

ARMSTRONG ECONOMICS FORECASTING THE WORLD

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Financial-Capital-Equity-Commodity & Political Trends
History is a Catalogue of Solutions

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BARBARIANS AT THE GATE RESTRUCTURING THE WORLD

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eing the world reserve currency is something that obviously Congress does not comprehend. About two-thirds of central bank reserves are in US treasury paper. What is going on in Washington right now demonstrates the total lack of comprehension of what is the role of the dollar (*i.e. the flight to Swiss & gold*). This also illustrates my point that the world cannot afford the dollar to be the reserve currency anymore because we are plagued by internal political conflict with no real hope in sight. This is no way to lead the world. At Princeton Economics, being multinational corporate advisor, we got called into so many disasters it was becoming second hat. What is going on in Washington now seems to be a strange secret ritual centered on a mystic suicide cult or a plot for the Manchurian Candidate.

Despite all the fancy corporate and government structural management maps showing there is a nice perfectly neat organizational chart as to how these entities function, the truth is such maps are just for show. In politics, you elect a representative and in theory he is independent and votes only for your interest locally. In reality, he then votes policy lines by the party of his affiliation or else he loses their support. The actual hierarchal structure that operates is striking different from the theoretical model portrayed. Corporately, departments compete against each other and rarely cooperate.

In 1995 I got one of those calls from government asking **Princeton Economics** to bail out a brokerage house owned by a French bank that was going belly-up. The Japanese Ministry of Finance asked us to rescue a French brokerage house in Japan that was about number 17 nationally in underwriting Japanese corporate debt. With each economic crisis, the government steps in and tries to sure up the confidence within the economy by merging failed institutions with ones that at least are limping along. In the case of Japan, the foreign firms were bailing out. The price of the yen was at its record high and there were no competitors available. When the government asks you for a favor, it's hard to say no if you intend to stay and do business there. It was unusual since we were not a brokerage house. The options for Japan simply ran out.

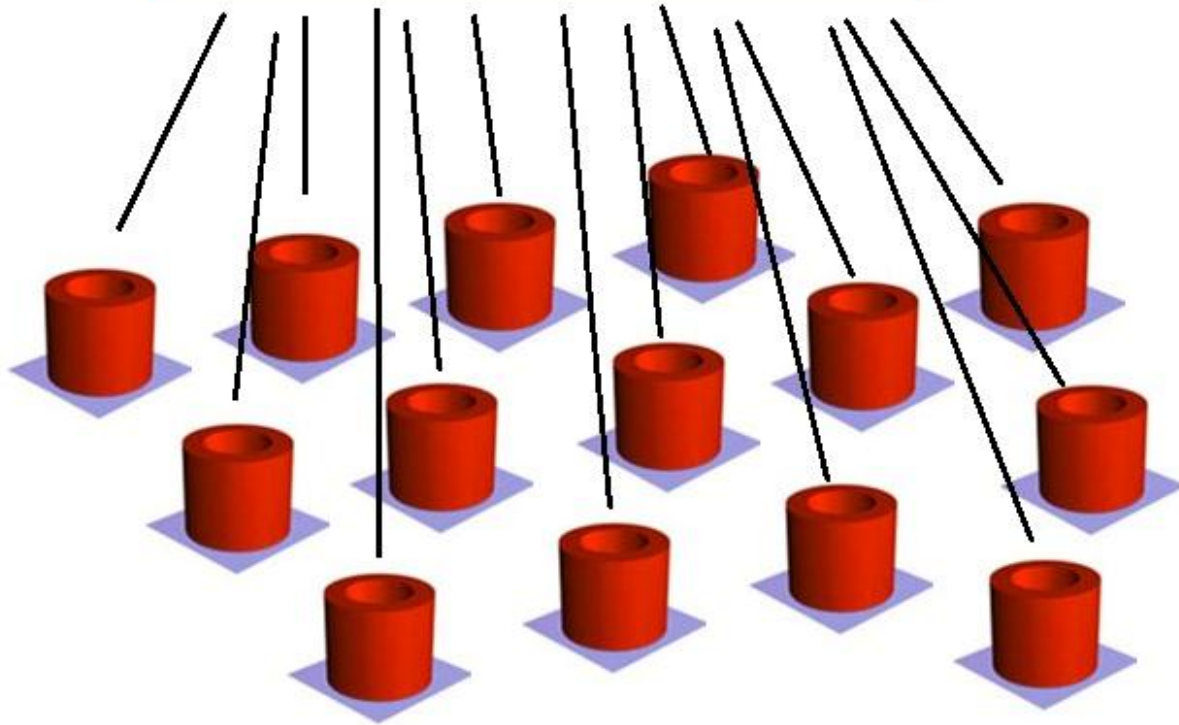


It was the shotgun-wedding of 1931 in Austria between **Credit Anstalt** and the second largest bank, its rival, the well-known **Bodencreditanstalt**. This forced merger made **Credit Anstalt** the largest bank in Austria whose deposits had accounted for nearly half that in the entire nation. The seeds for a global contagion were there in the books of **Credit Anstalt** for about \$75 million of its \$250 million balance sheet constituted foreign loans. This meant that if this bank failed, the ripple effect would go beyond the borders of Austria. This set in motion the **Sovereign Debt Crisis of 1931**. Government intervention is not always the smartest course. They took a default and leveraged it into 50% of the economy.

