



Monetary Policy and Weaseling Out of Debt

Posted by [Gail the Actuary](#) on August 28, 2007 - 3:00pm

Topic: [Economics/Finance](#)

Tags: [balance of payments](#), [debt](#) [[list all tags](#)]

This is some correspondence between me and an individual known here as [Shunyata](#). Shunyata is an individual who is involved with managing financial derivatives. Shunyata's education and careers have spanned several disciplines, including actuarial science, statistics, mechanical engineering, and financial engineering. These have given him a breadth of perspective on the world's financial situation.

Dear Shunyata,

Some of the financial things I have been reading lately are downright alarming.

I keep seeing comments by people concerned that other countries will cut off the US debt spigot.

One concern is the huge amount of sliced and diced debt that has been sold around the world with very questionable assets behind it.

Another is the US Balance of Payments:

<https://www.cia.gov/library/publications/the-world-factbook/rankorder/21...>

A third issue is the extent to which countries are unhappy about the US overstepping bounds militarily.

Any thoughts?

Sincerely,

Gail

Dear Gail,

At the risk of sharing too much opinion, I will speak frankly about my perspective. Of course these are entirely my PERSONAL opinions.

The current prosperity of the US is the same prosperity seen in a person with a large home loan, a large car loan, and a mountain of credit card debt. He's living lavishly and living at the mercy of his creditors. The US is VERY affluent and has a LOT of debt. And taking the Machiavellian view, the US likes spending other people's money and has no wish balance its accounts if it can borrow without genuinely repaying.

How do interest bearing loans get repaid? There are three ways:

1. Devote your future productivity to repaying principal and interest (this is painful and no one wants to think about this).
2. Expand your monetary wealth through efficiency gain (exceedingly difficult) or converting your assets to cash (e.g. pumping oil out of the ground or consuming other endowments).
3. Inflate your way out of debt (more on this, and this scares me the most).

A huge amount of our expanding economy (and hence easy debt repayment) has come from consumption of our natural endowments. You only need to look at the correlation between energy consumption and GDP, both across time and across nations, to see that we have been relying heavily on 'spending the inheritance'. This realization will slowly dawn on us, although not voluntarily, and we will modify our behavior accordingly whether we like it or not. There is a nice graphic comparing a photo of the dark side of earth from space with a map coded for per capita GDP. It shows electric lights (energy consumption) line up exactly with per capita GDP!

The inflation angle is more insidious because we are talking about monetary policy. So long as people think they NEED dollars, the US can print as many as they like and in effect simply print money to pay off its debts. In the '70s we went off the gold standard (so that a dollar's value is based in demand for dollars rather than intrinsic value) and negotiated with the Saudis to trade physical protection from hostile neighbors for an agreement to conduct all oil transactions in dollars. What a coup! Now everyone who needs oil needs dollars and we are all too happy to provide them. (There is evidence/conjecture that dropping the gold standard and establishing dollar-denominated oil was a deliberate, coordinated plan.) Rising oil prices are our friend because we can print more money to pay off our debts and at the same time mitigate the US impact of rising oil prices. After all, there are more dollars floating around to buy it! Why do you think the economy hasn't been crushed by \$70 oil and \$3 gasoline?

This coup is threatened from several fronts:

1. Economically competing countries like China hold vast reserves of these dollars we have been printing. They are also wise to the fact that their dollar reserves are being eroded away by the day as we print more dollars. (The Saudis are also well aware of this. They are effectively only getting \$50/bbl thanks to the diluted dollar.) They have begun selling their dollars thereby reducing the global demand for dollars and our ability to inflate our way out of debt. Heaven help us if we ever really annoy them. They could destroy our country over night by flooding the world with dollars - more certainly than a nuclear strike! In fact, China has leaked military documents to this effect!
2. Several countries are moving to euro-denominated oil bourses - further eroding demand for dollars. The first Iraq invasion was within a few months of Saddam moving

to set up just such a bourse. Iran launched one earlier this year. Unfortunately I'd say a US military reaction is within the realm of likelihood, if not outright probable.

3. The rest of the world is becoming concerned that our currency (and ability to purchase goods or repay debt) could collapse catastrophically. You see comments from various central banks to this effect, although very obliquely.

The net impact is that the dollar has been hemorrhaging furiously for the last year or so. The US and Canadian dollars are virtually one-to-one now! So far this has been an orderly and tame development. But the currency markets are wanton and can move catastrophically with lightning speed. And if our currency collapses we will have no time to even think of a response. Instantly we will lose all global purchasing power and all ability to borrow.

If we are running out of resource endowments and we can't inflate our way out of debt, our only recourse is to tighten our belt and divert our productivity from leisure (and hopefully not subsistence as well) and apply it to debt repayment. I fear interesting times lie ahead.

Regards,

Shunyata

What do you think? My note doesn't mention other issues like the tight oil supply. This is the opinion of one individual. Does this make sense to you? Are there some happy endings that might come out of all of this?



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