

Edinburgh 2013

Are we Just Tinkering?

Alan Lucas



Edinburgh 2013

Are we Just Tinkering?

Why do I ask?
Because
Things aren't what they seem!

This Presentation

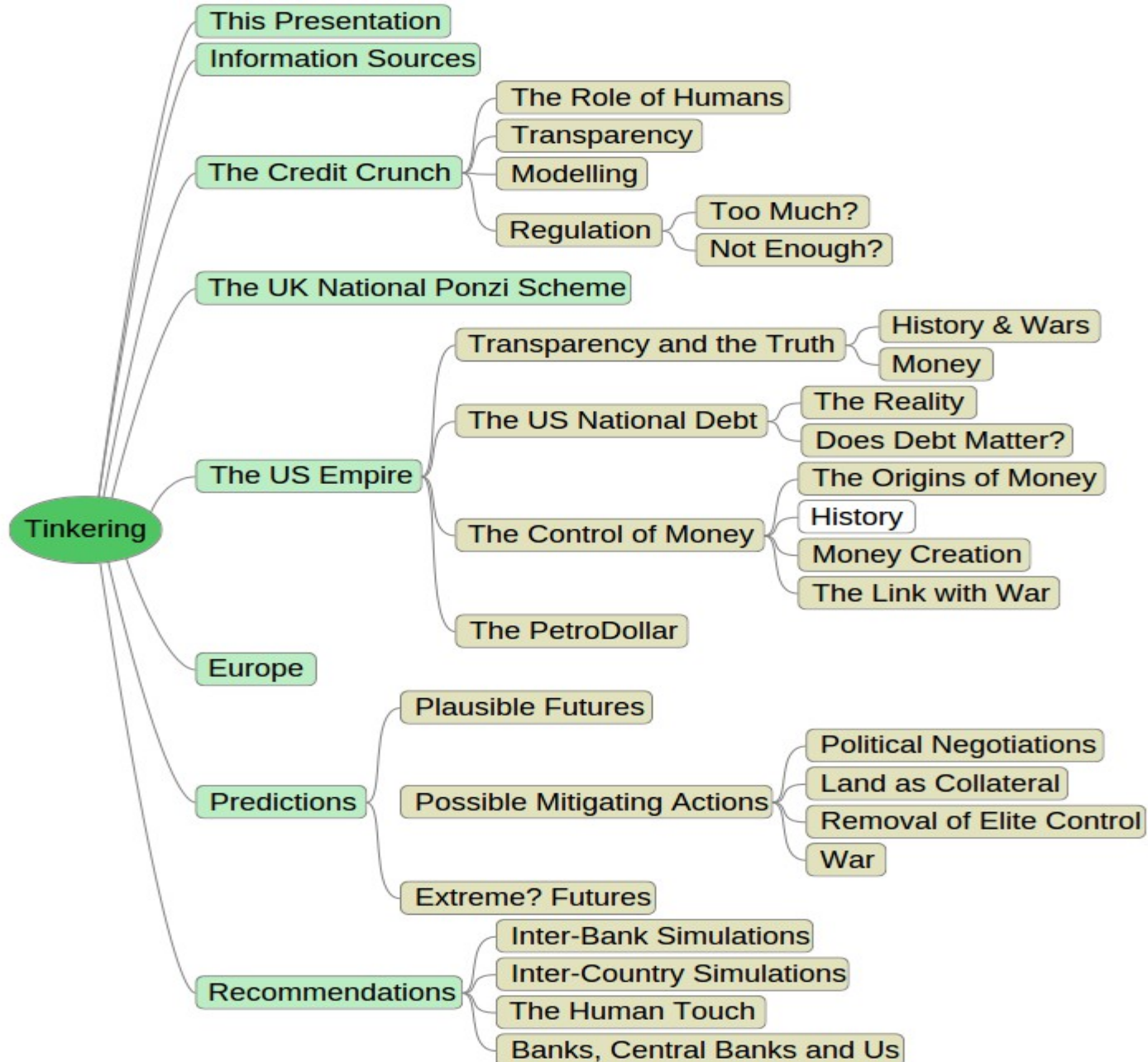
Objectives

- This is a high-level presentation suggests a re-focus towards systemic risk and should be of interest to regulators, bankers and **academics**

Central Thesis

- There are storm clouds ahead
- We are not really modelling them
- We need to focus on
 - **Big issues rather than minor ones**
i.e. to include of world economic events in stress scenarios that are plausible projections from the current situation but which have been hitherto ignored or portrayed by the media as being extreme. In particular revisit history!
 - **Inter-bank simulations**
The historic focus on individual lenders causes replication of effort
 - **Eurozone (or Europe-wide) simulations**
- We need to include human behaviour and human mendacity in the models₃

This Presentation



Information Sources

References

- Sources
 - Economic Papers
 - Books
 - Economics / Forecasting
 - Anthropology
 - Psychology
 - History
 - Novels
 - On-Line Videos
- Disclaimer
 - I am not an economist, historian, psychologist, anthropologist or novelist.

