Redstone Advisors

Economic and Market Review

Third Quarter 2010

"So when the money failed in the land of Egypt and in the land of Canaan, all the Egyptians came to Joseph and said, 'Give us bread, for why should we die in your presence? For the money has failed.'"

Genesis 47:15, NKJV

A note to our clients and readers:

This economic review will represent something of a marked departure from our typical reporting style. We believe that our readers will find this review to be less topical and quantitative, in favor of a more philosophical and introspective commentary on the current state of affairs facing the US, and to a large extent, the West today. At its core, economics is simply the science of human choice. It is not, as it is so predominantly portrayed today, a quantitative discipline. We live in a world of uncertainty, and what is uncertain is by definition, both unknowable and non-quantifiable. As such, the act of choosing by self-interested human beings is not well explained by either probability distributions or mathematical algorithms, no matter how sophisticated. Acting man determines and chooses in an effort to attain a certain end. Therefore, one of the primary goals of the science of human choice is to evaluate the fitness of the "means" chosen to achieve a particular end. As most of our readers are aware, we have been agitating against the means chosen by our government and our monetary authorities for many years, specifically the perpetual expansion of money and credit and the resulting intentional debasement of our currency via inflation and its insidious impact on society. This policy of postponement is, to borrow a phrase coined by French economist Jacques Rueff, ***"the monetary sin of the west."*** *And while we have put forth our objections in many forms over the years, the emphasis within this review will be more upon the nature of the injustice rather than upon the mechanics of its implementation. We will return to a more normative report format next quarter.*

According to the biblical record, seven years of famine followed seven years of plenty. And as the famine conditions grew worse, the Egyptians fell into dire need as there was no bread in all the land and the people were ready to die. So the people came to Joseph seeking food for their families, parting with all their money, so that in time the money ran out or **"failed"**. After the money ran out, they traded all their cattle for grain. And when they had sold all their stock from off their land, they sold their land. For what good would land be to them, when they had neither corn to sow it nor cattle to eat of it? Finally, when their land was sold so that they had nothing left to live upon they sold themselves so that they might secure food by their labor, for ultimately everyone must eat their bread by the sweat of their brow. Therefore they pledged to Joseph: *'You have saved our lives, we will be Pharaoh's servants'*. And while clearly a distressing situation, the people nevertheless agreed to such severe measures that they might eat and not starve. For as Samuel Johnson once observed, ***"The prospect of hanging concentrates the mind wonderfully."***

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Today, minds throughout the West are also being "*wonderfully concentrated",* and well they should be. For to intone another biblical injunction, *"with all our getting*, [we need to] *get understanding"* and for this reason our story was selected to suggest several important insights. First, our story in Genesis perfectly illustrates money's sole function – **money is a medium of exchange period!** Men do not directly satisfy any of their wants with coined or paper money. If they are hungry, they want bread; if naked, clothing; if they are cold, they want shelter and fuel. The real wealth of a country consists in the abundance and the proper distribution of all such useful things. And so the first insight that we may glean from our story is that **money is not wealth**. Instead to the extent it arises naturally from the exchange of labor and production, it merely represents an outstanding claim on wealth, thereby serving to facilitate the transmission of real wealth from one to another. As such if a man lacks money to buy bread from his neighbor, the cause is not to be seen in an alleged scarcity of money. Rather the cause is always that the man did not succeed in earning the requisite amount of money needed through the sale of goods or the rendering of services for which people are willing to pay. This is true regardless of whether his inability to pay is due to a lack of industry on his part or an increase in the price of the goods demanded. This leads to another insight, namely that money does not act as a fixed measure of value, i.e., **all value is subjective**. By an act of God, the famine had reduced the supply of grain, causing the price of the much needed grain to rise and conversely the value, or purchasing power of the money to fall. This serves to discredit the age-old fallacy that value is an intrinsic quality inherent in things and not merely an expression of people's eagerness to acquire them. People buy and sell only because they value the things acquired more than the value of those things given up. If this were not true, no exchange would ever take place. Value, like beauty, is ultimately in the eye of the beholder, not the issuer of the currency. And so our story permits us to clearly see that no amount of money production could have increased the supply of grain, thus ameliorating the distress of the people, since money cannot purchase grain that no one has raised. Likewise, no action taken on the part of any monetary authority could have prevented the recalibration of the value relationship between grain and money. Nevertheless, so strong is the money delusion that we are confident that had the Egyptians been under the benevolent oversight of today's Keynesian planners, the solution would no doubt have involved the creation of more money. And while, unlike the days of the Pharaoh's when money was gold, today's paper money cannot run out as long as our central planners are in possession of Gutenberg's technology, it can still **"fail"** through the **debasement of its value**. And so not unlike the mythical King Midas, a nation hell-bent on turning everything into gold [money] may yet discover that the *"golden touch"* is but a curse and ultimately **"starve"**. For as J.R.R. Tolkien once wisely observed; ***"All that is* [true] *gold does not glitter."***

