

“If we didn’t have the US dollar as the de facto reserve currency of the world, we’d be Greece. We are broke, bankrupt. REALLY bankrupt.”

James Baker III, former US Treasury Secretary and Secretary of State, 4/10/11

The foregoing comment made to Fareed Zakaria on CNN and, hence, heard literally round the world, speaks for itself. As brash as this statement is, Jim Baker was a soft-spoken superstar in both the Reagan and elder-Bush administrations. His appraisal of the current situation reflects his powerful knack for sizing up, clarifying and condensing the complexities of government, while avoiding partisan filters, a skill that no doubt helped him quickly convince all sorts of world governments to commit, *in advance*, to finance sending US military forces into Kuwait, in order to chase away Saddam Hussein’s invading army .

Currency crossroads

What Baker did not say here was implied: if global market powers and major holders of US Treasury debt.... China, Germany, Brazil, Japan¹.... decide together that the dollar no longer deserves to be their reserve currency², then the US Government’s current financial condition will move from serious to critical.

Is reserve currency status *really* that important? Or, is it mostly a pride and status thing? Yes, it’s that important. When you are the world’s biggest debtor-nation and you routinely run huge trading deficits with the world, reserve currency status is the mechanism which fends off a currency crisis. The base source of US strength in the world is its economy’s massive middle class wealth and

consumption. Reserve currency status allows us to buy and consume more than we produce and sell without suffering a currency collapse. Let’s put that in perspective: Japan is now suffering its 15th year of domestic recession, but its foreign sales have consistently outpaced its purchases; result: the yen has remained a very strong currency. For 2010, Japan’s trading surplus was +\$166 billion (second-only to China’s +\$272 billion). By contrast, last year *the US bought \$561 billion more goods and services than it sold to the rest of the world....* 191st place out of 191 trading countries; (troubled Spain came in a distant second-worst, at negative \$66 billion).

Prominent advocates of de-frocking the US dollar have been expressing their opinions for some time. Indeed, on February 10, 2011, the International Monetary Fund issued a report that delved into the details of replacing King Dollar. To be sure, no such decision would be made without a transition period to what would likely be a flex-weighted currency market basket. But, if/when a transition does begin, it will predictably be dramatic; world commodities would surely and quickly be priced in basket-currency units, rather than dollars; the center of the world’s banking universe would likely shift away from New York (just as the New York Stock Exchange may be about to do now, via being acquired by the German bourse).

1 The aggregate volume of domestic transactions (GDP) in China, Japan, Germany and Brazil is \$16.7 trillion, versus the US’s \$14.7 trillion, according to the International Monetary Fund.

2 The US Dollar has been the undisputed world reserve currency, since 1944 (Bretton Woods Agreement); for most of the previous 100 years, British Pound Sterling was king.

The lesson of Rome: fiddling leads to disaster

In our special November Bulletin last year, we were skeptical to the extreme that President Obama, or either of the Congressional political parties, would give more than a casual look at the [then pending] December 1st recommendations of the National Commission on Fiscal Responsibility and Reform (commonly called the Commission on Debt and Deficits).

Created by Mr. Obama in early 2010, the commission was composed of 18 current and former members of Congress and it was given a narrow mandate: Develop a plan for the US to balance its annual budgets (before interest payments) by 2015. The commission accomplished its mission on time and rather impressively. Bah! we reasoned at the time. Congress routinely shrugs off pain-causing legislative recommendations of blue ribbon commissions.

In January, the President's State of the Union message curiously, even blatantly, ignored any reference to his commission's recommendations, despite the presumption that November election results were sure to disrupt budgetary business-as-usual, because 83 congressional seats had gone to narrowly focused Tea-Party-brand Republicans. In February, the President presented his budget proposal for the year to end September 30, 2012, again without apparent recognition of the commission's recommendations.

