SEMI-MONTHLY FISCAL/MONETARY REPORT – FED FINANCES MOST OF US DEFICIT – WALL STREET JOURNAL SAYS US HAS CHINA WHERE WE WANT THEM, NOT ON YOUR LIFE!!

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THE DEFICITS AND THE FED

The new fiscal year for the US government started October 1st. In the two months ending 11/30, the current deficit has been $337B, up 10.4% from a year earlier, headed comfortably over $1T for the current year, up from $984B. As always, the increase in debt is higher, up $360B, the difference being the “off-budget” spending, mostly to finance the deficit in the social security entitlement account. Most years, this off budget spending totals a couple of hundred billions, still a serious amount of money.

It’s no coincidence that the Fed Balance Sheet has increased, from 9/25 until 11/27 by $194B so the Fed has financed about 57% of the two month operating deficit. It’s clear therefore that the Fed has no choice but to continue expansion of its balance sheet. Now at $4.095T, it is clear that a new high above $4.5T is in the cards by the end of the current fiscal year ending 9/30/20. Of course, the old high was put in place to stimulate growth in the wake of the 2008-2009 financial crisis. The new high will take place in the middle of “the greatest economy the country has ever experienced.”

THE QUESTION: What’s the matter with this picture?

THE ANSWER: In the 2008-2009 crisis the Fed balance sheet went up by $3.5T. Might the Fed need to take its balance sheet to at least $7-8T to forestall the next downturn. With any addiction it always takes a bigger hit to maintain the high. Economic policy would be simple if recessions (and worse) could be easily avoided by the printing of new money. Do you not suppose that a price must be paid at some point ? It's trite but true: if something can't go on forever, it won't.

OUR LEVERAGE, OR LACK THEREOF, NEGOTIATING WITH CHINA

Today’s Wall Street Journal describes how the US is in a relatively strong bargaining position relative to trade negotiations. We respectfully disagree. (1) Both economies are increasingly burdened by debt and supported by government spending. China, though growth is apparently slowing to a mid single digit pace, with financial strains to be sure, still owns the fastest growing major economy in the world. The US, with its own set of economic distortions, is growing at a tepid 2% rate. (2) China, though diversifying away from dollar denominated securities, still owns over $1T of our debt, and could create havoc by forcing worldwide interest rates higher with their sales. While the markdown on their remaining position might create some discomfort at home, this remains a possibility (3) China can offset new tariffs by weakening the Yuan, requiring retaliation by the US and other trading partners (4) China is dedicated over the long term to joining, or replacing, the US Dollar with the Yuan as a reserve currency. Most students of the situation believe that China is very substantially understating gold reserves. We believe that many other Chinese agencies besides the People's Bank of China have been buying physical gold, and far more than the PBOC has reported. Add the fact that adversarial Russia continues to purchase physical gold. Nothing would please China, or Russia, more than to replace the US Dollar with a new reserve currency that is backed by gold, and we believe that is where the worldwide monetary system is headed. It so happens that China and Russia are in the best position to do so. The key question remains: when ???

Roger Lipton