RIA Advice

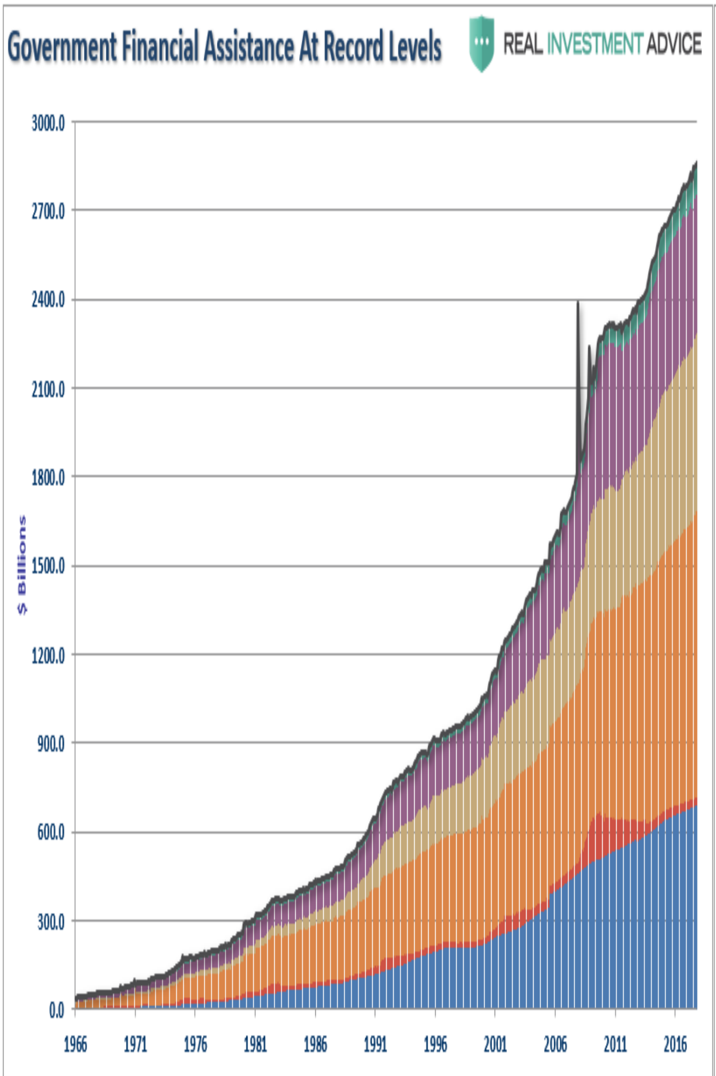
There is an age old fable describing•a frog being slowly boiled alive. The premise is that if a frog is put suddenly into boiling water, it will try and save itself. However, if the frog is put in tepid water which is then brought to a boil slowly, it will not perceive the danger and will be cooked to death. The metaphor is often ascribed to the inability, or unwillingness, of people to react to or be aware of threats which arise gradually rather than suddenly. This metaphor was brought to mind as I was writing last weekend's newsletter discussing the issue of Turkey and the potential threat posed to the global economy. Specifically, I was intrigued by the following points from *Daniel Lacalle*:

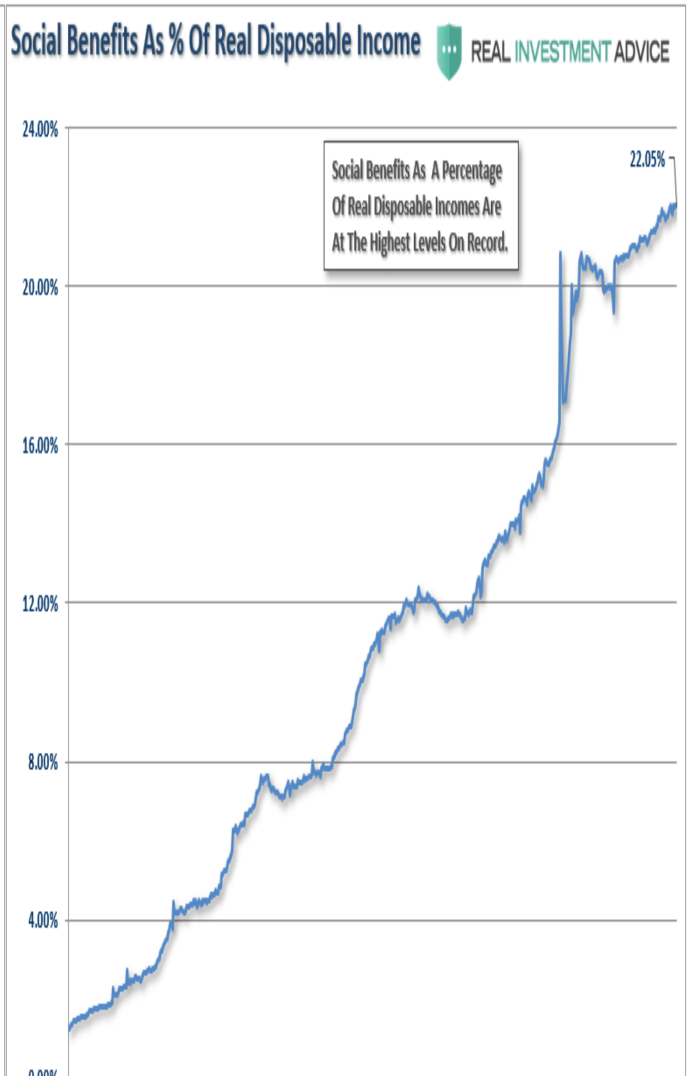
> ***"The collapse of Turkey was an accident waiting to happen and is fully self-inflicted."*** *It is yet another evidence of the train wreck that monetarists cause in economies.* ***Those that say that 'a country with monetary sovereignty can issue all the currency it wants without risk of default' are wrong yet again.*** *Like in Argentina, Brazil, Iran, Venezuela, monetary sovereignty means nothing without strong fundamentals to back the currency. Turkey took all the actions that MMT lovers applaud.•The Erdogan government seized control of the central bank,* ***and decided to***

