Chapter 1

Midas Reveals How to Create Money through Credit Fraud

The world financial system trembles—again. The question is raised once more: Will it survive, and if so, will it be restored to its former self or be totally transformed? The answer depends on whether the revived system continues to contain the basic faults that brought about the latest crisis, or if this time serious efforts are made to eliminate these defects. It is a matter of the separation of the control of money and its influential surrogate, credit.

Since the credit economy has been expanded continually and invariably into globalization, there is no longer any way to get around correcting these structural deficiencies. An expanded and expandable credit system without boundaries means that no state on the earth can protect itself from the consequences of its abuse, and neither can its citizens, its savers, or its economy. Credit fraud is identical with financial innovation born in and through capitalism: It is immanent in the system.

Does Progress in Developing Money Equal Progress in the World Economy?

Since time immemorial money has been "a public good." For several hundred years, money has been led on a short leash by the central banks working on orders of the state. The state is there to guarantee—although not always successfully—that the world of money and goods expands in the same volume and rhythm so that the "purchasing power" of money remains stable. The old perspective that money derives its value from gold was always based on an error. Even under the gold standard it was not the raw material of gold that provided money with its value as an end product, but rather the demand for gold for the purpose of monetization. The reason for the loss of the advantage of the gold standard as a basis for money and credit lay in its limited quantity: No money or credit could grow without being backed up by the precious metal, which economist Joseph Schumpeter called the "golden brake on the credit machine."[1] In contrast, since the gold standard has been abandoned the credit economy has enjoyed a free rein. Banks produce credit within their own regime. This credit creation originates from the business of providing money for investing or saving to third parties that lack capital or are "capital poor" entrepreneurs or firms. These borrowers then use the capital for economic purposes, as well as lending to the permanently money-hungry state, which inevitably finds itself in a conflict of interest, caught between easing its own conditions as a debtor and its duties in protecting the value of its citizens' money.

Money exchange and the granting of credit are among the oldest known professions. Since the existence of a market economy, foreign trade, and savings for retirement and the future, money has been pivotal to all three: a unit of account, a medium of exchange, and a store of ownership or investment. Evidently independently of one another, small communities and highly developed cultures around the globe shared in the discovery of this medium of exchange. Wherever financial capitalism has managed to transform the "lazy money" of depositors and investors into the productive activities of entrepreneurs and innovators, it has instituted highly successful wealth machines.

In recent times, where capitalist practices were missing or inadequately developed, as in communist countries or some Third World nations, local companies operated well below their potential. Even if the people labored for 12 hours or more a day, they could afford only a fraction of the goods and services that could be purchased by the same amount of work in the First World nations. Eventually these countries begin to ask, Why does it have to stay this way?

The West's historical lead in developing and refining the money and credit economy is responsible for its early leap into the modern industrial world, its early dominance in the world economy, its widespread prosperity, and its attractiveness as a social model. Monetary and credit innovations arose first in Europe and thereafter in the nations of the New World: the United States, Canada, Australia, New Zealand, and (later) Japan. People of all nations want to share in the blessings of capitalism, particularly those who have up to this point not been able to. However, the attraction of capitalism as a social model has already been dented by the first global economic crisis, beginning with the Wall Street Crash of 1929 and lasting until the outbreak of World War II in the democratic countries of the West: the United States and Western Europe. The financial crisis beginning in 2007 onward has exposed even more serious fundamental flaws. The inner fragility of the system, exacerbated by the disastrous lack of conscience on the part of many of its actors, is now out in the open. The formerly trusting saver and investor now observes that he can no longer depend upon either his bank or its recommendations.

Those dependent upon credit in the economy, particularly small to medium-sized businesses, have learned how little they can rely upon their local banks for a continuous supply of credit at reasonable interest rates. The present crisis made clear that the financial sector itself was a serious defect and deficiency in the engine of the economy and social progress: It covers the money it borrows on credit, not from deposits, which come in from investors who are creating value in the real economy, but by using resources that the bank itself has received "on loan" from other banks, which can then recall that loan if they are obliged to repay it themselves.

However, this is nothing new. Banks have always done this. They lend out money that they do not, in fact, have. Did this constitute progress in the money system, or transparent credit fraud?

Even Jesus was tormented by this question. The practices of the money changers disturbed him. Why else would he have expelled them from the temple? Perhaps he had heard the story that Herodotus, the father of history, passed down to posterity, a mythical tale concerning the King of the Lydians, Midas, who lived in the seventh century before Christ. He was the richest ruler of his time, and was granted the wish that whatever he touched he transformed into gold. Unfortunately this included the water in the glass from which he wanted to drink. On this "increase in value" of the water, he choked to death.

