

THE INFERNAL ENGINE OF THE DOLLAR

DAVID STOCKMAN – GRANT’S LONDON CONFERENCE – FEBRUARY 24, 2011

The subprime meltdown was a warm-up. The real financial widow-maker of the present era is likely to be U.S. government debt itself. This lugubrious prospect arises from Washington’s advanced state of fiscal incontinence---a condition of governance so enfeebled that even the fiscal hawks have not yet essayed the half of it.

The sheer facts of the current U.S. budgetary circumstance are bracing enough. It needs be recalled that fiscal year 2011 now underway will encompass not a recession bottom but the sixth through ninth quarter of economic recovery. During this interval of purported mid-cycle rebound, however, the White House now projects red ink of \$1.645 trillion. This means that 43 cents on every dollar spent will be borrowed, thereby generating a financing requirement just shy of 11% of national income.

One marker of the fiscal policy dysfunction beneath these elephantine figures is the steep deterioration from last year’s White House plan. The Administration’s prior budget projected sizeable progress by now---with the FY2011 deficit slated to come in at only \$900 billion, representing just 26 cents on the dollar of spending and 6% of GDP.

There is no mystery as to why the actual budget path has lurched southward again. Notwithstanding a full year of green shoots, soaring PMIs and a booming stock market, Washington embraced a monumental round of new fiscal stimulus in December. The

result was a trillion dollar Christmas tree festooned with fiscal largesse for every citizen--
-inclusive of the quick as well as the dead. Moreover, this bounty was extended without
prejudice to each and every social class---with workers, the unemployed, the middle
class, the merely rich and billionaires, too, getting a share.

If you own Treasuries and have been sleeping peacefully, you have undoubtedly
dismissed this budgetary eruption as a fit of transient exuberance. After all, the post-
election White House by the President's own admission was in a shellacked state of
mind, and in no position to restrain December's bipartisan stampede.

The less sanguine view of why the United States is clocking a 10% of GDP deficit for
the third year running, however, doubts this latest fling of budgetary promiscuity was a
misguided, one-night stand. Instead, it is more properly viewed as another episode in the
epochal collapse of U.S. financial discipline that began 40 year ago at Camp David.

That the demise of the gold standard should have been as destructive of fiscal discipline
as it was of monetary probity can hardly be gainsaid. Under the ancient regime of fixed
exchange rates and currency convertibility, fiscal deficits without tears were simply not
sustainable---no matter what errant economic doctrines lawmakers got into their heads.

Back then, the machinery of honest money could be relied upon to trump bad policy.
Thus, if budget deficits were monetized by the central bank, this weakened the currency
and caused a damaging external drain on monetary reserves; and if deficits were financed

out of savings, interest rates were pushed-up---thereby crowding out private domestic investment. Politicians did not have to be schooled in Bastiat's parable of the seen and the unseen. The bitter fruits of chronic deficit finance were all too visible and immediate.

During the four decades since the gold window was closed--- the rules of the fiscal game have been profoundly altered. Specifically, under Professor Friedman's contraption of floating paper money, foreigners may accumulate dollar claims or exchange them for other paper monies. But there can never be a drain on U. S. monetary reserves because dollar claims are not convertible. This infernal engine of fiat dollars, therefore, has had numerous lamentable consequences but among the worst is that it has facilitated open-ended monetization of the U.S. government debt.

Monetization can be done in two ways. First, there is outright monetization as is now being conducted by the New York Fed through its POMO program, that is, its purchase of \$4-\$8 billion of Treasury debt nearly every day the markets are open. Indeed, the Fed's QE2 bond purchases have been so massive that it is literally buying Treasury paper in the secondary market almost as fast as new bonds are being issued. During January, for example, fully 40% of the Fed's \$100 billion bond buy was from CUSIP numbers less than 90 days old.

Needless to say, putting brand new treasury bonds in the Fed's vault is functionally equivalent to printing greenbacks. After all, the coupons will end up as incremental profit at the Fed and be remitted back to the Treasury at year end. Stated differently, in the

present era of massive quantitative easing, newly issued Treasury securities amount to non-interest bearing currency without the circulation privilege.

But over the last several decades the preferred course has been indirect monetization; that is, the world's legion of willing mercantilist exporters from China to the Persian Gulf have printed their own money in vast quantities---ostensibly to peg their exchange rates-- but with the effect of absorbing trillions of U.S. treasury paper.

