

**Palisade Conference
October 21-22 Hyatt Jersey City**

**The Collapse of an Unsustainable Paradigm
Prosperity by Debt
What Happens Now?**

**Roy Nersesian
Monmouth & Columbia Universities**

Plenty of Examples of Unsustainable Paradigms

**Empires become unsustainable when internal resources cannot combat external forces of destruction
(Rome, Maya etc.)**

Easter Island (originally sustainable)

But human population grew to the point of:

- 1. Annihilating the animal population for food**
- 2. Extensive cultivation of soil destroying its fertility and lowering crop yields**
- 3. Excess harvesting of palm trees for canoes to fish reduced harvest of nuts and sap for food and**
- 4. Increased soil erosion from tree removal**
- 5. Cutting down the last tree to make the last canoe spelt the end of Easter Island**

No way to go, no food to eat, chaos, cannibalism, and the end of civilization on Easter Island – Haiti in same boat today except they can escape by boat!

Suboptimal Paradigms – Can Go on Forever

Middle Ages – purpose of international trade is to accumulate gold – nations established monopolies of favorite industries and preserved them from foreign competition by quotas, tariffs, and other trade barriers

Then the monarchs instructed the monopolies to export goods for nation to have a positive trade balance — gold will flow into the kingdom for the benefit of the monarch

What happened? Everyone's exports are somebody's imports and barriers to imports stifled international trade

Adam Smith – the purpose of international trade is not to accumulate gold, but the exchange of goods to take advantage of specialization of nations – trade blossomed and living standards improved

Consumer Debt Paradigm

We believe in consumer debt as a means of obtaining goods today without having to wait till tomorrow

Singer sewing machines – first hire purchase agreement (make a series of payments and on the last payment, title transfers to buyer)

Start of consumer credit and instant gratification

**Home mortgages became popular after Second World War
Heavy government involvement in promoting Fannie Mae and Freddie Mac**

Community Reinvestment Act of 1977

Home ownership extended even to those not qualified to meet standards of conventional mortgages, loans so made could be dumped into Fannie Mae and Freddie Mac or later syndicated as CMOs to poison the global financial system

Individual with No Consumer Debt

Income	\$100	\$100	\$100	\$100	\$100
New Debt	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
		-	-	-	-
Finance Charge	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Disposable Income	\$100.0	\$100.0	\$100.0	\$100.0	\$100.0
Units of Goods	10	10	10	10	10
Existing Debt	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Interest	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Amortization	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0

Income of \$100, with no debt servicing charges, becomes \$100 of disposable income

Goods cost \$10 per unit

10 units of goods can be purchased

A sustainable model that can go on forever

Individual with Consumer Debt First Month

	Month 1
Income	\$100
New Debt	\$10.0
Finance Charge	\$0.0
Disposable Income	\$110.0
Units of Goods	11
Existing Debt	\$10.0
Interest	\$0.1
Amortization	\$0.1

Suppose that an individual finds a bank willing to offer a consumer loan of \$10. The individual now has \$110 in disposable income and the units of purchased goods is now 11, an increase in an individual's standard of living of 10%.

Where does the money come from for consumer debt?

Presumably, the savings of others which is redirected by banks from savers to borrowers

This is a very small portion of debt

Proof:

Debt does not equal savings; debt vastly exceeds savings

Story of Banking

Earliest bankers were goldsmiths who had a safe to hold their gold

Other people entrusted their gold to goldsmiths for safekeeping

Suppose that a goldsmith had 100 oz and 900 oz of others in his safe
Goldsmith is confident that the depositors are not going to demand their gold back from past experience

Goldsmith lends out 700 oz keeping 300 oz as “reserves” in case of withdrawals

He makes prudent loans (not too large, not concentrated in one business) to creditworthy borrowers whose investments have every appearance of being successful (diversification of risk).

Interest is 1% to be paid in gold.

Goldsmith return is 1% of 700 oz loan portfolio or 7 oz on his 100 oz capital investment or 7%, a large return

There are three risks faced by the goldsmith:

1. Depositors of >300 oz withdraw their gold for various reasons

Unless he can call in some loans, the goldsmith is insolvent and has lost his 100 oz in capital

2. Loan losses – if they exceed 7 oz, goldsmith suffers loss of capital

3. (Actually 1 & 2) word spreads that there are loan losses, depositors lose confidence in the goldsmith and demand their gold back

Classic run on the bank from loss of public confidence

Huge vested interest to ensure that there is always adequate funds for lending

Bimetallism – 16 oz of silver equivalent to 1 oz of gold to expand money supply to meet credit demand of a growing nation

“Thou shalt not crucify mankind upon a cross of gold.”

William Jennings Bryant (1896)

Founding of Federal Reserve – a non-government organization owned by world’s largest banks U.S. and non-U.S. (actual ownership not publicly known)

Essentially controls limits of credit in U.S.

Fractional reserve banking – a 10% reserve requirement can generate \$100 in loans on a deposit base of \$10.

A \$10 deposit allows a bank to make a \$9 loan holding \$1 in reserves. The borrower deposits the loan of \$9 in another bank, which can now make a loan of \$8.10 keeping \$0.90 in reserves, which upon depositing in yet another bank, means that another \$7.29 can be loaned out keeping 10% in reserves – continue this process to logical end and the original \$10 deposit can create \$100 in loans

U.S. Government deficit spending also source of credit growth

If Treasury borrows from public, money is simply transferred from one account to another, no new credit formation and non-inflationary

If Treasury takes a two step process of issuing bonds without external buyers and the Federal Reserve buys the bonds and deposits cash in its Accounts with other bankers, then these funds can also create 10 X more credit in the system (monetizing debt)

Loss of Confidence

The solution to the problem of loss of confidence is FDIC, which now insures deposits to \$250,000 plus money market accounts plus whatever else has been thrust upon this organization

But an individual or corporation with \$20 MM in a bank that goes under loses all but \$250,000

Banks too big to fail syndrome

I've never known one example of a loan not being made because of a lack of credit

If a bank does not have enough borrowing capacity (maximum loan limit determined by bank's capital), then the loan is syndicated among several or many banks

Loans, for the most part, are created out of nothing – the whim of a stroke of a banker's pen

Most loans do not represent real money, but imaginary credit

Credit availability is not the constraint – loans that can be confidently repaid by borrowers are the true constraint in the investment/banking business

Once made, a loan must be repaid or the bank suffers a loss and the borrower bankruptcy. Loans made on imaginary credit are treated as though they were denominated in gold – they generate real losses if not repaid

Creating money out of nowhere, no matter what the mechanism, is inflationary

In 1915, Henry Ford stunned the world when he doubled his worker's pay to \$5/day, or \$1,300 per year. How much does a worker have to make today to have the equivalent pay?

\$21.36 of 2008\$ = \$1 of 1915\$

\$27,768 – but \$1,300 was take-home pay (no income taxes or social security)

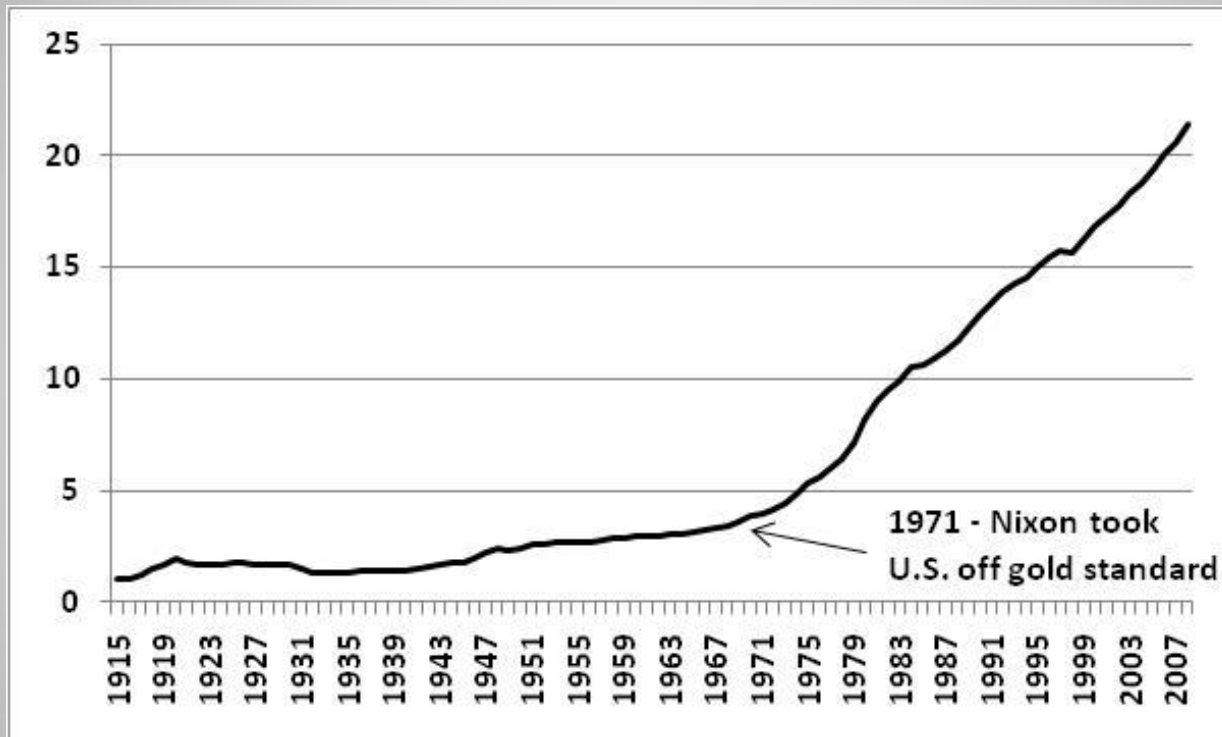
Assume both consume 30% of workers pay.

