

QEs, Currency Wars, Trillion Dollar Coins and “Modern” Inflation

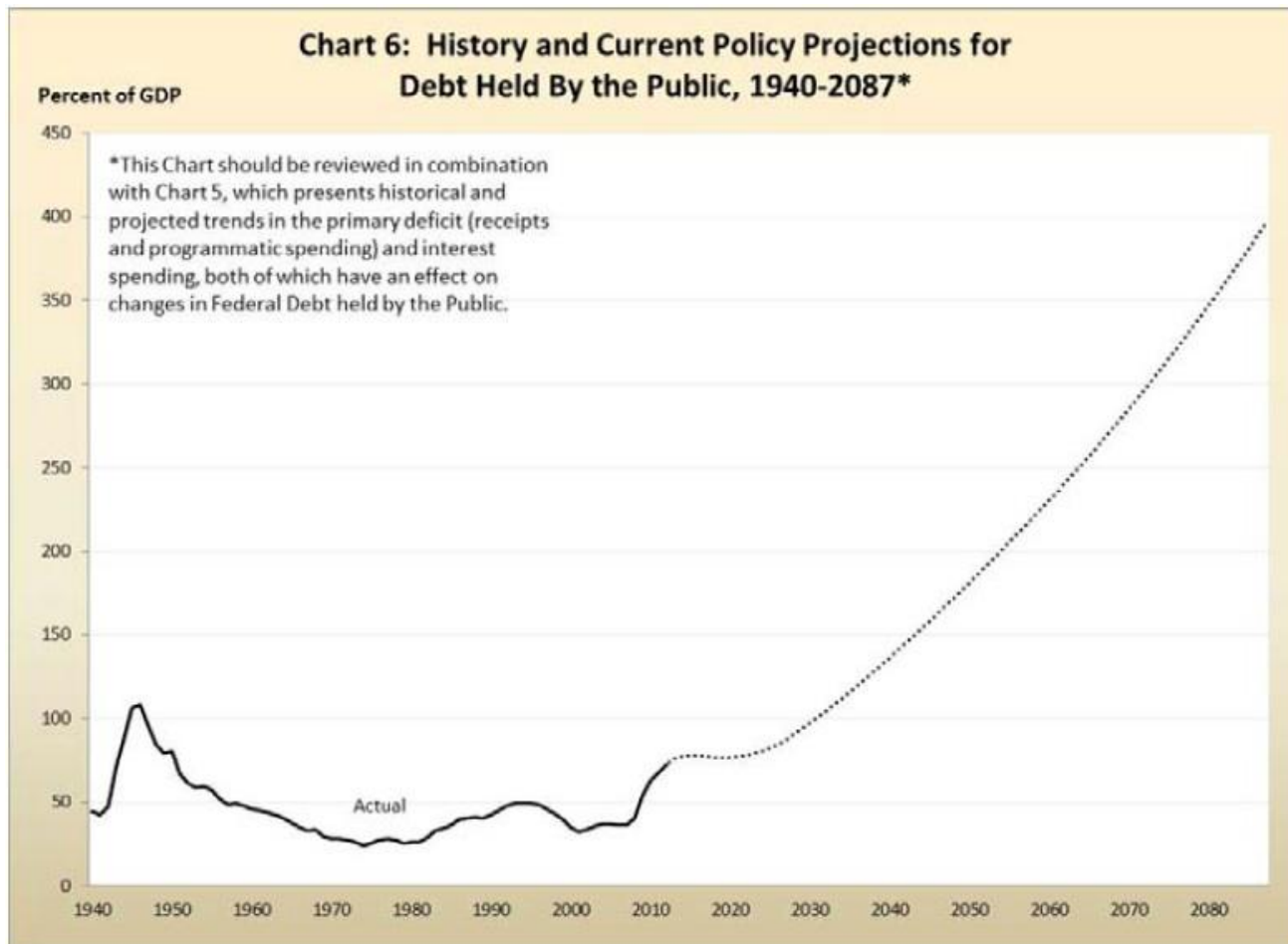
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US Deficits and the Growth of Debt

