Thinking notes for January 27, 2022
ARC-UK
UNDERSTANDING US SOVEREIGN DEBT AS A CASH FLOW PROBLEM WILL HELP US UNDERSTAND WHAT THE GOVERNMENT'S REACTION WILL BE

Working Title: "Money Creation: The Disease and the Cure"

Subject: Money creation due to government action
Theme: Money creation due to government action is a significant cause of the national debt problem, and it will also be the government's attempted remedy to alleviate the debt problem
Contrast: Government budget deficits are not very important

Hello everyone, welcome back to Finance Friday on the ARC-UK YouTube network. I hope you are all happy and well today. This is HardmoneyJim speaking from winter quarters in Coronado, California, the home of the United States Navy Seals basic training program.

This photo was taken just a few hundred yards from my house, where a new class of SEAL recruits undergoes BUD/S training every few months. BUD/S stands for "basic underwater demolition/SEAL," and it is one of the most challenging military screening courses in existence. The candidates are highly qualified, but the course is so rigorous that only about half make it through a typical six-month training class. We're proud of the SEALS in this neighborhood and are glad they choose to train in Coronado.

INTRODUCTION

OK, today is part two of a 3-part series. Part one was titled "Uncle Sam's Unpayable Debt," in which I argued that the US government debt has grown so big, and its future obligations so extensive and open-ended, that the total debt cannot be repaid in today's money, that is at today's purchasing power. We wish our monetary authorities were as rigorous in their spending as our special ops soldiers are in their training. Our politicians' only natural response to their self-imposed debt problem is something called" financial repression," which is a combination of

high consumer inflation characterized by high nominal GDP growth coupled with a forceful suppression of interest rates below the rate of increase in the consumer price index, resulting in negative real interest rates.

That's what many economists call "financial repression," and today, we will take up part two of this series, titled "Financial Repression: The Disease and The Cure."

What actions will the various government and financial institutions take as they try to alleviate the debt burden and implement financial repression? What will the Fed do? The commercial banks? The financial regulators? Congress? Money creation will likely be at the heart of their response to our overwhelming debt. The theme today is that just as money creation in the hands of the government is a significant cause of our debt problems, money creation will also be the government's proposed solution to these very problems. Our monetary institutions – the Fed, the banks, the congress, the financial regulators, and the executive branch – will implement policies designed to reduce the government's debt burden relative to GDP and close to tax revenue. So the main question today is, what laws, orders, and policies will our politicians and financial authorities invent to implement financial repression?

Addressing that question will prepare us for Part Three of this series, titled "Surviving and Prospering Under Financial Repression," where I will make some suggestions on what you can do to avoid being a financial victim. So next time, we will ask: How does financial repression change the investment landscape? Can we take advantage of it? How should we think about investing and saving for the next 5 to 10 years under financial repression? The third session, two weeks from today, will hopefully be your payoff for the time you've invested into understanding money creation and its consequences.

So that is our trajectory for today and the next session. However, before I do, I want to address a good question from a sharp subscriber. Here it is:

"I feel like I've been hearing about the train wreck coming from US debt for at least 30 years. I think about Ross Perot, as an example, emphasizing it. Eventually, it seems like the math dictates that the wreck comes. But understanding the timing of it is critical to investment decisions. How close are we to the wreck? If you had to give an inside date and an outside date, what would they be?"

I did not adequately answer this point last time, so I want to take it up today, and it may take a few minutes, so bear with me.

REPRISE OF WHY US GOVERNMENT DEBT HAS BECOME UNPAYABLE

Let's first make a general point I should have made in part one. When a government cannot pay its debts, what are its options? The range of possible responses can be broken down as follows.

1. Runaway or hyper-inflation: Government can pay off debts with made-up, depreciated currency. Weimar Germany and Zimbabwe are prime examples. Under this scenario, the economy collapses and everyone suffers. Under this scenario, out come the mobs with pitchforks and torches. Usually, an inferior outcome for the people in power. Although some pundits are predicting hyperinflation here in the USA, I disagree; hyperinflation is not our fate, which I will explain shortly.

2. Outright default on debts, i.e., government reneges on promises. The government just admits they cannot pay. They say, oops, we or the previous government over-promised, and now we must confess we cannot pay all our debts. We will cut Medicare way back and eliminate Social Security while keeping the payroll tax. You can see this would be so unpopular as to be foolhardy. This option also evokes the world of pitchforks and torches. Default is more honest than hyperinflation, but it's also a poor outcome for the people in power.

[If the debt is mainly owed to foreigners, default is a little easier. You can always justify default by casting foreigners as enemies. But if the debt is owed to citizens, which is the case with the USA's unfunded debt, it is a bigger problem for politicians who want to stay in office. The high price of political and economic disruption (the pitchfork and torch factor) makes this an unlikely scenario. (creditors suffer, then everyone suffers as the economy suffers, then there is a re-set as new politicians make new promises. I maintain outright default in the US is not an option.]

3. Austerity: Under what some economists call "austerity," the government raises taxes severely and defaults selectively on its less urgent promises (like maybe its foreign-held debt). But basically, you limit your budget to tax revenues. But you have to cut services being funded by borrowing, so you risk miscalculating about which promises you can break and which ones you must keep. Austerity is a bitter pill for the population and politically dangerous for politicians, so it's unlikely to be the solution to our debt problem.

[OPTIONAL COMMENT: There is a form of austerity that would work. If you could establish, as a principle, that spending could not rise faster than the inflation portion of GDP, you would ensure the real economy would grow faster than real government spending. GDP contains a real component that is not reflected in the nominal value. calculated inflation rate (the cpi), this would freeze nominal spending as a percent of nominal cpi. Then, nominal GDP would exceed CPI, which means you would have real economic growth that was not getting taxed away. Over a generation, the size of the government would decrease drastically. This policy might be considered "austerity" because in effect real spending would be frozen. Congress would have to make hard allocations and rationing decisions every year. Don't worry, it is not about to happen.]

4. Smoke and mirrors: Pay off debts in a depreciating currency while artificially holding your finance costs down. This is recovery by fooling most people some of the time. The most favored version of smoke and mirrors is "financial repression." Because financial repression spreads the pain through inflation, it taxes silently by keeping interest rates below the

inflation rate. It is the least painful policy of choice when dealing with unmanageable public debt, so it is the odds-on favorite.

