Great American Credit Collapse - Part I
Cash Will Disappear

We begin with a letter from a subscriber:

Bill: I just finished your book Hormegeddon and I am a recent subscriber to your newsletter. I agree with all of your predictions and everything you’re saying. What is the best way to position yourself to profit and protect yourself from the upcoming collapse we all know is coming?

I didn’t intend to answer the question. But I found I had a few ideas...

First, though, I will take a crack at trying to picture the circumstances... the events that lead to the calamity we need protection from.

This is a calamity that your correspondent has seen coming for so long, he’s beginning to feel he may be doing you a disservice by warning you. Like a podiatric surgeon who botched an operation, he looks at the dead patient and feels it is time to brush up on anatomy. Maybe the foot bone is not connected to the ankle bone after all.

The trouble is, the textbooks are written by people whose view of economic anatomy is mechanistic, not humanistic. They have fixes for every problem and wrenches in both hands.

Yes, we could go back to earlier tomes – by the great economists, Bas-
tiat, Say, Schumpeter, von Mises, and Hayek. There, we’d find the old-time religion... the real flesh and blood of real economics... with crime and punishment, sin and retribution, heavy hammers and swollen thumbs. But they lived in a different world... at least, that is what their critics tell us... before central bankers walked on water.

In previous issues, we’ve discussed why rusty nails are still rusty nails... and why the likelihood of stepping on one increases as the feds spread more of them around.

In this report, we'll take this analysis a big step further. What happens if they keep it up?

This report has taken longer to write than I wanted; it will surely take you longer to read too. For those who want a shortcut, here is the conclusion:

1. Central banks have several more tools up their sleeves; these could stretch this story out for years.
2. The economy is essentially deflationary... it “wants” to reduce debt levels.
3. Trying to hold off a credit contraction, indefinitely, will probably lead to a huge boom in asset prices (at least in nominal terms)...
4. Which will be followed by a terrible bust, marked by a sudden and almost absolute disappearance of credit.

As you can see, we admit that this report is premature. The feds could postpone the day of reckoning... perhaps for many years in the future. We also admit that since there are so many possible futures available to us, the odds that we have nailed the one we end up with seems remote.

Still, we try to look far ahead, to where we might be going, just to know how to pack.

For dramatic tension, let’s explore what it might look like to the average unprepared American. Come with me. Not into the future, for we can’t know what the future will be. But into a future...

“Temporarily Out of Service”

One day you will feel a horrible sick fear deep in your stomach... and a hot sweat on the back of your neck...

You will be suddenly, deeply upset with yourself. You knew there was something wrong with “the system”... You knew that at some level it just didn’t make sense; you knew it couldn’t go on like that forever.

You knew you should have done something to protect yourself. You knew it all had to come to an end somehow... sometime.

But it was always “too early” to make a big change. And now it is too late.

Everything seemed so normal for so long... you went along with everyone else... trusting... hoping it would all turn out all right. You didn’t want to look like an alarmist... or a nut.

And now, standing in front of your ATM, you will be on the brink of panic. Because you have exactly $29 in your wallet. You need more cash. This is the third machine you’ve gone to. All say the same thing: “Temporarily Out of Service.”

You knew the situation was spinning out of control. But the machines worked two days ago. Yes, they were already limiting the amount you could take out to just $200. Still, they worked. Why would they stop now?

And now, you need them more than ever. Everyone does.

This “financial crisis” is strange. Nobody wants cash... but everybody needs it! Cash is losing its value – fast. But how else can you buy things... and pay your bills?

There’s been some talk in Congress of forcing stores to accept credit cards and checks... But you’ve tried the Food Lion. “Credit Cards Not Accepted... Because of the Financial Crisis.”

You’ve tried the Whole Foods. Same story. “Cash Only.” And the cash machine has a sign on it: “Out of Order.” Someone has scrawled on it: BS.

You get back in your car. But you are down to an eighth of a tank. The gas stations stopped taking credit cards yesterday. They only take cash. Because they can take the cash out at the end of the day to one of the “money changers” who operate out of vans in mall parking lots. They just suddenly appeared a few weeks ago. Now, they’re everywhere.

You are getting desperate. You have food in the house for about 24 hours. Maximum. You need to buy more. But how can you buy anything without money?

You thought you were sitting pretty financially. After the third big crash, the government came up with the “QE for the People” program. And now your stocks are higher than ever.

But you don't have any money! Yes, you could sell your stocks. You could get a check. Who will cash it? Well, the guy at the money-changer van will... for a BIG discount.

Still, there are long lines at the “money changers.” Some people are desperate to get cash. Others are desperate to get rid of it. Really, desperation is what the whole thing is about. Everybody is desperate.

The “money changers” work like pawnshops... or outlaw banks. You take your
rings and other jewelry. They trade them for cash on the spot. Or, if you have cash... you take it there and buy whatever you think will hold its value. Merchants don’t take their cash to the banks; they don’t want to run afoul of the “anti-speculating” rules. So they take them to these money changers and get valuables in return.

And of course, the money changers are getting rich. Which people don’t like very much. There are reports that some have been arrested by the police. Some have been robbed. At least a couple of them have been murdered.

The whole country is jittery... and scared... Strange things are beginning to happen.

And now this. You will have to go get some of your wife’s jewelry and get in line. You know they’ll give you only a fraction of what it is really worth. That’s why you didn’t do it before. You knew it was a rip-off.

So, you hesitated... because you thought the problem would be fixed. Instead, it got worse.

What’s Anything Worth? Who Knows?

Who could have imagined a Dow at 50,000? You didn’t... but it recently shot past 100,000. Yes, some guys are making a fortune in stocks... and in real estate.

The house down the block... it sold for $350,000 in 2014. Last week, someone paid $1.5 million... You thought he was crazy. But now, you’re not so sure. It’s beginning to look like a smart move.

