

Conquer the Crash:

You Can Survive and Prosper in a Deflationary Depression

(Eight Complementary Chapters)

Robert Prechter

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Introduction

Enjoy your 8 free chapters from Robert Prechter's *Conquer the Crash: You Can Survive and Prosper in a Deflationary Depression*.

There is no question that *Conquer the Crash* foresaw and explained nearly every chapter of today's financial crisis, years before it happened. Just as he had forecast the great bull market's liftoff during the deep bearishness of 1979, Prechter again turned the tables amid feverish hype in 2002 and published his warnings of the coming devastation that would ruin the unprepared – including the plunge in stocks, the collapse in home prices, the subprime debacle, liquidity crisis, the Federal Reserve's failure to turn the trend, and lots more. **The unsettling part is how much of Prechter's book includes chapters about what is yet to come.**

It is not too late to steer a better course for yourself and your family, but that means you cannot wait any longer to follow the recommendations contained in the full book.

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Chapter 10: Money, Credit and the Federal Reserve Banking System

An argument for deflation is not to be offered lightly because, given the nature of today's money, certain aspects of money and credit creation cannot be forecast, only surmised. Before we can discuss these issues, we have to understand how money and credit come into being. This is a difficult chapter, but if you can assimilate what it says, you will have knowledge of the banking system that not one person in 10,000 has.

The Origin of Intangible Money

Originally, money was a tangible good freely chosen by society. For millennia, gold or silver provided this function, although sometimes other tangible goods (such as copper, brass and seashells) did. Originally, credit was the right to access that tangible money, whether by an ownership certificate or by borrowing.

Today, almost all money is intangible. It is not, nor does it even represent, a physical good. How it got that way is a long, complicated, disturbing story, which would take a full book to relate properly. It began about 300 years ago, when an English financier conceived the idea of a national central bank. Governments have often outlawed free-market determinations of what constitutes money and imposed their own versions upon society by law, but earlier schemes usually involved coinage. Under central banking, a government forces its citizens to accept its debt as the only form of legal tender. The Federal Reserve System assumed this monopoly role in the United States in 1913.

What Is a Dollar?

Originally, a dollar was defined as a certain amount of gold. Dollar bills and notes were promises to pay lawful money, which was gold. Anyone could present dollars to a bank and receive gold in exchange, and banks could get gold from the U.S. Treasury for dollar bills.

In 1933, President Roosevelt and Congress outlawed U.S. gold ownership and nullified and prohibited all domestic contracts denoted in gold, making Federal Reserve notes the legal tender of the land. In 1971, President Nixon halted gold payments from the U.S. Treasury to foreigners in exchange for dollars. Today, the Treasury will not give anyone anything tangible in exchange for a dollar. Even though Federal Reserve notes are defined as "obligations of the United States," they are not obligations to do anything. Although a dollar is labeled a "note," which means a debt contract, it is not a note for anything.

Congress claims that the dollar is "legally" 1/42.22 of an ounce of gold. Can you buy gold for \$42.22 an ounce? No. This definition is bogus, and everyone knows it. If you bring a dollar to the U.S. Treasury, you will not collect any tangible good, much less 1/42.22 of an ounce of gold. You will be sent home.

Some authorities were quietly amazed that when the government progressively removed the tangible backing for the dollar, the currency continued to function. If you bring a dollar to the marketplace, you can still buy goods with it because the government says (by "fiat") that it is money and because its long history of use has lulled people into accepting it as such. The volume of goods you can buy with it fluctuates according to the total volume of dollars — in

both cash and credit — and their holders' level of confidence that those values will remain intact.

Exactly what a dollar is and what backs it are difficult questions to answer because no official entity will provide a satisfying answer. It has no simultaneous actuality and definition. It may be defined as 1/42.22 of an ounce of gold, but it is not actually that. Whatever it actually is (if anything) may not be definable. To the extent that its physical backing, if any, may be officially definable in actuality, no one is talking.

Let's attempt to define what gives the dollar objective value. As we will see in the next section, the dollar is "backed" primarily by government bonds, which are promises to pay dollars. So today, the dollar is a promise backed by a promise to pay an identical promise. What is the nature of each promise? If the Treasury will not give you anything tangible for your dollar, then the dollar is a promise to pay nothing. The Treasury should have no trouble keeping this promise.

In Chapter 9, I called the dollar "money." By the definition given there, it is. I used that definition and explanation because it makes the whole picture comprehensible. But the truth is that since the dollar is backed by debt, it is actually a credit, not money. It is a credit against what the government owes, denoted in dollars and backed by nothing. So although we may use the term "money" in referring to dollars, there is no longer any real money in the U.S. financial system; there is nothing but credit and debt.

As you can see, defining the dollar, and therefore the terms money, credit, inflation and deflation, today is a challenge, to say the least. Despite that challenge, we can still use these terms because people's minds have conferred meaning and value upon these ethereal concepts. Understanding this fact, we will now proceed with a discussion of how money and credit expand in today's financial system.

How the Federal Reserve System Manufactures Money

Over the years, the Federal Reserve Bank has transferred purchasing power from all other dollar holders primarily to the U.S. Treasury by a complex series of machinations. The U.S. Treasury borrows money by selling bonds in the open market. The Fed is said to "buy" the Treasury's bonds from banks and other financial institutions, but in actuality, it is allowed by law simply to fabricate a new checking account for the seller in exchange for the bonds. It holds the Treasury's bonds as assets against — as "backing" for — that new money. Now the seller is whole (he was just a middleman), the Fed has the bonds, and the Treasury has the new money. This transactional train is a long route to a simple alchemy (called "monetizing" the debt) in which the Fed turns government bonds into money. The net result is as if the government had simply fabricated its own checking account, although it pays the Fed a portion of the bonds' interest for providing the service surreptitiously. To date, the Fed has monetized about \$600 billion worth of Treasury obligations. This process expands the supply of money.

In 1980, Congress gave the Fed the legal authority to monetize any agency's debt. In other words, it can exchange the bonds of a government, bank or other institution for a checking account denominated in dollars. This mechanism gives the President, through the Treasury, a mechanism for "bailing out" debt-troubled governments, banks or other institutions that can no longer get financing anywhere else. Such decisions are made for political reasons, and the

Fed can go along or refuse, at least as the relationship currently stands. Today, the Fed has about \$36 billion worth of foreign debt on its books. The power to grant or refuse such largesse is unprecedented.

Each new Fed account denominated in dollars is new money, but contrary to common inference, it is not new value. The new account has value, but that value comes from a reduction in the value of all other outstanding accounts denominated in dollars. That reduction takes place as the favored institution spends the newly credited dollars, driving up the dollar-denominated demand for goods and thus their prices. All other dollar holders still hold the same number of dollars, but now there are more dollars in circulation, and each one purchases less in the way of goods and services. The old dollars lose value to the extent that the new account gains value. The net result is a transfer of value to the receiver's account from those of all other dollar holders. This fact is not readily obvious because the unit of account throughout the financial system does not change even though its value changes.

It is important to understand exactly what the Fed has the power to do in this context: It has legal permission to transfer wealth from dollar savers to certain debtors without the permission of the savers. The effect on the money supply is exactly the same as if the money had been counterfeited and slipped into circulation.

