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The Financial Crisis As New Beginning

By Benjamin Gisin & Michael Krajovic

> Seeing the financial industry reveal its true identity as a welfare recipient is a tremendous breakthrough in understanding. It will inspire and create tolerance for the kind of thinking outside the box the world has been waiting for.

Photo - Benjamin Gisin

Financial process failures are already taking a deep toll on the economy and prospects for future economic capacity. Over 2,700 trucking companies have gone out of business in the United States in 2008. The nation's trucking capacity has correspondingly been reduced by 6.5 percent as Russian and Eastern European countries are importing trucks from the U.S. at rock bottom prices aided further by a weak U.S. dollar. This raises the question: Should we start looking to disengage the economy from the financial system?

There is a Chinese proverb that states defining things accurately is the beginning of wisdom. The definitions and explanations the financial industry uses to put forward its concepts and activities are flagrant in violating this principle of accuracy. Thus understanding of what is taking place, as well as attempts at correcting imbalances, are generally far off target. However, this confusion holds great promise. The public is hungry to understand. As clearer understandings emerge, the potential to find and effect solutions, at even the lowest grass-roots level, is materially enhanced.

The financial industry consists of two large sectors. The first, the banking sector, creates deposits (accessed by checks and debit cards) that serve as money. As such, the banking sector serves as the initial distribution point of money into the economy.

The second is the secondary lending sector (bond market, national debt, credit unions, payday loans — also referred to as the capital markets). The secondary lending sector lends bank deposits acquired by investors in the normal course of business. Wanting to invest, but not with a bank, these investors turn to secondary lending as the vehicle for their investments. The secondary lending sector plays a critical role in moving money throughout the economy to borrowers not using banks.

Out of the two sectors, secondary lending represents the largest and fastest growing segment of debt in the nation — five times the size of bank debt. Both sectors depend upon the creation of more debt to thrive.

The money created and distributed by the financial industry, sets the limits on production, consumption and development. Competition for the money created and distributed by the financial industry also determines how wealth is distributed.

When the financial industry runs afoul from flaws in its processes, much of the world's human energy is forced to idle. Despite a great desire by people to move their economy forward in times of recession or depression, it appears little can be done. As a people we are electing to wait as the financial industry clings to the government for salvation and the economy continues to shut down. Perhaps we shouldn't wait.

Recent reports reveal 15 percent of the world's shipping capacity is idled, in part due to importers being unable to obtain letters of credit from their banks. This year has seen over 2,700 trucking companies close their doors in America reducing U.S. trucking capacity by 6.5 percent. A weak dollar and cheap truck prices has helped fill demand for trucks overseas as trucks from the U.S. are being exported in record numbers to Russia and Eastern Europe.

"A record number of trucks, in a record amount of time, representing a record amount of the nation's (trucking) capacity has been taken out of service," said Donald Broughton, an analyst with the Avondale Partners research firm. "Even a small pickup in demand will create a very tight capacity situation very quickly."

The financial industry's sub-prime lending crisis, which quickly evolved into a national financial crisis has brought intense criticism of the nation's credit processes — which is fundamentally a criticism of how money is created and distributed in society.

The nation's credit processes are all there is when it comes to money. Said in another way, the entire financial industry — banking and secondary lending — is nothing more than a system of credit that keeps track of who owes who. At certain points along an accounting chain, what banks (including the Federal Reserve Bank) are obligated for, temporarily emerges as money. The money you claim as yours in your savings account is what the bank owes you.

To address the growing world economic crisis, it is essential to understand the economy runs on credit. And various forms of credit have been mistakenly defined using historical concepts of money. For simplicity, we will use the term money that in every case means a form of credit. ▶

And a form of credit is simply an IOU from a bank or the Fed.

Historically, money has been defined as paper currency, coin or other objects that serve the money function, leading the individual away from any hint that money is a form of credit. This sanitized definition of money has caused untold confusion for consumers and elected officials trying to make sense of the current financial crisis and its role in the larger global economic crisis.

How can money be credit? It begins with a circular accounting process where banks and their debtors engage in approving each other's credit and creating two debts in the process.

The first step is when a bank accepts your credit as good by getting a credit report, looking at your assets, liabilities and income. The bank then asks you to sign a promissory note and often pledge collateral, formalizing your indebtedness to the bank.

The second step is when you accept the bank's credit as good and you accept a bank's credit entry on your bank account as money. In reality it is not money, but an obligation of the bank to you.

So a typical bank transaction is that of a customer getting into debt to a bank and a bank getting into debt to the customer. When you write a check from your bank account to another party, what the bank owes you is transferred to what another bank owes the person you wrote the check to.

