



Tangible Ideas



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Bastiat's Iceberg



A Diapason Research Report by Sean Corrigan

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To many people, who today speak of unprecedented disaster, historic precedent is not only inconclusive but distasteful. There is some practical wisdom in this attitude, as far at least as it implies protest against misleading analogies in a world in which nothing ever reproduces itself with the mechanical exactness of a laboratory experiment. But recurrent the depressions are and certain features repeat themselves; and these recurrent features as well as those which are peculiar to any one crisis show some truths, which it would be much more laborious to establish without such illustrative material.

Joseph Schumpeter, *'The Economics of the Recovery Program'*, 1934

Picture, if you will, a scene in which a fire breaks out in an isolated little town, far out in the countryside. Immediately they are alerted, the neighbours rush to gather buckets and saucepans and all manner of containers and spontaneously organize themselves into a human chain to carry water from the village pump to the site of the blaze.

Once the line has been assembled, it needs little imagination to realize that if those forming it drop out for any reason, the flow along it will slacken, hampering the efforts of all. As the work progresses and the volunteer firefighters tire, if no-one thinks to provide refreshment or relief, if no-one is on hand to fix the buckets when their handles break, or to ensure that the pump handle is well-greased, the fight to extinguish the flames will also begin to falter.

Now, suppose that a group of mainstream economists and central bankers happens to be visiting the village when the outbreak occurs and its members congregate, just beyond the circle of heat and smoke, to watch the unfolding drama. Their main pre-occupation is to estimate the volume of water being poured in any given interval and in being so fixated upon what lies immediately before them, they remain largely oblivious to the chain of volition stretching all the way back to the spring.

If any of them does happen to look into the shadows to where men and women stand sweating and toiling, he quickly dismisses their activity, telling himself that the last bucket is all that matters, that the rest 'cancels out'; that to pay heed to it is to engage in 'double counting'.

Besides, as he conceives of it, the chain's constituents are not actual people, widely diverse as

to age, ability, or incentive. They are not subject to any vicissitudes of circumstance, they suffer no competing imperatives: they are a homogenous, faceless array of readily-interchangeable automata.

Thus, if the volume of water being delivered each minute begins to fall, our observer – if not a Planner himself, then surely an advisor to one – will have the solution readily to hand: more tinder must be thrown into the flames – that is to say, more 'effective demand' must be exercised by heightening the intensity of the conflagration!

While it is perhaps fortunate for all in the vicinity that the Krugmans, the Strauss-Kahns, and the Blanchflowers are not actually in charge of their hometown's respective fire services, they are each none the less culpable of propagating a similar error of comprehension. Furthermore, to the degree anyone bases actual policy upon their repeated Keynesian urgings, they are guilty of fostering a greater destruction of personal wealth than if they were arsonists themselves.

So, rather than listening with rapt attention when next they and their peers pontificate on how much more 'stimulus' (i.e., burning) is needed if we are to 'fix' that overarching entity they unthinkingly refer to as the 'economy' – a gross, smeared-out abstraction which actually encompasses the efforts and aspirations of untold millions of people, each trying to secure to themselves a livelihood – we should look up from the sizzle and steam of the last upturned pail and spend some time instead thinking about what it took to get it there in the first place.

Turning to what nowadays passes for analysis, the most commonplace observation heard from the

talking heads, who wish to appear profound without ever performing the hard work of actually thinking about it for themselves, is that the 'consumer is seventy percent of the economy'. Regrettably, this narrow reckoning of the fate of the water in the final pail is only true within its own perverse framework. It may well be the case that - in a nation as oriented as the US on what we shall henceforth call exhaustive consumption (i.e., on that which puts the involved resources beyond all possibility of their further use in producing other goods or services) - those engaged in what is, after all, an act of destruction typically account for over two-thirds of the statistical fiction known as GDP, *but GDP is not coterminous with the economy in its entirety.*

It cannot be emphasised too strongly that this misleading and decidedly partial truth usually obscures one of much greater import and inclusivity, namely that *Monsieur/dame Epuisement* are directly responsible for much less than a *quarter* of all the expenditures actually being undertaken at anyone time, even if our couple's satisfaction is the ultimate aim of the hidden to-and-fro which takes place in that lurking, sub-surface mass of a catallactic iceberg we are so conditioned to neglect, right up to the moment our mispiloted Ship of Hope rips out its innards on this shadowy, aquamarine bulk.

Moving from the water carriers of our allegorical chain to the consideration of the productive linkage of one real, functioning business with another, we should straight away be aware that the purchases each makes from - and the sales it makes to - another business far outweigh the transactions undertaken with exhaustive customers even if the true role of the choices made by the latter (the subjective preferences they express as they spend or save their incomes) is ultimately to determine - by a process of price imputation back from the contents of their shopping baskets - both the scale and the composition of all the entrepreneurial outlays remote from them (the ones said to be of 'higher order', in the jargon).

Moreover, as we shall shortly show, a goodly proportion of the money paid out by businesses in

the quest to earn an income for their proprietors ends up in the hands of said exhaustive consumers, whether they be private individuals acting on their own account or government spending agencies following their leaders' political whims in doling out the produce of others.

Thus, not only are the great preponderance of decisions about *expenditures* made by businesses, not end consumers, but the latter tend to derive the bulk of their own spendable incomes in the course of those very same business decisions - in their varying roles as managers, employees, shareholders, creditors, public-sector workers, or other recipients of tax monies extracted from the former groupings.

It should be kept at the forefront of one's mind that business decisions are, by their nature among the most 'discretionary' of them all, for while Acting Man-as-exhaustive-consumer may not long ignore the rumblings of his belly, or the cries of his thirsty children, Acting Man-as-entrepreneur has much greater freedom of choice. He may or may not order in new stock; he may or may not choose to replace his machinery, move to bigger premises, launch a new advertising campaign, or take on extra staff. He may even cut back on the dividend payable to his shareholders and opt to roll over, repay, or even reschedule his outstanding borrowings - each as he is persuaded by his intuition about the likely profitability of the selections from the menu of choices which continually confronts him.

In all this, he must try to gauge not only what his own customer is willing to pay, but what traffic his customer's customer further downstream will bear in his turn. As he does so, he must simultaneously reckon on what his supplier and his supplier's supplier *upstream* are seeking to accomplish - what they will attempt to charge; what they can deliver and when. He is not finished yet, for he must not only make allowances for what his direct competitors as makers of similar products are up to, he must be sensitive to what those in wholly *unrelated* industries intend, for they not only compete - if now at several removes - for the very same end-consumer's dollar, they are already vying with him to buy in the necessary factors of

production – the labour, the equipment, the raw materials, the land, the energy – even the space on the overnight freight express to the container port.

The Fruits of their Labours

If we take a glance at what our man can hope to earn by shouldering this heavy responsibility, the true miracle of entrepreneurship is rapidly shown

not to be that so many succeed at it, but that so many are willing to attempt it in the first place.

Collating various data from the Bureau of Census' Quarterly Financial Reports on trade and manufacturing, the BEA's Gross Output and NIPA series, and the Statistics of Income Bulletin produced by the IRS, we can breakdown the destination of the typical US company's income statement into the following schematic:-

REVENUES	100.0	GOVT	
COSTS	88.5	Own Tax (<i>i+ii</i>)	6.2
Labour	35.0	Others' Tax (<i>a+b+c+d</i>)	7.3
(i) Tariffs	4.5	Sub-Total	13.5
(a) Energy	2.0	Own Labour @20%	7.0
(b) Materials	20.0	Others' Labour	8.3
(c) Services	25.0	Sub-Total	15.3
Net Interest	1.5	Own Capital @30%	1.2
Misc.	0.5	Others' Capital	1.4
DEPRECIATION	6.0	Sub-Total	2.6
PreTax Profit	5.5	Total Tax	31.4
(ii) Tax	1.7		
AfterTax Profit	3.8	LABOUR (After-Tax)	
Dividends	2.6	Own	28.0
Retained Earnings	1.2	Others'	33.1
(d) Capex	7.2	Total Labour Income	61.1
CAPITAL (After-Tax)			
Own	2.9		
Others'	3.4		
Total Capital Income	6.3		

"Others'" contributions estimated by assuming the same proportion as the original firm and solving the resulting geometric series up the chain

Table 1

There are several things to note here. Firstly, the fact that each business is assumed to spend 54.2% of its revenues on the output of other businesses (2% on Energy, 20% on Parts & Materials, 25% on Services, and 7.2% in Capex) and that each of those

businesses, in their, turn maintains the same proportions in buying from their own suppliers. Essentially, this means that 54.2% - or 0.542 - becomes the repeated factor in a geometric series, and that, as a result, total revenues end up

somewhere in the region of 220% of the original 100 received. If we add the simplification that this very first, 100-unit business has a monopoly on selling to end, exhaustive consumers, we can loosely equate its numbers to those contained in the GDP report and so determine just who enjoys what portion of final income after all that effort, as laid out in the accompanying table.

Note that, when all is said and done, while labour bags three-fifths of the gains – with the State grabbing no less than three-quarters of anything left over - the average business makes a profit of only around 5% of total sales and then retains barely more than a fifth of that after rendering unto both Caesar and Crassus (i.e. after paying both taxes to the former and dividends to the latter). Observe next that routine capital investment needs typically absorb the whole of this small, residual sliver, together with the scanty ~6% depreciation allowance granted by the taxman, and the true, precarious nature of entrepreneurship should by now have become painfully evident.

In gambling terms, our man is accepting odds of close to 13/1 on and then having to pay out all his winnings on the cab ride to the track. Not many punters would be interested backing that particular pony, even if they had trained it and were allowed to ride it themselves.

There is more, for naturally not every entrepreneur will win each wager he takes against the dark forces of ignorance, consumer capriciousness, central bank folly, and government interference. In fact, the official statistics show that, over the quarter-century stretch from 1980 to 2004, inclusive, for every \$1 of positive net income earned, there were 30¢ of losses incurred – a legacy of failed aspiration which swelled to as much as 50¢ per \$1 in the worst economic periods.

Dearborn vs. Agathon

To visualize what is at work here, imagine that the whole system works like a giant assembly line in a vast, vertically-integrated company, digging the ore

out of the ground and smelting the metal therein; drilling for and refining the oil and petrochemicals it needs; fashioning tools with which to make more tools with which to make parts, and, finally, fixing them together to make a functional whole which is destined for final sale to a customer who will derive the wherewithal to purchase such goods by contributing either his present labour or his past labour, in the form of his savings, somewhere along the line leading to their production.

