



# The Privateer

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## **THE PRIVATEER:**

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## GLOBAL REPORT

### THE FED CUTS - AND RUNS

Faced with an accelerating collapse in the collateral which underpins the loans extended by the US credit machine, the Fed has panicked. On September 18, it cut both its Fed Funds Rate and its Discount Rate by 0.50 percent to 4.75 percent and 5.25 percent respectively. That's the cut. Soon, the Fed will have to run - away from responsibility - when the effects of these cuts show up as fast climbing consumer prices in the US.

What the actions of the Fed demonstrate is that both the US financial system and the US economy are so overextended that a fall in valuations in US real estate has driven a wedge under the US banks and all other lenders, putting their outright solvency into doubt. The Fed can pump all the "liquidity" it wants into the US monetary system, and from there into the broader US financial system, but it cannot create solvency out of thin air. Solvency is a function of any institution's assets and its liabilities.

In principle, the assets of any lending institution are its loans outstanding. They earn it a rate of interest. The liabilities are the deposits it created in order to make the loans. If a loan does not work out, any lender can legally take possession of the economic good which the borrower bought with the loan and sell it in the market. Here lies the real problem.

If the sale of the economic good returns less money than the loan it had leaning against it, then the original lender takes a REAL loss on the loan.

This loss comes right out of the capital of the lending institution. If enough of these losses pile up on its balance sheet, the SOLVENCY of the institution is at risk. If the assets (the loans issued) are worth less than the liabilities (the deposits), the institution goes bankrupt and the depositors lose their money, the assets not being worth enough to pay them.

### Historically UNPRECEDENTED Events In London:

The government of Prime Minister Gordon Brown has panicked. Faced with a small-scale (in the global monetary scheme of things) bank run on the British mortgage lender *Northern Rock*, the government has taken the totally unprecedented step of **NATIONALISING ALL THE DEPOSITS IN BRITAIN!**

The British government has come out and stated that it will guarantee all the deposits inside Great Britain. By this action, the British government changed bank deposits into a new form of "public debt" at the stroke of a pen. It is not the British Treasury which has acted here. Nor is it the Bank of England. It is the British government which has come forward as the guarantor.

British deposit liabilities are nationalised while the assets of the financial system remain in private hands!

## Historically Unprecedented Events In LONDON - Cont:

To repeat, British deposit liabilities are nationalised while the financial system's assets remain in private hands! This situation is on its face absurd. If it was to continue for any length of time, it would allow British lending institutions to lend without any restrictions in any amount whatsoever since the liabilities created thereby are no longer their responsibility. They are the responsibility of the government. The lenders keep all their gains from lending, while the British nation, through its government, is liable.

## U-Turn - And A Dead End Road Ahead:

In principle, there are two possible outcomes. The first is the sane route in which this action is undone very quickly by the British government. Incautious lenders are again allowed to go broke just as any other business does when it becomes insolvent and can no longer meet its liabilities. The other possible "solution" is, in principle, no solution at all. Having said that they will guarantee ALL bank deposits, the British government might just be stupid enough to leave this guarantee in place. That would mean that the government makes itself responsible for ALL lending by British financial institutions. De facto, the government will make its own judgement superior to the judgement of the market through new laws and regulations. The end result of this would be that with the legal and regulatory powers of the government - all new lending in Britain would be the result of POLITICAL decisions.

An enormous British government bureaucracy would have to set up to administer all this - piled on top of the bureaucracies now existing in the British banking and financial systems.

If this happens over the next few weeks, the British government will also have de facto nationalised the entire British banking system as well as Britain's broader financial system. Were any historian to try to find like instances, he would find it in Stalin's USSR. In time, the British economy would look similar.

## The REAL Political Nature Of Money:

Ludwig von Mises - from his book *A Theory of Money and Credit* originally published in 1912. Quote:

*"It is impossible to grasp the meaning of the idea of sound money if one does not realize that it was devised as an instrument for the protection of civil liberties against despotic inroads on the part of governments. Ideologically it belongs in the same class with political constitutions and bills of rights."*

*"The demand for constitutional guarantees and for bills of rights was a reaction against arbitrary rule and the nonobservance of old customs by kings. The postulate of sound money was first brought up as a response to the princely practice of debasing the coinage. It was later carefully elaborated and perfected in the age which through the experience of the American continental currency, the paper money of the French Revolution and the British restriction period had learned what a government can do to a nation's currency system."*

In short - Constitutions, Bills Of Rights and Sound Money stand side by side politically.

