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GLOBAL REPORT

JUNKING THE SYSTEM

In the annals of famous quotes about political economy, few have been more succinct and to the point than Ringo Starr's famous utterance:
"Everything the government touches turns to s**t!"

Right now, an unholy combination of government potentates, bankers (central and otherwise), mainstream analysts and (last but far from least) ratings agencies is once again proving the truth of that statement. The problem is that they are doing it in such a way that the potential consequences are far beyond anything that Mr Starr could have imagined when he gave vent to that quote decades ago. The focal point of it all is the insistence by the (US) ratings agencies that any Greek bailout which involves a downgrading of the capital value of their sovereign debt paper will be deemed a "default". Why? To quote *Moody's* take on the subject: *"We take the view that the exchange or similar restructuring will result in investors receiving less value than the promise of the original securities."*

There is a problem with this interpretation. In the history of government issued debt, there has NEVER been an instance where the "investors" who held this paper did NOT end up *"receiving less value than the promise of the original securities"*. By the nature of the instrument, no other outcome is possible. Franz Pick put it this way - government debt instruments are - *"certificates of guaranteed confiscation."*

We Rate It - It's Paper:

Like so many of the structures cobbled together as a backstop for DEBT-based "money", the credit ratings agencies came to prominence in the US. In their present form, they are wholly a child of the post-1971 global fiat money era based on the US Dollar as the "reserve" currency.

In 1975 the US Securities and Exchange Commission (SEC) cast their seal of approval over what they called the Nationally Recognized Statistical Rating Organization (NRSRO). Thus, the credit ratings agencies which then existed were elevated to a status where other US financial firms were

permitted to use their ratings - and ONLY their ratings - for *"certain regulatory purposes"*. Originally, there were seven such agencies, including the present big three. By 1993, the number had dwindled to three - *Moody's*, *Standard & Poor's* and *Fitch*. Today, there are ten agencies but nobody has heard of the other seven, the "big three" still rule the roost.

These "big three" ratings agencies have been "officially" rating debt paper - including debt paper issued by governments - since the mid 1970s. Over that period, they have watched HUGE swathes of the paper they rate fall to values *"below the promise of the original securities"*. In many cases, they have watched them become worthless. All of a sudden, they have turned over a new leaf. Why?

In Government We Trust:

If there is one thing above all others which has entrenched the steady growth of government power all over the world in the fiat currency era, it is the universal dependence on government debt paper as the “safest” investment in the world. This attitude has an extensive history, of course, and long predates the fiat currency era. In the nineteenth century in England, for example, when someone said “*I have 500 pounds a year*”, he “got” that amount in interest (and rents) on his investments. Outside land, the major investment was in “gilts” - the bonds of the British government.

In the era of Gold as money, this debt paper was looked upon as being “perpetual”. Nobody worried about the government repaying the debt. That was taken for granted. All they were concerned with was the government’s continuing ability to service it. Two other things were taken for granted. One was that the money lent to the government would retain its purchasing power over a long period of time. The other was that both interest and principal would be maintained - and paid - IN GOLD.

World War I ended both those assumptions in Europe. The aftermath of the 1929 crash ended them in the US and all over the world. Neither have ever resurfaced. But the trap did not snap completely shut until the last vestige of a Gold connection to the money in circulation was extinguished on August 15, 1971.

That was 40 years ago. For the past two generations, the world has lived with a financial system which is ENTIRELY composed of promises to pay. The “reserve” at the base of this pyramid of debt is the promises to pay of government, aka sovereign debt. And the “reserve” under this sovereign debt is the sovereign debt of the issuer of the reserve currency - the debt paper issued by the US Treasury.

Not one penny of US Treasury debt has been repaid for 51 years - the last time that US government funded debt actually decreased on a year-to-year basis was 1960. Ninety-seven percent of today’s funded Treasury debt total has been accumulated since August 1971. Sixty percent of it has been added in the past decade. Forty percent of it has been added since the first signs of the GFC emerged in early 2007.

This debt is universally looked upon as the “safest” investment in the world. No matter what happens in the financial world, there is always the “flight to quality” to fall back on. To repudiate this monstrous fallacy would be to repudiate the “bedrock” upon which the entire financial system, up to and including the medium of exchange itself, is based. If “confidence” in government debt is lost, the jig is up.

The risks now being taken by the (US based) ratings agencies are monumental. By insisting that the chances are rapidly increasing that the sovereign debt of a growing number of nations might end up worthless, they are risking a loss of confidence in ALL sovereign debt. Why are they doing it? To deflect attention from the growing cracks in the base of the structure - US Treasury debt itself.

