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Forecasting the World

Martin A. Armstrong
Former Chairman of Princeton Economics International, Ltd.

DEFLATION

To Be or Not to Be?

By: Martin A. Armstrong August 5th, 2010
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Please send comments by mail to:

Martin A. Armstrong
FCP Fort Dix Camp
#12518-050
PO Box 2000
Fort Dix, NJ 08640

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ACKNOWLEDGEMENTS

I would like to thank all the former employees, associates, sources, and contacts for their ongoing support and efforts to contribute to the writings I have been able to continue through their great efforts. I would also like to thank those who have looked after not just myself, but my family, and shown them support and kindness.

The purpose of these reports is to broden the understanding that is so vital to our personal survival. Government cannot save us, and will only assist the very economic disaster we face. This is a **Sovereign Debt Crisis** that threatens our core survival. There is no plan to ever pay off debts. The majority of debt increase is paying interest perpetually to roll over without any long-term plan. What you see in Greece and in the States, we have run out of other people's money. The socialists keep pointing to the rich. But to fund the deficits, we need to borrow now from foreign lands. We ran out of money domestically and to support the current system like Greece, we need foreign capital. But all governments are facing the same crisis and we are on the verge of another widespread government default. Adam Smith warned in his **Wealth of Nations** that in 1776, no government paid off their debt and had always defaulted. We will have no choice either.

There is no hope that politicians will save us, for they only form committees to investigate after the shit-hits-the-fan. They will NOT risk their career for a future problem that may hit on someone else's watch. There was a politician and a average man standing on top of the Sears' Tower when a gust of wind blew them off. The average man being a realistic-pessimist, immediately sees he is about to die and begins praying. The politicians, the ultimate optimist, can be heard saying **"Well so far so good!"** as he passes the 4th floor.

At Princeton Economics, our mission was simply to gather global data and to bring that together to create the world's largest and most comprehensive computer system and model that would monitor the world capital flows. By creating that model, all the fallacies of market and economic theories were revealed. The world is far more dynamic and every change even in a distant land can alter the course of the global economy. Just as has been shown with the turmoil in Greece, a CONTAGION takes place and now capital begins to look around at all countries. We can no more comprehend the future but looking only at domestic issues today than we can do so in every other area, such as disease and the spread of flu.

We live in a NEW DYNAMIC GLOBAL ECONOMY where capital rushes around fleeing political changes and taxes just as it is attracted by prosperity. All the people who migrated to the United States in the 19th and 20th Centuries, came for the same reasons as those still coming from Mexico - jobs and prosperity. In the 19th Century, America was said to have so much wealth, its streets were paved in gold. We must now look to both the past and the entire world to understand where we now are today,

DEFLATION

To Be or Not to Be?

By: Martin A. Armstrong

Former Chairman of Princeton Economics International, Ltd.
and Former Chairman of the Foundation For The Study of Cycles

DEPRESSION has long been the battle cry of so many, yet it is very much misunderstood. People have been touting another Great Depression is upon us and others ignore everything and argue that nothing is wrong, and life will resume as normal. Somewhere between these two views lies the truth. The problem that seems to exist, is the total absence of any real practical education that honestly reviews history and government's role throughout the course of time. I have written before that NEVER has any government paid its debt. They ALWAYS and without ANY exception, default. But how is default actually carried out? We actually in fact defaulted in 1971. We abandoned the gold standard and adopted a free float system of currencies. Where debt was once backed, it was suddenly not. But this is only one tiny aspect of default. Like ice cream, default comes in many different flavors. There is EXTERNAL default as well as INTERNAL default. As this implies, one can default on only those who hold debt overseas or domestic. However, the debate between DEFLATION and INFLATION incorporates default as well. For you see, the US has been defaulting on its debt on an ongoing basis. It does so by then creating INFLATION, which is the devaluation of previously held bonds. It is rare that DEFLATION would take place overall in the economy for it takes the deliberate acts of government to pay the debt off. That is what Nikolai Ceausecu the famous dictator in Romania did in the 1980s. The nation owed $9 billion to foreign bankers, and he paid it driving his country into depression forcing many to go without heat and factories to close. This was the sacrifice of DOMESTIC to EXTERNAL creditors.

DEFLATION is NOT a natural result of FISCAL MISMANAGEMENT. As I have stated on many occasions, 1929 from THE US VIEWPOINT was a DEFLATION because (1) we were the object of capital concentration, (2) the rest of the world defaulted on its debt forcing a flight to the dollar cutting off any trade reducing employment, (3) it was the final shift in the Industrial Revolution where 40% of labor was still farmers and the dust bowl killed that combined with the combustion engine that produced both cars and tractors reducing the need for raw labor, and (4) the collapse in major sovereign debt wiped out savings.

I have explained that such contractions take place following massive capital inflows such as into Japan for the 1989 Bubble High. The excess capital concentrates within that economy making banks flush and they increase their long-term lending based upon an influx of short-term "hot money" inflows. This lays the seeds to the banking crisis that ALWAYS takes place even among nations with stable national debts. The banking crisis simply takes place with regularity REGARDLESS if we are talking about the financial capitol such as the USA or some third world nation that becomes the object of global speculation. Banking crisis effect all nations regularly.

