Sunday, June 24, 2012

Money, Money, Money...

The Butcher, the Baker, the Candlestick Maker. Ahh, what a concept. Each of these skilled craftsmen produced something truly valuable and worthwhile to society. For their efforts, each received payment in coin or currency whose value was backed by something with universal and lasting value – Gold!

So that's the way it went until 1971. Now fast forward a mere 40 years, which by the way, is about one half of one percent of mankind's recorded history. Now it's the Hedge Fund Manager, the Investment Banker, and the Bond Trader, each contributing virtually nothing worthwhile to society. For their efforts each receives payment in dollars, backed only by the promise to print more as the need arises.

The shell game going on between the United States Treasury and the Federal Reserve is nothing short of a ticking time bomb. By now, anyone with a pulse should have some level of awareness of the world-wide financial crisis. The saving grace is that few really understand the systemic decay that is festering at the root of this. It's not just about Greece or Spain and will the Euro survive. If there was widespread understanding of this problem and its probable consequences, the entire world would be immersed in utter chaos which could lead to financial Armageddon. Thankfully, most of us just go about our business with our zombie-like, head-in-the-sand attitudes and just live day to day and hope for the best. Were it not for "the rule of law", one of the basic tenets of economic sustainability, we would all be in even deeper yogurt.

The shell game referred to above is the routine practice of the United States Treasury's issuance of new debt to the tune of $1 Trillion annually to finance our government's deficit spending. The portion of the debt issuance not absorbed directly by private citizens and foreign sovereign funds ends up in the hands of the dealers, the likes of which include such stalwart citizens such as Goldman Sachs, Morgan Stanley, and JP Morgan. The Fed then prints money to buy these bonds from the dealers, earning them handsome commissions for their roles as market makers. This process effectively increases the money supply. The bonds hit the balance sheet of the Fed as an asset, and an offsetting liability is created as a result of the money printed to finance the purchase. Is that cool or what?

Granted, managing the money supply is one of the stated purposes of the Fed. Expanding the supply during recessionary times has been a necessary practice. However, doing so only by printing money without an increase in the ***velocity*** of the money in circulation is just plain reckless and will end badly. Velocity occurs when the butcher borrows ten dollars from the banker for working capital. He then sells twenty dollars worth of meat to the baker who in turn sells bread to the candlestick maker. Meanwhile, the candlestick maker's business is thriving so he deposits his profits back with the banker. The banker now has more money to lend in excess of his reserve requirements and the cycle goes on and on. This is the healthy way to increase the money supply in a way that encourages and stimulates productive economic activity.