To be sure, the peoples' money warehouse in China and those in other mercantilist lands are pleased to label these accumulations as sovereign wealth portfolios. But the fact is, these hoards of sequestered dollars are not classic monetary reserves derived from a true, sustainable surplus on current account. Instead, they are simply the book entry offset to the inflated local money supplies that have been emitted by the global convoy of peggers-- that is, mercantilist nation central banks tethered to the Fed.

That this convoy is a potent mechanism for monetizing the U.S. debt is readily evident by way of contrast with classic monetary systems anchored on a true reserve asset. At the peak of its glory before the Guns of August 1914 laid it low, the sterling based gold standard operated smoothly with a London gold reserve amounting to 1-2% of British GDP. Likewise, in 1959 at the peak of the Breton Wood's system's stability, the U.S. held \$20 billion of gold reserves against a GDP of \$500 billion. Again, at about 4% of GDP the hard monetary reserves needed to operate the system were extremely modest.

The reason for parsimonious reserve quantities in fixed exchange rate, convertible currency systems was the fact of continuous settlement of trade accounts via the flow of monetary assets. In the case of a balance of payments deficit, the outflow of reserve assets directly and immediately contracted domestic money markets and banking systems---setting in motion an automatic downward adjustment of domestic wages, prices and demand and encouraging an upward move in exports and domestic production. In the cases of surpluses, the adjustments were in the opposite direction. Most importantly, with real economies constantly in adjustment, central bank balance sheets stayed lean and mean.

By contrast, under the contraption that Professor Friedman inspired, trade account imbalances are never settled. They just grow and grow and grow---until one day they become the object of fruitless jabbering at an international photo op society called G-20. In all fairness, Professor Friedman did not envision a world of rampant dirty floating. Indeed, it would have taken a powerful imagination to foresee four decades ago that China would accumulate \$3 trillion of foreign currency claims or more than 50% of GDP, and then insist over a period of years and decades that it did not manipulate its exchange rate!

Still, today there can be little doubt that China and the other mercantilist exporters operate massive monetary warehouses where they deposit treasury bonds acquired during their endless dollar buying campaigns. Up until now, of course, the apparatchik at the U.S. Treasury Department could not even acknowledge this elephant in the room for fear

that labeling China for what it obviously is---the most egregious “currency manipulator” in world history--- would ruffle diplomatic feathers, or worse. No more. The Vice-Chairman of the People’s Bank of China, Yi Gang, recently settled the matter in addressing “Why do we have so much base money?” Said Mr. Yi while answering his own question, “...the central bank buys up foreign exchange inflows. If it didn’t, the Yuan wouldn’t be so stable”.

So at the end of the day, American law-makers have been freed of the classic monetary constraints. There is no monetary squeeze and there is no reserve asset drain. The Fed always supplies enough reserves to the banking system to fund any and all private credit demand at policy rates which are invariably low. The notion of fiscal “crowding out” thus belongs in the museum of monetary history.

At the same time, the seemingly limitless emission of dollar claims by the U.S. central bank results not in a contractionary drain of monetary reserves from the domestic banking system, but in an expansionary accumulation of these claims in the vaults of foreign central banks. In less polite language, a growing portion of the Federal debt has ended up in what amounts to a global chain of monetary roach motels: places where treasury bonds go in but they never come out.

As of last Thursday evening’s report, in fact, foreign central banks held \$2.6 trillion of US Treasuries at the New York Fed---while the Fed’s own holdings totaled \$1.2 trillion. Add in a least a half trillion more Treasuries in official holding elsewhere around the

world and you have the startling fact that about \$4.5 trillion or 50% of the publicly held Federal debt has been sequestered by central bankers. With such a Mighty Bid from the world's central bankers, it is not surprising, then, that we have enjoyed what our classically trained forebears held to be impossible---a prolonged era of fiscal deficits without tears.

To be sure, it took American politicians a decade or so to realize that the old rules were no longer operative. Helped immeasurably by the collapse of the Soviet war machine in the mid-1990's, orthodox Senate Republicans and bourbon democrats achieved for a fleeting moment the appearance of fiscal balance at the turn of the century.

But it was not long before the cat was out of the bag. In making the case for the most monumental fiscal policy mistake in American history---the Bush tax cuts of 2001 and 2003--- then Vice-President Cheney summed-up the new reality, postulating that “Reagan proved deficits don't matter.”

What he meant was that the Republican politicians of the George W. Bush era had discovered they could borrow with relative impunity. Soon the GOP's tax cutting religion had an intense re-awakening. It was as if the floor of the U.S. House had become thronged with fiscal holy rollers---throbbing, shaking, jerking and gesticulating as they exorcized section after section of the revenue code. By the time Bush and the Congressional Republicans were through in FY 2009, the revenue had been reduced to

14.9% of GDP---the lowest level since 1950 and far below the 18.4% level extant when Ronald Reagan left office.