There have been countless Sovereign Debt defaults throughout history. Some have taken place because of a refusal to pay, as with the typical political revolution as we saw in China and Russia. When the communist parties took over, they did not pay those foreign capitalistic bankers. Often such events nationalize industries, as was the case in Britain, Iran, and even Venezuela just for example.

Some defaults thus take place because of this political unwillingness to repay. Others take place because of a inability to pay as was the case with Britain, Spain and France. As I said, defaults as well as the concept of DEFLATION and DEPRESSION come in a host of different flavors.

Yes there were at times war and what was called **"gunboat"** diplomacy when nations went into default. But such events are the result of a bigger nation bullying the much small third world nation, and appears to be very Anglo-Saxson. For example, Venezuela was the object of gunboat diplomacy in the mid-1890s when there were concerns that it would default on its debt. The USA even occupied Hati in 1915 to collect debts. This seems to have started with Britain who in 1876 invaded Istanbul when it defaulted and let us not forget Egypt in 1882 upon its debt default.

Ironically, it was England who was the first Sovereign Debt Defaulter in 1340 when Edward III borrowed extensively from the Florentine banking houses of the Bardi and Peruzzi. These were the real major bankers coming out of the Dark Ages. The Medici by no means were the first. They picked up the pieces after these bankers were wiped out and married into the family of the Bardi to gain the banking experience. In fact, the bankers were imprisoned until they would forgive all interest owed them by others. France confiscated their assets in their country because they funded the English invasion of France. SO England was the first to default, and <u>IT WAS AN EMERGING MARKET WITHIN THE EUROPEAN CONTEXT</u> compared to the more sophisticated economy of Northern Italy.

Sometimes a Sovereign Default has even cost its people their democratic liberty. Rarely discussed, was the default of 1936 in Newfounland found the nation compelled to become Canadian. Today, Newfoundland is a Canadian province. It lost its sovereignty because of its default upon its external debt. This is how Egypt also became a possession of Britain, and that default cost them their sovereignty. Yet England defaulted two more times after 1340, again in 1472 and then in 1594, during the reign of Elizabeth I (1558-1603). Yet this key default took place thanks to the DEBASEMENT of Henry VIII (1509-1547).

This is what I mean that DEPRESSION is far from a single set of facts to be then played out like a play on Broadway in New York or in the Haymarket. A country can and does default on its debt through INFLATION just as Germany did and others post-WW I. The "Great Debasement" of Henry VIII dropped the silver content of the coinage from 75% to about 25%. Thus, paying you with new coins containing less silver when you lent, was a partial default.

The chronic defaulters were Spain and France, which is why they never quite made it to prime time to ever rank as the main Financial Capitols of Europe. The French seemed to enjoy inflicting their reign of Terror, with the Revolution, but they not only confiscated the property of the Bardi just for fun, they would claim justification of some act being criminal to then execute the banker and thus restructure the debt by eliminating the bankers.

Sometimes defaults have taken the form of retroactively reducing the interest rate. Sometimes it has applied all previous interest to principal. Some countries have attempted to peg their currency to the dollar to help give confidence to foreign debt holders that they will not suffer a debasement in the currency (inflation) that results in a back-door default. The last to try that was Mexico in the 1980s when the peso was a de facto peg to the dollar.

There has been also nations that issue their debt in the foreign currency where they are looking to borrow. This was done just recently in Iceland. Australians will never forget selling the Swiss loans to lower rates of interest in the 1980s. This was done in Argentina in 1872. Argentina issued bonds in British pounds. Their default in 1890 is what force the Bank of England to bailout Baring Brothers for the first time.

While many will attribute more recent crisis events to the mobility of capial in our modern age of a Global Economy, I would argue that CONTAGIONS and international capital flows extend back into ancient time and can be shown to have existed during the 6th Century BC.

Alterations to the silver-gold ratio have set off flights of capital among the nations and created great gold shortages or silver shortages in ancient times as well as within the Middle Ages. This was the same problem the US encountered during the 19th Century that led to its near-death experience in 1896 where JP Morgan had to raise a gold loan to bailout the nation.

Consequently, when I say there will be NO DEPRESSION and the likely course of action is INFLATION, it is part of the big picture for DEFAULT that is assured. In order to go to DEFLATION, we need NO such default and everything will be OK.

But that statement seems to mask the issues of MOVABLE v STATIONARY assets. It is true that real estate is in a DEFLATION mode. However, this is due to the fact that it was the object of capital concentration and what has pulled back is lending and that means DELEVERAGING. However, the mere decline in real estate that is going to prevail broadly about 26 years from the big 2007 high, is NOT the measure of DEPRESSION simply because it declines.

I have also said unemployment will in fact continue to rise. However, whereas the sharp rise to 25% during the Great Depression was the collapse in agricultural sector employment, this TIME it will be the source that was the solution before - GOVERNMENT. Now we will see unemployment rise as the state and local governments are forced to start to live within their fiscal budgets.

