

## The debt crisis – underpinnings

A note to self to try to bring sanity to the senseless blame game our politicians are engaged in our nation's capitol. Why is it important? And how did we get here?

First: The rules of the game have changed in just how our debt is managed. Our government is divided into three groups; Executive who manage, Legislative who set the rules, and Judicial who referee the process. Each group make their own internal rules as to how they are going to handle their responsibilities. The difficulties we seem to be having are mainly in the legislative branch.

The Legislative group are two separate groups;

The House of Representatives which is, in total, representative of the people in the entire country and weighted roughly into districts of similar population. Not totally as each state has a minimum contingent and smaller states may end up slightly ahead. A parallel might be the House of Commons in England.

The Senate which is representative of the States included in the Republic, two from each State regardless of population. One might say like the House of Lords in England.

The legislative rules include that all laws providing funding must be initiated in the House. The House operates on a strict majority vote basis, a simple majority decides issues. The Senate is representing the individual States and is generally more reluctant to take action as they decided long ago to allow any Senator to stall proceedings with a “filibuster”, a continuous testimony by the senator for as long as he could. This would technically allow only one senator to kill any legislation. But the Senate rules also allow a motion of Closure, a method of putting an end to debate and securing an immediate vote upon a measure before the senate. This motion takes precedence and must be voted “do pass” by a super majority, two-thirds (60-40) of the senate effectively ending the filibuster, and a simple majority then decides the issue.

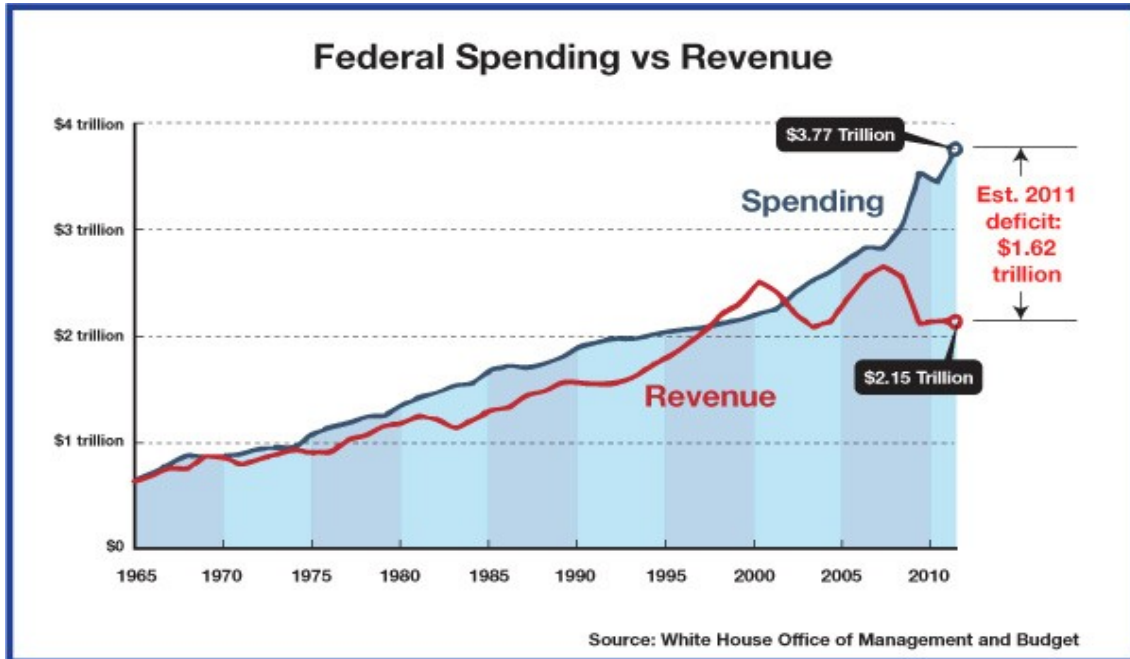
An obscure rule provides that, In matters of funding, to allow the more lengthy debate to be shortened, a matter just dividing an already approved funding item into different portions of its elements, a concept of “reconciliation” was added to the legislative rules wherein debate can be limited.

Committees in both the house and Senate consider the changes and the agreement is then decided by a simple majority in each with no stalling – a simple up or down vote. Not for a matter of what, but only how. This has worked for years as congress has often stalled on details of budgets.