And it wasn't as if the fiscal burden of the American Welfare State---and the Warfare State, too, for that matter---had gotten lighter in the interim. The fact was, as the new century dawned the baby boom was getting inexorably older and the U.S. economy was getting demonstrably longer in the tooth. Both trends urged the accumulation of fiscal reserves for the rainy days that were sure to come.

But nearly the opposite strategy---one of fiscal depletion--- was actually implemented. Even as the tax-cutting branch of the GOP was busily dismantling the revenue base in the Acts of 2001, 2003, 2005 and 2008, its neo-con War Department and its domestic porker divisions were pushing the spending levels to record post-WW II levels.

Here the neo-cons deserve a special chapter in the annals of fiscal infamy. Having pushed the American Empire to take its stand on real estate of dubious merit historically---that is, the bloody plains of the Tigris-Euphrates and the desolate expanse of the Hindu Kush--- they persisted for the better part of the decade in refusing to finance with honest taxation wars which they could not win, and would not end.

According to a recent CBO report, the cumulative tab for Iraq and Afghanistan now totals \$1.26 trillion. And therein lays a stark tribute to the efficacy with which Professor Friedman's contraption absorbs the Federal debt. The fact is, America's conservative

party did not even break a sweat as it bond-financed what were surely two of the most elective foreign policy adventures ever to come down the pike.

Again, the contrast with the canons of classical finance helps crystallize the picture.

Writing in 1924, Hartley Withers, eminent editor of the Economist and keeper of Bagehot's wisdom on matters of money and central banking, lamented that British finances were in shambles because the Government had broken all the rules of war finance during its battle with the Hun. Rather than obtaining at least 50% of its revenue from current taxation and the balance from the people's savings at an honest wage for capital, it had resorted to massive inflation of bank credit and issuance of paper money--- "shinplasters" as they were known--- to pay His Majesty's bills.

Withers took special aim at England's first War Chancellor, Lloyd George, thundering as follows: "It is difficult to exaggerate the evil effects of the economic crime that he committed when in the spring of 1915 he imposed no taxation whatever to meet the (massive) deficit which faced him".

So at the zenith of the monetary golden age, sound opinion held that it was an economic crime to run the printing presses--- even with a million enemy soldiers bivouacked across the Channel. Now, 100 years later, monetizing the expense of pursuing a tall man and 100 followers lost in the high Himalayas did not even rank as a misdemeanor.

It was in the domestic spending arena, however, where the newly liberated Bush Republicans put the pedal to the medal. During the Reagan era there had been a modicum of progress in throttling the domestic welfare state---with domestic spending dropping to 13.4% of GDP after having averaged 15.2% of GDP during the Carter years. Moreover, after a decade of divided government in the 1990s, the size of the domestic welfare state had drifted upward by only a touch----clocking in at 13.5% of GDP by fiscal year 2000.

The frightening thing about the American fiscal future lays in what happened next----- with Republican control of both Houses of Congress and the White House for six full years. Apologists such as Newt Gingrich had excused Reagan's mega-deficits on the grounds that conservatives were not obligated to serve as tax-collectors for the Welfare State. And fair enough. With divided government during Reagan's entire eight years, the political horsepower simply didn't exist to take on the three core entitlement programs--- Social Security, Medicare and Medicaid.

By fiscal year 2000, however, these Big Three entitlements cost \$740 billion or about 7.5% of GDP. The time for fundamental reform was long overdue. But a Republican policy offensive against the fiscal heartland of the American welfare state never came. Instead, Medicaid was actually expanded moderately at the behest of Republican governors; Medicare spending was swollen by a huge new entitlement benefit for prescription drugs courtesy of Big Pharma; and Social Security rolled along without even a sideways glance from the anti-spenders. Consequently, outlays for the Big Three entitlements doubled to \$1.425 trillion or 10.1% of GDP in Bush's final budget---

meaning that the fiscal burden on national income was now one-thirds larger than it had been only eight years earlier.

But wait, as the late night commercials admonish, there is more! In that modest 15% corner of the Federal budget known as domestic discretionary spending, Bush era Republican Government went on a veritable rampage. Homeland Security spending, for example, soared nearly five-fold---from \$13 billion in FY 2000 to \$59 billion by FY 2009. Likewise, outlays for veterans programs rose from \$47 billion in 2000 to nearly \$100 billion by 2009.

