



# The Genesis of a Crisis

By Dale DeBoer, Ph.D.

[Editor's note: This issue offers a collection of essays that were written at the request of CCEE and distributed to economics teachers throughout the state of Colorado.]

## Part 1: Too Much Money

It would be nice if the cause of the credit crisis could easily be pinned on poor government regulation, greedy lenders, or careless borrowers. Unfortunately, no one actor is to blame and the causes of the crisis extend back in time. This makes developing an understanding of the crisis a bit of a history lesson.

In 1973 (unfortunately, the story goes back at least that far), the Bretton Woods Monetary System came to an end. The Bretton Woods System was a global mechanism for maintaining fixed exchange rates and encouraging international economic interconnections. At the heart of the system was the U.S. dollar. Under this system, the U.S. government maintained (at least initially) a promise of backing every \$35 issued with 1 ounce of gold. This promise constrained U.S. ability to expand the money supply and provide liquidity to markets. Unfortunately, this promise proved unsustainable due to global and domestic need for more liquidity than was possible under the gold constraint. This led the Nixon Administration to move the dollar to an international "float" by 1973. By moving the dollar to a float, any inherent limit on the number of dollars in circulation was removed. Rather, the volume of money in the economy became constrained only by the good faith of the monetary authority – the Fed. Fortunately, the Fed maintained this faith well for 25 years. Unfortunately, it is clear that this restraint waned in recent years.

Adding to the complexity of events, by the 1980s the Japanese economy had attained economic maturity. With this economic maturity came high levels of savings. During the 1980s, a significant portion of these savings found outlet in the global economy. Given the dominant position of the U.S. economy, a large share flowed into the U.S. economy. This flow into the U.S. was greeted with some domestic alarm (a very visible instance centered on the Japanese purchase of Rockefeller Center in 1989), yet the inward flows continued.

The savings flow from Japan did slow somewhat with the downturn of the Japanese economy during the early 1990s. However, waiting to take up the slack were the South Korean and Chinese economies. The significant trade surpluses these countries ran with the U.S. kept a large flow of foreign savings coming into the U.S. These foreign financial inflows kept the cost of borrowing low in the U.S. and helped fund the strong economic performance of the U.S. economy during the 1990s.

Unfortunately, much of the world did not mirror the strong growth of the U.S. economy. Growth in the European economies was slowed by the costs of adopting the euro. Worse, the East Asian economies fell into a serious economic contraction in 1997 and the Russian economy was hit by a separate crisis in 1998. With the U.S. the dominant global economic actor, the

world looked to us to provide stability. Further, these crises had direct ramifications for the U.S. economy. The Dow Industrial Average saw a 10 percent fall in 1997, and an additional fall of 17 percent in 1998 (though there was a recovery in value between the two downturns). Beyond declines in the broader market, U.S. officials saw evidence of risk of a serious financial collapse with the failure of Long-Term Capital Management hedge fund. Fortunately (or unfortunately, as it may turn out), the Fed responded to these risks by utilizing the increased discretionary ability it gained following the collapse of the Bretton Woods agreement. It increased the money supply to stabilize the economy (this is seen by the  $\frac{3}{4}$  point lowering of the Federal Funds Rate in 1998-99). It is noteworthy that the Fed acted to stimulate the economy through an expansion of the money supply in the midst of the longest peacetime expansion in the history of the United States. For our story, the import lies with the Fed reinforcing the expansion in liquidity already underway due to the inflows of foreign savings.

Beginning in late 1999, the Fed did try to rein in liquidity by raising interest rates (to a high of 6.5 percent). Unfortunately, the economic downturn of 2001-02 forced the Fed to reverse this tightening, and by 2004 the Federal Funds Rate had fallen to 1 percent. The Fed was more aggressively pushing liquidity into the economy than at any time in history. And the policy was successful – the recession of 2001-02 was very shallow and short lived. But all that money needed an outlet; one turned out to be the market for housing.

It would be easy to make too much – or too little – of this part of the story. The high levels of liquidity generated by inflows of foreign savings and loose domestic monetary policy were not the cause of the current credit crisis. However, without this liquidity the run up in the housing market would have been unlikely to occur. As such, high levels of liquidity provided one important contributor to the ongoing credit crisis. The change in financial oversight provides another.