Midas had discovered that from a limited supply of metal coins, one could produce many more coins if one drastically reduced the metal content of each coin. With this process he liberated the money supply from its arbitrary limitation by a dead substance (available monetary raw materials) and at the same time freed the market from all financial bottlenecks. If the market needed funds, it could get them. Midas's money machine reacted to the increasing demand for its product, making available the additional financial means. Since the era of Midas no natural financial bottlenecks have slowed down the increasing prosperity in the free-market economy. From that time on, the technical progress of money (new forms of financing) and money fraud (the proliferation and devaluation of money) have made their appearances as Siamese twins. But, despite the interest in currency stability, their separation has not occurred up to the present day. Inspite of the common community interest in currency stability, they have yet to be separated. Just the opposite has happened: The more open and unregulated the economy, like the private household going from cash payments to loan payments to billing via bank accounts, credit cards, and bank cards, the more blurred the boundary between money progress and fraud. Coins and banknotes, although legal, are no longer common means of payment, but rather "commercial bank" or noncash loans.

Even Midas could not prevent shrewd money dealers from transforming his coins—which could no longer be weighed, but just counted—into credit, for which interest was paid. Why should he? The demand for the money increased his profits. But when the long-term users of this "light" money (the savers) discovered that the buying power of their assets no longer grew but diminished in value—exposing this financial progress as "fraud"—and when they rejected Midas's coins as a store of money assets, the crisis broke out. Midas's gold was transformed back into pure water!

The State as Accomplice or Controller of the Money Economy, or Both?

Ever since the era of Midas, money itself has remained a public good, under all regimes, for no prince or state has wanted to forgo the profit from its "mintage." In antiquity this was the case for the Greek city-states as well as for ancient Rome, and in medieval times it was true for principalities, or princes. The same principle applies today for modern nation-states and the United States, which—despite its deficits—makes close to 70 percent of its dollar circulation available to the rest of the world as savings or nest eggs. All these state bankers earned and continue to earn enormous sums from Midas's discovery that making money—on whatever raw material basis, be it metal, paper, or plastic—costs only a fraction of its market value. Whoever has the privilege of making money cashes in on the premium of being able to declare it as the legal tender—provided that this money continues to be accepted by the public. Since the rise of the modern credit economy, the state has ceded the same rights to the private banking sector.

These bankers were allowed to use their monopoly on the creation of credit to water down the value of the state's money through private paper or money in the form of chip-based credit cards, just as Midas did with his coins. And the state through its central banks permitted this devaluation of its currency through credit proliferation to go on for far too long.

Why?

Because the state has benefited from the increase in its standard of living through inflationary financing. This increase raises the state's ability to tax and the continual credit inflation fills its coffers with more incoming taxes. The state has always been an accomplice to those offering credit. It remains so today. Why slaughter the hen when it continues to lay golden eggs?

Nevertheless, in the world economic crisis of the 1930s, the first partial operation took place on the Siamese twins—if only at the national level. The German credit law of 1933–1934, together with the banking police supervising the credit, worked on this legal basis and introduced credit ceilings for permissible credit fraud. These became guidelines for similar regulations in Europe and the rest of the Western world. This also holds true for the measures and regulations simultaneously introduced in the United States: the insurance of deposits by the FDIC (Federal Deposit Insurance Corporation) and the Glass-Steagall Act, which blocked speculative American investment banks from access to central bank credits and aid. Unfortunately, President Bill Clinton supported the repeal of this important antispeculation law in 1999, preparing the way for the current financial crisis. President Barack Obama continues to push for resurrecting Glass-Steagall again fully, and not only partially, as has been the case to date.

Clearly these national controls of the money credit market are overdue if global banking activity moves out of state-controlled legal spaces into an illegal no-man's-land of financial markets. Since the International Monetary Fund (IMF) was stripped of power in spring 1972, the financial markets are dominated by the pre-state Midas freedom of private money creation. No controller monitors or interferes with this banking idyll, or at least none did so until recently. The banking world had created its own inexhaustible supply of money. It needed neither the money of savers as suppliers, nor the central bank as provider of "last resort," nor the state as supervisor (or in its eyes, interrupter) of its businesses. Yes, even the real economy itself became dispensable as a secure client of credit and producer of profits. Money could be borrowed and investments settled outside of the actual world of savers, investors, and the use of state control—and all of this could bring in fabulous profits.

The financial sector had reached an entirely new stage of its development: It lived from and with itself. It created its own world beyond the real one that it had served for so long and had once been dependent upon.

The Illusory World of Finance and the Fictional Capital of Banks

This new possibility of interbank debt without boundaries on the global financial market did not just cast aside the old dependencies on the river of savings and the refinancing credits of central banks. Now the building of capital and capital fraud became identical. Midas had to guarantee a minimum of precious metal in his coins. The loan money from banks before the globalization era still contained a substantial residual factor of real capital, or savings. To this extent it represented a transfer of purchasing power rather than the creation of purchasing power out of nothing. In this sense, the credit was inflation-neutral. This was not adequate for the new and globalized bank credit, which came from a *double* credit creation: the passive internal bank credits issued by other banks and the further use of these means in the outside world. But which means? Did the slowly but steadily growing world economy need so much new money, that is, credit? Was it possible to apply the incredible overproductivity of the deregulated global financial sector immediately to real sectors of the economy, accommodating the extent and growth of their gross domestic products (GDPs)? Not at all. Going into the crisis, Figure 1.1 shows the huge overhang of newly produced global financing above the real demand of the growing global economy and its national economies. For a world trade volume (exports, imports, direct investments) on the order of some US$12 trillion (2008), a volume of financing existed approaching US$800 billion. Less than 2 percent of this amount would have been sufficient to satisfy the financial needs of the real world economy!

