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Martin Armstrong on the Sovereign Debt Crisis

By Ron Hera
March 29, 2012

The Hera Research Newsletter is pleased to present a fascinating interview with Martin A. Armstrong, founder and former Head of Princeton Economics, Ltd. In the 1980s, Princeton Economics became the leading multinational corporate advisor with offices in Paris, London, Tokyo, Hong Kong and Sydney and in 1983 Armstrong was named by the Wall Street Journal as the highest paid advisor in the world.

As a top currency analyst and frequent contributor to academic journals, Armstrong's views on financial markets remain in high demand. Armstrong was requested by the Presidential Task Force (Brady Commission) investigating the 1987 U.S. stock market crash and, in 1997, Armstrong was invited to advise the People's Bank of China during the Asian Currency Crisis.

Based on a study of historical gold prices and financial panics, Armstrong developed a cyclical theory of commodity prices, which lead to the pi-cycle economic confidence model (ECM), used to make long term forecasts. Using the ECM, Armstrong predicted both the high-water mark of the Nikkei in 1989, months ahead of time, and the July 20, 1998 high in the U.S. equities market, as well as a major top in financial markets on February 27, 2007. The ECM was called "The Secret Cycle" by the New Yorker Magazine and Justin Fox wrote in Time Magazine that Armstrong's model "made several eerily on-the-mark calls using a formula based on the mathematical constant pi." (Pg 30; Nov. 30, 2009).

Hera Research Newsletter (HRN): Thank you for joining us today. Considering the Federal Reserve swap lines and the European Central Bank's (ECB) Long Term Refinancing Operation (LTRO), what's the outlook for the Euro?

Martin Armstrong: The structure of the Euro is fundamentally flawed. To put it in American terms, it would be as if all fifty states were able to issue federal bonds. It would be total, absolute chaos. What they did, to be politically correct, was to say that, since every member issues its own federal type bonds, they all have to be reserves and the large banks have to fairly allocate among them all. It's completely crazy. As countries like Greece and Spain and Italy crumble under the debt, it feeds back into the banking system. In the United States, we had the Long Term Capital Management (LTCM) collapse and we saw the government bail out a hedge fund so that they wouldn't be seen bailing out the New York banks. They have the same problem in Europe. Basically, the ECB bailing out European banks is really going through the back door to support European sovereign bonds.

HRN: Would it be fair to say that the bailouts of Greece have really been bank bailouts while the LTRO is a sovereign debt bailout?

Martin Armstrong: Sure. The two words "political" and "economy" should have been divorced when they first met. Politicians always do this. In the U.S. Savings and Loan (S&L) crisis, the politicians encouraged lending into local real estate markets by allowing thrifts to be federally chartered in 1980 and insuring them with public dollars. So the S&Ls concentrated their portfolios in real estate. Then the politicians needed money so they reduced the schedule for write-offs in real estate. And they didn't think that would change the market? They basically expanded credit for real estate, incentivized S&Ls to invest in real estate, then passed the Tax Reform Act of 1986. So then about a quarter of S&Ls went bankrupt and they had an S&L bailout and wanted to lock everybody up when they had created the problem in the first place. It's the same type of thing in Europe.

HRN: European politicians created the European sovereign debt crisis by rating all European sovereign bonds as reserves?

Martin Armstrong: Yes. By making all European sovereign bonds reserves and requiring banks to hold reserves, they made European banks hold the debt of countries like Greece and Spain. Greece, for example, was able to borrow at substantially lower rates than they would have normally. This year, €600 billion in debt has to be rolled forward only for Spain and Italy. All these bonds were issued at a very low rate. Now they have to be rolled forward and the new rates are around six or seven percent. The government budgets are going to grow dramatically and this is going to cause the real economic crisis.

HRN: Will the European Financial Stabilization Mechanism (EFSM) help to solve that problem?

Martin Armstrong: No. I told them in 1997 or 1998, when they were creating the Euro, that they couldn't do this and they had to have a single debt. They felt that it would be perceived as a bailout of members that had more debt at the time. The EFSM, which is part of the European Financial Stability Fund (EFSF), is moving in that direction but it's more of a bailout mechanism, not a consolidation. It's a half measure. They need to convert the existing debt into federal bonds and whatever new debt is issued by European Union member countries would be the equivalent of U.S. state debt and not acceptable for reserves.

HRN: Can the Euro survive?