- The numbers are staggering
- The currency deficit and already accumulated debt is a very small proportion of what is coming down the pike
- The Fiscal Gap estimate of the present value of 75 future years of deficits amounts to \$225 Trillion on an income base of \$15 Trillion
- These amounts are not RECOGNIZED on the books or in the political oratory
- Implications lot of debt to sell well in excess of what is currently outstanding

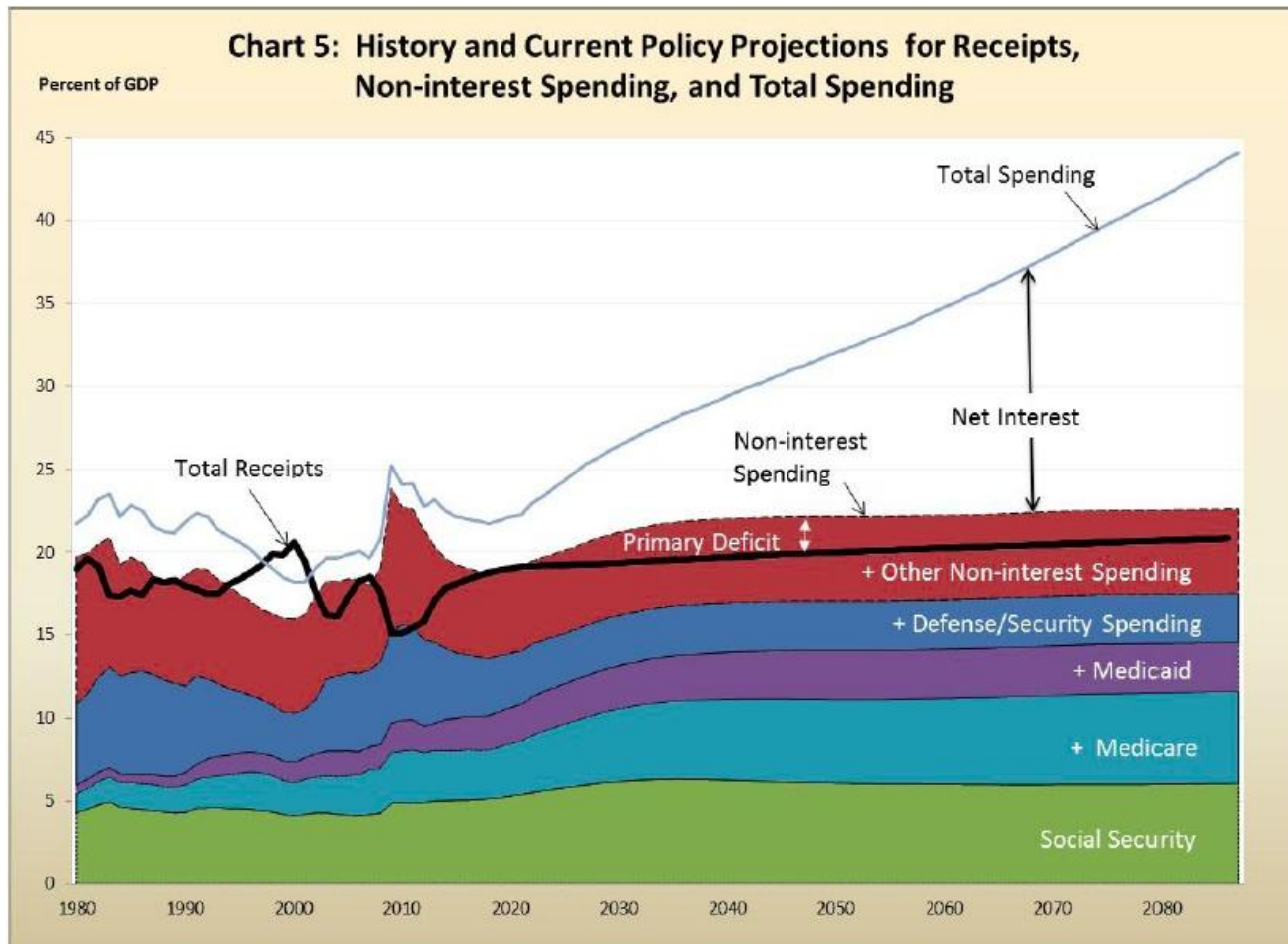
US Debt Projections



Can this debt be sold on the market?