To clear \$27,768, have to earn \$39,668 (\$19 per hour)

Minimum wage is \$7.25 or \$290 per week or \$15,080 per year

Many jobs today, particularly in the service industry, are close to minimum wage

The number of current dollars (dollars of the day) equivalent to one 1915 dollar



Note how debt financing of two world wars had a relatively small inflationary impact compared to Nixon removal of the gold backing from the dollar

Individual with Consumer Debt Second Month

	Month 1	Month 2
Income	\$100	\$100
New Debt	\$10.0	\$10.2
		-
Finance Charge	\$0.0	(\$0.2)
Disposable Income	\$110.0	\$110.0
Units of Goods	11	11
Existing Debt	\$10.0	\$20.1
Interest	\$0.1	\$0.2
Amortization	\$0.1	\$0.2

Suppose that consumer debt has interest of 1% (12% per annum) and repayment (amortization) is 1% per month (8 year repayment)

To keep purchasing power at 11 units of goods, consumer must borrow another \$10 plus financing charge to keep disposable income at \$110

Existing debt takes into account amortization or debt repayment; debt goes up by the interest charge

Consumer Debt Is Considered Good:

By politicians: More goods being purchased increases demand and employment and good economic times favors re-election

By industrialists and manufacturers: More goods can be purchased by consumers adding to demand leading to greater industrial activity

By labor: More jobs as line workers in factories and as construction workers building more factories

By bankers: More loans for consumers and to industry to expand capacity enhancing bank's earnings

And by consumers: higher standard of living today, don't have to wait to tomorrow

**G.W. Bush – “It is good that housing values keep going up because consumers can borrow against the increased equity of their homes, and spend the money, and in so doing, keep the economy rolling.”
(paraphrased)**

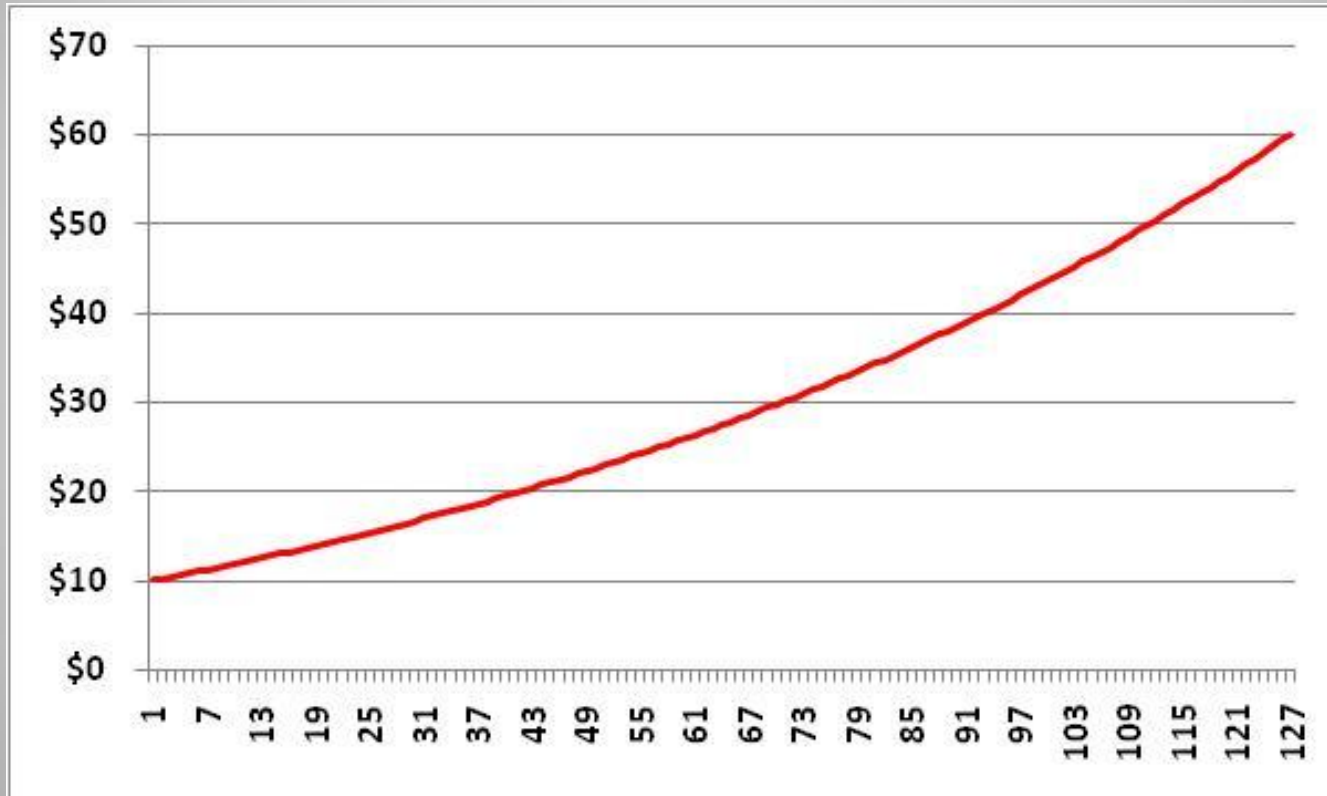
	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8
Income	\$100	\$100	\$100	\$100	\$100	\$100	\$100	\$100
New Debt	\$10.0	\$10.2	\$10.4	\$10.6	\$10.8	\$11.0	\$11.2	\$11.4
		-	-	-	-	-	-	-
Finance Charge	\$0.0	(\$0.2)	(\$0.4)	(\$0.6)	(\$0.8)	(\$1.0)	(\$1.2)	(\$1.4)
Disposable Income	\$110.0	\$110.0	\$110.0	\$110.0	\$110.0	\$110.0	\$110.0	\$110.0
Units of Goods	11	11	11	11	11	11	11	11
Existing Debt	\$10.0	\$20.1	\$30.3	\$40.6	\$51.0	\$61.5	\$72.1	\$82.9
Interest	\$0.1	\$0.2	\$0.3	\$0.4	\$0.5	\$0.6	\$0.7	\$0.8
Amortization	\$0.1	\$0.2	\$0.3	\$0.4	\$0.5	\$0.6	\$0.7	\$0.8

Note the rapid rise in debt to maintain standard of living and the increase in finance charges

	Month 122	Month 123	Month 124	Month 125	Month 126	Month 127
Income	\$100	\$100	\$100	\$100	\$100	\$100
New Debt	\$56.7	\$57.3	\$58.0	\$58.7	\$59.4	\$60.1
	-	-	-	-	-	-
Finance Charge	(\$46.7)	(\$47.3)	(\$48.0)	(\$48.7)	(\$49.4)	(\$50.1)
Disposable Income	\$110.0	\$110.0	\$110.0	\$110.0	\$110.0	\$110.0
Units of Goods	11	11	11	11	11	11
Existing Debt	\$2,366.7	\$2,400.4	\$2,434.4	\$2,468.7	\$2,503.4	\$2,538.5
Interest	\$23.7	\$24.0	\$24.3	\$24.7	\$25.0	\$25.4
Amortization	\$23.7	\$24.0	\$24.3	\$24.7	\$25.0	\$25.4

