What Went Wrong? : A Tale of Out-Of-Control Global Banking.

S. Joseph Kowalski, June 23, 2012

We are suffering through a very serious credit crisis which is the result of the super-liquidity wave (the availability of massive amounts of money injected into the financial system in a short period of time, a wave, and which facilitates massive investments, whether sound or unsound) generated by the global banking system, and which, in turn, spawned numerous fragile asset bubbles. The current liquidity boom, which is in its terminal state, was bred by never-ending debt which, in turn, produced a whole series of booms: the LDC lending boom of the 1990s; the 1990s stock market bubble; the commodity and real estate bubbles; the securitization boom of assets (i.e. real estate mortgages and credit card debt); the U.S. Treasury bond bubble; recycling of Japanese, Chinese, other Asian countries; Middle Eastern oil producing states trade surpluses, and, the 800-ponnd gorilla, the unfathomably massive derivative market. All of these bubbles are related to the monstrous mountain of debt accumulated by the Western world. This debt is so large that it can neither be serviced nor protected from default. It can be inflated away, and this seems to be the stealth course pursued by the global central banks. The 2007 credit crisis is symptomatic of the size and fragility of this massive liquidity injection, and its partner, the massive global debt. What went wrong was the massive accumulation of debt, whether public or private. This is nothing new – history keeps repeating itself. Global capitalism's parasitic 200 year history shows eight such lending waves each followed by a serious economic crisis. The present crisis is arguably the worst, and, in the worst case scenario, could result in a catastrophic implosion of the world-economies along with their fiat currencies.

The first two liquidity waves were the 1820s and 1830s English episodes. The development of limited-liability, joint-stock banking corporations along with the tremendous amounts of wealth that was looking for a return, encouraged massive investments whether sound or unsound. The joint-stock limited-liability banks took the wealth deposited and via factional reserve banking practices magnified the world-economy's investments. The money went into the Industrial Revolution's new industries: steam navigation systems, railways, gas lighting companies, canal building, etc. The investments were made in Europe and in all of the Americas.

British and French, along with some German banks were responsible for the 1864-75 lending wave, with the consequence being the 1873 depression commonly referred to in the U.S. as the "Great Depression." The money went to manufacturing investments, financial innovations, needs of both the North and the South during the Civil War.

Next came the 1886-90 British liquidity wave. The money again flowed into globalization and excessive lending. Defaults were the result. In the case of the Argentine default, the Baring Brothers bank failed and needed to be "bailed-out" by England.

The British, French, German, and some U.S. banks were responsible for the 1905-13 lending wave. The consequence: defaults, World War I, and the revolutions in Russia, the Ottoman Empire and Mexico.

Following World War I was the 1924-29 lending wave by mostly U.S. banks along with those from England and the Netherlands, and, whose consequence was the 1930s Great Depression. The huge accumulation of gold in the U.S. (accumulated as payments in World War I from sale of war materiel to Europeans) provided the wherewithal for this lending boom.

Then, the 1970-81 petro-dollar lending wave precipitated the 1970s-early 1980s stagflation. A global array of U.S., British, Japanese, German, and French banks was the source of this liquidity wave. A lot of the money went into mal-investments in third world countries.

Our current lending wave started in 1991 and continues. The source of the liquidity are the U.S., German, Japanese, British, and Spanish banks, and has precipitated the ongoing 2007 credit crisis,

These eight liquidity/lending waves precipitated the 19^{th}, 20^{th}, and 21st century financial crises.[1]