- Mission Impossible: At the margin, annual public purchases of government debt can't be 5 times years the annual saving pool
- Where is the disclaimer regarding past results might not be indicative of future results?
- Worse yet, if gov't debt were sold on the market the interest carry could not be afforded, even with higher tax rates

Interest Cost of Large Scale Deficits



Costless Financing Options all come down to money

1. Federal Reserve monetization of Treasury debt
2. Trillion dollar coin
3. Treasury Currency: The United States Note
4. Silver Certificates

Fed Monetization: The Balance Sheets



Direct Monetization

Treasury		Federal Reserve	
A	L	A	L
\$	T	T	\$

Consolidated Government

A	L
"IH 35s"	\$

Interest Cost Largely Negated

- Annual Rebate of Fed Net Revenue back to Treasury (past year \$89 Billion)
- The exploding interest expense that took down Greece debt will not happen, if debt is held by US central bank and interest is reimbursed
- This is the value of being able to borrow in debt denominated in a currency you can print
- Not true for Greece, Argentina or California

Trillion Dollar Coin: Same Result

- Can replace Treasury debt with anything that is a legal issuance of the Treasury
- Came up in the context of the debt ceiling as a substitute for Treasury debt which has a ceiling
- Under seignorage power authority “the Secretary of the Treasury may mint and issue platinum coins in such quantity and of such variety as the Secretary determines to be appropriate.”
- Consolidated balance sheets are the same and there is no interest to be paid

The Treasury Currency Option: Civil War Edition



Treasury Currency Option: Today's Version



Open Market Purchases by Fed



Fed Open Market Purchases

Fed		Investors	
A	L	A	L
T	\$	T	
		\$	
		Debt	
		Equity	
		Real Assets	
		Foreign Assets	

New Financial Market Liquidity Looks for New Home

- As investors select domestic assets there are liquidity driven market prices
- Potential for Boombustology
- If investors select foreign assets the plot gets thicker
- Foreign currencies become more expensive and as a result so do their exports to the US
- Those countries don't wish to have a deteriorating trade positions
- Result: "Intervention" in foreign exchange market to improve their trade positions
- Means sell their currency and buy US Dollars

Currency Intervention



Foreign Central Bank Intervention

A

L



Treasuries
(Official Purchases)

Home
Currency

Intervention Implications

- Foreign central banks sell their currency to keep their currency competitive (cheap) in order to export
- **This is called a currency war: a fight for the cheapest currency**
- There are 20 interventionists ranging from low labor cost emerging nations to developed countries to energy and commodity exporters
- Now Japan has joined in with a vengeance
- Furthermore, foreign central bank expansions have domestic commercial bank expansions to further increase money and credit
- Even more liquidity directed to goods and financial markets (asset bubbles)

