Redstone Advisors

Economic and Market Review

Second Quarter 2011

"Are these the shadows of the things that Will be, or are they shadows of things that May be, only"?

Charles Dickens, '*A Christmas Carol*'

With no relief in sight from the oppressive heat which has apparently settled immovably here in the Midwest, we thought it might be a pleasant diversion to conjure up a little Christmas in July as we ponder the question of the day: **what are the economic and financial implications of the US debt ceiling?** For this we have selected Dickens' popular Christmas classic, 'A Christmas Carol', a tale well suited for our purposes, not only because its' division into three tenses, past, present and future, are conducive as a literary device in advancing our story, but because at its core it is a tale of redemption: and redemption, by definition, involves **the recovery of something lost**. In Dickens' tale, redemption is procured through a review of history, aided by the illumination of timeless principals from a source both unseen and unlooked for. The Ghosts' appear, as it were, in an effort to *astonish our weak minds* and to startle us from our slumbering complacency. For surely *"if men's courses be departed from, the ends will change."*And change they must if we are to alter the shadows that currently beset us as a nation and *"sponge away the writing"* that is inexorably writ large on our national ledger.

But just what must be recovered if we are to alter our course? We must restore to our collective understanding, in both our public policy as well as our private commerce, that which we once knew so well; **credit is debt and nothing more**. In his excellent book 'Debt & Delusion', Peter Warburg parallels some of our long-standing arguments and writes convincingly that much of the prosperity enjoyed by the West for the past 30-plus years has in fact, been merely a ***delusion*** borne of a massive experiment with a reckless expansion of credit and a commensurate debasement of the currency. In fact so deep does this **"debt delusion"** run that today it is considered economic orthodoxy to equate an increase in money and credit with an increase in wealth. (Mr. Bernanke calls this the *'wealth effect'*) Far from axiomatic, this is simply *reductio ad absurdum* as the only wealth effect that takes place through the process of printing money is one of wealth redistribution by granting those who receive the "counterfeit money" a priority claim against existing wealth. No, the modern word *credit,* which was derived from the Latin word ***'credo'***, meaning *"to believe in"*, sets atop the pinnacle of what economist Jeremy Bentham called ***"impostor terms"***; words or expressions used in a deliberate attempt to hide a simple truth from those it was designed to deceive. Today as we grapple with the debate to raise the **national debt limit**, the success of the swindle is only too apparent. When one speaks with national pride regarding our AAA-rated **"public credit"**, the mind conjures up a vast sum of money on reserve in the public treasury. But dare to speak the truth and refer instead to the **"public debt"**, and suddenly the mind is filled with foreboding as it ponders a burgeoning sum which cannot be repaid. Ironically it was Karl Marx writing in his book 'Capital' who trenchantly observed; *"Public credit becomes the **credo of capital**. It endows barren money with the power of breeding and thus turns it into capital, without the necessity of its exposing itself to the troubles and risks inseparable from its employment in industry or even in usury. And with the rise of national debt-making, **want of faith in the national debt takes the place of blasphemy against the Holy Ghost**."* If this be true, and we believe that it is, then the hour is indeed late and we, like Scrooge, are perilously close to an *unpardonable sin*.

STAVE ONE

INFLATIONISM'S GHOST

"Inflationism is dead: to begin with. There can be no doubt whatever about. This must be distinctly understood or nothing wonderful can come of the story I am going to relate."

Credit has become debt again. Not unlike the story of Cinderella, the inflationist's unending attempt to turn debt into the stately carriage of credit upon which all industry travels has failed and midnight is fast approaching when public credit will lapse back into the deadweight loss which is the nature of debt. From Iceland to Greece, from Britain to Spain, and now to the shores of the US, replete with a contentious debate over our how much public debt is enough, we are re-learning the lesson which American author Garet Garrett observed from his ring-side seat during the Great Depression: *"Most of the follies we commit with the power of credit are from forgetting that debt is simply the other face of credit."* To the uninitiated, credit may appear amorphous. It is at once a stimulant and a narcotic. It accelerates commerce and it impedes it. It brings governments to power, and it brings them low. Yet as Freeman Tilden wrote in his depression-era book 'A World in Debt', *"there is one cause, and one cause only, of all panics and depressions in the economic world. That cause is debt. Credit is debt, and nothing more."*

Now as author Frank Herbert once observed: *"beginnings are such delicate times."* As such, we must at this point, make ourselves clear lest we be misunderstood. When we say that ***inflationism is dead***, we are not suggesting for one moment that **Atlas *will* shrug** and the stabilizers will cease and desist from their inflationary pursuits or their efforts to intervene in the markets. That would be the journalistic equivalent of recanting and retracting over a decade of polemical writing on the insatiable proclivities of the stabilizers. Alas, no such mea culpa will be forthcoming. We would choose instead to fall on our sword. No when we say that *inflationism is dead* we mean, to borrow language from Dickens, that while the stabilizers have *"sought to interfere for good"* (precisely who's good is a matter *capable of question*), inflationism as a policy, *"has lost its' power"* to forestall the day of reckoning, and as such it should be abandoned without further delay.

