The Monetary Crisis

By Doug Casey
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U.S. government debt, before taking into account the obligations of Social Security and Medicare, is quickly closing in on $9 trillion.

Of course one might cavalierly say, that's the government's problem and it doesn't concern me. But you know that the government will make it your problem. And most of your fellow Americans will be cheering it on. Why? Because starting in 2008, the largest population bubble in U.S. history-78 million Baby Boomers—will begin to retire. Some Boomers have lots of money, but most have lots of debt. The average Boomer has only about $60,000 in net worth, and that includes IRAs and other pension plans.

$60,000 might barely allow a Boomer to scrape by for a year or two of hard living in a trailer park. But it won't get many down the road for 20 or 30 years until they're folded back into the mantle. For that, they'll have to rely on the scraps the government feeds them, which makes Social Security and Medicare politically untouchable.

Adding in Social Security, Medicare and all the other unfunded obligations of the U.S. government, the current debt actually comes in at over $60 trillion—an amount so large, not one person in a million has a real sense of it.

A trillion is 1000 x 1000 x 1000 x 1000, or a million millions. In his first address to Congress, President Reagan, himself a profligate spender, accurately pointed out that a stack of $1,000 bills 4 inches high makes you a millionaire, and that a trillion dollars would be a stack of $1,000 bills 67 miles high.

A $60 trillion debt, therefore, requires a stack of $1,000 bills 4,020 miles high. Use one-dollar bills, and the stack extends for 4 million miles, about enough to make it to the moon and back... 17 times.

It's a lot of money. And it's not just any kind of money. Amazingly, this unbacked currency of a bankrupt government is still the reserve currency of virtually every nation in the world today. But not, we think, for too much longer.

To service the debt, the U.S. government must sell on the order of $1 billion per day in new debt, much of it shipped off to foreigners who are already sitting on something like $5 trillion of U.S. paper.

Recognizing that the U.S. has little capacity to rein in its profligate spending and neither the intent nor the ability to actually pay off all that debt in dollars that are worth anything, even unsophisticated foreigners are increasingly leery about continuing to pad their nests with greenbacks.

The more skeptical foreign investors become, the higher interest rates must go to entice them to continue to raise their hands at Treasury auctions.

But worse, personal debt in the U.S. is also at historic levels.

Personal Debt

Let's look at some numbers.

America has gone from a nation of savers to a nation of debtors. Net personal savings have been negative for over a year, the first time that's happened since the Great Depression.

Median household debt grew by almost 34 percent between 2001 and 2004, while net worth went up just 1.5 percent, according to the latest Survey of Consumer Finances (a report issued only every 3 years). We suspect that since 2004, the numbers have gotten much worse.

The household debt-service ratio hit a record high, just shy of 14%, in the first quarter of 2006 ... meaning that of every 100 after-tax dollars earned, 14 now go to servicing debt.

The average American household now is carrying over $90,000 in debt, much of it as adjustable-rate mortgages. In fact, interest rates on 22% of the $8.7 trillion in mortgages carried by Americans are scheduled to be reset this year. According to one observer of the housing market, the typical ARM will bump up from a manageable 3.6% to an uncomfortable 5.6%, that would mean an increase of $800 a month on a $500,000 mortgage.

It gets worse. In 2005, 40% of all new mortgages were adjustable-rate, and they will start resetting in 2008 and 2009. And Fannie Mae reports that almost two thirds of all sub-prime loans will be reset in 2006 and 2007. Many, perhaps most, of the borrowers will get squeezed, and more properties will hit the market after lenders repossess them.

It is already starting. The U.S. Foreclosure Market Report shows that in the first quarter of 2006 alone, over 320,000 properties went into foreclosure, a 72% jump over the same period the year before. In Colorado, where I hang my hat about a third of the year, nearly 4,200 properties went into foreclosure in May, accelerating to 10,500 properties by mid-July.

In the second quarter, year-on-year new home sales fell, on the average, by more than 25%. In some markets the bubble is deflating even faster. In the Los Angeles/Long Beach area, for instance, new home sales in the second quarter were off 50%, and in Tucson they were off 46%.

It's hard to overstate how important the housing market has been in supporting the U.S. economy. About 40 percent of all new jobs created in the U.S. private sector over the last few years were related to housing. As the housing market bites the dust, those jobs are going to disappear.

And rising housing prices were an artesian well for consumer borrowing. According to the Fed, Americans borrowed $600 billion against their homes in 2004, on top of $439 billion in 2003, and spent half of it on goods and services. The services are ephemeral, and most of the goods will wind up in a landfill. Worse, the well is now dry, but the debt will keep compounding interest.

The Fed still has the power to push interest rates up or down temporarily. But even with that power, it now has no good place to go. From here on, if it cuts rates, it risks triggering a flight from the dollar. But if it pushes rates higher to keep foreigners from abandoning the dollar, it hammers harder on the housing market.

So we're left with an inescapable choice between two dire scenarios. Continue raising rates to keep the dollar from collapsing and crush the domestic economy in the process. Or stop raising rates and let the dollar, lynchpin of the global economy, collapse.

Crisis at the Door

The monetary crisis has already begun, evidence of which is provided by interest rates rising pretty much across the board, a sign that inflation is embedded in the DNA of the global economy.

And note that every time the pundits announce that the Fed may have finished raising rates, the dollar takes a beating—a sure sign of flagging confidence. That's important because, as with all fiat currencies, the U.S. dollar is based on faith alone.

You wouldn't buy a stock if you didn't expect the company to perform well. And you'd sell a stock if you felt it was headed for trouble.

Similarly, foreign owners of the big green mountain of U.S. dollars have become uneasy and generally are looking to sell. There's no dumping, at least not yet. When it comes, the flight from the dollar will start slowly, then gain momentum before moving into a blow-off. Like a glacier sliding toward a cliff, movement that seems inevitable may take a puzzlingly long time to get underway. But once it does, things speed up at a surprising rate. Most of what happens happens rapidly, toward the end of the process.

Given the choice between (A) a dead housing market and scorched-earth depression in the U.S and (B) a collapsing currency, which at least has the virtue of reducing the real cost of paying off all those Treasury bonds, I'm forced to believe the U.S. government will choose (B) and sacrifice the dollar.

After all, our government—any government—is really nothing more than an old boys club. It's where hall monitors go when they're too old for school. There they can seek the adulation a lifetime of public "service" can bring, followed by genteel retirement on a generous public pension. Being drummed out of office (although I'd personally recommend either stoning or crucifixion) for running the economy into the ground isn't part of that agreeable vision.

The ultimate consequence of the world abandoning its reserve currency is anybody's guess. We are truly in terra incognita. For the time being, the only safe bet is to rig for a weak dollar and rising long-term rates.