

COLLAPSE!

A primer on the global financial crisis by Doug Meyer

"Give me control of a nation's money supply, and I care not who makes its laws"

- Mayer Rothschild

"The American consumer can no longer act as the motor of the global economy"

-George Soros

"We are witnessing the crack of history"

-Wall Street investment banker/trader

Is this the moment we've been waiting for? Economic Armageddon? Capitalism's unsustainability finally realized? Quite fittingly, in the first act of this tragedy, it wasn't an "externality" like resource depletion or ecological destruction that brought capitalism to its knees, but instead one of its own internal contradictions.

What happened? In a nutshell, the US became capitalism's first nation of burned out consumers. Apparently, there's only so much of the good life that people can take. Now we see that the free-market pipeline that makes raw materials into consumer products can't stay in place for too long on either the producing or the consuming end, because the pipe's diameter has to keep getting bigger all the time. That realization ought to be enough to kick start a global chess game into high gear. And we can only shudder at what that means for our little blue planet.

We've all heard how US financial firms precipitated the collapse by selling securities based on bad debt in the US mortgage market. When the truth became known, global losses were huge and unquantified, and credit dried up everywhere. A severe recession was on. But what about that problem of debt itself? Didn't capitalism reveal a fatal flaw here by demonstrating that the customer's overall debt burden has limits?

Let's take a good look at the US version of money and debt and then try to see how the World vs. USA chessboard is starting to take shape.

What is the Federal Reserve?

The Fed regulates the supply of US dollars created by the private US banking system and it's also supposed to control interest rates in the economy. It is chartered by the US government, with a governing body appointed by the President, but also has many directors elected by member banks, which also own the "stock" of the Federal Reserve. Its design attempts a compromise between private banking and the national interest. An "elastic" money supply was the goal, but Populism eventually lost out as the Fed became a strong central bank after the Great Depression.

How does a bank create money?

A signed promise to repay, by a borrower the bank chooses to lend to, along with the bank having a small fraction of the loan amount on reserve at the Fed, is all any bank needs to create loan money out of thin air in the borrower's checking account. Conversely, when borrowers pay down their debt, money is destroyed, but guess which process normally happens faster. The banking system is designed to grow money and debt, and we have the new populist maxim: Money Is Debt.

How does the Fed create money?

The idea is the same, only there is no reserve requirement. In this case, the borrower is the US Treasury. In extraordinary times like these, battling deflation instead of inflation while trying to keep a consumer economy afloat, the Fed buys brand-new Treasury issues, and it's called monetizing the debt. It is money creation on a macro-economic scale, and the Fed doesn't need permission from Congress to do it.

Besides the embarrassment of simply adding money to the system, what are some other concerns about monetizing the public debt?

Think Argentina in the 1990's, or the German Weimar Republic after WWI.

The Fed is supporting fiscal policy, completely outside its legal mandate.

The Fed is on a slippery slope because long-term interest rates are back up to where they were before the announcement. Creating money reduces confidence in long-term US finances, worsening the problem they're trying to fix.

The Fed's purchases of long-term Treasuries reveal already weak global demand for them.

China has since made public its desire for a new global reserve currency.

Why doesn't the US raise taxes to pay for some of this?

Ever since Ronald Reagan, that idea is sacrilege. When we say that we're putting the burden on future generations, we mean that THEY will have to pay higher taxes. Such is the essence of our hubris: we go into debt to maintain our current consumption rates while at the same time saying that we can't afford to pay for it.

If the Fed can create money out of thin air, why did the Treasury (ie, taxpayers) have to bail out the banks? Why didn't the Fed simply electronically increase the amount of reserves for each of its member banks?

Excellent question. But again, in capitalist banking, money is created out of thin air only when you have a corresponding promise to repay by somebody else. The banks needed real capital infusions and that meant real debt from the Treasury. Future US citizens will have to pay for the indiscretions of today's financial firms.

How does the Treasury bond market determine interest rates?

Like a bank competing for your deposit by offering higher interest, the Treasury would have to raise the interest rates it pays on its bonds if the auction didn't attract enough capital to match its borrowing needs. Mortgage rates would be immediately affected, because home buyers are effectively competing with the government for the same pool of capital. Conversely, when demand is high for bonds, interest rates go down.

What is the concern over long-term interest rates?

Investors come to the bond market with a time frame in mind. When will I get my money back? The Treasury offers maturities anywhere from 1 day to 30 years. The shorter the maturity, the more often the Treasury has to re-attract money back to its bonds. The average Treasury maturity ranged between 5 and 6 years during the 80's and 90's, but since 2002 has dropped to 4 years and is still falling. Any first year business student knows you can't finance 20-30 year economic reconstruction with 3-year debt. With few buyers for the long maturities, rates are pushing upwards and the Fed has had to step in with "newly minted" money.

How much money is the Fed creating and where is it going?

The Fed's balance sheet was less than \$1 trillion last September but will be over \$3 trillion by the end of 2009. M3, a measure of US money supply, is now at about \$15 trillion, so the Fed's \$2 trillion increase out of thin air is roughly 13% of all the money in the US.

The Fed is desperately trying to flood the bond markets with capital in the hopes of

keeping long-term interest rates down. In addition to monetizing \$300 billion of long-term Treasury debt, the Fed also plans to use \$1.4 trillion of created money to buy mortgage-backed securities. But central banks often lose this game because the total amount of money in the world dwarfs these figures.

What's the cash flow and total debt at the Treasury?

US government spending this year will be \$3.6 trillion, compared with \$2.7 trillion last year. Tax receipts this year will be about \$1.8 trillion, compared with about \$2.6 trillion last year. So tax income will be only half of spending, leaving a budget deficit of \$1.8 trillion, compared with \$0.2 trillion last year. That's \$1.8 trillion of new money the Treasury will have to raise on top of the roughly \$7 trillion of debt maturing this year. Total US outstanding debt right now is over \$11 trillion, including the Social Security trust fund.

