Our Currency and Our Problem

Myrmikan had long worried that the gold price would collapse when the global credit bubble unravelled and then soar only after global central banks began printing, as in 2008. Reasons to think this might not happen included that gold, then, had been in a multi-year uptrend, and the reverse is true today. In addition, sharp down days in the stock market have been met with gold strength, signalling that investors are trigger happy to join the trade. But there is a deeper reason why Myrmikan thought gold might not follow the same pattern, and that is the weakening structure of the dollar system.

From the beginning of central banking through the 1930s, central banks held mainly gold, short-term commercial bills (backed by invoices on goods sold, not assets), and a few short-term government bonds. Government bonds through the 1930s were sterling investments since government debt was kept low except in wartime, and even then it would be paid off in real terms.

Credit bubbles occurred not because of central banks but because private banks earned so much profit pyramiding their loans through the fractional reserve process. When the inevitable bust came, asset prices plunged in terms of real money—gold—and also in terms of government currency, which was backed by gold or instruments readily convertible into gold.

The balance sheet of the Federal Reserve has eroded steadily since the New Deal, but panics nevertheless have seen the dollar strengthen. Bubbles are based on debt, and when all debts come due at once through cascading defaults, there is a huge short squeeze on dollars, the world reserve currency. In those moments, it matters little by what the dollar is backed.

This story could yet play out again. There are around $3.3 trillion of base money (down from $4.1 trillion three years ago) while total USD denominated global debt exceeds $90 trillion. As the Fed raises interest rates, that debt becomes ever more burdensome and demands ever more dollars to service.

Witness what happened to Turkey last summer: external dollar loans had been used to finance domestic malinvestment. Once the dollar began to strengthen and the...
Turkish lira weaken, dollar debts became unpayable. The typical scenario is an IMF rescue in which Western banks get key domestic assets as collateral.

Yet, instead of prostrating itself to world bankers, Turkey has completely faded from the news. It seems to have wriggled off the dollar hook—at least for now. One reason is that the collapse of oil prices (which was targeted to hurt Russia, as in the 1980s) has greatly improved Turkey’s current account deficit. Second, Erdoğan issued an executive decree requiring all new contracts between two Turkish entities to be made in lira, and existing contracts must be reindexed to lira, making the domestic banking sector more resilient to a dollar shock. Third, Turkey has been courting China as an alternate source of financing.

According to Stratfor:

China, however, has the financial capacity to extend sizable loans to countries that hold strategic value, as can be seen in Beijing’s extraordinary financial patience with Venezuela and the imminent likelihood of it—instead of the IMF—extending a $10 billion loan to Pakistan. Similarly, China may see a strategic interest in building ties to a state, such as Turkey, that has critical connections to the Belt and Road Initiative, that is pivotal to both United States and Russian foreign policy.¹

Turkey needs dollars it doesn’t have; China has dollars it doesn’t need. China is busy beating the IMF at its own game: it has lent $143 billion to various African countries, taking strategic assets as collateral. China doesn’t want the dollars back, it wants the assets: loan-to-own. Witness the threatened foreclosure against Keyna’s Mombassa port, the collateral China took against its loan to the hopeless Kenya Railways Corporation. Kenya specifically waived its sovereign immunity in the loan agreement.² China has been lending aggressively to other strategic countries, such as Indonesia, Malaysia, and Venezuela, creating a new, Eastern financial system.

China’s ambitions are not just financial—money is but a means to power. According to Yi-Zheng Lian, a former senior adviser to the Chief Executive of Hong Kong:

The concept of sovereignty and national boundaries in imperial China was never as cut and dried as the norm established in the West with the 1648 Peace of Westphalia.

The roughly 2,500-year-old “Book of Documents,” one of Confucianism’s defining texts, describes a sovereignty system with the emperor’s compound in the middle and around it, five concentric rings. The further from the center, the less the center’s control and one’s obligations to it.

The model was fluid, though. The empire’s outer boundaries expanded and contracted with the ability of China’s dynasties to project military might and exercise effective rule from the center to the periphery, and beyond.³


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Witness China’s colonization of the South China Sea, as it claims sovereignty over and militarizes islands absurdly far from its shores, at least in Westphalian terms. The islands are properly part of China in Confucian thinking.

And what can the West do about China’s imperial ambitions? The Republicans spent America’s willingness to go to war on needless adventures in the Middle East, and the military spent eight years under Obama deploying gender-neutral bathrooms instead of developing the next generation of military technology. According to the Heritage Foundation’s 2019 Index of U.S. Military Strength:

As the U.S. rested on the investments of past Administrations, our competitors and adversaries capitalized on the growing availability of advanced technologies—drawing from global commercial innovation, stealing the intellectual property of American businesses and institutions, and developing indigenous capabilities to counter long-held U.S. advantages in every domain of warfare.4

Up until the recent past, foreign leaders who defected from the dollar system ended up dead: Saddam Hussein and Muammar Gaddafi made good examples, pour encourager les autres. More powerful countries such as Iran and Russia were frozen out of the dollar banking system and saw large U.S. military deployments on their borders, forcing them to negotiate.

