CHAPTER 1

Why the Debt Crisis *Was* Predictable

How was it that we, of all people, were able to successfully predict the major financial and economic crisis that continues even as we write these words today? What differentiates us from the army of economists, professors, analysts, bankers, fund managers, central bankers, politicians, and journalists who only recognized the impending calamity after it was well under way?

We are not whiz kids or members of Mensa. Nor do we have any secret access to knowledge.

Rather, our only strategic advantage is the willingness to swim against the tide, and to remain immune to the siren songs. Most human beings are gregarious animals who can believe—and sometimes, *must* believe—almost anything, as long as they are part of a group that subscribes to the same viewpoint. It seems no theory or thought is too absurd to be accepted by vast numbers of otherwise thoughtful people. Fictions that few could ever believe individually are trusted implicitly within the shelter of the group. Individuals who otherwise might be totally rational are swept up into irrational groups that suppress and inhibit even the most basic of common sense.

The second factor that has helped us distance ourselves from the crowd is the absence of any conflicts of interest. We view market analysis—which necessarily includes political analysis, social analysis, and even mass psychology—as one of the most worthy pure intellectual challenges that the world has to offer. We have no professional ties, contracts, or commitments that interfere with or bias that endeavor.

From a technical point of view, the key is our intensive focus on the phenomenon of the speculative bubble. A comprehension of its causes, its dynamics, its bursting—and the consequences thereof—has enabled us to see the period since the mid-1990s, when the largest stock market bubble of all time began, through different eyes from the majority of our colleagues. Furthermore, the internal logic of the speculative bubble forced us to ask further critical questions and to connect the dots to what others may have seen as unthinkable conclusions.

Finally, and most important, our understanding would be woefully incomplete if we were not familiar with the Austrian School of economics. The brilliance and consistency of its approach, dedicated to the cause of freedom, is both inspiring and persuasive. Its logic will propel you toward insights that cannot be reconciled with ready-made views of the world. But therein lies one of its great strengths. Moreover, it does not stop at the gates of institutions that continue to be regarded as sacrosanct. Quite the contrary, the Austrian School debunks the wisdom of the state's monetary monopoly, reveals the danger of its resulting system of central banks and fractional reserve banking, and exposes this monetary complex for precisely what it is. As we will document here, this monetary complex is the underlying root of the crisis now unfolding. Worse, the global official response to the crisis—unprecedented interventionism—threatens the continued existence of our free market system and, with it, individual freedom itself.

Keynes versus Mises and Hayek

Let us start this chapter about the huge differences between classical liberal thinking and Keynesianism with a central quote about money from F.A. von Hayek.

> The past instability of the market economy is the consequence of the exclusion of the most important regulator of the market mechanism, money, from itself being regulated by the market process.[1]

We refer again and again in our analyses to the insights of the Austrian School of economics, whose preeminent thinkers were Carl Menger, Eugen von Böhm-Bawerk, Ludwig von Mises, Friedrich August von Hayek, Walter Eucken, and Murray N. Rothbard.

At the heart of this school of thought, which extends far beyond the realm of economics, is freedom of the individual. And inextricably tied to freedom is, of course, property—specifically including ownership of the means of production. Freedom of contract and self-responsibility are the most important additions to these key concepts, which underpin classical liberalism and from which the political program of a free society emerges.

It goes without saying that the boundaries of the freedom of one individual lie where the freedom of another begins. It is easy to derive the rules governing cooperation from this basic principle.

At the same time, there are also thieves, liars, and fraudsters, seeking to acquire other people's property for themselves. It follows that certain measures must exist to protect property rights. Furthermore, freedom of contract would have little meaning were there no mechanism in place for the enforcement of contractual agreements.

At discussion of the precise form of such mechanisms—and what concrete proposals classical liberalism offers for their regulation—is beyond the scope of this book. Suffice it to point out that individual freedom continually faces a series of specific threats and that the greater threat to individual freedom comes not from other individuals but rather from powerful organizations.

Organized crime, like the Mafia, is a common example that springs to mind, but it is not the one that affects the most people most of the time. Rather, the single greatest threat to individual freedom comes not from common criminals, but from the mightiest organization of all—the state.

The Road to Serfdom

History is littered with examples of horrendous crimes. But the biggest, the worst, and the most devastating have, almost without exception, been perpetrated in the name of the state. This unmistakable conclusion has led the philosophers of freedom to adopt a healthy mistrust of government and its representatives.

Based on the most thorough analytical and empirical arguments, they see the government as the greatest threat to freedom, against which a society must protect itself at all costs, lest it degenerate into dictatorship. The separation of powers is one such protective mechanism. But equally important is strict adherence to a currency that *cannot* be multiplied at will, thus forcing the government to treat the nation's finances in a responsible manner, while protecting the people from the greed of the politicians.

In principle, there are two ways freedom can be abolished and slavery introduced: through revolution or evolution. The reader will certainly be familiar with revolutions that have led to the rise of dictatorships. The communist revolutions, causing untold suffering and poverty across great swaths of the globe have, after all, only recently been consigned to history. A repeat of this ghastly period in history hardly appears to be an imminent threat today, while the threat of Islamist revolutions seem more current, threatening the introduction of new tyrannies in several parts of the world.

In Europe, most of the Americas, and other regions, freedom is not currently threatened by domestic groups demanding revolution. Instead, the greater threat stems from an evolutionary process initiated long ago—a not-so-subtle, insidious progression in which the government spreads gradually like a cancerous tumor, increasingly limiting or abolishing individual freedoms.

