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We are now actually engaged in reducing our military establishment [by] one third, and discharging one third of our officers. We keep in service no more than men enough to garrison the small posts dispersed at great distances on our frontiers ... The session of the first Congress convened since republicanism has recovered its ascendancy [in the [Revolution of 1800](#)] is now drawing to a close. They will pretty completely fulfil all the desires of the people. They have reduced the army and navy to what is barely necessary. They are disarming executive patronage and preponderance, by putting down one half the offices of the United States, which are no longer necessary. These economies have enabled them to suppress all the internal taxes, and still to make such provision for the payment of their public debt as to discharge that in eighteen years ... they are opening the doors of hospitality to the fugitives from the oppressions of other countries; and we have suppressed all those public forms and ceremonies which tended to familiarise the public eye to the harbingers of another form of government.

U.S. President Thomas Jefferson
Letter to Thaddeus Kosciuszko (2 April 1802)

The United States owes debts everywhere. It owes debts not only to the countries of Latin America, Asia and Africa, but also to the countries of Europe and Oceania ... In appearance it is very powerful but in reality it is nothing to be afraid of; it is a paper tiger. Outwardly a tiger, it is made of paper, unable to withstand the wind and the rain. I believe the United States is nothing but a paper tiger.

Selected Works of Mao Tse-tung (14 July 1956)
Quoted in Gary North, [China's Monetary Tiger](#)

Debt is the original fair-weather friend. It is with you on the upside, and against you on the downside. So long has the financial sun been shining that it seems – especially to the bulls on Wall Street – as if the skies will never darken. But if you can acknowledge the possibility of even one inclement business season, you will want to reflect on the leveraged American condition. You will want to consider that debt may become just as unpopular one day as it is now popular. You may want to anticipate how a forward-thinking investor might profit from such a turn of events.

James Grant
“Michael Milken, Meet Sewell Avery”
Forbes (23 October 1989)

The Real Subprime Crisis: Why Should Uncle Sam Retain His AAA Rating?

In various statements since 11 September 2001, American, Australian, British and other politicians have vowed that their “war on terror” will last years, perhaps decades and maybe even generations. Since 2004, American politicians have referred to a [long war](#), and their lapdogs in Canberra have dutifully parroted the term (see, for example, John Howard’s use of the phrase “the long war against violent Islamic extremism” in [Why Our Troops Must Stay](#), *The Age*, 22 March).

Long wars, it stands to reason, require deep pockets. But more guns, “leaders” have assured their subjects, do not imply less butter. Quite the contrary: spending of all kinds will rise sharply. Not only are present “commitments” sacrosanct: other bribes, particularly medical subsidies required to assuage aging populations, will rise drastically. The anointed of America’s tax-consuming caste quite unapologetically, and its benighted tax-producers accept credulously, how the state will finance these obligations: the U.S. Government will graciously borrow and foreigners will dutifully lend. The true “coalition of the willing” comprises the savers and lenders of Asia and Europe. They underwrite America’s welfare at home and its warfare around the world.

Today, surprisingly few people question whether this “long war” is financially feasible; and virtually nobody is willing to canvass the likelihood that it and the government’s other grandiose ambitions will, in effect, push Uncle Sam into receivership (see, however, [Avoid the Rush: Prepare Now for America’s Bankruptcy](#)). Why should this possibility concern an Australian investment company? The plain and simple reason is that, for better or worse, perceptions about the U.S. Government’s creditworthiness calibrate the world’s economic and financial thermostat. For decades the conviction has been wide, deep and seemingly impregnable: U.S. Treasury securities are the planet’s safest credit risk. The yield of a Treasury bill has been the benchmark (or “risk-free”) rate of return; and other assets (ranging from American corporate bonds to European stocks to New Zealand real estate) are priced, if only indirectly, relative to its yield. In recent years, the yields of Treasury bills and bonds have stood at or near generational lows. These ultra-low yields have helped to generate what by historical standards are very high – and perhaps dangerously high – asset prices.

But what if these yields are far lower than they ought to be? What if, ironically, the “risk-free” rate is actually fraught with risk, and Uncle Sam’s sovereign credit rating overstates his creditworthiness? If so, then a disturbing possibility presents itself: in the future this rating may be downgraded – conceivably to “junk” levels. If that happens, then, to put it mildly, financial and economic shocks will reverberate around the world.

Whether it occurs gradually or suddenly, any change to the overall perception about America’s creditworthiness will, mostly through upward pressure upon interest rates and downward pressure upon securities’ prices, greatly influence the

types and the results of investment operations that firms like Leithner & Co. undertake. The stark reality is that if the financial statements and debt securities of the U.S. Government were analysed dispassionately – that is, by the same standards used to judge developing countries like, say, Botswana – then its pristine credit rating would fall. (Memo to Britons, Frenchmen, Germans and Japanese: your governments are also paddling in leaky boats.) This conclusion is not iconoclastic: one major ratings agency, Standard & Poor's, has taken it seriously enough to explore its implications (see in particular [In The Long Run, We Are All Debt: Aging Societies and Sovereign Ratings](#)).

America's national debt has increased from \$77m in 1789 to \$8.8 trillion (and rising rapidly) today. Its unfunded ("off-balance sheet") liabilities are at least \$53 trillion, perhaps as high as \$70 trillion, and are climbing rapidly. But most people either ignore or discount these developments. Yes, since the late 18th century debt has risen to hitherto unimaginable heights – but so too have standards of living. Observing this correlation, today's conventional wisdom infers that spending, particularly the debt-financed variety, causes prosperity. More of the former, they believe, necessarily produces more of the latter. This is America, its residents and their rulers proudly assert; and they act as if the laws of economics simply don't apply to them. Debts and deficits, to use the notorious phrase attributed to Dick Cheney, [simply don't matter](#). Major credit rating agencies apparently agree: despite the mountains of debt and their brisk rate of expansion, all award the U.S. the highest possible sovereign rating. The higher the rating, the lower is the perception that a government will repudiate its obligations, and the lower is the rate of interest creditors agree to receive from the amounts they lend. On that basis, everybody believes that Uncle Sam's promises are as good as gold.

