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26 June-26 August 2007

The semantic revolution which is one of the characteristic features of our day has also changed the traditional connotation of the terms inflation and deflation. What many people today call inflation or deflation is no longer the great increase or decrease in the supply of money, but its inexorable consequences, the general tendency toward a rise or a fall in commodity prices and wage rates. This innovation is by no means harmless. It plays an important role in fomenting the popular tendencies toward inflationism.

Ludwig von Mises
Human Action (1949)

For as long as I can remember, veteran businessmen and investors – I among them – have been warning about the dangers of irrational stock speculation and hammering away at the theme that stock certificates are deeds of ownership and not betting slips. The professional investor has no choice but to sit by quietly while the mob has its day, until the enthusiasm or panic of the speculators and non-professionals has been spent. He is not impatient, nor is he even in a very great hurry, for he is an investor, not a gambler or a speculator. There are no safeguards that can protect the emotional investor from himself.

J. Paul Getty
(Cited by John Hussman,
The Likely Range of Market Returns in the Coming Decade,
22 February 2005)

Few Americans give much thought to the Federal Reserve System or monetary policy in general. But even as they strive to earn a living, and hopefully save or invest for the future, Congress and the Federal Reserve Bank are working insidiously against them. Day by day, every dollar you have is being devalued.

The greatest threat facing America today is not terrorism, or foreign economic competition, or illegal immigration. The greatest threat facing America today is the disastrous fiscal policies of our own government, marked by shameless deficit spending and Federal Reserve currency devaluation. It is this one-two punch – Congress spending more than it can tax or borrow, and the Fed printing money to make up the difference – that threatens to impoverish us by further destroying the value of our dollars.

Congressman Ron Paul
The Federal Reserve Monopoly over Money
(9 April 2007)

Speculators Extrapolate; Investors Think "Regression to the Mean"

Leithner & Co. Pty Ltd is a private investment company that adheres strictly to the Graham-and-Buffett "value" approach to investment. Its goal is its method: to undertake investment operations which are based upon thorough research and cautious assumptions; to provide reasonable safety of principal and offer an adequate return; and to inform shareholders regularly, fully and in plain language about these investment operations. Like most Australian corporations, its financial year begins on 1 July and ends on 30 June. The approach of winter is therefore an appropriate time to conduct two exercises. The first is to contemplate the twists and turns, triumphs, trials and tribulations of the financial year drawing to a close; and the second is to subsume these events under principles, revisit these principles, learn one's lessons and adjust one's sails for the next twelve months.

For the past year – indeed, for more than five years – my view of developments has been unfashionably severe and my assessment of the road ahead cautious. Letter 24-25 (26 December 2001 – 26 January 2002), for example, stated "in many countries, including Australia, Britain, Canada and (especially) the U.S., the boom of the late 1990s sowed the seeds of bust. Australia's boom ended in 2000 and signs of bust gathered pace in 2001 … [Our] plans for 2002 are based on the premise that many of the excesses of the 1990s remain unrecognised and therefore unpurged, and that the bust may be extended and sharp". It continued "renewed misallocation of resources … may manifest itself in 2002 through a 'recovery.' Whatever the euphoria it incites in financial circles, such a recovery neither causes economic growth nor creates wealth. Rather, it misdirects Australia's small and eroding pool of funding and thereby weakens the potential for longer term and sustainable prosperity. Leithner & Co. will [therefore] be in no hurry to sing 'Happy Days Are Here Again.'"

Since 2003, most others have been celebrating. More than this, they've set new music to old words and are now lustily singing "It's Different This Time." As a prime recent example, consider the article splashed across the front page of the business section of *The Australian* (27 February 2007). It did not record the Who, What, When, Where and Why of a commercial event that occurred the previous day. Nor did it analyse or evaluate a "big picture" financial development. Instead, the chairman of one of Australia's most prominent brokers, boasting a blue-blood clientele and a lineage extending back to the 1890s, congratulated himself, his firm, the financial services industry – and above all the allegedly rude health of Australian and international financial markets.

"I should be beyond being surprised," the chairman enthused, "but I cannot believe how much money people have available for special opportunities. The level of liquidity amongst private clients is so much larger now than it has ever been." So far, so good. But then we part ways: the article's author reassured readers that this chairman "has seen his share of stock market booms and busts – including the 1987 crash – [and] does not see the current share market boom ending in tears." Yes, the chairman conceded, "some parts of the Australian market are fully valued, but some of the leading companies such as BHP Billiton and Rio Tinto are very good value by any historical and fundamental standards. While global markets might pull back, they are actually quite cheap." He concluded that the Australian market's boom since 2003 "is much more sustainable" than its predecessors; and thanks to China's meteoric rise, it rests upon stronger fundamentals than the booms of the past. "This one looks to be a lot more sensibly based." Liquidity rules and all's swell, OK?