The last time you filled your tank, gasoline cost you $20 a gallon. A Happy Meal at McDonald’s was $19. If this keeps up, that $1.5 million house could seem like a bargain.

All this happened so fast. In just a couple of months, everything that you thought was stable... and solid... It all turned to mush and muck. You’ve got both feet on the ground, but the ground gives way. What happened?

But there’s no time to think this through now. You barely have enough gas to drive home... let alone drive back to a money changer with your wife’s jewelry.

What are you going to do?

What are others doing?

That’s the trouble. There are about 300 million other people – in about the same boat. Everyone needs cash...

They need dollars to pay for gas. They need dollars to pay for food. They need dollars to pay for all the things we take for granted.

If you had the gas maybe you could drive to another ATM... or even another city... or go directly into the bank and ask for cash. But the banks have been closed because of the “emergency.” And according to your car radio, it is worse in other places:

Crowds of people broke into convenience stores in two Detroit neighborhoods this morning. Police report a wave of similar robberies in several cities. In at least one incident, robbers left credit cards with a note: “Charge my account... I didn’t have a choice.”

In Baltimore, Maryland, police were out in force throughout the downtown area. Mayor Catherine Pugh told reporters that “snatch-and-run crime has become an epidemic.” Most often stolen are food items from local convenience stores. One man was shot dead at Mondawmin Mall. Police believe the man was engaged in money changing.

If everyone needs cash, why won’t the government just print more? It will. But it takes time. News reports will tell you the government is preparing emergency dollars that will be distributed through the banks.

But what is this new money worth?

No Exceptions

What’s happening back here in the present that would cause that kind of breakdown?

What is going wrong?

In a nutshell, America does not run on cash. It runs on credit. In theory, America’s line of credit is unlimited... but in practice... it can get complicated, fast.

The U.S. is the first and largest economy ever to function on credit.

Americans have 3.75 credit cards per person. They do some 60 million credit card transactions every day: 67% of gasoline purchases are done with credit cards, 62% of travel expenses, 67% of clothing. About 40% of low- and middle-income households use them to pay
basic living expenses – rent, mortgage, groceries and utilities. And more and more shopping is done online – 100% of it with some form of plastic.

Today, less than a third of all commercial transactions are settled in cash. The rest are on credit. When the credit cards stop working, the economy stops.

Listen closely to your car radio after the crisis begins:

The financial crisis took a turn for the worse today. Governor Christie of New Jersey and Governor Brown of California announced emergency measures to force gas stations to continue accepting credit cards. But commuters in Northern New Jersey as well as Southern California found local gas stations closed this morning. Whether they closed to avoid having to accept credit cards... or whether they actually have no more gas has not been established.

Our news helicopters reported many abandoned vehicles along commuter highways. Apparently, drivers simply ran out of gas.

When a money system breaks down, everything breaks down.

Again, let’s listen to the radio of the future:

Las Vegas receives almost all of its food deliveries by truck and the truckers say they don’t have the cash to pay for fuel. California governor Brown had ordered the gas stations to accept credit cards, but the stations say they don’t have the fuel to sell.

With food deliveries slowed... and in some places, stopped altogether... shelves of many grocery stores are bare. For the moment, it’s calm here. Emergency supplies – usually made available only in the event of a natural disaster – are making their way to Las Vegas neighborhoods. But those will soon be depleted.

The financial shock seems to have reached far beyond Las Vegas. Reports coming into the newsroom tell us of desperate people all over the country... food riots have broken out in several places. And in Denver, what can only be described as a “money riot” left two men dead, after a crowd stormed a money changer’s van and overturned it.

The worst thing is that the chain of supply that fills shops, supermarkets and gas stations seems to have come to a stop. Experts say the gas stations are running out of fuel because they can’t settle their accounts. That is, they can’t buy more fuel because they don’t have the money to buy it. And the truckers don’t have the money to buy the gas even if the gas stations had any. It looks like the whole system is breaking down.

If this continues for more than a few days, we could be seeing some serious problems... the economy seems to be coming to a halt. And people need food.

Is this over-the-top paranoia? Is my doom and gloom out of control? I hope so. Maybe it won’t happen. Maybe it won’t be so bad. But history shows that financial catastrophes do happen.

No one wants them. No one plans them. But no one can stop them. Every credit expansion ends in a credit contraction. No exceptions.

Then, how will the biggest credit expansion in history end?

When the Money Goes Bad

Approximately $1.5 trillion changes hands – not including investments – in the U.S. every month. People buy milk and pay babysitters. They pay their mortgages and their taxes. Consumer spending alone is $11.2 trillion annually.

But as of 2017, there is only $1.4 trillion worth of dollars – physical money – in the entire world. Approximately 50%-75% of that is overseas. And much of the stock of dollars is “dead money” – stuffed in mattresses, safe deposit boxes, and so forth. (Don’t worry; it will come alive when the credit bubble bursts – and wreak more havoc.)

Credit is what makes the wheels turn. Without it, almost everything comes to a halt. The banks... the gas stations... the grocery and convenience stores, too. The delivery trucks stop, and we are all in very big trouble...

Credit depends on stable money. One person lends to another, expecting that what they’ll get back will be worth roughly what they lent out. When the value of money begins to change rapidly, folks stop lending.

Impossible? Unlikely? Not going to happen? Well, as you can see in the table on the next page, it’s already happened in other countries.

Something similar is happening in Venezuela. In recent years, inflation has run over triple digits. At time of writing, the black market exchange rate is 300 times the official exchange rate of 10.1 bolivars per dollar. At one point, speculators were giving the country a 91% chance of defaulting.