Now imagine that a new team takes over in the boardroom and starts hiving off the various units into distinct entities, spinning off the machine tool makers into a stand-alone firm; encouraging the accounting department to undertake a buy-out; removing the packaging designers from the payroll, while still contracting to use their services in much the same manner as before.

As the shake-up reaches its culmination, where once we had a bureaucratized behemoth within which true accounting of the costs and benefits accruing at each stage was exceedingly difficult to achieve and where the scope for initiative and innovation was becoming fossilized, we have a decentralized, flexible, loose network of individually specialized actors, every one of them now empowered to exercise his own entrepreneurial judgement about what he can make for the lowest cost and sell for the highest price to each of the other members of the network, else to the end, exhaustive customers upon whose desires all this effort is ultimately predicated.

It has to be faced that when talking about the new men in charge breaking up our economy-wide conglomerate, your author cannot but appear sympathetic to their aims, but this approbation will decidedly not be shared by the members of that sinister, all-pervasive, Wellsian-open conspiracy, the *Planners*, who will see this change as a distinctly retrograde step. This is because it is their 'fatal conceit' is to build monoliths, not to fragment them, the better to regiment their fellow citizens and the easier to substitute their own, privileged judgement for the working of the blind multitude in the market. This arrogation of choice, so they aver, is needed in order to reduce what they conceive of as the 'wastefulness' and 'irrationality' of a productive

structure which, in their jaundiced view, is not only inequitable, disco-ordinated, and inefficient, but is unlikely to reward them, the Planners, with the rewards they feel are their due.

In their Olympian disdain for the little man whose very breath they nonetheless now yearn to regulate, they are congenitally oblivious to the truth that the World can thrive without them: that, absent their heavy-handed interference, its form is highly articulated, intrinsically adaptable and – yes - partly redundant, but therefore gratifyingly robust.

These Planners who so plague our modern lives are all, at root, *château* generals, arraying their coloured counters in textbook fashion in the sandbox; serenely isolated from the mud and gore at the front; disastrously behindhand in their decisions; hopelessly divorced from the harsh realities of the fray – all failings which, of course, do not discourage them in the least in their pretence at deciding the destinies of the many.

The shrewd commander of the storm-troop, by contrast, is ever alert to the fact that the ‘want of a nail’ is emblematic of military failure and so remains conscious of the importance of logistics – of the necessity for the smooth functioning of that extensive rear-area ‘Tail’ (analogous to our non-GDP ‘Length’) to the delivery of combat power by the armed ‘Teeth’ in the battlezone. He also lives by the dictum contained in von Moltke’s lapidary phrase that ‘*no plan survives first contact with the enemy*’ and so knows that there is always a need for hands-on officership, for what we might usefully call an ‘entrepreneurship of war’.

If even the starchy *Junkers* of the Prussian army could learn to delegate as much responsibility as possible right down to men with their noses in the dirt – a doctrine known as ‘*Auftragstaktik*’ – why is it that, in civilian life, a dreadfully intrusive economic prescriptivism has been able to live so far beyond its many failures in the crucible of history?

Glance back, if you will at our assembly-line concept. Before our bright new management gurus got to work, we were confronted with a monstrous,

arthritic Collective which creaked and rattled and sputtered to a halt if a drill bit sheared off at the wellhead; or if the foreman called in sick and those forging bolts under his supervision took too long a lunch break; or if the Chief Planner forgot that he could use the steel he had ordered for the factory roof, or for automobile fenders, or for a light fitting at the filling station, but not for all three at once.

In its place has been crafted a spontaneously-ordered mutuality, in which an evolving entrepreneurial fitness will become the only gauge of who prospers and who does not and where the entrepreneurs’ benignly speculative attempts to make a profit will employ factors (i.e., means) which are relatively *undervalued* in order to turn them into goods (ends) which are relatively *highly-valued*. **In other words, in this Utopia, the entrepreneur becomes an arbitrageur of scarcity and the profit mechanism a marvellous adaptive search for the best practice in a constantly changing landscape.**

Here, the material rewards of success accrue not just to the individual but to the whole commonwealth as the stagnant pools of relative surplus are progressively drained and a fresh, revivifying liquid poured out over the arid wastes of relative dearth, wherever they can be identified.

[Please see Appendix 1 at the end of this paper for a diagrammatic treatment of this approach]

Double-entry accounting versus ‘double counting’

So much for the theory, but is there any evidence that this has any counterpart in the real world and, if does, what does it add to our analysis in general and for the present investment backdrop in particular?

Well, firstly, let us see if we can discover just what are the size and scale of business outlays in the US and then let us compare them to the exhaustive spending over which the mainstream obsesses so much. After all, if we are to do some ‘Macro’ of our own, at least let us make sure we are going about it

the right way before we plot a single line on our chart.

To do this, let us first take the definitive IRS data for business receipts and net income (which cover not just corporates but also partnerships and sole proprietorships). Using the accounting identity that revenues minus costs and depreciation equals profits, we can quickly derive above-the-line expenditures, while the BEA's investment numbers also allow us to add an estimate in for total, below-the-line capital expenditures.

Annual numbers are readily available for the period 1980-2006, but a little conceptual manoeuvring will allow us to retrocast the years 1972-79 as well as to project forward to 2007-09. With just a little adjustment, the annual Gross Domestic Output series, coupled with import data, helps us to estimate revenues and we can cross check this with the Census Bureau's monthly manufacturing and trade sales release as well as with Standard & Poor's quarterly revenues for the S&P500 index to verify that the projection is a sound one.

Having done all this, let us take that last year of the IRS record, 2006, by way of an example. Here, we see that while the official Nominal GDP number came in at \$13.4 trillion, business spending amounted to more than \$31 trillion, around 2 1/3 times bigger – the vast majority of it totally neglected by the mainstream army of statisticians, blind empiricists, and unthinking co-plotters of one curve with another to whom we unavailingly look for some skill in prediction.

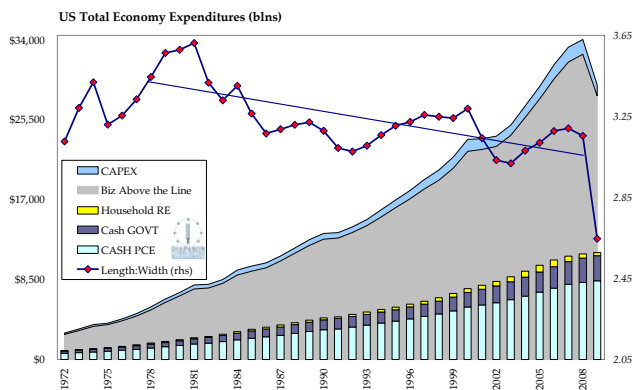


Figure 1: That's the Way the Money Goes

Let us next distil the GDP numbers a little further so as to make a more detailed methodological comparison. To begin with, we are keen to show that the exhaustive end consumption numbers are not the alpha and omega of economic analysis, so let us extract them by considering only the personal consumption and government spending parts of GDP. Furthermore, we will disregard their so-called 'imputations' component – virtual entries which attempt to evaluate non-monetary services, such as the free chequebook facilities offered to depositors which, believe it or not, amount to a \$210 billion-a-year line item. We want no statistical sophistry, here, only things for which hard cash changes hands in the marketplace.

Going back now to 2006, we can at last put our mountainous \$31.3 trillion in business outlays in a better perspective by comparing them with the lesser uplands of the \$7.6 trillion of cash personal consumption expenditures, as well as with the foothills of the \$2.3 trillion in government end-spending. In fact, over the whole period, 1972-2008, businesses typically spent \$4.30 for every \$1.00 spent by individual end-consumers, and \$3.20 for every \$1.00 spent by them and their rulers combined.

But it is not only the significant difference in size which makes this significant, but also that in their variability. While the mean year-over-year percentage change between the two is a near-indistinguishable 6.5% for business and 6.6% for the exhaustive component (funnily enough, each right in line with the contemporary 6.5% average annual increase in 'Austrian' money supply), the volatility of the first is 5.3 and its range stretches across no less than 5.7 sigmas, while the latter's volatility is a much lesser 2.3 and encompasses only a 3.7 sigma range.

To underline the point, when we look anew at business spending - what, with a nod to our Hayekian visualization, we shall call the 'Length' of the productive array – we can immediately get a far better sense of the scale of the current crisis, as well as recognising where the brunt of its impact has fallen. Whereas the 'Width' of the exhaustive outlays is likely to have *risen* by around 2% on the year when the final tally for 2009 is complete

(admittedly, its slowest nominal increase in the period under consideration), the 'Length' of the process giving rise to them will be seen to have plummeted by something approaching 14%.

Put into dollars and cents, households and governments will have probably have paid out around \$240 billion more this year than in 2008, while businesses will have trimmed a monster \$4.8 trillion from their budgets, taking them back to where they were in 2005. Repeat this exercise for Japan and Germany and it will be seen that the world's three biggest developed economies probably shed in excess of \$10 trillion in business outlays this year. Hence, the severity of the recession.

Length & Width v Labour, sigmas from mean%

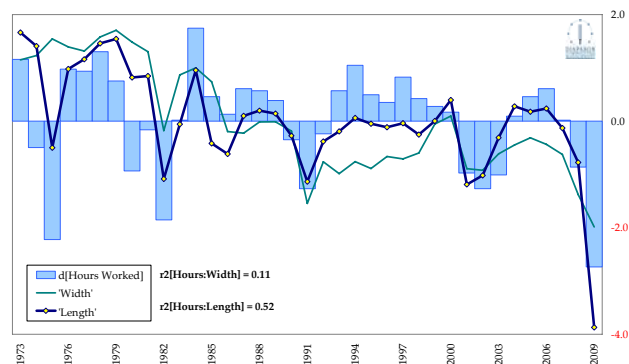


Figure 2: *Never mind the quality...*

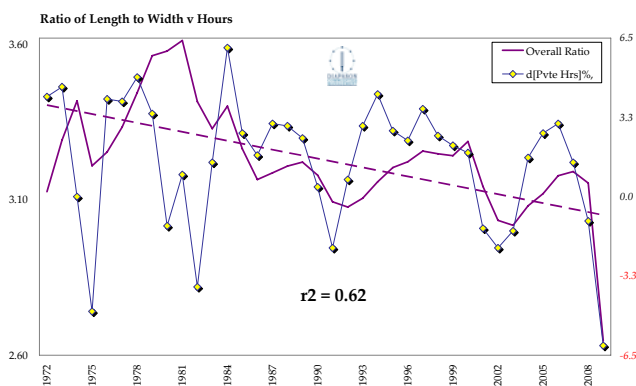


Figure 3: *...feel the LENGTH*

Further underlining the true economic importance of this way of thinking, note the much closer fit between variations in productive Length and the measure of total private hours worked ($r^2 = 0.52$) than between the latter and changes in exhaustive Width ($r^2 = 0.11$). Note, too, that the alterations in the

ratio between Length and Width – a construct utterly beyond the conception of the GDP junkies – correlates to changes in hours worked even more closely, with an r -squared of 0.62.