In the old days, governments would inflate the money supply by diluting their coins with base metal or printing notes directly. Now the same old game is much less obvious. On the other hand, there is also far more to it. This section has described the Fed's secondary role. The Fed's main occupation is not creating money but facilitating credit. This crucial difference will eventually bring us to why deflation is possible.

How the Federal Reserve Has Encouraged the Growth of Credit

Congress authorized the Fed not only to create money for the government but also to "smooth out" the economy by manipulating credit (which also happens to be a re-election tool for incumbents). Politics being what they are, this manipulation has been almost exclusively in the direction of making credit easy to obtain. The Fed used to make more credit available to the banking system by monetizing federal debt, that is, by creating money. Under the structure of our "fractional reserve" system, banks were authorized to employ that new money as "reserves" against which they could make new loans. Thus, new money meant new credit.

It meant a lot of new credit because banks were allowed by regulation to lend out 90 percent of their deposits, which meant that banks had to keep 10 percent of deposits on hand ("in reserve") to cover withdrawals. When the Fed increased a bank's reserves, that bank could lend 90 percent of those new dollars. Those dollars, in turn, would make their way to other banks as new deposits. Those other banks could lend 90 percent of those deposits, and so on. The expansion of reserves and deposits throughout the banking system this way is called the "multiplier effect." This process expanded the supply of credit well beyond the supply of money.

Because of competition from money market funds, banks began using fancy financial manipulation to get around reserve requirements. In the early 1990s, the Federal Reserve Board under Chairman Alan Greenspan took a controversial step and removed banks' reserve requirements almost entirely. To do so, it first lowered to zero the reserve requirement on all

accounts other than checking accounts. Then it let banks pretend that they have almost no checking account balances by allowing them to “sweep” those deposits into various savings accounts and money market funds at the end of each business day. Magically, when monitors check the banks’ balances at night, they find the value of checking accounts artificially understated by hundreds of billions of dollars. The net result is that banks today conveniently meet their nominally required reserves (currently about \$45b.) with the cash in their vaults that they need to hold for everyday transactions anyway.

By this change in regulation, the Fed essentially removed itself from the businesses of requiring banks to hold reserves and of manipulating the level of those reserves. This move took place during a recession and while S&P earnings per share were undergoing their biggest drop since the 1940s. The temporary cure for that economic contraction was the ultimate in “easy money.”

We still have a fractional reserve system on the books, but we do not have one in actuality. Now banks can lend out virtually all of their deposits. In fact, they can lend out more than all of their deposits, because banks’ parent companies can issue stock, bonds, commercial paper or any financial instrument and lend the proceeds to their subsidiary banks, upon which assets the banks can make new loans. In other words, to a limited degree, banks can arrange to create their own new money for lending purposes. Today, U.S. banks have extended 25 percent more total credit than they have in total deposits (\$5.4 trillion vs. \$4.3 trillion). Since all banks do not engage in this practice, others must be quite aggressive at it. For more on this theme, see Chapter 19.

Recall that when banks lend money, it gets deposited in other banks, which can lend it out again. Without a reserve requirement, the multiplier effect is no longer restricted to ten times deposits; it is virtually unlimited. Every new dollar deposited can be lent over and over throughout the system: A deposit becomes a loan becomes a deposit becomes a loan, and so on.

As you can see, the fiat money system has encouraged inflation via both money creation and the expansion of credit. This dual growth has been the monetary engine of the historic uptrend of stock prices in wave (V) from 1932. The stupendous growth in bank credit since 1975 (see graphs in Chapter 11) has provided the monetary fuel for its final advance, wave V. The effective elimination of reserve requirements a decade ago extended that trend to one of historic proportion.

The Net Effect of Monetization

Although the Fed has almost wholly withdrawn from the role of holding book-entry reserves for banks, it has not retired its holdings of Treasury bonds. Because the Fed is legally bound to back its notes (greenback currency) with government securities, today almost all of the Fed’s Treasury bond assets are held as reserves against a nearly equal dollar value of Federal Reserve notes in circulation around the world. Thus, the net result of the Fed’s 89 years of money inflating is that the Fed has turned \$600 billion worth of U.S. Treasury and foreign obligations into Federal Reserve notes.

Today the Fed’s production of currency is passive, in response to orders from domestic and foreign banks, which in turn respond to demand from the public. Under current policy, banks must pay for that currency with any remaining reserve balances. If they don’t have any, they

borrow to cover the cost and pay back that loan as they collect interest on their own loans. Thus, as things stand, the Fed no longer considers itself in the business of “printing money” for the government. Rather, it facilitates the expansion of credit to satisfy the lending policies of government and banks.

If banks and the Treasury were to become strapped for cash in a monetary crisis, policies could change. The unencumbered production of banknotes could become deliberate Fed or government policy, as we have seen happen in other countries throughout history. At this point, there is no indication that the Fed has entertained any such policy. Nevertheless, Chapters 13 and 22 address this possibility.

For Information

There is much information available on the Fed’s activities, but nowhere have I found a concise summary such as presented in this chapter. If you would like to learn more, I can start you off on your search. For a positive spin on the Fed’s value, contact the Fed itself or any conventional economist. For a less rosy view, contact the Foundation for the Advancement of Monetary Education or join the Ludwig von Mises Institute and order a copy of their 150-page paperback, *The Case Against the Fed*, by Murray N. Rothbard, which is just \$5 plus shipping from www.mises.org/catalog.asp. The most knowledgeable source that I have found with respect to the workings of the Federal Reserve System is Lou Crandall of Wrightson Associates, publisher of *The Money Market Observer*, a service for traders. Contact information is as follows:

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Chapter 13: Can the Fed Stop Deflation?

Consensus Opinion Concerning Deflation

Seventy years of nearly continuous inflation have made most people utterly confident of its permanence. If the majority of economists have any monetary fear at all, it is fear of inflation, which is the opposite of deflation. Two of the world's most renowned economists have reiterated this fear in recent months in *The Wall Street Journal*, predicting an immediate acceleration of inflation.

As for the very idea of deflation, one economist a few years ago told a national newspaper that deflation had a "1 in 10,000" chance of occurring. The Chairman of Carnegie Mellon's business school calls the notion of deflation "utter nonsense." A professor of economics at Pepperdine University states flatly, "Rising stock prices will inevitably lead to rising prices in the rest of the economy." The publication of an economic think-tank insists, "Anyone who asserts that deflation is imminent or already underway ignores the rationale for fiat currency — that is, to facilitate the manipulation of economic activity." A financial writer explains, "Deflation... is totally a function of the Federal Reserve's management of monetary policy. It has nothing to do with the business cycle, productivity, taxes, booms and busts or anything else." Concurring, an adviser writes in a national magazine, "U.S. deflation would be simple to stop today. The Federal Reserve could just print more money, ending the price slide in its tracks." Yet another sneers, "Get real," and likens anyone concerned about deflation to "small children." One maverick economist whose model accommodates deflation and who actually expects a period of deflation is nevertheless convinced that it will be a "good deflation" and "nothing to fear." On financial television, another analyst (who apparently defines deflation as falling prices) quips, "Don't worry about deflation. All it does is pad profits." A banker calls any episode of falling oil prices "a positive catalyst [that] will put more money in consumers' pockets. It will benefit companies that are powered by energy and oil, and it will benefit the overall economy." Others excitedly welcome recently falling commodity prices as an economic stimulus "equivalent to a massive tax cut." A national business magazine guarantees, "That's not deflation ahead, just slower inflation. Put your deflation worries away." The senior economist with Deutsche Bank in New York estimates, "The chance of deflation is at most one in 50" (apparently up from the 1 in 10,000 of a couple of years ago). The President of the San Francisco Fed says, "The idea that we are launching into a prolonged period of declining prices I don't think has substance." A former government economist jokes that deflation is "57th on my list of worries, right after the 56th — fear of being eaten by piranhas." These comments about deflation represent entrenched professional opinion.