How much money is there in the world and how much

is in US dollars?

Some estimates say that in the year 2000, it was about \$36 trillion. By August of 2007, when the sub-prime market imploded, it may have peaked near \$70 trillion. (So it took a couple hundred years for the first \$35 trillion, and about seven years to double it.) The crisis may have wiped out that seven year gain. Foreign governments hold about \$7 trillion in reserves, of which about 65% is held in US dollars. The Chinese government alone holds about \$2.3 trillion in reserves with about \$1.7 trillion in US dollars. Global Gross Domestic Product is about \$60 trillion annually, with US GDP at about \$14 trillion.

Is the Fed deliberately trying to devalue the US dollar?

At the very least, the Fed understands that it is weakening the dollar, and they hope to get away with it if it happens slowly enough. All other things being equal, debtors benefit by paying back their loans with money worth less than when it was borrowed. The cheaper dollar also helps reduce the trade deficit.

But the dollar losing value sets up a long-term problem for global producers: they need a new customer. You can be sure that the global economy is looking hard for a good alternative to US consumption and the US dollar.

How does the US get away with printing money like some two-bit dictatorship?

Since WWII, the US has been the world's consumer and the US dollar has been the world's reserve currency. The words "backed by the full faith and credit of the US government" on a piece of paper made that paper as good as gold (until Nixon ended the gold standard in 1971.) Now, a dollar is as good as, well another dollar.

What does the US dollar as the world's reserve currency really mean?

The US is the only country in the world that gets to pay for its imports with its own currency.

OPEC requires US dollars as payment for oil.

Outside of the US, many governments, multinational corporations, and individuals hold much of their savings in financial instruments denominated in US dollars.

International transaction systems use the US dollar as their base currency.

Why doesn't China just dump the US dollar?

Dumping the dollar would be dumping their biggest customer.

If they stop buying Treasuries, the Fed just prints more dollars, further eroding Chinese savings.

They don't want to worsen the dollar's weakening against the yuan, making Chinese imports more expensive in the US, thus slowing Chinese growth (see below).

What are some of the emerging global issues over the US dollar?

With no real influence on the Federal Reserve's devaluation of the US dollar, global interests, including China and Russia, have said they want a new currency for their savings. For the US, loss of the dollar's status as reserve currency would bring about the reckoning: raise taxes or cut consumption.



But absent some other dramatic developments, it seems that replacing the US dollar will take time. Cutting the US off cold would take the world economy down with it. On the other hand, China is fast developing lots of new consumers, with 300 million people ready to take on that role. Meanwhile, another billion people in China are still in the Third World, making the Chinese government nervous with anything less than about 9% annual growth to quell unrest in the hinterlands. So China is trapped by its own success.

Russia, with most of its income from energy sales outside the US, might be in a better position to move away from the dollar. It all depends on finding a replacement currency, (like the IMF's Special Drawing Rights) and whether all those rich Russian czars can convert their substantial dollar holdings to SDR's.

More importantly, the US is in denial about the meaning of the global financial crisis. Very little of substance is being done to transform the economy and move away from the consumer growth model.

In fact, global oil producers that take US dollars as payment are moving towards keeping more of it in the ground. That may seem unlikely given the 50% cut in US gasoline prices that kept the US on life-support last fall, but that was while the dollar briefly spiked as the world put it all of its cash on hand into short-term US Treasuries.

The Fed and Treasury would have us believe that China really has no choice but to continue selling cheap consumer goods and OPEC no choice but to continue selling cheap oil to the US while all of those nations just sit and watch their savings erode against other currencies. Again, we're waiting for the other shoe to drop.

What really has changed as a result of the global financial crisis?

Well, besides all that money being lost, business models everywhere now understand that US consumers are overburdened with debt and so are no longer capable of driving stock markets' previous expectations for global economic growth rates. They still need us to buy stuff, but now they know we won't be buying more and more of it every year. Capitalists have to look elsewhere for the growth they need to survive.

Expect another jobless recovery in the US. Corporations with heavy exposure to emerging markets may do well and the stock markets may recover a bit, but with so many people out of work, and global credit still tight, home prices and the overall US consumer economy should continue to lag. More importantly, the US is in denial about the meaning of the global financial crisis. Very little of substance is being done to transform the economy and move away from the consumer growth model.

But don't shed a tear for global capitalism yet, because it's planning to grow about 3 billion new global borrowers over the next few decades, plenty to keep the good times rolling along endlessly. That is, until Act III, the ecological ruin of the world.

Doug Meyer is the Zephyr's Colorado Plateau Bureau Chief and all-around smart guy... He lives in Flagstaff, Arizona.

**THE FOOTPRINTS
Top 10 List**

121 East 100 South...Moab, Utah 84532

Top 10 Pickup Lines for a Down Economy

10- Hey baby, want a job?

9- Hey baby, you got a job?

8- Hey baby, I've got a job.

7- Come up and see my bailout check

6- I still have 26 weeks of unemployment

5- Can I buy you a lottery ticket?

4- Can I buy you a foreclosure?

3- What's your hedge fund?

2- Your parents place or mine?

1- Say, weren't we in line together at the unemployment office?



TELL THE NICE PEOPLE OUT THERE THAT IS THEY DON'T JOIN 'THE BACKBONE' OR TAKE OUT AN AD, THIS SILLY CYBER-RAG MAY NOT EVEN SURVIVE...

OLLIE...I DOUBT ANYONE UNDER 40 EVEN KNOWS WHO WE ARE.

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