As we shall see later, the behaviour of this variable also has a great bearing upon the question of how changes in the pace of money creation are working to accelerate activity and how rapidly they will affect the development of prices in general. For now, however, let us merely state that, to the extent we can track its progression, here we have a powerful gauge of the health, or otherwise, of the economy and one which largely goes unrecognised elsewhere, to boot.

The Worm in the Bud

To an Austrian, none of this is unexpected since the school is founded upon the concepts of capital structure, the entrepreneurship which shapes and directs it, the saving of which it is composed, and the way that monetary and financial disturbances – largely caused by the presence of noisome, non-market pollutants – can disrupt the first and delude the practice of the second while needlessly squandering the third.

In the classical exposition of Austrian Business Cycle Theory – or ABCT – the secular progression to higher levels of material attainment is one achieved by the entrepreneurial transformation of voluntary savings into invested capital, thus amplifying the productivity of labour, lessening scarcity and thereby deepening the pool of available savings ready for further investment. This reduced urgency for goods today makes itself felt in a natural lowering of interest rates (a lower degree of 'time preference') and hence signals the possibility of a further intensification of the proportion of capital in the mix, in a virtuous circle of increasing general enrichment.

As part of this dynamic, ever greater levels of specialization of function are induced, introducing more links into the productive chain (increasing 'roundaboutness' in the slightly misleading original phraseology of one of the School's founding figures,

Eugen von Boehm-Bawerk) and increasing the Length of the whole in the manner we have described above.

Far from being a curse, there is no so-called 'Paradox of Thrift' where such saving is involved, for a surplus of resources required for immediate use (which is what constitutes 'saving' in the first place) also implies there exists a readily utilizable source of men and *matériel* with which to undertake projects whose ultimate fruition may (a) be somewhat delayed, (b) require the availability of other resources, or (c) involve the investment of capital in different, complimentary process at a subsequent juncture – this latter a crucial point which is often overlooked in rival expositions of the cycle.

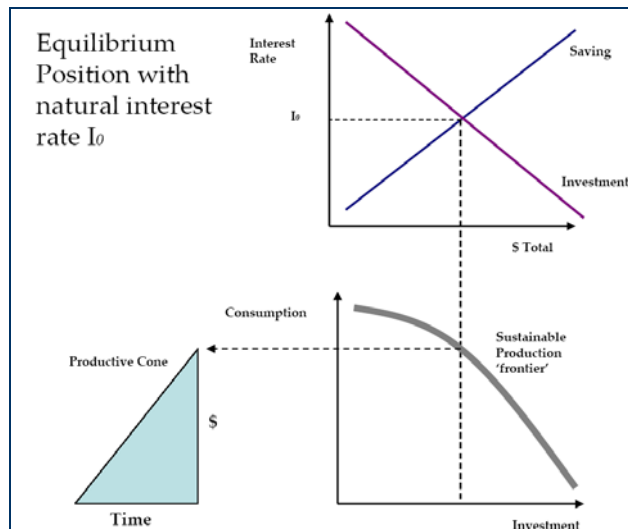


Figure 4: *Das Wohltemperierte Klavier* (after Garrison)

Thus, if more saving implies a momentarily reduced exhaustive Width, it also facilitates new additions to productive Length and hence aids the transfer from one focus of activity to another with no more than 'frictional' output losses along the way. There may be some slack in the market for existing goods but, as their prices fall, the market will signal that less effort needs to be devoted to their continued provision, while encouraging investments aimed at either reducing the cost of producing them (and so restoring the relevant profit margins), or into providing other, existing goods where demand is not so obviously well-satisfied, or even of developing an entirely novel range of wares with

which to tempt jaded consumer appetites in the future.

Sadly, there is a Serpent in this earthly paradise, a Deceiver whose speckled hide is made up of dollar, pound, and euro signs, for if there is one thing guaranteed to throw this harmonious creation of wealth into strident discord, it is soft money and elastic credit.

'Just pluck a quantum of unsaved credit from the Tree,' he hisses, 'and you can borrow while barely disturbing the interest rate. Better yet, if you let me offer you one of my largest and bitterest apples, we might even be able to finance you at a lower one and no need to persuade anyone to save while you're about it.'

Either way, those succumbing to the temptation will be distorting the crucial price signals about the availability of factors of production and about the appetite for the end-consumer goods to which their employment will give rise. Money market interest rates will no longer reflect the schedules of time preference in the market for *things*. Especially in a world so dominated by the astronomically leveraged flows which take place in financial space - where the outside world is often of no greater import than is the state of the pitch, or the condition of the weather, to the players in a sporting team - easy money boosts asset prices, lowering discount rates and risk premia well nigh regardless of the true balance between savers and spenders, between abstinence and appetite.

Adam the entrepreneur may well now embark upon an ambitious scheme of expansion, using this new purchasing power, but instead of bringing about a willing, temporary relinquishment of resources by someone who has previously earned a claim to them, somewhere along the line, \$2 will soon be vying for what \$1 used to buy and so, where a peaceful economic co-ordination of means and ends once ruled, the brassy trumpets of strife will soon resound to shatter Eden's peace.

Because of this, many prices will be higher than they should be – though this does not mean they must be lower in *absolute* terms since a fortuitous increase in their supply might coincide with the appearance of

this artificial new demand: the critical thing is that market signals will nevertheless be scrambled, entrepreneurial plans miscast, and capital woefully misallocated. In these circumstances, where the few, far-sighted Cassandras can only appeal to subtle counterfactuals to make their case for caution, is the sound of mocking, diabolic laughter particularly prevalent.

Finally, this confusion must lead to trouble, since, as the money filters through the hands of the multifarious buyers and sellers across the system, the original balance of their preferences – and hence a barely changed inter-relation of relative prices – will tend to reassert itself. Since the credit which set all this in train was plucked from the fateful Tree and not saved, these preferences do not, by definition, include any *ex ante* accommodation for resource use on the scale which Adam's plans require. Though he may initially have succeeded in hijacking what he was not really being offered, as his price margins move inexorably against him, Adam will be horrified to perceive the true nakedness of his net income stream, the paucity of which will require the fig leaf of another helping of unsaved credit to cover the hole in his accounts (assuming he is still deemed creditworthy enough to be granted one).

Even if he succeeds in securing one, this only postpones the inevitable day when the inflationary impact of more and more money becomes too obvious to ignore and when the growing economic malaise it has caused erupts into a full-fledged pestilence. Faced with an even more certain ruin if they continue on the same path, finally the banks – or the authorities notionally controlling them – start to restrict credit and the inevitable Bust ensues.

Different Strokes

At least, this is what happens if we follow the classic pathology of the disease as it was teased out by Mises and his circle in the early part of the last century. But times change and institutions alter, even if human caprice stays constant and economic law remains inviolate. Breeding in a different milieu to that of a hundred years ago, the virus has

mutated to produce a subtly different set of afflictions in many of its latter day hosts.

To see why this is, consider that the elaboration of the classic ABCT took place when 'fiduciary media' – i.e., unbacked credit – was issued primarily to producers, allowing them to 'force' savings upon reluctant consumers by bidding goods away from them. Eventually, higher prices and adverse margin movements – when not actively offset by further extensions of new credit – forced a struggle for inputs and drove up short-term interest rates as what Hayek called 'investment that raises the demand for capital' gave rise to that archetypal harbinger of doom, the inverted yield curve.

This signalled the belated reluctance of lenders to put any more dimes in the speakeasy pianola and was driven in those days by worries about their reserve ratios as well as, in all likelihood, by the straits imposed upon them by an external drain of the specie on which the inverted pyramid of money ultimately rested as payments for burgeoning Boom-time imports came greatly to exceed receipts booked against the manifest of increasingly uncompetitive export offerings.

Today, however, much of the borrowing is being carried out by and on behalf of end-consumers – to the extent that the non-financial corporate sector, even in savings-poor nations like the US and UK, have been acting as net *lenders* of funds to governments and households, a travesty of how a well-ordered economy should function.

Effectively, this is an act of financing one's own sales in order to conjure up a simulacrum of profitability; one whose continuation requires both that final payment is eternally deferred and that one's increasingly indebted customers can be induced into putting themselves deeper and deeper in hock with each turn of the product cycle, simply in order to maintain sales.

It also means that more and more debt is founded not upon potentially productive capital assets, but upon calls of ever longer tenor upon the increasingly-alienated income streams of people who are often one pay cheque – or one quarter of

subsiding property prices – from disaster. In such an environment, even that debt which does look as though it is erected on solid underpinnings may instead be secured upon the shifting sands of a business model reliant on things never quite reaching the vanishing point of vendor finance. These firms, too, have been seduced into crassly overbuilding their capacity – this time, making the structure too wide, rather than too long as in classic ABCT. Mass overconsumption now joins malinvestment - 'fostered dissaving' jostles with 'forced saving' - as a way to dissipate wealth.

