An historical perspective of the development of the economic ideas and series of political decisions that led to today's financial malaise. The wider intractable problems are described and some specific solutions are offered.

Sabotaging America

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SABOTAGING AMERICA

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HELMSMAN PUBLICATIONS, DALLAS

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ISBN 978-1-60910-032-2

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Printed in the United States of America.

Published by Helmsman Publications, Dallas, 2009
www.helmsmanpublications.com

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FOREWORD

The bookends of George W. Bush's presidency featured two financial fiascos caused by the same phenomenon; unregulated financial trading. The first of these fiascos was the collapse of Enron Corporation in December 2001; the second was the US banking collapse in September 2008. Bush stated that he believed in the free market. What he did not explain was that the market had become one that was free to be manipulated on a colossal scale, free from any kind of prudent regulation or constraint. However, Bush was not to blame for lack of regulations in financial markets. The officials of the Clinton administration in the 1990s had systematically and deliberately dismantled them.

Enron was able to rig the energy market by shutting down power stations in California and importing power from out of state, which was free from the price caps of California generated power. Other market manipulations were not so successful and mounting losses had to be hidden by off-the-books partnerships. Auditors Arthur Andersen went along with this financial misrepresentation and, consequently, just like Enron, went out of business.

Credit Default Swaps were the financial instruments that brought down the banking system in 2008. These were insurance contracts taken out against mortgage defaults. So great was the profit to be made that numerous contracts were taken out against the potential default of the same mortgage holder. Interested parties were able to persuade the regulators that these contracts were not a kind of insurance and should not be regulated as such. True insurance contracts are heavily regulated to ensure that funds are available in the event of a loss. The colossal losses resulting from sub-prime mortgage defaults broke the financial system.

Since the 1980s, Americans have been persuaded that any form of government intervention or regulation was against the public interest. The market was thought to be the arbiter of all financial dealings; laissez-faire governance was the guiding faith. This faith also applied to America's trading relationships, where free trade was the prevailing mantra. No national industrial policy was needed, and so the industries of America's northern heartland were permitted to decline to such an extent the entire cities are being downsized and suburbs returned to parkland.

American corporations have been busy downsizing their US operations and offshoring as much of their workforce as possible. The big-box retailers have made the overseas sourcing of goods their major business strategy. It is now rare to find an American manufactured product.

Americas elite has hugely benefited from the state of affairs just outlined, while failing to explain the consequences of their manipulations. The public is only dimly aware of the deep problems facing the country. The ever growing mountain of debt is totally unsustainable and been caused by completely irresponsible economic management. The total public and private debt has reached to over $57 trillion, of which almost $14 trillion is owed to foreign interests. The fundamental question is how is this laissez-faire farrago going to pay its way in the world?

America has been able to run up this huge debt by virtue of the US Dollar being used as the world's reserve currency. However, this situation is not permanent. The BRIC nations (Brazil, Russia, India and China) recently met in Russia and indicated that they may push for a new reserve currency. When that happens the debt markers will be called in, causing a collapse in the value of the Dollar and a rapid decline in America's standard of living.

Radio and TV talk shows throw various economic theories and prejudices about as if they were self-evident truths. Almost none of them are, but do have a long development stretching back over hundreds of years. To fully understand the nature of the dialogues concerning the current disaster one must delve into the history of these ideas to comprehend their relevance in today's crisis. The first few chapters of this book outline such a history to give a background and perspective for the later chapters.

The author believes that this country has been badly off-track for the past 30 years and that the 2008-9 crisis is the predictable outcome of both political parties placing themselves squarely in the pockets of the "haves" and their ideologies. The "haves" have immensely benefited from this arrangement, but the country has not. The "haves" have effectively sabotaged America by putting the county at risk. The rising levels of income inequality and the clear double standards operating between Wall Street and Main Street could lead to major social unrest. More importantly, however, the "haves" have placed the entire economic future of the country in jeopardy. They may have set de-industrialization in train to such an extent that economic decline cannot now be arrested. The "American Dream", with all its motivating hopes and promises may be over. This outcome, if it happens, will not be the result of external enemies, but a self-inflicted tragedy perpetrated by the greedy, incompetent, and immoral.

