



Economic Theory in Practice

A.P. O'Malley



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In Memory of
Kathleen Kilgallon (Nee Mellett)
1948 to 2012

Introduction

Economics is taught in colleges and universities around the world as a “social science,” yet there are huge gaps between how economies actually work in reality and the theory behind the subject “Economics.”

One of my first lessons in Economics was at the Leeson Street Institute of Education in Dublin, Ireland where a Mr. Lynam taught on a Saturday morning in the spring of 1987, over a quarter of a century ago. Mr. Lynam was a really direct teacher and didn't traffic in nonsense, ensuring that lazy students remained awake at all times during the class session.

The subjects taught were micro and macro, elasticity of demand, perfect competition, monopoly, fiscal and monetary policy, trade surpluses, budget deficits, full employment, and labor markets. These concepts and a host of other ideas and theories were supposed to actually work in perfect equilibrium in the REAL WORLD.

Then later while I was a young student at UCD (University College Dublin), Professor Desmond Norton taught on a Wednesday morning in the fall of 1987. Norton's lectures were pure theater and everyone attending was injected with an enthusiasm not since seen in any lecture attended in years by this author. Economics was no longer a mystery to me, and I decided to understand how everything was connected: finance, trade, monetary policy, employment, growth and every other component that constituted the “economy.”

Curiosity drove me to test everything against my own experience and against the reality of the world I lived in. Employment being scarce in the early 1990s, upon graduation, I was forced to emigrate to London, England, and later to New York City where I worked in several jobs and careers absorbing knowledge and experience, trying to make sense of the world of economics, finance, banking, marketing, and advertising. I eventually returned to college and earned a master's degree in business journalism and have been teaching business and economics at Baruch College-CUNY since 2004.

Once I moved to New York, I worked as a foreign currency trader, a trainee bond broker, a cater waiter, a doorman, a jewelry salesman, and even a bike messenger on the streets of Manhattan, always measuring the conventional theories against the reality within the economy and at the core of so-called Economics.

This book attempts to explain what *exactly* “Economics” is and whether or not the theories it espouses actually *work in the real world*.

It addresses how it is taught in colleges across the United States and the world, how it is deeply flawed and what the future holds for economies around the world, especially in the context of mega-banks that impact Main Street more now than they did in the past.

This book will explore how derivatives have swarmed the balance sheets of banks and how governments throughout the “free world” have guaranteed private profits for banks, but have socialized losses for these same banks, impacting the taxpayer, and putting the economy at increased risk as volatility and leverage increase over time.

It is written for ordinary people, students and academics alike, since we are all affected by economic policies, decisions, opportunities, and theory run amok.

CHAPTER 1

Colonialism and Economics

At what point did the word “economics” make its way into the lexicon of the modern world?

According to etymology dictionaries, the word emanates from the 1580s and referred to the “art of managing a household” and, circa 1792, from the French word *economique*, meaning the science of wealth.

Hence, a full two hundred years apart, the root of the word comes from two distinct origins: household budgeting and the scientific investigation of wealth. Most societies in the 1580s were feudal with monarchs, dukes, barons, and the peasantry. Economics was essentially a common sense way to keep a household viable. Basic resources originated locally and trade between large nations revolved around huge shipping companies, most notably the British East India Company chartered in 1600 by the royal decree of Charles I.

The New World was being explored by the Spanish, Portuguese, French, and English. Vast quantities of gold were being ripped from the land of the Incas and Aztecs and transported across the Atlantic from modern-day Peru, Ecuador, Mexico, and a myriad of other countries that formed part of the Inca, Aztec, Mayan, and Mixteca territories. Moctezuma II, the emperor of the great Aztec Empire, was killed by the conquistadores led by Hernan Cortes in or around 1520. Moctezuma’s father reigned from 1440 to 1469.

Economics suddenly had to deal with all of these mountains of resources plundered from the heart of the Aztec and Inca Empires that founded the Spanish and Portuguese wealth.

Around the same era, the Medici’s of Florence were building a vast banking network and had the ear and investments of the popes. From 1397 to 1494 the Medici family founded, built, and maintained the most

powerful bank in Europe, headquartered in Florence, the political center at the time.

They started branches in Bruges, Belgium, in London, England, in Naples and Milan in Italy, lending to kings and merchants, barons, and dukes all across Europe, amassing fortunes in interest and investing in factories, wars, backing secular rulers against monarchs and vice versa, all in pursuit of their banking interests.

Then in the year 1600 the English entered the fray with the aforementioned British East India Company (BEIC) founded by Sir Thomas Smythe, first governor of one of the world's first corporations. Over its lifespan English ships operating for the BEIC sailed to China, India, and Turkey, trading woolen cloth and silver for a myriad of spices, silks, precious stones, porcelain, and carpets. By 1640 the BEIC had built a trading center at Madras, India, using this as a base to trade with other countries in the East Indies. And by 1690 Calcutta was built as a trading center by the British.

The company lasted for over 250 years and issued its own coinage based on its trading, revenue, profits, and vast holdings throughout the now-burgeoning British Empire. By 1858 the BEIC was abolished partly due to a rebellion by the Bengali Army.

The British, having dominated the seas with their navy and to a lesser extent the networks set up by the BEIC, were the premiere colonial power; as the saying goes “the sun never set on the British Empire” because it was so vast. By the mid-1600s and early 1700s, Britain had a foothold from Ireland to India, from the New World to Africa, and as the wealth of the Realm increased so did the need to manage it.

The four factors of production were thus founded: Land, Labor, Capital, and Enterprise.

Land was plentiful now, having been plundered from the people in Africa, India, the New World (America), Ireland, the Caribbean Islands—St. Kitts, St. Lucia, Grenada, Barbados—parts of South America, Guyana, and several other territories across the globe.

Having secured land and resources from sugar to gold, rubber to timber, silver to opium, the next step was to provide labor, human effort to be exploited in the pursuit and maintenance of this vast wealth.

In 1672 King Charles gave his seal of approval to the Royal African Company, which monopolized the supply of slaves to the Caribbean, taken mostly from Africa. Before the abolition of the slave trade by 1833, 3.5 million African slaves had been transported to the Americas by British ships—a ready-made labor force that was not required to be paid a single penny!

An extract from the Royal African Company's accounts (1685) shows a page in the ship's ledger accounts.

As land was being amassed by the millions of acres and labor by the millions of human beings across the Empire, a new factor of production had to facilitate all of this: Capital.

Classic definitions of capital include “stock or property” from the Latin “capitale” circa 1610. Later the word became synonymous with social capital,” “natural capital,” and “spiritual capital.” The Bank of England, and later Lloyds of London, would play a major role in the financing of this and many other British slave and commodity trading companies throughout the late 1700s and early 1800s.

Lloyds of London began in the late 1600s, and between 1688 and 1807, one of its main sources of revenue was the insuring of slave ships. The free labor that was being hauled across the Atlantic Ocean had to be financially protected, and as the slave trade boomed, so too did Lloyds' business operations. Later when slavery was abolished in Britain, Lloyds reinvented itself with the 1871 Lloyds Act.

During this vast subjugation of colonies by the British Empire: Lands (plundered), Labor (via slavery), Capital (invested), and Enterprise (risk coordinating all four), necessitated a methodology that would efficiently and logically manage this newfound wealth. From afar, how could the fathers of acquisition of these new colonies exploit this vast wealth to the benefit of their own royal and non-royal coffers back in England?

It was decided that a manual would be written that would explain how to efficiently exploit these factors of production for the expansion of the Empire and the further accumulation of wealth within it.

Scotland would provide the solution.

Adam Smith, a dour Scottish lawyer, would be commissioned to write a tome of a book on wealth and all of the components that influenced the creation of that wealth.

His book “An Inquiry into the Nature and Causes of Wealth of Nations” (“The Wealth of Nations” the short title), published in 1776, created a new paradigm in how land, labor, capital, and enterprise were to be treated and managed, and above all, how the gospel of efficiency would be proclaimed throughout the civilized world.

Smith’s book would dominate the theories of economic efficiency over the next centuries, even though many of the assumptions inherent in his tome were followed to the letter in a world so different from when Smith lived.

CHAPTER 2

The Free Market Economy and its Pitfalls

In researching this book I was struck by the fact that most of the “free market” economies are saturated in debt, from government to private debt. Most financial institutions are leveraged more now than they have ever been in the past.

Sovereign debt or government bonds were low risk in the past, but now entire countries from Greece to Ireland have become very risky investments. Credit spreads are more important than ever. The more Spain’s credit spreads widen, for example, the more risky it becomes for global financial institutions, since all are linked through CDS (Credit Default Swaps). Spanish banks own Spanish government debt; German banks own peripheral Euro debt, Irish bonds, and Greek bonds, so the problem of too much leverage in any given country is a major problem for the entire global financial system.

Deleveraging, or the gradual repayment and stabilizing of these mountainous debts, can occur only through economic growth, yet current austerity programs in many parts of Europe and lowering government spending and budget deficits (Ireland and Greece especially) threaten any kind of growth and by default debt deleveraging.

Europe may be headed into a multi-year period where deleveraging becomes the key to all financial markets. Only massive liquidity injections by the Fed and European Central Bank (ECB) have softened the leverage risk.

Liquidity does not necessarily create economic growth, it just allows debt maturities to be pushed out further in time, putting off to tomorrow what needs to be done today.

Further, while the Fed embarks on the QE-2 and QE-3, it creates a war on savings. By artificially keeping interest rates low in the short term, older retirees are forced to put their money into the stock market and forms of investment that present higher risk, since there is no incentive to save when returns are a puny 0-0.2% offered by most major banks, themselves members of the Federal Reserve System!

“Free markets” are indebted throughout the Euro zone in 2010:

By 2012 Greece, Italy, the United States, Portugal, Ireland, United Kingdom, and Spain will most likely exceed debt- to-GDP percentages as economic growth slows, volatility increases, and unemployment climbs to more unmanageable levels across Spain, Ireland, Greece, and Portugal.

The problem is that many European banks own sovereign debt across the Euro Zone: Germany, the economic powerhouse of Europe, is exposed through its banks to Ireland’s sovereign debt, while Spanish banks are exposed to Portugal’s debt, a financial web with strands that, once broken (i.e., go into default), will cause a cascade effect from Greece to Italy, through Spain and Portugal, all the way to Ireland.

Governments across Europe have been attempting to collect revenue any way they can to bridge the gap between their expenditures and money flowing into their coffers. For example Ireland has attempted to collect a septic tank surcharge from farmers. This policy has backfired as the population realized that these charges were disguised taxes.

The Irish Experience: An Economic Case Study in Reality

In Ireland, for example, the government recently attempted to bring in a stealth tax under the guise of a “household charge” of 100 Euros (about \$132), but when the deadline of March 31, 2012 rolled around, only 50% of the eligible 1.6 million households had paid the “charge.” A massive 800,000 households *refused* to pay a penny and protested by the thousands across the length and breadth of Ireland. This has forced the Irish government to look closer at future stealth taxes and given the

ordinary people a belief that protest can work if coordinated and organized with a unifying message.

How can the theory of “free markets” create jobs, wealth, and social stability when the economies are strangled by debt, both private and public?

Ireland is a perfect example of the phenomenon of “free market” dynamics when the “Celtic Tiger” economy ran riot across the economic savannah.