How Politicians Think About Federal Spending

Cash requirements:
- Pay for **promises** and obligations
- Pay **interest** on existing debt

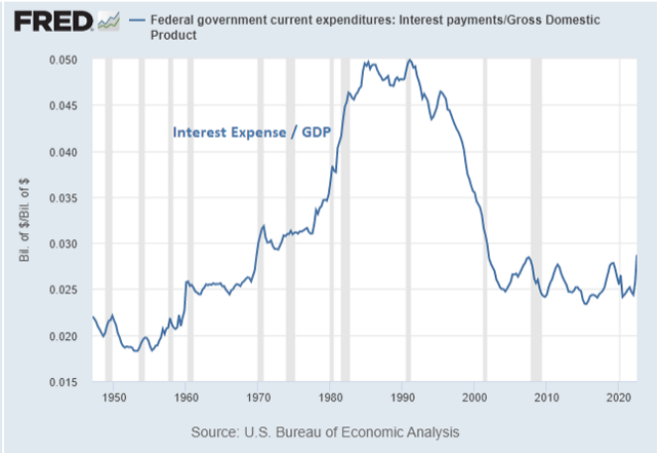
Paid for by cash sources:
- **Taxes** (all taxes, fees, duties, royalties, etc)
- **Borrowing** (in the Treasury market)

Let's go back and look at the politicians' cash flow problem. The government needs a net cash inflow to finance an expanding spending program. I concluded last time that their payouts could not be cut back in nominal terms, or the politicians would lose their jobs. And, because the size of the economy limits taxes, I concluded that growth in tax revenue is determined by GDP growth. Finally, as debt grows and interest costs rise, the ability to borrow becomes limited by ballooning interest payments.

So the government is stuck in a debt trap where rising interest costs constrain additional borrowing.

Again, Tom asked
How close are we to the wreck? If you had to give an inside date and an outside date, what would they be?"

It seems inevitable that the rising US debt will become an existential problem, but this has been going on for a long time, yet everything still seems to function. Tom has seen this movie before, which is why he wants to know the end game here and when it is coming.



Let's go back a few decades to the 1980s and see what Tom was talking about. The chart shows the government's interest expense as a percent of GDP, which reached 5% of GDP from the early 80s to the early 90s. At 5% of GDP, interest costs comprised 25 to 30% of all government revenue! We had seen significant deficits before to pay for wars, but now we were borrowing and incurring significant peacetime deficits. Moreover, we were borrowing to pay the high-interest costs because interest rates in the early 1980s were in the 15% range and higher. By 1990 the interest rate had fallen to 8%, but that is still historically high, so old debt got repriced at these high rates causing overall interest costs to remain high.

With interest rates that high, we were already at a point where interest rates were a critical factor in the politicians' cash flow equation. High deficits are financed by borrowing, some of which is monetized, which means the debt is transformed into new money. This additional money is inflationary, and it eventually drives prices higher, which requires higher interest rates, which raises the government's interest costs, which leads to higher deficits to pay these higher interest costs, which means still higher interest costs, in a vicious circle of higher interest costs and expanding debt.

That is what people were afraid of then. The deficit looked terrible then, and it attracted much political attention. That's the historical period Tom was talking about in his question.

Ross Perot

Portrait of Perot by Allan Warren, 1986

Born	Henry Ross Perot June 27, 1930 Texarkana, Texas, U.S.
Died	July 9, 2019 (aged 89) Dallas, Texas, U.S.

https://en.wikipedia.org/wiki/Ross_Perot

The political result of that widespread concern with the debt in the 1980s was this guy, Ross Perot, a Texas entrepreneur, who self-financed an independent third-party run for president. Based primarily on concerns about the deficit, Perot got 18.6% of the popular vote in the 1992 presidential election. He split the Republican party, and the result was that a Democrat, Bill Clinton, got elected president.

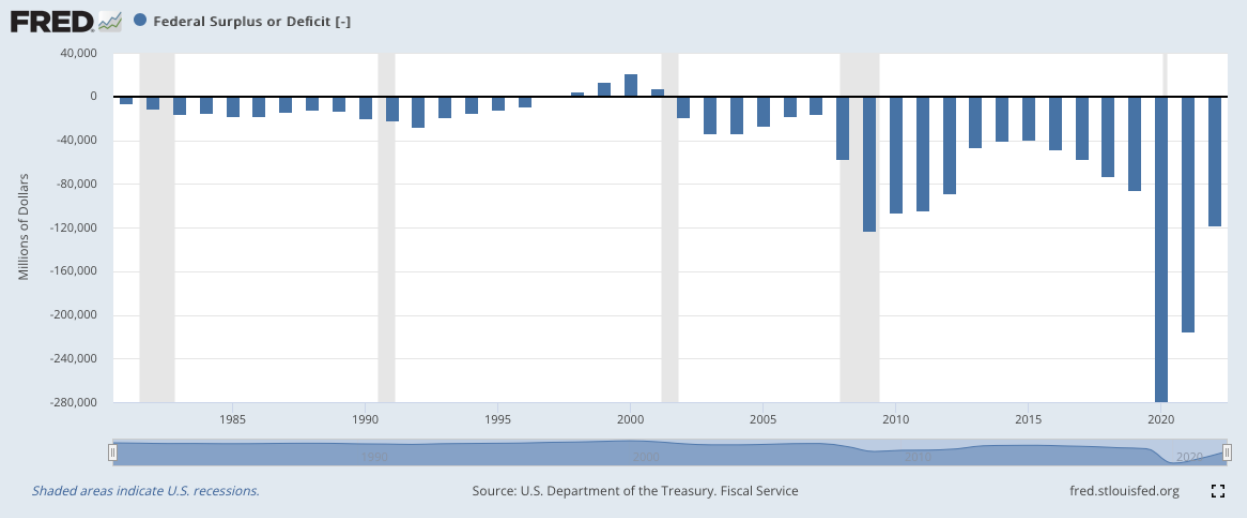
The End of Welfare as We Know It

America's once-robust safety net is no more.

