

Debt Denial

By James Rickards

The sovereign debt crisis has crossed a threshold. It's no longer about economics. It's about math and a complex system whose dynamics tell us there is little time to avoid catastrophe and almost no exit. Going forward, elections and policies will matter less as the debt plague takes hold and dictates hard outcomes.

It is the case that real debt cannot be repaid through any feasible combination of growth and taxes. We will soon arrive at the point where it cannot be rolled over. Debt includes contingent liabilities as well as bonds. In the U.S., this means social security, healthcare and housing obligations estimated at over \$60 trillion. That does not include unfunded pension obligations of the states whose plans use fanciful 8% growth assumptions to limit contributions. Pension debt grows exponentially; a toxic brew of increased benefits, contribution shortfalls and anemic performance.

Even what we call money is debt. Paper money is a contract between citizen and government. As with any contract, it pays to read the fine print. Embossed on each U.S. bill is the phrase "Federal Reserve Note." Give the Fed credit for full disclosure; these notes are liabilities. If the Fed's mortgage assets were marked-to-market the Fed itself would be insolvent. In short, it's all debt. Wealth is illusory if it involves a claim payable in dollars which are but a claim on an insolvent central bank backed only by its ability to print more debt. The situation is worse in the UK, Europe and Japan. The global financial system is a rope of sand.

If this system is illusory, how has it prospered over centuries? The answer is that for many years governments ran surpluses and at times had no debt at all. Growth was robust providing support to the tax base. Governments had the trust of bond markets to rollover maturing obligations. With some fits and starts, tangible wealth creation outpaced debt creation. And until recently paper money was backed by gold at fixed rates of exchange. Today all four legs of the table – surpluses, growth, trust and gold are gone or damaged.

There is no prospect for surpluses; nations hit the brink of disorder at the mere mention of 3% deficit-to-GDP ratios. Growth prospects are likewise dim given current policy. Obama grew spending on a feed-the-beast theory that forces taxes to rise to match spending. If Obama does not get his way, deficits will be ruinous. If he does get his way, taxes will stifle growth. You cannot tax your way to solvency in a world of low growth and compound interest.

As for market trust, go ask the Greeks. Each bond buyer has a critical threshold where he will not buy another bond. Picture bond buyers as theatre patrons. The image of someone yelling "fire" and patrons rushing out in a panic is familiar. More intriguing is the case in which just a few patrons rush out for no apparent reason. Do those remaining follow suit or stay seated? It depends on their individual thresholds. If high enough, everyone remains seated. But if some thresholds are low, those patrons leave too triggering other thresholds and so on until a cascade of exits empties the theatre.

In markets, the array of individual thresholds is immensely complex. The scale, interdependence and adaptability of market participants today are greater than ever. It would take very little to trigger a wholesale revulsion with sovereign debt.

What about gold? The view is that systems on a gold standard system cannot increase money supply as needed; of course, that's the whole idea. Increasing money beyond the modest levels at which gold supply grows is the Keynesian remedy. But empirical evidence shows the so-called Keynesian multiplier is fractional and therefore a wealth destroyer. Another attack on gold is that there's not enough of it to support money supply; but of course there's always enough gold; it's just a question of price.

The U.S. has never truly gone off the gold standard. The U.S. gold hoard today has a dollar value equal to about 20% of U.S. M1 money supply – a respectable ratio even in the heyday of the fractional gold standard. A gold price of \$5,500 per ounce would comfortably support a broader U.S. money supply on a one-to-one ratio and maintain confidence in the dollar and U.S. sovereign debt.

Is there an exit? One path involves hyperinflation to destroy the real value of debt followed by redenomination and a new paper money game. The other path involves a gold backed currency at a non-deflationary price. This is a choice between denial and frank talk. Sound money leads to sound growth and the creation of real, not illusory, wealth.