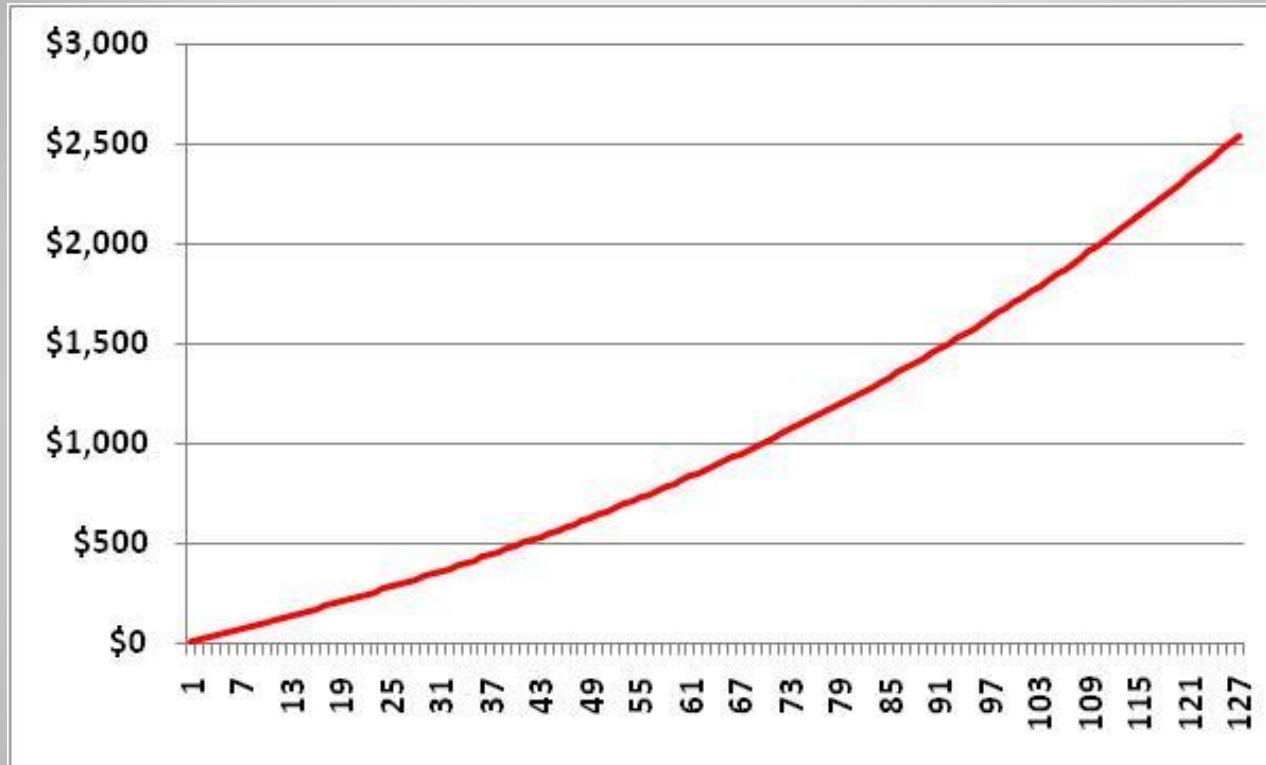
Financing charges in year 10 = half of income

Monthly Borrowing to Repay Interest to Keep Standard of Living At 11 Units of Goods per Month



Note that monthly income is \$100

The Accumulation of Underlying Consumer Debt



Note the convex shape, or the increasingly rapid accumulation of debt just to “stand still”

This is Known as Exponential Growth

How much gold would there be today if Joseph and Mary deposited 1 penny in a savings account at 3% compound interest at the birth of Jesus?

At 3% interest, balance doubles every 23.5 years.

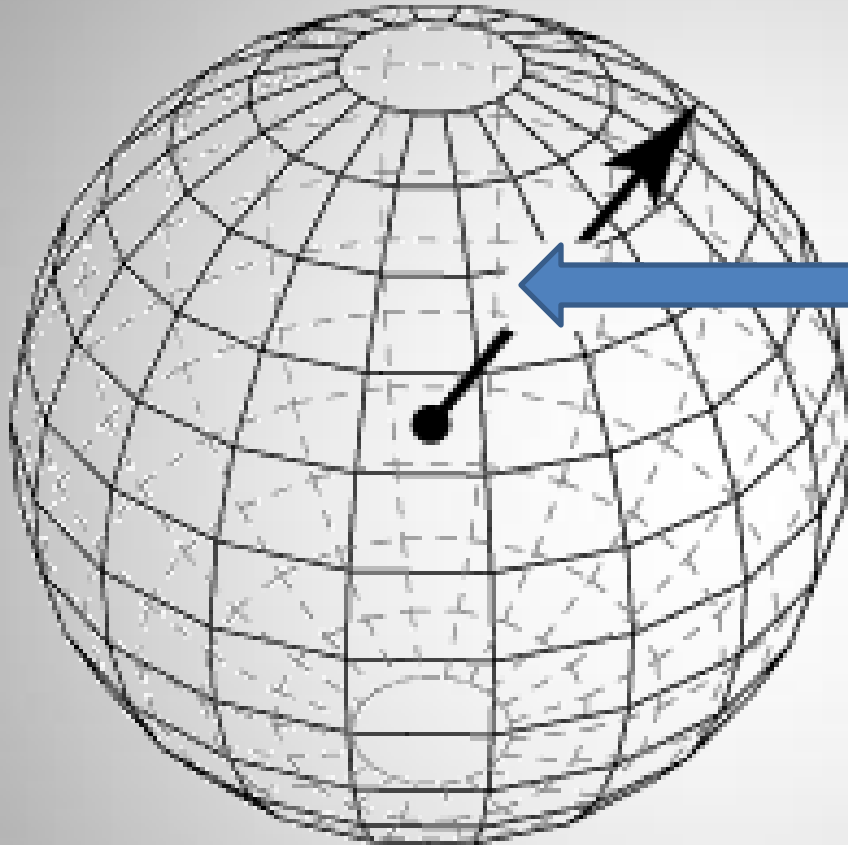
There are 85.5 doublings in 2,010 years.

Take 1 penny and multiply by $2^{85.5}$ and divide by \$1000.

How many ounces?

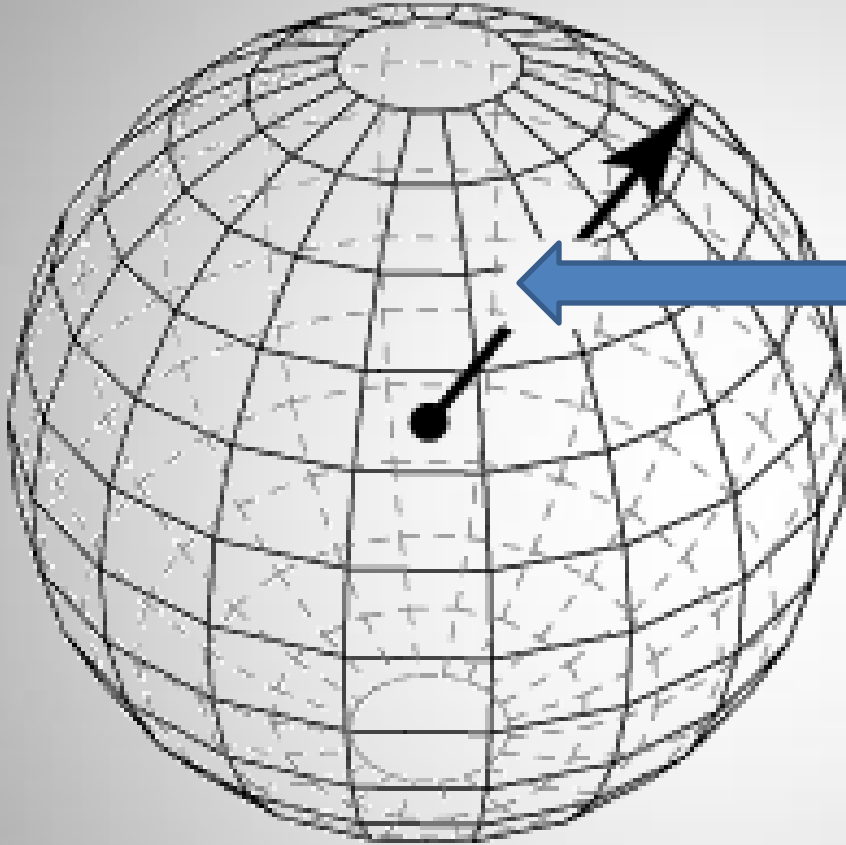
How large is a solid sphere of this amount of gold?

