

May 12, 2005

CAPITAL

 By DAVID
 WESSEL


Cutting Deficit Now May Spare Pain Later

May 12, 2005; Page A2

If the economy came in for credit counseling, the advice would sound like this: You're smart, ambitious, flexible -- and in better shape than others. But you're living beyond your means. You spent every penny you made last year, and then borrowed a further 6% of your income at favorable rates. Don't count on this continuing.

There is widespread, though not universal, agreement that the U.S. economy is on an unsustainable trajectory. It isn't prudent to expect foreigners to lend the U.S. 6% or more of gross domestic product indefinitely. It isn't prudent for the U.S. to keep expecting to consume more than it produces (importing from abroad to make up the difference) and to invest more than it saves (borrowing from abroad to make up the difference).

CAPITAL EXCHANGE


1


[Reader comments](#)² -- and David Wessel's answers -- about the Capital column. Published Tuesday mornings.

Submit comments to Mr. Wessel at capital@wsj.com³

The only question is whether all this ends with a bang or a whimper. "While the basic facts are undisputed ... every actor in this tale is spinning a different interpretation, blaming someone else and providing a different solution," notes Nouriel Roubini, a New York

University economist.

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

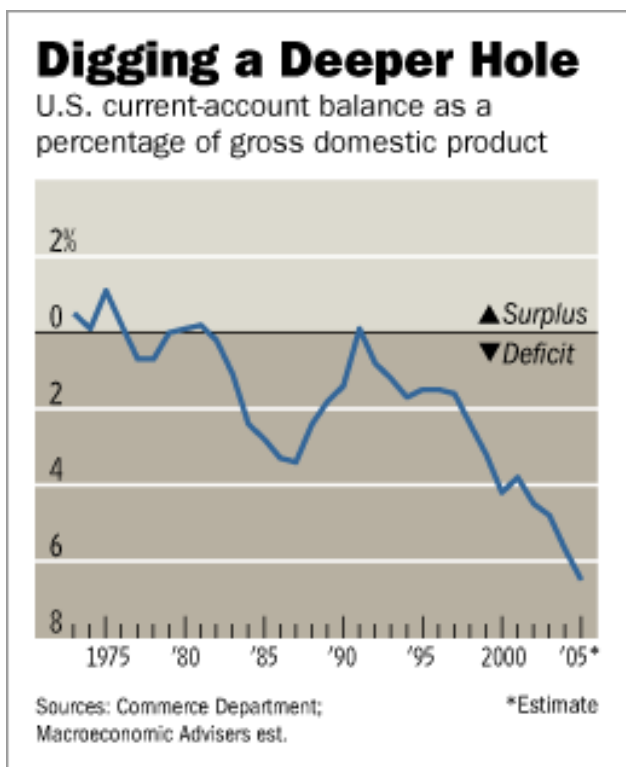
ABOUT DAVID WESSEL

David Wessel, 50 years old, The Wall Street Journal's deputy Washington bureau chief, writes Capital, a weekly look at the economy and the forces shaping living standards around the world. He also appears frequently on CNBC.

David has been with The Wall Street Journal since 1984, first in the Boston bureau and then the Washington bureau, where he was chief economics correspondent. During 1999 and 2000, he was the newspaper's Berlin bureau chief. He also has worked for the Boston Globe and at the Hartford (Conn.) Courant and Middletown (Conn.) Press. He has shared two Pulitzer prizes, one for a Boston Globe series on race in the workplace in

Europeans and Asians tell us that the global economy would be safer if we saved more and imported less. The U.S. replies that the economy would be safer if Europeans and Asians saved less and imported more. Some analysts say the key is for China to let its currency rise against the dollar so it imports more and exports less. Other analysts say the key is for the U.S. to save more so it relies less on borrowing from China. They're all right: No one of those solutions will suffice.

But the U.S. government, as is painfully evident, can't make China revalue its currency or prod European or Japanese consumers to buy more. It can't even make Americans save more. The one lever the government controls, sort of, is its own budget deficit, the amount that it subtracts from overall national saving.



There is no hard link between the budget deficit and the current-account deficit -- the amount (now more than \$1.8 billion a day, or \$2,250 per man, woman and child per year) that the U.S. borrows from abroad. When the U.S. ran budget surpluses in the late 1990s, it still borrowed a lot; foreigners readily lent to and invested in the booming U.S. economy.

But at some point -- and don't believe anyone who predicts precisely when -- foreigners aren't going to be willing to put increasing amounts into U.S. dollars. They'll invest elsewhere or use the money at home. (It's bizarre that a country like China with so much thirst for improving the lot of its people is pouring money into the U.S. so that Americans can save a few bucks a month on their mortgages.)

When that day comes, the dollar will fall and interest rates will rise. Americans will be forced to borrow less, spend

less (particularly on imports) and thus save more to replace foreigners' savings. The challenge to the U.S. is what to do now to reduce the risk that inevitable belt-tightening will cause a recession. "We shouldn't use all the rope that the rest of the world will give us to hang ourselves," advises William Kline, an international economist at the Center for Global Development, a Washington think tank.

That's where the budget deficit comes in. The bond market and the Federal Reserve will push up interest rates when the foreign appetite for lending to the U.S. wanes, but the increases will be less sharp if the government is borrowing less. And the only way to reduce future government borrowing is to act now to reduce deficits projected for the future. It's unpleasant, but it's the only plausible way to reduce the risk of a more painful outcome.

In contrast to his deficit-increasing first term, President Bush says he wants to reduce the deficit in his second term. But his goal is unambitious: His budget shows the deficit falling to 2.3% of GDP by fiscal year 2007 even though he projects the economy will have been operating at full speed for several years by then.

Boston and the other for Wall Street Journal stories on the corporate scandals of 2002.

He is the co-author, with fellow Journal reporter Bob Davis, of "Prosperity: The Coming 20-Year Boom and What It Means to You" (Random House/Times Books, 1998), which argued that the next 20 years will be better for the American middle class than the previous 20 years.

Write to him at capital@wsj.com⁴.

And there's justified global skepticism about whether the U.S. will actually hit the target: Congress already has rejected or reduced Mr. Bush's proposals to restrain Medicaid health spending and farm subsidies.

To reduce the deficit substantially over the next five years, Mr. Bush makes heroic predictions, such as pretending that Congress will freeze spending other than defense and homeland security. Beyond that, he can credibly promise a smaller deficit if he either acquiesces in tax increases or finds a winning political strategy to reduce spending on retirement, health, farm and other benefits programs. So far, there's no sign of that.

The U.S. budget deficit isn't the primary cause of the nation's risky overreliance on foreign savings. But reducing it is a big part of a prudent solution.

Write to David Wessel at capital@wsj.com⁵

URL for this article:

<http://online.wsj.com/article/0,,SB111585617259931203,00.html>

Hyperlinks in this Article:

- (1) http://online.wsj.com/articles/capital_exchange
- (2) http://online.wsj.com/articles/capital_exchange
- (3) <mailto:capital@wsj.com>
- (4) <mailto:capital@wsj.com>
- (5) <mailto:capital@wsj.com>

Copyright 2005 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our **Subscriber Agreement** and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.