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CHAPTER 1

HOW ECONOMIES BEGIN

Times are changing rapidly. Long established economic principles are dissolving, and new economic theories are born every day. The old "classical" economists are shaking their heads as they discover they no longer know what is happening. They realize the "traditional" techniques of restoring the economy no longer work. The ideas behind cost-push and price demand no longer hold true because we see that prices can rise while production falls off. Employment declines in one segment of the economy while wages rise in another. Why? What can we expect in the future?

Attitudes and Actions

Too often we react to events around us without understanding what is *really* happening and why. Overreaction is the norm, and in nearly any crisis the sequence of events is predictable—alarm, temporary panic, then apathy and disinterest.

We tend to look at the future with anxiety and worry. God says that worry is a sin. What is worry? Taking on a responsibility that belongs to someone else.

Unlike the majority of the population (who are not attuned to God's financial plan), we don't have to worry about circumstances. God has revealed in His Word what has happened and will happen. Parts of the Bible are history, parts are current events, and portions of it are prophecy. Through His Word God tells us what to expect in this economy and how to respond.

I did say *respond* as opposed to *react.* When we respond to something, we bring in the information, check it against known values, and act accordingly. When we react to something, we bring it in, amplify whatever we receive, and put it back out. That is *not* what God wants for us.

As we look at the economy today and where it may be headed tomorrow, we need to view it from God's perspective. The most important part of that perspective is the imminent return of Christ. When we hear that Christ may return during our time, we say that we believe it. But when God's plan is beginning to be unveiled to us, many refuse to accept it. Seemingly, we react as the early Christians did in Acts 12.

Peter had just been imprisoned and was to be executed. The Christians who traveled with him had retreated to his house to pray. They stayed that entire evening, praying that God would release Peter unharmed.

Then God performed a miracle and Peter walked out of prison a free man. He went to where the small group was praying and knocked on the gate.

A young girl answered and swung open the gate. There stood Peter. Shocked at the sight of him, she rushed back to the group saying, "Come quickly, Peter stands at the gate!" And what did they do? They chided her. "No, Peter can't be here," they said. "We're praying for him in prison."

Nevertheless, there he stood. They had prayed for a miracle. God had granted their prayer, and yet they didn't have enough faith to believe it.

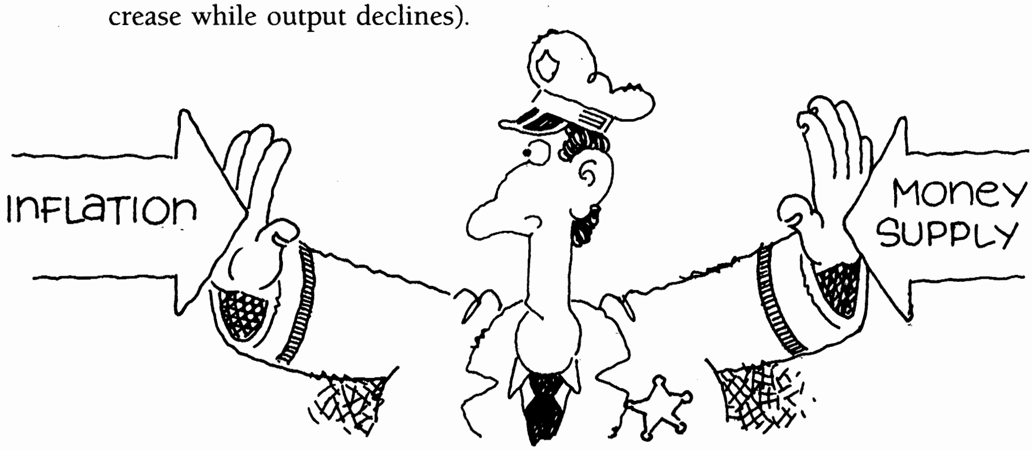
Sometimes we are the same way. We *say* that we believe the Second Coming is near, but when we see the imminent signs, including the changing pulse of the economy, we refuse to accept it.

The Economy

Isolating the economy from any other event, a prudent observer would say that we have a problem. Notice that the United States economy and most of the world's economy is very unstable.

