



# The Privateer

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## GLOBAL REPORT

### WHEN ZERO RATES ARE NOT ENOUGH

On November 20, the yields on shorter-term US Treasury debt paper all but vanished altogether. This is where yields fell to on that day:

Three-month to 0.01 percent - their equal lowest level ever

Six-month to 0.12 percent - their lowest level ever

Two-year to 0.71 percent - 0.01 percent above their lowest level ever

On the previous day, President Obama was quoted by the London *Financial Times* as saying this: “*I think it is important, though, to recognise if we keep on adding to the debt ... at some point, people could lose confidence in the US economy in a way that could actually lead to a double dip recession.*”

The *Financial Times* was not slow to point out that this warning came from Mr Obama on the day after he wound up his three-day visit to China. The paper speculated as to whether: “*His Chinese counterparts delivered stern warnings to Mr Obama about the consequences of continuing high US budget deficit spending.*”

This is a pretty safe speculation. The White House Chief of Staff quickly claimed that a plan for slashing federal deficits will be a “key component” of Mr Obama’s January 2010 State of the Union address.

### An “Interest Free” Year:

According to the latest White House estimates, the cost of servicing the US government’s funded debt this year will come in at \$US 202 Billion. That is less than the servicing cost in 2008, even though the official 2009 deficit was \$US 1.42 TRILLION and funded Treasury debt rose almost \$US 1.9 TRILLION over the fiscal year (to September 30). In fiscal 2009,

the US government’s average interest rate on new borrowing was below 1.0 percent - the lowest ever.

According to *T Rowe Price*, had the government faced the same average rates this year that it faced in fiscal 2008, their servicing costs would have more than doubled. Instead of \$US 202 Billion, the costs over 2009 would have been \$US 423 Billion - \$US 221 Billion or almost 110 percent higher.

The “savings” on servicing costs were gained by the Fed cutting its rates to ZERO in December 2008 while going on to buy more than \$US 1.5 TRILLION of Treasuries and Agencies. On top of that there was the \$US 300 Billion in quantitative easing that the Fed used between March and October 2009.

These are one-off measures. The Fed can’t cut its Funds rate any lower. Straight “quantitative easing” is officially over. And the Fed has promised to stop adding toxic sludge to its balance sheet by March 2010.

## Offsetting Bigger Debts With Smaller Interest Rates:

Over the next decade, the US government is projecting total borrowing of \$US 9 TRILLION. Next year alone, the deficit is officially projected to be \$US 1.5 TRILLION. Over the past three US fiscal years, the annual increase in Treasury funded debt has been approximately doubling every year. In 2007 it was \$US 500 Billion - in 2008 it was just over \$US 1 TRILLION - in 2009 it was about \$US 1.9 TRILLION.

Clearly, that annual doubling cannot continue. The only reason that Washington DC has been able to stay on this trajectory over the past three years is the dramatic fall in rates on Treasury paper. To see just how drastic the fall in the yield of Treasury debt has been since fiscal 2007, let's take the example of the two-year bond yield. For each of these fiscal years, we will take the highest yield and the lowest yield for the year and find the mid point by adding them together and then dividing by two.

Fiscal 2007 - high 5.02 percent - low 3.85 percent - mid point 4.43 percent

Fiscal 2008 - high 4.22 percent - low 1.35 percent - mid point 2.78 percent

Fiscal 2009 - high 1.82 percent - low 0.70 percent - mid point 1.26 percent

Fiscal 2010 - high 1.02 percent - low 0.71 percent - mid point 0.86 percent (since October 1)

On October 29, 2008, almost a month into fiscal 2009, the Fed cut its Funds rate to 1.00 percent. That equalled the low of the last great Fed rate cutting exercise in 2001-03. The Fed Funds rate was held at 1.00 percent from June 25, 2003 until June 30, 2004. Here's the record for the two-year yield then:

June 2003 - June 2004 - high 2.93 percent - low 1.27 percent - mid point 2.10 percent

That's as low as the yield on two-year Treasury paper got during the rate cutting orgy of the early 2000s. As you can see, the yield was far lower in fiscal 2009 and has been lower still over the first two months of fiscal 2010. It had to be. In late 2004, Treasury funded debt was \$US 7.5 TRILLION. Today, it is a tad over \$US 12 TRILLION. In essence, it is this progressive decline in Treasury yields over the past three and a bit years which has allowed the US government to ramp up its borrowing while holding down the servicing costs for its existing debt. That process is still going on. On November 24, the US auctioned \$US 44 Billion in two-year paper at an all time low "auction yield" of 0.802 percent.

Yields have never been this low. Government spending is at all time highs. You take it from there.

## Another "Flight To Safety"?:

Actually, there is another "flight to safety" going on, the one which has seen Gold climb to nearly \$US 1200 and regain its highs against most other world currencies, the exceptions being the currencies most favoured as the other half of the still expanding US Dollar "carry trade".