I’m intrigued… But I’ve been discouraged from visiting by the instinct of self-preservation. According to the U.S. embassy, foreigners – especially gringos like me – are targeted for robbery and kidnapping. Apparently, the criminals think nothing about
The person from whose lips these words came was standing in line in Caracas to buy food. A long line. And when she finally got to the counter, she found her options had been reduced. When the money goes bad, the whole economy goes bad. Prices go crazy. Government reacts with controls. The shelves empty. The economy sinks.

But you’re probably thinking...
Oh, the U.S. is nothing like those countries... it can’t happen here.
And you’re right. It won’t be much like any of those financial disasters. It could be worse. Much worse.

Why the Cash Disappears
All of the credit crises listed above might have been small potatoes... just a rehearsal for the big implosion of debt and credit that lies ahead.

Yes, financial chaos in Zimbabwe and Argentina and elsewhere was bad. People lost their savings. Some lost their homes and their retirements. Some even lost their lives.

<table>
<thead>
<tr>
<th>Country</th>
<th>Dates</th>
<th>Peak Rate of Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>1973</td>
<td>88%</td>
</tr>
<tr>
<td>Hungary</td>
<td>1923-1924</td>
<td>98%</td>
</tr>
<tr>
<td>Peru</td>
<td>1988</td>
<td>114%</td>
</tr>
<tr>
<td>Zaire</td>
<td>1991-1992</td>
<td>114%</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>1991-1994</td>
<td>118%</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>1992</td>
<td>118%</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1997</td>
<td>123%</td>
</tr>
<tr>
<td>Austria</td>
<td>1921-1922</td>
<td>129%</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>1992</td>
<td>141%</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>1992</td>
<td>157%</td>
</tr>
<tr>
<td>Belarus</td>
<td>1992</td>
<td>159%</td>
</tr>
<tr>
<td>Bolivia</td>
<td>1984-1985</td>
<td>183%</td>
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<tr>
<td>Argentina</td>
<td>1989-1990</td>
<td>197%</td>
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<tr>
<td>Georgia</td>
<td>1992</td>
<td>198%</td>
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<tr>
<td>Tajikistan</td>
<td>1992-1993</td>
<td>201%</td>
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<tr>
<td>Georgia</td>
<td>1993-1994</td>
<td>211%</td>
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<tr>
<td>Soviet Union</td>
<td>1922-1924</td>
<td>212%</td>
</tr>
<tr>
<td>Soviet Union</td>
<td>1992</td>
<td>245%</td>
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<tr>
<td>Zaire</td>
<td>1993-1994</td>
<td>250%</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>1986-1991</td>
<td>261%</td>
</tr>
<tr>
<td>Poland</td>
<td>1923-1924</td>
<td>275%</td>
</tr>
<tr>
<td>Ukraine</td>
<td>1992-1994</td>
<td>285%</td>
</tr>
<tr>
<td>China</td>
<td>1943-1945</td>
<td>302%</td>
</tr>
<tr>
<td>France</td>
<td>1795-1796</td>
<td>304%</td>
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<tr>
<td>Bosnia/Herzegovina</td>
<td>1992-1993</td>
<td>322%</td>
</tr>
<tr>
<td>Peru</td>
<td>1990</td>
<td>397%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>1945</td>
<td>399%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>1948-1949</td>
<td>399%</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>1992-1993</td>
<td>429%</td>
</tr>
<tr>
<td>Armenia</td>
<td>1993-1994</td>
<td>438%</td>
</tr>
<tr>
<td>Free City of Danzig</td>
<td>1922-1923</td>
<td>2,437%</td>
</tr>
<tr>
<td>China</td>
<td>1947-1949</td>
<td>5,070%</td>
</tr>
<tr>
<td>Germany</td>
<td>1922-1923</td>
<td>29,525%</td>
</tr>
<tr>
<td>Greece</td>
<td>1941-1945</td>
<td>158,000%</td>
</tr>
<tr>
<td>Republika Srpska</td>
<td>1992-1994</td>
<td>297 million %</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>2007-2008</td>
<td>8 billion %</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>1992-1994</td>
<td>313 billion %</td>
</tr>
<tr>
<td>Hungary</td>
<td>1945-1946</td>
<td>41.6 quadrillion %</td>
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But those foreign disasters were nothing compared to the one coming right here in the U.S. Why?

First, this one is much, much bigger. The Argentine economy was only $610.3 billion – about the size of Chicago's metropolitan area. Its total outstanding credit in 2000 was only $132 billion. Compare that to the U.S. with a GDP of $18.5 trillion and a total credit market debt of $63 trillion (all as of January 2017).

Second, this one is much, much wider too. Almost every modern economy is implicated. All have similar problems. All are reacting in similar – and similarly ineffective – ways. And, as of the end of 2016, the total debt worldwide is now more than $230 trillion. In 1980, before the big run-up in credit began, the total was just $900 billion.

Third, those are just numbers. The crucial thing to remember is that none of those countries depended on credit the way we do in the U.S. The Argentines and the Zimbabweans, for example, didn’t have many credit cards... or mortgages... or ATMs... or automatic gasoline pumps.

In Venezuela, at the time of writing, a few credit cards are still being used. And the interest rate on credit card debt is over 60%. You can see why the credit cards will soon cease working there. Inflation is expected to go over 1000% in 2017. Desperate consumers simply postpone paying their credit card debt, realizing that the inflation will run ahead of the interest rate.

Compounding at 1000% a year will turn a $10,000 debt into $146,000,000 in five years. In 10 years, it will be over $23 trillion. You don’t have to be a mathematician to see that the credit card companies will pull the plug long before that happens.

Credit stops when currency values become unpredictable or uncontrollable. And the resulting disaster is equal and opposite to the amount of credit that preceded it.

That’s why the Argentine disaster was peanuts. The Zimbabwe catastrophe was trivial in comparison.

