

JOHN MAULDIN'S THOUGHTS FROM THE FRONTLINE CATCHING ARGENTINIAN DISEASE

In this week's *Thoughts from the Frontline* John Mauldin uses the hyperinflation experienced in Argentina as an explanation of how things can get out of control if economic principles are not followed. The current US federal deficit has raised concerns while putting pressure on the dollar. He finishes the letter with a short appraisal of the latest US GDP figures, which were sharply higher.

Enjoy the read.

I have been in South America this week, speaking nine times in five days, interspersed with lots of meetings. The conversation kept coming back to the prospects for the dollar, but I was just as interested in talking with money managers and business people who had experienced the hyperinflation of Argentina and Brazil. How could such a thing happen? As it turned out, I was reading a rather remarkable book that addressed that question. There are those who believe that the United States is headed for hyperinflation because of our large and growing government fiscal deficit and massive future liabilities (as much as \$56 trillion) for Medicare and Social Security.

This week, we will look at the Argentinean experience and ask ourselves whether "it" - hyperinflation - can happen here.

The Ascent of Money

I will be quoting from Niall Ferguson's recent book, [The Ascent of Money](#). I cannot recommend this book too highly. In fact, I rank it up with my all-time favourite book on economic history, [Against the Gods](#), by the late (and sorely missed) Peter Bernstein. There are very few books I read twice. There are too many books and not enough time. This book I will have to read at least three times, and soon, and I have a lot of underlines and mark-ups in it already.

If there were one book I could require every member of the Congress to read, it would be this one. As I read it, I am struck again and again by how fragile and yet resilient our economic systems are. Fragile in the sense that governmental policy mistakes, no matter how well-intentioned, can destroy the wealth of a nation, and resilient in that it doesn't happen more often.

In his introduction Ferguson writes, "The first step towards understanding the complexities of the financial institutions and terminology is to find out where they came from. Only understand the origins of an institution or instrument and you will find its present day roles much easier to grasp."

As is often said, those who do not understand history are doomed to repeat it. If you want to understand what is happening in the economy, what the consequences of our choices could be, then I strongly suggest you get [The Ascent of Money](#). It is easy to read, engaging, full of moments where you are led to pull together different ideas into an "Aha!" Ferguson is a brilliant writer and historian, and we are lucky to have this book at a time when it is sorely needed. ([order it at Amazon.com](#))

As I have been writing, the United States in particular, and the developed world in general, are faced with a

series of very unpleasant, if not downright bad choices. The time for good choices was ten years ago. Now we face the prospect of painful decisions, no matter what we do. It is not a matter of pain or no pain, of somehow avoiding the consequences of our bad decisions, it is simply deciding how much pain we will take and when, or allowing the pain to build up to a climactic event. Today we look at what I think would be the worst choice of all.

Catching Argentinean Disease

At the beginning of the 20th century, Argentina was the seventh richest nation on earth. It's very name means "silver." "As rich as an Argentine" was a byword. Even after falling from the heights through a series of bad decisions, the country was still so wealthy that, in 1946 when new president Juan Peron first visited the central bank, he could remark that "There was so much gold you could barely walk through the corridors."

Argentina had actually defaulted on its debt in the late 19th century, not once but twice! But still they managed to avoid destroying the currency and devastating the country. But in 1989, after years of massive budget deficits that were financed with borrowing from abroad and Argentinean citizens, the country was left with so much debt and no one was willing to lend it any more money, that the leaders felt compelled to resort to the printing press.

My Uruguayan friend and Latin American partner, Enrique Fynn, tells me of his experience of going to Buenos Aires and buying a pack of cigarettes one evening. He went into the store the next morning for another pack, and the price had doubled. He came back that evening and the price had doubled again (thankfully for his health, he has quit!). There were no prices on any items in the grocery stores. There was a man with a microphone who would announce the prices of various items, often increasing the price every few hours by 30% or more.