3% compound growth – 85.5 doublings



**Solid sphere with a
radius of 37 miles**

5% Compound Growth – 141.5 Doublings



Solid sphere with a radius of 15.5 million miles – Mercury is 36 million miles from sun

We have been warned against the compounding of debt:

Deuteronomy 15 Verses 1 and 2:

Remission (cancellation) of debts every 7 years

Deuteronomy 24 Verse 19:

Prohibition of usury (charging interest)

Deuteronomy 15 Verse 6:

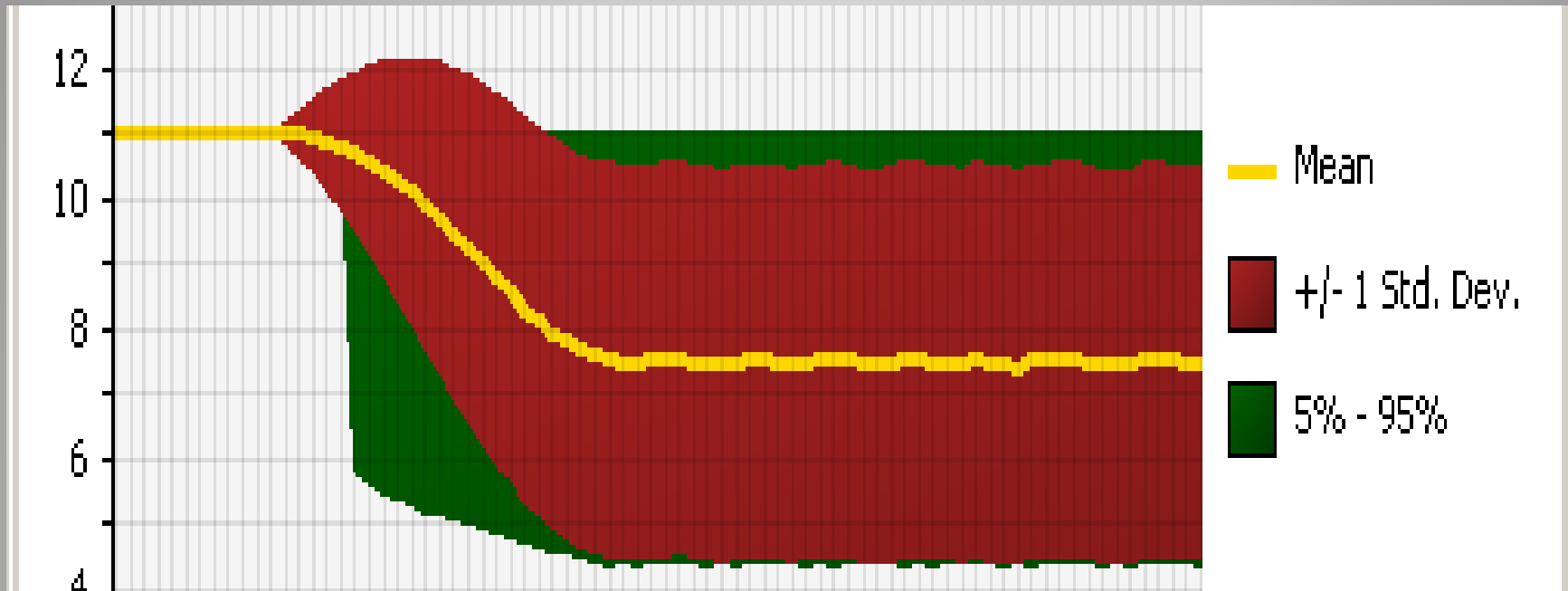
Lenders rule over borrowers

Proverbs 22 Verse 7:

The borrower is servant to the lender

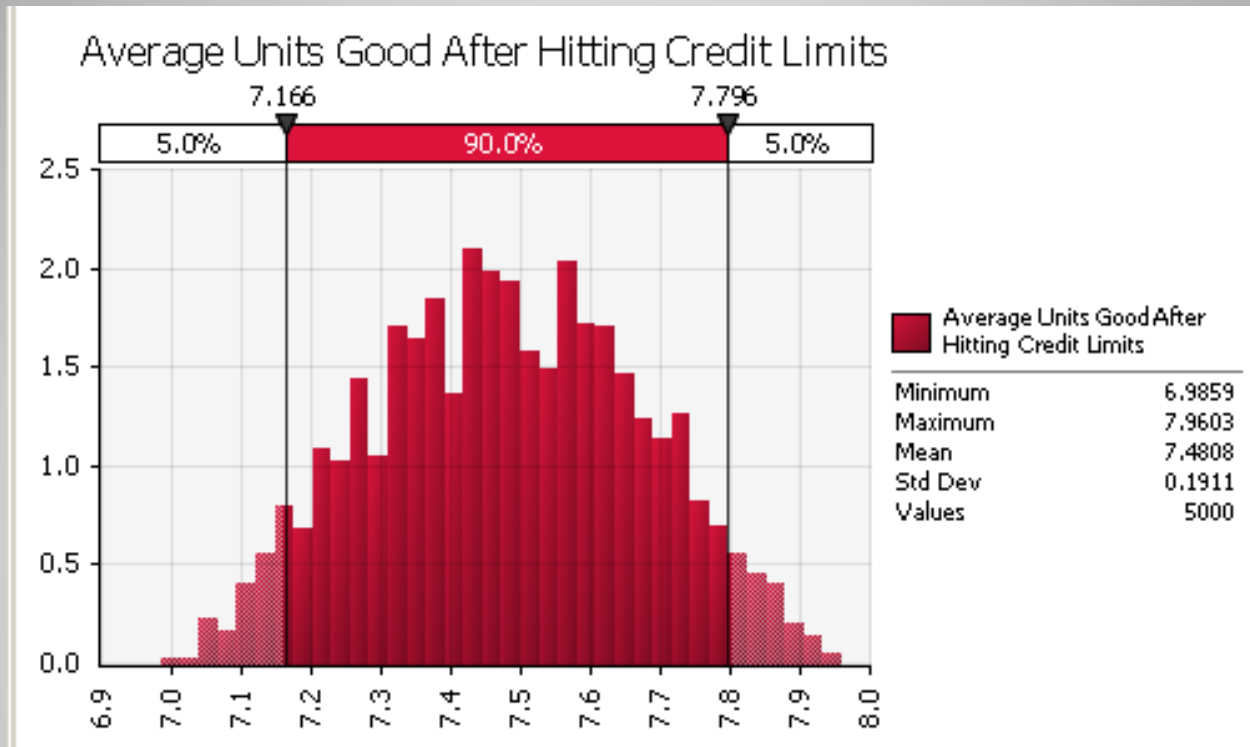
Suppose that somewhere between finance charges consuming 40-60% of income, the banks refuse to advance any further funds until debt has been reduced to less than the 40-60% limit.

Then the consumer is permitted to borrow back up to his limit.