To be sure, the distinction between can and should is a moral one. This is a point we have made often. To create money *ex nihilo* (from nothing) is to favor some at the expense of others. This breeds contempt for morality and civic virtue. By promoting a *theory of abundance* through **inflationism**, the stabilizers' have encouraged the repudiation of the immutability of the relationship between work and income, in favor of the Keynesian heresy of ***'something for nothing.'*** Yet even Lord Keynes himself conceded that *"by a continuing process of inflation"*, governments **confiscate** the wealth of their citizens, *"**impoverishing many**," and "**enriching some**."* We have written extensively regarding the nature of the injustice due to the uneven redistribution of wealth and the polarization of incomes that results from the stabilizer-induced **boom-bust-boom cycles**. It is through these hidden, yet insidious processes that the ***"some"*** are enriched and the ***"many"*** are impoverished almost imperceptibly, day by day. It is that loss, that small, undetectable act of **legalized theft called inflationism** which, after forty years, has swollen into a massive deprivation which today threatens many in the US and throughout the West with what we have described as a coming famine of epic proportions – **a famine of income** – which may ultimately place the US irrevocably on Hayek's ***'road to serfdom'***. Writing during the **"twilight"** of another former Republic, the Roman historian Plutarch observed: *"An imbalance between the rich and poor is the oldest and most fatal element of all republics."*

STAVE TWO

THE FIRST OF THE THREE SPIRITS

"The curtains of his bed were drawn aside. "I am the Ghost of Inflationism Past." . . . "Rise and walk with me!" "These are but shadows of the things that have been," said the Ghost. *"They have no consciousness of us.""*

The 'Preacher' has rightly said: *"What has been is what will be, and what has been done is what will be done, and there is nothing new under the sun,"* since ***"there is no remembrance of former things."*** (Ecc 1:9-11) Hence throughout all of economic history, the identical fallacies, delusions and heresies recur with appalling regularity. Yet we live in the long shadow of a civilization that outwardly was as magnificent and awe-inspiring as that of our own, and its' history and its' fate, not unlike Marley's Ghost, calls us to remembrance.

The "glory" that was Rome has been the unending subject of poets, philosophers and historians alike for over two millennia now. If we date the beginning of the Republic using its' traditional date of 507 BC, the Republic lasted over 500 years. If we include Gibbons' *"Golden Age of the Antonines"*, a transitional period of benevolent imperial rule known as the *Pax Romana* (Roman Peace), we can extend it to 700 years. Thereafter decline set in. The capital was removed to Constantinople and the city was repeatedly sacked by barbarians. Thus after five hundred years the great experiment in self-government failed, to be succeeded by a military autocracy veiled under republican forms. But it is the **warning signals** from this **"twilight period"** between the last half-century of the Republic and the first half-century of the Empire that now recommend themselves to our attention. Upon close examination, we find **boom years** succeeded by **bust years** culminating in panics, all of which encouraged ever increasing government intervention. Paraphrasing author H.J. Haskell from his book 'The New Deal in Old Rome'; "*As a result, business was disrupted and **wealth was redistributed**. To meet the demands of the military and of the **growing bureaucracy**, the government repeatedly resorted to a **devaluation of the currency**, accompanied by increasing taxation. The once energetic middle class was devastated and the poor were further impoverished. Finally there was complete regimentation into a totalitarian state. The heart had gone out of the people, and the Empire crumbled."* (Emphasis added)

The constant problem in Rome during this "twilight period" was that people of all persuasions were trying to find ways of escaping the increased taxes that the state needed for its' burgeoning population of civil servants due to the massive increase in the size of government and the military. From the time of Augustus to Diocletian, the size of both the army and the civil service increased by nearly three-fold. Continuing our paraphrase of Haskell; "*Essentially you had the imperial administration in Rome, a secondary level of administration in the governors of different provinces and then the primary governmental units in the Roman Empire were the cities.* [Sound familiar; Federal, State, Local] *So you had Imperial courts with their attendant Praetorian Guards and its staff. Under them were Praetorian prefectures, regional administrative units with their staffs and budgets, with dioceses under these, each with their own staff and so on. Under the diocesan rulers (vicars) there were the provinces. In Augusts' time, there were approximately 20 provinces. Three hundred years later, with no substantial increase in territory, there were over 100 provinces. The Romans had simply divided and sub-divided provinces for the purposes of maintaining internal control of the regions, i.e., the cost of policing and administrating the Roman state became increasingly enormous."*