In both countries, the typical citizen had no mortgage payment to make. He had no credit card either. He was used to using cash... and merchants were used to taking it.

And when their own cash went bad, they could switch to U.S. dollars... or British pounds... This time, it won’t be that easy. Even if you could put your hands on euro, or yen, or renminbi... it probably wouldn’t help you. Because the crisis is now global. (In fact, the spark will probably not come from the U.S... but from Japan. But we will come to that in a minute.)

Crucially... in Argentina and Zimbabwe... and Weimar, Germany... there was plenty of cash around... People were used to saving cash... holding cash... and using it, even for large purchases, such as houses. When the credit system broke down... it made little difference to most people.

And look again at the financial crisis that took place in Germany in the early ’20s. Then, credit cards hadn’t even been invented... there was no consumer credit to speak of in any form... and most people still lived on farms. People in the cities were devastated. But life in the country continued much as it had before. Almost. Gangs of hunger-mad city folk roamed the nearby countryside trying to find food. And woe to the farmer who stood in their way!

Now, in modern America, long, complex chains of production and distribution put food on your table.

More than nine out of 10 people live in cities or suburbs. Almost no one – not even the farmers themselves – can feed themselves from their own gardens on their own land. Instead, they all depend on credit.

The farmer uses credit to buy supplies, fuel, fertilizer... everything. The wholesaler, too, relies largely on credit to buy the raw food, process and package it. The trucking industry uses credit to buy fuel. The retailer needs credit to keep the lights on and the stores open.

Six out of 10 customers pay for their groceries using credit cards. And don’t forget America’s huge underclass. About 47 million people depend on electronic transfers from the government to their "SNAP" cards. Typically, these people have very little cash on hand... and almost no provisions of food. What happens when the food stores stop taking their SNAP cards?

Over half a century, credit has replaced cash in America. There was only $1 trillion of total credit in America in 1965. And very few credit cards; they were only invented in 1958. Today, I take out my wallet and count seven plastic cards. And the total amount of outstanding credit is 50 times what it was in the mid-’60s. Our whole economy... and our way of life... have been shaped by this explosion of credit. We live on it. We depend on it.

So what happens when the credit stops? The whole production chain stops with it. Which is why the coming financial crisis in America could be much worse than any the world has ever known.

But let me be clear. The disaster we’re looking at is not the collapse of the dollar... as so many analysts have forecast...
No, it’s not that simple. The dollar will lose value. But as it loses value, people will be desperate to have it. Because they’ll need dollars to pay their bills and to buy the things they need. They will be desperate to get rid of it, too... because a falling dollar is a threat to their wealth. Currencies have two main functions – transactions and savings. On both counts, the dollar will fail... but not immediately.

Economies breathe in and out. Inflation raises debt levels and prices. Deflation lowers them. Over the last 30 years, the expansion of credit has pushed real dollars out of the economy. Today, the typical American has less than $20 in cash on hand. Women may carry giant handbags, but they have little cash in them – often less than $10.

I once boarded a plane for a round-the-world business trip with barely $25 in my wallet. I was confident that ATMs would work wherever I went. And they did.

But what if the ATMs no longer have the cash to give out?

The Road We’re Following

The major economies are so reliant on cheap credit that they can’t give it up. We look to Japan, as the leader of the pack, to see what will happen next. For 25 years, Japan has managed to maintain the status quo by inputting huge amounts of credit and printing-press money. Government debt went from 60% of GDP in 1989 to 250% in 2017. Government deficits have averaged about 3.4% of GDP, but are around 6% in 2017.

While debt increased, GDP did not. So the ratio of debt to the ability of the economy to pay has gotten worse and worse. While it earned $1.40 (GDP) for every dollar of public debt in 1989, at the time of this writing, the ratio is around 45 cents for every dollar of debt. And that is just the government debt. All together, the Japanese have debt equal to six times annual GDP – the highest in the world.

If the rate of interest on this debt were a “normal” 3% or so... it would pose a terrible dilemma. Nearly one out of every five dollars of output would be required just to pay the interest. The government, already running in the red, would see its deficits explode as 25% of its tax revenues would be required to service past debt.

To make matters finally and irretrievably catastrophic, the birthrate fell to 1.46 per woman by the end of 2016, which is so far below replacement level that whole towns are being emptied out – not to mention the labor pool. By 2030, there will be only two workers for every retired person.

Under these circumstances, growing the economy faster than the debt is not possible. Debt will continue to grow faster than income. And it will have to be financed by the Bank of Japan, that is, by cash and credit from nowhere.

Japan is ahead of us. But the road is the same. While the U.S. and Europe could still turn off – by cutting spending, substantially – that is unlikely to happen.

The typical household now gets more money from the government than it pays in taxes; it will be opposed to cuts. And elite policymakers still believe that cutting government spending leads to reduced demand and slower growth (making it even harder to “grow” out of debt).

That is why, during the ’07-’10 period, for example, U.S. GDP grew by only 4.26% while debt grew 61%.

No Exit

America, Europe and Japan all suffer from the same problems... and apply the same solutions. All are shackled to the ball and chain of debt, with their central banks adding to the weight.

To make matters worse, artificially low interest rates, bailouts, “back-stopping stock markets” and quantitative easing misdirect capital to inefficient and unproductive uses... further slowing real capital formation and prosperity.

These problems, in Europe and Japan, particularly, but in America too, are exacerbated by falling rates of household formation and fertility. While the debts... and cost of social services... go up, there will be fewer people to pay them. None of the three major economies – given reasonable assumptions – can work its way down from the ledge. They cannot “grow their way out” of their debt problems. They will either jump... or be pushed.

We have never been in this situation before. Never have so many people depended on so much credit. Never has the world had so much debt. And never have so many central bankers done so much to pump up the global supply of “money.”