And for what purpose was the other 98 percent needed?

Lacking sufficient demand for new credit production in the real economy (a world GDP of "only" $50 trillion), the global financial markets created their own facilities at its doorstep. More

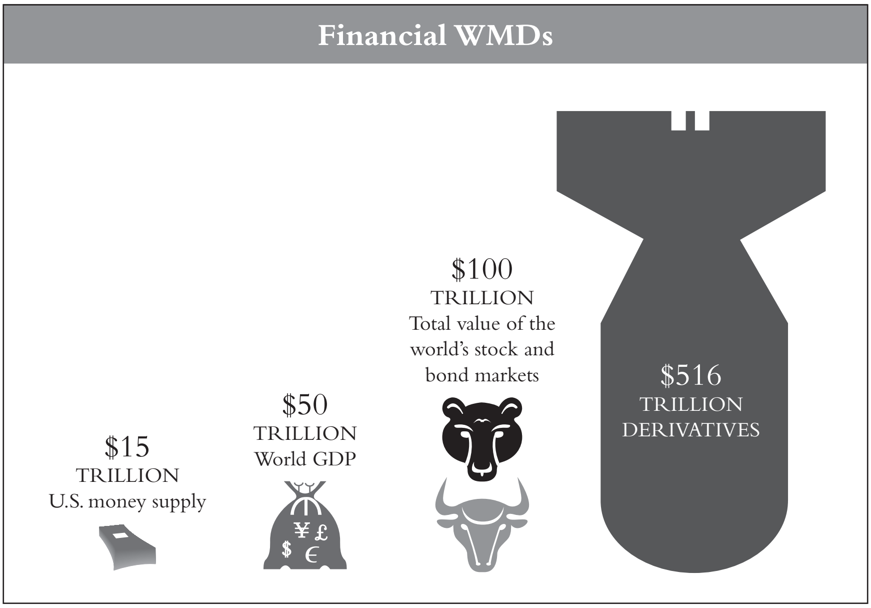

Figure 1.1 Global GDP ($50 Trillion) Compared with Total Derivatives ($516 Trillion) at Start of Crisis in Late 2007 (vs. Global GDP of $64 trillion and Total Derivatives of $795 Trillion in 2010)
SOURCE: U.S. Global Research (www.gamingthemarket.com/financial-armageddon-zombies .html).

and more investment banks, private equity firms, and hedge funds bought up more and more old (stock-exchange-traded) securities and investments, thus creating a climate for asset price inflation ("asset inflation") of the greatest intensity ever seen in recent financial history. The sheer volume of these new derivatives at the end of 2007 amounted to 10 times the real world GPD, or, as Figure 1.1 indicates, over $500 trillion!

The global financial industry does not need the real economy anymore. It divorced itself from the real economy and made transactions with itself: Alone in the United States, the Holy Land of global financial capitalism, its value rose from 2 percent of the national GDP in the 1980s to 8 percent in 2007, just before the crisis. This financial sector has quadrupled in size in the past quarter century and has grown faster than any branch of the real economy.

The financial industry and its hangers-on, ranging from economists and experts to politicians and leading commentators from the media, praised the borderless and unrestrained expansion of the sector and its products (which in reality dealt with the escalation of bank debts and credits without substance) as proof of its strength and superiority: The growth was seen as a dynamic (not as dynamite!) of the market economy, and its advantages were compared to the resources of a state capitulating to numerous problems. The state was granted oversight of the local neighborhood market, but not of the global financial market. It was assumed that the public should be protected from contaminated food but not from rotten credit and the effects of its unregulated growth on jobs and savings.

The old reactionary schools of economics came to life to criticize excessive state deficits and liabilities. The size of the even larger and more threatening private debts was seen as evidence of the debtors' ability to perform in the market rather than as symptoms of a system that was forcing risk upon society. Furthermore, overextended credit was not perceived as a heavy future mortgage being levied on children and grandchildren—as if their education and training as well as a comfortable infrastructure would be self-financing, for any financing for their well-being from the tax system was vigorously rejected.

Leading social politicians and their advisors openly recommended that people invest in the global casino as a secure pension fund for their old age; unregulated funds were presented to be ostensibly as reliable (and as profitable) as the state social system based upon the law and development of income. By these definitions, Germany's welfare state, although still a model for the world, has recently become financially unviable! The fact that profitability, particularly in pensions based on capital investments, is only another term for *high risk* was kept quiet. Now everyone is aware of it.