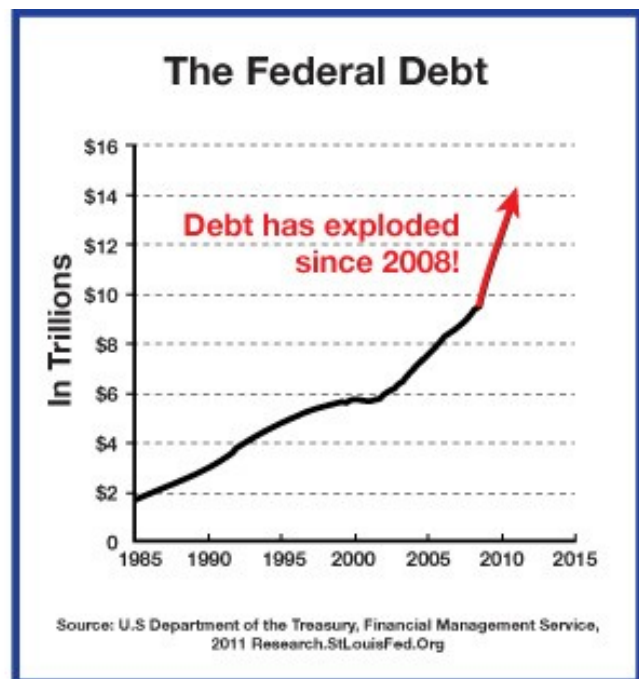
My view: In the election sweep of 2007, the democrats won control of the House, the Senate, and the White house. With total control, they elected to not pass a budget for the fiscal year beginning October 1, 2009, and then used the “reconciliation “ provisions to change the approved “continuing resolution” federal funding provisions by the health care provisions in that bill in what was known as “ The Health Care and Education Reconciliation Act of 2010”.

In the summer of 2010, the House again passed funding for the federal government under another “continuing resolution”, authorizing the current spending levels with some additions bringing the steady increases to an accumulated 900+ billion. Again no budget was passed. After the election of 2010 changed the composition of the House and the Republicans would take control in the following January, President Obama asked for approval of an increased debt limit. Senator Reid and House Majority Leader Pelosi decided they would leave that question to the new House as then the debt increase would be on their heads. That, in my opinion, was a major mistake and set an untenable position for the President. And it wasn't actually necessary until the middle of the summer.