To describe this process, Hayek coined the phrase "the road to serfdom."[2]

In this book we refer primarily to *Keynesianism*—to embody not only John Maynard Keynes's economic program, but also, to some degree, all schools of economic thought that seek to accord the government a sphere of influence extending far beyond the essential sovereign tasks of ensuring security at home and abroad.

For the sake of simplicity, we draw no distinction among multiple schools of economic thought, all of which have one major commonality: namely that they all demand an overly robust role for the government in the economy and society.

In this broader sense, we also characterize *monetarists* as Keynesians inasmuch as they advocate the government monopoly over money and the system of central banks, which that monopoly necessarily entails. Granted, in other realms, monetarists espouse thoroughly non-Keynesian positions that may seem to favor freedom. But for the purposes of this book, they continue to fall under the broader rubric of Keynesians.

The administration of former president George W. Bush and the neoconservatives, despite all their rhetoric to the contrary, were, in fact, out-and-out Keynesians. This is so obvious it should not even be worth mentioning. However, in the wake of the debt crisis, since the blame game and search for scapegoats is so ubiquitous, and since neoliberalism is first in the firing line, this observation is nonetheless necessary. It's ironic that liberalism and free market philosophies are getting lynched, when the real culprit that deserves to stand trial is Keynesianism.

The key point here is not whether government intervention in the economy—including massive economic stimulus programs—are financed by deficits or not. We know that Keynes proposed that the government should accumulate reserves in good times so that it could afford to finance stimulus programs in bad times. But because Keynes himself was, in large measure, a politician, it is inconceivable that even he considered the implementation of this proposal to be possible—let alone probable. The interests of politicians who depend on votes are diametrically opposed to Keynes's proposition of accumulating reserves in times of plenty. Voters almost invariably demand that surpluses be spent *today*—not in some elusive future.

To reveal a government's hidden agenda—even behind its smokescreen of public relations and propaganda—all that is typically required is to consider a few key variables: you can look at the trend in the government's share of total economic activity, the amount of legislation passed or, more commonly, the level of national debt. If each of these is expanding, you can be almost certain that the government is *not* pursuing a liberal agenda. It is immaterial what kind of rhetoric or propaganda the government is deploying. Do not let them fool you. And don't be hoodwinked by false critics, either. Judge both sides not by their words, but by their deeds.

Classical liberalism and the Austrian School of economics stand, as we do, for freedom of the individual—with no ifs or buts. Classical liberalism and the Austrian School are the offspring of unwavering philosophers of freedom. And these are philosophers who think ideas through to their logical conclusion with inexorable consistency, even in circumstances in which others would prefer to take a more relaxed view—to further their career or to avoid established taboos. It should therefore come as no surprise that thinkers of this provenance have no powerful friends. They are a thorn in the side of the powerful.

In *The Denationalisation of Money,* F.A. von Hayek sums it up as follows: “I fear that since ‘Keynesian’ propaganda has filtered through to the masses, has made inflation respectable and provided agitators with arguments which professional politicians are unable to refute, the only way to avoid being driven by continuing inflation into a controlled and directed economy, and [the only way to] ultimately save civilization, will be to deprive governments of their power over the supply of money.”[3]

We agree. But some of the most powerful men—controlling trillions of a nation’s money supply—do not.

Dr. Greenspan’s Great Experiment

“Dr Greenspan’s great experiment” was the title of an important chapter in our book *Das Greenspan Dossier*. We coined this term, with good reason, to refer to the policy of unrestricted use of the printing press to create money—a policy pursued aggressively at that time to counteract the consequences of the technology stock bust (the *Tech Wreck*) between 2000 and 2002.

The United States had witnessed the bursting of a giant stock market bubble once before, in 1929. And the Crash of 1929 proved to be the prelude to a serious banking crisis and a global recession that would later go down in history as the Great Depression. The causes of this historic crisis are the subject of extremely heated debate even today. Nonetheless, in recent years, the Keynesian view has increasingly prevailed—a view we regard as mistaken.

Believers in Government Omnipotence

On one side of this dispute are John Maynard Keynes and the school of thought that is now followed by the vast majority of economists. Above all, this school places its faith in the government. It maintains that the massive monetary and fiscal measures taken in the 1930s were fundamentally correct; it was simply the extent of government intervention that was believed to be insufficient to prevent the catastrophe. “Too little, too late” is the shorthand version of the analysis that predominates today.

Strangely, in their theory and worldview, the preceding boom, made possible by the lax monetary policy of the 1920s, plays no role. To be precise, it does not even appear in this theory at all.

Nevertheless, virtually every central banker and policy advisor, together with almost every economist in government, subscribes to this school. Naturally, he who pays the piper calls the tune. Unfortunately, it's ultimately the average citizen that gets stuck with the bill.

Free Market Economists and Skeptics of the State

On the other side of the debate are Friedrich August von Hayek and a beleaguered minority that's been consistently skeptical of government. They see the true cause of the 1930s bust not in the inadequacy of the government's response, but rather, in the monetary excesses that created the speculative boom that preceded it.

It was lax monetary policy that drove the credit-financed boom and stock market bubble of the 1920s. And it was the unprecedented monetary and fiscal government responses in the 1930s that prevented or postponed a long-overdue correction process, serving merely to prolong and deepen the depression.

As we said at the outset, we subscribe, without reservation, to the second point of view, based largely on the insights of the Austrian School of economics.