If enough borrowers fail to perform on their notes to the banking system, the bank fails to stand behind all of its obligations to its depositors. Defaulting bank loans act like dominoes causing a default in the banking sector's ability to make good on its deposits.

It is important to separate the financial system from the economic system. In so doing, it becomes possible to accurately isolate problems in the economy. Is our economy faltering because our products are poorly constructed or because we overconsume our natural resources? Or, is the economy faltering because credit as money is unstable and serves as a poor circulating medium to keep the economy going?

Defaulting loans at a bank quickly put the bank into insolvency and places your bank account in peril. Defaulting loans in the secondary lending market can quickly erode the financial wealth of investors within a wide array of insurance companies, pensions funds and mutual funds.

Illustration 1 is a summary of the commercial banking industry's assets and liabilities. It illustrates the two debts born out of every credit transaction. Loans are the debts of customers under Assets. Deposits are the debts of banks under Liabilities. Note also Equity Capital. If the U.S. Treasury ends up buying $250 billion in bank stock as part of the financial bailout, that would represent 22 percent of the total banking system's equity capital.

Being able to convert what a bank owes you to cash gives a superficial sense of security to customers in that they can convert their worries of a bank's failure to worries about the Federal Reserve's failure. If you look closely at a dollar bill, you can see at the top of the bill that it is a "Federal Reserve Note" or basically a promissory note by the Federal Reserve to pay you money it does not have.

Illustration 2 shows the secondary lending sector holding four times more home loans than do commercial banks. This is why bailout dollars are going to a broad range of investors, not just the banks.

Earlier in the year, Congress approved an economic stimulation package (tax rebates) that put a few hundred dollars into most consumers' pockets. It wasn't effective enough in that the stimulation package was far too small.

Banks and secondary lenders had a different agenda. They could not wait for increases in cash flows through the economy, as a result of stimulus payments, to prop up troubled borrowers.

Banks and secondary lenders approached the government with a demand: Make us whole for an amount equal to what debtors don't pay on their loans. This exposes the true nature of money and ▶

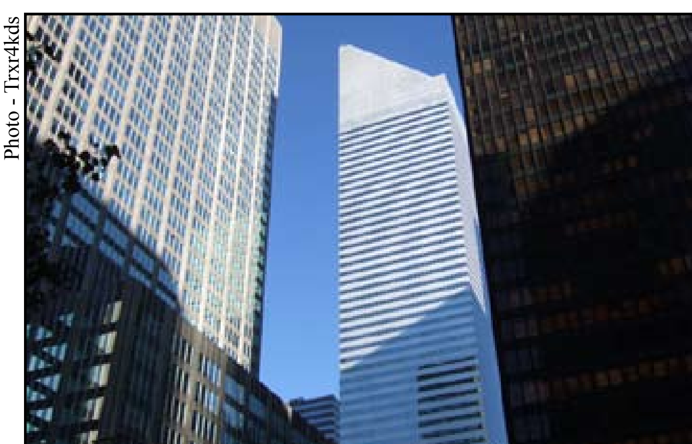
ILLUSTRATION 1

Consolidated financial summary of the nation's 7,178 commercial banks as of 6/30/08

(Source: Federal Reserve Bank of San Francisco)

ASSETS	TOTAL	11,320,358
	FOREIGN	1,579,230
	DOMESTIC	9,741,128
LOANS	TOTAL	6,615,636
	FOREIGN	549,049
	DOMESTIC	6,066,587
	REAL ESTATE	3,549,482
	COMMERCIAL RE	888,519
	SINGLE FAMILY RES	1,932,752
	COMMERCIAL	1,179,745
	CONSUMER	821,376
	CREDIT CARDS	348,796
	AGRICULTURAL	56,986
	OTHER LOANS	458,996
INV. SECURITIES	TOTAL	1,630,424
	U.S. TREASURIES	22,197
	U.S. AGENCIES, TOTAL	950,522
	U.S. AGENCIES, MBS	789,409
	OTHER MBS	255,605
	OTHER SECURITIES	402,100
LIABILITIES	TOTAL	10,156,572
	DOMESTIC	8,577,797
DEPOSITS	TOTAL	7,358,543
	FOREIGN	1,542,718
	DOMESTIC	5,815,824
	DEMAND	487,268
	MMDA & SAVINGS	3,097,537
	SMALL TIME	1,035,439
	LARGE TIME	1,007,005
	OTHER DEPOSITS	188,576
OTHER BORROWINGS		1,156,890
EQUITY CAPITAL		1,147,744

Photo - Trxr4kds



Citibank headquarters in New York. Citibank, the largest bank in history receives the largest bailout in history, effectively becoming one of the world's largest welfare recipients.

financial wealth. The extent to which loans default is the extent to which the nation's financial wealth and money is erased. The extent to which the financial industry cannot facilitate massive new debt is the extent to which the economy falters.