This perception raises the question: exactly how is a country's sovereign credit rating derived? Agencies do not reveal all of their methods. But in [Determinants and Impact of Sovereign Credit Ratings](#) (Federal Reserve Bank of New York *Economic Policy Review*, October 1996), Richard Cantor and Frank Packer analysed handful of key variables. They also remind us why a country's rating is important: among other things, it exerts a strong influence upon the ratings assigned to corporate borrowers domiciled within that country. Agencies seldom if ever assign a rating to a municipality, provincial government or private company that is higher than that of the issuer's national government. This rule of thumb could one day put agencies into an interesting bind. What, for example, would happen to the spotless ratings of top-flight companies such as Berkshire Hathaway if the U.S. Government's rating were downgraded?

Sovereign ratings and changes thereto have vital implications for investors, individual and corporate, around the world; and to analyse and apply Cantor and Packer's key rating variables dispassionately is an eye-opening exercise (see also Eric Englund's [Should the US Government's Sovereign Credit Rating be Downgraded to Junk?](#)).

Per Capita Income

The higher the average income within a country, note Cantor and Packer, the bigger its government's potential tax base. The bigger the flock and the fatter its geese, the more the government can steal. The more rapidly average income rises, in turn, the more secure (from the state's, as opposed to the income earner's, point of view!) the tax base; and the bigger and more secure a potential tax-base relative to the state's borrowings, the stronger is its ability to repay debt.

Uncle Sam's debts and liabilities, as well as American households' debts and liabilities, are growing more rapidly than Americans' "real" (i.e., net of CPI) incomes. The rate of growth of real disposable personal income grew by 2.9% per year during the decade to 2003. Since 2001 or so, this rate has been little related to the growth of real GDP (see, for example, [these charts and comments](#)). In 2005 it plunged to ca. 0%. It rebounded in 2006, to a rate of more than 4% per year, but more recently has been decelerating. As a result, since 1990 and net of CPI, Americans' incomes have grown by ca. 2-3% per year.

In 2005, the average household earned \$45,000 of after-tax income and owed approximately \$8,000 of credit card debt, \$12,000 of other consumer debt and \$65,000 of mortgage debt. It devoted approximately 13% of its after-tax income to the repayment of interest and principal. This figure, known as the "debt-service ratio," has in recent years remained slightly above 13%, whereas the financial obligations ratio (which incorporates other recurring expenses such as rents, auto leases, homeowners' insurance and property taxes that decrease the uncommitted income otherwise available to households) has hovered a bit above 18%. (For details, see [Credit Card Industry Facts and Personal Debt Statistics](#) and [American Housing Survey for the United States: 2005](#).)

Since 1990, the average household's total debt has increased at ca. 6.6% per year and roughly 40-50% of households, particularly lower-income ones, presently spend more than they earn. Also since 1990, the sum of Uncle Sam's on- and off-balance sheet obligations has increased at roughly 7.5% per year (see, for example, [U.S. National Debt Clock FAQ](#)). As the habit of saving has collapsed (the personal savings rate as measured by the St Louis branch of the Federal Reserve has fallen from 8.5% in the 1970s to 7.5% in the 1980s to 5.0% in the 1990s to less than 0.0% since 2002), the indulgence of borrowing has exploded. During the past decade, consumers' incomes have probably – but not by a wide margin – outpaced their current expenditures. But in two respects consumers have been fortunate. First, until recently price rises in the supermarket, at the petrol bowser, etc. have been restrained. Second, very low rates of interest have mitigated the impact of the growing burden of debt. But what if the CPI and interest rates revert towards longer term (multi-decade) averages? If prices and rates rise at a quicker pace, then pressures upon households will magnify. Under these conditions, households would experience the "magic of compounding" in reverse.

“In evaluating household debt burdens,” said Alan Greenspan ([Understanding Household Debt Obligations](#), 23 February 2004), “one must remember that debt-to-income ratios have been rising for at least a half century. With household assets rising as well, the ratio of net worth to income is currently somewhat higher than its long-run average. So long as financial intermediation continues to expand [that’s bureaucratese for “as long as anybody who needs to borrow can do so on easy terms”], both household debt and assets are likely to rise faster than income.” In James Grant’s apt phrase, America’s “leveraged condition” is proceeding apace. Alas, trees do not grow to the heavens, actions have consequences and debt must be serviced and ultimately repaid. Can households’ balance sheets forever expand more quickly than their income statements?

But Dr Greenspan seemed to be relaxed. “Without an examination of what is happening to both assets and liabilities, it is difficult to ascertain the true burden of debt service. Overall, the household sector seems to be in good shape, and much of the apparent increase in the household sector’s debt ratios over the past decade reflects factors that do not suggest increasing household financial stress. And, in fact, during the past two years, debt service ratios have been stable.” All true – at a time when mortgage rates were very low, the prices of residential real estate buoyant and virtually anybody who wanted a loan could get one. Do we still live in such times? Will we do so during the next 5-10 years?

Hence another interpretation – one that might more accurately describe a time when the market price of residential housing, which comprises the bedrock of the typical household’s net worth, is (at best) rising more slowly than hitherto, is stagnant in many areas and is (at worst) falling. Modest rates of growth of personal income, brisk rates of growth of personal and governmental debt and high absolute levels of debt – in these respects, America’s tax base may rest upon less-than-impregnable foundations. If a country’s sovereign credit rating depends upon its government’s ability to confiscate, then the robber’s ability to plunder ultimately depends upon its victims’ financial health. Just as many Americans (like many Australians, Britons, Canadians, New Zealanders, etc.) who buy petrol and shop in supermarkets suspect that the CPI is rising more quickly than their rulers admit, they are also right to wonder whether they are actually in less robust financial shape than their overlords claim.

The External Balance of Trade and Finance

A deficit with the rest of the world indicates that a country’s public and private sectors (considered as a whole) import some combination of goods, services and capital from abroad. To consume and invest more than one earns and saves is to borrow from the rest of the world; and persistent and growing deficits increase indebtedness to foreigners. The greater the debt and the quicker the rate of growth of obligations, say Cantor and Packer, the less creditworthy is the country.