But the planners will object that surely the problem facing the West today is one of a surplus of supply, not a shortage. How can a nation of such plenty possibly starve? A fair question to which we will respond in due time, but first tell us how the glut came to exist? Employing a loose paraphrase of an article written on March 11, 2009 by Alan Greenspan entitled 'The Fed Didn't Cause the Housing Bubble', the planners response would undoubtedly be some variant of the following;

> *"Why those evil foreigners and their mercantilistic policy of currency manipulation whereby they artificially reduce the price of their products for offer on the global markets thereby gaining an un-*

fair trade advantage for their products to the detriment of ours. As such, our manufacturing jobs gravitate to the lower cost areas, allowing them to acquire a massive 'glut of savings' in the form of foreign exchange which they then use to 'invest' in our stocks and bonds, driving our investment markets higher and our long-term interest rates lower than they otherwise would have been, triggering fantastic booms and manias in stocks and housing, the wealth effect of which served to underwrite an unprecedented rise in debt-based consumption, which, upon the booms going bust, saddled us with massive malinvestments and economic distortions, leaving us to deal with the prospect of a debilitating debt deflation as the excesses of the booms must now be corrected. Therefore what is necessary is to encourage an increase in demand and since all that is required for anyone to 'demand' is money, then it follows, that we only need make more."

Our first response to Mr. Greenspan's **"foreign savings glut"** explanation is to note that we must have *"fallen down a rabbit hole"* as such an explanation clearly belies a *"through the looking glass"* approach to cause and effect. Nevertheless to understand the causal relationships aright, we must first recall an ***"inconvenient truth"*** from history. In August of 1971, the US effectively **abandoned the 'birthright'** which it had secured in 1944 under the Bretton Woods monetary agreement, when the US choose to **renege** on its pledge to maintain convertibility, thereby committing a ***defacto*** **default** on its external debts. Under Bretton Woods the constellation of the global monetary system was constituted with the US dollar at the center as the global reserve currency, and all other major currencies orbiting as satellite currencies with their respective exchange rates fixed to the dollar. The stability of the system was to be firmly anchored by the **US commitment** to maintain full and free convertibility of the dollar at the exchange rate of $35 dollars per ounce. In this way, the US, by assuming the responsibility for providing and maintaining the sole source of liquidity to most of the world, would receive in exchange what Jacques Rueff described as the ***"exhorbitant privilege of running deficits without tears."*** However, with the **abandonment** by the US of its promise of dollar convertibility for gold, the world monetary system, devoid of any plausible substitute, moved by default to a **dollar standard**, whereby other sovereigns were not only free but were, by ***force majeure***, compelled to **manage** their respective currencies against an unanchored dollar that still dominated both global trade and investment. The arrogance that accompanied our **repudiation** was summed up by then Treasury Secretary John Connally's infamous remark to a delegation of Europeans concerned about the prospects of violent exchange rate fluctuations in a world without an anchor; ***"The dollar is our currency, but it is your problem."***

What's the point? After all, that was nearly forty years ago. Our point is that while we would certainly agree with former Treasury Secretary Henry Fowler who once remarked that *"providing reserves and exchanges for the whole world is too much for one country and one currency to bear",* nevertheless had the US **not reneged** on its commitment and suspended convertibility in order to recklessly pursue a massive inflationary domestic agenda of social welfare and military expansionism, choosing instead to live within its **fiscal means** and its **fixed boundaries**, any assault on a dollar which was a **"good as gold"**, would be **futile**. China or any other sovereign nation is today **"free"** to opportunistically pursue *'beggar thy neighbor'* policies solely because our **act of intransigence** permits it. As such, we have a massive trade deficit today with the world in general and with China in particular, not because of the acknowledged manipulation of the US dollar/renminbi exchange rate, but because of the inherent conflict between the stated twin goals of central banking, the pursuit of full employment and the stability of the currency. By pursuing the eradication of what Keynesians hold to be the sole impediment to the increase of wealth, i.e., the scarcity of money, and by extension the elimination of uncertainty through the nullification of the business cycle, all in a futile effort to ensure perpetual full employment, we have instead cultivated today's **"famine conditions."**