The Credit Crunch

- The Role of Humans
 - The players
[*“All the Devils are Here – The Hidden History of the Financial Crisis”* - Mclean/Nocera]
 - Psychopaths in business, politics and finance
- Transparency
 - Lack of knowledge of true debts meant banks would not lend to each other on the short-term market at affordable rates, causing liquidity problems for leveraged lenders.
- Modelling
 - Lack of focus on systemic risk
 - No systemic simulation models
 - Haldane's liquidity modelling is an example of the right way to go

The Credit Crunch

Regulation

- The Incidence of Fraud
 - A precipitating trigger for the financial crisis was the sub-prime mortgage crash. William Black [an associate Professor of Economics and Law, who was the Executive Director of the US Institute for Fraud Prevention and has also worked in the office of Thrift Supervision] in his testimony to the House Financial Services Committee is of the opinion that the housing bubble and collapse was the outcome of a massive fraud at all levels and that the banks and Savings and Loans societies were complicit.
- The Lack of Regulatory Bite
 - Virtually no-one has been prosecuted for the frauds (despite the fact that the US has the highest proportion of people in prison in the western world)
 - Downturn economic scenarios were ignored and regulation was light-touch

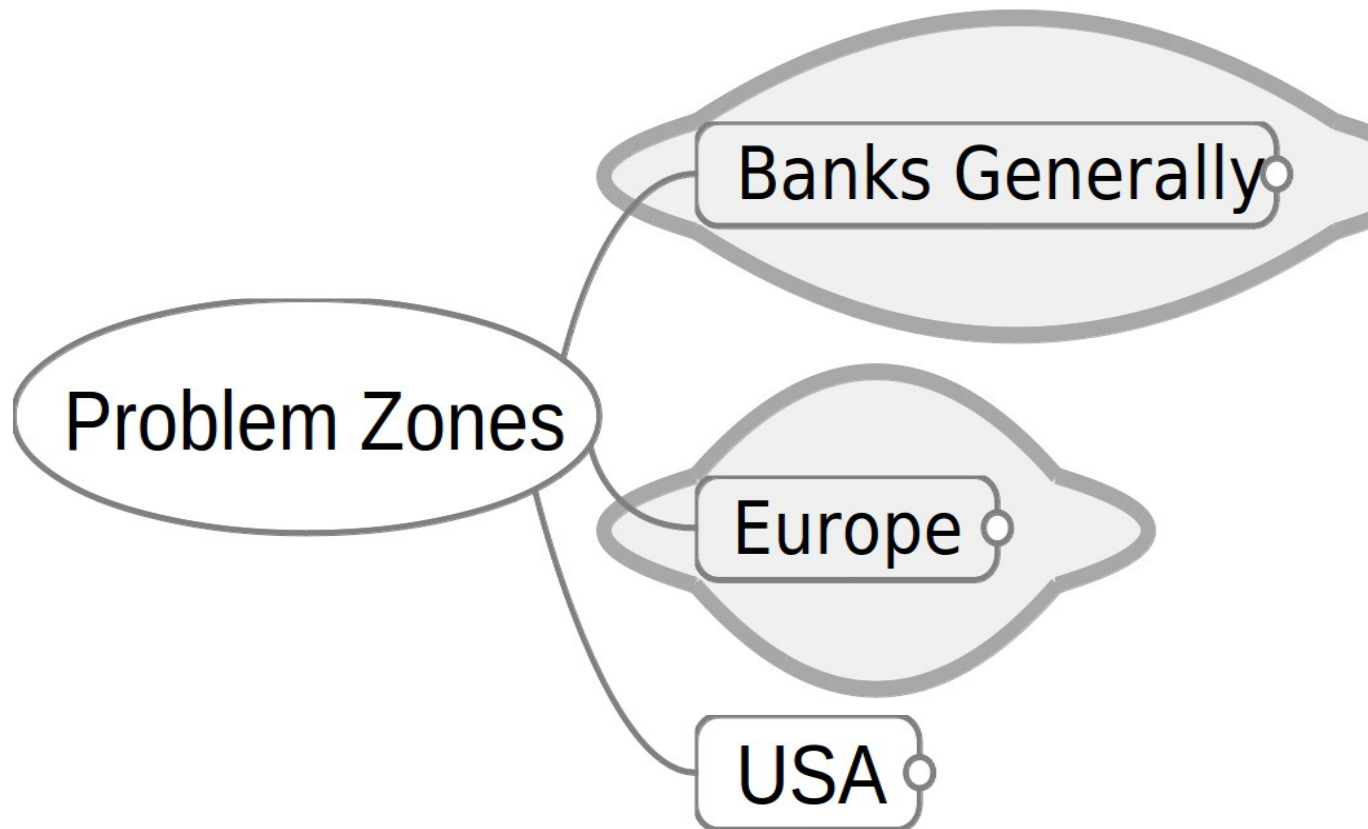
The UK National Ponzi Scheme



Table 3: The Real National Debt in Detail

£billion	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
1. Official National Debt (PSND)	311	314	346	382	422	462	498	622	742	890
2. Public sector consolidated gross debt (nominal)	382	380	409	447	486	537	579	617	798	1,005
3. Market value adjustment	32	20	34	27	25	41	25	44	62	124
4. Public sector consolidated gross debt (market value = 2+3)	414	400	444	474	511	578	604	661	860	1,129
5. Unfunded public sector pensions	434	467	557	639	758	907	931	1,104	1,119	1,283
6. Local Government Pension Scheme deficit	6	42	42	42	37	32	27	42	53	53
6. Unfunded state pensions	1,411	1,345	1,365	1,451	1,856	2,028	2,199	2,370	2,542	2,717
7. RBS/Lloyds debt	0	0	0	0	0	0	0	0	3,439	2,585
8. PFI (capital net of finance leases)	10	11	14	18	20	24	28	35	35	38
9. Network Rail debt	0	0	0	13	16	18	18	20	22	23
10. Nuclear decommissioning	14	18	21	23	24	31	37	44	45	45
Real National Debt (= 4+5+6+7+8+9+10)	2,289	2,283	2,442	2,659	3,222	3,617	3,844	4,276	8,114	7,873
Real National Debt as % of GDP	231%	221%	224%	230%	265%	285%	286%	302%	566%	560%
Public sector liquid assets	70	65	62	64	62	73	79	88	124	213
O/ W RBS/ Lloyds	0	0	0	0	0	0	0	0	20	91