By Alana Semuels

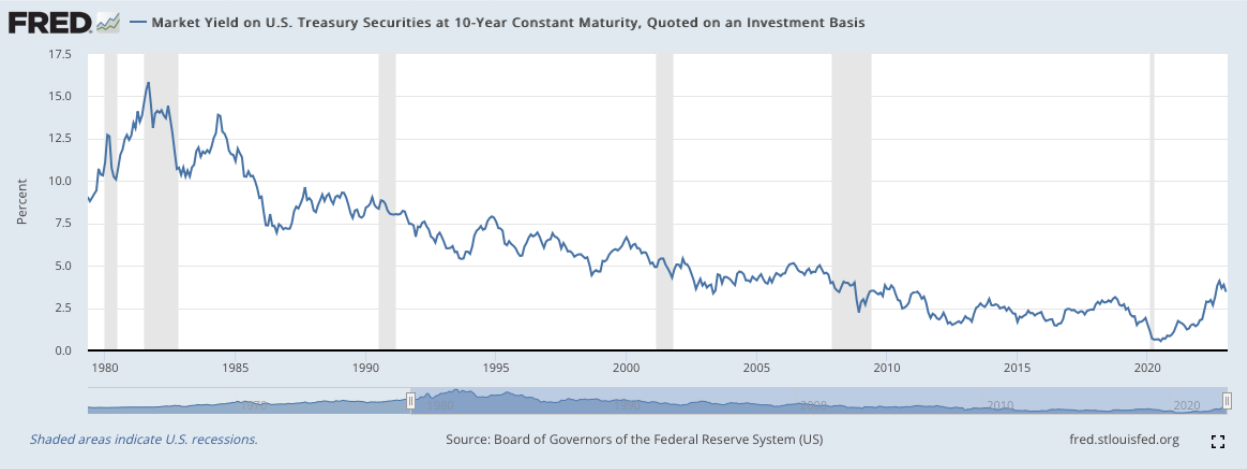
https://www.theatlantic.com/business/archive/2016/04/the-end-of-welfare-as-we-know-it/476322/

Excessive government spending was such a big concern that even Bill Clinton, a Democrat, said it was time to "end welfare as we know it," presumably driven by a genuine realization that there is a limit to other peoples' money, just as Margaret Thatcher had warned.

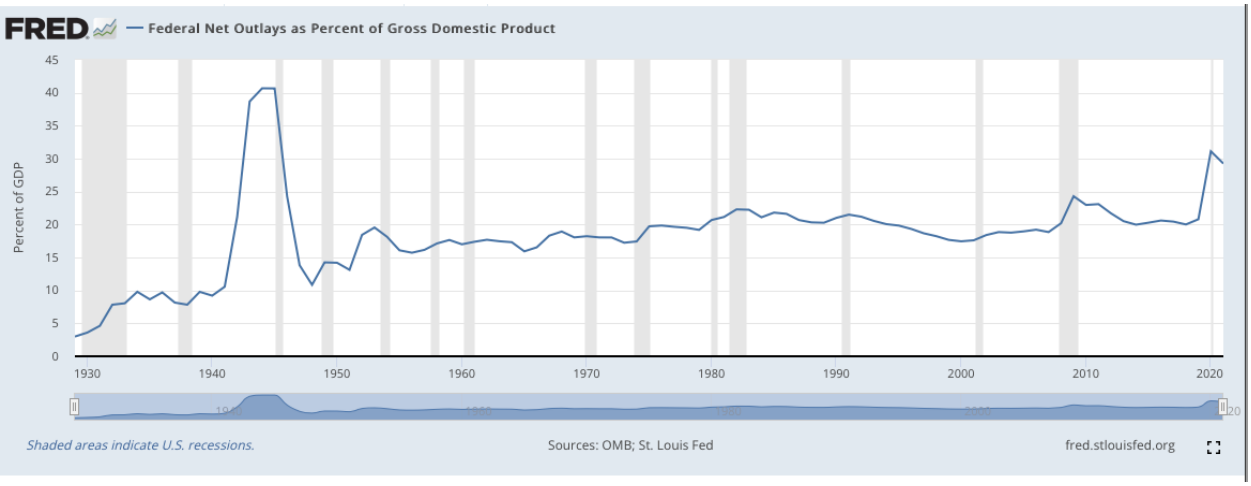


To illustrate how important the voters and the politicians thought the federal debt issue was, President Clinton then cooperated with the majority Republican congress and balanced the federal budget to achieve a small budget surplus of $21 billion in 2000. All credit Bill Clinton and the Republican Congress for this unusual, positive bi-partisan achievement. However, as you see, the surplus didn't last long; the deficits resumed in the early 2000s and began an increasing trend.

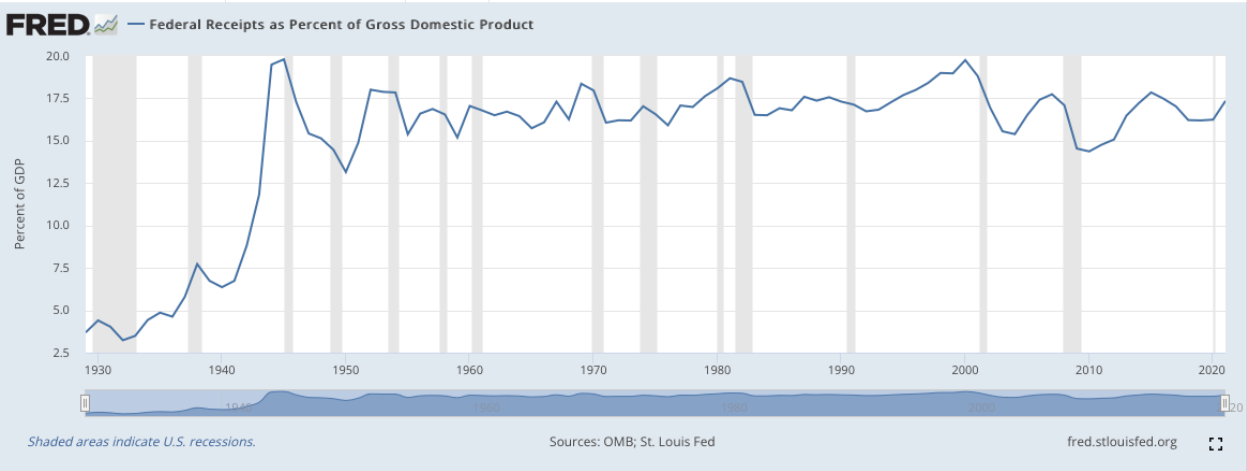
What enabled the budget surplus in the late 1990s was a combination of three factors.



1) A continued decline in interest rates (i.e., a 40-year bull market in bonds) eventually culminated in the lowest interest rates in 5000 years of recorded history. Look at the drop between 1990 and 2000.



