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The Slippery Slope: Consumers, Not Producers

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If the United States economy was a prizefighter and I was the referee, I would have mercifully stopped the carnage while the old pug still had his champion's pride and all his marbles. But the mismatch has been allowed to continue, round after bloody round. Past glory can get in the way of accepting present realities.

The economy of the United States, long the world's dominant creditor, now the world's largest debtor, is fighting a losing battle against trade and financial imbalances that are growing daily and are caused by dislocations too fundamental to reverse.

I'm not talking abstract economics here. Unless you take measures to protect yourself—and this book will tell you what those measures are—your dollar-denominated assets are going to collapse in value and your standard of living will be painfully lowered. I can't pinpoint the date this will happen—the

government has been successful in hiding the problem and buying time—but there is going to be a day of reckoning and it's already overdue.

In the short space of a couple of decades, and causing surprisingly little anxiety among economists, the nation has undergone a radical transformation in terms of its economic infrastructure and its economic behavior. A society that saved, produced, created wealth, and was a major exporter has become a society that stopped saving, shifted from manufacturing to nonexportable services, has run up record national and personal indebtedness, and uses borrowed money to finance excessive consumption of unproductive imported goods.

On a national level, our circumstances are similar to those of a philandering playboy who inherits a huge fortune and then proceeds to squander it. During the dissipation period, he lives the good life, and by all appearances he seems prosperous. But his prosperity is a function of the hard work of his ancestors rather than his own. Once the fortune is gone, so too will be the gracious lifestyle that it helped support. The problem is that most Americans, including most economists and investment advisers, have confused conspicuous consumption with legitimate wealth creation. Our impressive gross domestic product (GDP) growth, dominated as it is by consumption, is not a measure of how much wealth we have created but of how much we have destroyed (see Figure 1.1).

The result: a trade deficit of some $800 billion annually, a budget deficit running $300 billion to $400 billion, and a national debt of $8.5 trillion. (Of course, when unfunded liabilities, such as Social Security obligations, are included, the real national debt exceeds $50 trillion, or over six times the official estimates). Had the past two decades been characterized by genuine prosperity, we would have run trade surpluses and still be the world's largest creditor, rather than its greatest debtor. I believe that we are

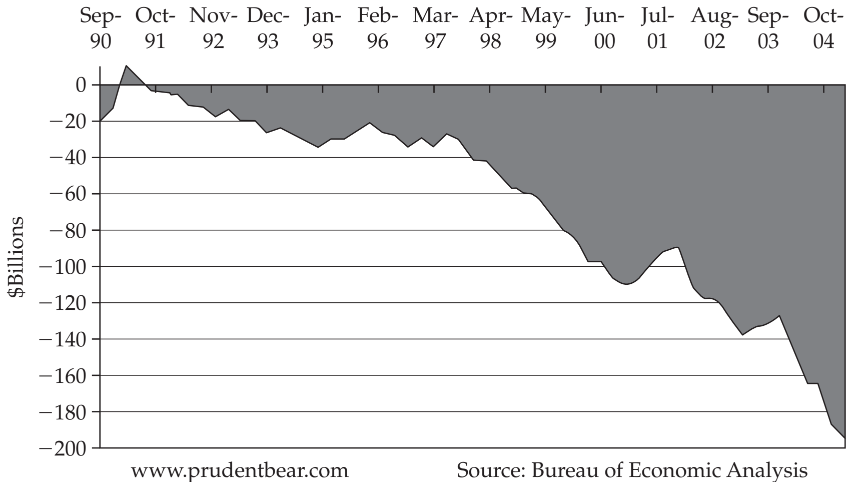

FIGURE 1.1 *U.S. current account balance, 1990–2005.* The U.S. current account deficit has exploded in recent years, with annual red ink now flowing at a rate close to $1 trillion. Such an abysmal economic performance is a national disaster of unparalleled proportions.
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fast approaching a perfect storm scenario, with a monetary collapse the most likely way it will play out.

It's analogous, I think, to a family—let's call them the Smiths—whose breadwinners have lost their jobs. To keep up appearances and maintain the same lifestyle, the family resorts to borrowing and goes deeper and deeper into debt. It is a situation that cannot go on indefinitely. Unless the breadwinners get jobs that enable them to repay their debt and legitimately finance their previous lifestyle, the family faces painful and humiliating adjustment.

Contrast this to a family—let's call them the Chins—who sacrifice, underconsume, and live below their means in order to accumulate a significant financial nest egg. During the

accumulation period, they appear far less prosperous than their spendthrift neighbors, the Smiths, who live high on the hog on credit card and mortgage debt. To the casual observer, judging only by the relative consumption patterns of both families, the Smiths appear to be the more prosperous family. However, beneath the surface, the Chins' current sacrifice allows them to build a bright future, while the Smiths' shortsighted profligacy comes at a great sacrifice to their future lifestyle.

To consume, you have to either be productive or borrow, and you can only borrow so much and for so long. So it is with nations. But while an individual breadwinner might get lucky by finding a well-paying job or winning the lottery, an entire nation cannot, since replenishing depleted savings and rebuilding a deteriorated manufacturing base will take time and require great sacrifice.

Because Americans are not saving and producing but are borrowing and consuming, we have become precariously dependent on foreign suppliers and lenders. As a result, we are facing an imminent monetary crisis that will dramatically lower the standard of living of Americans who fail to take action to protect themselves (see Figure 1.2).

