Part One

THE NEXT BUBBLE AND BOOM

Chapter 1

The Explosion of Debt and the End of the Super Bubble

How We Got Here

The road to bankruptcy is not an easy one. It can take years if not decades or generations to arrive, especially when you look at the United States with its vast resources of wealth. To fritter that away is not an easy thing. However, the amazing thing is how fast the United States has done it. Many other superpowers, such as the Roman and British empires, took hundreds of years to fritter away their wealth and power from when they became superpowers. The United States became the world's superpower during World War II and is on the verge of bankruptcy only 70 years later.

In this chapter, we will show you how the United States has wound up in this condition. We will explore how the country created its debt problem internally by expanding government. We will examine how this has led to inflation. We will see that foreigners allowed and even helped to trigger U.S. reliance on debt to finance its needs. We will also show you why access to this funding may end.

The Start of the Problem

In the 1930s, Franklin Delano Roosevelt began the welfare state with an avalanche of government programs. Many saw these programs as short-term solutions until private spending and the economy bounced back. As such, the U.S. government was still small by modern measures. At that time, the expectation was that government intervention would lessen over time and eventually shrink back to former levels. FDR even tried to get the books back into balance in 1937. It had more to do with the public mentality than economic theories. Despite or perhaps due to the frugality of the public's own spending habits, many did not agree with the federal government living beyond its means for an extended period of time. The U.S. government never really got carried away with spending during the Great Depression. Therefore, the internal spending of the government was still modest as compared to modern government budgets.

The Sixties—The Expansion of the Welfare State

The mid-sixties and early seventies were really the key eras in the turning point of the American economy. In the mid-sixties, we saw a huge expansion in the size of the federal government. The role of the government in the daily lives of Americans increased dramatically in scope.

Some of this was born out of confidence in the government itself. People believed government intervention would result in increased prosperity for the U.S. economy. After all, the expansion of government under FDR seemed to get the economy out of depression in the thirties. Plus, America had now won two world wars against Germany and the space program was a smashing success. And due to the lack of competition in the global economy post–World War II, the

U.S. economy boomed and seemed to have a never-ending source of funds and prosperity.

The major shift came under Lyndon Johnson. Johnson was a war hawk and a social liberal. He decided that he would fight wars against both communism in Vietnam and poverty at home. Programs such as Medicare and Medicaid were put into place. Government spending soared as Johnson increased social spending dramatically to fight the so-called War on Poverty. U.S. voters increasingly realized that they could vote themselves more things from the government.

Programs such as Medicare and Medicaid have turned into a spending nightmare, sucking the life out of the U.S. economy while steadily increasing its national debt. For example, the actual increase in expenditures—compared to the initial estimates at the time—have run anywhere from 500 to 1,500 percent over budget over the past 40 years, depending on the study. (We will discuss this more later in this chapter.)

The United States began to run structural deficits. A *structural deficit* is a deficit that is permanent because the expenditures that cause that deficit are permanent government expenditures (see Medicaid or Medicare) as opposed to a one-time expense (e.g., like a stimulus package). Aside from a few years in the sixties, the United States began to run a budget deficit nearly every year. During the fifties and sixties, the United States had all sorts of extra expenditures, which led to an explosion in spending and deficits. The United States had to pay for wars in South Korea and Vietnam and also make payments for Medicare and Medicaid. Finally, it had to come off the gold standard and there was huge inflation in the seventies to catch up with the printing of money and the spending done in the sixties.

According to www.usgovernmentspending.com (including states and local governments), total government spending as a percentage of GDP was 3.05 percent in 1900. Therefore, total government spending was approximately 3 percent of GDP. By 1940, this had increased to 20.5 percent of GDP. During World War II, due to the military buildup, the total of government spending became half the size of the economy as its spending accounted for over 52 percent of GDP in 1945. After the winding down of the war effort, the total of government spending stayed at a relatively small size throughout the fifties. By 1965, total government spending was just over 26 percent of GDP. This meant that the government made up just over one-quarter of the total economy. This was not the tiny total of 1900, but it was still small total government expenditure, especially when compared to the size of federal governments of other developed nations. The effect of Johnson was immediate; by the end of his term in 1968, total government spending was over 30 percent of GDP.

However, the problem was not so much Johnson's immediate spending but rather the future impact of that spending. Spending that was instituted in the mid-1960s has left a permanent legacy for future generations of the U.S. government. Usgovernmentspending.com estimates that total government spending will be nearly 44 percent of GDP for 2011.