The rapid intervention of the government into propping up banks helped divert the public's mind off the insufficiency of the FDIC fund, which at year end 2007 was a mere $52.5 billion. An amount glaringly insufficient to address the safety of bank deposits under the current crisis.

Today, the nation is focused on saving the banking system so it can continue to create deposits with each new debtor that walks through a bank's doors.

But are we missing something here? If the financial industry is sick from a nation awash with more loans then there are cash flows to repay, is making more loans the answer? Is shoring up the defaulting loans of banks and the secondary lending sector the answer?

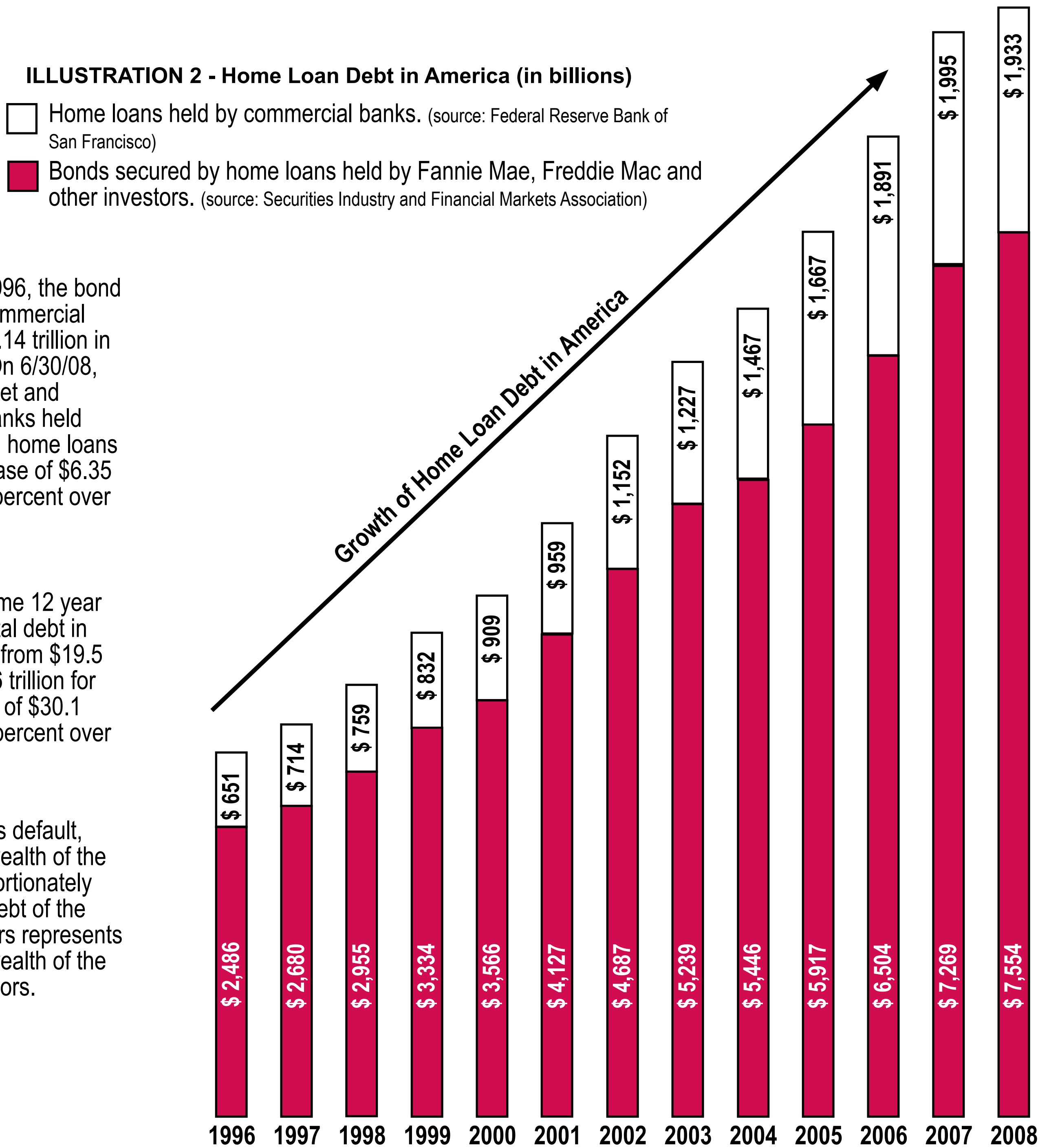
Even the Federal Reserve Bank is dropping interest rates to encourage the expansion of new credit. While dropping the interest rates makes loans easier to qualify for and repay, it still increases debt.