As you can see, anyone challenging virtually the entire army of financial and economic thinkers, from academic to professional, from liberal to conservative, from Keynesian socialist to Objectivist free-market, from Monetarist technocratic even to many vocal proponents of the Austrian school, must respond to their belief that inflation is virtually inevitable and deflation impossible.

"Potent Directors"

The primary basis for today's belief in perpetual prosperity and inflation with perhaps an

occasional recession is what I call the “potent directors” fallacy. It is nearly impossible to find a treatise on macroeconomics today that does not assert or assume that the Federal Reserve Board has learned to control both our money and our economy. Many believe that it also possesses immense power to manipulate the stock market.

The very idea that it can do these things is false. Last October, before the House and Senate Joint Economic committee, Chairman Alan Greenspan himself called the idea that the Fed could prevent recessions a “puzzling” notion, chalking up such events to exactly what causes them: “human psychology.” In August 1999, he even more specifically described the stock market as being driven by “waves of optimism and pessimism.” He’s right on this point, but no one is listening.

The Chairman also expresses the view that the Fed has the power to temper economic swings for the better. Is that what it does? Politicians and most economists assert that a central bank is necessary for maximum growth. Is that the case?

This is not the place for a treatise on the subject, but a brief dose of reality should serve. Real economic growth in the U.S. was greater in the nineteenth century without a central bank than it has been in the twentieth century with one. Real economic growth in Hong Kong during the latter half of the twentieth century outstripped that of every other country in the entire world, and it had no central bank. Anyone who advocates a causal connection between central banking and economic performance must conclude that a central bank is harmful to economic growth. For recent examples of the failure of the idea of efficacious economic directors, just look around. Since Japan’s boom ended in 1990, its regulators have been using every presumed macroeconomic “tool” to get the Land of the Sinking Sun rising again, as yet to no avail. The World Bank, the IMF, local central banks and government officials were “wisely managing” Southeast Asia’s boom until it collapsed spectacularly in 1997. Prevent the bust? They expressed profound dismay that it even happened. As I write this paragraph, Argentina’s economy has just crashed despite the machinations of its own presumed “potent directors.” I say “despite,” but the truth is that directors, whether they are Argentina’s, Japan’s or America’s, cannot make things better and have always made things worse. It is a principle that meddling in the free market can only disable it. People think that the Fed has “managed” the economy brilliantly in the 1980s and 1990s. Most financial professionals believe that the only potential culprit of a deviation from the path to ever greater prosperity would be current-time central bank actions so flagrantly stupid as to be beyond the realm of possibility. But the deep flaws in the Fed’s manipulation of the banking system to induce and facilitate the extension of credit will bear bitter fruit in the next depression. Economists who do not believe that a prolonged expansionary credit policy has consequences will soon be blasting the Fed for “mistakes” in the present, whereas the errors that matter most reside in the past. Regardless of whether this truth comes to light, the populace will disrespect the Fed and other central banks mightily by the time the depression is over. For many people, the single biggest financial shock and surprise over the next decade will be the revelation that the Fed has never really known what on earth it was doing. The spectacle of U.S. officials in recent weeks lecturing Japan on how to contain deflation will be revealed as the grossest hubris. Make sure that you avoid the disillusion and financial devastation that will afflict those who harbor a misguided faith in the world’s central bankers and the idea that they can manage our money, our credit or our economy.

The Fed’s Final Card

The Fed used to have two sources of power to expand the total amount of bank credit: It could lower reserve requirements or lower the discount rate, the rate at which it lends money to banks. In shepherding reserve requirements down to zero, it has expended all the power of the first source. In 2001, the Fed lowered its discount rate from 6 percent to 1.25 percent, an unprecedented amount in such a short time. By doing so, it has expended much of the power residing in the second source. What will it do if the economy resumes its contraction, lower interest rates to zero? Then what?

Why the Fed Cannot Stop Deflation

Countless people say that deflation is impossible because the Federal Reserve Bank can just print money to stave off deflation. If the Fed's main jobs were simply establishing new checking accounts and grinding out banknotes, that's what it might do. But in terms of volume, that has not been the Fed's primary function, which for 89 years has been in fact to foster the expansion of credit. Printed fiat currency depends almost entirely upon the whims of the issuer, but credit is another matter entirely.

What the Fed does is to set or influence certain very short-term interbank loan rates. It sets the discount rate, which is the Fed's nominal near-term lending rate to banks. This action is primarily a "signal" of the Fed's posture because banks almost never borrow from the Fed, as doing so implies desperation. (Whether they will do so more in coming years under duress is another question.) More actively, the Fed buys and sells overnight "repurchase agreements," which are collateralized loans among banks and dealers, to defend its chosen rate, called the "federal funds" rate. In stable times, the lower the rate at which banks can borrow short-term funds, the lower the rate at which they can offer long-term loans to the public. Thus, though the Fed undertakes its operations to influence bank borrowing, its ultimate goal is to influence public borrowing from banks. Observe that the Fed makes bank credit more available or less available to two sets of willing borrowers.

During social-mood uptrends, this strategy appears to work, because the borrowers – i.e., banks and their customers — are confident, eager participants in the process. During monetary crises, the Fed's attempts to target interest rates don't appear to work because in such environments, the demands of creditors overwhelm the Fed's desires. In the inflationary 1970s to early 1980s, rates of interest soared to 16 percent, and the Fed was forced to follow, not because it wanted that interest rate but because debt investors demanded it.

Regardless of the federal funds rate, banks set their own lending rates to customers. During economic contractions, banks can become fearful to make long-term loans even with cheap short-term money. In that case, they raise their loan rates to make up for the perceived risk of loss. In particularly scary times, banks have been known virtually to cease new commercial and consumer lending altogether. Thus, the ultimate success of the Fed's attempts to influence the total amount of credit outstanding depends not only upon willing borrowers but also upon the banks as willing creditors.

Economists hint at the Fed's occasional impotence in fostering credit expansion when they describe an ineffective monetary strategy, i.e., a drop in the Fed's target rates that does not stimulate borrowing, as "pushing on a string." At such times, low Fed-influenced rates cannot overcome creditors' disinclination to lend and/or customers' unwillingness or inability to borrow. That's what has been happening in Japan for over a decade, where rates have fallen effectively to zero but the volume of credit is still contracting. Unfortunately for would-be

credit manipulators, the leeway in interest-rate manipulation stops at zero percent. When prices for goods fall rapidly during deflation, the value of money rises, so even a zero interest rate imposes a heavy real cost on borrowers, who are obligated to return more valuable dollars at a later date. No one with money wants to pay someone else to borrow it, so interest rates cannot go negative. (Some people have proposed various pay-to-borrow schemes for central banks to employ in combating deflation, but it is doubtful that the real world would accommodate any of them.)