Are Americans living beyond their means? No doubt some of them have been, and the sub-prime mortgage imbroglio may well reveal that their number is

considerably greater than previously reckoned. But even if the mortgage and residential real estate woes are deeper and last longer than the optimists expect, it's extremely unlikely that Americans as a whole are candidates for bankruptcy. Is the U.S. Government living way beyond its means? Almost certainly. A review of American imports and exports of goods, services and capital that distinguishes clearly between individuals/private businesses on the one hand and governments on the other helps to corroborate these points.

A first important point is that since the Second World War (and probably since the early 19th century), *individuals' and businesses'* purchases of goods from abroad have tended to be producer goods (such as machinery, semi-finished goods, etc.) rather than consumer goods (such as plasma screen TVs, etc.). Further, during the past several decades the composition of private sector imports has changed notably. Consumption goods have comprised a steadily falling – and production goods a steadily growing – percentage of all imports. The classification of imports makes it difficult to distinguish producer from consumer goods. Nonetheless, and according to Sudha Shenoy ([Is America Living Beyond Its Means? Is That the Right Question?](#)), consumer goods constituted a bit less than one-third of private sector imports in the 1950s and 1960s, a quarter in the 1970s and ca. 23% in 2004. Further, American business' holdings of cash are presently near an historical high and their borrowings relatively low. Hence it does *not* appear that American individuals and businesses are borrowing against (or selling) assets in order to finance the purchase of foreign consumer goods.

A second point is that before ca. 1980 the U.S. was a net exporter of goods and capital; since then, it has become a net importer of all three. Since the early 19th century, America's private sector has imported capital from Europe. It still does, and Europe remains the single biggest source of foreign capital. According to Shenoy, Europe supplied 68% of total direct foreign investment in 1960 and 71% in 2004. Canada provided 28% of the total in 1960 but just 9% in 2004. Japan and all others provided 4% in 1960 and 20% in 2004. Indirect (a.k.a. "portfolio") investment – that is, buying shares of companies rather than directly buying land and entire businesses – has risen from a rather low base in the 1960s and now comprises a majority of foreign investment in the U.S. According to some, this reflects the attractions of American investments compared to non-American ones. Perhaps.

Related to this second point is the rough correlation between the U.S. household savings ratio and rising tide of capital imports. Over the decades, American households have "outsourced" their savings to foreigners. The savings which American households once supplied to American banks (who then lent it to American businesses) is now supplied mostly by foreigners. The gratification which Americans once deferred – that is, the discipline to save and consume less today in order to spend and consume more tomorrow – is now held much less in check than it used to be. And although current income continues to finance most of American households' consumption, a growing portion derives from borrowings (including borrowing against "home equity") and the sale of assets.

Some Americans, then, have been borrowing against (or selling) assets in order to finance the purchase of (mostly domestically produced) consumer goods.

The bull in the China shop is clearly the U.S. Government. As the supply of domestic savings has shrunk, Leviathan's demands have grown – and have thereby generated additional (i.e., in addition to private sector demand) and very large inflows of capital. These borrowings began to rise in the 1980s (to ca. 17% of all capital inflows), and since then have risen 2.5 times more quickly than foreign inflows into the private sector. By 2004, 34% of capital imported into the U.S. was earmarked for Uncle Sam's domestic welfare and international warfare. In Shenoy's words, "beyond argument, this is *the* exemplar of borrowing capital to finance current spending." Although he wasn't so blunt, Fed Chairman Benjamin Bernanke's testimony to the Committee on the Budget of the U.S. Senate ([Long-term Fiscal Challenges Facing the United States](#), 18 January) did not disagree.

What the Mainstream Calls "Inflation"

A high rate of "inflation" – that is, of growth of CPI – is, according to Cantor and Packer, a sign that structural problems are afflicting the government and its finances. The more marked the tendency of consumer prices to rise, the less secure the government's tax base, the less creditworthy the government and hence the riskier the debt it issues.

Like Alan Greenspan before him, Ben Bernanke never tires of emphasising that the CPI – whose rise, he always omits to mention, is an *eventual consequence* of inflation – is, compared to the 1970s and 1980s, quiescent. To the extent that the Man in the Street thinks about him, Dr Bernanke generates cognitive dissonance. Americans know full well (because they buy groceries and petrol) that some prices that are *not* supposed to rise are nevertheless steadily rising; and because they read the real estate section of the newspaper and look at estate agents' displays, they see that some prices that *are* supposed to rise are not (or aren't rising quickly enough). Yet they believe – and politicians fervently trust – that The Chairman has everything under control.

According to John Williams ([Government Economic Reports: Things You've Suspected But Were Afraid to Ask! Part IV](#)), however, the hunches of the Man in the Street are correct:

Inflation, as reported by the Consumer Price Index (CPI), is understated by roughly 7% per year. This is due to recent redefinitions of the series as well as to flawed methodologies ... In particular, changes made in CPI methodology during the Clinton Administration understated inflation significantly ... In a like manner, anyone involved in commerce, who relies on receiving payments adjusted for the CPI, has been similarly damaged. On the other side, if you are making payments based on the CPI (i.e., the federal government), you are making out like a bandit.

Williams concludes

Traditional inflation rates can be estimated by adding 7.0% to the CPI-U annual growth rate (3.8% + 7.0% = 10.8% as of August 2006) or by adding 7.4% to the C-CPI-U rate (3.4% + 7.4% = 10.8% as of August 2006) (see also [Haute Con Job](#) by Bill Gross).

