STORM WARNINGS

Vol. I, Issue 4: May 2012

Economics and geopolitical challenges

R. Michael Conley
Founder

The *Storm Warnings* newsletter is part of a larger initiative by its founder, R. Michael Conley, to carry the message to others.

"The message is frightfully simple: We are heading into a perfect storm that will forever change our lives, and we need to act on it while there is still time," said Conley.

Under the overall umbrella of his company, Weathering the Storm, LLC, its mission to *awaken, engage and help mankind weather the storm* is carried out in a number of ways.

"The *Storm Warnings* newsletter, which provides

The economy and jobs will be headline issues in this 2012 presidential election year. Parties and candidates will offer cosmetic solutions that play well on a sound bite but do little to reverse the unsustainable economic path we are on. In this hard-hitting interview, R. Michael Conley talks candidly about how today's economic trajectory is propelling us toward a perfect storm. The challenge is complex; the potential catastrophic.

WTS Staff

WTS: Would you comment on jobs and the economy in this election year?

Conley: Sure. But as serious as these problems are, they represent only the tip of the iceberg. The real threats go far deeper. They are global, multidimensional, and of a life-changing nature, and they are rapidly coming to a head.

Sadly, we've become accustomed to spending money we don't have for products we don't make using devalued dollars that purchase less. We've taken on unfunded entitlement programs that larger numbers of Americans will receive but fewer will pay for, and we've mortgaged our future with debt servicing charges that will stifle economic growth. We've printed money, monetized debt and borrowed heavily from foreign governments to finance deficits, and decades of uninterrupted prosperity have desensitized us to the unsustainable pathway we're now on. This is our new reality.

WTS: Sounds awful; how did we ever get to this point?

Conley: It's complex, but let me give you my rendition. The saga has many moving parts built around geopolitical power, oil and the petrodollar, misguided financial and monetary policies and unrealistic expectations. Looking first at the "global steroids" that have helped turbo-charge our economy, I'll suggest a domestic chain reaction that could push us over the top.

Let's start with the global currency system – the money and cash flows that grease the global economy and keep it moving. Since WWII, the international financial architecture has weighed heavily toward the American dollar. As the dominant world

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an in-depth look each month at a specific topic, is one way we hope to awaken and engage people, but we encourage folks to log in to our web-site for a full menu of offerings and services," Conley said. (www.weatheringthestorm.net)

The website will provide further details on other initiatives. Among them:

1. Lethal Trajectories – Conley's futurist novel on what it will be like to live through a perfect storm crisis
2. *Weathering the Storm Guide* – A guide on how to prepare for the storm
3. Weathering the Storm Seminars – In-depth seminars that are now available
4. Blog, links, other resources, and the Storm Warnings newsletter.

<u>About the Founder:</u> Mike Conley is the Founder of Weathering the Storm LLC, and currently serves as Chairman and CEO of the Conley Family Foundation. As a former Fortune 500 business executive, author, lecturer, and public policy activist, Conley has written and spoken frequently on topics related to the perfect

fiat reserve currency of choice, and the currency underpinning the *petrodollar* transactional system, it has given the U.S. an enormous economic advantage in terms of access to cheap and abundant capital. Often overlooked, it's a crucial factor about which I'll say more.

WTS: How has the *fiat* currency and *petrodollar* system benefited the U.S.?

Conley: A little history: When the U.S. went off the gold standard in 1971; the *dollar* was no longer redeemable for gold. Thereafter, it was backed only by the "good faith and credit" of the U.S. government and its relative value was pegged to a "floating" exchange rate. In effect, our government became free to print paper money by *fiat* – or decree – without an underlying requirement for a gold reserve to back its value.

Things got even "better" in 1975 when OPEC joined the Saudis in requiring that *all oil* transactions be made in the *American dollar*. Called the *petrodollar* system, it was a financial bonanza for the United States and helped solidify the dollar's role as the world's *fiat* reserve currency of choice.

Think about it: It meant that all nations needed American dollars to purchase OPEC oil, and it drove up the global demand for our dollars. Even better, OPEC and other nations recycled their excess dollars back into U.S. Treasuries and other securities. Called *petrodollar recycling*, it provided the U.S. with huge new pools of cheap capital; enabling the U.S. to borrow and spend lavishly while accumulating massive balance of trade deficits.

