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Mr Gary Banks
Chairman
The Productivity Commission
Level 3, Nature Conservation House
Belconnen, ACT 2616

2 December 2003

Dear Mr Banks:

Enclosed with this letter is a submission to the Enquiry on First Home Ownership. It is premised upon a fundamental point that other submissions (and politicians, bureaucrats, media, financial planners, etc) have overlooked: the "money illusion." This is the erroneous belief that one's financial position has been improved by the receipt of more units of money at a time when the price level also rising (and therefore the value of a unit of money is falling).

Leithner & Co.'s submission shows that, given some plausible assumptions and the money illusion, the real burden of loan repayments is greatest in low-CPI environments. More specifically, at times like the present when the growth of the CPI is subdued, the real burden of debt erodes relatively slowly over time and loan payments relative to income remain higher for longer. Finally, low-CPI scenarios tend to generate lower amounts of nominal homeowners' and shareholders' equity.

In the "low-inflation-and-low-interest-rate" régime presently prevailing in Australia, America and Britain, in other words, relatively high costs are being imposed upon (and low rewards dispensed to) people who borrow heavily. It is not just the participants in behavioural finance studies who succumb to the "money illusion." It appears that hundreds of thousands of Australians and millions throughout the English-speaking world have done and are doing so.

This submission has an unpalatable (because it is politically-explosive) implication. In recent weeks senior members of the Reserve Bank of Australia have uttered a range of cautionary words. They have referred for the first time to the levitation of property prices as a "bubble;" suggested that negative gearing of property be curtailed; and proposed targeted reductions of stamp duty in order to ease the burden on first-home buyers. The RBA (probably unintentionally but nonetheless correctly) has thus hinted that Australians have public policy to thank for some of the most important ills that presently afflict them. But it is a pity that it did not extend this reasoning to its logical conclusion: we have the RBA itself to thank for the real estate bubble.

Clearly, soundly-based prosperity requires savings, entrepreneurship and profit-generating capital goods – not more fiat money, credit and consumption. If so, then the boom conditions in real estate markets apparent today in many parts of Australia are partly illusory, and to a significant extent Australians are living on both borrowed time and borrowed money. "Investment" (much of which is actually consumption) encouraged by subsidised rates of interest can be continued only so long as central and commercial banks make credit available at sub-natural rates. It is this margin between the subsidised and the natural rate which misleads entrepreneurs and gives their investments the false appearance of profitability. It also misleads consumers and gives their shopping sprees the false appearance of sustainability. When the boom ends, as it always does, it does not cause difficulties: it merely makes apparent difficulties which inhered all along in the inflation (properly defined) which is ultimately created by the central bank.

The word "inflation" is almost invariably used by mainstream economists, politicians and market commentators and participants to refer to increases in the prices of raw materials, finished products and wages. Inflation is thus conventionally defined in terms of its several possible consequences rather than its single and definitive cause. Inflation, in other words, rarely if ever refers to an increase in the supply of money. Attention is thereby distracted from monetary expansion -- and from central banks' sole responsibility for this expansion. In 1978 Nobel Laureate Friedrich Hayek wrote a letter-to-the-editor of *The Wall Street Journal* which stated "could you please print in front of every issue in headline letters the simple truth that INFLATION IS MADE BY GOVERNENT AND ITS AGENTS: NOBODY ELSE CAN DO ANYTHING ABOUT IT. It might do some good". The *WSJ* published his note – alas, in lower-case letters.

On three occasions in recent months (18 and 25 August, 1 September), Gene Epstein, the "Economics Beat" columnist of *Barron's*, has advocated the abolition of the U.S. Federal Reserve. So did Ronald Reagan (*Reagan: A Life in Letters*, 2003, pp. 298-299), and on 17 July Congressman Ron Paul introduced HR2778 "to abolish the Board of Governors of the Federal Reserve System and the Federal reserve banks, to repeal the Federal Reserve Act, and for other purposes." Perhaps it is time, instigated by a recommendation by the Productivity Commission's Inquiry into First Home Ownership, that Australians did the same with the RBA. Its abolition would not only smooth the business cycle and remove the major source of asset "bubbles." The absence of expansionary monetary policy that accommodates profligate fiscal policy would also force the Commonwealth and state governments to shrink massively – i.e., to a size small enough to fit inside the Constitution.