I had a front row seat to see how corporate and government structure fails every time. We caught a glimpse of this after 911 when they realized that the downside to having so many regulatory agencies was the fact that they compete and therefore did not share information. That led to the creation of a new super agency, the **Homeland Security Agency**. The American way has always been when in doubt, create another layer of government. There is never any consolidation for this would not merely reduce the cost of government, but it just might make it even function for once.

I had advised the top brokerage houses around the world and the first thing that struck me was not only how transient the brokers were, but how the departments competed against each other. Relationships formed on a personal basis. Thus, if you had a good working relationship with a broker at Merrill Lynch and he moved to Deutsche Bank, he brought you with him. This tended to create even more isolation between departments and teams and loyalty was not always to a firm.

Management



Vertical Isolated Core Structure

This structure created an anomaly. If these personal relationships had a strategic advantage, they were not about to share it with another department within the same company. The internal structure of corporations as well as government is by no means lateral ascending through a hierarchy of management to the top. Instead, you have what I called these ***vertical isolated core structures*** that run up to the top with virtually no interaction among other ***vertical isolated core structures*** (departments and teams) that are seen as competition within the same firm since they are all competing against each other for the attention of the management (parent) at the top. In government, we had more than 10 agencies all overlapping the mortgage-banking industry yet not a single one had a clue as to what was actually taking place.

I took these observations of how the real structured world functions and tried to put them to work within our own company. The downside of having offices around the world instantly created competition among them kind of like among Americans there is a national identity, but internally major cities compete with their own sports teams. If a deal developed in Singapore, did it belong to Hong Kong or Australia? Whose deal was it? Then if a client in Switzerland set up a deal with the Australia office, did this infringe upon the domain of the London office? I saw these internal conflicts among client's

organizations and had often been in the middle of them. Citibank was in trouble again in the early 1990s. There was to be a major gathering of all international offices in Malaysia. The overseas offices wanted me there, paid for the time, and booked the travel arrangements. The overseas offices could see the problem easily from an international perspective but New York objected insisting they did not want to air their dirty laundry in front of an outsider. Competition exists at every level and these companies may appear to be one in name, but they are very much operating as independent **vertical cores**.

Our entire future lays hidden within this murky structure of how government is really organized. This **vertical isolated core structure** exists in everything. The Romans were aware of this structure in battle where every man fought for himself. The way the Romans conquered the western world was to bind individuals into groups of ten men (**contubernium**) and 10 such groups constituted a century (**centuria**) commanded by a **centurion**. Six of these **centurae** made a **cohort** commanded by its **senior centurion**. Ten of these **cohorts** constituted one legion (**legio**) commanded by the **legate (legatus)**. A general would then command a group of legions. The Romans organized to defeat this **vertical isolated core structure** of independent men screaming and yelling.

These small groups of ten men were bound in loyalty to each other and so then in battle each would look after the other. The barbarians were easily defeated because they lacked structure in organizing their troops that acted independently given rise to their downfall. Within this opposing structure of isolated competition with the same company and a coordinated team management lays the very essence of human nature. This is how we are as a species and it goes back a very long time.

At **Princeton Economics**, I tried a novel approach of following our own advice. To avoid following in that same path I observed in clients, I restructured the incentives. What I established was that 10% of the gross profits of the entire group were shared among all offices. Thus, they received their traditional **vertical isolated core structure bonus**, but this was topped off with a corporate bonus on all offices. This eliminated the personal relationships where someone in London would sooner deal with a friend at another firm than with a sister office in that region. Structuring bonuses on a department oriented basis in my observations over the years tended to create competition rather than coordination. Here lays a murky but essential next step in our evolution process if we are going to take one step forward for mankind.

When the 1987 Crash took place, the SEC blamed the CFTC and vice versa. There have been many proposals to merge the two agencies, but the prospect of eliminating government workers always curtails that measure. Nevertheless, this is precisely the problem underlying everything we try to do. We have to understand this inherent tendency to revert to a barbaric state of **vertical isolated core structures** that compete against each other rather than function as a group. In government, this mistake has proved costly, is robbing us of our future, and will destroy the entire structure just as the barbarians were easily defeated. They only won when Rome lost its structure – **United we stand – Divided we fall**. We are seeing this in the political battles now raging. It is this **vertical isolated core structure** rather than a look at the entire system as a whole.

