

## **Part 2 - 2014 the year of truth! A US dollar crisis, interest rates spiking and worldwide debt growing out of control and gold and silver through the roof!**

In this context one has to wonder how we are going to express the value of goods and services if the US dollar loses its value surely we will need a new benchmark/unit of valuation to price these.

So far there are only two currencies that haven't lost their value: gold and silver (l'argent). A gold standard regulates the debt levels another reason why you don't get into a downward spiral of reduced purchasing power. I believe that gold and silver will be the currencies of choice when the fiat paper system implodes. We are in serious need of monetary discipline, represented by a gold standard because the money creation is regulated by the amount of gold available and not the politicians' pork serving mainly their own interest!

### **To debauch (destroy or debase) the currency engages all the hidden forces of economic law on the side of destruction**

A lot has been written about the dangers of the debasement of the currencies. "To debauch (destroy or debase) the currency engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose and is noticed by only a few very thoughtful people, since it does not operate all at once and at a single blow, but gradually overthrows governments, and in a hidden, insidious way, is, however, striking" (Copernicus). Hence why we are witnessing the wealth of the middle class that can barely pay for its primary living needs, being eroded which could destabilize societies.

Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but also at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become 'profiteers,' who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.

Capitalism's final stage is what Hyman Minsky calls "Ponzi-financing", when debt payments can only be made by additional borrowing and diluting the currency in the process. This is what the US, the UK and Japan are doing today, having to borrow against tomorrow (because only from future excess income the debts can be repaid) in order to pay yesterday's bills. Just be reminded worldwide debt levels, 3 times the worldwide GDP, are rising 11% whilst world GDP is rising 3%-3.5%.

People's wealth and especially that of the middle class is being eroded because primary living needs are getting much more expensive. If you feel like we're still in a recession, are you imagining things? Next to me some economists think we're in a kind of faux recovery that masks deep harm still being done to the economic prospects of millions of Americans. Brad DeLong, an economist at the University of California, Berkeley, and a government policymaker during the Clinton administration, wrote recently that, "unless something returns the U.S. to its pre-2008 growth trajectory, future economic historians will not regard the Great Depression as the worst business-cycle disaster of the industrial age. Adjusted for inflation, GDP peaked in 2007 and didn't reach that level again until 2011. DeLong even argues that adjusting GDP for both inflation and population growth real (inflation-adjusted) GDP growth per capita, GDP is normally expressed as a figure of the goods and services produced for the whole country, won't reach the 2007 peak until sometime in 2014.

The growth in real economic output (GDP) per person has averaged about 2% per year for the past century. So if growth has been essentially zero for the past seven years (2007 to 2014), says DeLong, output is 14% lower than it would have been had the economy been growing at normal rates. That output gap, he says, amounts to about \$9,000 per person each year in terms of money not spent on goods and services that could have made people's lives better. That's roughly equal to a year's worth of mortgage payments on a \$200,000 home. For a family of four, the lost output adds up to about \$36,000 per year — the equivalent of a fully loaded Ford Fusion sedan.

That doesn't mean everybody would have automatically become wealthier if not for the 2008 financial meltdown and corresponding recession. Median incomes had been stagnant for nearly a decade by the time the recession hit, on account of factors such as globalization (outsourcing) and the digital revolution. The divide between haves and have-nots had been widening, too, with highly skilled technocrats generally prospering (because they have discretionary income, the amount of an individual's income that is left for spending, investing or saving after taxes and personal necessities (such as food, shelter, and clothing) have been paid) and lower-skilled workers in fading industries falling behind, perhaps never to catch up. Imagine if you would have \$100 or \$200 savings every month how long it would take to save \$50,000 and that is assuming you don't have any additional costs you have to take care of.

DeLong's calculations help explain the sense of backsliding many Americans seem to feel. In 2007, during the prior peak for real GDP, the Conference Board's consumer-confidence index was around 91. Today, with the total level of real GDP higher, it's at 78. Back then, 27% of poll respondents told Gallup they were satisfied with the way things are going in the United States; in the latest poll, only 20% felt this way. That would make sense since only the top 10%-20% of the population benefits from the inflation of the different asset classes.

A recent study by two prominent Harvard economists, Ken Rogoff and Carmen Reinhart, found financial crises such as the one that erupted in 2008 usually produce worse downturns than what we've experienced. And on average, they find, such panics cut per-capita real GDP by 9%, requiring 6.7 years for the economy to recover. The latest crisis, by their account, caused only a 5% decline in GDP, followed by a six-year recovery.