## Part 2: What Happened To Our Regulations?

Prior to the Great Depression banking was different than today. To see the differences, consider *It's a Wonderful Life*. Jimmy Stewart's George Bailey is a small town banker who knows his borrowers – they are his friends and neighbors. Credit reports are unknown. Banking oversight is an irregular affair. Deposit insurance does not exist so bankers must maintain depositor trust. This picture looks very little like the ATM banking of today. What changed to move banking from this bucolic image?

The alterations began in the early part of the last century. The U.S. economy grew rapidly (by historic standards of the day). Great wealth was accumulated and that wealth required an outlet. The outlet that was found was financial innovation – margin trading, futures markets, and stock speculation. The rapid turnover in wealth driven by financial innovations spurred an asset price bubble in the 1920s. The bubble came to an end with the market crash of 1929 and set the stage for the Great Depression.

Respected commentators of the day blamed the surge in asset prices on a lack of regulations over financial innovation. Responding to these concerns, the Roosevelt Administration and Congress placed regulations on, and support under, the financial sector. It empowered the Federal Reserve Bank (the Fed) to set margin trading requirements. It established the Securities and Exchange Commission (SEC) to regulate the securities market. It formed the Federal Deposit Insurance Corporation (FDIC) to back deposits in the hope of preventing future bank runs. Through the Glass-Steagall Act it gave the Fed the power to regulate interest rates on bank deposits (Regulation Q) and established a firm separation between commercial banks (deposit accepting institutions) and investment banks (that issue and sell securities). These depression era institutions continue to form the core of the regulatory structure of the financial sector today.

Placing regulations on the economy does not eliminate the forces that drive change; it merely alters the path along which the forces are expressed. Such was the case with the financial sector. With the economic recovery that followed the conclusion of World War II came a return of wealth accumulation. With the renewed wealth accumulation came a renewed push for financial innovation. In the U.S., these forces were broadly contained for several decades. Abroad they were not. This moved the locus of financial innovation overseas and left the U.S. financial sector at a serious competitive disadvantage. This disadvantage is witnessed by 9 of the 10 largest banks in the world all being Japanese by 1987.<sup>1</sup> Pressures mounted in the U.S. for changes in the domestic regulatory structure to equalize the global environment for financial competition. Broadly, this movement came to be termed deregulation.

The first substantive move in this direction came with the Monetary Control Act of 1980 that eliminated Regulation Q. This increased the ability of U.S. banks to compete for deposits. Next came an erosion of state level regulations on intrastate and interstate branch banking. This allowed for the formation of significantly larger financial institutions and eroded the notion of a Bailey-esque banker. The importance of this change should not be overlooked. A neighborhood banker has “insider” knowledge of his borrowers. This allows for an informal check on lending practices that is lost with the movement to large branch banks. With a branch bank, only on-record knowledge is available (for example, credit reports, employment histories, etc.). But on-

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<sup>1</sup> Clearly, the significant economic growth and high levels of saving in the period prior to the dominance of the Japanese banks also fueled the growth in bank size in Japan.

record items may miss important parts of an individual's credit worthiness.<sup>2</sup> This opens the door to worsened bank risk management.

The final significant regulatory change came with the passage of the Financial Services Modernization Act of 1999 that removed Glass-Steagal restrictions on commercial banks engaging in investment banking activities. Effectively, the passage of the 1999 act allowed for commercial banks, investment banks and insurance companies to compete with each other across a broad range of financial products. Further, passage of the act placed U.S. financial institutions on a roughly equal footing with foreign financial institutions. That this effort was successful sees some evidence in the three largest banks in the world all being U.S. banks by 2006.

On top of these formal regulatory changes, from the 1970s onward the U.S. saw a broad ideological shift towards reduced government interference with the market. This movement changed the behavioral expectations of government officials – when in doubt they became increasingly cautious to enforce regulations. Clear violations still required action; marginal violations were more likely to be given a pass. This change in enforcement practice likely had as large an effect on regulation as more formal changes in regulatory rules.

By itself, the movement towards deregulation would have been insufficient to drive the current crises. However, recall that the financial innovations allowed by deregulation were fueled by a significant inflow of foreign savings and loose monetary policy. This made the impact of the regulatory changes much greater. And one last force came into play – computing and information technologies (CIT).

CIT allowed for the development of new trading mechanisms and the development of new financial assets whose values could not have been established without the processing power offered by these technologies. That these technologies came with risk is seen by the blame program trading (securities trading driven by computer algorithms) has taken for the stock market crash of 1987 and the spectacular failure of the computerized risk control algorithms within Long Term Capital Management when it collapsed in 1998 (and precipitated part of the loose monetary policy that contributed to the credit crises). Further, these new products did not easily fit within the old regulatory structure. As such, their regulation was of necessity light.