Next there is the Department of Education—the site of several failed college tries at abolition by President Reagan. That department, too, doubled from \$33 billion to \$66 billion in just eight years under the Bush Republicans. While they touted this education spending explosion as evidence of “compassionate conservatism”, the more apt characterization is that once the GOP embraced yet another function for the American Welfare State it saw to it that no education lobby group would ever be left behind.

During the same eight years, housing and community development spending also doubled to \$60 billion—along with a 75% rise in spending on transportation, a swelling of farm support programs and enactment of a \$60 billion energy bill providing subsidies for exactly that menu of alternative energy technologies----solar, wind, fuel cells, clean coal, fusion and ethanol----that Republicans once held could be best sorted out by the free market.

In all, domestic spending during FY 2008 came in at a record high of \$2.3 trillion. After 30 years of a rolling referendum on the American welfare state, then, the verdict was clear. Eight years of Republican Government had brought the burden of domestic spending to 15.8% of national income-----a figure materially higher than the 15.2% average during the last period of unified Democrat government during the Carter era. Thus, while the impact of the Reagan Revolution on the size of the U.S. government had always been immeasurably modest, it was now totally erased.

The sorry Republican record on fiscal matters is not merely a morality tale. When the conservative party in a democracy embraces “starve the beast” on taxing and “feed the beast” on spending—then fiscal governance breaks down badly. You end up with two free lunch parties competing for the affections of the electorate---alternately depleting the revenue base and then pump-up the spending.

Needless to say, this outcome bespeaks irony. Milton Friedman was an unrelenting foe of big government and the American welfare state, yet the global monetary contraption he inspired insured its perpetuation. Consider, for example, the dynamics of the two-party free lunch competition that was unleashed during December’s trillion dollar Christmas tree bill.

While many a pundit saw the bill as a kind of Keynesian reprise-----a final measure of recession antidote---it was actually a colossal exercise in booby-trapping the budget.

Specifically, what has been happening over the last decade is that the basic tool of long-term fiscal policy---the ten-year budget projection---has been utterly corrupted by the need of both political parties to disguise the full measure of their profligacy.

Thus, a current year deficit of 10% of GDP can be made to look less ominous if the 10-year projection shows the ratio dropping steadily as it marches off into the sun-set. The most recent CBO baseline, for example, shows the Federal deficit declining from 10% of GDP this year to 3% by 2015. The problem with this sanguine scenario, however, lays in the distinction between what green eyeshades call current law versus current policy.

Historically, the current law projection was the neutral starting point for budgeting-----it priced out existing tax law, entitlements and discretionary spending into the middle and longer-term future, and provided a benchmark to measure the fiscal impact of proposed policy changes. But now the current law baseline is riddled with booby-traps in the form of major, costly entitlement and tax law provisions that expire in arbitrary, cliff-wise fashion one or two years down the road.

It is widely known, of course, that the Bush income tax rate cuts expire promptly at midnight on December 31, 2012----causing a \$200 billion per year revenue pick-up thereafter. But what also happens is that on January 1, 2012 the \$100 billion abatement of payroll taxes abruptly expires and so does the so-called "AMT patch". The latter means that the number of taxpayers facing the alternative minimum tax jumps from 4 million to

33 billion, and the annual revenue take rises from \$34 billion under the patch to \$129 billion. Likewise, the 15% tax rate on corporate dividends will jump to 39.6% in 2013.

Similarly, the estate tax rises from 35% on \$5 million to 55% on \$1 million. During the 2012-2014 period most of the business tax credits for R&D, ethanol and the like also expire, as do credits for child care, higher education and much more. Taken altogether, the December Christmas tree contained tax breaks worth 3.8% of GDP annually that will have completely expired by 2014. The result is that current law budget projections contain \$650 billion per year of incremental revenue that look antiseptic on the computer screen, but when these provisions expire in real life upwards of a hundred million taxpayers will take the hit. Consequently, many of these provisions won't expire---the can will just be kicked down the road.

The picture is not much different on the spending side. For the last decade something called the "doc fix" has been enacted repeatedly on a short duration basis. This causes current law spending to look about \$30 billion lower in the out-year projections but thanks to this recurring election year fix, the implicit 20% drop in Medicare physician fees never happens.

The story is precisely the same with extended unemployment benefits where about 10 million workers get various "extended" tiers of the unemployment insurance program at an annual cost of about \$150 billion.