4 https://www.heritage.org/sites/default/files/2018-09/2019_IndexOfUSSMilitaryStrength_WEB.pdf

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But now China and Russia have developed military technologies that impair much of the U.S.’s offensive capabilities. Chinese rear admiral Lou Yuan observed in a recent speech that the brewing trade war between the U.S. and China is “definitely not simply friction over economics and trade.” He noted that, “what the United States fears the most is taking casualties,” and suggested that China is now more than capable of sinking an aircraft carrier or two: “Attack wherever the enemy is afraid of being hit.”

Russia, for its part, has developed hypersonic missiles against which, according to a GAO report, “there are no existing countermeasures.” U.S. sanctions have done little to impact Russia’s economy, but it has prompted Russia to set up non-dollar payment systems with its trading partners, loosening the dollar’s grip on global trade and global debt.

The U.S. dollar system was founded at Bretton Woods on three pillars: American military supremacy, American financial hegemony, and American economic prowess. The U.S. is now the world’s largest debtor instead of the world’s largest creditor. China has supreme military, financial, and economic power in expanding concentric circles. Russia is carving out its own sphere of economic and military influence. Europeans now use the euro. As American power continues to ebb, the dollar will become increasingly unable to rely on geopolitical support.

If the dollar’s value cannot be maintained by an international short squeeze, the market will look instead to the Fed’s balance sheet, and the story there is dire. Far from being backed by gold and short-term commercial invoices, the Fed holds mostly Treasury bonds and mortgage backed securities (the anomalous data point is 2008 when the Fed loaded up on foreign central bank dollar swaps).

Worse, the duration of the Fed’s bonds have steadily lengthened. In 1972, for example, 31% of the Fed’s Treasury portfolio matured within 90 days and 2% matured after more than 10 years. Currently 4% mature within 90 days and 28% mature in more than 10 years. Rising rates are lethal to the value of the assets the Fed holds.

Source: Federal Reserve Bank of St. Louis, Myrmikan Capital, LLC

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Yet the Powell Fed is raising them. Official inflation is still tame, but unemployment below 4% and bubbling asset markets have the Fed worried about financial stability. Powell noted last summer:

Inflation may no longer be the first or best indicator of a tight labor market and rising pressures on resource utilization. In the run-up to the past two recessions, destabilizing excesses appeared mainly in financial markets rather than in inflation. Thus, risk management suggests looking beyond inflation for signs of excesses.  

Earlier this month, former Fed Chairman Bernanke quipped:

Expansions don’t die of old age. I like to say they get murdered. Right now—I don’t see anyone hiding behind the curtain.

Powell, in fact, was sitting right across from him. The murder weapon is Powell’s quotation above. Fed economists think that raising rates can set some new equilibrium for asset prices. Instead, in a debt-saturated economy, rising rates find tipping points: Apple is down 33% since October. FaceBook is down 34% since July, Goldman Sachs is down 35% since March (23% since November), the KBW bank index has dropped 15% since October.

Beyond the stock market, debt ETFs are seeing massive outflows. The high-yield bond market just had its first issuance in 40 days, the longest dry spell since 1995. The lucky company needs the money to pay back its maturing debt. The problem is that the new interest rate is 6.5% whereas the interest on the debt being replaced was 4.125%.

Real estate is also softening, with the median price of a Manhattan apartment the lowest in three years; Seattle home prices have dropped 11% in six months; home sales in Southern California collapsed 7.5% in October, the third month of declines in a row. Keep in mind that mortgage backed securities comprise 40% of the Fed’s assets.

The world may still be some distance from the next Lehman moment, but nearly a decade at zero rates bred massive malinvestment that cannot withstand a rising interest environment. Unless the Fed starts printing, and soon, and a lot, Lehman will come.

Given the probability that rising rates have accelerated the onset of the next credit crisis, let us consider the effect on federal budget deficits. The Keynesian theory of economic management holds that governments should run surpluses in good times so that they can run deficits to stimulate in bad times. The last recorded instance of this actually occurring may be in the Book of Exodus, but that is the theory. The reality is that (especially in a democracy) governments run deficits in good times and enormous deficits in bad: tax revenue shrinks at the same time that “automatic stabilizers” like welfare payments expand. This is especially true in our progressive tax system whereby falling incomes reduce not just the income to be taxed but also the overall rate of taxation.