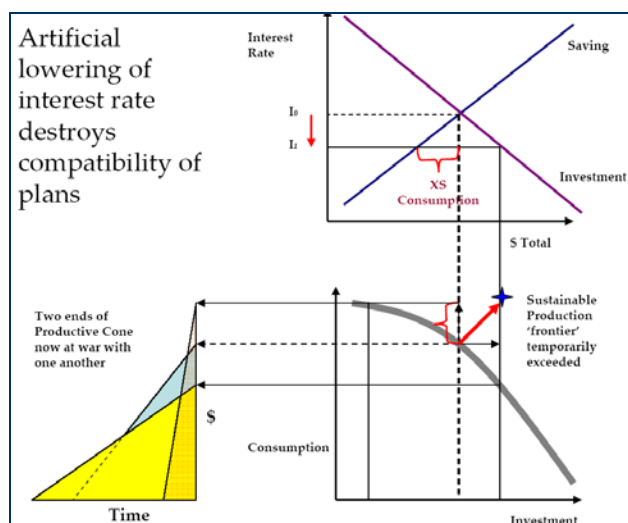


Figure 5: A tuneless old joanna

Ironically, in such a world, a flatter yield curve – even an inverted one – is no longer a sure-fire indication of stress, irrespective of whatever views the crowd of dull empiricists may assert about their blind extrapolations from the past. Rather, it may signal that asset markets have become so saturated (often with funds originating from abroad) that the local official setters of short-term rates may be calmly disregarded while an increasingly reckless 'search for yield' - combined with an often unremarked, *regulation-driven* quest for duration – depresses both longer benchmark bond yields and their associated credit spreads.

A third major difference is that – right up until last autumn's frightfulness, at least - banks' reserve ratios were, in most jurisdictions, little more than an antediluvian relic. In fact, banking 'capital' itself is

rather an ephemeral concept in this day and age since, for institutions which have nothing much other than disembodied monetary symbols on either side of their balance sheets, new 'capital' can be readily created *ex novo* – often by means of one bank 'buying' another's debt and then funding the purchase with the newly increased line of credit granted expressly for the purpose by the grateful recipient of this 'capital' infusion. (We shall not venture here into the murky back streets of obfuscatory securitization, or stray into the chicanery of buying of what purported to be 'insurance' from such serial chancers as the US monolines and AIG, a misdemeanour which took place on an unprecedented scale in the late Bacchanalia, solely in order to disguise true leverage and so to feign compliance with some risibly miscast prudential regulations).

Fourthly, while external drains (better known now as 'currency runs') do still occur – as we were again painfully reminded last year – this does not tend to be an immediate danger for the major developed economies, especially since the introduction of the euro has helped the most coquettish of peripheral Ma'm'selles on the periphery of the Continent to shelter behind the petticoats of their unflinchingly prim, Teutonic, maiden aunts to be found at its core (a development which, by greatly reducing the number of alternatives, also accorded the undeserving British pound something of a collector's premium in the eyes of the many mercantilist central bankers desperate for what they laughingly thought was a touch of foreign exchange reserve diversification).

As a result, even truly abyssal trade deficits offer few constraints as a Rueffian 'childish game of marbles' instead assures a painless replenishment of the borrowers' coffers - yet another case where the incorporeal memory of something which has already been exhaustively consumed is miraculously transubstantiated into an 'asset' and so confused with 'wealth'. Though one of the main arguments in favour of floating exchange rates was that they were thought to introduce the 'firebreaks' with which to impede the spread of a crisis from one country to another – a failing it was felt was inherent in a system of fixed parities and free

capital movements – this has in no way discouraged the peril of wholesale cross-border borrowing being conducted in the currency of whichever country has the lowest interest rates applicable: a stratagem which invariably increases the infectiousness of the Bust, but also – just as importantly - helps heighten the fever in the Boom which precedes it.

'Sinoflation': Cheap money = cheap goods

Aside from these more general considerations, in the specific recent experience, there has been another element in the mix. This is that, as the sleeping dragon of China has awoken to roar unrestrainedly from its factory furnace of a throat, it has greatly skewed the balance between the internationally traded prices of manufactured goods and those of the commodities which go into their creation.

For all the genuine progress made in China this past decade, it is also undeniable that the signal effect of copious amounts of cheap industrial credit; an arguably undervalued exchange rate; preferential access to land on easy terms; domestically-subsidised energy; state-funded infrastructure; an absence of onerous environmental regulations, and favourable tax and tariff settings – added to a labour force whose employment is not over-burdened with ancillary social costs – has been to foster both export-oriented industries, *per se*, and a fetish for physical output in general which one suspects has all too often transcended the bounds of economic rationality.

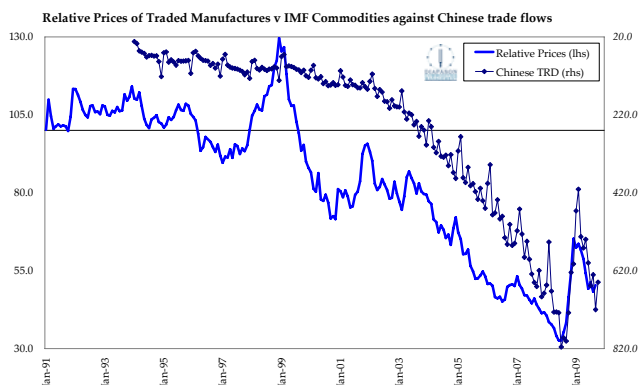


Figure 6: No visible 'inflation' = 'Great Moderation'

The upshot of all that is that China has been at once a voracious and none too discerning consumer of commodity inputs *and* an over-eager disposer of the resulting manufactured and semi-manufactured outputs – often finding itself a price taker on both sides of the trade, as a consequence.

This has contributed greatly to that same Satanic mirth to which we referred to above, for, if the effect of rising commodity prices has borne little weight in the counsels of the Wise - since they were often expunged altogether from the policy-makers' favoured 'core' CPI measures - the resulting suppression of finished goods prices loomed decidedly large in assuring our elect monetary Guardians that the Cheshire Cat version of 'inflation' which they exclusively monitor was still grinning benignly upon them even as the madness intensified all about them.

One consequence of China's deification of GDP-tallied 'growth' was that the grateful commodity exporters, suffering a complete *embarass de richesse* after years of relative penury, at once set about launching their own orgy of overbuilding, overconsumption, and overlending - one made all the more urgent by their refusal to let their currencies appreciate as the terms of trade shifted in their favour. Once again, what should have been a signal of scarcity and acted as a dampener came, for a long time, to act as a further stimulant, quickening an already over-rapid global economic tempo.

Here, it is worth pausing to make the observation that, to a certain extent, there has been a sharp geographical divide between places where the more classical Austrian business cycle has been in evidence and regimes where our modified, modern version has been more dominant.

It may be that this implies that ours is too parochial a view and that we could better picture our stylised assembly line as girdling the entire globe, not just spanning its individual political subdivisions. This way, we could simply say, that just as do some companies, some nations tended to specialize in higher-order malinvestment, others in low-end overconsumption. Either way, each was intimately

tied to the fate of the other and 'decoupling', go hang!

For example, in the likes of China – but also, to a degree, in the other export powerhouses such as Japan, Germany, and Switzerland – easy credit was predominantly responsible for promoting too many additions to the *Length* of the capital structure and was far less successful in stimulating exhaustive, end consumption; by contrast it unleashed a High Street-and-housing frenzy of excessive '*Width*' in the likes of the UK, Spain, and the US. When Lehman's fall and AIG's peril briefly snapped the nexus of vendor finance which had linking the two, the results were catastrophic – a disaster whose aftermath will be with us for a long time to come, despite the concerted efforts of many to reforge the chains spanning the great divide between Makers and Takers of goods.

As a direct result of this divergence, the consequences of the bust have also been markedly different in the two cases – real estate busts and much more severe falls in auto sales in New ABCT territories versus shocking plunges in capital goods orders and industrial output in the Classic ABCT ones. Sadly, both have since found out that they have destroyed trillions of dollars of wealth and wasted billions of man hours of effort. The first were merrily consuming their capital from the start in a Rakes' Progress of credit-enabled over-indulgence, yet the latter, though commendable for their hard work and diligence in striving manfully to guide their fully-burthened argosies upon the tide, succeeded nonetheless only in having them smashed into matchwood when they fell victim to the same bewitching melody, being trilled from her fateful rock by the Lorelei of Loose Money, that beguiled their most prodigal customers to a watery grave of their own.

Never waste a good crisis

Lastly, to complete our list of changed circumstances, we must take note that, compared to the Arcadia of *laissez-faire* which obtained when the first Austrians were developing their theory, the space in which private business can operate has

become much shrunken in the modern populist, Provider-State, a place where de Tocqueville's epitaph for the Republic - that it will endure until the politicians discover they can bribe the public with its own money – should be chiselled into every paving slab and stamped on each metallic scrap of its chronically depreciating coinage.

During what the Roosevelt cult likes to regard as the glorious apotheosis of the peacetime command economy in the 1930s, the government component of GDP as a percentage of the private sector residual ran up from a lowly, pre-Crash 10% to a peak of 19.1%, during which metastasis the largest annual deficit incurred was one of ~11% of private product, attained in 1934. This combination took Federal debt outstanding up by around 30% in six years to a highwater mark of 47% of pGDP in 1935.

It is therefore somewhat chastening to realise that in only three years since WWII (1947, 1948 and 1950) has the government share ever again been lower than 21% - two percentage points above the fraction reached at the climax of the earlier emergency. Such is the salutary lesson of the difficulty involved in confining the evils of government, once loosed, back within Pandora's box: a hardship we shall all yet have to face.

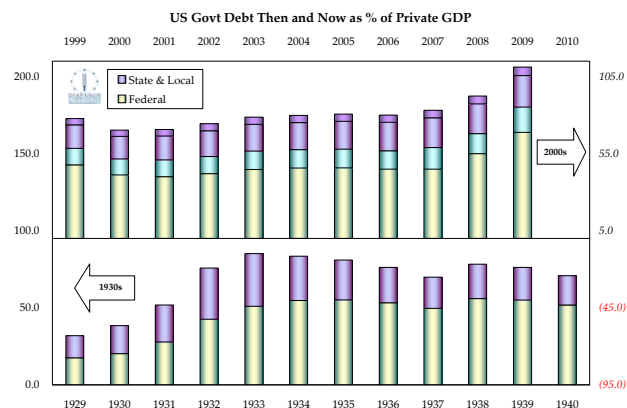


Figure 7: *New Deal? Big Deal!*

Moreover, the deficit this year will clearly exceed 12% of pGDP (again, above the Great Depression maximum and greater still if we add in a hefty state and local government shortfall, or if we consider the growth of the various other liabilities due the authorities). Indeed, the average for the past two years should come in at 11.7% where it will easily

surpass the maximum 8.8% recorded for that dire biennium of 1933/4. As a result, Federal marketable debt outstanding has risen 24% points relative to pGDP in six *quarters* and has clearly not finished its ascent by a long chalk, even though it is already higher than at any time in the modern era, excepting only the years surrounding WWII and the Korean carry-over from that conflict.