CHAPTER 1
INTRODUCTION

The World Economic Forum is a yearly gathering of the global elite. Politicians, businessmen, and financial mandarins all meet to ponder the world's problems. Generally, such topics as the Aids crisis, Poverty in Africa, and Global Warming take center stage. Normally, the atmosphere is one of warm, self-assured bonhomie that comes from being at the center of world power. Far-reaching proposals can be put forward with the knowledge that they will be noted with a degree of acceptance not found elsewhere, since almost everyone at this august meeting is on the same wavelength.

The January 2009 forum in Davos Switzerland was somewhat different in character. The usual bland self-assurance was strangely absent. Uncertainty and doubt about their own highly developed nations now perturbed the Western elites, who were used to gazing out onto the remote problems in the underdeveloped nations. However, the states vanquished in the epic cold war were now uncharacteristically buoyant. The leaders of both Russia and China roundly condemned the United States for playing the leading role in the latest collapse of the capitalist economic system. Both leaders complained that only a year ago, at the previous World Economic Forum, the West was extolling the ongoing stability of its own economic system.

At the current forum, the Chinese leader, in particular, was exceptionally caustic. He stated that the financial collapse was caused by, "…inappropriate macroeconomic policies of some economies and their unsustainable model of development characterized by prolonged low savings and high consumption."

He also cited, "…an excessive expansion of financial institutions in blind pursuit of profit [as well as] lack of self-discipline among financial institutions and ratings agencies…"

Almost everyone at the forum expressed the fear the World would now start to de-globalize: it would engage in protectionist policies, retreat into propping up its own banking entities, and fail to initiate the required international coordination deemed to be essential in restoring world finances. These fears were just those that were realized during the first collapse of capitalism, which occurred in the 1930s. During that period the precepts of classical economics held sway and prolonged the crisis for more than ten years. Now, even though classical economics theories have been largely discredited, many leading economists still promote them.

Interestingly, while the Western elites have been busy promoting "free market" capitalism, the reality of their own existence is somewhat different. In general one might state this reality as "capitalism for the poor and socialism for the rich." In this context, Capitalism is defined as the free play of the market place unhindered by any degree of government involvement or democratic constraint. Likewise, Socialism is defined here as government control of the market place to benefit the few and damage the interests of the country at large. It may be noted that, contrary to popular opinion, Capitalism and Socialism are not fixed, unchanging entities but can both operate in a wide variety of forms from one extreme to the other. An accepted version of Socialism is of democratic control that limits the excesses of the market and safeguards the interests of the country as a whole and especially its future.

The politicians at Davos were, of course, paid out of the public purse and most had never worked on the knife-edge of corporate existence. They enjoyed defined benefit pension plans coupled with fully funded medical plans that corporate drones could only dream of. The business leaders at Davos mostly operated in national oligopolies or international cartel arrangements. Since these leaders funded the election processes of the politicians, it is only to be expected that they were rewarded by legislation specifically tailored to their interests. The financial mandarins of the major institutions likewise were able to repeal constraining laws to their advantage and create legal financial instruments of such complexity that they managed to completely baffle themselves.

MASTERS OF THE UNIVERSE VS. JOE SIXPACK

The Davos elite, the so-called "masters of the universe," was relatively sanguine about its own future prospects. Although many of the elite were richly rewarded while causing the second crash of Capitalism, they were not financially penalized for their catastrophic activities. Their joint cumulative rewards and future benefits assured their future comforts. They only heard about the tribulation of "Joe six-pack ," who was not prudent enough to provide for his rainy day. He was, after all, only one of the "little people," one of the undeserving poor. It was very, very unfortunate that he would have to be evicted from his foreclosed house and that he could not afford to pay for his family's health insurance when he lost his job. Perhaps Joe would somehow be able to put food on the table once his state unemployment benefits ceased after a lifetime limit of six months. The best hope would be government food stamps, charity food pantries and soup kitchens.

Joe would have been cheered up to no end had he only known that he was part of the "creative destruction" Capitalist process, whereby old industries fail only to be replaced by more efficient ones. Thus, although Joe was down and perhaps out, the country as a whole would benefit in the long run. This is a quaint example of an academic proposition made by those not in Joe's dire position. These academics would probably also argue that any government assistance given to Joe would be detrimental to the recovery process since it might impede Joe's desire to get back into productive employment.