Today the believers in the fairy tale of the evil state and the good, oh-so-successful capitalists have greatly diminished in numbers. As happened 80 years ago after Black Tuesday (the Wall Street Crash of 1929), and during the subsequent Great Depression, the state is "permitted" to save capitalism, not the other way around.

But which state is responsible for the rescue of global (and stateless) capitalism? None! Nation-states can and must protect the assets of their citizens and firms (which, for tax purposes, are both natural and legal "persons") from banks, funds, and other financial institutions that are threatened with bankruptcy.

However, if the top institutions of the financial sector now expect that governments and central banks take over their risks and inflict themselves with losses based on the notion that they are "too big to fail" (nothing less than a transparent formula of extortion), they abuse the principles of the rule of law, property, society, and market economy: Everyone is responsible for himself. They ensnare the society in the danger of paralysis by "taxflation." Already taxes, which are too high, again have to be increased, and the inflation already looming threatens to be strengthened further.

And why? The financial sector does this to perpetuate one of the oldest and, in the present crisis, merciless structural defects of capitalism, namely, its ability to create real capital from "nothing," even though this is of highly dubious value for society. It is unjust to pardon a notorious and long-since-transformed assassin of the general good of the people, their democratic rights and social welfare state, and their social (not neoliberal) market economy. For the private credit and financial industry is only fighting for the preservation of its age-old privilege: using public money to operate private business. Questions concerning the risks arising from these transactions were countered by the unproven assertion that the collateral damage resulting from the bankruptcy of banks would be still higher: an argument used to demand the system-compromising "socialization of losses," a tactic followed by King

Midas when he watered down his coins. But this has to stop. For only when the credit money of the banks is under the same credit regulations for limits, amounts, and quality control imposed on the state banks regulated by the central bank is there a chance to break through the devilish cycle of inflation and crisis, of money devaluation, of the wresting of wealth from the savers, and the loss of jobs. Only then can the market economy become calculable and immune to crises and freed from the immorality of moneylenders. The present world financial crisis finally gives government leaders the chance to realize this vision.

Will Yesterday's Recipes Help Us Today?

This brings us back to Black Tuesday and the Great Depression 80 years ago. At that time the first systematic bank regulator and control came into existence, simultaneously in the United States and Germany, both states having been heavily traumatized by the crash. The Glass-Steagall Act was passed in the United States. It prohibited investment banks, which were purely speculative banks and had no savings deposits to protect, from recourse to central bank money and aid. So-called investment banks then had to operate their speculative stock market and investment business at their own risk. Just in time for the current crisis, President Clinton signed legislation repealing this law in 1999. As a result, the U.S. central bank could be a player in this crisis. Deposit insurance was created for the banks that took savings deposits and managed them; this is still the backbone of the U.S. banking supervisory system. In Germany, the Kreditwesengesetz (KWG), the Banking Act, came into force in 1934 and became a model for most countries in the world, including the present European Union. For three-quarters of a century the new systems met expectations. However, they could not prevent spectacular bank failures such as the bankruptcy of the Cologne Herrstatt Bank in 1972 in Germany or the savings and loans crisis in the United States in the 1980s and 1990s. But there was no global economic breakdown such as the one that occurred after 1929.

Even larger financial crises could be held within regional limits and controlled—as when the first oil shock broke out in Latin America, or smoldering fires were put out in the old protectorates of the Soviet Union after its collapse. The heated debt crisis of the "Asian Tiger" nations in the late 1990s was contained. Despite the escalation of credit and debt, the Western system of financial capitalism seemed to be more reliable in its operation than ever. This picture changed dramatically overnight. From Washington to London, to Brussels, to Paris, to Tokyo, to Beijing, and to Berlin, the governments of the large industrial and trading states, the so-called G-8, no longer discounted the unthinkable. The global financial system suddenly faced its greatest threat; its meltdown could lead to a dangerous chain reaction of bankrupt firms (of which there are plenty), with socially explosive mass layoffs and black holes in the accounts of the social systems and state budgets as a consequence. See Figure 1.2.

Therefore, the financial system had to be helped, even if it cost a lot of money. Already the G-8 nations had put up trillions for the purpose, an amount reliably estimated at $9 trillion, or the equivalent of close to three times the GDP of Germany. Experts feared that further incalculable sums could follow. One does not know what is more frightening: the sums or the justification. The amounts already constituted the largest public financing in peacetime. The rationale given to the people for this, the most adventurous action ever undertaken by democratically elected governments, would result in the creation of government debts of such vast sums that they could lead to the destruction of state credits, and to the printing of money in amounts that threatened to lead to hyperinflation after the crisis was resolved. The