Once past maximum credit limit # units of goods:

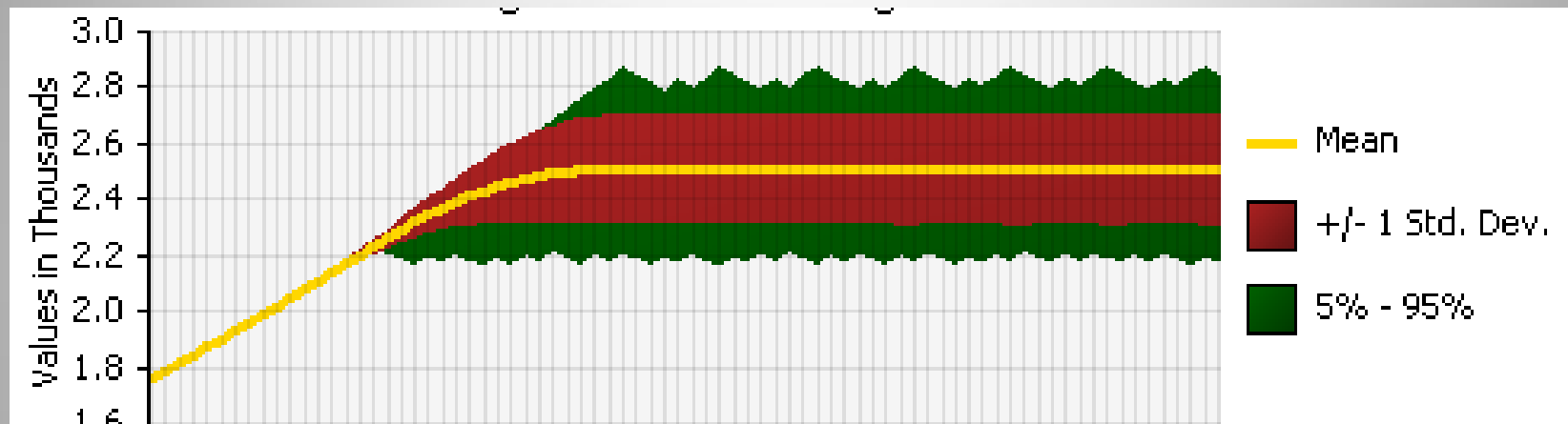
- 1. Around 4.5 while reducing debt below debt limit**
- 2. Around 11 while borrowing back to debt limit**
- 3. Average units of goods 7.5**



Units of goods is reduced from 11 to an average of 7.5

If you want to get out of debt, standard of living reduced to 4.5 units of goods

**When Borrowing Always Against Limits
Consumption Is Forever Reduced
Why?
Debt Is Never Reduced**



**Debt oscillates between \$2,200 and \$2,800
with a mean of \$2,500**

RESULTS

	Units of Goods	Sustainable
No Consumer Debt	10	Yes
Consumer Debt	11	No
Post-Consumer Debt Not paying off debt	7.5	Yes
Post-Consumer Debt Paying off debt	4.5 then 10	Yes

Sustainability means it lasts forever

For those trapped in post-consumer debt, the standard of living is PERMANENTLY IMPAIRED unless they get out of debt entirely (not likely given level of debt)

“Borrow and spend like there is no tomorrow”

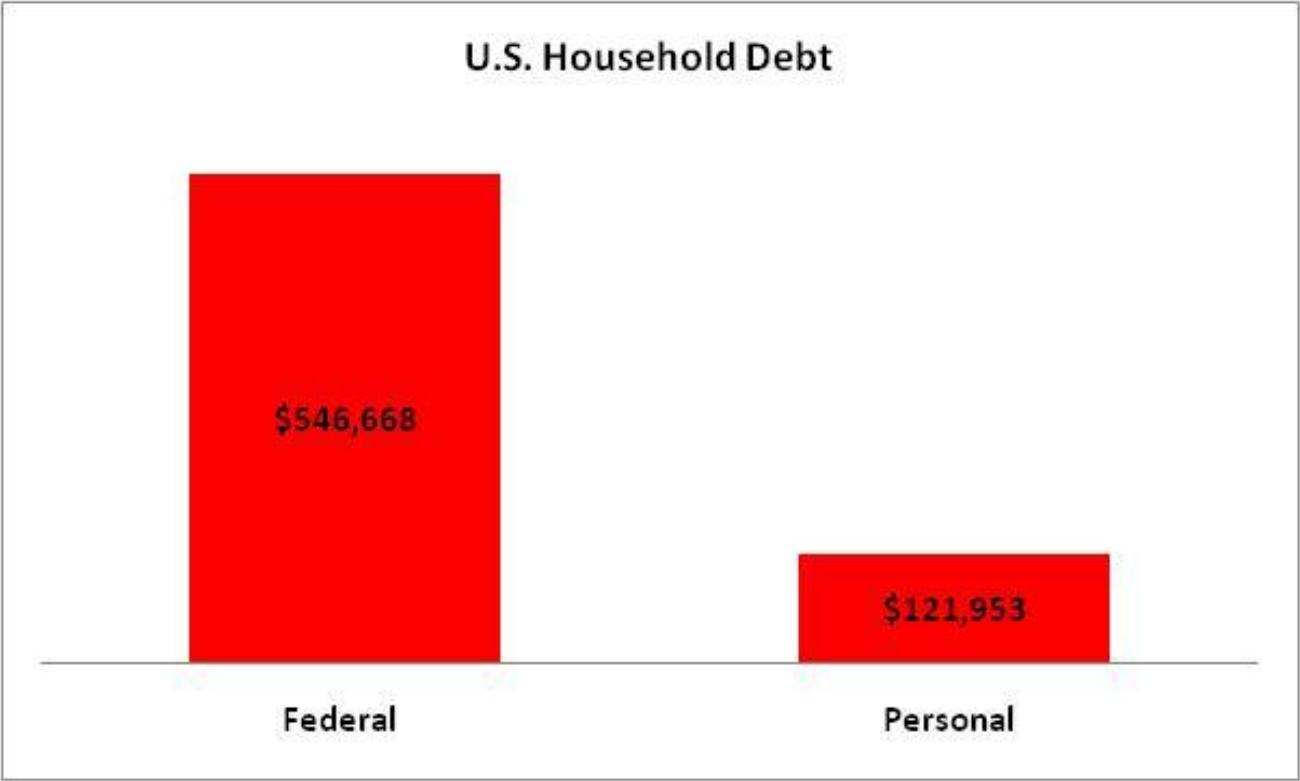
Guess what?

Tomorrow dawned!

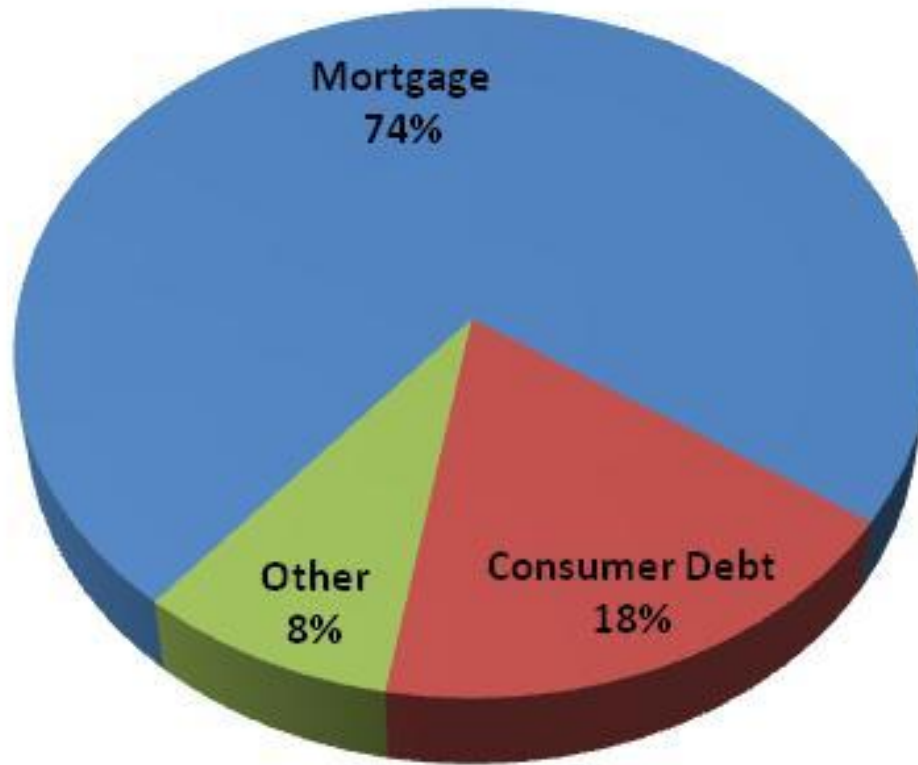
“Made-off” with your money \$65 billion Ponzi scheme collapsed when cash outflow became greater than cash inflow

In a way, was not borrowing against rising house prices a form of Ponzi scheme that collapsed when house prices began to decline?