But Gold is not what the financial community means when they talk about a "flight to safety". They mean shunning all "risky" assets in favour of US Dollars and Treasury debt. The "flight to safety" argument has held firm while Treasury debt climbed from \$US 0.5 TRILLION to 12.0 TRILLION and while the trade-weighted \$US index (USDIX) plunged from 165 in early 1985 to 71.3 in early 2008.

They are still talking about it now, with the yields on short-term Treasury paper (the favoured paper in all "flights to safety") at their lowest levels in history and with the USDIX having fallen by more than 16 percent since last March. The financial community is well aware that the face value of Treasury debt paper moves in inverse ratio to the interest rate on the paper - that as rates go up the value of the paper goes DOWN. They are equally well aware that rates are at all time lows.

Yet a "flight to safety" remains a flight to the US Dollar and government debt paper. No one in government circles or in the mainstream banking community dares to contemplate anything else.

## **The World Must Be Made Safe For Debtocracy:**

That title is penned with apologies to US President Woodrow Wilson, who conceivably had something quite different in mind when he said - "*the world must be made safe for democracy*" - in the course of seeking a declaration of war from the US Congress in April 1917.

The "debtocracy" in the headline is of course first and foremost the government but also the central banks and the major banks which they service. These are the financial entities which are benefiting from current low interest rates all over the "developed" world. In the case of the US, the beneficiaries are precisely those which are vital for the survival and continuation of the debt-based system.

The key player is the government of the given nation. In today's financial world, money is completely cut off from the "real" economy because there is nothing behind it except the promises of governments to pay. In the US, the lynch pin of the global system, the amount of debt which the government "promises to pay" has been growing without a break since 1960. Over the five decades since then, the amount of debt which the US government and Treasury "promises to pay" has grown from about \$US 280 Billion to about \$US 12,000 Billion.

This \$US 12 TRILLION in US Treasury debt paper is the foundation for the global financial system. It is the form of "reserves" which the world's central banks choose to hold to underpin their own systems. This has created the world's "debtocracy" with the monarch continuing to be the US government and central bank and the aristocracy being the rest of the world's central banks. The beneficiaries of this system are the financial entities within it which are legally entitled to create "money" out of thin air.

## **The Life Blood Of the Debtocracy:**

For 50 years, not one Dollar of new debt created by the US government to fund the activities it does not wish to tax for has been repaid. The debt has simply been "re-financed" with new debt being sold to retire the existing debt. In any process of this nature, an ever larger amount of new debt has to be created simply because the old debt has created no real economic wealth while having to be serviced with interest. At an interest rate of 5 percent, interest charges on \$US 280 Billion of government debt (its size in 1960) are \$5.6 Billion. At \$US 12,000 Billion, the interest charge at a 5 percent rate is \$600 Billion.

The bigger the debt becomes, the bigger the chunk it takes out of the not-borrowed resources of government - the taxes and charges of all descriptions they collect. At present, total revenues from individual US federal income taxes come to just over \$US 900 Billion a year. An average interest rate of 7.5 percent on Treasury debt of \$US 12 TRILLION would require that ENTIRE sum in servicing costs.

In September 1981, two-year Treasury yields peaked at 16.46 percent. In March 1989, two-year yields peaked at 9.68 percent. In the middle of 2007 at the dawn of what has since become the Global Financial Crisis (GFC), two-year yields were at 5.00 percent. Today, they are less than 1.0 percent. A reversion to even the rate levels of mid 2007, let alone the much higher levels of the early and late 1980s, would instantly produce a US government debt crisis of MASSIVE proportions.

The "system" and those who derive their power and influence from it depends on the ability to issue ever higher amounts of debt. Fifty years of ever increasing government debt in the US has produced a situation in which half of all annual government spending is done by means of borrowing. When the Fed lowered its funds rate to 1.0 percent to battle the last economic downturn in the early 2000s, the rate remained there for one year - from June 2003 to June 2004. The Fed lowered its rate to ZERO percent to battle the latest economic downturn on December 16, 2008. The first anniversary of that decision to eliminate interest rates from Fed reserves borrowed by US banks is just over two weeks away.

The USDX dive on November 25 shows that the Fed's "extended period" is being stretched very thin.

## Elastic Currencies Result In Rigid Interest Rates:

On November 16, Fed Chairman Ben Bernanke gave another speech to the Economic Club of New York. He said that the “*safe haven*” (there it is again) flows into the US Dollar of late 2008 - early 2009 had abated and that the US Dollar had “*accordingly retraced its gains*”. Leaving aside the fact that the US Dollar surge of late 2008 - early 2009 was produced by a global scramble to “deleverage” (pay down or pay off \$US denominated debt), the US Dollar has certainly been retracing its gains with a vengeance.

