



June 12, 2011

Letter from Washington

Poor Barack Obama. You could almost start to feel sorry for him. Just when things were looking up the rug gets pulled out from under him by the economy again.

The President played the Osama bin Laden killing just about right, only taking a small victory lap around New York City and giving the credit to the real heroes in the strange black helicopters. An uptick in approval ratings naturally followed after the successful mission in Pakistan, and coincidentally the President rode the crest of it into the formal announcement of his reelection campaign. Make no mistake, despite the understated post-Osama celebration, that event will figure large in the 2012 campaign, with the President figuratively carrying the body over his shoulder at every campaign appearance.

Reality intruded, however, in the form of an economic report that contained less than half of the expected new jobs created in May, and an increase in the unemployment rate back up to 9.1%. At the same time, it was determined that housing prices had declined nationally by a third in the last three years with no particular bottom in sight. There are an astounding number of Americans who are underwater on their mortgages with no good options at hand, and each foreclosure adds to the pool of unsold homes further depressing current values.

The conventional wisdom is that the 2012 election will hinge on the economy, and that no sitting President since the Great Depression has been reelected with the unemployment rate over 7%, with the exception of Ronald Reagan. In that election in 1984, the economy was noticeably better by November and Reagan was given credit for getting things back on track. Last week in a new Washington Post poll, Americans felt the country was on the wrong track by 2 to 1. 90% described the economy in negative terms and 60% thought that there was no recovery taking place despite the government statistics. Finally, over half strongly disapprove of Obama's handling of the economy. Grim statistics for the President, and his chief economic advisor resigned this past week to return to academia.

As the economy continues its anemic recovery without creating significant employment opportunities, the Democrats' impulse is to try to spend their way out of it to at least create some short-term government jobs and a little

good news somewhere. The Congressional Republicans are having none of it, and are pushing for significant spending reductions going into 2012.

Reasonable people on both sides of the aisle understand that the long-term solution to the US deficit and debt problem involves a combination of raising taxes, curtailing entitlements (especially Medicare) and reducing spending. But reasonable people are getting hard to come by in the Congress, as each side becomes more entrenched in its own dogma. The Democrats refuse to consider any structural reform to Medicare or Social Security, and for a Republican any talk of any kind of tax increase is an act of political suicide.

Following his usual pattern, the President allowed the Republicans to frame the issues by releasing their party's plan for long-term deficit reduction. The Ryan Plan (named after the Chairman of the House Budget Committee who largely authored it) goes right after entitlements, including Medicare. Ryan's concept is to turn Medicare from its present form as a defined benefit plan into a defined contribution plan for the elderly. Clearly older Americans' access to health care will be curtailed, as it must be in order to get control of the spiraling costs.

The Democrats have chosen to attack the Ryan plan as a heartless ploy to throw Granny out in the snow, but without proposing any solutions themselves. They believe that the Republican plan will sink of its own weight while they stand by and watch, and therein lies the crux of the problem.

Detached outside observers tend to think of the American electorate as uninformed and fairly simple-minded, and perhaps there is truth to that when Donald Trump and Sarah Palin can actually be taken seriously as presidential candidates. Barack Obama ran for president in 2008 on the theme of change, promising to reform health care in the US as the centerpiece, and was convincingly elected. Two years later, that same electorate that bought into health care reform has become focused on the deficit as the most important issue, but can't seem to make the connection between the two. For the deficit to go down, health care spending has to go down first, but the two sides are locked into their no-compromise positions with no signs of yielding.

Meanwhile, the President has an immediate problem in that the Congress has to authorize an increase to borrowing and the national debt by some time in August, or the United States of America may default on some obligations. Not surprisingly, the two sides are portraying a default differently. Republicans: no big deal; Democrats: Armageddon.

The President's problem is that he has to have that debt ceiling increase, and he has to have it large enough so that it doesn't come up again before the 2012 election --- more than two trillion dollars worth. The Republicans strategy appears to be that any increase in the debt has to be offset dollar for dollar by decreased federal spending. On the face of it, it seems like a

reasonable and responsible position, so the President is faced with agreeing to cuts that will require large scale dismantlement of parts of the US government --- sort of like performing your own autopsy --- or letting the US default.

