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Faces of Death: The US Dollar in Crisis

By Ron Hera
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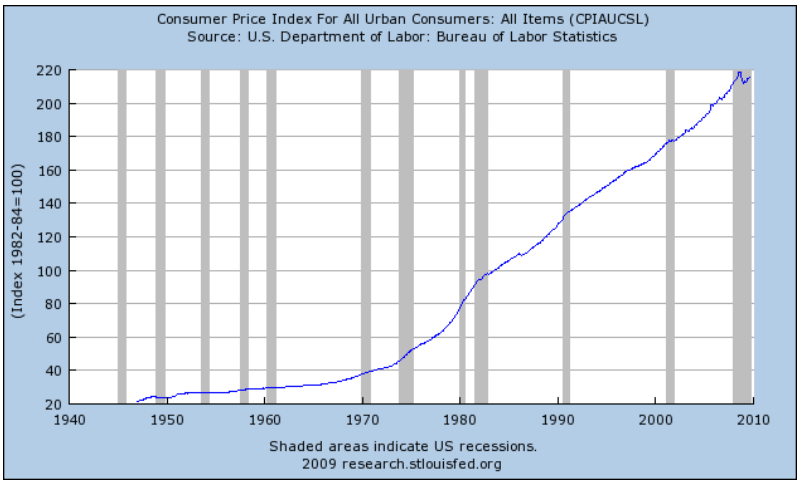
The US economy has been in crisis since 2008 and despite optimistic statements by officials and commentators there are no fundamental signs that the crisis will end in the foreseeable future. Current economic data suggests a number of diverging and unsustainable trends. The US economy has suffered a real estate collapse, a stock market crash, a banking crisis, a near systemic collapse on a global scale, a credit crisis, the worst economic downturn in the US since the Great Depression, and an unprecedented global recession. Following two sequential economic bubbles, the dot-com bubble and the real estate bubble, no one has yet correctly called either the bottom for the US economy or the start of a US economic recovery. Nonetheless, each day, news reports, articles and statements by officials and commentators reveal new economic data and offer new analysis. Unfortunately, both the economic data and the interpretations offered by officials and commentators are contradictory.

It appears that both inflation and deflation are occurring at the same time; that the US gross domestic product and consumer spending are declining while stock prices are rising; that government spending is rising while tax revenues are falling; that consumers are deleveraging and that the flow of credit has slowed while the total of debts and liabilities in the US economy continues to rise; that the US dollar is falling while price inflation remains nominal; that interest rates are near zero for banks but rising for consumers. The seemingly contradictory facts indicate economic distortions and therefore developing systemic instabilities. What ties all of the economic data together is the US dollar. Rather than considering what impact unsustainable economic distortions might eventually have on the US dollar, could the developing systemic instabilities instead be the symptoms of a currency crisis already in progress?

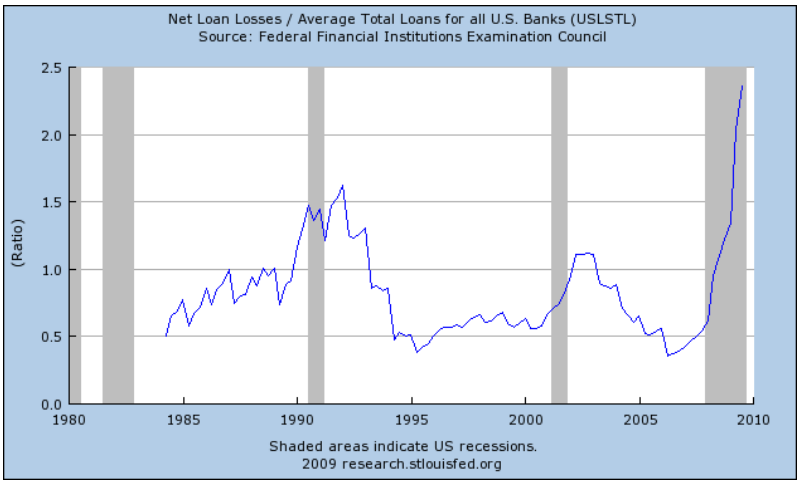
The debate over inflation versus deflation in the US economy tends to overlook the fact that both inflation and deflation are occurring at the same time but in different areas of the economy. The policies of the US government and Federal Reserve are inflationary but there are vast deflationary pressures with no apparent relief in sight. Inflation, of course, is simply an increase in the money supply rather than rising prices, which is one of the effects of inflation. Deflation is simply a reduction in the money supply rather than falling prices, which are one of the effects of deflation. Nonetheless, the effects of inflation can always be seen in the long run in consumer prices, i.e., the dollar looses value as a function of monetary inflation thus prices tend to rise.