This school is the primary foundation of our analyses and forecasts. And it's the Austrian School's far-reaching perspective that enabled us to give our readers advance warning of the dangers of the 1990s stock market bubble and, later, of the real estate bubble. It is also this approach that enabled us to recognize the extent of bad investments and economic imbalances associated with the real estate bubble early on, together with the enormous attendant risks.

To drive home the importance of this approach, don't be surprised if we sometimes repeat ourselves. The repetition is deliberate, as many of our observations and conclusions will be new to most readers, and perhaps a little disconcerting.

Dr. Greenspan's Great Experiment

When the stock market bubble burst in the year 2000, Alan Greenspan's Fed reacted with drastic cuts in interest rates and massive borrowing to finance ever-larger government intervention. America's monetary policy makers, virtually all of whom subscribe to the Keynesian worldview, wanted to avoid what they believed to be the great blunders of the 1930s. So they opted for no half measures.

Around the world, central bankers, all believers in government by virtue of their office, followed Greenspan's lead and pursued some of the most lax monetary policies of all time in each of their respective countries.

At first, the extraordinarily low interest rates had the desired impact. A correction process, which had begun when the stock market bubble burst, was indeed halted. The recession of 2001 was short and shallow, and a new economic upturn began. But by almost any established measure, it was one of the weakest recoveries since the end of World War II.

Nevertheless, despite the weak results, a very high price was paid: the largest real estate bubble of all time. And this real estate bubble emerged as the central axis around which the bulk of the economic upturn revolved. In a nutshell, the true consequence of Dr. Greenspan's great monetary experiment—to combat the stock market bust—was simply the creation of a far *larger* bubble, this time in the global market for homes.

In *Das Greenspan Dossier,* we gave our appraisal of Greenspan's high-risk experiment, warning that he was creating a bubble; that the bubble was likely to burst; and that it risked crashing the stock market, triggering a severe recession, toppling America's mortgage giants, even threatening the entire financial system.

How did we know? Because anyone with some knowledge of the Austrian School—and a modicum of common sense—could see that the consequence of an asset bubble is an asset bust. There is no other likely outcome.

The Long Road to the Worst Central Banker of All Time

Fast forward to 2010 and we now have, strewn before us, the undeniable results of Greenspan's irresponsible series of experiments in monetary policy. As we commented in *Das Greenspan Dossier:*

> Because we are ourselves primarily and irresistibly propelled through life by Faustian curiosity, we can fully appreciate the significance and beauty of this experiment and also the pleasure that

> the maestro may derive from its execution. However, we would feel considerably more at ease if it were only the poor soul of the experimenter which were at stake, and not the economic well-being of us all.[4]

Thus, we stand by our earlier prediction that Alan Greenspan will finally take his well-earned place in history as one of the worst central bankers of all time, a fate that his self-righteous autobiography cannot prevent. Whether we're right or wrong, however, it will be cold comfort to the millions of innocent people who have had to suffer the consequences of his blunders.

Today, Greenspan's successor, Ben Bernanke, is sparing no effort to upstage him. But, at their core, his policies are merely a continuation of the Greenspan doctrine. Yes, they break new ground in regard to tactics (as we explain further on), but not by virtue of their rationale or goals. Alas, despite Bernanke's best efforts to destroy your prosperity, it remains to be seen if he will someday inherit the title of worst central banker of all time.

Whiskey for the Alcoholic

The central engine of lax Greenspan-Bernanke monetary policy is the concept of fighting fire with kerosene, flushing whiskey down the throat of an alcoholic, using Beelzebub to drive out the devil. Worse, the economic distortions and disasters that inevitably flow from their misguided monetary excesses are met with a repetition—or even massive escalation—of precisely the same excesses.

Again and again, we have compared this course of action to the treatment of a drug addict suffering from the initial stages of withdrawal. Repeatedly, we have warned against the disastrous long-term consequences of this myopic approach. And never have we left any doubt as to what the result would be: more bubbles, more busts, and ultimately, a far deeper economic crisis than the one they're seeking so desperately to avoid.

Failure without Insight

From an analytical point of view, recognizing the bubble, understanding its consequences, and forecasting its bust was relatively straightforward. But we were not particularly surprised when Keynesians, with their blind faith in government, stuck their heads in the sand. What is very surprising—even shocking—is that they have persisted in their failed theory even in the wake of its self-destruction during the 2008–2009 debt crisis. Even though the Keynesian experiment failed miserably, they stood stubbornly by their government-based theories, prescribing even larger doses of the very same policies that caused the disaster in the first place.

Meanwhile, free market solutions—corrections that have historically been instrumental in restoring balance in line with market forces—are not permitted. Instead, politicians and their central bankers experiment with ever more expansionary manipulations of the market. Only by this means, they tell us, can they prevent an even darker scenario—a "systemic collapse" that they refuse to define or describe beyond vague references.

What's most unfortunate is that, with their interventions, governments punish all those who would save or invest prudently, help build a nation's capital base, and promote stability. Simultaneously, they reward those who spend lavishly, speculate wildly and, in the long run, undermine the nation's future growth. Worst of all, this ultimate moral hazard, which we discussed at length in *Das Greenspan Dossier,* has now been taken to such an extreme that it threatens the very foundation of capitalism and Western society.

Nationalization as a Response to Burst Bubbles and the Shattered Dreams of Central Bankers

The forecast we published back in 2004—that a future housing bust would bring the entire financial system to its knees, with Fannie Mae and Freddie Mac among the prime casualties—has since been borne out in dramatic style.