The classical economists would be staggered to see it. If you could tell them about it, they probably wouldn’t believe you. Still, they might help us understand where it leads.

Happily, we don’t have to figure everything out ourselves. At least six generations of serious thinkers have
studied, analyzed, and observed financial disasters. Ludwig von Mises, for example, was on the scene during Germany’s hyperinflation of the 1920s. Here, he explains how the phenomenon develops:

If once public opinion is convinced that the increase in the quantity of money will continue and never come to an end, and that consequently the prices of all commodities and services will not cease to rise, everybody becomes eager to buy as much as possible and to restrict his cash holding to a minimum size. For under these circumstances the regular costs incurred by holding cash are increased by the losses caused by the progressive fall in purchasing power.

The advantages of holding cash must be paid for by sacrifices which are deemed unreasonably burdensome. This phenomenon was, in the great European inflations of the twenties, called flight into real goods (Flucht in die Sachwerte) or crack-up boom (Katastrophenhausse).

He could not comment on a breakdown in a credit-based system. No such system existed.

But note that the “flight into real goods” and the “crack-up boom” both anticipate the same thing: a big increase in the velocity of money. This is just what the central banks are hoping for.

They want you to spend your money rather than save it. And this is what they are likely to get, probably more than they were bargaining for.

Currently, prices are rising more slowly than the authorities would like.

Richard Duncan is chief economist at Blackhorse Asset Management in Singapore. He is also a friend of ours and an adviser to our family office. Chris Lowe interviewed him recently. Richard had an apt analogy:

The global economy is like a big rubber raft. Instead of being inflated with air, it’s inflated with credit plus commodities, including gold, and 7 billion people.

The problem is the raft has now become fundamentally defective, flawed because so much credit has been created that the income of the 7 billion people is insufficient to service the interest on the debt, and they keep defaulting.

When they default, the credit leaks outside of the raft.

People are not spending... not hiring... and not investing with much gusto. Just the opposite. There is no broad economic boom in any major economy. An increase in the velocity of money – which will lead to the kind of buying frenzy von Mises anticipated – is not even on the horizon.

Down... and Then Up

In 1978, Paul Volcker took over at the Fed. His plan was to jump. That is, he was willing to endure the pain of recession in order to bring inflation under control.

That was then. This is now. In 1978, the U.S. government owed $789 billion. Today, it owes $20 trillion. Then, interest rates were high. Now they are low. Then, money was turning over too fast. Now, it stays put. Then, stocks were low. Now, they are high.

Then, Volcker and the U.S. political establishment could grit their teeth, raise rates and get it over with. Now, the pain would be too much to bear.

Richard Duncan again:

There’s only one possible policy response and that’s to pump in more credit. That’s what the QE is about. They pump in more credit and when they do the raft reflates. Asset prices all go back up again and the people have dry feet and they’re all happy again.

What happens if they completely cut off the money printing now and don’t step in with some other policy like more aggressive fiscal stimulus again, then the raft would sink just like it did in 1930. We would get sucked into a deflationary whirlpool and the international banking system would collapse and global trade would collapse.

Officials can’t let the raft sink. Or they think they can’t.

Paul Volcker was facilitating a natural turn in the credit market, from high yields to lower ones. Janet Yellen and her colleagues are desperately trying to prevent another major shift, from low yields to higher ones. No secret as to why. Were interest rates to go back to 7%, where U.S. mortgage rates were as recently as 2001, the interest on the government debt would take more than $1 trillion per year. It would be catastrophic!

The next phase of the drama is likely to come when stock prices fall heavily. U.S. stock prices have been going up for the last eight years. They are now so high that our in-house model, called DAMA – based on a retrospective of market cap to GDP, adjusted for debt and demographics – predicts NEGATIVE 8% per year from U.S. stocks over the next 10 years.

It hardly matters. We know stocks are always subject to occasional bear markets and crashes. We know that
Debt markets are subject to big losses too – even as the Fed holds down interest rates.

This is the future the Fed is firmly committed to preventing. To that end, I see four measures coming:

1. Direct and indirect equity purchases, designed to imitate a “wealth effect.”
2. Direct money funding of government debts; central banks will buy government debt... perhaps all of it.
3. “Helicopter money” – bypassing the banking system, the feds will give tax credits to individual households, financed – along with huge new fiscal stimulus programs – by central banks.
4. Finally, the central banks will write off the government debt.

All of these initiatives have the same goal – to keep debt expanding rather than contracting. The first is ongoing in Japan... beginning in Europe... and “on hold” in the U.S. The second is under way in Japan... still not engaged in other major economies. The third will only come out after a major negative shock to the system. The fourth will happen when the other options are exhausted.

The last of these was suggested by economist Richard Koo of Nomura Securities in Tokyo. It is his solution to the Japanese debt problem. Since so much of the debt is owned by the central bank... and since the central bank is an arm of the government... the debt can be written off, no harm, no foul.

At first glance, this seems to be a real solution. All of a sudden, the debt disappears. And nobody is worse off. Now, the government can borrow more money from the central bank... on and on... forever and ever. Amen.

It sounds too good to be true. And it is. What has actually happened? The government has absorbed real assets and paid for them without collecting taxes. It has simply printed pieces of paper (or the electronic equivalent). And nobody is the worse off?

If this really could be done, every country in the world would run its public finances this way. But von Mises tells us why central bankers who don’t jump eventually get pushed off the ledge:

... then finally the masses wake up. They become suddenly aware of the fact that inflation is a deliberate policy and will go on endlessly. A breakdown occurs. The crack-up boom appears. Everybody is anxious to swap his money against “real” goods, no matter whether he needs them or not, no matter how much money he has to pay for them.