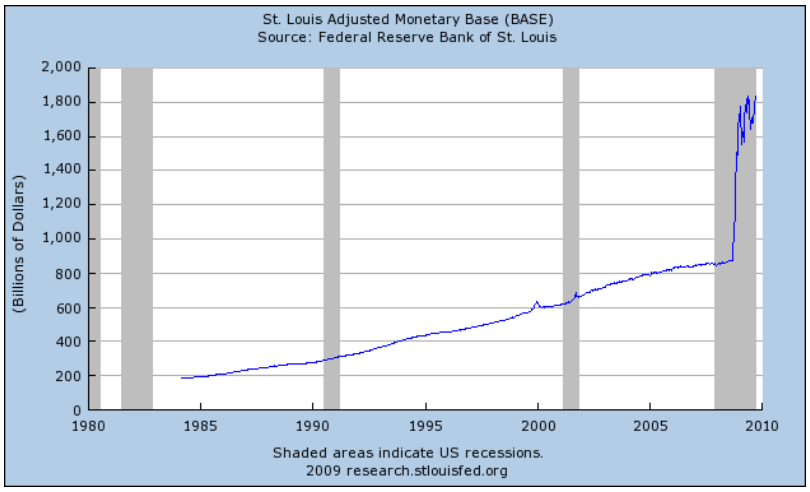
Faced with the imminent collapse of the US baking system in 2008, averting a deflationary depression, such as the Great Depression, was obviously desirable but whether the radical inflationary policies of Federal Reserve Chairman Ben Bernanke combined with US government bailouts can ultimately save US banks remains to be seen. An inflationary outcome and a corresponding fall in the value of the US dollar could ultimately be as destructive to the US economy as a deflationary collapse would have been. At the same time, monetary inflation in the financial system is a technical fix that does not address the deflation in the broad US economy. The broad US economy has continued to decline since 2008 despite having saved the banking system and despite massive Keynesian interventions by the US government (deficit spending and stimulus programs).

The relationship between the banking system and the broad US economy hinges on the levels of debt in the economy. Since the mechanism of money creation is debt, the broad money supply cannot be inflated without increasing debt levels outside the banking system. It is primarily debt defaults that create deflation via bank losses and failures while the engine of inflation (the issuance of new debt) has been separated from the broad US economy and is now concentrated in the banking system and in US government debt rather than being distributed over consumers and non financial businesses. This fundamental change may signal the end of US economic expansion characterized by debt levels rising faster than economic output. Since consumers and non financial businesses remain unable to take on new debt, deflationary pressures continue to stress US banks.

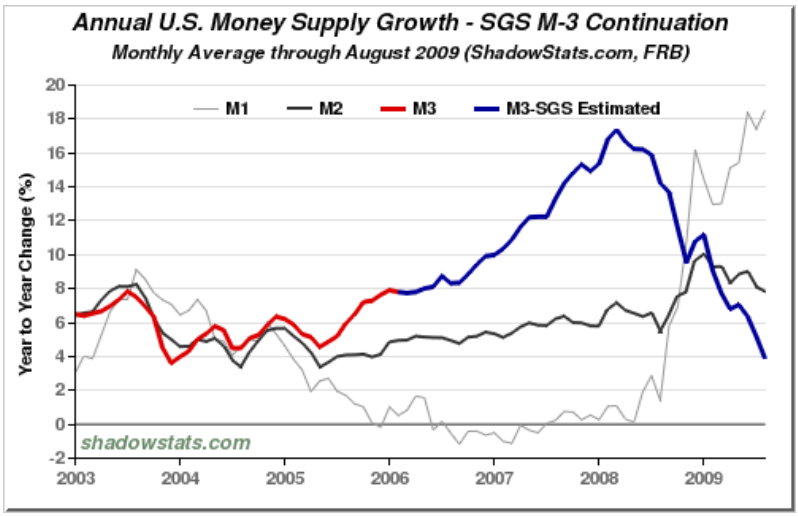
According to the Federal Reserve Bank of St. Louis, the monetary base (MB) has approximately doubled in roughly the past 12 months. The increase appears to contradict the fact that deflationary pressures impacting US banks continued virtually unabated. Mortgage and credit card defaults have resulted in 170 US bank failures since 2007. A recent Bloomberg article indicated that the number of lenders that cannot collect on 20% or more of their loans hit an 18-year high, signaling more bank failures ahead. Evidently, fewer bank failures have taken place than would have occurred otherwise had it not been for the massive interventions of the US government and the Federal Reserve.