WHY THE GLOOM? THE GOVERNMENT SAYS THE ECONOMY'S FINE

If you're wondering why you keep reading and hearing that the economy is doing just fine, don't think you're hallucinating or that I am. Modern politics is premised on the high expectations of American consumers, and the government has mastered the art of making bad economic news look like good economic news, thereby keeping the public happy and the politicians in office. (The midterm elections of 2006 that changed the leadership

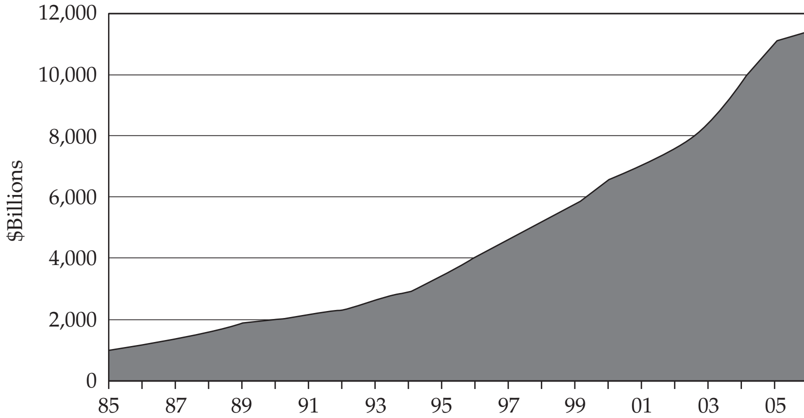

FIGURE 1.2 *Rest of the world holdings of U.S. financial assets, 1985–2006.* America's unprecedented consumption and borrowing binge has put record amounts of liabilities in foreign hands. If not repudiated, servicing this debt will suppress national income and domestic consumption for generations to come.

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of the House and Senate might indicate the public is waking up.) Government officials—aided by an accommodative Federal Reserve empowered to create credit—manipulate economic data routinely to simultaneously maintain the domestic consumer confidence and foreign lender confidence required to keep the party going. But with every bit of time they buy, the basic problems worsen.

For their part, the foreign central banks continue to use accumulated dollars to buy our Treasury and mortgage-backed securities, helping finance our growing deficits and keeping our housing market propped up (see Figure 1.3). They get the same sunny economic news we do, and they also have the naive belief, although there are signs that this belief is beginning to

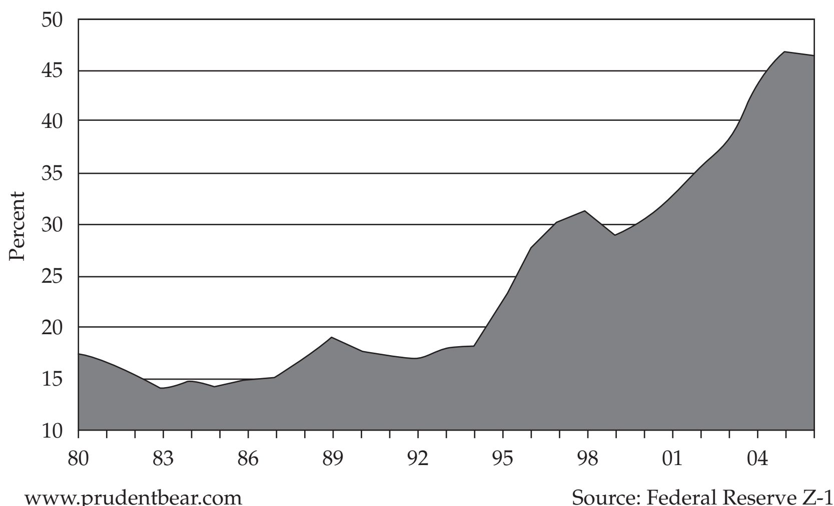

FIGURE 1.3 *Foreign holdings of U.S. Treasuries as percent of total, 1980–2006.* Due to insufficient domestic savings and profligate government spending, an increasing percentage of U.S. Treasury debt is now held abroad. We certainly do not "owe it to ourselves" anymore.
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waver, that the U.S. economy is too big to fail. If they woke up to what's actually happening and stopped buying our Treasury securities, our choice would be to further tax an already overburdened citizenry or default like Russia did in the later 1990s. We are in a real mess.

That brings me back to my prizefighter analogy. Remember when Iron Mike Tyson wore the heavyweight crown, was knocking out everybody in sight, and was so fearsome it seemed inconceivable he could lose? Well, as always happens eventually, he finally met his match. Buster Douglas beat him, and after that he just kept getting beaten. It was the same Mike Tyson, but Buster had broken a psychological barrier.

Any reality check that pierces the myth that the American economy is too big to fail could begin the process of unraveling.

Our days as the dominant economic power are numbered. The dollar is going to collapse, and Americans are going to experience stagflation on an unprecedented scale in the form of recession and hyperinflation. Those of you who act smartly and quickly by taking measures I outline later in this book not only will avoid loss of wealth but also will have positioned yourselves to prosper while your neighbors suffer a painful period of reconstruction and reform.

It is important to remember that in market economies living standards rise as a result of capital accumulation, which allows labor to be more productive, which in turn results in greater output per worker, allowing for increased consumption and leisure. However, capital investment can be increased only if adequate savings are available to finance it. Savings, of course, can come into existence only as a result of underconsumption and self-sacrifice (see Figure 1.4).

The fatal flaw in the modern economy is that any attempt to save and under consume, which would surely bring about a badly needed recession, is resisted by government policy, the sole purpose of which is to postpone the inevitable day of reckoning. In their selfish attempt to secure reelection, American politicians have persuaded their constituents that they should indulge their every whim and that self-sacrifice or underconsumption are somehow un-American, a character flaw uniquely Asian.

As a result, those same American politicians, with the help of the Federal Reserve, will succeed in doing what no foreign power ever could have: They will bring the U.S. economy to its knees, as sacrifice and underconsumption will ultimately define the U.S. economy for generations to come.