Between 1997 and 2007, the Irish economy “grew” by 5% to a whopping 15% every year. But bank lending as a percentage of GDP tripled for the same period. The “Free Market” Celtic Tiger was injected by financial steroids in the form of massive debt, causing a debt bubble and housing bubble, and since construction was the backbone of the “economic miracle,” housing became the driver of prosperity. The reality was that banks made out like bandits while ordinary homeowners ended up locked into mortgages that were unsustainable.

House prices in Dublin, Ireland (a hot bed of construction and housing speculation) skyrocketed during boom time—1997 to 2009—in Celtic Tiger land.

Ireland was undergoing a boom of historic proportions in property prices, but the wages and salaries were not rising at any rate resembling the absurdity of housing prices. This lag between earnings and the ultimate collapse in housing would come back to haunt the ordinary Irish worker, leaving many in equity traps and, from 2008 when everything fell apart up until the present, forcing tens of thousands to emigrate.

At the time of writing of this book the International Monetary Fund (IMF) was embarking on a program of enforced “austerity” measures, mostly rejected by over 50% of Irish workers and taxpayers. An extract from the full document drafted by the IMF on February 13, 2012 (a referendum was held on May 31, 2012) states on page 31 in section 37 that:

The authorities have reiterated their commitment to an ambitious public asset disposal program . . . with the suitability for disposal of a number of state owned assets will be discussed with external partners.

The core of this statement involves the selling off of the Electricity Supply Board (ESB), the Gas Board (Bord Gais), Aer Lingus (state airline) and a host of other semi-state and mostly profitable entities that were built up over decades by the Irish people—taxpayers and workers—many of whom received subsidies via the taxpayer since their inception. The Irish economy, so often heralded across the world as the “Celtic Tiger Miracle,” will be reduced to an IMF-controlled colony with foreign multi-nationals owning key national assets due to government mismanagement of the economy and monstrous banking mistakes that were then granted guaranteed bailouts.

CHAPTER 3

Foundations of the U.S. Economy

When considering the gross domestic product (GDP) of a country, it is important to understand the various contributions made in assessing the entirety of its value; for the United States, it was over \$15.3 trillion by the end of 2011. Estimates suggest that 2012 will come in at just above this number.

What is the U.S. economy dependent upon as a major contributor to GDP?

Consumption and Consumers

Consumption is the most important component of U.S. GDP, contributing 71.1% to the total of \$15.319 trillion, as of December 2011, according to the BEA (Bureau of Economic Analysis [BEA.gov]), with government accounting for a further 20.1% of total GDP. Private domestic investment, which includes small- and medium-sized businesses and corporations, contributing 12.5% to GDP. Net exports of goods and services were -3.7% , making the grand total 100% (Table 3.1). Much of what the United States consumes is manufactured in China at sweatshop wage levels (see “China Factor” later in this chapter).

Table 3.1.

GDP components	% Contribution to GDP	\$ Value	Notes
Consumption	71.10%	\$10.891 T	DPI down 2.1%
Government	20.10%	\$3.079 T	FGS up
Private Inv.	12.50%	\$1.9148 T	CP up \$39.8 B
Net Exports	23.70%	2\$566.803 B	Trade Deficit
Total	100%	\$15.319 T	
DPI = Disposable Personal Income;			
FGS = Federal Govt. Spending;			
CP = Corporate Profits			

Data from BEA.gov (Dec 2011 GDP and the Economy). Table by Author.

To use an anatomical metaphor, the primary muscles that determine and ensure a constant backbone of consumption are marketing and advertising.

Annual spending on advertising in the United States is estimated at \$147 billion for 2012, up 4% from 2011. But the business model for advertising spending and a return on investment of marketing (ROI of M) is changing dramatically, and global corporations (the biggest ad spenders) are demanding better returns from their marketing budgets.

Government spending is dependent upon political expediency. Of the 20.1% impacting GDP, defense, Medicare/ Medicaid, interest on the debt, and social security have a massive effect.

If the total amount of federal government spending for all of 2011 was \$3 trillion (that's \$3,000,000,000,000), then Health and Human Services gobbled up 24% or \$720 billion, Department of Defense 20% or \$600 billion, and so forth. Even interest on the U.S. national debt, which surpassed \$15 trillion on November 11, 2011, gobbled up 7% of the total or \$210 billion.

U.S. GDP is dependent on massive government spending to ensure that the defense industry continues into the future.

This contributes to the economy in terms of job creation and exports, and any politician going for re-election cannot afford to vote for a decrease in defense spending. To vote against defense budget expansion would be political suicide!

Education and the Economy

According to a story in the *New York Times* in May 2012, national public spending on education is at a 25-year low, while tuition costs at universities and colleges have spiraled out of control, driving most students to take out loans to cover their basic undergraduate education.

In May 2012, outstanding student loan balances across the United States totaled \$904 billion, according to the Federal Reserve Bank, and are expected to reach one trillion by the end of 2012. That's \$1,000,000,000,000 in loans taken out by aspiring graduates who are facing shrinking job prospects as the U.S. economy continues to out-source jobs abroad at an increasing rate.

From 1980 to 2006 student loans were a negligible percentage of U.S. GDP, but by 2008 student loan balances made up 2% of U.S. GDP and are expected to reach 6% within the next eight years.

A worrying trend toward an economy is increasingly dependent on undergraduates becoming burdened by debt before they get out of college and get a job, forcing them to take whatever they can get to begin the arduous task of repaying tens of thousands of dollars for a degree that may no longer be relevant upon graduation.

And increasing numbers of graduates are defaulting on their loans as they struggle to survive on a basic level to pay rent or mortgages, and grocery and utility bills. Student loan trends point to a bubble bursting similar to the housing mortgage boom-bust in 2008, leaving a trail of destruction in its wake punctuated by foreclosures, vandalized houses, families forced to move into motels, and bank repossessions on a vast scale.

Will we see a generation of young people forced to work two jobs to repay loans that were bought by so-called guarantors adding fees and garnishing wages in a bid to profit from the misery of aspiring graduates?

China Factor

U.S. manufacturing has been eviscerated over the past 30 years and, according to the U.S. Department of Commerce in conjunction with the St. Louis Fed, trade deficits with China since 2002 (China was admitted to the World Trade Organization on November 10, 2001) have risen from \$100 billion to just shy of \$300 billion a mere 10 years later. In fact

part of China’s entry was hailed by Robert Zoellick, U.S. Trade Representative to the WTO, as a historic step. The United States depends on importing billions of Chinese-made products.

Since Zoellick’s “historic step” comment just two months after the September 11 attacks, according to the U.S. Bureau of Labor statistics, U.S. manufacturing jobs have fallen from 17 million in 2000 to fewer than 12 million in 2011.

And cities like Detroit, Michigan, are testament to this evisceration of manufacturing jobs, mostly auto jobs that have shrunk and moved to China and Mexico.

In a recent documentary, “Detropia” (2012) by filmmakers Heidi Ewing and Rachel Grady, the implosion of the auto industry and its consequences on jobs in Detroit illustrates how countries like China and Mexico have reaped the benefits of manufacturers moving en masse to cheap labor environs.

Figure 3.1 shows the dramatic destruction of manufacturing jobs beginning in 2000 and accelerating in 2001 when the World Trade Organization rules allowed China’s entry.

By ensuring that the United States imports cheaper and cheaper goods from China, the two biggest winners in this scenario are Chinese factory owners and U.S. corporations that use cheap labor to make products from shoes to apparel and computers to iPhones and iPads. The biggest losers in this equation are U.S. factory workers and the middle class who

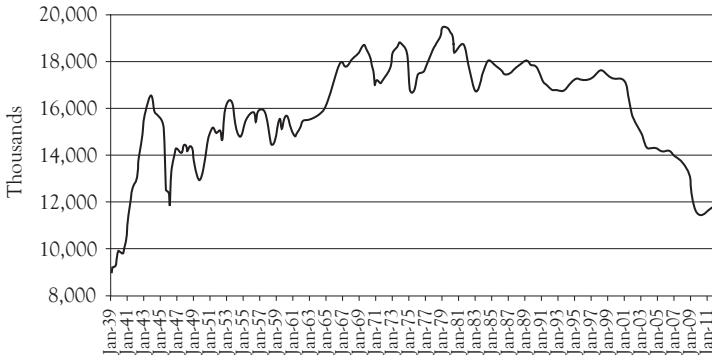


Figure 3.1. U.S. Manufacturing Jobs 1939 to 2011

Source: Bureau of Labor Statistics. Copyright in the Public Domain.

are forced to work at minimum wages in the same outlets that import vast quantities of junk goods from China: Wal-Mart, Costco, etc.

In fact, the United States has a trade deficit not only with China but also with almost all countries it trades with. The Republic of Ireland, with a population of about 4.5 million (excluding Northern Ireland), Mexico, with a population of 114 million, and Malaysia, with a population of 29 million, all had trade surpluses with the United States, with a population over 300 million.

In 2009, the United States had trade deficits with Mexico of \$50 billion, with Ireland of about \$20 billion, and with Malaysia of about \$10 billion.

In 2010 and 2011 these three countries—a snapshot of over 200 trading with the United States—showed increased trade with the United States and a widening of trade deficits with all three. By 2011, these had increased to \$64.4 billion with Mexico, to \$31.7 billion with Ireland, and to \$11.5 billion with Malaysia. That was a 28.8% increase in trade deficits with Mexico, 15% with Malaysia, and a whopping 58.5% increase with Ireland.

The U.S. trade deficit trend shows no sign of abating, and the longer this goes on, the fewer jobs will be created in manufacturing over the coming decades. The United States has become a service-job-creating economy and policies have consistently undermined the creation of jobs that *actually make something* of value, upon which a decent economic wage can be earned by workers across the fifty states.

China has become America's factory and India its office, servicing the plethora of corporations that depends on low wages into perpetuity. This decision to outsource assists in the amassing of consistent profits and the minimization of taxation on those profits as more and more desperate countries offer tax advantages to American corporations in return for "good jobs."

Silver Linings in U.S. Manufacturing

Although millions of jobs have been lost over the past decade and a half, there are some bright spots in specific industries on the manufacturing horizon.

According to recent published reports, U.S. manufacturing unit labor costs (MULC) have declined slightly over the past 30 years, from 2008 to 2010, while Germany's have almost doubled (up 88%).

This will make the United States a more attractive place to manufacture over the next few years as hourly wages in many Asian countries continue to rise and workers in factories there become more organized and form unions.

Similarly in China, in 2000 average wages were a paltry 50 cents per hour, but by 2012 they had *increased sevenfold* to \$3.50 per hour. As a result of this development, Asia's competitive advantage in manufacturing is disappearing. And India's middle class has climbed above 300 million people, predicted to increase well beyond the entire population of the United States in the next decade. A wonderful documentary "1-800-INDIA" from 2005 illustrates the impact outsourcing has had and continues to have on modern India.

Not only have average hourly wages increased in China, according to the *FT (Financial Times)*, "trucking costs in China's two biggest export regions are \$2.75 a mile. In contrast, it's \$1.75 a mile in the United States" (April 30, 2012).

Labor costs and transportation costs contribute to competitiveness in both countries, and as China's costs pressures rise relative to the United States, manufacturers may consider moving back to America in the next few years. And as the U.S. dollar loses value against the Euro, the U.S. manufacturing environment may offer sizable cost advantages to companies with major markets in North America.

According to *Bloomberg News* (May 12, 2012), Continental AG, the German rubber and tire conglomerate, is planning on spending \$524 million on building a new tire plant in the United States, adding 1,200 jobs in the chosen state. Siemens too is planning to expand its Charlotte, NC, facility and will serve as an export base to North America, Mexico, Arabia, Korea, and Japan.