The two mortgage giants, which underwrote almost 80 percent of the entire U.S. mortgage credit market in 2007, are *de facto* bankrupt. Yes, the U.S. government prevented a potentially ugly free market resolution of the bankruptcies—a deeper housing depression. But in the long run, the path it chose instead—outright nationalization—could be the greater of the evils.

From the outset, Fannie Mae and Freddie Mac owed their existence to the U.S. government and enjoyed a close relationship with its policy makers. Fannie Mae was formed by the government in 1938 to breathe new life into the mortgage market, and Freddie Mac followed 32 years later.

Armed with a government mandate and an implicit government guarantee, they were able to gain an enormous market share—mostly based on a business model that was, at best superfluous, and, at worst, a major force that greatly distorted the marketplace.

In the final analysis, Fannie and Freddie crowded out the less privileged private sectors, took on huge risks, and helped foster the greatest debt bubble of all time—all centered around home mortgages. They also stood at the very crest of a huge wave of bankruptcies that swept through the banking sector.

Fannie and Freddie have already cost the taxpayer dearly, and there is no end in sight. In the third quarter of 2008, Freddie Mac alone, the smaller of the two, posted a loss of $25 billion. And subsequent losses were even worse. And looking ahead, we confidently anticipate that considerable *additional* losses will be laid at the taxpayer's feet in the coming quarters, if not years. For shareholders, too, the institutions nationalized at the start of September 2008 proved to be massive destroyers of money.

As you can see in Figure 1.1, the shortsighted risk taking of Fannie Mae's management has totally destroyed the value the stock. Stockholders have suffered huge losses. But unfortunately, that's not the end of the story. Now you, the U.S. taxpayer, are on the hook for further losses, very much

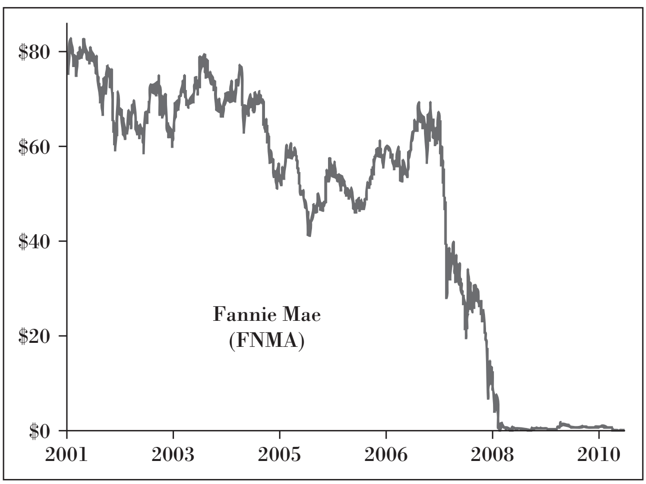

Figure 1.1 Riches to Rags: Fannie Mae (Stock Price of Fannie Mae)

to the delight of the holders of Fannie Mae's bonds who have been bailed out by the government's rescue package, as have the bondholders of many other de facto bankrupt financial institutions rescued by the government.

Fannie and Freddie have now become wards of the state. Nor are they alone. All over the world, major segments of the credit markets and banking system are passing from private to government hands in the wake of massive losses.

The nationalization of the banking system, a traditional demand of socialists and communists, is rapidly being implemented by the very same leaders who, in any other circumstances, would be steadfastly opposed to such demands.

And ironically, Great Britain, the cradle of free market economics, has been leading the movement to nationalize big banks, and we expect this process to resume as soon as the next phase of the current crisis gets under way. Indeed, by the end of the Great Recession, which may ultimately be recognized as a depression, much of the financial sector could be nationalized—not just in the United Kingdom, but throughout most of Europe and the United States as well.

East Germany as a Model?

Surprisingly, few are taking the needed time out to engage in a higher-level political discussion about the true, unintended consequences of these measures. Free market principles are being thrown overboard. Giant steps are being taken along the path toward socialism and serfdom. But voices of protests are muted or deliberately drowned out.

Nevertheless, current and historical evidence of the longer-term economic consequences of this policy is everywhere: the obvious failures of every economy locked behind the Cold War Iron Curtain, the declining ability of socialist-leaning nations to compete in the global economy, and, now, the existential threats to the euro and the entire European Union.

The big picture that emerges is a protracted decline in prosperity with ever-greater curtailments and encroachments of freedom. If you want a better grasp of where this road may take us, then recall the decay and rot that permeated former communist East Germany. Slowly and stealthily, the country degenerated into a mere caricature of its former self, riddled by political capriciousness, nepotism, bureaucracy, and worse.

Looking ahead, as we put the finishing touches on the English-language edition of this book in the summer of 2010, we proceed from the assumption that the shocking and spectacular bankruptcies witnessed in recent months are not over. More are to come in the United States, Europe, and indeed, throughout the world. And more countries—especially the large ones in the epicenter of the global debt trap—are bound to fall victim to the contagion now commonly called "the sovereign debt crisis."

Some analysts worry that governments will, at some point, simply let corporations, banks, and even entire nations fail, much as the United States did with Lehman Brothers in September 2009. But what would, in our view, be even more worrisome is the opposite outcome: a commitment to save them all, ultimately driving virtually the entire financial sector into government hands. The redemptive hand of powerful friends, who can only afford to exercise that friendship through the use of taxpayers' money, will seek to make this a certainty.

The Financial Arsonists Remain Vigilant

Reuters News amused us on September 10, 2008, with the headline "The financial crisis continues—ECB chief warns against complacency."[5]

They were referring to European Central Bank president Jean-Claude Trichet. But to whom Trichet was addressing this landmark warning remains an open question.