Within a very short time, within a few weeks or even days, the things which were used as money are no longer used as media of exchange. They become scrap paper. Nobody wants to give away anything against them.

Today’s money won’t even help you start a campfire. It is credit, not paper. In our imagined future, this credit will go bad when the breakdown occurs.

This is the future central banks are working so hard to prevent. It is where the can is kicked... the future no one wants. No one plans for it. No one is ready for it.

And yet, it is the future we should all be prepared for.

To Answer Your Question...

No one can know what will happen. But you should be prepared to meet the future the feds claim they can avoid.

Remember, a crack-up boom can send good assets up to hallucinogenic levels. Good companies survive, and can even prosper. Good real estate remains. Bonds – good and bad – do not.

The simplest and easiest thing to do today is to make sure you have a supply of real money – cash.

Have on hand some silver bullion coins for transactional purposes. Keep some for savings too.

Stay diversified, with 10% to 40% of your wealth in real money (gold)... and the rest in real estate and solid stocks.

Keep a healthy supply of food and necessities on hand too. If the supply chain breaks down – unlikely perhaps, but possible – many people will be desperate. You don’t want to be among them.

I know it is not practical for everyone, but it is also a good idea to have a small farm or rural property where you can wait out a real crisis. Food, water, a fireplace and a woodpile... a few gold coins... friends and family...

Hey, what more do you need?
Today, we have bad news and good news. 

The good news is that there will be no 25-year recession. Nor will there be a depression that will last the rest of our lifetimes.

The bad news: It will be much worse than that.

“A long depression” has been much discussed in the financial press. Several economists are predicting many years of sluggish or negative growth. It is the obvious consequence of several overlapping trends and existing conditions.

First, people are getting older. Especially in Europe and Japan, but also in China, Russia and the US.

As we’ve described many times, as people get older, they change. They stop producing and begin consuming. They are no longer the dynamic innovators and eager early adopters of their youth; they become the old dogs who won’t learn new tricks.

Nor are they the green and growing timber of a healthy economy; instead, they become deadwood.

There’s nothing wrong with growing old. There’s nothing wrong with dying either, at least from a philosophical point of view. But it’s not going to increase auto sales or boost incomes – except for the undertakers.

Second, most large economies are deeply in debt. The increase in debt levels began after World War II and sped up after the money system changed in 1968-71.

By 2007, US consumers reached what was probably “peak debt.” That is, they couldn’t continue to borrow and spend as they had for the previous half a century. Most of their debt was mortgage debt, and the price of housing was falling.

The feds reacted, as they always do... inappropriately. They tried to cure a debt problem with more debt. But consumers were both unwilling and unable to borrow. Their incomes and their collateral were going down. This left corporations and government to aim only for their own toes.

Central banks created more money and credit – trillions of dollars of it. But since the household sector wasn’t borrowing, the money went into financial assets and zombie government spending. Neither provided any significant support for wages or output. So, the real economy went soft, even as the cost of credit fell to its lowest levels in history.

Third, the developed economies have been zombified. The U.S., for example, is way down at No. 46 on the World Bank’s list of places where it is easiest to start a new business (at the time of writing). And only one G8 country – Canada – even makes the top 10.

Paperwork. Expenses. Regulation. High taxes. High labor rates. Entrenched competition with aging, loyal customers. All are endemic from Boston to Berlin to Beijing.

Leading industries – heavily controlled and regulated, including defense, education, health, and finance – are practically arms of the government. All are protected with high barriers to entry and low expectations. Competition is barely tolerated. Innovation is discouraged. Mistakes are forgiven and reimbursed.

Meanwhile, the masses are encouraged to become zombies too, with generous rewards for those who 1) do nothing, 2) pretend to work, or 3) prevent other people from doing anything. After all the zombies, cronies and connivers get their money, there is little left for the productive economy.

The Solution Begins When Markets Crack

Typically, these problems – too much debt, too many zombies, and too many old people – lead to financial crises. Then, they are “solved” by either inflation or depression. And the solution begins when markets crack.

Markets never go up forever. Instead, they go up, down and even sideways. They breathe in and out. And after sucking in air for the last 30 years, US financial assets are ready to exhale. Legendary asset manager Bill Gross comments:

When does our credit-based financial system sputter/break down?
When investable assets pose too much risk for too little return.

Not immediately, but at the margin, credit and stocks begin to be exchanged for figurative and sometimes literal money in a mattress.

When that happens, problems begin to take care of themselves, in one of two ways...

A quick, sharp depression wipes out the value of credit claims. Borrowers go broke. Bonds expire worthless. Companies declare bankruptcy. The whole capital structure tends to get marked down as debts are written off and financial assets of all kinds lose their value.

Or, under pressure, the feds print money. Debts are diminished as the currency loses its value. The zombies still get money, but it is worth less. Inflation adjustments cannot keep up with high rates of inflation. Pensions, prices and promises fade.

Either way, the slate is wiped clean and a new cycle can begin.

But what rag will clean the slate now?

The Beginning of the End

The logic of the “long depression” is simple: aging populations, debt, zombification – all of which slow growth.

How many old people and zombies do you need before an economy comes to a halt?

Nobody knows. But the drag from debt is observable and calculable.

Over the last three decades, approximately $33 trillion in excess debt has been contracted – above and beyond the traditional ratio to income – in America alone. And growth rates have fallen in half.

That’s because dollars that would otherwise support current spending are instead used to pay for past spending. Our old debts have to be retired with current income.

The money doesn’t disappear, of course. Some goes to creditors who spend it. Some comes back as capital investment, which is a form of spending. But as credit shrinks, generally, so does the economy.

And that brings us to the impossible situation we’re in now.