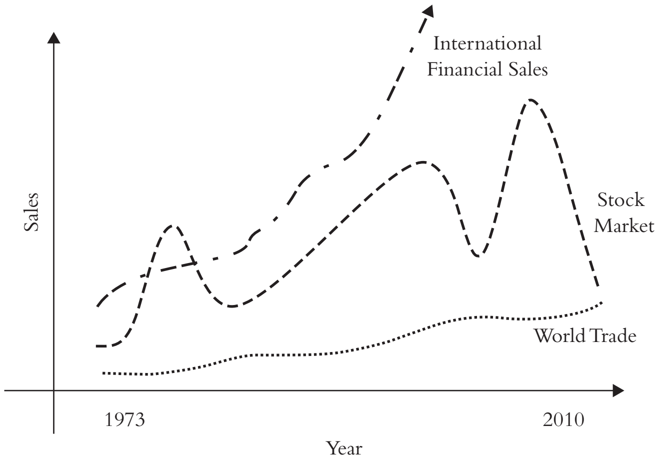

Figure 1.2 Fever Thermometer of Our Sick Financial Economy

argument, however, that the damage to society and the state would be even worse without these means was persuasive neither from a moral perspective nor from the viewpoint of a market economy.

The financial world still assumes that no state can afford to allow its largest financial firms to fail. But they seem not to recognize that it is exactly this condition of being "too big to fail" that is the real threat for the world of nation-states. Nations are learning in this crisis something they did not realize from the previous one—that single actors who are too big, powerful, and influential can extort them and show little reluctance to do so. Only by keeping these financial dinosaurs from failing can a society avoid becoming their prey.

Thus we must consider why the control and warning systems erected since 1929 have failed us so miserably.

The Finance Sector Always Underestimates the Risks of Its Innovations

On a visit to the London School of Economics on November 5, 2008, the British Queen asked: How could this credit crunch happen? She did not get an immediate response, but this question *can* be answered.

A comparison with former great crises of past centuries makes clear what is new this time, and what is old. Each of the major financial crises of the past was due to financial innovations. The inventors or users of these innovations became so enthusiastic, one could say blinded, that they overlooked or grossly underestimated the risks for themselves and for others. And what role did the regulators or "policemen" of the financial sector play? If they existed, as in the case of the United States and Germany since the 1930s, then they necessarily oriented themselves by their former experience—stretching back 80 years or longer. But the question is: Did the established knowledge of the regulators keep up with the advances in the technological innovations of the financial world?

Can regulators ever keep up with innovators?

Since biblical times, have not the angels of darkness always been brighter than those of light? It is not unusual for criminals to be ahead of the regular police in their knowledge of how to crack security systems or to hack computers. Why should it be different in the financial sector?

But this time it could have been different. For there was writing on the wall before the crisis erupted. The inspectors had the opportunity to prevent it. They behaved as did Belshazzar in Babylon: They did not want to admit what they saw. For this time the *macroeconomic* consequences of financial progress were clearly as recognizable as accumulating explosives for the national and world economy. One could see that for decades the banking world had wandered from the regulated zones of state control to the deregulated no-man's-land of the global interbanking markets. It was common knowledge that the international banking community tested out new financial techniques in this regulation-free zone and replaced the old established and best rules of accounting and evaluation with new and dubious ones.

The consequences spoke for themselves: What one owned ("asset prices") rocketed up higher and higher, forming one inflationary bubble after another in the capital and investment markets. And the inflationary gains in the financial sector did not remain hidden, and not only among top managers. Every macroeconomist could calculate the consequences to be expected from anticipated "second round" effects: Those in the financial sector earned value worth multiple times what the corporate sector managed to produce—but with what? Not with real economic growth, productivity, and increases in capital in production facilities, but always from higher (inflationary) surcharges on real existing assets. That stocks and other monetary investments always became more expensive did not signify that real property and business assets grew in value to the same extent.

Nor did the maldistribution of income remain invisible: The actual earned incomes from companies and earnings stagnated, remaining way behind those in the financial branches. The consequence for economic development was a lack of demand, which continued to weaken. Demand had to become weaker! For the new Midases and Croesuses could not spend so much to put enough money back into the income stream to keep it going.

What actually remained, and was nevertheless not clearly recognized as "systemic" or identified as "bursting" by any of the 20-plus surviving Nobel laureates in economics, was the constant upgrading of ultimately "dead" capital from shares, real estate, and other financial claims on property and investments that had been around a long time: an inflation of capital stocks that already existed, namely the asset inflation mentioned earlier. And ignoring the resulting consequences for the real economy, its laws of circulation and interactions were just as striking and dangerous. Phony but economically effective "excess savings" were extent. The new rich did not invest as much in the real as in the nominal, by putting money into always new, far more lucrative financial investments, and by extension into bubbles that they were continuously pumping up. This money was lost for the financing of new investments in the real economy or for job creation.

However, when the air, which they had earlier pumped into the bubbles, escaped (usually only partially), and what they owned again lost value, they were then bitten by the dog that they themselves had let off the leash. This had been obvious for decades, yet an official warning was never given. Everyone was taken by surprise: politicians, regulators, and the army of experts. Now that the child lies in the well, there is no paucity of ex-post analyses and explanations as to how it got there. Just as in Max Frisch's drama *Firebugs*, the zeitgeist analysts and commentators calmly watched as the arsonists lit the fuse. Each short circuit in their heads could be the spark that set off the fire. And so it happened. . . .

