The West's Dismal Future

BY PAUL CRAIG ROBERTS AND JOHANNES MARUSCHZIK

Bubbles, bubbles, and more bubbles.

When the real estate bubble burst and the derivatives and casino bets based on the bubble endangered the large banks, the U.S. Federal Reserve supplied an unlimited amount of liquidity in an effort to keep the banks solvent. The injection of liquidity began in 2008 and has now entered its sixth year. Called Quantitative Easing 3, the Federal Reserve is purchasing $90 billion worth of Treasury bonds and mortgage-backed financial instruments each month, which comes to $1.08 trillion in debt monetization annually.

This enormous outpouring of liquidity has produced a bubble in the bond market where prices are so high that real interest rates are negative despite the inflationary implications. In the U.S. stock market, the liquidity has driven the market back up to, and beyond, its pre-crash peak, despite the report that U.S. GDP declined in the fourth quarter of 2012 by 0.1 percent, later revised to a 0.1 percent increase in GDP.

As large as the stock and bond bubbles are, the U.S. dollar bubble is even larger. As the world's reserve currency, the dollar is

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supposed to serve as a store of value. How can the dollar be a store of value when dollars are being created at a far greater rate than the U.S. and the world economies are growing?

Foreigners own 34.2 percent, or about $5.5 trillion, of the U.S. national debt. In addition, foreigners own many other dollar-denominated financial instruments and real assets.

With the United States creating more than $1 trillion in new debt and new money each year, the U.S. dollar itself is a huge bubble waiting to burst.

How long can the Federal Reserve keep the three bubbles growing? The answer depends on how long investors can continue to fool themselves for the sake of short-run profits. The liquidity that the Federal Reserve is pumping into the banks can continue to drive up U.S. bond and stock prices until investors flee the dollar.

This raises the question: Into what alternative currencies or investments can those fleeing the dollar move their wealth? The lack of an obvious answer and the desire of investors not to set off a decline in the value of their dollar wealth has protected the bubbles from bursting.

Many have fled into gold and silver bullion as the enormous price rise in precious metals in the twenty-first century indicates. If there were to be widespread flight from dollar-denominated assets, bullion prices would explode upward. However, bullion prices can be driven down and capped by selling naked shorts in the paper bullion market. This is the way that the Federal Reserve protects the dollar while debasing it with debt monetization. Why else would a rising bullion market be shorted if not to stop the rise?

With the Fed operating against bullion, so far the U.S. bubble economy is protected by the lack of obvious alternatives. Formerly, the euro was seen as a dollar rival, but the euro itself has proven to be a bubble. The euro serves neither rich Germany nor poor and over-indebted Greece. To be a member of the eurozone means being deprived of a central bank that can serve as creditor to the government and create money to service debt—Greece's need—or to conduct a prudent policy that minimizes inflation—Germany's preference.

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For poor or heavily indebted countries, this means that in order to acquire needed financing from the European Union, the countries must agree to EU control over their budget and tax or fiscal policies. For the rich EU countries, it means that they must accept the costs of bailing out the poor members.

The euro itself has proven to be a bubble.

Consequently, the main function of the euro is to be the route by which Brussels seizes central control over the EU member governments. A country that loses control over its fiscal policy is no longer sovereign.

One cost of the sovereign debt bailout is the loss of representative government in Europe. Another other cost is the creation of euros by the European Central Bank in order to serve as creditor to the member countries that cannot service their debts. The consequence is that even fiscally prudent EU countries become subject to the perils of currency inflation.

If Greece had to print its own currency in order to pay off its debts, Germany's currency would not also be inflated. However, with a common currency, money creation necessary to stabilize debts in some countries affects euro prices everywhere in the union. The euros created in order to bail out Greece will not stay within Greece. Indeed, they will flow out to the German and Dutch banks that are Greece's private creditors.

The West is on the economic and political precipice. In the United States, power has been concentrated in the executive branch at the expense of Congress, the judiciary, and the Constitution, and the economy is dependent on ever-more liquidity. In Europe, the sovereign debt crisis is being used by Brussels to consolidate economic policy in its hands and to give the European Central Bank the power to create liquidity without limit. These mixtures of tyranny and money creation indicate a dismal future for the West. ◆