When banks and investors are reluctant to lend, then only higher interest rates can induce them to do so. In deflationary times, the market accommodates this pressure with falling bond prices and higher lending rates for all but the most pristine debtors. But wait; it's not that simple, because higher interest rates do not serve only to attract capital; they can also make it flee. Once again, the determinant of the difference is market psychology: Creditors in a defensive frame of mind can perceive a borrower's willingness to pay high rates as desperation, in which case, the higher the offer, the more repelled is the creditor. In a deflationary crash, rising interest rates on bonds mean that creditors fear default.

A defensive credit market can scuttle the Fed's efforts to get lenders and borrowers to agree to transact at all, much less at some desired target rate. If people and corporations are unwilling to borrow or unable to finance debt, and if banks and investors are disinclined to lend, central banks cannot force them to do so. During deflation, they cannot even induce them to do so with a zero interest rate.

Thus, regardless of assertions to the contrary, the Fed's purported "control" of borrowing, lending and interest rates ultimately depends upon an accommodating market psychology and cannot be set by decree. So ultimately, the Fed does not control either interest rates or the total supply of credit; the market does.

There is an invisible group of lenders in the money game: complacent depositors, who — thanks to the FDIC (see Chapter 19) and general obliviousness — have been letting banks engage in whatever lending activities they like. Under pressure, bankers have occasionally testified that depositors might become highly skittish (if not horrified) if they knew how their money is being handled. During emotional times, the Fed will also have to try to maintain bank depositors' confidence by refraining from actions that appear to indicate panic. This balancing act will temper the Fed's potency and put it on the defensive yet further.

In contrast to the assumptions of conventional macroeconomic models, people are not machines. They get emotional. People become depressed, fearful, cautious and angry during depressions; that's essentially what causes them. A change in the population's mental state from a desire to expand to a desire to conserve is key to understanding why central bank machinations cannot avert deflation.

When ebullience makes people expansive, they often act on impulse, without full regard to reason. That's why, for example, consumers, corporations and governments can allow themselves to take on huge masses of debt, which they later regret. It is why creditors can be comfortable lending to weak borrowers, which they later regret. It is also why stocks can reach unprecedented valuations.

Conversely, when fear makes people defensive, they again often act on impulse, without full regard to reason. One example of action impelled by defensive psychology is governments'

recurring drive toward protectionism during deflationary periods. Protectionism is correctly recognized among economists of all stripes as destructive, yet there is always a call for it when people's mental state changes to a defensive psychology. Voting blocs, whether corporate, union or regional, demand import tariffs and bans, and politicians provide them in order to get re-elected. If one country does not adopt protectionism, its trading partners will. Either way, the inevitable dampening effect on trade is inescapable. You will be reading about tariff wars in the newspapers before this cycle is over. Another example of defensive psychology is the increasing conservatism of bankers during a credit contraction. When lending officers become afraid, they call in loans and slow or stop their lending no matter how good their clients' credit may be in actuality. Instead of seeing opportunity, they see only danger. Ironically, much of the actual danger appears as a consequence of the reckless, impulsive decisions that they made in the preceding uptrend. In an environment of pessimism, corporations likewise reduce borrowing for expansion and acquisition, fearing the burden more than they believe in the opportunity. Consumers adopt a defensive strategy at such times by opting to save and conserve rather than to borrow, invest and spend. Anything the Fed does in such a climate will be seen through the lens of cynicism and fear. In such a mental state, people will interpret Fed actions differently from the way that they did when they were inclined toward confidence and hope.

With these thoughts in mind, let's return to the idea that the Fed could just print banknotes to stave off bank failures. One can imagine a scenario in which the Fed, beginning soon after the onset of deflation, trades banknotes for portfolios of bad loans, replacing a sea of bad debt with an equal ocean of banknotes, thus smoothly monetizing all defaults in the system without a ripple of protest, reaction or deflation. There are two problems with this scenario. One is that the Fed is a bank, and it would have no desire to go broke buying up worthless portfolios, debasing its own reserves to nothing. Only a government mandate triggered by crisis could compel such an action, which would come only after deflation had ravaged the system. Even in 1933, when the Fed agreed to monetize some banks' loans, it offered cash in exchange for only the very best loans in the banks' portfolios, not the precarious ones. Second, the smooth reflation scenario is an ivory-tower concoction that sounds plausible only by omitting human beings from it. While the Fed could embark on an aggressive plan to liquefy the banking system with cash in response to a developing credit crisis, that action itself ironically could serve to aggravate deflation, not relieve it. In a defensive emotional environment, evidence that the Fed or the government had decided to adopt a deliberate policy of inflating the currency could give bondholders an excuse, justified or not, to panic. It could be taken as evidence that the crisis is worse than they thought, which would make them fear defaults among weak borrowers, or that hyperinflation lay ahead, which could make them fear the depreciation of all dollar-denominated debt. Nervous holders of suspect debt that was near expiration could simply decline to exercise their option to repurchase it once the current holding term ran out. Fearful holders of suspect long-term debt far from expiration could dump their notes and bonds on the market, making prices collapse. If this were to happen, the net result of an attempt at inflating would be a system-wide reduction in the purchasing power of dollar-denominated debt, in other words, a drop in the dollar value of total credit extended, which is deflation.

The myth of Fed omnipotence has three main counter-vailing forces: the bond market, the gold market and the currency market. With today's full disclosure of central banks' activities, governments and central banks cannot hide their monetary decisions. Indications that the Fed had adopted an unwelcome policy would spread immediately around the world, and markets would adjust accordingly. Downward adjustments in bond prices could easily negate and

even outrun the Fed's attempts at undesired money or credit expansion.

The problems that the Fed faces are due to the fact that the world is not so much awash in money as it is awash in credit. The amount of outstanding credit today dwarfs the quantity of money, so debt investors, who can always choose to sell bonds in large quantities, are now in the driver's seat with respect to interest rates, currency values and the total quantity of credit. So they, not the Fed, are also in charge of the prospects for inflation and deflation. The Fed has become a slave to trends that it has fostered for seventy years and to events that have already transpired. For the Fed, the mass of credit that it has nursed into the world is like having raised King Kong from babyhood as a pet. He might behave, but only if you can figure out what he wants and keep him satisfied.

In the context of our discussion, the Fed has four relevant tasks: to keep the banking system liquid, to maintain the public's confidence in banks, to maintain the market's faith in the value of Treasury securities, which constitute its own reserves, and to maintain the integrity of the dollar relative to other currencies, since dollars are the basis of the Fed's power. In a system-wide financial crisis, these goals will conflict. If the Fed chooses to favor any one of these goals, the others will be at least compromised, possibly doomed.

The Fed may have taken its steps to eliminate reserve requirements with these conflicts in mind, because whether by unintended consequence or design, that regulatory change transferred the full moral responsibility for depositors' money onto the banks. The Fed has thus excused itself from responsibility in a system-wide banking crisis, giving itself the option of defending the dollar or the Treasury's debt rather than your bank deposits. Indeed, from 1928 to 1933, the Fed raised its holdings of Treasury securities from 10.8 percent of its credit portfolio to 91.5 percent, effectively fleeing to "quality" right along with the rest of the market. What path the Fed will take under pressure is unknown, but it is important to know that it is under no obligation to save the banks, print money or pursue any other rescue. Its primary legal obligation is to provide backing for the nation's currency, which it could quite merrily fulfill no matter what happens to the banking system.

Local Inflation by Repatriation?

