

# Overview of the financial crisis

By Daan Joubert

## Part 1

### Some of the real reasons why it developed

#### Introduction

"So long as risk is effectively concealed from borrowers and lenders or actually shifted to others, risk-taking will be excessive. The initial phase of excessive risk-taking will manifest itself as an economic boom, but eventually, when actual losses begin to change the perceptions of borrowers and lenders and begin to impinge upon unsuspecting others, the boom will give way to a bust....[A] market system whose credit markets involve risks that are partially concealed from the lender and partially shifted to others will be biased in the direction of excessive risk-taking. And excessive risks are converted in time into excessive losses."(1)

"But the real problem is sowing the seeds of long-term, sustainable, organic economic growth. This is really the crux of the policy challenge. The United States in the midst of the worst economic downturn in 80 years as the result of a panoply of extremely poor economic policy choices. Economist Roger W. Garrison draws an important distinction between "healthy economic growth, which is saving-induced (and hence sustainable), and artificial booms, which are policy-induced (and hence unsustainable)."(2) In other words, monetary policy that kept interest rates low for an extended

period of time, tax policy that favored debt over equity, regulatory policy that allowed financial institutions to operate opaquely, and social policy that pushed home ownership regardless of affordability, all combined to create artificial economic demand that could only be financed with debt because the savings (i.e. equity) to purchase them did not exist.” (3)

(These quotes are from “Reality Bites”, by Michael Lewitt. See [Time and Money: The Macroeconomic of Capital Structure](#) (New York: Routledge, 2001), Roger Garrison pp 11, 120 and 56 resp. )

*Quoted from Bloomberg 3-06-09:*

*Volcker, who ran the Fed from 1979 to 1987, said the financial industry’s problems stem from larger issues. “I don’t think this is just a technical problem, it’s a societal problem,” he said. He cited bankers on Wall Street receiving multimillion-dollar bonuses for engineering failed mergers.*

*“There’s something wrong with the system,” Volcker said. “What are the incentives, what’s going on here?”*

*Any effort that has self-glorification as its final endpoint is bound to end in disaster. Robert M. Pirsig (Author of “Zen and the art of motorcycle maintenance”).*

Much has been written about the current crisis and why it erupted. Most of the popular diagnoses, I believe, are well wide of the mark, because the focus of the search is on the visible symptoms of the real cause, rather than the true societal pathology that underlies the problem.

The above quotations come closer to the crux of the matter, the real reasons why a financial and economic crisis developed in the US, than the attempts so far to find scapegoats, with banks and other financial institutions high on the list of culprits. Similarly, the measures being sought and now implemented to prevent a repetition of the crisis treat symptoms and not the underlying causative factors. These cures will prove to be expensive and increasingly restrictive and, of course, futile over the longer term.

The decades leading up to the start of the crisis saw an increasingly raunchy orgy of debt and risk taking, within an official climate that purposefully nurtured the pursuit of risk and the taking on of ever more debt by all parties in the economy. More recently, during the later 90's the situation worsened when an even more debilitating climate was promoted by a president who saw self-glorification as a high priority, with little regard for the longer term consequences of his policies.

This first part of a three-part essay deals with reasons why the crisis did develop – reasons that are more fundamental to the problem than greedy banks and other financial institutions, the culprits which Congress appears to be favouring. In the second part, the more immediate causes are examined. Finally, in the third part, the main theme is how an unintended consequence of official meddling with CPI statistics is creating more severe problems that lie just over the time horizon. At the same time, this meddling has resulted in a situation where current attempts to forge a recovery in the US economy are almost certainly doomed to failure.

An analogy

The search – official and in the media – for who is primarily responsible for the crisis reminds of the story in which some cruising cops spotted a gentleman in evening dress, after midnight, walking around below a street light, bent over as if searching the ground. On being asked whether he had a problem, he said, “I have lost the keys to my car.” As one would expect, the officers joined him in the search. After a minute or two without success, one cop asked the man whether he had any idea where approximately he had lost the keys.

“Yes”, he said. “Down that lane, not far from the entrance to the social club.”

Amazed, the same officer asked, “But then why search here, far from where you have lost the keys?”

“Because the club is closed and now it is far too dark there.”, came his response.

The subject of this essay is to hazard an analysis of the true causes of the current crisis, searching in the murky past where these lie, not those reasons that appear obvious to the authorities, much of academia and the media. When one considers the ongoing search for scapegoats, it is clear why the analogy comes to mind. In similar fashion, the solutions being implemented, again, take the easy way out – casting money at anything that moves – rather than determining what has really gone fundamentally wrong and then effectively dealing with the true reasons for the crisis. Voices, like Volcker’s, that pointed this out, have been ignored.

Early in 2009, LEAP2020, the European think tank, with a history of accurately anticipating the development of this crisis, brought out a report in which they saw a bleak 2009:

[http://www.leap2020.eu/4th-quarter-2009-Beginning-of-Phase-5-of-the-global-systemic-crisis-phase-of-global-geopolitical-dislocation\\_a2805.html](http://www.leap2020.eu/4th-quarter-2009-Beginning-of-Phase-5-of-the-global-systemic-crisis-phase-of-global-geopolitical-dislocation_a2805.html)

*Back in February 2006, LEAP/E2020 estimated that the global systemic crisis would unfold in 4 main structural phases: trigger, acceleration, impact and decanting phases. This process enabled us to properly anticipate events until now. However our team has now come to the conclusion that, due to the global leaders' incapacity to fully realise the scope of the ongoing crisis (made obvious by their determination to cure the consequences rather than the causes of this crisis), the global systemic crisis will enter a fifth phase in the fourth quarter of 2009, a phase of global geopolitical dislocation*

The geopolitical dislocation they foresaw is not yet openly visible, but various analyses do point to increasing strain in international relations – some of it arising from a dollar under stress, despite its volatility and recent strength. Their ongoing analysis however does illustrate that the crisis was not completely unforeseen by objective observers.

In an open letter to the March 2009 G20 meeting, they warned US authorities that they have two alternatives; either they admit the (true) reasons for the crisis and suffer through 5 bad years while the situation is properly resolved, or they refuse to do so and merely treat the symptoms,

in which case it would expose the US to a full decade of real economic misery.

The latter option is of course the alternative that is being implemented. Political expediency demands that a choice between say two years of apparent recovery followed by a decade of misery on the one hand and up to five years of 'biting the bullet' right now is no choice; the "it won't happen on my shift" rule applies.

Digging out the roots of the problem

The root of the problem situation may well be found in a change in the culture of the US since WWII, a change that has spilled over to many western countries. Since time immemorial, the requirements of society were always deemed to be of paramount priority, of greater importance than whatever were the demands and even the rights of the individual. It was taken for granted under long established societal rules and norms that the individual was subservient to the needs of the society in which he lived and in order to be considered a valued member of that society he had to conform closely to what was deemed acceptable behaviour.

For a long time, the pace of change within society was slow, with the majority of people living essentially in much the same fashion year in and year out; within a circle of family, friends and colleagues that changed little over time. People lived frugal lives, largely content with their shared circumstances and willing to spend years saving for the more important material things, a motor car or a home. Debt was seen as an abomination and avoided as much as possible.

When boom and bust economies developed, as they did even then, the man on the street was less affected in a lasting way than the moneyed classes, those who were primarily responsible for the boom and bust and suffered relatively more.

In the decades following WWII this all changed quite drastically; the pace of life speeded up substantially and greater mobility and urbanisation brought a large proportion of the population out of their original, often nurturing, environments to live among relative strangers, frequently with different norms and values.

The many reasons for these changes and their specific nature are well outside the scope of this essay. But life in general changed dramatically between the 1940's and the 1970's, extending into the 1990's and beyond. During this early period, the middle classes expanded and grew materially and financially wealthy in the US (and also in other industrialised countries) – which is one of the factors that proved fertile for the developments that eventually culminated in this crisis.

Expectations in the population changed; traditional willingness to save, often for years, in anticipation of the purchase of some desired and expensive good, was replaced by a growing, for many over-powering, desire for instant gratification.

A major element in this process is the pervasiveness and intensity of a new world view in which one is primarily predicated to “Look after Number One, even at the expense of all the faceless others’ in society”. Widespread self-centeredness negated the by now outdated view that society's norms and

rules and even laws mattered and had to be obeyed to be considered a 'good' member of society. In this new morality, one was free to pursue selfish interests with practically no constraints – the only 'Law' that mattered was that one should be caught out.

In particular, this view flourished among politicians as a class. Whether it was a change or whether this has always been so and simply became more obvious in recent times is not clear. H.L. Mencken, quoted below, had an opinion on this.