Keeping The Home Fires Burning:

In late 2009, the ratings agencies started to warn about debt levels in peripheral Europe and then began to downgrade their ratings on the sovereign debt of the “PIIGS” (Portugal, Ireland, Italy, Greece, Spain). They knew full well what would happen. They knew that interest rates on the sovereign debt of these nations would rise. They knew that the global “recovery” so ballyhooed in the mainstream media at the time would pass these nations by because they would not be able to fund their deficits at rates they could afford. They knew that inevitably, the European Union would have to step in with bailouts. They knew that these bailouts would only delay the inevitable. And finally, they knew that the “*European debt crisis*” would call the future viability of the Euro itself into question. They were right on all counts.

The ratings agencies have downgraded peripheral European sovereign debt to junk and are now casting a jaundiced eye on almost every nation outside the US - including China. They are even threatening to downgrade Treasury paper - unless the US government gives itself permission to go on borrowing more.

Can't Borrow - Can't "Grow":

The most laughable aspect of the entire mess in Greece is the wringing of hands in the mainstream financial media wondering how on earth Greece (or Portugal, Italy, Ireland, Spain et al) can avoid defaulting on its debt when the economy can't "grow". How in the world can an economy grow when the government cannot borrow the wherewithal to make it grow? Greece cannot afford to keep its borrowing stable, let alone increase it. The ratings agencies and the financial markets have seen to that. Greece cannot devalue its debts away. Its use of the Euro as its national currency has seen to that. Greece can't afford to take a meat axe to its spending because half the population works directly or indirectly for the government. It truly is a sad situation but there is nothing "new" about it. Governments have been borrowing and spending themselves into a similar hole for many decades.

The ratings agencies have said that they will view any "rescheduling" of Greek debt as being the same as a default. If the same restrictions had been placed on similar instances in the past, the fiat currency era would not have made it past its first decade. Mexico would never have made it through its 1982 crisis. In the late 1980s, Latin America as a whole would have collapsed had it not been for the invention of "Brady Bonds" which converted unrepayable Latin American sovereign debt into "tradeable instruments" which the (mostly US) creditor banks could get off their balance sheets. Then there was the Russian default of 1998 and the Argentinian collapse of 2000-2001. All of these were literally papered over without a murmur of protest from the ratings agencies.

The rationale which has always stood at the base of arguments in favour of a central bank is that economic growth is a function of an increase in the "supply" of money. The Fed was born out of the professed need for an "elastic" currency. An "elastic" currency redeemable in Gold is not impossible - the ratio between the gold and the paper can always be changed - but it is difficult. The "solution" is to ban Gold from the system altogether. Once that has been done, the only "substitute" is government debt paper. With this "sovereign debt" now underpinning the system, the assumption is that if government cannot go on increasing its borrowing, the nation it governs cannot continue to "grow".

That assumption has not been challenged since the mid-1982 Mexican bailout and the start of the great global paper asset boom. That is why government debt is everywhere out of control and everywhere unsustainable. The assumption is being challenged today - everywhere EXCEPT the US.

Assumptions For Greece - Assumptions For The US:

"How can a nation of 11 million people expect to pay off a government debt amounting to 475 Billion Euros?" We have read variations on this question many times in the mainstream financial media. We have yet to read this question: *"How can a nation of 310 million people expect to pay off a (funded) government debt amounting to \$US 14.5 TRILLION?"* If you do the arithmetic you will see the ratio of debt to population is slightly lower in Greece than it is in the US.

Over the past eighteen months, the average servicing costs of existing Greek sovereign debt have at least quintupled. Greek debt as a percentage of Greek GDP is rising fast. Why? Because Greek government borrowing (a component of any nation's GDP) is being constrained by the blowout in yields. Greece is held to be a basket case facing the inevitability of default because they cannot devalue their currency.

Since the early 1980s, the average Fed Funds rate has been 5.7 percent. Since the end of 2008, it has been 0.00 percent. In their projected deficits between now and 2020, the Obama administration assumes a rate of 2.5 percent. A return to the average rate would add \$US 4.9 TRILLION to the deficits. Further, the size of the deficits depend on an assumption of annual growth rates averaging 4.2 percent over the next three years. A normal growth rate of 2.5 percent would blow out the deficits by another \$US 4 TRILLION by 2020. The US CAN devalue its currency and has been doing so for ten years. It is held to be solvent because it CAN raise its debt "limit". Greece can't do either. That's the only difference.

A “Balanced Budget Amendment?”:

Rand Paul, a Republican Senator from Kentucky and son of Ron Paul, has announced that a group of US Senators will propose tying any increase in the Treasury’s debt limit to the passage of a balanced budget amendment. There are as yet no details as to the time frame in which the budget is to be “balanced”. Nor is there any recognition of the fact that the passage of such an amendment would require a “yes” vote of two-thirds in both houses of the US Congress.