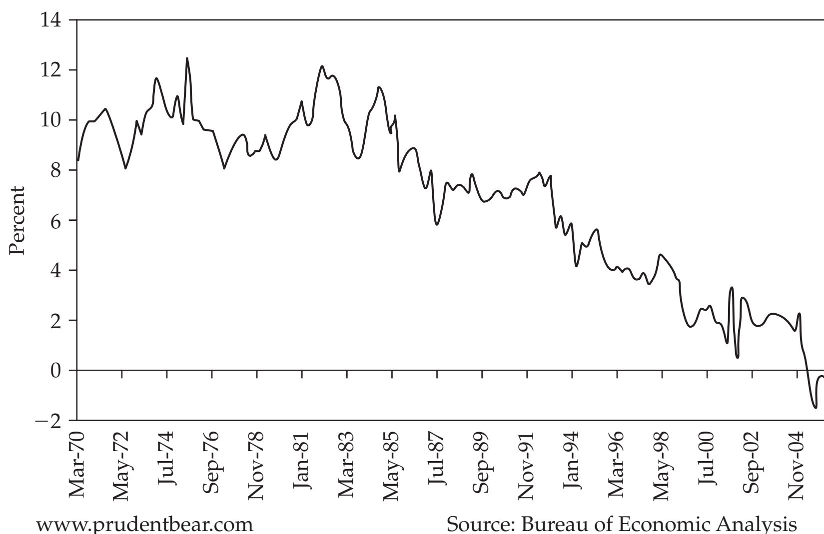

FIGURE 1.4 *U.S. savings rate, 1970–2006.* The collapse of personal savings has led to the unprecedented accumulation of external liabilities and the demise of the U.S. industrial base. Rebuilding national savings and the capital investment it finances will be a hallmark of the coming economic austerity.

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HOW WE GOT INTO THIS MESS

In a very real way, our success as a military and industrial power and the period of great affluence that followed World War II seeded the developments that have caused the fix we're in and allowed it to fester.

Reserve currency status, a badge of America's preeminence, has been both a blessing and a curse. Bestowed on the United States by the Bretton Woods agreement of 1944 (see Chapter 3) and still enjoyed by the United States today thanks to complacent central bankers abroad, the U.S. dollar's status as the world's

reserve currency has shielded the United States from the consequences of persistent and growing trade imbalances.

The Bretton Woods accords made the U.S. dollar the currency used by other governments and institutions to settle their foreign exchange accounts and to transact trade in certain vital commodities, such as gold and oil. It thus behooved countries involved in international trade to accumulate dollars and build ample reserves. That the dollar was originally accepted by the world as its reserve currency was due to America's unequaled industrial might, its status as both the world's leading exporter of manufactured goods and its greatest creditor, and the fact that its currency was fully backed by, and redeemable in, a fixed quantity of gold. None of these attributes currently exist, and the dollar would not qualify for comparable status were a similar accord attempted today.

However, because its reserve currency function was inseparable from its own import/export activities, the United States was permitted to run trade deficits exempt from the free market forces that would otherwise have forced their adjustment. Thus we were spared the economic impact that a devaluation of the dollar would have caused.

Our trading partners could, under the Bretton Woods rules, force us to deal with the issue, but bureaucratic central bankers have so far been complacent and allowed our deficit to reach increasingly dangerous levels.

But that complacency could change. There is also speculation that reserve currency status might be transferred to the euro or to a combination of foreign currencies. In any event, the U.S. dollar's status as a reserve currency immune from market pressures cannot last indefinitely. When it ends, all those surplus dollars will come home to roost, creating hyperinflation domestically.

The shift from manufacturing to services caused growing trade deficits. The erosion of our manufacturing base with

its value as a producer of exportable goods and a source of high wages was the result of a number of factors. Aggressive labor unions demanding worker benefits, increased government regulation, higher taxation, aging plants and equipment, a "bigger is better" attitude that allowed too much waste and encouraged too little conservation and discipline, a smugness with respect to quality and design—these and other factors put U.S. manufacturing at a disadvantage to competitors abroad that were playing catch-up.

Abroad, in contrast, there was a spirit of rebuilding, an awareness that natural resources were scarce and must be conserved, lower taxes and wages, and generally fewer government obstacles to economic development. America's most formidable overseas competitor was Japan, whose answer to America's "bigger is better" was "higher quality is better." Gas-guzzling, chrome-laden "Detroit iron" was suddenly challenged by durable, economical, electronically sophisticated competition from Toyota and others. Resources, human and natural, were to be used with more care, more skill, and more discipline not to make money but to make products of greater excellence that in turn would make money. Nor was the Japanese government averse to self-serving trade policies, which the United States was willing to tolerate in exchange for an ally in its all-consuming war in Vietnam.

David Halberstam, in his book, *The Next Century* (Morrow, 1991), observed:

> *America in the postwar years became a political society that assumed the essential health and bountiful quality of the American economy. Japan, by contrast, was an economic society, where wealth had to be renewed each day by the nation's most talented people. . . . We were obsessed with the cold war then the hot war, but the Japanese were obsessed with commerce.*

As our manufacturing base shrank, a service economy expanded in its place. Service economies do not reduce trade

deficits. Consisting of businesses such as retailing and wholesaling, transportation, entertainment, personal services, and other intangible and intellectual property, the service sector not only produces fewer exportable goods but also makes us dependent on goods imported from economies that do save and produce. How would we otherwise stock our shelves?

The popular notion that in the postindustrial service economy money-valued services are an acceptable substitute for goods because both generate money ignores the distinction between money and wealth. Money is a medium of exchange. Wealth is what is received in that exchange.

I agree with those who argue that information technology can be an exportable product equal to goods, but I don't agree that we can ever replace manufacturing with information. There is simply an insufficient quantity of such products, and the diversity of cultures abroad limits the marketability of the entertainment and educational output coming from the United States. The facts speak for themselves. We are simply not exporting enough information technology to pay for the real goods that we import. The resulting trade deficits prove that our so-called information/service economy is in reality a sham.

Another problem with an economy based primarily on services is that jobs in that sector pay less than manufacturing jobs. Making matters worse, there are high-end and low-end, skilled and unskilled jobs in the service sector, and in the United States the growth is in the low-end jobs. When we talk services, we're talking mainly about flipping hamburgers.

Debunking a Popular Fallacy

A popular fallacy is that America's transition from a manufacturing-based to a service-based economy is an example of progress comparable to its transition during the nineteenth century from an agrarian-based to a manufacturing-based economy. During the

nineteenth century, efficiencies made possible by capital investment financed with savings enabled more food to be produced by fewer farm workers. This increased farm productivity freed up labor to make a transition into higher-paying manufacturing jobs similarly created by capital investment financed by savings. The growth in farm productivity that made the industrial revolution possible also resulted in huge exports of American agricultural products and agricultural trade surpluses.