Under current law, however, nearly two-thirds of this cost is temporary---meaning that out-year budgets forecast only \$50 billion of annual expense. The reality, however, is that in order to avoid a cold turkey shock to millions of households, the various temporary benefit tiers have has been repeatedly extended at the midnight hour---something which is sure to occur again at the next expiration on the eve of the 2012 presidential election. .

What we have overall, therefore, is a yawning gap between deficit projections under current law--- which decline rapidly but on the thoroughly misleading assumption that all the fiscal booby-traps will be allowed to expire---and the dramatically more frightening path of actual current policy for revenues and spending as it has emerged from the two-party competition in free lunch fiscal policy.

Going forward, there can be little doubt that the GOP is determined to forestall nearly all of the tax law expirations currently scheduled—including the rate cuts, the capital gains, the dividend and estate tax provisions, and the business tax credits and capex incentives. This means that baseline revenue is only about 16%-17% of GDP according to current Republican policy doctrine.

At the same time, when you remove the spending expiration booby traps, it appears that current policy for outlays as advocated by the Democrats---and most of the Republicans, too---is about 24% of GDP. So if you go by the math of it, the current bipartisan policy path results in a permanent fiscal deficit of 7-8% of GDP. That would be amount to about

\$7 trillion in new bond issuance over the next 5 years, and take total public debt in the United States to over 100% of GDP.

In reality, with nominal GDP growing at less than \$500 billion per year, you can't actually grow the debt at \$1.5 trillion per year or three times that rate--- as under the current policy baseline--- for very long. Nevertheless, it will take a thundering external shock to elicit a change of course in Washington because American politicians no longer fear these boxcar deficits. Instead, they now implicitly assume that the monetary roach motels of the world will provide an expansive place for government bonds to hibernate indefinitely.

So for the present time, fiscal policy is just an exercise in political horse-trading and juggling the budget booby-traps, not a serious process of allocation and discipline. Thus, during the December debauch, Republican's traded the payroll tax abatement and extension of unemployment benefits for a two-year deferral of all of the expiring tax cuts. At the same time, President Obama folded faster than a lawn chair on tax cuts for the rich in order gain another year for the expiring spending programs. There is every reason to believe that the very same maneuver will replay itself once again on the eve of the 2012 presidential campaign.

If this were the whole story, the case against Treasury bonds would be compelling but not conclusive. After all, there is no telling how much sovereign debt the monetary roach motels of the world can ultimately absorb. But the problem is the aforementioned \$7

trillion of current policy deficits over the next five years assumes that we are having a Keynesian moment, not an Austrian one.

The new White House budget, for example, assumes that the Keynesian medication worked like a charm. Thus, there will be no recession for the next 10 years, although we have averaged one every 4.3 years since 1947. It also assumes that real GDP growth will average 3.2% over the next decade---or double the 1.7% average during the past decade. Finally, it projects that the U.S. economy will generate 20 million new jobs during the coming decade compared to only 1.7 million between December 2000 and December 2010. As the man said, good luck with that!

In any event, the already baleful deficit projections would grow by trillions under more plausible economic assumptions. But the more crucial point is that the dead hand of Richard Nixon keeps showing up on the fiscal playing field. Echoing Tricky Dick, today's GOP has once again embraced the Keynesian faith --- even if it has been robed in the ideological vestments of the prosperous classes; that is, it prefers to ameliorate cyclical weakness with tax cut stimulants rather than spending sprees.

But the underlying diagnosis has much in common with the Democrats; namely, that the economy is still in an early stage of cyclical rebound and remains much too fragile to tolerate the jarring fiscal actions, including tax increases, that the fiscal arithmetic requires. So to the extent that the U.S. economy remains "weak", the renascent Keynesian consensus will result in kicking the fiscal can down the road again and again--

- on the faith based notion that stronger economic growth will eventually do the heavy lifting when it comes to deficit reduction.

It is here that the true nightmare scenario arises--- owing to the possibility we are experiencing an Austrian moment, not a Keynesian one. In fact, it may be that the massive excess debt burden accumulated on the U.S. balance sheet after 1971 is what brought the economy down in 2008, and what has kept it weak during the 19 months since NBER dated the recession's end. In that event, we would be in the midst of an Austrian debt deflation, not a Keynesian cyclical recovery.

From a fiscal perspective, a prolonged debt deflation would be the coup de grace. That's because debt deflations crush nominal GDP growth, owing to the evaporation of credit fueled additions to spending. In turn, low nominal GDP growth is bad news for revenues because what we tax, obviously, is money incomes.