Reason: most banks affected by the crisis have found out the hard way that the crisis is far from over. On the executive floors of Citibank, Goldman Sachs, and other financial giants, the erstwhile dancers on the rim of the volcano were certainly greedy, shortsighted, and deficient in their judgment. But they never struck us as particularly complacent.

Rather, complacency was far more evident among the world's central bankers—Greenspan, Bernanke, and Trichet himself. Each failed to recognize the dramatic consequences of the real estate bubbles, which had been made possible only by their own monetary policies. On Sunday talk shows, each sought to exonerate himself by pontificating (correctly) about the moral hazard of rewarding risk . . . only to trample their own insights in their Monday-to-Friday policy making.

Bernanke warns Congress about federal deficits. Trichet and others declare, "*We must remain vigilant*."[6]

Agreed. But does that now mean we can all relax, safe in the knowledge that they will keep the vigil to prevent double-digit monetary growth and the next speculative bubble? We think not. They are the true financial arsonists. They are the foxes guarding the chicken coops.

We cannot underscore this point more forcefully: it was the misguided policies of these arsonists in the guise of central bankers that started the fires now still raging throughout the financial system. It was their misguided response to these fires that has brought us the sovereign debt crisis. And it is thanks to them that the largest and supposedly most powerful economies of the world are now caught so deeply in the global debt trap.

The outcome of their policies was—and is—easy to predict. And now these same arsonists are telling each other to remain vigilant? If the likely consequences were not so serious, such performances would be comical.

Are Falling Asset Values Good or Bad?

In 2008, values fell globally and across many asset classes—not only in the United States, but also in Europe and Asia; not only in the real estate sector and in stocks, but also in corporate bonds, commodities, and even a variety of other supposedly safe investments.

Until early 2009, those declines continued. And despite a temporary, government-engineered recovery through early 2010, similar or greater declines are bound to return.

Here's the key: most people—including consumers, investors, analysts, and policy makers—automatically assume that falling values are bad, while rising values are good.

But, in reality, that depends on whether you own them or you're seeking an opportunity to buy them; whether you were caught flat-footed by the declines or were prepared for them.

If you were seeking to buy a home in the United States in the early 2000s, surging prices were bad. Likewise, the subsequent housing price declines were good, giving middle class families new opportunities to own a home.

If you were looking for a chance to invest in the stock market, before the recent declines, the pricy valuations of most worthy stocks represented a major obstacle to your investment success. Conversely, price declines that created low valuations created attractive opportunities.

And if you have good tools to help you anticipate the declines, the profit opportunities—both during the declines and after—are even greater.

Many analysts and commentators described 2008 as a very bad and difficult year—in relation to both economic trends and the equity markets. But we do not subscribe to this assessment. It only applies to the vast majority—those experts for whom the property slump, the recession, the banking crisis and, of course, the bear market in stocks were a surprise.

But for the objective minority—those with eyes to see, an open mind, and a willingness to understand the lessons of history—it was actually an opportunity.

How the Objective Minority Saw the 2008 Recession

The 2008 recession was clearly and unmistakably signaled in advance by a series of relatively reliable alarm bells—not only the stock market itself, but also an inverted yield curve and sharp declines in the U.S. index of leading indicators.

These are not rare, unknown indicators that only a few people can see. They are classic early signals of recession that were largely ignored or explained away by some of the nation's leading economists and politicians.

In the prior economic cycle, these economists conjured up the image of the grand Internet superhighway to justify bad business models and bad investment decisions. This time, the spin doctors used what was called the *decoupling theory* to ignore the handwriting on the wall.

The grand boom in Asia, went the theory, had completely altered the global economy. It more than compensated, they said, for any signs of weakness in the United States. Thus, they concluded, the global boom would continue unabated.

These were the same pundits who, in the earlier bust, had blustered—even back then—about the abolition of the economic cycle, enabling them to believe in their theory of a boom without end. In both cycles, they urged their followers to hold their stocks and even buy more. Then, as now, they caused untold financial misery.

The bursting of the stock market bubble in the year 2000 marked a watershed event. World stock markets have been in a secular downtrend

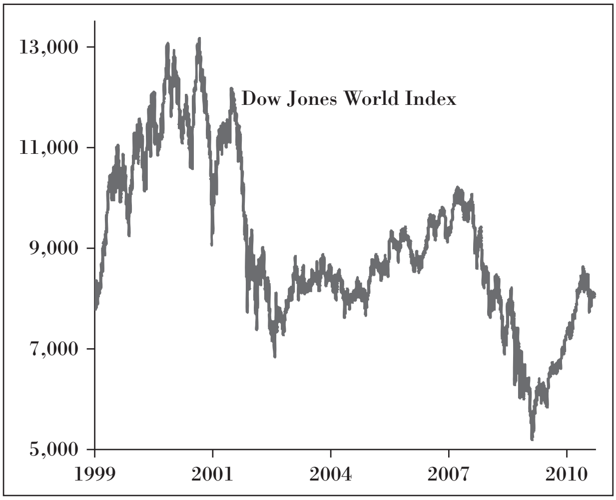

Figure 1.2 Decade-Long Global Bear Market Began in 2000 (Dow Jones World Stock Index in Euros)

since then, as you can see in Figure 1.2. The buy-and-hold mantra has delivered nothing but huge losses. Unfortunately, the end of this secular bear market has not yet come.