The system made it easy for the U.S. to disregard the fundamentals of sound fiscal and monetary policy and use instead the easy leverage of the petrodollar and printing press to foster economic growth. Akin to putting the giant American economy on steroids, it later confirmed the adage that "there's no free lunch."

storm. He graduated from the University of Minnesota, after serving in the United States Navy, and later completed a post-graduate program at Stanford University. He is also active on several boards and advisory groups.

WTS: What do you mean by "there's no free lunch?" Are we in for hard times?

Conley: We're learning that what's intoxicating on the way up can be devastating on the way down. While enjoying decades of unparalleled prosperity, our haphazard fiscal and monetary policies are now taking a toll. As the dollar continues its downward slide, foreign investors are concerned with the eroding value of their investments in American government securities – something that happens when the falling value of the dollar approaches or exceeds the rate of return made on it. They're also concerned that the U.S. is exporting inflation to their countries via the petrodollar system. Their thinking is that if it takes more *devalued* dollars to buy oil, and their purchases are tied to the petrodollar, they too will pay more for oil and/or other commodities transacted in the devalued dollar.

WTS: Could we lose the petrodollar status and what would happen if we did?

Conley: We could, and it would be a catastrophe. It won't happen overnight, but my guess is that OPEC will eventually migrate from the petrodollar to a blended "basket of currencies" transactional system. The currency basket might include the Euro, Yen, Yuan, Dollar and others. With it, the need for the dollar would diminish and foreign banks would dump their excess dollars on the open market. The value of the dollar would plummet, and the cost of capital would skyrocket as we raised interest rates to stabilize the dollar and/or attract and retain foreign capital. The spillover would create a huge drag on our economy and housing market. The devalued dollars flooding the country would also inflate prices and clobber folks on a fixed income. Our ability to print money and monetize debt would be constrained by the risk it posed of hyperinflation.

WTS: Do our political leaders get it?

Conley: It's hard to say, but I doubt many appreciate the crucial importance of protecting our dollar currency and the advantages it provides. They're more preoccupied with jobs and the stock market than long term structural problems. Far easier, it seems, to postpone tough choices than incur voter wrath with painful cures. Barring something as odious as devaluing our currency or defaulting on our debt, the "cures" revolve around some combination of: a) raising taxes, b) cutting spending, or c) borrowing more. We've gravitated, in our political gridlock, to option # 3 – a sure prescription for disaster.

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The alarm bells are ringing: Our balance of payment deficits, unfunded entitlement liabilities, rising debt to GDP ratios and crumbling dollar are sending a message. The S&P downgrade confirmed it and chinks are now appearing in the petrodollar armor and our world currency reserve status. The dollar is no longer as dominant as it was, and we've seen what has happened to European Union countries that let their budgets get out of hand. The warnings are there but we're not responding.

WTS: You've painted a less than cheery picture of the global situation. What about the domestic outlook for the United States?

Conley: Sadly, it's our domestic financial and monetary policies and rising expectations that have caused much of what I have just said to happen, so obviously we are not in good shape in this area. Let's focus on three things:1) our budget deficits and long term debt, 2) the impact of future unfunded entitlement obligations, and 3) our unrealistic expectations and the rude awakening we may soon face.

WTS: Okay. Let's take them one at a time starting with our deficits and debt.

Conley: Sure. The deficit refers to the fiscal year budget and shortfall between revenues and expenses; debt refers to the *accumulated* deficits and other liabilities now on our balance sheets.

In fiscal 2011, for example, we spent about $1.5 trillion dollars more than we took in. Accordingly, we had to borrow or print an equal amount to cover the deficit. The money isn't free. The stakeholders buying our government debt – foreign countries and others – expect interest on their money. The accumulated "carrying charge" on our debt in 2011 was $200 billion and will grow to an estimated $500 billion by 2015 and $800 billion in 2020. If interest rates increase in the future – as they surely will – the carrying charges will be far greater.

The accumulated *federal* debt from *all* sources is now about equal to our $15 trillion dollar GDP and growing. Sadly, it's only the tip of the iceberg. Our unfunded federal entitlement liabilities dwarf these numbers, and the red ink will suffocate future growth. The problem is compounded by state, local and private debt.

