The Oil Drum: Campfire

Discussions about Energy and Our Future

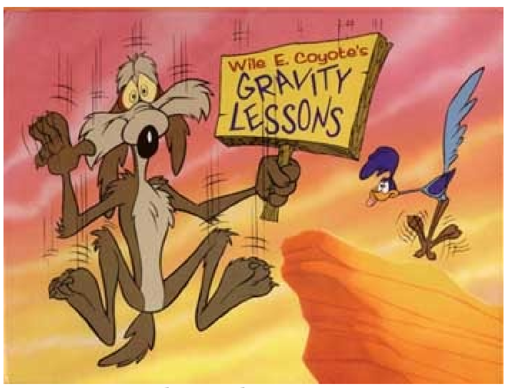
Debt/Resource Thought Experiment: How Would YOU Craft G20 Policy?

Posted by Nate Hagens on September 27, 2009 - 9:03am in The Oil Drum: Campfire
Topic: Policy/Politics

The past few days, delegates from 20 of the worlds largest economies met in Pittsburgh Pennsylvania to further develop international strategies to deal with the ongoing financial, energy and social crises. The "Leader's Statement" could reasonably be summarized by this excerpt:

"*We further committed to additional steps to ensure strong, sustainable, and balanced growth, and to build a stronger international financial system.*"

Considering there was no mention of biophysical limits, nor of mankinds underlying consumptive drivers and considering that 'strong' is at cross purposes with 'sustainable' and 'balanced', I am left with the frustrating conclusion that our same old cargo cult beliefs - that growth and consumption will follow money/debt - are unfortunately alive and well. Below the fold is a brief overview and a chance for TOD readers to play G20 policymaker.



Fiat vs. Real - A Wile E. Coyote moment...

First, some relevant quotes from Karl Polyani's 1944 book, "The Great Transformation":

> "By the end of the seventies the free trade episode (1846-79) was at an end; the actual use of the gold standard by Germany marked the beginnings of an era of protectionism and colonial expansion. The symptoms of the dissolution of the existing forms of world economy -- colonial rivalry and competition for exotic markets -- became acute. The ability of haute finance to avert the spread of wars was diminishing rapidly. For another seven years peace dragged on but it was only a question of time before the dissolution of nineteenth century economic organization would bring the Hundred Years' Peace to a close."
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> "The breakdown of the international gold standard was the invisible link between the disintegration of world economy since the turn of the century and the transformation of a whole civilization in the thirties. Unless the vital importance of this factor is realized, it is not possible to see rightly either the mechanism which railroaded Europe to its doom, or the circumstances which accounted for the astounding fact that the forms and contents of a civilization should rest on precarious foundations.
>
> "The true nature of the international system under which we were living was not realized until it failed. Hardly anyone understood the political function of the international monetary system; the awful suddenness of the transformation thus took the world completely by surprise... To liberal economists the gold standard was purely an economic institution; they refused even to consider it as a part of a social mechanism. Thus it happened that the democratic countries were the last to realize the true nature of the catastrophe and the slowest to counter its effects. Not even when the cataclysm was already upon them did their leaders see that behind the collapse of the international system there stood a long development within the most advanced countries which made that system anachronistic; in other words, the failure of market economy itself still

> escaped them." [p. 20]
>
> "The transformation came on even more abruptly than is usually realized. World War I and the postwar revolutions still formed part of the nineteenth century. The conflict of 1914-18 merely precipitated and immeasurably aggravated a crisis that it did not create. But the roots of the dilemma could not be discerned at the time. The dissolution of the system of world economy which had been in progress since 1900 was responsible for the political tension that exploded in 1914."
> [p. 21]

Note: 100 years ago today, the NYTimes ran a piece on dissipating misapprehensions for a Central Bank".

And here are some excerpts from yesterdays G20 joint statement (bold added by me) :

> *7. Today, we reviewed the progress we have made since the London Summit in April. Our national commitments to restore growth resulted in the largest and most coordinated fiscal and monetary stimulus ever undertaken. We acted together to* ***increase dramatically the resources*** *necessary to stop the crisis from spreading around the world. We took steps to fix the broken regulatory system and started to* ***implement sweeping reforms to reduce the risk that financial excesses will again destabilize the global economy.***
>
> *9. The process of recovery and repair remains incomplete. In many countries, unemployment remains unacceptably high. The conditions for a recovery of private demand are not yet fully in place. We cannot rest until the global economy is restored to full health, and hard-working families the world over can find decent jobs.*
>
> *10. We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too.* ***We will avoid any premature withdrawal of stimulus.***
>
> 16. To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis. **Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual**.
>
> 17. We committed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take. **Standards for large global financial firms should be commensurate with the cost of their failure.**

A Cargo Cult

Some observations:
1) Money is not a resource
2) Governments plan to reign in excessive financial risk taking in the private sector, but increase their own.
3) The word 'sustainable' appeared 51 times in the Leaders Statement.