The combination of these factors – reduced regulations, a culture of softer regulation, the end of the neighborhood banker, and the introduction of new technology-dependent financial instruments – fundamentally altered the operation of the financial sector in the U.S. It is important to note that these changes had good effects along with bad. Costs of borrowing were lowered. Ownership of corporate stock became more widespread. Home ownership was encouraged. Unfortunately, the good effects, as with the inflow of foreign savings, came with a cost – a second push towards the current financial crises.

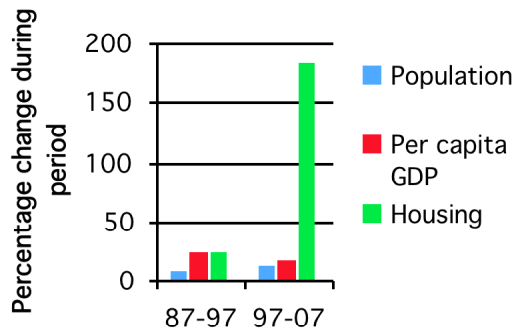
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<sup>2</sup> It should be noted that the movement away from casual information does tend to constrain discriminatory lending practices.

### Part 3: The Housing Bubble

- Between January 1987 and December 1996, average home prices increased by 24 percent.
- Between January 1997 and December 2006, average home prices increased by 184 percent.
- Between June 2006 (the peak of the market) and August 2008, average home prices fell by 22 percent.<sup>3</sup>

A house is a financial asset. While it is also a place to live, a keeper of memories, and a projection of whom we are, it is also the largest store of wealth for many households in the United States. Therefore, it is a financial asset. As an asset its value is subject to predictable influences – population size, average income, and the cost of related goods. In the recent past, these determining factors changed. U.S. population grew by 24.5 percent between 1987 and 2007. Real per capita GDP increased by 45 percent over the same period. Interest rates on a 30-year conforming mortgage fell from 11.26 percent in October 1987 to 5.23 percent in June 2003.<sup>4</sup> Home ownership rates increased by 5 percent between 1987 and 2007.<sup>5</sup> These changes drove increased prices for housing. But are these changes sufficient to explain *all* of the increase in the price of housing? Unfortunately, no certain answer to that question is possible. However, contrasting the changes in population, income, and housing that occurred in the decade after 1987 to the changes that occurred after 1997 offers a hint at an answer – it appears not (see the chart below). The change in market determinants is similar during each period, but the market outcome is markedly different.



How is the difference in market outcome explained? First, mortgage rates became increasingly inexpensive. During the decade after 1987, they fell 3 percent. During the decade after 1997, they fell an additional 2 percent. This fall is the result of inflows of foreign savings and loose monetary policy.

As mortgage rates were falling, the Clinton Administration pushed Fannie Mae and Freddie Mac to accept lower rated mortgages in the secondary mortgage market.<sup>6</sup> The goal of loosening the requirements was to increase home ownership rates by increasing the number of subprime loans available in the primary mortgage market – a goal that was successfully achieved. However, by lowering requirements for lending on quasi-government backed loans, downward pressure on creditworthiness was encouraged throughout the industry.

<sup>3</sup> Calculations of home price changes based on the S&P/Case-Shiller Composite Home Price Index.

<sup>4</sup> Calculations based on Federal Reserve Bank data.

<sup>5</sup> U.S. Census Bureau

<sup>6</sup> The secondary mortgage market is the market where existing mortgages are purchased by other lenders.

Beyond the actions of the government-sponsored entities, the broader secondary mortgage market grew markedly after 2000 with the growing use of sophisticated financial derivatives such as Collateralized Debt Obligations (CDOs).<sup>7</sup> CDOs package collateralized debt from multiple sources together and sell the debt package. In general, the risk of default on a collection of debt is significantly lower than the risk of default on any one loan. This allowed CDOs to be sold at a premium relative to the discount required to sell any one loan. The financial attractiveness of this differential markedly increased the size of the secondary mortgage market and brought many new buyers of mortgage-backed debt into the market.

Unfortunately, the growth of the secondary market appears to have undermined risk management by mortgage issuers. Since the secondary market grew rapidly, any primary mortgage issuer readily found a buyer for any mortgage. Since this effectively reduced default risk for primary issuers, it appears that their lending oversight practices declined.<sup>8</sup> This allowed many non-qualified buyers access to mortgages.