It is a sorry attestation to the spirit of the times that this long persistence of what were initially seen as emergency policy settings is now regarded as being a thoroughly routine minimum. Whether the talk is of 'Keynesian stabilizers' or, more worryingly, of so-called 'state capitalism' (read: soft fascism), it is now taken for granted that even more governmental interference is a desideratum in the struggle to make up for the failures of that misshapen chimera of public:private miscegenation which the mainstream insists on confusing with 'capitalism' proper.

That the public authorities might take some limited steps to remedy the most grievous of the mistakes to which their own actions have greatly contributed *may* be something which forms the basis of a reasoned debate, but seriously to suggest that the current collapse of the perverse incentives inherent in what we might euphemistically term 'inflationary corporatism' somehow gives grounds for a further damaging politicization of society is merely to pile error upon error.

To sum up, though we need to be cognisant of its differences when trying to analyse the investment backdrop, this new genus of ABCT still springs from the same family as its classic antecedent in that it is a theory which deals with the dreadful results emanating from a widespread falsification of the crucial signals sent by prices, both between goods and across time. It cannot, however, be too strongly emphasised that to garble these signals on a nationwide, if not a pan-global, scale - and so to mislead so many well-intentioned individuals into contributing unwittingly to their own ruin - can only be done within a framework which has nothing at all to do with the 'free market' and everything to do with state interventionism.

The primary, mutually reinforcing evils to which the latter has given rise are central bank-supported, fractional-reserve, fiat money banking and the pernicious rot of what Janos Kornai (from bitter, personal experience) has memorably termed the phenomenon of 'soft budgets'. By this latter we mean the capacity of loss-making, state-sponsored (or state-sheltered) entities to ignore accounting realities for as long as the wealth of others can be transferred into them, whether bluntly through taxation, licensing, and a compulsion to use their 'services'; more subtly via subsidies and preferential treatment; or insidiously via inflation.

The latter, of course, is the default setting, for soft budgets and soft money are often inextricably linked in the destruction of a people's capital.

Reallocate labour, reallocate stocks, reallocate real estate

Even among the scant remnant who are willing to grant that the Austrians have something useful to say about economics, there are those who reflexively charge that what Mises, *et al*, have elucidated is nonetheless a partial theory in that it deals well enough with the Boom and the Bust, but then has precious little to say about the process of recovery. Its many influential enemies among the various cabals of Planners take this vilification much further, spitting venomously that its devotees are naught but spiteful 'Liquidationists'.

Like all good jibes this has just a kernel of truth, but, like all gross calumnies, it also archly leaves out more than it says. To an Austrian, the Boom and Bust is a tale of the ultimate collapse of a sustained, government-sanctioned, thoroughly Canutian attempt at violating the laws of economics. Just as an avoidance of such attempts would – under this construction - preclude the inception of the cycle itself, so, too, does recovery call for a process of holistic, entrepreneurial recuperation not more Politburo tinkering.

As even Schumpeter (only an 'Austrian' by birth, not by intellectual pedigree) rightly pointed out: *'most of what would be effective in remedying a*

depression would be equally effective in preventing this adjustment [to change]'. He went on to add: 'this is especially true of inflation which would... undoubtedly turn depression into the sham prosperity so familiar from European postwar experience, but which... led to a collapse worse than the one it was called in to remedy.'

Yes, we are 'liquidationists' in the sense that we believe that a swift and rigorous process of bankruptcy would most readily clear the decks of the debilitating clutter of irrecoverable sunk costs and thus allow for either a resumption of use, or a reallocation of the remaining physical capital stock in ways suitable to the greatly changed economic matrix of the post-Crash world and therefore at prices newly remunerative within it. This is not to say that we are ardent Deflationists, much less moral Samsons who want the temple pulled down around us so that sinners everywhere can receive their just desserts.

Mises himself was at pains to contrast the desirable act of abstaining from further inflation - however painful the withdrawal symptoms inherent in such an abnegation - with the inadvisability of a deliberate policy of deflation, cautioning against the latter in no uncertain terms and excoriating the British for attempting it in 1925 by classifying it as '*a display of inexcusable ignorance of economics as well as of monetary history*'. The idea, then as now, is to let prices adjust as rapidly as possible to a stable supply of money, regardless of how large that has become in the boom. That way, we let changes in the real value of the money stock take the place of forced alterations (in either direction) of its notional one.

By contrast, Hayek - particularly in his later years - was foolhardy enough to go further, suggesting that it was the money flow which should be stabilized, though at least he was still consistent enough to confess that to effect this in practice not only contravened much of his own philosophising about the limits of knowledge but also risked introducing more of the very distortions he was so anxious to avoid. Alas, this is not a humility shared by today's central bank chiefs who will try any degree of pecuniary CPR in order to get Lazarus to pick up his bed and walk.

Certainly, compared to the soft budget pharmacopoeias of the Stiglitzes and the Kamei's, the Austrian medical bag must seem dispiritingly empty of patent cures, its prescriptions boiling down to the bare Hippocratic injunction, 'Do no harm', while recommending that anything which adds to the employer's costs or reduces his flexibility (follies especially prevalent with respect to nominal wage taboos) should be eschewed to the utmost degree.

Nonetheless, there is a great, overlooked merit in such studied minimalism - not least the avoidance of unintended consequences of a deeply negative kind and the chance it offers to de-escalate an already heightened sense of unease among people trying to come to terms with a harsh, but yet not totally hopeless new reality. Do the vociferous proponents of 'overwhelming force' in dealing with the crisis not see it is ludicrous to expect the would-be architects of a brighter Tomorrow to start building upon such violently shifting sands as their policies would perpetuate?

It is clear that one of the main aggravating factors in the Great Depression was exactly that while new money could readily be created - especially when the inconstant discipline of the bantling gold exchange standard was abandoned and currencies were freely 'floated' (i.e., scuttled with all hands) - the foredoomed battle to restore the *status quo ante* meant that doors to entrepreneurial endeavour kept on slamming shut instead of being prised determinedly open and so the newly-minted money was not as powerful a stimulant as it might have been. It was not just the tariff barriers, but the cartelisation of the NRA (see the thoughts of Lee Ohanian at UCLA if you will not take an Austrian's word for this); the mandatory, scorched earth follies of the AAA; the abdication to the extortionism of organized labour in the Wagner Act; the monopolisation of markets by the likes of the TVA; the quixotic changes in the value of the dollar; and the attack on profits that so utterly stultified private business.

Worse than any of these impediments taken singly - substantial as many of them were - it was the sheer inconsistency of their announcement, application,

and (often) their arbitrary abandonment as political cronyism and electoral opportunism took the place of genuine consumer preference and commercial acumen in deciding what got done and who got paid. One telling sign of the paralysis this inflicted upon decision makers outside the precincts of the capacious State orphanage was that the current-cost average age of private equipment rose sharply from 7.2 years in 1925 to a 74-year sample high of 10.1 in 1935.

Current cost-averaged age of private equipment & software in years

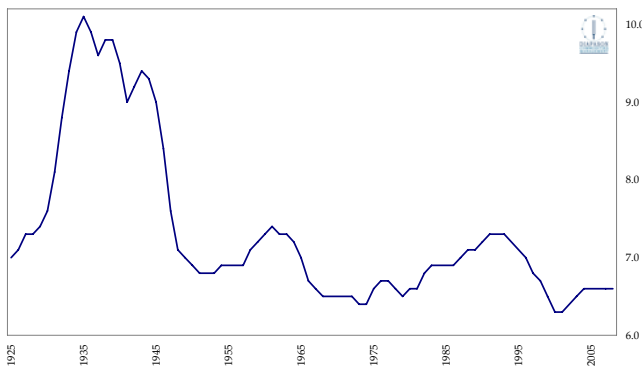


Figure 8: A mountain of errors

Of course, today's policy makers will not dine from exactly the same menu of stupidities as did their revered predecessors in office, but, even if we tend to downplay the chances of suffering such self-inflicted wounds as a reversion to naked protectionism, we still face the prospect of the many zombie firms which have arisen sucking up vital oxygen while being used both as social props and naked vote generators (GM, for example); of labour costs being artificially boosted by such measures as Obama's ill-timed universal health care programme; and of the hockey stick-brandishing Green Commissars of Holy Mother Gaia bursting forth from that neopagan Council of Trent taking place in Copenhagen, all zealous to add greatly to the cost base of struggling companies everywhere.

To an Austrian, it is only through an encouragement of an active, diversified, adaptable entrepreneurialism that the present woes can be overcome and fresh opportunities exploited amid the Ozymandian ruin of yesterday's dreams. The Austrian also insists that this can only take place by using those resources recently freed up either

by failure or fatigue in ways narrowly focused on making profits and so replenishing a badly depleted pool of capital. This is precisely the reason why the vampiric presence of so many of the Corporate Undead is decidedly detrimental to the prospects of achieving a lasting recovery.

None of this is to deny the impact of monetary policy, but only to caution that its effects may be rather different from those the inflationists had hoped for.

Escape Velocity

We wrote a long piece earlier this year (September's 'Resource Ruminations: Show me the Money') in which we tried to make clear the separate qualities of 'money' and 'credit', though many would argue, along with Hayek himself, that the demarcation line is not only a blurred one, but that shifts in where it falls are one of the characteristics of the Boom-Bust cycle. Indeed, his late-stage musings that intervention should be targeted at offsetting the evaporating 'moneyness' of many credit instruments which takes place during the Crash could even be taken to justify the extra-ordinary Quantitative and Qualitative Easing programmes of today's central banks. Here, we would strongly demur.

Certainly, it is true that credit can seem to act like money – that it can 'stretch' or multiply its efficacy – and never moreso than in the Boom. But the plain fact is that credit is an agreement to defer final settlement – an act for which a culminating transfer of money is a *sine qua non*. Conversely, those trading in and out of the Boom are, in the main part, swapping one form of deferral for another: money is the *last* thing with which they wish to be saddled!