The MB data reflect increases in bank reserves partly attributable to the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) program. Whether banks can successfully borrow their way past their losses depends not only on the magnitude of the losses relative to their revenues, reserves and balance sheets but on future business performance. The strategy cannot work as long as the US economy continues to contract, thus shoring up reserves with zero interest loans from the Federal Reserve is only a short-term fix. In any case, while new money has flowed into banks, it cannot filter out into the broad US economy which continues to decline.

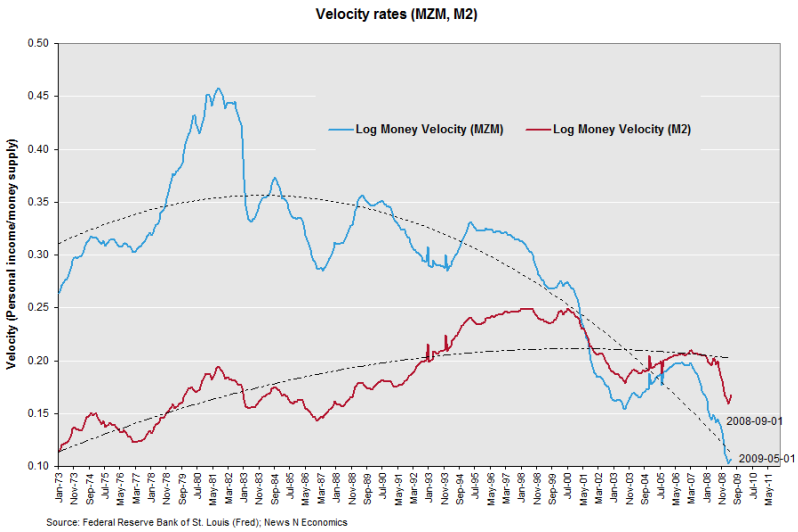


The dramatic increase in MB is not apparent in more broad measures of the money supply such as M3. M3 includes currency in circulation and all types of deposit and money market accounts as well as other liquid assets. Although the Federal Reserve ceased publication of the M3 monetary aggregate in March 2006, it is still calculated by John Williams of Shadow Government Statistics. M3 has been in a sharp decline since 2008 and there is no indication that the rate of decline is slowing. The M3 data reflect monetary deflation in the broad US economy.



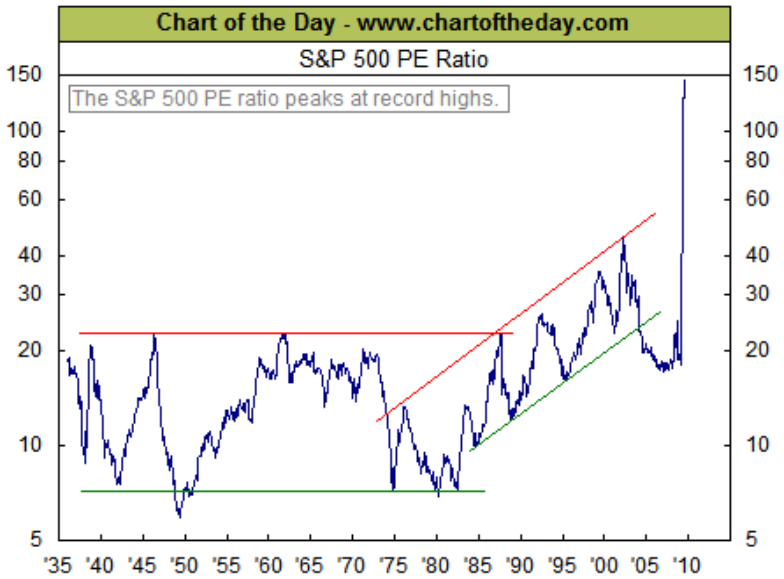
Economic recovery cannot take place in a deflationary environment simply because money is less available to individuals and non financial businesses. In particular, small businesses provide roughly 2/3 of all jobs in the US economy and the flow of credit to small businesses has been sharply curtailed. The reduced availability of credit to consumers and non financial businesses has had a strong dampening effect on the broad US economy. At the same time, consumer credit card interest rates have gone up sharply in advance of the US consumer-protection law slated to go into effect in February 2010 despite a prime rate near zero. Consumers are deleveraging (paying off debt) and non financial businesses, hesitant to borrow in the face of declining revenues and economic uncertainty, are cutting costs as well as jobs. Unless banks issue new loans, deleveraging is, in effect, a deflationary force in the broad US economy outside of the banking system.

