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**WSJ** Print Edition

***Americans don't want to give up deficit-financed consumption that in time will hobble the economy.***


CHAD CROWE



# Without Spending Cuts, Brace for Slow Growth

**By Edward Conard**

Trade deficits and the mistaken belief that they chiefly fund business investment have led to a debt-fueled increase in American consumption. This surging consumption contributed to the 2008 financial crisis and unsustainable federal deficit spending while doing little to boost domestic production. It has left voters addicted to deficit-financed consumption and determined to stick someone else with the bill.

Unless the U.S. begins painful fiscal consolidation—unlike anything it has undertaken before—it will inevitably face slower long-term growth. Although the tyranny of the majority will fight to keep what it has and push costs onto others, Republicans shouldn't waste their opportunity to cut spending. Swing voters in the Rust Belt may support tariffs, but if they reduce trade deficits—without spending cuts or tax increases—tariffs could drive up interest rates and send America's fiscal imbalance spiraling out of control.

While trade deficits can pull savings into the U.S. from abroad when the demand for domestic investment exceeds the supply of domestic savings, this hasn't been the case for the past 25 years. Instead, the supply of foreign savings—chiefly from China, Japan, Korea, Germany and the oil-rich Middle East—has ex-ceeded the demand for domestic investment. Over this period, real interest rates fell to near zero and funded an increase in debt-financed U.S. consumption of foreign goods that reduced domestic savings.

If the demand for business investment primarily drove trade deficits, real interest rates and trade deficits would rise with the demand for domestic business investment. But since 2000, real interest rates have tended to fall as trade deficits expand—at least until recently. Business investment hasn't been correlated with trade deficits or interest rates.

Before the 2008 financial crisis, when America's trade deficits rose and domestic business investment fell relative to gross domestic product, offshore savings indirectly funded subprime homeowners. Those homeowners borrowed against the value of their properties, consumed their embedded equity and destabilized the banking system. After the crisis, policymakers recklessly borrowed offshore savings at near-zero interest rates to fund tax cuts and spending increases that politicians used to buy votes.

Federal government spending has risen from 19% of GDP before the 2008 financial crisis to more than 23% today, while taxes have remained at a lower-than-average 17% of GDP. Publicly held federal debt has grown from 35% to 100% of GDP and that share will continue to rise according to the Congressional Bud--get Office. The future will likely be worse than CBO's forecast, which assumes no budget-busting recessions.

Fiscal deficits have surpassed an unprecedented 6% of GDP during a period of economic expansion. Debtfinanced consumption now devours savings that otherwise would have funded business investment.

When Americans consume foreign- made goods, domestic demand for American-made goods declines. Foreign workers replace this lost demand by buying American-made goods and balancing trade. When they lend Americans their income instead of balancing trade, Americans must spend these savings to replace the otherwise lost domestic demand. At best, trade deficit-financed consumption merely borrows and consumes foreign-made goods.

Although proponents of trade deficits can point to examples of foreign investors funding risky U.S. investment, perhaps as a matter of strategy, foreign savers have avoided such risks by buying mostly U.S. government-guaranteed debt. Risky investments are overwhelmingly funded by American businesses that borrowed to pay dividends and buy back stock.

Even when foreign savers crowd domestic ones out of governmentguaranteed debt, neither has underwritten much risk. Until recently, both have accepted near-zero real interest rates while governmentguaranteed debt has grown to capitalize on their aversion to risk.

Trade deficits have predominantly funded consumption rather than investment because America has evolved from a capitalintensive, manufacturing- driven economy with faster population growth to an expertise-intensive, innovation-driven economy with slower population growth. During this period, tangible business investment by large, publicly traded U.S. companies has fallen 80% relative to the installed base of capital and become divorced from interest rates and the supply of savings. Tech companies once gushed cash and grew without regard to the availability of savings. Now they are pouring investment into artificial intelligence because the technology has ripened and the cost of falling behind their competitors is far greater than that of changes in real interest rates. In neither case has the supply of risk-averse savings had much effect on their investment.

We can pretend that exchanging paper IOUs for consumable goods gives America an economic advantage. In fact, it inflicts costs on the U.S. economy through higher taxes, interest expense, inflation, and cuts in government spending. Voters blame all of the above for slowing growth. But unproductive spending doesn't fund growth—it slows it. The bill is coming due.

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