

## GETTING DOWN TO BUSINESS (Of Federal Debt & Deficits) Consensus: present course is unsustainable

### Does debt matter?

There is no shortage of business press and TV coverage about US government and the individuals who hold “power” in it. But, what power is that? Elected politicians do, and always did understand that they simply have no power, means, or tools to create *productive* jobs. But political speechmaking, egged on by a cable TV world that needs ongoing themes to feed its 24/7 yack-format had framed the 2010 general election to be all about jobs, jobs, jobs. Voters went to the polls in unusually large numbers and collectively, more or less said “We’re really scared about the country going bankrupt, and that’ll shrink jobs even more”. The two-year election tide has ebbed away, leaving behind a new Republican beachhead. And now, the jobs mantra has been replaced by debt and deficits (spending and taxes).

As we saw in 2010, the meager impact of the 2009 “stimulus” package proved what many elected pols apparently did not know: that, besides an inability to produce jobs, government is also ineffective at changing the direction of a swooning economy (and, we repeat what we say so often: US Presidents do not “manage the economy” now, or ever). This ineffectiveness became especially problematic when the Congress’s stimulus was attempted via: (a) using money borrowed by the US Treasury, from (b) the Federal Reserve Bank, which simply printed that money. Normally, the Treasury borrows whatever it needs from investors in the marketplace\*. This daisy-chain of stimulus/Treasury borrowing/Fed money printing had to be accounted for and the Fed duly reported to the world that the assets on its balance sheet had simply ballooned..... tripled..... over a period of about two years. And, if in fact the Fed prints another \$600B, that triple will become a quadruple. In effect then, this money printing to fund Treasury borrowings is not merely a continuation of the US Government’s traditional methods of floating deficits; *this is a new financing course which, viewed from wherever you sit in the world, is significant.*

But, back to the question we posed above: What impact will US Treasury/Fed high finance have on the average Joe? Answer: Lots more dollars in the world = less buying power for each one of those dollars. Result: Whenever you buy a loaf with US dollars, you will either: (a) need more dollars, or (b) get a smaller loaf.

Tip: The realistic way to view dollar value-erosion is not by listening to US policy-makers, but by keeping an eye on the global dollar-prices of commodities.

\*Actually, the Treasury first “borrows” and spends all the cash that the Social Security system collects in excess of its immediate payouts of current benefits; then, it turns to the bond market for all of its remaining borrowings.....until now.

### Picking up the pieces: The US Fed’s printing press hums into 2011

Standing beside the ashes of the stimulus program, Federal Reserve chairman Bernanke announced in November, as expected, that the Fed would unleash another US Treasury bond-buying spree, to the tune of \$600 billion. Presumably, these purchases will mostly be the new Treasury paper being issued to fund the nation’s 3<sup>rd</sup> straight \$1 trillion+ annual deficit. For good measure, the Fed also announced it will purchase some maturing Fannie Mae/Freddie Mac debt securities....a backstop that will allow those two national basket cases to sidestep paying the principal that is now coming due on their bonds.

We couldn’t have said it better than Ben Bernanke (in November 2002) who was, at the time, one of seven members of the Federal Reserve Board of Governors: *“The conclusion that deflation is always reversible under a fiat money system follows from basic economic reasoning. A little parable may prove useful: Today [2002], an ounce of gold sells for \$300, more or less. Now suppose that a modern alchemist solves his subject’s oldest problem by finding a way to produce unlimited amounts of new gold at essentially no cost.... Like gold, [paper] U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government*

*has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost."*

Following a clearly negative market reaction and public discourse about the new \$600B Fed buying program, Bernanke issued a statement saying that the program is not causing a significant amount of new currency to be put into circulation; thus, in so many words: *quitcher bellyakin'*. This back-of-the-hand rejoinder to his many critics must have been intended for members of Congress and cable TV audiences, rather than sophisticated market-makers. There is not much complexity involved in understanding that the Fed's purchases of marketable securities using bookkeeping entries instead of cash wire transfers from a bank account is surely "printing money", precisely as Bernanke described in 2002.

To be sure, the Fed has a dirty job, under the current circumstances.... it's the last man standing who can hope to clean up the bi-partisan fiscal messes of multiple spendthrift Congresses and profligate

presidents. Significant cost/price inflation has traditionally been a situation the Fed works overtime to prevent. But this time it's different; indeed, the Fed's apparent hope is that inflation, or the threat of it will actually *replace* the threat of economic contraction.

As we have described nearly two years ago, a strong dose of dollar-decline will eat away the value of fixed-rate debt investments and, in so doing, give the US Treasury and other present day mega-borrowers the chance to repay what they owe using cheap future dollars. Stated another way: a sustained period of US fiat currency issuance will (for dollar-based consumers and investors) produce: (a) ever higher commodity prices, including housing and interest rates, (b) strong *nominal* growth in corporate earnings, stock prices and returns on savings accounts and (c) debtors of all ilk will enjoy greater leverage; indeed, the longer the loan payback period, the more their leverage will be, and, on the flip-side (d) investors who own most types of fixed rate debt securities will suffer significant, permanent, *real* losses.