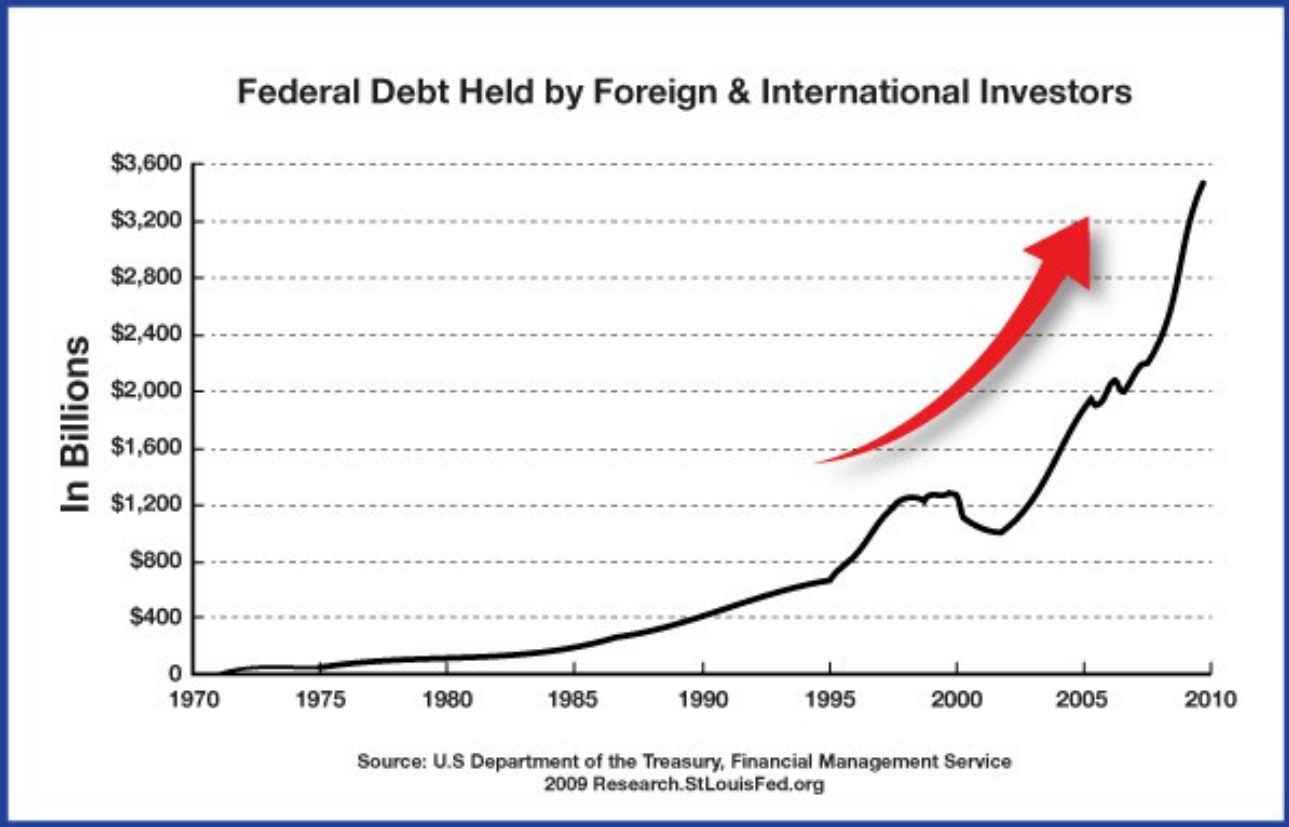
When the new congress was seated in spring of 2011, the House passed a budget for the next fiscal year to begin October 1, 2011 with the start of four trillion in cuts to be applied over the next ten years. It included the scheduled end of the revenue tax cuts that had been in effect since 2003 and many restructuring items. It was tabled immediately by the Senate Majority Leader as unacceptable – no action.



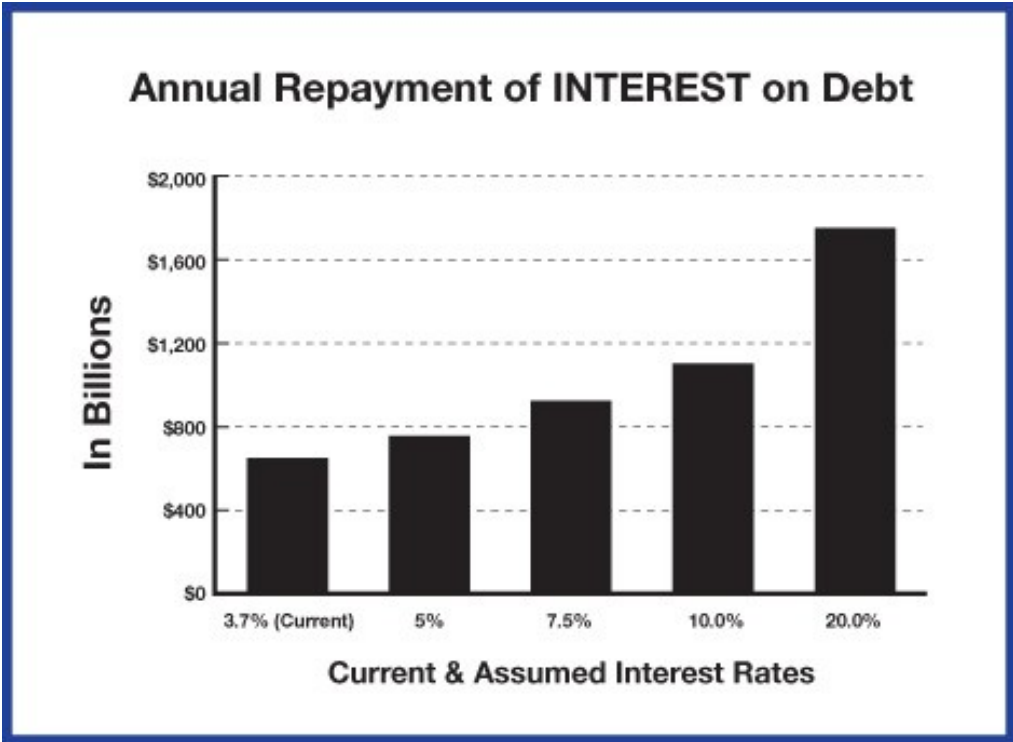
The situation on spending our income



Our debt increased as much in the last two years as in the previous eight – accelerating!