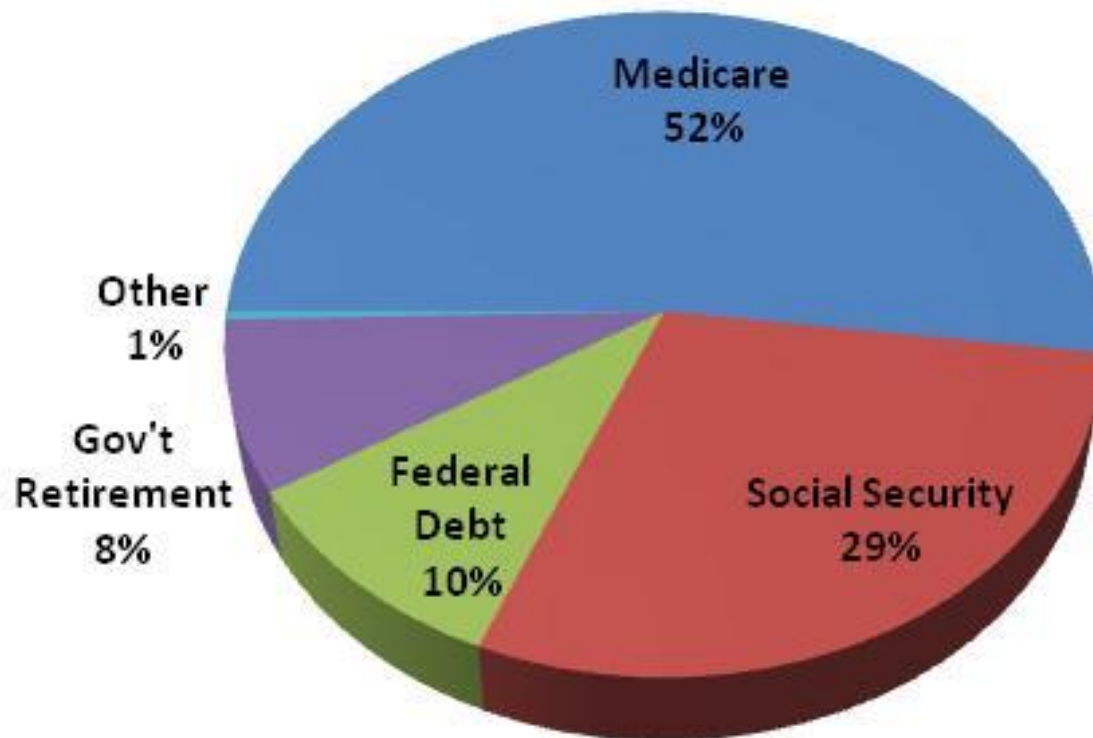
U.S. Household Debt Totals \$668,621



Personal Debt



Federal Government Debt Mostly Unfunded Obligations



**Thomas Jefferson
(1789)**

Then I say the earth belongs to each...generation during its course, fully and in its own right. The second generation receives it clear of the debts and encumbrances, the third of the second, and so on. For if the first could charge it with a debt, then the earth would belong to the dead and not to the living generation. Then, no generation can contract debts greater than may be paid during the course of its own existence.

We are slated to add \$9 trillion in deficits over the next decade, no number of generations will be able to pay this off!

**A Person Addicted to a Drug
“Enjoys” the Benefits of a Drug**



The Drug was Propofol plus a Host of Others



The Enabler



In any drug, a small amount gives a certain stimulus, but with time, the amount has to be increased for the same impact. Dr. Conrad Murray enabled Michael Jackson to receive increasing doses of a dangerous anesthetic until the drug had to be administered nearly continually to have the same benefit.



**The inevitable outcome of
drug addicts who cannot
kick their habit**



The Consumer Era: Booming Economies



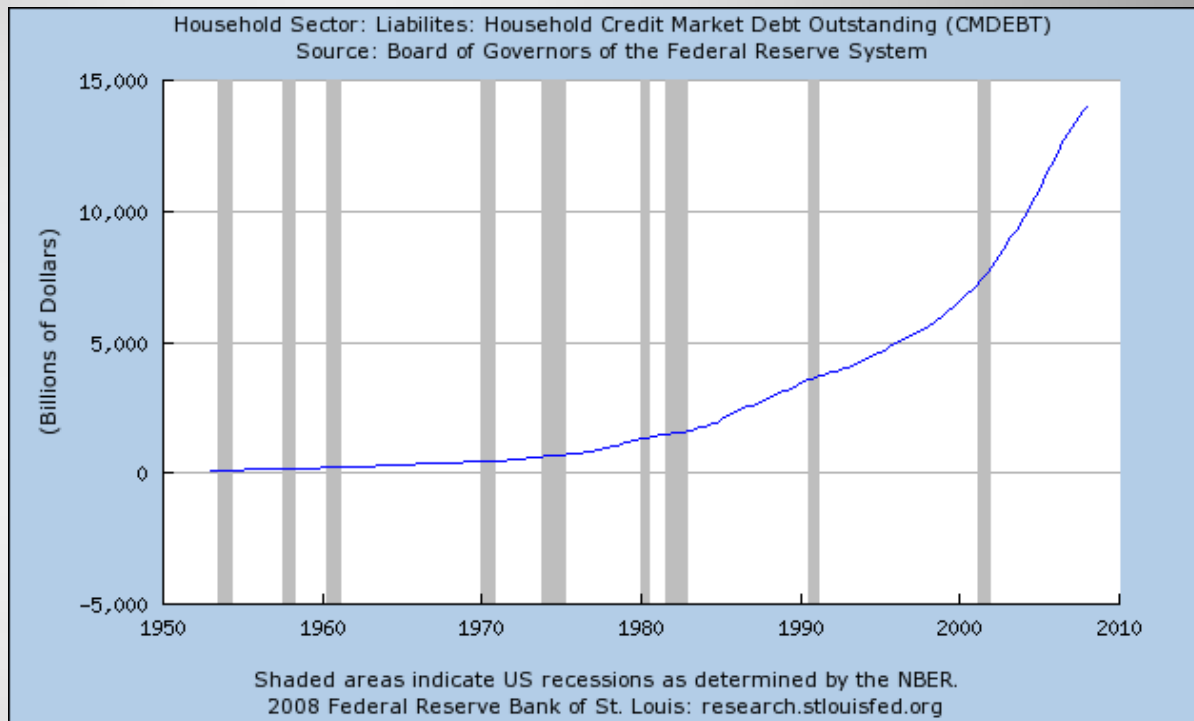
Drug - Consumer Debt

**Total Household Debt
Peaked \$15 Trillion
Before Meltdown**

**Preponderance
Mortgage Debt**

Note Exponential Shape

**More and More Debt
Just to Stand Still**





Enablers

Barney Frank

No matter how unqualified (e.g. illegal aliens with no visible means of support), everyone deserves a mortgage to have his/her own home

Has he learned his lesson?

No, he wants to reduce mortgage requirements for co-ops!



Allan Greenspan

Low interest rates, an accommodative stance to credit demand

“Wall Street would never do anything that would jeopardize its long-term capacity to remain in business” (Paraphrased)

“Even if I had known about the toxic waste infusion into our financial system, there is nothing I could have done about it!” (Paraphrased)

Plus Other Enablers

Wall Street investment bankers who packaged up toxic waste as Collateralized Mortgage Obligations, Collateralized Debt Obligations plus \$560 trillion in swaps (yet to be played out) and Credit Swap Defaults (partially played out AIG)

Received billions in real bonuses based on pseudo-profits

S&P, Moody, Fitch credit rating services that put a Triple A rating on a collection of C, D, and Junk rated trash

Supply chain management encouraging manufacturing in China at cost of U.S. manufacturing capacity with the result of a ballooning trade deficit

Humongous U.S. trade deficits accumulated overseas wanted to invest in other than low interest U.S. government bonds – Triple A rated high interest CMOs and CDOs were the answer

Global demand for CMOs/CDOs spurred need to create more mortgages and corporate debt of doubtful creditworthiness for Triple A packaging

Outcome

Boom Turns Bust



Stock market collapse – 50% recovery based on anticipation of turnaround

Jobless claims (based on those actually getting unemployment)