Martin Armstrong: I don't think it will go off the boards. I think they will do everything in their power to keep it there. Politicians never want to admit a mistake. If they have to inflate they will inflate. Germany has capitulated.

HRN: Will this cause another financial crisis?

Martin Armstrong: The next crisis we're going to see will be from 2015 on. It doesn't take more than a three year old with a pocket calculator to see the long term trends.

HRN: Do you mean the European sovereign debt crisis?

Martin Armstrong: It's not just the Euro zone. The entire idea that you can borrow perpetually year after year and never pay anything back and that, somehow, that's less inflationary than if you just print money is absolutely insane. In the U.S., if we had just printed the money, the national debt would only be 40% as much as it is today. We're both creating currency and also paying interest on it.

HRN: Do you see Japan as having the same problem as well?

Martin Armstrong: Japan's debt is slightly below 300% of GDP. The only reason the yen has remained strong is because money is being drawn back into Japan. I think we're approaching a bottom in Japan that will be followed by inflation and that will probably be the last straw.

HRN: How would you compare the U.S. dollar to the Euro and the yen?

Martin Armstrong: The U.S. dollar is the best looking of the three ugly sisters. Europe is a basket case because of its structure. They'd have to federalize Europe and I don't think there's a political will to do that. Japan is totally hopeless at this stage.

HRN: Does this call into question the whole concept of central banking?

Martin Armstrong: Central banks can step up and add cash to the system when necessary, taking in the longer term assets. That was basically the original idea of the Federal Reserve.

HRN: Isn't the Federal Reserve System the main reason why the U.S. national debt is so high compared to what would have happened if the U.S. government issued its own currency?

Martin Armstrong: When the Federal Reserve was created there really wasn't any national debt. The U.S. national debt began with World War I and then World War II. When the Federal Reserve wanted to stimulate the economy it bought corporate paper not federal bonds and that really did stimulate the economy. The politicians have completely distorted what the Federal Reserve was supposed to be. In order to issue all the debt for the wars, the politicians instructed the Federal Reserve not to buy corporate paper but to buy federal paper. Throughout World War II they also instructed that the Federal Reserve maintain the par value of those bonds.

HRN: Politicians altered the role of the Federal Reserve?

Martin Armstrong: When the Federal Reserve was created, in 1913, it really was a kind of an insurance mechanism to help manage the banks and it was owned by them. It wasn't as sinister as many people have portrayed it. It was closer to something like the Securities Investor Protection Corporation (SIPC) or the Federal Deposit Insurance Corporation (FDIC). It was World War I that changed the role of the Federal Reserve. They came up with this theory that inflation was an increase in the money supply and, since the Federal Reserve was in charge of the money supply, the politicians basically said to the Federal Reserve that inflation was their problem. The vast majority of the members of Congress don't think they have any responsibility for the economy. They throw their hands up in the air and say "well, that's the Fed's job."

HRN: Fractional reserve banking systems are inherently inflationary.

Martin Armstrong: Well, it's really a leveraging system. You're increasing the money supply by taking the same money and lending it out several times, so if I deposit $100 and the bank lends you $100 we both think we have $100 but there's only one $100 deposit. Take the mortgage market where the Federal Reserve created trillions by buying mortgage backed securities (MBS). The mortgage market contracted by maybe $5 trillion from the top. So, you have deleveraging at the same time. If the Federal Reserve created $3 trillion when there was no deflation then that would be inflationary, but, in this type of system, every time you get a decline in the economy it's deflation and deleveraging. In a deflation, everyone wants cash so asset values fall. The cash is only a small fraction of the total asset value at the peak. If Bill Gates sold all his Microsoft stock at once it wouldn't be worth as much as it is on paper. It's a yin and yang between leverage and deflation.

HRN: What's the difference between leveraging deposits to loan out $10 for every $1 on deposit and creating money out of thin air?

Martin Armstrong: The current banking system that we have in the world today is really a fraud. You used to pay the bank as a storage facility to store your money but they began lending it out to make more money. They figured out a long time ago that they only needed to keep 6% or 10% of deposits. When the economy goes down it's a kind of a run on the bank. But the real problem is that they borrow short term on demand deposits and lend long term to make the spreads. When a crisis comes, their assets are tied up for ten or twenty or thirty years but they've got short term demand saying 'give me my money now'. So the system doesn't really work on a perpetual basis.