What IS "sound" money? It is Gold currency circulating in daily life and in business and trade with each coin being an invariant weight of Gold. The ultimate virtue of sound money is that it takes the purchasing power of the monetary unit OUTSIDE political control. Mises favoured the Currency School's approach of 100 percent specie reserves to demand liabilities - money on account in the banking system. This meant that no bank or other lender could create new deposits on account by the means of issuing a new loan and crediting the sum lent to the borrower's account if it had not FIRST been the recipient of an inflow of new Gold coin deposits. A lending bank had to enter into a contract with any Gold coin depositor to have permission to re-lend the money for a specific period of time. For that, the depositor could NOT ask for the money but received a rate of interest for allowing the bank to use the money.

## **Liberalism - As It Once Was:**

Today, sadly, one has to call this total system of integrated philosophical ideas “Classical Liberalism” to make it distinct from the modern term “Liberalism” - which is simply a euphemism for Socialism.

We again quote von Mises: *“The idea of liberalism starts with the freedom of the individual. It rejects all rule of some persons over others; it knows no master peoples and no subject peoples, just as within the nation itself it distinguishes between no masters and no serfs.”* Adhere to this political principle and the first thing obviously jettisoned is the income tax. The income tax is a sad holdover from the age of Feudalism where there were indeed masters and serfs and where the serfs had to pay serf dues.

## **The Opposite To Sound Money Is Legal Tender Laws:**

Feudalism was overturned by the simple means of most serfs buying their right to be Freemen from their former masters. This process was speeded up by massive and spontaneous public mass uprisings. Historically, Feudal masters were addicted to ostensive display and that cost a lot of money. As a consequence, the Kings, Barons and Nobles were usually deeply in debt. A serf who could make a loan to his Lord is not unknown to history. Once the loan to the Lord was large enough, it was easier to forgive the loan to the Lord in return for freedom. The serf of the Middle Ages actually had an advantage which we do not have today. His or her hard earned Silver pennies kept their purchasing power over time. That is what enabled many serfs to buy their freedom - their savings maintained their value.

We do not have that advantage - because of our “legal tender” laws. All legal tender laws are an arbitrary claim by those in government that whatever they choose to call “money” IS money! And what is our “money”? It is a piece of paper (or plastic) on which the government has printed some numbers. Opposite to that is Gold and Silver coinage which function happily as money without any legal tender laws at all. Gold and Silver coinage need no legal support of any kind. Both ARE money. It is only the coloured pieces of paper which need legal coercion.

## **“This NOTE Is Legal Tender For All Debts Public And Private”:**

Paper circulating as money once said: *“pay to bearer on demand”*. Today, it says (in effect): *“It is forbidden to refuse to accept this in payment”*. Less than one hundred years ago, all bank notes, US Treasury notes and even Federal Reserve notes had printed on them **“Pay To Bearer On Demand”**. The amount of the payment was the amount of Gold stated in print on the note. Then, they took the Gold away! But all the notes remained and they became “legal tender”. This opened a door miles wide for those in government to acquire the real wealth of the public by making pretend payments. This HUGE “con” can be seen through very simply. Nobody, government included, can make a real payment with a NOTE. In financial terms, a “note” is what one holds until the purchaser of one’s goods or services renders full payment at a later date. The full and final payment voids the note. To accept a “note” is to give credit. When presented with a US Federal Reserve “note” as the offered “payment”, what is in fact happening is this. The person who tenders a Federal Reserve note as payment has previously given “credit” to the US Federal Reserve in order to acquire it. When you “accept” (having no choice in the matter) the Federal Reserve “note” in payment for your goods and/or services, you are the one who is now giving credit to the Fed. The other party to the transaction leaves with your goods.

Over the past few decades, there has been ever increasing talk about the “cashless society”. In the English-speaking world, that “society” is all but a reality with the vast majority of “transactions” being done by means of credit cards or electronic transfers of all descriptions. Even the use of cheques is dying out. In continental Europe, the “progress” towards this state of affairs has not gone nearly as far. It has gone still less far in Asia. In the rest of the world, especially in the “third” world, cash is still offered and accepted in payment. But whatever means of payment is used, the same VITAL ingredient is missing. There is no FINAL means of payment. There are only notes (and token coins). There is no CURRENCY.

## Notes Versus Currency:

What circulates today as money is a NOTE - a government-printed piece of paper. What once circulated was a CURRENCY - a specific weight and grade of Gold and Silver coinage. The cardinal difference is that a currency is no man's debt while a note is. A currency has a value independent of law or edict and can be used in any type of exchange. When one exchanges some currency for another form of economic goods, one no longer has the amount of currency surrendered but has the goods. The seller no longer has the goods but now has the currency. This means that a currency, the bedrock of sound money, can be used to extinguish a note or any other instrument of debt such as a mortgage or a bond. It is only the actual existence of a currency that enables all FINAL payments of all debts to be made.