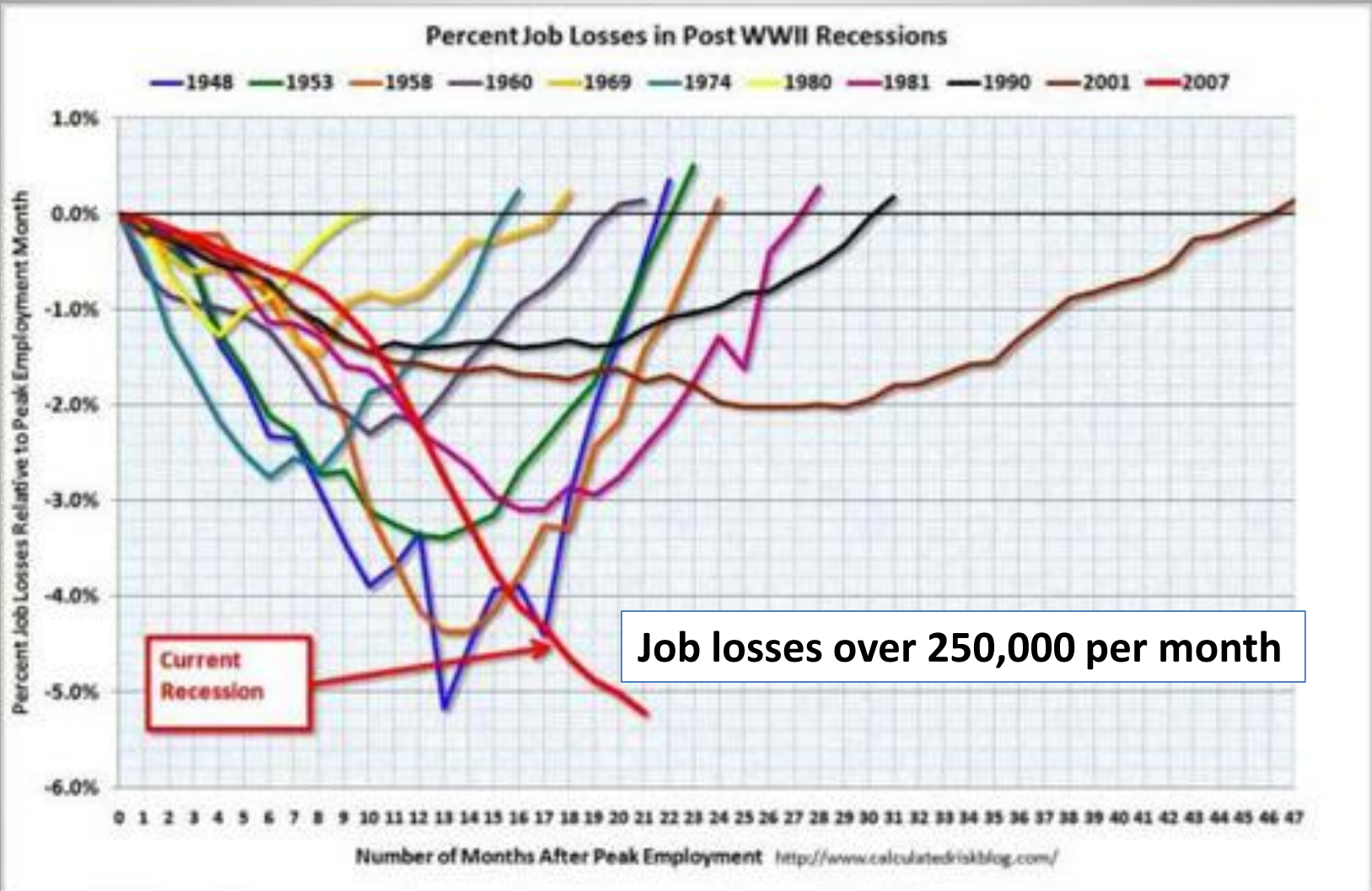
Those whose benefits are expired or who are partially employed

boost real unemployment to 16%, some say 20% or more

Housing prices still declining

Bankruptcies of financial institutions and industrial concerns (GM & Chrysler)

Amazing that some say that we are in a V-shaped recovery!



The Paradigm of Prosperity Through Debt Is Clearly Unsustainable

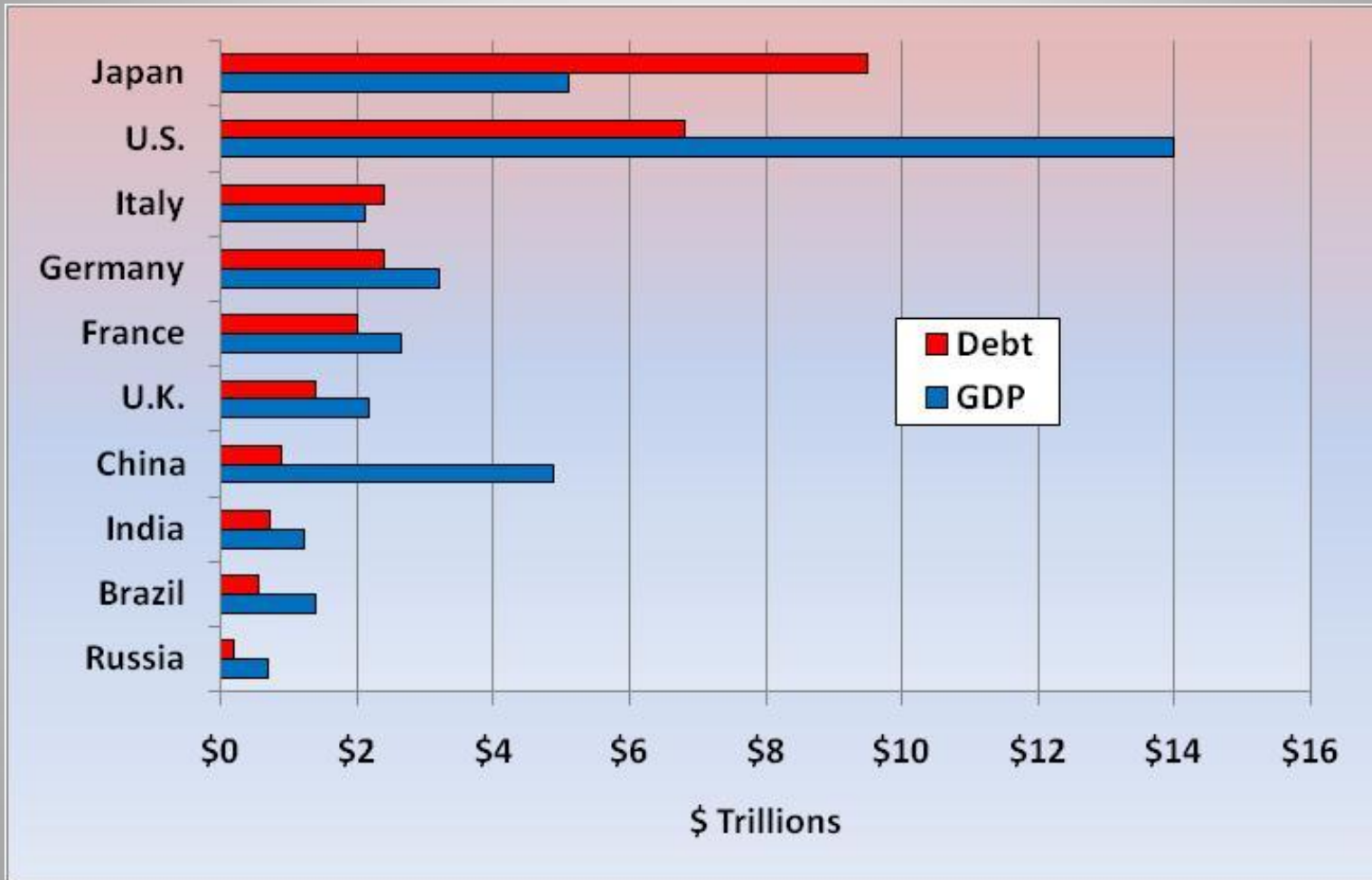
What are we to do?

This is a global problem, let's first look elsewhere:

Japan, Korea, Taiwan, Singapore and Hong Kong have strong domestic markets based on exports to U.S. and Europe. The U.S. consumer through automobile, electronic devices, and personal computers largely responsible for these nations bootstrapping themselves after Second World War (at a cost to our manufacturing base).