Yet, even as they touted more stocks, equity markets had long since risen to historic levels of overvaluation. And even as they continued to chant their "buy-buy-buy" mantra, the world's leading stock market indices were already breaking down from well-developed topping formations. It's not just in retrospect that those signals were clear. Even then, it was hard to imagine a clearer advance warning of a bear market and a recession.

Now, in the summer of 2010, the picture looks similarly bleak. But most pundits are looking the other way again, still predicting prosperity and rising stock prices.

The reason highly remunerated experts saw no recession or financial crisis coming cannot be explained by the complexity of our times. Instead, it lies in these two factors:

1. Career risk and the herd instinct.
2. Questionable models, questionable theories.

Career Risk and the Herd Instinct

In the first instance, the all-too human self-interest of the principal actors creates a tendency toward bullish forecasts, come what may. Far less effort—or none at all—is made to predict economic downturns and recessions.

The primary reason: No analyst was ever fired and no wise man of economics ever thrown onto the street for failing to predict a stock market slump or recession. But anyone who stands out as one of the few who fails to foresee—or make money in—boom times is at risk of losing one's job and damaging one's career. In the United States, this rather distasteful tendency is known by the term *career risk*.

Result: both Wall Street pros and Washington policy makers have a clearly discernible inclination to provide bullish or optimistic forecasts, while it is well known that a terrible fate has historically awaited the proverbial messenger of bad news.

There is also an important psychological reason underlying the systematic bias of financial and economic forecasts toward optimistic outlooks that cannot be supported by objective facts: in his memoirs, Henry Kaufman, once among the most influential analysts in America and well known for his ability to swim against the tide, explained it this way:

> Most predictions fall within a rather narrow range that does not deviate from consensus views in the financial community. In large measure, this reflects an all-too-human propensity to minimize risk and avoid isolation. There is, after all, comfort in running with the crowd. Doing so makes it impossible to be singled out for being wrong, and allows one to avoid envy or resentment that often afflicts those who are right more often than not.[7]

Questionable Models, Questionable Theories

Secondly, the models and theories used by the overwhelming majority of modern economists almost invariably lead to an incorrect assessment of the actual situation.

"We are all Keynesians now," wrote Nobel Prize-winning economist Milton Friedman in the 1965 year-end issue of *Time* magazine; and "I am now a Keynesian in economics" echoed President Richard Nixon as he took the United States off the gold standard in 1971. More so than ever before, this same statement applies to the vast majority of economists.[8]

Keynesian theory, which we never found convincing, dominates economics curricula at universities, research departments at major Wall Street firms, and think tanks in Washington. Entire generations of economists, financial advisors, and management experts were brought up with Keynesian theory.

Keynesian theory drives politics itself, serving to justify and promote the increasing expansion of bureaucracy and boundless government intervention. Indeed, Keynesian theory supports a self-fulfilling cycle of success for politicians. The theory is used to rationalize almost any form of intervention, which, in turn, imbues them with ever more power over the economy and society.

Ultimately, Keynes's theories have now come to dominate not only the United States, but also the central banks of most major nations—not to mention their oversized bureaucracies. Around the world, central bankers, who administer the government's monopoly over money, were supposed to protect the value of their currencies. Instead, they are now among the most zealous Keynesians promoting inflation. If one believes what they say, one must conclude that they seriously believe in their ability to solve economic problems and provide for the general welfare—strictly with the aid of the money printing press.

The Austrian School and Common Sense

We repeat: in place of Keynesian macroeconomic models, the sound common-sense insights and theories of the liberal Austrian School of economics stand at the heart of our analyses. This school provides substantially more convincing explanations of economic realities and relationships than do the models of modern economists.

In essence, modern economists are playing Hermann Hesse's glass bead game,[9] in which the rules of the game are forever shrouded in mystery. Their attempt to apply mathematical approaches—which work successfully in the natural sciences—to economics, which reflects politics, social interaction, and mass psychology, seems to us extraordinarily naïve and distant from reality.

This is especially true regarding the economic cycles since the late 1990s, each characterized by huge speculative booms and busts. The insights of the Austrian School enabled us to detect early on the treacherous trends that were emerging—and the threats to the economy, the financial system, and the stock market that they entailed. Armed with the insights and foresights of the Austrian School, the widespread asset destruction of 2008 came as no surprise.

The events of 2009, however, were not so predictable. As we wrote in the German original from which this book is derived, "The massive government interventions termed variously *rescue packages* and *economic stimulus programs* will inevitably have effects and side effects that render free market processes more or less inoperative, thus making the work of an analyst much more difficult."

But governments can alter the natural economic tides only temporarily. And in 2010, those same governments suddenly suffered Mother Nature's revenge, as market forces unleashed the sovereign debt crisis, first pounding the weakest countries like Greece and then spreading to Spain, Portugal, the United Kingdom, and ultimately, even the United States.

The Brilliant Failure of the Keynesian Model

Science teaches us that models should achieve three things: they must describe that part of the world to which they refer; they must explain its processes; and they must help make forecasts that are, more often than not, borne out in fact.

Measured against these established requirements, recent years have demonstrated, in the most convincing manner, that the Keynesian stimulus programs—implemented as a response to the bursting of the stock market bubble between 2000 and 2003—failed monumentally. They did not overcome the undesirable trends and imbalances that were obvious even then; they merely delayed their negative consequences, creating an additional layer of even greater dangers.