Yours sincerely,

Dr Chris Leithner
Leithner & Co. Pty Ltd
Toowong, Queensland

Leithner & Co. Pty Ltd
Submission to the Inquiry on First Home Ownership

> *… Indeed, under a fiat (that is, paper) money system … U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper money system, a determined government can always generate higher spending and hence positive inflation.*
>
> Professor Benjamin Bernanke
> Board of Governors, U.S. Federal Reserve
> 21 November 2002

The Money Illusion

Let us say that three members of an extended family, Peter, Paul and Mary, come from different generations and have lived most of their lives on different continents. They meet for the first time at a family reunion and are intrigued to discover that at one time or another each has bought a house, held it for exactly one year and then sold it. Even more interestingly, each paid the equivalent of $200,000 in today's money for the house. Yet their selling prices were very different. Peter, by far the oldest, bought and sold during the Great Depression. In his year of ownership the Consumer Price Index (a rough gauge of the purchasing power of money and therefore of the cost of living) fell by 25% and he sold for today's equivalent of $154,000. During the year in the mid-1970s that Paul owned his house, the CPI exploded by 25% and he sold for today's equivalent of $246,000. Mary, by far the youngest, bought her home for $200,000 in today's money during the late-1990s. During the year that she owned it, the CPI remained virtually unchanged and she sold for $196,000 in today's money.

Peter, then, lost 23% of the money he had invested in the house, Mary's capital shrunk 2% and Paul enjoyed a 23% capital gain. Alas, the budding friendship of these newly-acquainted distant relatives was strained because they were unable to resolve two seemingly simple questions. Ignoring the costs of buying, holding and selling the houses, but taking into consideration any changes in the purchasing power of the currency, which of the three "did best" from these transactions? Which "did worst"?

Eldar Shafir, Peter Diamond and Amos Tversky conducted an experiment that presented to its participants a scenario very similar to this one (see their article "Money Illusion," *Quarterly Journal of Economics*, 112, 2, 1997:341-374; see also Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes and How to Correct Them: Lessons from the New Science of Behavioral Economics*, Simon & Schuster, 1999, ISBN: 0684844931). They asked that participants assess how each seller fared relative to the other two. Most reckoned that Paul did best and Peter did worst. Alas, the majority is incorrect. Taking into proper consideration the change of money's purchasing power during the year that each owned his home, and assuming that investors strive to maintain and preferably to increase the purchasing power of their capital, Peter's results were the best and Paul's and Mary's were equal worst.

Peter received 23% fewer dollars when he sold the house than he required a year earlier in order to buy it. Critically, however, during that year the cost of living fell - hence, the purchasing power of a dollar rose 25%. Goods and services that a year before cost $1.00, in other words, could now be purchased for $0.75. Yet when he sold, Peter received $0.77 for each dollar he had used to buy the house. The purchasing power of each of Peter's "post-sale" dollars *at the time of sale* was thus greater than that of each of his "pre-purchase" dollars *at the time of purchase*. Given the increase of 25% in the currency's power to buy goods and services, Peter's decision to buy the house for $200,000 and then sell it for $156,000 increased the purchasing power of that capital by 2%. It is likely that he nonetheless rued his decision - had he maintained that capital in the form of cash, a bank deposit or commercial paper, then one year later its purchasing power would have increased at least 25% - but he should regret his choice less than Paul and Mary should lament theirs.

Paul's experience is a mirror image of Peter's. (So too, although the numbers involved obscure it, is Mary's: hence the results of Peter and Mary's choices are identical.) Paul received 23% more dollars when he sold the house than he had expended a year earlier. During that year the purchasing power of a dollar fell 25%; accordingly, goods and services that last year cost $1.00 now cost $1.25. Yet, when he sold Paul received only $1.23 for each dollar he had spent a year earlier. The purchasing power of each of Peter's "post-sale" dollars was thus less than the purchasing power of each of his "pre-purchase" dollars. More specifically, given the rate of shrinkage of the currency's purchasing power during that year, Peter's decision to buy for $200,000 and then to sell for $246,000 decreased the real value of that capital by 2%. Paul may not regret his decision - had he maintained his capital in the form of cash, then one year later its purchasing power would have plummeted 25% - but he should regret his decision more than Paul might bewail his.

