History Repeats as the Off-Balance Sheet Money Supply Explodes, Then Contracts

by Geraldine Perry / October 9th, 2008

As current events make chillingly clear, derivatives — whose main purpose is to hedge risk for specified parties — not only undermine a nation's real economy but they also undermine global financial stability. Why? Because they help create many times more substitute money through the international financial markets, rather than the central banking system which is governed by more transparent and definable rules. Thus as analyst Paul B. Farrell explains, "Derivatives are now not just risk management tools. As Gross and others see it, the real problem is that derivatives are now a new way of creating money outside the normal central bank liquidity rules. How? Because they're private contracts between two companies or institutions."[1]

More troubling still is that both history and recent events reveal that when the speculative bubble bursts this "off-balance sheet" money, created through heavily leveraged debt, evaporates. What happens next is graphically described by John Kenneth Galbraith in his book *Money Whence It Came*: "Whatever the pace of the preceding build-up, whether slow or rapid, the resulting fall is always abrupt. Thus the likeliness to the ripsaw blade or the breaking surf. So did speculation and therewith economic expansion come to an end in all of the panic years from 1819 to 1929…"

In 2007 testimony before Congress, economist and former investigator for the Senate Banking Committee Robert Kuttner painstakingly drew numerous parallels between what is happening today to what happened during the years leading up to the 1933 Glass-Steagall Act.

Interestingly the Glass-Steagall Act — which was repealed by the Gramm-Leach-Bliley Act in 1999 — was designed as a method by which to protect depositors from risks associated with securities transactions. It did this by prohibiting commercial banks from participating in investment banking activities and from collaborating with full-service brokerage firms, but as Kuttner says later in the same testimony the lines quickly became blurred by de facto and actual, subsequent regulatory measures. It is also well worth noting that the Glass-Steagall Act then led to the creation of the FDIC, which put taxpayers on the hook as final guarantors of all deposits and assets in private, for-profit banks — perhaps setting the stage for today's virtual tsunami of taxpayer funded assistance to the banking industry.

The following excerpts from Mr. Kuttner's testimony sheds important light on what happens to the real economy and real people when "traditional" (albeit fractional reserve) banking practices are ignored and derivatives are allowed to serve as "off-balance sheet" money creation tools:

> The most basic and alarming parallel [to the Depression Era] is the creation of asset bubbles, in which the purveyors of securities use very high leverage; the securities are sold to the public or to

> specialized funds with underlying collateral of uncertain value; and financial middlemen extract exorbitant returns at the expense of the real economy. This was the essence of the abuse of public utilities stock pyramids in the 1920s, where multi-layered holding companies allowed securities to be watered down, to the point where the real collateral was worth just a few cents on the dollar, and returns were diverted from operating companies and ratepayers. This only became exposed when the bubble burst…
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> A second parallel is what today we would call securitization of credit. Some people think this is a recent innovation, but in fact it was the core technique that made possible the dangerous practices of the 1920s. Banks would originate and repackage highly speculative loans, market them as securities through their retail networks, using the prestigious brand name of the bank — e.g. Morgan or Chase — as a proxy for the soundness of the security. It was this practice, and the ensuing collapse when so much of the paper went bad, that led Congress to enact the Glass-Steagall Act …
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> A third parallel is the excessive use of leverage. In the 1920s, not only were there pervasive stock-watering schemes, but there was no limit on margin. If you thought the market was just going up forever, you could borrow most of the cost of your investment, via loans conveniently provided by your stockbroker. It worked well on the upside. When it didn't work so well on the downside, Congress subsequently imposed margin limits. But anybody who knows anything about derivatives or hedge funds knows that margin limits are for little people. High rollers, with credit derivatives, can use leverage at ratios of ten to one, or a hundred to one, limited only by their self confidence and taste for risk. Private equity, which might be better named private debt, gets its astronomically high rate of return on equity capital, through the use of borrowed money. The equity is fairly small. As in the 1920s, the game continues only as long as asset prices continue to inflate; and all the leverage contributes to the asset inflation, conveniently creating higher priced collateral against which to borrow even more money.
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> … In the 1920s, many of these securities were utterly opaque. Ferdinand Pecora, in his 1939 memoirs describing the pyramid schemes of public utility holding companies, the most notorious of which was controlled by the Insull family, opined that the pyramid structure was not even fully understood by Mr. Insull. The same could be said of many of today's derivatives on which technical traders make their fortunes.
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> By contrast, in the traditional banking system a bank examiner could look at a bank's loan portfolio, see that loans were backed by collateral and verify that they were performing. If they were not, the bank was made to increase its reserves. Today's examiner is not able to value a lot of the paper held by banks, and must rely on the banks' own models, which clearly failed to predict what happened in the case of sub-prime…[2]

The Panic of 1907 revealed similar oft-forgotten lessons. The following passage described by then U.S. Representative Charles A. Lindbergh his 1913 book *Banking and Currency and The Money Trust* adds a political layer to such events which may be instructive:

> The king bankers put in motion, in 1907, a great scheme. They had gambled and speculated on Wall Street until so many watered stocks and bonds had been manufactured on speculation, that numberless speculators, big and small, sprang up all over the country, and stocks and bonds, and credits were pyramided, and re-pyramided. Of course such a condition could not last and a crash was the inevitable result … There was to be a panic in the fall of 1907 that would be advertised as

> the result of our bad banking and currency laws…

So it is then that history, together with present day circumstances, indeed provides important lessons for understanding the destructive effects of derivatives — and the ensuing, predictable response of the public and their elected officials to sales pitches, propaganda and economic pressure put forth by the "king bankers".