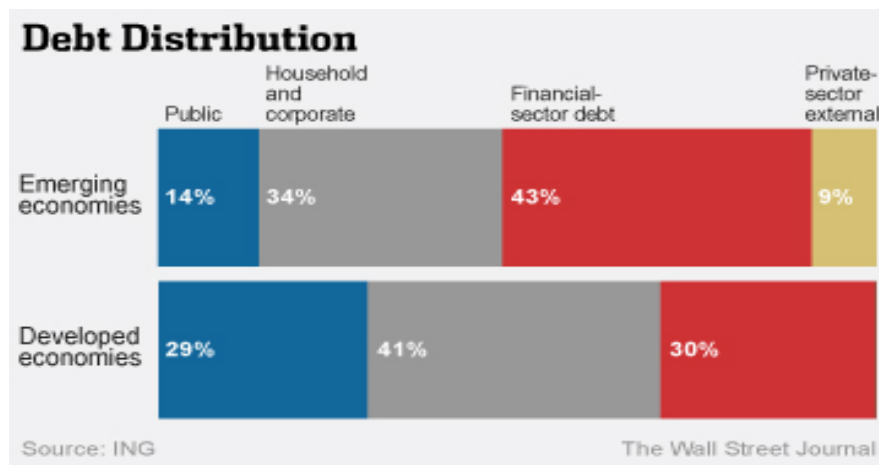
The take here is that living cost inflation, without wage inflation, is impoverishing households that can narrowly pay for their living needs whilst at the same time enriching the top earners because they have ample surplus money, discretionary income, enabling them to strongly benefit from the asset inflation we have seen in recent years! The difference with deflationary forces is that the poor and the rich both “suffer” because all asset classes diminish in value.

**Anyway lets have a look at the estimates for the worldwide debt estimated to be in excess of \$220trn or \$220,000bn!**

As mentioned here above if we get “strong” figures in January we will be fried because interest rates will go up strongly and the economy is not strong enough to bear the higher interest costs! And they will rise everywhere and the mayhem will be incredible. Next to that if we get weak economic figures, as precluded by the December weak unemployment figures we should be concerned about a dollar crisis (caused by an unsuccessful \$4trn dilution of the US dollar), which would ultimately, also lead to higher interest rates after we first see lower interest rates. In any case in this context it is interesting to review an ING and other studies of the calculation of the worldwide debt and the possible consequences of different economic circumstances.

According to a study done by the Dutch bank ING the total indebtedness of the world, including all parts of the public and private sectors, amounts to some \$223.3trn or 313% of global gross domestic product!!

Advanced economies tend to draw attention for their debt at the government and household levels. But emerging markets are gathering debt at an increasing pace to drive their economic development, building infrastructure etc.



Economists at ING found that debt in developed economies amounted to \$157 trillion, or 376% of GDP of \$42 trillion. Emerging-market debt totaled \$66.3 trillion at the end of 2012, or 224% of GDP of \$30 trillion.

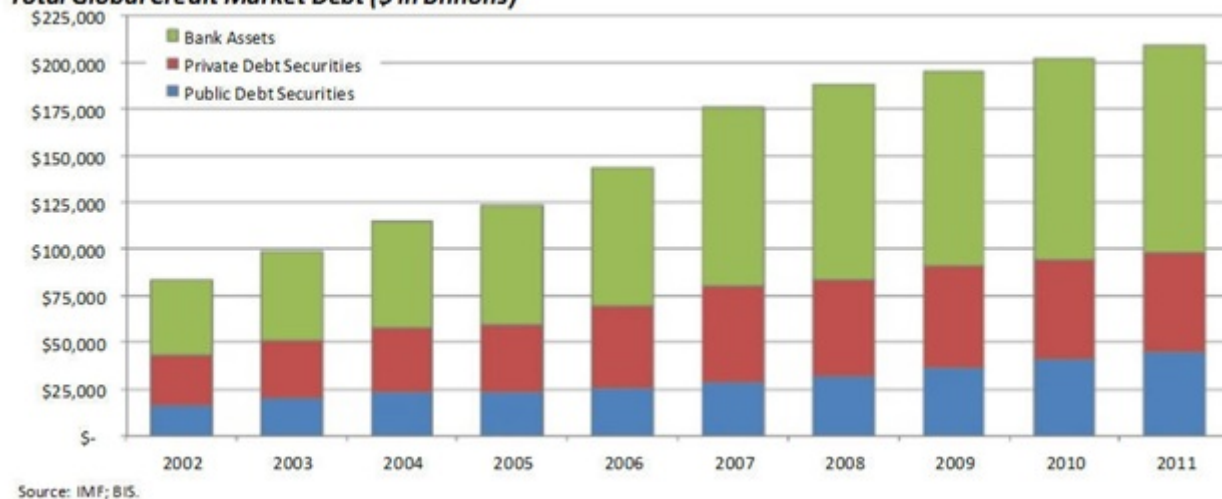
The \$223.3 trillion in total global debt includes public-sector debt of \$55.7 trillion, financial-sector debt of \$75.3 trillion and household or corporate debt of \$92.3 trillion (The figures exclude China's shadow finance and off-balance-sheet financing). Estimates are that, including the Special Purpose Vehicle (SPV) debt in China; used to finance urban expansion, Chinese Debt/GDP ratios are around 200%. In addition recent trade figures for China are indicating a slowdown of exports. It very much feels like China's momentum is over for the moment and that the country is undergoing a transformation that could get ugly and bring the imbalances to the surface. By the way is this why China has expanded the Air Defense Identification Zone over disputed waters in the East China Sea in order to have leverage over the lower wage countries like Vietnam, Cambodia, Philippines and control their food supply?