This should be particularly evident if we consider that only a trifling minority of the trades conducted across the major stock and futures exchanges do not end up being netted out between counterparties. OTC derivatives, too, are often novated or cleared via a prime broker who may automatically fund his client for the balance due; while a seller of a security may often invest the funds due to him in a repo

which effectively pays for the sale. None of this involves much in the way of money.

However, what is all too often overlooked, is that it is the stock of money-proper (or *gnesio*-money, as we shall refer to it hereafter) which determines how much of a net withdrawal – how large a final settlement - can be achieved at any one time. What the market loosely calls ‘liquidity’; - i.e., the ease with which positions can be swapped inside the circle of players – is not to be confused with the amount that can be simultaneously liquidated. Naturally, during the upswing, few *do* wish to cash out, or liquidate, so the inverted pyramid of credit can become ever more top-heavy – if you will, a Ponzi scheme can predominate wherein credit increasingly pays for credit (a concept which the oft-quoted Minsky may have popularised, but which he hardly originated). This then whirls on and on, with inflated prices boosting collateralisation and so cultivating more inflation, until the market finally breaks, the *sauve qui peut* begins - and bemused traders rediscover, to their cost, Cantillon’s sobering dictum that ‘*silver [gnesio-money] is the sinews of circulation*’.

It is not entirely clear to this Austrian that there is a case to be made for facilitating the transmutation of this pyramid of misplaced hope into hard money upon demand, only for trying to ensure that, in a world where much of that money is principally both called into existence and extinguished by changes in the volume of credit, that its stock is held reasonably steady so that the stabilizing feedback of its real worth increasing as prices fall does not become too viciously short-circuited.

With that understood, we can also look anew at the interlinkages between developments in the supply of money and changes in the business revenues which mark its circulation. Given the cardinal importance of the latter which we have hopefully demonstrated above, it is here, if anywhere, that we find the pivotal degree to which economic decision-makers choose to *spend* the money which comes into their hands or *hold* it for its own sake as the ultimate in risk insurance; as a kind of economic option straddle whose premium is the opportunity cost of not holding an earning asset instead.

We can think of this as showing up in the behaviour of money ‘velocity’ and consider what impacts it might be having on the wider economy.

To digress for a moment, the very idea of ‘velocity’ is actually a touch problematical to an Austrian since it is the quotient of one wrongly-applied, aggregative entity (nominal GDP, not overall sales) divided by another, the wrongly-employed M2 or M3 (which are largely credit, not money measures) in the tautological ‘equation of exchange’. Even beyond this, we Austrians have an epistemological issue, since, to us, macro aggregates are no more than exercises in a convenient, confirmatory, statistical shorthand which give a feel for the sum total of countless millions of micro-economic decisions being taken by individuals according to their unique subjective preferences. They thus provide a snapshot of results, not causes, nowhere moreso than in the use to which money is being put at any given moment.

The first hint that attitudes have changed in the recession is that US non-financial companies themselves now hold more quasi-money (the real thing plus foreign deposits, time & saving deposits, and money market fund shares), both in dollar terms and as a percentage of net worth, than ever before, having seen the first increase by 25% since 2006 to \$2.3 trillion and the latter rise from the cycle low point of 8.5% to 12.8% at the latest count.

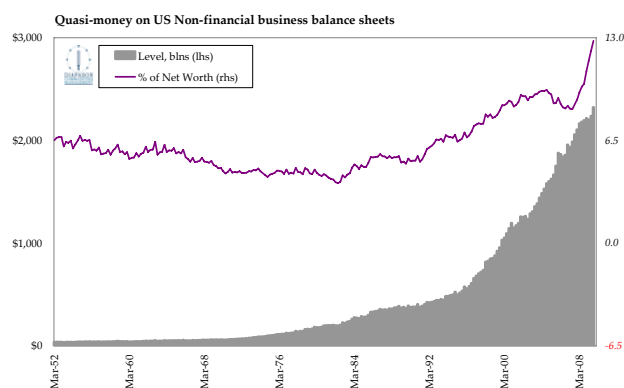


Figure 9: *Buying themselves an option*

Next, although it is clear that the rate of increase of real money in the various systems provides a good leading indicator for the likes of the ISM Purchasing

managers' report, the German Ifo index, Japanese small business survey cash flows, the Tankan, the Shanghai Composite, Chinese industrial production and electricity use, it is also evident that, in this particular crisis, actual business turnover has been very sluggish to respond to the vast infusions of gnesio-money which have taken place – 'velocity' (if you insist) has fallen sharply.

FRB, ECB & BOE Excess reserve balances (blns)

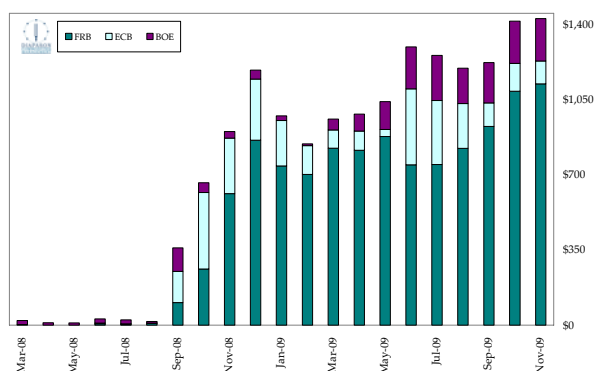


Figure 10: Bah, Humbug!

Incidentally, this should have been rather difficult to bring about in a system where the amount of money held in physical banknotes is a relatively minor fraction of the overall money supply, for, once the rest is placed in a bank as a demand deposit, the banks should have little alternative but to lend it or spend it and so begin anew the classic, fractional spiral of money begetting money.

The great irony is, then, that by encouraging the banks to park vast excesses of reserves on their balance sheets - and so allowing money to 'leak' out of active circulation - the central banks may well have helped window-dress commercial bank balance sheets and boost securities prices, but they have also partly neutralised their own frantic efforts to kick start the system. It may be, of course, that they were wise enough to realise this would be the case *ex ante*, calculating that it enabled them to meet the increased demand for money occasioned by the crisis without risking an immediate inflationary overshoot, but, given their avowed readiness to take the wildest of measures imaginable in order to stimulate the swiftest growth of credit aggregates with the least possible delay, one cannot but suspect

that it may also have been a somewhat comical (if fortuitous) misstep.

Be that as it may, the inference is that if the biggest of all spenders – *businesses*, not exhaustive consumers – are not eagerly playing pass-the-parcel so as to parlay cash into goods as rapidly as possible, then those prices still mostly set in the real world (and not across the gaming tables of the re-enthused capital markets) should not be subject to much in the way of upward pressure. Empirically, we can demonstrate this by plotting business sales over gnesio-money against changes in the CPI index. The fit, as you can see, is a good one.

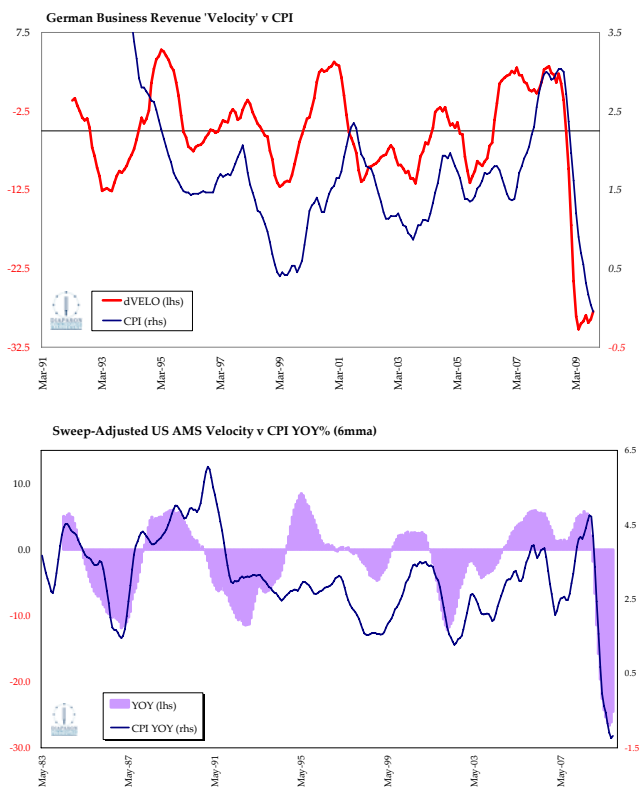


Figure 11: Die Schildkröte and the Tortoise

Mises already knew this years ago, of course, though we doubt the *Gedanken* master ever drew a graph in the whole of his long and fruitful career. 'Only when the recovery begins to take shape does the change in the money relation, as effected by the increase in the quantity of fiduciary media, begin to manifest itself in the structure of prices,' is how he phrased it.

Translated, this means that once entrepreneurial activity passes the threshold where those firms newly expanding outweigh those contracting, all the extra money which has been created will begin very much to matter. Given that what we have been experiencing this past year or so is what Mises called a 'simple inflation' - i.e., one where central banks and governments spend money straight into existence - rather than a productive structure-altering 'credit expansion', this is likely to feed all the more rapidly through into disconcertingly rapid price rises for all kinds of goods and services.

Should that happen, central bank policymakers will be set something of a challenge and nowhere is this more likely to happen in fairly short order than in a China where banks may be dysfunctional in their own way, but where they have not yet become as functionally impaired as have those in the West. Nor are Chinese businessmen notably shy about drinking their fill at the government faucet, even if their Occidental counterparts remain a little more circumspect than is their wont.

Thus, while the focus of most has been on the loose relationship between credit expansion and output growth, what has been overlooked is the rather tighter one which obtains between money growth and headline CPI. This latter strongly suggests that we might be in for a rather nasty surprise by the end of the first half of 2010.

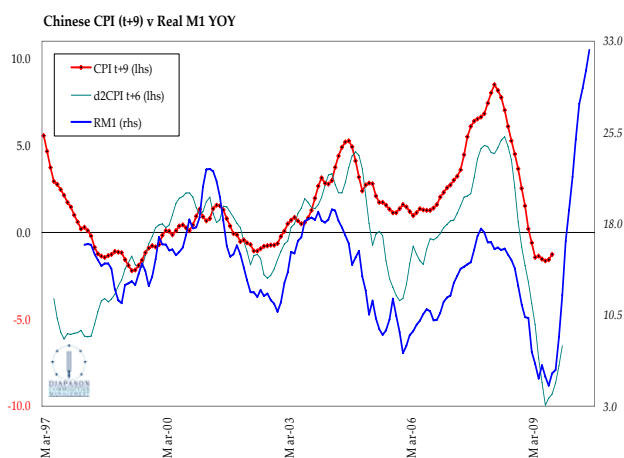


Figure 12: THE single biggest risk for 2010

QE or QED?