That situation does not exist today. Exchanging a stack of US Federal Reserve notes (aka US Dollars) as the final payment on a mortgage is NOT the same. Examine the transaction closely and you will find that these Dollars are a liability of the US Federal Reserve and therefore a debt in their own right. One cannot pay one debt (the mortgage) by exchanging for another (the US Dollars). The former holder of the mortgage stands with the stack of US Dollar bills used in the "payment". That literally means that it is the new holder of these Federal Reserve notes who has given his credit to the US Federal Reserve.

## The Haunting Background Of US History:

The US stock market crashed in October 1929, after the prolonged credit expansion known as the "Roaring Twenties". Over the next few years inside the US, many other prices broke downwards following the US stock market. As these price breaks took place, the valuations of more and more economic goods, land and housing in particular, had their collateral foundations torn out from under them. As the underpinning collateral fell in value and prices fell too, they acted to tear the heart out of the US banking and financial system. If the collateral was sold, it would not come even close to covering the amount of the loan leaning against it. The difference - the losses - hammered the balance sheets of the US banks and other lenders. When they had sustained enough damage, the banks went broke and closed in what was then known as a "Banking Holiday". This left all the depositors standing outside their closed doors unable to get their money - there being no money left for them to get.

In their book - *A Monetary History of the United States, 1867-1960* - Milton Friedman and Anna Schwartz demonstrated that this process led to a contraction in the US total stock of money of about 38 percent. In fact, using this term legitimately, the US stock of money had been deflated by that amount. The remaining 62 percent of the US stock of money back in the 1920s and early '30s consisted mainly of Gold and Silver coin, still circulating US Federal Reserve notes and the deposits of the financial institutions which survived the carnage. When Gold coin and the ownership of Gold was outlawed in the US in 1933-34, the US monetary bedrock was the stock of Silver coin. The US stock of money could not contract or deflate to less than that - and that placed a floor under the bank failures. Obviously, with a greatly diminished total stock of money, prices and valuations had to be adjusted downwards to find the levels at which sales could again be made. But this was resisted by the Roosevelt Administration which tried time and again to pump US prices up to their pre-crash levels.

## It Is VERY Different In The US Today:

Gold coin vanished from circulation in the US in 1933-34. Silver coin vanished in 1965-66.

With a circulating CURRENCY, the US stock of money could only contract or deflate to the level of that circulating currency. Today, there is NO Currency in the US monetary system. The total stock of US money seen as Fed Paper notes and deposits, can indeed contract to its present stock of "cash" should the broader US banking and financial system fail in a catastrophic way. Were that to happen, what would remain would be the stock of Federal Reserve notes, a minuscule amount compared to total US deposits. A reversion to "cash" today would be a deflation of the US stock of money of near 90 percent.

## **There Is NO “Monetary Stability” In A Credit Money System:**

This “task” which the Fed has allegedly set itself is in fact impossible. In a monetary system where bank deposits created as loans consist of only 10 percent of the total stock of money, a contraction of half the deposits lent into existence would only contract the total stock of money to 95 percent. Even this mild deflation would still mean that some selling prices were too high to clear the market and that some valuations of other economic goods would have to be adjusted downwards. The situation is radically different where the total stock of money consists of 90 percent bank deposits lent into existence. In this case, a similar contraction of half the bank deposits would lead to a contraction (deflation) of the total stock of money all the way down to 55 percent. Again, such an event would lead to selling prices having to come down hard in order to clear the market. This would mean that valuations would plummet over the entire field.

## **The Critical Deposit Base:**

The situation just described, well known to the monetary authorities, makes the deposit base critical.

If it were to contract for any reason, the economic effect of falling selling prices and even faster falling valuations arrives in short order. Insolvencies and bankruptcies follow after the deposit base contraction.

That is why the monetary authorities always act before the insolvencies or the bankruptcies arrive. The problem here strikes to the core of the fatal flaw in any credit money system. The “authorities” can only act by re-igniting the credit expansion. To re-ignite the credit expansion once again causes both debts and the deposit base to expand. And once again, a point arrives where the debts owed by private individuals and businesses reach a height where all free remaining cash flow is being used simply to pay the interest due on past debts. At that point, the credit money system has reached its own final limits. In effect, it has found its own “debt ceiling”. This limit to debt is also the limit to all credit expansions. Once that point is reached, there is only one way the credit money system can go. It is doomed to a contractionary (deflationary) mode as debts are either being paid down by borrowers or simply being defaulted upon. In either case (debts paid down or outright defaults), the deposit base of the credit money system contracts and the total stock of money in the credit system deflates. After that, most prices have to follow downwards to clear the market and then valuations too start descending.