Other countries hold Treasury securities in their central banks as reserves, and their citizens keep dollar bills as a store of value and medium of exchange. In fact, foreigners hold 45 percent of Treasury securities in the marketplace and 75 percent of all \$100 bills. Repatriation of those instruments, it has been proposed, could cause a dramatic local inflation. If in fact investors around the world were to panic over the quality of the Treasury's debt, it would cause a price collapse in Treasury securities, which would be deflationary. As for currency repatriation, if overall money and credit were deflating in dollar terms, dollar bills would be rising in value. Foreigners would want to hold onto those remaining dollar bills with both hands. Even if foreigners did return their dollars, the Fed, as required by law, would offset returned dollar currency with sales of Treasury bonds, thus neutralizing the monetary effect.

Can Fiscal Policy Halt Deflation?

Can the government spend our way out of deflation and depression? Governments sometimes employ aspects of "fiscal policy," i.e., altering spending or taxing policies, to "pump up" demand for goods and services. Raising taxes for any reason would be harmful. Increasing

government spending (with or without raising taxes) simply transfers wealth from savers to spenders, substituting a short-run stimulus for long-run financial deterioration. Japan has used this approach for twelve years, and it hasn't worked. Slashing taxes absent government spending cuts would be useless because the government would have to borrow the difference. Cutting government spending is a good thing, but politics will prevent its happening prior to a crisis.

The government's "tools" of macroeconomic manipulation are not mechanical levers on a machine, either. The very decision to use them is subject to psychology, as is the subsequent choice of methods and then the extent of their use. Have you noticed the government's increasing fiscal conservatism over the past decade? Even Democrats have been voicing the virtues of a balanced budget! This is a sea change in thinking, and that is what ultimately causes trends such as inflation and deflation.

Endgame

Prior excesses have resulted in a lack of solutions to the deflation problem. Like the discomfort of drug addiction withdrawal, the discomfort of credit addiction withdrawal cannot be avoided. The time to have thought about avoiding a system-wide deflation was years ago. Now it's too late.

It does not matter how it happens; in the right psychological environment, deflation will win, at least initially. People today, raised in the benign, expansive environment of Supercycle wave (V), love to quote the conventional wisdom, "Don't fight the Fed." Now that the environment is about to change, I think that the cry of the truly wise should be, "Don't fight the waves."

Currency Hyperinflation

Although I can discern no obvious forces that will counteract deflation, what comes after deflation is another matter. At the bottom, when there is little credit left to destroy, currency inflation, perhaps even hyperinflation, could well come into play. In fact, I think this outcome has a fairly high probability in the next Kondratieff cycle.

When a government embarks on a policy of currency hyperinflation, such as the Confederate States did in the 1860s, Germany did in the early 1920s or France did after World War II, the monetary path is utterly different from that of deflation, but ironically, the final result is about the same as that of a deflationary crash. At the end of hyperinflation, total bank accounts denominated in the hyperinflated currency are worth far less than they were, sometimes nothing at all. Total debts have shrunk or disappeared because the notes were denominated in depreciated money. In the severest cases, even the money disappears. In this sense, even with hyperinflation, the end result is the destruction of money and credit, which is deflation.

The Markets Will Signal Inflation

Despite my conclusions, I recognize that international money flows are massive, central bankers can be ingenious, and politics can be volatile. Perhaps there is some way that inflation, whether globally or locally, could accelerate in the immediate future. How can you tell if my forecast for deflation is wrong and that inflation or hyperinflation is taking place instead of deflation?

One way is to monitor the ebb and flow of the quantity of credit outstanding. As long as total system liquidity expands, deflation will remain at bay. When it contracts, you will know that deflation is in force. To stay informed, investigate a website called TrimTabs.com. Free trial subscriptions are available via the following avenues:

TrimTabs.com Investment Research
Website: www.trimtabs.com
Email: info@trimtabs.com
Address: 520 Mendocino Avenue, Suite 350,
Santa Rosa, CA 95401
Phone: 707-874-9546
Fax: 707-525-1011
Director: Michael Alexander
Editor: Charles Biderman

You can anticipate major changes yourself by monitoring the two most sensitive barometers of monetary trends. One is the currency market. If the price of the dollar against other currencies begins to plummet, it might mean that the market fears dollar inflation. On the other hand, it might simply mean that credit denominated in other currencies is deflating faster than credit denominated in dollars or that foreign demand for dollars to buy U.S. stocks, property and products has waned. The other monetary barometer, which is more important, is the gold market. If gold begins to soar in dollar terms, then the market almost surely fears inflation. The bond market will not make the best barometer of inflation because much of it will fall under either scenario. I hope to recommend gold at lower prices near the bottom of the deflationary trend, but if gold were to move above \$400 per ounce, I would probably be convinced that a major low had passed. The ideas in Chapters 18 and 22 will show you how to protect yourself simultaneously against deflation and a collapse in dollar value.

A High Degree of Complexity

Stocks are not registering a Supercycle top like that of 1929 but a Grand Supercycle top, per Figure 4-1. This means that the ultimate — if not the immediate — consequences will be more severe and more confounding than the consequences of the 1929-1932 crash. As Chapter 5 of *At the Crest of the Tidal Wave* explains, the entirety of Grand Supercycle wave (should last a century and comprise two or three major bear markets with one or two intervening bull markets. This book addresses primarily the first bear market, although the two preceding sections attempt to outline some of the longer-term risks. Because in some ways the financial world is in uncharted waters, this book may not have all the answers.

Chapter 23: What To Do With Your Pension Plan

Make sure you fully understand all aspects of your government's individual retirement plans. In the U.S., this includes such structures as IRAs, 401Ks and Keoghs. If you anticipate severe system-wide financial and political stresses, you may decide to liquidate any such plans and pay whatever penalty is required. Why? Because there are strings attached to the perk of having your money sheltered from taxes. You may do only what the government allows you to do with the money. It restricts certain investments and can change the list at any time. It charges a penalty for early withdrawal and can change the amount of the penalty at any time.

What is the worst that could happen? In Argentina, the government continued to spend more than it took in until it went broke trying to pay the interest on its debt. In December 2001, it seized \$2.3 billion dollars worth of deposits in private pension funds to pay its bills.

In the 1930s, the world heard a lot of populist rhetoric about why "rich" people should be plundered for the public good. It is easy to imagine such talk in the next crisis, directed at requiring wealthy people to forfeit their retirement savings for the good of the nation.

With the retirement setup in the U.S., the government need not be as direct as Argentina's. It need merely assert, after a stock market fall decimates many people's savings, that stocks are too risky to hold for retirement purposes. Under the guise of protecting you, it could ban stocks and perhaps other investments in tax-exempt pension plans and restrict assets to one category: "safe" long-term U.S. Treasury bonds. Then it could raise the penalty of early withdrawal to 100 percent. Bingo. The government will have seized the entire \$2 trillion — or what's left of it given a crash — that today is held in government-sponsored, tax-deferred 401K private pension plans. I'm not saying it will happen, but it could, and wouldn't you rather have your money safely under your own discretion?

By the way, if you are normally in a high tax bracket and find yourself in a year with zero income or significant business losses, you can cash out part or all of your plan with either less tax (since you will be in a lower tax bracket) or no tax, if your earned-income losses cancel out the income from the plan. If you are under the age of 59½, you will normally have to pay a penalty, which is currently 10 percent of the value of the distribution. If you use the funds to pay for college tuition, though, you can even avoid the penalty. When you cash out your plan, you can still keep the money in the same investments if you wish, but then they will be in your own name, not in the name of a plan. Be sure to consult a tax advisor before proceeding.