We proceed with more relevant and pertinent discussion of reasons for the crisis without further elaboration on this philosophical theme, except to repeat that the US may have been the breeding ground of this new morality, but this philosophy was greedily accepted as a new norm by other countries around the world.

Volcker's "societal problem" has become a global plague.

Politics and policy

*"Man is by nature a political animal." Aristotle*

*A good politician under democracy is quite as unthinkable as an honest burglar - H.L. Mencken*

Politics have been said 'to be the art of the possible'. The implication is politicians – in pursuit of the common good – ought to select the best possible compromise between many conflicting yet desirable alternatives, none of which may be fully achievable for various reasons.

The problem with political power is that it is so easy to forget 'best compromise' has to be measured against the 'public good' – a true compromise, intended to benefit the most people in the best way; not decisions that are slanted to favour the interest of the politician or of his cronies. When, not if, that happens, politics become a game of self-glorification and self-enrichment, with a high priority for the goal of being re-elected to the position of power; something that inevitably results in poor government practice. Politicians soon find it lucrative to dispense unearned largesse to voters – symptomatic of democracy as a dictatorship of the majority, to which even a constituted Republic is not immune.

This was the situation that faced president Clinton early in his first term in office – how to improve his chances for re-election. He rode into the White House on the mantra of, "It's the economy, stupid!", thereby preventing Bush senior from enjoying a second term. He feared the same destiny might befall him unless he could make sure voters went to the polls in 1996 on a high, upbeat because the economy was in full swing again.

Circumstantial evidence makes it is clear that he was scared to leave the economy to the vicissitudes of the markets as that would be taking undue risk, Clinton thus brought in experts to engineer an economic boom. As the overall coordinator for his plans he called on Bob Rubin, CEO of Goldman Sachs (no surprise, surely!). He also brought Greenspan onto his close-knit team; Alan Greenspan, as Chairman of the Federal Reserve, was essential if Clinton's plans were to succeed.

Central features of the re-election strategy that unfolded during the mid 1990's and that would present Clinton as one of the great presidents of the post WWII era, included:

- The economy had to receive a boost through consumer spending. With the growing 'export' of US manufacturing plants to where labour was cheap (initially Mexico and the Philippines, later east Asia and China) Clinton's push for globalisation meant that consumer spending had to expand to take up the slack in GDP caused by this trend. People had to be enticed to spend and spend, even if they had to borrow more to do so, so that the consumer-driven economy would grow. This in turn necessitated high growth in the money supply, which action carried threats, of inflation in particular, but also of asset bubbles. The latter, of course, would be an advantage, since the resulting 'wealth effect' would have people spending even more
- Since the late 1950's, US households had been increasing their borrowings at a faster rate than the increase in their disposable income ("The story of a bubble and its aftermath" [Joubert 1999](#)). By late 1994 the situation needed lower interest rates to make additional debt affordable and attractive as a means to enjoy a good standard of living. The yield on the US Treasury 10 year note declined from 8% late in 1994 to 4.5% in 1998, enabling increased consumer spending primarily by taking on more debt. The booming hi-tech bubbles and an improving property market inspired a wealth effect that made it easy to take on more debt in order to satisfy demand for all the good things life had to offer. The Reagan administration had also set an example of 'debt does not matter' through its profligate budget deficits

of the 1980's; an example eagerly followed by American households keen to keep up with the latest in all kinds of consumer goods and services

- Low interest rates and the greater use of credit traditionally trigger higher inflation. A high rate of inflation would be bad for the dollar; this in turn would also require an increase in the interest rate. Clinton did not want an inflation threat to develop, as the cure would be counter productive for his objectives, even though he intended to do exactly the things which would fuel higher inflation. The Boskins Commission, after examining the way CPI is calculated, came up with the right solution to this problem – a new method of calculation that resulted in a substantially reduced value for the official CPI by comparison with the methods used previously
- Low inflation would be positive for the dollar, but low interest rates might see money departing the US in search of higher rates. Therefore the dollar had to remain strong, so that investors, foreigners (Asians) in particular, would keep on investing in the US. A sustained inflow of investments was needed to balance the trade deficit that was becoming systemic as more of US manufacturing departed for foreign shores. Therefore an integral part of Clinton's strategy was frequent repetition by key officials of the mantra that the US had a "Strong Dollar Policy". This had the advantage that it helped to keep attention off the growing money supply
- Giving teeth to the 'Strong Dollar' mantra, the new strategy incorporated something Volcker, previous Chairman of the Federal Reserve, said when talking about his battle to reduce inflation and stabilize the economy, back in the late 1970's. He was quoted as

saying his biggest mistake at the time was the he failed to control the price of gold. Clinton's team did not make the same mistake. In February of 1996 they launched an outright assault on the gold price, at the time primarily through a 'Gold Carry' trade. The gold price kicked above \$400/oz in January 1996, following an extended sideways trend. However, its stay above \$400 was very brief. The new bull market reversed and the subsequent decline lasted four years, reaching bottom at \$252 late in 1999 and making a second bottom in 2001. During this period the dollar gained more than 30% against the euro. The strong dollar policy worked very well indeed

- The contribution made to the economy by manufacturing was declining as factories were being 'exported' to other countries. Increased debt-funded consumer spending made up for the loss, but it was seen as advantageous if other sectors of the economy could improve their contribution to GDP. The boom in a number of US markets was just the right time to stimulate the financial sector by relaxing constraints that were imposed on banks and other financial institutions after the Great Depression of the 1930's, in order to prevent a repeat of the excesses that caused that calamity. Today we are reaping the whirlwind that sown by these actions

Clinton's strategy worked well and he was re-elected. Helped by high tax income from the booming late 90's and by using all the excess money flowing into the Social Security system as cash in hand for the government, Clinton could even claim he had balanced the Federal budget and that all was well with government finances; including that the National Debt would be paid off soon.

Of course, a balanced budget paid for with Social Security contributions was a sham. The National Debt later exploded when the Bush administration found Clinton's strategy so successful and enticing that they took it over lock stock and barrel. Then 9/11 changed the ball game and loosened any remaining constraints on the Federal budget. Growth in the US National Debt accelerated into a higher gear and the money spigots too were opened to promote a 'borrow and spend' climate among US households. For Bush, these difficult years made it even more imperative to abide by the Clinton doctrine; consumers had to be convinced to keep on borrowing and spending; heaven forbid that they would start paying off debt and, even worse, begin to save.

Any criticism of these policies brought the counter-argument that central bank gurus, with Greenspan pre-eminent among them, had over the years become so adept at fine-tuning the economy that the risk of anything serious going wrong was receding rapidly. By the 90's the gurus knew so much more than the folks of the 1920's or even the 1980's that a repeat of the 1930's mess or the October 1987 Panic was unthinkable. Hubris ascendant.

As we know now, this assumption was incorrect; the gurus had failed to learn from history, which was a very silly thing to do, with devastating consequences. In Part 2 we take a closer look at the real reasons for the crisis and in Part 3 we learn why the odds of a successful economic recovery through the current Obama intervention are quite low. The opposite is more likely to happen – a severe, traumatic double dip.

[To be continued in "Overview of the crisis - Part 2" ]

Part II © January **Overview of the crisis**

Deregulation, Hubris and Globalization

*“There needs to be a shift in ethics on Wall street”. Barack Obama*

*Capitalism should not be condemned, since we haven't had capitalism –  
Ron Paul*

*“The bail-out of Fannie Mae and Freddie Mac by the combined forces of the US Treasury and the Federal Reserve Board is the ugliest exercise of its kind I have ever observed outside early transition economies and mature banana republics.”- Professor Willem Buiter, London School of Economics*

**Herb Stein’s Law, “If something cannot continue indefinitely, it will stop”**

**Giving the financial sector free rein**

The last item under the Clinton strategy mentioned in Part 1 was that constraints which had been put in place after the Great Depression were removed in order to enable the financial sector to grow and expand its activities – as can be expected, much of this reprieve was reward for campaign contributions and other support. A close symbiotic relationship between the Capitol and Wall Street has existed for a long time. Coupled to the ‘free for all, anything goes’ climate that had taken full hold by the later

90's, this freedom to act almost as one wished with reduced, or no oversight, resulted in a financial licentiousness that became the proximate cause of the ongoing crisis.

The financial sector is not the only part of the economy to gain benefit from such changes in policy that directly or indirectly promoted economic growth, in many cases irrespective of consequences – such as allowing resource exploration in wildlife areas – but it serves as an example of what was done on a wider scale. A necessarily brief overview follows.