Many of the participants in the Shafir, Diamond and Tversky study and the three members of this fictitious extended family have a vague idea that assets whose market price roughly tracks changes in the Consumer Price Index help to mitigate the effects of a decrease in purchasing power - indeed, that is a sensible reason to own real estate. At the same time, however, they did not explicitly incorporate changes of their capital's purchasing power into their deliberations and therefore succumbed to the "money illusion." This term, coined by Irving Fisher in the late 1920s and adopted (and, predictably, muddled) by John Meynard Keynes in the 1930s, refers to the tendency to make inadequate allowance in economic decisions for governments' debasement, debauchery and corruption of the currency. Those subject to the money illusion respond to changes in nominal values - even if there are no changes in real values.

In 1979, Nobel Laureate Franco Modigliani and Richard Cohn found that investors did not properly account for the effects of a galloping CPI upon companies' income statements. They termed this effect "money illusion". More generally, Shafir, Diamond and Tversky's experiments demonstrate that, depending on whether it is presented in a way that emphasises nominal or real quantities, people can respond very differently to the same decision problem. These three authors "propose that people often think about economic transactions in both nominal and real terms, and that money illusion arises from an interaction between these representations, which results in a bias toward a nominal evaluation."

Most people regard a dollar as a fixed amount of money. In a nominal sense this is true; but between the First World War and the early 1970s a hard-commodity money (i.e., $1 backed by and exchangeable for - indeed, defined as - a specified weight of gold in a bank's vault) was bastardised and eventually extinguished and replaced with fiat money (i.e., a government-imposed dollar backed by nothing whatsoever and exchangeable only for loose change). As a result the purchasing power of currencies such as the $US or £ has plummeted - i.e., fallen at a greater or slower rate - over time (see

in particular Murray N. Rothbard, *The Case Against the Fed*, Ludwig von Mises Institute, 1994, ISBN: 094546617X and What Has the Government Done To Our Money?). Alas, consumers and taxpayers are only indistinctly aware of this change. Accordingly, for most people a pay rise of 3% that is granted during a year in which the purchasing power of money falls by 5% would likely generate some grumbling but few strong reactions. In sharp contrast, a decision to cut salaries by 2% in a year when the prices of goods and services remain unchanged would probably provoke a huge uproar. Although the economic effects of these two situations are identical, people are likely to react to them very differently.

The money illusion, then, confuses "nominal" changes in money (i.e., more or fewer dollars in your bank account, income statement or balance sheet) and "real" changes in money (i.e., more or fewer goods and services that a unit of currency can buy). Erwin Esser Nemmers (*Dictionary of Economics and Business*, Littlefield Adams, 1973, ASIN: 0822600331) defines the money illusion as "the erroneous belief that one's position has been improved by the receipt of more units of money at a time when the price level is rising in proportion (and therefore the value of a unit of money is falling)." In *Economics Today* (Pearson Addison Wesley, 2002, ISBN: 0321117530), Roger LeRoy Miller describes the absence of a money illusion in these terms: "a worker will not be fooled into thinking that he or she is better off by a doubling of wages if the price level has also doubled during the same time period." Alas, to succumb to the money illusion is to risk difficulties and perhaps dangers.

The Origin of Mistaken Beliefs

"You can't go wrong with bricks and mortar. My net worth, thanks to the market price of my residential real estate, has skyrocketed. I don't care about either 'inflation' or interest rates - I'm rich!" This refrain, or one very similar to it, has in the past several years been uttered endlessly and triumphantly at dinner parties in Australia (first in Sydney and Melbourne, later in the other capital cities and now in many regional areas) and also in southern England, parts of Canada and the East and West Coasts of the U.S. Those who propound it regard themselves as prosperous not only because estate agents' appraisal of their house's current market price tells them so: they also believe they are rolling in it because a phalanx of journalists, financial planners and politicians chant in unison that it is so. Significant numbers of those who are subjected to this dinner party bluster will quite reasonably think to themselves that they too deserve the good life just as much as - hell, probably more than - that smug bastard at the head of the table. They therefore resolve that they, too, will borrow heavily, "invest" and thereby accumulate wealth.

Australian business journalists and financial planners never miss an opportunity to remind their audiences (and politicians and central bankers never miss a chance to congratulate themselves) that the rate of growth of the Consumer Price Index and the rates of interest charged by commercial lenders are presently at their lowest levels in decades. It is therefore neither surprising nor alarming, they reassure us, that more and more Australians are assuming bigger and bigger debts. According to figures released on 11 August in the Reserve Bank of Australia's Statement on Monetary Policy, since 1995 household credit in this country has grown at an annual compound rate of 14.2%, and by 19.6% in the past year. (Analogous figures for America are 8.0% and 10.3%, and in Britain are 7.4% and 9.4%.)

