US Debt: A Recipe for Economic Disaster?

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The foundation of the US dollar is already under threat. If it collapses, it will take other economies and currencies down with it.

The United States has dug the biggest economic hole in human history. It's become so severe that if you listen carefully, you'll hear the Chinese — the biggest holders of American debt — wondering if they'll ever get their money back. The foundation of the US dollar is already under threat. If it does collapse, it will take other economies and currencies down with it.

At the summer 2010 meeting of G20 countries, European countries including the United Kingdom and Germany urged President Obama to implement austerity measures with them. The American president refused. Instead, he steered the economy in the opposite direction — by pumping billions more into the economy.

The United States is moving to the left. Meanwhile, European countries, recognizing some major flaws in their system, are moving right. Some socialist aspects of their societies are being reduced. For example, the tax burden on citizens and companies are being relaxed even as they decrease government spending. Europe is moving toward free enterprise.

In essence, the Obama administration plans to tax and spend the country back into prosperity. While it might make sense in theory, the policy has never been attempted in this magnitude before and it can fail (at my firm, we're believers in a small government). It's also important to note that more than four out of every 10 dollars today is already borrowed — in stimulus spending. Another concern is that "redistributing" the wealth is inefficient.

For most, however, the above reasons are relatively easy to accept because there are limited choices on the matter. But the third consideration is more serious: The United States is already bankrupt. Continuing free-spending policies might hurt rather than strengthen the country's economy. There's no longer enough genuine wealth to buy a way out of the debt that just seems to grow bigger each day.

Lower Purchasing Power

In 2007, the US Senate and the House of Representatives increased the federal government's spending baseline to over $4.4 trillion. There's no money to pay for all the stimulus money. Already, the government is borrowing $0.41 for every dollar it spends. By August 2010, the country already has a debt of more than $1.47 trillion. In one way or another, taxpayers will have to foot the bill.

According to government reports, consumer prices only experienced an annual increase of

1.1%. But when you look around, basic food prices have increased by a dramatic 48% over the past year! This statistic is measured by the price of corn, wheat, canola, and oats. There are a lot of worrying implications to this development — it suggests that the jump in gold and silver prices is not only about supply and demand, it's also driven by the lower purchasing power of consumers. It's already showing up on the price of physical goods.

Aiming for Demand-Based Inflation

The Federal Reserve has recently auctioned off $32 billion worth of three-year Treasury Notes as part of its short-term plan to sell $66 billion of debt. The notes have an all-time record rate of 0.57%. While the move has its champions, it's not without critics as well. Michael Berry, an investor and former fund manager, provides his insights. According to Mr. Berry, "Deficit spending is not working. So, ultimately, we have to grow out of this economic malaise, but right now organic growth doesn't look like a plausible solution to the problem."

As was mentioned in a previous article, inflation may be the only way out for the United States. However, Fed Chief Ben Bernanke has commented that inflation is too low. Another round of quantitative easing is expected. It should be pointed out though, that despite Fed efforts, the multiplier effect (banks lend out most their cash, some it return as deposits, which is once again lent out and so on) doesn't seem to be happening. Mr. Berry said that, "The kind of inflation that's being stimulated now is the cost-push inflation rather than demand-pull inflation. What Chairman Bernanke really wants and needs is a demand-based inflation, but it is not evident in the economy at this time." As a note there — at my firm, we prefer to define inflation as an increase in the level of prices caused by the increase in the money supply.

Given the magnitude of the problem, is there a way out? The solution is to reduce the deficit by cutting back on entitlement spending. This process will be highly unpopular and even painful for individuals who rely on Social Security. Manipulating money supply is no longer enough. Structural changes are necessary. Cutting back on spending can help balance the budget but it won't be an immediate solution. This is because even if it's implemented, the unemployment rate is still at 9.6% while underemployment (people working but not doing so at their full capacity, for example, because they are highly skilled but work in low-skill jobs) is at around 18.6%.

How Precious Metals Fared This Week

Gold and silver are increasingly being viewed as "real money" that's capable of storing its value. It is also interesting to note that **JPMorgan** (JPM) and other large US banks are restoring their old vaults to store the yellow metal and silver. The demand for physical gold remains strong and it will continue to be in the foreseeable future.

In the long-term chart (courtesy of http://stockcharts.com) of silver above, we can see that the rally has stopped at the $24 level. Looking at previous patterns, the target level of around $21 seems to be the point of correction and consolidation. Should that correction materialize, we expect it to be a pause in the rally, definitely not the end of the bull market.

There are certain investors who think that gold can top the $3,000 level in the next five years while silver might go as high as $50. In our view, even prices twice as high ($6,000 and $100) aren’t out of the question. These are incredible predictions at this point. However, it’s also reminiscent of October 2002 when silver was trading at $5. No one would have believed it could reach $24. The situation was the same for gold. Just a few years back, in 2004, it was valued at $400.

Precious metals strengthened on Thursday morning against the American dollar. Gold hit $1,345 an ounce while silver is now trading at $24 an ounce. With regards to other metals, their value is likely to rise in the long run as well. Take platinum and palladium: They both have industrial characteristics. This will contribute to the increase as the emerging world rebuilds and develops. Meanwhile, uranium is also predicted to go up even if the United States isn’t significantly building up its nuclear capability because other countries are keen to go ahead.

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