The budget deficit for fiscal 2009 was over 11 percent of GDP at $1.42 trillion. The only budget deficit in the history of the United States that was larger was in 1945, when the United States was expanding spending due to World War II. That year, the budget deficit was just a little over 20 percent of GDP.

Now that we have so much so-called "essential" spending, such as for social programs and military, it would be a major undertaking to reduce the structural deficit and shrink the size of government.

At some point the debt problem will become bad enough that the United States will be *forced* to cut spending as it will not be able to finance its deficits. History teaches us that when a nation falls into or near the brink of bankruptcy—marked by high inflation and unemployment rates and social unrest—it usually takes a significant leader or drastic changes to the economy and government to get it out of such a mess. Things can get ugly as this occurs. For example, when New Zealand came out of fiscal insolvency in the eighties, it deregulated the economy, privatized government-owned industries, and streamlined the economy. The same goes for the United Kingdom in the early eighties, when the British economy became dominated by socialists and union leaders. A showdown eventually culminated in coalminer strikes as Margaret Thatcher "broke" the unions in the United Kingdom in an attempt to rein in their power and get the country back to fiscal responsibility.

However, at the moment there is *no* political will in the United States to cut the deficit. In Britain and other European countries there is a debate at the moment about whether to cut spending and raise taxes because of the debt situation due to the impact of various financial crises. However, in the United States all we hear is talk of fiscal stimulus, more "jobs," health-care reform, public bailouts, how to revive credit growth, and Tiger Woods' libido. There is no talk of tightening belts to deal with the coming debt crisis. (Currently, Tiger's belt loosening and tightening appears to generate more talk than any other issue.)

The coming national debt crisis is the *most* important issue in the United States at the moment. However, virtually no one is talking about it.

The End of the Gold Standard and the Beginning of Inflation

From 1873 to 1934, the United States was on a gold standard. This meant that a certain number of dollars would buy an ounce of gold. The intention of the gold standard, whether it is admitted or not, was that the number of dollars in circulation could not be increased indefinitely. It was intended to create a stable exchange system. For example, if $500 equaled one ounce of gold under the gold standard, it meant that roughly $500 of money should be in circulation for every ounce of gold that the government had in reserves. This system was designed for the sole purpose of keeping governments financially stable. Essentially, governments could not print paper money unless they had the mandated ratio of gold to dollars in their reserves. In other words, the government had to add 10 percent more gold to its reserves if it decided to circulate 10 percent more currency or increase its expenditures by 10 percent. That is the gold standard in theory.

In 1971, the United States went off the gold standard. The system became a completely *fiat* system, meaning the dollar was linked to nothing. The government could print as much money as it wanted with no limitations. The central bank had begun to print more and more money to pay for ventures and the pressure was too much for the pegs at $35 an ounce to hold. This created inflation because they printed more paper money than they had gold in their reserves. After the United States went off the standard, the dollar was linked to nothing.

It is no accident that on this purely fiat money system we have seen a huge increase in government spending and consequently the amount of debt in the economic system. The United States started down that treacherous road of increased government spending with the growing size of the welfare state and later when it had pay for wars in Vietnam and Korea.

The fiat money system has also resulted in financial bubbles, which have been caused by excessively loose monetary policies. From 1933 to 1971, when the United States was pegged to gold, there were no financial bubbles. The Fed during that period of time thought that its mandate was to control inflation—in other words, to stop the punchbowl from being spiked when the economy and financial markets got overheated. The gold standard helped it to do this by keeping in line the number of dollars that could be in circulation (e.g., if it wanted to go crazy printing, the government would have to add gold or reserves to its vault to justify this printing). However, after 1971, the Fed could print as much money as it wanted. As a result, in the 38 years since the abolishment of the gold standard, there have been no fewer than four major financial bubbles, including:

1. The commodities and inflation bubble of the late seventies
2. The stock market and technology bubble of the late nineties
3. The real estate and leverage bubble of the 2000s
4. The current bond market bubble (and the coming debt and second inflation bubble)

The reason you get these bubbles in a fiat monetary system is simple. The gold standard acts as a discipline mechanism that prevents governments from spending too much and the Fed from printing too much paper money and creating too much credit. When the Fed can print all the money it wants, this creates massive dislocations and therefore creates massive bubbles.

With no discipline on spending programs, spending is unchecked and goes wild.

Domestic Government Spending + Expenditures Abroad = Bankrupt America

As we will learn in this section, government spending on domestic social programs and expenditures overseas is out of control. This is worrisome as the decline of most empires is characterized by an over-extension of spending both at both at home and abroad.