When Mr Bernanke made his remarks on November 16, the USDIX stood at a 15 month low of 74.92. In a step unusual for a Fed Chairman, Mr Bernanke said that the US central bank would “*continue to monitor these developments closely*”. We assume the Fed is continuing to “monitor” the US Dollar, especially since the USDIX is now below that November 16 level, closing on November 25 at 74.32.

Mr Bernanke is the latest in a long line of Fed chairmen whose REAL task has been to ensure that the US Dollar stays as “elastic” as possible. They have been very successful in this task, given the fact that it now takes a Dollar to buy not much more than a penny bought when they began their task in 1913.

The problem is that as the Dollar becomes ever more “elastic” and as debts based on it spiral ever higher, the interest rates which apply to this debt must be steadily lowered - to the point where they are rigid. That point was reached for the Fed a year ago. In a sane financial system, the opposite situation prevails. The currency is rigid, being defined as a given amount of metal of fixed weight and fineness, while interest rates are set according to the individual circumstances of lender and borrower in an open market.

## Swamping The Productive:

According to the *US Debt Clock* (<http://www.usdebtclock.org>), the current US population is 308 million. Of that total population, just over 35 percent (108.7 million) are taxpayers. The rest are those who pay no net tax, government employees, dependents and those who are unemployed and/or on welfare. These percentages would be similar in any nation with a mature welfare state.

If you subtract Americans under 18 from the almost 200 million Americans who do not pay tax, the US is in a situation where many more people vote for a living than work for one. This too is an inevitable end result of any mature welfare state. The fact remains that in the US, 108 million productive people are supporting almost 200 million drones. Those same 108 million people are paying the ever increasing interest bill on the so-called “public debt”. And finally, those same 108 million people are the only REAL source of the wherewithal to eventually repay the debt. At current levels of US federal government spending, it would take a cut of more than 50 percent just to balance it - especially after the servicing costs on the existing debt are taken into account. To actually BEGIN to pay the debt would take budget cuts even bigger than that. As long as more people vote for a living than work for one in the US, that simply is NOT going to happen. A productive minority CANNOT support a non productive majority.

## Debt Repayment In Microcosm:

A recent Associated Press (AP) poll has shown that 93 percent of Americans say they will spend the same or less this year than they did last year on their holiday shopping. Worse for the “debtocracy”, 80 percent of respondents say they will do the majority of their shopping using cash. And of those who said they were going to use credit cards, 75 percent said they would pay the bill in full as it came due. US retailers don't much like this as 40 percent of their annual sales come in the month between now and Christmas.

Savings rates are up in the US. Yet nationwide data shows that the average balance on an American's credit cards is \$5,600, up from \$US 4,900 six months ago. More broadly, the AP claims that Americans on average carry \$46,000 debt in total (including mortgages). The median (half above - half below) annual income of Americans is about \$US 27,600. Clearly, even the private sector is still struggling.

## Everyone Is “Concerned”:

Ever since the BIG bailouts began with collapse of *Lehman* last year, governments around the world have been expressing their “concern” at the borrowing and spending practices of the US government with ever greater vehemence. There are three reasons for this. The first is that these governments fear that the underpinning of the entire global financial system - US Dollars and Treasury debt - is becoming unviable. The second is that they are staring at HUGE losses when the US Dollar eventually crashes. And the third reason (especially for Asian governments) is that they have chosen to inflate their currencies and financial systems in an attempt to minimise the trade disadvantage they face from a plummeting US Dollar.

Up until recently, this concern was singularly unshared by the US “authorities”. Sure, Mr Geithner made some ritual noises about a “*strong Dollar policy*”, but the actual policies were the exact reverse. During and after Mr Obama’s trip to Asia, however, the tune from Washington DC is starting to change.

“*As the economy recovers, I intend to take serious steps to reduce America’s long-term deficit*”. So said Mr Obama at the APEC meeting in Singapore. The US Treasury has said it will start to increase the maturity of its new debt so as to lock-in present low rates for as long as possible. Mr Bernanke is “monitoring” the US Dollar closely (as is almost everyone else, of course). There are plans afoot to increase tax rates on high incomes to “pay” for Mr Obama’s health plan, even though his budget director has claimed that it will add nothing to the deficit. There are also plans to increase tax rates (again on “high incomes”) to defray the rumoured troop build up in Afghanistan.

It is starting to dawn even on those in Washington DC that they can’t go on spending like this.

## It’s Not Going To Get Any Easier:

Unless the Treasury can manage to push it out into 2010, a debate on the raising of their present \$US 12.1 TRILLION debt “limit” is predicted to begin before the year is out. Right now (November 24), the Treasury’s debt “subject to limit” stands at \$US 11.96 TRILLION. The current debt limit was put in place on February 17, 2009. It raised the limit by \$US 789 Billion, almost identical with Mr Obama’s \$US 787 Billion stimulus package. Both these expedients have now all but run out of time - and money.