Contrast that with the modern transition from a manufacturing-based to a service-based economy. In this case, labor was freed up because American manufacturers, increasingly burdened by high taxes, excessive regulation, and trade union demands tantamount to extortion, were driven out of business by more efficient foreign manufacturers, resulting in huge trade deficits as we imported all the stuff we could no longer produce competitively at home. The fact that those displaced factory workers were forced to accept lower-paying jobs in the service sector is indicative not of progress but of colossal failure.

Another fallacious comparison was made during an interview I had with Mark Haines, host of CNBC's *Squawk Box*. Mark misinterpreted my position that the United States cannot hope to pay for imports solely through reliance on the service sector as my advocating that the country return to the equivalent of a buggy whip economy. His "buggy whip" reference is to the classic example of creative destruction, a concept of economist Joseph Schumpeter, whereby an innovation such as the automobile represents an improvement so major that it causes the destruction of a mature industry, such as whips for horse-drawn buggies.

The application of the creative destruction concept to the atrophy of manufacturing in the United States is flawed, however. When buggy whip companies went out of business, Americans did not start importing foreign-made buggy whips.

American businesses stopped making buggy whips because the invention of the automobile made them obsolete. Today, the very same highly desirable, state-of-the-art consumer goods that were formerly produced in the United States are now being produced abroad.

That's very different from the creative destruction of manufacturers of obsolete buggy whips by manufacturers of innovative automotive supplies. Today's example is pure destruction. There is absolutely nothing creative about it.

Baby Boomers are Consumers, Not Savers

Born to a generation of people who lived though a depression and then returned from a world war to a victorious country offering the GI Bill and a future filled with possibility, the baby boomers, as the bulging population born following World War II became known, grew up knowing affluence and building it into their life expectations. Those expectations naturally became the promises of the politicians they elected. Amid a business boom driven by leverage and making credit an integral and acceptable part of modern life, financial services organizations, now deregulated and free to expand and diversify, relaxed their lending standards and aggressively foisted auto loans, credit cards, mortgages, and home equity loans on a market as vulnerable as it was demographically irresistible. With personal expectations now tantamount to a sense of entitlement, the stage was clearly set for the spending binge we have today.

Savings? Who needs savings when you own stocks that can only go up in price and a home that gains equity every year? Let the dismal scientists worry that stock values or home equity might simply be the result of inflationary bubbles created by an irresponsible Federal Reserve, or that when the bubbles burst, all that will remain are the debts they collateralized.

WHAT'S TO WORRY ABOUT? WITHOUT THE UNITED STATES THE ASIAN PRODUCERS WOULD BE ALL DRESSED UP WITH NOWHERE TO GO. NO?

You hear this argument all the time, and if you believe it I've got some oceanfront property in Indiana to talk to you about.

The world no more depends on U.S. consumption than medieval serfs depended on the consumption of their lords, who typically took 25 percent of what they produced. What a disaster it would have been for the serfs had their lords not exacted this tribute. Think of all the unemployment the serfs would have suffered had they not had to toil so hard for the benefit of their lords. What would they have done with all that extra free time?

The way modern economists look at things, had the lords increased their take from 25 percent to 35 percent, it would have been an economic boon for the serfs because they would have had 10 percent more work. Too bad the serfs didn't have economic advisers or central bankers to urge such progressive policies.

Here's my favorite analogy to illustrate why it's idiotic to think the world benefits from Americans' excess consumption and would suffer without it (see Figure 1.5).

Let's suppose six castaways are stranded on a desert island, five Asians and one American. Their problem is hunger. So they sit down and divide labor as follows: One Asian will do the hunting, another will fish, the third will scrounge for vegetation, the fourth will cook dinner, and the fifth will gather firewood and tend the fire. The sixth, the American, is given the job of eating.

So five Asians work all day to feed one American, who spends his day sunning himself on the beach. The American is employed in the equivalent of the service sector, operating a tanning salon that has one customer: himself. At the end of the day, the five Asians present a painstakingly prepared feast to

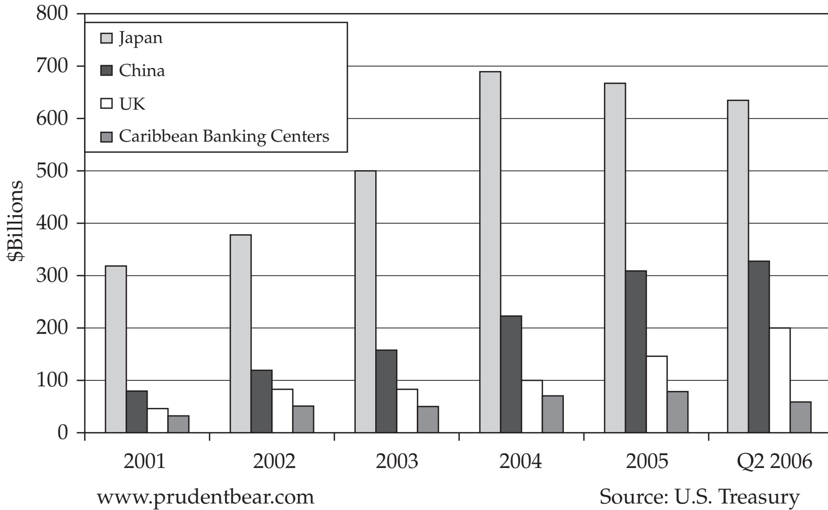

FIGURE 1.5 *Holdings of U.S. Treasuries by selected countries, 2001–2006.* The significant percentage of Treasuries purchased by Asian nations, in particular Japan and China, represents the greatest international subsidy since the Marshall Plan, the main difference being that the United States intended its aid to be charity, whereas Japan and China actually expect to be paid back.

