The Budget Crisis, Treasury Bonds and the US Dollar: Breakdown of the Global Economic, Financial and Monetary System

By Global Europe Anticipation Bulletin
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The 15 September 2010, GEAB N°47 issue was headed « Spring 2011: Welcome to the United States of Austerity / Towards the very serious breakdown of the world economic and financial system ». Yet at the end of summer 2010, most experts believed first, that the debate on the US budget deficit would remain a mere subject of theoretical discussion within the Beltway (1) and secondly, that it was unthinkable to imagine the United States engaging in a policy of austerity because it was sufficient for the Fed to continue to print dollars. Yet, as everyone has been able to see for several weeks, Spring 2011 really did bring austerity to the United States (2), a first since the Second World War and the setting up of a global system based on the ability of the US engine to always generate more wealth (real from 1950 to 1970, increasingly virtual thereafter).

At this stage, LEAP/E2020 can confirm that the next stage of the crisis will really be the "Very Serious Breakdown of the world economic, financial and monetary system" and that this historic failure will occur in autumn 2011 (3). The monetary, financial, economic and geopolitical consequences of this "Very Serious Breakdown" will be of historic proportions and will show the crisis of autumn 2008 for what it really was: a simple detonator.

The crisis in Japan (4), the Chinese decisions and the debt crisis in Europe will certainly play a role in this historic breakdown. On the other hand we consider that the issue of government debt of countries on Euroland's periphery is no longer the dominant European risk factor here, but it is the United Kingdom which will find itself in the position of the "sick man of Europe" (5). The Eurozone has in fact established and keeps improving all the monitoring systems needed to address these problems (6). Management of the Greek, Portuguese and Irish problems will therefore take place in an organized fashion. That private investors must take a haircut (as anticipated by LEAP/E2020 before summer 2010) (7) does not belong to the category of systemic risks, displeasing the Financial Times, the Wall Street Journal and Wall Street and City experts, trying every three months to rerun the "coup" of the early 2010 Eurozone crisis (8).

In contrast, the United Kingdom has completely missed its attempt at "preventive budgetary amputation surgery" (9). In fact, under pressure from the street and particularly more than 400,000 British who roamed the streets of London on 03/26/2011 (10), David Cameron is forced to lower his target for reducing health care costs (a key point of his reforms) (11). At the same time, the Libyan military adventure has also forced him to rethink his goals for Defense Ministry budget cuts. We already mentioned in the last GEAB issue that the British government's financing needs continue to rise, reflecting the ineffectiveness of the measures announced whose implementation is proving very disappointing in reality (12). The only result of the Cameron / Clegg (13) duo policy is currently the relapse of the British economy into recession (14) and the obvious risk of the ruling coalition imploding after the next referendum on electoral reform.

In this issue, our team describes the three key factors that mark out this Very Serious Breakdown of autumn 2011 and its consequences. Meanwhile, our researchers have begun to anticipate the progression of the Franco-Anglo-American military operation in Libya which we believe is a powerful accelerator of global geopolitical dislocation and that it usefully illuminates some of the current tectonic changes in the relationships between major world powers. In addition to our GEAB $ index, we expand on our recommendations for dealing with the dangerous quarters to come.

Basically, the process that is unfolding before our eyes, of which the US entry into an era of austerity (15) is a simple budgetary expression, is a continuation of the balancing of the 30 trillion of ghost assets which had invaded the global economic and financial system in late 2007 (16). While about half of them had disappeared in 2009, they have been partially resurrected since then due to the volition of the major global central banks, and the US Federal Reserve in particular and its “QE 1 and 2”. Our team considers, therefore, that 20 trillion of these ghost assets will go up in smoke beginning autumn 2011, and very brutally, under the combined impact of the three US mega-crises in accelerated gestation:

. the budgetary crisis, or how the United States plunges willingly or by force into this unprecedented austerity and takes whole swathes of the global economy and finance with it

. the crisis in US Treasury bonds, or how the US Federal Reserve reaches the “end of the road” which began in 1913 and must face up to its bankruptcy whatever accounting sleight of hand is chosen

. the US Dollar crisis, or how the jolts in the US currency that will characterize the ending of QE2 in the second quarter of 2011 will be the beginnings of a massive devaluation (around 30% in a few weeks).