We presumed there is an actual management structure and that the guy at the top must know everything. This leads to conspiracy theories where a collapse is then perceived to be the divine plan of

some mastermind. It could be worse. It just might be the bumbling antics of the three stooges. The problem we have is we do don't understand these **vertical isolated core structures** that are the NORM rather than the rarity.

There is a tendency for people to assume that events must be planned. No matter what crash that has ever taken place, there is the presumption of a sinister figure must be lurking in the shadows like some Greek god who enjoys tormenting the souls of men as a pastime. When the 1929 Crash took place, Hoover admitted receiving a phone call telling him it was a secret plot to short the market to destroy his presidency and the Republican Party. He launched a senate investigation that continued into FDR's administration. The outcome was the creation of the SEC. Nobody was ever found. They subpoenaed everybody they could get their hands on and put others on trial who were too ill to be there destroying their careers, reputation, and lives of them and their families. Herbert Hoover wrote in his memoirs that the inquisition was at his direction.

"I urged that the committee launch an investigation of practices of the Exchange, with a view to legislation and I gave them much information to start on. I was extremely loath to take this step as we had enough burdens to carry without all discouraging filth such exposure entailed... There was some doubt as to the constitutionality of the Federal control of the stock exchange...But when a representative government becomes angered, it will burn down the barn to get a rat out of it."

The New Yorker Article **Rational Irrationality; Will Lloyd Blankfein End Up in the Dock?** by John Cassidy (June 2, 2011), highlights to a large extent this assumption that Blankfein lied to Congress and it centers around this entire issue of **vertical isolated core structures**. The premise is that Blankfein told Congress that during 2007 and 2008 Goldman didn't maintain a big short position in subprime mortgage securities. He admitted that one department of the firm (**the prop trading desk**) did at various times sell short a lot of mortgage bonds. Nonetheless, Blankfein claimed that other parts of the firm had a big long position in similar securities, and that the two positions largely offset each other. <http://www.newyorker.com/online/blogs/johncassidy/2011/06/goldman-sachs-subpoena.html>

I have not been a fan of Goldman Sachs after what I believe they did to **Princeton Economics**. I certainly loath what I also believe to have been their reverse take-over of government to secure the perfect trade and eliminate future prosecutions. I believe that thought crossed their mind when the bigger competitor Salomon Brothers got caught with their hand in the cookie jar manipulating the US Treasury Auctions no less – talk about big brass ones! But I would be guilty of doing to them what I believe they did to me if I did not bring this inherent problem of the **vertical isolated core structure** to the forefront.

It is assumed that the man at the top knows everything and that whatever the company or government, there is some coherent management in place. This assumption is false. Because of this natural tendency for groups to devolve into these **vertical isolated core structures**, any idea that there is some grand shared plan coordinated across all departments is just nonsense. It is common that two departments will even have opposite positions for they do not coordinate with each other, but compete in their own self-interest. I am not speaking of just Goldman Sachs despite their bullshit that they are smarter than everyone else which I believe is the code word for being better connected than everyone else. This is an inherent problem in **ALL** corporations and most importantly, more so in the American government than

even Europe. The USA has far too many regulatory agencies and that fragments any hope of real management. It ensures chaos and confusion and increases the cost of government while preventing real practical management. In England, there is the FSA and the Bank of England. Even there when just two authorities existed, there was no coordination and regulation still failed. There can **ONLY** be **ONE** agency overseeing one financial system. The more you fragment the oversight, the more myopic the perspectives to the point you can only see a tree at one time and never the forest. More fragmentation, the worse management becomes – not better.

Now enters Cyrus Vance, Jr., the Manhattan D.A., who has subpoenaed Goldman Sachs. The whole American justice system is far too corrupt for these prosecutors become famous by taking down a big name. Without question, a successful prosecution of Blankfein would launch Vance on the career path of Rudolph Giuliani who made his name on prosecuting John Gotti and Michael Milken. The feds will not touch Goldman for the Obama Administration is just another **vertical core** of Government Sachs as are the Republicans. But Goldman is also not stupid. They hired officials from New York State as well and Alan Cohen was the son-in-law of former DA Robert Morris Morgenthau who just retired in 2009. The likelihood of Goldman getting criminally charged is slim, but it is a 1000 times greater in the state than it is in the Feds where Goldman appears to control even the courts. The firm would not be charged, but individuals could be or threatened and forced to step down as was the case with Maurice "Hank" Greenberg of AIG by former prosecutor and then Governor Eliot Spitzer. I have always personally believed that someone set Spitzer against AIG to remove Hank Greenberg and that opened the floodgates for AIG to start issuing CDOs. When Spitzer thought he had conquered Wall Street, then came the hooker scandal to remove him from office; all very neat and coordinated. Without that, it would have been difficult to create the degree of the mortgage bubble that was achieved.