Perhaps you have no such opportunity for a tax saving and do not want to pay the penalty attached to premature withdrawal. If your balance is high enough, you may wish to consider converting your retirement plan investments into an annuity at a safe insurance company (see Chapter 24). It is highly likely (though not assured) that such investments would be left alone even in a national financial emergency.

If you have money in a captive corporate or government employee retirement plan with limited options, move it out of stock and bond funds. Park it in the safest money market fund available within the plan. Investigate the rules that pertain to cashing out and decide your next course of action.

If you or your family owns its own small company and is the sole beneficiary of its pension or profit sharing plan, you should lodge its assets in a safe bank or money market fund. As an alternative, depending upon your age and requirements, you may consider converting it into an annuity, issued by a safe insurance company. Such insurance companies are few and far between, but the next chapter shows you where to find them.

Chapter 28: How To Identify a Safe Haven

As I said in Chapter 26, the real risk of social unrest will probably involve not so much roving itinerant bands looting your home – a classic fear that is rarely realized — as much as international conflict and domestic repression. In a bear market, both international and domestic tensions increase, and the resulting social actions can be devastating.

Far more people in the past century had their lives wrecked or terminated by domestic implosions than by war. Whether you lived in Russia in the 1920s, Germany in the 1930s, Europe in the 1940s, China in the late 1940s, Cuba in 1959 or Cambodia in the 1970s, the smart thing to do early was to get out of Dodge. However, if you ever make such a decision, you will have to be lucky as well as smart. The people in Europe who decided in 1937 to move away before things got worse were the prudent ones. But one or two of them might have said, “Let’s go somewhere far away and safe. Let’s go out to the Pacific and live on one of those sleepy islands in the Philippines.” In other words, you might guess wrong.

One good guide to the world’s developing crisis spots is Richard Maybury’s Early Warning Report. If you are an Asian, African or Middle Eastern resident, his analysis is especially pertinent. Maybury has also published some excellent primers on inflation and justice. You may contact him through the following means:

Early Warning Report

Website: www.richardmaybury.com

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Fax: 602-943-2363

Editor: Richard Maybury

If you live in a country with unstable politics, you should think about where you might go if things get oppressive. Like everything in a developing crisis, it is imperative to be prepared well before you have to make a final decision.

Some readers, admittedly only a few, may find merit in the idea of spending some time outside of their home countries while a depression unfolds. After researching the international scene for free and stable Western-style English-speaking countries, I find five top candidates: the United States, Canada, Australia, New Zealand and Ireland.

The world’s #1 choice for refuge is the United States. Indeed, the philosophical foundation of the United States and its (sometimes dormant) embodiment by many of its citizens bodes well for a low likelihood of severe domestic repression. Nothing is impossible, of course, and some people argue that the history of civilizations suggests that, on a multi-century basis at least, the peak of U.S. world power is at hand and repression will follow. Potentially more dangerous is the international threat. The U.S.’s penchant for involving itself in other countries’ disputes has made it a prime target for terrorists and certain governments. Any sustained or coordinated effort by America’s enemies could make domestic life highly unstable. Alternatively, if authoritarians assume power at the federal level near the bottom of

a depression (which happened throughout Europe and Asia in the 1930s and 1940s), difficulties could arise from domestic sources.

Simply preparing to move might not prove to be enough. Before you actually take that crucial action, your country of choice might shut its borders. Your country of origin might shut its borders. If terrorists infect a city in your nation with a biological warfare agent, you may be banned from entering any other nation. If you ever reach the point that you are sure you want a foreign refuge, you should move right then. If you choose a safe haven, and if the threats pass, you can always return to your home country.

At minimum, make sure that your passport is current, since demand for passports may increase later and delay processing. Another great idea is to obtain a “green card” or permanent resident visa in the country to which you would probably move if you came to such a decision. Usually they are issued for a period of five years or so, at which time you must renew them from inside that country. Permanent resident visas generally cost about \$US 4000 in legal fees to obtain, although most attractive countries have do-it-yourself forms available on the Internet. Like everything else, though, getting an extended visa takes time. You have to fill out forms and meet fairly stringent requirements. Even if you are quick and efficient, your legal representative or your host government might not be. Silly roadblocks can crop up that require another piece of paper, and so on. The point is, to get what you want, act early. Before actually packing up to move, you should consult an attorney in your chosen country so that you understand its laws.

A great way to get to know other countries from your armchair is by way of the Eyewitness Travel Guides, by Dorling Kindersley Publishing. They are not only packed with information, like most travel guides, but they are also loaded with breathtaking and informative photos. Their current cost is \$24.95 each. For specific information about these countries’ visitation and extended visitation policies, investigate the following websites:

United States: www.bcis.gov

Canada: www.cic.gc.ca/english

Australia: www.immi.gov.au

New Zealand: www.immigration.govt.nz

Ireland: www.justice.ie

Some of these sites are easier to use than others; you may have to poke around to find what you want. Sometimes web addresses change. If any of these sites move, or if you wish to investigate countries other than those listed above, just perform an Internet search on key words. Most immigration offices have their own websites.

I thought about filling up a couple of chapters with the pros and cons of these and other nations, but in the end, what really matters is what matters to you. Some of these countries have a better set of laws, others better weather, others a better culture, others better infrastructure, others more convenience. I am unfamiliar with non-English speaking countries that other people have been recommending, such as Argentina, Chile and Costa Rica, partly for the reason that I am unconvinced that they would be stellar havens of peace in a global depression. There are also many beautiful small island countries around the world, which rarely seem to be the focus of international conflict. You will have to sift through the data, the books and the brochures and decide for yourself. Of course, the best way to approach

such a question is to visit selected locations personally. They make great vacation spots, so you will hardly regret it. Who says contemplating a depression can't have its pleasures?

Chapter 29: Calling in Loans and Paying off Debt

People and institutions that best weather the system-wide debt liquidation of a deflationary crash and depression are those that take on no debt and extend no risky credit. This is the ideal situation for most people most of the time, anyway.

Handling Credit

In this book, we have already covered many topics that pertain to the problem of risky credit. Make sure that you do not lend your money to a weak debt issuer, whether corporate, governmental or any other entity. If you have already done so, trade it for something better.

There is also the question of personal credit extension. Have you lent money to friends, relatives or co-workers? The odds of collecting any of these debts are usually slim to none, but if you can prod your personal debtors into paying you back before they get further strapped for cash, it will not only help you but it will also give you some additional wherewithal to help those very same people if they become destitute later.

Handling Debt

If at all possible, remain or become debt-free. Being debt-free means that you are freer, period. You don't have to sweat credit card payments. You don't have to sweat home or auto repossession or loss of your business. You don't have to work 6 percent more, or 10 percent more, or 18 percent more just to stay even.

If you can afford it, the best mortgage is none at all. If you own your home outright and lose your job, you will still have a residence. When banks are throwing others out of their homes, you will still have a place to live. If you can't pay the rent on your business space, you can move your business into your house. And so on. I would rather own a crackerbox outright than have a mansion with mortgage payments I can barely make.