Other central banks have set the precedent of beginning to raise their controlling rates. India has done it. Israel has done it. Norway has done it. Australia has done it - twice - and many expect them to do it a third time in early December. The current speculation in the US media is the Fed will start to raise rates between August and October 2010 - shortly before the Congressional mid-term elections. Should they wait that long, the Fed funds rate will have remained at ZERO for almost two years.

According to the Mortgage Bankers Association, one in seven US mortgages was in foreclosure or at least one payment past due in the third quarter of 2009. This total was the highest ever seen in the survey and fully one-third of these mortgages were “prime” fixed-rate loans. Add to this the pending collapse in the commercial mortgage sector. Fannie and Freddie have already been declared “worthless”. Now, the Federal Housing Administration (FHA) is on course to join them. The FHA guarantees 20 percent of all US mortgages. Its “insurance” fund has dwindled to 0.53 percent of the total valuations of those mortgages, about one-quarter of the Congressionally mandated loan loss reserve minimum.

The tax revenues of the US states have fallen for the fourth consecutive quarter with a 10.7 percent decline in the third quarter of 2009. The Rockefeller Institute estimates that as a whole, state budget deficits will exceed \$US 350 Billion over the next two years. As *The Privateer* recently reported, most of the Obama stimulus package went directly to the state governments to help them shrink their deficits.

Zero interest rates and monstrous stimulus packages are no longer “enough”. What the US faces next year is the choice between draconian spending cuts and Mr Bernanke’s long delayed “helicopter”.



## **INSIDE THE UNITED STATES**

### **A DEAD GIVEAWAY - TAXING TO FUND WAR**

All of a sudden, Washington DC has awakened to the fact that the US taxpayer and the financial machinations of the Fed and the Treasury do not make up the unlimited money cornucopia they thought it did. The conclusive proof of this has now been given by the Chairman of the Appropriations Committee, David Obey (D-WI). Mr Obey and his Democrat colleagues - up to and including House Speaker Nancy Pelosi - are proposing a new piece of legislation entitled the "*Share The Sacrifice Act of 2010*".

A more nauseating title for a Congressional law has probably never been coined.

Central banks and government borrowing were "invented" in the first place so that a government at war could keep its citizens "onside" by NOT taxing them for the full costs of the war. The world's oldest major central bank, the Bank of England, was chartered in 1694 for the express purpose of bailing out King William III who had been running up huge debts in his wars on the continent of Europe. Every major war since has been fought as much with the printing press as with the bullet. WWI saw US government debt balloon from \$US 2 - 28 Billion. WW II saw it surge from \$US 40-260 Billion.

#### **Paying For Afghanistan:**

As you know, President Obama has been vacillating for months about how many more troops to send to Afghanistan. His budget director, Peter Orszag, has estimated that each new soldier he sends will cost \$US1 million a year. Can anyone imagine a budget director (or any other official) in the Bush Administration making such a statement in public? All of a sudden, wars cost money!

This is what prompted Mr Obey and his cohorts. They are proposing to tax the American people for the cost of how ever many additional troops Mr Obama decides to send to Afghanistan. As usual with any new tax, this is a "soak the rich" scheme. There will be three levels. The first level is for those earning less than \$150,000 per year, the second for those earning \$150,000 - \$250,000 a year and the third for those earning more than \$250,000 a year. Taxes on the first level would be increased by 1.0 percent while taxes on the two higher levels would be increased to whatever level the President deems appropriate to "fund" the war in any given year. Members of the military would be exempt, not that the tax would impact much on any members of the military doing any actual fighting in Afghanistan.

This is a near duplicate of the "soak the rich" measures being proposed to "fund" Mr Obama's health care scheme. It is also the first time for a VERY long time that taxes have been proposed specifically to fight a war. If ever there was an indication of the growing desperation for revenue in Washington, this is it.

#### **And Just What Will These Taxes Fund?:**

Mr Obama will announce his Afghanistan decision in a speech at West Point on December 1. The "consensus" is that he will ask for between 30,000 and 40,000 new troops.

Will these troops be fighting with the Afghan military or, as was the case in Vietnam, will they be fighting FOR them? Recent data released by the US Defence Department has answered that question.

In the year ending in September 2008, one out of every four combat soldiers quit the Afghan National Army (ANA). In the main, these were desertions. The rate of desertion by ANA combat soldiers has been accelerating for years. Worse, the number of combat ANA troops coming to the end of their three-year enlistment is going to accelerate rapidly over the next two years. However many US troops Mr Obama decides to send, they will not be "augmenting" Afghan troops, they will be REPLACING them.