Next to urbanization global trade has played a leading role in driving debt dynamics as emerging markets increasingly supplied low-cost labor and raw materials in recent decades. A decade ago, total emerging-market debt was \$18.8 trillion, or 214% of GDP, now it's \$66.3 trillion, or 224% of GDP. Per-capita indebtedness is still just \$11,621 in emerging economies (and rises to \$12,808 if you exclude the two largest populations, China and India). For developed economies, it's \$170,401. The U.S. alone has total per-capita indebtedness of \$176,833, including all public and private debt. In general I don't pay much attention to the per-capita indebtedness it only starts to matter in my point of view when things are getting out of whack and give us an idea how resolvable the situation is or not. And then we even haven't touched on the effects of "**Oba-no-care**" which will increase personal debt for a lot of Americans seeing their annual medical insurance premiums double or even more. Indebtedness is still increasing instead of declining and we are heading for the wall.

In a recession the private sector normally leads in debt reduction whilst government debt continues to rise, due to recession. However, history shows that, under the right conditions, private sector deleveraging leads to renewed economic growth and then public-sector debt reduction. Though we don't have the right conditions as illustrated by the fact that despite the worldwide trillions of QE there is no strong and sustained recovery in employment and GDP growth. And in my point of view that is the case because we have passed the tipping point with unrepayable debts that are depressing future growth because of increasing debt servicing costs. Another reason we don't have the right conditions is the distorting effect QE has on the different income bracket groups. The income earners that have no discretionary income are suffering more and more because the primary living needs are getting more expensive as a result of the QE whilst only the people who have ample discretionary income are benefiting strongly from the asset inflation (\$3trn-\$4trn QE).

Kyle Bass is coming to a similar conclusion about the seriousness of our worldwide debt problem. According to the chart below in 2012 the worldwide debt was in excess of \$220trn up from \$80trn, which has been compounding by some 11% per year since 2002.

**Total Global Credit Market Debt (\$ in Billions)**



**Debt is income brought forward from the future and requires economic growth to be repaid.** Bass asks the question “Do you think the global economy can repay interest and principle over the next 30 or 100 years?” and the answer of course is NO! **How can a global \$72 trillion dollar economy growing 3% to 3.5% (and that is optimistic under the current circumstances) service and repay a \$220trn+ debt (three times as big) growing 11% per annum? It can't.**

If one takes an average 3% interest rate for all debt outstanding one would get to total interest expenses of \$6.6trn or 9.2% of global GDP of \$72trn. If let's say average interest rates in 2014 would rise to 4% the interest expense will rise by \$2.2trn or \$2,200bn to \$8.8trn or 11.8% of \$74.5trn (\$72trn +3.5% assumed GDP growth = \$74.5trn)!! Considering Debt/GDP is \$220trn/\$72trn or 305% it means that if interest rates rise by 100 bp (1%) or \$2.2trn that world GDP (\$72trn) needs to grow by at least \$2.2trn or 3.05% (1% of 305%) to \$74.2trn just to meet additional interest payments and then we virtually don't have any room (\$74.5trn - \$74.2trn or \$0.3trn/\$300bn) for any new expenditures or repayments. And that is all excluding the yearly 11% debt growth and even if it is included you understand the math. Anyway it is clear defaults and/or hyperinflation will be inevitable (see the outcome of the recent IMF study here below)!

