DEEP IN DEBT, CAUGHT IN A NET

By Hans Sennholz

"Deep in Debt, Caught in a Net"... This old English proverb concisely describes the financial condition of many Americans. Household debt is rising at an 8.8 percent annual rate, home mortgage debt at 14.2 percent. Total debt in the United States doubled from 1998 to 2002, from $16 trillion to $32 trillion, and may double again in the next five years.

The Federal government, which sets the pace, reported a $555 deficit for the 2003 fiscal year; its total debt is given at $6.783 trillion. For the next two years the budget deficits are estimated at $566 billion to $644 billion each, which should increase its total debt to more than $8 trillion, or some $27,000 for every man, woman, and child.

Economists make an important distinction between "productive" and "consumptive" debt. Although the difference may not always be clear and exact and, therefore, may give rise to much controversy, it is significant as to motive and effect. A debt incurred for productive purposes, e.g. a commercial or industrial investment designed to earn future incomes, may cover its interest costs and even yield entrepreneurial profits. In contrast, new debt in the form of a second mortgage on a home may finance the purchase of a vacation home, new furniture or another automobile, or even a luxury cruise around the world. The debtor may call it "productive," but it surely does not create capital, i.e. build shops or factories or manufacture tools and dies that enhance the productivity of human labor.

Similarly, a debt incurred for the purpose of expanding Medicare may improve the health and looks of many elderly and, therefore, be deemed "productive," but it does not create capital that makes workers more productive and raises the levels of living of all. It actually may consume capital and thereby depress standards of living.

Private debtors may find it difficult to pay for bread that has been eaten. It is likely to become ever more difficult in the future as the cost of debt is likely to double and triple. At the present, interest rates are far below market rates due to massive monetary and fiscal stimulation by both the U.S. Treasury and the Federal Reserve System. The basic Fed rate stands at one percent, three-month money

market instruments at 1.11 percent, one-year paper of 1.78 percent, and two-year government notes at 1.77 percent.

For a while, government may ignore and even outlaw market prices, market wages, and market rates of interest and mandate its own, but price and rate edicts invariably disrupt the smooth functioning of the market order. They cause business misdirection and maladjustment that lead to ever more business losses and failures. In economic disarray, the Fed may have no choice but to raise its rate to market heights that enable businessmen to readjust to the judgments and wishes of the people.

Public debtors may view their debts in a different light. They may call them "a national bond" which, in Franklin D. Roosevelt's words, is "owed by the nation to the nation." In reality, it is unlikely that future generations of taxpayers will willingly bear the bond of debt. Like so many before them, they may choose currency depreciation, which offers the most advantageous escape from a burden of debt. It depreciates all debt and, in terms of purchasing power, may even reduce debt faster than new deficits are added. In the end, no matter how large the budget deficits may be, debt depreciation may outpace the deficits, which benefits all debtors, public and private, and defrauds all creditors.

Many creditors are exposed to yet another danger. The currency depreciation may accelerate if foreign creditors should begin to question the quality of the American dollar and liquidate their dollar claims, seeking refuge in other countries and other currencies. While many domestic credit institutions are legally barred from investing in foreign currency claims, foreign creditors usually have no such limitation; they are free to shed dollar investments at any time and search for profitable opportunities elsewhere.

Every such liquidation would reduce the demand for dollars and aggravate its depreciation. Moreover, it would cast doubt on the special position of the American dollar as the world's primary trade and reserve currency. For many years this special position has allowed the Federal Reserve System to provide the world with ever more of its notes in exchange for ever more goods and services. If the world should ever lose its trust in the U.S. dollar and convert some of its holdings, more than $7 trillion of American assets and claims, the consequences would be too calamitous to contemplate.

Our debt generation is a sad generation misguided by false notions and doctrines, and preoccupied with its own needs and wants. When economic conditions begin to deteriorate it may grow ever more egocentric and wretched, which tends to aggravate the social tension and strife. Clinging tenaciously to its transfer claims and rights, the unhappy society thus may deteriorate into a militant assembly of diverse pressure groups feuding and fighting each other.

When the political conflict finally explodes into violence, the transfer society urgently needs a peacemaker who is

prepared to suppress violence with superior violence. In the end, a society that can no longer work together in peace must submit to the dictates of a strong president armed with an array of emergency powers. In other places, at other times, he would be called Caesar.

Regards,

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For the Daily Reckoning

Editor's note: Dr. Hans Sennholz is president emeritus of The Foundation for Economic Education (FEE) in Irvington, NY. His essays and articles have appeared in over thirty-six major German journals and newspapers, and 500 more that reach American audiences. Dr. Sennholz is also the author of 17 books covering the Great Depression, Gold, Central Banking and Monetary Policy. You can write to him by sending an e-mail to this address: hans@sennholz.com.