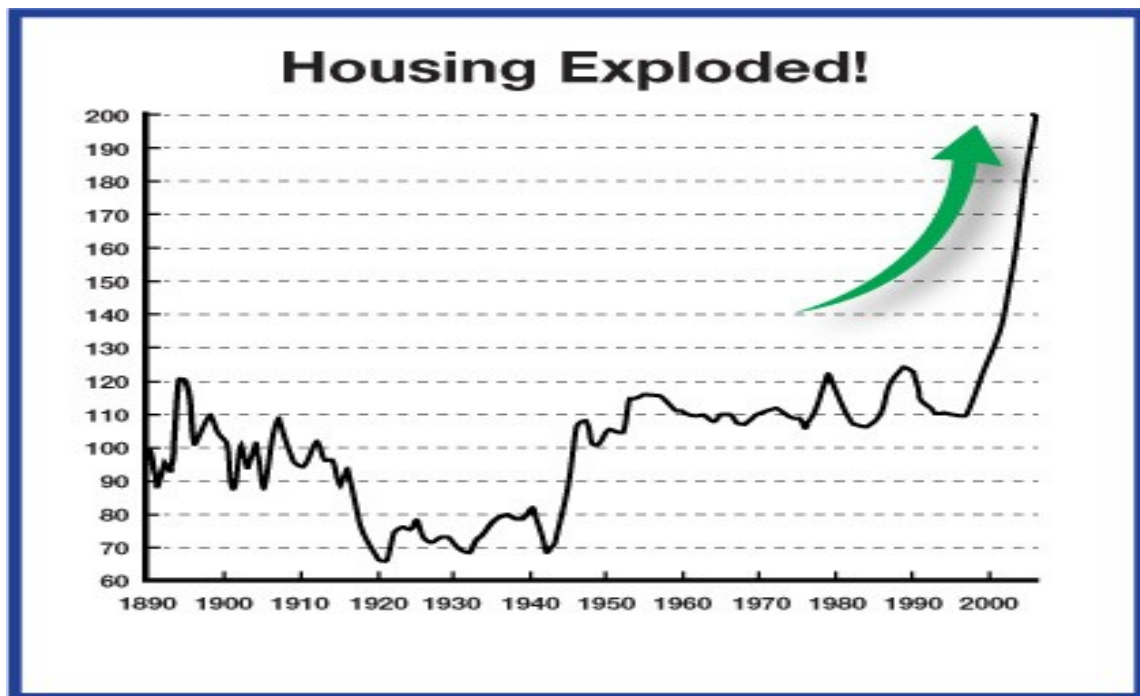
And half again to foreign investors – and accelerating also!