### Glass-Steagall

In 1994, during the first Clinton administration, CitiBank was given a waiver so that it could merge with Travelers Insurance Corporation, in clear violation of the Glass-Steagall Act of 1933. By putting up firewalls between pure banking and other financial functions, the G-S Act was intended to prevent risky excesses by large multi-functional financial institutions that become 'too large to fail'; a factor that played a major role to deepen the Great Depression and is again relevant.

In 1998, the Gramm–Leach-Bliley Act completely removed the Glass-Steagall Act off the law books, thus to legalize a merger of multiple financial functions in one institution. The door for many more cross-financial-sector mergers was opened to result, among others, in the expanded CitiGroup and the mergers of Bank of America with Nations Bank, and JP Morgan with Chase Manhattan. The effect of the GLB Act resulted in, "*Such mergers have rapidly increased national concentration of banking assets in*

*the ten largest banking companies.” [Bank Mergers in a Deregulated Environment – Bernard Shull, Gerald A. Hanweck]*

Since 1998, these bank holding companies became diversified across financial sectors, most with assets in the \$100-200 billion range and up, which meant they became too-large-to-fail; with near disastrous consequences, as we now know.

Concentration of assets in a few major institutions and the ‘synergy’ of having different financial functions under one roof, brought great profits (and bonuses) and enabled all manner of innovative financial strategies and instruments. Over time, as nothing untoward happened to shock the markets, increased exposure to risk became acceptable and resulted in similar conditions that had contributed to the Great Depression. Institutions with similar risk profiles became increasingly vulnerable to discontinuities that would ripple through the whole system

Surely, the looming and growing risk was not unknown to various authorities; but then, the prevalent wisdom was that one could always rely on derivatives to diversify away the risk. Even more so, by the late 90’s hubris was rife among central banks; financial oversight authorities, the media and investors perceived these entities as if they has become near infallible when required to deal with any crisis that may rear its head, including the risk of inflation.

This belief was cemented when the sudden collapse of SE Asian economies in the late 90’s came as a nasty surprise, yet was quite brief, soon resolved and largely contained to the region by measures taken by

the IMF and central banks. This success made it clear that the gurus were able to live up to the confidence placed in them and it became accepted wisdom that the central banks had learnt exactly how to manage an economy – even to heal one when it did experience problems.

Secondly, no-one could conceivably imagine something like what struck in SE Asia ever happening in America.

An overblown belief in the ability of central banks to control inflation, and, by extension, mitigate the effects of deregulation and with recent evidence of how rapidly a major crisis could be defused, blinded career politicians for the risks they were unleashing and left them unprepared for the consequences.

## Globalisation

Over-eager pursuit of the advantages of globalised trade is another example of how short-sighted policy could be. The probable objective was to import from countries with low labour costs in order to counteract inflation. However, among other changes, it brought about *en masse* export of US manufacturing to countries with cheap labour, many of them in Asia, China in particular. At the time, this may have been seen as a 'good' thing; the cost of consumer goods fell steeply, helping to contain inflation – which was still the bugbear of politicians after the experience of the 70's; also the Achilles heel of the Clinton Strong Dollar policy.

In a national economy it makes sense to let economic activities migrate to regions where these activities can be performed most effectively, given sufficient infra-structure to distribute the products to their markets easily

and cost-effectively. 'Nationalised trade' works because just a single currency is involved, while the workers can move to where work is relatively easily obtainable.

When different currencies are in play, as it is in globalised trade, major problems arise when bi-directional funds flows between two countries that trade heavily with each other are consistently uneven. Changes within a national economy, such as when one region blooms while another withers, are accommodated by demographical changes; people migrate to pursue better job opportunities. This has no effect on the currency, only on regional economies within the country.

However, as American corporations moved their manufacturing and purchasing activities to Asia (China largely), laid off American workers could not emigrate in order to look for jobs in these new centres of economic activity. America also suffered a massive net outflow of dollars as it imported goods manufactured in US-owned factories located outside its borders. Job losses and ever increasing trade deficits became the rule, not as a temporary aberration, but with mounting and persistent negative effects for the whole of the US economy. Combined with regular, growing Federal budget deficits, these trends made the US substantially more vulnerable to concealed threats developing within its financial system.

As a consequence of the above, there was even more policy pressure to achieve increased growth in the services sector, financial services in particular. Greater latitude was given to financial institutions to experiment with and introduce ever more complex yet unregulated financial products. America had changed from being the manufacturing power-house of the

world to one where shifting paper money around had become a major activity. Any expectations that the export of services, knowledge and the results of innovation might balance the import cost of foreign manufactured goods, were of course disappointed. The trade deficit is a permanent fact of US economic life and can no longer be easily reversed.

Again, surely it must have been known in advance to US authorities that these disadvantages and risks would result from the pursuit of a global trade policy, yet they did not heed any warnings that may have been voiced. In this respect Herb Stein's Law again comes to mind. A situation that will inevitably result in persistent trade deficits is clearly one that cannot be sustained indefinitely and it is equally clear that when it has to stop the effects will be both widespread and probably near catastrophic for the deficit economy. Which implies the authorities apparently were either unaware of Stein's Law as it applies to trade deficits, or it was believed that the effects could be managed and neutralised. A cynic might say the people responsible knew they would no longer be around when the Law kicked in and foreign import trade effectively came to a halt.

The results of this hubris, both with respect to matters internal to the US and in its international relations, have become deeply problematic at best and may still prove to be catastrophic.

### Sarbanes-Oxley

Earlier mishaps, well before the crisis itself, when some enterprises became over-keen in their pursuit of profit, to result in the demise of Enron, WorldCom and, by contagion, Arthur Andersen, resulted in the Sarbanes-

Oxley Act. President Bush said it was, "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt." As later events were to prove, he was very wide of the mark; the financial conglomerates were hardly affected at all by the new law; they continued on their merry way, finding all manner of loopholes to keep on enjoying ever increasing profits and larger bonuses.

Despite presidential praise, closer auditor scrutiny and assignment of even more responsibility to the Board and management, Sarbanes-Oxley was circumvented by introducing new mechanisms to hold and value the rapidly growing volume of derivatives, including the establishment of off-balance sheet entities to conceal the amount of risk that had been taken on. In this, they were abetted by gullible rating agencies (?) that had no qualms in rating complete junk as AAA, provided that enough statistics could be invoked to obfuscate the situation.

Further, instead that derivatives diversified risk away, as believed by Greenspan, they obscured the degree and amount of real risk that was being carried on and off the balance sheets of large financial institutions. It seemed that no authority was concerned about the extreme vulnerability of these inter-linked institutions to a major shock that would avalanche through the complex network of counter-parties involving all major US banks and many other institutions.

Further, the introduction of credit default swaps (CDS), instruments intended to insure securities against default, resulted in a concentration of risk in a few large writers of CDS's. To compound this absurdity – and the overall amount of risk – one could even purchase CDS 'insurance' against

default of debt that one did not in fact own. In this sense, the CDS market inevitably became the largest legalized gambling and betting system in the US, if not the world.

Then, in 2004, with Hank Paulson as a primary advocate pleading their case, the Wall Street investment banks received permission from Congress to substantially reduce their capital adequacy, thus allowing their gearing to increase more than 3-fold. No wonder Wall Street bonuses subsequently increased to record levels. Yet, this lapse by Congress contributed substantially to the devastation suffered by the New York banks. It is ironic that as the crisis hit, Paulson initially played a key role as the saviour of these self-same banks he had prepared for slaughter.

Also refer to an article in the Washington Post (October 2008); it tells how less restrictive regulations, as a matter of official policy, contributed to the severity of the crisis.

[http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343_pf.html)

One wonders what other unintended consequences may still arise from what the government has done since the start of the crisis, 'to solve the problem', and the other solutions still to be implemented as the early attempts fail to work.

Obama, Geithner and Bernanke have executed a 'quick fix' of the crisis, printing money in large enough quantities to paper over the black holes that a derivatives melt-down has left in the balance sheets of the banks and other large institutions. However, treating mainly the effects of the problem

disregards the real causes of the crisis and is surely not a recipe for long term success.

A moral morass

A book can be written about the way American politicians in particular exploited taxpayers and raped the economy for near-term political gain – very pertinently so since 1994 when Clinton realised he had to do something drastic to prime the economy if he wanted to be re-elected. It would surprise if the above quite gross – in both senses of the word – examples not representative of the complete style of government that the US had to suffer from since at least the early 1990's and which by all appearances are still continuing.

The shortsightedness of politicians and their advisors in their pursuit of personal near term goals speaks of criminal negligence for the consequences that are now beginning to be experienced. It would further appear that 'morality' and 'ethics' are no more than mere words in a dictionary as far as the majority of US political leadership is concerned; the moral morass is perpetuated across administrations and expressed in their policies.