But the increase in the expenses of running the Empire did not stop there. On top of the expanded reach of the state, the pay for the civil servants and the military escalated substantially, including the direct consignment of food, clothing, shelter and other commodities (Read *benefits*) in lieu of the depreciating coin of the realm. So much so that by the time of Diocletian at the end of the 3rd century, ***"donatives"***— gifts of money which originated as **discretionary bonuses** given to vouchsafe the loyalty of soldiers upon the accession of a new emperor – were considered mandatory, and so became a *de facto* part of the soldiers' basic salary. (A precursor to today's entitlement programs) Additionally, throughout the Empire cities began to spend a disproportionate part of their revenues on such amenities as games, theatres, baths, and other **"pyramids."** *"Overspending,"* writes Professor F.E. Adcock, *"so weakened the financial and economic resources of the Empire that the crises that were to come in the third century were part of the price that the world had to pay for the* ***gilding*** *of the Golden Age of the Antonines."* (This accords with Warburton's contention that much of our recent prosperity has simply been a delusion built on an unstable and unsustainable increase in debt)

This drove the emperors to pursue never ending schemes to **debase the coinage** in order to underwrite the costs (Read *raise the debt ceiling*) of an ever-expanding imperial government and military from an ever decreasing revenue source – taxes – with the result being **rampant inflation**. Under Augustus in the 1st century AD, the Roman denarius (the equivalent of our modern day dollar) was worth twenty cents. In two hundred years it had fallen to around five cents. And in the fifty years of military anarchy that followed, it fell to less than one-half of one cent. And while records are sparse, we do know that in the Roman province of Egypt wheat went to **fifteen thousand times** its pre-inflation price. (Can you say Weimar?) Interestingly, despite the increasing worthlessness of the debased Roman coinage, economic historians tell us that in terms of its purchasing power, the value of gold remained stable from the first through the fourth century.

Retuning again to excellent prose of Haskell: "*A wretched proletariat developed in the slums of Rome. For those who worked, wages were kept close to the subsistence level by slave competition. Large numbers of the submerged class stolidly accepted their lot. For those who could not or would not find work, the government made what provision it felt necessary. They were at least able to obtain a living from the dole. There were free entertainments, including the brutal gladiatorial combats, and the extensive public baths furnished the facilities of modern athletic clubs for a nominal fee. This lazy living had its appeal. And while it would be a gross oversimplification to assert a narrow economic justification for the collapse of Rome, there is one thread that runs through the entire one thousand years that helps to explain the course of events. From the early days of the Republic down through the fatal third century and beyond, there is a persistent struggle between the Haves and the Have-nots that suddenly bursts forth, is suppressed, only to burst forth again. The fortunate classes were corrupted by wealth that was largely unearned.* [In the opinion of Kansas-born historian Tenney Frank, Rome became a nation of **"coupon-cutters."**] *The less fortunate were corrupted by their poverty, choosing dependence upon the public distribution of free grain over the tilling of the fields. As a result, many people preferred relief to wages."* And once it had taken hold, Rome, while quick to offer **"bread and circuses"** (the old world equivalent of Keynesian deficit spending), was never able to cure the disease of **"curse avoidance"**. In his book 'The Blue Wound', American journalist Garet Garrett aptly described this struggle; *"There is no hope for mankind in the escape from the curse. Those who succeed in putting their toil off on others have not escaped. They have only the illusion of escape. For a little time of ease and leisure they have delivered their future to the powers of destruction."*

Not unlike the problems facing the West today, the failure of the Roman system to provide that which it had promised (though like 'State' today, cannot provide), stability, security, and an ever increasing standard of living for the masses of people (Read *entitlements*), was a fundamental cause of its' instability, both politically and economically. The decay of moral character that was attended by the sudden rush of great wealth undermined the Republic even before it was beset by civil wars. (Read *monetary stimulus* and *financial speculation*) Later, in a society already destabilized through social bitterness, inflationism through extravagant public spending would prove fatal (Read *the solution is the problem*). The spending for non-productive public works (malinvestments), for the bureaucracy (public pensions), and for the army, led to the continual debasement of the currency (devaluation), excessive taxation (progressive tax code), and finally the evisceration of the essential middle class. (Read *a famine of income*) It destroyed those whom French historian Leon Homo calls, *"the general staff of civilization."*