Finally, households and investors began viewing housing as a speculative asset; since its price was going up rapidly, it was expected to keep going up. This drove new buyers into the market and gave the final critical push to housing demand – the surge in home prices was on!

Unfortunately for speculators, and those caught in the speculative downdraft, no unrealistic surge in prices lasts – the price bubble had to burst. In this case, the downturn was – unintentionally – engineered. Between June 2004 and June 2006, the Fed raised the Federal Funds Rate target from 1 percent to 5.25 percent to slow budding inflationary pressures.<sup>9</sup> Unfortunately, this had two effects on the housing market. First, it reduced the availability of loanable funds throughout the economy. This made getting a mortgage both more difficult and more expensive. This slowed the growth in demand for housing.

Second, with the Federal Funds Rate increasing, variable rate mortgages began resetting to higher rates. This drove some highly leveraged borrowers into positions where they could no longer afford the payments on their existing mortgages. As these no longer affordable properties were put on the market, the supply of housing increased.

A simple supply and demand story ensued – falling demand combined with rising supply pushes prices down. Unfortunately, as housing prices fell some buyers began finding themselves with negative equity and walked away from their homes. As these units hit the market, the dramatic housing market collapse began and prices spiraled down.

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<sup>7</sup> Collateralized Mortgage Obligations (CMOs) are a subclass of this type of derivative.

<sup>8</sup> Such changes were exacerbated by clearly illegal lending practices, but it would be a mistake to place primary blame on the small number of illegal actions.

<sup>9</sup> It is worth noting that during this period China – under U.S. pressure – began revaluing its currency. This revaluation necessitated a reduction in financial outflows from China to the U.S. This further exacerbated the reduction in credit availability.

## Part 4: The Downward Spiral

The initial downturn in the housing market came as the Fed tightened monetary conditions for the economy. The tightened monetary conditions pushed up interest rates, including rates on variable rate mortgages. The reset of variable rate mortgages made some mortgage obligations unsustainable and pushed a number of loans into default. These defaults were primarily concentrated among sub-prime borrowers and served as the trigger to the crisis.

Though the defaults were of great importance to the individuals involved, the upsurge was not significant enough to be a crisis. Unfortunately, these loans had been repackaged and resold as Collateralized Debt Obligations (CDOs) and other mortgage-backed securities. Further, with the partial revocation of the Glass-Steagall Act, mortgage-backed securities had come to be a significant – though far from majority – component of banks' financial capital. Therefore, mortgage defaults spurred mortgage-backed securities defaults, while failing mortgage-backed securities eroded bank capitalization.

By law, banks must have financial capital backing their operations. As a rough approximation, each \$1 of capital supports roughly \$10 of lending capacity by a bank. Therefore, as bank capital fell, banks needed to issue \$10 fewer loans for every \$1 of lost capital. Making matters worse, bank restrictions on loans put further downward pressure on housing prices – and the downward spiral began.

This decline was heightened by a change in accounting rules that came into force during the early stages of the crisis. In November 2007, the Financial Accounting Standards Board required financial assets to be "marked-to-market." Basically, this rule requires assets to be valued at their going market price, rather than historic purchase price or some other valuation. Unfortunately, when CDOs began failing, the market for these assets fell markedly. As the market collapsed, the price fell. With accounting standards requiring these new lower prices be used to determine asset valuations, the dollar value of bank capital assets fell dramatically – far more than they would have fallen under previous accounting rules.

While the effects of these events on the mortgage market and housing were dramatic, banks cannot in general reduce loans for just one segment of the economy. As they tighten, credit availability becomes broadly constrained. This caused the effects of the housing focused crisis to spiral outward to all parts of the economy as non-housing related firms began to experience difficulty in obtaining operating capital. With this outward spiral, the problems in the housing market became a full-fledged financial crisis and tipped the economy into recession.

Will the downward spiral continue without government action? No, but it will continue until (1) all the loans that will fail, have failed, (2) all the failing financial derivatives linked to the housing downturned have failed, and/or (3) the capital assets backing bank lending stop falling in value. Broadly, these three alternatives point to how government action may serve to shorten the crisis. First, the government may buy mortgages that are falling into default and offer new terms to stop their continued collapse. Second, the government may purchase failing mortgage-backed securities from banks to stop the collapse in bank capitalization. Finally, the government may directly inject capital into banks. Any of these options offers the promise of shortening the crisis – though not without risks for the economy.