Invariably, the monetary authorities cut their official rates at this point and add massively to the official reserves of the commercial banks to assist them in renewed lending. But if the public is reluctant to borrow enough, no amount of interest rate lowering can get the credit expansion started again.

## **Cutting Interest Rates Risks The Currency:**

Any emergency lowering of official interest rates runs the climbing global risk that the currency will fall in international value. That will make imports more expensive to buy because internal prices always start climbing after external prices have moved upwards. Inside a few months after the currency has fallen in international value and internal prices have begun to climb, the cry of “inflation” (seen as climbing prices) covers the land. And then internal market interest rates start to climb no matter what the “official” rate is. Internal lenders cannot stand by and lend money at less than the rate of price inflation without losing money themselves. When, for example, internal prices climb at 8 percent per annum, to lend at 6 percent for a year means that the lender is losing purchasing power of 2 percent.

That is the point at which the monetary authorities lose the game. Having reached the final limits to credit expansion, lowering the “official” rate cannot prevent rises in MARKET rates. There is nowhere else to go. The long staved-off economic recession hits. With that, the real danger is closing in. The deposit base might contract violently. It did back in the 1930s as valuations and prices fell after the credit deposit base was savaged by US bank failures and debt defaults across the land.

## INSIDE THE UNITED STATES

### **HENRY PAULSON - RAISE THE US DEBT CEILING**

On September 19, Treasury Secretary Paulson told Congress that the US government will hit the current debt ceiling on October 1. He sought quick action to increase the limit, saying it was essential to protect the "full faith and credit" of the country at a time of financial market turmoil. The current limit is \$US 8.965 TRILLION. The Senate Finance Committee has approved increasing the limit on the debt to \$US 9.82 TRILLION! That \$US 850 Billion boost would be the fifth increase in the debt limit since President Bush took office in 2001. Pentagon officials have warned Congress that they will have used up all existing war funds by about the second week of October and would have to dip into money set aside for other programs if Congress does not act by then. The Treasury, the Pentagon and the US itself is broke.

The US Senate panel has set the new US national debt limit at \$US 9.82 TRILLION, \$US 4 TRILLION higher than when President Bush first took office. Once the limit is raised, and it will be, the Treasury can resume borrowing and spending. And that points at the foreigners who will have to supply the funds.

#### **A Grave Warning From The BIS:**

The Bank for International Settlements (BIS) is the Central Bankers' Central Bank. It has stated that debt deflation, not inflation, is the great economic danger we face at the beginning of the 21st century. Debt deflation and credit contraction are two different ways to describe the same economic event. The BIS has chosen the first, *The Privateer* the second. The BIS is now warning of a debt collapse induced crash.

#### **The Ebbing Inflow Of Money Into The US:**

The US Treasury showed that foreign buying of US securities slowed in July to the weakest pace in seven months as a rout in the subprime mortgage market sapped global demand for all American bonds. US government data on foreign holdings released this week shows a collapse in foreign purchases of US bonds from \$US 97 Billion in June to \$US 19 Billion in July - with outright net sales of US Treasuries.

The net foreign financial inflows into the US fell to \$US 150.9 Billion in the second quarter from \$US 181.9 Billion in the first quarter. The US current account deficit has narrowed to \$US 190.8 Billion in the second quarter, or 5.5 percent of gross domestic product, the US Commerce Department reported on September 14. A cursory glance at this data shows that the US economy was underfunded by foreign lenders in the second quarter to the tune of \$US 39.9 Billion. The US deficit on goods alone rose to \$US 204.2 Billion from \$US 200.9 Billion over the two quarters. For all of 2006, the US current account gap grew to \$US 811.5 Billion, the biggest ever. This data presents the greatest danger to both the US economy and to the US Dollar. The US economy has become addicted not only to the massive flows of foreign manufactured goods, but also to these massive inflows of foreign funds. Were these inflows of foreign funds to ebb away or even to reverse, internal US market interest rates are sure to climb.

#### **When Life Support Is Withdrawn From The US Dollar:**

The US Dollar is at equal risk. The massive inflow of foreign funds has also acted to keep the international value of the US Dollar higher than it otherwise would have been. If this inflow of foreign funds continues to ebb, the result across the currency floors will be the onset of a lesser global demand for US Dollars. The result of that will be a global fall in the value in the US Dollar. The horror scenario is that this ebbing inflow of foreign funds turns into a massive OUTFLOW of US Dollars as scared foreign holders of US Dollars and Dollar-denominated paper both inside and outside the US bolt for the exits. Were this to happen in the next few days or weeks, the US Dollar could crash spectacularly.