Another silver lining assisting the changing manufacturing environment in the United States is the wide availability of cheap natural gas found in the United States.

Natural gas prices for manufacturing are just under \$2.80 per MBTU (manufacturing British thermal unit) in the United States, compared to \$16 in both Japan and Korea, and \$10 in Germany.

In an interview with the *Wall Street Journal*, Chesapeake Energy CEO Aubrey McClendon stated that the United States had:

an incredible advantage headed its way as Asian labor costs rise, as the cost to transport goods from Asia to the United States rises, as oil prices rise . . .

He continued, adding that gas prices in the United States will cost between \$3 and \$5 per cubic foot in the medium term. Longer-term gas will cost \$4 to \$6 per cubic foot, and as suppliers are encouraged to produce at those levels, the United States will have broken OPEC's stranglehold on the economy.

The United States has the capacity to expand its production of natural gas, but do the politicians have the necessary mettle to nurture this truly natural resource or will they impede its expansion and application in the manufacturing sphere?

Recent job reports issued by the Bureau of Labor Statistics (BLS) point to a modest increase in manufacturing employment versus non-manufacturing employment in the United States for the first time in 35 years.

The reason for this increase is based on a trio of economic factors:

1. Lowering labor costs relative to other potential manufacturing destinations;
2. Lower energy costs (especially natural gas as discussed above);
3. Lower exchange rates (USD versus Euro etc.).

Although U.S. car manufacturers are suffering, foreign car makers are increasing production here.

Nissan increased production in the Americas from 70% of vehicles sold in the region to 85%. Toyota North America is planning expansion of exports of its cars manufactured in the United States all over the world.

In fact U.S. vehicle exports have gone from 1.4 million to 1.56 million between 2010 and 2011 and are estimated to top out at 1.65 million by the end of 2012 and pass the two million mark by 2015.

All of these increases will come from the expanded capacity of foreign car manufacturers throughout the United States and will result in

additional jobs. Nissan, Toyota, Kia, and Honda are expected to expand capacity over the next five to seven years.

The Economic Policy Institute estimates that for every manufacturing job created in the United States, three more jobs are created, as manufacturing jobs act as multipliers of other jobs.

The industries that offer the most potential are as follows:

- *Petroleum Refining*
- *Utilities*
- *Manufacturing*
- *Chemicals*
- *Automobiles*
- *Electrical Machinery*
- *Paper*
- *Construction*

Finally, U.S. manufacturing corporate profits as a percentage of total profits have gone from 50% in the 1940s to less than 25% in the 2000s. They were a mere 15% in 2005 but have been marginally rising since 2007, and are expected to rise to just under 20% between 2012 and 2015 (Table 3.2).

Table 3.2.

Year	Manufacturing profits as % of total corp. profits	Decrease/Increase per decade
1940	50	
1950	53	-3%
1960	47	-6%
1970	42	-5%
1980	42	0
1990	25	-17%
2000	22	-3%
2010	19	-3%

Data from Bureau of Labor Statistics. Table by Author.

Policies to encourage manufacturing in the United States over the next three to five years—and beyond—*must go beyond* partisanship in Congress, and if these elected representatives really care about the state of the U.S. economy, they must encourage the renaissance that is occurring in manufacturing across the United States.

To impede this would be economic suicide, adding to the already dismal job picture and ensuring that any hope of building a middle class through decent job creation would be stomped on by the bureaucratic boots of the bigwigs in Washington, D.C., peering across the country from ivory towers of arrogance.

But many in Washington seem oblivious to the greasy, hardscabble world of *making things that are useful* to others. Instead they have degrees in law and insist on making things that are harder for others. Silly laws impede job creation through pragmatic methods, using the already naturally endowed resources of the United States and allowing these resources to be either misappropriated from or underutilized for the betterment of the overall U.S. population.

CHAPTER 4

Economic Indicators

Students of economics are usually bombarded with statistics that measure the health of an economic system. One of the most important of these statistics is unemployment; in the United States the BLS, which is part of the U.S. Department of Labor, is responsible for the weekly and monthly unemployment numbers.

Here is how it usually works: The BLS measures how many unemployed workers are getting weekly unemployment insurance checks and adds to that number the number of long-term unemployed—those on welfare who also get weekly checks. These two groups are considered to be the core of the “unemployed.”

So John or Jane Doe just got laid off and is eligible for six months of unemployment insurance. On June first John gets fired from his job as a Wall Street analyst in a small downtown firm. He is shocked that his company fired him after 10 years of hard slog, but single, he decides to take it easy. It's almost summer and he wants to enjoy the months of sunshine and freedom ahead.

Officially his unemployment insurance (the part he's been paying into over the course of the 10 years he worked) lasts for six months.

By December first it will run out, unless the government extends it by six months. Assuming his eligibility ends in December 2012, the BLS now considers John Doe “not unemployed.”

But the reality is very, very different. John, realizing that September had rolled around, searched for jobs and had the odd interview, but still is unemployed, and on December 1, he is no longer eligible for unemployment insurance. John is NOT EMPLOYED, but the BLS no longer counts him as “unemployed.”

How many John Does are just like our example here?

How many part-time workers who desperately want to become full-time are there across the United States and are counted as “employed” when they are partly employed, working just 15–20 hours a week but want to be working longer than that?

And as the election approached, unemployment magically kept moving downward!

Of course if the BLS continues to *exclude* those workers who have run out of unemployment insurance and part-timers looking for full-time work, the picture looks rosy indeed.

The reality is disturbing.

The more accurate measurement is referred to as U-6 and this number is much higher than the statistically distorted 8.1%. U-6 is *more than double* the BLS number and stands at just about 17%.

It differs from state to state, but on average across the United States, the U-6 number is cause for concern. If one considers the total labor force to be around 155 million, the U-6 of 17% means that 26.35 million people in the United States have no job or work part-time and want a full-time job, but cannot find one.

Another way to look at this is how many workers participate in the labor markets?

Since 2007 before the bank meltdown and the resulting recession, participation was just over 63%, meaning that 37% of the total population (includes ineligible labor participants—kids, elderly) did not participate.

This plunged from 63% in 2007 to 58.5% from the end of 2009 (Figure 4.1) and hasn’t recovered since. Even taking into account the birth rate, baby boomer retirement, and other demographic factors, the unemployment picture doesn’t look very optimistic and will continue to worsen.

A more disturbing addition to all of this is the number of manufacturing jobs lost in the United States over the past several decades.

Figure 4.2 aptly illustrates this point.

The United States has become a more service-oriented economy as more and more manufacturing jobs migrate to low-cost countries or disappear entirely. Also the advent of NAFTA (North American Free Trade

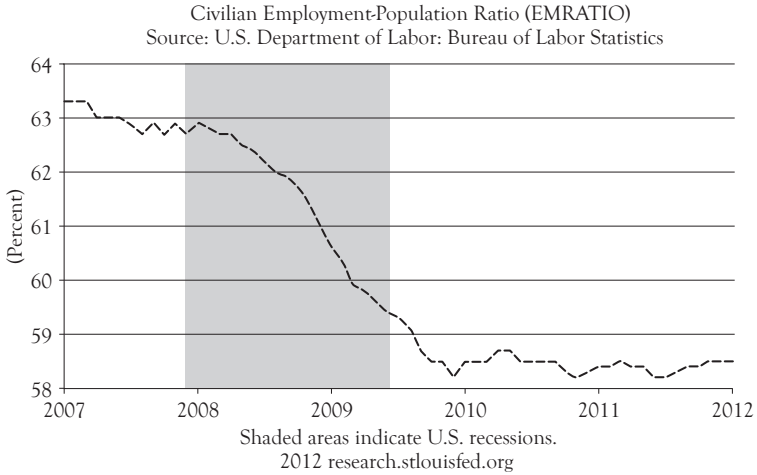


Figure 4.1.

Source: Bureau of Labor Statistics. Copyright in the Public Domain.

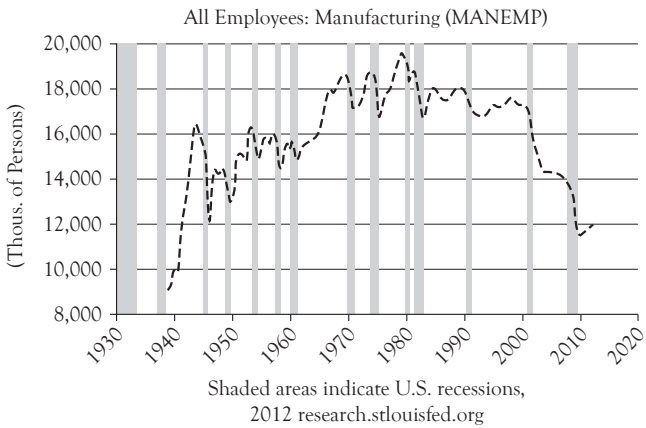


Figure 4.2.

Source: Bureau of Labor Statistics. Copyright in the Public Domain.

Agreement), signed by Bill Clinton in 1994, encouraged millions of jobs to move south of the U.S. border to Mexico. Then later the CAFTA (Central American Free Trade Agreement) was signed by George W. Bush in 2004, just 10 years after NAFTA. CAFTA includes low-wage countries such as Dominican Republic, El Salvador, Honduras, Nicaragua, Guatemala, and Costa Rica.

According to CAFTA Intelligence Center (CAFTA Intel-ligencecenter .com), there are a myriad of industry opportunities from apparel to

aviation and financial services to manufacturing to be exploited. From Chart 4.3 manufacturing jobs almost doubled between the war years 1939 to 1943 from nine million to just under 17 million.

But after NAFTA was signed manufacturing jobs dropped again and more dramatically in 1999, from over 17.5 million to fewer than 12 million 10 years later. In 1999 several WTO (World Trade Organization) agreements were signed by Clinton and ensured jobs would move away from the industrial heartland of America to low-wage countries offering grants, cheap factory space, and minimal human rights laws.

It is no mystery as to why so many manufacturing jobs disappeared: U.S. trade policy under Clinton (NAFTA) and Bush (CAFTA) resulted in 5 million jobs moving away and destroying entire industries across entire states in the United States.

Unemployment levels spiked and a job tsunami moved to Mexico and Central America, leaving in its wake entire communities without decent wage earners, forcing those left behind to get jobs in the service industry or resign themselves to a life of long-term unemployment.

Add to this the attacks on September 11, 2001 and the 2008 banking meltdown, and the unemployment picture becomes clearer.

U-6 (Figure 4.3)—which measures those who have used up their unemployment benefit and given up looking for work, plus those working part-time but would like to work full-time—is the real rate.

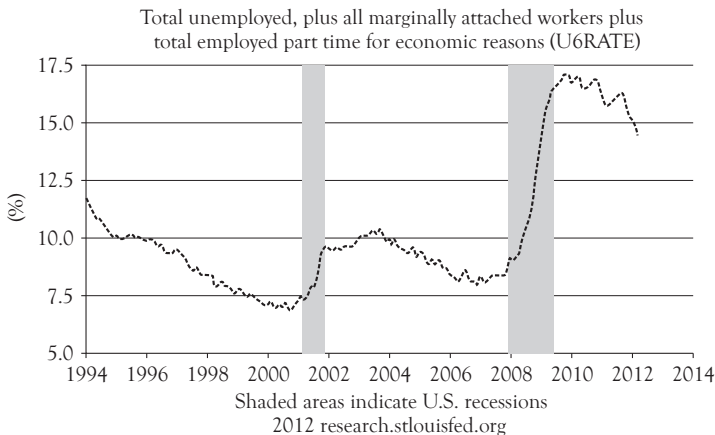


Figure 4.3.