**Even the IMF is now finally coming to the insight that we are all in the same boat with now also “developed” countries in danger of default and need of haircuts**

Debt burdens in even developed nations have become extreme by any historical measure, as mentioned here above, and will require a wave of haircuts, warns an IMF paper. **Much of the Western world will require defaults, haircuts, a savings tax and higher inflation to clear the way for recovery as debt levels reach a 200-year high, according to a new report by the International Monetary Fund.**

“The size of the problem suggests that restructurings will be needed, for example, in the periphery of Europe, far beyond anything discussed in public to this point,” said the paper, by Harvard professors Carmen Reinhart and Kenneth Rogoff (both ex IMF employees).

The paper said policy elites in the West are still clinging to the illusion that rich countries are

different from poorer regions and can therefore chip away at their debts with a blend of austerity cuts, growth, and tinkering (“forbearance”). The presumption is that advanced economies “do not resort to such gimmicks” such as debt restructuring and repression, which would “give up hard-earned credibility” and throw the economy into a “vicious circle”. The “overly or unrealistic optimistic” assumptions risk doing far more damage to credibility in the end and causes the crisis to drag on, blocking a lasting solution. In my point of view this is part of the political behavior of playing Santa Claus with other peoples money (the taxpayers) whilst not having to take the responsibility for the far-reaching consequences their actions will have for the taxpayers.

While use of debt pooling in the Eurozone has kept at bay massive defaults so far, it comes at the cost of higher burdens for northern taxpayers who except for Germany now also start to suffer. The fact that the taxpayers aren’t up in arms about these far reaching consequences is an expression of diffusion of responsibility, a socio-psychological phenomenon whereby a person is less likely to take responsibility for action or inaction when others are present. It is considered a form of attribution whereby the individual assumes that others either are responsible for taking action or have already done so. The phenomenon tends to occur in groups of people above a certain critical size and when responsibility is not explicitly assigned. It rarely occurs when the person is alone and diffusion increases with groups of three or more. Hence why politicians can get away with their incompetent decisions till there is revolt.

Anyway the sharing of the burden could drag the EMU core states into a recession and aggravate their own debt and ageing (read entitlement and loss of productivity) crises. Throwing good money after bad money. The clear implication of the IMF paper is that Germany and the creditor core would do better to bite the bullet on big write-offs immediately rather than buying time with sharing debt. The paper says the Western debt burden is now so big that rich states will need same tonic of debt haircuts, higher inflation and financial repression - defined as an “opaque tax on savers” - as used in countless IMF rescues for emerging markets. Cyprus here we come!

Most advanced states wrote off debt in the depression during the 1930s, though in different ways. First World War loans to the US were forgiven when the Hoover Moratorium expired in 1934, giving debt relief worth 24p% of GDP to France, 22% to Britain and 19% to Italy. The US itself imposed haircuts on its own creditors worth 16% of GDP in April 1933 when it abandoned the Gold Standard. In other words it happened before and also in the USA! So don’t exclude this option and don’t believe it won’t happen in the US.

Financial repression can take many forms, including capital controls, interest rate caps or the force-feeding of government debt to captive pension funds (Argentina) and insurance companies. Some of these methods are already in use but not yet on the scale seen in the late 1940s and early 1950s as countries resorted to every trick to tackle their war debts. The policy is essentially a confiscation of savings, partly achieved by pushing up inflation while rigging the system to stop markets taking evasive action. The UK and the US ran negative real interest rates of -2% to -4% for several years after the Second World War. Real rates in Italy and Australia were -5%. Considering that the top 10% earners (earning more than \$123,136 annually) pay in excess of 68% of the total income tax revenues any additional tax burden could force them to give up their US citizenship and thus only make things worse. Times have

changed and so has the mobility of top earners.

**BIS veteran Mr. William White says global credit excess worse than pre-Lehman and there are very good reasons to listen to him!**

According to an article in The Telegraph by Ambrose Evans-Pritchard on 15 Sep 2013 extreme forms of credit excess across the world have reached or surpassed levels seen shortly before the Lehman crisis five years ago, the Bank for International Settlements has warned.