It is a telling comment on U.S. society that, in a country where a politician must wear Christianity on his sleeve to be elected, the majority really do not have a great deal of compassion for Joe. The sort of compassion that would have made Joe's plight unthinkable and would have instituted automatic effective remedial actions. But such is not the way with current Anglo-American political economy, where maximum labor flexibility is a tenet of faith. In situations where Christianity and Capitalism collide, the inevitable winner has been Capitalism of the meanest variety. In the U.S., it is Religion rather than Christianity that has been practiced and television evangelists most often ask for rewards from Mammon rather than from the Almighty. It is one of the world's greatest ironies that the largely godless Scandinavian countries have the most effective social "safety nets." Scandinavians are always at, or near the top of, the league in education, health care and economic performance.

Will o' the wisp finances

2008 exposed the fragile nature of global finance. All at once, the glut of money that was available in 2007 vanished. Banks refused not only to lend to sound business concerns but also to other banks. The Davos elite swore that they did not see the financial crisis coming; it was unprecedented, unpredictable; they were all caught by surprise. Certainly the central bankers of the planet seemed to be surprised, since during the first half of 2008 they were still expressing concerns over inflationary conditions. The rising prices of food, most commodities, and especially gasoline gave rise to these concerns. Central banks have a primary duty to control rising inflation, which requires interest rates to be increased, certainly not decreased. There were, however, several lone voices predicting imminent financial crisis and recommending that interest rates be sharply decreased to ward of such a catastrophe. One such voice was David Blanchflower, a U.S. economist from Dartmouth College, is currently one of the 12-member Monetary Policy Committee of the Bank of England. In early 2008, he was the only member to recommend a *cut* in the interest rate in light of the coming crisis he foresaw. However, the other 11 members—all from Oxford or Cambridge Universities—out-voted him. The central banks ignored all such loan voices and failed to move until the crash was obviously upon them.

Therefore, 2008 was a year of turbulent market conditions, during which it was felt that *something* was happening, but most were unsure of its extent and implications. However, there also were a few investors who knew very well what was happening and profited enormously. A good example is John Paulson of Paulson & Co., a brokerage firm engaged in the purchase and sales of securities.

In 2005, Paulson, a hedge-fund manager, discovered that certain bonds, which should have lost value, did not move as expected even though some of the companies were in bankruptcy. Paulson then turned to credit default swaps, or insurance instruments, that would pay out when mortgages default. In 2006 he lost money, but in 2008 his bet against the housing sector resulted in his two hedge funds rising 590% and 350%, respectively.

Some of the elite (See "The Cozy Money Club" described in Chapter 6) had a hand in knowingly looking the other way or actively taking part in causing the crisis. The reason is not hard to find, since such dramatic market moves provide excellent financial rewards if understood and acted upon. Market manipulation, although illegal, can be achieved as simply as making a casual comment or providing true but incomplete information. Selling at the top at the market and buying in again at the bottom, as well as making money on the way down is easy if you understand what is happening. Unfortunately, the general public, untutored in these matters and not in on the game, tend to buy at the top and sell at the bottom while losing money on the way down.

Illusory Wealth

A great deal of the apparent increase in wealth of the nation during this period was an illusion. For example, say a house increased in market price from five-hundred thousand dollars to nine-hundred thousand dollars over the years from 2001 through 2007, but in 2009 decreased again to five hundred thousand dollars. The actual house did not change and, perhaps, even suffered some deterioration over the eight years. The house still retained the same value to its owner as always, even though its market price had wildly fluctuated, since the owner continued to need a residence. No one actually gained or lost the four hundred thousand dollars. It was never actually there; it was purely an opportunity not taken. Even had the owner sold the house for nine hundred thousand dollars, an equivalent one would have cost as much, and his wealth would have been unchanged. The distinction is between price and value, a dichotomy that has entranced economists for centuries. *Wealth only increases if one can purchase more valuable goods than before*.