Source: Bureau of Labor Statistics. Copyright in the Public Domain.

Traditional unemployment measurements need to be substantially revisited and altered to reflect the reality in an economy that depends on low-wage countries to manufacture and outsource many of the jobs that historically provided the foundation for strong communities and a robust tax-revenue generator.

“Infallibility” of Inflation Measurements

As unemployment rates are under-counted and the rate is distorted, so too is the rate of inflation, because the components within the CPI (Consumer Price Index) do not include very important costs in average households: gasoline and heating oil.

In lay terms, inflation refers to the cost of living. How much money does John Doe need to fulfill the necessities of Life? When this author arrived in the United States in the late 1980s, a pint of beer was \$3.25. Table 4.1 illustrates the point.

Commuting costs, heating costs, and entertainment costs are a large percentage of the wages most workers earn, but if we were to depend on the CPI, the information shown in Table 4.1 wouldn't be reflected in the weighted components of how inflation is currently calculated. The CPI is pictured in Figure 4.4.

One glaring flaw with this conventional and frankly obsolete measurement of inflation is the weighting given to “Medical” versus “Apparel.”

The idea that ordinary people spend nearly as much on apparel as on medical care or that inflation rates are as impacted by apparel as medical bills are is illogical.

Table 4.1.

Good / Service	1989	1999	2009	2012
Pint of Beer	\$3.25	\$4.50	\$5.50	\$7.00
Rental NYC (monthly)*	\$400	\$600	\$1,100	\$1,400
Gallon of Gas	\$1.10	\$1.30	\$2.15	\$4.00
Subway weekly ticket	\$7.00	\$17.00	\$27.00	\$29.00

*Studio in Manhattan

Source: Author's Living Expenses 1989 to 2012

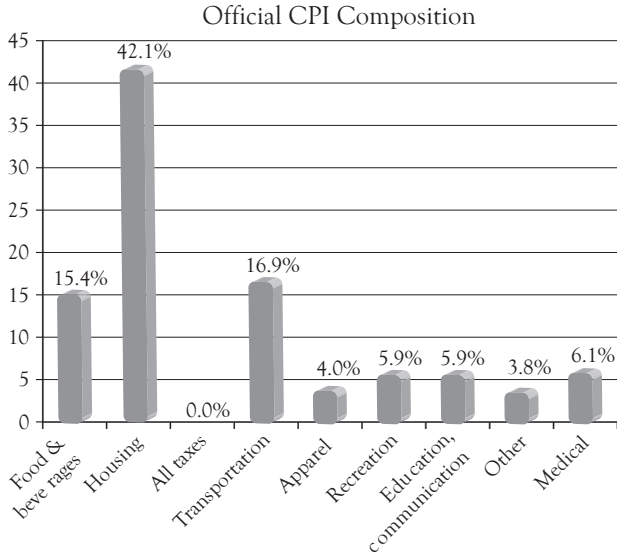


Figure 4.4.

Source: Bureau of Labor Statistics. Copyright in the Public Domain.

If one considers that the majority of apparel purchased in the United States is sourced in low-wage countries such as El Salvador, Mexico, and Dominican Republic, then the impact clothing plays on the disposable income is much less than that of medical costs. Tens of thousands of people in the United States go bankrupt due to their inability to pay medical bills, not due to excessive spending on apparel!

Education is given a weighting of 5.9%, another very expensive cost on ordinary people. For example, according to The National Center for Education Statistics (nces.ed.gov/fastfacts), from 1980 to 2012, the cost of a community college degree increased by nearly 300%!

To give education a weighting so close to recreation is again severely flawed.

And finally a glaring omission in the entire CPI is gasoline prices. To include transportation without separating out the cost of a gallon of gasoline makes little sense. The majority of urban dwellers may take the subway to work, yet there are millions of Americans who drive to work every day from the suburbs and spend many millions of dollars a month filling up their gas tanks.

CHAPTER 5

“Too Big to Fail” Banking and the Federal Reserve

In the post-1929 crash era, the Glass-Steagall Act (GSA) was passed to ensure that big banks would never again impact the economy to the extent they did in the years leading up to October 29, 1929. The most important aspect of the GSA was to separate commercial and investment banks from depository banks, disallowing banks from engaging in both activities, i.e., take in customer deposits and at the same time operate in the investment banking arena underwriting risky investments or betting on volatile financial outcomes.

For 66 years, 1933 to 1999, GSA maintained a strong firewall between investment banks and depository banks. Then along came Bill Clinton and his new “liberalization” act: Gramm-Leach-Bliley (named after three sponsoring senators). GLBA allowed the likes of Citibank and JPMorgan Chase (JPMC) to engage in *both* depository banking and investment banking. This opening up of the banking industry is discussed in an excellent film, “Inside Job,” which won the Oscar for best documentary in 2010. This author has viewed the film several times and shared the viewing with students of business and economics; clearly the GLBA is one of the major factors that contributed to the meltdown of the financial markets in 2008.

After 1999 a plethora of mergers and acquisitions between some of the biggest banks occurred, followed by a frenzy of mainstream media stories heralding the “synergies” of JP Morgan and Chase Manhattan Bank, Citi and Travelers, and several other megabank “marriages.”

According to the 2011 annual report of the Dallas Federal Reserve Bank, this frenzy of mergers has given rise to what are referred to as

Too Big to Fail Banks (TBTF), financial entities that, should they incur massive losses on derivatives or extremely risky investments, would be bailed out by taxpayers. The Troubled Asset Relief Program (TARP) (see more on TARP toward the end of this chapter) was a most controversial piece of emergency legislation and was dampened down by the then-treasury secretary Henry “Hank” Paulson under pressure from ordinary Americans who e-mailed, phoned, and faxed their elected representatives in a bid to prevent these banks from getting carte blanche bailouts into perpetuity.

This latest Fed-Treasury intervention has become a scheme whereby massive losses are socialized, while massive profits are privatized. Fed transparency was fought against tooth-and-nail by those insiders who have no intention of explaining how the Fed balance sheet is structured. It was Vermont Senator Bernie Sanders who put pressure on the Fed to be more transparent as the TARP controversy spiraled.

“Free markets” would suggest that if a bank makes a dumb investment that causes it to go bankrupt, it should be allowed to fail, end of story. But the powers-that-be proclaim the gospel of free markets in public, while in practice nothing resembling free market non-intervention occurs.

Why, for example, was Bear Stearns sold to JPMC, while Lehman Brothers was allowed to fail?

Why was AIG bailed out while Merrill Lynch (ML) was forced to merge with Bank of America?

What role did Goldman Sachs play in designing, directing, and implementing TARP?

What outstanding derivatives in silver and gold does JPMC control? Has JPMC cornered these markets?

These questions are being answered as the American people see how TBTF banks are operating on a daily, weekly, monthly, and quarterly basis, some making healthy profits while others struggle to stay afloat.

The Federal Deposit Insurance Corporation (FDIC) issues lists every month with details on failed banks across the 50 states.

Most of these banks are smaller- to medium-sized banks with excessive exposure to foreclosed mortgages. When they fail they must merge with other banks or have their deposits and outstanding (healthy) loans taken over by bigger, financially stronger banks, creating even

bigger regional banks in many states, thus lessening efficiency and competition.

So much for free markets in the U.S. banking industry; rather what we have in reality is an oligopoly controlled by the megabanks such as Citibank, JPMC, Bank of America (BOA), and Wells Fargo, all members of the Federal Reserve System and bursting with lobbyists in Washington DC.

In my self-published book, *The Federal Reserve Bank, Treasury, Income Taxes and Debt: Connecting the Dots?* (2011) available on Amazon, I trace the link between how the Treasury collects taxes via the IRS and uses a portion of those taxes to pay the principal and interest on maturing U.S. bonds, while the Fed continuously purchases newly- issued bonds, the majority of which are snapped up the Fed itself through its network of member banks, foreign investors (China owns \$1.02 trillion, Japan about \$1 trillion), state and local governments, and other financial institutions inside and outside of the United States.

All of these bondholders expect a return on their investment in the form of yield. Short-term low yield on one-year bonds and longer-term higher yield on five-year, 10-year, 20-year, and 30-year bonds (phased out but still circulating in the financial economy).

So how does the banking system actually operate in the current environment?

At any given moment a bank may hold *only 10 percent* of deposits inside the bank, and this is due to the fractional reserve banking system in the United States (and throughout the developed world) that by law demands banks maintain a 10:1 ratio of deposits to loans.

Here’s an example:

Bank ABC has deposits of \$10,000 with 100 customers, each having an account worth \$100. The chance of all 100 customers coming on the same day to withdraw their money is slim and the chance of a single customer coming is 1/100. So by law the bank is required to hold just \$1,000 inside its vaults. The other \$9,000 deposited in Bank ABC is lent out to some of its 100 customers at a rate of interest decided by the Fed, say 5%. Meanwhile those who keep their money in the bank receive a puny interest rate on savings, say 0.5% if they’re lucky! So the fractional reserve system allows the bank to lend out the customers’ money at 5% while paying just 0.5% in savings interest.

Table 5.1 Basic Banking

ABC bank rates	\$100	\$1000	Profit	Mark-up
Savings	0.5%			
Loans		5%		
Formula	$.5 \times 100 / 100$	$5 \times 1000 / 100$	$50 - 0.5$	$49.5 / .5 \times 100$
Interest	50 cents	\$50	\$49.50	9900%

Source: Author Table (based on current interest rates)

The spread is a whopping 4.5%, which calculates to a 900% ($4.5 / .5 \times 100$) mark-up on the commodity it sells, i.e., money in the form of car loans, mortgages, etc.

Over a year, the saver gets 0.5% on \$100 (50 cents) and the borrower pays 5% on, say, a \$1,000 loan (\$50).

This is a very basic example, but the wider banking system works in exactly the same way.

Before GLB in 1999 there was a firewall, a safety perimeter around deposits.

It existed for 66 years. Now there is no such firewall.

The difference in the sophisticated world of modern banking is *scale*: hundreds of billions of dollars on deposit with trillions out on loan, allied with massive nominal amounts of outstanding financial derivatives.

Banks such as Citi, JPMC, BOA, and Wells Fargo have exposure to hundreds of billions of financial derivatives, and should one of these banks take a massive loss on one of these sophisticated derivatives, what is stopping the bank from siphoning customers' deposits or failing outright, resulting in a customer run on the bank?

This couldn't happen, you say, dear reader!

It already did in the UK when Northern Rock, a significant medium-to-large bank, failed in September 2007 due to intense overexposure to property mortgages and liquidity problems. It was nationalized on February 22, 2008 by the Bank of England.

UK taxpayers were exposed to a sudden increase in liability of 200 billion pounds, according to *Time* magazine.

It happened in Ireland, too, when in 2008, Anglo Irish Bank failed with billions of Euros of bad loans on property exposure gone sideways.

And it will likely happen again in the United States or Europe, or both, in the coming months or years because of the unbridled and rapid rise of complicated derivatives on everything from probability of bond defaults to gold and silver futures, from collateralized debt obligations to interest rate and currency option derivatives.

How will the physical economy be affected by a major implosion in the financial system?

How will access to credit for small- to medium-sized companies be impacted?