> ***print and keep extremely low rates to 'boost the economy' without any measure or control.*** *Turkey?s Money Supply tripled in seven years, and rates were brought down massively to 4,5%. However, the lira depreciation was something that was not just accepted by the government but encouraged.•**Handouts in fresh-printed liras were given to pensioners in order to increase votes for the current government, subsidies in rapidly devaluing lira soared by more than 20% (agriculture, fuel, tourism industry) as the government tried to compensate the loss of tourism revenues due to security concerns with subsidies and grants.** Loss of foreign currency reserves ensued, **but the government soldiered on promoting excessive debt and borrowing. Fiscal deficits soared, and the rapidly devaluing lira led to a rising amount of loans in US dollars. This is the typical flaw of monetarists,**•they believe monetary sovereignty shields the country from external shocks and loans in foreign currencies soar because no one wants to lend in a constantly-debased currency at affordable rates. Then the central bank raises rates but the monetary hole keeps rising as the money supply continues to grow to pay for handouts in local currency."*

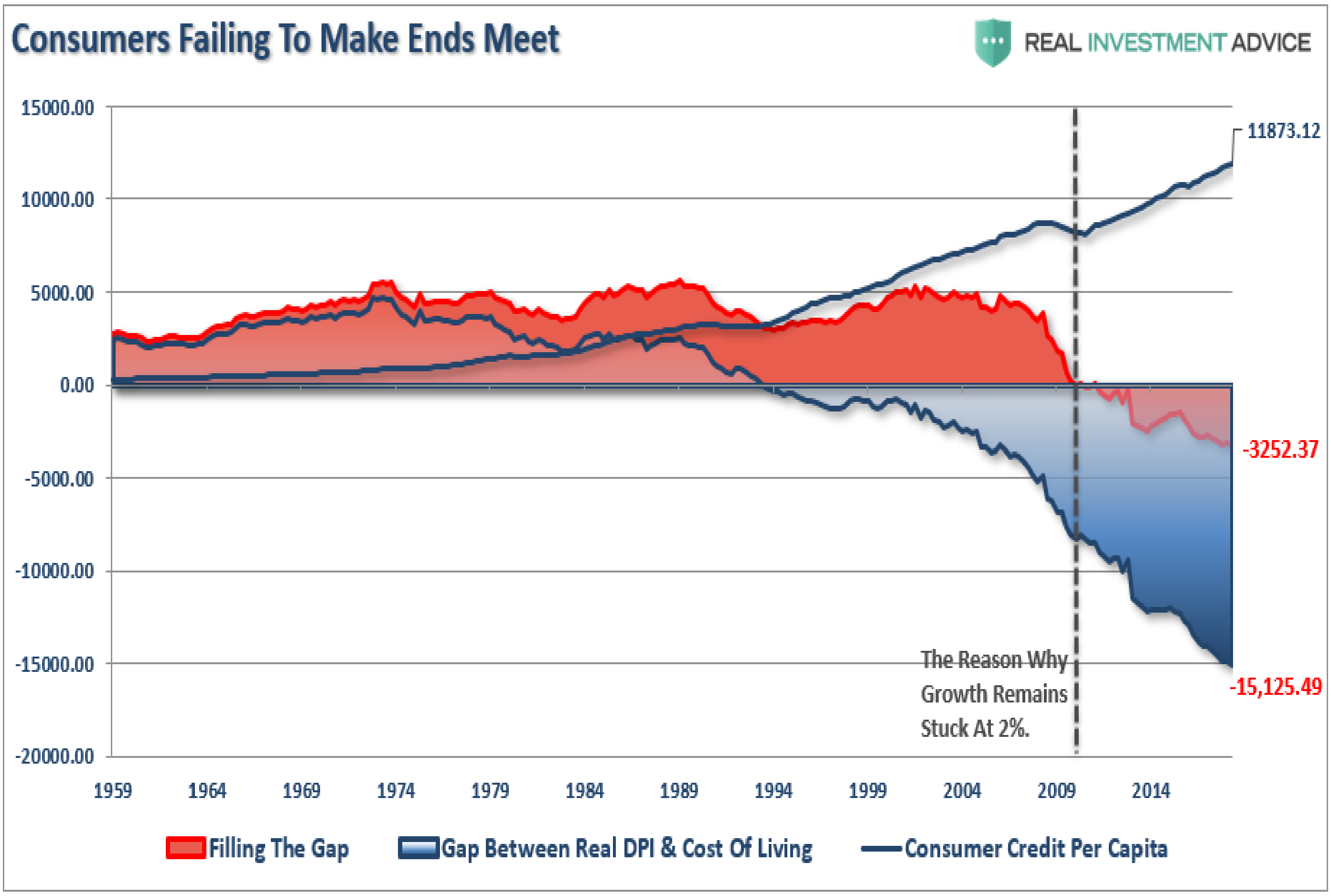
Frog Meets Water•

If any of Daniel's commentary sounds familiar, you shouldn't be surprised. The U.S. has been doing much of the same for the last several decades under the same *faulty Keynesian/MMT set of beliefs.* But, lets make a big distinction, the U.S. is not Turkey. While the U.S. may be vastly different than Turkey in many respects, such doesn't mean pursing the same policies will have a different result. For example, as Daniel notes, Turkey has provided *"handouts"* to secure votes. But the U.S. has done, and continues to do the same thing via programs like *"paid leave," "child tax credits,"* a sm•rg•sbord of welfare and entitlement programs. In fact, government assistance programs now make up a record level of disposable personal incomes as 1-in-4 households depend on some form of government program.