These massive lending waves generate massive mountains of debt which debtors can neither repay, nor service (pay the required interest payments) and, therefore, must default. Inflation (another form of default) has been the historical tool for liquidating sovereign debt. When private and public debt increases beyond some upper limit, the country's ability to service its debt comes into question. The country's credibility deteriorates, and its creditors demand higher interest rates for new debt issues. A current example is Spain. Spain's credibility has deteriorated. It has excessive debt, its economy is likely not growing, and, therefore its ability to service its debt is in question. Interest rates have soared, and now Spain is in a debt trap. With interest rates above its growth rate, it is unable to service its debt. With its economy stagnant, at best, it is unable to pay the annual interest charges on its debt. It is being sustained temporarily by Ponzi finance. Europe is "kicking-the-can", trying to buy time by lending money to Spain for it to maintain interest payments. This is Ponzi finance and is unsustainable. The Spanish financial system is fragile, and at some point, will suffer a deflationary contraction. Spain is already suffering a depression, and the inevitable financial collapse will bring untold miseries. This is the pattern of the historical "busts", and is the pattern today that the entire Western world faces. The mountain of global debt has allowed us to live beyond our means. By borrowing from the future, we have been able to maintain our desired living standards. Now is the time to pay the piper. The Western world's living standard will be significantly reduced.

A liquidity contraction (a massive removal of bank deposits because of a perceived risk results in a loss in bank asset price value, and with positive feedback into the loop, results in defaults and a deflationary environment), as we see in the present crisis, is inevitable. Since 1991, the global economy has had massive liquidity injections. The code word for this massive injection of liquidity is this is economic “growth. The so-called ” growth” that we have experienced for the past decades while large has, in reality, been mostly illusionary. After the credit crisis began in 2007, central bankers embarked on more massive liquidity injections, *The Great Reflation*,[2] which supposedly was meant to save the economy, but in reality, was to save the banking system. Likely, *The Great Reflation* will only worsen the final contraction and extend the duration of the new Great Depression. Europe is now in the forefront of the liquidity contraction. Greece, Ireland, and Iceland have succumbed. Spain looks like the next domino to fall followed by Italy. England, France, Japan, China, and the United States are also facing massive liquidity contractions.

The 2007 Credit Crisis brought the late twentieth century super debt cycle to its end. We are now living with the wreckage which it produced. The astronomical quantity of liquidity (via debt) injected into the economy had again reached its limit. Since late in 2007, policy makers have and are attempting to keep the debt bubble from collapsing, which in turn, would collapse the banking system, and ultimately, the economy, the dollar and the fiat money system. History tells us that they will not succeed. This chain of events, if it occurs, would likely be the death knell for capitalism.

What went wrong was that the debt bubble reached such a size that it was unstable, or what is called the Minky “moment”. The world-economy could not longer support the servicing cost of its massive debt bubble. As in the other seven liquidity expansions, the time has come for the default of the massive debt – a deflation. Depression is quickly spreading throughout the world-economy. And, because of the quantity of liquidity that has been generated, the suffering will extend for at least a decade. The so-called recent growth was illusory. It was the illusion constructed by the parasitic banking system and the mountain of liquidity that it injected into the world-economy.

The Industrial Revolution, which began early in the 19th century, was the engine for the massive 19th century accumulation of wealth. Later, but still in the 19th century, Europe and the United States began economically exploiting the world: the colonization of Africa, and the control of the economies of India, China, Central America, South America, and, the Middle East. The combination of the Industrial Revolution and the exploitation of the non-Western world generated outstanding wealth for the European countries and for the United States.

Starting in the first quarter of the 20th century, capitalism was no longer endlessly able to accumulate wealth. Capitalism had already picked the low-hanging fruit of the 19th century Industrial Revolution. The 19th century technological revolution of substituting mechanical energy for human and animal energy by the innovation of harnessing the energy of coal to the invention of the steam engine propelled a massive and real prosperity. Many fortunes were made via the new industries which coal energy connected to the newly invented steam engine spawned: looms for textile weaving; rail transportation; coal mine dewatering; the electric industry – electric light bulbs, electric motors, and electric generating systems; the vast chemical industry; the steel industry; and, etc. Capitalism enjoyed *endless accumulation of capital*. After the turn of the 19th

to the 20th century, innovation, while still robust, was unable to significantly increase industry's total profits.