It is generally conceded by both sides of the debate over the raising of the debt limit that the US government is now borrowing somewhere between 40-45 cents of every Dollar it spends. This being the case, a truly balanced budget would require the US government to cut their spending almost in half or to almost double their tax take or to find some mixture of the two which did the job.

Let’s assume that the US government actually did that. First, such an act of political bravery would not cut already existing Treasury debt at all, it would merely stop it from expanding further. The short-term cost to the US economy would be beyond excruciating. Over the past three completed fiscal years (fiscal 2008 - 2010), the funded debt of the US Treasury grew by an average of just over \$US 1.5 TRILLION a year. This is more than three times the record annual debt increase in any previous year in US history.

This unprecedented borrowing binge has resuscitated the US paper markets but has done NOTHING for the US economy. Nor has it done much more for US economic “growth” other than to compensate for the banks which are not lending and the US public which is not borrowing. To go from annual government debt increases of \$US 1.5 TRILLION to annual increases of \$US 0.00 would propel the US into an instant and savage economic implosion. Greece is not the only nation which cannot grow unless it can borrow. The US is in exactly the same position. Like that of any other nation, the US economy is geared to and dependent on borrowing and spending. That borrowing and spending has dried up and/or is drying up in the “private” sector. Since the US Fed dropped its controlling interest rates to effectively zero at the end of 2008, the global economy has become dependent on government spending just to stand still.

Were this borrowing to cease, as it would have to under a balanced budget amendment, this precarious “equilibrium” would be instantly shattered. When unsustainable and unrepayable debt is the foundation of a global system of finance, no other outcome is possible. There is no escape from this. The only solution is to change the system - right down at the root - at the level of money itself.

Getting Out From Under:

The Global Financial Crisis (GFC) is said to have been precipitated by the *Lehman* failure in 2008 which froze inter-bank lending on a global basis and almost brought down the system. It is said to have been prevented by a massive and global increase in new money creation. In reality, had economic nature been left alone to take its course, there is a good chance that the world would be fast emerging from its financial black hole by now. At a minimum, most of the malinvestments would have been discounted to the point where they would no longer act as a dead weight on future savings and investment.

Economic “miracles” (so-called) have happened before. The US emerged from a deep recession in 1920-21 because the government and the central bank did NOT interfere. Germany emerged from the actual physical rubble of WW II for exactly the same reason. So, to a lesser extent, did Japan. In all these cases, debts which could not be repaid were not held on life support by central banks, they were written off. In all these cases, creditors took very severe “haircuts” indeed while many debtors literally had to start again from scratch. In all these cases, the LACK of government impediments or government largesse meant that a recovery took place in a much shorter time frame than would otherwise have been the case.

Economic distortions today are HUGELY bigger than they were then. That means that the recession will be deeper and the recovery phase possibly longer. But until it is allowed to begin, there is no way out.

The Forgotten Concept - A Medium Of EXCHANGE:

In the 40 years since the beginning of the global debt-backed monetary system, world population has increased from 3.8 to 7.2 billion people. Today, a far larger proportion of the world's population is able to feed, clothe and house itself at a level at least approaching comfort than was the case 40 years ago. To speak of a "consumer society" in China, India, Russia or many other places in 1971 was laughable. That is not the case today. There is still a HUGE amount of real wealth in the world, more than there was on a global per capita basis back then. The problem is not a lack of wealth, it is the lack of a sustainable means by which that wealth can be exchanged in the marketplace.

Every scarce resource in the world has an economic value. That value does not reside inside the economic good, it is discovered in the process of exchanging economic goods in the marketplace and differs with every person active in the marketplace. Exchange can be done through barter or through the use of a medium of exchange - a money. Where money is used, prices evolve. Whether money is used or not - at some exchange ratio between goods or at some price - all markets clear. There are no exceptions.

When a medium of exchange is NOT someone's liability, it retains its utility in exchange and thus retains its purchasing power. When a medium of exchange IS someone's liability, it does neither of these things. A money based on a government's power to FORCE its use in EXCHANGE is a grotesque contradiction in terms. Where force begins, exchange ends. So do markets, freedom, prosperity and confidence in the future. And so, over time, does any form of financial system underpinned by FIAT money.

The fact that modern money comes into existence as a debt is well known. The fact that this form of forced money creation is unsustainable is now becoming too obvious to ignore much longer. Today, the situation has become desperate for the global financial powers that be. The best measure of their desperation is that "some" nations are being held to this hard truth in the hope that this will distract us from the realization that ALL nations are in the same boat. Sink Greece and its equivalents so that the rest of us can keep swimming is the order of the day.

The problem is that government control comes from the acceptance of government coercion. And at the root, this coercion is "financed" by imposing a medium of EXCHANGE by force. It can't work. It won't work. It has never worked. It will never work. No "solution" to the present crisis is possible unless and until money is returned to its vital function of facilitating exchanges between the owners of wealth.

