

Nothing

By Terry Coxon, Editor, [The Casey Report](#)

We don't yet know how many trillions will be swallowed up by the government's rapidly breeding herd of stimulus-bailout-help!help! measures. But additional bold steps are sure to come, some already in R&D and others to be invented on the fly to answer each new wave of bad news. Expect price tags suitable for proving how serious and determined the authors are.

The doubts that meet each new plan – does it really need to be that big... hasn't something like that been tried before... is it smart to keep wrong-headed decision makers in high places... isn't too much debt at the heart of the problem... if you don't know what causes inflation, are you sure you know what causes babies – are all answered with the same rhetorical question: “We can't just do nothing, can we?”

Yes, we can. But we won't, because the decisions about our wealth and our freedom are being made by career politicians, for whom stepping aside is the only truly unacceptable plan. Nonetheless, even though the idea of government doing nothing in the face of credit crisis, bank insolvencies, and recession has been reduced to a hypothetical, such a policy deserves a little exploring, since it can tell us something about where all the big-dollar solutions coming out of Washington are likely to lead.

Background

It's possible to train people to be crazy. If you're acquainted with a psychotherapist (socially, of course), ask him to explain how it's done. Training people to be crazy wasn't what the U.S. government set out to do when it ended the dollar's convertibility to gold in 1973. But it turned out to be one of the results.

Untethered from the gold standard, the Federal Reserve was free to create new dollars whenever it saw fit. But the policy it drifted into wasn't steady inflation, day in and day out, it was rescue inflation. The Fed would step up the expansion of the money supply whenever it saw a risk of widespread defaults in credit markets. The unintended effect was to train both lenders and borrowers, by repeatedly rescuing them from damaging defaults, to appraise financial risk unrealistically and to regard what is in fact a source of danger as a manageable nuisance. It made the managers of financial institutions functionally crazy, and the longer rescue inflation continued, the worse they got. (When you read about investment bankers running a business with 30-to-1 leverage and tell yourself, “Those people must be crazy,” you've got it about right. But they weren't born that way. They were trained.)

That's how the credit crisis was nurtured. And here is what the government has done about it so far.

August 2007. The credit crisis is just going public. Commercial banks, investment banks, and other financial institutions are waking up to the reason they were getting such great returns on junk paper – it really is junk. To ease the shock, the Federal Reserve begins a vast and unprecedented program of swapping out Treasury securities from its own sizeable (nearly \$1 trillion) investment portfolio in exchange for the embarrassing and worrisome securities that seem to be paralyzing the lending departments of the banks that own them. A novel approach, and not really inflationary, since no new cash is produced.

September 2008. Lehman Brothers informs the Federal Reserve that the novel approach, admirable though its inventiveness might be, isn't working and drops dead in front of Ben Bernanke's desk. The Fed abandons the hope of a non-inflationary remedy and begins a vast and unprecedented program of expanding the monetary base (buying Treasury securities and other IOUs in the open market with brand-new dollars).

October 2008. President Bush signs a vast (\$700 billion) and unprecedented bailout bill. It has been sold to Congress as a measure to help banks survive and keep lending, but the details are vague in the extreme, leaving the secretary of the Treasury with the authority to use the money for almost anything, including, if he should find it advisable, “for carrying on an undertaking of great advantage; but nobody to know what it is.”

Other vast and unprecedented programs have followed, including tens of billions for any car company willing to drive (not fly) to the teller window, hundreds of billions to get messy home mortgages house-trained, and unspecified mega-billions for Timothy Geithner's proposal to unburden banks of bad assets through a plan of great advantage but nobody to know what it is.

And today, 21 months after the doctors started scribbling prescriptions, most markets continue down, the economy is still shrinking, and worries are still growing.

Now roll the tape back to August 2007. What would have happened if the U.S. government had simply kept its long-standing commitments (in particular, protecting FDIC-insured deposits and preventing the money supply from shrinking) and otherwise had done nothing? No good-asset-for-bad-asset swaps, no wild expansion in the monetary base, no bailouts, no arranged marriages with taxpayer-financed dowries for failing institutions.

Nothing.

If that sounds extreme, perhaps you'll find it a little more acceptable if I put it this way: what would have happened if George Bush, Ben Bernanke, Nancy Pelosi, Harry Reid, Barney Frank, and Barack Obama had done nothing?

It would have been spectacular, a mass die-off of the incautious. Bear Stearns, Morgan Stanley, and other practitioners of ultra leverage, including perhaps Merrill Lynch, would have folded. When you borrow to carry \$30 of investments for each \$1 of company capital, it only takes a

3.4% drop in the prices of your assets to put you under water. And when you're getting that 30-to-1 leverage through overnight borrowing, even a whiff of doubt can make it impossible to roll over your financing from one day to the next. Either way, you're out of business.