The effects of the credit crisis can be seen most clearly in the velocity of money (MZM) which shows that spending on the part of consumers and non financial businesses has slowed dramatically. MZM is the average frequency with which a unit of money is spent in a specific period of time. Saving and deleveraging on the part of consumers (as opposed to financing consumption via credit), reduced borrowing on the part of non financial businesses, and unemployment all contribute to falling MZM.



As deflation makes money more scarce (falling M3), consumer and business spending slows down (falling MZM) exacerbating falling business revenues, business failures, and unemployment, which in turn put additional stress on US banks. This is the short formula for a deflationary depression. Comparing the present situation to the Great Depression, the main difference is that deflation due to bank failures is being prevented, or at least slowed down, by a combination of bailouts (TARP and PPIP) and FDIC insurance, and by radical interventions by the Federal Reserve and the US Department of The Treasury, such as the TALF program and the suspension of the Financial Accounting Standards Board (FASB) mark-to-market rule. Unfortunately, saving US banks has not prevented the decline of the broad US economy.

Another interesting difference in the present situation compared to the Great Depression is that stock prices no longer appear to accurately reflect business performance, e.g., the S&P 500 average price-to-earnings (P/E) ratio is currently a multiple of the overall historical average.



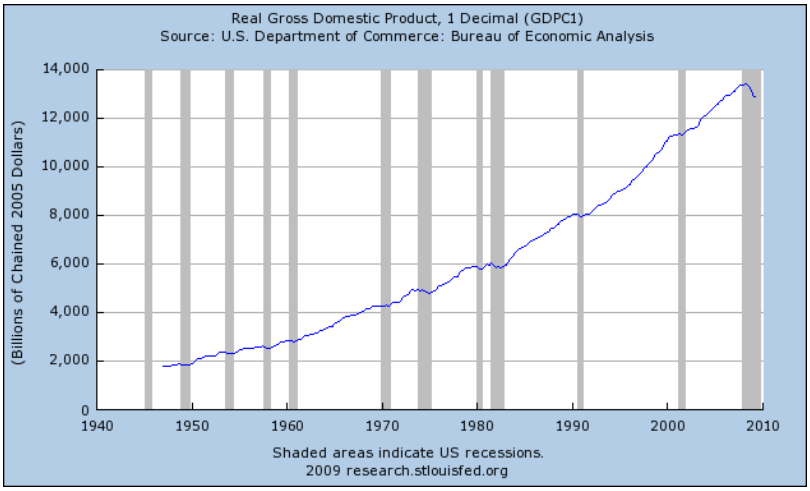
Source: Chart of the Day (http://www.chartoftheday.com/)

Unsustainable P/E ratios are typically the result of a stock price bubble. However, in the present situation they reflect that widening gap between the US banking system and the broad US economy. The trend in stock prices is pulling away from indicators that more closely reflect the broad US economy. Although deflation in the banking system as well as in financial markets appears to have been held in check by various interventions, economic recovery cannot take place unless and until deflation in the broad US economy can be reversed.

