Leithner Letter No. 136-139 26 April -26 July 2011

The U.S. debt situation is at a "tipping point," Dallas Federal Reserve Bank President Richard Fisher said on Tuesday, and urged the U.S. central bank to refrain from any further stimulus measures. "If we continue down on the path on which the fiscal authorities put us, we will become insolvent. The question is when," Fisher said in a speech at the University of Frankfurt.

Fed's Fisher: U.S. Debt Situation at Tipping Point
(Reuters, 22 March 2011)

"If I were sitting before Congress," [Bill] Gross recently remarked, "and giving testimony on our current debt crisis, I would pithily say something like this: 'I sit before you as a representative of a \$1.2 trillion money manager, historically bond oriented, that has been selling Treasuries because they have little value within the context of a \$75 trillion total debt burden. Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies – inflation, currency devaluation and low to negative real interest rates.'"

Eric Fry
Why the World's Largest Bond Fund is Now Shorting Treasuries
(12 April 2011)

The Distemper of Our Times and The Evil Princes of Martin Place

Since April, judging from major stock and bond markets in America, Europe and elsewhere, people have sporadically recognised economic reality. Perhaps they are beginning to understand that the welfare-warfare state is not just morally bankrupt: it is financially insolvent. Greece currently hogs the headlines, but the real story is the bankruptcy of Britain, Japan and above all the U.S. Who knows whether this latest outbreak of sanity is ephemeral or will be durable? Clearly, however, events are (in fits and starts) unfolding as they eventually must – and as the mainstream strenuously and indignantly denies that they possibly can. According to Lawrence Summers, the Charles W. Eliot University Professor in the Kennedy School of Government at Harvard University, the Secretary of the Treasury from 1999 to 2001, the President of Harvard University from 2001 to 2006 and a Director of the National Economic Council until late in 2010,

> The central irony of financial crisis is that while it is caused by too much confidence, borrowing and lending, and spending, it is only resolved by increases in confidence, borrowing and lending, and spending. Unless and until this is done other policies, no matter how apparently appealing or effective in normal times, will be futile at best.

How to still a panic and combat a bust? According to the best and the brightest, enable or force banks (whether sound or bankrupt) to lend even more, and encourage households, businesses and governments (whether sovereign or private, solvent or broke) to borrow yet more, than they had hitherto! To the high priests of economics and finance, the cure of a massive hangover is yet another – and even bigger – blinder; and the antidote to the drunk's *delerium tremens* is an even stiffer dose of the very toxin that threatens his life. Our rulers' and alleged betters' prescription is medieval: bleed the patient and apply leeches!

Brad DeLong's blog of 13 June, which quoted Summers, belies the contemporary mainstream's self-delusion. I suspect that he's gravely mistaken – but hardly alone – to refer to the Global Financial Crisis (GFC) in the past tense. And as it is to all mainstream economists, a coherent theory of capital is as alien to him as the dark side of the moon. Not surprisingly, DeLong seems quite seriously to believe that economic growth is a matter of alchemy. He rightly states that "the task … is to actually create the high-quality savings vehicles people [thought] they had before the crash." He correctly continues that it is "not to spray-paint lead bars with gold," but then drops the ball. The task, as he sees it, is "to use a real philosopher's stone [sic] to create real gold bars themselves." In his defence, at least he's talking (however incoherently) about savings and gold.

Prof Summers isn't the most prominent apostle of "confidence, borrowing and lending, and spending." In an infamous op-ed article ("What the Fed Did and Why: Supporting the Recovery and Sustaining Price Stability," *The Washington Post*, 4 November 2010), the Fed's chairman, Ben S. Bernanke, stated