Most people seem to agree. Hence their promulgation of what is, in effect, a law of extrapolation. They state (correctly) that during the past several years virtually everything that can go well has done so; and for this reason they assume (I believe rashly) that the tide of good fortune must continue to swell. The International Monetary Fund emphatically agrees. According to *The Australian* ("Outlook Brightest Since 60s, Says IMF," 13 April), "rapid growth in the world economy is set to continue for years and will not be upset by financial instability, according to the IMF's chief economist. He said the [outlook for economic growth and inflation] was better now than at any time since at least the 1960s and growth prospects were more balanced around the world now than they were then. 'I think we can sustain growth in GDP at around 5% a year for some time to come,' he said … ' You will have some ups and downs in financial markets, but as long as the macroeconomic policies are sound the issues in finance will not be of first order importance.'" He forgot to mention (it doesn't seem to matter because nobody's asking) what might happen if macroeconomic policies are not and have not been sound, or if people belatedly decide that "issues in finance" – such as valuations – are, after all, vital.

If consumption is everything, savings are irrelevant and the creation debt is a perpetual motion machine, if the All Ords can more than double within four years and if the IMF forecasts that more to come, then, most people are concluding, investors' fortunes *must* be secure and their future bright. An assumed shortage of all kinds of infrastructure, China's insatiable appetite for minerals and above all the "fundamentals" of supposedly low inflation and soundly-based growth will combine to make it so. Why save for a rainy day if jobs grow on trees and the ASX effortlessly provides? If you've never had it better and things can only improve, then why *not* drop anything that's not "performing"? Why *not* chase the "hottest" stocks and the "best-performing" managed funds?

Two reasons come to mind. First, and as Benjamin Graham's *Security Analysis* reminds us, "many shall be restored that are now fallen, and many shall fall that are now in honour." Regression to the mean, in other words, pervades financial markets. True, for several years it's been dormant. The trouble is that it eventually rouses itself and swings its legs out of bed; and the longer it has slumbered, the more brutally it tends to rampage once it wakes. Investors were also exuberant during the late 1960s, but the next 15 years fell short, to put it mildly, of their rosy expectations. They were also ebullient during the 1990s, but for some the losses of the early 2000s have not yet been recouped.

The hard fact is that since 1965 (the period for which I have reliable data) the yields of five-year Commonwealth bonds have regressed towards their overall mean. If so, then Australians can expect yields to rise – perhaps considerably – during the next several years. Will they be able to cope? Rates of EPS growth since the 1960s also display strong mean-reverting tendencies. If so, then investors should expect "earnings surprises" and even shocks. But are they? Price-to-earnings ratios and five-year total investment returns regress towards their historical averages. In short, if the long-term past provides a very rough guide to the medium-term future, then to expect that the stellar results of the past several years will continue without interruption during the next several years is to skate on thin ice. The trouble is that most people extrapolate from the near past into the more distant future. They assume that a sunny present implies a cloudless tomorrow. In contrast, few are aware of long-term "base rates;" and still fewer realise that exceptional short-term "case rates" eventually (and sometimes suddenly) regress towards their more mundane long-term means.

The trouble with today's boom, given the human tendency to overdo it, is that it sows the seeds of tomorrow's stagnation or even bust. Alas, misperceptions of "the fundamentals" of the past 10-15 years, together with the moral hazards they have spawned, have encouraged many to conclude that "Goldilocks" conditions are normal rather than exceptional, and thus that they will be permanent rather than transient. Moral hazards and the apparent success of ever riskier strategies have obscured the less-than-pleasant memories of the 1970s, early and late 1980s, early 1990s and early 2000s. They have encouraged Australians to think that their rulers are omniscient and omnipotent and – in the unlikely event that anything untoward ever occurs – will ride quickly and effectively to the rescue.

Hence the second reason to be cautious: the conditions prevalent since the mid-1990s have also erased the memory of – and respect for – the Grahamite principles that, since the 1930s in a range of countries, have generated decent investment returns during trying times (see, for example, the classic What Has Worked in Investing). To cite just one example: Benjamin Graham's view, expressed in *The Intelligent Investor*, is that "every non-professional who [borrows in order to buy stocks, bonds, contracts for difference, etc.] is *ipso facto* speculating, and it is his broker's duty so to advise him. And everyone who buys a so-called 'hot' common-stock issue, or makes a purchase in any way similar thereto, is either speculating or gambling." These days, most people would dismiss this view. The lift-out section of *The Australian Financial Review* (12 April), entitled "Leveraged Equities," encapsulates the *zeitgeist*. Its lead article, entitled "Investors Scramble Aboard the Gearing Bandwagon," implicitly regards Graham's injunction as outré as flared trousers – and a sure route to "underperformance."

The practice of borrowing money to buy securities and derivative instruments is presently booming in Oz. "The positive share market has certainly excited and continues to excite people about leveraged investing opportunities," says a leading lender and arranger. "But there is growing interest that can be attributed to better-informed investors feeling more comfortable about investments and strategies that involve leverage … It's not just speculators who have been attracted to derivatives, but also the more conservative investors looking for alternate ways to invest. *The more conservative ways may be through products like self-funding instalment warrants and 100% geared managed funds"* (italics added). One shudders to think about the less conservative ways to "invest." Graham, who died thirty years ago, would surely be shaking rather than nodding his head.

Stagflation, Are We There Yet?