Medicaid and Medicare—The Black Holes of Domestic Spending

Government programs are a perfect example of when monetary policy meets political policy. When the government can print money for these programs and has no accountability for the limits of spending on them, spending gets out of control. Most government programs are well intentioned. Food stamps to feed the poor, health care for those who cannot afford it, benefits for those who have lost their jobs—who can argue with those programs? However, problems develop when vote-seeking politicians, who don't have the real dollars to finance them, implement programs come hell or high water.

The best examples of government spending gone awry are Medicaid and Medicare. It is no coincidence that the huge run-up in health-care costs coincided with the creation of Medicare. Medicare is an insurance program for the elderly with compulsory premiums. Medicaid is a program by which state governments use government monies to pay for health care for low-income individuals. We should note that Medicaid is one reason that state budgets have also exploded since the sixties.

According to Harry Browne, in his book, *Why Government Doesn't Work* (Liamworks, 1995), Medicare was created in 1965 with an estimate that in 1990 its costs would be $3 billion. Adjusted for inflation in 1990 dollars, that would come to $12 billion. The actual cost in 1990 was $98 billion. The estimated cost for the 2010 budget is $453 billion. The payroll tax to help cover these costs has risen from 0.9 percent in the mid-sixties to over 4 percent today. It will have to go even higher in future years to cover future Medicare costs. Medicare would actually be bankrupt except that the government keeps raising payroll taxes to pay for it.

Browne also notes that the pattern for Medicaid is almost entirely the same. When Congress passed Medicaid in 1965, the budget was $1 billion. By 1993, it was $76 billion, and it was $290 billion in 2010. According to www.inflationcalculator.com, something that cost $1 in 1965 would cost $6.87 today for an inflation rate of 586.8 percent in those 44 years. Yet Medicare expenditures have increased by 7,500 percent!

The Cost of War—The Black Hole of Expenditures Abroad

War and defense is playing a part in the deterioration of the U.S. financial situation, but not as much as you would think. As of 2010, the United States will spend $895 billion or 6.14 percent of GDP on its military. Most of this is not even for the wars in Afghanistan or Iraq, but rather to pay for its armed forces, which feature bases in nearly 140 nations.

If the United States cut its military expenditures to normal levels and stopped policing the world, it would help the country's finances. For example, global war expenditures as a percentage of GDP are approximately 2.4 percent according to the Stockholm Peace Institute's *2009 Yearbook*. If the United States were to cut to the global average, it would save the country about $550 billion. With the 2010 deficit running at about $1.45 trillion, that would cut the deficit to $900 billion a year.

So we can see that the military plays a large role in the current fiscal problems of the United States. Pension and health-care expenditures are estimated to be $1.6 trillion combined in 2010, and by 2015, according to usgovernmentspending.com, it will increase to $2.0 trillion (more than doubling the expected expenditures of $900 billion budgeted for the military that same year). This means that by 2015, pension and health-care expenditures will be over 10 percent of GDP, whereas the military will be under 5 percent! Yes, the cost of defense is excessive, but again, only about 13.8 percent of the total government's budget is spent on the military. And this number will shrink in the coming years; 86.2 percent of the government's expenditures are coming from *outside* the military. The decline of the American Empire will in all probability come from within.

The perfect example of a country that was crushed by debt by both its empire and domestic policies is the United Kingdom. After two world wars decimated its coffers, the U.K.'s debt as a percentage of GDP went from just over 30 percent in 1913 to over 250 percent by the mid-forties. The U.K. needed a bailout of $3.5 billion from the Americans just to stave off insolvency after the war and then began to dismantle its empire to cut expenses drastically. Then in 1976, with inflation and spending out of control (a deficit of nearly 6 percent of GDP), the U.K. had to go to the IMF for a £2.3 billion ($3.5 billion) loan as it was unable to raise money on the public markets. This shows us the twofold effect of debt. The first U.K. debt crisis of 1946 led to the collapse of the empire as the easiest thing to cut first was foreign expenditures. The second debt crisis was caused by excessive social spending and out-of-control inflation. This inflation led to super-high government bond yields that the government could not afford to pay.

Can the Government's Debt Be Sustainable?