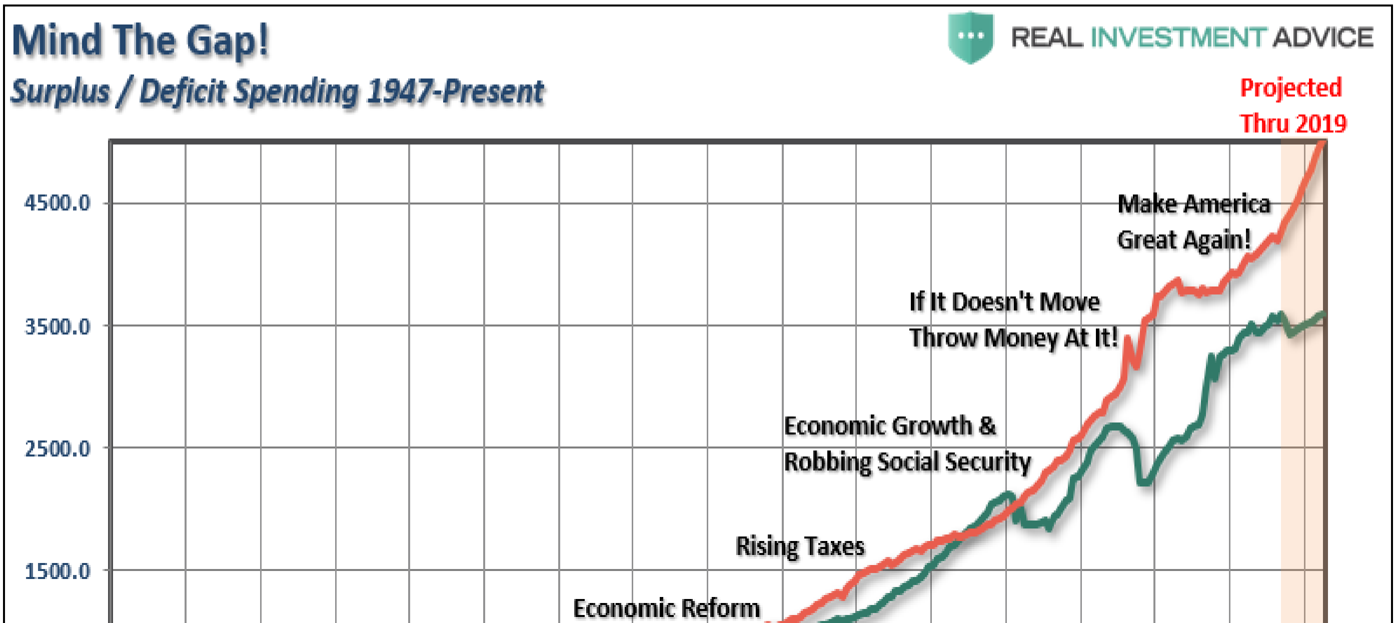




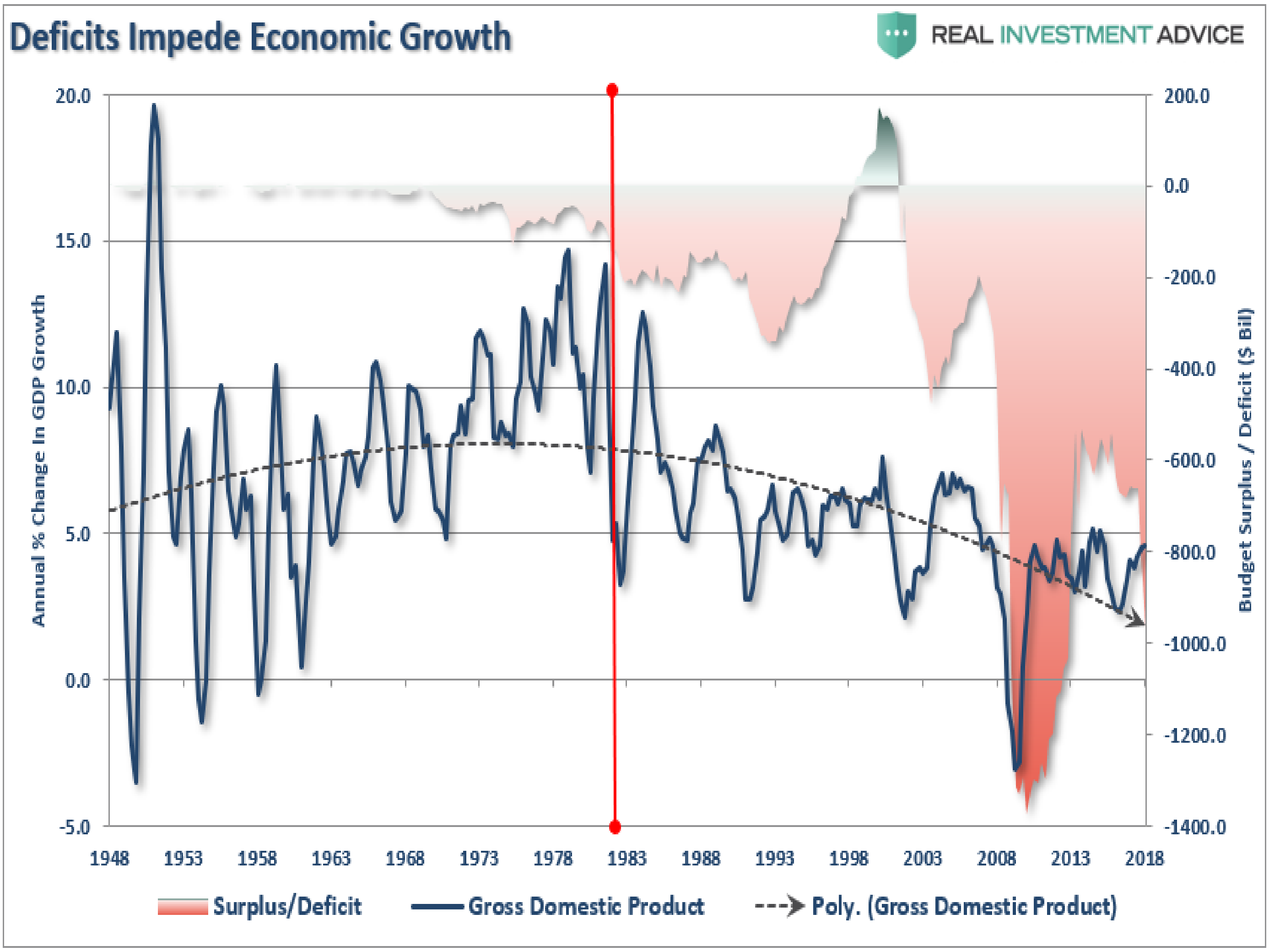
This continued push to provide more governmental assistance, and the rise of *"socialist"* political leanings, should not come as a surprise in an economy where there is an annual deficit of more than $3250 to maintain the standard of living **after** consumers have exhausted wages, savings and credit.



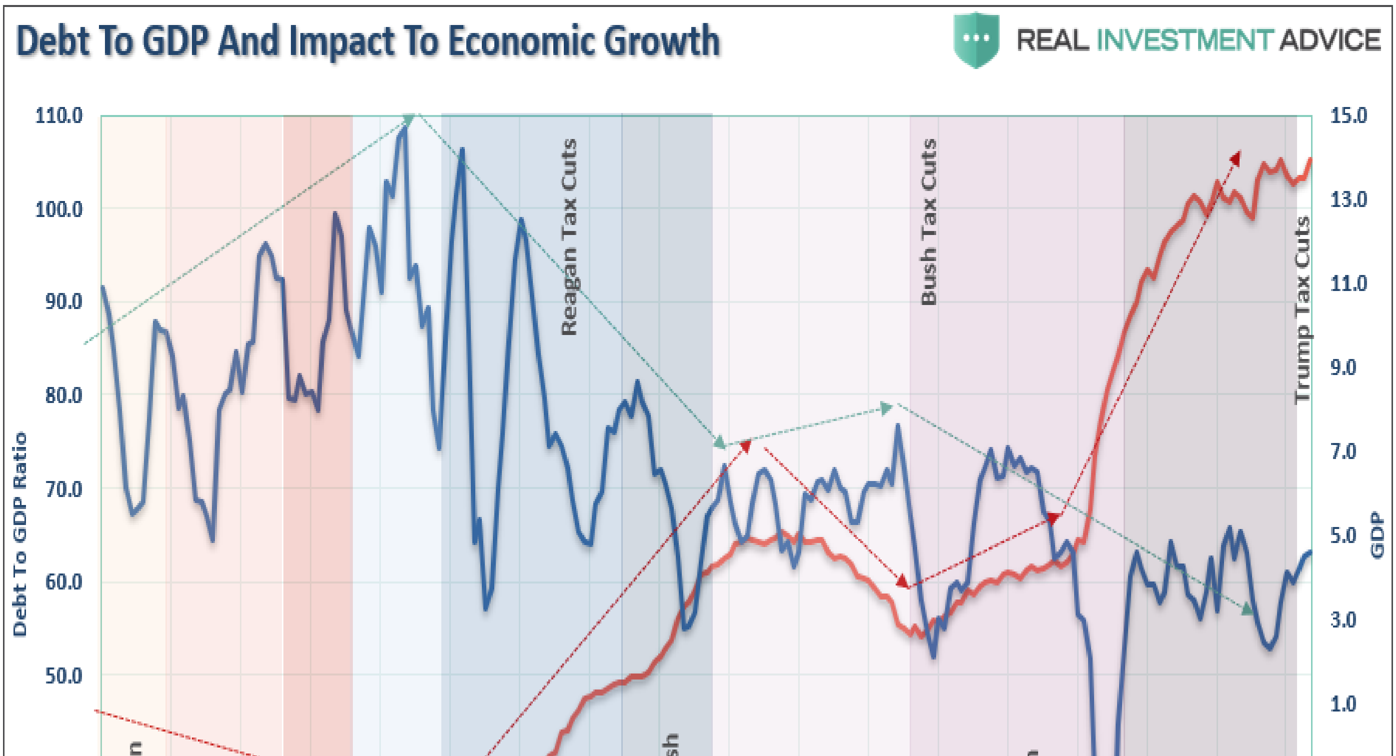
This is not just about securing votes of the less fortunate. For example, military spending, corporate tax cuts and banking de-regulation to name a few examples, help line the pockets of shareholders and corporate executives and certainly influence their voting patterns. Since there is simply not enough tax revenue to fund these programs, the government must rely on debt issuance to fund the shortfall. More importantly, since fiscal policies like *"tax reform"* lower government revenue, when those programs are not offset with real spending cuts, deficits increase more quickly. Despite assurances from the current Administration that tax reform would lead to higher tax revenues and reduce the deficit - it is actually quite the opposite that has occurred. As shown below, spending has surged while tax receipts have stagnated. As a result the deficit is set to explode and the amount of government debt outstanding will increase by over $1 trillion in each of the next four years.