Figure 1 (p. 7) summarises developments that continue to lead me to factor the prospect of "stagflation" (a term coined in the 1970s in order to denote the simultaneous occurrence of economic stagnation or recession, as well as rising consumer prices and interest rates) into my investment plans (see also This Manager's Folksy Manner Belies His Record – and Worries by Michael Hudson and Joanna Slater). Politicians, policymakers, journalists and market participants almost invariably use the term "inflation" to refer to increases in the prices of raw materials, finished products and wages. They define inflation not in terms of what it *actually is* (as classical economists did and Austrian School economists still do), but in terms of *one of its possible consequences.* To the mainstream, inflation never denotes an increase in the supply of money. They forget that under current arrangements, only the central bank can create money; accordingly, only it can create inflation. Conveniently, the standard conception distracts attention from monetary interventionism, the great damage it invariably causes and the central bank's sole responsibility for it.

Because nobody ever asks them, Messrs Howard, Costello and Stevens never have to admit that inflation, traditionally defined, has long been one of the Commonwealth's cornerstone policies. They blame its consequences upon everybody and everything except themselves, and thus (and much like the firebug who joins the local bushfire brigade) escape accountability for the conflagrations they create. Inflation's inevitable result is the debasement of the currency's purchasing power. The routes to this destination are various. Inflation's possible consequences include galloping prices of raw materials, capital goods, consumer goods and services, wages and financial assets (or some combination of these things); overweening and overbearing government; redistribution from poor to rich; malinvestment; rising interest rates and – eventually – recession.

Market participants usually rejoice when the prices of securities climb, and homeowners swell with confidence when the price of their dwellings levitates. But few realise that these things are not manna from heaven, and still less are they solely the products of investors' acumen. Instead, to a considerable degree they stem from central banks' relentless debasement of money. Accordingly, hardly anybody points to the average house in a state capital city, notes that its price has risen beyond the average family's capacity to buy, and traces the problem to the RBA's inflationary doorstep. Similarly, few point at the ASX's levitation, realise that (like all booms) it will one day end in tears – and identify it as a consequence of the RBA's inflation.

Still fewer people realise that over time the river of inflation has run in different channels: sometimes it boosts the prices of stocks and houses, and at other times it ignites the prices of goods, services and wages. In Gough Whitlam's and Malcolm Fraser's day, inflation produced high food and low stock prices; in John Howard's era, it has begotten comparatively quiescent consumer prices and surging asset prices. The problem is that a torrent of money not backed by savings, which only central banks can create and unleash, underwrites government and private recklessness. Hedonism, in turn, eventually begets hangovers; and the morning-after sometimes includes stagnation and other times severe recession.

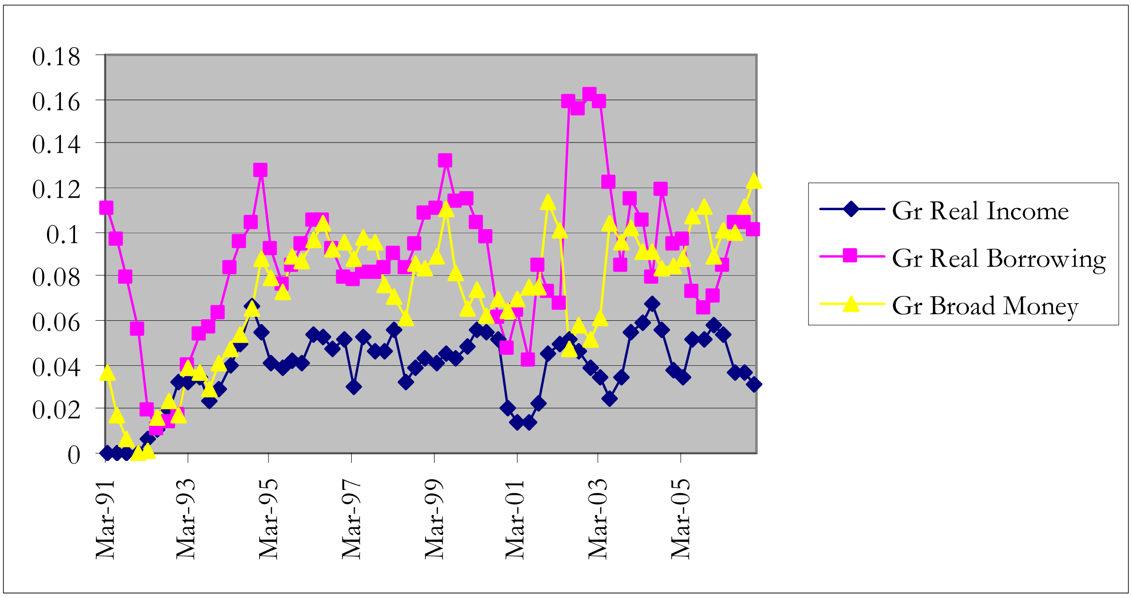
Inflation, as Ludwig von Mises knew before Milton Friedman was even born, is always and everywhere a monetary phenomenon: that is, it is a product of monetary policy. And as Friedman eventually and grudgingly accepted, under current monetary arrangements (which dictate that money is what your rulers say it is) only the central bank can generate inflation. But the path that inflation scours through the structure of production varies. *In terms of its effects, in other words, inflation need not be a consumer price phenomenon.* Hence three points utterly escape both Keynesian and monetarist schools of socialism. First, the central bank's inflation does not immediately produce – and need not manifest itself primarily through – rising consumer prices. The second is that inflation, properly understood, invariably sets in train a cycle of boom and bust. Third, central banks do not attenuate the business cycle: they aggravate it. Although various tendencies may delay and obscure its eventual consequences, inflation always creates strife.