Herein lies the big difference between this crisis and all others. Unlike those crises past, the present crisis could have been stopped by the knowledge of the banking system on the part of central banks, financial forecasters, and qualified gurus in science, politics, and the ever-present media. Accordingly, it is worthwhile to look back a moment.

Four Fatal Innovations of Global Banking

What in the current world financial crisis is so new that it blew the old fuses? The global financial world, domiciled mainly in Anglo-Saxon England and the United States, has been steered since the middle of the 1970s by four basic financial engineering innovations enabled, in turn, by bad policy decisions. These innovations have in common the backdrop of the suspension of the Bretton Woods international monetary system in the spring of 1973 (see the discussion in Chapter 5).

First, globalization and the world unification of financial markets made it easy for the global players, including the leading institutions of high finance, to withdraw from the laws and regulations of their central banks and regulatory offices and to discover entirely new financial products and refinancing techniques. These innovations permitted them the following actions.

Second, global players cut the umbilical cords to their central banks and decoupled their interests from their traditional suppliers, savers, and depositors. In a two-step banking system they could replace the first money circulating function between money-creating central banks and the mainly private commercial banks that brought this central bank money into circulation, with a second, "in-house" function. Instead of having to pump money from the central bank against collateral, they created liquidity through their own production—the lending from bank to bank.

Thus, from time to time the financiers could procure means in their own sector: in their self-constructed global interbanking market. There every bank became indebted to others and paid with new, self-created "innovative products"—the often-mentioned derivatives. Within a few years the highest and most fragile tower since Babel was erected in the extraterritorial no-man's-land of global financial markets—only made up of the paper of unsecured bank-to-bank liabilities.

However, the new market with new products was open only to the leading institutions of high finance. The world of small regional and local banks remained shut out of this paradise of the ability to create money independent of the central bank. The small financial branches were permitted to invest, that is, hand over money, but not to borrow. On paper the national money constitutions still existed, yet only with limited validity.

Once invented, the new world of high finance permitted fantastic sales and profits. In the last year before the outbreak of the crisis in 2007, financiers calculated only in thousands of billions:

trillions. Financial transactions in terms of credit and investment ran ahead of the real world of global gross domestic product with seven-league boots. With their numbers and unreal profits the financial world arrived in the stars, and even though called "global," they left the world behind.

Third, with its new, inexhaustible bubbling sources of profits, the financial sector ended its oldest contract with capitalism—service for the real economy. It became superfluous; one could earn much more from securities trading and portfolio investment activities. One could do without credit customers such as entrepreneurs and outside investors. Why bother to lose time with them if as an investment (or, more accurately, "speculation") bank, one could earn much more on the asset markets of the world (stock markets, real estate, and other financial paper investments) than with bread-and-butter businesses in the real world?

Fourth, the financial sector made an even greater discovery. One could recapture the fixed money and reinvest and reliquidate it. One only had to "securitize" it. Out of the assets already financed one could create new ones and sell them under competent- and secretive-sounding names such as asset-backed securities (ABSs), credit-default swaps (CDSs), and collateral-debt obligations (CDOs) and sell them not only to one's own branches, but through unsuspecting advisors to an even more unsuspecting public. The financial world had discovered a *perpetual motion machine*: Money that could be used for internal debts and then reinvested could be brought back and bundled into securitization of existing commitments! The newly discovered "second" money circulation among banks, savers, or real investors ran like clockwork without the disturbance of central banks and brought in profits that real-world investors dependent upon the products of entrepreneurs could not even begin to dream of. High finance arrived not only in heaven, but in seventh heaven!

Of course, sometimes it became snared and there were losses due to friction in the perpetual motion machine. But there was always a counter that could be brought to bear; one shifted to an ad hoc temporary storage or a general-purpose alternative: Innovation 4a. Special-purpose vehicles (SPVs) could take over at short notice, transforming products that are hard to sell into investments on time. Meanwhile, of course, "on time" had come to mean forever, or in the new language used in the industry for contaminated investments, toxic waste mills. These purchases were made on credit, which the SPV received, because the lenders used the toxic waste as security before its real value was known. The buyers got their money, and their auditors a "clean" balance sheet, which remained obscure for their nonaccounting partners in the sister subsidiaries of the SPV. The organizations for regulatory control (supervisory boards, auditors, and regulators) considered this SPV to represent paying customers. Only when an accident occurred (e.g., if the SPV was threatened with insolvency) did the regulators notice that it was a matter of "illegitimate" daughters of the banks that they had to back up, given the agreements they had made previously. The banks neither consolidated the SPV in the balance sheet of the mother nor accounted for the liability obligations "below the line."