8 https://www.federalreserve.gov/newsevents/speech/powell20180824a.htm
9 https://outline.com/AENtGB
10 https://www.wsj.com/articles/a-junk-bond-drought-is-making-investors-nervous-11547116200

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The recession of 1990 never saw government revenues decline, but “automatic stabilizers” did boost spending by 18% over two years, increasing the deficit by 47%. The panic of 2000 saw government revenues fall by 13% over two years and spending jump by 15%, turning a surplus into a $500 billion dollar deficit. Military spending played a role, of course, as it did in 1991, but that’s just part of “stimulus,” and the deficit moderated only slightly afterward. The panic of 2008 saw government revenues decline 20% from the 2007 peak and spending increase by 25% in non-military stimulus, boosting the deficit from $500 billion to $1.5 trillion.

Keynesians argue the state should run surpluses in good times and deficits in bad.

The latest surge in deficits beginning in July 2017 seems anomalous because the economy was still expanding. It reflects a few things. First, the chart above is not of the official deficit: it includes payroll taxes and social security payments. As the baby boomer retirement wave accelerates, the deficit must rise—there is no “lock box.” The chart also reflects the Republican spending spree—the GOP may talk tough about deficits when out of power but never fails to juice spending once back in power. The last three data points (Q1–Q3 of 2018) also reflect the recent tax cut.

The scary question is what happens in the next credit crisis. The current credit bubble is larger than in 2008 (which was larger than in 2000), but let us assume that the dynamics are the same as last time, that government revenue will decline by 20% and spending increase by 25%. If we use the last data point, Q3 of 2018, as the current baseline, the next credit crisis will see deficits explode past $3 trillion—annually, at least for a couple of years. If the past is any guide, deficits will then stabilize as the previous crisis’s extreme, or around $1.5 trillion per year. Note that even $1.5 trillion deficits will not begin to fund the Democrat’s “Green New Deal” proposals.

Exploding deficits have had no ill effect for decades, convincing many that the U.S. can forever run “deficits without tears,” as Jacques Rueff put it. The reason why deficits have not mattered since the 1970s is displayed in the next chart: falling interest rates have made debt relatively easier to carry.

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Note the bend upwards in the total debt outstanding line around 2008 and that the tail end of the chart above is starting to curl higher. Federal bonds have fixed interest rates, and the average maturity of the bonds held by the public is nearly 70 months (40% mature in under two years)—it takes a couple years for rising rates to feed into funding costs.

**THE END OF DEFICITS WITHOUT TEARS**

![Chart showing total federal debt and interest payments as a percent of federal debt outstanding from 1966 to 2011.](chart1)

Sources: Federal Reserve Bank of St. Louis, Myrmikan Capital, LLC

The chart of the interest burden above may look somewhat benign, but that line is a rate on the debt line that is exploding higher. The chart below shows the interest payment in nominal dollar terms.

**FEDERAL INTEREST PAYMENTS BEGIN EXPLOSIVE MOVE HIGHER**

![Chart showing federal interest payments on federal debt from 1966 to 2011.](chart2)

Source: Federal Reserve Bank of St. Louis

What happens when the higher rates start filtering through to new Treasury issuances to fund a growing debt burden? What happens in the next credit crisis when—if the deficit assumptions above prove to be accurate—a $5.7 trillion budget is supported by only $2.7 trillion in taxes? Who is going to finance the balance?
And that is where America’s international position becomes so critical. When the Europeans balked at supporting American deficits in the early 1960s, Kennedy told them: “The fact of the matter is the United States can balance its balance of payments any day it wants if it wishes to withdraw its support of our defense expenditures overseas and our foreign aid.” In the context of the Cold War, it worked. When they complained again in the 1970s, Nixon defaulted on America’s obligation under Bretton Woods to convert European dollars into gold. Nixon’s the Secretary of the Treasury famously told the Europeans: “The dollar is our currency, but it’s your problem.” The Europeans disagreed, and the ensuing decade saw high inflation as foreigners fled the dollar.

The credit bubble that began in the 1980s hid the dollar’s problems and allowed them to metastasize to an enormous degree. Thinking strategically, the best course for the U.S. may now be a radical devaluation of the dollar. Such an action would relieve the government of its debt burden (not to mention large financial institutions), devalue the enormous hoard of Treasury bonds the Chinese hold, pop their credit bubble, and allow strategically important countries to escape the China debt trap. It would also act as a protectionist measure, destroying the Chinese export model and boosting temporarily domestic demand for American labor. The cost would be soaring retail prices, especially for the middle class, but what is the alternative?

From 1958 to 1971, the U.S. desperately tried to keep its currency strong, defending the $35 per ounce gold peg by smashing the gold market in London every time it tried to rally. America’s gold holding plunged as a result.

When stark reality hit one August day in 1971, the U.S. decided its interest lay in a weak dollar. Policy makers may soon arrive at a similar conclusion. The market will take the dollar lower in any case, but official support for a weak dollar would certainly accelerate the process.