Confusions about inflation and deflation have led practically everybody to declare that all has been well in Oz since the early 1990s *because* consumer prices have been rising at a modest (by the standards of, say, the 1970s) pace. Obviously, however, in a high-inflation environment consumer prices can rise slowly because other forces – most notably an increase in the supply of goods and services and a strong demand for money – can offset inflation's impact upon prices (see in particular Murray Rothbard, America's Great Depression). But these countervailing factors do not repeal the cycle of boom and bust the central bank initiates. Accordingly, it is muddle-headed – and, for our rulers, irresponsible – to define inflation as a general rise and deflation as a decline of the price level.

Applying these insights to the present, what do we see? *The Australian* (2 April) hit the nail on the head: "Australia's money supply is growing more rapidly than at any time since the great bursts of inflation that began in the 1970s was brought to heel in 1990." So does Frank Shostak ("RBA Policy 'Causing Inflation,'" *The Weekend Australian*, 21-22 April). He "has a warning for investors. The Reserve Bank's monetary policy is 'out of control' and that means inflation is heading up, interest rates are set to rise and the share market is only being supported by excessive money supply." And so it is in the Old Country. Interest Rates "Could Reach 7.5pc" provides a decent overview – note, however, how monetarists get a few things right and many others badly wrong.

Figure 1 shows that, properly and traditionally defined, the rate of inflation in Australia increased from 0% in 1991 to 10% in 1996; that from 1996-2005 it fluctuated at ca. 8-9% per annum; and that since 2005 it has accelerated to ca. 14% p.a. At only one juncture since 1990, namely during and immediately after the recession of 1990-92, has Australia been a low-inflation country. Similarly, with only one exception (i.e., briefly during the near-recession of 2002-2003) at no time since 1993 has the rate of inflation fallen below 5% per annum. So forget the Commonwealth Government's fantasies, ignore mainstream economists' craven propaganda, and instead face the reality: *inflation in John Howard's Australia is now raging at a higher rate than at any time since Gough Whitlam occupied The Lodge*. And ponder the implication of this reality: whether or not Little Johnny and the RBA realise it (the latter likely do; who knows about the former), upward pressure upon rates is likely to intensify. Another consequence, given that the prices of most financial assets vary inversely with yields, is that rising rates will exert downward pressure upon the prices of stocks, real estate and fixed-interest bonds.

Figure 1: Annualised Growth of Inflation, Borrowing and Gross Income



So why, despite such high inflation, has the Consumer Price Index remained relatively subdued? The answer is that inflation need not – and usually will not – influence all prices uniformly. It initially affects only some prices, or some more than others, and only over longer periods of time will it corrupt most prices. In any given situation, inflation's effects depend upon (1) how and where the new money enters the structure of production and (2) the initial recipients' objects of expenditure. The first owners of the new money ginned by the central bank and laundered by commercial banks money boost their demand for the things that they wish to purchase, and will thereby tend to bid up their prices. The sellers then receive this money, second-hand as it were, and find themselves in a position to demand more of the goods and services they desire, and so forth. In the words of Ludwig von Mises, "variations in the value of money always start from a given point and gradually spread out from this point through the whole community."

Figure 1 shows that, since the RBA restarted the engine of inflation in 1993-94, it has made its presence felt forcefully in the market for loans. The demand for credit has grown at roughly the same pace as – and, except in 2002-2003, roughly in lock-step with – the RBA's inflation. During the early 1990s, and reacting first to massive increases of mortgage rates and then recession, the annualised rate of growth of real borrowing collapsed from 11.5% to 1.6%. It then rose to 12.9% in the December quarter of 1994 and averaged 9.8% per annum during the rest of the decade. This tide of borrowing placed mammoth amounts of credit in the hands of individuals, and they used it above all to purchase residential and "investment" real estate. Many people, in short, borrowed huge amounts of dollars backed not by savings but by thin air; and they directed this vaulting supply of dollars disproportionately to the purchase of a relative static supply of real estate. First in Sydney, then in Melbourne and eventually the rest of the country, by the early 2000s this very strong demand for housing lit a bonfire under its price. But during 2002-2005 the demand for loans rose ever more slowly; and during this interval, except in Perth and Darwin (where the mining boom put a rocket under prices), so too have the prices of houses.

The bulls retort "bravo!" and "so what's wrong with that?" and hail John Howard as their standard-bearer. In his words (Brisbane Radio 4QR, 19 September 2003), "anybody who owns a house is very happy that the value of that house has gone up, let's be quite straight about that. I haven't found anybody in seven and a half years shake their fist at me and say 'Howard I'm angry with you for letting the value of my house increase.' So it is not a problem if you own a house."