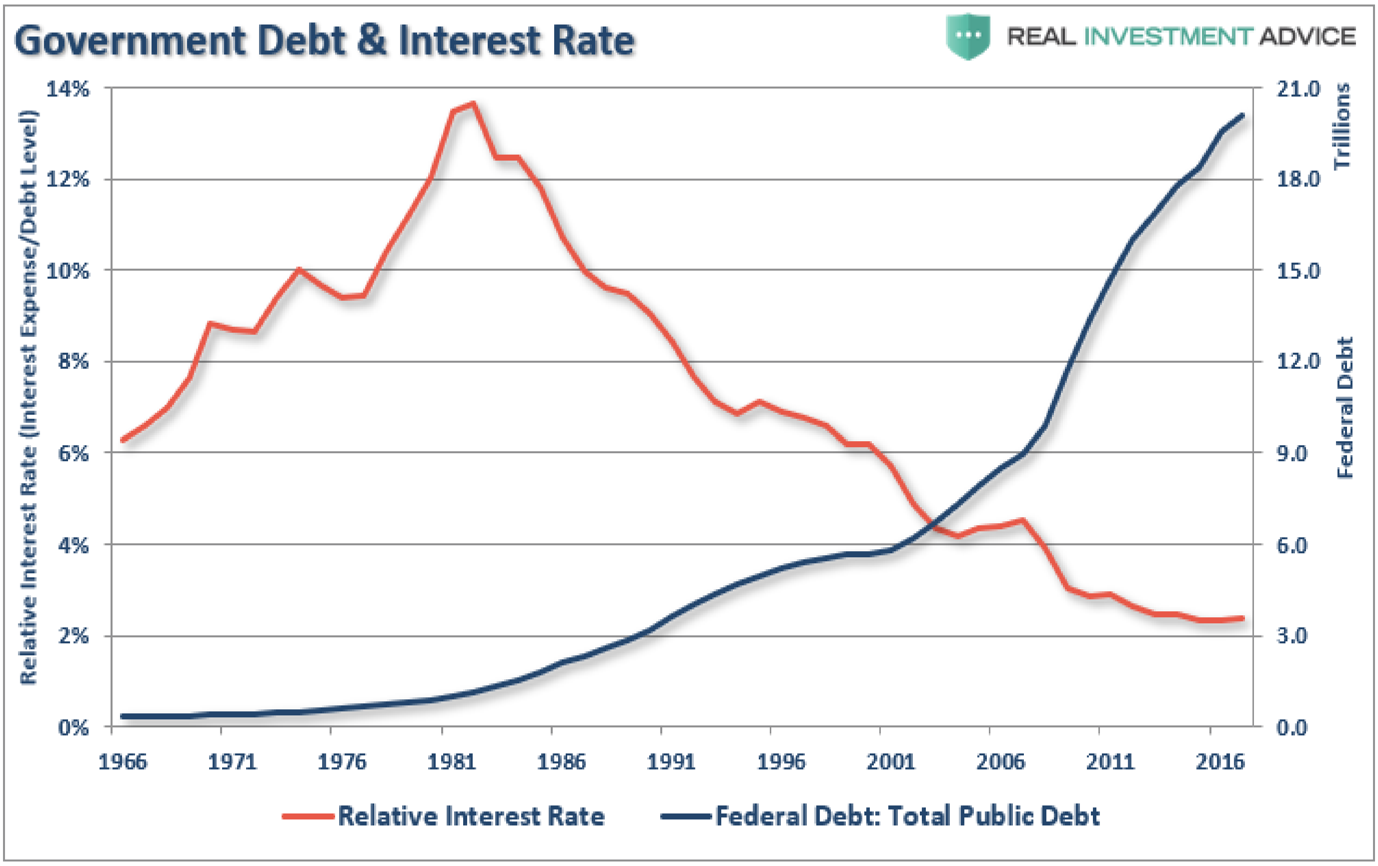
While most modern economists believe that debt and deficits have little to no consequence, the data suggests otherwise. While deficits continue to be a "*talking point*" for conservative politicians wanting to win elections, unbridled spending has become the *"fiscal policy"* of choice. Of course, economic growth has been the ultimate sacrifice. The surge in the deficit in the coming months will reverse the recent spat of economic growth as the boost from a slew of natural disasters last year and tax related boosts fade.