Junking Sovereign Debt:

Greek sovereign debt was reduced to "junk" status way back in April 2010. On July 5, *Moody's* widened the net of the ratings agencies by lowering Portuguese sovereign debt to junk. According to a New York fund manager, this is "*a reminder that the sovereign debt crisis does not end with Greece and that risks remain with other nations.*" Which "*other nations*"? The fund manager does not say.

This has ignited an instant response from Europe (more on that in our *Inside The European Union* page) and beyond, labelling *Moody's* downgrade - "*an act of financial vandalism*". *Standard & Poor's* has stood up for its colleague with the amazing statement that the importance of the "big three" ratings agencies comes from - "*the fact that they have proven to be accurate in their ratings issued over many years.*" *Moody's* response was more to the point - saying that it had little choice once EU leaders began to insist on "burden sharing" for private holders of Greek debt.

Here we come to the crux of the matter. The financial system is underpinned by sovereign debt paper and nothing but sovereign debt paper. To endanger the perceived "risk free status" of this paper is to threaten the underpinnings of the whole structure. That is what the US and its "ratings agencies" see Europe as doing. This is why the risks of these downgrades have been taken - they are now willing to sacrifice the periphery to save the centre - US Treasury debt and the US Dollar. They are buying very expensive time.

INSIDE THE UNITED STATES

AHA - IT'S UNCONSTITUTIONAL!

On July 6, President Obama went online to take questions from all sides on the ongoing debate over whether and how much to raise the present Treasury debt limit. He confidently proclaimed that Congress and the White House can make a deal within the next week or two. And what if they can't? Well, Mr Obama did not rule out using the 14th Amendment to the US Constitution to force a debt limit rise. But he downplayed that, saying the issue should never become a Constitutional question.

What is the 14th Amendment? It was enacted in July 1868 as one of the three "Reconstruction Amendments" passed by Congress in the wake of the US Civil War. The Amendment has four sections. The one relevant to Mr Obama's comment is the fourth section - which begins like this: "***The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned.***"

Mr Obama is taking the first and last clause in that sentence and ignoring the stuff in the middle - ***THE VALIDITY OF THE PUBLIC DEBT OF THE UNITED STATES SHALL NOT BE QUESTIONED!*** As President, Mr Obama took an oath to "preserve, protect and defend the Constitution of the United States of America! Clearly, he can not stand idly by while members of the US Congress question the validity of the public debt of the United States by refusing to pass an increase in the Treasury's debt limit or by putting any conditions on the size of that increase. That would be UNCONSTITUTIONAL!

Actually, this "idea" has been floating around inside the Obama administration and the Democrats in Congress for a while. On May 25, just over a week after Treasury debt was frozen at the present \$US 14.29 TRILLION limit, Treasury Secretary Geithner was asked about the debt limit debate and possible default. He responded as follows:

"I think there are some people who are pretending not to understand it, who think there's leverage for them in threatening a default. I don't understand it as a negotiating position. I mean really think about it, you're going to say that-- can I read you the Fourteenth Amendment?"

There's A Precedent Too!!:

Mr Geithner went even further in suggesting that the President could override Congress and simply enforce an increase in the debt limit by edict. He cited a precedent for the use of the 14th Amendment going back to 1935 and what have come to be known as the "*Gold Clause*" cases. These were cases brought by holders of Treasury bonds issued prior to 1933 which stated that all principal and interest would be paid "*In United States gold coin of the present standard and value*".

When these bonds were issued by the Treasury, their value was based on a US Dollar legally redeemable in Gold at a ratio of \$US 20.67 per ounce. In 1934, the first Roosevelt Administration passed the "Gold Reserve Act". Amongst its other provisions, this act nullified the "Gold clause" on existing Treasury debt, made the possession of Gold illegal for American citizens, and raised the now non-redeemable (except by foreign governments and central bankers) US Dollar ratio to \$US 35 per ounce of Gold.

In three famous cases in 1935, private holders of pre-1933 Treasury debt paper now maturing demanded payment in Gold coin at the ratio (\$US 20.67 per ounce) stated on the bond. All three of the cases lost. In at least one of them, the Supreme Court found the abrogation of the Gold clause on Treasury debt unconstitutional but refused to confirm the right of the holder to the payment stipulated by the clause. This would be illegal, said the Supreme Court, because Congress has made Gold ownership illegal.

Clearly, NOBODY can be allowed to challenge the "validity" of US Treasuries - then - OR NOW!