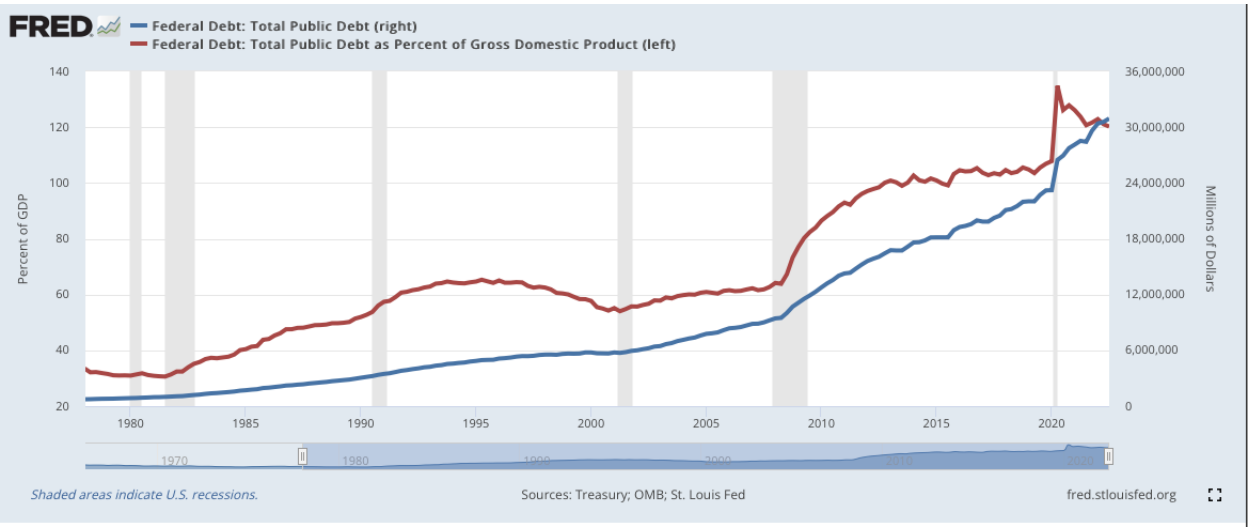
2) The second factor enabling the budget surplus was that government spending grew slower than GDP. Between 1990 and 2000, government outlays as a percent of nominal GDP went from 21.5% to 17.5%, while GDP grew nicely, uninterrupted by a recession.



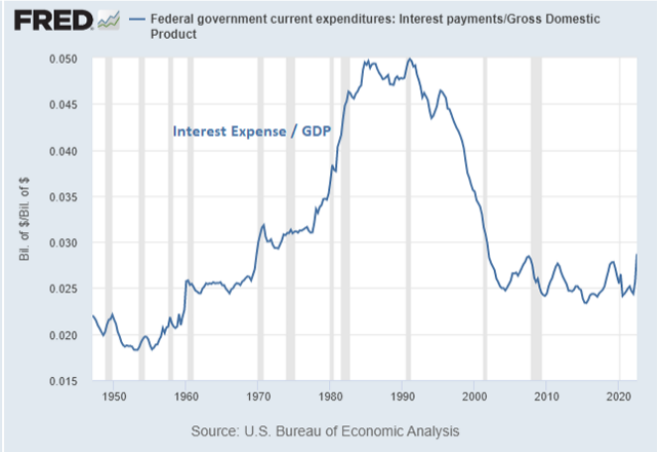
3) Finally, government revenues as a percent of GDP were high and rising during this decade, reaching the 20% upper bound right around 2000. So by 2000, tax revenue was maxed out.

So with a bit of fiscal discipline, a strong economy with rising tax revenue, and rapidly declining interest rates, they managed to balance the budget for a couple of years.

But in the early 2000s, fiscal discipline started evaporating.

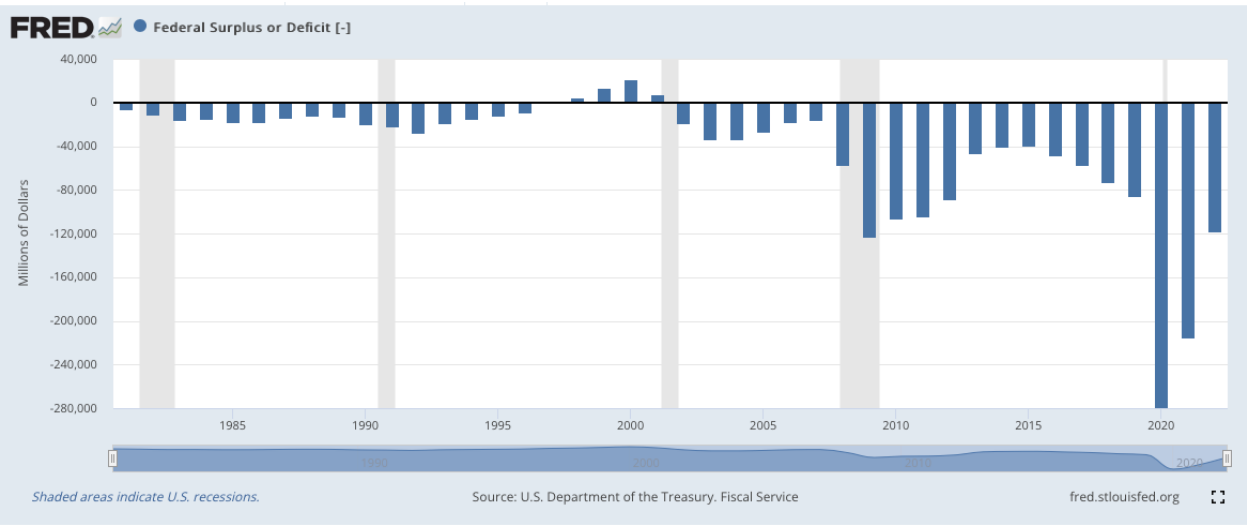


Notice that from 2000 to 2010, the total debt (blue line) and debt/ GDP (red line) were increasing, and the deficit was accumulating.

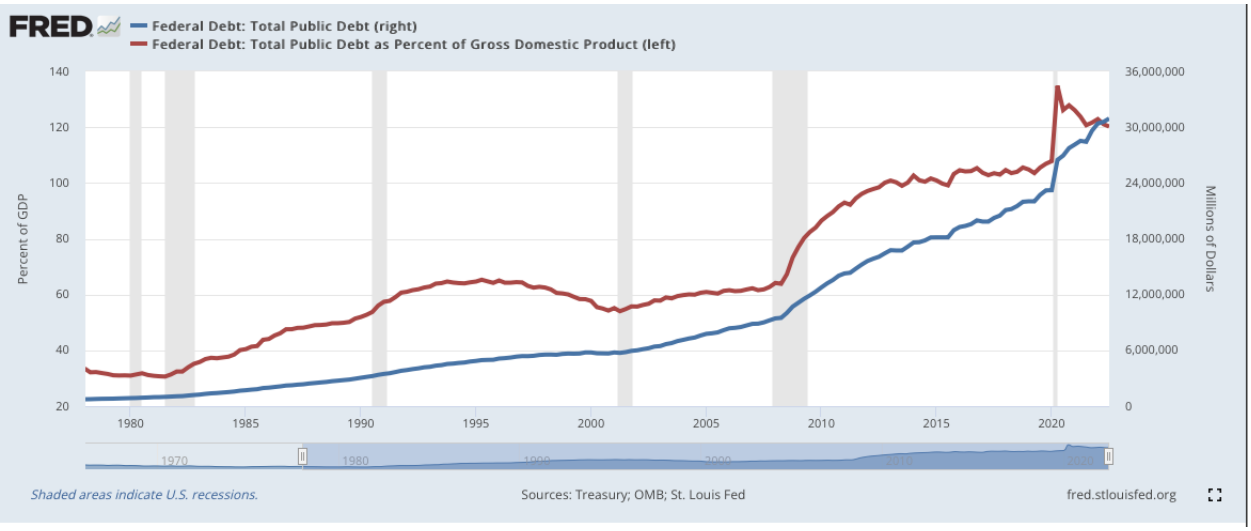


However, declining interest rates allowed the interest burden as a percent of GDP to stay pretty constant after 2000. Because of rapidly falling interest rates, by the time we got to the early 2000s, interest cost as a percent of GDP was back down to 2.5%, or about 13% of government receipts, and was no longer an immediate problem.