The Swiss-based 'bank of central banks' said a hunt for yield was luring investors en masse into high-risk instruments, "a phenomenon reminiscent of exuberance prior to the global financial crisis". This is happening just as the US Federal Reserve prepares to wind down stimulus and starts to drain dollar liquidity from global markets, an inflexion point that is fraught with danger and could go badly wrong. "This looks like to me like 2007 all over again, but even worse," said William White, the BIS's former chief economist, famous for flagging the wild behavior in the debt markets before the global storm hit in 2008. "All the previous imbalances are still there. Total public and private debt levels are 30% higher as a share of GDP in the advanced economies than they were then, and we have added a whole new problem with bubbles in emerging markets that are ending in a boom-bust cycle," said Mr. White, now chairman of the OECD's Economic Development and Review Committee. Again the most important part of White's quote in my opinion is "nothing has changed" and he also emphasizes things have only got worse but they have been masked so far by the performance of the bond, stock and housing markets which represent a fake confidence building exercise.

The BIS said in its quarterly review that the issuance of subordinated debt -- which leaves lenders exposed to bigger losses if things go wrong (because of forced sales to meet debt obligations)-- has jumped more than threefold over the last year to \$52bn in Europe, and jumped tenfold to \$22bn in the US. The share of "leveraged loans" used by the weakest borrowers in the syndicated loan market has jumped to an all-time high of 45% ten percentage points higher than the pre-crisis peak in 2007-2008. In my view a clear expression of misplaced confidence.

The BIS said interbank credit to emerging markets has reached the "highest level on record" while the value of bonds issued in off-shore centers (Caymans, the Antilles, Hong Kong, Cyprus, Malta, etc.) by private companies from China, Brazil and other developing nations exceeds total issuance by firms from rich economies for the first time, underscoring the sheer size of the debt build-up in Asia, Latin Africa, and the Mid-East. Claudio Borio, the BIS research chief, said the disturbances in emerging markets since the Fed turned hawkish in May is a warning to investors that they must tread with care when US interest rates start to rise.

**Mr. Borio said nobody knows how far global borrowing costs will rise as the Fed tightens or "how disorderly the process might be". Again I want to remind the readers about the interest rates swaps amounting to in excess of \$400trn which could really create havoc if the changes in interest rates happen too fast.** "The challenge is to be prepared. This means being prudent, limiting leverage, and avoiding the temptation of believing that the market will remain liquid under stress, the illusion of liquidity," he said. I fully agree with Mr. Borio I believe that investors too much believe in the safety net theses that the Fed will not let

adverse situations happen. Though don't be mistaken there are certain numbers and forces the Fed won't be able to control as we almost witnessed in 2008. Bernanke and Paulson both initially didn't have a clue how serious the situation was because they had their "rosy" glasses on.

The BIS enjoys great authority. It was the only major global body that clearly foresaw the global banking crisis, calling early for a change of policy at a time when others were being swept along by the euphoria of the era. Mr. White said the five years since Lehman have largely been wasted, leaving a global system that is even more unbalanced, and may be running out of lifelines. **"The ultimate driver for the whole world is the US interest rate and as this goes up there will be fall-out for everybody. The trigger could be Fed tapering but there are a lot of things that can go wrong.** I very am worried that Abenomics could go awry in Japan, and Europe remains exceedingly vulnerable to outside shocks."

Mr. White said the world has become addicted to easy money, with rates falling ever lower with each cycle and each crisis. "There is little ammunition left if the system buckles again." As I have stated many times in my previous articles when the toolbox is exhausted there is nothing left that will come to the rescue but a breakdown of the system! This could be very dangerous because it will rip the fabric apart that is keeping the society together. Especially in the context of the breakdown of the different income groups of US society where the bottom 50% or over 68 million US households live on an AGI (adjusted gross income) of \$35,000 or less. This is telling given the rising costs of college education, healthcare, real estate, and food. This group pays only 11.55% of all income taxes. The top 10%, who earn \$120,000 or more pay 68% of all income taxes. This is a wealth inequality at levels last seen since the Gilded Age. Again the balance of things is off the scale.

"I don't know what they will do: Abenomics for the world I suppose, but this is the last refuge of the scoundrel," White said. The BIS quietly scolded Bank of England Governor Mark Carney and his Eurozone counterpart Mario Draghi, saying the attempt to use "forward guidance" to hold down long-term rates by rhetoric alone had essentially failed. "There are limits as to how far good communications can steer markets. Those limits have become all too apparent," said Mr. Borio. This is at the crux of the situation we are in which is not supported by fundamentals whilst the politicians keep going on in their old ways endangering the welfare of the population. Instead of analyzing the situation and correcting imbalances they will do everything politicians in general do and that is looking after their own interest first i.e. make sure they get reelected and thus not make the necessary tough choices looking after the long term interests of the people they represent.

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