A unique situation that is saving the United States at the moment is low interest rates. Unlike the U.K. in 1976, the United States is still paying very low interest on its debt. One of the things that cause governments to go insolvent is a spike in bond yields. For example, if interest rates double or triple, it causes interest payments to soar and this development squeezes out spending on other things such as military or social programs. The United States has benefited from being the reserve currency of the world. When the financial crises hit in 2008 and then the Greek crisis hit in 2010, interest rates plunged as investors fled to the so-called safe haven of U.S. Treasuries. At some point, these interest payments are going to rise. Estimates are that in 2010, the U.S. government will spend $309.2 and $384 billion on interest payments. That is about 4.8 and 5.6 percent of GDP. However, by 2015, total government interest payments are expected to double as interest rates and the total government debt rise, to $762.0 billion or nearly 8.8 percent of total government expenditures. These figures are based on government estimates, which almost always assume the rosiest scenarios possible. We must remember that these numbers are also based on total expenditures. Current total expenditures are totally unsustainable. If the budget were to be balanced in 2015, that 8 percent number would probably rise to about 12 to 15 percent depending on the amount of revenue the government took in at that time as total government spending would have to be cut.

We can be sure that economic growth and government revenue will not grow as fast as the government's numbers state. This means more debt and higher interest payments. In addition, I believe that the U.S. long bond and the interest rate market in general are in a bubble (more on this in Chapter 2). I feel that interest rates are headed much higher in the coming years. As just stated, the current low interest rates are the only thing keeping the United States from entering a debt crisis. The reason that Greece went from being solvent in 2009 to a crisis in 2010 was that its bond market woke up and the yield on 10-year Greek bonds went from 4 to 14 percent in 6 months. This increase in interest payments made the rest of the budget insolvent. What happens if the United States sees rates spike like the Greeks in 2010 or the Brits in the mid-seventies? Interest rates would have to spike to attract foreign investors; that development would lead to a totally out-of-control runaway budget deficit and debt crisis. If interest rates were to double or triple from current low levels, the scenario is set for interest payments to represent 20, 30, or maybe even 40 percent of total spending.

If this scenario were to occur, you would see similarities to the fall of other empires. In an interview with *Newsweek*, published on November 28, 2009, Professor Niall Ferguson tells us that France (before the revolution) was spending 62 percent of total revenue on debt service in 1788; the Ottoman Empire was paying 50 percent of its budget on interest by 1875. In the interwar years in the thirties, Britain was paying 44 percent of its budget toward interest. A spike in rates would have the United States at these near-bankrupt levels.

I am not even including the negative effects and increased expenditures from the financial crises. I have not talked about the so-called *emergency loans* to General Motors and Chrysler, or the nationalization of Freddie Mac and Fannie Mae, or the TARP program, or the $700 billion stimulus. What is obvious is that the increased spending and deterioration of the nation's finances has been occurring for years. As the population ages, we will see increases in the need for expenditures for Social Security, Medicaid, Medicare, and the new health-care plan being proposed by Congress. According to an article published in *USA Today* (May 29, 2007), the costs of these unfunded liabilities could ultimately be as high as $59.1 trillion! We must also remember that if Congress is telling us that the new health-care proposal will cost $940 billion over the next 10 years, it will probably end up costing 3 to 5 times that amount or even more and add to the deficit even further. This is not a book to rant about the size of government, nor am I going to preach on why the United States must cut back, and so on. However, the inescapable fact is this: The current growth of U.S. government debt is not sustainable.

The Parabolic Curve

When a move is unsustainable in the markets, it tends to be something that goes straight up in price. This is reflected in diagram form by the infamous *parabolic curve*. A parabolic curve often occurs near the end of a bubble. It is a move straight up on a chart at a near-90-degree angle that is totally unsustainable. NASDAQ stocks in 2000, Japanese stocks in 1989, and U.S. stocks in 1929 are all examples of asset classes that saw parabolic curves and crashes.

Figure 1.1 shows the total U.S. debt as a percentage of Gross Domestic Product (or a percentage of the total goods and services produced in a nation in a given year). This is an important tool to calculate debt. Debt is not all bad. You can use debt to build roads, fight wars, and so forth. In the long run, as long as that debt increases at a slower pace than the economy, your *debt-to-GDP ratio* is going down and is sustainable. If a government runs a deficit at around 1 to 2 percent of GDP and the economy is growing at 3 to 4 percent, its debt in relation to the size of the economy is going *down* and that small amount of debt will not put a stranglehold on a nation.

However, if the debt is growing too fast in relation to the economy, it is unsustainable as revenues and economic activity will not be able to keep up with the amount of debt in circulation. Just look at your own finances. If you grow your income by 5 percent a year, but grow your debt at 10 percent a year, at some point you will not be able to service the debt you have built up and you will go broke.

