

Book Excerpt

CHAPTER FOUR: THE FINANCIAL RECKONING DAY ARRIVES The traditional immunity of advanced countries like America to a Third World-style crisis isn't a birthright; we are facing a serious day of reckoning.

- Robert Rubin, former U.S. Treasury Secretary

America is at a significant crossroad in its history. Domestically, we are drowning in a sea of red ink as public, private, and corporate debt now exceeds \$48 trillion, and our annual budget deficit grows by more than \$1 billion a day. Entitlement programs, transfer payments, pension funds, fiscal liabilities and demographics threaten to bankrupt the Welfare State. Asset bubbles in stocks, bonds, derivatives, real estate and mortgage markets have been fueled by an orgy of speculation and credit expansion in recent years and could potentially trigger a financial meltdown. The middle class is reeling from high taxes, inflation, job losses, and stagnant wages. Illegal immigration and terrorist threats continue daily as our nation sinks into moral degeneracy and culture wars.

Internationally, our trade deficits widen by \$2 billion each day as manufacturing and other jobs are being exported overseas. The U.S. dollar continues to weaken in international trading, and U.S. currency reserves and foreign bond liquidations could strategically collapse our economy. As Alex Wallenwein, publisher of The Euro vs Dollar Currency War Monitor, signals, "Whatever the ultimate fate of the dollar will be, it already lies in the hands of foreigners; it is no longer in the power of the Federal Reserve or the U.S. government to reverse the fall of the dollar." Additionally, our military campaigns are costing billions and war drums are beating in the Far East and throughout the Islamic world.

These macroeconomic and geopolitical forces are gaining momentum, and eventually they will pose a major systemic risk to our highly leveraged financial markets and bubble economy. We should not, in our own arrogance and vain hubris, think that America is immune from an economic or political collapse in the 21st century. Our prolonged experiment with Keynesian economics is going to end badly. And it will ultimately result in a serious day of reckoning, as noted by James Dale Davidson and Lord William Rees-Mogg in their book, The Great Reckoning:

One way or another, we expect a great reckoning. A settling of accounts. We expect the long economic boom and credit expansion that began with World War II to come to an end. The end, when it comes, will not only reveal the insolvency of many individuals and corporations, it may also bring bankruptcy to the Welfare State and widespread breakdown of authority within political economies; More than you may now imagine, you are vulnerable to financial, economic, and political collapse.

Bureaucracy, reckless spending and political agendas have made us all vulnerable to fiscal bankruptcy and breakdown of our present political system, and these events may be closer than we imagine. Many are convinced that our leaders are not only anticipating these critical developments, but that some of them have also been instrumental in causing them. In his book, Financial Terrorism, John McManus refers to these individuals as powerful "insiders" who are working behind the scenes to create a New World Order. "They are determined to use debt, deficits, and government control to destroy America's might and ease us into their New World Order," says McManus. This is essentially the same group of individuals that have been responsible for creating the UN, IMF, World Bank, Export-Import Bank and drafting the GATT, WTO, GATS, NAFTA, CAFTA, and other trade agreements in recent years that help benefit their transnational corporate empires.

In 1950, during a U.S. Senate hearing, Establishment insider James P. Warburg (son of Paul Warburg) tipped his hand when he declared, "We shall have world government, whether or not we like it; and the only question is whether world government will be achieved by conquest or consent." In 1993, Henry Kissinger enthused that the NAFTA proposal (passed in 1994) was "not a conventional trade agreement, but the architecture of a new international system; the vital first step for a new kind of community of nations." In the same manner in which bankers and politicians exploited the Bank Panic of 1907 to create the Federal Reserve, and later the United Nations following World War II; they are now putting America in position to adopt the Free Trade Area of the Americas (FTAA) legislation that will create a regional government of 34 nations in this hemisphere similar to the European Union. The North American Union (NAU) initiative is seen as an important step in this direction.