To what famine conditions do you refer, will come the reply? After all, the US economy's biggest problem, as businesses and policymakers alike will agree, is a surfeit of supply in search of demand. To which we would respond that we do not deny the ***existence*** of a surplus, merely its ***composition***. The surplus is not evenly distributed across the productive structure of the economy rather it is, as predicted by the Austrian theory of economics **maldistributed**, being concentrated predominantly in housing, autos, certain commodities and all things financial. These sectors have been the primary **"beneficiaries"** of the massive on-going expansion of credit un-backed by a commensurate increase in production. As such, it has been the exponential rise in debt, not wages or income that has fueled the "surplus" so readily identified.

However neither Keynesian nor Monetarist theory recognize this causal link as they both suffer from a flawed theory of capital and production. Both of these schools hold to a static concept of capital whereby capital is a permanent social fund which automatically and instantaneously generates income. In addition, they hold that production and consumption occur simultaneously, and as such, they ignore the impact of the passage of time on the productive process. By assuming capital is a self-sustaining fund, immune to destruction, in a production process that does not involve time, they are prevented from recognizing the real life impact to the structure of production resulting from changes in savings and credit expansion. As such, both are purely macroeconomic theories which ignore the microeconomic effects on the productive structure of the economy due to individual choices of creative entrepreneurs played out across time. Owing to monetarism's infamous **equation of exchange,** MV=PT, where; M=money supply, V=velocity of money, P=general price level, and T=total quantity of goods/services produced; both schools assume a direct causal link between total money in circulation and total production (GDP). Holding the velocity (V) or turnover of money constant, they postulate that an increase in the money supply (M) will result in a increase in nominal GDP (P x T). As such, they hold that in the long run, money is neutral because an expansion of the money supply will **proportionately** raise the general price level. Therefore a credit expansion gives rise to excess monetary **demand** which is said to be **uniformly distributed** over all goods and services and as such there can be no impact to the **structure of relative prices** which could result in the disruption or disco-ordination of the productive structure of the economy. By explicitly ignoring the impact of the effects on the structure of relative prices due to the actions of individuals taken across time, they utterly fail to comprehend the misdirection of resources and the accompanying displacement and structural unemployment caused by the expansion of credit. For this reason, advocates of both schools never fail to campaign for an increase in the money supply in order to fight a recession or a crises. They fail to realize that by pursuing a **policy of postponement** through the perpetual expansion of credit, we prevent the liquidation of malinvestments, thereby prolonging the length and increasing the severity of the inevitable day of reckoning by preventing an adjustment of prices and wages in the relative productive structure which would allow recovery to begin. Rebutting the **"money illusion"** argument in lectures given long ago, Austrian economist Friedrich Hayek warned; *"Any attempt to combat the crises by credit expansion will, therefore, not only be merely the treatment of symptoms as causes, but will also prolong the depression by delaying the inevitable real adjustments."*

But what could possibly be wrong with delaying such a correction? To quote another Austrian economist Eugen von Böhm Bawerk; *"Just as natural phenomena are governed by immutable eternal laws, quite independent of human will and human laws, so in the sphere of economics, there exists certain laws against which the will of man, and even the powerful will of the state, remain impotent."* We have written extensively about the destructive impact of the Keynesian philosophy of impeding the necessary adjustment of relative prices by pursuing a policy of postponement through the expansion of credit. Relying on the **Law of Inevitability** as so eloquently stated by Bawerk, it has been our position that all of the efforts to forestall a meaningful correction of the malinvestments and distortions to the productive structure of the economy, and so avoid the proverbial *day of reckoning*, has only served to further subvert capital and resources which could be redirected to productive sectors. As such, the continuing monetary expansion has simply increased the volume of competing claims outstanding against wealth without a commensurate increase in real wealth and therefore we have stubbornly maintained that the **solution is the problem**. Nevertheless our detractors will insist that despite the severity of the current crises (itself a culmination of prior postponement operations), and the potential for an extended period of high structural unemployment and substandard economic growth *a la* Japan, economic Armageddon has not occurred, giving rise to the belief that the day of reckoning need never fully arrive, thereby vindicating the policy of postponement. To such an assertion we would suggest that the real danger inherent in a strategy of postponement lies not in its **illusory respite** from unavoidable misery, but in its **asymmetric dissemination**.