All bubbles trade the same way. They start on a slow increase. The speed of the ascent begins to quicken as the bubble rolls on and then the bubble experiences the mania or blow-off phase. In technical terms, this is the parabolic curve. This final blow-off phase of a parabolic curve can cause a particular market that is in a bubble to double or triple in just a short period of time. However, the rate of the increase is totally unsustainable and it eventually collapses.

There is only one time in the 200-plus-year history of the United States that the nation has experienced a debt bubble. This was in the mid-1940s, as debt ballooned to help fight the war effort.

Figure 1.1 shows that debt grew slowly in the early part of the twentieth century. Debt as a percentage of GDP grew from 10 percent in 1900 to about 20 percent in 1917, then in the twenties it continued to grow and was in the low 30 percent range at the 1929 stock market top. It then increased at a more rapid rate in the thirties as increased government spending and decreases in revenues began to take their toll on the public finances. By the end of the thirties, the debt-to-GDP ratio stood at nearly 65 percent. It then exploded during the war in a five-year period from 1941 to 1946: Debt as a percentage of GDP more than doubled from 54 percent to 128 percent due to the war effort. Of course, a more-than-doubling like this every five years was totally unsustainable. It was the top of the debt bubble.

When bubbles blow up, they blow up fast. Usually, the last blow-off phase of the bubble is lost within a few years of the bubble. By 1957, the debt-to-GDP ratio had collapsed to 70 percent of GDP; by 1967, it fell even further to 52.83 percent. You can see on the chart in Figure 1.1 the parabolic move upward, followed by this collapse. Debt as a percentage of GDP then bottomed out at 43.53 percent in 1982. That was the end of the 36-year downtrend in debt.

However, the rate of increase was subdued; by 2001, the debt-to-GDP ratio stood at 73.19 percent. That was the start of the bubble; during

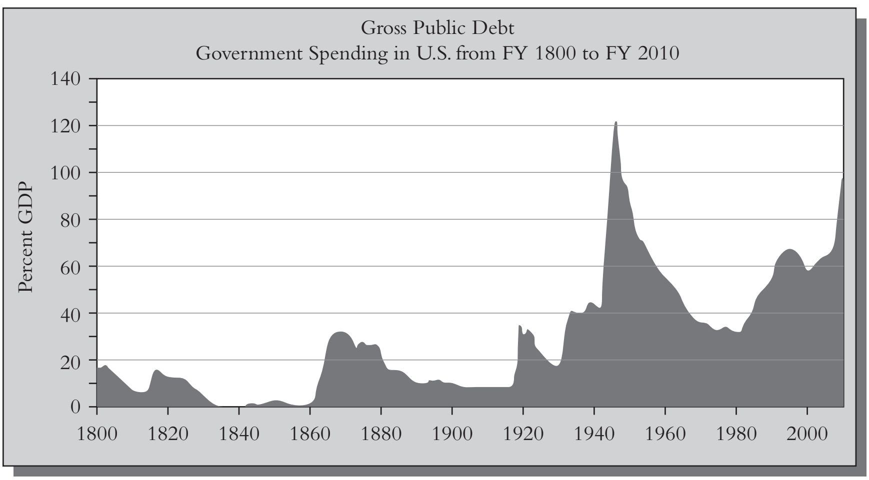

Figure 1.1 Debt as a Percentage of GDP.
In the 1870s, due to the Civil War, the United States saw a mini-debt bubble as the U.S. debt climbed to just over 30 percent of GDP before falling back in the early 1900s. The first major debt bubble was in the 1940s; we are now building for the second debt bubble.
SOURCE: www.usgovernmentspending.com.

the period of 2001 to 2009, the bubble picked up steam in order to pay for the wars in Afghanistan and Iraq, among other things. By 2009, the debt-to-GDP ratio increased to 89 percent of GDP.

We are now entering the blow-off phase. Debt-to-GDP in 2010 is estimated to be over 110 percent of GDP; this marks the first time since World War II that the debt-to-GDP ratio will be over 110 percent. By 2014, it is estimated to be over 125 percent of GDP. Again, if you are like me and you feel that the costs of Medicare and Medicaid will go up faster than the government says due to the aging of the population, and that economic growth will be less robust than the government predicts (highly likely in a post-bubble environment), then this number will be even higher.