Workers would get their pay in cash and rush to the store to buy anything, as by the end of the week their pay would be worthless. Of course, shelves were empty. The US dollar was king, and could purchase things at amazing prices. I heard stories that were truly compelling. (It made me wish I had gone shopping in Buenos Aires at the time!)

Interestingly, the dollar is still the real medium of exchange. I was told by several people that if you want to buy a house for half a million dollars, you bring the physical cash to the closing. One person counts the money and the other checks the paperwork and title. Argentina has the second largest hoard of physical dollars in the world, only exceeded by Russia. Is it any wonder they are concerned with the value of the dollar?

Let's look at some quotes from Ferguson (emphasis mine):

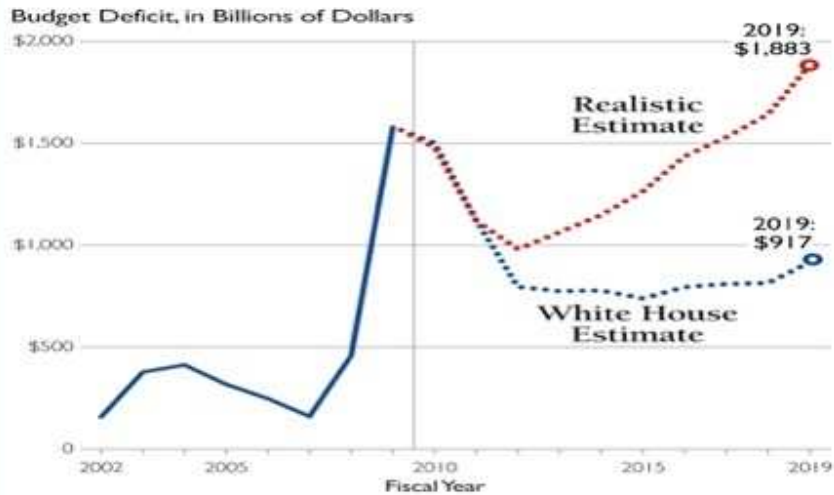
"The economic history of Argentina in the twentieth century is an object lesson that all the resources in the world can be set at naught by financial mismanagement... To understand Argentina's economic decline, **it is once again necessary to see that inflation was a political as much as a monetary phenomenon...**

"To put it simply, there was no significant group with an interest in price stability..."

"Inflation is a monetary phenomenon, as Milton Friedman said. **But hyperinflation is always and everywhere a political phenomenon**, in the sense that it cannot occur without a fundamental malfunction of a country's political economy."

Look at the chart below. Using realistic assumptions, it suggests that the annual US government fiscal deficit will approach \$2 trillion in 2019. How can we come up with what looks to be about \$15 trillion over the next ten years? The Argentinean answer was to print the money.

Obama Budget Agenda Would Bring Annual Budget Deficits to Nearly \$2 Trillion



Source: Heritage Foundation calculations based on data from the Congressional Budget Office and U.S. Office of Management and Budget.

Chart 2 • 8 2319 heritage.org

In the US, the short answer is that unless the US consumers become a massive saving machine, to the tune of 8% or more of GDP and rising each year, and willingly put their savings into US government debt, it's not going to happen. So sometime in the coming years, interest rates are likely to start to rise in order to compensate bond investors for what they perceive as risk. That will bring us to some very difficult and painful choices.

As I wrote a few weeks ago, this scenario could be averted IF the Obama administration produced a credible plan to lower the deficit over time and stuck to it. But today's thought process is about what happens if they don't.

Ferguson pointed out in the quotes above that hyperinflation is always and everywhere a political decision. Governments have to choose to print money. In theory and in practice, what would happen if the Fed decided to accommodate a politicized US government that wanted to spend money on favourite projects and support groups, maybe even deserving programs like health care or defence or pensions or Social Security? Money they could not borrow?