For many years we have insisted, that despite its inevitability, the day of reckoning would be a ***process and not an event***. We have detailed how the stabilizer-induced boom-bust-boom cycle both **redistributes** and **destroys** wealth through the debauchment of the currency, but that it does not do so evenly. The favored few who receive the new emission of credit first [the banking oligarchy] obtain a **"claim"** against existing wealth that did not arise from productive activity. As such they stand in a position to exercise their claim and so command or **"draw off"** existing wealth before any adjustment to the relative price structure can take place. For despite the Keynesian and Monetarist claim to the contrary, the new emission of money does not adjust all prices either **immediately** or **equally**. However, those who possess the new money at the moment of its depreciation will obtain a **smaller gratification** for the same amount and it is in this way that they are **impoverished**, almost imperceptibly, day by day. For as described by the great French economist Frederic Bastiat; ***"A monopoly transfers wealth from one pocket to another, but it always occasions the loss of a portion in the transfer."***

It is that **"loss"** referred to by Bastiat, that small, undetectable act of legalized theft which, **after forty years**, has swollen into a massive deprivation which today threatens many in the US and indeed throughout much of the socialized West, with a **famine of epic proportions**. Not a famine of grain, but a **famine of income** as reflected by the **stagnation of real incomes** and the ongoing **polarization of**

income between the wealthy and the poor. The abandonment of the Bretton Woods gold standard in 1971 in favor of the ***"something for nothing"*** promise of paper money, has led directly to an increased concentration of wealth and the demise of real income growth in the US. In his analysis, Professor Raghuram Rajan of the University of Chicago points out that *"of every dollar of real income growth that was generated between 1976 and 2007, 58 cents went to the top 1 per cent of households."* Today, the wealthiest 1 per cent of households in the US owns 35 percent of all net household wealth and 56 percent of all stocks, while the top 20 percent owns 85 percent of all net household wealth and 80 percent of all stocks. This is aptly borne out by **Figures 1** and **2**. **Figure 1** illustrates the rise in the number of Americans beneath the official poverty level as well as the marked increase in the polarization of income since the abandonment of the Bretton Woods agreement in 1971. It is not the total wealth of a nation, but its **distribution** that is of paramount importance. For if it is grossly imbalanced, a significant proportion of the population will ultimately be unable to ride out the storm, delaying the onset of the famine only through the loss of personal liberty. Quoting the Roman historian Plutarch; ***"An imbalance between rich and poor is the oldest and most fatal element of all republics."***