HRN: Let's talk about the gold standard. Would it have prevented the European sovereign debt crisis?

Martin Armstrong: No. In the U.S., they could have kept the gold standard but they had to raise the price of gold. They kept the official price at $35 and went to a two tier system in 1968 where the free market also had a price. They continually issued more paper but didn't change the ratio. They didn't think, at some point, it was going to go bust? Politicians always spend more than they have. We had a gold standard and they blew it up. It's "vote for me and I'll give you a chicken in every pot." Nothing is funded. In the U.S., there has been no planning for Social Security. It's just politicians standing up and saying "vote for me and I'll give you this and that" but nobody pays for it.

HRN: Do you favor returning to a gold standard?

Martin Armstrong: We have to deal directly with the government spending. Eliminate the ability to borrow. That's more important than what you are going to call money. In theory, what are they trying to do with the gold standard? They are trying to say, if we put the gold standard in then you can't create money beyond what you have in gold, but they did that the last time. I don't see where that is some sort of magic bean that's going to stop them from doing it again. It gets to a stage where it doesn't matter if you use conch shells for money or gold. There is no fiscal responsibility in government. We have to eliminate the core problem and eliminate government borrowing except in time of war.

HRN: Is that an argument for smaller government?

Martin Armstrong: Absolutely. During the Great Depression, unemployment had only gotten up to where it is now but then we had the Dust Bowl. It was what Schumpeter called creative destruction. It started the American workforce on a path to skilled labor. Before the Great Depression nearly half of the workforce was in agriculture. By 1980 only 3% was in agriculture. We are facing the same problem now only 40% of the workforce is in government. They produce nothing and don't contribute anything at all to the gross domestic product (GDP). Of course, the government statistics include both the government's spending and also the wages of government employees, so, if the government hires someone, the GDP goes up twice as fast.

HRN: That would suggest that the debt to GDP situation is worse than it appears.

Martin Armstrong: Yes. The government basically finagles every number under the sun. We're looking at a very, very serious situation. The only country that has funded its pension plan is Australia. The U.S. has $60 trillion in unfunded liabilities. At the peak, in 2007, the total of U.S. mortgages was $15 trillion. We are facing dire circumstances ahead. This is why the government is going after what they call the rich, etc. The rich now include anyone with household income of $250,000 or more. If you and your wife both have a job that pays $125,000 per year you're part of the rich. Since young people are staying with their parents longer, their income may be a part of household income too.

HRN: Isn't that what's left of the middle class?

Martin Armstrong: They always bring out people like Warren Buffett or Bill Gates but there aren't that many of those people and if the government took everything they had it wouldn't even balance the budget for a year. This is effectively a war against the American middle class. The ceiling will start to cave in when they can't sell bonds anymore. At that point, the bond market will be absolutely devastated.

HRN: Do you expect the Federal Reserve to continue monetizing U.S. Treasuries: QE3, for example?

Martin Armstrong: They are forced into monetization but it won't stimulate the economy. It isn't only Americans that own 30 year bonds. Maybe the Chinese sell their bonds to the Federal Reserve and then say thanks and take the money back to China. You can't stimulate just a domestic economy. The theories the Federal Reserve has are antiquated. They're based on the domestic economy and even on the old gold standard. These are theories based on things that don't even exist anymore. Look at the universities. They don't even teach hedging at the London School of Economics. It's amazing.

HRN: Do you think we'll see U.S. dollar hyperinflation?

Martin Armstrong: No, because the economy would not survive long enough to reach the stage of hyperinflation. Everything would collapse before that happens. What's important to understand is that Americans tend to focus on American numbers but Europe is in far more serious trouble. A lot of the European banks are still owned by the governments.

HRN: What can the U.S. government do to get the economy back on track?

Martin Armstrong: It's hard to get them to do anything that's actually going to be beneficial to the economy. They don't get it. There are also record highs in terms of corporate cash in the U.S. because the politics are so bad.

HRN: What is it that members of Congress don't understand?

Martin Armstrong: I testified before the House Committee on Ways and Means in 1996 and they wanted to know why no American companies had gotten any of the contracts to build the Yellow River dam. I said that the U.S. and Japan are the only countries in the world that tax worldwide income. We hear about companies paying their fair share, but if they're not in the United States, what is a fair share? As far as the U.S. government is concerned, you're an economic slave. If you're born in the United States, you owe taxes in the U.S. even if you're not in the U.S. and don't receive any benefits. Other countries don't do that. A German company, for example, bidding on the same contract in China is automatically cheaper than an American company.

