S. Treasuries, but exposes the country to autocratic and totalitarian regimes whose people are suppressed and whose values are antithetical to our own. For decades presidents have espoused the merits of reducing reliance upon foreign oil, yet the U.S. presently imports 61% of its requirements.[2] There is no well-communicated vision of energy mix for the status quo versus target environment in the next several decades, the cost of getting there, and the needed sacrifices. What we see as a nation is a blur of terms and exhortations about them: clean coal, nuclear, hydroelectric, solar, wind, algae, and natural gas.

The value of currency reform by China, a welcome action to encourage more consumption by China, must still be kept in perspective. Although the Yuan appreciated from about 15% against the U.S. dollar from 2005-2008,[3] the U.S. trade balance actually worsened in those years.[4]

Reduction of the corporate tax rate, which ranges from 35% to 41.2%[5] has been embraced in principle by the Deficit Commission, as well as by the President, who has also called for reorganization and consolidation of the entities of the federal government – although the State of the Union Address was silent on public sector unionization and pensions.

The challenge is whether a pluralistic democracy, where people want things they don't want to pay for, and a system of free markets can prevail and allocate resources in pursuit of not only profits, but also for economic security. There are many who believe in American exceptionalism from the beginnings of the Republic – and the challenge to the future of the United States as the leading global power is equally exceptional right now. But we have to get serious about it.

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[1] U.S. Energy Information Administration, *Annual Energy Review 2009*, August 19, 2010.

[2] Federal Reserve Economic Database, *TheDailyPickens,* January 19, 2011.

[3] OANDA, Average Exchange Rates. Available at: http://www.oanda.com/currency/average

[4] U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, Washington, D.C. 20233.

[5] Tax Foundation, "Comparing U.S. State Corporate Taxes to the OECD 2011."