Will another TARP be enacted and rushed through by Congress under the auspices of “troubled relief” again, while the ordinary U.S. taxpayer witnesses a physical infrastructure crumbling all around us: bridges, roads, highways, and water reservoirs?

Derivatives and the Economy

In Charles Ferguson’s “Inside Job,” the impact of derivatives in the economy is discussed in detail, and banks that engaged in massive derivative trading operations—including Goldman Sachs, Citigroup, Merrill Lynch (now part of BOA), and several non-U.S. banks—impacted entire economies, especially Iceland. The banking sector dwarfed the entire GDP within just five years.

When derivative trading affects the infrastructure of an economy with devastating impact on basic economic activity, TBTF banks accelerate economic volatility and instability, causing ordinary people to distrust the entire financial economy—this is bad for investment, bad for pension funds and bad for retirees.

In November 2011 the Bank of International Settlements (BIS.org), based in Switzerland, produced a report on OTC (over-the-counter) derivatives, collating a 32-page overview of the value of notional amounts (value upon future expiry today) outstanding throughout the global economy.

The report for the period January 2011 to June 2011 cited a total of \$708 trillion in OTC derivatives outstanding.

That's 708 with TWELVE zeros: \$708,000,000,000,000.

And in a survey by the ISDA (International Swaps and Derivatives Association), a global trade association for OTC derivative trading companies, it was found that of the 71 banks participating, global derivative trading had increased from \$86.612 trillion in 2002 to \$466.778 trillion by 2010.

That's over a five-fold increase in global derivative trading in less than eight years. And this includes just 71 banks across the world.

Participating banks were based in Greece, Canada, Norway, Scotland, Switzerland, Spain, Japan, and Belgium, UK, United States, and many other countries involved in the global derivative trading economy.

In the debacle that followed AIG's bailout in 2008, many commentators wondered why AIG was bailed out but not Lehman.

The reason as far as this author is concerned is that AIG had massive exposure to derivatives underwritten by Goldman Sachs, and if AIG was allowed to fail, it would have a cascade effect on Goldman's business in the derivatives markets, causing even more volatility across the global financial system. So the compliant American taxpayer was called to the rescue against his will, citing "financial Armageddon" as the reason to bail out AIG.

The U.S. government, through taxpayers, still owns 77% of AIG, and according to the *New York Times* (NYT) in a story from February 28, 2012, the company made a "profit" of \$19.8 billion, of which \$17.7 billion was a "tax benefit" from the U.S. government. Since 2008 AIG has received an injection of \$182 billion from the US taxpayer.

Are U.S. taxpayers getting the benefit of this newer, profitable AIG?

They have a long way to go to repay this "loan" granted them by the ordinary U.S. taxpayer through government handouts. According to a story, again in the *NYT* from March 16, 2009, AIG listed 20 banks to which it owed money due to its rescue. Among them were Goldman Sachs, \$12.9 billion; ML, \$6.8 billion; BOA, \$5.2 billion; and Citigroup, \$2.3 billion; along with a host of foreign banks including Barclays, a British bank, \$8.5 billion; and UBS, which received \$5 billion, all courtesy of the ever-facilitating U.S. taxpayer.

Many economists and finance practitioners are questioning the business model operated by these global banks where it seems when a trade is overexposed and over-leveraged, the taxpayer is called upon to bail out

the reckless bank, but when massive profits are locked in, taxpayers get not a cent. In his 1998 book, *Bill Gross on Investing*, in a section entitled “The Savvy Investor,” Bill Gross, CEO of PIMCO, the world’s largest bond company, wrote:

Most derivatives are created by breaking up a security and selling off the pieces.

And that is exactly what big banks did during the housing bubble, buying up hundreds of thousands of mortgages and breaking them up under securitization to sell them off to investors across the globe, very far from the origin of the actual mortgage.

In theory banks and financial institutions are supposed to assist in the efficient flow of goods and services through provision of credit and accessibility to deposits by their customers. But recent fiscally reckless decisions by banks and other financial institutions have called into question the trust ordinary Americans have in the core of the banking system.

According to the FDIC 2011 report on bank failures, by October 2011, 74 banks had failed outright. The FDIC maintains a failed-bank list, updating it when banks are taken over, implode, or cease to exist. The list shows five banks that either failed or were acquired in March 2012, four acquired in February 2012, and seven in January 2012.

In July 2012, Barclays Bank PLC was fined the equivalent of \$453 million when the information emerged that traders working at the bank manipulated trades in the LIBOR (London Interbank Overnight Rate). This distorted the rates of what Barclays’ clients paid, including the mortgage rates ordinary people paid, and had the effect of ensuring that pricing of interest rate derivatives were marked up for Barclays’ benefit.

The Financial Times reported on July 10, 2012 that the interest rate derivative market is valued at \$500 trillion and traders at Barclays manipulated rates on derivatives in a bid to accelerate Barclays’ profits and their own bonuses based on those profits. As of the time of writing, nobody was charged with any criminal activity in this fraud.

Modern global banking has for several years now served its own needs and not the needs of those who deposit their hard-earned cash within bank vaults. At the time of writing of this book, a whistleblower from UBS (United Bank of Switzerland) collected a whopping \$104 million

for uncovering a list of tax-dodging wealthy U.S. citizens using Swiss bank accounts to hide their money.

Bradley Birkenfeld, who spent two-and-a-half years in prison for withholding information for his own role in tax avoidance schemes, was released in September 2012 and will receive the whistleblower award from the IRS in the coming months. His revelations have shone a financial light on how exactly the Swiss banking system works in the service of super-wealthy U.S. citizens.

Insiders in the banking industry who believe in fiduciary responsibility and honest service to their clients are tarred with the same brush when a scandal breaks. The majority of those who work long hours at these institutions play by the rules and are paid on the basis of their performance on *behalf of the client* and then the bank, not the other way around. Unfortunately a small minority in their quest to make easy, quick money are willing to bend or break the rules to line their own pockets, breeding further mistrust in the minds of ordinary people who already suspect Wall Street as the major culprit in the banking crisis of 2008, from which we have not recovered.

The reality of the crisis is much more complicated. And blame needs to be evenly apportioned in a five-way split to each of the following:

1. The financial engineers within the investment houses, collectively known as “Wall Street,” who securitized vast pools of mortgages;
2. The U.S. government and the Fed for ensuring that interest rates were kept artificially low for so long;
3. The mortgage holders who took out loans to purchase houses far beyond their earning ability;
4. The mortgage brokers who sold mortgages as if they were hamburgers at a fast-food joint, not bothering to check paperwork, sign off properly (robo-signing for expediency), or explain the pages of footnotes in fine print in the mortgage agreement;
5. The discredited “credit” rating agencies—Standard and Poors, Fitch, Moody’s—all of whom granted AAA ratings to the mortgage-backed securities that had junk hidden at their core.

Of all the culprits of these five groups, how many have gone to jail?
Answer: zero!

TARP (Troubled Asset Relief Program)— Financial Tarpaulin

When one thinks of the word “tarp,” a tarpaulin comes to mind: a plastic sheet placed over a garbage heap or over a dead body. The word conveys disaster or the hiding of something. And so the TARP was a governmental “injection” of money into the banking system. In a bid to “get the financial markets working again,” according to those behind the scenes in the Treasury and the Fed, over \$700 billion was rifled from the taxpayer to help those institutions that engaged in reckless financial behavior, such as Countrywide Bank under its CEO Angelo Mozilo.

After the TARP monies were disbursed to the distressed banks, the Office of the Special Inspector General for TARP was set up. The so-called SIGTARP prepares quarterly reports on which financial institutions have paid back what exact amounts.

As of June 30, 2012, \$109.1 billion had yet to be repaid to taxpayers, with \$302.5 billion having been repaid.

Which banks and financial institutions were given TARP money and more importantly, why?

On October 3, 2008 under ferocious pressure from the imploding short-term credit markets, Henry “Hank” Paulson, head of the Treasury, with the passage of H.R. 1424, enacted the Emergency Economic Stabilization Act of 2008. Bear Stearns and Lehman Brothers had imploded, and Paulson created a fund of \$700 billion for the banking and financial system to access.

According to ProPublica.org, a public-interest journalism website, the following list (Table 5.2) illustrates what was disbursed in 2008 and what the institutions owed in September 2012.

Of the total 926 recipients of TARP, \$603.8 billion was disbursed and a *total net loss* of \$176.2 billion remains outstanding as of September 2012.

The full bailout list on ProPublica.org is astounding.

Many regional and local banks received disbursements under H.R. 1424 (Emergency Economic Stabilization Act of 2008), and this shows how precarious the banking system was back in 2007/2008 due to the reckless mortgage mentality that permeated financial institutions just four years ago.

Table 5.2 Top 7 TARP Recipients and Their Outstanding Balances, as of September, 2012

Institution name	Amount disbursed Billions \$	Outstanding owed/profit (Billions)
Fannie Mae	116.149	-90.617
Freddie Mac	71.336	-51.199
AIG	67.835	-2.610
General Motors	50.745	-27.200
Bank of America	45.000	4.567
Citigroup	45.000	12.355
JPMorgan Chase	25.000	1.731

Data from <http://projects.propublica.org/bailout/list>. Table by Author.

A culture of funding 110%, no-money-down, no-questions-asked, no-accurate-paperwork-required mortgages dominated the financial and banking spheres during this period. And taxpayers, under TARP, were tapped to come to the rescue of these reckless, and in some cases fraudulent, institutions.

Has anything changed in the world of banking? Have any of the key actors been sent to jail?

Banking has become more concentrated over the past four years, and as far as jail time for those who knew what was going on and when, not a single day in jail has been served by anyone noteworthy.

CHAPTER 6

What the International Monetary Fund Is and How It Works

Most textbooks give the usual history of the IMF, its *raison d'être*, what countries control it, and its impact around the world.

In his 2003 book *The IMF and Economic Development*, James Vreeland looks at Tanzania, Nigeria, and Uruguay and the impact the IMF has had on them between the years 1970 and 1995. The IMF's primary objective is growth, according to Michel Camdessus, former IMF managing director, quoted in Vreeland's book.

But do the IMF's austerity measures contribute to growth or rather act as financial colonial conduits, exercising immense financial and economic power over countries?

In this chapter, the modern mandate of the IMF will be examined with specific references to Greece and Ireland.

Recent riots in Greece have pointed to how the IMF has attempted to ram through its austerity measures against the wishes of the ordinary Greek people. Violent protests and anti-IMF and anti-Greek government riots have impeded progress through Greece, and Athens remains the central battleground between Greek citizens and security forces acting at the behest of the Greek authorities.

The Greek economy is in a bad shape with Greek government deficit spending reaching close to 17% of total GDP, an unsustainable long-term fiscal strategy, increasingly tragic the longer it went on unchecked.

On March 15, 2012 the IMF lent another \$28 billion to Greece. According to its website, this installment was made under the "Extended

Fund Facility,” and in return Greece is to embark on “deep seated structural reform.”

One of the deep structural reforms mandated by the IMF is to cut government spending (50% of GDP) and increase tax revenue above the current 39% of GDP, to repay the loans granted and approved to Greece.

At the time of writing Greece received 110 billion Euros in 2010 and a further 130 billion Euros in 2011. This is the equivalent of \$319 billion owed by the Greek people to the IMF and banks that are part of the IMF system. To put this in perspective: the entire Greek economy produced about \$312 billion in goods and services in 2011.

Monies from the long-term maturation of public debt across the European Union are owed to the EU via the European Central Bank (ECB) and other international banks.