In the background, Gold is inexorably climbing, fulfilling its historical role as a crisis barometer.

## INSIDE CHINA - AND - JAPAN

### THE UNEASY ASIAN US DOLLAR HOLDERS

There is a fast climbing unease across Asia brought about by the monetary, financial and economic events inside the US. China today has official foreign exchange reserves of \$US 1.33 TRILLION, of which at least 70 percent is in US Dollars or in US Treasuries. Japan stands with \$US 932 Billion with about 70 percent of that in US Dollars and Treasuries. And so it goes, right down the line of the Asian nations, according to reports from the Asian Development Bank (ADB). Asia as a whole, adding in Taiwan and the smaller Asian nations, stands with US Dollars and US Treasuries to the tune of around \$US 4 TRILLION. Please note that these are just the Asian nations' official reserves. On top of them comes the uncounted but enormous investments of Asian businesses and financial institution investments in the form of US Treasuries, US shares and US corporate bonds all the way down to US subprimes.

#### **When A Currency Falls - ALL Investments In It Lose Value:**

All these massive Asian investments in US financial assets of all descriptions have been losing value in terms of their own national currencies as the US Dollar has fallen against most of them in the past month.

#### **The Approaching Asian Pain Threshold:**

All of economic history shows that in a situation where a "class" of investment is steadily losing value, a point can be and is reached where the pain of accumulating losses simply becomes too much to take. That sets the stage for a MASS sell-off. This is now the risk, and it is climbing. There has already been some Asian central bank selling of US Dollars and US Treasuries. But so far, it is been small. It has, however, sent a clear signal. When former buyers turn into sellers, it is VERY hard to turn them into buyers again. The broader signal is that when former buyers turn into sellers, most of them look for an opportunity to sell what they formerly bought. That is the real danger. Any temporary upswing in a market provides such an opportunity. In the wake of the Fed's 0.50 percent rate cut on September 18, US stock markets have provided just such an opportunity. So, until the rate cut, did US Treasury debt paper.

Nervous holders of assets in any market are always looking for a level at which to sell out. They often act as a price "ceiling", selling into any rally in the market. If these markets rally hard, these sellers sell hard, acting as a barrier to any further climbs.

#### **Observing A Falling Market:**

The situation is entirely different when a market has established a downward trend. Most nervous sellers are already looking at losses on their investments and are intent on minimising them or, at best, getting out "even". Since further losses are what they fear, it follows inescapably in the logic of their situation that each have them has a different level for US Dollars, Treasuries, etc. at which, in a fast falling market, they will try to sell BEFORE all the other nervous sellers jump in. This is the reason why nervous sellers can literally break financial markets or currencies. When the British had to call the IMF in to rescue them in 1975, the reason was that all their markets were breaking right across the line. They were breaking because longer-term holders of British financial assets could no longer stand the pain of ever climbing losses. They sold out in an unstoppable tidal wave of selling. These sellers all took even further losses in the process. But having sold, they also knew that they would take no further losses. Today, this situation is precisely what the entire US economy, the US Dollar and US Treasury is facing.

And that is why the worst possible thing the Bernanke Fed could have done is to lower its interest rates. That signals, not only to Asia but to the world, that the US doesn't care about their losses.

The US Congress is on the verge of raising the debt ceiling. After that, the Treasury will try to borrow!?

## INSIDE THE EUROPEAN UNION

### THE BRITISH - U-TURNING THEMSELVES IN KNOTS

On the evening of September 17, the British Prime Minister Gordon Brown held talks with US Treasury Secretary Henry Paulson who had flown across the Atlantic to discuss the global credit crunch.

Then, Britain's Chancellor of the Exchequer announced on September 18 that the government would “*put in place arrangements that would guarantee all the existing deposits during the current instability in the financial markets.*” Britain scrapped the usual statutory limit that gives a maximum protection of 31,700 Pounds (\$US 62,000). Also on Tuesday, September 18, the Bank of England doubled the amount of emergency loans made available to British banks caught short in the global credit squeeze.

#### **British Financial Bootleg Turns:**

U-turns followed with dizzying rapidity during the rest of the week. First, no sooner had the Brown government inadvertently guaranteed (i.e. nationalised) all the bank deposits in Britain than they let it be known that these guarantees only applied to the customers at the Northern Rock mortgage lender and NOT to any other depositors elsewhere in the British financial system. Later in the week that was further “clarified” by the Brown Government with the statement that these guarantees to the depositors in Northern Rock would NOT apply to any NEW depositors with Northern Rock.

What has still not been “clarified” in this chaos of emergency announcements is whether the removal of the maximum protection for British depositors is still in place or whether the former limits again apply.