INSIDE CHINA - AND ASIA

NOT PLAYING BY THE "RULES"

In the course of his visit to Europe late last month, Chinese Premier Wen Jiabao let it be known that China's latest plans are to stimulate domestic demand and reduce its foreign trade surplus as a means to progress towards what he termed "balanced growth". Wen was especially insistent on reducing China's reliance on exports to fuel its economy. China can see the financial writing on the wall in both Europe and the US. The government knows that the wherewithal to go on "absorbing" Chinese consumer goods is wearing thin. They also know that their days of converting the currencies they receive in return into the debt paper of the nations which print them cannot go on much longer without stark risks of huge losses.

The orthodox method of stimulating domestic demand, revered in the hallowed halls of Western financial "management" for many decades, is for the central bank to lower rates. That makes borrowing easier and cheaper and entices more people to CONSUME!

So what did the Bank of China do on July 6? It RAISED its controlling interest rates for the third time this year. The reason given for this rate rise was even more at odds with orthodox financial attitudes. While China is concerned that raising rates "too far" might encourage more speculative capital into the country, it is even more concerned that its own citizens are struggling with negative real rates on their bank deposits despite the rises so far this year.

In short, China acknowledges that its currency is losing purchasing power faster than the rates which it allows banks to pay their depositors are rising. This is in stark contrast with the attitude in the West (and in Japan), particularly in the US and the UK where deposit rates are non-existent while purchasing power is plummeting. Of course, the financial powers that be in the US and the UK know that their "subjects" have no savings anyway and they don't want to encourage any because that would lower "growth" even further. In China, the financial powers that be know that their subjects have HUGE amounts of savings and are very worried that they might pull them out of the banks and start chasing yields in the markets.

Western "consumers" made that switch two decades ago. China doesn't want Chinese consumers to follow suit. So they are trying to damp down price rises while at the same time increasing the reward for saving. And how is this supposed to aid in "stimulating domestic demand"? Well, China knows that it cannot keep shipping real goods out of the country in return for government "IOUs" much longer. Their hope is that if they can give their people a domestic market in which the currency appears to hold its purchasing power they can stimulate more purchasing.

That's the way it used to work in the days when currencies DID hold their purchasing power. The problem for Mr Wen and the Chinese government is they still "back" the Yuan with other peoples' debt. Until that practice ends, the Chinese currency is just as vulnerable as all the others in the world.

And Speaking Of Vulnerable Currencies:

The Union Bank of Switzerland (UBS) recently conducted a survey among central bank reserve managers who, between them, control more than \$US 8 TRILLION in foreign exchange reserves. More than half the managers polled predicted that the US Dollar would lose its global reserve status - within 25 years.

The UBS conducts this survey annually. This is the first time that those polled have put a "time limit" on global US Dollar reserve status. The identities of the managers polled were not revealed and their responses were not "weighted" according to the amount of "assets" they controlled. Since Asia is by far the largest holder of reserve assets, it is a safe bet that Asian responses were included. On the surface, 25 years is a long time. But it's a lot shorter than the responses of previous years which were - in effect - never. In financial circles, once a "time horizon" has been set, it tends to shorten very quickly.

INSIDE THE EUROPEAN UNION

COULD ANYTHING BE CLEARER?

On June 29, amid rioting in the streets in Athens, the Greek government voted in favour of the even more “austere” plan demanded by the European Union (EU) and the IMF as a pre-requisite for having Greek sovereign debt protected from roll-over costs that neither they nor any other major nation in the world could pay. While the Greek people rioted, global markets celebrated. Yields on Greek debt paper on the secondary markets plummeted as did the yields of other suspect European nations like Portugal and Ireland. The “risk on” trade is on again. In the US, celebrations included a \$US 20 dive in the Gold price on July 1 as US markets “prepared” for their holiday weekend.

The Greek government had done its part, it had voted “YES”. The Greek people had done their part. They had held the obligatory “riot” in Athens, thereby illustrating that the “austerity” measures that their government had just passed were the real thing! The paper markets had done their part, they had rebounded very satisfactorily. But the EU was refusing to do its part.

The EU - specifically the relatively more solvent governments of such nations as Germany, Holland and Austria - were still insisting that this bailout should not be “underwritten” solely by European taxpayers. They had and have the temerity to point out that these European taxpayers were not the ones who bought the debt and therefore should not be held ultimately responsible for servicing it and ultimately repaying it. They wanted those who DID buy the debt to bear some of the expense of keeping it from collapsing.

This is NOT the way it is “supposed” to work. After all, the US government did not save the financial world in late 2008 by forcing those who held mortgage based securities to take a hit. The US central bank simply took the sludge onto its balance sheet by paying the holders 100 cents on the Dollar. Surely these recalcitrant European governments can see that this “works”? Surely they can see that it is the only way to stave off financial Armageddon? And it’s true - this is the only way to STAVE OFF Armageddon.

The problem is, the longer you stave it off, the bigger the Armageddon is when it finally hits.