But Innovation #4 was fatal for the previous three. When it suddenly became clear that the new financial products could not be sold, the crisis broke out with the elementary force of a volcano. One market segment triggered the mistrust in the new derivatives: the U.S. housing market. The business in undercollateralized or subprime mortgages collapsed after it had been formed and the resale of these mortgages in the form of massive bundling and securitization sparked widespread distrust. One debacle triggered another. The market for securitized paper turned into a seller's market overnight, and the seemingly inexhaustible bubbly credit donors turned into a huge black hole: All that was to be received and that existed in "interbanking liquidity" disappeared down its throat. The perpetual machine came to a halt with a sudden jerk; the new securities turned into "junk paper" overnight and had to (and still have to) be written down to nothing, or almost nothing. This depreciation eats up *trillions* in equity in leading institutions: It is what is really going on at the very best addresses in global (mainly Western) finance.

The crisis revealed that the most innovative and lucrative banking business in the past 20 to 25 years was in reality the most brazen, obvious, and yet best-organized financial swindle of all time!

Essential Reforms

The nucleus of the systemic crisis was latent in all the financial crises in Black Tuesday of 1929 and the Great Depression of the 1930s (the beginning of the globalized financial economy). It can spread anytime through the global networks of the financial sector, like a flu epidemic. In this context the old crises have become global due to national and social innovation risks. There was never a systemic risk associated with the financial crises of the times before 1929. At that time those who went bankrupt in the financial sector posed a danger neither for the state nor for the stability of the financial system. The gold standard held the world of states and currencies together: It immunized the system from the consequences of a speculation crisis. To learn this again is one of the homework assignments yet to be completed by political elites at the high tables of policy today. The United States is particularly inexperienced in this regard, having joined the gold standard late (*de jure* in 1913, *de facto* in 1914) as the paper dollar could be backed up by gold after the great victory of the United States in World War I.

The first systemic crisis emanating from the financial sector was that of 80 years ago. Not only did it produce official bank control and financial supervision, but this era shapes our understanding of the crisis today—but, alas, with the wrong direction and emphasis. The regulatory laws and, on this basis, the active controllers still view the danger of the crisis to be located in the dangerous interaction between banks and the public they have seduced with the reduction in the costs of speculation. However, the place where the crisis occurs and from which it radiates to the real sectors of the economy is not the same source as in the past. It is no longer the stock market, but the interbank market.

The extent to which anachronistic 1929 imagination still dominates financial market supervision was illustrated recently when the put option of short selling was banned by German financial market supervision. Moreover, a study of the 1929 crisis demonstrated that exactly these policies promoted the decline of prices through the floor. The current world financial crisis teaches a different lesson: It stems neither from the public, which underestimates its speculative risks, nor from the stock exchange, on which its impact has abated. (This is particularly the case in Germany, for example, since only 1 percent of all German businesses has access to the stock market and can take out credit from there.) The trigger and center of the current financial crisis is the globally interconnected large banking system of high finance: They and their innovations are the cause of the crisis—not the public.

Therefore, the present crisis cannot be compared with earlier financial crises, and not with the one following 1929. Because the supervisory authorities, scientific consensus, and a host of financial analysts and banking advisors denied that such a crisis could develop, it evolved without resistance into a global pandemic. And what damage it has caused.

Four Conclusions from the Financial Crisis

Four conclusions can be drawn, which also identify the core principles for a coherent plan for crisis management in order to prevent further crises from developing along these lines:

1. The control of the interbank markets has to be returned to the central banks, which are responsible for monetary and financial stability. The commercial monopoly of money and credit creation founded by global investment banks that began with the liquidation of the world monetary system of Bretton Woods must be ended and its foundations removed, or the crisis will return in the future. It is still unclear how this de facto cartel of global investment banks and its offshoots (investment funds of all varieties, with 90 percent of hedge funds precrisis being registered in the unregulated Cayman Islands) can be controlled or deterred. But it will require a system of global bank supervision or a new world monetary system similar to the gold standard that limits the expansion of financial markets.
2. National bank regulation must become more sharply focused upon *macroeconomic* criteria in the future instead of being satisfied, as in the past, with controls based on legal and microeconomic technical balances. Macroeconomic consequences of error-ridden banking behavior not only pose a systemic threat, but are also easier to detect than the microeconomic discrepancies. From the macro perspective the sinners cannot simply disappear in the maze of their accounting systems, which can be wiped away or retouched. Asset inflation (the building up of bubbles, the dichotomies between financial and real economic growth, the consequences of income and wealth distribution, the numbers and warning signals of the statistical offices and international

organizations) are all in the public record. Any macroeconomist can draw the conclusions from this information.

3. However, this macro-oriented process does not make the classical control of banking and balances superfluous. On the contrary, these classical controllers must learn from the most recent crisis and build this learning into their framework. This control must target another powerful, de facto global cartel largely unknown in the public sphere: the *rating agencies*. The three leading rating agencies in the world control 90 percent of the market for the evaluation of bank balances and financial assets: Standard & Poor's (40 percent), Moody's (40 percent), and Fitch (10 percent). These agencies significantly contributed to the outbreak and intensification of the crisis by changing the good old conservative "lowest value principle" (enshrined, for example, in the German Commercial Code of 1897) to the "fair value principle" of the American International Accounting System (IAS)—on their own initiative. The IAS permits the use of variable criteria for evaluating assets rather than keeping reliable, unchangeable evaluation criteria in the middle of the duration period of a contract. The banks could, in consultation with their auditors, determine the risk assessment of the content of their own holdings. Auditors were thus made into accomplices!