More recently, however, it's become obvious that it is a problem, and a big one, if you don't. The average baby-boomer, the price of whose house has skyrocketed, also has an average number of children; and they tend to possess an average level of training and earn an average wage. Yet the price of the average house in each state capital city has risen well beyond the average first home buyer's budget. *A major consequence of the RBA's inflation, in whose slipstream the Liberal-National coalition in Canberra has been more than happy to glide, is the growing likelihood that younger Australians will – unless their boomer parents help them – be unable to afford the Great Australian Dream.* Thanks heaps, Ian and Stevo. And thank other pollies too: like night follows day, one stupid government intervention begets a litter of bloody stupid interventions – none of which belie any idea about the ultimate cause of the problem.

As an example, consider Under the Hammer, the episode of SPS's *Insight* program broadcast on 24 April. Its publicity blurb stated "is the Australian dream of buying your own home getting too tough for first time buyers? The price of houses is shooting up twice as fast as incomes and many young people are taking out big loans – only to end up in debt and possibly lose their home. The effect of the housing boom is also making it more difficult for renters … So how do you afford a home? What lengths are young people being forced into in order to own their own house? And will prices ever go down? We'll be joined by first home buyers, their parents and the country's leading economists to find out what the future holds for Australia's housing market."

What, according to the country's leading economists, has caused the price of real estate to skyrocket? The tragedy is that, although his conclusion is perceptive and his grasp of history reasonable, this economist's premises and his description of the mechanism that yields this conclusion are (I believe) dangerously wrong:

> JENNY BROCKIE: Ross Gittins, houses have seemed unaffordable before in Australia. Is what we're seeing now any different to what it's been like before?
>
> ROSS GITTINS (Economist, *Sydney Morning Herald* and *The Age*): I think it is. I think you're right. We've had periods where we've been worried about housing affordability lots of times before. Basically we have a housing boom about once every decade and after that boom's over the spotlight turns to worrying about how first home buyers can afford to buy a house at these prices but I think this time is much worse than what we've seen in the past.
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> JENNY BROCKIE: Now, how has that happened? What's caused that?
>
> ROSS GITTINS: Basically the biggest single reason, not the only reason, but the biggest single reason is the return to low inflation and the halving of mortgage interest rates which increase people's ability to borrow and then when everybody went out and tried to buy a better house at the same time because they were able to borrow more, but there was no particular increase in the supply of houses, that just pushed up the price of houses. We managed by doing that, by everybody at the same time saying, "I'd like to move to a bigger, better house," we managed to double the price of houses.
>
> JENNY BROCKIE: So by keeping interest rates low, we've actually fuelled the boom?
>
> ROSS GITTINS: That's right.

The Bourbon kings of France, it is said, dependably remembered nothing and learnt nothing. Exactly the same point, it seems, applies to many economists. During the next recession – in whose creation, they will probably tell us, if we ask them, the central bank has played no part and is otherwise as innocent as a newborn baby – the RBA will charge reliably and efficiently to the rescue:

> JENNY BROCKIE: Ross, can I get your views on this? First of all, this 0.75% increase [of interest and particularly mortgage rates that another discussant has predicted] over five years – would you see it being something like that or more?
>
> ROSS GITTINS: I think that's a very conservative – that is to say pessimistic outlook. I'd be very surprised if in five years time interest rates are 0.75% higher than they are now. But, I mean, it's … When you …
>
> JENNY BROCKIE: So do you think they'll be higher or lower?
>
> ROSS GITTINS: No, I think they'll be lower or at least I don't think they

> will have risen by that much and I'm not at all sure that in the next five years we won't see a recession. If we do see a recession, rates will be coming down, not up.
>
> ROBERT MELLOR (Director, BIS Shrapnel): Here's the negative. Obviously if we don't get higher interest rates the only reason you get lower interest rates is if you go through a significant economic slowdown, growth gets back to 1%-2% or if you go into recession and it's down near 0% growth rate then interest rates might fall a percentage point or so.

It never occurs to any mainstream economist that his prescription for our current ills – which is inflation, for how else can banks suppress short-term rates below their free market levels? – is the very same thing that has caused our current predicament. And what causes recessions, anyway? As they see it, nothing in particular: in effect, recessions are like plagues and outbreaks of pestilence. They are random acts that occur every so often, but which nobody can foresee and for which no fallible human agency like a central bank is responsible:

> JENNY BROCKIE: You mentioned a recession before. Now how likely do you think a recession is? The economy's chugging along and everyone's saying it's doing well.
>
> ROSS GITTINS: I can't see signs right out there now that says I can see a recession coming. I just know I've been around long enough to know that if you wait long enough you get another recession and we've actually been waiting 15 years. There's a sense in which the next recession is overdue. So I don't doubt that, one of these days, for reasons that take us by surprise, perhaps something happening overseas, we will have another recession in Australia. When that happens, and when people start losing their jobs, that's when you will really see, housing pressure and pressure on people's mortgages.