Ultimately, **inflationism** *per se*, did not destroy the Roman state. Rather what it destroyed was the **liberty** of the Roman people. The systematic devaluation of the monetary standard of a nation committed to the principals of equal justice under law, involves, at the most fundamental level, a corruption of our most foundational and inalienable right – the right to the disposition of our possessions and persons as we think fit within the bounds of law. This principle was clearly enunciated by John Locke in his 'Two Treatises of Government' and was ably set down in the Declaration of Independence by Thomas Jefferson. So to those who speak of the impending collapse of our nation, we say be of good cheer, for the **Ghost of Inflationism Past** reminds us that just as the Roman state survived, so too will ours. But to those who prefer liberty to "stability" and freedom to "safety", the Ghost offers only a warning. If we remain committed to the Keynesian philosophy of **inflationism**, the coming collapse that we will face will not be a **sovereign default**, but rather like Rome before us, we will face the long, slow decline into mediocrity and autocracy. Writing in the early 5th century, Christian priest Salvian of Marseille offered his explanation for why the Roman state was collapsing in the West. *"The Roman state was collapsing,"* Salvian said, "*because it had denied the first premise of good government, which is to secure justice to the people."* Viewed from this perspective, the Roman state was the enemy; the barbarians were merely the liberators. The early history of the Roman Republic has been described by Haskell as the "*history of ordinary people doing extraordinary things*." Yet according to Professor F. Lot, *"at the end there were not Romans left to do the work of Rome."* The Preacher reminds us that without remembrance there can be no redemption. Unfortunately it is satirist Stephen Colbert who correctly gauges our priorities: *"There's an old saying about those who forget history. I don't remember it, but it's good."*

STAVE THREE

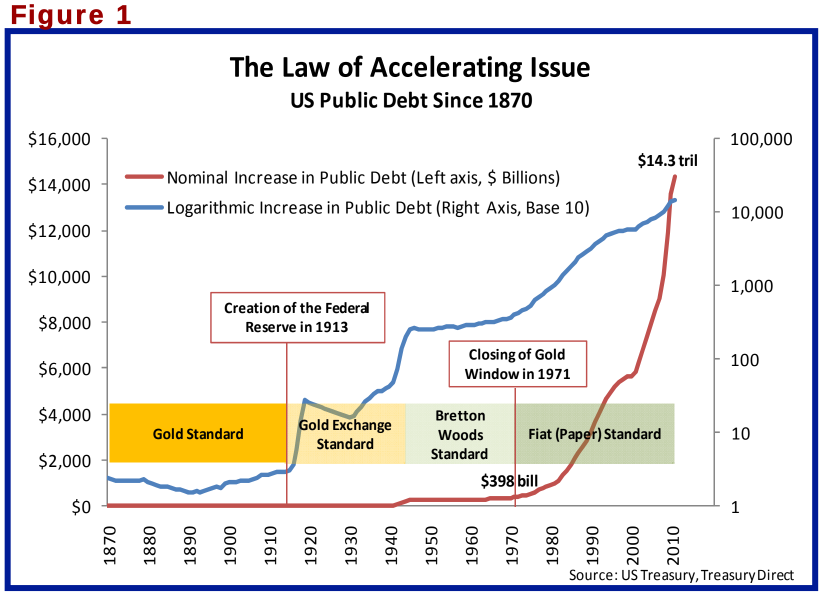
THE SECOND OF THE THREE SPIRITS

"Come in! And know me better, man! I am the Ghost of Inflationism Present," said the Spirit. "Look upon me!" "Spirit," said Scrooge, "conduct me where you will Spirit. If you have aught to teach me, let me profit by it.""

For many years now, we have labored to establish the prominent role played by the long-term decline of the US monetary standard in the recurring economic and financial crises that have beset our nation, at one point co-opting the title of economist Jacques Rueff's book 'The Monetary Sin of the West' to encompass the whole of our story. But time is growing short (and this letter overly long) so we must hurry on so that we may *"look upon"* and consider our present condition.