It was like repeatedly refinancing your house for more money at lower and lower interest rates. Many people did that during the declining interest rates and housing bull market of the early 2000s and pulled lots of cash out of their appreciating house prices. Similarly, for a while, declining interest rates created an ATM machine for the big spenders in government.



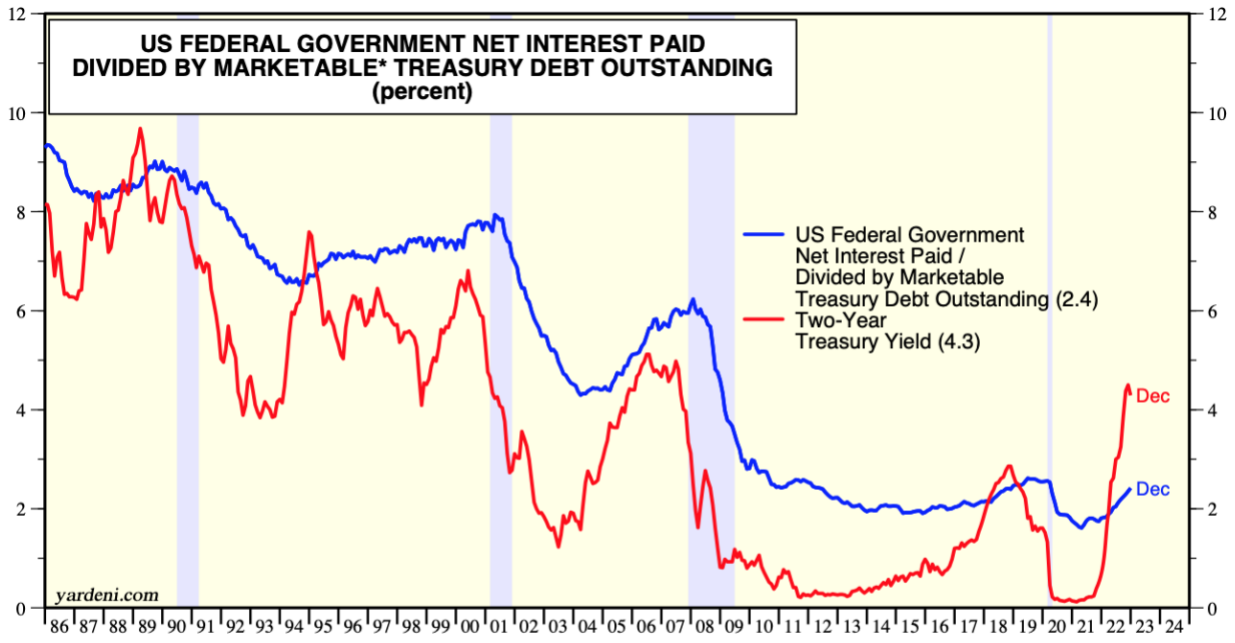
In the early 2000s, right after the dot-com crash, the deficits returned to stay, but the politicians no longer cared. As I mentioned last time, it was in 2003 that Dick Cheney famously remarked, “Reagan taught us that deficits don’t matter.” (I hope you notice that the big spenders and borrowers come from both sides of the political aisle. There are very few heroes in this story.)



There was some plausible justification for Cheney's statement. The deficit was not a problem, not just yet. From 2000 to 2010, total debt rose, but as a percentage of the growing GDP, it grew slowly. It was only 60% at the start of the great financial crisis.

Even when the 2009 financial crisis hit and the Fed responded with massive borrowing and Quantitative Easing, the ballooning debt didn't seem to matter. Why? Because interest rates kept declining. Eventually, this long period of declining interest rates allowed debt as a percent of GDP to climb rapidly, topping at over 125% (its currently at about 120%)

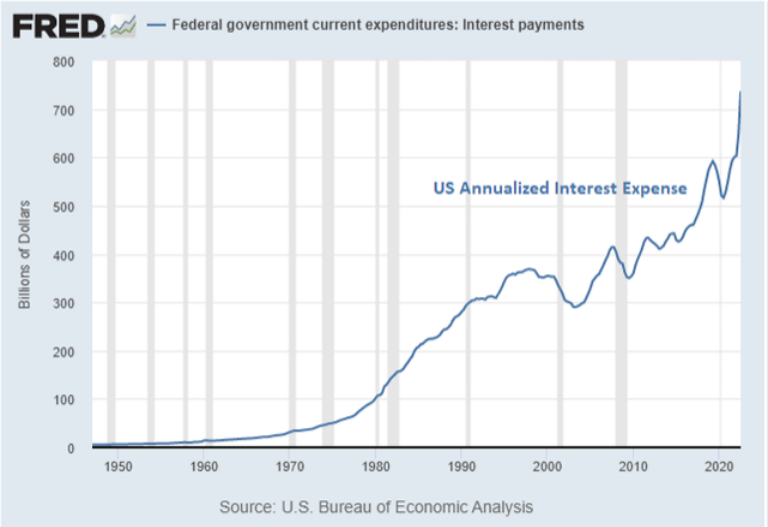
Even then, government borrowing was not yet encumbered by interest costs because interest rates were still falling, and they continued this downward path to near zero during the Pandemic. (Think of it: if interest rates were permanently at zero, there is no limit to what you could borrow.)



* Marketable interest-bearing bills, notes and bonds.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: US Treasury Department.

https://www.yardeni.com/pub/usfedfin.pdf

But then came the Pandemic-related financial panic of 2020. Unprecedented monetary stimulus gave us something we had not seen in a long time: a big spike in consumer price inflation. And with inflation came the Fed tightening and much higher interest rates. The blue line is the effective interest rate paid by the US government on its debt. The red line is the two-year treasury yield, a good proxy for the average rate the government pays as it rolls over existing debt. You can see that interest costs for the US government are set to double in a very short time.