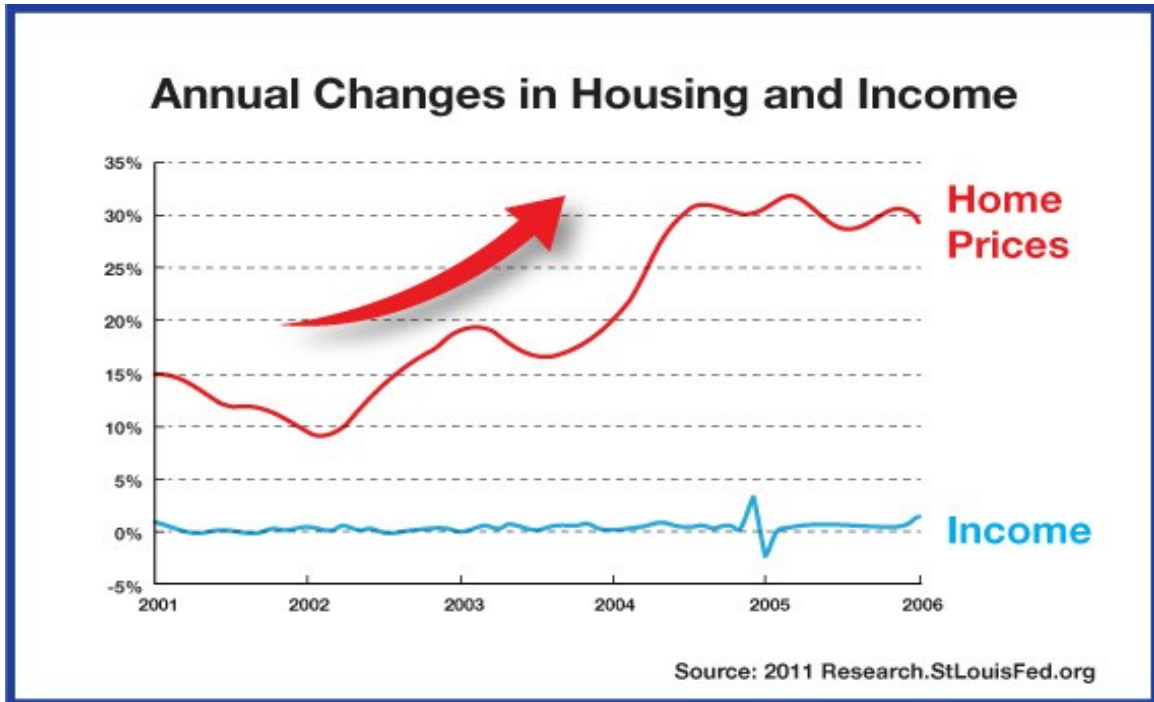
We are enjoying low rates on that debt though so what could go wrong?

And the country just got out of a loss of trillions because of housing boom and bust. Those losses sopped up trillions added to our economy since 2000 through the unreal price inflation in home values, much of which was borrowed in the form of home equity loans refinanced in new mortgage loans, packaged as collateralized debt obligations, and sold into the investment community rated as AAA by the rating agencies, Moody's, Standard and Poors, and Fitch, whose standards were questioned severely when the values plunged.

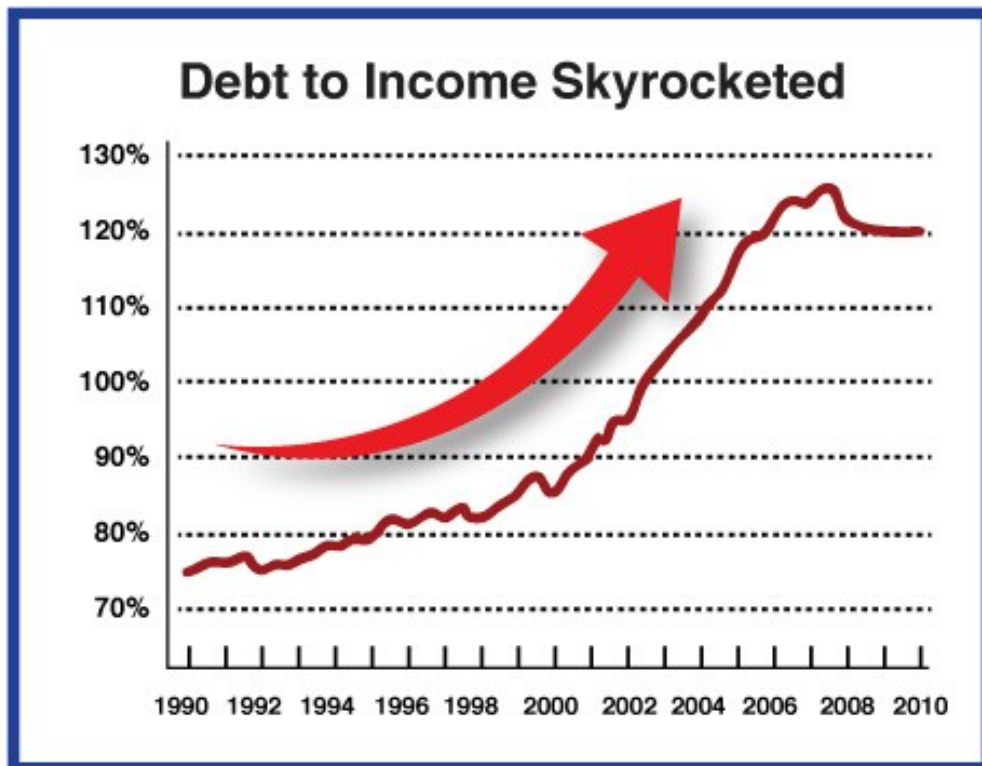
Why?