In the wake of the bear market of the early 2000s, they merely created a new bubble in real estate, which was echoed in the equity markets. These bubbles, in turn, tricked the financial world and participants in the real economy into thinking that everything was in perfect order once again, that central bankers had things under control, and that the groundwork for "a new, sustainable recovery" had been laid. The consumer regained confidence. An orgy of debt gathered greater momentum, particularly in the United States and United Kingdom. Finally, share prices in many countries reached record heights once more, as the Dow Jones World Stock Index exceeded its high water mark for the year 2000 by about 25 percent. And in contrast to the bull market of the 1990s, many commodity prices also climbed to spectacular new highs.

Money printing has unwelcome side effects. Sooner or later it leads to rising prices, somewhere, somehow. During the mid-2000s, not only housing prices surged, but commodity prices were also driven to extreme highs as Figure 1.3 demonstrates.

In reality, however, these new bubbles of the mid-2000s only served to drive the devil out with Beelzebub. The alcoholic suffering the initial stages of withdrawal was again treated with a large dose of whiskey. The result of this policy was soon evident: the near-collapse of the entire financial system, prevented only by massive government intervention and huge

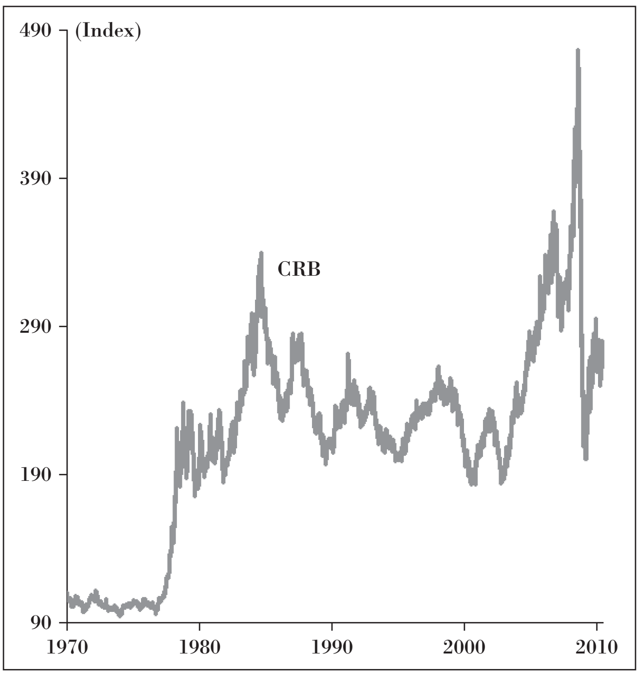

Figure 1.3 Money Printing in Early 2000s Leads to Commodity Surge in Mid-2000s
Source: Reuters/Jefferies.

government guarantees. It was the greatest crisis since the 1930s, which, in many respects, had—and still has—the potential to dwarf even the Great Depression.

One would think that this disastrous outcome would cause any rational supporters of the Keynesian model to rethink their theories and reverse course. At the same time, one would expect that it would prompt established economists to acknowledge the obvious—that the few analysts who predicted the debt crisis did so thanks largely to their understanding of the Austrian School. This is no coincidence; indeed it is almost a precondition, since it is only the Austrian School that provides an insight into the root cause of this extreme boom-and-bust cycle: central bank manipulation of interest rates.

Despite Everything, Keynes Is *Still* on the Rise!

Ironically, however instead of discarding the discredited Keynesian models, adopting the theory that has now proven itself to be scientifically correct, and following the path of common sense, establishment economists have, so far, sought to do precisely the opposite. Indeed, the insights of the Austrian School and their clear success in forecasting the events of recent years remain, as before, almost completely ignored.

Virtually everywhere in the world, another, even larger wave of Keynesian stimulus measures was set into motion. What about the simple, common-sense reality that governments did not have the money? Until the sovereign debt crisis erupted, the question wasn't even asked! Billions, nay, trillions were patronizingly frittered away. Why? And most important . . .

Where did all that stimulus money come from?

From China to Singapore, from the United States to the United Kingdom, and from every financial center to the ends of the earth, governments felt compelled to combat the recession through Keynesian stimulus programs. Trillions of dollars, euros, yen, and yuan were poured into this well-intentioned global project. But as is so often the case, good intentions are not sufficient to achieve good results. The obvious reason: The sources of the money.

In theory, three principal sources of money are available.

1. Domestic savings.
2. Foreign savings.
3. The printing press or, to put it more precisely, money creation within the financial system.

In practice, however, although all played some role in the greatest Keynesian stimulus programs in history, it was the printing presses that were deployed by most Western governments most of the time.

When the government taps domestic savings to finance its expenditures, it competes with the credit needs of private enterprises, which often depend on external capital for their investment plans. There is consequently a crowding-out effect at the expense of the private sector. This is obviously counterproductive. The aim of an economic stimulus program is to support the economy. But if the government depletes the available supply of domestic savings and pushes up interest rates, its stimulus has the opposite effect, dampening growth or even helping to precipitate the next recession.

If, instead of domestic savings, external ones are accessed, then the crowding effect does not impact home-based corporations. But because almost all countries reacted to the global economic crisis with similar economic measures and because of the interconnectedness of the global economy, only a few countries have had the privilege of financing their government debt at the cost of other countries.

The third possible path is printing presses and the resulting inflation. We fear that this source of money will, at the end of the day, be the primary one. In any case, beginning in September 2008, the world's two most powerful central banks—the U.S. Federal Reserve and the European Central Bank (ECB)—set a clear course for inflation. The balance sheet totals of both, a necessary precondition for all further money creation by the banking system, were expanded dramatically.