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the American, who sits at the head of a special table built by the Asians specifically for this purpose.

Now the American is practical enough to know that if the Asians are going to continue providing banquets they must also be fed, so he allows them just enough scraps from his table to sustain them for the following day's labor.

Modern-day economists would have you look at the situation just described and believe that the American is the lone engine of growth driving the island's economy; that without the American and his ravenous appetite, the Asians on the island would all be unemployed.

The reality, of course, is that the American is not the engine of growth, but the caboose, and the best thing the Asians could do would be to vote the American off the island—decoupling the caboose from the gravy train. Without the American to consume most of their food, they'd have a lot more to eat themselves. Then the Asians could spend less time working on food-related tasks and devote more time to leisure or to satisfying other needs that now go unfulfilled because so many of their scarce resources are devoted to feeding the American.

Ah, you say, but that analogy is flawed because in the real world the United States does pay for its "food" and Asians do receive value in exchange for their effort.

Okay, then let's assume the American on the island pays for his food the same way real-world Americans pay, by issuing IOUs. At the end of each meal, the Asians present the American with a bill, which he pays by issuing IOUs claiming to represent future payments of food.

The castaways all know that the IOUs can never be collected, since the American not only produces no food to back them up, but also lacks the means and the intention of ever providing any. But the Asians accept them anyway, each day adding to the accumulation of worthless IOUs. Are the Asians any better off as a result of this accumulation? Are they any less hungry? Of course not.

Suppose an Asian central banker suddenly washes up onto the island and volunteers his services. Now each day the central banker taxes the other Asians on the island by confiscating a portion of the scraps of food the American throws them each day from his table. The central banker then agrees to return these morsels to the other Asians each day, in exchange for each Asian's daily accumulation of the American's IOUs, less a small percentage for himself because he, the central banker, also has to eat.

Does the existence of a central banker change anything? Do the Asians have any more to eat because their own central banker gives them back a portion of the food he took from them in the first place? Do the American IOUs have any more value because they can now be exchanged in this manner? Of course not.

THE ASIANS WILL BE BETTER OFF WITHOUT US

The real-world lesson is that if it doesn't make sense for the six make-believe Asians to support one make-believe American, it does not make sense for billions of real-world Asians to support millions of real-world Americans. The fact that they do so in exchange for worthless IOUs in no way alters this reality.

There is no question that in the short run, by allowing U.S. dollars to collapse (in effect, voting millions of Americans off the island), there will be some disruptions of Asian economies. Of course, there will be some initial losers, particularly among those Asians who currently profit from the present arrangement. However, these profits come only at the expense of greater losses borne by the entire Asian population.

In the end, the cessation of America's excess consumption, which is not a benefit Asians enjoy but rather a burden they now disproportionately bear, will be the best thing that can happen to them. Like the serfs being liberated from their lords, their scarce resources will be freed to satisfy their own needs and desires, and their standards of living will rise accordingly. As their savings finance increased capital investment, rather than being squandered on American consumption, their future standards of living will rise that much faster as well.

CHINA'S "WARTIME" ECONOMY

As noted earlier with reference to Asia in general, the mainstream of economic thinking holds that China will continue to finance the U.S. current account deficit indefinitely because American consumption is vital to the survival of China's export-driven economy. Quite to the contrary, China's own capacity to consume is much greater than ours and the productive capacity needed to serve it is already in place—in China!

In many ways the modern Asian economies are reminiscent of the wartime economy of the United States during World War II, when the nation's industrial might was concentrated on supplying the war effort. We had 10 million men under arms spread across three continents, our ships patrolled the Atlantic and Pacific Oceans, and our bombers blackened the skies. Factories that had previously produced passenger cars, sewing machines, and farm equipment had been retooled to make fighter planes, jeeps, tanks, rifles, bullets, artillery shells, destroyers, aircraft carriers, submarines, uniforms, helmets, boots, mess kits, and military radios.

At the time we were a very busy nation. Our factories were in operation 24/7, and more people than ever before were working, including legions of women previously absent from the workforce.

Given this full-throttle activity, economists of that time period might have argued that we never should have stormed the beaches at Normandy or Iwo Jima. After all, if the war ended, a disaster would befall our wartime economy. Millions of soldiers and factory workers would lose their jobs and corporate profits would collapse, as there would be no more demand for all the weapons and military equipment they were producing. Because victory abroad would surely bring recession at home, the war needed to be waged indefinitely.

As ridiculous as this argument sounds, it is exactly what most believe the Chinese should do today, as in reality their export-driven economy is basically no different from our wartime economy in 1944.

During the war, American consumers did not receive any direct economic benefit from their hard work and economic activity. In fact, they sacrificed greatly. Because factories were producing military goods, consumer goods were in short supply. In addition, scores of common staples, such as butter, nylon stockings, and gasoline, had to be rationed so that they or the resources needed to produce them would be readily available for the military. Similarly, Chinese citizens now produce export goods from which they themselves derive no direct economic benefit. In effect, consumer goods are rationed in China so as to make them plentiful in the United States.

However, when World War II ended, American factories didn't shut down; they merely returned to consumer goods production. Soldiers didn't lose their jobs; they merely put their labor to more productive uses. Instead of being wasted on a war (which unfortunately had to be fought), resources were applied to civilian purposes, leading to a postwar economic boom.

The same would apply in China today. As Americans once sacrificed to defeat the Nazis and Imperial Japan, the Chinese now sacrifice merely to support the purchasing power of Americans. If China allowed the dollar to decline against the yuan, American purchasing power would by definition be transferred to the Chinese. In China, factors of production would therefore be reallocated as they were during the postwar period in the United States. Factories would retool and labor would seek more productive employment. Instead of wasting scarce resources producing goods to export, China would instead produce goods for domestic consumption.

The time has come for China, and the rest of Asia for that matter, to redirect their vast resources to raising their own standards of living rather than propping up the living standards of Americans. As soon as the Chinese stop producing goods for Americans they can finally begin producing more for themselves.

