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Likely cure for borrowing is more debt

By GREGG ERICKSON
COMMENT

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I wrote my first column on the unraveling economy in December 2004. "Americans are importing more than we can afford, using more government services than we are willing to pay for, and skipping investments in the future so we can live high on the hog today." Since then I've written five columns examining various aspects of our deteriorating economy.

American households and government have for years been using borrowed money to support a higher level of consumption than we could pay for. Only the willingness of foreigners to loan us money has allowed this to continue.

The mortgage meltdown represents only a piece of the problem. Wages haven't kept pace with rising prices, so real household income is falling. With the stock market in the tank and house prices down 16 percent from a year ago, droves of Americans turned to their credit cards to maintain their lifestyle. As of July, consumer debt was growing about 25 percent faster than earnings. The banks that initially make these "revolving" loans have been able to bundle and sell them to others as "collateralized debt obligations," much the same way they did with mortgages. Foreign lenders now have lost their appetite for this debt, so banks are curtailing the flow of consumer credit. As with housing, the standard-of-living bubble is now deflating.

Policymakers face two challenges: They must maintain faith in the financial system, and, as Americans tighten their belts and buy less, they must keep the real economy from collapsing.

The government response has been to pump out money via stimulus payments and rescue packages. At this point that's the only response that can deter financial panic. In a panic, sound institutions are swept away along with the rotten, leading to a cascading collapse of the payment system. Checks bounce.

Financing the massive infusion of government money with taxes is a political and economic nonstarter, so the money must be borrowed. Unless foreign lenders step forward, the Federal Reserve will finance this borrowing. That would mean the sort of double-digit inflation we haven't seen in this country since the early 1980s.

A worldwide depression won't be a walk in the park for anyone, but Alaska is better positioned to weather the storm than most states or countries. Inflation will weaken the U.S. dollar, improving the competitiveness of Alaska's private sector in foreign markets for tourism services and natural resources. Our real estate sector is reasonably sound. Households are flush with the $3,269 checks eligible residents received from the state.

The state government, so important to Alaska's economy, has been generating huge surpluses. Those surpluses end when oil prices drop below $75 per barrel, which they did on Friday, but even with a return to chronic deficits the state can fall back on its bloated savings accounts.

Looking ahead from the standpoint of personal investing is harder. Two weeks ago my wife confronted me with her laptop in hand, her Vanguard retirement account on the screen. She was not happy. "I've lost more money since Dec. 31 than it would cost me to buy a new Lexus." She updated that couple of days ago: "Four Lexuses."

The unspoken question is, if you're so smart why have you allowed this to happen?

Sometime during the 1990s, following my advice, Judy consolidated all her retirement money in Vanguard stock and bond index funds. Every six months or so I rebalance our accounts to maintain our respective asset allocation targets. I chose that very conventional approach because it does not require me to predict the timing of market changes, something I am no good at.

My stock funds have lost much more value than my bond funds, falling from 60 percent of my assets to 54 percent. Sticking with my plan requires I switch some of my bond investments into stocks. Psychologically, that's hard. It requires buying stocks just as the market news is screaming bail out of stocks entirely.

When it comes to investing, "the key organ in the body is the stomach, not the brain," wrote author and investment manager Peter Lynch. Those with the stomach to stay the course are the most likely to come out of this intact. My plan is to stick with my plan, rebalancing in monthly 1 percent increments until I get back to my target. I hope Judy does the same.

Juneau economic consultant Gregg Erickson is editor-at-large of the Alaska Budget Report. He is the former treasurer of the New York-based Robert Schalkenbach Foundation and currently serves on the foundation's investment committee. He can be contacted at gerickso@alaska.com.