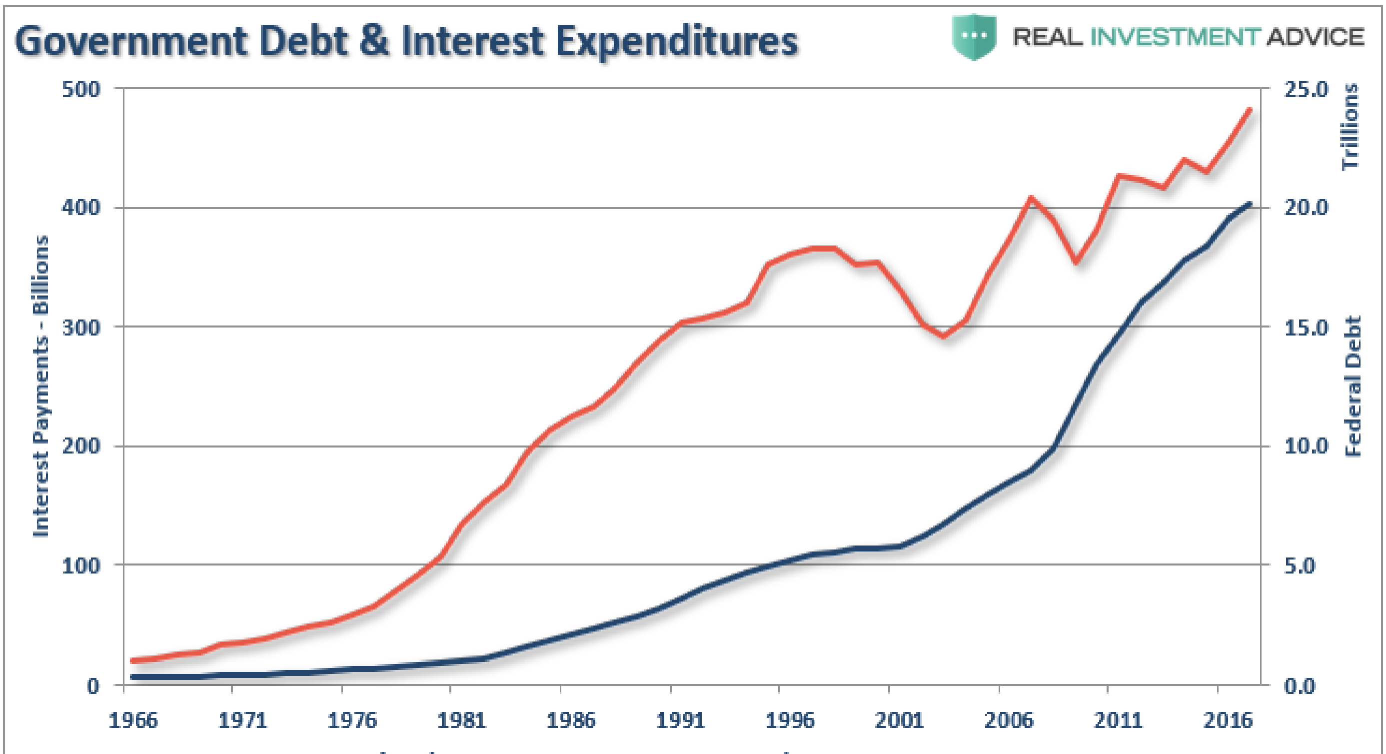


As I stated, in order to fund that spending, the money has to come from either taxpayers or debt issuance. As shown in the next two charts, government debt as percentage of economic growth continues to climb.