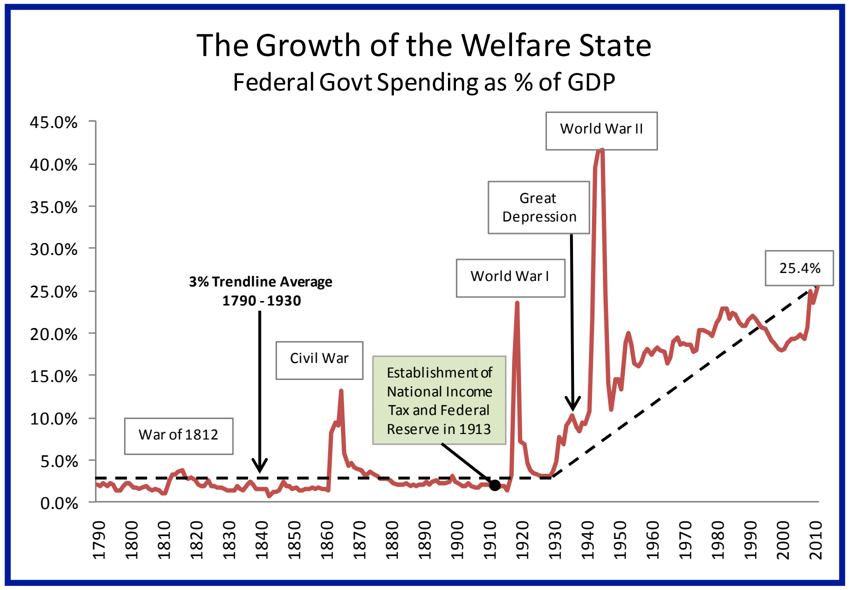
As we have stated in previous writings, the undertaking that has dominated the political economy of twentieth and now twenty-first century America, has been a deliberate program of increasing the volume of money and credit and the confidence of lenders and borrowers in an effort to facilitate the illusion that permanent prosperity, defined as the elimination of scarcity and the diminution of the business cycle, can be achieved through the perpetual expansion of credit, i.e., **inflationism**. In the past, we have dubbed this undertaking **"The Great Experiment"**, referring to the perpetual increase in credit as the **institutionalization of inflation** and the economy's resultant increased dependence on financial markets as the **financialization of the economy**. A key part of the program to make credit easier to obtain and lighter to carry was the transition from a monetary standard governed by the automatic stabilizer of gold (convertibility), to a paper standard governed by the 'stabilizers' at the Federal Reserve (inconvertibility). The demonetization of gold, a calculated effort to dissociate credit movements from gold movements, is illustrated in **Figure 1** which illustrates the **exponential growth** in the US public debt since 1870. The chart denotes the steady deterioration in the monetary standard of the US, from the restraint of convertibility under the gold standard, to today's inconvertible paper standard, the history of the US monetary standard is one of continual decline. Two important dates are called out on the chart: 1913, the creation of the Federal Reserve which inaugurated the decline and initiated a period of transition of declining convertibility, and 1971, the closing of the gold window, denoting the end of the transition period and the start of our **Great Experiment** with paper money. In our opinion, the key to the new **economic imperialism** of the US was the creation of a Central Bank to coordinate the credit inflation and act as a lender of last resort to protect the interests of the banking cartel. It was the massive expansion of the money supply by the Federal Reserve through bank lending that gave rise to the boom of the Roaring 1920s that ultimately went bust in the Great Depression of the 1930s.

Figure 1



The nominal growth of the public debt is represented by the red line. Aside from the sheer size of the public debt, two items stand out on this line across the passage of time. First, the marked acceleration in the level of debt outstanding after the closing of the gold window in 1971, and second, the marked increase in the trajectory of the debt expansion after the 1998 LTCM crisis and 2000 stock market collapse. Since 1971 the outstanding public debt of the US has increased from $398 billion to $14.3 trillion, an increase of nearly **forty-fold**, representing an annualized rate of increase of **9.7%** per year for forty years! That's a lot of manna. Since 2007 alone, it has increased **$5.8 trillion**, or just over **11% per year**. If sustained at that rate, the public debt would **double again** to nearly **$29 trillion** in less than **six and one-half years**. The blue line presents the same data using a logarithmic scale. On a logarithmic scale, a given vertical distance on the y-axis represents the same percentage change in price so that the distance from 1 to 10 represents the same percentage change as the distance from 10 to 100, except the latter distance of 10 to 100 is ten times greater on the nominal axis. The key insight to be gleaned from the logarithmic scale is that the expansion of public credit (inflationism) and the concomitant increase in the **growth of the welfare state** (**Figure 2**), began immediately after the creation of the Federal Reserve and the abandonment of the convertibility restraint under the gold standard, and has continued unabated ever since. Looking only at the nominal increase in the debt as measured by the red line, it appears that the expansion of credit did not begin in earnest until post-1971. The problem is that because the nominal value of the debt has increased so dramatically since the 1970's, those numbers are **many orders of magnitude larger** than the debt prior to that date. By using a linear scale to graph the nominal debt values, the information contained in the data points prior to that time are effectively lost. In our opinion, this chart graphically illustrates the **"law of accelerating issue"** which follows from the naïve pursuit of a policy of **inflationism** under a paper-backed monetary regime (a modern form of ancient "coin clipping") in order to support the ever burgeoning costs of government. (Remember the Roman "twilight") If you find yourself struggling with the immensity of the sums involved, you are not singular. According to Dr. Albert Bartlett, Professor Emeritus of Physics at the University of Colorado: *"The greatest shortcoming of the human race is our inability to understand the exponential function."* Unfortunately this is one nation-wide attention-*deficit*-disorder that we must not fail to overcome.