#### **Background Briefing:**

What has become abundantly clear this week is that the confidence of the British public in their own financial system is very fragile indeed. Further, what should have been essentially a purely British crisis was turned into a full international crisis of confidence when US Treasury Secretary Paulson flew to London on September 17 to have his face-to-face talks with British Prime Minister Brown.

The question here is why should a bank run on a moderately sized British financial institution be such a concern to the US Treasury Secretary? The answer is clear. There have already been some small bank runs inside the US - the one in California was reported in a recent *Privateer* - which have now ebbed away. The common denominator is the bank runs. The fear in political circles on both sides of the Atlantic has to be that confidence of both the British and the US public in their banks is so fragile that a cascade of bank runs could start at any time. That is why, in the wake of Mr Paulson's visit, the British Government issued one ill considered statement after another to reassure the public.

#### **For The Record:**

The initial decision of the British government was announced like this: In a bid to shore up confidence, British Chancellor of The Exchequer Mr Alistair Darling announced on September 17 that the government would guarantee all deposits in Northern Rock, even if the bank should collapse, and would extend similar guarantees to any other troubled financial institution that approached the government.

#### **A GLOBAL Late Flash From Asia:**

China is to enforce a freeze on all government-controlled prices! This sudden order freezes a vast array of prices still under the control of government in China ranging from oil, electricity and water to the cost of parking and park entrance fees. This order was issued jointly by six ministries overnight on September 19. In inflationary times, price controls only cause two things - black markets and shortages.

## AUSTRALIAN REPORT

### THE TWO ESSENTIAL THINGS WORTH KNOWING

These are where the Australian economy is and what it is heading towards. Both can be encapsulated in two economic facts. First, Australians now stand with debts to the tune of 161.3 percent of their “disposable” incomes. On top of that, they have piled \$A 41 Billion onto their credit cards - that’s about \$A 2000 PER CAPITA. Never in history have Aussies been so deeply in debt. The slightest internal economic slowdown would financially undo thousands. An economic downturn would be disastrous.

#### **External Portents:**

Global (base) metal prices peaked in early May. Since then, they have fallen about 30 percent. Since metals, coal and iron ore are a very large part of how Australia earns its bread and butter internationally, these falls shows that the terms of trade will shortly turn down. Australia cannot expect to get prices at the heights they were less than six months ago. There are exceptions of course - Gold, oil and also wheat - but Aussie exports of these are nowhere near enough to compensate for the base metals and coal.

#### **Internal Portents:**

The latest official figures released on September 11 show that lending overall dived by 17.2 percent in July compared to the lending that took place in June when new loans soared 22.3 percent. Both of these figures are annualised. What is noteworthy here is the drastic turn itself and the fact that it happened so suddenly. What is not clear yet is whether this happened because lenders all got scared and slowed down new lending or whether it was the Aussies who balked at more debts.

#### **The Sum Of Portents:**

An international economic slowdown is now rolling towards Australia. It will have internal economic effects. A sudden and hard internal slowdown in the credit expansion now seems to have occurred. That will also have internal economic effects. Both of these effects are negative and contractionary. Australia is now on the edge of a sudden economic downturn even if all the public voices are yelling at the top of their lungs that our business conditions have never been better. That is true, but Australia’s still excellent terms of trade cannot last and makes it that much easier for our business conditions to get worse. If it can’t get better, an economic downturn is ahead.

This too is denied as the idea of a perpetual economic boom is the fundamental outlook of most Australians. The problem which those same Aussies ignore is that it was a boom with borrowed money.

#### **The Hard Facts:**

Total Australian personal debt has increased from about \$A 46 billion in January 1996 to \$A 133 billion in November 2006. That is \$A 87 Billion in new loans poured into the economy in ten years. Any economy of about 20 million people would “boom” with that amount of new borrowed spending power poured into it. The Australian private debt to GDP ratio is now 153.9 percent. Ten years of borrowing and spending has not grown productive capacity by much. What HAS grown is internal and external debts. Now the credit cycle is turning down. The business cycle is sure to follow with only a lag in time.

Interestingly enough in plain political terms, these past ten years of binging on credit coincided closely with the Howard period in government. The smartest thing Howard and the Liberal Party can now do is to make sure to lose the next Federal election and hand the incoming Labor Party the recession and the whole debt mess. That would make THEM wear the odium of the economic distress that is sure to come. Aussies should not forget, though, that it was John Howard and his “Liberals” who caused it.