In the process, consumers (and, in some places, impediments to the development of land) in these countries have helped to levitate - in some places and over some short intervals by astonishing amounts - the prices of residential real estate. The resultant unrealised capital gain (i.e., the difference between the price the owner paid in the past and the price a buyer is willing to pay today) is "equity" against which the owner can and often does borrow. The fall of bank rates has provided an

opportunity to refinance one's debts and to devote the cash thereby released to current consumption. It has also enabled "investors" to borrow more and buy more real estate or perhaps a leveraged portfolio of stocks. Few people, it seems, have used the fall of bank rates to retire debt.

The 7 August 2003 issue of *The Marshfield News-Herald* ("the best place to live in Wisconsin and the eighth best place to live in America") contained words of wisdom that put to shame major publications such as *The Wall Street Journal*, *Business Week* and *The Financial Times*. This small-circulation newspaper stated that "most consumers instinctively believe that the best time to borrow money is when interest rates [and changes in the CPI] are low. In fact, the opposite might often be the case [and] perhaps a word of caution wouldn't go amiss. This phenomenon is commonly known as 'the money illusion,' and it can wreak havoc on your immediate financial well-being as well as your long-term financial health."

CPI, Bank Rates and Four Scenarios

To see this, consider a few assumptions. Let us say that your household's annual pre-tax income is $80,000, you wish to buy a particular house for $200,000 (i.e., an amount equivalent to 2.5 times your income), you have saved $50,000 and you wish to borrow the remaining $150,000. Also assume that a bank or other lender is willing to extend to you a twenty-year fixed-rate loan, repaid in equal monthly instalments, and that during its duration both your salary and the market price of house will rise at the same rate as the CPI.

Now consider two pairs of scenarios. The first pair relates to the CPI's rate of growth during the 20-year course of the loan. In the "low-inflation" scenario the CPI rises 2.5% per year, and in the "high-inflation" scenario it rises by 7.5% per year. The second pair of scenarios relates to the interest rate charged by the bank. In the low rate scenario, the bank charges 6.0%; and in the high rate scenario it charges 10.0%. If the rate is 6.0%, then the loan will be repaid at the rate of $1,074.65 per month and will entail total cumulative payments of $257,914.52 (including interest of $107,914.42). If the bank rate is 10.0%, then the monthly payment will be $1,447.53 and cumulative payments of $347,409.09 (including interest of $197,409.09) will be made. Clearly, and hardly surprisingly, the higher the rate of interest the greater the total amount repaid to the lender. Far less obviously, however, from these two pairs of scenarios emerge four general scenarios (set out in Table 1) that might confront the borrower.

Table 1: Four General Scenarios for a Borrower

	Rate of Bank Interest	
Growth of CPI	Low (6.0%)	High (10.0%)
High (7.5% pa)	Scenario B: Low/High	Scenario D: High/High
Low (2.5% pa)	Scenario A: Low/Low	Scenario C: High/Low

Tables 2-5 outline several implications that follow from these assumptions. Table 2 lists the "real" (i.e., net of the growth of the CPI) loan repayments that will be made under each of the four scenarios in the loan's 5th, 10th, 15th and 20th year. It shows that the real burden of loan repayments is heaviest in low-CPI environments (i.e., scenarios A and C) and that it is lowest in high-CPI environments (i.e., B and D). At each of the four points in time, real payments are highest in scenario C and lowest in scenario B. Payments are generally second-highest in A and second-lowest in D. Further, real payments fall most slowly over in time scenarios A and C (i.e., by 32% from the loan's 5-year point to its 20-year point) and most quickly (by 69%) in scenarios B and D.

Table 2: Real Payments Under the Four Scenarios

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
A (Low Interest, Low CPI)	$946.87	$834.25	$735.06	$646.74
B (Low Interest, High CPI)	$727.75	$492.84	$333.68	$225.67
C (High Interest, Low CPI)	$1,275.42	$1,123.72	$990.11	$872.43
D (High Interest, High CPI)	$980.27	$663.84	$449.46	$304.42

Table 3 depicts this result - namely that the real burden of loan repayments is greatest in low-CPI environments and lowest in high-CPI environments - from a somewhat different point of view. It sets out monthly loan repayments as a percentage of the household's projected real income under each scenario. At each of the four points in time, the percentage of income that must be devoted to repayments is highest in scenario C and lowest in scenario B. Payments are generally second-highest in A and second-lowest in D. Indeed, in scenario C's twentieth year the household is devoting a greater percentage of its income to the loan than is the household in scenario B's first year. Further, the percentage burden of income required to repay the loan falls most slowly in scenarios A and C (by 29% and 32%, respectively, from the 5-year point to the 20-year point) and most quickly (by 73% and 67% respectively) in scenarios B and D.