Doug Noland of The Prudent Bear shares neither central bankers' opinion about the CPI nor the general public's (or financial journalists') opinion about central bankers. On 31 December 2004 he wrote in his *Credit Bubble Bulletin*:

The U.S. economy is in the midst of a distorted boom, with an increasingly ingrained inflationary bias. Asset bubbles are heavily influencing spending and investing patterns, hence the underlying structure of the economy. The nature of the U.S. bubble economy – where gross financial excess is required to fuel minimally acceptable employment gains – will be an issue for 2005. Current market rates and liquidity conditions appear poised to initially foster stronger-than-expected demand domestically and globally, although the unstable and unbalanced nature of the current global expansion will continue to provide fodder for those arguing for an imminent slowdown. I expect the Chinese and Asian inflationary booms to become increasingly problematic. Energy and commodities will remain in tight supply, with prices extraordinarily volatile but with a continued upward bias. The current minority Fed view that [a rising CPI] and marketplace speculation pose increasing risks has potential to become consensus. And I can certainly envisage a scenario of increasingly anxious central bankers eyeing inflationary pressures and unstable markets across the globe.

Growth of Gross Domestic Product (GDP)

If a country enjoys a relatively high rate of economic growth, Cantor and Packer reckon, then the burden of debt that exists at any point in time will, if it remains stable or grows more slowly than GDP, become easier to service over time. It is surely a coincidence! Tell us it isn't so! Not only does the CPI understate the extent to which American prices are rising: GDP figures exaggerate the extent to which the American economic pie is growing. Williams states in [Part V](#) of his series

The Gross Domestic Product (GDP) is one of the broader measures of economic activity and is the most widely followed business indicator reported by the U.S. Government. Upward growth biases built into GDP modelling since the early 1980s, however, have rendered this important series nearly worthless as an indicator of economic activity ... The distortions from bad GDP reporting have major impacts within the financial system ... With reported growth moving up and away from economic reality, the primary significance of GDP reporting now is as a political propaganda tool and as a cheerleading prop for Pollyannaish analysts on Wall Street.

The problem is that the same entity – the U.S. Government – plays the roles of economic advocate, judge and jury. The counterfeiter who owns the printing press (and can thus depreciate the currency at will) also arrogates to itself the measurement of economic growth. The heart of the problem, of course, is that the state collects economic statistics. Sir John Cowperthwaite:¹ where is your American opposite number? The official statistics that quantify the welfare-warfare state's untrammelled interventionism also provide the basis for credit agencies' assessments of that state's creditworthiness. Do Uncle Sam's statistics depict the results of his economic policies in the best possible light? Bill Gross, the world's biggest bond investor, expresses little doubt: "The rating agencies must come to understand that the federal government is putting out works of fiction with respect to the CPI and to GDP growth."

Solvency

A solvent entity is one that is able to pay its debts and meet its obligations when they become due. Individuals and private sector organisations use voluntary means to remain solvent, and coercive sector organisations use coercive and even violent means. Governments service their debts and other liabilities with taxes or proceeds from the sale of assets – both of which they have confiscated from individuals and the private sector. So if you don't already know it, here's something that you absolutely must keep in mind whilst perusing a government's financial statements: the assets on its balance sheet have been stolen; the valuation of assets is arbitrary but probably vastly overstated; and the extent of liabilities is probably hugely understated (see in particular Michael Rozeff's excellent [Washington's Assets Are Our Liabilities](#)).

Also bear in mind that Uncle Sam's financial condition is simply unauditably. In his [comment](#) on 2005's [Financial Report of the United States Government](#), his internal auditor (there is, of course, no external auditor), the Comptroller General, found – yet again! – that his financial statements are unreliable and that his financial controls inadequate. In particular, "A significant number of material weaknesses related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation continued to

¹ To minimise the temptation towards and the possibility of state intervention, Sir John (who was Hong Kong's Financial Secretary from 1961 to 1971) urged that the British government "should abolish the Office of National Statistics." The state's statistics, he knew, were handmaidens of bureaucrats' meddling in the marketplace. He also knew these interventions would certainly do no good and probably much harm. In his obituary, *The Guardian* wrote: "He refused to collect all but the most superficial statistics, believing they led the state to fiddle about remedying perceived ills, thus hindering the working of the market. This caused consternation: a Whitehall delegation was sent to find out why employment statistics were not being collected, but the Financial Secretary literally sent them back on the next plane."

Sir John's hands-off approach generated almost daily battles with Whitehall. On one occasion, when HMG insisted that the income tax be raised, he flatly refused. In his first speech as Financial Secretary, he stated an axiom that no bureaucrat can bear to hear: "In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralised decisions of a government, and certainly the harm is likely to be counteracted faster." Sir John was a formidable exponent of liberty and prosperity. As Denis Healey recalled, "I always retired hurt from my encounters with the redoubtable Financial Secretary."

1. hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information;
2. affect the federal government's ability to reliably measure the full cost as well as the financial and non-financial performance of certain programs and activities;
3. impair the federal government's ability to adequately safeguard significant assets and properly record various transactions; and
4. hinder the federal government from having reliable financial information to operate in an economical, efficient, and effective manner.

Because of the federal government's inability to demonstrate the reliability of significant portions of the U.S. Government's accompanying consolidated financial statements for fiscal years 2006 and 2005, principally resulting from certain material weaknesses, and other limitations on the scope of our work, described in this report, we are unable to, and we do not, express an opinion on such financial statements. As a result of these limitations, readers are cautioned that amounts reported in the consolidated financial statements and related notes may not be reliable ...

More generally, the financial management of the federal government's largest agencies fails to meet requirements enacted in 1996 (see [Accounting and Accountability in Government](#) by Karen de Coster). The Department of Defence is the major offender. In 2001, its Inspector General stated "we identified \$1.1 trillion [yes, that's a "t" and not a "b"] in department-level accounting entries to financial data used to prepare DoD component financial statements that were not supported by adequate audit trails or by sufficient evidence to determine their validity. In addition, we also identified \$107 billion in department-level accounting entries to financial data used to prepare DoD component financial statements that were improper because the entries were illogical or did not follow accounting principles. . . . [In conclusion], DoD did not fully comply with the laws and regulations that had a direct and material effect on its ability to determine financial statement amounts" (for details, see [The Government Needs to Get Its Own Accounting House in Order](#) by Robert Higgs).