In the next two years, 2012 to 2014, no loans are due for payment upon maturity to the ECB or IMF. But the year 2015 will usher in a plethora of maturities (almost 10 billion Euros due to the IMF) followed by 2016, 2017, and 2018. Then 2020 will see another nearly 10 billion Euros maturing and repayable to the IMF. But the period 2018 to 2020 sees 17 billion and 27 billion Euros maturing in total to “Other” banks.

Case Study: Ireland, Debt, and the IMF Impact

On May 15, 2012 the Irish government, through the Central Bank, published its quarterly financial accounts with an increase of 2%, to 173.3 billion Euros, for total government borrowing. Twenty percent of total liabilities were loans consisting of €34.2 billion from the EU-IMF.

According to the Economic Social Research Institute (ESRI. ie), Ireland’s total GDP in 2011 was 156 billion Euros.

From these numbers the ratio of GDP to total government debt is a whopping 111%. The country *owes* more than it produces in goods and services.

Year-End 2011:

GDP = 156 billion Euros

Govt. Debt = 173.3 billion Euros

The IMF in its takeover of the Irish economy has demanded medium- and long-term privatization of national assets. Electricity and gas, peat and transportation are all to be privatized, forcing the Irish taxpayer to repay loans over the next few decades, indebted into perpetuity.

In the March 2012 IMF Country Report (Volume 12/48), the long-term financial and economic future of Ireland is laid out for all who care to see. Of course the citizens of Ireland have no input on their economic well-being and the repayment of loans taken out on their behalf.

The 83-page report shows in the “Structural Reforms” section on page 20 details that will “combine a leaner universal component” to child benefit, something that has worked well in the past, but will be curtailed severely in the future.

And the older potential retirees will be forced to put off their golden years until well past 68 as per the IMF prescriptions for austerity!

The Irish economy has been depressed in 2012, and household spending will exhibit negative growth while government spending will shrink by 2.2%, with the only bright spot being exports, mostly of foodstuffs.

How can austerity “fix” an already ailing economy on every measure?

At the time of writing of this book, Spain, Ireland, Greece, and Portugal were all facing street protests and government opposition to the IMF austerity measures that are planned well into the next decade.

The IMF has developed into a financial and economic colonial landlord, reflecting the old feudal systems of the Middle Ages, where monarchs sat in luxury inside their well-protected castles and chateaus, while the masses outside the walls and moats scrimped and scraped for morsels of economic and nutritional sustenance.

The modern feudal lords in the decades to come will be international banks and bondholders who will exert increasing power on sovereign nations in the pursuit of repayment of massive debts disbursed by the International Monetary Fund under the prescription of austerity.

According to the Irish Central Bank and the NTMA (National Treasury Management Agency), an Irish governmental authority that was set up to “manage” the national debt (not to be confused with NAMA, set up to manage the banking assets of the notorious Anglo-Irish bank), 80% of Ireland’s national debt is owned by foreign investors.

And according to the NTMA (National Treasury Management Agency), another governmental authority set up to “manage” Irish bond issuance, the interest on the total debt as a percentage of total tax revenue was 7.7% in 2009.

However, in the years to come, this percentage, i.e., the ratio of tax revenue to interest on the total debt will rise to 14.2% in 2010, 17.4% in 2011, and a whopping 20% in both 2012 and 2013.

This assumes that tax revenue generated remains at current levels. Official Irish tax data reported a total tax take in 2009 of 33.04 billion Euros. Of this about 2.5 billion Euros was swallowed up in interest paid to bondholders.

Who exactly are these foreign investors? Why are they so invested in Irish bonds and who repays these bonds? What interest can they expect to receive from their investments?

In its glossy, 124-page 2009 annual report, the NTMA estimates that of recent bond offerings, auctioned and maturing in 2025, 45% are owned by mutual fund managers from across the globe, 27% are owned by banks, 7% by insurance companies, and the remaining 21% owned by various entities (p. 15).

The author tracked one such bond.

The case of the bond, ISIN NUMBER# XS0307691559: Back at the height of the Celtic Tiger economic boom in Ireland, a 400,000,000 Sterling bond was issued on June 28, 2007, by an Anglo-Irish bank to a British bank.

(ISIN stands for International Securities Identification Number.)

The original owner of the bond most likely sold it to another bank over the interim. Regardless, it has to be paid back.

The basics of the deal were that Anglo borrowed a five-year loan from the British bank in the form of the aforementioned bond.

Five years later this bond, ISIN # XS0307691559, must be repaid: 400,000,000 Sterling plus 61,095,101 Sterling in interest upon maturity on June 28, 2012.

The original lender, a British bank, would get the initial principal of 400 million pounds (\$675.76 million) plus interest of 61 million Euros and change (\$95.577 million). The original amount lent in dollars would balloon to \$721.337 million including interest five years later. Here’s the

part that ordinary Irish taxpayers may not have known (and may never know, even though they have to repay it through taxes) about this particular bond: it was at the time of issuance and maturity UNSECURED!

An unsecured bond basically means that if the bank that issued the bond went bankrupt, the lender would, by law, not have to be paid back and would have no security on the bond. But the inept Irish government in September 2008 decided to make guarantees on all deposits in Irish banks, including the fraudulent Anglo-Irish.

The author has located a spreadsheet courtesy of a publication of the Irish Central Bank that shows several of these bonds, most of which are UNSECURED and by law do not have to be repaid to the bondholders.

This bond ISIN # XS0307691559 is one of many, some of which are in the billions and also unsecured.

Instead the IMF-ECB-EU triumvirate is forcing the Irish people to repay loans issued to these banks at the expense of hospital funding, road building, education funding, old-age pension payments, the timely construction of prisons, and a host of other services that every taxpayer has a right to receive.

And to the further dismay of the Irish taxpayer are future plans to sell off national assets ESB (Electricity Supply Board), the Gas Board, and a plethora of other state assets.

This is scandalous.

The Irish government has sold the people's national sovereignty down the IMF river.

Why should a bank be repaid a whopping \$721 million unsecured bond (that's just one bond of many) at the expense of ordinary people?

Are the Irish people destined to be serfs to bondholders around the world?

Why should the bonds issued by the now-defunct, poorly run Anglo-Irish bank be repaid in the first place?

Bond number # XS0307691559 is a symptom of a very, very disturbing trend in financial circles: the swift privatization of massive profits and the long-term socialization of massive losses.

A list of the bondholders of Anglo-Irish bonds, AIB, and Bank of Ireland is also available on several finance-related websites.

Some of the bondholding banks and insurance companies include Goldman Sachs, Aberdeen Asset Managers (London) Ltd., KBC Asset

Managers (Belgium), AXA Investment Managers (Paris), Rothschild and Compagnie Gestion, Credit Suisse Asset Management, and many, many more European and international financiers.

The Irish Stock Exchange website (www.ISE.ie) has a list of all of the bonds outstanding, when they were issued, and their maturity dates.

The aforementioned bond was listed (now matured and repaid) under the newly founded Irish Bank Resolution Corporation Limited, an organization working under the Irish government on behalf of the big banks who are owed billions from Anglo-Irish and other poorly run Irish banks.

Here's its mission according to its website:

IBRC is an asset recovery bank committed to working out its operations over time in a manner consistent with its European Commission (EC) approved restructuring plan.

An unsecured bond is not an asset and need not be “recovered.”

As to the original owner of bond number # XS 0307691559, its eventual identity appeared as the maturity date approached June 28, 2012.

At the time of writing of this book, the bond had matured, the loan repaid with added interest of \$95.977 million, and the taxpayer is none the wiser. All of this will be guaranteed over the next decade by the overseers of the Irish economy—the IMF.

CHAPTER 7

Understanding Fiscal and Monetary Policy

As of the time of writing, the U.S. national debt stood at a whopping \$16 trillion (to the penny, as of September 2012: \$16,045,678,692,730.63), according to the U.S. Treasury. (Fiscal policy refers to sources from which the U.S. government gets its revenue, while monetary policy refers only to money supply and interest rate policy.)

Fiscal Policy

To put context on this, one trillion dollars looks like:

The tiny figure to the far left—barely visible—is of a man of average height, standing by the corner of two pallets stacked high with hundred dollar bills.

The U.S. government *OWES 16 times* this amount.

The total GDP of the United States as of August 29, 2012 stood at \$15.5 trillion while the U.S. debt tipped above \$15.8 trillion, according to the U.S. Treasury. Thus the debt- to-GDP ratio currently in the United States is a very worrisome 101.93% and those fiscally responsible for repaying the debt are the taxpayers.

Where does the U.S. government, via the Treasury, get the majority of its tax revenue from?

According to the U.S. Debt Clock (USDebtClock.org) and U.S. Treasury sources, in 2011, total federal tax revenue amounted to \$2.161 trillion (Table 7.1).

Table 7.1

Fiscal year	W-2 taxes (Billions)	Payroll taxes (Billions)	Corporate taxes (Billions)	Total tax revenue
2011	1,108	841.3	212.3	2,161.6
Ratios to Corp Tax	5.22 times	3.96 times		
Sources as % of Total	51.26%	39%	9.8%	

Data from U.S. Debt Clock/U.S. Treasury. Table created by author.

The ratios are quite revealing in terms of how much tax revenue is derived from ordinary taxpayers, people who receive W-2 forms on their earned income. In fact this group accounts for 51.26% of the total federal revenue collected by the IRS and routed to the U.S. Treasury. Compare this to 39% of the total collected from small- to medium-sized businesses. These two sources, ordinary workers and small- to medium-sized business owners, account for a whopping 90.2% of all federal revenue collected by the Treasury through its conduit the IRS.

Corporations, on the other hand, paid just 9.8% of total federal revenue collected.

But the ratios between these is what is frankly shocking: W-2 earners paid 5.22 times what corporations paid, while small- to medium-sized business owners paid almost four times what corporations paid.

The two combined paid 9.1818 times what corporate America paid in total federal taxes.

When the federal government issues debt in the form of U.S. government bonds, these bonds upon maturity have to be paid back in full, with interest. The monies collected by the Treasury through the IRS are used to repay all maturing bonds as they come due. For example, a 10-year bond issued in June 2002 will have come due in June 2012 and must be repaid, all principal plus interest. And similarly, bonds issued in 2012 will come due in 2022 if 10-year, 2017 if five-year, or 2015 if three-year, all paying interest and all demanding full repayment of the original amount lent to the U.S. government.

You and I, the taxpayers and the business owners, will be required to repay these bonds as they come due.

In my book, *Federal Reserve, Taxes, and the National Debt* (Amazon) November 2011, I connected the dots on how all of the fiscal rectitude of the U.S. federal government will undoubtedly put further pressure on income taxes as foreign owners of the debt, China and Japan, continue to invest and continue to be repaid with interest.

Monetary Policy

The Federal Reserve Bank decides what the interest rates in the United States should be; the price a consumer of a bank pays for money is simply the rate of interest paid on a loan. This can be defined as monetary policy and includes the value of a dollar relative to basic necessities.

For the past two decades, earlier under Alan Greenspan and then under Ben Bernanke, the Federal Reserve's monetary policy has been to ensure that Fed Funds' interest rates in the United States are kept at or below 6% as much as possible.

In the world of banking, Fed Funds is the rate of interest each depository institution must pay to ensure that its reserve requirements are within the ratio dictated by the Fed.