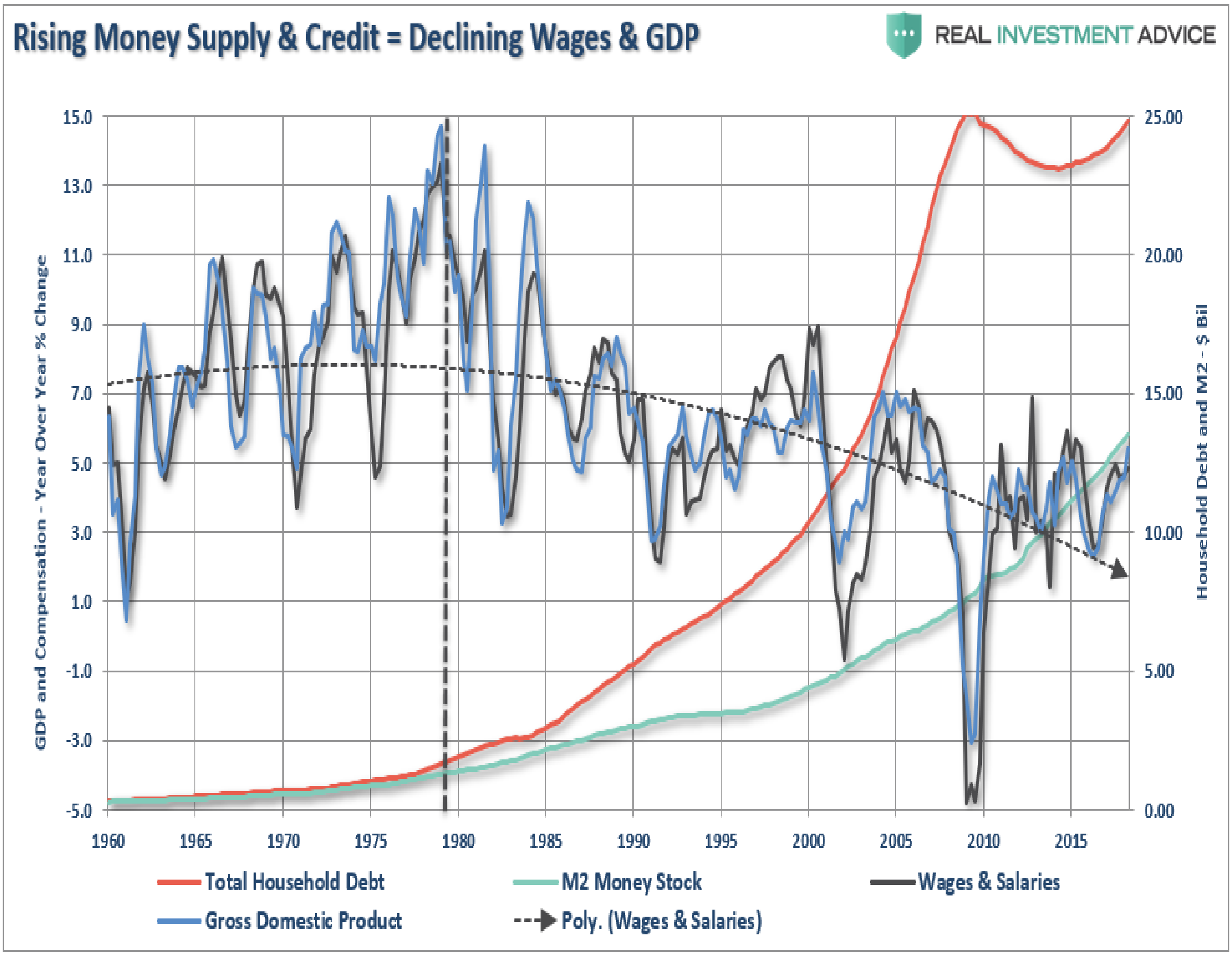


The saving grace currently is that interest rates remain at some of the lowest levels on record historically speaking. While that may seem good, lower rates only feed more economic problems as Michael Lebowitz recently discussed in **Wicksell's Elegant Model**: *"Where capital is involved, discipline is either applied or neglected through the mechanism of interest rates. To apply a simple analogy, in those places where water is plentiful, cheap, and readily available through pipes and faucets, it is largely taken for granted. It is used for the basic necessities of bathing and drinking but also to wash our cars and dogs. In countries where clean water is not easily accessible, it is regarded as a precious resource and decidedly not taken for granted or wasted for sub-optimal uses.•In much the same way, when capital is easily accessible and cheap, how it is used will more often be sub-optimal."* Those low rates have allowed the government to issue substantial levels of debt without having to "pay" a significant financial consequence as of yet. However, even with the government currently paying some of the lowest effective interest rates in history for the debt outstanding, debt payments have risen to the highest level on record.