America is currently on a path to financial ruin. But the Fed, corporate insiders, and political leaders are standing by with their plan to restructure our political economy and steer us into their New World Order. It is a desperate gamble, but it helps explain our current administration's fanatical push for the CAFTA legislation in 2005 which now serves as a

prelude to the FTAA legislation being debated in Congress. This also helps us understand why our standard of living among the middle class is being lowered in America and why our political leaders are completely indifferent to illegal immigration which is seen as an important step towards integration and becoming "a new kind of community of nations."

This kind of betrayal, lust for power and greed has already been discussed in this book, and is not uncommon among the passions of unscrupulous men. Treasonous behavior like this has been repeated often throughout history. And our times are no different. In this chapter we will take a deeper look into these political developments and economic issues that are threatening to reduce our nation to a Third World status. The following facts, figures, and statistics will help put our current situation into perspective and should remove any doubt that our country is heading into a financial storm.

Scripting the Perfect Financial Storm

There can be no better appreciation for our looming fiscal/political crisis than to understand our current account deficit with foreign nations and the declining value of the U.S. dollar. Since World War II, America has experienced a long economic boom, and this has occurred for two important reasons. First, in July of 1944, the U.S. dollar was established as the new reserve currency for international trade and commerce at a global conference held at the Mount Washington Hotel in Bretton Woods, New Hampshire. Officially known as the United Nations Monetary and Financial Conference, this gathering was hosted by none other than Fabian socialists John Maynard Keynes and Assistant Secretary of the U.S. Treasury, Harry D. White (who was later exposed as a Soviet spy), and was attended by Establishment insiders, financiers and politicians. The focus of this important meeting was the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development, commonly known as the World Bank.

The World Bank was created to assist war torn nations, while the IMF was implemented to maintain fixed exchange rates between national currencies. Central to this scheme was the requirement that all major world currencies would abandon their current exchange rates and any internal gold standard. Current exchange rates would be pegged to the U.S. dollar which could be redeemed in gold at the official price of \$35 per ounce. This effectively removed the gold discipline for 16 major currencies and also replaced the British pound sterling as the premier currency in the post-war period. Professor Murray Rothbard provides this comment:

Just as the United States was to use World War II to replace British imperialism with its own far-flung empire, so in the monetary sphere, the United States was now to move in and take over, with the pound no less subordinate than all the other major currencies. It was truly a triumphant "dollar imperialism" to parallel the imperial American thrust in the political sphere.

In early 1947, the IMF began operations and appointed Harry Dexter White as the new Executive Director. Member nations pledged "credits" which were really nothing more than monetary pledges to be backed up with taxation, and the IMF became a de facto world central bank with a nominally gold-backed paper standard. This action allowed member nations to inflate their fiat currencies, and also allowed the IMF to act as the lender of last resort by restructuring loans against "credits" through the World Bank. The backdrop of war and tragedy had presented an ideal opportunity for political insiders and bankers to advance their mechanism for a central banking authority. As reported in the April 20, 1971 issue of *The American Banker*, Keynes had been lobbying for a World Bank several years prior to WW II, "while White had been instructed by the U.S. Treasury only a week after Pearl Harbor to start drafting plans for an international stabilization fund after the war." Such were the plans by forward-thinking globalists who have used the IMF and World Bank to advance their corporate/socialist agendas throughout the world since 1947.

Thus, the second reason America became the dominant world economy after WW II was the fact that we could export our "dollar imperialism" and the equally important fact that we had no real trading competition. Europe was in shambles, and the Far East was either communist or too impoverished to pose a threat to American hegemony. The U.S. could set its own price on world markets, and the world had to pay in U.S. dollars. But all of this started to change during the Nixon administration. During WW II, the U.S. Treasury had accumulated vast gold reserves from nations as trade settlement for war expenses. This was an important development for supporting the U.S. dollar as the new reserve currency around the world. By the late 1960s, however, industrial economies in Japan and Western Europe were recovering from their war damages and started exchanging their excessive dollar reserves for gold payment. This sell off was rapidly depleting the U.S. gold inventory.