Central banks, the global banking system, pension funds, multinationals, commodities, the US population, Dollar zone economies and/or dependent on trade with the United States (17) … everyone structurally dependent on the US economy (of which the government, the Fed and the federal budget have become central components), assets denominated in dollars or commercial dollar transactions, will suffer the head on shock of 20 trillion in ghost assets purely and simply disappearing from their balance sheets, from their investments, and causing a major decline in their real incomes.

Remittance of funds by US immigrant workers to their countries of origin (first number in local currency at the dollar exchange rate end 2008/second number: the same, at the exchange rate end 2010) – Source: Wall Street Journal, 04/2011

Around the historic shock of autumn 2011 which will mark the definitive confirmation of significant trends anticipated by our team in previous GEAB issues, the main asset classes will experience major upheavals requiring the increased vigilance of all players concerned for their investments. In fact, this triple US crisis will mark the true exit from the “world after 1945” which saw the US play the role of Atlas and will, therefore, be marked by many shocks and aftershocks in the quarters which follow.

For example, the dollar may experience short-term effects of strengthening value against the major world currencies (especially if US interest rates rise very quickly following the ending of QE2), even if, six months after that, its 30% loss of value (relative to its current value) is inevitable. We can, therefore, only repeat the advice that has appeared at the head of our recommendations since the beginning of our work on the crisis: in the context of a global crisis of historic proportions like the one we are experiencing, the only rational objective for investors is not to make more money, but to try to lose as little as possible.

This will be particularly true for the coming quarters where the speculative environment will become highly unpredictable in the short term. This short term unpredictability will be particularly due to the fact that the three US crises that trigger Very Serious Breakdown in the world in autumn are not concurrent. They are very closely correlated but not linearly. And one of them, the budget crisis, is directly dependent on human factors with a big influence on the timing of the event; whilst the other two (whatever those who see the Fed officials as gods or devils think (18)) are now, for the large part, included in the significant trends where US leaders' actions have become marginal (19).

The budget crisis, or how the United States plunges willingly or by force into this unprecedented austerity and takes whole swathes of the global economy and finance with it

The numbers can make the head spin: "6 trillion in budget cuts over ten years" (20), said the Republican Paul Ryan, "4 trillion in twelve years" retorted the 2012 candidate Barack Obama (21), "all this is far from sufficient", bids one of the Tea Party referents, Ron Paul (22). And anyway, sanctions the IMF, "the United States is not credible when it speaks of cutting its deficits" (23). This unusually harsh remark from the IMF, traditionally very cautious in its criticism of the United States, is in any case particularly justified in terms of the psychodrama which, for a fistful of tens of billions of dollars, nearly shut down the federal state absent any agreement between the two major parties, a scenario that will, moreover, soon take place again over the federal debt ceiling.

The IMF is only expressing an opinion widely shared by creditors of the United States: if, for a few tens of billions USD in deficit reduction, the US political system reached that degree of paralysis, what will happen when, in the coming months, cuts of several hundred billion dollars a year will be required? Civil war? This is the new California governor Jerry Brown (24) opinion in any case, who believes that the United States is facing a regime crisis identical to that which led to the Civil War (25).

Public and private sector borrowing (1979 – 2010) (in red: public/in blue: private) – Source: Agorafinancial, 04/2011

The context, therefore, is no longer mere paralysis but really an all-out confrontation between two visions of the country's future. The closer the date of the next presidential election gets (November 2012), the more the confrontation between the two sides will intensify and take place regardless of any rule of good behaviour, including safeguarding the country's common good: "Whom the gods would destroy they first make mad", says the ancient Greek proverb. The Washington political scene will increasingly resemble a psychiatric hospital (26) in the coming months, making "the bizarre decision" increasingly likely. If, in order to reassure themselves about the dollar and Treasury bonds, Western experts repeat in turn that the Chinese would be crazy to get rid of these assets which would thus only hasten their fall in value, it's that they haven't yet understood that it's Washington and its political mistakes that can come to the decision that hastens this fall. And October 2012, with its traditional annual budget vote, will be the ideal moment for this Greek tragedy which, according to our team, won't have a happy ending because this isn't Hollywood, but really the rest of the world which will write the scenario's sequel.

Whatever the case, by political choice, by closing down the federal government or by irresistible outside pressures (27) (interest rates, IMF + Euroland + BRIC (28)), it is really in autumn 2011 that the US federal budget will massively shrink for the first time. The continuation of the recession coupled with the ending of QE2 will cause interest rates to rise and thus significantly increase federal debt servicing costs, against a backdrop of falling tax revenues (29) caused by a relapse into a deep recession. Federal insolvency is now just round the corner according to Richard Fisher, president of the Federal Reserve Bank of Dallas (30).