Illusory wealth is created out of thin air by the operation of the money supply. Once, say, one hundred dollars is deposited in a bank, the bank is required to hold a given fraction in reserve. If the reserve requirement is ten percent, then the bank holds ten dollars and is free to loan out $90. In time, this $90 flows back to the bank as a series of deposits, at which point the bank keeps nine dollars in reserve and loans out the remaining $81. If this process continued indefinitely, the original one hundred dollars would give rise to one thousand dollars in loans. This effect is called the *Keynesian* However, the deposit-loan cycle based on the original one hundred dollars *Multiplier*. dwindles to nothing well before the full multiplier is reached. This dwindling occurs because not all the money loaned out by banks is spent. Some finds its way back into the banking system; some is kept as cash on hand; some is hoarded and some spent on such things as vacations overseas.

Moreover, the speed of the cycle is highly dependent on consumer confidence. If times are good, consumers are eager to borrow and the cycle speeds up. The reverse happens when times are bad. The theoretical ten-fold increase in money is not an increase in wealth, even though tangible goods have been bought and tangible salaries paid. It is merely an increase in borrowed money, which has to be repaid at a future time from actual income. Clearly, a man who borrows one billion dollars is not a Billionaire but a chronic debtor.

As a nation the USA has not paid its way in the world since the late 1970s and is now the world‘s largest debtor nation. Since 1985, the cumulative trade deficit has reached over seven trillion dollars. It has had to rely on the savings of much poorer nations to fund its purchases. Today, the bulk of the borrowed money comes from the Peoples Republic of China. The wealth created by national debt is an illusion created with borrowed money. As with all chronic debtors, the day will come when the level of debt is unsustainable. Clearly a financial crisis will occur followed by a dramatic drop in the national standard of living.

As it happened, the Chinese were not about to call time on the understanding that had been reached with the U.S. It was, in fact, a mutually beneficial arrangement. The U.S. was able to live beyond its means and have its Federal debt financed. The Chinese were able to acquire technology, build up an industrial base, provide better jobs for its people, and—above all—maintain the Communist party in control.

THE 2008 CRASH

Unsustainable borrowing was not the direct cause of the 2008 financial meltdown, but rather an indirect cause. The flood of outgoing U.S. Dollars required to pay for the trade deficit had to go somewhere. Since the U.S. Dollar is the world's reserve currency, most nations like to hoard Dollars to pay for ongoing expenses, just as you and I like to have cash in our pocket plus a little put aside, "…just in case." However, once these Dollars have built up beyond a certain amount, nations like to earn some interest on them, just as you and I put money into a savings account once "cash on hand" is enough. The global financial system then recycles these Dollars back to the U.S. by facilitating the purchase of U.S. Treasury securities, consumer debt, and tangible assets. This flood of returning Dollars gave rise to the advent of low-interest-rate "easy money," which may be termed a *cash bubble*. This bubble had—and has, as will become evident—grave consequences for America.

The mountain of recyclable Dollars reached such a peak that only the U.S. mortgage market had sufficient capacity to absorb it. But not quite. It turned out that there were not enough creditworthy new borrowers to match the Dollar supply. The genius of the Capitalist system came to the rescue to solve this problem in several ways. Obviously, more mortgage demand had to be created to equal the increasing funding supply. Lending standards were gradually relaxed, so that more and more mortgage applicants could become eligible. The final relaxation was the provision of so called NINJA loans, meaning that the applicant had no verifiable income and no verifiable job. Mortgages made on this basis became famous as "sub-prime" loans. The U.S. law was changed (more on this later) to enable banks to become investment houses to process such loans. One result of this was that these "near banks" did not fall under the same Federal Reserve regulations as traditional banks. The Federal Government looked on benignly, since it encouraged the growth of home ownership in a "property owning democracy".

The Dollar supply was also somewhat mopped up by another interesting feature of the supply-demand equation. The enlargement of the supply of new mortgage applicants increased the demand for houses. Initially there was an insufficient supply of houses and, consequently, housing prices began to escalate. Gains of 20 percent per year were quite common, which prompted buy-to-let and buy-to-flip investors to enter the market. The classic market bubble was under way on a grand scale, with frenzied buying taking place. As usual, no one asked if the merry-go-round might stop, since vast profits were to be made and house prices would rise forever. Everyone was happy with this state of affairs