MONEY AS DEBT

Since the creation of the Federal Reserve System governing our money spigot in 1913, money (debt) has been continually created to match the demand for credit, irrespective of future resource flow rates. Following the demise of the Bretton Woods agreement in 1971, (and US oil peak the year prior), there has been no natural speed-bump to this expansion of the money supply. Central banks controlled monetary policy via adjusting the discount rate, the Federal Funds rate, the reserve requirement %, and various other rule changes. Contrary to the distant past, when increases in money would require new energy and materials expenditures to procure more gold from mining to back the new currency issue, under the regime of the last 40 years, commercial banks under the permission of Fed, could create money (credit) at will. As long as there was a demand for credit, the money supply could grow with only a paper tether to the real goods it was designed to represent. As long as prior period debts could be serviced in dollars, money as debt increased, as people accepted it as a resource proxy itself and increased extraction and consumption of real goods accordingly. This was not a problem confined to the United States - virtually all countries, (and all major economies) use fiat currency - backed by nothing other than the faith of government.

It stands to reason that such a system would eventually decouple, not slightly but significantly, from its biophysical tethers - (much of what has been written on these pages since 2005 has in fact been attempts to quantify such departures). Roughly, the world now has hundreds of trillions in debt (government, private, financial and public) that requires servicing, bumping up against a depleting high quality energy supply (the infrastructure of which has been long since paid for with 1960s-80s embodied energy). Not included in this is financial credit risk, derivatives etc. As all this debt is not really a zero-sum game but is more a marker money supply gone wild via social and policy responses over 4 decades, the amount of natural resources we'll have available per unit time is extremely unlikely to allow us to repay but a fraction of this debt. (I will be presenting "Abstract Energy Gain and the Permanent Recession" at ASPO in Denver where I will hash this out in more detail).

In sum, absolutely nothing has been 'solved' in recent months. The components of the debt pyramid have just shifted ledgers. (Market analysts are now projecting the government will never get repaid on its recent loans, let alone other debt. In many real ways we fell off the cliff last fall and a giant airgun (govt intervention not based on real resources) has allowed us to continue the feeling of levitation since. Over 30% of G20 GDP has been guaranteed by G20 central banks via loan guarantees, commercial paper purchases, various Cash-for-coyote programs, etc. The result of these measures has been a moderate recovery in notional GDP, with costs of fewer resources and less time to deal with the real underlying problems. If we are unable to grow, let alone in a 'strong', 'sustainable' or 'balanced' fashion, the whole *'increase-money-supply-each-year-enough-to-pay-off-prior-debts'* model not only hits a wall, but goes in reverse.

There are 2 fundamental disconnects with reality prevalent among those advising our decisionmakers: 1) a misconception that money is somehow a resource and not the debt albatross it really is, and 2)that energy is treated the same as any other commodity input, parsable into dollar terms by the market. Following these two faulty assumptions, we have painted ourselves into a dangerous corner - we expect by printing money and government guarantees, that our cargo will eventually resume flowing again, like magic. As such, after the phantom (government fiscal/monetary stimulus led) recovery in next year or so, I expect the financial system to unravel via an across the board debt repudiation, or the Fed and other parties trying to print their way out the problem. The latter strategy seems less likely as the sums involved would be extreme.

Though few benign paths are left, we have enough knowledge to make better choices. Can we?

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CAMPFIRE QUESTIONS:

1) Can you articulate a concerted policy response that would indeed lead to 'strong', 'sustainable', and 'balanced' growth?

1a) If not, what sort of 'economic triage' policy would you recommend? Think bold.

2) What will it take for international economists, policymakers and authorities to understand that money/credit is not a resource, and does not on its own produce cargo?

Please focus on the middle question - assume my view is generally correct for the moment - what could be done?