Figure 2



Our present condition then, in brief, comes to this. The abandonment of **"honest money"** guaranteed under the Constitution, and by this we mean hard money backed by gold of uniform and unchanging measure, has been instrumental in the pursuit of a **policy of inflationism** as the means to provide for the unrestrained **growth of government**. The results have included a massive increase in total debt within the US, not the least of which has been public or government debt. However, as we have discussed in great detail over many years, in a debt-based monetary system, **all money is debt**. As such, the Achilles' heel of such a monetary system is a **debt deflation**. American economist Irving Fisher who literally *"wrote the book"* on debt deflation, believed that only two preconditions needed to be met for a debilitating debt deflation to take place. First, there had to be an abundance of debt in place, and second, asset prices had to be falling. According to Fisher's deflation theory the sequence of events which accompany the bursting of the debt bubble include the following:

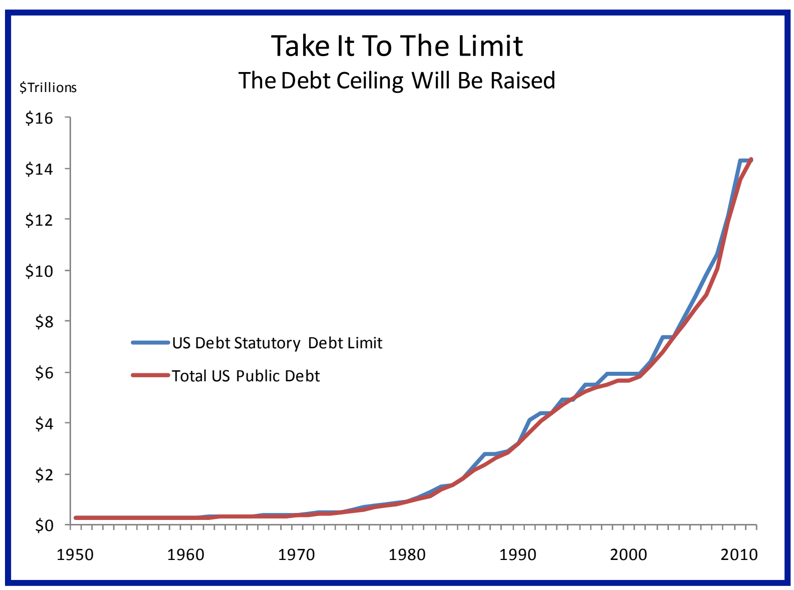
1. Debt liquidation and distress selling.
2. Contraction of the money supply as bank loans are paid off.
3. A fall in the level of asset prices.
4. A still greater fall in the net worth of businesses, precipitating bankruptcies.
5. A fall in profits.
6. A reduction in output, in trade and in employment.
7. Pessimism and loss of confidence.
8. Hoarding of money.
9. A fall in nominal interest rates and a rise in deflation adjusted interest rates.

Even a superficial review of the sequence of events which may ensue according to Fisher under a debt deflation, gives us insight as to why the maxim of central bankers of all stripes is that **deflation is something to be avoided, not corrected**. We have contended for years that this is the real reason why the stabilizers have gone to such unprecedented levels of intervention in order to avoid a debt deflation primarily through the manipulation of asset (Read stock) prices. It is because they know that if the US were to sink into the black hole of a debt deflation, they have no monetary tools which would be effective in fighting it. One need only reflect on the history of the Great Depression or more recently, Japan's own deflationary **'Lost Decades'** to apprehend the impotency of monetary policy to overcome the gravitational pull of a debt deflation.