China was not yet through this stage of economic development and has lost its export markets in U.S. and Europe, but its domestic GDP is growing around 8% mainly through infrastructure improvement projects

Total Global Public Debt - \$35 Trillion
Following 10 nations - \$27 Trillion



Japan's debt is almost 2X and Italy's debt about 1X domestic economy

The Paradigm of Prosperity Through Debt Cannot Be Fixed

Those in debt will spend the rest of their lives with reduced consumption until the debt is significantly reduced/repaid – not a do-able solution for most people

The problem is debt; the solution is to get rid of debt

Many families have already done this by walking away with or without declaring bankruptcy from their mortgages and charge cards

But debt, once created, never goes away

When individuals renege on their debts, the banks now hold bad debt

The government steps in and deposits huge amounts of cash into banking system to keep it solvent

Personal bad debt becomes government debt via cash infusions

Bush/Obama have spent X Trillions to save banking system, insurance and automobile companies, plus expand FDIC guarantees in amount and to cover money market funds

First and foremost, a trillion dollars is a lot of money

A stack of a trillion \$1 bills, each 0.0043 inches thick, with no air spaces, is 68,000 miles high, about one-quarter of the distance to the moon

For \$100 bills, only 680 miles high

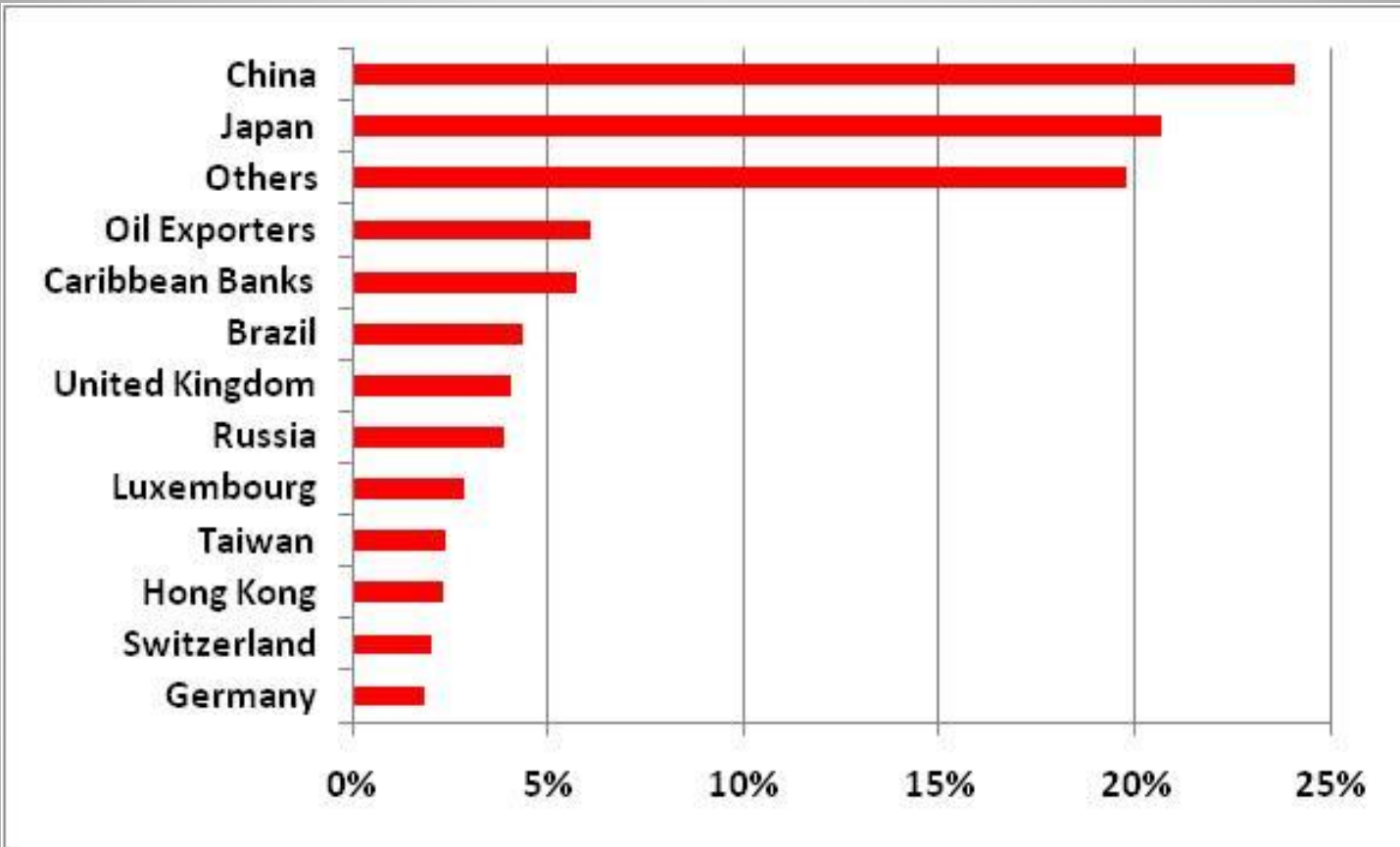
U.S. GDP is \$14.3 trillion in 2008

U.S. National Debt \$11.7 trillion

U.S. Personal Debt \$15 trillion

Plus municipal and state governments and corporate debt

Foreign Holders of \$3 Trillion U.S. Debt



Half in the hands of China, Japan, OPEC

China and OPEC diversifying away from U.S. dollar

Calling for a new international currency such as a basket of currencies (e.g. SDR)

Everyone wary of future of U.S. dollar

What do you do if you're buried in dollars:

- 1. Convert to other currencies**
- 2. Convert to commodities or real assets or stocks**
- 3. Minimize further accumulations**

What do you do if you can't sell your debt to cover deficits?

One Option

Monetize debt just like a banana republic

Destroy currency through run-away inflation

Pay off all debts with worthless currency

Issue new currency (1 new "doller" for 1,000 old dollars)

Or is this all a symptom of something else

A sideshow to distract our attention

The U.S. is overextended as the world's single superpower not unlike the Roman empire in external military conflict coupled with a disintegrating internal economy and financial system

One way to deal with a problem that cannot be solved internally is an external solution

Either accept an external solution or have one imposed upon us

The proposed solution is not a cabal of international bankers nor a conspiracy of Luciferians because the proposed solution is right in front of our eyes

We have accepted a world of globalization of manufacturing

Europe has integrated 27 nations (plus 3 candidate nations) with a common political, economic, financial system and a common currency (Euro)

Who would have thought that the Europeans would sacrifice their individual currencies for the Euro or let EU Council/Parliament set rules and regulations where each nation must abide?

George H. W. Bush made no secret of the emergence of a “New World Order”

There is strong support among American intellectuals for the formation of a global government

There is a call for a “multi-polar” world, various centers of power and influence, To replace the “uni-polar” world of the U.S. being the only superpower

The external solution to the internal financial crisis is to favorably view the formation of a global government

This subsumes our sovereignty and the sovereignty of every nation

We will have to abide by laws made by others just as European nations do including global taxation

Besides a global economic, political and financial system, and a global capital like Brussels for the EU, which will not be located in the U.S., there will also be...

A Global Currency

My guess is that the issuance of this global currency will be on cash holdings and will eliminate all debt by fiat – could also be “cyber-money” of credits and debits only –

Debt not only eliminated by fiat, but any new debt can only be created on a strictly controlled basis (U.S. states must balance their budgets just as European governments are under strict controls with regard to budgetary deficits under the European monetary authority)

It is not just the U.S. unable to pay debts that will benefit, nearly all oil importing nations including Europe, Japan, and all third world nations are burdened with debt that cannot be paid off

This may be the carrot for nations and their citizens to sign on

A First Step?

UN wants new global currency to replace dollar

The annual 2009 UN Conference on Trade and Development (UNCTAD) Report concluded that the system of currencies and capital rules which binds the world economy is not working properly and was largely responsible for the financial and economic crises.

The present system, under which the dollar acts as the world's reserve currency , should be subject to a wholesale reconsideration. The report recommends not a basket of currencies such as the SDR, but a whole new “global” currency that will replace all currencies.

I personally believe that we will not have runaway inflation, or if we do, there will be plenty of warning signs

We are actually experiencing deflation:

Falling house values

Falling consumer goods prices (take another 40% off all sale items)

Falling wages

**“I can’t find a job, but when I see a job that someone else has got, its salary is half of the \$15 per hour I use to make.”
(Observations of a heavy equipment driver)**

But there is inflation in commodity and stock market values as investors turn dollars into real assets such as oil, commodities, and stocks (China stock market buoyed by government stimulus money diverted to stocks.)

Commodity price hikes as global investors search for a safe haven will cause price inflation for motor vehicle fuels and food, which has a large energy component, plus industrial metals in consumer goods

Most of U.S. government money is parked in banks to shore up their capital structure or in financial guarantees out of reach of people

Of the \$800 billion stimulus package, <\$200 billion has actually been spent

Inflation cannot occur unless the money reaches the people

High unemployment and underutilized factories can absorb some excess money before affecting prices – we are far from that point

Enormous unused factory capacity in China where tens of millions of workers have been sent back to their home villages – these can absorb dollars without a huge impact on inflation

Think about it – is there another alternative to solving this problem?