Table 3: Monthly Repayments as Percentage of Real Income Under the Four Scenarios

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
A (Low Interest, Low CPI)	14%	13%	11%	10%
B (Low Interest, High CPI)	11%	7%	5%	3%
C (High Interest, Low CPI)	19%	17%	15%	13%
D (High Interest, High CPI)	15%	10%	7%	5%

Table 4 shows the amount of nominal (i.e., unadjusted for the decrease of the currency's purchasing power) "home equity" generated under each scenario at each point in time. Equity is the difference (net of the amount of the loan that remains outstanding) between the price the owner paid in the past and the price a buyer is willing to pay today. At each point in time the high-CPI scenarios (B and D) generate the largest amounts of equity and that the low-CPI scenarios (A and C) generate the lowest amounts of equity. The lower (higher) the CPI's rate of growth, in other words, the more slowly (quickly) the value of debt erodes. Further, and not surprisingly, given a particular rate of growth of CPI, a lower rate of interest (i.e, scenario B rather than D and A rather than C) generates a greater amount of equity.

Table 4: Nominal "Home Equity"
Under the Four Scenarios

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
A (Low Interest, Low CPI)	$82,455	$132,943	$211,132	$331,840
B (Low Interest, High CPI)	$107,281	$225,040	$465,102	$951,022
C (High Interest, Low CPI)	$74,108	$116,531	$192,793	$331,837
D (High Interest, High CPI)	$96,421	$197,259	$424,703	$951,013

Finally, Table 5 shows the amount of real (i.e., adjusted for the decrease of the currency's purchasing power) equity generated under each scenario at each point in time. It shows that low-CPI scenarios (A and B) generate the equity slightly more quickly than the high-CPI scenarios. In this sense a slow rate of growth of the CPI makes a loan slightly cheaper in its early years. Given the assumptions that underlie the analysis, however, all generate precisely the same amount of real equity when the loan is extinguished.

**Table 5: Real "Home Equity"
Under the Four Scenarios**

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
A (Low Interest, Low CPI)	$72,651	$103,203	$144,414	$200,000
B (Low Interest, High CPI)	$72,651	$103,203	$144,414	$200,000
C (High Interest, Low CPI)	$65,296	$90,463	$131,870	$200,000
D (High Interest, High CPI)	$65,296	$90,463	$131,870	$200,000

The Consequences of Mistaken Beliefs

These conclusions might dismay the hosts and guests of smart dinner parties at which residential real estate is a staple topic of conversation. Everybody "knows", likely because "experts" and politicians incessantly remind them, that Australia is a "low inflation" country; but how many realise that the real burden of loan repayments is greatest in low-CPI environments? More specifically, at times like the present when the growth of the CPI is subdued, the real burden of debt erodes relatively slowly over time and loan payments relative to income remain higher for longer. Moreover, how many know that low-CPI scenarios tend to generate lower amounts of nominal homeowners' equity?

What a party-pooper: in the "low-inflation-and-low-interest-rate" regime prevailing in Australia, America and Britain, relatively high costs are being imposed upon (and low rewards dispensed to) people who borrow heavily. It is not just the participants in the Shafir, Diamond and Tversky study and the three members of this fictitious extended family who succumb to the "money illusion". It appears that hundreds of thousands of Australians and millions throughout the English-speaking world have done so.

George Trefgarne (The End of the Best of All Worlds, *The Daily Telegraph*, 16 November 2002) seems to concur. "The real danger is that individuals are running up debts on the basis of what economists call a 'money illusion'. This occurs when they get muddled up about the real value of money. After two decades of inflation - prices [in the UK] rose an average of 13% in the 1970s - most people are still adjusting to the fact that it is no longer with us." Trefgarne continues: "many people have yet to wake up to this problem. Instead of focusing on paying off their debts, they are looking at the low cost of servicing them - or paying the interest. They are still living in the 1970s or 1980s, when the roaring level of price rises and the consequent salary increases tended to make a big dent in the real outstanding value of loans. [Mervyn King, deputy governor of the Bank of England] frets that people could one day see through the money illusion".