For this reason, every effort, both fair and foul, has been made by the stabilizers to postpone a debt deflation by **preventing prices** from falling to **market clearing levels**. This includes prices of assets, wages and interest rates. Quite frankly, in the absence of a hard money system and with the current degree of **impairment** to the current global dollar standard, the option of allowing supply to re-adjust to demand through the process of falling prices is simply unthinkable. As such we have continued to maintain that **'Atlas' will not shrug** and the stabilizers will continue to intervene and supply liquidity to the markets in an effort to reflate asset prices. (QE3 to QE-Z) However, this led to another of our long-standing themes – ***"the* solution is the problem."** Or to paraphrase Fisher's two conditions; **supply creates its' own deflation**. Pursuing a policy aimed at postponing a debilitating debt deflation – one of the two preconditions of which is an abundance of debt – through the creation of even more debt in order to forestall the second condition (falling asset prices) – is surely a triumph of **Orwellian doublethink**. Doublethink was a term coined by George Orwell which referred to the act of simultaneously accepting two mutually contradictory beliefs as true. Wasn't it Einstein who remarked that *"insanity was doing the same thing over and over again and expecting different results"*?

As we go to press with our report, the political **"game of chicken"** that has become our legislative process is in "full vigor" as the political peacocks' posture for 2012. Someone has aptly described the political process as **"failure by compromise,"** a definition we simply cannot improve upon. But whatever "political failures" will come of this current inanity, one thing we have learned with certainty from the **Ghost of Inflationism Present** and so may *"profit by it"*: **There will be no outright default of US Treasury debt!** Why? For that answer we refer you to **Figure 3** as we again quote Freeman Tilden: *"When the government becomes a debtor, it must be the less able to properly govern. The conflict between the interests of creditor and debtor is eternal. In such a position, how can government, itself a debtor, be unprejudiced? It cannot, and it is not. In normal times the creditor class will be patronized, for reasons both adroit and reasonable: but when the prosperity and credit of the state is so shaken the government must choose between the legal claims of the debtor class, its course is indicated: it is itself a debtor, and will profit, as government, from any lifting of the debt burden."*

Figure 3



STAVE FOUR

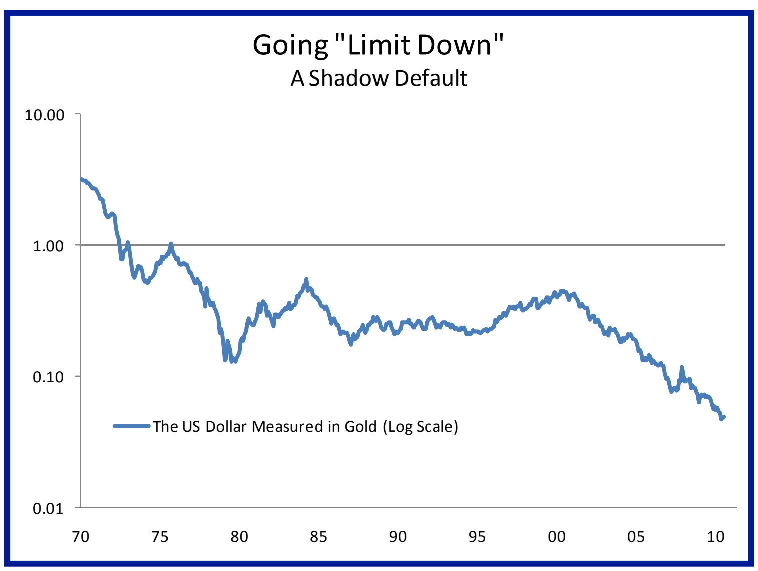
THE LAST OF THE SPIRITS

"Ghost of the Inflationism Future!" said Scrooge, "I fear you more than any spectre I have seen." "Men's courses will foreshadow certain ends, to which, if preserved in, they must lead," said Scrooge. "But if the courses be departed from, the ends will change. Say it is thus with what you show me!"

The Ghost of Inflationism Present assures us that because the alternative is simply unthinkable, no matter what mayhem the bumblers in Washington may contrive, happily we *will* raise the debt ceiling and there will be no **Selective Default** on US Treasury debt. The US Treasury will continue to remit checks and refund its debts through the auction process in a timely fashion (Even if the Fed must print the money to do so). Nevertheless, despite this pledge of no outright default on US Treasury debt, the **Ghost of Inflationism Future** assures us that there will be a ***'de facto default'*** via the continued **devaluation** of the US dollar. We would remind our kindly readers that there are no physical assets standing behind the Treasury debts of the US government. With the demonetization of gold, a creditor to the US Treasury cannot demand repayment in gold anymore than he can demand a fragment of the Lincoln Memorial or a cubic yard of Yellowstone National Park for satisfaction of the debt. No, under our **legal tender laws**, the creditor must accept payment **"in-kind"**, that is, he must accept another IOU from the Treasury in settlement of his claim. This irony was not lost on Freeman Tilden: *"While it is naturally difficult for the uninitiated to realize, that though a government may print as much token money as it pleases, the money is always a liability of the government, always a debt."*