In 1971, U.S. dollars offshore — known as eurodollars — totaled more than \$36 billion against \$18 billion in U.S. gold reserves. By late 1971, the Bretton Woods Agreement started breaking down from international pressure as France and several OPEC nations led the way in exchanging their eurodollars and petrodollars for gold. President Nixon could not let these events continue, or the U.S. dollar would cease being the guarantor of the world's monetary order. On August 15, 1971, President Nixon finally signed an Executive Order which officially "closed the gold window" and suspended payment in gold for U.S. dollars. This action was deemed only "temporary";

by the U.S. Treasury which then devalued the dollar to \$38 per ounce of gold in 1972 and then later to \$42 in 1973. But eventually the window was shut. William Greider remarks:

Finally, by March 1973, exhausted and unable to keep the international bargaining alive, officials conceded that the old order was dead beyond resurrection. The U.S. gold guarantee was permanently abandoned and so were the fixed exchange ratios among the other major currencies. Henceforth, the dollar would find its own value in the currency markets. Fixed exchange rates were replaced by a system of "floating exchange." A dollar was still a dollar, but its international value would fluctuate daily, depending on the judgments by millions of economic players on what a dollar was really worth compared with other kinds of money.

Similar to what the FDR administration had done 40 years earlier when he removed the convertibility of our domestic currency for gold specie, the Nixon administration now did on a global scale. Political pressure and Keynesian monetary policy had finally conspired to demonetize gold, and fiat currency values would now be based on the shifting tides of human emotion, the momentary judgment of currency traders, and the collective wisdom of central bankers. The U.S. would manage to maintain its dollar imperialism in foreign markets in this new system, but the dollar would be steadily discounted in value as a result of monetary inflation and open competition with other kinds of money.

One of the initial reactions to the floating exchange policy was a dramatic 400% increase in the price of crude oil by late 1973. The OPEC oil cartel, formed in 1960, had insisted that all crude oil contracts be invoiced in U.S. dollars for international trade. OPEC leaders were nervous that their vast dollar surpluses — known as petrodollars — had already suffered inflationary losses prior to 1971, and they were anxious to hedge against further losses on currency markets. This price hike was also seen as direct retaliation for U.S. support for Israel during the Yom Kippur War in October 1973 and was followed by an oil embargo, which lasted until March 1974. Unable to redeem petrodollars for gold at the official price of \$35 or \$42 an ounce, OPEC nations soon entered the open market and helped bid the barbaric relic up to \$850 an ounce by 1980 — an increase of 2023%. This trend was also attributed to heavy gold acquisition in the U.S. after private gold ownership was restored to the American people in 1974.

Since 1971, and the breakdown of the Bretton Woods Agreement, the world has embarked on a perilous journey since the entire international monetary system is merely based on the issuance of paper money by central banks. The U.S. has had a distinct advantage in this monetary arrangement since it can supply the world's reserve currency and inflate its own currency without suffering the full negative effects like other countries. As financial analyst Jim Puplava has observed, "The U.S. government has avoided the full inflationary effects of its money printing by exporting dollars to the rest of the world. As long as foreigners accept our dollars, we can continue to export our inflation." This economic distortion has been caused by a steady flow of trade deficits in which the U.S. imports more goods than it exports to other nations. The U.S. simply finances any trade difference by borrowing or creating money.

In the 1970s, the U.S. trade deficit was relatively small. But starting in the 1980s it started to grow by \$80 to \$150 billion a year, and then up to \$300 billion in the 1990s. By 2003 the trade gap widened to \$500 billion, in 2004 it was \$600 billion, in 2005 it was \$700 billion, and in 2006 the figure is nearly \$800 billion, or almost 7% of GDP. These are big figures, notes James Turk in his book *The Coming Collapse of the Dollar*. "Looked at from virtually any angle, the U.S. trade situation is unprecedented. The annual trade deficit is larger than the budgets of Social Security, and the military, and twice as big as Medicare." A recent issue of *The Economist* additionally comments, "America has habits that are inappropriate, to say the least, for the guardian of the world's main reserve currency: rampant government borrowing, furious consumer spending and a current account deficit big enough to have bankrupted any other country some time ago."