Moreover, the actual GDP data suggests that debt deflation is already resident in the numbers. Total U.S. credit market debt essentially stopped growing in late 2007 at a level slightly above \$50 trillion compared to a \$14.3 trillion level of GDP. During the three years since, total debt growth has been at a tepid 1.5% annual rate---with public debt growing much faster than this and financial and household sector liabilities actually shrinking. Not surprisingly, nominal GDP has gained only \$530 billion during those 36 months, meaning that the annualized growth rate has been only 1.2 percent. There is no three-year streak like that anywhere in the data since the 1930s.

Again, that figure is for money GDP, not the Commerce Department's guesstimate of the inflation-adjusted kind. Even if you allow for the alleged cyclical rebound since Q2 2009, the rate of money GDP growth has only been 3.8%, and was actually just 3.2% in the most recent quarter.

By contrast, the new White House budget, which assumes a Keynesian cyclical rebound, projects money GDP growth of 5.6% per annum over the next five years, and the CBO figures are roughly similar. So if we are experiencing an Austrian moment, now would be the time to shout the proverbial, "Houston, we have a problem."

Specifically, at the 5.6% OMB growth rate----which is not out of line with the last two cyclical rebounds--- nominal GDP would reach \$20 trillion by the fifth budget year. By contrast, at a 3.5% growth rate—which is triple the growth rate of the last three years and in-line with the post-June 2009 rate of advance----money GDP would come in at only \$18 trillion by 2016.

This \$2 trillion variance might be written-off to wild-blue speculation. Then again, at the current marginal Federal tax yield, the implied revenue shortfall is another \$400 billion annually. Stated differently, the current policy deficit may actually be in the \$2 trillion annual range after factoring in realistic incomes and revenues.

The infernal engine of the dollar may thus have been doubly diabolical on the fiscal front. First, it hooked the American political system on the “deficits don’t matter” theorem by eliminating the economically painful squeezes and drains on the monetary system that traditionally accompanied fiscal deficits. Secondly, to the extent that it fueled the debt super-cycle that swelled from 1980 until 2008, it generated a false prosperity and bubble-derived fiscal windfalls that have now evaporated.

Indeed, if we are in an Austrian moment, no comfort can be taken from the fact that the so-called “cyclically adjusted deficits” touted by Keynesian sophisticates are substantially lower than the reported deficit figures. That is because during a prolonged debt deflation, it can be expected that income and revenue growth will remain low, and unemployment will stay high. Stated differently, the Keynesian automatic stabilizers will fail to shrink the fiscal deficit in the period ahead because this time the collapse of revenue and surge of spending is structural and persistent, not cyclical and transient.

Shortly after Nixon closed the gold window in August 1971 Secretary Connally famously told an assemblage of foreign central bankers that “the dollar is our currency, but it’s your problem”. The esteemed Secretary had studied at the Wright Patman School of Texas Finance, of course, not the University of Chicago. But he nevertheless shared Professor Friedman’s assurance that floating the dollar would eliminate the nettlesome problem of the U. S. current account deficit; that is, such trade adjustment as might be needed would be done by the non-dollar speakers in the global economy.

History now says otherwise---and resoundingly so. The cumulative U.S. current account deficit since the late 1970s exceeds \$7 trillion, and the annual current account shortfalls at 3% to 5% of GDP have become chronic.

Thus, rather than accepting cheaper and cheaper dollars as demanded by the Texas version of monetarism, the East Asian exporters and Persian Gulf oilies have pegged their currencies, retained their trade surpluses and accumulated treasury bonds, instead. Accordingly, the \$9 trillion of current global forex reserves----mostly held by the aforementioned peggers---are not monetary reserves in any meaningful sense; they are effectively vendor financed export loans, and they are what make the present economic world go round.

They are also what made the U.S. balance sheet go parabolic. For more than a century after resumption of convertibility in 1879, the ratio of total U.S. debt----both private and public---to national income was remarkably stable. Despite cycles of war and peace, boom and bust, this national leverage ratio oscillated closely around 1.6X.

Call this remarkably stable ratio of total debt to national income the “golden constant”, and puzzle for a moment as to why it broke-out and began an abrupt rise after the events of August 1971. This new leverage path reached 2.0X by 1990, rising to 2.6X by the middle of the decade. Thereafter it literally soared, reaching 3.6 times national income by 2007---where it remains. Stated differently, we have added two full turns of debt on the national income since 1980---an outcome which amounts to a nationwide LBO.