## **INSIDE CHINA - AND JAPAN**

### **THE CHOICE FOR CHINA - AND - A JAPANESE BUNFIGHT**

During President Obama's visit to China, the topic which evoked the most speculation did not appear in the public statements by the two leaders. There was hardly any mention at all made of the fact that the Chinese monetary authorities have "pegged" the Yuan to the US Dollar since July 2008. Over the three years between July 2005 - July 2008, the Yuan rose 21 percent against the US Dollar. Over the same period, the USDX fell 10.5 percent. The Yuan is not one of the six currencies in the USDX. China's currency was rising twice as fast as the "trade-weighted" US Dollar was falling over that period.

Since July 2008, the Chinese Yuan - US Dollar exchange rate has been locked solid, similar to the situation with the Hong Kong Dollar which has "pegged" to the US Dollar for decades. Nothing has ever been said about this currency manipulation, but the Yuan - US Dollar peg has become one of the top bones of contention throughout the financial world.

Despite the post July 2008 peg, the Chinese Yuan has still risen further against the \$US than the USDX has fallen since July 2005. The Yuan is still up that 21 percent while the USDX is down 16.7 percent.

#### **To Peg Or Not To Peg:**

The Chinese can maintain their "parity" with the US Dollar only by continuing to have its central bank buy up the US Dollar earnings of its exporters and recycling them into Treasuries and other forms of \$US denominated debt. By doing so, it can certainly maintain its international competitiveness, but only at the cost of further inflating its "reserves" and remaining at the mercy of US fiscal and monetary policy.

It is the stated goal of the Chinese government and the fervently advised policy "goal" which Mr Obama has prescribed for China that the Chinese rely less on exports and more on internal consumption. China has already gone a fair way in this direction, but the problem of their excess reserves is showing up much more in reckless bank lending and even more reckless speculation on paper asset markets.

To "unpeg" the Yuan from the US Dollar, all China would have to do is to STOP recycling its trade surpluses. What Mr Obama and the US government are studiously ignoring is the fact that this recycling (by China and other Asian nations) is literally paying for the bailouts and stimulus programs which have kept the US financial and banking system AND THE US DOLLAR from imploding utterly. Without Chinese and Asian purchases of US debt paper, US interest rates would be MUCH higher than they are.

It is true that a rising Yuan would adversely affect China's huge stash of Treasuries. It is true that an end to artificially low interest rates in China would expose a lot of over and malinvestments. But the other side of the coin is lower consumer prices in China and higher rewards for genuine savers. China faces financial pain now by ditching the "peg" or much greater financial pain later by keeping it. And, of course, if the Chinese ditch their "peg", the rest of Asia will have no choice but to follow.

#### **The Financial Fracas In Japan:**

The Japanese Finance Ministry and the Bank of Japan (BoJ) are at each other's throats. The Finance Ministry is yelling that Japan has lapsed back into "deflation". The BoJ is claiming that the economy is "picking up" and that future prospects look brighter still. The bone of contention is simple. The Finance Minister of the newly-elected DPJ party is petrified that the BoJ might be considering raising Japanese rates from their present 0.1 percent level. The Japanese government is the most highly indebted nation in the world with gross debt at nearly three times GDP. Any rate rise would cripple government finances which are critical to even begin to address the election promises made by the DPJ.

## INSIDE THE EUROPEAN UNION

### **EMBATTLED ALBION - AND - ONE SMALL STEP FOR THE ECB**

On November 18, Britain's Labour government pledged to create a bill which would halve the budget deficit within four years and reduce debt every year for the next decade. This was apparently thought necessary because the "pre-budget" report from the Chancellor of the Exchequer is due out in December.

The gloss on this ambitious promise lasted about 24 hours. On November 19, it was revealed that government borrowing over the month of October was 88 times higher than it had been in October 2008. In Britain, October is the month when corporate taxes arrive in the government coffers. This HUGE year on year deficit blow out shows all too clearly how deeply the UK economy is still mired in recession.

On top of that piece of news, an OECD report predicted that even if Britain reduces its deficit "*in line with other leading nations*", it will still have the developed world's biggest deficit from now until 2017. While the usual political promises rain thick and fast, *The Privateer* has not noticed many "leading nations" actually reducing their deficits. There is certainly nothing on the horizon in Britain in that direction, especially given the fact that unlike the Fed, the Bank of England recently decided to increase its program of "quantitative easing".

Please note the ridiculous wording of the "bill" pledged by the UK government. They talk about "halving the deficit" within four years and reducing debt every year for the next decade. Halving a deficit still leaves a deficit. In order to pay down debt at all, let alone for "the next decade", a SURPLUS is required.