One bank might have surplus balances and thus needs to earn interest on that amount, while another might have a deficit and may need to borrow that amount. Transactions are usually overnight and can amount to millions or hundreds of millions. When the author was a trader for Allied Irish Bank (AIB) in the mid-90s, overnight Fed Funds rates were about 5%.

Many times I would have to sell millions of dollars of excess funds to other banks at an overnight rate *higher than* the rate we were giving to the corporate client. Once a large airline leasing company deposited \$500 million in the bank and I had to sell about \$450 million of that cash at one-eighth or one-sixteenth more than what the company was getting. Figure 7.1 shows what the effective Fed Funds rate was over the past 72 years.

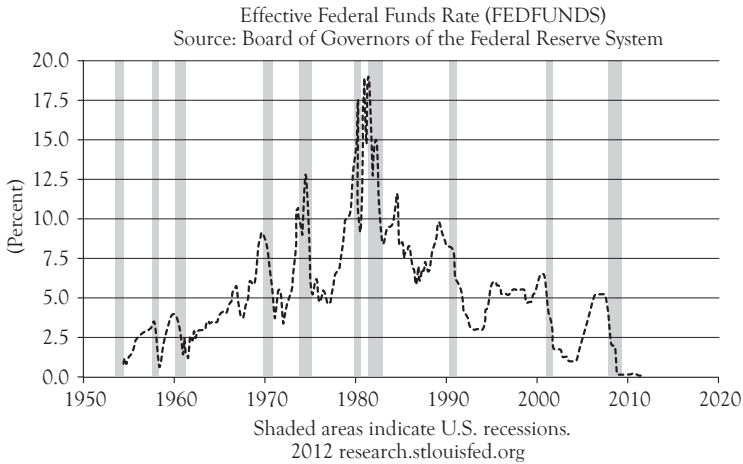


Figure 7.1 Fed Funds Rate 1950 to 2012

Source: Bureau of Labor Statistics. Copyright in the Public Domain.

The Fed’s strategy of attempting to keep Fed Funds as close to zero as possible over the past two years has had two very important consequences:

1. It has acted as a severe DISINCENTIVE for ordinary people to place their earned cash in savings accounts because the rate they get on their savings is near zero.
Ordinary wage earners have to find higher returns on their savings or 401k or IRAs, thus forcing them to invest in stocks and/or bonds as a way to get a return. Often the stock market can become quite volatile and many investors lose money over the short to medium term.
2. Corporations have been able to finance their own massive debts at cheaper and cheaper rates, since the rate of corporate loans and bonds is decided by the Fed and the Fed Funds rate acts a benchmark for all interest rates throughout the U.S. economy and even sometimes beyond.

But as this strategy involves the “sophisticated” and frankly quite reckless Fed policy termed “Quantitative Easing” (Q-E-1 and Q-E-2), long-term interest rates will likely increase to attract more investors into U.S. government bonds, which will put upward pressure on Fed Funds and domestic interest rates. This will cause the interest rates on credit cards,

mortgages, and car loans to increase, hurting the economy, and creating another impediment to sustainable economic growth.

The Federal Reserve's low-interest-rate/disincentive-to-save monetary policy will backfire, causing huge shocks to the system and lowering the value of the dollar over time.

And it matters not whether Obama gets a second term or Romney is elected president, because the interest rate policy of the Fed and its effect on the U.S. economy will dictate how and when the economy begins to gain momentum, create jobs, encourage manufacturing, and build a middle class back to pre-1990s levels.

Under Greenspan and later Bernanke, the U.S. dollar has lost value not only against other currencies but also against basic necessities—wheat, housing, gasoline, college tuition and education, and a host of other raw materials for living. And under these policies the Fed and the Treasury will continue to print money into perpetuity, while ordinary citizens will have to work harder for a dollar that is worth less and less over time.

Quantitative Easing (QE-1, QE-2, and QE-3)

QE-2 does not refer to the luxury cruise ship the *Queen Elizabeth II* that sometimes docks on the west side of Manhattan unloading its tourists from around the world onto the streets of New York City. Rather, it is the two-word phrase the Federal Reserve Bank has come up with to explain to the taxpayer, the markets, and the rest of the world what it intends to do to control interest rates and boost investment in the economy through house purchase and business expansion.

Instead this theoretical approach to the real economy is debasing the dollar's purchasing power. It is the equivalent of printing money from printing presses in the Treasury's minting department.

Between November 25, 2008 and March 31, 2010, the Fed's QE-1 initially "printed" an extra \$500 billion by purchasing mortgage-backed securities; in the first quarter of 2010 it purchased another \$1.25 trillion worth of mortgage-backed securities. This had the effect of magically "printing" a further \$1.25 trillion.

So QE-1 created about \$1.75 trillion in "extra money" in the sixteen months from November 2008 to March 2010.

After the initial controversy of QE-1, the ever-stubborn Fed engaged in QE-2 from November 3, 2010 to June 30, 2011, a seven-month period. Mortgage rates during the QE-1 period drop from 6.33% to a low of 5.00%, a decline in rates of 133 basis points.

But did this QE-1 offer the desired boost to the housing market? Or was it a short-term magic trick by the Fed? The jury is out on this, but no matter; the Fed has just engaged in a further “round” of QE, and according to a Reuters’ story, “Stocks, more than housing, seen as initial QE3 winners” on September 16, 2012, the “winners” in round three of QE are going to be stocks rather than housing.

Here’s what Reuters’ Jason Lange and Leah Schnurr had to report on QE-3:

The Federal Reserve’s new economic stimulus plan involves printing vast sums of money to help people buy homes, but over the next year the program could do more to boost the economy by lifting stock prices.

The Fed said last week it would buy \$40 billion every month in mortgage backed securities until the labor market improves substantially. The program, known on Wall Street as “QE-3,” will likely lower interest rates for mortgages and also help some people refinance their home loans.

Many critics of this policy of the Fed’s intervening in the mortgage markets and “printing money” believe that QE-3 forces increasing numbers of people to abandon a savings approach in favor of an investment approach to their retirement. Further, to depend on the housing markets alone to get the U.S. economy on a more stable footing doesn’t address the stubborn unemployment rate (U-6, the more accurate rate of joblessness).

By engaging in another round of QE, the Fed is indirectly driving down the value of the dollar, causing U.S. bonds’ interest rates to decline in the short term, and assisting banks with inter-lending over the *short term only*. Longer-term QE cannot work because interest rates are being artificially held down by a determined and, frankly, out-of-control Fed.

Note: The Fed is a private institution, not a public one. It represents its members, the entire banking system in the United States, all of whom are chartered under the Federal Reserve. The printing of money and purchasing of mortgage-backed securities is a massive gift to the banks that created them in the first place. The Treasury collects taxes from taxpayers, and that money is used to print money via the Fed's purchases in QE-1, QE-2, and QE-3.

The Fed has gone beyond its own mandate (FederalReserve.gov):

The Congress established the statutory objectives for monetary policy—maximum employment, stable prices, and moderate long-term interest rates—in the Federal Reserve Act.

The Federal Open Market Committee (FOMC) is firmly committed to fulfilling this statutory mandate. In pursuing these objectives, the FOMC seeks to explain its monetary policy decisions to the public as clearly as possible.

There is nothing about QE-1, QE-2, or QE-3 in any part of this statement of the Fed's mandate.

Maximum employment hasn't been achieved from any of these QE policies and inflation (stable prices) has increased, if more accurate measurements are used rather than the out-of-touch CPI, and long-term interest rates will by default *not remain moderate*.

China's Currency Sterilization

When I was a currency options trader in the mid-90s, there were a myriad of free-floating European currencies, Irish Punt, Swiss Franc, French Franc, Italian Lira, Spanish Peso, German Mark, etc. I traded German Marks, Japanese Yen, and British Pound.

China hadn't entered world markets yet.

But since the time of China's entry into the global market, a unique phenomenon has been implemented by the People's Bank of China (PBOC—Central Bank of China).

The PBOC has been intervening in the foreign exchange markets buying massive quantities of dollars, estimated at \$500 billion every year.

According a *Wall Street Journal* story, “China’s Real Monetary Problem: Focus on Yuan Sterilization” on September 17, 2010, this practice inhibits the money supply within China and adds further amounts of foreign currencies (mostly U.S. dollars) to the PBOC’s balance sheet. Here is what the *Journal* wrote on this phenomenon:

China’s real sin is sterilization, which insulates its domestic economy from the money-creating effect of a currency board. When a company like GE invests in a Chinese factory, or a retailer like Wal-Mart buys Chinese-made goods, they exchange dollars for yuan. The Chinese government then buys those dollars with yuan. But instead of adding to the money supply, it removes those yuan from circulation by selling bonds and raising reserve requirements. Without a rise in the general price level, China’s trade surplus with the world persists and grows as productivity rises.

By purchasing these dollars invested by foreign companies inside China, the PBOC “sterilizes” the impact these dollars might have had on the economy if allowed to circulate naturally as yuans through the system. Instead they are withdrawn by the PBOC.

Or the PBOC uses these dollars to purchase U.S. bonds, thus adding to their share of the national debt of the United States. Sterilization has allowed China to increase its U.S. Treasury bond holdings.

According to the Federal Reserve Bank, China’s holdings of U.S. bonds more than doubled from 2007 to 2012, from about \$500 billion to almost \$1.164 trillion. Of the \$5.1 trillion owned by foreign countries, China holds the most at almost 23%. As the PBOC continues its sterilization policies, it will continue to add to its U.S. Treasury holdings well into the second half of this decade.

Paul Krugman, in the *New York Times* in March 2010, writes that:

At that point China was adding about \$10 billion a month to its reserves, and in 2003 it ran an overall surplus on its current account—a broad measure of the trade balance—of \$46 billion.

Today, China is adding more than \$30 billion a month to its \$2.4 trillion hoard of reserves. The International Monetary Fund expects China to have a 2010 current surplus of more than \$450 billion—10 times the 2003 figure. This is the most distortionary exchange rate policy any major nation has ever followed.

China is adding billions to its reserve hoard as it continues this sterilization policy. And Krugman asks the question, what if the Chinese decided to “sell a large share of its U.S. assets”? The first consequence would be a rise in long-term interest rates in the United States, something that the Fed is constantly fighting to avoid.

Krugman asserts, correctly, that it would not be in China’s interests to sell vast quantities of U.S. assets, i.e., U.S. government bonds:

It’s true that if China dumped its U.S. assets the value of the dollar would fall against other major currencies, such as the euro. But that would be a good thing for the United States, since it would make our goods more competitive and reduce our trade deficit. On the other hand, it would be a bad thing for China, which would suffer large losses on its dollar holdings. In short, right now America has China over a barrel, not the other way around.

Since Krugman’s article in September 2010, many economists have attempted to measure the amounts of U.S. currency being put through this sterilization process. Professor Peter Morici, at the University of Maryland, estimates the number to be \$450 billion a year. And right before the financial collapse of 2008, China’s foreign currency reserves had grown by \$75 billion in April 2008 alone.

Conclusion

This chapter attempts to shed light on the economic problems and opportunities ahead, especially the global nature of debt, banking, and the effects of the banking sphere on ordinary people, whether here in the United States or in Europe or Asia or South America.

It attempts to illustrate how the middle classes across the United States and indeed across the world are being debased—financially, in terms of employment, and more importantly under political leadership. Most political leaders are unaware of the consequences of the massive sovereign debts mounting across Europe and their effects on the United States and other countries, especially the banks exposed to these debts.