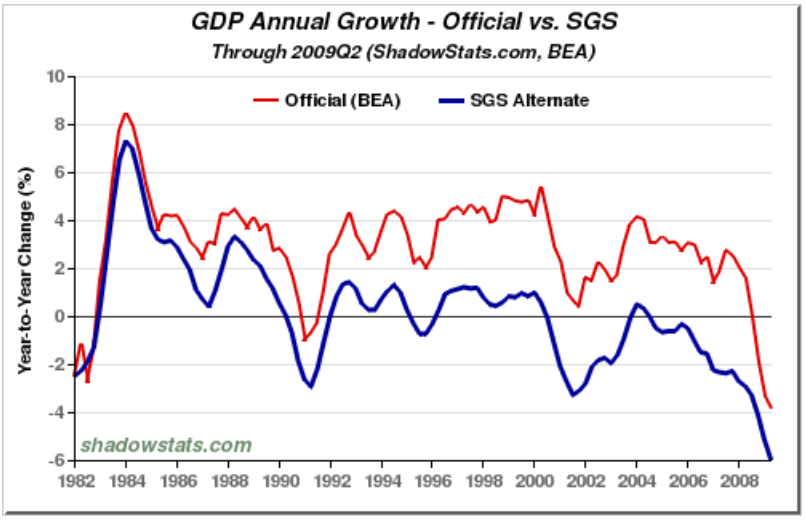
The current policy framework of the Federal Reserve (and the view of modern economics in general) is that monetary inflation not only supports economic growth by expanding the money supply but stimulates economic activity (boosting M3 and MZM), thus inflation stimulates economic growth. As a result, there is a theoretical optimum level of inflation that can not only maximize economic output by matching the supply of money to demand, i.e., to maintain a stable currency value, but also a level that can maximize economic growth. Since inflation is the result of debt there must also be an optimum or "healthy" level of debt for an economy relative to its gross domestic product (GDP). Since GDP growth is stimulated by inflation and inflation requires increased levels of debt, maintaining an optimum level of inflation requires debt levels not to increase disproportionately.

Whether the levels of inflation required to accommodate normal economic growth, optimize economic activity, maximize economic growth, and maintain a healthy level of debt in the economy are the same seems to be a vitally important question. If not, the theory that economic output can be maximized by manipulating the money supply beyond the scope of supporting normal economic growth (as opposed to growth linked to inflation resulting in excessive levels of debt relative to GDP) would in practice systematically create economic instabilities that would ultimately be unsustainable. If that were the case, then the current unsustainable economic distortions could be viewed as the inevitable consequence of inflation characterized by excessive levels of debt relative to GDP, i.e., excessive inflation.

At a glance, it seems that US GDP, while in decline, remains near an all-time high in nominal terms. Interestingly, the GDP growth curve mirrors that of cumulative CPI, which is directly a function of inflation.

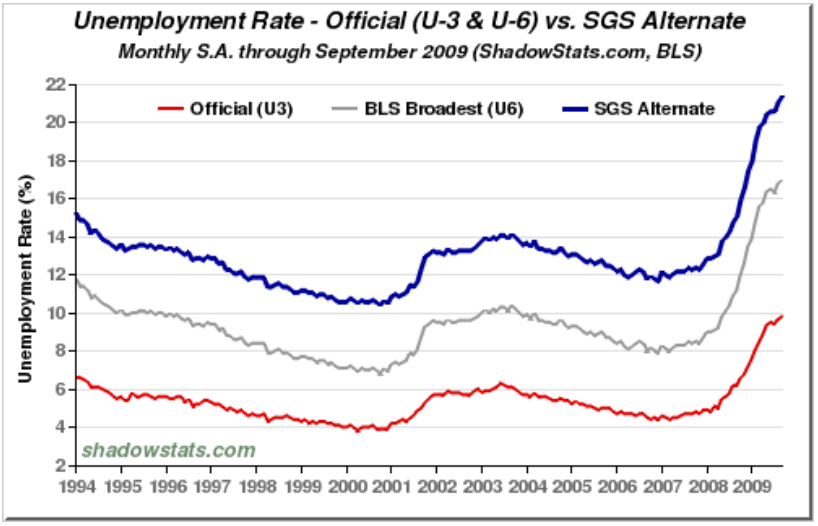


Looking at the percent change in GDP tells a different story. The way that the US government measures GDP has changed over time. John Williams of Shadow Government Statistics still measures GDP using the pre-Clinton era formula.