The European governments in question, even the more profligate ones, know this. That is why they have been trying to implement “austerity” programs for more than two years now. That is why the European central bank raised its controlling rates for the second time in three months on July 7. Europeans know that it is impossible to print one’s way to “prosperity”. They have centuries of history to prove it.

A Tragic Mess:

The US ratings agencies have made it clear that they will rule the Greek government in default on its debt if the EU rescue plan includes any provision to make the debt holders bear some of the cost of a bailout. This brings into stark relief the fundamental reason why government debt has been seen for so long as the world’s “safest investment”. Sovereign debt holders have always had “faith” that governments would always be able to make good their “credit” on the backs of their taxpayers. The entire global system of debt-backed money rests on that assumption. The old “*we owe it to ourselves*” argument is here exposed in all its transparent hypocrisy. The “*we*” are the ones who own the debt paper. The “*ourselves*” are the ones who are expected to service and repay it, no matter how many generations that might take. And the “*ourselves*” in question - the present and future taxpayers - have deluded themselves that the benefits they get in the way of government handouts and welfare outweigh the costs. That has been easy to do since the cost keeps getting fobbed off to future generations. At least it did - until now.

Every government, including the European governments, has waxed fat on this delusion. Of late, some of the European governments have begun to very gingerly suggest that this cozy arrangement might actually not last too much longer. But they haven’t tried hard enough and have left it MUCH too late.

AUSTRALIAN REPORT

DISGUISED STIMULUS - AND - SHRINKING THE MONEY SUPPLY

While Americans were enjoying their July 4 picnics, the Aussie financial media was wondering what had happened to their glowing expectations about the future of the economy. Their latest “surprise” was the release of retail spending figures for May. Retail sales across the Aussie economy dropped by 0.6 percent - the biggest month on month fall since October last year. They had expected a 0.3 percent increase. Much worse, new housing approvals fell by 7.9 percent in May. They had expected a 0.7 percent drop.

This is the same Aussie financial media which has been printing stories about Australians buckling under the huge rise in their cost of living for months. They have reported double digit percentage increases in the price Aussies pay for government “services” of all descriptions. They have bemoaned the soaring utility bills faced by Aussie households. They have reported 16-20 percent rises over a two-year period in a typical “basket of food” bought from the supermarket. They have reported more double digit rises in prices of all descriptions which are expected over the year to come.

Yet they professed “surprise” at the sudden dive in Aussie retail spending!?! Why? Because the Reserve Bank of Australia (RBA) hasn’t raised its official rates since last November. Surely Aussies can afford to borrow more? Many of them surely can. But they have decided not to. Hence the slump in retail sales.

The Government Doesn’t Like It:

According to all the polls, were an election to be held now in Australia, the governing (by the skin of their teeth) Labor party in Canberra would be decimated. In such a situation, one would expect the government to shy away to the extent they can from the announced policies which are most responsible for their plummeting popularity in the polls. The single issue which has been most responsible for Labor’s fall from electoral grace has been their plan to introduce a “carbon tax”, even though Prime Minister Gillard stated clearly that her government would NOT do so if they were elected.

But the Labor government is NOT backing away from their carbon tax. They now have the means to pass it because their “allies” the Greens, took over the balance of power in the Aussie Senate on July 1. Prime Minister Gillard is busy telling the Australian people that there is “nothing to fear” from a new take on the age-old government practice of taking with one hand so that they can “give” with the other.

The first to feel the cold hand of government “largesse” will be the pensioners, who will apparently be getting an extra \$A 210 in the first year of the tax. Then there are the Aussie families. Ms Gillard has pledged to give some monetary “compensation” for the effects of the tax to 9 out of 10 of them. “*We’ll look after the families, we’ll look after the battlers. We’ll look after the pensioners*”, she says.

Should the carbon tax pass, and it almost certainly will, it will not go away. It will of course do absolutely nothing whatsoever to alter the amount of carbon generated, but this is not its purpose. Its purpose is threefold. First, it is a new source of revenue for the government. On whatever pretext it is levied, a new tax is almost never repealed and is almost always increased over time. Second, it is in the short-term a form of “stealth stimulus program” because of all the “compensation”. And therefore third, the government fervently hopes that at least in the short-term, it might be a sorely needed vote getter.

Another Coin Bites The Dust?:

Back in 1990, the Australian government “shrunk the money supply” by removing all one and two cent coins from circulation. Now, the Australian Mint is calling for all five cent coins to be scrapped because of the cost of minting them. The government is “considering” it. Remember the old song - *Brother can you spare a dime?* Aussies had better remember it. There will soon be nothing less to “spare”.

GLOBAL MARKET REPORT

DEBT - WHERE IS THY STING?

