The Economic Effects of Reckless Fiscal Spending on Global Markets.

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Abstract

The 2008 Global Financial Crisis severely damaged the trust the public had in the global financial system. It was the triggering event for many Americans to begin questioning the role of the Federal Reserve in creating money. De-regulation and debasement of the dollar led to the 2020 Covid induced recession, which the Fed attempted to solve by printing, even more, historic quantities of money in a practice known as "Quantitative Easing." Q.E. might seem to have solved the problem, but in this paper, I'll attempt to dig deeper into the consequences of such lackluster monetary policy on the global markets. Further, this paper will also attempt to answer the age-old question of "What is money?", attempt to explain the complex mechanism by which the Federal Reserve "prints" money -- a mechanism called "The Mandrake Mechanism"-- and will provide an opinionated hypothesis of where the global markets are headed.

The Economic Effects of Reckless Fiscal Spending on Global Markets

Growing up in a world of abundant wealth, I never really knew where all of this wealth came from. It wasn't until months before moving to the United States that my father told me and my brother a seldom known fact: "The U.S Dollar isn't back by Gold, or Silver, or Oil. It is backed by nothing but faith in the American Government." I was amazed at this discovery and wondered why no one had mentioned it before. In fact, only ~1/3 of Americans know the U.S. Dollar is backed by nothing (Genesis Mining, 2019). This conversation, about 5 years ago, is what started my journey of trying to understand what this "money" thing was really all about. After years of reading, chatting, and investigating, I've developed an understanding of what it is, where it comes from, and what the effects of manipulating its supply are -- both locally and globally. This paper, therefore, is a summary of my findings; The contents of which will be used to provide evidence for the following hypothesis: Given the massive increase of the money supply worldwide (Russel Nappier, 2021), financial markets are doomed. But before we get to that, we must start by answering the age-old question: What *is* money?

What is Money?

For an asset that is heavily wanted by the public, it is extremely difficult to find a definition of what it is. This is in part because not everyone agrees on a formal definition of what money actually is. For correctness' sake, I'll be using the Dallas Federal Reserve definition of money: "Money is anything that is widely accepted as a form of payment for goods and services or repayment of debts." This definition, however, is too broad, so in order to clarify this further, I will proceed to explain the different types of money.

Types of Money

Money may be classified on any of the following forms: (1) Commodity money, (2) Receipt money, (3) Fractional money, and (4) Fiat money (G. Edward Griffin, 2010).

Commodity Money. A type of money that has an intrinsic value -- that is, it is worth something because of the nature of what it is rather than by a governing body assigning it a value. A great example of commodity money throughout history is precious metals, e.g. gold and silver, whose intrinsic value is derived from their scarcity and the labor required to extract it. This type of money has the advantage of not being manipulable by governments but lacks portability and it isn't easy to trade with.

Receipt Money. Receipt money was a natural evolution of commodity money. After all, why would you carry gold and silver coins on you at all times and risk losing them? Goldsmiths understood this and started offering the safe storing of money on their vaults in exchange for a fee. In return, they issued a receipt, paper money, that represented the total worth of the metals deposited in the vault, often partitioned in many different bills, which contained the words "PAY TO THE BEARER ON DEMAND" to guarantee to those taking the receipts as a currency that there was real value backing the worthless paper they were accepting as money.

Fractional Money. Fractional money was created out of the following realization: Having the money of many customers in a vault meant that it was extremely unlikely for all customers to demand their coins back all at the same time, so in the meantime, Goldsmiths could lend those coins -- that is, the receipts of those coins -- in order to accrue even greater profits. This is, by the way, the foundation of modern-day banking. It is important to note however that having "fractional money" means that all money receipts are no longer backed in a 1:1 ratio by precious metals. Further, the stability of such a system requires secrecy, after all, if all customers knew that their coins were no longer in the safe deposits that they were promised they will be at, there would be mass hysteria, and all customers will go and withdraw their coins in a process that we now call a *bank run*.

Fiat Money. Fractional money is just a transition step before fiat money. Fiat money is a government-issued currency that is not backed by a physical commodity, which is also declared legal tender by government decree (James Chen, 2021). A couple of key takeaways from Fiat money is that its supply is completely controlled by central banks, such as the Federal Reserve, and that there isn't a historical case in which a Country, or State, that adopted Fiat Money ever survived the consequences of doing so, often collapsing economically due to hyperinflation as a result of massive money printing, e.g Ecuador, Venezuela, Panama, Mexico, Ancient China, the Thirteen Colonies, and any other government that has ever instituted fiat money (G. Edward Griffin, 2010). It is also important to note that this **is** our current monetary system.