WTS: Why are the unfunded entitlement liabilities so high?

Conley: It's our Achilles heel. Unlike most private pension or health plans, future entitlement liabilities have not been pre-funded. It's all pay-as-you-go. Until recently, the so-called Social Security "trust" fund had generated huge surpluses that were plowed back into our general operating budget with an IOU given in return. But, with a huge influx of baby boomers now collecting SS benefits, payouts will exceed revenue. With no real cash in the IOU account, we'll have to draw from the general operating budget to cover shortfalls. The problem is the tank is empty; our only recourse will be to raise tax withholds, cut benefits or borrow more money – with emphasis on the latter.

Medicare is in even worse shape. Simply put, as a flood of new baby boomers swell the Medicare ranks, live longer and use costlier medical care, the medical cost curve will explode. And, with fewer active workers left to support a growing base of retirees, the math is ugly. The *combined* unfunded liabilities for Social Security and Medicare, in fact, are estimated to be in the range of $45 trillion dollars and growing – three times our current GDP. Does anyone really believe this is sustainable?

WTS: What is the prognosis for future generations?

Conley: Sadly, we've mortgaged their future. Like a Ponzi scheme dependent on growth to survive, we may need annual growth rates in the 3-5% range or more just to keep it all going. But, with rising entitlement payouts, growing debt servicing charges and higher oil prices, we are unlikely to generate this level of growth. Something has to give.

WTS: You mentioned "expectations" earlier on. What do you mean by that?

Conley: We've had it our way for so long; it's hard to think the American Dream could ever end. And yet, there's no way we can live the way we've been living. We can prolong the day of reckoning through reckless spending and borrowing, but we're in an unsustainable credit bubble. The quicker we realize it, live within our means and recalibrate our expectations to this new reality, the better off we'll be.

When the credit bubble bursts – as it surely will – we are ill-prepared for the draconian countermeasures it'll take to stem the tide in terms of tax increases, budget cuts, and a curtailment of expectations – as a nation and as individuals. We can't grow our way out of it, as some on Wall Street have suggested, and we can't reduce expenses enough to save our way out of it. It will take a blend of aggressive actions – perhaps along the lines of a turbo-charged Bowles/Simpson Plan – to turn the tide. Unfortunately, there's little political will to do so at this time.

WTS: Your message is depressing. Are there any bright spots?

Conley: There could be if we recognized our peril and responded as we did after Pearl Harbor. It'll probably take such a crisis to awaken and galvanize America and get us to think beyond our quick fix, short term focus on quarterly earnings, winning the next election and me, me, me.

But imagine the possibilities: Imagine the crisis as a catalyst and springboard for transforming America into a robust 21st century economy. Imagine reenergizing and organizing our technologic and innovative talents toward the creation of a new clean energy infrastructure not dependent on foreign oil. Imagine an all out effort to recapture our manufacturing base, export products of value and reverse our massive balance of trade deficits. Imagine the value of rediscovering our identity as a nation and people plugged into hard work, shared sacrifices and an ethic for living within our means.

Is it doable? We have a chance if we can bust out of a paradigm that suggests we are "entitled" to the good life by virtue of our American citizenship and instead face up to our daunting challenge with the resolution of our forefathers. It won't be easy, but it's in our hands. That said; let me leave you with three closing thoughts:

1) We live in a global economy, but access to cheap capital through our favored currency position may soon be over,
2) We are living beyond our means in an unsustainable credit bubble that's ready to burst, and
3) We would be wise to face reality as it is, recalibrate our expectations and boldly use the coming crisis as a springboard for transformation.

It's a tough message, but I hope I've connected a few dots and provided a context for further discussion. After all, that's the purpose of my Storm Warnings newsletter. The economic trajectories just discussed are now crashing against massive energy and environmental forces of tectonic proportions – covered in previous newsletters – and propelling us toward a perfect storm. In my next newsletter, I'll discuss how our behaviors and expectations factor into the equation. Until then, please check out my website at www.weatheringthestorm.net and download my free "Weathering the Storm Guide." It provides a step-by-step process for helping you prepare for the perfect storm.