We will visit Clinton and the effects of his policy changes again in Part 3 to find a further example of the Law of Unintended Consequences.

Other measures that have similar intent to the examples mentioned above, were introduced; the combined effect was reduced regulation, less effective oversight and greater freedom for financial giants to make use of new and risky strategies in pursuit of more profits and bigger bonuses. GDP grew

through a combination of debt-funded spending by all participants in the economy and increased paper shuffling by the financial giants. The latter abused their greater freedom to come up with new and risky financial instruments; the greater profits these provided meant they could afford larger bonuses for management and more substantial contributions to political war chests; a win-win situation for corporates and the politicians.

Other sectors than the financial, such as oil and mineral exploration, mining and lumber, also obtained benefits from relaxed regulatory and other restrictions.

These changes fermented a climate of rampant abuse of institutional and private investor trust, with a disregard for prudence that has since brought many banks and other large financial entities to the brink of disaster; perhaps into free fall, were it not for the waiver that they could value the toxic assets on their balance sheets at will, no longer according to mark to market.

Yet, popular media seemed to paint an increasingly rosy picture of the situation, taking official pronouncements at face value and not digging deeper to ascertain the true facts – such as the real effect on profits and on financial statements of the mark-to-market waiver, which are allowing the banks to act like those applicants for mortgages during the ‘good old days’ who gave false personal information, if they provided any at all. Allowing this was profitable for the mortgage brokers and their banking sponsors, but we now know the havoc that it caused.

One wonders what the unintended consequences will be of allowing the banks to effectively choose whichever valuation of these assets best suits their books. Will it be a repeat, on a much grander scale, of what happened to liar mortgages?

Intermediate conclusion; the current situation

It is almost certain that after more than two years of the crisis the end is not yet in sight; many more tax-payer dollars will be pumped into the near bottom-less pit of a collapsing economy before it is realised that while symptoms may have been treated and the crisis temporarily neutralised, there is little permanent success; the disease still lingers. While the true causes of the problems remain unchanged and untreated, long term recovery for the US economy is most doubtful. In fact, since the cure that is being applied is intended to promote exactly the kind of consumer behaviour that had contributed so much to the whole crisis in the first place, a more severe downturn can be expected once the treatment loses effect.

The following points are relevant. Keep in mind the crisis did not result from one single cause, but lies at the confluence of various corporate and official practices, much which find their primary origin in changes in official policy; changes that brought focus to near term gains and advantages, at the price of increased longer term risk. These changes are considered to be a logical outcome of the climate of “Me first, at the expense of anyone else”, that has become so endemic.

The practice of “crony regulation”, or perhaps it should be “crony deregulation”, is one major factor that, since the mid 90’s, made it even

more feasible to take on excessive risk in the pursuit of profit; government was clearly on the side of the risk takers. The initial absence of any major financial crisis, or significant failure of a large financial institution, meant complacency became widespread. Natural fear of being vulnerable no longer had to be taken into consideration, because it became so easy to “diversify risk away”, both from the institution and from the market, through use of the fast growing volume of derivatives. Or so it was said.

The property bubble relied on a number of factors for its success: eagerly urged on by official and other measures to make it easy to purchase a home, criteria for writing mortgages became ever more lax, to include buyers who clearly would not be able to service them. Dispersing these toxic assets by means of derivatives, much of it to foreigners, was easy and profitable, given an appearance of low risk through flagrantly optimistic ratings for credit derivatives from the major rating agencies. The damage done by this to foreign confidence in US business practices and integrity may only become evident in time.

Enron, WorldCom and similar events were perceived as isolated occurrences, in full the result of misdeeds if not criminal acts by top management. These events did not in any way taint the overall perception of a safe, solid financial system in the US and did not raise any serious questions about the risks posed by bubble markets and a mountain of derivatives based on these.

Even so, events brought the lame-duck Sarbanes-Oxley Act onto the law books. Supposedly, corporate Boards and management were now

individually and also collectively at risk for the effect their decisions and actions have on shareholders.

The term 'lame-duck' for the S-O Act may strike some readers as excessive. They can easily counter-attack by listing how many Directors and CEO's of banks, have been charged under the S-O Act for what they have done. These people are responsible for the mess through blatantly poor but personally advantageous decision making and near criminal disregard for risk in the run up to and even during the current crisis, driven by pure greed. Perhaps, in time, class action suits from disgruntled shareholders may still remedy this lack of official reaction.

Politics and general policy symptomatic of widespread cronyism, lax regulation over more than a decade and the manipulation of official statistics – as we shall see in Part 3 – have all contributed to the crisis. Washington had a climate of pure complacency with respect to business practices and pursuit of risk, in which the desire for profit and bonus took precedence over both ethics and prudence.

This imprudent pursuit of risk by financial institutions is one aspect of the crisis for which a solution is now being sought. The introduction of new regulations and a promise of firmer oversight, with concomitant growth in the regulatory burdens of government, is supposed to close the door on too risky practices by the banks and others. However, the role of government in fomenting a climate in which greater risk-taking became a priority is glossed over. And history is bound to repeat itself when, as happened in the 90's with respect to 1930's constraints, fresh complacency again will result in relaxation of these new constraints.

In addition, also as recently happened, loopholes will be found to take on more risk in pursuit of improved profitability, so that top management can continue to earn the salaries and bonuses to which they have become accustomed.

A truly sustained and effective solution to the deficiencies in ethics, politics and policy that lie behind this crisis may forestall a repeat at some distant time, yet it will do little to resolve the continuation of the current crisis and the low odds for lasting success of the measures being implemented.

As first step to bring the economy back to health, it is essential for Congress to stick its collective hand into its own bosom and honestly admit its contributing role to what we are going through at the moment. Without them doing so, it will not be easy to find and implement an effective and permanent solution for the matters raised in this essay.

The reader can speculate about the odds of that really happening.

A matter of ethics and integrity

*“Anyone that wants the presidency so much that he'll spend two years organizing and campaigning for it is not to be trusted with the office.” David Broder*

In a broader sense, that applies to just about every senator and congressman

The following quotation – as the date shows – was from before the inauguration.

From NY Dailynews:

Thursday, December 18th 2008, 8:55 PM

Olson/Getty

Barack Obama

WASHINGTON – Barack Obama scolded Wall Street Thursday for a me-first mind-set that fed the financial meltdown - and held up financier Bernie Madoff as exhibit A for greed.

“There needs to be a shift in ethics on Wall street”, Obama said . . .

What about a shift of ethics in government?

How ethical is it to berate businessmen for the size of the bonuses they receive at corporations they have successfully managed for the year, while the members of Congress have voted themselves substantial pensions, often out of proportion to the time they had served in Congress; life-long pensions that has to paid by those self-same taxpayers they have served so poorly while in office?

The problem is that, paraphrasing integrity, ethics can not be imposed on you nor purchased by you; but it can be freely discarded as unwanted baggage.

Which is a point essentially made earlier in this essay; a “me first” attitude that brings with it little regard for the rights and well-being of others has not even a nodding acquaintance with ethics. However, it was not Wall Street

alone in their blind pursuit of the next dollar, ethics be damned, that lie behind the mess; the authorities and Congress, with their short sighted focus on near term personal advantage are as guilty. By osmosis the disregard for ethics is becoming endemic in segments of US culture where 'Look after Number One' is a primary directive.

Consider, as one example, the mortgage brokers who sold 'liar' mortgages as fast as they could, knowing exactly what they were doing and what would happen. Then they disappeared with massive windfall profits once the mortgage bubble burst. Unfortunately this is true not only of the US, but of many other countries too. When, in such a climate, control and oversight are lax and regulatory fences are lowered, the wolves get to the flock easily, with substantial damage to the whole system, as we see today.

Adding insult to injury when this happens, is the appointment of a wolf to clear up the mess he has made, with reference to Paulson and subsequently, Geithner, and Summers among others. No wonder the solutions being promoted are very similar to the kind of behaviour that contributed so much to the crisis.

As per the opening quotation in Part 1, for as long as US politicians primarily exploit the power they have in pursuit of self-glorification and the job security it brings, the next financial Armageddon is already waiting in the wings.

Some points are belaboured again and again in the first two parts of the essay – and gets noted again in Part 3. It is necessary to really bring home the fact that the authorities, acting within a climate of declining ethical, even

moral standards, are primarily responsible for the current mess. It is not the banks or the mortgage brokers and other parties that are primarily responsible; they simply exploited an opportunity given to them. How they did this did however place them in the same ethical “Me first and always” camp as the authorities.