Read more in GEAB:

. The budgetary crisis, or how the United States plunges willingly or by force into this unprecedented austerity and takes whole swathes of the global economy and finance with it
. The crisis in US Treasury bonds, or how the US Federal Reserve reaches the "end of the road" which began in 1913 and must face up to its bankruptcy whatever accounting sleight of hand is chosen
. The US Dollar crisis, or how the jolts in the US currency that will characterize the ending of QE2 in the second quarter of 2011 will be the beginnings of a massive devaluation (around 30% in a few weeks)

Notes:

(1) An American term for Washington's politico-administrative heart, situated in the middle of the local ring road, the Beltway.

(2) From grim cuts in the US overseas aid budgets to reductions in social programmes; public organizations and whole sections of the US population (Latinos, the poor, students, retirees, …) will now be severely affected by what is still only a drop in the bucket of adjustments needed. The grassroots demonstrations are beginning with students at the forefront. Sources: House of Resentatives, 04/13/2011; Devex, 04/11/2011; HuffingtonPost, 04/13/2011; Foxnews, 04/14/2011; Foxbusiness, 04/12/2011

(3) The world banking system (including Europe), still under-capitalized and mainly insolvent, is also one of the components of this Very Serious Breakdown of autumn 2011.

(4) In GEAB N°55 our team will give its anticipations on the world nuclear question, using the political anticipation method as a decision-making tool on the subject.

(5) The magnitude of the United Kingdom's budgetary crisis is far more serious than the current British leaders are telling who, however, claim to have told the truth. There are in fact two ways of lying to a people: deny the existence of a problem (the position of Gordon Brown's Labour) or only tell part of the truth (clearly the choice of the Cameron/Clegg pair). In both cases, the problem is not resolved. Source: Telegraph, 03/26/2011

(6) And from now and the definitive establishment of Euroland as the main European engine at the European summit of 11 March last, the four countries that do not participate in the "Euroland +" financial stabilization pact, i.e. the United Kingdom, Sweden, Hungary and the Czech Republic, will be asked to leave the room during discussions on financial and budgetary matters related to the pact. EU Observer of 03/29/2011 describes the panic which then seized the delegations of these four countries whose leaders play the thugs in front of the media and in speeches intended for their respective public opinion, but they well know they are now confined to a second-rate European role.

(7) Source: Irish Times, 03/22/2011

(8) A very pertinent and very amusing must read article by Silvia Wadhwa, CNBC's European correspondent, which makes fun of the caricatural anti- Euroland and anti-German articles of his colleagues in other Anglo-Saxon media, and rightly points out that differences in economic situations are bigger between US states than within Euroland and the debt problems of Greece or Portugal are nothing compared to those of a state like California. Source: CNBC, 04/12/2011

(9) We will come back to the British case in more detail in the GEAB N°55, barely a year after the Conservative/LibDem victory.

(10) This protest against cuts is the largest demonstration in London for over twenty years and has been accompanied by serious violence against "symbols of wealth" with attacks against HSBC, the Ritz Hotel and Fortnum & Mason for example. As we have repeatedly emphasized in the GEAB, it is quite significant to note that this historic demonstration in the UK hardly made the headlines and then became invisible 48 hours after it happened. When a few thousand Greeks or Portuguese demonstrate in Athens or Lisbon on the other hand, we are entitled to an avalanche of shocking pictures and comments describing these countries on the brink of chaos. This "two weights and two measures" mustn't deceive the clear-sighted observer. On the one hand, there are serious difficulties that are now managed within a powerful group, Euroland; on the other, there are major problems that can no longer be managed by a completely isolated country. Believe the media or think for yourself to guess the rest! Source: Guardian, 03/26/2011

(11) Source: Independent, 04/03/2011

(12) Moreover the financial markets realize this and no longer really believe the British government's martial message of austerity, again leading to a downward spiral in the British Pound. Source: CNBC, 04/12/2011

(13) Nick Clegg has become the most hated politician in the United Kingdom for having betrayed nearly all his campaign promises one by one. Source: Independent, 04/10/2011

(14) And to push British households into a loss of purchasing power only similar to that of the post-World War I crisis in 1921. Source: Telegraph, 04/11/2011

(15) As the Europeans have done since 2010.

