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April 2019

<u>Dangers of Dollar Debasement (….think MMT)</u>

For decades, the Federal Reserve claimed that monetary policy worked on an 18-to-24-month lag. Today, the Federal Reserve says that it is data dependent. It cannot be proactive and reactive simultaneously.

By making this shift, the Fed will fail, once again, to focus proper attention on longer-term consequences of its actions, and now the stakes are higher. The Federal Reserve's post-crisis policy of 0% interest rates and quantitative easing has already been accused of widening inequality, creating asset bubbles, fueling indebtedness, and sowing seeds of moral hazard. A return to these experimental accommodative measures today risks creating a catastrophe.

Fueling its pivot is an old failed theory which has reared its ugly head again, but with the new moniker 'Modern Monetary Theory' or MMT. MMT argues that countries will not pay a penalty for having their central banks purchase government bonds to finance deficit spending. Nothing could be further from the truth, because central bank asset purchases and debt forgiveness risks debasing the US dollar (USD).

Aided by the Fed's low interest rate policy, US federal debt recently surpassed $22 trillion. According to the CBO it will hit $34 trillion by 2028. (These figures do not include the $123 trillion of the unfunded Medicaid and social security costs.) No doubt, the Federal Reserve's asset purchases and low interest rates have accelerated and enabled US deficits.

To underwrite these large future debt levels, the US will need foreign countries to continue to use US Treasuries as the anchor of their foreign exchange reserves. At present, the USD is the world's currency and Treasury securities are the collateral that fuels the global financial system.

But buyers can lose faith in a reserve currency. In the 1960's, economist Robert Triffin outlined what became known as the 'Triffin Dilemma'. An issuer of a reserve currency faces incentives to run a balance of payments deficit <u>and</u> surplus at the same time. A deficit is necessary to provide liquidity to other countries in need of foreign exchange reserves. However, a chronic deficit, in turn, undermines confidence in the USD.

In practice, there must be a limit to chronic deficits. That limit is the point at which foreigners lose faith in the long-run value of a currency.

Treasuries are viewed as risk-free assets. They are risk-free because the government controls the money printing press which it can use to pay back debts. However, a foreigner will always ask what the purchasing power of those USD's will be when they are received in the future.

If the US falls into recession, deficits and debt will grow even larger and the dollar will sink. The Fed might react by cutting rates to zero again and execute further QE purchases. Such actions would undermine the value, real and perceived, of the USD. Foreigners could flee dollar-denominated assets, or at a minimum, re-cycle fewer dollars into the US assets. Treasury yields would spike and the Federal Reserve could face a crisis of its own making.

Fiat currencies derive value from the promises of the sovereign issuer to pay back its debt. When money is no longer acceptable for repayment of debt, it then ceases to be money, regardless of its status as legal tender. This happened in the Weimar Republic, Zimbabwe, and Venezuela long before their currencies were officially retired or redenominated.

Central bank money printing with 'fiat' currencies is a main reason why Bitcoin and other crypto-currencies are so popular. The dollar alternatives are an early warning sign of central bank aggression.

Investors would be wise to ask themselves a few questions. What would happen to the USD and Treasury yields if the Federal Reserve lowers interest rates? Would the Federal Reserve ever raise interest rates amidst economic weakness in order to stabilize a sinking USD? What are the risks that very low interest rates give further incentive to dangerous and experimental domestic economic policies like MMT?

It is time that Washington begins to think more broadly about what allows the United States to keep its position as reserve currency hegemon. It is also time that the Federal Reserve begins to think about the unintended consequences of its low interest rate and QE policies.