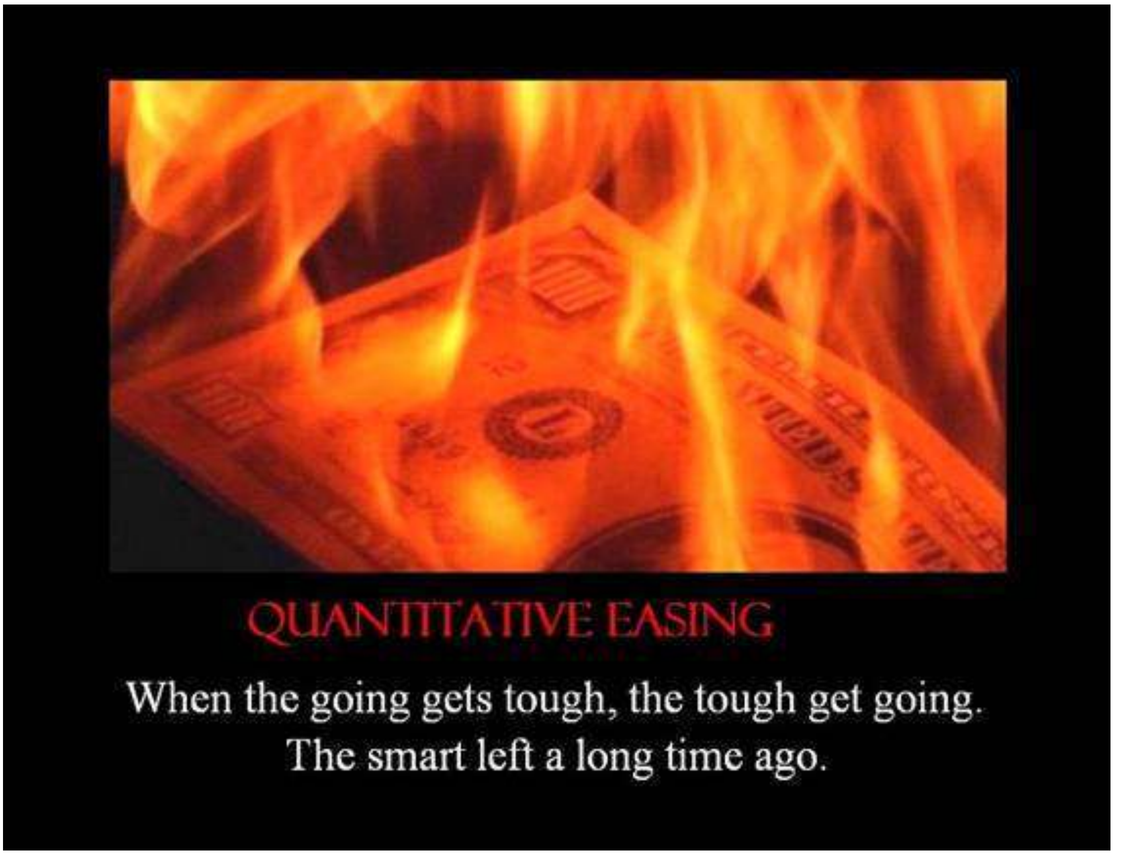
> The [Federal Open Market Committee] decided this week that, with unemployment high and inflation very low, further support to the economy is needed. With short-term interest rates already about as low as they can go, the FOMC agreed to deliver that support by purchasing additional longer-term securities, as it did in 2008 and 2009. The FOMC intends to buy an additional $600 billion of longer-term Treasury securities by mid-2011 and will continue to reinvest repayments of principal on its holdings of securities, as it has been doing since August.
>
> This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.

Since November, events haven't transpired as Bernanke intended. But he is unfazed, and his views remain unrevised, unrepentant – and utterly deluded. On 14 June, in a speech with the Orwellian title "Fiscal Sustainability" delivered to the equally preposterous Annual Conference of the Committee for a Responsible Federal Budget, he had the hide to say:

> The Hippocratic Oath holds that "first we should do no harm." In debating critical fiscal issues we should avoid unnecessary actions or threats that risk shaking the confidence of investors in the ability and the willingness of the U.S. government to pay its bills.

"Grant me chastity and continence, but not yet," St Augustine of Hippo prayed – and later repented for his presumptuousness. Bernanke's corrupt theology mocks piety: "grant us fiscal discipline and solvency, but not yet." In the meantime, he pleads to Congress, raise the debt ceiling and thereby allow Leviathan to descend even further into bankruptcy. As a result, outsiders suffer and will continue to suffer as a result of insiders' refusal to confess their failures and repent for their sins.