The volume of incremental debt now being lugged about by the national economy owing to this debt spree is startling. In round dollar terms, total credit market debt would currently be about \$22 trillion under the “golden constant” (i.e. at 1.6 times GDP of \$14.5 trillion) compared to today’s actual debt level of \$52 trillion (at 3.6X GDP).

Wall Street bulls and Keynesian economists---to indulge in a redundancy----insist that this extra \$30 trillion of debt is no sweat. Presumably, they would otherwise not be forecasting 10 years of standard growth rates with no recession, and would not be capitalizing corporate earnings at the 15X EPS level established during the era of the golden constant.

Put another way, by the lights of mainstream opinion, our recent parabolic departure from the golden constant apparently represents nothing more than a late blooming enlightenment---the shedding of ancient superstitions about the perils of too much debt in households, businesses and governments alike. If this were true, it would be a pity. Had our benighted financial forebears only known better, they would have levered up the USA long ago---producing unimagined surges of growth and wealth.

Indeed, economic miracles like the internet might have been generated at a far earlier time---say in 1950, not 1990; and it might have been invented by Senator Albert Gore Sr. of Tennessee rather than his son Albert Gore Jr. of Hollywood.

The alternative possibility, however, is that our forebears actually knew a thing or two about finance. Perhaps they understood that in not settling our accounts with the world--- we were merely borrowing GDP, not growing it.

The numbers, in fact, suggest exactly that. During the era of the golden constant, about \$1.50 of debt growth accompanied each dollar of GDP growth. By 1989, each dollar of GDP growth took \$2.50 of debt increase-----and the requirement rose to \$3.30 by 1999; that is, in the final year of the last century, it took \$2 trillion of total debt increase to generate \$600 billion of nominal GDP growth.

After that it was off the races. When the debt super-cycle apogee came in 2007, it took \$4 trillion of debt growth to produce a gain of just \$700 billion of GDP. At the point, the debt-to-income growth ratio had climbed to 6.5X, and shortly thereafter the man from Citigroup finally stopped dancing.

The evaporation of artificially inflated income growth and the bursting of the asset bubbles which inexorably followed this kind of debt super-cycle have arrived at their appointed time. And the financial condition of the household sector suggest that the postulated Austrian moment may have a hang-time measured in years or even a decade, not months or quarters.

First, the adjustment in household balance sheets to date has been in the marking down of housing assets, not any material shrinkage of debt outstanding. Specifically, household

net worth has dropped by \$9 trillion or about 14% since the final quarter of 2007.

However, only \$380 billion or 4% of this decline is attributable to reduced debt. The rest is owing to shrinking asset values.

So by the lights of the golden constant, we still have a long ways to go. Back in 1975 when America's baby-boom households were still young, total debt including mortgages, car loans, credit cards and bingo wagers was \$730 billion or about 45% of GDP. After an epochal financial party, American households were a lot older by 2007, but now also had \$13.8 trillion of debt---a figure which amounted to 96% of GDP. Three years later, households were older still but had not shed many pounds: total debt outstanding was still \$13.4 trillion.

It is always possible, of course, that our 78 million man (and woman) army of baby-boomers, which is now marching straight-away into retirement, will hit the credit juice one more time. But the only household debt which is actually growing today is on the other end of the demographic curve. Thanks to double digit growth rates, outstanding student loans---subprime credits by definition--- now total \$1 trillion and exceed all of the nation's outstanding credit card debt. But as to the outlook for these massively ballooning subprime student loans, we have seen this movie before: a boom in defaults, not renewed consumption spending, is the likely next stage.

If in the future households have to earn--- not borrow---what they spend, that 3.5% assumption about money GDP growth would look more than plausible. The fact is, organic income is not growing at even 3%.

One of the more shocking points buried in the statistics of our government medicated recovery is that since the time of the Wall Street heart attack in Q3 2008 consumption spending is up by \$400 billion or nearly 4%. But private wages and salaries are still down \$100 billion or 2% below where they were before the September 2008 plunge. Again, these figures are in nominal, not deflated, dollars. Looking at the data since 1950, you can't find a period in which private money wages was down for even three months, let alone nearly two and one-half years.

Consequently, we have been able to keep up the appearances of consumption spending growth---even if tepid---only by resort to Uncle Sam's credit card. As of the December release from the BEA, government transfer payments--- all of which were funded on the margin with new borrowings---- had risen by nearly \$500 billion from the Q3 2008 annual rate. Thus, the Fed and its global convoy of monetary roach motels have been the source of the entire intervening gain in U.S. personal consumption expenditures, and then some.