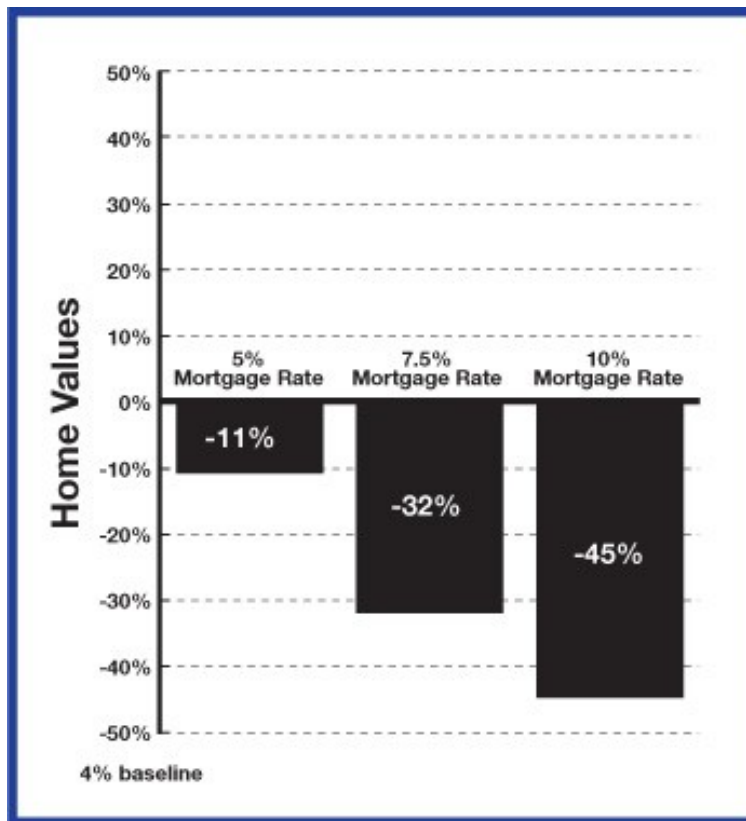
The collapse of housing values that increased far above a reasonable relationship to income;



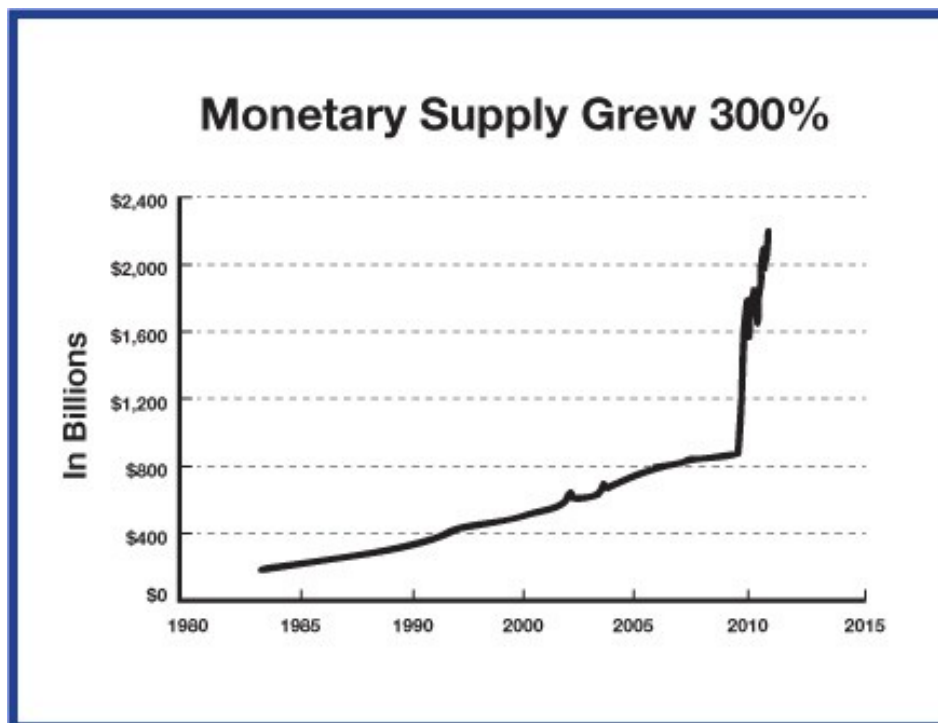
And the ratio of private debt to income ballooned, changing people's opinion of “debt danger”;