Bernanke would do well properly to understand his own words. That is, he should resolve that the Fed do no harm. *The Evil Princes of Martin Place* shows logically and empirically that the Fed (like all central banks) has repeatedly wreaked enormous



harm since its creation in 1913. Not only have it and other central banks like the Bank of England and Reserve Bank of Australia destroyed the purchasing power of their respective currencies; they have also financed the Leviathan that has waged war on its own people as well as foreigners (Libyans are the latest in a very long list), and have repeatedly launched the epochal boom that begets the colossal bust. The problem is not, as Col. Jessep shouted from the witness box at Lt. Kaffee in *A Few Good Men* (1993), that "you can't handle the truth!" The problem is that monetary central planners haven't the faintest idea about the truth. And the truth, which many Americans are beginning to suspect, is that the central bank is a principal cause of the problem rather than any part of the solution.

According to a recent (June 2011) poll, 48% of Americans believe that "another Great Depression" is likely to erupt within the next 12 months. For three years they have awaited the "recovery" that Bernanke and Obama have promised; instead, they see growing indications that the economy is in a very bad way and that before long it will sink even lower. The prices that consumers pay are rising, but the wages that employees earn are not. Tens of millions of Americans are prepared to do almost anything in order to land a decent job. The "misery index" has risen to its highest level in almost 30 years; similarly, the percentage of Americans who believe that their country is on the wrong track is higher than it was at any point during Ronald Reagan's presidency – when unemployment peaked at 10.8% after the 1981-82 recession. Meanwhile, state and local governments are drowning in debt, the Leviathan-Within-the-Beltway is drowning in debt and welfare-warfare states across Europe are drowning in debt. Given these circumstances, it isn't surprising that half of Americans believe that another Great Depression is nigh. Nor is it surprising that the mainstream media fixates upon the views of an anointed group of anointed tenured economists, and that it virtually ignores millions of benighted Americans who must earn an honest living in the real world.

The Evil Princes contends that the GFC is not a thing of the past – indeed, in Australia it has barely begun. Governments' edicts since mid-2007 have attempted to protect privileged insiders – and have thrown the majority of outsiders to the wolves. Many Americans who live beyond Wall Street and outside Washington's Beltway have belatedly realised this truth, as well as the generalisation that subsumes it: namely that their overlords and their political puppets are stupid or evil (or both). Perhaps Australians eventually will, too. Seth Klarman's conclusion (which appears on p. 509, and was originally quoted in Jason Zweig, "Why One Legendary Investor Is More Worried Than Ever," *The Wall Street Journal*, 22 May 2010), whilst directed towards the U.S., applies doubly to Australia:

> We didn't get the value out of this [Global Financial Crisis] that we should have. For our parents or grandparents, it was awful to have had a Great Depression. But it was in some ways helpful to carry a Depression mentality throughout their later lives, because it meant they were thrifty with their money and prudent in their investment decisions. All we got out of this crisis was a Really Bad Couple of Weeks mentality. I am [therefore] more worried about the world, more broadly, than I ever have been in my career.

Today, that wary stance remains appropriate. Equally clearly, adherence to the principles of investment pioneered by Benjamin Graham and to the laws of economics rediscovered by the Austrian School – that is, a resolute and reasoned rejection of the mainstream – can pay dividends. Leithner & Co.'s results for 2010-2011 are its best since its formation in 1999; and behind the scenes and below the surface several shareholder-friendly plans are progressing towards completion. (Click here for the updated results.)

It's imperative that investors keep this point uppermost in mind: *those who didn't see the GFC coming (and remained willfully blind after it erupted) – the very people who incurred big losses in 2007-2009, which they've not recouped – today remain resolutely upbeat about the future. They were diametrically wrong then; why should anybody think they're less wrong today? In sharp contrast, the doughty few who anticipated trouble and who have consistently generated profits since 2007* *remain downcast today*. It's demonstrably false to assert, as the mainstream has since 2007, that "nobody saw it coming." What's certainly true is that the few who foresaw the GFC and now see that we're merely in the eye of the storm, were then and today remain, from a mainstream point of view, "nobodies."