An Enduring Lesson

What, then, to do? Hope that the CPI recovers from its slumber and resumes its brisk pace of the 1970s? Hardly. Inflation, properly understood (see, for example, Is Australia Really a "Low-Inflation" Country? and Inflation and Deflation: Some Dissenting Thoughts for Value Investors), will not remedy our ills. Quite the contrary: it has caused them.

"Austrians," writes Stephen W. Carson, "understand money inflation in this way: money substitutes are created that do not represent actual goods and services. So to draw an analogy to education, we might say that education inflation would be the issuing of degrees that do not represent actual learning. Fiat degrees, like fiat money, would over time experience a devaluation. This is precisely what we have experienced. There was a time when having a high school degree really meant something. Some older friends were telling me that in the '30s and '40s to be a 'college man' marked one out as in a small, select and respected group. Now people with Bachelors' degrees are a dime a dozen. A Masters or Ph.D. is really ideal to distinguish oneself as educated. But even PhDs (in some fields) seem to be over-produced. Ironically, the premier example of this is PhDs in Education – which are turned out by the boatload and typically signify very little learning."

It was not always thus. Grover Cleveland was the last president of the U.S. (1885-1889, 1893-1897) who properly upheld that country's hands-off tradition and defended its Constitution against all comers. He vetoed more than 300 bills proposed by Congress, most for the eminently sensible reason that they were plainly unconstitutional. The previous twenty-one presidents had vetoed a cumulative total of only 132 bills; hence Cleveland was known as "the Veto President." In sharp contrast, George W. Bush has yet to veto a single measure enacted by the most profligate Congress in U.S. history. Similarly, Jacques Rueff, unknown to all but a few of today's Europeans, was the last of that continent's statesman properly to deserve that title. Cleveland and Rueff repay our attention because each championed honest money in the form of the classical gold standard. Each championed sound prosperity; accordingly, each abhorred and indefatigably combated the proponents of inflation.

Alas, apart from Ron Paul, virtually no contemporary politician is heir to President Cleveland's forgotten legacy (see in particular his address delivered to the House of Representatives on 25 July 2003 and entitled Bring Back Honest Money); and today's central bankers stand first, foremost and four-square for monetary profligacy and shenanigans. Can one therefore assume that governments' fiscal and central banks' monetary policies can engineer prosperity? Again, hardly. According to Charley Reese, "given the low level of competence among politicians, [everyone] should become a libertarian. The government that governs least is certainly the best choice when fools, opportunists and grafters run it. When power is for sale, then the government's power should be severely limited. When power is abused, the less power the better" (see also Llewellyn Rockwell's excellent Stimulating Nonsense).

George Akerlof, the 2001 Nobel Laureate in Economics, goes much further. In a remarkable interview with the German magazine *Der Spiegel*, he contends that "future generations and even people in ten years are going to face massive public deficits and huge government debt. Then we have a choice. We can be like a very poor country with problems of threatening bankruptcy. Or we're going to have to cut back seriously on Medicare and Social Security … The government is not really telling the truth to the American people [and] what we have here is a form of looting … I think this is the worst government the U.S. has ever had in its more than 200 years of history. It has engaged in extraordinarily irresponsible policies … Now is the time for people to engage in civil disobedience."

How, then, does a sensible investor respond the pervasive - and deceptive - allure of debt? By recognising that in the financial world everything has its season - and that seasons turn neither regularly nor predictably. In James Grant's words (*Minding Mister Market: Ten Years on Wall Street With Grant's Interest Rate Observer*, Farrar Straus Giroux, 1993, ISBN: 0812924843), "borrowed money is no more likely to prove a permanent sure thing than one-decision stocks, portfolio insurance or bags of silver coins. The habits of a long prosperity have bred the conviction that asset prices always appreciate: they don't … [and] years of easy money have popularised the balmy idea that you can always get a loan: sometimes you can't". In its season, then, debt provides a pair of wings; but when it goes out of season it can quickly become a ton of bricks. Grant has also noted that, more often than not, "where the [present] action and excitement are *not* is often where the prospective returns *are*. This outcome depends upon rational valuation - a subject of identical relevance both at towering tops and epochal bottoms". It is therefore in that latter season – but not before – when hard work, thrift and sobriety are topics of earnest conversation at dinner parties, that it might behove a sensible first home buyer to wax confidently about borrowing and debt.

Dr Chris Leithner
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