Mortgage brokers, who had been blue-collar workers the week before, now were out in force finding clients. In fact, anyone who was breathing and could sign documents was a potential mortgage candidate. It was a quantity and not a quality business. It also had the twin rewards of earning huge commissions and putting smiles on the faces of new homeowners. Job satisfaction does not come higher that this. The new "near banks" took their fees and passed the mortgages on to the financial wizards of Wall Street, thereby incurring no financial risks themselves. The wizards, ever capable of inventing new chicanery, went the whole hog. They turned common or garden-variety mortgages into exotic financial instruments, securities that could be sliced and diced to obscure their underlying worth. Such was the obfuscation achieved by the wizards that the rating agencies, Standard and Poors together with Moodys, passed them with the very highest AAA rating. These securities could be packaged and repackaged and then sold on to the elite investment houses, not only those on Wall Street but also those on every financial main street around the world. Top investment bankers were rewarded with multi-million dollar bonuses; the very top 12 or so pocketed more than a billion dollars each.

Then, starting in 2007, a slow trickle of mortgage defaults began to grow beyond the normally accepted level. In mid 2007, the value of the Dow Jones Index, which is a key indicatory of market sentiment, faltered, recovered and then faltered again. The realization had dawned that the game was up; that the income required to support interest payments on these exotic financial instruments was not there. In 2008, the Dow Jones Index went into free fall. The month of September was especially bad when the full extent of the disaster became clear. Most of the major financial institutions had lost vast amounts of money, and several were essentially bankrupt.

In the end, stricken Wall Street houses disappeared and major banks all agreed to receive multi-billion dollar bailouts provided by the U.S. Treasury. A few top wizards were forced to resign and several huge investment fraudsters were unmasked by events. “Joe six-pack” and his kin had to come forth and rescue “the masters of the universe.” A Republican senator said he woke up and thought he was living in France, given the major government intervention into the very heart of the Capitalist system.

Who is to Blame?

It is not to be concluded that the U.S. was the sole "villain of the piece" in this financial catastrophe. The UK aped its U.S. cousins step by step, leading to the nationalization of a major bank and government taking controlling interest in many others. Over the previous few years, only Vincent Cable, Treasury spokesman for the UK Liberal Democratic Party, had warned of such events. Of course, he was unheeded. In Spain, the Santander Bank said its finances were sound since it avoided "sub-prime" loans. Santander's president said that he did not invest in anything he did not understand and was widely praised for his prudence. It was later revealed that Santander had been taken to the cleaners by Bernard Madoff, Wall Street's champion swindler. In France and Germany, leading banks suffered significant losses as the "sub-prime" packages they had acquired came to grief.

Up till the Autumn of 2008, while Wall Street was hurting, Main Street had been continuing along quite well. However, once the market crashed, compounding effects began to take place: consumers began to tighten their belts and slow down spending, then the downward spiral of the Keynesian cycle (described earlier) ensued. Banks, whose reserve limits were near maximum, had no room to expand loans (in many cases they did not know how to value their reserves). Moreover, while Treasury secretary Paulson poured in cash to increase bank reserves, both business and consumer loan demand had fallen. Consumers do not want to get into increasing debt when unemployment is looming. Businesses do not want to expand capacity when demand for their products or services is falling. A full-scale recession was underway. The AIG crash pointed up a secondary problem in the $60 trillion derivatives market that was potentially an even greater crisis that the sub-prime crisis. In 1998, Brooksley Born—named to head the Commodity

Futures Trading Commission (CFTC) in 1996 and a powerful Washington lawyer with a track record for activist causes—had warned that derivates, such as credit default swaps, "…may pose grave dangers to our economy"(credit default swaps are insurance against mortgage defaults). Ms. Born was opposed by Alan Greenspan and Robert Rubin (U.S. Secretary of the Treasury, 1995-1999). The US Congress imposed a six-month freeze on CFTC authority to regulate derivatives and, in 1999, made that permanent.

In the last quarter of 2008, monthly U.S. job losses rose to more five hundred thousand a month and the GDP (Gross Domestic Product) declined at an estimated annual rate of 6.2 percent. This rate of economic decline was the steepest since 1982. The Federal Government and financial institutions had reacted too slowly to prevent the disaster on Wall Street tipping over to the whole economy.

UNCONTROLLED BUBBLES

The 2008 crash is an example of uncontrolled economic activity causing an economic crash. In earlier centuries, such "bubbles" were confined within individual nations, but as 20th-Century international trade and finance grew, economic sins in one global area rippled out to visit economic destruction on a truly global scale.