The Federal Reserve

As I've mentioned before, The Federal Reserve is the Central Bank of the United States. The Federal Reserve is where all money comes from. However, don't let its name fool you: It isn't Federal and it isn't a reserve. The Fed is in fact a privately owned company (Thomas D. Schauf, 1992). Its origins can be traced back to a secret meeting off the coast of Georgia on Jekyll Island. The date on which it took place is unclear, official reports only mention November of 1910. The attendees of the meeting were: Nelson W. Aldrich, Abraham Piatt Andrew, Frank A. Vanderlip, Henry P. Davison, Benjamin Strong, and Paul M. Warburg (Federal Reserve Bank of Richmond, 2015); All very powerful financiers and businessmen of the era. The purpose of the meeting is unclear to the public to this date, but as Edward Griffin put it in his book *The*

Creature from Jekyll Island, "Simply stated, [the goal] was to come to an agreement on the structure and operation of a banking cartel. The goal, as is true with all cartels, was to maximize profits by minimizing competition between members, to make it difficult for new competitors to enter the field, and to utilize the police power of government to enforce the cartel agreement. In more specific terms, it was to create a blueprint for the Federal Reserve System." It took 3 years after the first meeting for the *Creature From Jekyll Island* to spring into existence; On December 23, 1913, President Woodrow Wilson formally signed the Federal Reserve Act into law thus giving birth to the creature.

Though the origins of the Fed are themselves questionable, the mechanism by which the Fed "creates" money is even more questionable. Although there isn't an official name for this process, Griffin coined the term *The Mandrake Mechanism* to describe the procedure.

The Mandrake Mechanism

To fully understand how this mechanism works one must understand the following principle: Money is not created until the instant it is borrowed, and by the same token it is destroyed the moment at which that debt is repaid (G. Edward Griffin, 2010). This also means that the money supply is backed by nothing but pure debt. Of course, this means that it is in the best interest of the Fed for people, and governments, to be in debt; The more money is borrowed the more money that can be created. Furthermore, commercial banks are required to keep only 10% of all funds available at hand, this is called a *reserve ratio*, meaning that for each $1000 deposited into a bank account, the bank is allowed to lend up to $900, this requirement has changed in recent times, and this change is key to my hypothesis, but we'll get into that later. Now let's explain the Mandrake Mechanism.

The following explanation was paraphrased from the contents of the aforementioned book by Edward Griffin, the nature of the explanation is meant to be confusing. The process goes a little something like this: The act by which the Federal Reserve creates money out of thin air starts with Government Debt. First, the Federal Government issues bonds or T-Notes. These notes or bonds are then given to the Fed where they classify them as “securities.” Securities are considered assets, a positive balance, which are then used by the Fed to issue another piece of worthless paper called a “Federal Reserve Check,” which the Fed promptly gives back to the Government. The Federal Reserve check is then sent by the Government to one of the Federal Reserve Banks where they, through the magic of the financial system, become “Government Deposit(s).” Now that the deposits are in the government’s account this money becomes liquid. The recipients of this money, usually government contractors and other types of government-related expenditures, now deposit their freshly printed money into their own bank accounts where those same dollars now become “Commercial Bank Deposits.” These deposits are considered, from the commercial banks’ perspective, assets, and through the magic of the financial system and fractional banking, they get transformed into “Bank Reserves,” where the Commercial Banks must only keep 10% on hand in order to satisfy the Fractional Banking Requirements, given a reserve ratio of 10-to-1. The other 90% gets reclassified as “Excess Reserves,” which in turn get magically transformed into “Bank Loans.” It is important to understand why Banks have the ability to issue loans from money that isn’t theirs. As I mentioned before, the only way that money can be created is through debt and the moment in which an individual or corporation takes on a loan, based on the Excess Reserves that the commercial bank had in their books, new money gets printed, because every time a loan is given out, that money must go to someone's account in a bank, and when that money gets deposited into an account, the same process repeats, totaling up to 9 times the originally printed money.

Inflation

Inflation is just the result of an augmentation of the money supply which causes the purchasing power of every dollar to decrease; If there are $100 chasing a basket of goods, that basket will be worth about $100, but once the money supply is artificially increased to also include an extra $400, you now have $500 dollars chasing the same basket of goods, due to the law of supply and demand, the price of that basket will go up -- that process is inflation.