HRN: Are you saying that the U.S. federal government's tax policies have driven companies offshore?

Martin Armstrong: In order to compete internationally, American companies have to leave the United States. It isn't just because of the labor costs because you have to have a skilled labor force. I helped take a lot of companies into Europe. You have to balance the type of labor force versus tax advantages. You can't just put an automaker in Zimbabwe. It's much more of a delicate balance than what politicians tend to say.

HRN: Is there anything that policymakers can do to bring companies back to the U.S.?

Martin Armstrong: One of the primary things is that the tax rate should be cast in stone and it should not change for every election. That is why corporate cash is at record highs. Why should a company start to hire people when all you hear is "we're going to get the rich", "we're going to get the corporations" and they're going to have to pay more. This is why corporate cash is at an all time high. Why should you start hiring people now and then next year you might have to pay 20% more? You can't do things that way. No one, on a personal level, would go sign a lease on an apartment where the lease said the landlord can change your rent at any time he wants if he spent too much money for himself. A contract is a contract and you're not going to have stability until you have something set in stone. A lot of countries have attracted capital by doing precisely this. If you go there and set up a plant, they guarantee not to increase taxes for 20, 30, 40 years. If you're going to do a business plan then you need to know what your costs are. It can't be maybe $1 mill this year and next year it's 25% more. Business plans don't work like that. The politicians need to just cast it in stone and that's it; take it off the table. Stop the rhetoric. They're not going to create jobs without that. Why should anyone build a plant in the U.S. if the government can change everything in 6 months? That's not the way to build an economy.

HRN: So, uncertainty is one of the main problems with the U.S. economy?

Martin Armstrong: The major problem is the whole debt structure. Uncertainty is why cash is at record levels and it's been that way for at least 2 years now. Lack of stability dampens confidence. In order for somebody to invest, there has to be confidence. This is why interest rates can go to 0%, but if you don't think you can make 1% then you're not going to borrow at 0%. Interest rates always go down dramatically during a depression because no one is willing to borrow. There is a lack of confidence in the future, so you're not going to have somebody opening a new restaurant or hiring a bunch of people. Small companies, in particular, are not hiring because they can't get a loan from a bank. They're cut off more than a large company. A large company, if it's public, has shares and banks will lend more against them then they will against a small business owner. Small businesses create the most jobs but they get bashed the most by the banks and they are less likely to hire because they can't borrow to do so.

HRN: What else should the U.S. government do to get the economy back on track?

Martin Armstrong: The government has to stop the perpetual borrowing and we have to really deal with the national debt. It would have to change the tax policies and they would have to cast it in stone that it can't change. It can't flip back and forth for every election because when you do that then you are undermining confidence. Why should somebody build a plant or hire more people until after the next election?

HRN: How can monetary policy help?

Martin Armstrong: As soon as something happens the politicians throw their hands up in the air and say it's the Federal Reserve's fault. It's not the Fed's fault. The politicians are the ones actually doing the spending. The Federal Reserve can't control Congressional spending. There's not much it can do to change the dynamics of the problem. The Fed can seize any company it thinks is too big to fail, so now we're outside the scope of banking. They can seize Ford Motor Company if they want to. We are so far from what the Federal Reserve was supposed to be, it's just insane. It wasn't supposed to be in charge of the money supply. It wasn't supposed to be in charge of inflation or bailing out companies that are too big to fail. It was never designed to do this, it was simply there as an insurance fund for banks, period. The Congress assumes they have no responsibility. Nobody takes responsibility. It's just one big party down in D.C.

HRN: Thank you for your time.

Martin Armstrong: It's my pleasure.

After Words

Martin Armstrong, founder of Princeton Economics, Ltd. is one of the most sought after experts in the world on financial markets, global capital flows and currencies. His frank assessment of the monetary and economic problems facing the U.S., the EU and Japan today points to government spending, tax policies and meddling in the banking system by politicians as the root causes. The solution starts with cutting government spending, instituting consistent, long term tax rates and tackling the real reasons why American companies have moved offshore. Without fundamental changes, out of control spending, failure to take responsibility, lack of accountability and crippling uncertainty will prolong poor economic conditions and high unemployment indefinitely.

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