The cash bubble, described previously, that occurred in the early 21st Century gave rise to the housing bubble, which—combined with speculation and greed—caused the housing bubble to burst. Note: economic bubbles are quite distinct from trade cycles, the origins of which puzzled 18th- and 19th-century economists. Trade cycles are caused by *uncontrollable* economic events, rather that *uncontrolled* events. Economic bubbles are always caused by uncontrolled economic events, as distinct from uncontrollable events. An example of an uncontrollable event is a very bad harvest that leads to rapid price increases of food. Money absorbed by inflated food prices is denied to other parts of the economy causing their slowdown. The trade cycle dips downwards, only to be revived by the next good harvest, which reduces food prices and slowly restores the economic balance.

Economic bubbles have a long history. The first speculative bubble was reputed to have taken place in the 17th century in Holland, just after the introduction of a new type of tulip bulb. The interest in the new bulb grew to such a pitch that the contract price for a single bulb rose to more than ten times the annual income of a skilled craftsman. The bubble is said to have burst and ruined many speculators. This story, which may be apocryphal, is an example of human emotions driving a specific economic activity. Once the prospect of financial reward becomes widely known, whether true or not, an uncomprehending "herd instinct" takes over. A speculative mania takes on a life of its own and only comes to an end when the next "bigger fool" cannot be found. Mini-manias of the sort are found every day on the stock exchanges of the world. No one knows who starts them or who ends them. It is the magic of the market.

JOHN LAW, HARBINGER OF TROUBLE

John Law was a Scotsman, who left a vast trail of woe behind him; the echoes of his work linger to this day. Scots reputedly have a lot to answer for in the fields of economics and finance; however, Law was probably of the most notorious. After killing a man in a duel over an imprudent liaison, he escaped prison to avoid the hangman. He came to Paris in 1697 and later used his knowledge of the mathematics of probability to win a fortune at the gaming tables. He also had revolutionary ideas concerning how to finance the needs of the state; more specifically, the needs of King Louis XIV, who had to resort to raising loans from Paris financiers. Law proposed that the way to increase the required money supply was to create a national bank and issue money made from paper. The strategy would overcome the limited availability of gold and silver. He tried to present this plan to the King in 1706, but had no success. However, he did, at that time, meet the King's nephew Phillippe, Duc D'Orleans.

In 1715, Louis XIV died and Orleans became the ruler of France. The year 1716 saw France in greater financial distress and, at last, Law's scheme was seen at a solution. He was granted a charter to open his Banque General. Law's influence with Orleans enabled the Bank to survive several early setbacks. He established innovative mechanisms for enabling foreign transactions. His issuance of banknotes increased the money supply, which enable commerce to recover.

Another opportunity for Law arose when the state gained control of the French colony of Louisiana, which comprised far more territory than the modern U.S. State of Louisiana and even contained parts of Canada. Law proposed to re-capitalize the colony by raising 100 million *livres* through the selling of 200 thousand shares via a stock company. Investors would benefit by owning part of the vast riches forecast to exist in the colony. The crown would benefit since Law would accept crown debt at very favorable rates of interest. The Mississippi Company was born in 1716 and with it the age of share ownership. Law had pulled off a masterstroke and he was, as managing director of the company, effectively master of half of America.

Not content with this masterstroke, in 1718 Law persuaded the state to take over his bank, which now became the Banque Royale. He continued as Banque Royale's director. Paper bank notes now became generally accepted. Law moved to shore up the Mississippi Company by acquiring tobacco growing rights and, more importantly, by a merger with the French East India and China Company. To that end, he issued another 50 thousand shares. His ventures began to show small profits. His investors believed that he must have had inside knowledge and others were attracted. As share prices rose, Law restricted supply and the share price doubled.

In mid 1719 Law issued another 50 thousand shares to purchase the rights to the Royal Mint. Such audacity increased the share price sevenfold. In September 1719, Law issued one hundred thousand shares followed by two more issuances of similar quantity and, finally, one of 24 thousand. The proceeds of this massive fundraiser went to buy up the national debt and the right to collect state taxes. This time there was no restriction on share dealing, and shares could be bought by putting only ten percent down. Even lower-order citizens were able to profit by buying and selling Mississippi Company shares. The flood of apparent wealth fuelled property speculation. The makers of fancy carriages and luxury goods flourished. Law was the toast of the town; high society fawned on him. Being a canny Scot, he bought vast amounts of property, fine art and jewelry. The term *millionaire* was invented to describe an individual of fabulous wealth.