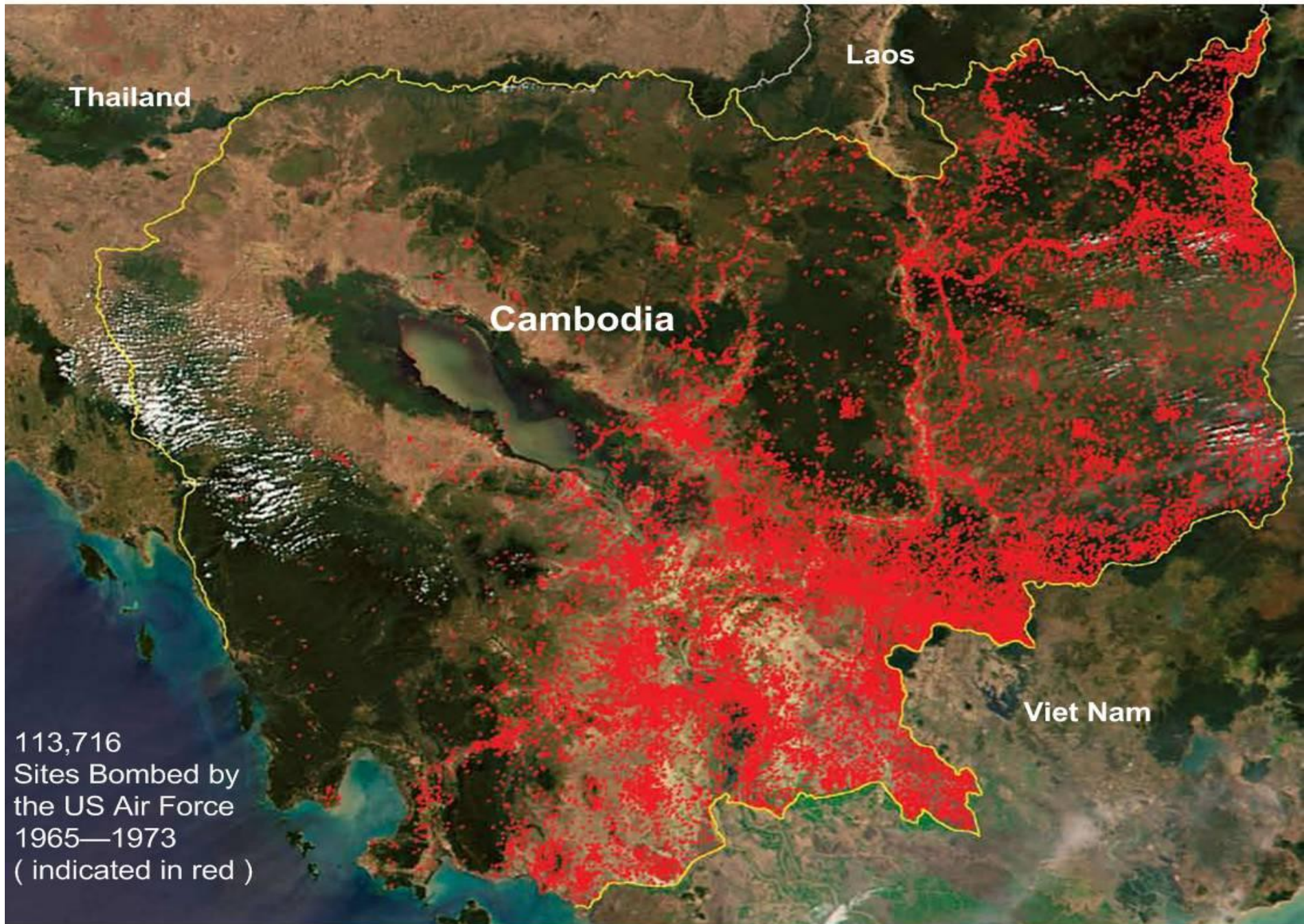
The Key Areas



The US Empire

- The US has imperial might and has exercised this might since the second world war
- Prof Noam Chomsky:
"Hegemony or Survival - America's Quest for Global Dominance"
 - US has over 900 military bases in the world
 - Cambodia episode
- The age of empires has progressively shortened

Transparency and the Truth



Transparency & the Truth

- Opacity can hide Mendacity
- This was obvious in Cambodia but also applies in Finance
- Outside of the TARP programme and Quantitative Easing the Federal Reserve, which is a private central bank, had been lending money to selected banks at 0.01% interest rate (effectively free) to the tune of multiple trillions of dollars.
- When questioned by the politician Alan Grayson a very revealing on-line video of a congressional enquiry showed that the Fed would not explain to congress where the money had gone - i.e. to which banks (let alone what the collateral arrangements were, what agreements had been made with the banks to use it and pay it back etc.)
- What can one expect of banks in general if they follow the regulator's example?

The US National Debt

- What is the US debt?
- It is not \$16 trillion!
- Including the “present value” of Medicare, Medicaid and Social Security (which the government is obliged to pay by law). This calculation has been made by **Laurence Jacob Kotlikoff** - a Professor of Economics at Boston University. **Kotlikoff's calculation is \$222 trillion: 14 times the official figure!**
- The US is effectively bankrupt as it can never pay off its debts unless it reneges on its promises to the electorate to cover pensions and healthcare. Moreover, the employment situation is nowhere near as rosy as official figures suggest:
 - For a more realistic appraisal of US employment see the detailed presentation by Stefan Molyneux of Free Domain Radio. The number of Americans on food stamps is staggering and many employed workers hold very low paid temporary jobs (20% on poverty-level wages). A stark examination of the problems can be seen in the well-known presentation by Porter Stansberry [Stansberry].

Does Debt Matter?

- There is an argument put forth by some economists that the true debt does not matter for two reasons:
 - (a) Other countries need to trade with the US and it is not to their advantage for the US to be declared bankrupt or for the US to default
 - (b) The US can get around any problems by printing money.
- Remember: *The dollar, like many other currencies, is Fiat Currency. This is a currency that a government has declared to be legal tender, despite the fact that it has no intrinsic value and is not now backed by reserves*
- In my opinion
 - The debts are too large for this to work
 - The dollar will lose its value (see next section)
 - Countries will lose confidence in the US currency

The Control of Money

The Origins of Money

- Where does money come from?
- **Myth:** Promulgated in economics 101 textbooks:
 - *“Early Man began bartering. This was seen to be inefficient for various reasons that are obvious on reflection and money was introduced to replace barter systems”*
- The prominent anthropologist David Graeber, who has studied this in detail, has written a complete rebuttal within his tome “Debt – the First 5000 Years”:
 - Basically there are no anthropological instances where money replaced barter.
- Money is created by banks when they lend. They then earn interest on the money they create! (note: for the last few years the US has stopped publishing its M3 money supply figures!). **Think about this!**
- The US uses “Fractional Reserve Banking”. The UK does not.