If the processes of the financial industry in creating and distributing money does not work, continuing the marriage of our economy to the financial industry may prove less than fruitful as the nation's physical economy continues to shut down.

The financial crisis is illustrating that using credit as money, thereby creating unpayable debts, is not sustainable.

The savings and loan crisis of the '70's was a precursor to the current sub-prime lending crisis. While both of these crisis criticize the lending processes, the fact remains the nation, with little exception, has nothing other than lending processes to facilitate economic activity.

ILLUSTRATION 2 - Home Loan Debt in America (in billions)



At year end 1996, the bond market and commercial banks held $3.14 trillion in home loans. On 6/30/08, the bond market and commercial banks held $9.49 trillion in home loans for a net increase of $6.35 trillion or 300 percent over 12 years.

During this same 12 year time frame, total debt in America grew from $19.5 trillion to $49.6 trillion for a net increase of $30.1 trillion or 255 percent over 12 years.

As home loans default, the financial wealth of the nation is proportionately erased. The debt of the nation's debtors represents the financial wealth of the nation's investors.

While all of this may seem overwhelming, it can be simplified into a few key points of understanding:

1) The use of credit as money leads to ever growing levels of debt that make each passing year more difficult for debtors to pay.

2) The sub-prime lending crisis is merely an overzealous use of the credit system by profiteers. The sub-prime lending crisis landed on a credit system already teetering from too much debt.

3) The financial crisis is a wake-up call for individuals, local communities and the global human family to evaluate the use of money (an instrument of debt) as a sustainable means of exchange.

4) It is ironic the financial system, known for its aggressive collection practices, has become a welfare recipient, asking for aid from the very people it is foreclosing on?

There is mounting evidence the financial system is a dinosaur, whose approaching extinction cannot, at this time, be comprehended by government, the educational system or much of the lay public.

If we want a financial solution to the financial crisis, it would be a program that effects robust cash flows through the economy, particularly at the poverty level. For it is only robust cash flows flowing through everyone's hands that has the ability to prop up loans on the verge of defaulting and the physical economy in the process of shutting down. This grass-roots kind of action means we have to eliminate the concept of a minimum wage and replace it with a living wage and we have to cooperate instead of compete.

While a divorce between the financial system and the economy may be an idea whose time is emerging, we are vulnerable in that re-creating a new exchange system from the bottom up is not going to happen overnight — we need more time.

We have all been on teams and learned to cooperate with team members to achieve a victory against the interests of other teams. Nowhere is this more prevalent than in how we compete against each other for the money created by the financial industry. The financial crisis is revealing that competition, as a cornerstone of the economy, is as shallow and false as basing our means of exchange on unsustainable credit expansion.

It is time to think of creating an exchange process that does not require competition or debt and re-establishes our trek to higher standards of living. This change can start at the local level and re-create the economy from the bottom up.

In the immediate present, there is tremendous value in recommending our elected officials approve a stimulus package (getting money into the hands of the average citizen) of a size that could be considered mind boggling. We cannot risk the economy shutting down further. Every job that goes away and every business that closes is much harder to bring back to life the deeper the economy declines.

In the next issue of Conscious Economics, we'll reveal a "quick fix" plan to financially stimulate the economy (create robust cash flows) in a way that uses the existing financial structure, but does so without further cost to the taxpayers. The plan itself will reveal aspects of the Federal Reserve and U.S. Treasury rarely known to the public. It's purpose would be to buy time as the human family re-discovers cooperation and the exciting trek to a new economy built from the bottom up. ■

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Benjamin Gisin

Gisin comes from a 20-year banking career culminating as senior agricultural approval officer for one of the nation's top 10 agricultural banks. Since 1997, he has been a consultant to agricultural enterprises in negotiating some of the largest debt settlements between farm borrowers and their creditors. Understanding the monetary system from the ground up, his understanding of how the monetary system works is highly sought after by monetary reformers. He is author of "Farmers and Ranchers Guide to Credit" and hundreds of published articles on banking and finance. Since 2005 he is the publisher of *Touch the Soil* magazine and lectures nationally on both monetary and food security.

Michael Krajovic

Mike Krajovic has over 20 years of professional experience in community and economic development. He has served on the boards of numerous agencies, and leads a group of non-profit agencies in Pennsylvania. He has expertise in community planning and implementation using comprehensive local and regional approaches. As a social innovator, he has been involved in all aspects of improving the quality of life in a community such as education, agriculture, economics, land use, environment, infrastructure, work force development, government, tourism and finance. He holds a Bachelor of Science in Engineering and Masters degrees in Business Administration and Social Artistry.

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