Consider the bank's situation in times of financial stress. Suppose you have paid off enough of your mortgage so that you own 50 percent of your home, which reflects the average equity held by homeowners nationwide. Suddenly, you find that you can't make further payments because of money problems in a depression. At that point, even if house prices had fallen by a whopping 50 percent, your bank would see it as no drop at all. It can place your property (actually its property) on the market. If the house sells for only 50 percent of its peak value, the bank gets 100 percent of its outstanding loan back. You can see why banks are pressured to sell properties in such situations. Of course, you end up homeless after slaving to pay off half the mortgage on the house over many years. That's what happens to many homeowners in a depression.

I suppose it might be possible to be creative in an otherwise impossible situation. Some people might decide to borrow as much of the home's value as possible, put the proceeds in a safe money-market fund and use those funds to meet the mortgage, thus assuring no missed payments for the duration. The problem with this idea is that many people are their own worst enemies, and they lack the discipline to protect the needed cash. They can find themselves both broke and homeless either way.

One way out of a debt load is personal bankruptcy. I don't recommend it because it isn't honest. People lent you their hard-earned money; you should pay it back. If you truly are a victim of unforeseen circumstances and must declare bankruptcy, apologize to your creditors and tell them that you hope the experience taught them a lesson about under-collateralized lending.

Chapter 30: What You Should Do If You Run a Business

Avoid long-term employment contracts with employees. Try to locate in a state with “at-will” employment laws. Red tape and legal impediments to firing could bankrupt your company in a financial crunch, thus putting everyone in your company out of work. If you run a business that normally carries a large business inventory (such as an auto or boat dealership), try to reduce it. If your business requires certain manufactured specialty items that may be hard to obtain in a depression, stock up.

If you are an employer, start making plans for what you will do if the company’s cash flow declines and you have to cut expenditures. Would it be best to fire certain people? Would it be better to adjust all salaries downward an equal percentage so that you can keep everyone employed?

A cynic might recommend that if you are an employer, you should try to pay in stock or options, but if you share the expectations presented in this book, that course of action would be dishonest. Besides, an employee who gets gypped is hardly going to serve your company well. Don’t forget, depressions don’t last forever; when the next upturn comes, you will want a loyal staff to help you prosper in it, and they will want a healthy company to help them prosper, too. To encourage that result, pay what and how you need to for the talent you require.

Most important, make sure you get paid. If you sell retail, don’t be responsible for large amounts of credit. If you are a supplier to other businesses, give a discount for cash up front. Try to cut back on the number of firms that habitually pay you 60, 90 or 120 days in arrears of your providing products or services to them. The higher your “accounts receivable,” the more you are expending effort and money in exchange for debt. If the businesses whom you supply go under, you won’t collect on monies owed. Worse, you may even lose the last few payments they did make to you. Did you know that bankruptcy law allows lawyers to recall all payments that a defunct firm made within 90 days before it filed for bankruptcy? Who do you think pays for the legal costs of hand-ling a bankrupt business? You do, the hapless supplier. But if you operate for cash up front, at least you won’t have to send back the latest payments and forfeit the rest of what you are owed. A moment’s thought will reveal how dangerous this law will be in a depression, as payout call-backs will stress or perhaps even crush businesses on the margin that needed those previous payments to survive. By the way, if you have arrangements in which you supply goods for others to sell, be sure to file a UCC Financing Statement in the office of the Clerk of Court in the county where your seller resides. This statement gives constructive notice of a secured party’s interest in its own property and keeps the bankruptcy vultures from trying to claim that your consigned property is a debt of the bankrupt company.

If you manage a bank, insurance company, money management firm or other financial institution, try to work out of your speculative derivative positions, particularly bullish ones. Reduce stock market risk as much as possible. If you must be heavily invested in stocks — for example if you manage a stock mutual fund — hedge your positions with options. Tidy up your mortgage portfolio. Get rid of all second-tier debt paper. If you have invested in municipal bonds, consumer debt, real estate debt, junk bonds or anything other than top-grade

paper, sell it at today's lofty prices. Get on a solid footing with investments that are high quality, liquid and commonly understood.

Finally, plan how you will take advantage of the next major bottom in the economy. Positioning your company properly at that time could ensure success for decades to come.

Chapter 32: Should You Rely on Government To Protect You?

In one sense, the answer is yes. You always have to live somewhere. If you are fortunate enough to live in a safe, free country, you can probably tell that those benefits are greatly a product of its philosophy of government. To that extent, you should rely on the best government you can find. Other than that, government can be a disappointing guardian.

Compounding the Problems

Government is rarely prepared for national financial calamities or economic depressions, and when it is, they are unlikely to occur. This is not a result of personal failures so much as an aspect of collective human nature. People are often prepared for the past but rarely for the future.

Generally speaking, the intelligent way for an individual to approach the vagaries of his or her financial future is to have savings or buy insurance. Governments almost invariably do the opposite. They spend and borrow throughout the good times and find themselves strapped in bad times, when tax receipts fall. Like their counterparts around the world, the Social Security, Medicare, Medicaid and “welfare” systems in the U.S. have been dispersing billions of dollars throughout decades of mostly good times. Even today, political forces are trying to raise the government’s payouts, for example to include coverage of mental as well as physical illness, which seems to be another express ticket to insolvency.

When the bust occurs, governments won’t have the money required to service truly needy people in unfortunate circumstances. They are likely then to make things worse by extending “unemployment benefits,” which sucks money away from employers and makes them lay off more workers, by raising the cap on retirement benefit taxes, which takes money away from employees and makes them unable to save and spend, and by increasing taxes generally, which impoverishes productive people so that they cannot spend and invest. It’s sad, but the pattern is almost always the same.

Dependencies To Avoid

Don’t rely on government programs for your old age. Retirement programs such as Social Security in the U.S. are wealth-transfer schemes, not funded insurance, so they rely upon the government’s tax receipts. Likewise, Medicaid is a federally subsidized state-funded health insurance program, and as such, it relies upon transfers of states’ tax receipts. When people’s earnings collapse in a depression, so do the government’s tax receipts, forcing the value of wealth transfers downward. Every conceivable method of shoring up these programs can lead only to worse problems. A “crisis” in government wealth-transfer programs is inevitable.

Don’t rely on projected government budget surpluses. A couple of years ago, the U.S. government declared a budget surplus, projected it years into the future and predicted healthy trends for its wealth-transfer programs. Was that a proper conclusion? Well, in 1835, after over two decades of economic boom, U.S. government debt became essentially fully paid off for the first (and only) time. Conventional economists would cite such an achievement as a bullish “fundamental” condition. (Any time an analyst claims to be using “fundamentals” for macroeconomic or financial forecasting, run, don’t walk, to the nearest exit.) In actuality, that

degree of government solvency occurred the very year of the onset of a 7-year bear market that produced two back-to-back depressions. Government surpluses generated by something other than a permanent policy of thrift are the product of exceptionally high tax receipts during boom times and therefore signal major tops. They're not bullish; they're bearish and ironically portend huge deficits directly around the corner.

Don't rely on any government's bank-deposit "insurance." The money available through the FDIC, for example, is enough to cover only a small fraction of U.S. bank deposits. As Japan's troubles increase, its government has proposed lowering the value of insured deposits; that could happen in any country. The whole idea of having other banks and taxpayers guarantee bank deposits is theft in the first place and thus morally wrong and thus ultimately practically wrong. Government sponsored deposit insurance has lulled depositors into a false sense of security. After the 1930s, when thousands of banks failed, depositors became properly wary of profligate banks. Today they don't know or care what their bank officers are doing with their money because they think that the government insures their deposits. Deposit insurance will probably save accounts in the first few distressed banks, but if there is a system-wide money and credit implosion, this insurance won't protect you.