(16) Average estimate by LEAP/E2020 made in 2007/2008.

(17) Beyond traditional foreign trade, the chart below shows the extent of the reduction in transfers to their countries of origin by immigrant workers in the United States, because of

the declining US Dollar. This reduction will increase further from Autumn 2011.

(18) In the US today, the diabolic vision is the most common among public opinion, unlike 2008 when the Fed officials seemed to be the last resort. This psychological change, as we have pointed out, is not meaningless and contributes significantly to limit Fed officials' leeway. And it's not the US Central Bank's historic legal defeat, which forced it to reveal the recipients of hundreds of billions of dollars in aid distributed after the 2008 Wall Street crisis, which will improve this situation, quite the opposite. A little story, revealed by RollingStone magazine, illustrates the US people's worsening grievances against its central bankers: beneficiaries of this Fed aid are two wives of leading Wall Street figures who have created a custom-made instrument allowing them to collect 200 million USD from the Fed to buy failed securities … the profits go to them and the losses to the Fed! Sadly, this is just one example among many that are currently circulating on the Net and have now definitively shattered the respect of US people for its benchmark monetary institution; an explosive situation in the context of the current crisis. Source: Rollingstone, 04/12/2011

(19) The dollar's fate, like US Treasury bonds, is now largely in the hands of operators around the world who will take a very "clinical" look at the exit from QE2 which was forced on the Fed during the second quarter of 2011. It's the Fed's collective opinion (already heavily criticised), not the way it is "presented", which will be decisive.

(20) Source: Politico, 04/04/2011

(21) Source: Boston Herald, 04/13/2011

(22) Source: Huffington Post, 04/11/2011

(23) And all the more so since they continue to break the records of financing needs for their deficits, and that the deficit forecast for the next decade by Obama commitments amounts to 9.5 trillion USD. On one side, he devises policies that increase the deficit, on the other he announces reduction targets… hardly credible, really! Sources: CNBC, 04/13/2011; Washington Post, 03/18/2011

(24) Brown is an original US character with a great deal of political experience having previously served as governor of California from 1975 to 1983, and was twice a candidate for the Democratic Presidential nomination. His opinion on the ruinous state of the US political system is, therefore, not to be taken lightly. Source: CBS, 04/10/2010

(25) For those who find the picture risqué, our team reminds that one of the Civil War's main causes was the irreconcilable vision of what the federal state and its role should be. Today, around budget issues, the role of the Fed, military expenditure and social spending, we are once again seeing the emergence of two diametrically opposed visions of what the federal state should be and what it should do, with its procession of growing institutional blockages and an atmosphere of hatred between political forces. Many illustrations have been given in previous GEAB issues. Source: Americanhistory

(26) How else can one describe people who are barely able, and by dint of repeated crises, to cut a few tens of billions from a budget, and who suddenly announce that tomorrow they will cut thousands of billions of dollars from this same budget? Fools or liars? In any case irresponsible, because the constraints that require these deficit reductions in any case are building up.

(27) Global government debt is at its highest since 1945 and, at 10.8% of GNP, the US has become the leading major country in terms of government deficits. Sources: Figaro, 04/12/2011; Bloomberg, 04/12/2011

(28) Regarding the BRIC countries (now BRICS with South Africa), it is very interesting to note that their third summit, which took place on the Chinese tropical island of Hainan, is finally enjoying significant media coverage from the Western media. We were one of the first and few Western publications to mention the first summit (at Ekaterinburg) three years ago and emphasize the importance of the event, but until now the major international newspapers persisted in considering the BRICs as a simple acronym without serious geopolitical clout. Obviously things have changed. Moreover from Libya to the dollar, the Hainan summit clearly positioned itself as a counterweight to the US and its surrogates (fewer and fewer in this case having regard to what is happening in Libya). As regards the dollar, the BRICs have decided to accelerate the process allowing them to use their own currencies for their trade: another sign that we're rapidly approaching a severe monetary shock. Source: CNBC, 04/14/2011

(29) Those who still believe in an improvement in US economic conditions, beyond the effect of QE2 "doping", should dwell on the moral of the SMEs in the US which have begun to deteriorate significantly and the fiction of the upturn in employment which will be sharply corrected (even in official statistics) from summer 2011. And we refer to previous GEAB issues regarding the fiscal crisis of the federated states. Sources: MarketWatch, 04/12/2012; New York Post, 04/12/2011

(30) Source: CNBC, 03/22/2011

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