It's time for China to declare peace. Unfortunately, as Americans are the principal profiteers in China's war, we stand to lose the most when it ends. So while peace means China's days of sacrifice, rationing, and underconsumption will soon end, it means ours are about to begin.

Unfortunately for Americans, being decoupled from the Asian gravy train means it's time to get back to work. In the simple terms of our island castaways analogy, this means a whole lot more hunting and fishing (in the commercial sense) and a whole lot less eating.

REBUILDING A PRODUCTIVE ECONOMY

For Americans to revert from consumers to savers following the economic collapse will probably be less difficult than one might imagine. It is in their fairly recent tradition to be savers, and it will also be a matter of survival.

But rebuilding a manufacturing base from the investment of those savings will be a daunting challenge and will take years to accomplish. Although the devalued dollar will create a favorable environment for exports once factories are up and running, rebuilding modern manufacturing facilities that can compete successfully with those in other countries is largely a matter of building from the ground up. Much of the existing equipment is now obsolete. The government will have to adopt policies that relax onerous and costly regulations, provide tax relief, and

generally encourage economic development, which includes having a role in the education of appropriately skilled workers.

Manufacturing anything is a complex process requiring natural and human resources and the presence of a community of supporting industries and services. Just take something as simple as an ordinary lead pencil. To make it you need incense cedar, specially grown, harvested, and selected in a form and grade suitable for the product; lead, which is graphite obtained from mines around the world; metal (for the erasure ferrule); rubber for the eraser; and various stains, glues, and paints. The manufacturing process involves mixing graphite and clay; baking it; cutting, slating, grooving, gluing, and milling wood; fabricating metal and rubber; painting; and engraving.

I'll spare you my comparison to the automobile as an example of complexity at the other extreme, since I've hopefully made my point: Once a particular manufacturing industry (which, to be competitive, is really a community of related industries contributing in various ways) has been dismantled, recreating it is a formidable undertaking, requiring capital investment and years of time.

COMPARING APPLES AND ORANGES: A CLARIFYING PARABLE

The issue of our enormous trade deficit is central to our economic crisis, and Wall Street has gone to mind-blowing lengths to minimize the importance of it. I will conclude by sharing a simple analogy I use in my seminars to illustrate a complex subject and put it into its proper perspective.

A Tale of Two Farmers

Farmer Chang grows only oranges. Farmer Jones grows only apples. Each grows only the fruit he produces most efficiently,

trading his surplus for the fruit grown by the other. Both farmers benefit from comparative advantage and free trade. The sole reason that Farmer Chang "exports" oranges is so that he can afford to "import" apples, and vice versa.

Suppose that one year a flood wipes out Farmer Jones' apple crop. Not having any fruit to trade, but hungry nevertheless, he proposes to trade apple IOUs for Farmer Chang's oranges. Since Farmer Chang cannot eat all the oranges he grows anyway, and since Farmer Jones' IOUs will pay 10 percent interest (in extra apples, of course), he accepts.

Farmer Chang accepts Farmer Jones' offer only because of the apples that Farmer Jones' IOUs promise to pay. By themselves, the IOUs have no intrinsic value. Farmer Chang cannot eat them. It is the promise to pay additional apples that gives the IOUs their value.

When Farmer Jones issues his apple IOUs in exchange for real oranges, he does not actually pay for the oranges. Payment will not really be made until the following year when Farmer Jones redeems his notes by giving Farmer Chang all the apples his IOUs obligate him to pay. Only then can the notes be retired and the transaction be completed.

Now suppose that the following year Farmer Jones' crop is again destroyed, this time by a hurricane. He and Farmer Chang once again make the same deal, with Farmer Jones getting more of Farmer Chang's oranges, and Farmer Chang accepting more of Farmer Jones' IOUs.

Further suppose that similar natural disasters continue to besiege Farmer Jones for several more years, until it finally dawns on him that he is eating pretty well, without actually farming. He therefore decides to turn his apple orchard into a golf course and simply play golf all day while enjoying farmer Chang's oranges. In other words, Farmer Jones now operates as a service economy.

Farmer Chang, by contrast, is so busy growing all those oranges that he never gets a chance to play Farmer Jones' course. In fact, he has been accepting Farmer Jones' IOUs for so long that he no longer remembers his original reason for doing so. He now counts his wealth based solely on his accumulation of Farmer Jones' IOUs. Farmer Jones actually enjoys such a good reputation within the farming community that Farmer Chang is able to trade some of Farmer Jones' IOUs for goods and services provided by other farmers and merchants. However, as a result of Farmer Jones' good reputation, no one notices that his apple orchard has been turned into a golf course. His IOUs are now worthless since Farmer Jones no longer possesses the ability to redeem them with actual apples.

Some might argue that the entire community now depends on Farmer Jones and his worthless IOUs and that Farmer Chang and the others will simply accept them indefinitely to avoid acknowledging the reality of their folly. Of course, were these revelations to occur, any unfortunate holders of Farmer Jones' IOUs would officially be forced to realize their losses. However, their true financial situations would improve, as any further accumulation of worthless IOUs would end. As for Farmer Chang, he would once again, literally, enjoy all the fruits of his labor.

The real loser, of course, would be Farmer Jones, for without a viable apple orchard or the ability to buy oranges on credit, he would starve. It would take years to transform his golf course back into an orchard, regain his lost knowledge of farming, and replace his obsolete and dilapidated farming equipment (provided he hadn't already traded it in for golf carts and titanium clubs).

In the end, Farmer Jones' only alternative might be to sell his golf course to Farmer Chang and take a job picking fruit in his orange grove.

2009 UPDATE

The slope was slippery, all right! The ink in *Crash Proof* was hardly dry before the phony, borrow-and-consume U.S. economy began to unravel. As I had predicted, it started when the real estate bubble, already leaking air, finally burst in 2007, triggering a credit crunch that quickly became global and plunged the American economy into deep recession and virtual bankruptcy. In a paradox as valid as it is bizarre, that's actually the good news!