The U.S. balance of payment deficit has been the result of massive consumer spending at home and fierce trade competition coming from abroad, particularly from Asia. In the U.S., our annual economic output (GDP) is approximately \$12 trillion, but each month we must borrow \$60 billion or more to buy foreign goods. Under normal conditions this would be enough to bankrupt any nation. Brazil suffered a currency collapse when its trade deficit reached 5% in 1987, Mexico's currency crisis was the result of a 7% deficit in 1994, the Czech devaluation occurred at 8% in 1997, and Argentina's account deficit was only 3.5% when it was plunged into a financial crisis in 2001.

So how has the U.S. been able to survive this steady outflow of money in foreign trade? In the past we have always financed our trade deficits through money creation. In more recent years we have been able to recycle exported U.S. dollars from our trading partners. In his book, *The United States of Europe: The New Superpower and the End of American Supremacy*, T.R. Reid explains:

The United States can sustain this steady outflow of money because the rest of the world has been willing to send back the dollars we use to buy foreign goods. This return flow comes in the form of investment — foreign investors buying American stocks, or more commonly lending its money by buying corporate or government bonds. When the U.S. Treasury spends more than it receives in taxes, it makes up the difference by floating Treasury bonds. Those

foreign investors putting their funds into Treasury bonds are lending Americans the money we use to buy more imports.

Through an amazing cycle of trade, foreigners are helping us finance our trade deficit so we can keep borrowing to buy their goods. For this reason, some have suggested that the U.S. actually has a trade "balance," but this trading cycle is creating a huge structural "imbalance" that will eventually do irreparable harm to America. China and Japan have largely contributed to this trade imbalance in an effort to support our consumer-driven economy, which in turn has helped their own economic growth.

The way this trading relationship works is as follows: both China and Japan are hoarding U.S. dollars (eurodollars) in order to prevent these same dollars from circulating and causing inflation to weaken the dollar. If the dollar is weak the Fed must raise interest rates which will curb lending activity, which will slow the U.S. economy and result in less consumer spending for foreign goods. By propping up the dollar, China and Japan also cause their exports to be more affordable on U.S. markets. "If China simply spent its dollars, it could flood the world market with American currency and quickly drive the dollar down," writes Ted Fishman in his book *China, Inc.*, "But China, no fool, is not interested in pushing the dollar down." And neither is Japan. At least not for now.

Together these two countries prefer to exchange eurodollars for U.S. Treasury bonds which fuels our economy and theirs. When these bonds mature, the debt is rolled over, and new bonds are issued. China and Japan currently hold \$275 billion and \$775 billion respectively and together represent 65% of all U.S. bonds held offshore. To make sure this exchange keeps flowing, the People's Bank of China has \$725 billion in U.S. currency reserves which is almost equivalent to one-half of their \$1.5 trillion GDP. The Bank of Japan has the largest currency reserves at \$840 billion. It is estimated that Japan issued ¥35 trillion yen in 2003 in order to buy up all U.S. currency reserves in their own country so they could keep buying U.S. debt and keep their exports affordable!

So how big are these currency reserves? Out of \$3.8 trillion in total world currency reserves held by central banks, 64% is in U.S. dollars and 20% in euros. China and Japan hold 65%, or \$1.5 trillion, of these U.S. dollar reserves. For China this kind of leverage could represent a strategic advantage in any future trade war or conflict over Taiwan. Trade with China has risen from 1.7% of our foreign trade in 1987 to 25% today. During this same period, Japan has gone from 35% down to 11%. China's industrial revolution has boomed since economic reforms in 1978, while China also maintains a low currency peg of 8.28 yuan to the U.S. dollar. This dynamic trade development and China's geopolitical significance in the world will be discussed in more detail in the following chapter.