While the rate of decline in US GDP may be questioned, the fact of decline remains, i.e., the US economy is in recession. Whether nominal GDP indicates sustainable economic growth depends on the levels of inflation and debt in the economy. Specifically, if nominal GDP growth is accompanied by a disproportionate rise in debt, GDP growth is unsustainable at best and illusory at worst.

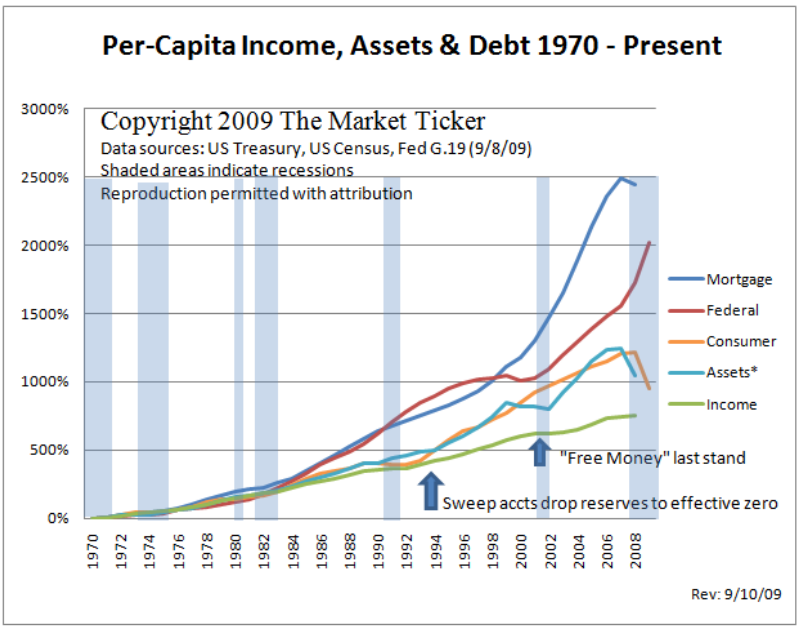
US unemployment data point to a further contraction of GDP. In an economy where GDP growth has been associated with rising debt levels and where consumer spending accounts for roughly 2/3 of GDP, unemployment cannot be considered a trailing economic indicator and must instead be seen as a leading indicator.



A further drop in consumer spending can be expected as a function of rising unemployment. The policy response of the US government has had little effect in terms of GDP or unemployment.

The key question with respect to US GDP is whether total debts and liabilities in the US economy are sustainable. If not, new borrowing on the part of consumers and non financial businesses cannot take place and deflationary pressures will persist in the broad US economy. Karl

Denninger (The Market Ticker) has published a number of articles discussing debt levels in the US economy.



US mortgage and consumer debt levels, as well as asset values, have been in decline since 2008. At the same time, public debt has accelerated due to a dramatic increase in US government borrowing. Unfortunately, government spending on behalf of consumers and non financial businesses cannot offset deflation or halt the overall slowdown of the broad US economy. While Keynesian intervention (government stimulus) may be effective in the short run to offset a mild recession, the theory does not account for severe or prolonged declines or systemic instabilities. Japan's "lost decade", for example, can be viewed as a failure of Keynesian intervention.

A closer look at debt levels in the US economy suggests that debt levels may not be sustainable and that points to further bank failures ahead. When discussing debt levels in the US economy, it may be difficult for those outside of banking or economics to understand what the numbers mean, but simple calculations can paint with a broad brush where the US economy stands today. According to data published by the US Debt Clock Organization:

- The current US national debt is roughly $11,813,000,000,000 (equal to roughly 90% of official GDP) or $38,400 for every citizen (excepting approximately 11 million illegal aliens).

- US household debt (mortgages, credit cards, student loans, etc.) is roughly $7,523,000,000,000 or approximately $24,500 for every citizen.