Figure 1

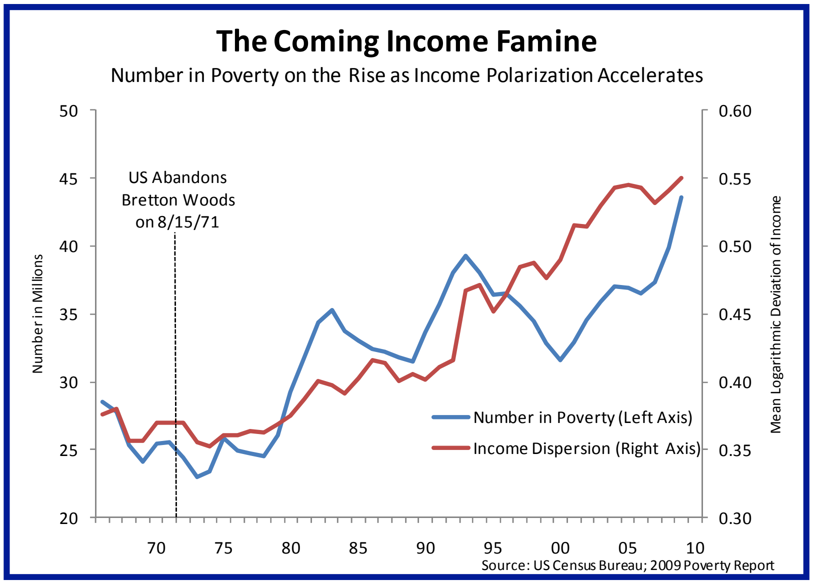
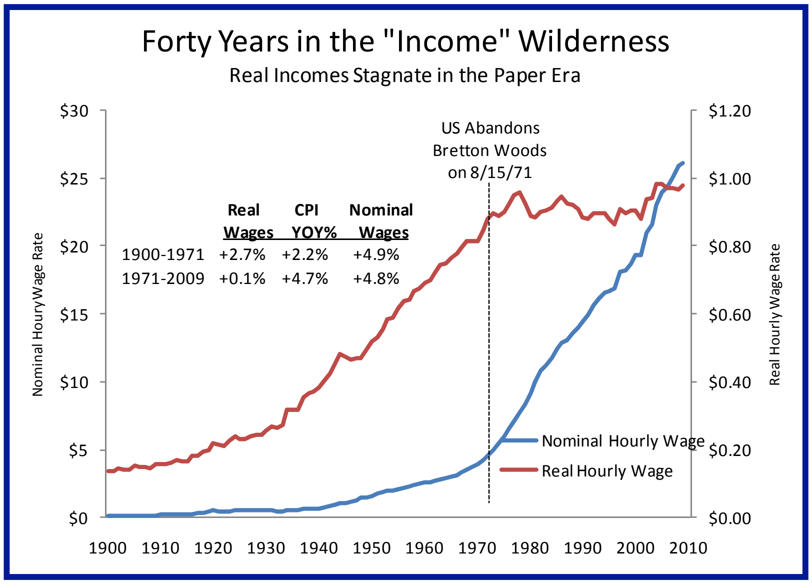


Figure 2 illustrates the stagnation of real income that has transpired since the initiation of the paper money era. Between 1900 and 1971, nominal wages rose 4.9 percent annually, with inflation only accounting for 2.2 percent per year, real wages rose nearly 3 percent per year due to real productivity increases. However subsequent to the abandonment of Bretton Woods, nominal wages have increased 4.8 percent per year, but with inflation accounting for 4.7 percent of the increase, real wages have been effectively **unchanged for nearly forty years**. This is reflective of the transfer of wealth predicted by Bastiat due to the abandonment of honest money in favor of the establishment of a credit-based money monopoly. With the grant of exclusive privilege conveyed on the banking oligarchy, they can, through the magic of fractional reserve banking, create debt ex nihilo, i.e., out of nothing. And as all debt carries an interest rate, it **draws wealth** from the economy at regular intervals just as the moon draws the tide. And while there is certainly nothing inherently wrong with earning interest on debt, this debt did not require the rendering of a real service in exchange. As such, over time, those with the most collateral have the advantage in borrowing new money into existence. Writing in the early twentieth century, Sir Josiah Stamp, then a director of the Bank of England described this insidious privilege: ***"Banking was conceived in iniquity and was born in sin. The Bankers own the earth. Take it away from them, but leave them the power to create deposits, and with the flick of a pen they will create***

enough deposits to buy it back again. However, take it away from them, and all the great fortunes like mine will disappear and they ought to disappear, for this would be a happier and better world to live in. But if you wish to remain the slaves of Bankers and pay the cost of your own slavery, let them continue to create deposits."

Clearly the ancient feudal system between the landed aristocracy and the bonded serfs, paled in comparison to the modern day paper monetary system in its ability to **rob** its constituents. Nevertheless, as Bastiat once observed; *"To rob the public, it is necessary to deceive them. To deceive them, it is necessary to persuade them that they are being robbed for their own advantage."* And just what advantage could be offered that would make us insensible to such a crime? Why nothing short of the Keynesian Holy Grail itself, the **promise of something for nothing**. In short, they offer the fruit of the money monopoly to the masses. When the monopoly is isolated, it never fails to enrich the one granted the privilege under law. But when all seek the same privilege, spoliation is reduced to a system which offers the illusion that everyone *gains more from a general market impoverished by all*. The heart of Keynesian philosophy is that what drives the economy is the **demand for things**, and as such, any downturn is simply the result of insufficient demand. And in the Keynesian framework, an increase in demand not only lifts the overall output of all things, but that output is magically increased by a multiple of the initial increase in demand, thereby enabling the attainment of the promise of something for nothing. And even though we would agree that labor is not desirable for its own sake, but rather for consumption, sadly the idea of relying on work and entrepreneurship as a means to well-being has become a poor second idea to acquiring resources by theft. And while as our story from Genesis clearly illustrates, it is only by the sweat of our collective brows that we eat bread, it is equally true that *everyone wants as much bread and as little sweat as possible*.