Part 3 of this essay deals with ‘US households and penury.’ – a situation which is going to be a key stumbling block, if not barrier, towards an economic recovery in the US for a long time. This situation is a direct result of official policy.

### Overview of the financial crisis - Part 3

#### Part III The US is facing a sustained state of penury

*In my own simple terms, trees cannot grow in some unlimited manner to the sky. Families cannot grow debt without limit beyond the growth of their incomes. And countries have the same constraints. While growth of debt in the short term is viable, growth of debt faster than the growth of GDP is not viable over the long run. This is not debatable. It is a simple fact.- John Mauldin*

*“As goes General Motors, so goes America” – Anonymous (?)*

At first glance the use of 'penury' in this context might seem too harsh to many readers – and, if not, will America really follow the example set by GM?

Secondly, 'this simple fact', quoted from John Mauldin, is much more pithily set in Stein's Law, "*If something cannot continue indefinitely, it must stop.*", which applies to so much of what is covered in this essay So very simple, yes, yet what Mauldin views as unsustainable was apparently not understood by the majority of the economists who saw golden years ahead for the US, but failed to recognise that the economy had no solid foundation.

A rate of growth in household debt that is faster than the increase in disposable incomes, simply could not be sustained indefinitely, even with much help from what clearly had become a series of asset bubbles strongly promoted by the low interest rates and poor regulatory oversight. (See [Joubert 1999](#) for a very early warning regarding this 'simple fact'.)

Opinions of most economists consistently echoed public statements by politicians and officials on the rosy future that would last for a decade, if not longer, with not a hint of dark clouds on the economic horizon. It would appear these learned people were blinded either by the herd instinct, or perhaps by the ancient fear of what might happen to the messenger who brings bad news.

They failed the economy, they failed the people and they failed themselves.

In the first part of this essay, the focus was on self-aggrandising and self-serving behaviour of the politicians – behaviour that disregards the overall

good of the people in favour of parochial favours and naked self-interest; intended largely to curry favour with Big Money and to promote the chances of their re-election.

In pursuit of these selfish objectives, Congress did not hesitate to make changes to the law, often at the cost of the common good. They relaxed restrictions to ease the way to more profits for selected vested interests, certainly expecting payback through campaign contributions. To conceal what they were and still are doing, the government and its friends consistently use outright spin and misinformation in an all out attempt to keep voters unsuspecting, content and loyal.

As illustrated by what has been happening over many decades, more so in recent years, politicians, to achieve personal objectives, see nothing wrong in loading future generations with massive debt that in all probability can never be repaid, even if future wage earners sold themselves into taxation bondage.

As a generalisation, these people behave as if what they can gain for themselves in the present outweighs any future price, any future cost, by such a wide margin that what they do to their children and children's children is of no consequence. A simple guideline seem to apply; 'we take what we want; let the children pay'.

Plato would be horrified to observe this kind of mis-government!

Now we have the Obama Plan to 'solve the problem'. In a scandalous, continued effort to save the large banks, crony politics continue unabated, while the riches and inheritance of future generations are being spent on

what almost certainly is to be a futile attempt of 'throwing as much money as it takes' at any and all signs of trouble. One reason why this attempt will fail later concludes this essay.

As usual, the 'sheeple populace' are kept docile, because they react positively to statements such as 'we are acting vigorously to revive the economy, to prevent further financial heartache for you, the people', without realizing it is their tax money and that of their children that is being spent at a rate never seen before; with little result.

It is clearly unthinkable for the powers that be to pay the harsh political price by 'doing the right thing' and have the country submit to economic pain for their own mismanagement of the economy and for the excesses that resulted over the past two decades,. Each administration cannot accept they specifically should be the ones to suffer severe political penalties for the distressed financial system and the ruination of the economy brought about by earlier administrations.

Their predecessors took on too much debt, disregarded increasing risk, allowed financial supporters far too much leeway to do things 'their way'; and motivated consumers to fall deeply into debt; purely for their own personal advantage and improved odds of re-election. They instituted a hedonistic CPI policy, without a thought for the wider consequences this may bring – but perhaps they did know what would happen and just did not care.

Now the current wielders of political power are emulating exactly the behaviour of their predecessors, doing so in spades, by throwing unlimited

funds at all that moves in an attempt to rectify a calamity partly brought about by over-spending at all levels of society. If not solve the problem, they hope at least to keep the ship of state on even keel until the next election. These people do not hesitate in the least to adding another imponderable amount to the national debt, knowing that the children of today will have to try and repay in the course of time – if they can – as has become fixed habit in the Washington and other corridors of power.

However, as set out below, there is reason to believe we will before too much time has passed experience a financial and economic re-enactment of the Titanic.

Under the current strained circumstances, continued self-serving behaviour by the authorities will prove to be a major stumbling block in the way of the wished for US recovery. When an economy is strong, not merely reported to be such by official statistics, there is room for ill-considered behaviour by the authorities and some mis-allocation of resources, without dire consequences. When an economy is mired in survival mode, such behaviour at best indefinitely delays recovery, at worst topples the economy much deeper into longer-lasting depression.

The reader can ponder the possibility that the powers that be in Washington will change their ways. From what is happening within the Obama-plan, the odds for this look slim. Very slim indeed.

US Households in penury

*Penury: a cramping and oppressive lack of resources (as money) ; especially : severe poverty. [www.merriam-webster.com](http://www.merriam-webster.com)*

*"The road to tyranny, we must never forget, begins with the destruction of the truth."- Bill Clinton*

A word from him who knows. President Clinton during his two terms added a number of new concepts to the American and, indeed, the global scene. These do not have to be elaborated on; a number of them have even entered every-day speech. There is however another legacy of his that played a significant role in the development of the current financial crisis – it is also the primary reason why the efforts of Hank Paulson and those of Tim Geithner, as well as many measures announced by president Obama, can be expected to offer no long term solution to the crisis. And, in fact, may come to worsen the situation beyond belief.

As described earlier in Part 1, by 1994 Clinton realised that the economy was not speeding up at a rate fast enough to ensure his re-election in 1996. To address the problem, he brought Bob Rubin in from Goldman-Sachs (déjà vu?) as Secretary of the Treasury. In due course, with help from Fed Chairman Alan Greenspan (perhaps with an own agenda – [Joubert 2002](#)) the team implemented an array of measures to achieve Clinton's objective. These have already been discussed.

A low inflation was central to the strategy and, via the Boskins commission, the necessary was achieved to ensure the official CPI be low enough to meet their requirements. This was a big mistake.

A low GDP offered them a number of advantages. Primarily, since nominal GDP is deflated by the CPI, a low CPI will deliver better official than actual

growth in the economy, thus boosting Clinton's chances come re-election time.

Low inflation made low interest rates possible; this in turn promoted borrowing and spending by consumers, which was another essential factor in the strategy.

Thirdly, low inflation meant the government could get by with small increases in entitlements that would greatly assist Clinton's ideal of the first balanced budget in two decades.

Various measures were introduced to result in a lower CPI than was previously calculated. The table below shows the effect of these measures of which the first was introduced as long ago as 1981, but picking up speed under Clinton.

Estimated CPI adjustment factors to bring it back to reflecting reality

Amount, As of cumulative date	Source data	A more conservative amount
+1.0%	1982 <a href="#">Homeowner's equivalent rent, BLS</a>	+1.0%
+1.5%	1993 <a href="#">Hedonics, BLS</a>	+1.5%
+2.5%	1997 <a href="#">Boskin Commission Report</a> results	+2.5%
+3.5%	2001 <a href="#">Hedonics, BLS</a>	+3.0%
+4.0%	2004 <a href="#">Hedonics, BLS</a>	+3.0%
+4.5%	2005 <a href="#">Hedonics, BLS</a>	+3.5%
+5.0%	2006 <a href="#">Hedonics, BLS</a>	+4.0%
+6-6.5%	2007 <a href="#">Hedonics, BLS</a>	+4.5%

(Credit and kudos to John Williams at [Shadow Statistics](#))

The table from [http://www.nowandfutures.com/cpi\\_lie.html](http://www.nowandfutures.com/cpi_lie.html)

The chart below shows the effect of these interventions in the CPI calculation.