When all else fails, of course, the possibility remains that a rebound of job growth could revive wage and salary incomes and get the GDP juices flowing again at rates more

compatible with Keynesian recovery rather than an Austrian deflation. Well, as the man also said, good luck with that one, too.

The January nonfarm payroll number was 130.27 million---a figure first reached in October 1999. And that is the encouraging part of the story! Way back then, there were 72 million “breadwinner” jobs in the U.S. economy---that is, jobs in manufacturing, construction, trade and distribution, FIRE , information technology, the professions and mainstream white collar services, which had pay levels at about the median income or \$50,000 per year in today’s dollars.

A decade later in January 2011, there were only 65 million breadwinner jobs---10% less. Too be sure, this large drain was nearly off-set by a 6 million job gain over the decade in the HES Complex—health, education and social services. One problem with the resulting 30 million total jobs in HES Complex, however, is that average pay is much lower at about \$35,000 per year---so we are trading down,

More importantly, funding is almost entirely derived from the public purse. Judging by the commotion in Madison Wisconsin and on the floor of the U.S. House in recent days, it might be supposed that the era of robust job growth in the HES Complex is nearly over.

Indeed, the evidence is already in: HES Complex employment growth averaged 50,000 per month during 2000-2007; fell to 35,000 per month during the Great Recession;

declined further to 26,000 per month during the rebound since December 2009, and clocked at only 13,000 in January 2011.

That leaves what might be termed the Part Time Economy---35 million jobs in retail, bars, restaurants, hotels, personnel services and temp agencies. The average wage in this segment is just \$19,000 per year. Thus, from the point of view of economic throw weight---not so much. Other than providing intermittent spells of gainful employment for bell boys and barhops, this segment supports no families and funds no savings---even if it does give Wall Street economists something to count.

Since the jobs bottom in December 2009, the total nonfarm payroll count has rebounded by 675,000---and represents just 8% of the 8.4 million jobs lost during the Great Recession. Yet fully 575,000 or 85% of these gains have been in the Part Time Economy, while the count of Breadwinner jobs has declined by a further 200,000 since the jobs bottom was allegedly put in.

None of this bodes well for a spirited Keynesian recovery---or even a toothless one.

Accordingly, the U.S. economy is likely stuck in an extended Austrian moment and the U.S. Government deficit is likely beached in the \$1.5 to \$2.0 trillion annual range. When it soon becomes evident that the \$60 billion of appropriations so noisily cut by the House Republicans actually consists of \$20 billion of pure windage, \$20 billion to be compromised with the Senate, and \$20 billion to be restored in supplemental

appropriations later, the test of Professor Freidman's floating rate, fiat money contraction may finally come.

Maybe there is room for trillions more of government bonds to be absorbed by the Mighty Bid of the Fed and its chain of monetary roach motels. But returning the clock to 1971, it seems possible that even the visionary Richard Nixon did not then realize the ultimate consequence of closing the gold window and opening the door to China in close couple.

At that moment, the China rural economy—the only one it ever really had---was prostrate under the weight of 45 million dead from starvation and far more debilitated and destitute owing to the Great Helmsman's economic follies. By underwriting a 40-year debt super-cycle, however, the newly unshackled Fed fueled unstinting American demand for the output of East China's rapidly expanding export factories. In so doing, it also drained China's stricken rice paddies of their nimble young fingers and strong backs, thereby jolting the developed world's wage and cost structure with the addition of young factory workers by the ten millions willing to work Dickensian hours at quasi-slave wage rates.

In this context, the contra-factual perhaps supplies a clue to next phase of this saga. Had Nixon kept the gold window shut, China would have accumulated bullion, not bonds. America would have experienced deflationary austerity, not inflationary bubbles. And fiscal deficits would have mattered. Thus, today's terminally imbalanced world has evolved at complete variance with a sound, sustainable outcome.

The risk is that the doomsday system for global money and trade which has metastasized since 1971 may be approaching its end game. By all appearances, Mao's great rural swamp has now pretty much been drained. Global wages will therefore start rising because even Wal-Mart has not been able to discover another country inhabited by millions of \$1 per day workers. In that environment, the people's printing press in China will have to drastically slow its creation of RMB, and therefore its capacity to absorb treasury bonds. Its fellow traveling central banks throughout its feeder system of mercantilist exporters will likely follow its lead.

At that point, the Fed will be the last bid standing. But if it keeps buying bonds, Mr. Market may be inclined to sell dollars with prejudice. If it stops buying the bond, at what price can trillions more find a place in private portfolios? Either way, it will be a grand experiment. But as they say on television, it's definitely not something that should be tried at home.