Ironically, in Europe, the nations in banning together to create the EURO, indeed eliminated one avenue of default - currency depreciation by inflation (devaluation). That means, Greece cannot devalue the currency (external default) and will have no solution but to reduce jobs in government or withdraw from the EURO. Europe has transformed itself into the position of the states in the USA.

Therefore, it is just not so easy to look at charts from the 1930s and claim it will be just another instant replay. If it were that easy, quite frankly, I would shut up and retire to some beach. It is simply not that easy.

Princeton Economics became famous for our Capital Flow Analysis. That was tracing capital back to ancient times and studying how and why it moved from one place to the next. That was driven by war and defaults in general, but the variety of combinations of these events required extensive models and vast databases. That was what we did.

Sovereign Debt Defaults seem to be the great dirty little secret that is often burried in the details. Socialists have ignored them because it would be a warning not to try to alter the practical economic truths to create a world that cannot be sustained.

There is nothing wrong with having a savings program or social security or even national health care. The problem is the lack of fiscal management and borrowing to accomplish such goals is no different than the borrowing to wage war that also ended in massive defaults.

Thus, the outcome of what we are headed into is complex to say the least. It is not going to be a walk down memory lane. There are far too many variables and far to many different scenarios behind the curtain to discuss in this brief space. This is why I am working hard on a book that seems to have been a long-time coming and why no one seems to have written such a work before.

There is a wealth of specialist books written on specific events. There have been major studies gathering data for the Medici banking operations and even debasements. But it seems no one has put everything together from ancient times to the present that reveals a pattern of actions.

So there will be NO repeat of 1929. It is just not going to be that easy. It's something far more sinister that we face so you may have to rent a boulder instead of just a rock to hide under until the economic storm blows over.

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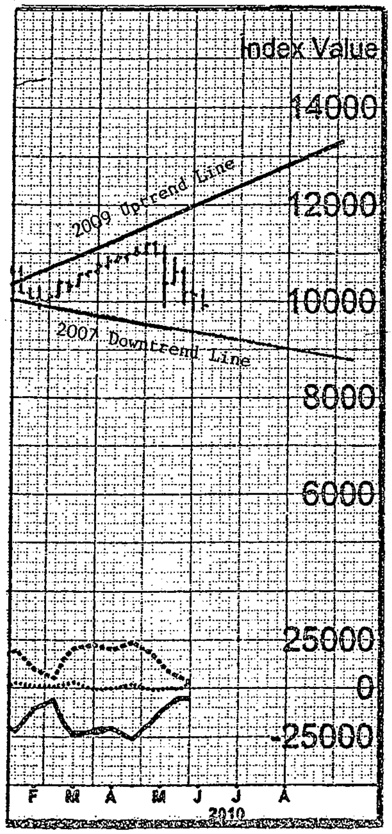
Special Update Report

Dow Jones Industrial Index
Weekly - CASH



Martin A. Armstrong
Former Chairman of Princeton Economics International, Ltd.

The Dow Jones Industrials (CASH) is showing that the big TURNING-POINT will be August. Thereafter, it appears that the opposite trend should unfold into Oct/Nov. The primary support lies at 9400 level and a monthly closing beneath 9675 will warn that the downtrend would become severe, but not new lows.

There are two primary resolutions. There is the crowd that is calling for the Dow to collapse and a Great Depression as was the 1930s. We must understand that all of the world defaulted on their debts with few exceptions (Britain called for a suspension of debt payments) France was the last nation to cling to the gold standard even after the US devalued the dollar under Roosevelt. The dollar rose because it was GOLD. Once Roosevelt confiscated gold, he introduced inflation and that sent stocks up between 1932 and 1937.

Therefore, if the Depression were to repeat, the Doomsday Boys got it wrong! Capital flight was to the dollar because it was GOLD! That's it! Therefore, it is GOLD, not the dollar, that would soar in price!

In the book I am rushing to get done, I go over also forgotten Depressions of the 1340s and the Financial Crisis of 1557 to 1647. This was the period of a series of sovereign debt defaults from Spain and France. In fact, it was so bad, France could not borrow a dime in 1574.

Short-term, there is a potential for the Dow to make a low in early June and then rally into August with the traditional drop in the Sept/Oct time frame. However, making new lows beyond the week of June 14th, will warn of a August low. A key week appears to be the week of August 2nd.

SPECIAL UPDATE REPORTS BY EMAIL

Because of the dramatic increase in volatility, a SPECIAL UPDATE REPORT has been created on a specific market outlook. As we head into the economic storm of **Sovereign Debt Crisis** that is brewing around the world, it is going to be critical to be able to address key events on a more timely basis. Everyone is invited to sign up for thie FREE service at:

ArmstrongEconomics.COM

This will cover the world markets and economies. Please sign up as soon as possible. The event horizon is coming in rapidly. We need to stay vigilant to survive the years ahead for government will only form committees **AFTER-THE-FACT** to investigate why something happened. They will NEVER take steps to prevent an obvious economic crisis. We are on our own. The best course of survival is to stay INFORMED and to understand the nature of what is taking place since no one should ever follow anyone blindly. This is all about educating what is the new reality.