If these opinions are representative, then Australians are not just clueless about one major consequence of the RBA's policy of high inflation: their leaders are also utterly indifferent to, or blissfully unaware of, that policy's very existence! Perhaps most depressing is the reality that, no matter what is the matter, Australians look first and foremost to the government. What is the solution to the residential real estate mess into which government intervention has tossed Australians? More intervention! God help us all …

> JENNY BROCKIE: In the meantime, is there anything that can be done about housing affordability in this country at the moment? Are there things that Government could be doing to improve the situation?
>
> ROSS GITTINS: There are. I think …

After a sharp deceleration in 1999-2001, and again in 2002-2003, the RBA's next wave of inflation – which has now become a tsunami – has helped to ignite a boom on the ASX. Similarly, the growth of real borrowing skyrocketed to 16.4%

per annum in June 2002, remained above 16% until the March quarter of 2003, fell erratically through 2005, and has now reaccelerated. Judging from anecdotal evidence, margin loans and other forms of borrowing have comprised a rising and cumulatively significant portion of this wave; and this leverage, in turn, has greatly increased the demand for stocks and has thereby put strong upward pressure upon their prices. Clearly, these developments are not the only ones that have boosted prices. Australia's terms of trade and the share of profits as a percentage of GDP – both of which have reached levels not seen in a generation (see the graphs on p. 12ff) – have also played important roles. But prices on the ASX, as everywhere else, are formed by the most eager buyers and sellers. Equally clearly, eager lenders have provided many market participants the means to bid confidently and aggressively.

After the housing and stock markets, through which channel might the torrent of inflation flow next? The RBA's repeated bursts of inflation over the past decade have belatedly placed upward pressure (which is stronger in some quarters than others, and has been obscured by the rising $A) upon the prices of producer goods, wages and consumer goods and services. As these prices rise, so too does the pressure upon interest rates. Not surprisingly, the PM has recently bobbed, weaved, babbled, partly retracted and otherwise misrepresented the claims he made several years ago about rates. Yes, mortgage rates presently remain well below the levels they attained during the ALP's last stint in power (during which, by the way, they were still lower than the heights that bank bill rates scaled when The Man of Steel was Malcolm Fraser's Treasurer). At the same time, however, interest rates of most kinds and durations have also risen well above the depths they plumbed early in the Liberal-National Coalition's tenure. It's often delayed and obscured by myriad and partly countervailing factors, but the principle holds: the inflation that the central bank creates today causes producer prices, consumer prices and interest rates to rise tomorrow.

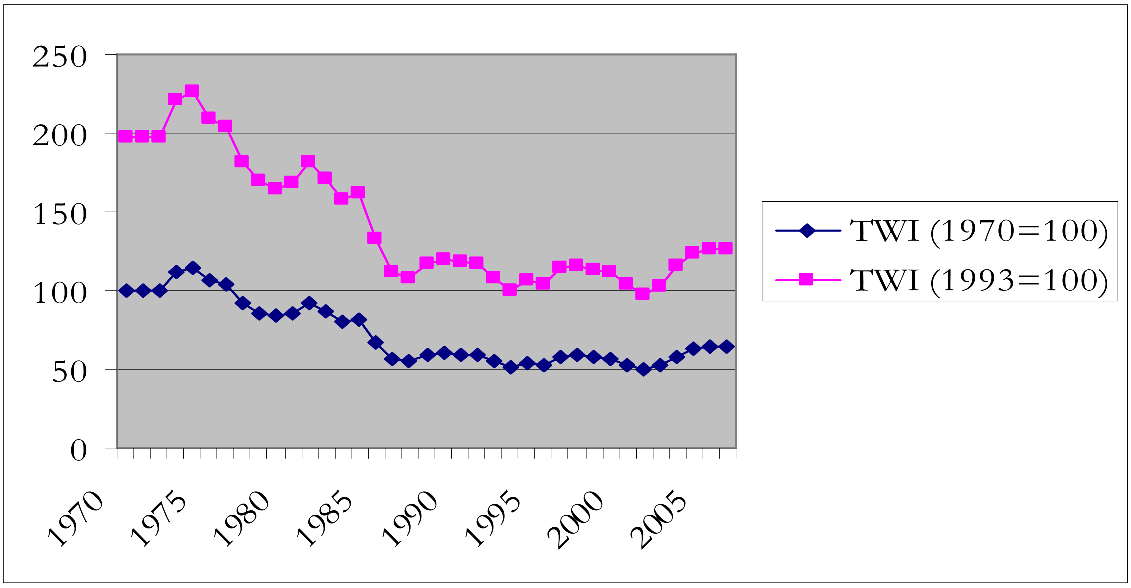
Mr Keating's high-rate recession bequeathed to Mr Howard a falling-rate recovery, and Mr Howard subsequently ignited a low-rate, high-inflation boom. Will The Rodent bestow a high-rate bust to Mr Costello or to Mr Rudd? Will economic historians one day regard the start and end of Mr Howard's premiership as the bookends of one of the luckiest intervals of the Lucky Country's history? If the biggest mining and commodity price boom in decades had not intervened, we might already know. The mining boom has saved his – and, for the time being, the country's – bacon. Ross Garnaut agrees. "The resources boom has saved Australia from a potential recession, says one of the nation's leading economists … What would otherwise have been the recessionary consequences of [the dangerous imbalances generated by an unsustainable housing and consumption boom] was relieved by the strength of the resources boom" (*The Australian* 18 May 2006).