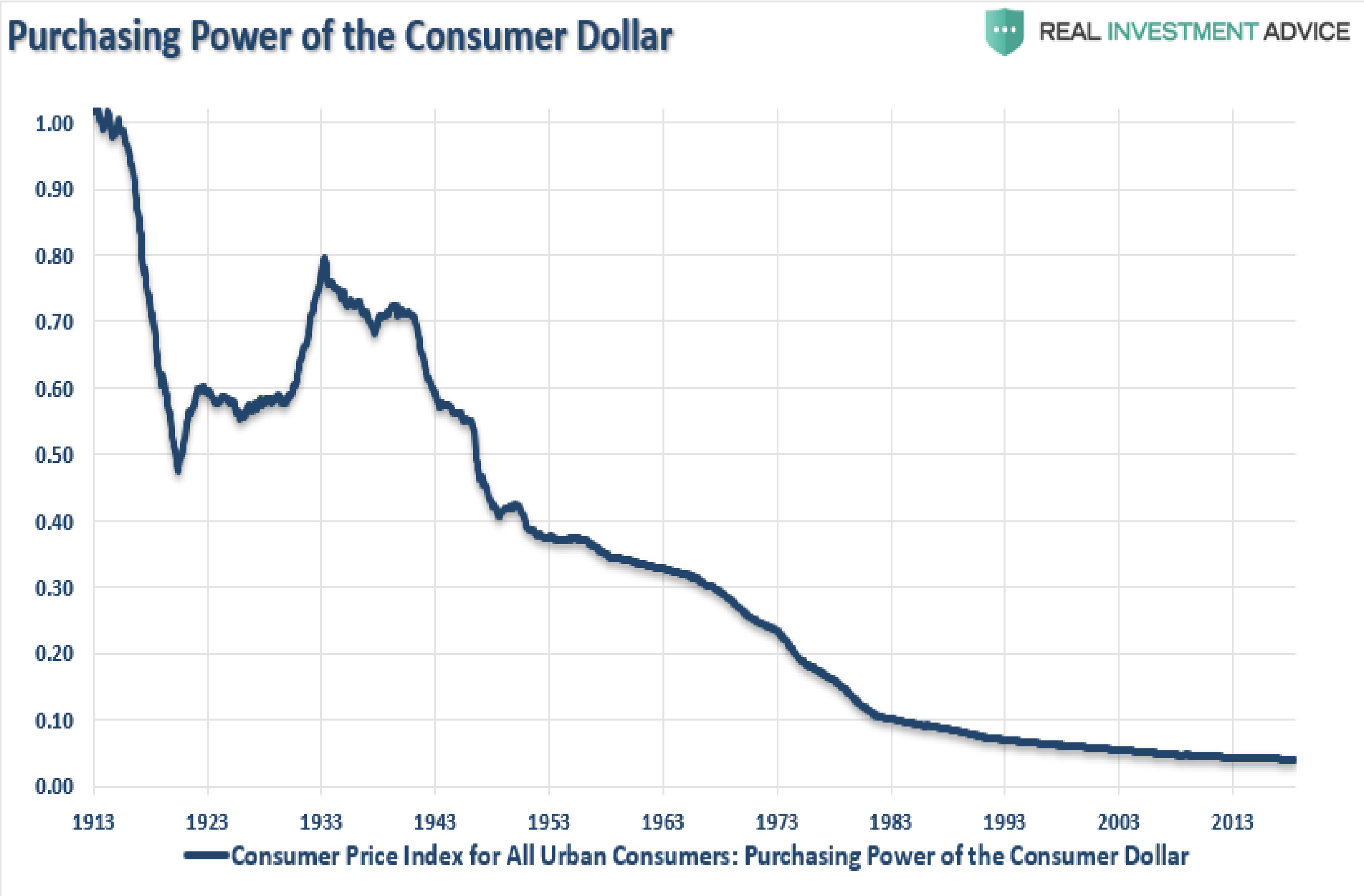




At the current run rate, which will massively accelerate if rates do indeed rise, the *"debt service"* will become on the largest budget items for the U.S. in the not too distant future. Currently, debt service and social welfare consume almost 75% of every tax dollar and in the next decade are slated to consume almost 100%. This leaves all other spending, and there is a lot of it, a function of debt issuance. Issuing more debt to fund a debt problem is not economically viable long-term as the majority of socialist countries eventually come to realize. Not unlike Turkey, the U.S. has also engaged in a massively increasing its money supply. The result of which has not been surprising. Beginning in 1980, the surge in the monetary base along with household debt has led to an unsurprising and very predictable outcome.



Of course, with wages and economic growth stagnant, and the purchasing power of the dollar continuing its long-term decline, the need for debt and government assistance will continue to increase.



Given the slowing demographic trends, the structural changes to the economy which continues to erode productivity, and the inevitable increase in debt, the net effect will continue to slow rates of economic growth as deflationary pressures build. As Jesse Colombo noted earlier this week:

> ***"Turkey?s economy has become reliant on cheap credit, and the recent interest rate hikes mean that the country?s cheap credit era has come to an end. Higher interest rates are going to cause a credit bust in Turkey, leading to a serious economic crisis.*** *While most commentators believe that Turkey?s current turmoil is the result of U.S. sanctions, the reality is that the country?s crisis was already 'baked into the cake' years ago. The recent political clash with the U.S. is simply the•catalyst•for the coming Turkish economic crisis, but it is not the actual•cause. I am also highly concerned that Turkey?s current turmoil will lead to further contagion in emerging markets, which have also similarly thrived due to ultra-loose global monetary conditions that are now coming to an end."*

The U.S. Is Not Turkey.

However, there are many more similarities than most politicians and economists wish to admit. The biggest of which is our current dependence on *"cheap debt"* to fund everything from Government handouts to corporate buybacks, capital expenditures, and household consumption. Despite hopes of economic resurgence, the reality is likely quite the opposite. Economic trends are hard to reverse and governmental policy trends are impossible to change. The good news is that the U.S. will eventually start making meaningful fiscal policy reforms. **The bad news, like Turkey, is that those changes will come through•*"force"* rather than *"choice."*•**But such has been the case for every empire in history from the Romans, to the Greeks, to the British. Without real, substantive change, the U.S. will likely face a similar outcome. We have the time to make the right choices. The only question is do we have the will? Or, are we simply the *"Turkey"* in the pot of water.