In fact, just in the first four months following the failure of Lehman Brothers in September of 2008, the consolidated balance sheet total of the ECB and the national central banks in Europe rose from 1.5 trillion euros to 2.0 trillion euros; that is, by a third. And in the United States the explosion was even more drastic. The Fed's balance sheet total rose from $950 billion to $2.2 trillion, or 130 percent.

What's most shocking of all is this: in prior, smaller episodes of money printing—such as in preparation for a feared Y2K crisis in 1999 and in the wake of the terrorist attacks of 2001—as soon as the crisis subsided, the Federal Reserve quickly restored its balance sheet by sopping up the excess funds from the economy. But this time, the Federal Reserve, along with the ECB, have done nothing of the kind. Quite the contrary, they have continued to expand their balance sheets throughout 2009 and into the first half of 2010.

This is the basic stuff inflation is made of. This is why we are convinced that inflation is on the way. The inflation creators are on the warpath. They have been forewarned. But they have failed to change course.

Politicians Want Us to Believe They Know What They're Doing

Let us now turn our attention to the question of *why* the politicians are doing what they're doing. Why are they, as Friedman wrote 45 years earlier, all Keynesians now? Why do they keep on doing the wrong thing? There is a straightforward answer: politicians always try to give the impression that what they are doing is not only beneficial, but essential. There is of course an abundance of both theoretical and empirical evidence pointing to the futility of political intervention, particularly when it comes to the economy. Everybody understands, in principle, that politicians cannot create prosperity, but can only redistribute the prosperity created by certain segments of the electorate to particular interest groups that support them. Furthermore, following the bankruptcy of the communist bloc in Eastern Europe, everyone should know that a planned economy is an economic system categorically inferior to free markets.

In this context, the burden of proof is on politicians to continually seek a way to justify their actions. When an economic boom occurs, they must be able to point to the economic measures that they have themselves taken, so they can claim credit for the recovery and exploit it for political ends. And when a downturn occurs, they must revert to herculean measures to set the course for the next upturn or somehow convince voters that it was they who prevented an even worse outcome. They can get away with it for the simple reason that, in the final analysis, no one can say, with any certainty, what could or would have happened had the politicians done nothing.

When one considers this nexus, the success of Keynesian theory is immediately comprehensible, for it provides politicians the arguments they need to pursue massive state intervention. It helps them justify their devil-may-care politics that has been their hallmark for decades, leaving future generations to pay the bills. Because nobody knows where the end of the flagpole may be, each politician can live in that hope that the poisoned chalice will pass him by, and that dealing with the inevitable dire consequences of their irresponsible policies will always fall to a future successor. The United States and Western Europe, including Germany, have been governed by this sad scheme for decades. And now the whole world has begun to extend the flagpole once more—even though the dire consequences are now far more visible.

The First Results of Mr. Greenspan's Great Experiment

One of the most important aims of this book is to bear witness to the entire trend of recent years, which is now reaching its sorry climax, as *not* a consequence of the free market. Quite the contrary, the real estate bubble itself would quite simply not have been possible without the fateful decisions made by central bankers like Mr. Alan Greenspan.

Central banks are not part of freely operating markets. Even if their bureaucrats are nominally empowered to make independent decisions, the fact remains they are part and parcel of the government. Central banks are monopolies under government guarantee, which have constructed a banking cartel around themselves. This system has little to do with free markets. Indeed, especially in recent years, central banks in capitalist economies have been, in many respects, akin to central committees in former communist economies, manned by individuals who owe their primary allegiance to the state.

In the United States, unlike their predecessors William McChesney Martin and Paul Volcker, Fed Chairmen Greenspan and Bernanke have rarely defied the policy agenda of the executive branch and have almost invariably been its most aggressive militants. In Germany, the Federal Debt Administration—along with the Labor Office—has already been renamed in true Orwellian newspeak style. It is now called the Finance Agency. We can't wait to learn when the central bank will get its new name, one that obscures its true character even further. And everywhere, the fox is minding the chicken coop, as the very people who have done the most to create inflation are dubbed *monetary guardians*—another so-far successful experiment in obscuring the truth.

The big picture: the events we've witnessed since the dawn of the new millennium and continue to experience today—the late 1990s stock market bubble and the ensuing bust, followed by the housing bubble and collapse, and now the sovereign debt crisis—have nothing whatsoever to do with capitalism. Neither can it be termed socialism. Capitalism is steeped in the fundamental principle that both profits and *losses* are a private concern. And even under socialism, both profits (although rarer) and losses are kept in the same realm—under the umbrella of the state.

What we've seen in the Western nations of the early third millennium, however, is neither an example of capitalism nor socialism. Instead, thanks to the policies aggressively pursued by America's two central bankers of our era—Alan Greenspan and Ben Bernanke—what we have is an entirely unholy and unsustainable mix whereby *profits may be private but losses are socialized*.

It is the ultimate moral hazard.

This corrupted economic system is nothing more and nothing less than an extreme form of crony capitalism—a very unique kind of nepotism—that, if pursued, can ultimately only lead to a fate similar to that of Iron Curtain countries themselves.

The banking crisis of 2008 and the sovereign debt crisis of 2010 are not failures of the market, but rather the consequences of monumental failures in monetary policy. This central truth is rarely recognized in the media or policy circles. Wall Street and Washington portray the inflationists as monetary defenders, and the arsonists as the fire chiefs. Don't let them fool you. And never forget: Politicians do not create prosperity. They merely redistribute it.