It's therefore vital that investors understand the premises that underlie their – and others' – contentions about matters economic and financial. As Benjamin Marks writes, "Mises, Rothbard and others in [the Austrian School] tradition do not hide their assumptions or basic propositions; they typically begin their essays and books with a list of them, so it would be easy to point out which assumptions were wrong if someone wanted to make a sincere attempt at criticism. Hoppe lists some of our main propositions here. Five of them are:

1. "Whenever two people A and B engage in a voluntary exchange, they must both expect to profit from it. And they must have reverse preference orders for the goods and services exchanged so that A values what he receives from B more highly than what he gives to him, and B must evaluate the same things the other way around."
2. "Whenever an exchange is not voluntary but coerced, one party profits at the expense of the other."
3. "Of two producers, if A is more productive in the production of two types of goods than is B, they can still engage in a mutually beneficial division of labour. This is because overall physical productivity is higher if A specializes in producing one good which he can produce most efficiently, rather than both A and B producing both goods separately and autonomously."
4. "Whenever minimum wage laws are enforced that require wages to be higher than existing market wages, involuntary unemployment will result."
5. "Whenever the quantity of money is increased while the demand for money to be held as cash reserve on hand is unchanged, the purchasing power of money will fall."

Marks continues: "anything there that conflicts with human nature? Acknowledging those five observations alone makes you a radical Austrian School economist."

The Evil Princes builds upon foundation stones such as these. Grounded in natural law – and not utilitarianism – the laws of economics begin with elementary, *a priori* and hence unarguable axioms. Most notably, nobody can purposefully refrain from action; the intention of every action is to improve the actor's subjective wellbeing; saving must precede lending, production must precede consumption. From these axioms, scholars have deduced laws of human action. In *Democracy: The God That Failed*, Hans-Hermann Hoppe rediscovered one that's as compelling as it is unfashionable: namely that private property (i.e., individual ownership and rule) and democracy (i.e., collective ownership and majority rule) are incompatible. Just as two people cannot simultaneously stand in the same space, two or more people cannot simultaneously own the same item of property. Similarly, a deposit is not and cannot (damn the mainstream) become a loan; two people, A and B, cannot morally agree to defraud a third party, C; and the existence and theory of property logically precedes and underpins the theory of contract.

The Evil Princes is not just our assessment of the tremendous damage governments and mainstream economists have relentlessly wrought over the decades (like the Great Depression, World Wars and GFC) and will continue, like Typhoid Mary, to spread; it is also our roadmap that will help us to navigate the many hazards the anointed will continue to throw in our path. Mary Mallon (1869-1938), popularly known as Typhoid Mary, was the first person identified as a "healthy carrier" of the pathogen associated with typhoid fever. According to Wikipedia, "some difficulties surrounding her case stemmed from Mallon's vehement denial of her possible role, as she refused to acknowledge any connection between her working as a cook and the typhoid cases [she spread]. Mallon maintained that she was perfectly healthy, had never had typhoid fever, and could not be the source."

Mary infected ca. 50 people in New York City, three of whom died; as agents of monetary central planning, on the other hand, minor central banks like the RBA diffuse their toxins from one end of Australia to another – and major ones like the Fed and European Central Bank spread them around the world. Only when she entered quarantine did Mary cease to infect others. Analogously, only when

1. we recognise that monetary central planning is the ultimate source of our financial and economic distemper, and when it either collapses or is consigned to the dustbin of history, and when
2. 100%-reserve banking and sound money replace fractional reserve and central banking and fiat currency,
3. will the ruinous cycle of boom and bust become a thing of the past.

In Australia, reviews of *The Evil Princes* (which is available from Amazon.com, Amazon.ca, Barnes & Noble and elsewhere) have appeared at Menzies House (re-printed at onlineopinion.com.au) and at Economics.org.au – the latter is worth an extended visit. In Canada, reviews have appeared in English and en français. On 5 April 2011 on ABC Radio Queensland, Steve Austin and I discussed the book's arguments and implications; see also An Interview with Chris Leithner on Austrian Economics and Australian Central Banking (11 July). An electronic (Kindle) edition is nearing completion, and (I hope) will appear during the next several weeks. A presentation entitled "The Evil Princes of Martin Place: The Panic of 2007-2008 and Why We Should End the RBA" has been scheduled for 26 November in Sydney. Finally, a Canadian edition – entitled, naturally, *The Evil Princes of Wellington Street* – is in the works.

Chris Leithner