## **Part 5: What Comes Next?**

The previous parts of this essay provided a short discussion of the origins of the current economic crisis. Ideally at this point in the discussion, resolution of the crisis could be considered. Unfortunately, only now are the full ramifications of the crisis becoming apparent. It seems that the U.S. and global economies are experiencing a very serious downturn. What does this mean for the future health of the U.S. economy? Three different answers are possible. Broadly, these answers depend on how far into the future one looks.

### **Short-term: the next 2 years**

Any look at the near-term prospects for the economy leaves a negative impression. With credit conditions tightening, business operating capital has become markedly more difficult to obtain. This difficulty, leveraged onto the widespread decline in household spending, pushed the economy into recession. The only question left is how deep will the recession be?

Earlier this year, the inevitability of recession was not clear. During the early part of the current downturn, the crisis was focused on the U.S. economy. Having the crisis focused on the U.S. drove down the value of the dollar against other major currencies. The exchange rate movement artificially reduced the cost of U.S. goods and drove a surge in U.S. exports. The surge in exports provided a measure of protection for the U.S. economy. Unfortunately, the crisis spread beyond our borders. During times of crisis savers look for “safe havens.” Traditionally, the U.S. has filled this role; we appear to be filling this role again. The inflow of foreign funds seeking a safe haven is driving up the value of the dollar, driving down exports, and removing the last support from under the economy.

While any recession is painful, the potential depth of this recession raises the concern of a deflationary spiral. Deflation occurs when average prices throughout the economy decline. While this may seem benign, deflation only arises during the worst of economic times (for instance, during the Great Depression or during the decade-long recession in Japan in the 1990s). Deflation is costly as it severely harms corporate profitability (costs are incurred at higher prices, sales revenues at lower prices) and makes people very hesitant to spend (Why buy now? Wait for prices to fall!). Worse, once deflationary expectations take hold it becomes increasingly difficult for the government or central bank to alter the state of the economy. While this risk seems slight at present, it is a risk. If this risk is realized, the current recession will become both much deeper and much longer. At present, it appears that the Fed is sufficiently aware of this risk that it will take all actions necessary to preclude the onset of deflation.

### **Intermediate-term: 5 to 10 years**

Assuming that the economy avoids a prolonged, deflationary recession, where will the economy be in the middle of the next decade? Unfortunately, economists are no better at using crystal balls than anyone else. Therefore, what is indicated here is a cautionary tale, not a foretelling of the future.

If you look back at the causes of the current crisis, two factors stand out. First, technological change generated new finance products whose risks were not well understood. Second, widely available, cheap money fueled the crisis. These driving forces are currently being repeated.

Technology does not stop advancing. Therefore, new financial products will continue to emerge in the market. While this generates risks, it would be wrong to view such innovation as wholly bad. Financial innovation offers the potential to mitigate financial risks. Financial innovation increases the funds available for loans, spurring and deepening economic activity. Financial innovation tends to be more “color-blind” – increasing financial access to previously

underserved groups. Unfortunately, full realization of these gains depends on the prices and risks of new financial products being well understood. This condition is not met for many new products. Hence, to get the gains, a period of increased risk from mis-pricing must be absorbed. During this period of increased risk, the economy is at greater risk of suffering a crisis.

In normal periods, this risk is not experienced as there are insufficient funds flowing into new financial instruments to fuel a crisis. This leaves any mis-pricing with only a modest effect on the economy. But during periods when money is cheaply available, significant sums may flow into these instruments. Currently, two forces are again pushing cheaply available funds into the economy. First, foreign investors seem to be returning to the US economy in search of a “safe haven.” Second, the Treasury Department and the Fed are acting to offset the effects of the current downturn. This is a very reasonable stance to shorten the recession and preclude deflation. Unfortunately, no policy change alters only the present; the effects also come in the future. Hence, any current loosening of credit conditions alters the state of the economy 3 to 5 years from now. Consider the implications of that statement – 3 to 5 years from now the current crisis is likely to have abated. At that time, loose financing will still be entering the market. Where will it go? The risk is that it will go into fueling the next crisis.

A natural objection to that statement is that surely we will learn from the current crisis. Unfortunately, history does not support that contention. The U.S. experienced a serious recession in 1981-82, a financial crisis in 1987, a mild recession in 1991, a financial crisis in 1997-98, and a financial crisis and recession in 2001. While none of these events has exactly the same causal forces, each was followed by the promise that the future would be different – our lesson would be learned. It appears that the economy is too fluid and too complex to be completely understood. This complexity means our best efforts at reform will fall short. Worse, our current actions are likely providing the funding needed to generate the next crises.