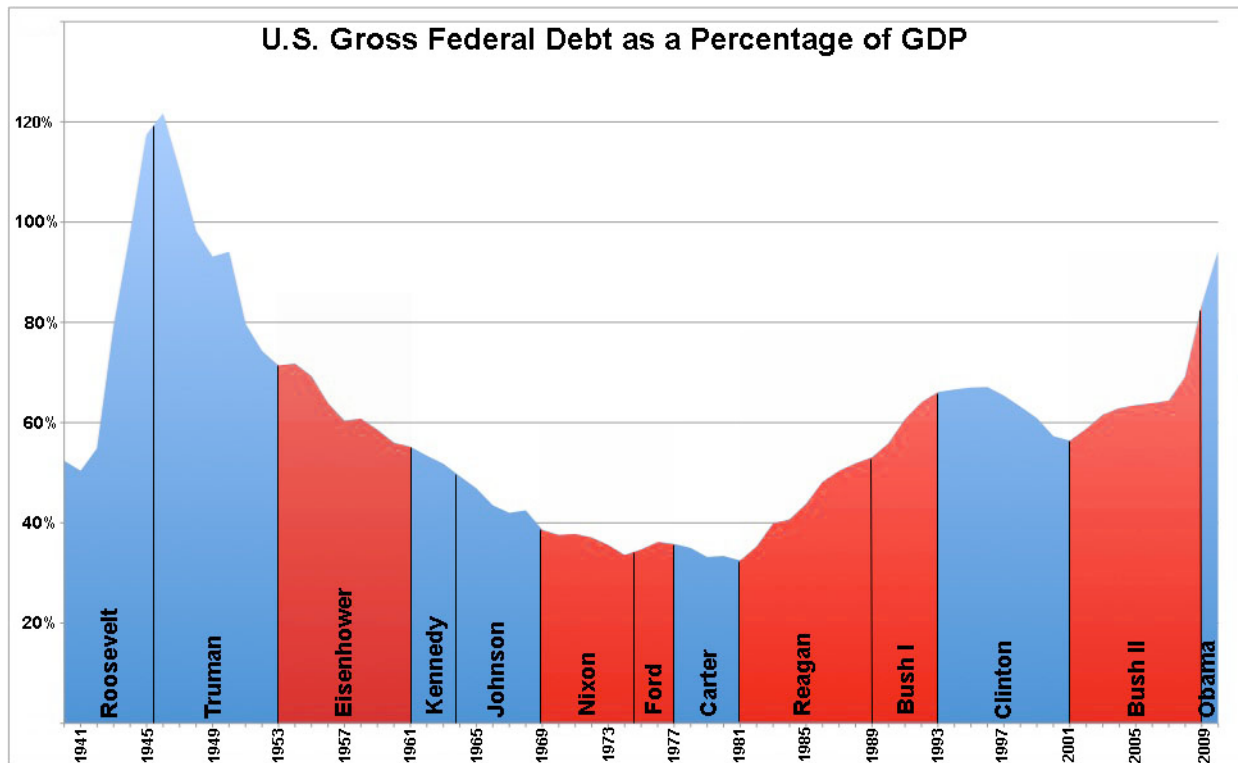
But now, in April, both the President and the Congress have turned serious faces toward the annual deficits measured in trillions and the accumulated debt that is soaring toward 15 of those trillions (equal to about 100% of GDP; historically, it's been about 40%). Not even the rosier scenarios for a future turnaround in the US economy over the next few years can sidestep the gloomy forecasted outcomes for the government's future annual bottom lines. And there are other lines... battle lines which, despite the urgency, promise to be rigid among the three

Congressional political factions (traditional Republicans, Tea-Party Republicans and Democrats). Their single point of agreement is that there will be no escape from slashing of government spending.... a "realization" that seems late in dawning because, nearly a year ago, Britain and all of Europe's economically problematic PIGS (Portugal, Ireland, Greece and Spain) had already signed onto serious belt-tightening.

A fix-it message to Nero

According to the two largest credit rating companies (Standard & Poors and Moody's), the US Government is skating on very thin ice with respect to keeping an AAA rating on its bonds. There are only 19 out of 127 rated countries that hold a triple-A; among those 19, S&P opined that the US has done the least to turn its budgetary tide toward a healthy financial direction. Consequently, it lowered its outlook for US debt to "negative" for the first time ever. In its commentary S&P has, in effect, given the US two years to re-jigger its currently unsustainable debt/deficit path *and to actually begin its implementation*, or else face an actual credit downgrade.... a result that would drive the government's already significant interest cost to critically high levels. Moody's announced a more hopeful appraisal: it believes that while President Obama and US House Budget Committee Chair Paul Ryan have staked out strongly dissimilar budgetary approaches, in Moody's view, either plan, or a presumed compromise would likely maintain the US's present credit standing.