Figure 1.2 takes the debt bubble one step further. This takes into account projections made by the CBPP (Center on Budget and Policy Priorities) and shows that debt as a percentage of GDP will hit nearly 300 percent of GDP by 2050 if nothing is done. It is surely an

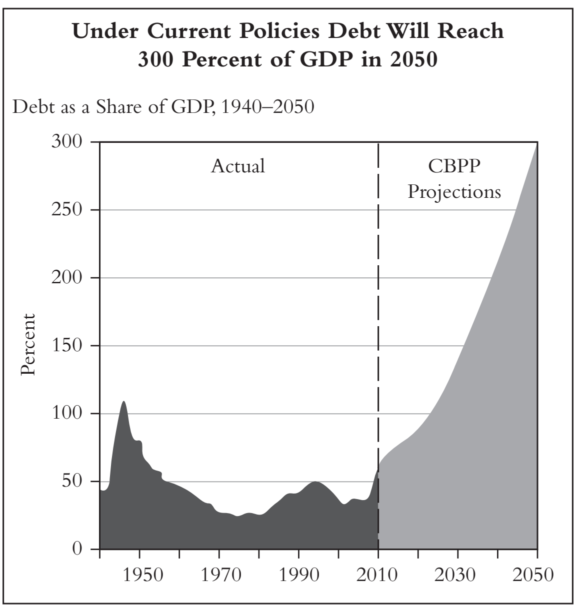

Figure 1.2 Government Debt as a Percentage of GDP (Estimate)
NOTE: CBPP projections based on CBO data.
SOURCE: cbpp.org.

unsustainable bubble to eventually have government debt *three times* the size of the economy.

However, I do *not* think we will reach that level. At sometime in the next 15 years, and more likely in the next 10 years, we are going to reach a point of emergency where the debt bubble will be out of control and will then collapse. It will be a forced collapse. The government will be all but bankrupt and forced to cut expenditures.

Government Underestimates Its Debts

I hate to depress you, but not only is this debt unsustainable but it is even worse when you include the huge growth in unfunded liabilities and government-controlled corporations. As I mentioned previously, the government actually underestimates debt and reports lower numbers.

On top of the typical state, local, and federal government debt that we have used in all our calculations, we must remember that with the bankruptcies of Fannie Mae and Freddie Mac and the government takeover of these institutions (it is an equity stake but in reality a takeover), the government has essentially added $5.3 trillion in mortgage debt to the federal debt. Let's face it: If these mortgages were defaulted en masse, the companies would simply *not* go bankrupt and you would see the government having to absorb this debt. We do realize that not all of this $5.3 trillion of debt is bad debt. But having to take on that sort of debt is scary, indeed.

For argument's sake, however, $5.3 trillion in Fannie and Freddie debt would put the total government debt up from the 2010 estimate of $17.7 trillion to $23.0 trillion overnight!

Huge Growth in Private Debt

Not only has the government seen a huge amount of growth in debt but the private sector has as well. I am not going to get into the nitty-gritty details of the average person's debt, but I will add the private numbers together with the government numbers to show you just how dire the situation has become.

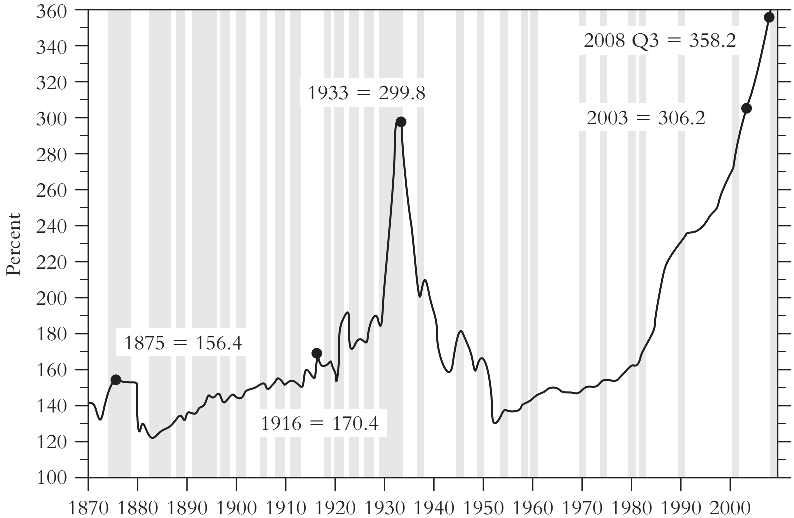

Figure 1.3 Total U.S. Debt as a Percent of GDP
NOTE: Annual, through Q3 2008.
SOURCE: Bureau of Economic Analysis, Federal Reserve, Census Bureau: Historical Statistics of the United States, Colonial Times to 1970.