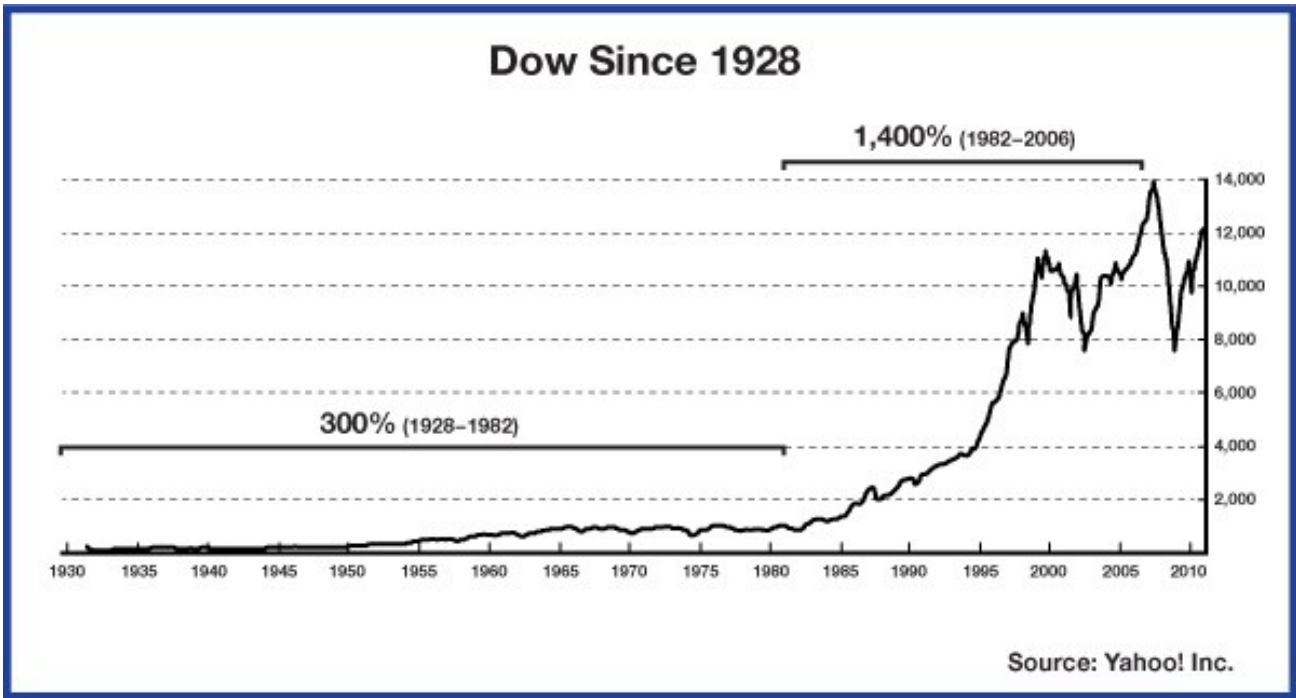
Along with the fear of further price declines with increasing mortgage rates;



But a few good things happened. The first was the stabilization of the financial markets by an action of pumping money into the system dubbed QE1, Quantitative Easing, phase 1.