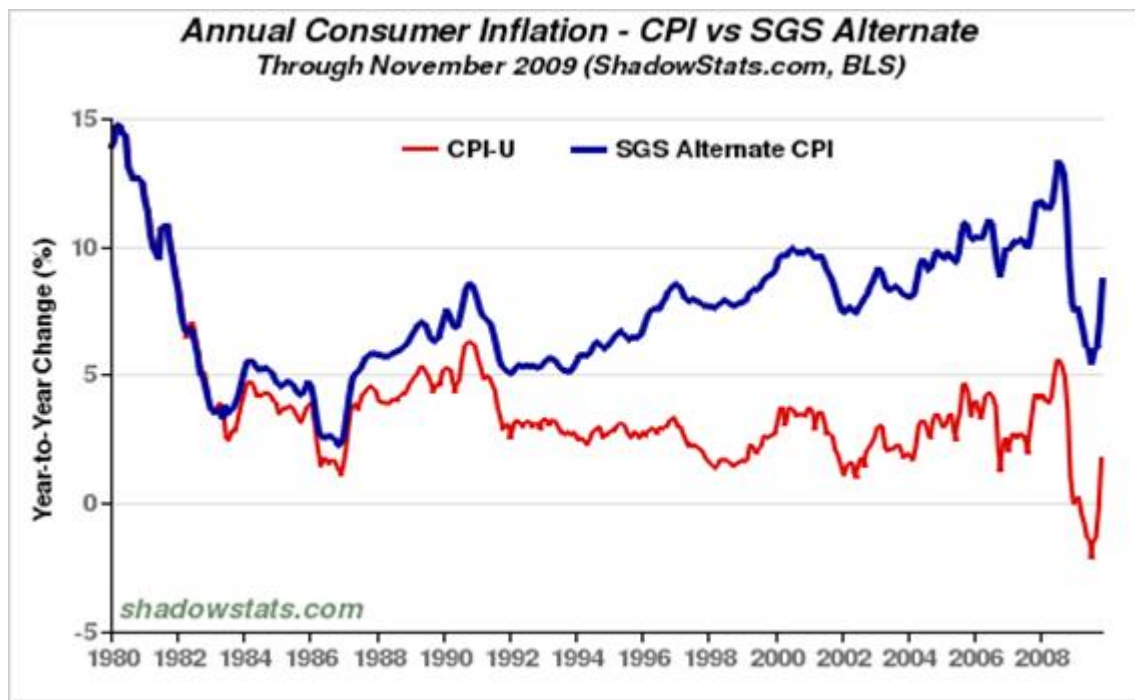


Chart 1: Official CPI vs. Reconstructed CPI using older methods  
([www.shadowstats.com](http://www.shadowstats.com) ) via ( [www.nowandfutures.com](http://www.nowandfutures.com) )

The chart above shows the difference between the year on year rate of change in official CPI (red) and a CPI that is corrected at [www.Shadowstats.com](http://www.Shadowstats.com) to reflect the original methods for the calculation of the CPI (blue), from before 1980, when the CPI was still intended to reflect a stable and consistent standard of living.

The difference between 'true' CPI – as a measure of how rising prices affect the consumer's standard of living – and the official CPI, which was intended to make the economy and Clinton and his successors look good,

was accelerating up until the deflationary phase of the crisis; then had similar effect on both calculations.

Another change in the focus on cost of living was the prominence given to core inflation, i.e. excluding food and energy, over total inflation. This made sense at a time when the prices of food and energy fluctuated in a relatively tight range, by removing more volatile components of the CPI. However, when prices of food and energy went into a sustained rising trend, not merely swinging to and fro in sideways volatility, excluding the rising prices from the CPI helped to keep the 'official' inflation rate below the radar screen and thus justified the low interest rates that was required by the Clinton strategy.

The financial media of course love the lower core rate. Low inflation boosts the 'real' GDP and also the markets, which help ensure reader and viewer interest, ensuring their job security. Consumers, in turn, enjoy the low interest rates made possible by low inflation, even while rising debt poisoned their balance sheets

Objectively, and without regard for the consequences, one simply has to admire the Clinton team for their success with their well-designed multi-factor strategy. It was applied right through the Clinton second term and was so successful his successor, president Bush II, had little reason to deviate from the Clinton plan. It now appears that the Clinton strategy also has been embraced by Obama.

The first insidious effect of this strategy was that households, in pursuit of the 'good life', made large amounts of debt relative to their income. That

this trend, unless it was reversed, inevitably would result in really major problems for the US economy, could not have been difficult to identify. The author could write in 1999 that for an economy to remain sound such a trend was not sustainable at all – in effect this was a prime example of Stein's Law.

It is now widely stated that it was difficult to foresee at the time that the debt binge promoted by the authorities through low rates, an expansionary monetary policy and other measures, further abetted by ruthless financial giants which were taking full advantage of the situation, would result in such a mess.

Given that the author, not a trained economist, could observe one trend and see the danger it would bring, it is unthinkable there was no knowledge within the Clinton advisory community of what would happen if households continued to increase consumer debt at a rate faster than their increase in income.

Neither, as mentioned, did a majority of economists raise their collective voices to protest official actions that promoted a certainly unsustainable and definitely unstable trend.

The chickens are scratching at the door

Earlier, mention was made of an aspect of the Clinton strategy that is coming home to roost as an unintended if not unforeseen consequence – a problem with which the Obama administration soon will have to cope and which will be a major stumbling block for their attempts to get the economy going again.

The problem originates in the 'cooking' of the CPI to no longer reflect consistent standard of living, but to accept a hedonic scaling down of the enjoyment of life by consumers through the changes forced upon them as a result of inadequate income – income that is mostly keeping pace with the official CPI and therefore substantially below the true cost of living.

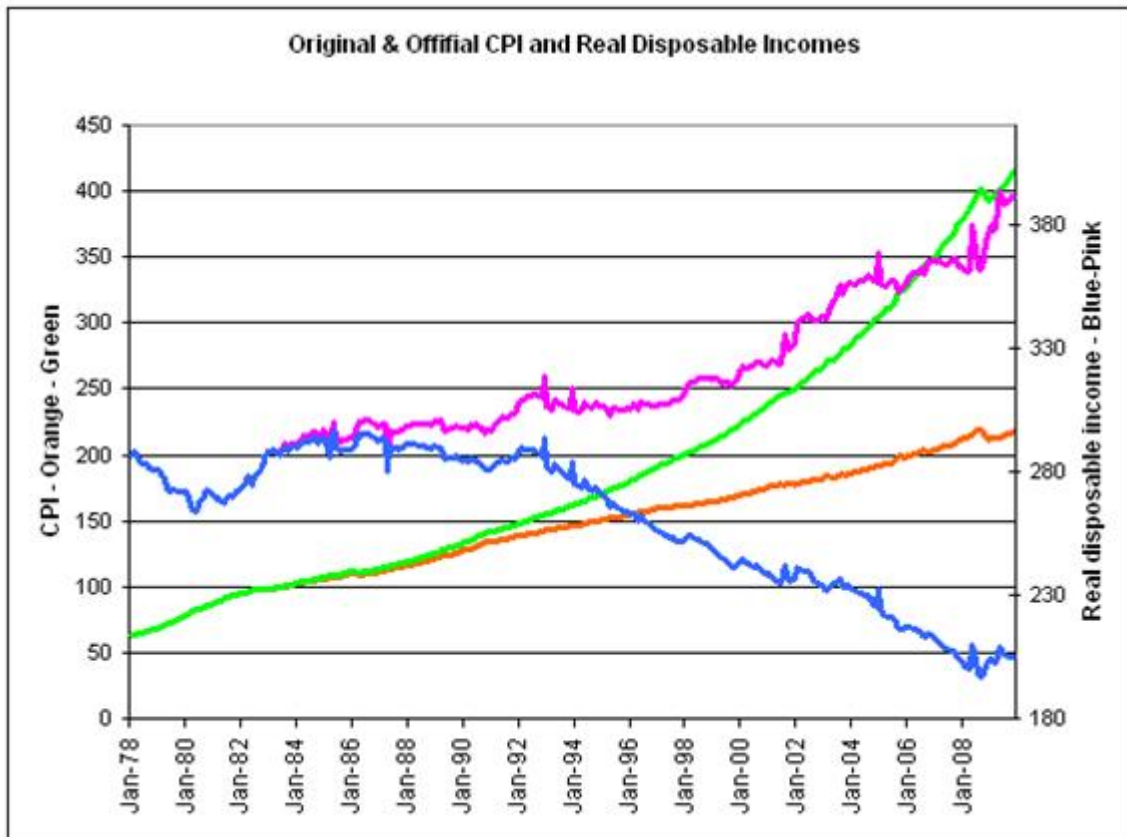
The recommendations of the Boskins commission implied that when the price of table grapes go up, consumers can change to eating less expensive apples. When one can no longer afford the prices at The Gap, it is always possible to get clothes that fit at Target or Walmart, even if these may not carry upmarket labels. When one can no longer afford a BMW or a Mercedes, there are always the Japanese.

