The Origin of the Upcoming Financial and Economic Meltdown

As an engineer I was trained to seek the **root cause** of complex problems. i.e. don't stop digging until you've asked "Why?" at least five times! Also, I will utilize Dr. Alan Greenspan's recent book, The Age of Turbulence, as a frequent reference.

The world of high finance is far more complex than any one mortal can comprehend. However, the *origin* of this complexity is within the *financial world paradigm*. By analyzing that which drives and distorts the "Real Economy" within the *real world paradigm*, we will discover the origin of the divergences between the two, which helps to explain the upcoming economic meltdown.

First, are there diverging paths of logic that can explain how the "financial asset world" including stocks, bonds, and real estate equity embarked upon a "justifiable" self-perpetuating growth path of its own apart from the "real asset world" including goods, services, and human capital that was simply plodding along? What is the origin of this logic that enabled the most extraordinary **disconnect** between the "financial economy" and the "real economy" in the history of the Republic?

If you view the macro economic world from the "real economy" [(1)] paradigm, it is relatively simple to search for the root cause. The reoccurring question is how and where are the multiple disconnects between "real" and "financial" logic elements happening? The financial economy "emperor" has layer upon layer of clothes masking *illusory* wealth underneath… The real economy "emperor" has no clothes at all!

Once you accept the fact that ***real wealth*** [(1)] can only be created by work and natural resources, and that Real Debt growth rates cannot exceed Output growth rates [(2)], then you may begin looking for the origins of the various disconnects. A nation utilizing a fiat currency with its price and quantity controlled by humans having not only the power, but also the mandate to proactively adjust them, enables massive manipulation of the perceived wealth embodied in money and credit. Since those in power of the money and credit are also in power of critical statistical calculations, it is no surprise their calculations yield results that can be manipulated or spun in any manner to justify short-term politically expedient agendas. This fiat monetary base has enabled the creation of multiple layers of illusory financial wealth through use of leverage and faux insurance all cleverly peddled as high-rated, low-risk solutions to enhance yields for hapless investors.

This article will focus upon one of the most highly regarded Central Bankers in modern history, *Alan Greenspan.* He was certainly not alone in enabling the growth of asset bubbles and malinvestments from which we suffer today, but we know that scores of other contemporary intellectuals embrace the same dangerous paradigms collectively enabling the noted disconnects. In his book, The Age of Turbulence [(3)], the disconnects between the financial world and the real world were glaring…

The Alan Greenspan Hubris

At first I reluctantly read The Age of Turbulence [3] during a recent vacation, then became pleased that I invested the time. How else can you understand the paradigms from which others view macroeconomics? Following are snippets from the Age of Turbulence [3]...

Mr. Greenspan and Robert Rubin enjoyed a very cordial relationship over 4 ½ years routinely having breakfast weekly…[4]

> "…pooling information, crunching numbers, strategizing, and brewing ideas…[4]
>
> …Democrats joyfully labeled the constellation of economic policies "Rubinomics". Looking back in 2003, a *New York Times* reviewer of Bob's memoir called Rubinomics "the essence of the Clinton presidency." He defined it as "soaring prices for stocks, real estate, and other assets, low inflation, declining unemployment, increase in productivity, a strong dollar, low tariffs, the willingness to serve as a global crisis manager, and most of all a huge projected federal budget surplus."[4]
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> …President Clinton set a little challenge for me and for two Fed officials he appointed at the same time… "There is now a debate, a serious debate in this country, about whether there is a maximum growth rate we can have over any period of years without inflation," the president told reporters…. He wanted to see what this rocket could do." …[5]

Reading that passage gave me a chill. If ever there were a 5-year period in the history of our Republic that did more to fortify the imminency of a subsequent economic depression, the late 90's would be a slam-dunk fit. The lethal combination of "easy money" policy responses to any financial crisis that occurred, or even threatened to occur (e.g. Y2K), and massive debt asset sterilization primarily by the Asians enabled extraordinary asset overvaluation (bubbles in stocks, bonds, and real estate) encouraging massive misallocation of resources or malinvestment.

What irks me is the self-gratification and swagger of those who drove the gravy train of illusory wealth creation. If you are endowed with the power to create money and credit (liquidity), and there is willingness by some to hold a growing mass of paper assets (esp. Asian sterilization of U.S. debt securities), then blowing the greatest asset bubbles in history proved to be irresistibly popular.

The most chilling part was that a President and a couple of economists actually believed they could have significant influence upon "what this rocket could do". The last time I checked I believe it is the entrepreneurs with their employees and capitalists operating in a free market with stable money who are the ones that enable the "rocket" to even get off the ground! Government's manipulation of money and credit is the foundation of the formation of bubbles and misallocation of resources. Unfortunately, voters readily associate the economic euphoria enabled by endless bubble blowing with effective governance.