Here is the actual trajectory of interest costs. By the end of this year, as Treasuries mature and are refinanced at higher rates, the annual run-rate of interest costs will be about $1 trillion per year or about 20% of tax revenues and still climbing.

As I mentioned last time, the Congressional Budget Office projects interest costs to be over 11% of GDP (nearly 60% of government revenues) by the year 2050. That's 27 years from now. The CBO has typically underestimated deficits, so it's possible we could reach those levels sooner. Long before we get to 2050, I contend, the bond market will want much better interest coverage than that, or it will want higher interest rates to compensate for the growing risk.

So, today, the US government's ability to borrow is once again constrained by high and rising interest costs, just as in the 1980s. But there are several important differences between funding conditions now and those of the 1990s when the debt concerns proved to be a false alarm. Now at long last, we are getting closer to answering Tom's question.

The first difference is that because of consumer price inflation, interest rates are rising, not falling, and the likely trend of rates is set to increase interest costs radically. That is not in our favor.

The second difference between now and the 90s is that debt / GDP is now 120+% of GDP, as opposed to 50 or 60% of GDP in the early 90s. The importance of this ratio is not in its absolute level but in how it affects total interest costs, which always must be paid. Because the higher debt level is a significant determinant of total interest costs, we will need to take on additional interest costs when we borrow more, even if interest rates stay at current levels.

Finally, there is another significant difference between the 1990s and now. Unlike in the 1990s and early 2000s, today the traditional buyers of US debt are becoming scarcer. We have to ask the question: Who, besides the Fed, will buy US debt? And how will we know if they are going to stop buying it?

If your lender was a banker, he might say that if your interest costs as a percentage of your income went above 20%, he would not renew your loan. That would be a provision in your loan contract so that you would know your borrowing limit. The bond market has no such published rules, but it does have a limit on how much it will lend. But no one knows what that limit is because the limit varies among the various bond buyers. So, as US creditworthiness deteriorates, the skittish buyers start to drop out of the lending market incrementally unless they are compensated with higher interest rates.

What you see in practice is a temporarily poor market for bonds and spiking interest rates, which the central bank can take care of temporarily through QE. So our debt problem will become more acute whenever an important bond buyer refuses to purchase incremental debt. An example was the UK pension liquidity crisis which the Bank of England solved last September

with a promise of open-ended QE. Then it will be back to business as usual for a while, until the next stressful incident. Lather, rinse, and repeat until something breaks.

So we will see that the frequency and intensity of these little bond market brush fires gradually increase as we flirt with insolvency. But it is probably a gradually developing problem that results not in an explosion but more like a spreading forest fire.

We will not get to the point of actual insolvency because all these warning signs will be noticed by politicians, who will implement financial repression in response. They will see these dangerous little credit fires, and they will act. If they see some funding markets closing, they will try to open up other funding markets, perhaps even by force. If interest costs are too high, they will try to suppress interest rates. The harder the funding conditions become, the more resourceful the government will be in finding more money to keep their spending going.

So I hope you understand why there will NOT be a monetary explosion, a debt bomb, or one particular emergency or incident that changes our money and banking system overnight. More likely, we will see an evolution based on a pattern: a problem, followed by a response that is a patchwork solution, then another problem, another answer, until we evolve into a new monetary order that will change so slowly that it will look different only from a historical perspective.

I'll be surprised if you ever hear the words "financial repression" uttered by a career politician. It is not as if "financial repression" will ever be an official or well-planned solution implemented by the government. But it is a system that will evolve as politicians search for ways to fund their spending.

So the question I'm now asking is: If you want to follow the gradual process of credit deterioration and the political response to it, what kinds of these brushfires can you look for that provide a warning about funding problems in the US treasury market?

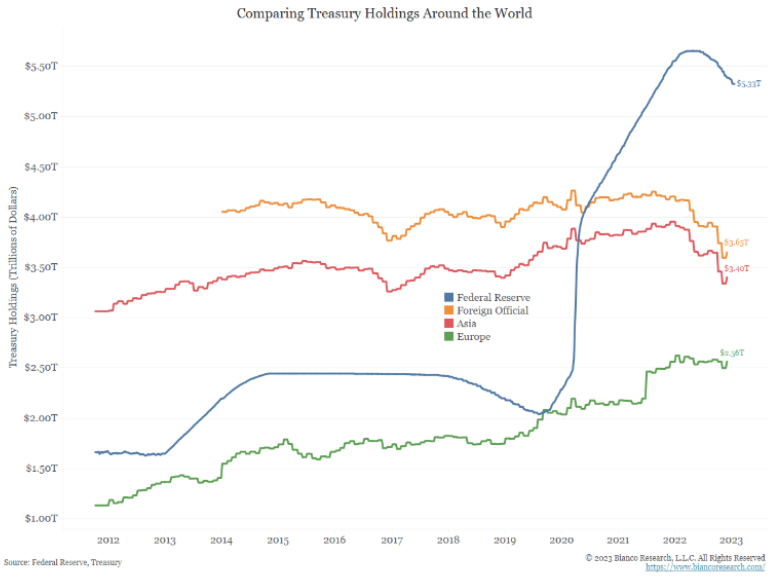
[Optional comment: So please observe that the Fed's current interest – raising rates and lowering GDP-related inflation – is precisely the opposite of what the US government needs to keep itself alive in the future. The fed believes that "inflation" (as they understand it) can only be lowered by destroying economic demand for labor and finished goods, which are the main elements of GDP. They do this by raising interest rates until they wring out the high rate of consumer price increases in the economy. So there is this tug-of-war developing between what the government needs and what the Fed wants. In the long term, the government will win this battle.]

We have some great recent examples of these little brushfires I'm talking about.

- We had the 2019 repo scare, in which the Fed had to rush in to provide liquidity to save the hedge funds. The Fed now provides nearly all the money for money market funds through its reverse repo facility. You might not have heard much about that.

- We had the 2020 financial meltdown, a major panic in the financial markets that the Fed addressed by unprecedented, massive money creation.
- We had the UK pension fund scare, temporarily cured by market intervention by the Bank of England and its promise of unlimited QE

That's all recent, but where else can we look in the immediate future? Let's look at what's happening in the Japanese bond market, of all places.



This excellent chart from Bianco Research illustrates the problem. The US government's borrowing needs are skyrocketing, but who is lending, that is, who is buying Treasurys? The red line is Asian lenders, well known to be Japanese and Chinese, with the Japanese the largest owners. Their holdings are dropping fast, even as the Fed has been the biggest buyer since 2019. But now the Fed, too, is reducing its holdings. So: Who is going to fund the US government?