One of the most important features of the derivatives trade, as Mr. Kuttner said, is that unlike "traditional banks" which require both transparency and reserves, these speculative, privately negotiated "off-balance sheet" derivatives contracts require nothing to back them up — so the possibilities of creating "off-balance sheet" money are virtually limitless. We can see for ourselves this growth of "off-balance sheet" money by looking at M3 figures.

The total money supply is, or rather was prior to March of 2006, measured primarily by three categories. M3 was considered to be the "broadest measure" of the money supply. M1 represents the most "liquid" form of money and it should also be noted that M1 — which represents cash and checkbook money — is the basis by which our money, as loans, is created through standard fractional reserve banking practices.[3].

M2 adds passbook and savings accounts to M1 figures. M3 of course adds the huge institutional funds to the calculations for the M1 + M2 money supplies. What is most remarkable about this is that since the 1980's, the growth of the M3 money supply has increasingly outstripped M1 growth. In March of 2006, the Fed discontinued publication of M3, claiming that "M3 did not appear to convey any additional information about economic activity that was not already embodied in M2."[4]

Despite the Fed's action, reconstituted M3 estimates can now be found on the internet which tell an intriguing, if somewhat frightening, tale. What these charts show is that somewhere around mid-2005 the growth of the M1 money supply began to trend significantly downward to zero and below while the growth of the M3 money supply began to trend dramatically upward, increasing some 12% in a little over three years. [John Williams' Shadow Government Statistics: Alternate Data Series]

Because the only difference between the M1 + M2 measurement and the M3 measurement is the addition of huge institutional funds it is clear that these funds are where nearly all the new money was being created — and it was being done primarily through the highly leveraged, non-transparent, risk-laden, "off-balance sheet" derivatives market. This market of course is the exclusive playground of heavy rollers who have the where-with-all to deal with large institutional funds not to mention incredible risk.

In other words, a new "off-balance sheet" highly leveraged and highly privileged money creation system — a shadow banking system if you will — has in effect been operating through the derivatives markets. Until recently and without question, this new system of money/debt creation has been on steroids, as reflected in M3 growth.

But what goes up must come down, and that means that tax-payers will increasingly be put on the hook for "capital building" otherwise known as taxpayer debt — which helps to increase M1 figures. This is born out by data provided at John William's Shadow Stats website for the relevant months of 2008 showing an up-tick in M1 as "liquidity" was being pumped into the system through taxpayer funded bailouts — and a corresponding down tick occurring in M3, as the "off balance sheet" money supply began to implode.

Interestingly, the most recent M1 data posted at Shadow Stats shows a decisive down-tick in M1. Could the reason for this be due to the Fed's aggressive use of its reserves to inject liquidity into the global market place as well as here at home? If so, the decline in reserves may be at least part of the reason why taxpayers were required to immediately fund a $700 billion Wall Street bailout, since the corresponding government debt would increase reserves. No matter, because as one analyst remarked, "Net net, all these liquidity injections are merely moderating the collapsing credit facilities, and not actually injecting much in the way of credit into the economy."[5]

Despite the current and substantial contraction taking place in the M3 money supply, the fact is that over the long term — and especially since the 1980's — the U.S. money supply has increased dramatically, going from less than $2 trillion in 1980 to an estimated $14 trillion in 2008. Significantly, in 1980 total public and private debt totaled roughly $5 trillion, with about $1 trillion of that representing public debt. Today public and private debt totals roughly $50 trillion, with over $10 trillion of that representing public debt.

What these figures clearly show is that total debt has been outstripping the money supply for many decades due to the cumulative effects of unpayable interest. This fact alone makes it ever more difficult to deny — among all but the most hardened apologists — that the entire money creation system is, as Dick Distelhorst of the American Monetary Institute wrote in a recent newsletter, "an oxymoron — 'the more money we have, the deeper in debt we are.' This is ridiculous on its face, and yet we continue to accept it."

Tragically, our collective, continued acceptance of the current money creation system means that we will be forced to participate in what may well be the most massive upward transfer of wealth in history, even as we face the potential of an almost limitless, globally connected daisy chain of meltdowns, for which governments will increasingly be looking to taxpayers for the funds needed just to keep their economies going.

- Read Part 1, Part 2, and Part 3.

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1. Derivatives Are the New Ticking Time Bomb, Paul B. Farrell. [↩]
2. Testimony of Robert Kuttner before the Committee on Financial Services of the U.S. House of Representatives, October 2, 2007. [↩]
3. Money in the Economy, Federal Reserve Bank, San Fransisco, 1981. [↩]
4. The Money Supply, Federal Reserve Bank of New York. [↩]
5. Money Supply Growth? It's Much Worse Than That! Barry Ritholtz. [↩]

Geraldine Perry is co-author of The Two Faces of Money *and creator of its related website which includes recent reviews. This website also has an abundance of related material and links, along with a free, down loadable slide presentation describing the two forms of money creation and the Constitutional solution, which is not the gold-backed dollar as popularly believed. As a means of imparting accurate information on health and nutrition to as broad an audience as possible she developed the web site The Health Advantage. Read other articles by Geraldine.*

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