Alan's Take on the Current Account Deficit…

> "… there are a lot of imbalances, especially our potential federal deficit, to worry about in the years ahead. I would place the U.S. current account far down the list." (6)
>
> "… Developing countries, which accounted for half of those surpluses, were apparently unable to find sufficiently profitable investments at home that overcame market and political risk." (7)
>
> "… The key contributors, as I see it, have been a major decline in what economists call "home bias" and a significant acceleration in the U.S. productivity growth… Home bias is the parochial tendency of investors to invest their savings in their home country… …A decline in home bias is reflected in savers increasingly reaching across national borders to invest in foreign assets." (8)

My take on the Current Account deficit? When the owner of the world reserve currency (the U.S.) embarks on the greatest liquidity expansion scheme in history ensuring unprecedented bubble expansions in all U.S. financial assets, especially during the late 90's, why wouldn't any "Tom, Dick, or Chang" in a foreign country not "invest" in this exciting Ponzi scheme? Many earlier U.S. citizens paid dearly to build the U.S. into an economic powerhouse with the most credible currency on earth. Unfortunately, with one stroke of the pen, President Nixon dumped the remaining gold-backing market control that maintained some level of stability in our currency when he ended the Bretton Woods agreement in 1971. It has been a fiat currency and credit expansion folly acceleration ever since. The late 90's "investment rush" into U.S. assets severely over-strengthened the U.S. dollar, which enabled the greatest capital stock transfer into foreign hands in history by discouraging U.S. manufactures from producing goods locally and outsourcing anything from gasoline refinement to high tech programming to Barbie dolls.

The Current Account Deficit "Hole" we've dug ourselves into will be one of the most painful imbalances to correct. It is a simple matter of time before foreign trading partners "get it" and begin dumping the U.S. "paper" assets they have been accumulating in exchange for their real goods and services because they will suddenly realize total redemption of this "paper" without massive value dilution is impossible.

Efficiency Improvement via "Financial Engineering"?

Alan continues….

> "…The resulting advance of global financial markets has markedly improved the efficiency with which the world's savings are invested, a vital indirect contributor to world productivity growth…." (9)

When the grand master of money boasts about the "efficiency" of the financial world I become extremely suspicious.

Does “efficiency” mean…?

- “Efficiently awarding a sub-prime class borrower a car, appliance, or home loan with no realistic likelihood of repayment?
- “Efficiently” Bundling and packaging weak loans with more creditworthy loans, then peddling them to unsuspecting investors; hence, inviting rampant moral hazard?
- “Efficiently” awarding loans to any borrower without a thorough income or ability-to-pay validation?
- “Efficiently” finding investors anywhere on earth who can be suckered into buying the clever “financially engineered” securities.
- “Efficiently” disbursing high-risk securities to spread the pain of defaults.
- “Efficiently” engaging AAA-rated insurance companies to cover bond defaults (via Credit Default Swaps) that have no more than a pittance of reserve capital that is only sufficient for boom time conditions?

From an “enginomic” context efficiency would mean performing **all** checks and balances that are necessary to sufficiently ensure accurate risk assessment utilizing an expedient and less laborious process. That does not mean cutting corners, skipping steps, and making dangerous assumptions.

If Alan Couldn’t Regulate It, Who Could?

Mr. Greenspan continues…

> “… Markets have become too huge, complex, and fast-moving to be subject to twentieth-century supervision and regulation. No wonder this globalized financial behemoth stretches beyond the full comprehension of even the most sophisticated market participants…”
> “… The purpose of hedge funds and others is to make money, but their actions extirpate inefficiencies and imbalances, and thereby reduce the waste of scarce savings. These institutions thereby contribute to higher levels of productivity and overall standards of living…” (10)

Wow… What a ringing endorsement for the most egregious credit-leverage zealots that have done wonders to distort market signals, thus creating the greatest aggregate malinvestment in history. The foundation of the financial economy is a fiat currency whose price and quantity are controlled by a few elite humans with no clue of how a massive liquidity-expansion Ponzi scheme years in the making has distorted asset valuations. Hence, why wouldn’t you expect that these most innovative minds will connive ways to originate, package, and peddle illusory securities all over the world in the most complex fashion possible. The root cause of this financial asset mess is our fiat currency money foundation, and it’s completely out of control…

Conclusion

The disconnects in logic between the "Alan Greenspan" mindset representing the "financial economy" and the "real" mindset paradigm representing the "real economy" are readily apparent. If monetary policy is based upon this "financial" logic, then by design it will tend to appear very attractive as illusory financial assets grow in a Ponzi scheme fashion. We are now, as I have written countless times, in the inevitable period (2008-2010) of discovering the so called asset bubbles as the Boomers all over the world will be leaving the work force and attempting to cash in on the illusory financial assets. No human on earth can stop this process. At best, they can only attempt to construct yet more illusory assets via currency debasement to attempt a slow diffusion of the most prolific bubbles created in U.S. history. Because of the extraordinary magnitude of the aggregate bubbles (stocks, bonds, and real estate), a "slow diffusion" is very unlikely. A return to a commodity-based currency (e.g. gold, silver, etc.) would categorically eliminate most of the illusory wealth creating power in the hands of a few elites, and return it rightfully to the entrepreneurs and capitalists who actually create real wealth.

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(4) The Age of Turbulence, 2007, pp 160-161
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