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Real Money: Money, credit can be creative or destructive

By Rob Rikoon | For The New Mexican

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Next year is the 100th anniversary of the U.S. dollar.

Before 1913, cities, counties, banks, gold companies, pretty much anyone who pleased was free to issue their own currency. In the Wild West, gold and silver bullion deposited in a vault became the basis on which paper IOUs were drawn up to facilitate local and national commerce. With some frequency, the authenticity of the "real" valuables backing up the paper came into question, causing runs on these informal banks. Panic and bedlam ensued.

How far have we come since then!

Through federal dictates, the dollar became the only script that was legal and in several steps, control over money was centralized in Washington D.C., under the Federal Reserve Bank in 1935 with the promise that Fort Knox gold would back up the new system. This arrangement gave way in 1971 when President Richard Nixon removed us from the gold standard, and a new system based purely on government promises was installed. The Federal Reserve tightly controlled commercial banks, which were allowed to issue their own paper -- loans and credit, so long as they remained circumspect in the amount and to whom credit was issued.

Under Ronald Reagan's administration, banking was deregulated and the modern financial world was born. Restrictions on the amount and type of credit went out the window. The savings and loan industry imploded due to new competition from money market funds, investment banks and other new types of financial service companies. Conservative commercial banks began to trade stocks and bonds while traditional investment houses took in public money so they could share in larger profits while taking on less risk to themselves personally. This helped create the boom financial years of the 1980s and 1990s, the greatest explosion of paper wealth in history.

As everyone knows, the technology stock-driven bull market ended in 2000, but the amount of credit continued to expand due to unfettered creation of more and more complex types of financial instruments in relatively unregulated markets. After a brief hiatus, much of this money flowed into real estate and construction, both here and abroad. Good times continued until 2008, when the creators of the new types of credit were seen to be what they really were -- stacks (now electronic) of promises that were good only so long as everyone else in the industry believed they were good. One or two cracks in the system and everything threatened to grind to a halt.

To put this into simple numbers, think of the Old West as a system that created one dollar of paper for every one measure of gold dust deposited in the vault. When the Federal Reserve took over, it allowed staid bankers to create five dollars of loans for each U.S. government-issued currency on deposit at the bank. After Reagan, nonbank banks could issue loans and paper securities at pretty much any

multiple they wanted and when traditional banks got caught up with the game, the new ratio was 20-to-1 or 50-to-1 or, in the case of Lehman Brothers and Bear Stearns, 70-1. It's worth noting that the advent of electronic computing power is partially what made the explosion of credit possible to create, sell and sort of track, but that is another story.

We now live in a world where the Fed and other central banks around the world want their commercial bankers to go back to something like a 10-to-1 ratio of "government issued currency" to loans or credit. The only way many of them can accomplish this is by trading (gambling) their nonregulated securities accounts or by selling assets.

What about the government itself? Its ratio of loans to real money in its vaults is currently about 13 to 1, worse than the standards set up for the banks. This does not include the cost if the unfunded retirement benefits promised government employees or the implicit guarantees that the government has given the banking industry come home to roost. One estimate is that there are now four times the amount of obligations out there, not reported on anyone's books, as there is in official debt that gets reported to the public. This means the true ratio of "real" money to credit in the U.S. could be about 52-to-1 -- just as bad in Japan, Europe and China.

The reality is that any country with $50 of debt to $1 of real capital cannot work its way out of debt. The debt can be whittled away by raising taxes and cutting services, as in Ireland, Spain, Portugal and Italy, but that involves a great deal of immediate pain for the public with very slow improvement in economic results.

Countries can try to devalue their currencies, like Japan and the U.S. are doing, but that entails very high costs in terms of depleting national reserves of currency. Devaluation has limited results that benefit mainly the manufacturing sector of the economy and if enough countries try to devalue at once, everyone gets hurt and no one benefits.

Defaulting on one's debt is another option, as Iceland has done and as Greece may soon do. This allows one to restart the game after getting sidelined for some period of time during which no credit gets extended and society goes back to barterlike system. The other method of working one's way out of a mountain of debt is through inflation.

Taxpayer, consumers, investors and working people need to anticipate what an environment combining austerity and inflation will bring. Next month's article will focus on who might be the winners and losers in such an economy.

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