Law knew that a share's price depended upon public confidence, which was tied to the prospects in Louisiana. He bought a tract of land in what is now Arkansas, funded its settlement and encouraged others to do the same. He scoured the land for would-be immigrants, but in early 1720 the supply of immigrants dwindled as unfavorable reports filtered back from the "Promised Land." The share price wavered, and Law launched a new investment vehicle call a "prime ," which enabled an investor to deposit one thousand livres for the option to buy a share priced at ten thousand livres later. In modern investing terms a "prime" would be called a call option.

Naturally, many people sold their existing shares to buy "primes ," which would increase their leverage. Law was forced to fund this activity as shares lost their value. In addition, many of the shrewdest investors were selling shares and demanding to be paid in gold or silver coin. Regulations were passed to prevent coin being exported. Later, the purchase of jewelry was prohibited to prevent its export. To assuage the crown, Law bought back its share holdings. The share price plunged by 26 percent in a week after he withdrew official support for the share price. He ordered that no one could hold more that five hundred livres in coin.

Law reversed his decision to withdraw support for the share price and renewed it at nine thousand a share. Unfortunately, this reduced confidence even further and caused a run on the bank. Law responded with a proposal to phase out gold and silver coinage altogether. The printing presses began to run at full steam, and the country was flooded with paper money. In modern parlance, this activity is called "quantitative easing" (a 2009 activity in response to the 2008 crash). In May 1720, Law reset the share price at five thousand livres and proposed gradually reducing the value of banknotes. During the riots that followed, Law feared for the safety of his family and removed them from Paris. The crown ordered the share price support level be restored to nine thousand. The next week the price fell to four thousand (the crown had not learned from King Canute - no, the tide would not retreat at royal command). Law was dismissed from bank directorship and placed under arrest. None the less, he was supported by his allies and tacit support from the crown. He returned to the bank and, to great astonishment, continued his activities. He now believed that confidence could only be restored by reducing the quantity of banknotes in circulation. Dramatic bonfires of notes and shares heralded this new policy, which only served to increase the demand for coinage. Quantities of copper were imported to provide for this demand.

Law was finally undone by an uncontrollable event: an outbreak of plague started in Marseille and spread throughout Provence. The ports of Toulon and Marseille were closed down, trade diminished, and a slump ensued. One of Law's last desperate moves was an edict to replace all paper notes with metal coins. Towards the end of 1720, Law resigned his bank directorship and on December 14th left for England. He was never able to regain his fortune in France and died in Venice in 1729 while acting as an agent for England in Austria

Greed is a like a contagious virus that infects all who approach it. In London, shares in the South Sea Company saw an eight-fold price increase over six months in 1720. Stock markets in Hamburg and Amsterdam were also booming. Inevitably—as surely as night follows day—all such booms come to unhappy ends, which often come quite quickly. South Sea Company shares fell by 64 percent in little more than two months, and share prices in other European stock markets also plunged.

Lessons Unlearned

It would have been instructive to the many perpetrators of the 2008 crash to have studied and learned from Law's activities almost three hundred years before. However, it is doubtful if many had even heard of him. It is much more likely that they were too busy using the writings of Adam Smith to justify their "free market" mantras. Much more on Smith and his plausible, but over-simplified, economic theories later.

Law's Mississippi Company venture was nothing more than a "get rich quick" scheme that was too good to be true. His investment prospectus, such as it was, had a grain of truth that was wildly exaggerated by advertising hype. The scheme was conveniently located in a far away colony, which hid the risks from would-be investors. The slicing and dicing of today‘s “sub-prime” loans similarly hid risks from both rating agencies and worldwide investors.

Megalomania took hold of Law as he expanded his business empire with a series of acquisitions all financed by the expansion of credit. Capitalism seems to go through a phase of merger mania every so often, where debt is piled upon debt. Collapse comes when two plus two no longer equals five and, most probably, always equaled three. Conglomerates, very popular in the 1970s, become too large to manage effectively and never achieved the synergy promised. A slight economic downturn causes incomes to drop and makes highly leveraged debt obligations impossible to meet.