With official sanction to what is really a progressive 'sub-standard of living' CPI, it is quite reasonable of employers to give wage increases that are somewhat in line with official inflation; usually a little higher. Why offer workers an increase of 9%+ when the government says the rate of inflation is only 3%? Or less.

The cumulative effect on worker's wages of this divergence between the official CPI and what it costs to maintain a constant standard of living, has now caused penury in many households. Firstly, in an attempt to maintain their standard of living, households had to take on much debt to augment their income.

Secondly, while this tactic worked well during the spendthrift 90's and after 200, today, with strained credit and much debt, households have no option but to cut back severely on their living expenses.

After 15 years of significant divergence between what the official view of their income has become and what they can actually buy with their wages, the effect is much more than one would expect off hand, as shown in the chart below.



*Chart 2: Official and actual US CPI and real average disposable incomes*

Because of the data used, which contain approximations, this chart itself is only an approximation to illustrate the effect of 'official CPI' on household income.

Data on the official CPI, Disposable Income and the number of non-farm workers were obtained from the Federal Reserve (St. Louis). The Disposable Income and number of non-farm employees were used to

obtain an approximate disposable income per worker – approximate because not all US workers are included. The CPI values read from Chart 1 were used to obtain approximate values of the spread between official and original CPI, which were then used to calculate a CPI according to original calculations, thus reflecting a consistent standard of living. (Actual CPI – Green; Official CPI – Orange; the CPI scale on the left)

Average disposable income, as calculated, was converted to reflect the two real average disposable incomes. Firstly, an 'official' real average income by using the official CPI and then an actual real average income by using the actual CPI. (The official real average disposable income – Purple; Actual real average disposable income – Blue; Real average income scale on the right; treat this as an index value because of approximations which are not large enough to disguise the trends)

Real income that is needed to maintain a constant standard of living, is now at an index value of 225, down by more than 20% from the 1982 real income index of 285. As a guideline to what this means, think for a moment what a 20% decline in income would do to your standard of living; a decline that gets worse the longer the CPI is manipulated to make the economy – and the politicians – look better than it and they really are.

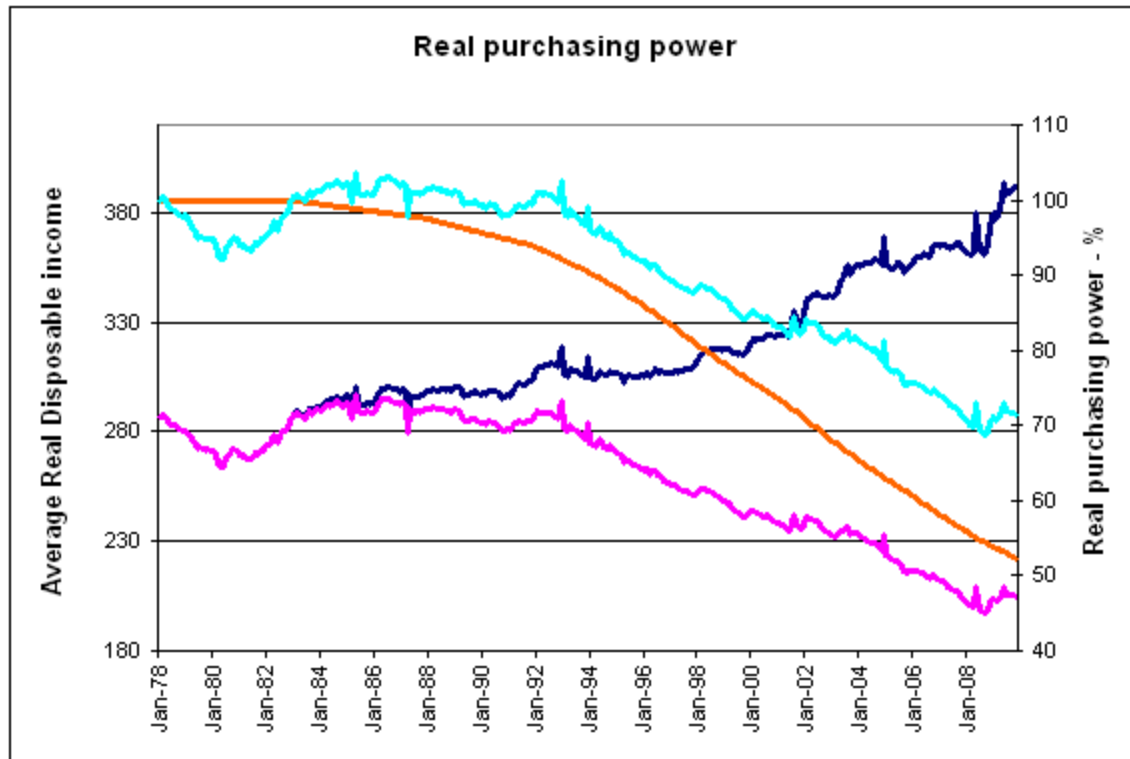
The message told by the chart is easy to recognise. The actual CPI, as derived from the spread between the official and actual year on year changes in the CPI, displays the effect of small cumulative increases over an extended period of time. When the Boskins recommendation were implemented in 1995, it implied people who can no longer afford steak can buy hamburger; the concept of a consistent standard of living for the man

on the street was swept away. In other words, to make themselves look good, officialdom was happy to compel common people to a lower standard of living to fit their declining real income.

Unfortunately they did not look far enough into the future. Or did they?

Even worse, Clinton's two successors, Bush and Obama, both are continuing the farce that Clinton created and now the cumulative effect is building up to a true disaster for a large portion of the US population. That crisis will erupt soon.

The unintended consequences of the reduced standard of living are arriving and people now have to spend their disposable income mostly if not completely on essentials'. It might not be a bad guess to state that many households have had to switch away from eating hamburger to whatever else in the line of protein they can afford. Steak is no longer anything but a memory.



*Chart 3. Real and relative purchasing power of actual average disposable income*

The chart shows the by now familiar average real disposable incomes as per the official and actual CPI indices – dark blue and purple respectively. The orange line shows the ratio between the two real incomes, while the light blue line is the value of the purple line normalised to 100 at the start of the chart in 1978.

Average real disposable income according to the official CPI now has purchasing power that, at 390, is 37% higher than in 1978; people can afford much more than 30 years ago. However, actual average real income is now ‘worth’ just over 50% of the presumed real income according to the official CPI and – according to the light blue line which is at 72% of the 1978 purchasing power – workers would need a 43% increase in

disposable income to afford today what they could buy in 1978. It is a very different picture.

Of course this reasoning does not apply to everyone. Many households earn in excess of say \$80 000 per year and can still afford steak; not hamburger. But at the lower end of the income scale, where workers were happy to get any increase above the official rate of inflation while they at least still had a job, the situation must be getting bad; very bad indeed.

It gets worse, however. Think of the retirees who by now are more than ten years into retirement; the really elderly among us who are surviving on Social Security. On the day of retirement, their allowance was already down in purchasing value relative to a decent standard of living, mainly because Clinton wanted to get re-elected. Since then the increases in their pensions failed by a good margin to keep in step with the cost of even a meagre living standard.

What are they eating in the place of hamburger to satisfy their need for protein? Forget standard of living; for them it has all to do with survival.

A two tier society

*The forces in a capitalist society, if left unchecked, tend to make the rich richer and the poor poorer. Jawaharlal Nehru.*

*"If there must be trouble, let it be in my day, that my child may have peace." – Thomas Paine, "The American Crisis," 1776*