Uncle Sam resembles nothing so much as an inept, hopelessly spendthrift and disorganised man who hurriedly stuffs a shoebox full of whatever documents and receipts he can find – and then throws the mess into a bewildered accountant's lap. In the private sector, people who generate massive waste and loss face the ire of shareholders are usually denied access to capital, often receive pink slips and running shoes and sometimes land in gaol. In the coercive sector, however, mismanagement is virtually never punished. Instead, it is typically lauded and rewarded. Given its shenanigans, the U.S. Government's balance sheet probably overstates its assets. It is certain that it vastly understate its liabilities.

Table 1: There's (Literally!) No Accounting for the U.S. Government

	30-09-04	30-09-05 (Restated)	30-09-06
Assets	(Billions of \$US)		
Cash and other monetary assets	97.0	85.8	97.9
Accounts, loans and taxes receivable	277.3	287.9	289.6
Inventories	261.5	272.0	281.3
Property, plant and equipment	652.7	670.2	688.5
Other assets	108.8	132.0	139.2
Total Assets	1,397.3	1,447.9	1,496.5
Liabilities			
Accounts payable	60.1	67.9	58.4
Debt securities held by the public, accrued interest and loan guarantees	4,372.5	4,624.2	4,867.5
Federal employee/veterans' benefits payable	4,062.1	4,491.8	4,679.0
Other liabilities	612.4	730.9	808.0
Total Liabilities	9,107.1	9,914.8	10,412.9
Net Position	(7,709.8)	(8,466.9)	(8,916.4)

The notes to financial statements often use soporific words but contain startling information, and the U.S. Government's are no exception. These notes blandly inform the reader that the government's balance sheet, or what passes for one, does not reflect intra-governmental debt holdings. Nor does it include accrued liabilities such as the net present value of Social Security, Medicare and other obligations. Clearly, it grossly understates the enormity of the U.S. Government's deficit of net worth. The *2004 Financial Report*, for example, contains a section entitled "Liabilities and Additional Responsibilities." It brings to the surface the staggering scope of Uncle Sam's liabilities:

The [30 September] 2004 balance sheet shows assets of \$1,397 billion and liabilities of \$9,107 billion, for a negative net position of \$7,710 billion. In addition, the Government's responsibilities to make future payments for social insurance and certain other programs are not shown as liabilities according to Federal accounting standards; however, they are measured in other contexts. These programmatic commitments remain Federal responsibilities and as currently structured will have a significant claim on budgetary resources in the

future ... The net present value for all of the responsibilities (for current participants over a 75-year period) is \$45,892 billion, including Medicare and Social Security payments, pensions and benefits for Federal employees and veterans, and other financial responsibilities. The reader needs to understand these responsibilities to get a more complete understanding of the Government's finances.

Yes, you read that correctly: in 2004, the net present value of the federal government's future obligations was nearly \$46 trillion. Add the "on balance sheet" liabilities to these "off balance sheet" liabilities, and in 2004 Uncle Sam's total negative net worth exceeded \$50 trillion. You think that's bad? This figure has grown and continues to rise rapidly, and is presently approaching \$60 trillion. It is true that the present value of future tax increases would offset part of this burden. But that is the point: massive increases of tax will be required in order to service – or draconian cuts of benefits will be necessary in order to reduce – today's obligations (see also [Is the United States Bankrupt?](#) by Laurence Kotlikoff).

On 30 September 2004 its "net worth" was negative \$7.7 trillion. A year later, the shortfall was \$8.5 trillion and in 2006 it approached \$9 trillion. In his Statement dated 1 December 2006, the Comptroller General added

... the U.S. Government's total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total approximately \$50 trillion, representing approximately four times the Nation's total output (GDP) in fiscal year 2006, up from about \$20 trillion, or two times GDP in fiscal year 2000. As this long-term fiscal imbalance continues to grow, the retirement of the "baby boom" generation is closer to becoming a reality with the first wave of boomers eligible for early retirement under Social Security in 2008. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary in order to address the nation's large and growing long-term fiscal imbalance.

Can such a government continue in perpetuity to service its long-term obligations? Yes – but by means that are hardly reassuring. Perhaps the biggest temptation will be to "monetise" these liabilities – that is, inflate the supply of money so aggressively and trash the purchasing power of the \$US so comprehensively that \$60 trillion becomes a "manageable" figure. Argentina and Brazil have followed this path: why not America? Another option, which appears to be becoming more politically popular by the day – perhaps because it has been used in the past – is to repudiate that portion of the national debt held by foreigners. A telling hint was dropped in a report dated December 2004 and entitled "[Trouble Ahead – Trouble Behind.](#)" Chris Dialynas, PIMCO's Managing Director, proposed that America's foreign creditors forgive a portion of the U.S. Treasury debt they hold.

The world's greatest military power is also its greatest debtor. Will it use its military might to redress its financial weakness? To intimidate its lenders and

repudiate its debts? Perhaps it's just a coincidence that the U.S. Government becomes most aggressive when countries (such as Iraq in 1989-90 and Iran since 2004) consider the use of a currency other than the \$US to transact petroleum exports (see also [Iran Asks Japan to Pay Yen for Oil, Start Immediately](#)).

Economic Development and “Undevelopment”

Cantor and Packer's analysis indicates that credit rating agencies incorporate into their assessment of a sovereign credit risk a “threshold effect” of the relationship between economic development and risk. Once a country attains a given level of development, its probability of default decreases markedly.

But as a matter of elementary history, the past does not proceed without bumps into the future. It is a mistake to extrapolate the one into the other; accordingly, one must not automatically equate a country's past glory and its future prospects. Past performance, as financial planners and funds managers rightly say, need not be a reliable indicator of future results. Steve Miller, the CEO of Delphi Corp., one of the world's largest auto parts manufacturers that entered bankruptcy protection proceedings in late 2004, concurs. He told *Business Week* (11 October 2004):

Let me turn to what I think is the broader context in which the Delphi drama is being played out. The two overarching themes here are globalisation and our aging population ... The implications for America are enormous, and it boils down to this: if you want your kids to enjoy the great American dream, get them a good education. The days when manual unskilled labour can deliver \$65 an hour are disappearing.