In 1719 a strange crowd mania took place that persuaded even the most astute individuals to allow themselves to be swept up an illusory investment scheme. It takes a certain kind of very disciplined investor to go contrary to the general mood of the market. When any asset moves up with a steady gain of 20 per year every year—let alone one that rises sevenfold in a matter of months—something must be amiss. Yet, few seemed to notice in 1719 or in 2007.

Law understood quite early on that investor confidence was the key to an every rising share price and to the eagerness to buy shares issue after issue. His introduction of novel investment instruments to entice fresh interest was innovative. As with today’s financial wizards, he fooled himself when they backfired.

Law’s easy-credit scheme caused a massive inflationary spiral in the prices of all tangible assets, helped along by being able to buy shares on margin. When things became out of hand he, reacted—as today’s central bankers have—with a series of draconian measures that betrayed an unbelievable level of floundering incompetence. Each measure was portrayed as the certain solution to the current problem, only to be followed by the next crisis. Financial regulations, which might have stopped or mitigated the disaster, were virtually unknown in Law's time. New-Deal era regulations, which might have staved off the current debacle, were systematically dismantled by self-interested parties. In both cases, the few individuals who were concerned about the wisdom of innovative financial instruments were either denigrated or ignored.

There is one very significant difference between the 2008 crash and the Law debacle of the early 18th century. Whereas Law lost his entire accumulated wealth, perpetrators of the 2008 crash were not required to pay back any of their salaries or bonuses. After all, as one Wall Street wizard stated, "I brought in a couple of billion worth of business for the company, and am I am entitled to my multi-million dollar bonus." Time will tell whether or not an enraged U.S. public will actually stand for such a blatantly warped sense of values.

REALITY OF PSEUDO SCIENCE

After World War II, the U.S. emerged as the dominant world economic power. Even though its world trade was only a few percentage points of its GDP, it dictated the structure world financial arrangements. Its wishes were paramount in setting up the structures of the World Bank and the International Monetary Fund. The British, on the verge of bankruptcy, were granted a long-term loan, only fully repaid in the 21st century. The generous Marshall plan enabled Western Europe to recover from the ravages of five years of total war.

The Eisenhower era in the 1950's were years of unprecedented prosperity. Unemployment was very low, and the standard of living rose for everyone. The only blight on the horizon was the fear of expansionist tendencies by the Soviet

Union, which had acquired both the atomic and hydrogen bombs with surprising speed. U.S. leaders called on the nation to line up shoulder to shoulder behind all U.S. institutions, which were self-evidently the best in the world. It was deemed unpatriotic to question American institutions, and few did. The FBI rounded up any "fellow travelers" and other subversive elements. The House Un-American Activities Committee (HUAC) held well-publicized hearings to investigate and root out those with deviant "left-of-center" ideas. Of especial interest to HUAC were those in positions of influence and power, such as movie directors, actors, and playwrights. The resulting blacklist caused many to lose their jobs and some to emigrate. It was not America's finest hour.

The majority of Americans were unaffected by HUAC or its machinations. However, they did, as is natural, support American ideas and institutions. The "free market" and especially the financial systems were regarded as cornerstones of American prosperity. There was no need to question or really understand their operation since everything seemed to work so well.

In fact, whereas the laws of the natural sciences, such as physics or chemistry, are not manmade, the theories behind economic and financial systems are. Behind all the sophisticated mathematical equations lies the reality that economic practice is more of an art rather than a science, and should be treated as such. Such theories form a body of knowledge that can best be described as having only a pseudo-scientific basis.

The 2008 crash was a severe jolt, causing the majority of American to conclude that a change was needed. The election of Barack Obama as president was a clear signal of a national mood swing. However, change can mean many things now that the certainties of the Eisenhower years are over. The remaining chapters of this book explore in detail why traditional ideas no longer work—and how America can become a fairer, more content, and more successful society.

An historical perspective of the development of the economic ideas and series of political decisions that led to today's financial malaise. The wider intractable problems are described and some specific solutions are offered.

Sabotaging America

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