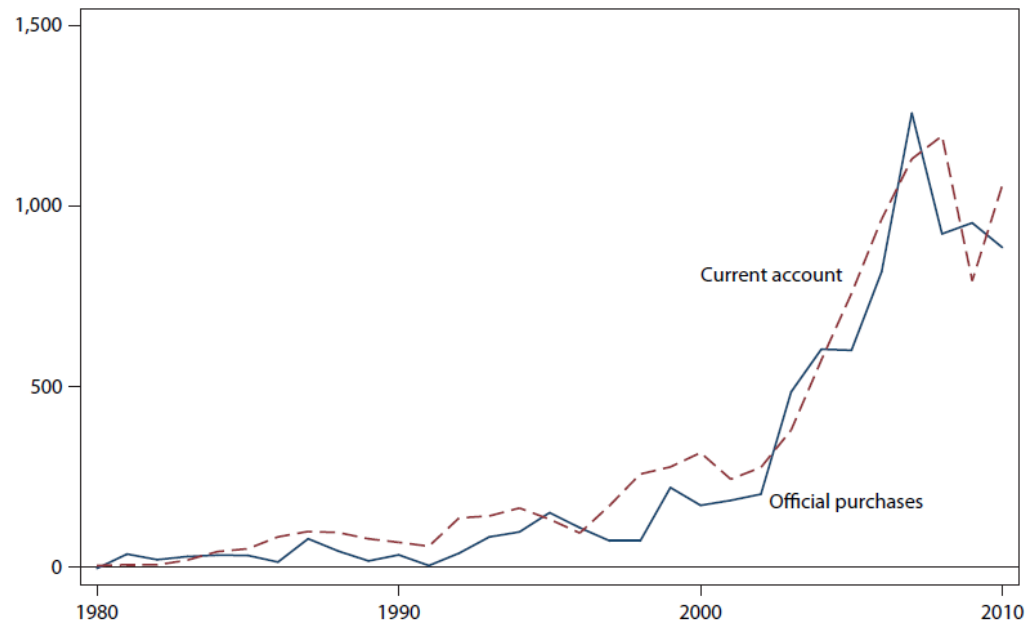
Currency Wars Work (in the short run)

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Figure 1 External balances of currency manipulators, 1980–2010