As can be seen below, we have been here once before (1942-45)... the peak of immensely costly World War II. But, by the time the US reached that peak, the seeds of economic boom were already sprouting; unemployment was nearly non-existent and war production had factories humming 24/7, which gave way to post-war euphoria and the release of pent-up consumer demand for almost everything that was available for sale, following stringent war-time rationing.



Historical footnotes: Although the 20-years-long Vietnam/Laos/Cambodia conflict (1955-75) progressively drained away considerable US dollars during much of the Johnson and Nixon administrations, the debt-to-GNP ratio steadily declined.... a surprisingly favorable result, considering that Johnson's "Great Society"/ "guns and butter" domestic spending programs were nearly unconstrained. Only six years later, the Reagan Administration's major income tax rate reductions (1982) and sharply increased defense spending combined to send the debt ratio significantly upward again.

Is PIMCO a reflection of US debt and currency turmoil??

In recent months, the all-time king of the bond-hill, Pacific Investment Management Co (\$1 trillion under management), disclosed that its highly popular, consistently market-beating Total Return Bond Fund (\$236 billion) had sold all of its US Treasury holdings. In late 2007, PIMCO had loaded up on Treasuries, before the 2008 financial crisis, a maneuver which turned out to be nicely profitable for the fund's investors. In fact, this fund recently went

even further: it moved to a modest short position in Treasuries and has re-deployed some assets into the debt of Mexico, Brazil, Korea and Russia, while taking currency exposures in Brazil, Australia, and Canada. We report these movements because they appear to represent important marketplace evidence that our persistently grim comments about the foreseeable path for US Treasury debt and its dollar currency were not overdone.

Beware of numbers in a nutshell

From city hall to the US Senate, budgeting shell-games are never closed down. The game can always attract a crowd. Despite the fact that they have always lost, they play again and, each time of course, they fail to track the pea. The game is built on perception-fallacy: the shells appear to be, and are *presumed* to be nature's own, but they are instead specially constructed tools.

The political budgeting game has at least three manipulable "shells": (1) Forecasting: prepare long term budgets....as long as is necessary to hit the results-target (in this case 10, or even 12 years); publicize and discuss only the long term results,

despite the fact that base conditions and new legislation during the forecast period will predictably drive the original numbers into meaninglessness; (2) **Shuffling**: divide up the costs of “sacred”, controversial programs and spread them among various departmental budgets; the programs’ political enemies will thus be satisfied and neutralized, or they’ll at least gain political cover for their cause; (3) **Accounting**: unlike what is required of corporations, the federal government routinely does not quantify and account for its unfunded long term liabilities. *The present \$14+ trillion of on-the-books national debt is dwarfed by the un-accounted-for present value of future unfunded obligations for Medicare, Medicaid and Social Security, estimated in 2009 by GAO at \$45.8 trillion. Approximately \$7.7 trillion relates to Social Security, while \$38.2 trillion relates to Medicare and Medicaid. In other words, health care programs are nearly five times as serious a funding challenge as Social Security.*

How will the Fed follow its own act?

In late autumn last year, Federal Reserve Chairman Bernanke announced that the Fed would follow its recession/deflation-fighting, “Quantitative Easing” (QE) program of printing money to be used for all

sorts of purposes with a new \$600 billion money printing program (deemed QE2) to be spread in equal monthly amounts between November 2010 and June 2011. As announced, the new QE2 money is being used to buy a significant portion of the US Treasury’s output of new debt issued to fund this year’s \$1.6 trillion budget deficit; in addition, the Fed is soaking up much of the maturing mortgage paper issued by Fannie Mae and Freddie Mac (who are now in what amounts to bankruptcy).

Some of the Fed’s own policy-makers are agitating for an early end to QE2, not only because the US economy seems to be ready to take wing on its own, but also because the other major nations have already begun to raise interest rates in the face of rising commodity prices and their weak currency status. What will the US Fed do after June 30? Even the financial publications are clueless. What we do know is that (a) the US Treasury will have to continue churning out debt at a record rate and (b) the bond market may have to fend for itself, probably meaning higher interest rates, as the Treasury segment returns to more normal pricing forces.