The Control of Money

The History of Money

- The present situation is not the way it has always been. Many times in the history of the US the government has been in control of printing money.
- Countries have had disasters when Fiat money has been privately printed (e.g. this caused financial collapse twice in France in the 19th century)

The Power of the Unelected:

- In a nutshell the main argument that “radical” economists and free thinkers have is that the US financial system now controls the political scene and that a few unelected bankers have the power to (a) make themselves very rich at the expense of the electorate and (b) to wield financial weapons that can destroy nations (including the US) without any checks, controls or balances
- Their argument is that “The current financial system appears to be inevitable because in our lifetime that is all that people have known, but historically (e.g. before the formation of the Fed in 1913) currency was (with various gaps) issued by the government and that private control of the currency always ends in disaster and poverty of the workers”.

The Link with War

- Michel Rivero has produced an historical exposé of the wars the US has been involved in since the war of independence, linking every one to financial aims
- The same can be said for other countries such as the UK
- Discussion on alternative reasons behind the second Iraq war and the Libya aggression

What the Key Players Think

- *Thomas Jefferson, (Attributed)*
3rd president of US (1743 - 1826)
 - *"I believe that banking institutions are more dangerous to our liberties than standing armies. If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around [the banks] will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered. The issuing power should be taken from the banks and restored to the people, to whom it properly belongs."*
- *Baron Nathan Mayer Rothschild*
 - *"I care not what puppet is placed on the throne of England to rule the Empire, ... The man that controls Britain's money supply controls the British Empire. And I control the money supply."*