Financial Capitalism, the system of creating credit out of thin air (the ability of banks, via the fractional reserve banking system, permits banks to loan more money than it has on deposit), or, as also called, money-printing became a rival to the wealth producing Industrial Revolution. Fortunes were made. *Financial Capitalism* began early in the 19th century, and, to this day, is a parasitic engine of profitability. Money and credit was now organized into an integrated, international system headquartered in London. *Financial Capitalism* has been at the center of all economic crises described by Michael Pettis in his book *Financial Capitalism,* has enjoyed massive profits, but also has created giant financial panics.

What went wrong? What are the likely consequences? The answer: a 200-year old, parasitic, banking system has been responsible for both our booms and for our depressions. Murray Rothbard's many books and his other writings, lucidly explains all of this from his Austrian economics viewpoint. The Keynesians, monetarists, and neo-classical economists deny that excessive debt generates financial crisis. Their economic religion believes that banks, debt, and money are not proper elements in analyzing the economy. Since 1945, the voodo economic priests, their bunko-economics, have justified the banker's parasitic behavior.

The world-economy has hit the wall because of the mountain of private debt, public debt, financial entity debt, and derivatives. The world economy can't pay off this debt, nor can it easily increase it. The world-economy faces a synchronized global recession, which will have far more serious consequences to the economy than that of the Great Depression. What might these consequences look like? Raoul Paul's comments are typical of the best analysts.

- "We don't know exactly what is to come, but we can all join the very few dots from where we are now, to the collapse of the first *major* bank…
- With very limited room for government bailouts, we can very easily join the next dots from the first bank closure to the collapse of the whole European banking system, and then to the bankruptcy of the governments themselves.
- There are almost no brakes in the system to stop this, and almost no one realizes the seriousness of the situation.
- **The problem is not Government debt per se. The real problem is that the $70 trillion in G10 debt is the collateral for $700 trillion in derivatives…**
- Yes, that equates to **1200%** of Global GDP and it rests on very, very weak foundation. From an EU crisis, we only have to join one dot for a UK crisis of equal magnitude.
- *And then do you think Japan and China would not be next?*
- *And then do you think the US would survive unscathed?*
- That is the end of the fractional reserve banking system and of fiat money.

- **It is the big RESET."[3]**

The more astute analysts identify derivatives as the main financial problem. As Raoul Pal states, the real crisis will begin when the first European bank collapses. The failure chain will then be: collapse of the European banking system; bankruptcy of the European governments; then, a similar collapse of the United Kingdom; then, collapses of Japan and China; and, finally, the collapse of the United States. This is so because of the inter-connectivity, and because of the deficiencies in the global banking systems, and of those in both the fiat money system and the fractional banking system.[4]

In my opinion, Raoul Pal's failure chain has strong similarities to the collapse of the Soviet Union. Tuur Demester in his May 2011 report, *Special Report: EU = USSR REDUX*, states the most important factors in the USSR collapse were: (1) centralized money system; (2) planned economy; (3) centralized basic services: (4) high and rising government debt; (6) external shock [falling oil prices of the 1980s]; (7) transparency and reform; (8) internal political unrest; (9) rising inflation; (10) and, bailouts from the central bank.[5] At this time, the United States shares with the Soviet Union all ten factors. Tuur Demester's work suggests that the United States faces an implosion similar to that of the Soviet Union,

All reports conclude that the United States will need to cope with serious political, economic, and social problems.

After all this, will there be a world capitalistic system? And if not, what kind of system will evolve? These are interesting, but also, dangerous times.

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[1] Michael Pettis, *The Volatility Machine:Emerging Economies and the Threat of Financial Collapse* (Oxford University Press, Oxford and New York, 2001) page 52.
[2] J. Anthony Boeckh, *The Great Reflation:How Investors Can Profit from the New World of Money* (John Wiley & Sons, Inc., 2010)
[3] Ibid.
[4] Ibid.
[5] Tuur Demesester, *Special Report: EU =USSR REDUX* (http://www.scribd.com/doc/54659210/ReportEUvsUSSR