Nonetheless, setting up and manipulating someone like Spitzer is child's play. Feeding a prosecutor information that will launch his career is like throwing a guard dog a thick juice stake while you rob the joint. Running an organization where the person at the top actually knows what is taking place below him at every level is absurd. You have to come to understand these **vertical isolated core structures** that are truly inherent barbaric tribal organizations or lack of organization. As a society, we would like to think that we retain free will and this is that spirit of individuality. People who ignore cycles assume that to believe in them means they lose that barbaric freedom of individuality, which of course is not true since there are always two opposing forces that create the cycles (bulls v bears).

I doubt seriously that Blankfein is not telling the truth. There were opposite positions among the various departments most certainly. However, that does not negate that Goldman saw the decline as pretty much any experienced trader should have, and Blankfein was a trader, not an accountant. It does not mean that still some departments were long **similar** markets not expecting a CONTAGION. However, that does not transform into a superior knowledge of all the ramifications that are set in motion by a change in trend. Had Blankfein drawn simply on his trading experience, picking the high should have been a piece of cake, **but what came afterward was not.**

This same **vertical isolated core structure** means there is also no coordination of individual groups banning together in some sinister master plan to take-over the world. It is clear that removing Hank Greenberg from AIG stripped it of that trader instinct leaving the first run by back-office schmucks who wouldn't understand how to trade if you handed them tomorrow's Wall Street Journal today. And there is banning together to manipulate a single trade. But the idea of some grand master plan gives (1) far too much credit to individual knowledge, and (2) diminishes the complexity of the economy as a whole.

The idea of some master conspiracy is akin to the theory of God. We assume everything that happens must be God's will, even though we do not understand the objective or the reasoning. We attribute this same attribute to government and these conspiracy theories assuming they know what they are doing even though we do not, and it must be driven by greed with some sinister objective.

In reality, there will never be such coordination because there will never be universal agreement. Just as within each company there are these **vertical isolated core structures** that prevent it from truly acting as a single entity in most circumstances, when you try to group together these companies into a single unit, the same **vertical isolated core structures** then emerge. The competition between the firms prevents the very coordinated body that people attribute to them during a crash. The proof of this is actually the fact that Goldman needed also to be bailed out. Buffett lent them money and they were given access to the Fed window not to mention the TARP funds. They were right on the trade, but failed to consider the **CONTAGION** that would be unleashed. They failed to grasp that difference of a mortgage debt crisis from a mere crash in a commodity or the stock market where the scope is limited. A mortgage collapse affected the entire credit system and nearly brought down the entire house of cards. That certainly Goldman did not expect or else they would have been prepared and would have had short positions much beyond the mortgage CDO market. It is easy to assume the crash was deliberate, but in reality, not even Goldman figured out the **CONTAGION** factor. This was in part due to the tunnel vision created by the **vertical isolated core structure**.

Nevertheless, our greatest problem is that government operates on this same **vertical isolated core structure**. We are doomed because there is no coherent organization and the cost of government rises under this structure as the efficiency of management declines. Our organizational skills are seriously lacking. We have far too many agencies all regulating in an overlapping manner and this increases the cost as well as the inability to actually manage anything. This was one of the complaints in the Declaration of Independence: ***He has erected a multitude of New Offices, and sent hither swarms of Officers to harass our people and eat out their substance.***

It is time to understand this inherent barbaric tribal tendency to create a legion of regulators all operating in competition seriously disrupting the economy and ensuring we are about to collapse in a very big way. We have to gut government and it is time to reorganize the system from the bottom-up. If we are going to continue to be barbarians with a plethora of competing interests within government, then we will be headed toward civil war. Unfortunately, those who benefit from government waste will yell and scream the most. These are the very people who would sooner destroy the nation than act just once rationally for their own long-term survival.

The young Republicans are refusing to compromise. They are changing the dynamics of politics more so than most expect. This is the start of the third party movement that may take hold by 2016. They are refusing to follow the party and are demanding deep cuts. They see half the problem correctly as it is the debt, but they are not addressing any lasting changes to the system ensuring this is going to get much worse. The current debt ceiling crisis illustrates the problem of fragmentation and competition. Unless there is a full scale willingness to review the entire structure and respect that everything has to be reorganized, we should expect more of the same. This is competition, not cooperation. So grab your socks – this is approaching the Barbarians at the Gate.