## THE GLOBAL MARKET REPORT

### SHOW US THE MONEY

*“September 18 and the FOMC meeting is now just over a week away. Every effort between now and then will be bent to “stabilising” the USDX at or above its present level of 79.91. A fall of any magnitude from this level would push the US Dollar to all time lows. ...any move by the Fed to lower official rates would not “improve” the situation, it would make it worse, potentially MUCH worse.”*

*The Privateer - - Number 586 - September 9, 2007 - “What’s Next?”*

That was how we ended our previous issue two weeks ago. Well, the FOMC has met of course, and has lowered both their Fed Funds and their Discount rates by 0.50 percent. On September 17, the day before the rate cut, the USDX closed at 79.65. By September 20, it had fallen to 78.48.

The US Dollar Index (USDX) has been compiled since March 1973, the year and the month when the post Bretton Woods fixed exchange currency regime collapsed irretrievably and the global “fiat currency” era began. Ever since then, the USDX has NEVER fallen below the 80.00 level (spot future close) for any length of time. There are conflicting reports on the all time spot future closing lows for the USDX. Depending on the data source, it is either 78.19 or 78.33 and was set in 1992. What is certain is that the USDX has been below 80.00 ever since September 7, the date of our last issue, see the quote above.

The USDX has never remained below 80.00 for that long before, not once since its inception in March 1973. It is in no way an exaggeration to say that the US Dollar is on the edge of an abyss. Any fall below 78.00 on the USDX would take out the all time low and with it - what *The Privateer* has called on numerous occasions: **“The most important support point in the world”**. Worse still, nearly all of the fall in the USDX over the past two weeks has come since the Fed cut rates on September 18.

#### **“Define Your Unit”:**

*“Gold is an asset that people want to own as protection for risks they can’t really analyze and get their arms around. That risk has gone up.”*

Mr Stuart Schweitzer - JP Morgan Private Bank

There is a famous quote attributed to Sir Isaac Newton when, as Master of the Mint in the UK, he fixed the Gold content of the Guinea at 129.4 grams of Gold, a “fix” which remained unchanged for more than 200 years. Newton was, of course, one of the greatest scientists of his or any other age, the man who discovered the laws of gravity and formulated his famous laws of motion. When Sir Isaac was asked WHY he had fixed a specific weight for the British currency, he is said to have responded like this:

**“Gentlemen, in order to calculate, YOU MUST DEFINE YOUR UNIT.”**

Consider this carefully. Could a house be built by tradesmen working with “elastic” inches or centimetres or pounds or kilograms? Could the tolerances required to make almost anything bought and sold today be achieved unless the standard of the units used to measure them were FIXED and unchanging?

Economic calculation, like all other forms of calculation, also makes use of “units”. It makes use of fractions or multiples of the unit of money, whatever the name - Dollar, Euro, Yen, Franc, Pound, Yuan, Dinar, etc. etc. - given to the unit. There was a time when all of these names referred to a specific weight of Gold, just like Isaac Newton’s Guinea. The unit was defined specifically, in precisely the same manner and for precisely the same reason that an inch or a mile or a ton is defined.

Without such precise units, economic calculation is impossible. Without such calculations, risks cannot be analysed. When this is realised, and Mr Schweitzer (see his quote above) is right, the realisation is dawning worldwide, we get such phenomena as bank runs and a flight to Gold.

## A “Created” Money Is Always Destroyed:

According to science, matter can neither be created nor destroyed. A boulder can certainly be smashed into a pile of rubble and then ground down into the finest of dust, but it cannot cease to exist. Sadly, that is not true of a money that exists merely as a piece of paper, given its status as a medium of exchange through political edict.

For thousands of years, Gold (and Silver) has been the world’s choice as that form of “matter” which best fulfilled the requirements of a medium of exchange. Gold as money in coin form goes back nearly three thousand years. All the modern paper money circulating today traces its history back to the days when it represented a specific weight of Gold (or Silver) and could be exchanged at any time for that precise weight of Gold (or Silver) on demand. This, and this alone, made it a “sound” money.

Sever this connection and the money instantly becomes unsound. It becomes a medium of exchange given force by edict and without any connection to the real world of production, consumption and exchange of economic goods. As economic history proves without any exceptions, such a “fiat” money is doomed to destruction. A money divorced from economic reality is not a money at all.

## The Dawning Realisation:

The last time that the nature of the world’s “money” was even partially out in the open was in the fifteen years between 1965-1980. In 1965, Charles de Gaulle, the man who, along with his financial advisor Charles Rueff forced the US government to choose between money and paper, was asked how the international monetary system could be reformed. He said this: *“Actually, it is difficult to envision in this regard any other criterion, any other standard than Gold. Yes Gold, which does not change in nature, which can be made into either bars, ingots or coins, which as no nationality, which is considered, in all places and all times, the immutable and fiduciary value par excellence.”*

Observing that the US, the only nation left whose currency still had a connection with Gold, was taking no steps in the direction he advocated, De Gaulle began to exchange the Dollars France earned with its exports for physical Gold. In 1971, faced with the choice of ending the creation of new Dollars or losing all the Gold left in the US Treasury, President Nixon declared that the last remaining tie between Gold and the US Dollar was severed. The world has not had a circulating money redeemable in Gold since.