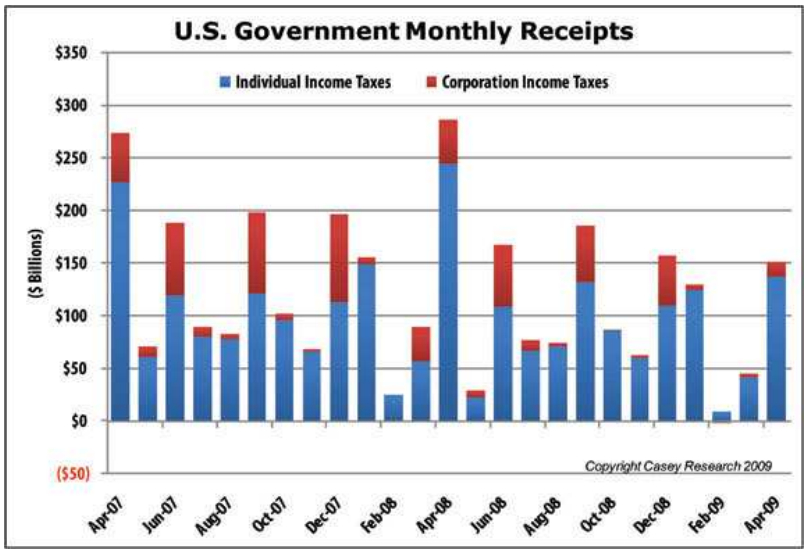
- Unfunded US government liabilities are roughly $59,000,000,000,000 or approximately $192,300 for every citizen.

- According to Neil M. Barofsky, Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), bank bailouts, loans and guarantees related to the financial crisis total $23,700,000,000,000 (based on government data), or $77,126 for every citizen.

Federal and household debts and liabilities for the entire US economy, not including commercial debt, total $332,326 per citizen. Since there are approximately 2.6 persons per household, according to the US Census Bureau, debts and liabilities total approximately $862,000 per household. According to the Social Security Administration, the national average annual wage is $40,405, thus the average citizen would work roughly 21 years without pay to equal their theoretical share of total non commercial US debts and liabilities. For a household with one income, the wage earner would work roughly 63 years to pay their household's theoretical share of total non commercial US debts and liabilities. While such estimates include current debt and other liabilities and do not account for changes in wages or the value of the US dollar, they clearly suggest a sobering reality: debt levels in the US economy are not sustainable.

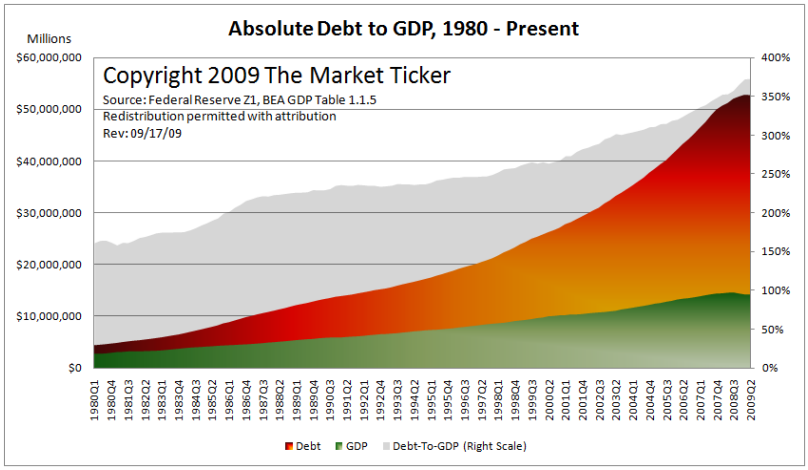
Excessive debt levels in the US economy point to excessive inflation in the past and suggest that GDP growth, having been over-stimulated, will contract more severely than expected. Similarly, bank balance sheets must contract for debt levels to return to sustainable levels.

Consumer debt, however, is not the main problem. As unfunded liabilities come due, the US public debt will rise and servicing the public debt will grow significantly compared to tax revenues. Fiscal 2009 federal tax revenues were approximately $1.6 trillion, while spending was roughly $3 trillion. Interest on the US public debt was roughly $361 billion, thus the cost of servicing the public debt represented roughly 25% of tax revenues. At the same time, federal tax revenues have been in decline.



Considering a scenario where the US public debt doubles, as is planned by the current administration, servicing the public debt could result in a situation where it is impossible to balance the federal budget and where the public debt will necessarily increase purely as a function of mandatory spending. The eventual default of the US government and a corresponding crash of the US dollar would be inevitable.