If you add the private numbers to the public numbers, you get another debt bubble (Figure 1.3).

We can see the first bubble in Total Debt as a Percentage of GDP. This bubble blew off in 1933, 13 years before the public debt bubble did. With the collapse in the economy, this actually peaked in 1933 at a level of 299.8 percent of GDP. This meant that total debt and government debt in 1933 was about 3 times the size of the economy.

Note that Figure 1.3 also traded like most other bubbles. There was a very small increase from 120 percent of GDP in 1870 to 160 percent in 1919. There was an uptick in acceleration to about 185 percent of GDP in 1929, and then a parabolic blow-off from 185 percent to 299.8 percent from 1929 to 1933 as the economy collapsed during the Great Depression. Again we must remember that these numbers were influenced by the collapse in the economy. Government increased debt from 1929 to 1933, but the GDP shrank.

Government increased its debt from $33.41 billion in 1929 to $41.61 billion in 1933, but the economy contracted from $103.6 billion in 1929 to $56.4 billion in 1933. Much of that bubble was caused by a decrease in economic activity. Again, if your income is halved but your debt stays the same, your debt as a percent of your income is going to increase.

We can see that this bubble collapsed in the 20 years following. This occurred despite the *huge* run-up in government debt that lasted until 1946. The main reason for this collapse was due to the fact that corporations and individuals deleveraged big-time, cutting their debt during the Depression and into the forties. By the early fifties, total debt as a percentage of GDP had fallen to just over 130 percent of GDP.

At that time, the next bubble began. Until 1980, total debt as a percentage of GDP slowly increased to roughly 160 percent of GDP. It then exploded until 2008, reaching over 358 percent of GDP! Again, this is totally unsustainable and at some point must collapse.

We have already seen the private sector begin to deleverage much like they did in the thirties and forties. However, for argument's sake, let's say that the government sector is 13 years behind the deleveraging just as they were in the 1933-to-1946 period. That would mean that the government would not begin to deleverage or cut its debt until about 2022!

Having a debt that is 3.5 times the size of GDP is totally unsustainable. To again quote professor Niall Ferguson, he indicated in the opening statement he made during a debate at the PanAmericanCenter about the Global Economic Crisis, "Once you end up with private and public debts in excess of three and a half times your annual output (GDP), you *are* Argentina!"

Middle Class in Decline

All of this debt has led to a decline in the standard of living of the American middle class. As the average standard of living has declined, people have used this debt to try to keep their standard of living high.

One of the marks of a great society is building a middle class. During their periods of power, the Romans and British had a large middle class. In the post–World War II period, the United States built the largest middle class in the history of humankind. This was marked with the ability to finance properties via mortgages and cars via loans or leases.

These were managed debts that helped to expand the U.S. economy and in turn increased the standard of living of the average person.

In the eighties, however, as people on the lower and middle end of the income spectrum could not keep up their standard of living, they attempted to maintain their living standard by relying on debt. The savings rate by the year 2000 was in the negative as consumers used debt and stock and housing gains to live on. This was totally unsustainable and it collapsed in the 2000s.

For example, if we break up the nation into five quintiles, the top quintile of income earnings (to 20 percent) followed by the second quintile, followed by the third (middle 20 percent), fourth, and fifth quintile (lowest 20 percent) of income earnings, we can see a real disparity in the past 30 years.

According to a study undertaken by the Congressional Budget Office (CBO) in 2007, the following income adjustments (adjusted for inflation) occurred since 1980:

Top Quintile = increase by 69 percent.
Second Quintile = increase by 29 percent.
Third Quintile = increase by 21 percent.
Fourth Quintile = increase by 17 percent.
Lowest Quintile or 20 percent = increase by only 6 percent.

This decrease in standard of living has helped lead to excessive debt levels of individuals as many in society who have had a hard time keeping up have turned to debt to artificially support their standard of living. It also means that the middle class is making less and therefore paying less in taxes. This leads to less income for the government, which leads to bigger deficits and bigger public debts as well. The entire situation is a vicious circle, which means more debt for the government and the private individual.

The Explosion and Implosion of the Super Bubble

George Soros, the hedge fund manager who gained fame from his Quantum fund's unparalleled returns and as the man who broke the Bank of England in 1992 (making billions from the collapse in the British pound that year), published a book in 2008 entitled *A New Paradigm for Financial Markets*. This book dealt with the credit crises of 2008. Soros is a brilliant mind whose main belief is in a theory he calls *reflexivity*. This complex theory states that financial markets are not always right, but rather they are always wrong and they shoot to the upside too far and then shoot too far to the downside.