The failing banks, corporate and personal bankruptcies, massive layoffs, falling stock, and real estate prices, home foreclosures, and other consequences of the current economic collapse, however painful the personal and social effects, are free-market forces trying to correct economic imbalances and restore economic viability. An overleveraged economy—leverage referring to debt—is trying now to reverse its errant ways by deleveraging. What is perceived as the problem is really the solution. The problem is what I described earlier in this chapter. The government should get out of the way and let the markets rebalance our economy. It won't, though, and that is the bad news.

Keeping Our Collapses Straight

The collapse I was predicting when I chose my original title, *Crash Proof: How to Profit from the Coming Economic Collapse*, hasn't happened yet. It is largely still ahead of us. The ill-fated dollar, after a bear market rally in 2008, still has a long way to fall. Inflated bond prices, the inverse result of artificially low interest rates, are a bubble still searching for a pin, with effects potentially more devastating than the real estate meltdown.

Maybe a couple of fairy tales will help clarify my point. The mess we are in happened because our government defied

free-market forces and tried to engineer a "Goldilocks" economy, one neither too cold nor too hot, but just right. That seemed for a while to be working, but it was actually working against us. What we had instead was a "Humpty Dumpty" economy that sat high on a wall and had a great fall. Now our friends in Washington are trying to do what all the king's horses and all the king's men couldn't do, which is to put Humpty Dumpty back together again. That exercise in futility has a price tag of trillions of dollars, which we will have to either borrow or print at the cost of crippling debt or massive inflation. When I wrote *Crash Proof*, excluding Social Security, Medicare, and other unfunded obligations, our government owed the better part of $8.5 trillion. The figure is now over $10 trillion and about to start mounting much higher. The budget deficit, which was running $300 billion to $400 billion annually, is projected to exceed $1.8 trillion this year and despite government projections, to keep growing thereafter.

The main problem is that the very individuals who assured us that all was well are the ones now entrusted to solve the problem. But how can they solve a problem they still do not understand? The Goldilocks crowd wants to rehabilitate their prodigal daughter. If they can just get her borrowing and spending again, she can once again skip blissfully picking daisies. It has not dawned on them that they embraced the wrong fairy tale and are now unknowingly scrambling to put Humpty Dumpty back together again.

The Real Estate Meltdown and Its Consequences

As I predicted, subprime mortgages granted on indiscriminate terms to unqualified borrowers, which totaled a staggering $600 billion or 20 percent of all new mortgages in 2006 alone, became a nationwide foreclosure problem in 2007. But defaults quickly

spread to prime mortgages, as neighborhoods got seedier and housing prices declined, wiping out the home equity Americans relied on as a substitute for savings and a source of available credit.

Mortgage lenders and institutional investors, such as banks, Wall Street investment banks, and other investors in mortgage-backed bonds or structured mortgage-backed securities called collateralized debt obligations (CDOs), took huge write-offs that jeopardized their required leverage ratios or resulted in insolvency.

With loan portfolios full of toxic paper, banks stopped lending, not just to homeowners but to everybody, including businesses large and small and even other banks. Some got emergency cash infusions from external sources (Citigroup got $7 billion from Abu Dhabi, for example) and others from that bottomless well (of printer's ink), the United States Treasury. Such bailouts were deemed necessary because the recipients were presumed to be "too big to fail." (Paul Volcker, former Federal Reserve chairman and now economic adviser to President Barack Obama, took a small liberty with that phrase in February 2009 when he sardonically and perhaps prophetically observed they were "too big to exist," a rather profound comment when you think about it.)

The result was a global credit freeze. Businesses curtailed operations and consumers reduced spending, causing declining sales, bankruptcies, and massive layoffs. The CEOs of the big three automakers boarded separate corporate jets and flew to Washington with hats in hand, telling Congress that without a government bailout they (with the exception of Ford) would go out of business and take a network of parts suppliers and dealerships with them (Unfortunately they got their bailout money, then got even more when they filed for bankruptcy anyway several months later).

By 2009, the U.S. economy was in free fall, economies abroad were in varying degrees of distress, and states, businesses, and

strapped consumers were getting more desperate by the day. In efforts to stimulate bank lending and consumer spending, the federal funds rate was cut to a range of zero to ¼ percent, rebate checks were mailed to taxpayers under a Bush program, and half of a $700 billion bank bailout bill known as the Troubled Asset Relief Program (TARP) was used to bolster the capital at several banks. None of that stimulus made a dime's worth of difference. Rather than lend the money, the banks added to their reserves or acquired other banks. Government intervention was proving impotent in the face of market forces, which were having a constructive effect, as I look at things. To my way of thinking, a bank that got into trouble making bad loans deserves applause rather than opprobrium for being unwilling to use a cash bailout to make more bad loans. Similarly, consumers who are cutting back on spending are doing what I believe they should be doing, creating savings that will become the basis for future bank lending and provide the capital investment that entrepreneurs need to create jobs and finance the production of exportable goods.

The Wrong Way to Go

The Obama administration's Economic Recovery and Reinvestment Program initially provides some $800-plus billion in combined spending and tax relief, but has the expressed aim of spending whatever money is required to create jobs, get credit flowing again, and put the economy back on track. A small but important percentage of the funds will go to states and municipalities for public works projects that will replace deteriorated infrastructure and perhaps ultimately improve productivity. The projects are supposed to be "shovel ready" and thus will create new jobs within a short time frame.

While some of the infrastructure spending is likely long overdue and badly needed, making the repairs will not help the

economy. The bottom line is that we simply cannot afford to pay the bill right now. Imagine an out-of-work, overly indebted individual deciding to have her kitchen remodeled to solve her financial problems. Even if her kitchen were badly dated, with avocado appliances, orange counter tops, and dark wood-paneled cabinets, going deeper into debt to fix it up would only worsen her predicament.

The reality is there are more pressing uses for our scarce resources right now than making our roads nicer. Once we rebuild our savings and start producing stuff again, then we can afford to remodel. Until then we need the government to get out of the way and allow market forces to reallocate resources, including labor.

