

The Economy & The Fat Kid

Credit-based economies constantly need to expand in order to service constantly increasing levels of debt. Central banks adjust the flow of credit to maintain the balance between economic expansion and economic contraction.

Then one day, a fat kid shows up at the playground. While everyone knows it's a private playground and admittance is strictly controlled, no one knows where the fat kid came from or how he got in. Nonetheless, the fat kid's there.

Then the fat kid walks over to the teeter-totter and sits down. The fat kid's end of the teeter-totter slams to the ground as the other end skyrockets up; tossing all those on the high end off. The name of the fat kid is risk.

DON'T BLAME THE FAT KID THE ROLE OF RISK IN FREE MARKETS

When the dot.com bubble burst in 2000, it was the largest collapse of a speculative bubble since the Nikkei, Japan's stock market, crashed in 1990. The Nikkei had plummeted from its high of 38,957 down to 7,607, dropping 80% over thirteen years and setting in motion deflationary forces still in effect today.

It was the unexpected return of deflation that spooked Alan Greenspan and US central bank *kreditmeisters* to open up the floodgates of credit in 2002. After the Great Depression receded, central bankers had come to believe that unlimited fiat credit had forever banished deflation. But Japan proved them wrong.

When Japan's economy continued to succumb to deflation during the 1990s, Japan's central bank desperately slashed its interest rates to zero in 1999. But even this radical infusion of cheap credit couldn't reverse the cancer-like deflation eroding the Japanese economy. US monetary authorities, however, believed Japan had done too little too late.

In 2002, the US Federal Reserve Board of Governors wrote:

We conclude that Japan's sustained deflationary slump was very much unanticipated by Japanese policymakers and observers alike, and that this was a key factor in the authorities' failure to provide sufficient stimulus to maintain growth and positive inflation... we draw the general lesson from Japan's experience that when inflation and interest rates have fallen close to zero, and the risk of deflation is high, stimulus—both monetary and fiscal—should go beyond the levels conventionally implied by forecasts of future inflation and economic activity.”

Ten years after the Nikkei collapsed, the US dot.com bubble also collapsed and Alan Greenspan and the US Federal Reserve were to get their own turn at the wheel of fortune.

Perhaps they were right, perhaps Japan had waited too long, perhaps *stimulus—both monetary and fiscal—beyond the levels conventionally implied by forecasts of future inflation and economic activity* would produce better results.

In 2002 as the US economy contracted in the wake of the dot.com collapse and slid into recession, Alan Greenspan and the Federal Reserve Board moved decisively and quickly, slashing US interest rates to 1 %; and the crisis of deflation feared by Greenspan and the US *kreditmeisters* did not materialize—but another crisis did

ALAN'S GARGANTUAN BLUNDER

Although 1 % credit from the US Federal Reserve staved off a potentially lethal wave of global deflation in 2002, *monetary and fiscal stimulus beyond the levels conventionally implied by forecasts of future inflation and economic activity* caused a collapse of credit markets that is today threatening the underpinnings of credit-based finance and global capital markets; and, it did so by inadvertently banning market risk for five years.

Between 2002 and 2007, risk went into hiding as central banks flooded the markets with cheap money; allowing capital flows to mask losses while boosting asset values to record levels. Billions of dollars of central bank credit translated into trillions of dollars of leveraged bets creating bubbles in all asset classes—real estate, stocks, commodities, and bonds.

But global market risks, temporarily hidden by cheap credit, have now reasserted themselves with a vengeance. With many AAA rated bonds now suddenly worthless, buyers of Wall Street's now suspect wares have deserted the credit markets in droves. The rush for returns has been replaced by a rush to safety, reflecting the sentiment penned by the 19th century humorist Mark Twain:

I am more concerned about the return of my money than the return on my money.

Risk is back and no matter how often the playground supervisor tries to reassure us, we know the playground is no longer safe. Even the big kids are getting hurt. The fat kid's back and so is the whiff of deflation.

RISK IS IN THE HOUSE

LIBOR's getting high
As central bankers try
To calm the markets down
But risk is back in town

Risk is in the house YO!
Risk is in the house

Credit lines are drawn
Where's the money gone
Spreads are growing fast
Markets sucking gas

Risk is in the house YO!
Risk is in the house

Triple A means squat
Commercial paper rots
Monolines are down
'Cause risk is back in town

Risk is in the house YO!
Risk is in the house

Risk is going 'round
Can you hear the sound
As tranches hit the ground
'Cause risk is back in town

The bubble bloated assets of the *kreditmeisters*, e.g. real estate, stocks, and bonds, are now about to disappear into the maw of the bankers' resurgent balrog. Deflation, an increasing cycle of decreasing demand, is now again waiting in the wings.

In the coming months and years, safety will command the market's highest premiums. Traditionally cash and government securities, these havens will prove to be wanting in the troubled times ahead.

...*the US Treasury's 10-year Note lost 20% of its value compared to an ounce of gold since August 20* [sic 6 months]

Gary Dorsch, Global Money Trends Magazine, January 2, 2008

Fiat credit, fiat money, fiat government IOUs will offer but temporary shelter in wealth's flight to safety; and, as deflation follows in recession's wake, the *Kreditmeisters'* ***stimulus-- monetary and fiscal--beyond the levels conventionally implied by forecasts of future inflation and economic*** might well deliver us into even more dire circumstances.

In these times, playing with money is the same as playing with fire. The leverage of debt-based fiat money has yielded multiple returns in the past. In the future, the dangers of doing so will be obvious. The precious metals—gold and silver—the very antithesis of fiat money will offer both the greatest leverage and the greatest safety in the days ahead.

Note: I will be speaking at Gold Standard University Live in Dallas, TX, February 11-17 presented by Professor Antal Fekete. This is a unique opportunity to hear Professor

Fekete who is an expert on gold and its role in monetary matters. Some scholarships are available. Details are available at www.professorfekete.com .

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