As we have noted, however, 'quantitative easing' has - as planned - acted to boost security prices. It has done this not only by relieving the market of some of its existing holdings of paper and by absorbing some of the torrent of government paper flooding into the market now the shade of Keynes has been summoned up from the Eighth Circle of the Inferno, but also by placing more gnesio-money in the hands of non-bank financial institutions such as insurers and pension funds. This has sparked its own kind of fractional reserve whirligig as each has tried to disencumber himself of this most closely-dentally inspected of gift horses.

This has been effective even unto the second power since the abhorrence of having anything but the most exiguous smattering of 'liquid assets' in the portfolio has grown in lockstep with the rise in the price of stocks and bonds. The so-called 'smart money' may have gone over the Angel Falls fully invested last year, but Heaven forbid that they now have the wit or the moral courage to tell those to whom they have a fiduciary duty that they have learned a little prudence from the ordeal - not when they have a benchmark to chase and fees to earn.

Thus, for example, the percentage of such assets held by US stock mutual funds - having risen by only a few percentage points during the rout (partly, one suspects, as the price of everything else tumbled) - are already back to within a whisker of their lowest ever levels.

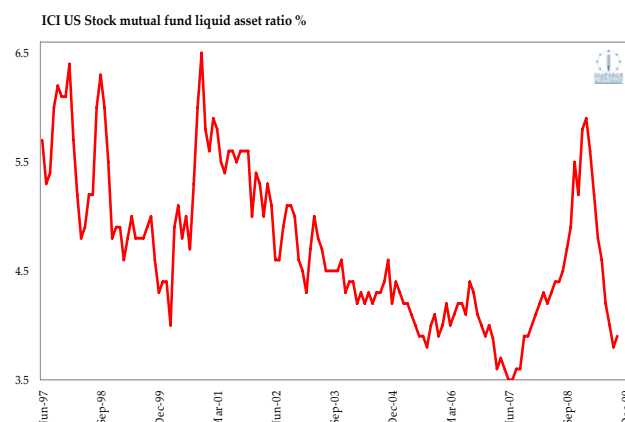


Figure 13: Mutual funds – Going all in

It should also be noted that, for all the much-bruited endeavours of individuals and non-financial businesses to wean themselves off debt (whether by redemption or repudiation!), the countervailing thrust of the Soft Budget sectors – governmental aggrandizers and state-sponsored banking speculators – has been enough to negate much in the way of an overall reduction of leverage.

'The evil Banksters won't lend to us,' cry the small businessmen with whose salvation they are supposedly entrusted. Too right! Why go to the effort and expense of performing the diligence on and later monitoring of what amounts to a mere *micro-credit* to one of the surviving Behemoths when there are a host of sour, old positions to be nursed, a plethora of lucrative, new market gambles to be taken, and a torrent of steep yield-curve, zero risk-weighted sovereign paper to absorb, each at almost no charge and at what seems like very little risk?

That pithy seer of the Unseen, Frédéric Bastiat, must be spinning furiously in his grave!

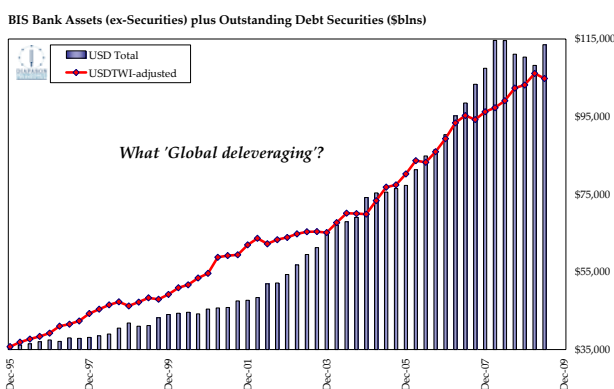


Figure 14: Global Credit – Relax, Irving!

Here, therefore, we find a major failing of the central policy of reinflation: namely that it has instigated another, potentially disastrous, tsunami of speculation in assets, increasingly divorcing their prices from the harsh reality of the earning potential of the firms and individuals underlying them. This has come about because, far from being supported by measures to smooth the transition of capital away from a productive array locked into assumptions about a scale and composition of demand which no longer hold good, it has helped

finance all manner of expensive political expedients designed to pin it firmly in place.

Examples of these are almost too numerous to list, but among them are the ringing European declaration of economic insanity that ALL of the *Euroraums'* banks are 'strategic' and hence cannot be allowed to fail; the nudge-nudge, wink-wink of regulators, happy to collude in gross violations of accounting principles; the schemes to bring forward purchases of houses and durable goods (mainly cars); the programmes which keep sadly redundant labour turning up for make-work at their now-floundering employers; the unimaginative 'two masses for the dead' nonsense of infrastructure spending conducted for its own sake, and - perhaps most spectacularly of all - China's worldwide welfare initiative for the support of commodity producers everywhere via its purchases - both direct and by proxy - of stock-piles of, e.g., aluminium, copper, steel, and iron ore - as well as of the cars and other wares into which they are wrought.

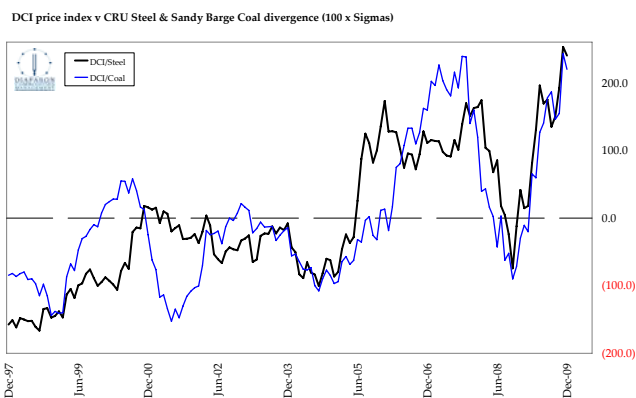


Figure 15: Value v Price - Guess which trades most

As the head of Chase National, Winthrop Aldrich, told a Wise Monkey meeting of the Senate (in a testimony no doubt ghosted by his estimable chief economist, Benjamin Anderson) as part of a hearing into the causes and remedies of the nascent Great Depression in 1933:-

'The net effect of these [valorisation] efforts to maintain the price of wheat was merely to defer the facing of facts. Production held up more than it would otherwise have held up... surplus was accumulated...'

Plus ça change, you might think.

But, believe it or not, you cannot fool all of the entrepreneurs, all of the time, and so the urge to cut costs and to buttress the balance sheet as a means to adapt to what might be a long-lasting lowering of revenues is not to be denied by an astute breed of men and women who are subject to justifiable, if often unarticulated, fears about the unwelcome side-effects of state-intervention. Some of these are centred on the amount of favouritism likely to be shown to the otherwise uncompetitive zombies to whom Leviathan must continue to funnel both resources and orders for the resulting output: some relate to the uncertainty about which particular stimulus programme will end when - and so collapse the various pockets of artificially-elevated demand. Perhaps most worrying of all, they are profoundly concerned about the size of the future tax bill and about the viciousness of the assault on capital which must result when the Shepherd eventually decides that all this expensive husbandry must be paid for, both in fleeces and, *in extremis*, in lamb cutlets, too.

All this remains in flux at the moment and its determination is therefore the object of an avid enquiry across the whole spectrum of political and economic opinion. As we have argued, however, far too many of the seekers after truth are peering into the wrong end of the telescope – looking only for signs that end-consumers have been magically touched once more with the Keynesian fairy-dust of ‘confidence’. We hope to have persuaded you here, Dear Reader, to stop your ears to their incantations and, putting the horse firmly back in the shafts ahead of the cart, to focus on what businesses are doing instead.

Pick a card – any card

In that same address to which we alluded above, one ironically delivered by the son of the one of the men instrumental in setting up the Federal Reserve during the disquieting pause offered before Roosevelt’s frenetically harmful expansion of executive power by his selfishly aloof interregnum, Aldrich continued thus:-

‘The volume of bank credit... does not depend alone on the volume of bank reserves... [but] on the temper of the business community, and on the movement of goods and on the prices at which the goods move. Given the restoration of the export trade and revival of...raw material prices, credit will expand rapidly. There is no use trying further to force it from the other end by an artificial increase in bank reserves...’

Everything we have set out in the pages above tends to the exact same conclusion: let us hope that the *ignoratio elenchi* to which this incontrovertible reasoning is nonetheless almost universally subject does not lead to the same sorry outcome as it did in Aldrich’s day.

In the meanwhile, a certain amount of caution is warranted thanks to the fact that the provision of what has turned out to be an otiose superabundance of money has led us to inveigle ourselves into a situation where the market is pricing in a pace and a magnitude of recovery which may never, in fact, materialise. Accordingly, the break, if it comes, will be all the more violent and the resulting disappointment risks being horribly self-aggravating, not only through the shock to a fragile confidence it would impose, but because it could shatter whatever simple faith people may have in the capabilities of the Planners. After all, the conjuror can only produce a penny from behind your ear just so many times before you weary of the illusion and begin to entertain doubts about both his repertoire and his competence.

It may be that, in the coming year, the audience quits the theatre, its members happy for their hour of diversion and eager now to be about their own affairs once more. If they do, that particular example of an exit needs to be rigorously followed up by the kind so liberally promised by our legion of pump-primers, or ‘velocity’ will rise as transactions pick up and excess money will feed straight back into disruptively higher prices.