By the mid-1980s, corresponding with the acceleration of asset inflation, leading banks in the United States and Germany had shifted to the new IAS accounting rules. The extent to which the IAS has functioned as procyclical, intensifying the crisis, only recently became clear with the fixing of the write-downs in the bank balances: Because too little was written off before the crisis, providing for too little in reserves, one now had to make up for lost time during the crisis. Suddenly, leading international banks and large asset managers had to reveal that because of back-dated depreciation up to this point, as much as two-thirds or more of their own liable equity capital had been lost. These banks and the liable states behind them have worked out an obscure arrangement with the IAS that continues to aggravate the crisis as costs hit both the states cleaning up the mess and their taxpayers. Either the IAS must be reformed in the light of the experience of the crisis, or the institutions of high finance must return to the standards that apply to banks in business outside the front door, that is, people's banks and savings banks. Surely the spirit of the honest businessperson does not dwell only in these local banks and not show up at all in the top institutions of the world financial system!

4. Were the bank supervision institutions in the United States, Germany, England, and Switzerland—the home countries of the largest and most vulnerable individual institutions—really as overwhelmed as they now claim? This can be seriously questioned. No examiner could overlook the superior profits of these institutions in their trading of financial products, particularly the innovative ones. Nor could any expert overlook the fact that for decades these banks were on the verge of abandoning their traditional bread-and-butter business credit customers. For these high-finance institutions the good old "3-6-3 rule" no longer applied: 3 percent was the price of the money paid by the bank in interest, 6 percent was paid by the customer for credit, and as of 3 o'clock one was home or on the golf course!

Once one left the passive deposit business of savings and central banks, the focus shifted to the active business of loan customers. Accordingly, the charted curve of safe interest income of all major players in the industry has gone down over the past decade, particularly at the banks involved in the ongoing "sanitizing" process (from HSBC to UBS to Deutsche Bank). Their fabulous returns did not come from the old respectable banking business, but from the new

> risky one. No bank examiner could overlook that in all these institutions the credit business related to investing in industry (in relation to total balances and their own equity) had been sharply reduced while the duration and trade related to portfolios of securities and other financial stocks had greatly increased—the lion's share being new and now-toxic financial products.
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> Under the eyes of the auditors investment banks had become wholesalers in financial titles. They were obviously playing with fire. The auditors could have warned them before they got burned. The European Union also failed to contribute to the safe operation of the European banking system as evidenced in their guidelines adopting the IAS rules. One can be thankful that not all credit institutions followed this precarious advice. Only in the case of off-balance-sheet risks—that fine-spun but fraudulent false accounting technique—could mitigating circumstances be claimed.

If the state is called upon to help people in this crisis, then it should be to aid the victims, not those who brought it about! This help is cheaper for the society than bailing out the banks—both financially and socially. It costs a fraction of what the taxpayer had to put up to take over worthless bank assets and debts. At most, the cost is in the billions, not the trillions.

For the period after the crisis it is important to note that the present distribution of money between the financial and real sectors in the crisis-ridden countries is wrong and must be corrected; it must not be carried forward in any event. "Too much money" in the financial sector caused this crisis. Now "not enough money" threatens to lengthen and deepen the crisis in the real economy (for investment as well as for consumption). The bailout packages of governments struck by crisis-panic on both sides of the Atlantic work toward perpetuating this status of the financial sector, thereby preparing the way for the next crisis. For the transfer of bank debt to government accounts ("bad banks") and the subsidies and guarantees for their battered capital lead not to the salvation of capitalism but rather threaten its demise.

Keynes, Properly Understood

The governments in the United States as well as in old Europe have fallen into adopting the role of system destroyer. They follow Lenin's cynical advice (according to Keynes) that whoever wants to destroy the bourgeois society only needs to debauch its currency. Lenin pursued this actively whereas Keynes feared it would result out of a lack of understanding of those in power and out of a lack of morals on the part of money managers and actors. For it is deeply inappropriate to reward those who cause damage: both to demand it, and then to do it. Such an attitude and policy cannot be justified even in the short run. For the money overhang in the financial sector cannot bring the economy to life, but only trigger the next asset inflation. Therefore, the current shortage of money in the real economy must be eliminated quickly, because it will prevent sustainable recovery, burden the labor market, and drive the country into even higher debt.

Whoever believes that the damaged world of the big banks can save the currency and state finances through unlimited fiscal-deficit spending invokes a different Keynes than the author of his books. It was Keynes who called on the governments of states to put the money economy into the service of the real economy, and not vice versa.[2] Listening to the real Keynes is one of the few ways to determine whether the Midas cult will gain the upper hand or be banned for the sake of prosperity in the brave new world economy.