Many do not agree with his politics or political views. However, I believe that Soros has figured out the reasoning behind this huge debt bubble.

Soros says that the debt bubble was the Mother of All Bubbles (my words, not his) or the Super Bubble. The Super Bubble was essentially a shift made in the early eighties where markets were opened up through globalization and market fundamentalism. Soros states that the United States abused its position as the reserve currency of the world. Basically, there was a shift toward what Reagan called "the magic of the markets" in the eighties and toward more open global finance. As the United States was the center of global finance, it benefited from this liberalization. Many of the rules of the International Monetary Fund and global finance put strictures on smaller, undeveloped nations (e.g., the size of the deficits they could run, etc.). However, the United States did not need to play by these rules. That benefited the United States and allowed it to live beyond its means as huge amounts of funds flowed into the United States. That is Soros's theory. I agree with most of it. I do, however, need to add my own tidbits.

Super Bubble

As the global economy became freer and there were cheaper labor markets, U.S. products lost their luster (the United States had already started to lose its manufacturing superiority to the Germans and the Japanese in the sixties and seventies).

As many other nations started to come online in the global economy, they had low labor costs. They became great candidates for cheap products. The United States was the largest consumer economy in the world. Its labor was pricing itself out of the global manufacturing community at the same time as there was a market for exporting into the United States. In addition, as the United States now had its currency linked to nothing, developing cheap foreign labor markets would allow it to print as much money as it wanted to without creating huge amounts of inflation. America simply allowed itself to take advantage of cheap labor and products in foreign markets and import lower-cost products, thereby temporarily importing deflation.

Therefore, there were huge shifts of money into the United States to keep interest rates low and support the Super Bubble. This allowed the United States to live beyond its means. It was a beneficial agreement; the Japanese, Chinese, and others could buy U.S. bonds. They funded the U.S. current account and trade deficits (current account = balance of trade + net factor income from abroad + net unilateral transfers from abroad).

Foreigners would buy U.S. bonds to help keep U.S. interest rates low and U.S. spending high. In turn, the United States would buy their goods (mostly from China and Japan) and keep these nations' economies roaring. In addition, the United States would initially import deflation due to the cheap cost of goods because of the abundant cheap labor these nations possessed. Despite the fact that the United States was printing huge sums of money and running up huge debts, it was not seeing huge inflation.

However, the Super Bubble blew up when the United States took this relationship to an extreme and abused it. As U.S. citizens and their government lived way above their means, the *current account deficit* started to get out of control; by the mid-2000s, the current account deficit was growing toward 6 percent of GDP. In addition, the United States had to turn increasingly to debt to fund these finances. During the 2000s, the savings rate actually turned negative for a while, as consumer and government debts continued to explode.

Adding fuel to the fire, the Federal Reserve went crazy printing money and implementing easy monetary policies. After the events of 9/11 and the recession caused by the explosion of the tech bubble, Alan Greenspan panicked. He cut rates to 1 percent to stave off another Great Depression. Greenspan also printed a seemingly endless supply of money and did not raise interest rates until 2004—nearly three years after the economy came out of recession. This easy money led to a gigantic housing boom and leverage boom and debt bubble.

Concurrently, there was a huge demand for U.S. debt to meet the demands of the Super Bubble. In other words, foreigners wanted U.S. debt to keep interest rates in the United States low, which would keep the U.S. consumer spending, who was in turn buying foreign goods. As an example, if rates went down, Americans' equity in their homes would go up; they would feel richer; they could spend more on foreigners' goods; foreigners could pump more money into the United States; and the U.S. consumer could buy more and more! It was the ultimate Ponzi scheme.

This loose credit spread into the subprime market. Wall Street packaged these garbage investments and leveraged them 30 to 1, Moody's and S&P rated them as AAA, and they were sold all over the world.

The subprime market blew up; investment banks exploded; the housing bubble burst; U.S. consumers lost equity in their homes; they could not buy as much stuff from foreigners; and foreigners had less money to pump back into the U.S. economy. It was a vicious circle that fed on itself. The Super Bubble burst. Americans could no longer live beyond their means.

This brings us to a major future problem: The United States is planning to issue trillions of dollars of debt in the coming years to meet its so-called obligations, but foreigners have less reserves and money coming in to buy those Treasuries. There will be less demand for dollars at a time when there are even more of them being issued.

How will the United States pay for all of its debts? It will *print its way out!* The next chapter deals with this phenomenon.