#### **A Very Small Step By The ECB:**

Late last year, when the GFC became acute after the *Lehman* collapse, the ECB made public their absolute determination that their payments system was NOT going to seize up as it had in the 1930s. What they were seeing then is what is being deliberately misinterpreted now as a "flight to safety" as the US Dollar suddenly started to soar and as bank lending all but halted altogether.

What the ECB and the rest of the world was actually seeing was a huge global panic to "deleverage". Everything in the way of paper assets up to and including non US sovereign debt paper was being desperately sold, the proceeds then converted to US Dollars and used to pay down outstanding debt. As US denominated debt was reduced, a genuine global DEFLATION (a decrease in the total stock of money) reared its ugly head. Europe, more than Asia or the rest of the world, understood this and took steps to circumvent it.

One of the major steps the ECB took was to drastically lower their standards determining the collateral they would accept in return for loans. By March this year, when global stock markets bottomed, the ECB was estimating that 20 percent of all collateral posted with the ECB was of a standard that the ECB would NOT have accepted before the GFC hit. This is the ECB's equivalent of the ballooning of the Fed's balance sheet since mid/late 2008.

The problem for the ECB and all other central banks is that this easing of credit standards (along with very low official interest rates) has not led to a renewed burst of bank lending. It has instead led to a global burst of speculation in the paper asset markets, notably the stock markets. On November 21, ECB President Trichet warned European banks that they risk becoming "addicted" to this "cheap liquidity".

President Trichet knows that the banks have long since become addicted, so the ECB has just announced the first small step towards getting them to quit before they go broke. Next March, the ECB will begin the process of once again tightening their standards of the credit-worthiness of paper assets they accept in return for lending to European banks. A small step, but a first indication of an end to European stimulus.



## **AUSTRALIAN REPORT**

### **A PARLIAMENT IN DISARRAY**

At present, Australia has a government but does not have a viable opposition in the Parliament. The leader of the opposition Liberal/National coalition is facing a revolt within his own party, serious enough that half a dozen (and counting) of his colleagues have resigned their shadow cabinet positions.

The catalyst for this implosion in opposition ranks is proposed legislation put forward by the Rudd Labor government named the Carbon Pollution Reduction Scheme and known within politically incorrect circles as a carbon tax. This is what *The Privateer* said about this scheme when it saw the light of day in 2008.

*A carbon tax is a tax placed on those producers and industries producing so-called greenhouse emissions. Electricity prices will increase by 40 percent by 2020 under professor Ross Garnaut's greenhouse target. Professor Garnaut states that most of these added costs would come back to the government in the form of revenue from auctioning emissions trading permits. In short, this is simply a tax grab. Professor Garnaut has said that Aussie climate change measures could lead to a fall in our GDP of 8 percent and in wages of 12 percent. Under his plan, the cost of electricity goes up while wages and the economy go down. Apparently, none of that matters."*

This legislation, with several amendments designed to make the legislation more palatable to Australian business and to the opposition, has already passed the House. It has not yet passed through the Senate, though, and that is where the whole thing has become unstuck.

Prime Minister Rudd has portrayed anyone who opposes this legislation as a neanderthal skeptic on climate change rather than a person who objects to a new tax regime imposed on Australians. Note that what was up until recently labelled global warming is now re-labelled as climate change. Inconveniently, recent research from even climate change advocates show that the globe is not in fact warming, as the recent leaked emails from "climate change scientists" at the University of East Anglia bemoaning the fact that the facts they were unearthing were not in concert with their theories make very clear.

### **The Sad State Of Modern Politics - Australian Style:**

Prime Minister Kevin Rudd likes the big stage. He was positively ecstatic when the G-20 took over from the G-7 as the "premier" gathering for global discussions on financial and economic issues. Australia would never have been part of the G-7 but it IS part of the G-20. Now, Mr Rudd is keen for more international kudos. He wants to go to the Copenhagen climate change summit on December 7 - 18 as the leader of the only government which has actually passed legislation mandating lower carbon emissions.

As little as six months ago, opposition leader Malcolm Turnbull was opposing Mr Rudd's climate change legislation on four rational bases. It would raise the costs of Australia's major exporters in the natural resources area, making them less competitive. It would, by the government's own estimates, raise almost all prices. The nation would have hobbled its economy before there was any indication that the rest of the world would follow suit. There are many ways of reducing GENUINE pollution which do not require either government subsidies, government legislation or increased government taxation.

These arguments have been abandoned. Mr Turnbull made a "deal" with Mr Rudd to pass his legislation in the Senate, fearing that not doing so would bring on an election in which his party would be roundly defeated. That deal has now been shot down by his colleagues' defection, and Mr Turnbull's hold on the leadership is fast slipping away. The only saving grace in the whole sorry mess is that there are still members of the opposition party who want to oppose this tax grab. The sad state of affairs is that most Aussie political pundits are now sure that opposition to ANY government policy is now fatal to the party which has the temerity to do it. The meat in this unsavoury sandwich, as always, is the Aussie people.