In order to get back to a healthy ratio – say approximately $1.50 worth of debt for every $1 in income – you’d need to erase all that excess that has already been contracted. In other words, you’d have to take $1 trillion out of the consumer economy every year for the next 33 years.

It would be the longest and deepest depression in US history.

A Credit Crisis, Complete with Howling, Whining, Finger-Pointing

Take a trillion out of the U.S. economy and you have about a 4% decline in GDP. Then, as the economy declines, the remaining debt burden becomes even heavier.

Try to pay down debt and it becomes harder and harder to pay down. You stop buying in order to save money. Your local merchants lose sales. Then they try to cut expenses, and you lose your job.

In other words, no “steady state slump” is possible.

When the credit cycle turns, it will not be a gentle slope, but a catastrophic cliff... a credit crisis, complete with howling, whining, finger-pointing... and more clumsy rescue efforts from the feds.

As we said yesterday, there are two solutions to a debt crisis. Inflation or deflation.

Central banks can cause asset price inflation. But it is not always as easy as it looks. Consumer price inflation requires the willing cooperation of households.

With little borrowing and spending from the household sector, credit remains in the banks and the financial sector. Asset prices soar. Consumer prices barely move.

U.S. consumer price inflation in recent years, for example, was approximately zero.

The assumption behind the “long depression” hypothesis is that central banks cannot or will not be able to cause an acceptable or desirable level of consumer price inflation. As a result, the economy will be stuck with low inflation, low (sometimes negative) growth and low bond yields.

But what about deflation? If inflation won’t reduce debt, why not let deflation do the job?

Deflation Works!

We’ve been exploring how the credit bubble resolves itself. Inflation? Deflation? Are we locked into a long, long period of stagnation, slump and economic sclerosis?

A foreshadow of the long depression crossed the planet like a total eclipse of the sun twice in the last 100 years.

The first time was America’s
Great Depression. You know that story. Stocks crashed. Businesses went broke. People lost their jobs. Banks failed. Events were following the typical depression script, which probably would have bottomed out and recovered within a couple of years – as happened in the depression of 1921.

But then, the federal government stepped in. It froze prices, including the price of labor. It cut off trade. It blocked liquidations. It arrested the progress of the correction.

Murray Rothbard analyzed the policies of the Hoover and Roosevelt administrations in his 1963 classic, America’s Great Depression. He showed how government, trying to stop the Depression, actually prevented it from doing its work.

The short, quick deflationary shock – which should have slashed bad debt, bad businesses, and bad investments – turned into a long, agonizing slump. The Depression, which should have been over by 1933, continued until the 1940s and was only ended then by the biggest public works spending program in history – World War II.

This, by the way, did not actually make people better off economically, but it “put people to work” and largely disguised the drop in living standards which that war and the Depression had caused.

The second long depression was in Japan, following the crash of its stock market in 1990. It has now been over a quarter of a century since that crash. Japanese GDP has scarcely advanced, as you can see in the above chart.

And the Japanese stock market? From a high of nearly 40,000 in 1990, at the time of writing, the Nikkei index now trades at around 20,000. It’s taken 25 years to claw itself back to a 50% loss!

Real GDP Growth: 1995 to Present

The blame for the longness of the depression can be placed squarely on the government. To this day, it continues to meddle in the economy – essentially forestalling a genuine cleanup of bad debt.

Instead of allowing the bad debt to be written off and reduced, policymakers have added more and more debt over the entire 25-year period so that today, Japan’s government is the most indebted in the world.

And now Japan is running out of time and money. Its aging population is no longer saving for retirement; now retirees expect to spend those savings. This means that the government can no longer count on financing from Japan’s savers. Now it must return their money.

But how? It has no money to give them. Like the U.S., it has been running budget deficits for years.

Japan’s economy is in a crisis. It’s been five years since the Shinzo Abe government began its stimulus program. But wages are actually lower today than they were when it began. And this is happening against a backdrop of falling labor supply; the labor pool is expected to shrink by 20% over the next 25 years. The main goal of the stimulus program was to raise Japan’s inflation rate. But you could multiply recent prices increases by nine and still not reach the government’s 2% target.

In the U.S., too, inflation has been disappearing as fast as good manners. In recent years, consumer prices have been approximately flat. And that is despite a 400% increase in the Fed’s assets – the nation’s money foundation – over the last six years.

If that kind of money printing doesn’t cause an increase in the CPI, what would? We’ll come back to that question in a minute.
Cheap Credit Keeps the Wheels Turning

If inflation can’t be counted on to reduce the world’s debts, what about deflation?

The feds fear it, loathe it and try to prevent it every way they can. But deflation works. It knocks down sales, prices, and employment, forcing borrowers into bankruptcy. Then, their debts are worthless.

Alas, in a zero-rate world, the banana peels disappear from the sidewalks. It is almost impossible to go broke, default, or fall on your face.

Grant’s Interest Rate Observer told the story of one company: Radio Shack. The company lost the plot back in 2007, says Grant’s. The Onion satirized its chief executive, Julian Day, putting the following words in his mouth:

There must be some business model that enables this company to make money, but I’ll be damned if I know what it is.

But Radio Shack stayed in business – borrowing even more money as its credit rating declined from BB- to D (or “junk”) over the following eight years. Finally, it bit the dust in February 2015.

There’s nothing like unlimited cheap credit to keep the wheels turning – slowly. In 2009, a grim year for American business, 60,837 firms declared bankruptcy. In 2016, there were over 25,000 bankruptcies.

What is surprising is not that there were so few, but that there were so many. When you can borrow for nothing... or close to nothing... why does anyone ever default?

Of course, not all firms have equal access to the free money. The little guys go broke. The big guys stay in business. The economy stays alive, but on life support.

The big limitation of this system is that as the slump worsens, prices fall and real interest rates actually go up. That is, the feds may lend at zero, but if prices are falling, the effective, real borrowing rate may rise.