Many ordinary taxpayers will be held financial hostage to the mistakes made by reckless banks in the United States and Europe especially. And the creeping power of the IMF in Europe will engage in so-called austerity programs in a bid to privatize national assets, paid for and subsidized by the taxes of ordinary workers, whether blue or white collar.

Wealth Gap

In his recent book, *After Shock: the Next Economy and America's Future*, Professor Robert Reich writes in Chapter 2 that the U.S. economy of 2008–2012 has several parallels with the U.S. economy of 1928.

He observes:

The share of total income going to the richest 1 percent of Americans peaked in both 1928 and in 2007, at over 23%. The same pattern held for the richest one-tenth of 1% (0.1%) representing 13,000 households in 2007: Their share of total income also peaked in 1928 and 2007, at over 11 percent.

After these share of incomes peaked, in both cases, long and deep valleys resulted.

The point Reich makes in his book is that when there is a concentration of income among the super-wealthy, the economic system of wealth circulation is impeded. Instead of money circulating through the economy and impacting more and more people, it remains within the confines of a financial matrix. Wealth remains inside a monetary system and not outside, affecting the economic system. As a result access to credit is stunted, thereby creating a class of interest-earners who move money around, evading and avoiding taxes by whatever means necessary. At the flick of a computer key stroke, millions are moved from one financial regimen to another more favorable one, earning a better return for the investor.

More than 100 years earlier, Upton Sinclair wrote in his classic work, *The Money Changers*, when he describes the shenanigans of a character on Wall Street back in the early 1900s:

It was interesting to Montague to see the actual property of the Mississippi Steel Company. Sitting in comfortable offices in Wall Street and exchanging pieces of paper, one had a tendency to lose sight of the fact that he was dealing in material things and disposing of the destinies of living people.

The economic system depends on inputs: energy from ordinary people, creativity, innovation, and manufacturing of real things in order for it to grow in a sustainable way. When an economy becomes too dependent on sophisticated financial transactions and risky derivatives, that economy is in danger of crashing more often, as it did in 2008 after the banking and credit crisis.

Authors Reich and Sinclair, writing a century apart, understood the dangers of an economy where a concentration of wealth among the financiers and speculators would create a casino economy where bets are placed on failure, and bonuses are earned not due to excellent performance but rather due to the placing of massive bets *against* a positive outcome, thereby undermining the efforts of ordinary workers, many of whom are struggling daily to pay the bills and make ends meet.

And it is the W-2 income earners who make up the backbone of economic activity in the United States, those same who are subsidizing the massive financial losses of banks due to risky bets on derivatives. Big banks ensured that securitizing dud assets mitigated risk for their bottom line, but socialized any losses that may have resulted.

Derivatives and Too Big to Fail (TBTF)

In 2005, before the financial crisis that sank Lehman Brothers and Merrill Lynch and ensured a \$700 billion bailout for banks that were too big to fail (TBTF), Professor Raghuram G. Rajan, at the University of Chicago, warned in his paper “Has Financial Development Made the World Riskier?” that:

Banks make returns both by originating risks and by bearing them. As plain vanilla risks can be moved off bank balance sheets into the balance sheets of investment managers, banks have an incentive to originate more of them. Thus, they will tend to feed rather than restrain the appetite for risk.

This was indeed a prophetic observation, as many of the over-leveraged banks had liabilities 30 to 50 times higher than their assets. These over-leveraged banks had a domino effect on the real economy, forcing Main Street to bail out depository institutions such as Citibank and JPMorgan Chase as their liquidity positions were put into jeopardy due to stupid risk-taking and a total lack of understanding of the downside of derivative trading.

At the time of writing of this book, total notional values of global derivatives stood at over \$700 trillion. According to a BIS publication on November 2011, “Over-the-counter (OTC) derivatives rose by 18% in the first half of 2011, reaching \$708 trillion by the end of June 2011.”

Rather than teaching TBTF banks a lesson in comporting themselves with upstanding prudence and fiscal responsibility, it seems the 2008 crisis has prompted them to take on even more risk.

These banks are now better armed in knowing what not to do and how not to get caught the next time around.

The reason for this is simple: these banks know from experience that there is now a political culture and economic environment of socializing losses, while profits can be neatly privatized in the form of huge bonuses.

As banks become bigger, competition between them shrinks and an oligopoly begins to form.

Banking Conglomerates and Oligopolies

Since 1970, the big banks have been getting even bigger, swallowing up local and regional banks as they move from state to state.

Page 6 of the annual report of the Dallas Fed publication (referenced in chapter 5 of this book) shows what has happened in just 40 years: massive banking concentration and the permitting of banks under the GLBA to engage in trading of risky derivatives while also taking in deposits from ordinary workers and small- to medium-sized businesses, all of which are the real engines in the economy.

The size and scale of these banks and their fraudulent and illegal activities were reflected in the recent scandals involving Barclays bank in the UK with the manipulation of LIBOR (London Inter-Bank Rate) and the laundering of \$7 billion in narcotic-trafficked money by the global banking giant HSBC (Hong Kong Shanghai Banking Company). As banks are deeply embedded in the global economy of the 21st century, their actions can destroy the trust ordinary people have for the orderly functioning of economic activity and the fiduciary citadels those banks are supposed to be.

Scandals: No Jail Time

In a *New Yorker* piece on July 30, 2012, “Bankers Gone Wild” by James Surowiecki, the LIBOR scandal proves yet again that “self-regulation” by banks is no regulation.

Surowiecki writes:

Rigging LIBOR was shockingly easy. The estimates aren't audited. They're not compared with market prices. And LIBOR is put together by a trade group, without any real supervision from

government regulators. In other words, manipulating LIBOR didn't require any complicated financial hoodoo. The banks just had to tell some simple lies.

The main point here is that banks, once held as trustworthy and fiscally responsible entities, are exhibiting behaviors that suggest otherwise, and depositors are getting steadily sickened by all of these scandals.

HSBC, according to the *Washington Post*, reporting on July 30, 2012 “apologized to shareholders”:

The bank will pay a fine of \$700 million for its money-laundering activities but not a single person will go to jail for this clear breaking of the law under the USA Patriot Act, (section 312, October 2001).

In the story the following quote illustrates just how immune to jail time bankers in the 21st century seem to be.

HSBC Mexico acknowledged in a statement that it failed to report 39 suspicious transactions and had been late in reporting 1,729 others. The bank's chairman, Douglas Flint, and Chief Executive Stuart Gulliver apologized for the money-laundering infractions.

“We must demonstrate that we have learned from earlier mistakes,” Flint said.

If an ordinary citizen brings over \$10,000 in cash into or out of the country, or attempts to lodge it with a depository institution, the authorities will react with swift and, at times, brutal enforcement.

Section 365, subsection 5331 (a) of said act, states that:

Any person who receives more than \$10,000 in coins or currency shall file a report with the Financial Crimes Enforcement Network.

Clearly complying with this law seems to be overlooked where amounts *700,000 times* this (\$7 billion in Barclays' case) are concerned and the perpetrator is a global bank.

Choices and Lobbyists

Increasingly banks, instead of serving the economy, are at the root of its illness, intertwined with speculating on the economic activity of ordinary workers, medium-sized businesses, and corporate behemoths.

As the next president considers what tools exist in his economic arsenal, the options remain few and narrow. Lowering interest rates has already been tried, luring China into buying U.S. bonds is ongoing, reversing outsourcing seems impossible, cutting taxes across the board seems probable, and slashing government spending seems likely.

But beyond these basic panaceas, there remains little else because the main political parties are awash with hundreds of millions in campaign money, used to buy lobbying power and ensure the financial industry status quo.

A cursory look at the excellent website OpenSecrets.Org, which tracks campaign finance and donations from industry lobbyists, shows that the big donors to both political parties between 1989 and 2012 include Goldman Sachs \$39.8 million, Citigroup \$30 million, JPMorgan Chase \$25 million, and Morgan Stanley \$23 million.

These four donated a total of almost \$118 million in lobbying funds to ensure the GLB Act of 1999, and the absurd bonus cultures remained intact and were not tampered with on any level.

Other banks include UBS, Credit Suisse, and Merrill Lynch at \$18.2, \$14.9, and \$14.4 million, respectively, donated to the two biggest political parties.

European Chaos

The ongoing economic woes of many countries in Europe (the so-called PIIGS, Portugal, Ireland, Italy, Greece, and Spain) will continue into 2013 and beyond. IMF austerity programs will threaten to derail social spending and act as incendiaries to urban unrest in Lisbon, Dublin, Rome, Athens, and Madrid.

At the time of writing, Spain's parliament in Madrid was surrounded by hundreds of thousands of ordinary people, sending a message to the Spanish government and the IMF that austerity will not be accepted.

Unemployment in these countries is at all-time highs, especially youth unemployment.

Spain's overall unemployment is heading toward 25% and will most likely go above that next year. Greece isn't too far behind, and Ireland and Portugal are at 15% and rising. Italy's unemployment is approaching 10%.

As of the time of writing, the ECB (European Central Bank) was engaging in its own version of QE (Quantitative Easing) by engaging in LTRO (Long Term Refinancing Operations), another scheme emulating the Fed's "money printing" policies.

In fact since May 2010, the ECB has been stealthily buying Italian and Spanish bonds worth 200 billion Euros! According to published reports the ECB has no choice but to engage in massive QE to save the Euro. Yet officials at various central banks throughout Europe insist that such activity will not occur anytime soon.

When central bankers make statements that imply "no time soon," they really mean that it is happening right at this moment. But in order not to panic the markets, they have to be seen not endorsing particular policies, especially QE activity a la Fed.

Reuters' Marc Jones reported on September 17, 2012 that the:

ECB Governing Council member Coene said it was "very unlikely" that the ECB would ever engage in outright quantitative easing but that the central bank had a number of other options to ease monetary policy.

"You could further lower interest rates, you can also try to extend the LTROS to some extent, you can also do some LTRO with private credit claims as collateral," he said during a seminar organized by the European Economics and Financial Centre.

Asked on charging banks to deposit cash at the ECB overnight he added: "That is certainly one of the options that is not at all excluded."

Coene is the head of the Belgian central bank, a position which brings with it a seat on the ECB's 23-member Governing Council.

The ECB's vow to buy potentially unlimited amounts of Italian and Spanish bonds if the countries admit themselves into fiscal rehab programs has seen a dramatic reduction in the market turmoil which was threatening the euro's future.

The ECB, despite its public pronouncements on emulating the Fed, will have no choice but to implement a coordinated and massive QE campaign in the near future.

And that future will affect the U.S. dollar, the Euro, and the financial markets across the world.

Such policies will have an adverse effect on the value of currency in people's bank accounts and pockets. Longer hours will have to be worked for currency worth less and less, and people will realize that their economic interests are not being represented by policies from their governments, implemented by bankers, the IMF, and leaders in ivory towers disguised as "economic leaders" using taxes for their own purposes and ensuring that unemployment is not properly tackled.

The economic future is in the hands of those who really understand the nature of resources, the control of those resources, and the distribution of those resources, either for the benefit of the many or the myopic and disastrous benefit of the few.

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Economic Theory in Practice

A.P. O'Malley

Anthony O'Malley earned his degree in Business at University College, Dublin, Ireland, and his M.A. at Baruch College, CUNY. Currently he teaches in the Marketing and International Business Department at Baruch College. Professor O'Malley previously worked as an options trader for a major Irish bank. He has written and published numerous books, including *The Federal Reserve Bank, Treasury, Income Taxes, and Debt: Connecting the Dots*.



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