The disenchantment of the Democratic Party base with the President's willingness to compromise on their key issues has already been made clear. When Obama gets rolled by the Republicans on the debt ceiling, at best he will have to deal with his base not showing up on Election Day 2012, at worst a primary challenge from within his own party.

To ratchet up the stakes a little higher, Moody's Investors Service, indicated that it would follow Standard & Poors in downgrading US debt ratings if the debt ceiling and deficit problems were not resolved quickly. The two rating institutions have essentially given the US government a vote of no confidence.

While the President was taking his minimalist victory lap in New York, Defense Secretary Gates was taking his farewell trip around the globe. Gates, a true American patriot and one of the few responsible adults left in government, has had a brilliant tenure as secretary. Unlike his predecessors, he has killed major weapons systems, brought back accountability to the DoD through several high profile sackings, and spoken his mind on key issues.

The issue that concerns him most at this point is the creation of a hollow force over the next 6 years through cutting the wrong things. Gates has said that although defense did not create the budget deficit it must be part of the solution, and that the worst thing would be a defense-wide "haircut" in which an across-the-board percentage reduction is enacted. He has made the point in several of his valedictory addresses that America is better off with a small superbly-equipped and trained force, than a larger ill-equipped and untrained military. He has stood up a Pentagon group to determine how to define the President's requirement to cut \$400B over the next ten years in a way that defines and then preserves critical military capabilities. The other side of the equation is that there are some DoD capabilities that will be lost, but he is going to make the political leadership acknowledge that up front and not claim surprise later. Instead of "what shall we cut?" his exercise is more along the lines of "what missions are you willing to be unable to carry out in an uncertain world?"

Gates has put his marker down that all of the remaining big-ticket programs (JSF, the 767 tanker, the new SSBN program, the next generation global bomber, etc) are all critical to national security and there is no cash cow waiting to be cut. As always, the real money is in the personnel accounts, and Gates seems willing to trade force structure for modernization. The risk of course is that once force structure is gone it is irretrievable, and a later set of political choices might kill the modernization programs as well.

At the same time, Chairman of the Joint Chiefs Mullen, has made the point in recent talks that despite the sizeable defense rollback that is coming there are certain critical parts of our national security industrial base that must be preserved and protected --- ship building being the most often cited example.

So the good news is that whatever the Congress ultimately does in terms of DoD funding, it will have had the benefit of well thought-out strategic analysis, conducted by men of honor and good intent, the question is whether they will choose to follow it.

Gates' nominated successor, Leon Panetta, has a long history of government service. Currently the CIA Director, he started as a Congressman from California and worked his way up to chairmanship of the House Budget Committee. Later he served as President Clinton's Director of the Office of Management and Budget, and ultimately as White House Chief of Staff when he was brought in to restore order after the Monica Lewinsky affair.

Panetta has handled the CIA well over the last two years and certainly has the makings of another responsible adult. The fear is that at heart he is a politician with a long record of budget activity, and that the urge to cut may overcome his responsibility to maintain a robust defense establishment.

Finally, from the "you just can't make this up" file, Washington is reveling in yet another sex scandal. Representative Anthony Weiner (D-NY) got caught up in the social networking thing to the point that he sent pictures of little Anthony to various women in greater cyberspace. Of course it became public, and of course he denied it, and the viewing audience has been treated to yet another minor celebrity self-destructing in public. The Republicans are taking particular pleasure in this one because Weiner has made in-your-face partisanship an art form, and his very public, very humiliating downfall has few people on either side feeling particularly sorry for him. The Republicans had a similar but less egregious incident with one of their own several months ago, and House Speaker John Boehner forced his immediate resignation. Weiner's combative narcissism will keep him in the spotlight and the subject of late show monologue jokes for a long time.

One more unwanted distraction for Barack Obama.