While it may be interesting to conceptualize debt levels in terms of individual or household liability and to consider whether tax revenues will be sufficient to service a far larger public debt, what is most important is how debt levels relate to GDP.



According to data from the Federal Reserve and the US government, the rise in debt levels has been pulling away from GDP growth at an accelerating rate since the mid 1990s. With GDP in decline, or in sharp decline as measured using pre-Clinton era methods, the ratio of total debts and liabilities in the US economy to GDP is unsustainable under any realistic GDP growth scenario.

Unsustainable debt levels are the root cause of deflationary pressures in the broad US economy. There are only two ways to eliminate excessive levels of debt: deflation and inflation. The policy response of the US government and Federal Reserve has made clear that deflation will be prevented as far as it is possible to do so, i.e., to avoid a deflationary depression. The largest banks have been preserved under the "too big to fail" theory and the US government, as has been demonstrated in the past year, stands ready not only to borrow and spend whatever amount of money may be necessary without regard for the public debt or future tax or budgetary consequences, but also to take on virtually unlimited liabilities. The question is: will it work?

The current policy response might work if the US dollar were devalued significantly since that would reduce the value of debts in real terms after prices, wages and asset values rose to accommodate the reduced purchasing power of the dollar. The US government could manage a far larger public debt if each future dollar used to service the debt were comparable, for example, to $0.33 today. With a lower value for the US dollar it might be possible to preserve bank balance sheets and at the same time bring the ratio of total debts and liabilities, measured in real terms, in the US economy closer to a sustainable level relative to GDP. In other words, the process of monetary inflation would have to be greatly accelerated.

Whether accelerated inflation would be more unstable or more destructive than deflation is unclear. The obvious risk is that the US Federal Reserve could miscalculate the rate of inflation, as it now appears they may have done in the past, and loose control crashing the US dollar along with the US economy. In any case, it appears the US dollar is headed for a significant decline if not an outright crash under the current policy response. The risk of hyperinflation in the future seems insignificant compared to past levels of inflation and the resulting levels of debt currently in the US economy. It even seems possible that "hyperinflation", meaning prolonged excess levels of inflation (perhaps characterized by a series of asset price bubbles) has already occurred and that what is taking place now is only the result.

Although the US dollar rallied in 2008 as the global financial crisis brought world economies to a precipice, the US dollar in 2009 appears much less attractive.

Setting aside the US dollar inflation of past decades associated with the excessive levels of debt in the US economy today, a rapidly expanding Federal Reserve balance sheet and quantitative easing ("money printing") are directly weakening the US dollar while foreign appetite for US debt is waning. On a global basis, there is a growing shift away from the US dollar both as a reserve currency and as an international medium of exchange, as well as a developing US dollar carry trade threatening to put additional pressure on the dollar.

In theory, the slide of the US dollar can be stopped simply by reducing federal spending and raising interest rates. However, a rise in interest rates would bring about loan defaults in all categories and result in deflation due to greatly increased bank failures. Raising interest rates would accelerate, as compared with drawing out, the inevitable process of purging excessive levels of debt from the US economy, thus paving the way for a return to stable economic growth. Of course, the idea of attempting a managed deflation is heresy to current US economic policy.

The ongoing inflationary policies currently helping to maintain the balance sheets of US banks mean that the total of debts and liabilities in the US economy remain excessively high relative to GDP, preventing genuine economic recovery. Bank balance sheets can be expected to continue slowly crumbling as mortgage, credit card and other loan defaults continue while the recession drags on for what looks to be a period of years. It seems unlikely that mortgage backed securities, regardless of how they are valued for accounting purposes, will not become liquid in the foreseeable future, thus US banks will remain in a state of decay. In other words, it does not appear that the policy response will work in the long run.

The apparent choice between inflation and deflation may itself be illusory because both assume the US dollar can survive the developing systemic instabilities in the US economy and growing pressure on the dollar. The US policy response does not address the root cause of the problems in the US economy: excess levels of debt. Since monetary inflation is tied in lock-step to debt levels, an inflationary policy response at this point can only produce unsustainable economic distortions. The fact that managed deflation was rejected as a policy option from the start suggests a failure to recognize the root cause of the problems in the US economy. At this point, it is too late to put the inflation genie back in the bottle, thus there is no fundamental way to stop the slide of the US dollar in the long run.

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