billions of US dollars

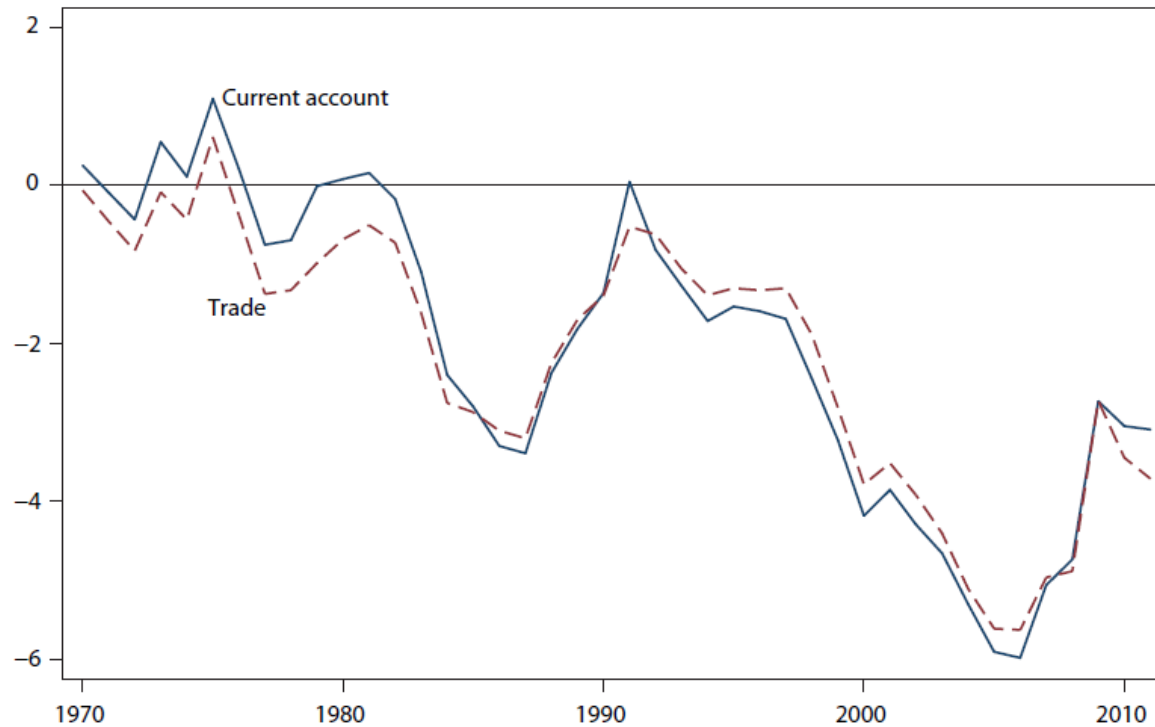


Sources: IMF, *International Financial Statistics* and *World Economic Outlook* databases; Truman (2011, table 1); central bank and finance ministry websites of countries in table 1.

Currency Wars Cost the US

Figure 2 US current account and trade balances, 1970–2011

percent of GDP



Source: IMF, *International Financial Statistics* database.

US Turns the Other Way

- There is no WTO complaint over manipulation and resulting trade deficits
- Because the interventionists use the dollars purchased on the Forex market to, in turn, purchase additional Treasuries
- This adds to our ability to finance the US deficit but in this case with an interest cost

Putting It All Together

- ***Short term US benefits of being able to finance government spending without more taxes to cover debt service***
- Most in Washington do not see beyond that benefit
- But, US money increase is more than matched by foreign money increases and more than matched by foreign commercial bank expansions
- **There is a global money supply multiplier that is very large as a result of the ramped up response to US monetary expansion**

The “Modern” Inflation Route

- US Treasury/Fed Operations force foreign central bank expansions and the inflation will hit abroad first
- The US imports foreign goods at higher prices and inflation travels here
- How long until inflation depends on rate of absorbing global resources (3% global slack, 5% US slack)
- Likely 2 to 3 years

The Cost of QEs

- The currency war causes the US to continue to lose in trade so economy stays 3 to 4% below where it should be (\$300 to \$500B/year)
- Continued loss of global market share of goods at the cost of 3-5 million unemployed
- Economy stays sluggish and piles up larger fiscal deficits
- But “social security” checks go out and not based on taxes raised

Summary: Short Term Gain and Long Term Pain

- Fountainhead of money comes from US (the QEs) and more than matched abroad: Results in global money supply multiplier (both central banks and commercial banks)
- US central bank and foreign central banks purchase Treasuries in large numbers
- Currency interventions stop the dollar depreciation relative to other currencies but ramp up the potential global inflationary threat to fixed income and currency holdings
- **Currency wars imply the world looks for an alternative reserve currency**
- Skittish investors are looking at alternatives

When does the global money supply multiplier produce inflation?

- It's demand side stimulus on steroids
- Mostly stimulating the interventionist countries especially those with solvent banking systems
- That is, we force expansionary monetary policy on both their central banks and commercial banks
- We import their inflation
- **When inflation depends on running out of global excess supply capacity (best guess 2 to 4 years)**

The Wild Card Opportunity

- High return to a country to provide the market test for a safe reserve currency by not monetizing or intervening
- Capital will flow in and like Brazil can have a capital inflow tax
- Reserve currency candidates
 - UK
 - Canada
 - China
 - Texas, if it were to secede
 - If, none of the above gold by itself or as a partial solution

Conclusions

- This is the outer limit of demand side policies
- Sustaining growth and fiscal commitments better served by doing everything possible to incenting entrepreneurship – that is winning the global production war with efficiency
- We are in for Boombustology: few years of boom and over investment in favored sectors such as housing again or perhaps energy
- Ultimately US citizens flee paper currency in general, the dollar and gravitate to another non-inflating country and commodity money
- Constraints already being erected to prevent this
- Exit taxes, reporting of global wealth holdings etc.
- Better act now for global diversification and wealth preservation

US Pre-emptive Steps

- Capital outflow restrictions already in progress for US citizens
- Exit tax for US citizens
- Foreign asset reporting, etc.

Follow up discussion of individual options

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- Lewis.Spellman@McCombs.utexas.edu
- **the Spellman Report**
Where the Economy and Markets Meet