One hint as to why the next crises will come is offered by considering “moral hazard.” Moral hazard occurs when offering protection from a current bad outcome increases the likelihood of the occurrence of a future bad outcome. To see how this might arise, consider a subprime borrower – Bob – who borrowed too much. At present, he is at risk of losing his property. If he does, the personal costs will be great – bankruptcy, loss of access to credit, loss of housing, etc. These costs should make him very cautious in taking on future debt. However, if the government steps in, buys the mortgage, and refinances at lower rates, Bob is shielded from the costs of his actions. It is likely that this shielding will lead him to be less cautious in future borrowing than if he bore the full cost of his past actions. Worse, other borrowers will expect such protection if they repeat Bob’s incautious actions; the moral hazard extends beyond just the protected individual. The encouragement to risky behavior in the future is moral hazard.

Would the story be different if the protection were offered to lenders, rather than borrowers? No – the moral hazard simply switches from borrowers to lenders. In either case the “bailouts” serve to undermine the cautionary lessons of the crisis. This alone helps push the economy towards the next crisis. Does this discussion argue against current government action? While it does, the risks of inaction must be weighed against the risks of fueling moral hazard and future crises. It is facile to view the government action as being without risk; but it is equally facile to ignore the real human costs of government inaction.

### **Long-term: Beyond 10 years**

Over the longer term, the consequences of the current crisis run counter to the short-term risks. In the short-term, the risk is of recession and deflation. In the longer-term, the risk is of great inflationary pressure. To understand this portion of the story requires looking backward. Since 1990, the U.S. has experienced a long period of stable, non-inflationary growth. The non-

inflationary growth was at least partially driven by the inability of domestic producers to raise prices given the availability of low-priced imports. Given the significance of China to the production of these inexpensive imports, this became known as the “China price.” This advantageous inflationary window appears to be closing as the Chinese economy matures. The eroding of this artificial inflationary cap opens the door to greater domestic inflation.

Unfortunately, inflationary pressures are likely to increase over the next 10 to 20 years. Currently, the national debt stands at over \$10.6 trillion. Since the cost of the current “bailout” will likely be more than \$1 trillion, it is reasonable to expect that the national debt will balloon to close to \$12 trillion over the next 18 months. While this is an almost incomprehensible sum, the size itself is not the critical issue. The national debt is borrowed money. This means that as long as ready lenders are available, the debt can be covered. Who are these lenders?

At present, the lenders are domestic households, domestic businesses, foreign sources, the Fed, and other parts of the government. Consider that last element, intra-government borrowing. Over the past 30 years the government has significantly over-collected Social Security taxes. By law, surplus tax collections must be used to purchase government debt; hence, the Social Security tax surplus has been used to fund the general government budget deficit. This debt from the government general budget to the Social Security System is what is termed the “Trust Fund.” Unfortunately for the funding of the national debt, the surpluses in the Social Security System will disappear by 2015 (barring changes to the system). Hence, the relatively costless coverage of budget deficits by Social Security surpluses will end in less than 10 years. Worse, the Trust Fund is an obligation by the federal government to a particular program. Hence, the government must begin returning those funds; this will place an additional burden on government finances.

Where will the government get the needed funds to cover the loss of loans from the Social Security System and to pay off the Trust Fund? Several options are available. First, the government could begin to run a budget surplus. Given the consistent budget deficits of the past 40 years and the cost of the current corrective actions, this seems unlikely. Second, the government could borrow more from foreign and domestic sources. However, to induce these greater financial flows significantly higher interest rates will need to be offered. Higher interest rates significantly increase the burden of the debt by further straining the government’s budget (interest payments on the debt are already exceed \$450 billion per year) and by pushing up interest rates throughout the economy. The first burden makes the debt self-perpetuating. The second tends to slow economic growth.

The final option is for the government to sell the debt to the Fed. The transfer of debt to the Fed effectively converts the debt into money. However, monetizing the debt markedly increases the domestic money supply. Any substantial increase in the money supply generates inflationary pressures. With the likely end of the “China price,” these pressures will be given full reign. As this is the easiest option, it is likely the economy will experience a surge in inflation over the coming two decades.

It is important to note that the current corrective actions do not generate this problem. Inflation was likely to be a problem without the current downturn. The crisis and correction simply provide an additional \$1 trillion of fuel for a future inflationary fire. Given the challenges facing the economy, being an economic observer should be very engaging for the foreseeable future.