If that means people are going to lose jobs in the service and financial sectors, it is a sacrifice we must make. Human resources should be allocated where they are productive and contribute to a strong economy that benefits everybody. Nobody wants to see people out of work, but which is more humane: 5 million unemployed today, or 10 million unemployed a few years from now? In my view, that is the choice we face.

Lost in translation, of course, is that we do not want jobs merely to keep ourselves busy, but for the purchasing power that working at a job creates. But nonproductive government jobs, or private sector jobs subsidized by government money, confer limited purchasing power to workers; in the end we may all be employed but have little to show for our efforts.

I fear that government spending on the scale being contemplated will change the character of our economy by moving us in the direction of central planning. That is the opposite of free-market capitalism. Our economy needs to be restructured from the foundation up to regain the viability it had when profit-minded people were making the important decisions and the United States was becoming the world's leading industrial power.

Yet what the government is about to do is spend massive amounts of taxpayer money to reflate a consumer-driven bubble economy. Its objective is to get consumers using credit again, to go back to the malls, to buy more cars, to carry more credit cards, and to take out more student loans. But buying stuff we couldn't afford with money we didn't have was what got us into this fix. We've consumed too much and have more than we need, and until we stop consuming and start saving and producing, our economy will never enjoy a real recovery.

Get credit flowing again? There's nothing to flow. The banks blew their money on bad loans. That money is gone. The only way we can restore our banking system is with savings. To get from here to there, we have to allow a lot of banks to fail. We can't just print money and tell banks to lend it out. There is no productivity associated with that.

It also appears that first on the agenda of Treasury Secretary Timothy Geithner is to revitalize the market for asset-backed securities. He wants to help Wall Street securitize more consumer debt (mortgages, credit cards, and auto and student loans) and sell it to leveraged hedge funds and overseas investors. In other words, he wants to re-create the very conditions that brought our economy to the brink. Rather then encouraging American borrowers to once again tap the savings of foreigners, we should allow our domestic pool of savings to be replenished. The main reason securitization flourished in the first place was that after we depleted our own savings, securitization was the best way to gain access to everyone else's. But since the money financed consumption, we simply lack the productive capacity to pay it back.

President Obama says if we don't act quickly on a rescue plan, we're in for a catastrophe. I say if we *do* intervene we're in for a bigger catastrophe, which, in a worst-case scenario, means a repeat of the Great Depression, this time with hyperinflation

instead of deflation. In short, the government is about to pour gasoline on the wildfire it set.

The Hoover/Roosevelt and Bush/Obama Analogy

It's nearly everybody's understanding that the Great Depression was caused by Herbert Hoover's inaction and cured by Franklin D. Roosevelt's New Deal intervention. That enduring misconception is used all the time to support the argument that an impending depression can be averted by New Deal–type programs. The fact is that both men were interventionists, FDR more so than Hoover, but in different ways. Hoover, caricatured as the capitalist from central casting, actually distrusted free markets and favored government planning, although within strict constitutional limits. Roosevelt railed about what he saw as the abuses of capitalism and favored big government operating in experimental ways to achieve progress, even if it meant abandoning constitutional orthodoxy at times.

The asset bubble we know as the Roaring Twenties that ended with the Crash of 1929 was the result of an easy money policy not unlike the one that has led to our present crisis.

In dealing with the Crash, Hoover, far from inactive, intervened in major ways but made mistakes—ordering wages up when they wanted to go down; raising taxes when the public couldn't afford them—that turned what should have been a stock market correction, albeit a major one, into the start of an economic depression.

Roosevelt, elected in 1932, inherited the depression and proceeded to create a panoply of regulatory, relief, and aid agencies, some of which worked and some of which didn't, but in general contributed to an environment characterized by unpredictability and antibusiness bias that discouraged private investment and kept the depression going until the end of the decade.

The "depression within a depression" in 1937 was followed by heavy government spending preparatory to World War II, causing an upswing in the economy that continued when the wartime economy began in 1941.

Bottom line: When it comes to the New Deal as an antidote to depression, I ain't buying.

The Impact Abroad of the United States' Economic Problems

I am absolutely unshaken in my conviction that foreign producing economies, such as China, Japan, and other Asian and European exporters, will eventually decouple—that is, stop subsidizing U.S. consumption and begin producing for themselves. I have always said, however, that it wouldn't happen overnight. The recent rally in the dollar, something I'll get into in a later chapter update, resulted from foreign governments and investors seeking the perceived safety of U.S. Treasury securities. Here we are, virtually bankrupt and preparing to print or borrow trillions more dollars to jump-start a car clearly headed for a cliff. Yet countries with fundamentally strong economies and with trade and budget surpluses put their money here because they want to keep it safe and because they still think our consumption is vital to their economies. So their initial reaction is to prop up our economy and our currency. By doing so, they are preventing complete decoupling, because they are preventing our purchasing power from being transferred abroad. This will be the case as long as foreign central banks keep intervening to buy up dollars and keep currency pegs in effect.

They are only hurting themselves. In effect, Americans are not spending because they are out of dollars, and foreigners are not spending because they are hoarding dollars.

Financially, of course, the foreign economies are hurting. When the largest consumer and borrower goes broke, obviously suppliers and lenders are going to feel it. But ultimately they will be better off without a customer that requires vendor financing, the extended payment time a commercial seller gives a buyer that can't pay its bills. The credit crunch is global because they lent us money we can't repay and now we're asking to borrow more. Our borrowing needs are crowding out investment all over the world. And every time we pass another stimulus bill, we up the ante. So it's not the collapse of the American economy that is crippling the rest of the world, but the huge cost of trying to prop it up.

But how much longer will the rest of the world suffer to subsidize the United States? It's absolutely unarguable that they, not we, are the engine of economic growth. We are the caboose that's keeping the train from getting up to speed. As Abe Lincoln said: "It is true you may fool all of the people some of the time; you can even fool some of the people all of the time; but you can't fool all of the people all the time."