## THE GLOBAL MARKET REPORT

### **DUBAI AND THE SIGNPOSTS TOWARDS THIRD STAGE DEFLATION**

The situation with the requested “freeze” on \$US 80 Billion worth of debt by Dubai instantly became the number one topic in the mainstream financial media all over the world. We will spend as little “ink” as possible on it here. In Dubai, state-owned corporate conglomerates led by *Dubai World* and *Nakheel PJSC* announced on November 26 (conveniently Thanksgiving day in the US) that they were facing trouble in rolling over debt as it became due and needed a freeze on its debt. Dubai’s property boom had been the biggest and most reckless in the world - and its bust the most spectacular. Property prices there have already been cut in half - falling 50 percent from their peak. *UBS*, the Swiss bank, estimates that prices could fall a further 30 percent over the next 18 months.

The first tranche of debt paper, issued by the property developer *Nakheel*, was to come due on December 14. On November 27, the day after the “freeze” request, *Nakheel* bonds fell by 50 percent. *Nakheel*’s 3.17 percent “Islamic” bonds dropped on the day from 71 cents on the Dollar to 50 cents, down from their \$1.07 price a week before on November 20. The initial global reaction to this move by Dubai was a plunge in stock markets and all other forms of leveraged paper assets (including commodities and precious metals) and a so far anaemic rebound for the US Dollar. US bond yields also fell, of course. The spectre of a sovereign debt default has been raised and is roiling the financial world this weekend.

#### **The REAL Price Of The “Green Shoots”:**

In our previous issue (Number 642), we discussed the only REAL “green shoots” visible in world economies today - world stock markets since the credit freeze bottom of March 2009. The impact of the Dubai announcement was a big one-day global fall on world stock markets, on many markets the biggest since March 2009. The big falls came in the markets which had been the most favoured recipients of the deluge of new credit creation put out by banks backstopped by government guarantees. The biggest falls came in those markets which have been, in addition, the main beneficiaries of the US Dollar carry trade.

US markets were closed on November 26 and thus immune to the first and biggest reaction. On November 27, futures trading in advance of the (half day) market opening indicated a 300 plus point fall on the Dow. As things worked out, the Dow fell 285 points intraday but closed with a loss of 154 points.

It is a stone cold fact that the HUGE global stock market boom since March this year has taken its fuel from the same source as has the turnaround in economic “growth” as measured by GDP. This fuel has come from government borrowing and spending. Almost all of this borrowing and spending has been facilitated by the central bank and channelled through the major banks of the nation in question. These banks, which are all now firmly in the “too big to fail” basket, have once again happily leveraged their way towards repairing their capital by means of an orgy of speculation. On top of that, there is the US Dollar carry trade which has seen an ocean of US Dollars borrowed at low or no interest with the proceeds converted into other currencies and then plowed back into the paper markets.

Global central banks took a meat cleaver to their official interest rates in September/October 2008. By December, the Fed had eliminated its Funds rate and all other major central banks had their rates at lows not seen for at least 50 years. There was a huge deleveraging panic as debtors strove to minimise debts and build up some kind of “cash cushion”. They were met with no place to stow this cash that earned them a rate of return. Don’t forget, at the time, global stock markets were still plummeting.

As 2009 began, discontent with the level of interest rates in the REAL economy were rife. When “quantitative easing” began in March and stock markets hit their lows, the protests rose. The only way to quell these protests was to revive the prospect of investment rewards WITHIN the debt based system. The banks were bailed out, the banks piled back into the stock markets, the task was accomplished.

## Deflation In Three Stages:

In a global debt-based financial system, the total stock of money rises as new debt is borrowed and spent. This entails the unavoidable cost of servicing the ever expanding amount of debt necessary to keep the system going. There ALWAYS comes a point where the pace of new debt creation necessary to keep the system “healthy” is no longer sustainable. That point came, worldwide, between mid 2006 and mid 2007.

Suddenly, boom turns to bust. A slow down in new debt creation first shows up in the economy when the sectors of the market most dependent on it falter and then start to fall. **Stage One** of the current global deflation was ushered in by the slump in stock and real estate markets which began in late 2007.

For a year, the pullback in both stock and real estate markets was comparatively orderly. Then came *Lehman* in September 2008. Suddenly, the fall on the paper markets became a rout. Not only were paper markets of all descriptions decimated, but there was a mad global scramble to “deleverage”. In some cases it was compulsory as margin calls went out worldwide. In other cases it was voluntary as US Dollars were bought to pay down or pay off debt. In ALL cases, the shrinking debt was directly DEFLATIONARY as the amount of debt-based money shrank. This was **Stage Two** of the deflation.