My recent experiences have been with three industries that are undergoing profound change – as CEO at Bethlehem Steel, as a board member at United Airlines and as CEO at Delphi. Steel, airlines and autos. What those three industries have in common is a social contract, worked out over the past half-century with strong centralised labour unions, to elevate their workforces with elaborate defined-benefit retirement programs. Back in the days when you worked for one employer till age 65 and then died at 70, and when health care was unsophisticated and inexpensive, the social contract inherent in defined-benefit programs perhaps made some economic sense.

Today, defined-benefit programs are an anachronism, and we are witnessing the slow agonising death of defined benefits as industrial compensation policy. First off, they force people to stay with one employer, even though we have a much more mobile and flexible population these days. The lack of portability of defined benefits is a real issue. Second, the notion of having all your retirement eggs in one basket – your employer – is a concentration of risk that is simply inadvisable for anyone in today's fast-moving economy. Finally, these programs have a way of threatening the existence of traditional large

employers. GM is a junk-bond credit these days as it staggers under a burden of \$150 billion of combined pension and health-care retirement obligations.

Beyond Delphi, things are going to get messy for the Big Three [U.S. automobile manufacturers]. The current labour agreements expire in 2007, and it will be a historical collision point for all these social and economic forces that are at work. GM has already declared it can't wait till then to trim its \$80 billion of accrued retiree health-care obligations. Clearly, they are headed down the same Chapter 11 path as Delphi, unless there is dramatic change in their staggering legacy labour burden.

My worries go beyond the auto industry. What I am describing is also embedded in our debates over Social Security and Medicare. The overwhelming voltage in the political third rail of touching these entitlements will forestall corrective action for years, but the problem will only grow. I fear something like intergenerational warfare, as young people increasingly resent having their wages reduced and taxed away to support social programs for their grandparents' income and health-care concerns.

History of Default

Other things being equal, reason Cantor and Packer, a country that has defaulted on its debt in the past is a greater credit risk than a country that has a pristine record of repayment. Alas, their analysis succumbs to a pervasive myth. Virtually everybody believes that the U.S. Government's debt obligations are default-proof. They believe that it has never refused, and will never refuse, to honour its promises to pay. To perpetuate this myth is to ignore history. In the past, the U.S. Government has not just disavowed its financial obligations: it repudiated the very international monetary system that it imposed upon other countries.

Remember Bretton Woods (1944-1971)? Murray Rothbard ("The World Currency Crisis," in *Making Economic Sense*, Ludwig von Mises Institute, 1995) does:

For two decades, the system seemed to work well, as the U.S. issued more and more dollars, and they were then used by foreign central banks as a base for their own inflation. In short, for years the U.S. was able to "export inflation" to foreign countries without suffering its ravages. Eventually, however, the ever-more inflated dollar became depreciated on the gold market, and the lure of high-priced gold they could obtain from the U.S. at the bargain \$35 per ounce led European central banks to cash in dollars for gold. The house of cards collapsed when President Nixon, in an ignominious declaration of bankruptcy, slammed shut the gold window and went off the last remnants of the gold standard in August 1971.

In that month the U.S. Government suspended the exchange of foreign-owned \$US for gold. It renounced its obligations to its non-American creditors, and

unilaterally reinterpreted them to suit itself. At the stroke of a pen, the \$US became a monetary unit of no fixed or defined value. No longer backed by gold, it was henceforth “backed” solely by Uncle Sam’s ability to tax his subjects and inflate the money supply. The incentive for Washington to moderate its debt and restrain its expenditure disappeared, and its incentive to spend as if there were no tomorrow and to devalue what it owed to its creditors became overpowering.

So much for the U.S. Treasury’s treatment of foreign creditors. Has it ever shafted its own citizens? Yes. In his [infamous Executive Order of 1933](#), FDR decreed that any American who owned gold coins, bullion and certificates thereby committed a criminal offence. He thereby repudiated the U.S. Government’s promise to pay its creditors in the prescribed gold coin. Citing the terms (set by the Treasury!) of his bond, a certain Mr Perry sought to redeem it for gold. The Feds not only refused: they forced him – and everybody else who wanted to sell their securities – to accept the “legal tender” it could print in limitless amounts. Stated in dry legalese, the essential facts of [Perry v. United States, 294 U.S. 330 \(1935\)](#) were

Plaintiff brought suit as the owner of an obligation of the United States for \$10,000, known as “Fourth Liberty Loan 4¼% Gold Bond of 1933-1938.” This bond was issued pursuant to the Act of September 24, 1917, 1 et seq. (40 Stat. 288), as amended, and Treasury Department circular No. 121 dated September 28, 1918. The bond ... provided: The principal and interest hereof are payable in United States gold coin of the present standard of value.

Must the state honour the terms of its promises to its own subjects? According to Justice Stone of the Supreme Court, speaking for the majority,

There is no question as to the power of the Congress to regulate the value of money: that is, to establish a monetary system and thus to determine the currency of the country. The question is whether the Congress can use that power so as to invalidate the terms of the obligations which the government has theretofore issued in the exercise of the power to borrow money on the credit of the United States ...

As much as I deplore this refusal to fulfil the solemn promise of bonds of the United States, I cannot escape the conclusion, announced for the Court, that in the situation now presented, the government, through the exercise of its sovereign power to regulate the value of money, has rendered itself immune from liability for its action. To that extent it has relieved itself of the obligation of its domestic bonds ...

The Court’s ruling allowed the state, unilaterally and arbitrarily, to change the rules of the contracts it had exchanged with U.S. citizens. People who had lent to Uncle Sam in good faith subsequently lost up to two-thirds of their capital’s purchasing power. To those who equated gold with money, the sanctity of contract with civil order and stable monetary arrangements with civilisation, these developments spelt catastrophe. Justice McReynolds delivered the Court’s dissenting opinion:

The record reveals a clear purpose to bring about confiscation of private rights and repudiation of national obligations. To us these things are abhorrent ... The Constitution, as many of us have understood it, the instrument that has meant so much to us, is gone. The guarantees heretofore supposed to protect against arbitrary action have been swept away. The powers of Congress have been so enlarged that now no man can tell their limitations ... If the dollar be depreciated to five cents or possibly one, then, through fraud, all Government obligations could be discharged quite simply. Shame and humiliation are upon us now. Moral and financial chaos may confidently be expected.