Foreign direct investment (FDI) in the U.S. has now reached \$11 trillion, and a lot of this investment is coming from Asia. Foreigners now own \$1.5 trillion in stocks (14%), \$1.7 trillion in corporate bonds (24%), and hold \$3.2 trillion in eurodollars (the M-3 money aggregate). In 1925, foreigners only held 5% of U.S. publicly held Treasury debt, whereas today it is almost \$2 trillion, or 40%. Foreigners are also underwriting the huge asset bubble in U.S. real estate, and now own 38%, or \$3.3 trillion of U.S. real estate debt totaling \$8.8 trillion. Since the 1990s, in a process known as "securitization," banks and mortgage companies have bundled their structured loan portfolios and sold them to investors. According to Grant's Interest Rate Observer, foreign purchase of these bond portfolios is up 60% in the first quarter of 2005. Ted Fishman further notes:

China almost certainly has a large stake in the market for bonds issued by Fannie Mae and Freddie Mac, the companies that buy home mortgages from banks and thrift institutions and resell them as bundled securities. This means that billions of dollars' worth of investments belonging to the Chinese are plowed, indirectly, into the American real estate market, and that an ever increasing share of Americans' mortgage payments pour into the coffers of the government of China.

Here is another case of foreigners recycling our debt and pushing up a speculative asset bubble in real estate. Low interest rates and loose lending practices have led to a literal buying frenzy in the U.S., which is beginning to concern regulators. Unlike the old 30-year loans with 20% down, today's marginal buyers are taking out interest only, adjustable rate, and negative amortization loans. According to Fitch Ratings, 46% of all new loans are adjustable rate mortgages which are highly sensitive to interest rate hikes. In addition, consumers are stripping the equity in their homes with highly leveraged 125% equity loans in order to consolidate record levels of household debt. This "equity stripping" now represents \$800 billion in the mortgage lending industry!

A majority of this creative financing is originating with commercial banks (55%), thrifts (14%), credit unions (7%), and mortgage companies like Countrywide and Ditech (24%). While first time home buyers account for the bulk of this lending activity (64%), several are betting on the "greater fool theory" as speculators and investors in second homes (36%). William Greider remarks, "Whether it is stocks or bonds, corner lots in big cities or undeveloped swampland in Florida, speculative bubbles all derive from one conviction: the buyers are convinced that in a few days or weeks or months they will become sellers and unload their purchase at a profit." This rush to buy real estate has driven up prices sharply in Florida (46%), California (33%), Nevada (29%), Hawaii (26%), Arizona (24%), and New Jersey (23%) with average homes ranging from \$300 to \$600 thousand. This mortgage bubble is about to burst, and when it does it will shake \$8.8 trillion in consumer debt down to its very foundation. Already, in late 2006 and now early

2007, the housing market is suffering from a serious decline and this trend will get worse.

Because the U.S. has a debt-based (credit-based) economy, Americans are increasingly servicing more debt than they can reasonably handle. Since 1990, median family income has risen only 11% after adjusting for inflation, while outstanding household debt (consumer, mortgage, and credit card) has jumped 80%. In 1995, consumers added \$4 of new debt for every \$1 in savings. In 2004, consumers added \$20 for every \$1 in savings, or \$2.7 trillion against \$133 billion in savings. This 20 to 1 debt ratio has turned the entire American economy into a giant hedge fund, and some economists are starting to worry about rising interest rates by the Fed. Any rise in the Fed funds rate could have negative effects throughout the entire economy as indicated by Jim Puplava:

As the Fed rate hikes continue, risk to the financial system increases because all markets are interlinked. Systemic risks to the financial system have increased and may converge. A misplaced bet in structured debt could backfire – causing interest rates to rise. Narrowing credit spreads could cause the carry trade to unwind – forcing leveraged players to dump their bond holdings – leading to a jump in interest rates. A trade war could create friction in the credit markets – forcing central banks to dump their Treasury holdings or go on strike with new buying. A rise in interest rates could make mortgage payments untenable for overburdened households – triggering bankruptcy…. Each tipping point could lead to the next as they are all connected in a daisy chain.

The U.S. debt pyramid in the private and public sector is creating the perfect conditions for a financial storm. Sub-prime mortgage debt is particularly vulnerable as millions have signed on to incredibly risky debt obligations. A series of defaults could lead to a contraction of bank assets and available credit and spread throughout the banking sector. This risk contagion could lead to a systemic collapse and cause the Fed to intervene as the lender of last resort. In a recent speech sponsored by the Stanford Institute for Economic Policy Research, former Fed chairman Paul Volker warned that the economy is “…skating on increasingly thin ice.”