There lies the basic problem at the root of all the economic, financial and market upheaval that the world has faced ever since that day. For nearly four decades, the financial and economic world has been held hostage to the fact that the bedrock which underpins it all has been literally ripped out from under it. That bedrock is a SOUND money, and a sound currency does not exist.

Financial earthquakes of huge magnitudes taking place all over the world have been the legacy of this condition. There have been market crashes, debt repudiations, currency collapses, bank runs and all the other woes attendant with this all over the world. Japan, the second biggest economy in the world as measured by GDP, saw the bubbles on its stock and real estate markets burst simultaneously at the end of the 1980s. It has been in recession ever since. Its property market has not recovered. Its stock market remains nearly 60 percent below the level it reached at the end of 1989, almost eighteen years ago.

One nation, the US, has been seemingly “immune”. Its global power and its possession of the world’s reserve currency has meant that, having no substitute, the world went on accepting its debt paper and its fiat money as the “bedrock” supporting their own financial systems. The cardinal difference with the current financial crisis from all the previous ones is that THIS one has as its “epicentre” the US itself.

The global financial structure depends on the perceived viability of the US Dollar as a “sound” money. That viability is coming into question, as shown by the Dollar dive. The realisation is dawning.

## A “Strong Dollar” Or A SOUND MONEY?:

Treasury Secretary Paulson is, of course, busy regurgitating the “party line”: *“I feel very strongly that a strong dollar is in our nation’s interest ...”* He said that in Canada on September 21 while Canadians all around him were celebrating the fact that the Canadian Dollar had reached parity with the US Dollar for the first time in 31 years. This would be hilarious if it was not so bullheadedly tragic.

Today, the US Dollar has only two remaining pillars of “support”. One is naked force - the known military might of the Bush Administration and their demonstrated willingness to use it. The other is the fact that the rest of the world now holds many TRILLIONS worth of \$US denominated debt paper and stands to lose hugely if they do NOT continue to add to their holdings. The problem is, of course, that they have been losing hugely for years, that their losses are accelerating, and that their comes a point in all such situations where the only remaining alternative is to get rid of the paper to stop the bleeding.

That process has actually now begun, as illustrated by the accelerating fall of the US Dollar and by the dwindling inflow of money into the US - see the *“Inside The United States”* page in this issue. What has yet to begin is the global questioning of the nature of what the world is using today as “money”. That process is very close, as illustrated by the bank runs in the UK a week ago. It is a short step from lineups outside banks yelling *“Show us the money!”* to a swelling demand to *“Give us a PROPER money!”*

### Recent Events:

The last two weeks can be conveniently divided into - before September 18 - and after. Since 1971, every major nation in the world has faced, at one time or another, a precipitous fall in the exchange value of its currency. In every case, without exception, the Central Bank of the nation so afflicted RAISED its official interest rates, often precipitously. We can remember a DAY in the mid 1980s when the Australian Reserve Bank raised rates by 4.00 percent in one day to stem an Aussie Dollar collapse.

Faced with a similar set of circumstances, the US Fed chose to LOWER rates. US stock markets rebounded, of course, but the US Dollar, which had been fairly “stable” in the lead up to the FOMC meeting, dived. Worse still, yields on longer-term US Treasury paper ROSE. The only surprising aspect of these two events is that anyone could be “surprised” by them. Of course, Gold has hit new bull market highs in \$US terms while the \$US oil price has hit all time highs.

### Gold:

Please see Gold This Week (GTW):

<http://www.the-privateer.com/subs/goldcomm/gold.html>

### What’s Next?:

Secretary Paulson has demanded that the Senate raise the Treasury’s “debt limit” by October 1. This, all by itself, has the potential to push the USDIX down to lows never before seen in the floating currency era.

On US stock markets, the Dow is a mere 180 points below the 14000 all time high it set just over two months ago. On global currency markets, the US Dollar is on the verge of potential collapse if the USDIX continues to fall. One of the all time “cosmic jokes” in market history would be a new all time high on the Dow being set at or about the same time as the USDIX makes an all time low.

Feeling the pressure, the Bush Administration is once again ramping up the war drums - this time aimed at Iran. Both Russia and China have warned against any attack. Mr Putin visits Tehran in October.