Figure 2



The US and the West, are in many ways, at a crossroads. Faced with the growing realization that everyone cannot be enriched at the expense of everyone else, governments are grappling with how best to **renege on promises** that in fact, were never possible to keep. This has always been the calumny of socialism. To paraphrase Margaret Thatcher, there always comes a time when you run out of other people's money, i.e., when ***"the money fails"***. And that time, even if it has not yet fully and finally arrived, can at least be *"seen from here."* As such, plans and policies for austerity [a government euphemism for bankruptcy] are currently being advanced throughout Europe. One only has to read the news reports of strikes, rioting in the streets and of other acts of civil disobedience to apprehend the attitude of those who are being asked to accept the need for the **suspension of the promises made**, and so make do with less. '*But a promise is a promise*', they will say, even an unjust one. And so the cries of creeping collectivism will continue to go up for governments to do something about it. Regrettably, armed with a barren philosophy and faced with the prospects of a coming debilitating famine of income, the something that is always pursued is an increase in the supply and availability of debt-based money. This, as we noted at the outset of this report, is the real **monetary sin of the west**.

As we have maintained for years, faced with the prospect of an inevitable debilitating debt deflation [a famine of income] as a consequence of a policy of perpetual inflation, the postponement of the day of reckoning has become the default **political option of choice**. This policy of postponement long pursued by the stabilizers in their pretence to overcome scarcity and so annul uncertainty is reflective of a choice to take the *road most traveled* and pursue the **soft political option** with respect to the production of more money. As such, the ultimate **point of no return** for a nation seduced by the siren song of the Keynesian money miracle of *turning stones into bread* is **not financial**, but it is rather a **moral one**. As such, the identification of a specific **"tipping point"** into hyperinflation for a nation committed to a policy of perpetual inflation through the production of money need not be sought on a **graph** of currency devaluation or the balance of payment deficit. Rather it lies on the **falling curve of political possibility** which reflects the diminishing degree of **political courage** that a nation or its government is able to muster as the severity of the inevitable outcome of its own unsound action increases. This, in our opinion, is the real **"Tragedy of the Commons"**, when a nation finds it **politically untenable** to take action that, though morally right and in the best interest of the country in the long-run, would exacerbate unemployment and increase dislocation in the short-term, the ultimate consequences of which would be the disempowerment of the very government with the responsibility to take action. This is in fact, the conclusion of history. As such, the collapse of the global hegemony of the US, should it come, like Rome, France, and Britain before us, will be first and foremost, a moral one.

And so we find both a **parallel** and a **paradox** with our story from Genesis. For the parallel, we can see that in both cases, the **failure of the money** led to great hardship and ultimately to servitude. Yet if all the Egyptians had done for themselves during the seven years of plenty as Joseph as Prime Minister of Egypt had done on behalf of Pharaoh – purchasing and setting aside one-fifth of the produce of the land as a reserve against a time of famine – they would not have found themselves in such dire straits. But they did not regard the warning they had received of the coming years of famine, concluding that tomorrow would be as today, next year as this year, and each more abundant. This warning stands equally true for us today. And what of the paradox? In our story from Genesis, the **cause** of the famine was an **act of God**, and as such, it was **inevitable**. A divine famine brought about the **failure of the money**. But for the US and the West, the cause and effect are reversed. It will be the **failure of the money** that will bring about the **famine**. Therefore the **cause** will be, not an act of God, but an **act of man**, and as such, it **need not be inevitable**. This, we believe, is the sole reason for optimism. Economics, as we stated earlier, is the science of acting man. And as nothing has been divinely ordained, we can still take action as individuals and as a nation to prevent the **failure of our money**.