From there, the trouble would have fanned out. The firms just pronounced dead were counterparties to trillions of dollars in derivatives. The investors on the other side of all those deals (largely banks, insurance companies, and other brokers) would have been left holding the bag. Some of them would have failed, and all that survived would have been left weakened and living in fear.

Growing mortgage losses would have forced Fannie and Freddie (and also Countrywide Financial) into bankruptcy, which would have turned their trillions in outstanding bonds into junk debt, doing great injury to the banks, insurance companies, and other investors that held them. Citibank and Wachovia would have gone under. And with Fannie, Freddie, and Countrywide gone, the biggest sources of mortgage money would be unavailable, which would have turned the housing market from a corpse into a mutilated corpse. AIG, which had turned itself into a sink of follies by insuring other companies against losses on junk debt, would also have joined the departed – and the companies that had been depending on AIG credit insurance would have gotten sorted out between the failed and the merely damaged.

Bank of America, having been spared the irresistible invitations to acquire Countrywide and Merrill Lynch, might be in much better shape than it is today.

With a hundred-car pile-up in the financial sector, lending to businesses and consumers would have shriveled, and the rest of the economy would have slipped into a depression. No more General Motors. No more Chrysler. Ford maybe.

And those are just the big names. Tens of thousands of other companies would have gone out of business. Most others would have laid off workers. The unemployment rate would have moved deep into double digits. With so many companies cutting inventories to raise cash for survival, the wholesale price index would have gone off a cliff, and the consumer price index also would have slumped.

It's an ugly picture, with pain and hardship for millions of people and grave worries for the rest. But before you start preparing thank-you notes for the good people in Washington who've acted so boldly, consider this:

If they had done nothing, the whole sorry business might be over by now. Without the promise of rescue and blow-softening, events would have moved quickly. The collapse of the overleveraged financial companies would have started soon after credit market jitters began in August 2007. (Leverage built on overnight borrowing invites swift justice.) The disaster in the financial sector might have been over by the end of that year or soon after. The year 2008 would have seen the wave of layoffs and bankruptcies in operating companies and the fall in wholesale and consumer prices.

A simple process would have brought the contraction to an end. With the prices of most things

falling, the real value of the money in everyone's pocket would be rising. That would continue until large segments of the population came to feel cash rich and started spending. Dollars appreciated in value, not dollars newly printed, would finance the recovery.

And it would be a thoroughly healthy recovery, because the bankruptcy proceedings that came before it would remove the billion-dollar bunglers of recent years from positions where they can make expensive mistakes. Decision making about the allocation of capital would fall to the survivors, who, by their survival, had proven their ability and readiness to decide wisely.

There is precedent for this. In the depression of 1920-1921, for example, wholesale prices fell by nearly one half, and most of that fall occurred in a period of just six months. It was a violent experience, with widespread bankruptcies, but it was over in a year and a half. It ran fast because the government did so little to try to stop it. Nancy Pelosi hadn't been born yet.

So much for the hypothetical. Instead, with all the government efforts to make things right, we have:

- An economy that continues to contract;
- A continuing mystery as to which banks are solvent and which are not;
- Financial institutions still under the control of individuals who've proven they should be doing something else;
- Car companies on apparently permanent life-support at taxpayer expense;
- A retarded decline in housing prices that is extending, by years, uncertainty as to how severe mortgage losses are going to be;
- A flock of new government programs that will continue to soak up billions of dollars per year long after the recession is over;
- A vast and unprecedented (that again) increase in the basic money supply, which is jet fuel for price inflation;
- A vast and unprecedented increase in peacetime government borrowing, which, when the recovery begins, will trap the government in a choice between letting interest rates rise (and risk choking off the recovery) and continuing to inflate the money supply (and kiss runaway price inflation on the mouth).

Yes, it does seem cruel to do nothing when disaster is unfolding. But consider the likely consequences of the alternative.

Doing nothing might be appropriate for Washington at this point in time... but it is not what you should do as an investor. Making the trend your friend is the strategy that will get you through tough economic times like this and provide you double- and triple-digit returns.

The Casey Report focuses on emerging trends to profit from even in highly volatile markets – whether it’s shorting stocks squarely in the way of the accelerating economic avalanche or investing in commodities that stand to gain big in the coming months. Test it now risk-free with our 3-month, 100% money-back trial... [click here to learn more.](#)