Meanwhile, consumer price inflation and interest rates are rising in Japan. The Bank of Japan has been buying unlimited amounts of Japanese Government Bonds to hold down interest rates, but this has caused the exchange rate of the Yen to plummet, so the BoJ has been selling dollar-denominated investments, i.e., Treasuries, to purchase yen-based assets to support the dollar/yen exchange rate. But there is a lot of evidence that Japan may not be able to suppress its bond yields much longer. CPI inflation is running at 3 to 4% in Japan, the highest in many decades, while the BOJ tries to hold their 10-year bond yield to 50 bps (one-half of one percent).

«If the past is prologue and if the great bond bull market is over, then on form, we are looking at what could be a very prolonged and perhaps gradual move higher in interest rates»: *Jim Grant.*

Zerohedge, January 17, 2022

I want to partially quote Jim Grant on the risk this presents to US financial markets.

> "I think Japan is perhaps the most important risk in the world…The risk is this: Every business day, the Bank of Japan is spending tens of billions of dollars' worth of yen to enforce governor Kuroda's yield curve interest rates suppression program. To put this into perspective: In the UK, when the little crisis over liability-driven pension investing in late September happened, the Bank of England spent around $5 billion. The BoJ does that before breakfast.
>
> [Meanwhile] Governor Kuroda, whose term is up April 8, insists yield curve control is here to stay….
>
> The Japanese…have an immense amount of net savings, and some $3 trillion of Japanese assets are invested in non-Japanese markets, of which half are domiciled in the United States…What is going to happen if suddenly Japanese yen-denominated rates become rather attractive? Well, a lot of this money may be repatriated and the result of that repatriation will be a rise in volatility in markets we can't really identify now… I think the time is getting ripe for a significant change in Japanese rates structure and therefore in interest rates…worldwide."

The first visible evidence for this might be volatility in the bond market. So if rates finally rise in Japan, and Japanese investors sell their US investments to buy Japanese investments, this will put downward pressure on the US dollar and dollar-denominated assets and upward pressure

on US yields. In other words, Japan's condition might cause yet another brushfire, maybe a big one, but you might not see it coming before it erupted.
There are other places to look for these little fires. As I pointed out in a Substack in April of last year called "Banks and the Dollar: Governments New Favorite Weapons," there is pressure on many countries to find alternatives to the US dollar for international trade. Russia, China, Saudi Arabia, India, and other countries would love NOT to be tied to the dollar as a reserve currency.

Recent evidence is that China and Saudi Arabia are working towards a deal to buy oil for yuan, not dollars. That means the Saudis will have to reciprocate trade with yuan, using yuan to source Chinese products, and they would settle short-term trade imbalances in gold. So we are talking here about a proposal for a gold-backed petro-yuan. The Chinese interest in this is apparent, but the Saudis also see an advantage. This development helps explain why central banks are currently buying unprecedented amounts of gold instead of US treasuries to use as bank reserves. So the question remains: Who will continue to buy Treasurys as the dollar's status as a reserve currency weakens?

So we are finally in a position to answer Tom's question. When will you know the tax-borrow-spend system is about to fail, that the end is nigh? The bad news is that you won't know because the system will not really die. As problems arise, politicians will adjust to keep the funding system going incrementally. But the good news is, there won't be a catastrophic failure of the US currency or a breakdown in government functioning because the funding suddenly dries up. The funding will not dry up because the sources of funding will change. So you don't have to time anything precisely, and you could not do it anyway. You can jump off this ship any time as it sails into rougher and rougher waters. In my opinion, the sooner you get into your personal sailboat and go your own way, the better. But no specific point of failure says you must abandon ship now.

So, Tom, I hope you are happy with that long answer, and I hope you understand why I could not give you a date or a range of dates within which you have to act. I don't think this is that kind of problem.

WHY MONEY CREATION IS AT THE ROOT OF THE DEBT PROBLEM (why is it the disease?)

I want to pause and be sure we all understand why money creation is at the center of this discussion on unpayable debt. I said money creation is both the disease and the cure. Why is it the disease? It's because the government's ability to control the amount of money created and who gets that new money first is the very thing that enables them to take on so much debt. Look at what central bankers all over the world are doing. Central bankers claim they manipulate the money supply and control interest rates to maintain healthy economies. But what they accomplish by monetizing government debt and suppressing interest rates is to allow governments to spend beyond the limits permitted if direct taxation was their only long-term source of funds.

That's the problem that Maggie Thatcher spoke of: "The problem with socialism is you eventually run out of other peoples' money." Other people's money is easily identified if you tax them too much. But if you, the government, can create new money, you can always claim you didn't steal that money from anyone else. There is no specific, visible victim, so it is easier to remain unaccountable. Never mind that you took wealth from everyone to spend it on those who help you stay in power. They get away with this because it is hard to detect and poorly understood.

By analogy, It's as if you are a dairy farmer who keeps a big milk tank on the farm. Every night your neighbor comes over and helps himself to some milk but replaces the volume he steals with water. You may not detect it because the milk looks the same and may taste the same. You only notice it when people become unhealthy because of the reduced nutritional content of the milk you sell.

So I hope you see that once we understand money creation, we will never move the government and the Fed toward sounder money policies. Only voters can force the government in a non-violent direction. So once we understand money creation, we can only get them to stop their destructive spending and debt programs. They are getting away with it because not enough of us know what they are doing. OK, call that my soapbox motivation for understanding money creation and its consequences.

Finally, I want to turn directly to the title of today's podcast: "Money Creation: the disease and the cure.:

As I just described, money creation is the disease because it's the thing that makes our politicians' spending and borrowing abuses possible. It may be surprising that money creation will also be the government's proposed cure for the problems they caused by spending beyond their means and paying for it with inflation. Hence the title of this podcast.

HOW CAN MONEY CREATION CAN BE USED TO IMPLEMENT FINANCIAL REPRESSION

So let's talk about how money creation can be used to implement financial repression. The question before the house is, what should we expect the government (the Congress, the President, the Treasury, the Fed) to do about their worsening debt dilemma?

There are several reasons financial repression is an attractive solution for politicians. First, it is easy to implement through the existing money-creating institutions that government already controls, such as the banks, the Fed, and the financial regulators. Second, politicians are confident their voters will accept it because the pain inflicted will be gradual, and the voters will not understand it, allowing the politicians to remain unaccountable.

Financial repression is also convenient for politicians because it can be implemented gradually, year-by-year, as the little funding fires flare up. This gradual pattern coincides nicely with Congress's short-term cash flow model. So imagine that every year there is a little problem, a small brushfire, that makes funding the government in the traditional way a little more complicated, but every year Congress meets and enacts some new policy or law that keeps their money flowing. In their world, short-term problems can be dealt with by a series of short-term solutions. This is another reason financial repression will go unnoticed by most people: It is evolutionary rather than revolutionary.