The stock market also gyrated widely;

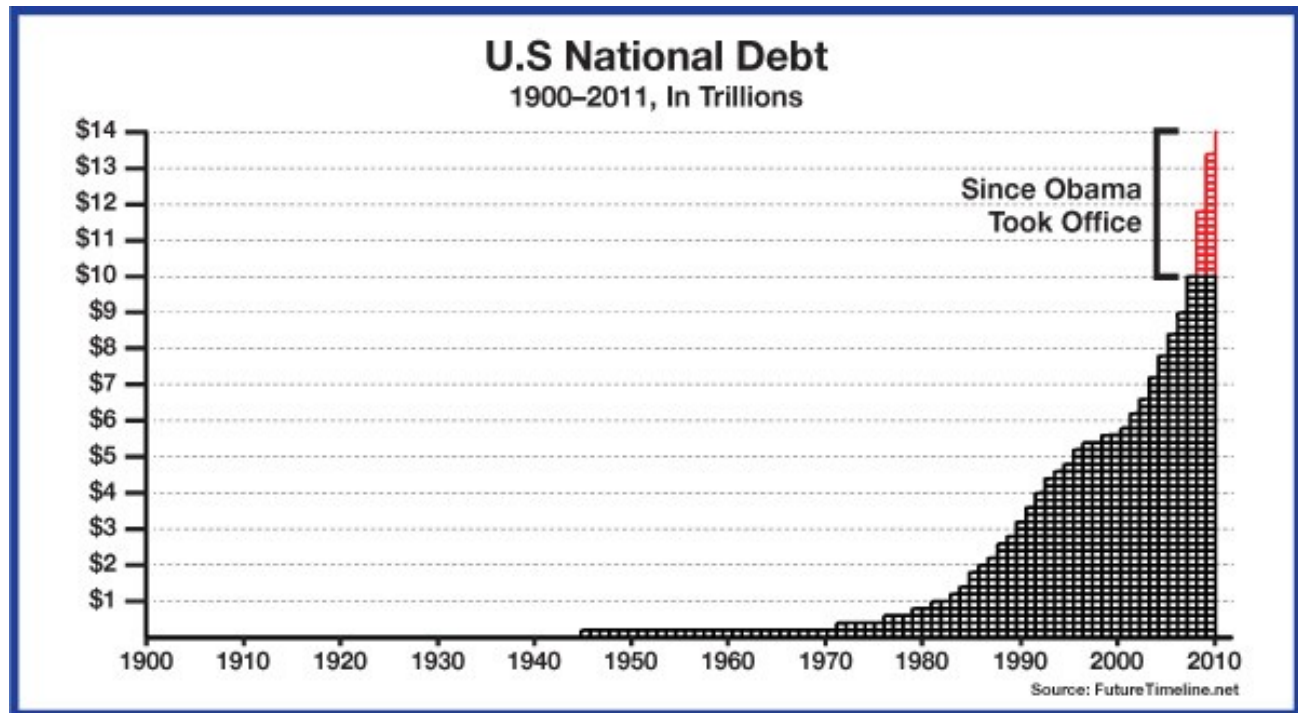


but had recovered by the start of the crisis with improving earnings reported by corporations and it looked like we had averted disaster with a slowly recovering economy.

Some say the 14,000 Dow was totally bogus and a result of the funds from the housing boom;



But I am concerned that the action taken to resolve the debt ceiling has been too little to stop the national debt growth given that we added as much debt in the first two years of the Obama Administration as we did in the eight years of the Bush Administration.



As the effects of QE1 and QE2 are being absorbed in the financial system, the administration is considering a QE3. As the economy heats up, the Treasury will have to tighten the supply (lessen the demand) which is done by raising domestic interest rates which will raise the cost on our borrowings. The concern is also surfacing that we as a country will continue to build the debt because of entitlements already committed (awarded but not funded) which are not reflected in our debt. The disbursement of those payments will have to result in an ever-increasing federal expenditure and we have shown no move to control them. As the principal of sovereign debt is largely made meaningless by inflation in the total system, funding such deficits by increasing the debt level will add to the demand we will have on foreign sources. As the recovery progresses, those funds will become harder to wring out of their economies. Unless we get our expenditures under control we are in danger of losing our country to rampant inflation. And the deal to raise our limit by making minor cuts is insufficient.

And now we have a downgrade issued. Interesting how only S&P noticed, eh? Especially since they all missed the danger in the CMO ratings they issued. Is it possible they are overreacting? Was the 10 billion suit filed by AIG against Bank of America today only the first of many to come? Will Bank of America be the next rescue target of for the use of the left over TARP funds? Is the poor employment progress a factor?

Or is it just a political statement, "It's the economy, stupid!"? Troubling times indeed. Look what the market did today and remember, a 20% drop usually means a **BEAR** market.

DRF 8/8/2011