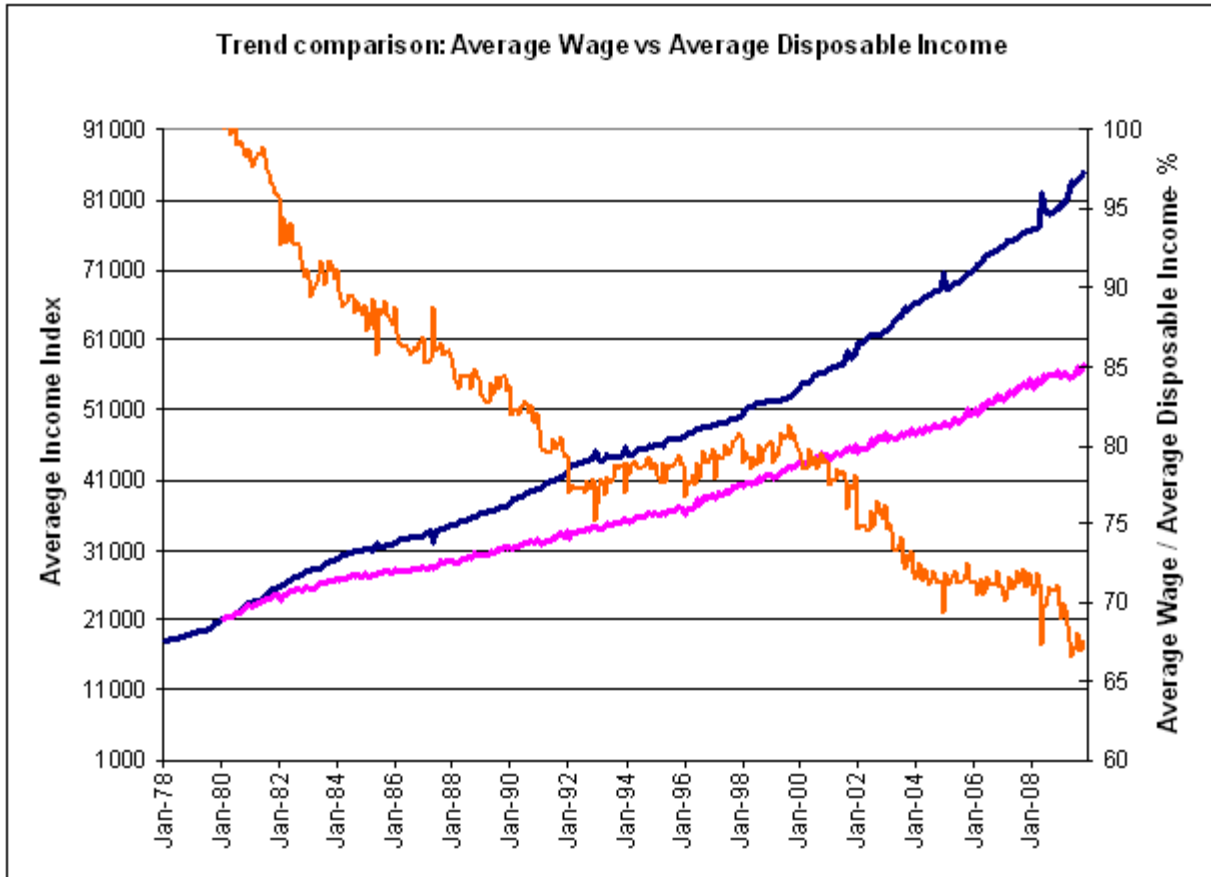
The average disposable income is a measure how much the average American has to spend after some deductions from his gross income; taxes

and so on. The calculation done here of course excludes all farm workers while including their disposable income. Doing so distorts the value of the result a little, but it should have little effect on the trend, which is what we are interested in.

A question that arose during this work related to whether different segments of the American population were affected to a different degree by what the Clinton strategy and the way it has been carried forward by his successors has done to incomes. Was the effect the same for high income earners and for lower earning workers. The chart below was generated to show this difference. Again, since the chart of average disposable income is an approximation, it is more the trend that is of interest than actual values.

The dark blue line is the by now familiar average disposable income. It is a chart of nominal values, without inflation adjustment. The purple line shows average weekly wage, obtained from the US Bureau of Labour Statistics (BLS).

These two charts are normalised to be the same in January, 1980, so that it is the trends that are important, not the actual values.



*Chart 4. Nominal average disposable income with average weekly wage and their ratio*

The orange line presents the ratio of average weekly wage to average disposable income. The fact that the two incomes are normalised in 1980, disposes to some degree of the problem that one number is weekly and the other is monthly.

Observe the wide separation of the two income charts; it is clear that the trend in average weekly wage over time seriously lags that of average disposable income. Consider further that the average disposable income includes both high and low income earners and it is clear that the difference

between these two categories of earners is even greater than the chart shows.

America has become an extreme two-tier society – since 1980 worker wages have declined by more than 30% relative to average disposable income and much more than that relative to higher income earners. The widening trend is destined to continue as long as the manipulated CPI plays a role in wage increases, as it obviously have been doing now for much longer than two decades.

With disposable income data that includes very highly paid specialised people as well as owners of businesses, it is to be expected that in the booming times since 1982 average disposable income should increase faster than worker wages.

However, it is clear the difference accelerated since the turn of the century, by which time the manipulated CPI had time to really show effect.

### The household debt problem

Total US household debt, similar to what has been happening in other countries, is at high levels relative to income. However, in the same way that the average disposable income conceals the presence of the two-tier income divergence, the debt picture likely conceals the true situation that exists in a two-tier society.

One group within the society earns enough not to have been forced to make use of debt in order to maintain their standard of living. Sure, they could be carrying a high load of debt, having taken it on in pursuit of a life

of luxury in excess of what they can easily afford; many of the high earners likely sit with mortgages that are under water. However, for most of this group their financial survival is not necessarily at risk; they probably afford to maintain their normal lifestyle.

As a class, relatively high income earners do not suffer as do worker households where disposable income, in the form of a weekly wage, has been systematically eroded by a policy of an artificially low official CPI. As a consequence, since the mid nineties at least, most wage earners have had to use debt in an attempt to maintain the same standard of living. It is therefore to be expected that worker households carry a disproportionate level of consumer debt relative to income.

As time passed and credit dried up, they were increasingly compelled by their circumstances to scale back on expenses other than necessities, avoiding luxuries. These people are loaded with debt and may even refuse more credit if offered. Their ability to repay the debt is practically non-existent; for many by now it may well be a battle for financial and even physical survival.

The Obama team can pump as much money into the economy as they wish, but most worker households will not increase their spending – they simply cannot do so. Should Bernanke make good on his helicopter joke, the money dropping from the air will be used to repay debt; not spent on consumer goods.

This disparate situation, largely brought about by the manipulated CPI, is getting worse year by year and will continue to do so as long as the

manipulation and its side-effect on wage increases continue. Sooner or later it will become untenable, likely with rather disastrous consequences for the US economy and possibly also for the political system. At that time, if workers should be informed of the fact that government had wittingly created the untenable situation in which they find themselves, the possibility of civil turmoil cannot be excluded.

The effect of the artificial CPI on worker households is a theme that ought to be properly investigated by real economists; hopefully those brave enough to attract the maximum attention to their findings.

The odds of an imminent recovery

*In economics, the majority is always wrong. J.K. Galbraith*

Obama, Bernanke and colleagues are warning that the recovery will be slow and long. One wonders what data they look at, because popular media reports tend to paint a more rosy picture of imminent recovery now that the recession is over, or so they say.

America, like probably all developed countries, rely on consumer spending for the larger part of GDP; in the US it is of the order of 70% of GDP that originates in household purchases.

It would belabour the issue to expand on the vicious cycle that begins with low household spending, then reduced corporate profits followed by lay-offs of more workers which then reduces consumer spending even more – and so on. It has been well covered by so-called doomsday writers who stand outside the majority of commentators on ‘the dismal science’ who only see

success for Obama and his strategy and thus a rosy future ahead, even if it will take some time.

Suffice to say, should the picture painted here be a reasonable representation of what the situation in the US really is like, the odds of even any recovery within a reasonable time frame are minimal.

In fact, once the ability of the government to cast money onto the economy by the wagon load is over and done with, for whatever reason, a much more severe dip than the first one is on the cards. It is likely to become much worse than what it has been so far and last a lot longer than all but the pessimists expect.

## Conclusion

*The best way to destroy the capitalist system is to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. John Maynard Keynes*

*"The future ain't what it used to be..." - Yogi Berra*

What has been described in Part 3 has to do with the internal situation in the US.

What happens there, will have widespread ramifications on the relationship of the US with the rest of the world. Given the outlook for the US presented here, it seems almost certain that this international relationship will change substantially over the next few years. The value of the dollar will be the barometer for what is happening and, with the debasement of the currency

being undertaken over the past 2 years, this is another disaster in waiting – but a subject for another essay.

The main conclusion of this three-part essay is easy to sum up in a few words.

A change in the post WWII societal climate in the US gave rise to a “Me first at all costs” attitude, very prominent among US politicians, and many of their peers in other parts of the world. In the US, Clinton applied this motivation to the full; by doing everything possible to become re-elected, he set a pattern of meddling and accommodative government that is the primary cause of the crisis – abetted by the behaviour of households and the banks as the more direct cause.

Sustained allegiance to the Clinton strategy by Bush and Obama perpetuates the negative effects of this strategy. The disastrous effects of this ‘plan’ are already evident in US economic statistics and now have reached a level where the odds of a recovery in the economy are receding rapidly in favour of a deep double dip.

Even worse, the long term effects of Clinton’s strategy includes the formation of a markedly divergent two-tier society in the US that is bound to end in social and political disaster.

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