The 2008 Financial Crisis

Now that the intricate mechanism by which our economy operates has been explained to the best of my abilities, I must move on to the next big piece of the puzzle: The Global Financial Crisis of 2008.

In summary, the crisis was a direct result of President Bill Clinton's campaign proposal "Putting People First," whose sole goal was to achieve affordable housing for as many people as possible in the United States (Phil Gramm et. al., 2013). This as well as many deregulations bills created an environment in which bankers were incentivized to give sub-prime mortgages to as many people as possible without checking the creditworthiness of the applicants. As Eric Rauchway put it: "The American Dream was sold on too-easy credit."

The reason why the crisis got so out of hand is that as a result of deregulation, bankers got the authority to purchase and sell riskier derivatives, chief among them, the infamous Collateralized Debt Obligations (CDOs). A CDO is a bundle of mortgage-backed securities with a low rating

(Carla Tardi, 2021) which were considered less risky than sub-prime mortgages due to the diversity of the underlying mortgages. Many pension funds and investment banks around the world bought these CDOs, as well as many other Mortgage-Backed Securities and derivatives, which nearly caused the global economy to collapse.

In the wake of the crisis, the Federal Reserve vastly expanded its balance sheet by buying almost $2.5 trillion in debt related to housing loans between December 2008 and August 2010. The Federal Reserve ended its second round of quantitative easing (QE2) in June 2011, mind you this wasn't the last QE round. They also aggressively cut interest rates and offered dollar swap lines. The government has taken numerous measures such as introducing new regulations, enforcing existing laws, and creating new agencies to regulate and oversee aspects of the financial system in order to prevent or at least mitigate the effects of such similar crises in the future.

This, of course, wasn't enough to stop the public backlash. By 2011, many financial institutions had been bailed out whereas citizens had been foreclosed on their properties. This resulted in a series of events that triggered The Occupy Movement.

The Occupy movement started as a protest against economic inequality, financial greed, and corruption on September 17, 2011, at the SandLoanet, a privately owned public park across from the New York Stock Exchange. The protestors, estimated at just over one thousand people, were expressing their frustrations with the financial system, specifically with its role in the ongoing global economic crisis. Occupy protesters set up a permanent campsite called "Occupied Wall Street" near Wall Street and moved on to become an international protest movement against social and economic inequality, greed, and corruption which spread to more than 9000 cities in 82 countries.

The Covid Induced Recession of 2020

The Coronavirus Global Pandemic was an unprecedented event that caused global economies to be halted for at least 6 months in most places. As a response, Congress authorized a, yet again, historical amount of money to be printed by the Federal Reserve in an attempt to ease the economic situation. Though the total amount of money injected into the economy is still uncertain, most estimates put it at around $10 Trillion dollars (Matthew Cage, 2020). The Fed also adjusted the reserve ratio from 10% to 0% (The Federal Reserve, 2020), to facilitate lending. Taking these factors into consideration, it is now time to express my hypothesis.

Conclusion: The Next Global Financial Crisis

As I mentioned before, Inflation is a direct result of an augmentation of the money supply, what I failed to mention however is that inflation lags behind monetary policy (Batini & Nelson, 2001). That is to say, all the money printed in 2020 is just now affecting our prices. Moreover, inflation is not the only problem that we have at hand. While Job openings are at record highs, there are currently more job openings than people in unemployment (Jeff Cox, 2021), meaning that labor force participation is at record lows. But again, that isn’t our only concern, all supply chains were disrupted in 2020, food and gas shortages have become a deep concern for many countries across the Globe. Though all of these events themselves are tragic, it is important to understand what caused them all: A lackluster Monetary Policy.

As a response to the 2020 Crisis, the Federal Reserve was forced to cut rates to near 0%, this is what allowed for such extreme borrowing to take place, not only from individuals but also from businesses. What is not understood, however, is that all the Quantitative Easing is causing prices to rise across the board, which in turn reduces the profit margins of the business owner which will inevitably cause business owners to either close shop or raise prices. The problem with this is that rising prices will cause businesses to become less appealing to consumers, which will inevitably lead to lower profit margins. Either way, businesses still have to service the debt that they had to incur in order to reopen their business after a devastating year. After that capital runs out, they might need to seek extra funding, and rumor on the street has it that the Federal Reserve is planning to hike rates in November, this might prove fatal to those business owners. Due to time constraints, this is a far as I'll develop it, but it is important to know that it isn't a single event that will trigger the next financial crisis, but rather a sequence of events.

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