Then Peter Schiff and like-minded thinkers would be right. Once you start down that path, it is hard to stop short of the brink. Brazil got to 100% inflation per month and has really lowered that level over time, but it is not easy.

In such a scenario, you want to own hard assets. Gold. Foreign currencies. Stocks. Almost anything other than the currency that is being printed.

I was asked at almost every speech about that scenario. In Latin America, hyperinflation is not a theoretical issue; it has been reality. More than one person commented on that no one in US economics schools studies hyperinflation. It is required material in Latin America. For many Latin Americans, the dollar has been their safe haven. And now they are worried, with good reason.

For the record, I do not think the US will experience hyperinflation as long as the Fed maintains its independence. Read the speeches from various Fed governors and regional presidents. These are strong personalities, and they understand that going down that path ends in massive tears. Bernanke warned just

a few weeks ago that the government needs to get serious about the fiscal deficit. Watch the rhetoric from the Fed heat up after his reconfirmation and the confirmation of two new governors in the first quarter.

The Fed has committed to buy a fixed amount of government debt in its quantitative easing program. That commitment will be finished by the end of the first quarter (if I remember correctly). Then comes the tricky part.

I have been writing for a long time that the main force in the economy right now is deflation. The Fed will fight deflation tooth and nail. But they don't have to buy government debt to fight deflation. They can buy mortgage securities, credit card securities, commercial paper, etc. That will have the effect of easing without encouraging the government to run massive deficits. And such debts are naturally self-liquidating, while government debt is not, at least not in the same way.

I believe the Fed will maintain its independence. Not to do so is to court economic disaster of the first order. These are bright and serious men and women. They get it.

The Independence of the Fed Threatened

The risk is that something changes to compromise their independence. And sadly, there is some risk. Let me quote my fishing buddy friend David Kotok:

"It's now official. The proposed legislation to reform America's financial service supervision includes granting the Secretary of the Treasury a veto over Section 13(3) emergency action by the Federal Reserve Board of Governors. If this becomes law, it will be a sad day for the independence of America's central bank.

"The Secretary of the Treasury, a very senior cabinet position, is appointed by the President and meets with the President in the Oval Office weekly. The governors of the Federal Reserve Board are also appointed by the President. Both cabinet officers and Federal Reserve governors are confirmed by the US Senate. There are supposed to be seven governors; politics has purposefully limited this to five throughout the three-year financial crisis period.

"The Federal Reserve governors are supposed to serve staggered 14-year terms with all seven seats filled. Instead, we have been governed by the present five-member, politically configured board.

"The original seven-governor construction was designed to insulate them from political pressure, for very good reasons. Decades of monetary history throughout the world have disclosed what happens when political influence on a central bank intensifies. The Weimar Republic and Zimbabwe are evidence of the worst inflationary effects of politics. The Great Depression in the US and the nearly two-decade deflationary recession in Japan demonstrate that monetary policy is not only inflation-prone. When central banks are under political influence you can get fire or you can get ice.

"In Japan, the central bank contends with two members of the cabinet sitting in on its deliberations. There is no way to know how much of the last 15 years of deflation and recession is attributable to the inside political pressures placed on the governors of the Bank of Japan. But there is evidence to suggest political influence, especially when you observe how little the Bank of Japan has engaged in asset expansion during this crisis."

This is the nose of the camel under the tent. Starting down this road is very worrisome indeed. I find it appalling that Tim Geithner and Larry Summers went along with this. This is a very clear attempt by the political class to put political pressure on the Fed. I hope the Fed responds with vigour. I can tell you that the officials of whom I am aware will not take kindly to pressure. And that might be an understatement.

(Yes, I am aware of the problems of the Fed being able to decide whom to bail out and why. It is not a perfect world. But better the Fed than Congress.)

All that being said, if the Fed starts to increase its buying of government debt above its initial commitment, then my "optimistic" scenario of a very rough economic patch, which I have been outlining the past few months, is far too rose-colored. I do not think it will happen, but I can guarantee you, I and a lot of other people will be watching.