The authorities would be “zero bound,” unable to take nominal rates below zero and unable to keep the real price of money at nothing.

Until recently, it had been presumed that rates could not sink below zero. People would not pay for the privilege of holding cash in a bank or a bond; they would just take the cash and hoard it.

But all over the world, central governments have begun a “war on cash” designed to force people to use credit, rather than cash. The feds can monitor, tax, and control credit. They can even force you to pay for the privilege of having it.

The European Central Bank and the Swiss National Bank already require depositors to pay for storing money. And in recent years, JPMorgan Chase began charging depositors a “utilization fee” to hold their money.

Meanwhile, economists are advocating taxing cash or even, like Harvard economics professor Ken Rogoff, making it illegal. France has already made it illegal to pay bills of more than 1,000 euros with cash. And the U.S. requires financial industry workers – such as bank tellers – to rat out customers by filing “suspicious activity reports” on anyone who comes in with what they consider an inappropriately large amount of cash.

Why the “war on cash”?

Partly to control you. And partly to control the economy. If they can create a NIRP world – with negative nominal interest rates – they may be able to keep the credit flowing to cronies and zombies, maintaining the economy in a coma for many years.

Businesses that should go broke will have access to credit. Speculators will still make money. Governments will continue to print money and borrow it from themselves. The zombies will throw rocks and bottles every once in a while, but they will still get their cash and the system will survive.

Long, draw-out depressions are caused by governments.

The politicians respond to today’s capital interests, not tomorrow’s. Today’s retirees vote. Today’s stockholders give campaign contributions. Today’s cronies control the power and money of today’s society.

And all of them fear one thing more than any other: the future.

They all know they will die, and that the process of capitalism is creative destruction – today’s wealth owners must be stripped of their money and power so that tomorrow’s generations can take over. And that’s why government’s essential role is to look into the future and prevent it from happening.

This is just another way of saying that governments will always try to stop depressions, because depressions are creative destruction in action.

Capitalism chops down today’s trees so that tomorrow’s saplings can get some air and light.

But trying to stop creative destruction does not stop the future. It just changes it. Instead of a dynamic, honest and growing economy, we get stagnation, economic gangrene and financial rigor mortis. Long depressions, in other words.
Don’t Expect the Fed to Sit Tight

As we have seen, Japan has already had a 25-year slump. The U.S. is now in Year 10 of its slump, with fragile growth at only half the rate of the last century. They could get better... or worse.

Negative rates could keep the croonies in business. The slump itself – combined with peak debt and 500 million Chinese laborers – could keep inflation in check.

But the point comes when investors see that the risk of loss (because something can always go wrong) is greater than the hope of gain. That moment must be approaching in the U.S. stock market. Prices are near record highs, even as the economy flirts with recession.

One day, perhaps soon, we will see stocks falling – as much as 1,000 points in 24 hours.

Jacking up the stock market has been the Fed’s singular success. Activism has been its creed. Interventionism is its modus operandi. It will not sit tight as the market falls apart and the economy goes into recession.

Instead, it will announce QE 4. It will try to enforce negative interest rates. And it will move – as will the Japanese – to “direct monetary funding” of government deficits. That is, it will dispense with the fiction of “borrowing” from its own central bank. It will simply print the money it needs.

The U.S. Fed of 1930 was not nearly as ambitious and assertive as the Fed of today. In the ’30s, it watched as the economy chilled into a Great Depression. As Ben Bernanke told Milton Friedman, “We won’t do that again.”

It couldn’t if it wanted to. Back in the ’30s, consumer debt had barely been invented. Most people still lived on or near farms, where they could take care of themselves even if the economy was in a depression. Few people had credit. Instead, they had savings. There were no food stamps. No disability. No rent assistance. No zombie industries. No student debt. No auto debt. No cash-back mortgages. And cash was real money, backed by gold.

Today, a long depression in the U.S. would be unbearable. The public couldn’t stand it. Six out of ten households live paycheck to paycheck. Can you imagine what would happen if those paychecks ceased?

Supposedly, the U.S. economy is still growing... with the stock market near record highs. Yet, one out of every five households in America has not a single wage-earner. Among inner-city black men, ages 20-24, only four out of 10 have jobs. Half the households in the U.S. count on government money to make ends meet. And 50 million get food stamps. What would happen to the cities – and the suburbs – in a real depression?

What would Janet Yellen do? Would she repeat the words of Andrew Mellon in 1929 to “liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate... it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.”

Mellon was just suggesting that creative destruction be allowed to do its job. He was the last Treasury secretary to make such a forthright and honest comment. Thenceforth, Treasury secretaries and central bank governors could no longer accept the tough love of a free enterprise economy. They had to offer bogus rehab and claptrap therapy. They had to stop creative destruction. They had to “tell it like it wasn’t” because that’s the way people wanted it. They had to pretend to make a better world by improving the market economy.

We Need Another Mellon

Today, a central banker or Treasury secretary who let deflation purge the rottenness from the system would be dismissed before sundown. Too much wealth, too many reputations, too much power and status depend on the continuation of the credit expansion. Instead of a Mellon, we will have a Greenspan, a Bernanke, or a Yellen. And we will soon find out whether Mr. Bernanke spoke the truth in 2002 when he said:

"We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

Threatened with deflation, the authorities will want to turn the tide in the worst possible way. What’s the worst way to stop deflation? With hyperinflation.

Yes, we may suffer a year or two more of sluggish growth... or even deflation. Stocks will crash and people will be desperate for paper dollars. But sooner or later, the feds will find their feet and lose their heads.

Most likely, the credit-drenched world will end... not in a whimper of deflation, but in a bang. Hyperinflation will bring the long depression to a dramatic close long before a quarter of a century has passed.