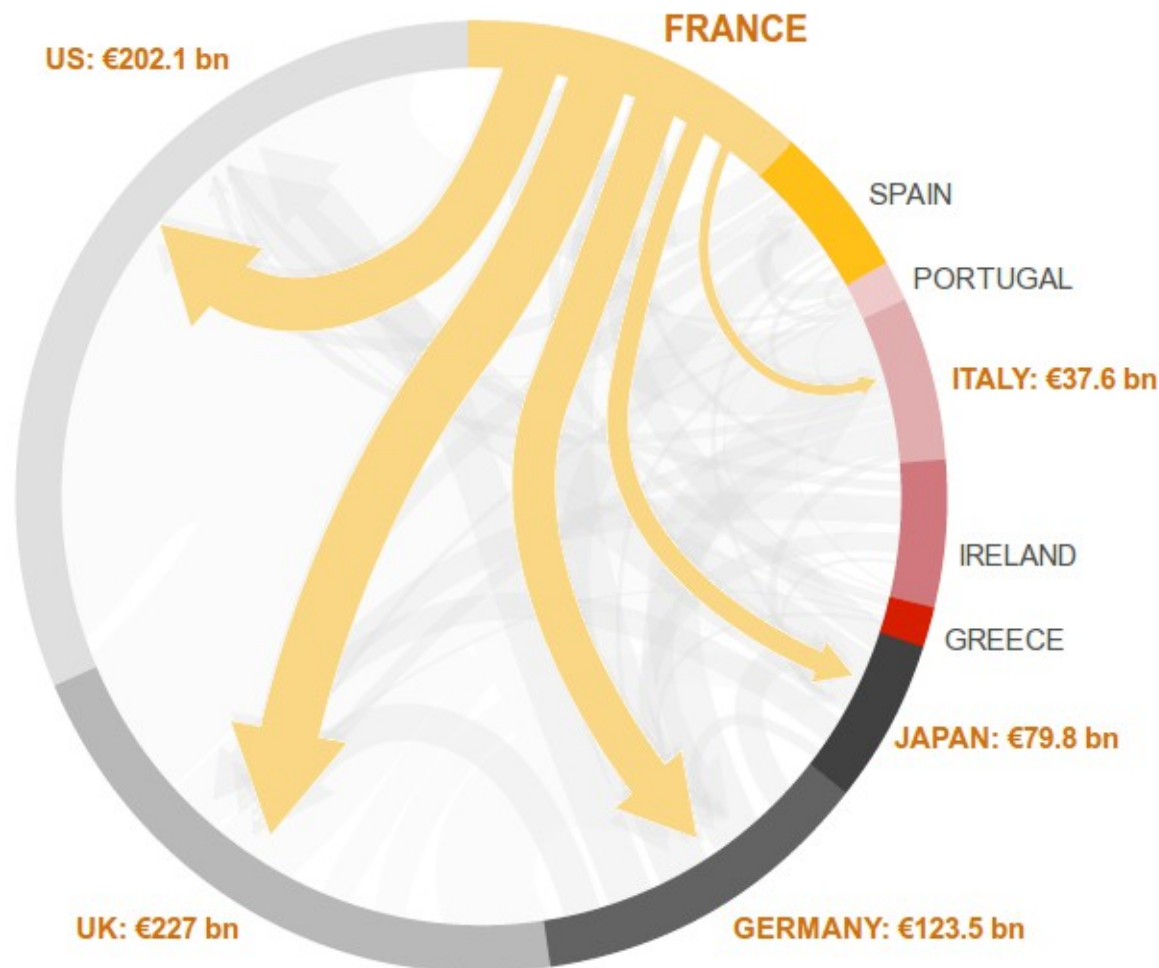
The PetroDollar

- **The dollar is the world's reserve currency**
 - Almost all of the oil in the world is traded in U.S. Dollars. This is because in 1973, a deal was struck between Saudi Arabia and the United States in which every barrel of oil purchased from the Saudis would be denominated in U.S. dollars. Under this new arrangement, any country that sought to purchase oil from Saudi Arabia would be required to first exchange their own national currency for U.S. dollars. In exchange for Saudi Arabia's willingness to denominate their oil sales exclusively in U.S. dollars, the United States offered weapons and protection of their oil fields from neighbouring nations, including Israel, in effect acting as the oil policeman.
 - By 1975, all of the OPEC nations had agreed to price their own oil supplies exclusively in U.S. dollars in exchange for weapons and military protection. This petrodollar system, or more simply known as an "oil for dollars" system, created an immediate artificial demand for U.S. dollars around the globe. And of course, as global oil demand increased, so did the demand for U.S. Dollars.
- **This is about to end** - best estimate is within 5 years!
- **Consequence:** the dollar will attain its true value!

Europe

Eurozone debt web: Who owes what to whom?

The circle below shows the gross external, or foreign, debt of some of the main players in the eurozone as well as other big world economies. The arrows show how much money is owed by each country to banks in other nations. The arrows point from the debtor to the creditor and are proportional to the money owed as of the end of June 2011. The colours attributed to countries are a rough guide to how much trouble each economy is in.



FRANCE

GDP: €1.8 tn
Foreign debt: €4.2 tn

€66,508
Foreign debt per person

235% 87%
Foreign debt to GDP Govt debt to GDP

Risk Status: ■ MEDIUM

Europe's second biggest economy owes the UK, the US and Germany the most money. However, like in Germany's case, these countries also owe France billions in return. France's problem is that it is greatly exposed to the eurozone's troubled debtors. Its banks hold large amounts of Greek, Italian and Spanish debt. This is causing market turbulence, especially against a backdrop of faltering French growth and low consumer spending.

[Back to introduction](#)

Predictions



Plausible Future - US

Scenario

- The dollar will collapse
- The Fed could continue to print money, which will only exacerbate the situation in the long term. Even if it de-leverages it will not help.
- The national debt will increase to gigantic proportions
- There will be civil unrest
- The army will be used to quell the unrest and imprison citizens
- The US will go to war to cover its internal problems

Timescale

- ~10 years?

Consequences

- Investors will lose faith in the dollar
- The US economic collapse will trigger a world recession

Possible Mitigating Actions?

