



Financing the Past with Future Dollars October 2009

Strong Dollar Policy

One hallmark of all US Treasury Secretaries in the 21st Century has been their public claims to unflagging support for “a strong dollar policy”; this, in contrast to the fact that each of their tenures oversaw, and is overseeing new record levels of deficits, relative to overall US economic activity. The process has resembled images of the Global Warming Movement’s “poster-glacier”, shearing off massive chunks of ice into the ocean. In brief, what has long been the world’s greatest economy has recently been steaming ahead with an open vein.... Its currency has long been the only world-class money, placing a burden on US import/export activities that is borne by no other nation, a burden that was carried rather well for decades.

Meanwhile, a market-basket index of world currencies compared to the dollar traces a clear dollar-devaluation trend. Actually, the dollar-decline versus other currencies began in 2002 and would very likely have reached much lower than it is now (see chart), if it had not been interrupted by a panicky, global flight into US Treasury securities during late 2008/early 2009. Beginning in March of this year, the dollar resumed its decline, literally as soon as the first rays of enthusiasm about economic bottoming began to bend the direction of deeply depressed equity market values.

US Dollar Index (USD vs. currencies market basket – NY Board of Trade)



As we have been predicting in these commentaries, skyrocketing annual US deficits and the certainty of many more to come eventually causes things priced in dollar terms to inflate. The leading edge of such

things is now best seen among the globally traded items that have exclusively US dollar price-tags....oil and gold, both of which are in a major upward price trend.

Light Crude Oil (NY Mercantile Exchange) Are we resuming the 2002-2008 trend?



So, just as American households did, until last year, the US Treasury is now pumping out a mighty stream of new debt, not only in quantity, but also in relationship to measures such as the GNP; in addition, there is (always) the monthly routine of re-financing maturing debt. To the extent that foreign (mostly Peoples Bank of China) buyers have recently more or less had their fill, the ultimate debt-buyer has become the US Fed, using freshly printed money which simply adds to the world’s supply of dollars.

A quote from the US Treasury Department’s Bureau of the Public Debt web site...

“Our Strategic Plan: The strategic plan for [the Bureau of] Public Debt sets an exciting and challenging course that is filled with promise—for our programs and for our customers.”

We can’t imagine devising an insightful comment on this tidbit.

A modest solution to servicing massive US debt (without default)

The suction-like investment market downdraft that began little more than a year ago (which feels like three years to most people) found the world's financial businesses, homeowners and investors awash in debt which they had believed was "leverage", but, as things turned out, it was actually "negative equity" they were using. The US economy has turned on a dime, going, in a matter of months, from a negative household savings rate to about 6% of its spendable income, while businesses allowed inventories and other financed assets to shrink precipitously and banks raised their bars for lending to a point where "qualified" borrowers are the ones who don't need to borrow.

According to most financial industry analysts, many hundreds of commercial banks are still holding real estate and other loans on their books at values which are unrealistically high in relation to their likely collectability, as of now. Their expectations apparently reflect a quick recovery scenario. Much of the commercial real estate debt out there is going to need re-financing within the next three years, while the outlook for a return to the 2005-level of rental income from a shopping center, or office building is considerably further away than three years.

All of the above debt scenarios, from the US Government to the jobless homeowner and many borrowers in between need a workout solution...fairly soon. Except for the very low probability that we will see a China-style economy in the US, we are faced with a normally adequate GDP growth rate that will struggle to have much left over after covering our scheduled debt service. (Any discussion of "debt service", in our view, must include increasingly massive cash flow shortfalls from Medicare and, by 2017, Social Security benefits.) Tax increases, plus new kinds of taxes will be necessary. That said, we would need to look back at least 70 years to find worse timing.

Most nations that amass a debt burden that they can no longer service (e.g. Argentina, Mexico, etc.) simply default. But, because of its "too big to fail" status in the world, the US has a more elegant tool at its disposal: Debt Repudiation-via-Inflation. Although the US Fed's mission statement includes significant focus on managing the rate of domestic price-inflation in the economy, it is easily apparent that the least painful tool for managing away the current and intermediate term future blowout of dollar-denominated debt is to allow the medium of repayment....the US dollar....to decline in value. In other words, using a tried and true formula from the 1970s, borrow \$1,000 today to buy, say, 500 loaves of bread, then make future repayments using freshly

printed (devalued) dollars with which the lender can only buy 400 loaves. Such a deal, and it doesn't even show up as a red mark on the US's FICO score! That's not all. Using the same scenario, debt incurred today to purchase a house, will shrink in proportion to the house's future, inflated value....just like the good ole days.