A Few Quick Thoughts on the Dollar, GDP, and the Recession

Just a few quick notes. When world trade collapsed, so did the need for US dollars, which is what the world uses to transact business. The data looks like world trade is finding a bottom and maybe even recovering somewhat. That means there will be the need for more dollars. And since everybody and their mother are short the dollar, there could be a vicious snap-back rally. I am still bearish the US dollar (and the yen and the euro and the pound) over the long term, but there is the potential for a real rally here.

And my friend Mish Shedlock [commented](#) on the US GDP report, which said the US GDP rose 3.5%:

"Today the market is cheering over what is actually an ugly report. A misguided Cash-for-Clunkers added a one-time contribution of 1.66 percentage points to GDP. Auto sales have since collapsed so all the program did is move some demand forward. Government spending increased at 7.9 percent in the third quarter which is certainly nothing to cheer about. Personal income decreased \$15.5 billion (0.5 percent), while real disposable personal income decreased 3.4 percent, in contrast to an increase of 3.8 percent last quarter. Those are horrible numbers. The savings rate is down, which no doubt has misguided economists cheering, but people spending more than they make is one of the things that got us into trouble. The only bright spot I can find is exports. However, even there we must not get too excited as imports rose much more."

John Williams notes that **one-time stimulus or inventory items represented 92% of the reported quarterly growth**. The nature of the stimulus-related gains was that they tended to steal business activity from the future. The months ahead are the future. Accordingly, fourth-quarter quarterly GDP change will likely turn negative, again. (The King Report)

And David Rosenberg writes: "Only economists see the recession as being over; the man on the street sees it a little differently, perhaps less enthused by the fact that a lower rate of inventory destocking is arithmetically underpinning GDP growth at this time. Put simply, a Wall Street Journal/NBC News poll just found that 58% of the public believe the economic recession still has a ways to go -- and that is up from 52% in September and means that the private investor, unlike the hedge fund manager, is not interested in adding risk to the portfolio even after a 60% surge in the equity market.

"Only 29% of those polled believe the economy has hit bottom -- imagine having that psychology with nearly zero interest rates, a bloated Fed balance sheet and unprecedented fiscal deficits (poll was taken from October 23-25). Nearly two in three (64%) said the rally in the stock market (still a bear market rally -- not the onset of a new bull market) has not swayed their view (or ours for that matter)."

Uruguay, Philadelphia, Orlando, and then...

I am finishing this letter in Montevideo, Uruguay. I have been in Buenos Aires, Sao Paulo, and Rio de Janeiro this week. I must say that Rio is beautiful, very green and lush with marvellous beaches, which I sadly only got to drive past. I will come again. I fly back Sunday and am home for a week, then speaking trips to Philadelphia and Orlando. Then my schedule only shows a few days in New York in early December for Festivus with the gang from Minyanville, and Europe in January. I am sure other things will come up, but I am looking forward to being home for awhile.

My friends at *International Living* have been writing about Uruguay, and I was really looking forward to visiting the country. I have spent a few days with partner Enrique Fynn in this delightful place. Turns out it is the Switzerland of South America. Reasonable bank secrecy laws, and trades zones where you are not

taxed on any business you do outside of Uruguay. Many international companies set up their headquarters here. Beautiful beaches, friendly people, and the charm of a small country, plus what will be a brand new airport in a few weeks, which can get you several times a day to any part of the region, directly to Europe, and one hop away from any major city in the world. You can learn more about the country, and other countries you may want to live in or have a second home in, by subscribing to [International Living](#).

One of the laugh lines I use in my speeches down here is that if the Fed actually does start to monetize the debt, I will have to move to Uruguay. I could make worse choices.

Have a great week. I think this weekend I will switch it up from the heavy reading I have been doing and find some science fiction. Reality is way too scary.

Your ready to be in his own bed analyst,

John Mauldin

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