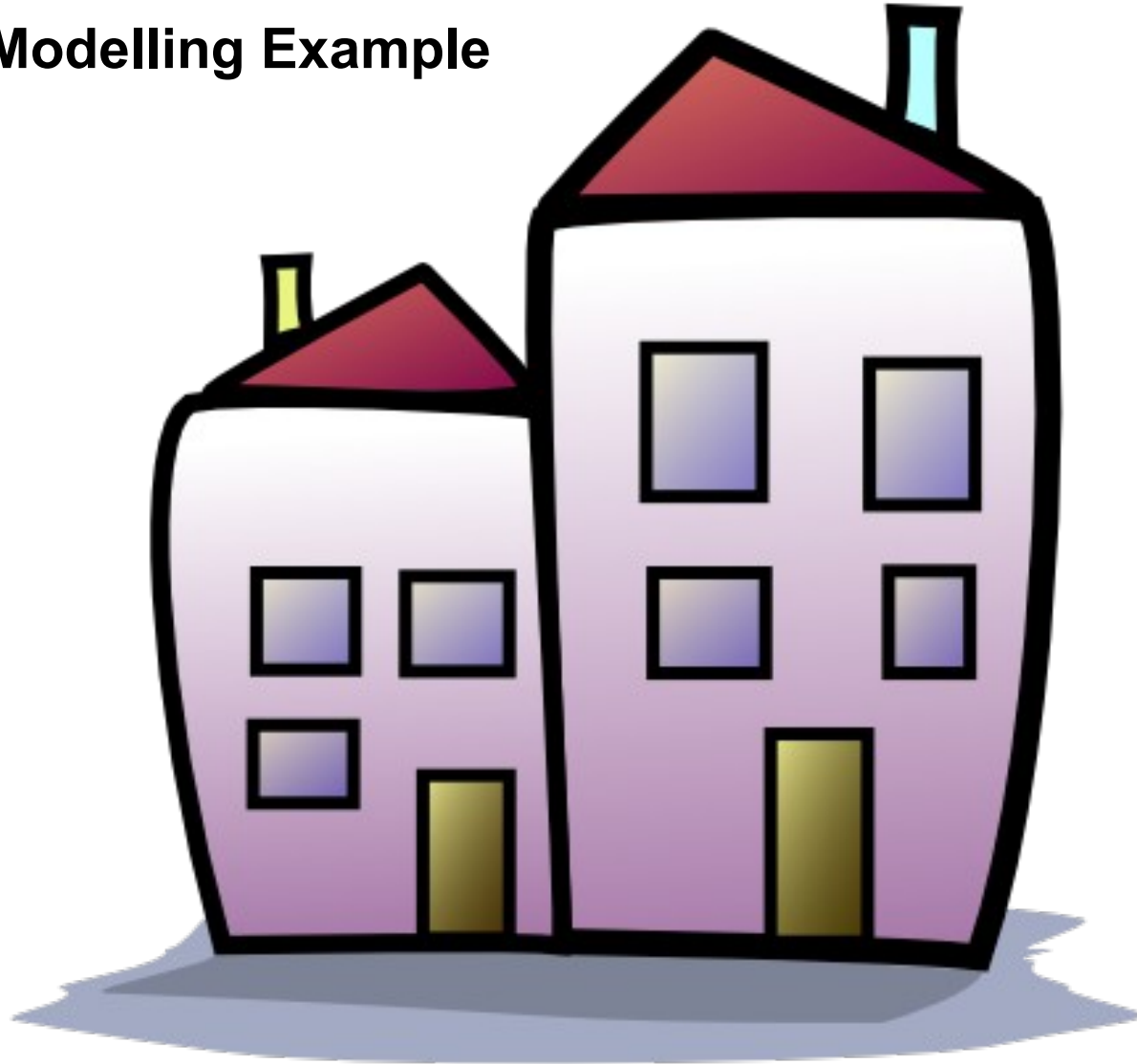
1. Political Negotiation
 2. Asset Sale / Land-Grab
(see the France historic example)
 3. Limited War
 4. Removal of power from the elite; removal of monetary control from the Federal Reserve
-
- My view is that, despite the desire for (4) by some eminent politicians (e.g. Ron Paul), (4) will not happen because (a) the elite already have too much power and money and (b) the rubicon has been crossed
 - For (1) Possible negotiations with investors, trading partners, creditors etc. such as China could help.
 - For (2), bear in mind that in the US (Nixon) had sequestered mineral-rich wilderness land to replace Gold as collateral (after Bretton Woods) when countries wanted to redeem their dollars or treasury bills. Selling wilderness land for debt will be a likely scenario. However, I think that again the rubicon has already been crossed as the true debt is too large.
 - (3) is hence likely