I have said the government has to inflate GDP while suppressing interest rates, so let's take those two items in turn. First, how can the government make nominal GDP grow faster? GDP is a proxy for total aggregate spending in the economy. Higher GDP means higher nominal profits and incomes, which garners higher taxes. As I detailed in a June 17, 2022, podcast titled "Why did inflation take so long to show up?" the Fed throwing money at the financial markets under QE raised asset prices. Still, it did not produce much in consumer price inflation until we got to Pandemic QE, which stimulated the consumer directly. The Fed's QE did not get money into GDP-producing activities. So the new policy has to be: get money into GDP-producing activities. Consumer spending and business investment are most of GDP, so that is where the new money has to be directed. How can the politicians accomplish this?

First, helicopter money. Direct stimulus to the consumer and businesses is an option, but not a good one because it is unproductive. It causes high consumer price inflation while discouraging people from working, as seen in the Pandemic.

A "better" option is credit creation directed at industries the government wants to grow. You can do this through the banking sector in several ways. First, you can nudge the banks to lend to your favorite target industries. One way is through loan guarantees, in which Congress would authorize Treasury to guarantee industrial loans to, say, green industries like solar panels and carbon capture. Banks will cooperate as long as they make a profit, so if their profit is guaranteed, banks will make these loans.

Consider the advantages to the government of a guaranteed loan program. First, the government can get the banks, not the taxpayers, to finance its pet projects. It only takes 5 or 10 percent in reserve to guarantee even a lousy loan program. So it costs the government almost nothing to guarantee a sweetheart loan program, and the loan does not show up on the government's budget except as a small contingent liability. So banks, not the government, create the new money to finance the government's latest boondoggle. This kind of central

industrial planning is easy to implement under the existing regulatory structure, and it creates money that finds its way almost immediately into the taxable economy.

I might add that guaranteed loans are already an important part of banks' lending portfolios here in the USA, but even more so in other countries like the UK. The economist Russel Napier has reported on a guaranteed lending program to support shipbuilding. And guess what? Shipbuilders are getting their capital. In the USA, guaranteed loans were implemented as part of the CARES act, the first pandemic stimulus program. We will likely see more of this.

Another way to jack up GDP is to prevent it from shrinking if big businesses or industries get into trouble. The Fed can intervene directly in essential companies that are failing by lending directly to them, purchasing their debt, or backstopping bank lending to them. For example, if American Airlines gets into financial trouble, you can bet they will not be allowed to go bankrupt.

The regulators can also encourage increased bank purchases of government debt. Currently, banks are limited in the bonds they can own due to a requirement to hold a minimum amount of capital against government bonds. That could be waived, opening up a significant new source of demand. The banks might join the Fed by becoming even bigger buyers in the government bond market.

Regulators could also change the mark-to-market rules on government bonds, so banks don't have to take a loss on their profit and loss statement as interest rates rise. This kind of thing has been done before selectively in other crises.

CPI rule changes raise the odds of a "soft landing" in our view (for a few months at least) (FFTT, 1/17/23)

By **Luke Gromen** • Published on **January 17, 2023**

In August 2021, the BLS announced interventions were considered to mitigate possible measurement errors caused by the COVID-19 pandemic during 2020, but the standard biennial update procedure was ultimately chosen.

-US BLS, 2/25/22 *(when US policymakers still believed "Inflation is transitory")*

There are other things government can do. For example, if you want inflation but you don't want the optics of high inflation numbers, change the way inflation is measured to make things look better than they are. This takes the pressure off the Fed, which can pretend not to raise its inflation targets, allowing them to reduce interest rates sooner while retaining some credibility.

Or regulators could encourage forbearance on bad bank loans. This is known as "Extend and pretend." This policy prevents the money supply from shrinking because it prevents loan defaults.

So these are all ways to create more money and get it into GDP-enhancing activities. If it sounds like a command and control banking system, congratulations, you've been paying attention.

What about the other side of financial repression, suppressing interest rates and explicitly keeping interest rates below consumer price inflation?

Here it's clear the government will have to require or encourage large institutional bond buyers to purchase its bonds at below-market interest rates. You can suppress the interest rate if they have to buy your bonds and you don't allow them to invest in other higher-yielding alternatives.

As mentioned, the Fed could require or encourage the banks to buy more treasuries by relaxing solvency and capital rules.

Congress could encourage state and municipal authorities to buy more treasuries by changing fiduciary requirements. For example, you could require that state pension plans own more long-term treasuries to qualify for federal aid. They would justify this in the name of financial safety.

Congress could encourage (or require) private savings institutions to do the same. Insurance companies and private pension funds could be forced to hold more treasuries in the name of financial safety. Also, the relaxation of specific accounting rules could make holding treasuries more attractive here.

We could see programs to encourage direct investment in treasuries by the public. For example, Japan's national debt is mainly held by private household savers and has been for years, despite very low-interest rates. If we see a central bank digital currency from the Fed, they will make it easy and perhaps mandatory to "invest" the CBDC in US Treasurys.

And let's not forget standard interest rate suppression by the Fed. I expect you will see the Fed implement a technique called yield curve control, in which (like the Bank of Japan) they suppress long-term interest rates to help decrease the government's interest costs.

Then there is something called capital controls. As the real interest rate in the home country is suppressed, investors will want to venture abroad for better returns. The government will need to make that difficult to keep the money at home invested in low-yielding government debt. So they will institute capital controls designed to discourage investment outside the USA. They likely will not make it impossible, just more difficult for the average saver/investor.

If all this sounds like a soft takeover of the financial system, especially of the banking system, by the government, you have it right. What used to be known as "commercial" banks will increasingly become financial utilities in the service of the government.

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We know this policy can work to reduce the government debt burden because it has worked in the past, even though it exacts a nasty toll on ordinary citizens. Economist Russell Napier chronicles the post-WW2 history of France and Britain, which had a very high debt/ GDP ratio because of war debts. They radically reduced debt/GDP in about 15 years by implementing the policies I've mentioned here.

To summarize, what happens is that as nominal GDP grows, along with it grow tax receipts. Interest rates are suppressed, removing the burden of increasing interest costs. Gradually, debt declines as a percent of GDP, and the ability to borrow heavily is again restored. It is an obtuse way of paying off existing debts in depreciating dollars, a variation on the same trick governments have used since the time of the Roman emperors.

Next, we should consider how to react, that is, how to survive and prosper as this financial repression develops.

But that is Part three, so let's draw a line there for this week, and we'll continue the discussion two weeks from now.