QE 2 may be officially over, but the Fed has not stopped monetising Treasury debt paper. As of the week ending on July 6 - the first "post QE2" week, the Fed's balance sheet hit yet another record high. As a whole, the balance sheet was \$US 2.854 TRILLION of which \$US 1.625 TRILLION was Treasury paper.

According to *CNNMoney*, over the life of QE2, the Fed bought \$US 250 Billion in Treasuries in addition to the headline \$US 600 Billion program by means of reinvesting the principle of other "assets" in its balance sheet that matured. This process is to continue, as Mr Bernanke made very clear at the press conference after the June 22-23 FOMC meeting. According to one US bond trader - "*For the foreseeable future, the Fed will have to maintain an accommodative stance. It's the only game in town.*"

Actually, it is only half of "*the only game in town*". The other half is taking place in Washington DC where the two supposed sides of US politics are locked in an arm wrestle to determine the size of the Treasury's new credit card limit and under what circumstances that limit is to be increased.

QE2 supposedly had a "time limit" of June 30, 2011. In reality, it had no such thing. The Fed is going to go right on buying US government debt paper. The only thing which has changed now that we have hit July is that the Fed will not be buying as much of it - unless and until QE3 is unleashed. The new Treasury debt limit supposedly has a time limit on it too. Actually, there are two of them. One is August 2, the date on which Treasury Secretary Geithner has said that he runs out of ways to keep the debt under the current limit. The other is July 22, after which Congress says that it won't have time to pass the legislation through both Houses and get it signed by Mr Obama before August 2.

The notion of "risk free debt" is coming under pressure like never before. Yet so far, the paper markets in the US and throughout most of the world are blithely oblivious to it all. They cannot conceive of a situation in which the US government would NOT give itself permission to go on borrowing. And they cannot conceive of a situation in which this permission is all that is required to keep the debt "risk free".

Getting Back To A "Supportable" Level:

As almost anyone who makes a living on Wall Street would freely and cheerfully acknowledge, the vast majority of their "investable funds" are now coming from the US government and its central bank. In fact, few would argue with the assertion of the bond trader that the Fed is now "*the only game in town*". At the end of June, it was reported that over the month, US institutions pulled out of US "prime market funds" at the fastest pace in well over a year. Funds that are "eligible" to buy US corporate debt saw withdrawals of over 10 percent of their capital during the last two weeks of June. All of this money was switched to funds that invest ONLY in US government-backed "securities" - the "risk free" stuff.

Pimco made headlines earlier this year by declaring that it was getting rid of its US Treasuries. Some even suspected it was actively selling US Treasury debt short. But this caution has definitely not rubbed off on the rest of the US investment community. Yields on shorter-term (two years or less) Treasury paper are still all but non-existent. And the last week of official QE2 Fed Treasury buying - June 27 to July 1 - saw one of the biggest rises this year on US stock markets. The complacency is striking.

Both sides in Washington are talking about making a "deal" to get the increase in government debt back to a "supportable" level. On July 10, the deficit reduction package was fixed at 2 TRILLION over a decade in return for a \$US 2.4 debt limit hike to last the Treasury until November 2012. That implies that the Treasury needs \$US 2.4 TRILLION in new borrowing limits to keep going for the next 15 months. Over a decade, that comes to a figure of almost \$US 20 TRILLION - ten times the proposed deficit reduction. This is the modern definition of "solvency" in US political AND financial circles.

Do It - Or Have It Done For You:

On June 26, the Bank for International Settlements (BIS) - the central bankers' central bank - came out with its annual report. Prominent in this report was the insistence of the BIS that major central banks MUST raise their controlling interest rates to avoid high inflation becoming "entrenched". The BIS warned that of the four "major central banks" - the Fed, the ECB, the Bank of England and the Bank of Japan - the ECB is the only one to have raised its rates since the *Lehman* crisis of September 2008. That remains the case, although the ECB has now raised twice since April 13, 2011.

The great risk, says the BIS, is that "*long-term inflation expectations will start to climb.*" Given the HUGE increase in government debt issuance all over the world and the fact that this government debt is the foundation of the global monetary system, this statement is fatuous in the extreme. This government debt issuance IS inflation, it is the highest powered inflation there is. It facilitates the growth of the global stock of money in more direct a way than any other government action could.

The BIS is not talking about inflation expectations, they are talking about an entrenched fear of rising prices for goods and services. That is the central banker's definition of "inflation". The problem is that rising prices are the flip side of the FALLING purchasing power of money. As this becomes more apparent, so does the pressure on interest rates - including the interest rates on sovereign debt paper. Once it becomes clear to enough potential "investors" that price rises are not as "transitory" as Mr Bernanke and Bank of England chief Mervyn King keep insisting they are, interest rates will rise. Given the sheer size of the debt creation over the past three years, the potential for an explosive rise is huge. What the European PIIGS now face is what lies in wait for ALL nations whose governments and central banks refuse to budge from their "accommodative stance" on official interest rates.