The real estate, mining and stock market booms have lifted most boats – some more than others. Importantly, however, Figure 1 shows that they haven't caused the overall rate of growth of income to accelerate. Further, and as Figure 2 shows, they have lifted the Trade Weighted Index (basically a ratio of the prices of

Australian exports to imports) to levels last seen in the 1980s. At the same time, today's TWI remains at a fraction of the level it attained during the 1970s. *In short, Figures 1 and 2 provide little corroboration of the expectation, which is rife, that the mining boom has unleashed and will continue to disgorge unprecedented bounty upon the Lucky Country.*

Figure 3 (overleaf) confirms that since the mid-1990s corporate profits – particularly in the finance sector – have soared. But the other side of the coin, as Figure 4 shows, is that during this time wages and salaries have risen only tepidly. As a result, only when supplemented with bribes (that Canberra has extorted from business and unmarried and childless wage earners) has the growth of the average family's disposable income approached the rising cost of living. One result is the widespread use of debt to bridge the gap between budgets and desires; another is that Australians now rank among the Western world's most debt-addled, wages-stressed and savings-starved (see Figure 5, p. 14) people. In John Howard's relaxed and comfortable Australia, ever more people depend heavily upon the proceeds of the Commonwealth's extortion of Peter in order to bribe Paul, and upon the ready availability of cheap and easy credit, in order to supplement their pre-tax income sufficiently to buy the goods they can't otherwise afford.

Figure 2: Of Sheep's Backs and Trade-Weighted Indices;
Or, You Spot the Mining Boom



Finally, note in Figure 1 that the slower the growth of income, the lower has been the demand for credit – which, in turn, has attenuated the growth of income. In 1991-92, lending's rate of growth plunged and that of gross income ground to a halt. In 1992-95, it soared to manic levels and income rebounded strongly; during the remainder of the decade, each rate of growth remained constant; both fell steeply in 2000-2001, and so on. *The gilded prosperity since the recession of the early 1990s supposes that ever more heavily indebted people will always be able to obtain or refinance loans on easy terms.* Will this assumption always hold? If not, then perhaps the prosperity of the Howard Era does not, after all, rest upon "strong fundamentals."

Figure 3: Oz Has Become a High-Profits Country (Corporate Profits Relative to GDP)