The stage for **Stage Three** deflation is set when the economy literally falls out from under its government. The slowdown in productive economic activity starves the government of the revenue it needs at the same time as its spending is skyrocketing to meet the huge increase in demand for its welfare state payments AND the subsidies and debt guarantees needed to keep its banking system intact.

It is clear that the world is already IN **Stage Three** deflation. This can be seen by the spending cuts being forced on lower (municipal, city, county, state) levels of government as their revenues have plummeted. It can also be seen in the global blow-out of budget deficits by national governments everywhere.

## The First Crack In A Brittle Facade:

Dubai is a member of the United Arab Emirates which owes \$US 130 Billion to the global banking system. This, scoffs a typical “hedge fund” spokesman, is a mere pittance, the equivalent of a paltry 0.4 percent of worldwide exposure. Given that fact, total exposure worldwide is \$US 32.5 TRILLION.

This “mere pittance” has instantly caused the biggest upheaval seen on global markets since March. As legions of investment analysts everywhere have pointed out, the global sell-off is sobering proof of the brittle nature of the “confidence” which has been injected back into the system by the stock market rally.

But how was this rally generated in the first place? In the US, for example, it was generated by federal government borrowing in fiscal 2009 which was officially more than triple the amount borrowed in any previous year in US history. Some of this additional borrowing has been spent in the blowout of social welfare payments, notably unemployment benefits. Some of it (most of Mr Obama’s stimulus package) has been spent on alleviating to some extent the debt burden on the states. But most of it has gone to underpinning the financial viability of the BIG US banks. These banks are NOT lending into the US economy. They have been leveraging their reserves into the global paper (notably stock) markets in an attempt to recoup the MASSIVE losses suffered between September 2008 - March 2009.

That is why “confidence” the global market rally remains brittle. Those who have produced it know where the “money” has come from. The purpose of the stock market rally has been twofold. It has given the banks and other big financial entities a means to recoup losses and shore up balance sheets. And it has provided a facade of “prosperity” in the midst of real world economic carnage for those who have become used to equating a booming stock market with a “healthy” economy.

The global cost has been HORRENDOUS. Now, with Dubai, comes the first hint of the bill to come.

## **The Ultimate Spectre - SOVEREIGN DEBT DEFAULT:**

Every major global market slump has a rally in it, and the slump that began in late 2007 has been no exception. By March this year, almost every stock market in the world had fallen more than 50 percent. Just as in the period after the October 1929 crash, a rally was inevitable. The problem now, as was the problem then, is that the government's chosen "cure" for the original slump has been to make the situation which led to it in the first place far worse in order to buy time.

The debt generated market rally since March this year has been by far the most costly in history. To understand how costly it has been for sovereign governments everywhere, all that is required is to look at the blowout of their deficits and debts. Dubai has buckled under the pressure. And now, the speculation is rife all over the world as to who will be next.

In Japan, the government is promising to hold their annual deficit this year at levels below the record set last year. In the UK, the government is promising legislation to halve its budget deficit. In the US, there is legislation mooted in Congress to institute new taxes to fund both Mr Obama's health care program and his yet to be announced plans to increase US troop numbers in Afghanistan. In Australia, the government is pushing a new "carbon tax" as a means of meeting the anticipated need for future revenues.

Third stage deflation is when national governments go broke. More precisely, it is when they are SEEN to go broke. What has been clear throughout the global financial crisis is that the huge increase in government borrowing was not sustainable. Now, governments are talking about taxing as they spend, but there is as yet no actual talk about REDUCING sovereign debt levels. Now, Dubai must be bailed out or it WILL go broke. It almost certainly will be bailed out, but the latest precedent has been set.

### **Recent Events:**

On November 27, Asian markets were still slumping. European markets, which were not the favourite destination of those plying the global US Dollar carry trade, regained the losses sustained in early trading and most ended the day in the "black". US markets were insulated from the worst of the effects since they were shut on November 26 and opened for a half-day session on November 27. Now, the world awaits news of whether and when there is to be an official "bailout" for Dubai.

Most notable was the effect on ALL world markets of the possible debt default of one small nation owing, according to the "hedge fund" spokesman already referred to, a comparative pittance. Most dangerous was the crack in the only facade of "business as usual" left standing as stock markets slumped.

### **Gold:**

For MUCH more on Gold - please see Gold This Week (GTW):  
<http://www.the-privateer.com/subs/goldcomm/gold.html>

### **What's Next?:**

On December 1, President Obama announces his plans for Afghanistan, possibly including a mention of how they are going to be paid for. Two days later, Mr Obama convenes a domestic US "summit" to discuss unemployment. As was demonstrated so tragically in the 1930s, there is nothing so potentially devastating to the REAL economy as desperate government measures to "fight" unemployment.

Meanwhile on world markets, the real impact (or lack of same) of the Dubai default will be revealed.