Don't rely incautiously on government's obligations to you if you are a retired government worker. In Argentina in recent weeks, the government suspended state pension payments to 1.4 million retired state employees. It had no money to pay because times got tough, and it had never saved when times were good. The same thing could happen to many governments around the world, whether national, state or local, which pay billions of dollars annually in pensions. All of them are dependent either upon wealth transfer or upon managed funds that may or may not be properly invested.

Don't rely on all governments to pay their debts. In the 1930s, Fulton County, Georgia, where I grew up, was formed from two bankrupt counties that defaulted on their bonds. By 1938, state and local municipalities had defaulted on approximately 30 percent of the total value of their outstanding debt. Much of it was eventually resolved; some wasn't. U.S. investors today own billions of dollars worth of municipal bonds, thinking they are getting a great deal because that bond income is tax-exempt. This tax break may be a bonus in good times, but like so many seemingly great deals, this one will ultimately trap investors into a risky position. Governments that have borrowed to the hilt were running deficits even in the booming 1990s, so the risk of default in a depression is huge. If the issuers of your tax-exempt bonds default, you will have the ultimate tax haven: being broke. Quite a few munis are "insured," which salesmen will tell you means the same as "guaranteed." Such guarantees work fine until defaults drag down the insurers. That is to say, when you really need the supposed guarantees, they can fail. Given the huge extent of today's municipal indebtedness, such failures are inevitable.

Don't rely on your central bank, either. Ultimately, it is not in control of your country's stock market, bond market or interest rates. It mostly reacts to market forces. People think that the Fed "lowered interest rates" in 2001. For the most part, the market lowered interest rates. Declining interest rates are not a "first cause" designed to induce borrowing; rather, a dearth of borrowing is a "first cause" that makes interest rates decline. Interest rates on perceived safe debt always fall when an economy begins to deflate. So the record-breaking decline in short-term U.S. interest rates last year was not any kind of "medicine." It was not primarily administered but an effect. Japan's prime interest rate fell to nearly zero over the past decade because of its ongoing deflation. That drop in the cost of borrowing didn't change the

economy. Why? Because the economy was in charge of the drop. The most that a central bank can do is distort normal market trends and make credit a bit tighter or looser than it would otherwise be. Unfortunately, every such distortion has a counterbalancing market-induced correction later. The Fed's record-breaking monetary looseness during 2001 has revived the economy and propped up asset markets for a few months, but it probably won't last much longer than that. Ultimately, it will simply serve to make the contraction worse.

Don't rely on government to bail out the banking system. When Barings Bank failed, the Bank of England declined to save Barings' depositors. The World Bank and the IMF did not bail out the banks that collapsed in Southeast Asia in 1997. The Japanese Ministry of Finance has not been bailing out troubled Japanese banks. No one is bailing out Argentina's banks today. The French government bailed out Credit Lyonnais in a series of bailouts from 1994 through 1998 that drained more than \$20 billion from France's tax intake. This was not much of an exception, though, because the bank is state-owned. Financial institutions and the U.S. government, through the FSLIC and then the Resolution Trust Corporation, bailed out the Savings & Loan industry a dozen years ago to the tune of \$481 billion. These were unfortunate actions. Yes, unfortunate, because they lulled French and American bank depositors, who might otherwise have become wary, into thinking that they are protected against anything. How many more bailouts can France afford? Or the U.S.? If many big banks get in trouble, prudence will dictate that even the richest governments stand aside. If instead they leap unwisely into bailout schemes, they will risk damaging the integrity of their own debt, triggering a fall in its price. Either way, again, deflation will put the brakes on their actions.

Don't expect government services to remain at their current levels. The ocean of money required to run the union-bloated, administration-stultified public school systems will be unavailable in a depression. School districts will have to adopt cost-cutting measures, and most of them will result in even worse service. Encourage low-cost free-market solutions, which will benefit both children and teachers. The tax receipts that pay for roads, police and jails, fire departments, trash pickup, emergency (911) monitoring, water systems and so on will fall to such low levels that services will be restricted. Look for ways to get better services elsewhere wherever it is legal and possible.

Don't rely on government "watchdogs." They rarely foresee disasters. U.S. regulators did not anticipate the Savings & Loan industry collapse. Subsequent investigation revealed several years of immense corruption. Enron created some 850 suspicious partnerships and employed an army of "inventive" accountants. Still, the SEC and the FASB were clueless about anything being amiss. A \$68 billion company collapsed, impoverishing countless employees and creditors. Now the watchdogs in Congress are holding "hearings." Do you think this will help the employees and investors who bet the farm on Enron? Well, when the Insull utility trust similarly collapsed in 1931-1932, no investor was reimbursed a nickel; no manager ever went to jail. With 20/20 hindsight, Congress passed a few new laws.

Be smart. Don't let your financial future end up depending upon proceedings covered by C-Span.

Chapter 33: A Short List of Imperative “Do’s” and Crucial “Don’ts”

Recall the old Chinese character that entwines crisis and opportunity in the same glyph. Position yourself to take advantage of what’s coming.

Don’t:

- Generally speaking, don’t own stocks.
- Don’t own any but the most pristine bonds.
- Generally speaking, don’t invest in real estate.
- Generally speaking, don’t buy commodities.
- Don’t invest in collectibles.
- Don’t trust standard rating services.
- Don’t presume that government agencies will protect your finances.
- Don’t buy goods you don’t need just because they are a bargain. They will probably get cheaper.

Do:

- Fight the inertia that will keep you from taking action to prepare for the downturn. Start taking steps now.
- Involve your significant others in your decisions. Put your home or business partners in tune with your thinking before it’s too late.
- Talk to heavily invested parents or in-laws who may be planning to pass on their investments to you. See if you can get them to become safe and liquid.
- Think globally, not just domestically.
- Open accounts at two or three of the safest banks in the world.
- Invest in short-term money market instruments issued by the soundest governments.
- Own some physical gold, silver and platinum.
- Have some cash on hand.
- Make sure that you have insurance policies only with the safest firms and make sure that they deal only with safe banks.
- If you are so inclined, speculate conservatively in anticipation of a declining stock market.
- Sell any collectibles that you own for investment purposes.
- If it is right for your circumstances, sell your business.
- Make a list of things you want to buy at much lower prices when they go on “liquidation sale.”
- If you want to have kids, hurry up. Statistics show that fewer people feel like doing so during a bear market.
- Give friends a copy of this book.
- Keep up with our Bear Market Strategies page, a continually updated report on-line at <http://www.elliottwave.com/conquerthecrash>.
- Contact the services mentioned in this book! I am a market analyst and forecaster, not a banker, insurer, money manager, institution rater or depression strategist. These services can help guide you through the maze. Some of them can help you design your whole strategy in a matter of days.

- Plan how to take advantage of the next major uptrend. For example, go back to school during the decline and come out with extra skills just as the economy begins to recover. Apprentice in a job for low pay and learn enough to start your own business at the bottom so you can ride the next big upwave of prosperity. Investigate troubled businesses to buy at the bottom at deep discounts.
- Smile! because you will not be jumping out of the window; you'll be preparing for the incredible opportunities listed in the next chapter.

End

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