**Does fiat money drive inflation? Markets do not talk...but they can speak quite loudly**

**Investable gold shares, priced in US\$ - 5 years up by 140%**



**US Dollar versus Swiss Franc – 5 years**

down by 27% - despite the 2008, temporary “flight to dollar” panic



**Light Crude Oil, priced in US\$ - 9 years**

up by 300%, without any significant supply/demand imbalances (despite the spike & slump of 2008)



**China’s disturbing, but logical role**

The Peoples Republic of China has become, by far the single biggest thorn in the bleeding side of Treasury Secretary Geithner. Despite years of cajoling and shadow-boxing from the US, China has barely responded to the pressure for up-valuing the Chinese yuan against the US dollar, opting instead to keep the yuan closely pegged, while plowing nearly a trillion of those constant-valued dollars back into US Treasury debt securities. Part of the heat generated by the

declining dollar’s purchasing power for world-priced commodities shows up as de-facto de-valuation of the yuan’s purchasing power. Given China’s the torrid internal growth rate, this dollar-caused result injects inflationary pressure onto Chinese consumers. The stage appears set for China to gradually disconnect from the dollar, or partially do so; limited yuan trading has recently been approved by their government. In the long run, de-coupling will be a good thing for both the US and China, but it will not

likely help to restore the US's dominance in world trade.

China accumulated its mountain of dollar-cash because, for 20 years or so it was, and is selling almost everything US consumers use, at very low cost, while the Chinese were reciprocating via buying a few Boeing aircraft. [US-labeled big-ticket goods, such as cars, that are now being snapped up by increasingly well-off, free-spending Chinese consumers aren't helping to offset the US's insatiable appetite for Chinese imports. Why? Because essentially all of the manufacturing of those items is done at home, in China....as required by the Chinese government; the latest: China is requiring goods sold in China to also be *designed* there, particularly technology items; this new maneuver will likely deliver to China a veritable brain-trust, presumably made up of the people who have been living in Silicon Valley, Seattle and other US enclaves from which the US could continuously lay claim to being the world's #1 source of creativity and innovation.]

### **Smooth sailing for stocks(?)**

The foregoing discussion actually lays a predicate for a potentially significant upward valuation of US common stocks. Devaluing US dollars also tend to be reflected in dollar-based stock prices.... for a time, but probably not for the entire run. US business fundamentals are strong and de-levered. As the world begins to buy and sell again, business is running in super-efficiency mode, having cut all fat, some muscle and even a bit of bone. Part of the outcome impact of the dollar drama would depend on the speed and size of its emergence. All equity bets would be off if, for example, we re-visit 1973-74 (sudden, chronic commodities shortages that led to business hoarding and inventory bloating, combated by Fed-induced soaring short term interest rates which reached 20%, killed the bond market and sucked the air out of stocks).

**Getting religion: reducing business-stifling government:** President Obama has unabashedly gone on a market-based crusade, only weeks following the pasting he and his party took in the November elections. On January 18, he issued an Executive Order which he described that day in a Wall Street Journal op-ed article as follows: "This order requires that federal agencies ensure that regulations protect our safety, health and environment while promoting economic growth. And it orders a government-wide review of the rules already on the books to remove outdated regulations

that stifle job creation and make our economy less competitive. It's a review that will help bring order to regulations that have become a patchwork of overlapping rules, the result of tinkering by administrations and legislators of both parties and the influence of special interests in Washington over decades..... we are also making it our mission to root out regulations that conflict, that are not worth the cost, or that are just plain dumb."

**Getting a grip: Will regulatory foxes successfully bring on economic growth and reduce spending in the federal henhouse?** The most influential Washington regulatory bureaucrats typically have careers that span several presidencies; the security of their jobs largely rests upon the maintenance and growth of their agency's body of regulations. As with all government-wide Presidential orders, the implementation details of Mr Obama's well-intended regulatory Executive Order will be the devil that emasculates its stated purpose and outcome. (Just ask former President Jimmy Carter, who boldly tried and failed to force the agencies to use "zero-based budgeting" techniques... each year's budget request to the Congress was required to begin with a clean sheet of paper.)

To be realistic about the human nature's impact on a bureaucrat's role, we should assume that the particular regs which will be judged to have flunked under the President's "rooting-out" order (especially the ones that earn a Just-Plain-Dumb rating) will be those which are very old, are not being enforced and were drafted by now-retired, or deceased bureaucrats. The net result, then, could easily turn out to be an exercise that retires a numerical boatload of existing regulations, but: (a) eliminates nothing from the workload of the agencies, (b) contributes nothing toward stemming the robust growth rate of regulations and, most importantly, (c) produces nothing that will reduce any federal agency's future budget appropriation requests, or the cost burden of private business's regulatory compliance.

To be fair, it is not only the bureaucrats' jobs which ride the rails of regulation....a gigantic sub-universe of private professional jobs is dependent on providing compliance-assistance services. So, for reasons that are easily transparent, the tag-team of agency insiders and well-heeled external pros creates a formidable lobby that has a unique ability to trivialize serious regulatory reform efforts, even when the premise for reform is urgent and its Congressional support is bi-partisan.