Extreme? Futures

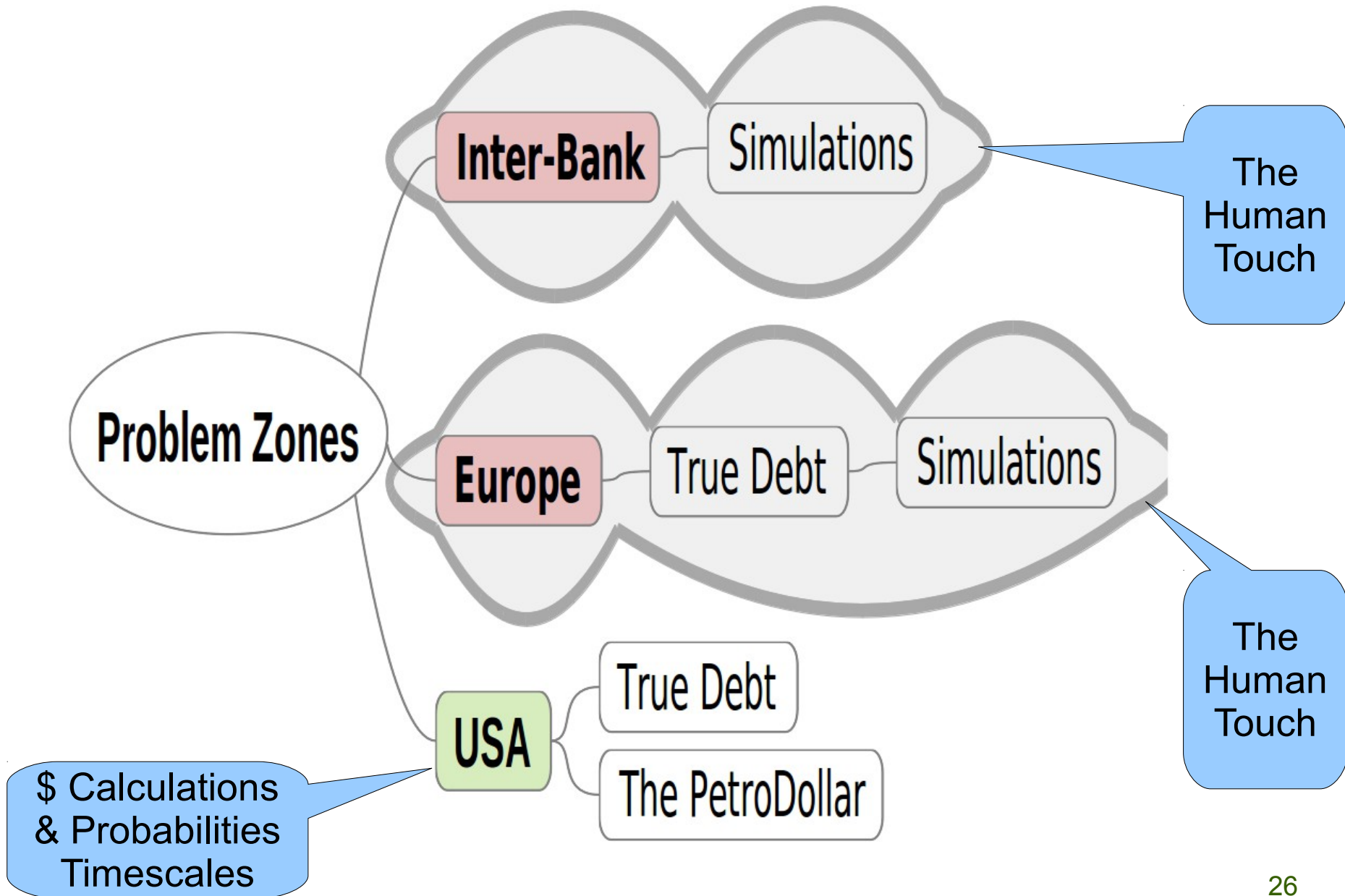
- Global currency
 - The IMF has already considered the implications of a global currency. Dominique Strauss-Kahn, when he was managing director of the International Monetary Fund, actually called for a new world currency that would challenge the dominance of the dollar and help curb future financial instability. A report was produced to support this recommendation.
- Global government
 - In my opinion a global currency is predicated on a global government
- Global war
 - In my opinion a global government is probably predicated on a global war or a global environmental disaster

Application of Focus & Resources

Mortgage Modelling Example



Recommendations



Simulation Models

- Four important advantages of simulation models over analytical solutions are:
 - They can be better understood by decision-makers because they involve network diagrams that can be visually checked
 - They can accommodate situations where there are no exact analytical answers.
 - They can provide answers over time
 - They can easily allow for policy interventions
- Haldane et al. has already done a liquidity simulation. Despite the paucity of real data this has shown that tipping points can cause contagion in the system.
- Psychopathic tendencies can be modelled: (a) bank interest or interest of the directors, (b) use of opacity in actions and accounts, (c) immediate gratification versus deferred gratification, etc..
- For inter-bank simulations all financial transactions are potentially in scope. Economy provide exogenous input (i.e. no full economic simulations)
- European simulations are probably easier as they can be kept at a higher level

Finally

- Academics (economists) to take further
 - Correct calculations
 - Probabilities & Timing
 - Simulation models
- Plenty of considerations have been omitted but could be included in a more thorough examination.
- Remember – things aren't what they seem
 - Despite what economics books say
 - Money did not replace barter
 - Not all countries use fractional reserve banking
 - Despite what governments say
 - The true debt of western countries is multiple times larger than stated
 - War is usually linked to financial gain
 - Despite what markets say
 - The value of the dollar will plummet

Are we Just Tinkering?