So far, the only "major central bank" which has taken ANY steps to defuse this potential situation is the ECB in Europe. The longer the other central banks delay, the higher the risk that the "markets" will make the decision for them. That is the real fear of the BIS and the reason why they state in their report that - "*the current ability of the US to easily finance its deficit cannot be taken for granted.*"

Tell that to Wall Street and the other major markets for paper assets. They've been taking it for granted for more than half a century. And old habits of entrenched thought die hard.

"Recovery" Is Slapped In The Face:

In our *Australian Report* in this issue, we talked about the "surprise" of the Aussie media and investment community at the latest report on plummeting retail sales. That "surprise" vanished right off the radar in comparison to the outright shock when the US Labor Department released its latest employment figures on July 8. The June unemployment rate rose to 9.2 percent from the May rate of 9.1 percent. US "jobs growth" was a ridiculous 18,000 over the month, a full 83 percent below the average "expectations" of those who the US mainstream media rely on to predict such things.

Among other things, this "shocking" employment report instantly spawned conjecture of not whether but WHEN the Fed would embark on QE3. Naturally, President Obama and his Democratic leaders in Congress immediately blamed the numbers on the impasse over the Treasury's new debt limit. Mr Obama claimed that once the debt limit deal was done, US businesses would have the "confidence" to start hiring again. Congressional Democrats immediately demanded that economic "stimulus" be added to the deal over the Treasury's new debt limit.

The end of the second quarter of 2011 marks the second anniversary of the official emergence of the US economy from "recession". After two years of "recovery", there obviously is no recovery at all. While Washington DC is fighting tooth and nail to prevent that realisation from dawning on the American people, Wall Street remains oblivious. As long as the money keeps getting created, they are happy.

First It “Stings” - Then It HURTS!:

Since the end of April, the political and financial establishment have been resorting to ever more blatant measures to keep the eyes of their subjects off the main game. At the end of April there was the sudden announcement of the death of Osama bin Laden. The effect of that has long since died without a trace. Then in mid May as the Treasury hit its limit there was the “sting” operation which forced Dominique Strauss-Kahn out of his position as head of the IMF. The case against Mr Strauss-Kahn has now fallen in a heap. After that, on June 23, there was the announcement of the oil sale from strategic reserves. The oil price is now back above the level it was the day before the sales were announced. The \$US Gold price - the REAL target of that oil sale announcement - has not yet made it back to its level of June 22. But over the first week of June, Gold posted its biggest weekly rise in US Dollar terms this year.

On July 9, House Speaker Republican John Boehner announced that his negotiators in the debt limit talks had halved their plans for a \$US 4 TRILLION deficit reduction package over a decade. Mr Boehner said he was constrained by stiff Republican opposition to tax hikes as part of the deal and by the refusal of the White House to accept a bigger reduction package without tax hikes.

Both sides of the “debate” continue to make a farcical comparison between deficit cuts over a decade and a \$US 2 - 2.5 TRILLION debt limit increase which will not last much more than a year. Mr Boehner still wants a deal that “*meets our call for spending reforms and cuts greater than the amount of any debt limit increase*”. This is the kind of rabid nonsense to which the US political and financial establishment has been reduced in their frantic efforts to continue to have their cake and eat their people too.

US interest rates are not going to weather this stuff much longer. And when they rise - they’ll RISE!

Recent Events:

QE2 has come to an official end. In reality, the size of the Fed’s shopping spree in the Treasury market has been toned down by a bit less than two-thirds. And this is pending any further shocks like the just announced June US employment numbers which might push the Fed into a QE3. On the financial markets, the art of “brinkmanship” is reaching new levels as Wall Street and the rest of the world continue to assume that nothing can possibly stand in the way of the Treasury continuing to borrow.

On July 7, the Dow closed within 100 points of its 2011 high after a gain of well over 7 percent since the day after the strategic oil sale announcement on June 23. The June unemployment numbers released on July 8 stalled this rise. And three-month Treasury yields have remained at 0.00 percent since mid July.

Gold:

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

What’s Next?:

July 22, the deadline for getting a debt limit deal and writing it into legislation before Mr Geithner’s cut off date of August 2, is now less than two weeks away. Ten days after that comes August 2 itself.

The biggest threat to world markets today, and for the “foreseeable future”, is a sudden spike in Treasury yields. If (or much more probably when) the increase in the Treasury’s limit is announced, the danger will increase. If a debt limit increase is NOT announced, it will skyrocket. Either way, the paper markets are sitting on a proverbial powder keg in their refusal to face or even think about what is coming at them.