FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Paper Promises

I just finished reading Paper Promises: Debt, Money and the New World Order (4 stars) by Philip Coggan, which was published in 2012. This sober (and sobering) book explains the situation in which we now find ourselves. From the dust jacket: "For the past 40 years, Western economies have splurged on debt. Now, as the reality dawns that many debts cannot be repaid, we find ourselves again in crisis. But the oncoming defaults have a time-worn place in our economic history. As with crises in the 1930s and 1970s, governments will fall, currencies will lose their value, and new systems will emerge....In the process, rich will be pitted against poor, young against old, public sector workers against taxpayers, and one country against another. To understand the origins of this mess...Coggan shows us how our attitudes toward debt have changed throughout history—and how they may be about to change again."

I started reading this book some time ago but set it aside a number of times, as the first three fifths of the book was a bit of a slog, but the rest was fairly interesting.

Coggan highlights one of the perverse incentives that the Fed and federal government created when they bailed out banks in 2008 that they deemed "Too Big to Fail." Namely, it made sense for banks to become Too Big to Fail so that they would be bailed out during the next financial crisis. So now the banks that were Too Big to Fail in 2008 are even bigger today.

Coggan also notes the unintended consequences of the federal government's creation of the FDIC following widespread bank failures during the Great Depression: "This leads to a 'moral hazard' problem. Depositors have no incentive to monitor the health of their banks since governments stand behind them and will guarantee their deposits....Banks ceased to compete on safety. Instead they competed to attract shareholders by the size of their profits, creating the incentive to take more risk. The banks profited when their bets paid off, but the taxpayer ended up with the bill when the bets were unsuccessful." Silicon Valley Bank, Signature Bank and First Republic Bank competed on virtue signaling, not safety.

Coggan writes that "developing countries used to be notorious for having governments that were in cahoots with, or controlled by, a few powerful businessmen. But now that could be said of the U.S." He quotes the authors of the book 13 Bankers: "The Wall Street banks are the new American oligarchy—a group that gains political power because of its economic power, and then uses that political power for its own benefit." Coggan notes that Hank Paulson "was the second Goldman Sachs alumnus, after Robert Rubin, to be Treasury Secretary within a decade." Now JPMorgan Chase CEO Jamie Dimon is making noises about running for President.

Coggan explains why bankers are no longer in the Sound Money camp: "Modern bankers have no interest in deflation; they have every interest in ensuring that the gravy train of higher debt and rising asset prices keeps rolling....there [is] no real financial lobby for balanced budgets or higher interest rates."

Coggan quotes Arnaud Mares of Morgan Stanley: "The question is not whether [governments] will renege on their promises, but rather upon which of their promises they will renege, and what form the default will take." Coggan continues, "The main problem is that debt regularly needs to be refinanced....Every time that happens, the creditors have to believe the debtors are good for their money; it is like a regular vote of confidence. And loss of confidence is contagious. If one debtor defaults...lenders may fear that other debtors will follow suit. The higher the ratio of debt-to-GDP, the worse this potential problem becomes."

Coggan points out the demographic time bomb that will collapse the Ponzi scheme: "In America, there were 5.3 workers per retiree in 1970, 4.6 in 2010, and there will be 2.6 in 2050." Meanwhile, state pension systems didn't change as life expectancy dramatically increased. For example, in Britain, the average retirement period increased by 75% from 1950 to 2008. Coggan continues: "...the key difference of the last 300 years has been that each generation has been bigger than the last. The ageing of the developed world means this is no longer the case."

Coggan cites a report by Standard & Poor's that forecasted that "the median advanced country's budget deficit will rise from 4.7% of GDP to 7.5% in 2020 [I'm sure it was higher than that due to COVID], 9.7% in 2030 and 24.5% by 2050. Age-related spending would absorb 27% of the typical advanced economy's GDP by 2050. That will push the median…debt-to-GDP ratio to 78% by 2020, 112% by 2030 and 329% by 2050."

Coggan explains why so many pension funds are underfunded today, many of them severely: "Many companies used the bull market of 1982-2000 to take a contribution holiday. The temptation [to reduce contributions] is just as great for government bodies." For example, the governor of New Jersey "increased the assumed rate of return on the pension fund…[which] allowed him to lower the contribution rate….His successors further eased the accounting assumptions and increased the benefits. As a result, by… 2010, the state pension fund had a deficit of $173 billion…a figure three times its official debts. This problem was replicated all over America. According to one calculation, the…states had a collective pension deficit of $3.2 trillion…."