So while a continuing policy of postponement through inflationism will guarantee the continued emission of US Treasury debt, *in-kind*, the **real value** of that debt will be falling via a **"shadow default"**. (See **Figure 4**) Alas, but this is only one symptom of the disease called **inflationism**, not the disease itself. Other symptoms which the **Ghost of Inflationism Future** has long portended are a protracted period of sub-par economic growth that we have termed a **"rolling recession"** *a la* Japan, intractable structural unemployment (echoing our "Jacob and Esau" theme involving the sale of our birthright [manufacturing jobs] for low-cost imported goods) and the continued **redistribution of wealth** and **polarization of income** which we have referred to as a coming "famine of income." Addressing the issue of an outright default versus a **pretended** or **shadow default**, economist Adam Smith said: *"A pretended payment* [via currency devaluation], *extends the calamity from the creditors to a great number of other innocent people. It transfers wealth from stronger hands to weaker hands."* This is the progression of the disease which if inflationism, for: *"When the cure is worse than the disease, the addiction is likely fatal. So it is with drugs and alcohol. So it has always been with governments that have overdosed on unlimited paper money."* And so it was with Rome.

Figure 4



STAVE FIVE

THE END OF IT

"I will live in the Past, the Present and the Future!" said Scrooge. "He had no further intercourse with Spirits, but lived upon the Total Abstinence Principle, ever afterwards."

We have addressed the issue of an outright or selective default but one question remains. Will US Treasury debt lose its' AAA-gilded rating? Unfortunately that will predominantly be a political, not a financial question, and as such we do not pretend to foresee that outcome with certainty. But if that were permitted to occur, it would surely be the biggest political blunder since the stabilizers refused to bail-out Lehman, and as such we regard such an occurrence to be a genuine **"black swan"** event. (As an aside, even if a downgrade should occur, as the largest and most liquid debt market in the world combined with the dollar's ongoing status as the world's sole reserve currency, to whom shall both the investors and mercantilists of the world go?) Nevertheless, the reputed empiricist David Hume would not have been as sanguine. *"The public is a debtor,"* said Hume, *"whom no man can oblige to pay. The only check which the creditors have upon her, is the **interest of preserving credit**; an interest which may easily be overbalanced by a **great debt**."* How great a debt would impair our credit? Not even the Ghosts can say for sure. But we repeat here our warning given in our last quarterly review: *"We are literally steaming toward a veritable iceberg of **unfunded liabilities** which have been conservatively estimated at $44 trillion, which when added to the current level of public debt already issued, the total is nearly $60 trillion. In many ways, the $14.3 trillion in current outstanding public debt is equivalent to Bastiat's that which is seen, it is the proverbial tip of the iceberg, while the vast majority of the threat, which is just as real, remains unseen, still safely submerged from our radar screen with the only thing separating them being the mere **passage of time**. This is the chief danger and the critical point to apprehend is that no action whatsoever is required for that which is unseen to become that which is seen."* Einstein once remarked: ***"The only reason for time is so that everything doesn't happen at once.***" We would add that it is also the blessing of time that we still have time to *"depart from our current course, and so change the ends."*

"The history of national fiscal management is," said Freeman Tilden*, "bluntly stated, the continuous struggle: first, to regulate the income and outgo of a nation so that the practice of currency swindling will not become necessary; and second, the valiant effort of responsible minds, when budgets have been unbalanced through war or the excesses of peace, to restore equilibrium through Spartan self-denial. Taxation is the true tonic of a disordered financial body. Debt is merely a poisonous stimulant that defers the honest reckoning or hastens the dishonest failure. Only by paying bitterly and at once for their mistakes do people realize what those mistakes have been, and learn how to avoid them."*

At last we come to the end of this overlong letter. We have heard from the Ghosts of Inflationism Past, Present and Future. And still the question stands before us: will we remember and learn, or like those who came before, continue to *"fiddle and burn"*? As we have argued, the debt ceiling will be raised, but for the reasons outlined in this paper, it *should not* be raised, at least not permanently. (There are alternatives, including eliminating the $1.6 trillion of US Treasury's held by the Fed) The problems we face are both real and serious and they call for serious people seeking long-term solutions. If we, like Scrooge, can learn to live upon the **Total Abstinence Principle** against inflationism, then perhaps it may truly be said of all of us in time, *'God bless us, everyone!'*