The value of the U.S. dollar is shrinking on the world market. Consequently, most other countries that have depended on our stability in the past are pushed to virtual bankruptcy. The economic balance has shifted to the Mideast cartel where little money is actually necessary. What does all this mean? Where are we headed?

Obviously, inflation is growing. In recent years it has increased at an alarming rate, whereas real production has dropped off. Major industries are pursuing a self-preservation attitude—some of them to the brink of disaster. Prices continue to soar while real production declines. Thus a new term has been coined, "inflationary recession" (prices increase while output declines).



Inflationary recession is not unique in the world economy, but it is unique in the United States. For years we touted our fiscal controls in the belief that it couldn't happen here. It was believed inflation could be halted simply by reducing the money supply, and recession could be controlled by the opposite technique. This is no longer credible. If we enter an inflationary period and begin to control the money supply, the economy immediately slips into a recession. Then, in order to get out, it is necessary to flood the market with additional money which, in turn, fans the fires of inflation even further.

Economic Trend

These events should alarm economic decision makers, because they verify that the highly publicized controls no longer work. The trend toward economic collapse—runaway inflation followed by major depression—seems irreversible.

Lack of fiscal discipline and sound management is partly responsible for the trend. These inadequacies reflect an economic system created by popularity. Politicians who make decisions based on what is popular rather than what is financially sound have virtually bankrupted us.

It is hard to visualize the kind of political climate necessary to reverse this trend.

Rather than working on a feasible solution to our problems, government officials quibble about which group should get the most handouts. They grant price supports to one group, unemployment benefits to another, and gratuities to many people who are undeserving. They provide grants to New England ski resorts because of insufficient snow one year, then support beaches in the South because of too much rain. They pay people not to grow products in a time of shortage, apply price supports to foods when they begin to drop, and then complain of runaway inflation on these same products.

The Federal Reserve System cuts off credit to industries that are profitable, protesting that they should become self-sufficient without credit, when for forty years the system promoted the use of nothing but credit. Nor is the "average" American guiltless either. Most families today live on the brink of disaster. The excessive use of personal and business credit has weakened the already shakey family structure. All of these factors contribute to an almost uncontrollable economy.

Understanding the Economy of Today

In order to understand *where* our economy is, it is necessary to understand *what* an economy is. Let's go back to an earlier time and see how an economy comes into existence.

For simplicity's sake, let's look into a community where people were basically barterers. Residents of the community include Dan

Dairyman, who raised cows; Frank Farmington, who raised corn, wheat, and barley; and Blake Smith, who manufactured horseshoes and nails.

Dan Dairyman decided he would like to build a barn for his cows. He had lots of timber on his property. He was able to cut down his trees and store his timber until it was cured and ready to use, but he was tired of using wooden pegs to put up his buildings—it was so much trouble to drill holes, pound pegs, and sand them down. Then he had an idea.

He thought, *Boy! I'll bet I could build a great barn if I used nails, instead of wooden pegs!* So he went to see Blake Smith and said, "Blake, if you'll make me up a large sack of nails, I'll trade you this cow. How about it?

Blake said, "It's a deal, Dan."

After he got the nails, Dan used them to build his barn and was so pleased he decided to get some more to repair his house. He went back to Blake Smith and asked if he would trade for some more nails.

"Sure, Dan. I'll make you some more nails but, for now, one cow is all I can use. Sorry!"

Dan was disappointed at the blacksmith's refusal. He went to his neighbor, Frank Farmington, and told him about the problem.

"I understand your dilemma, Dan. Let me swap you some corn for the cow. Then you can trade the corn for some of Blake Smith's nails," Frank Farmington told his friend.

Dan now took the corn he had swapped the cow for and approached the blacksmith again.

"Now we have got a deal, Dan! I can really use some corn. I'll have your nails ready right away," said the blacksmith.

Dan Dairyman happily repaired his house and began to promote the virtues of using nails to all his friends. And soon other people began going to Blake Smith to trade their products for nails.

Blake was doing a thriving business. Soon it struck him that he wouldn't have to make horseshoes anymore because the nail business was so good. So he began to "specialize" and manufacture only nails.