Sen Carter Glass added “it’s a dishonour ... This great government, strong in gold, is breaking its promises to pay gold to widows and orphans to whom it has sold government bonds with a pledge to pay gold coin of the present standard of value.” FDR consulted Sen Thomas Gore about the annulment of the gold clause. Quoth the Senator: “why, it’s just plain stealing, isn’t it, Mr President?” In sharp contrast, Sen Elmer Thomas called it “the most important proposition that has ever come before any parliamentary body of any nation of the world” and rubbed his hands at the massive transfer of wealth from creditors to debtors – particularly the U.S. Government (see James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken*, Farrar Straus & Giroux, 1992). Memo to America’s foreign creditors: hire good economic historians, read their research and heed their warnings.

Why Shouldn’t America Be Rated Below Botswana?

In August 2002, the world’s major debt rating agencies downgraded Japan’s sovereign credit rating. Standard & Poor’s and Fitch lowered it to a level equal to Botswana’s, and Moody’s reduced it below Botswana’s. For several years, this African country has boasted the same S&P rating as Greece, Cyprus, Kuwait, Malta and Slovenia; and it has a higher credit rating than many of the strongest countries in Central Europe, Latin America and Asia – including Argentina, Chile, the Czech Republic, Hungary, Korea, Malaysia, Mexico and Poland (see, for example, [Standard and Poor’s Releases Botswana’s 2004 Sovereign Credit Rating](#)). Officials in Tokyo, partly embarrassed and mostly outraged, demanded that these agencies justify their actions. Moody’s sent representatives to testify to a parliamentary committee, S&P sent the committee a detailed analysis (which was debated *in camera*) and Fitch released a summary statement as a press release.

At first glance, and as summarised in Table 2 (see also [Should Japan Be Rated Below Botswana?](#) by Syed Ehsan and [Should the US Government’s Sovereign Credit Rating be Downgraded to Junk?](#) by Eric Englund), Japan compares favourably to Botswana in some respects (such as per capita income), unfavourably in others (GDP growth) and equals it in the rest (external balance). If each of these factors were accorded an equal weight, then the two countries’ sovereign ratings would roughly be equal. Clearly, some variables weighed more forcefully, and others less heavily, upon the rating agencies.

For decades, the rate of growth of per-capita income in Botswana has ranked among the fastest in the world. Since it obtained independence from Britain in 1966, [Botswana's economy](#) has enjoyed one of the world's highest rates of economic growth – averaging about 9% per year to 1999. [Since then](#), the growth of “real” GDP has slowed to ca. 5-7% per year. It boasts an extended history of budget surpluses, has little domestic debt, a very small foreign debt and has stockpiled foreign-exchange reserves equivalent to several years of current imports. Public sector net external assets are among the world's highest. Botswana, then, is well-managed. Its small size, dangerous neighbourhood, very heavy reliance upon the export of minerals (particularly diamonds) and very high infection rate from HIV-AIDS have pressured, but have not lowered, its sovereign rating.

Table 2: You Pick the Deadbeat

	Botswana	Japan	USA
Per capita income	Low but rising	High	High
GDP growth	Strongly positive	Mildly Positive	Positive
“Inflation”	Modestly rising CPI	Stagnant CPI	Modestly rising CPI
Fiscal position	Strong surplus	Astronomical deficit	Astronomical deficit
External balance	Surplus	Mammoth surplus	Very high and rising deficit
External debt	Very low	Very low	Very high and rising
Level of economic development	Low but rising	High	High but with “undeveloping” tendencies
Default history	No	No	Yes

Japan, too, as its officials reportedly berated Moody's analysts, possesses major economic strengths. It is the world's largest creditor nation; has one of the world's largest reserves of foreign exchange and the world's biggest external balance; and boasts the world's largest pool of domestic savings. Credit agencies acknowledged these strengths – but added that large and growing weaknesses outweigh them. Prominent among them are Japan's enormous and rapidly growing fiscal deficit, its decade-long stretch of negative economic growth and “deflation” and its then-sickly banking system. But what weighed most heavily upon the agencies was their perception that Japanese politicians lacked political will not just to *correct* these various problems: they could barely bring themselves to *acknowledge* them.

With respect to default history, inflation, external balance and external debt, the U.S. is clearly inferior to Japan. Similarly, on several significant dimensions America compares unfavourably to Botswana. A stark conclusion therefore presents itself: if two agencies assigned the same ranking to Japan as to Botswana,

and another assigned a lower rating to Japan than to Botswana (which reveals that the agencies showed no particular favouritism towards Japan), then logically the U.S. should have been assigned a lower rating than Botswana. But America enjoys the highest possible rating. Why? Does this paradox call into question the credibility of the major rating agencies? (Interestingly, the Japan Credit Agency continues to accord its government the highest possible – AAA – rating.)

Major agencies are hardly oblivious to this issue. In a research report released on 22 March 2005 and entitled [In The Long Run, We Are All Debt: Aging Societies and Sovereign Ratings](#), S&P concluded that unless they move quickly and forcefully to balance their budgets and reduce their spending, spiralling pension and medical expenditures will within 30 years reduce the debt status of the world's richest industrialised countries to non-investment grade status. If current policies remain unchanged then the sovereign debt of France, presently rated AAA by S&P, will become “junk” (i.e., plummet to sub-investment grade) by the early 2020s. That of the U.S. and Germany will do so before 2030 and the UK will follow by 2035 (see also [Mona Lisa Up for Sale in French Doomsday](#) by Matthew Campbell).