Conversely, however, if the thought of the gale still howling outside keeps most of the house sitting in their seats for an encore, they may rapidly turn restive at seeing the same, tired, old tricks being performed, even if the accompanying drum rolls

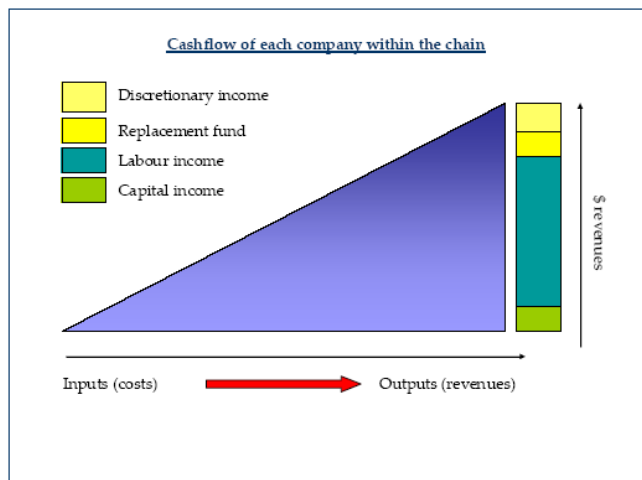
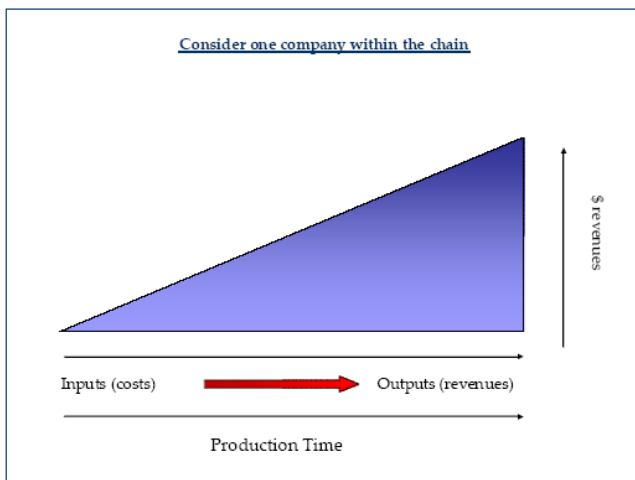
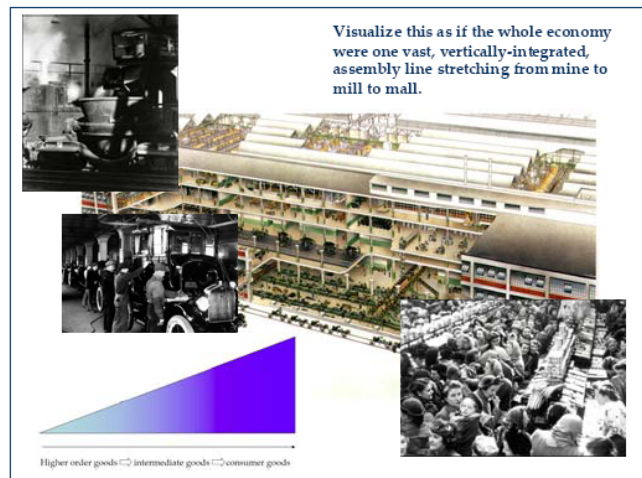
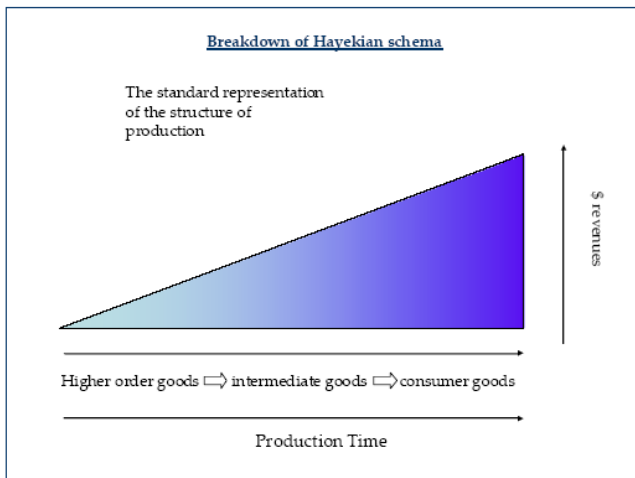
and cymbal crashes swell to a desperate crescendo in an hysterical bid to retain their interest.

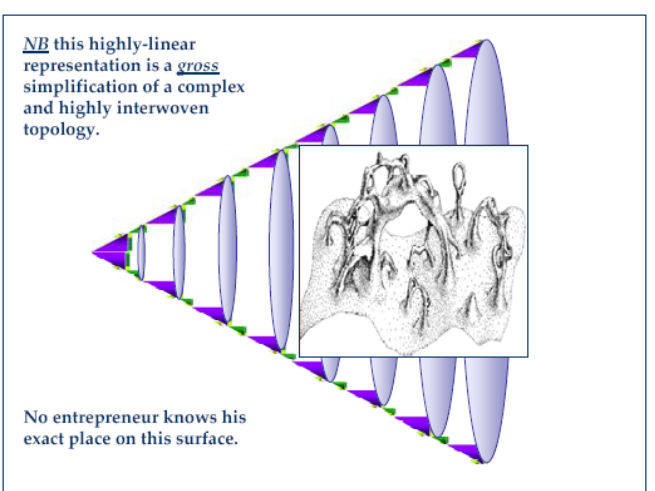
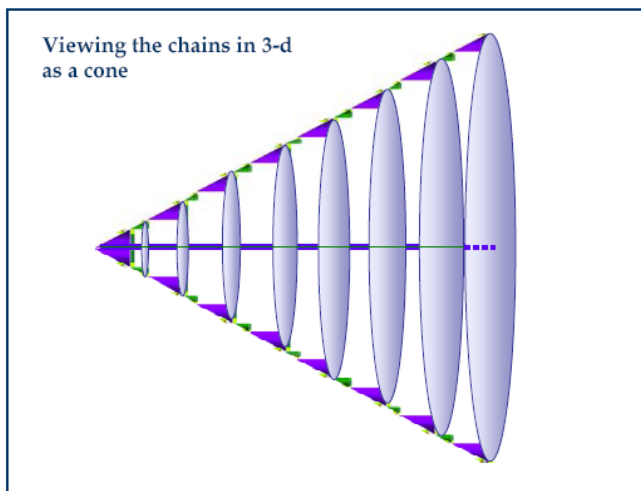
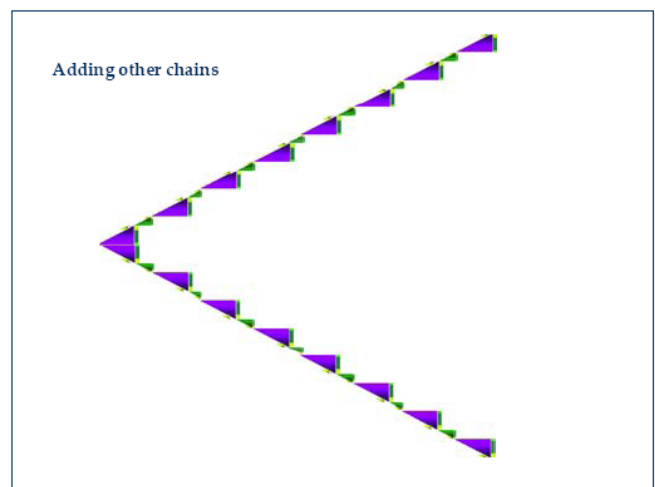
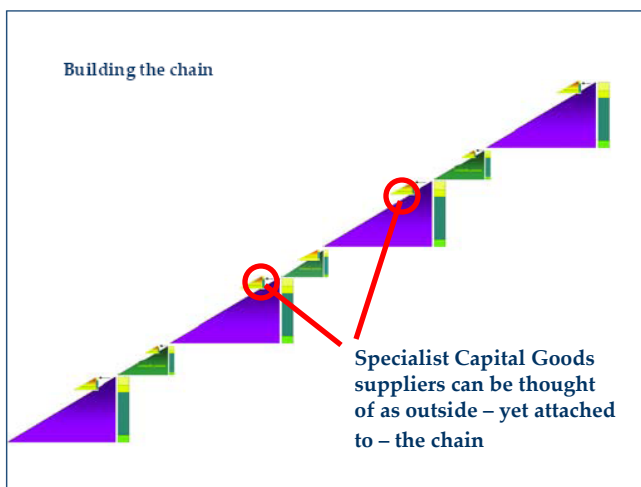
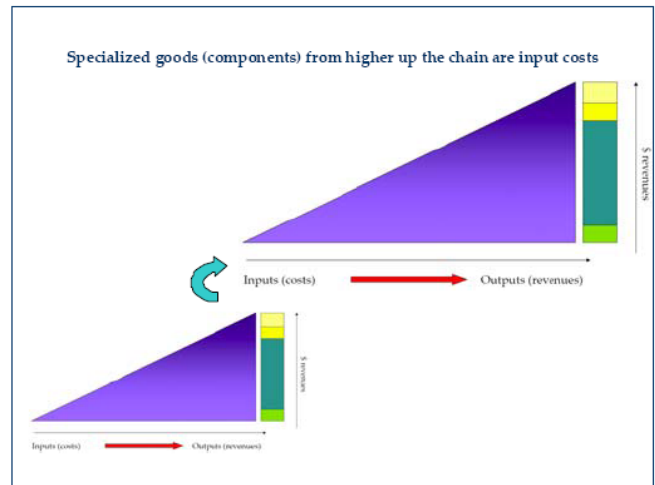
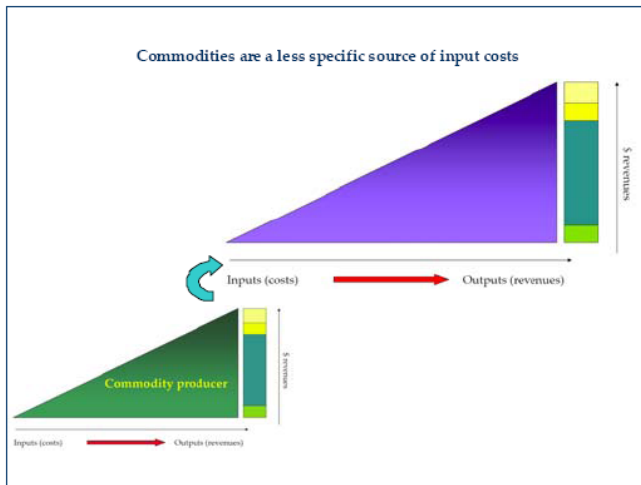
Either way, as the curtain falls on 2009, he may be revelling in the applause, but 2010 might just be the year when the Great Marvo finds himself booed roundly off the stage, not hubristically featured on the cover of Time Magazine.

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Appendix I

The delocalized assembly line & Hayek's triangles – the Structure of Production





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