As more and more people used nails, the blacksmith developed a flourishing business. Everybody wanted nails to trade for other items. Nails became what we call "money." Money, in any system, must satisfy three basic functions: It must have *value,* it must be *storable,* and it must be *divisible.* Blake Smith's nails satisfied every one of these aspects and so they were used as money.

Blake had been in business several months when Frank Farminton placed a large order for nails. He came by to pick them up one afternoon and asked, "Blake, you got my hundred bags of nails made up?"

"Yep, I've got them right here," replied Blake.

"Good!" Frank said. "Now here's what I want you to do. Hold on to my nails, and write me out a piece of paper saying you have them and they belong to me. Okay?"

"Sure Frank!" the blacksmith replied.

When Blake Smith wrote on a piece of paper that he had one hundred bags of nails that belonged to Frank Farmington, he had created a new medium of exchange—*paper money.* This paper money had to satisfy the same basic functions that our original money does to be called *money,* and it did. Nothing new was created by this paper. It merely represented the nails in storage.

The distribution of paper money, rather than nails, continued as more and more people discovered that it was easier to carry pieces of paper than nails.

Blake began to notice that most of the nails he was making for his customers remained in his warehouse. Although they belonged to somebody else, he always had surplus nails. He began to think, *Why should I let these nails sit idle? No sense in making more nails when all these are just sitting here.*

Then one day Fred Farmer needed some nails but didn't have the money to pay for them and had nothing to swap until his crops came in, so Blake loaned him some nails to be repaid later. But this time, instead of making new nails, he had Fred sign a piece of paper and loaned him some nails already stored in his warehouse.

What had Blake Smith become? A banker. He stored money (nails) for some and loaned it to others. Blake had created a new kind of money—*credit.* Now credit seemed like a good thing. Without even knowing it, others were able to use this credit to build houses and barns. Blake's business prospered through his use of *credit*—other people's money.

Unfortunately, to keep his business growing, the blacksmith was forced to expand, using more and more credit. Then one day a depositor came to collect a large order of nails that Blake was supposed to be storing for him.

Marvin Messenger said, "Blake, I've got an order here for 500 bags of nails, and I need them right now!"

"Uh, just a minute Marv . . . I've just got 250 bags in stock, and I'll make up the rest by tomorrow. Okay?" Blake asked hesitantly.

A red-faced Marvin shouted, "Whaddayamean? This paper says, 'On demand,' not 'tomorrow.' " He stomped out and immediately called a meeting of the other men who had nails stored. A discussion revealed that one had 1,000 bags coming, another 500, another 350, and so on. It was obvious something was wrong!

They all rushed to Blake Smith and demanded their nails.

What happened? The blacksmith went bankrupt (or "nailrupt" if you will). Why? Credit was his downfall. When his "depositors" lost confidence in him, Blake was finished as a banker. He just loaned too many nails that belonged to others.

Frank Farmington and the Federal Reserve have a lot in common. Frank went from producing nails to letters of deposit, to lending based on average balances in his "nail bank," to "nailruptcy." In reality, the Federal Reserve, created by an act of Congress in 1913 has the ability to do the same thing.

The Fed, as it is called, has the ability to create money (credit) out of thin air by purchasing government debt (Treasury bills or bonds), thus expanding the money supply. This system works reasonably well as long as most people trust the system and don't demand too much of their money back at one time. If they do, the same thing that happened to Frank's nail deposit system would happen to our banking system. On any given day there is never enough ready cash in the banking system to cover deposits. The system succeeds or fails, based on trust—not cash.

In the early stages of our nation many people, including Benjamin Franklin, warned against allowing a central banking authority, such as the Federal Reserve, to acquire too much control over our currency (paper money). Without a controlling element (such as gold or silver) to back the currency, there is always the risk that the money supply will be hyperinflated, and the whole banking system will collapse.

You see, although credit looks like money, it isn't. Credit is storable and divisible, but it lacks one essential element—*value.* Credit costs nothing to create.

As we will see later, this same difficulty has occurred in real economics as well. Governments, playing the role of world bankers, have issued credit until few people realistically believe they can repay their debts.