Coggan describes what happened when the Baby Boomers went from being hippies to yuppies: "…there should have been a surge in the savings rate in the 1990s and 2000s as the baby boomers moved into the 45 to 55 age range. The odd thing about American baby boomers, however, is that they did the opposite. The savings rate was very low, by historic standards, between 1990 and 2010." That's OK, keep spending away, Gen Xers and the stupid taxpayers will pay for it all.

Coggan emphasizes the key role that confidence plays in the financial system. Vendors accept our fiat currency "because they believe the paper has value and can be passed on to someone else; we deposit money in the bank because we believe it will always be there….At root, this confidence depends on our belief in the state….And that in turn requires creditors…to believe that its economic policy is sound and that its taxpayers have the capacity to pay those debts back. Thanks to the crisis of 2007 and 2008, some countries have reached the stage where creditors no longer have that belief."

Coggan makes a point that I've made several times before: "…if the answer to our economic problems is to hold interest rates near zero, and for governments to spend far more than they take in taxes, mankind would surely have discovered this solution long ago. Life cannot be that easy." Coggan quotes two hedge fund managers: "Printing money and extending credit do not create wealth. If they did, all the world's problems could be solved with a few computer keystrokes."

Coggan quotes economist Peter Bernholz, who has studied hyperinflation: "There has never occurred a hyperinflation in history which was not caused by a huge budget deficit of the state." Bernholz believes that the tipping point comes when the deficit reaches 40% of annual government revenues. According to the U.S. Treasury's own data, that ratio is currently 38.4%.

Coggan points out, as I have a number of times before, that the federal government has the mother of all adjustable rate loans: "In the case of America, the average debt rolls over in less than five years." What do you do when you have to roll over about $7.5 trillion of debt every year, and interest rates suddenly spike?

Coggan quotes bond king Bill Gross, who wrote in 2011, "nearly 70% of the annualized [bond] issuance since the beginning of QE2 has been purchased by the Fed…[so] the legitimate corollary question is—who will buy Treasuries when the Fed doesn't?" Fewer buyers mean higher interest rates.

Coggan writes that when a government decides to default on debt that is held mostly by its own citizens, it's a momentous decision. "It means punishing savers, who may well be elderly and have no means of replacing their lost income....And it may well result in the failure of the domestic banks. The banks are locked in embrace with their governments like two drowning men, each dragging down the other. Often the domestic banks are big holders of government debt since such safe assets are deemed to bolster the balance sheet. So a government default may cause some banks to bear heavy losses or even go bust."

As I wrote about in Issue #34, thanks to Basel III, today banks (and pension funds) are stuffed to the gills with government debt that may soon be worth far less. Coggan writes, "Domestic investors such as pension funds were forced to lend to governments through regulations that restricted their investment freedom....It is not too much of a stretch to see the Basel III rules, agreed after the 2007-08 crisis, as a step down the road to financial repression. Banks are being forced to hold more capital, a policy that will lead them to own more government bonds. Pension funds also own more government bonds these days....financial repression may re-emerge in the guise of prudential regulation." Trying to prevent a repeat of the last financial crisis will in fact help precipitate the next one.

I should also point out that in recent years, the federal government has tried to find ways to "nudge" employees into holding its debt (and thus reducing its borrowing cost) by making automatic enrollment in 401(k) plans the default choice, and making some type of stable value fund (which are heavily invested in U.S. Treasuries) the default investment option. Many 401(k) plans include "life cycle" funds as investment options (sometimes as the only option), and many of these funds also own a lot of Treasuries. Thus the government can find more Dumb Money to buy its debt. They will be the last ones to figure it out and will be left holding the bag.

Since 2009, I've said that the next financial crisis will be the worst in human history, and Coggan seems to agree: "...the debt is unlikely to be repaid in real terms....Any of [these] outcomes—inflation, stagnation or outright default—is likely to result in a crisis at some stage. This crisis will be at least as severe as the one in 2008, with falling markets, troubled banks and corporate bankruptcies."

Coggan writes, "From the late 1990s onwards, the main investors in government bonds were not retail investors or...fund managers....Instead they were central banks and sovereign wealth funds in Asia and the Middle East...." If the U.S. gets drawn into a war in the Middle East on the side of Israel, it will be interesting to see what Arab sovereign wealth funds do with their U.S. Treasuries. If Arab countries can impose an oil embargo on the U.S. (as they did in 1973), they can certainly sell their Treasuries.

In closing, in academic finance, the U.S. Treasury bill is assumed to be the risk-free asset, but in recent years, pundit James Grant has said that Treasuries now provide "return-free risk." Similarly, Coggan writes, "The European [sovereign debt] crisis has shown that government bonds are not the risk-free asset that they had been assumed to be."

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