S&P's report emphasises that this scenario is not a prediction. “It is a simulation that highlights the importance of age-related spending trends as a factor in the evolution of sovereign creditworthiness. In reality, it is highly unlikely that governments will allow debt and deficit burdens to spiral out of control. The example of Italy in the past two decades is instructive: once governments are confronted with unsustainably rising debt burdens they do react, however reluctantly, by tightening [their] fiscal stance.” Well, maybe. As the report itself acknowledges, aging is only one factor that imperils Western governments' solvency. Their presently feeble fiscal position, above and beyond the pressures of age-related spending, is another. If American, British, French and German governments balance their budgets and then keep them in order, then in 2050 their projected debt ratios would on average be only about one-half as great as they would otherwise be – even without squeezing age-related outlays. This “forcefully underlines the need to embark on a prudent fiscal stance as early as possible to be able to better absorb the surge of entitlements ahead.”

But there is precious little evidence that these governments are heeding this message. The question for investors is thus: do you believe that major Western governments will repair their appalling finances sufficiently to avert the slump of their credit ratings that S&P projects will occur if they do not? People aged 75 and above can safely ignore this looming train crash (if that is what it is); those aged 20-75 might take steps to shield themselves; and those aged 0-20 – to say nothing of the unborn – could, for once, have real grounds to resent their elders.

On [Inside Business](#) (7 May 2006), Marc Faber raised this generational point:

MARC FABER: ... We are in a global boom but it doesn't change the fact that it is an imbalanced boom and it's driven largely by

credit creation in the US, leading to overconsumption, leading to a growing trade deficit, current account deficit, the accumulation of reserves in Asia and a global boom. But it is nevertheless an imbalanced boom and one day there will be a problem, certainly with the \$US dollar. The \$US is a doomed currency.

ALAN KOHLER: Doomed?

MARC FABER: Doomed. Will be worthless. Actually, each one of your [viewers] should buy one US Treasury bond and frame it – put it on the wall so they can show their grandchildren how the \$US and \$US-denominated bonds became worthless as a result of monetary inflation.

Four Modest Suggestions

What, then, can and should Americans do? My guess is that, whether they like it or not, reality will ultimately oblige them to turn towards the conception of their country that its Founders held. At this conception's core lie four ideas. First, government is inherently evil: and that state which is least evil has a weak Executive, is securely chained to a constitution and is restricted insofar as possible to local affairs. In a letter to Elbridge Gerry on 26 January 1799, Thomas Jefferson wrote "I am for preserving to the States the powers not [explicitly assigned] to the Union, and to the legislature of the Union its constitutional share in the division of powers; and I am not for transferring all the powers of the States to the General Government, and all those of that government to the executive branch."

Before the Civil War, the United States (plural) were a voluntary association joined by sentiment and natural law. Since 1865, the United States (singular) has been a centralised union cemented by bald lies and brute force. But truth and peace are robust things that occasionally pierce through the statist haze. And their lesson is unequivocal: whatever the alleged "problem" or "issue" at hand, (a) the proposed (and these days almost invariably interventionist) "solution" is probably illegal because the federal government has no constitutional authority to execute it, and (b) in the very unlikely event that a government can or should play any useful role, jurisdiction properly resides at the state or (preferably) municipal level.

A first suggestion is thus to purge the evil legacy of Abraham Lincoln (see in particular the research of [Thomas DiLorenzo](#)). Residents of the U.S. would be far freer and richer if weeds grew on the deserted thoroughfares of Washington DC; if the old Articles of Confederation replaced the Constitution; and if an American regarded himself first as a resident of (say) Albemarle County, then as a Virginian and third (if at all) as an American.

Jefferson's letter to Gerry continued: "I am for a government rigorously frugal and simple, applying all the possible savings of the public revenue to the discharge of the national debt; and not for a multiplication of officers and salaries merely to

make partisans, and for increasing, by every device, the public debt, on the principle of its being a public blessing.” If Americans wish to return to their roots, then they must abandon the awful legacy of Herbert Hoover, FDR and their camp followers. They must scrap the New Deal, Fair Deal, New Frontier, Great Society and all the rest (see also [The Book on FDR We Don't Have](#) by Gary North).

Jefferson was “for relying, for internal defence, on our militia solely, till actual invasion, and for such a naval force only as may protect our coasts and harbours from such depredations as we have experienced; and not for a standing army in time of peace, which may overawe the public sentiment; nor for a navy, which, by its own expenses and the eternal wars in which it will implicate us, will grind us with public burthens, and sink us under them.” Truly patriotic Americans seek to abandon the “war on terror,” dismantle the warfare state, ditch the empire, close all the overseas (and almost all domestic) military bases, and repatriate and then disband the troops (see also [Financing the Empire](#) by Mark Thornton).

Finally, Jefferson told Gerry “I am for free commerce with all nations; political connection with none; and little or no diplomatic establishment. And I am not for linking ourselves by new treaties with the quarrels of Europe; entering that field of slaughter to preserve their balance, or joining in the confederacy of kings to war against the principles of liberty.” The sooner Americans abandon the evil [Wilsonian](#) fantasy whereby the U.S. Government is (i) the world’s moral guardian, (ii) the adjudicator of complex and intractable religious, ethnic and other disputes and (iii) the underwriter of democracy, the better. If Americans reclaim their roots, then they will realise, as [Rose Wilder Lane put it in a letter to Ludwig von Mises](#) (5 July 1947),

... as an American I am of course fundamentally opposed to democracy and to anyone advocating or defending democracy, which in theory and practice is the basis of socialism.

It is precisely democracy which is destroying the American political structure, American law, and the American economy ... (see also [F.A. Harper on Democracy](#) by Gary Galles).

If [Ron Paul](#) has anything to do with it, Thomas Jefferson and his ideals of decentralisation, a minimum state and the maximum reduction of debt, anti-militarism and anti-imperialism, free markets and free trade will again have their day (see also [Ron Paul's Summer Reading List](#) and his [Statement of Faith](#)). In the meantime, nobody should blindly assume that the U.S. Government’s vast and growing pile of debt – long regarded as the safest of investments – is “risk-free.” Nobody, therefore, should confidently expect that in the future interest rates will be so low and the prices of assets so high.

Chris Leithner