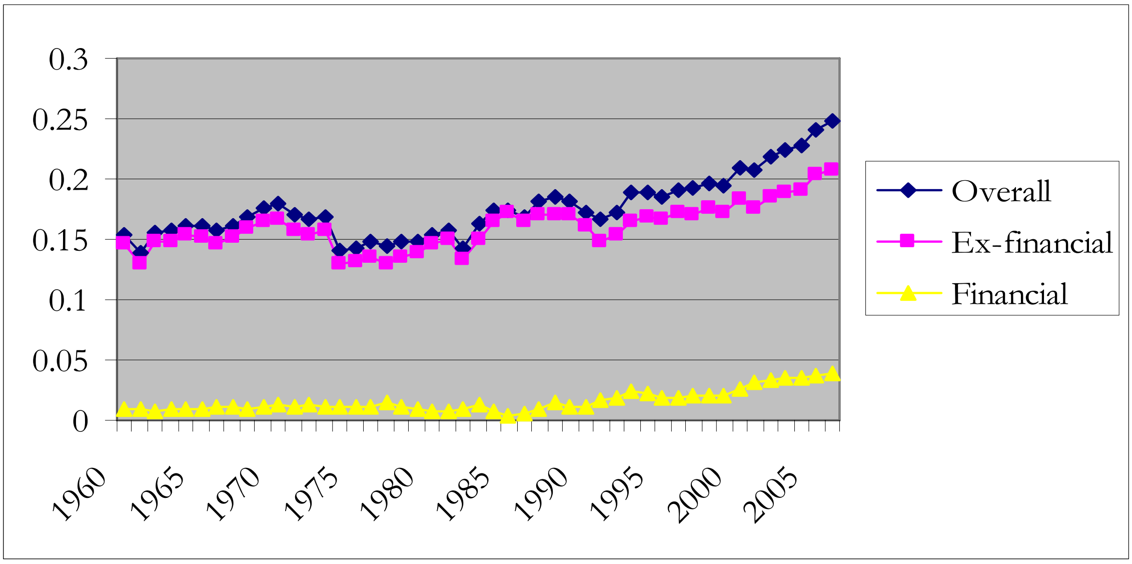
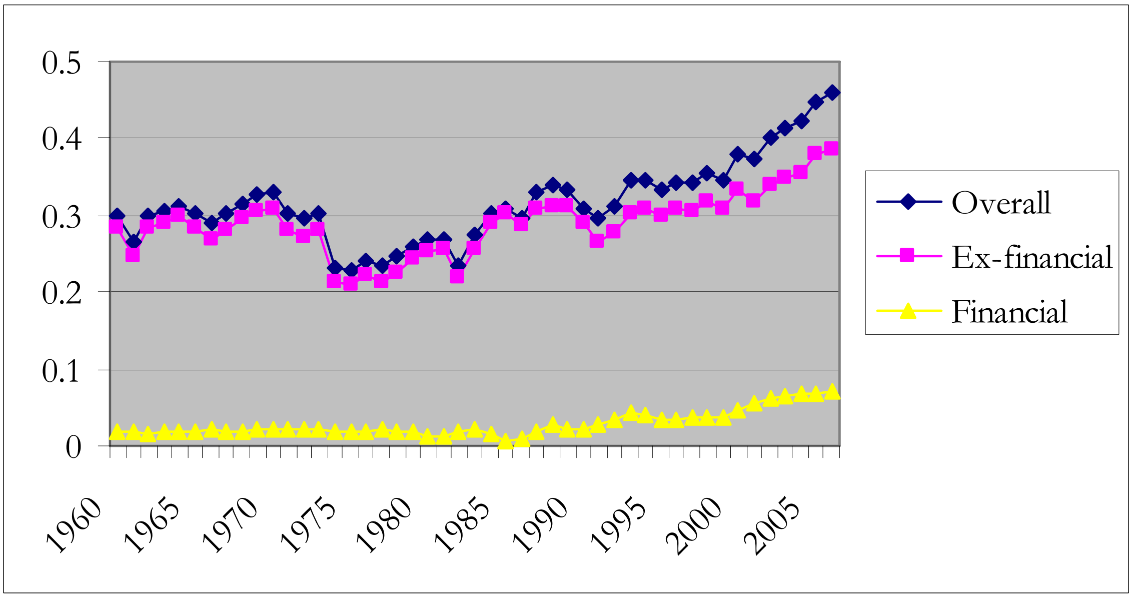
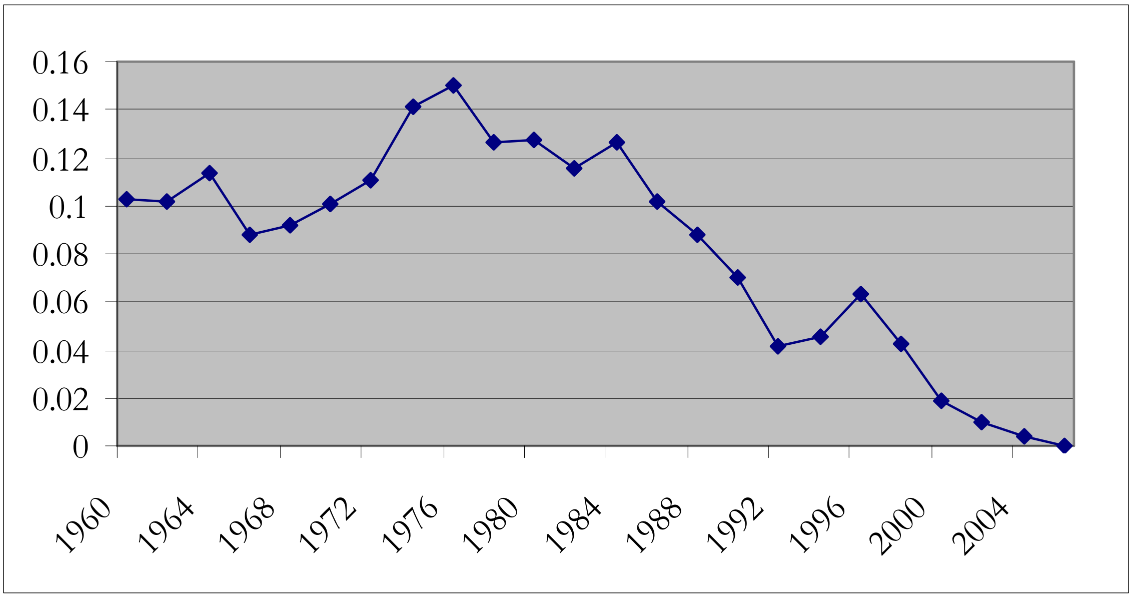


Figure 4: Oz Has Also Become a Moderate-Wages Country (Corporate Profits Relative to Wages)



Does this state of affairs, in which rising incomes presuppose more inflation and the accumulation of more debt in consumers' saddlebags, imply anything about the RBA's upcoming behaviour? For several years now, central banks in Australia – and also Britain, Canada, New Zealand and above all the U.S. – have found themselves in binds of their own making. In each country, their aggressive inflation of the past 15 years has greatly boosted the demand for loans; and aided by vast quantities of cheap and easy money, borrowers have bid the prices of real estate, stocks and bonds to hitherto-unimaginable and now unattractive levels. But now that so many are so bloated with so much debt, and interest and mortgage payments swallow one-third of many households' incomes, Australians (and Americans, Brits, etc.) are less able to maintain their hitherto-insatiable appetite for debt. *But no matter: the RBA has continued to inflate, and recently has accelerated its inflation such that monetary conditions are presently the loosest in a generation.* Why such laxity? Perhaps because the average household's unprecedented burden of debt, and its record vulnerability to stagnant and falling asset prices, compel the RBA to maintain its inflationary stance. Slowing the inflation crimps the growth of income, which trims demand for loans, which weakens the floor under asset prices, etc.

Figure 5: Australia Has Become a No-Savings Country (Savings Relative to Disposable Income)



Albeit for different reasons, mainstream and Austrian School economists agree that inflation (each using their own definitions of the term) puts upward pressure upon interest rates. But there the agreement ends. The bottom line, it seems to me, is either (a) bitter medicine today or (b) more jam today and even worse medicine tomorrow. Option (a) means an end to the inflation, consumption- and debt-driven celebration. It means higher rates; a retrenchment of government and private spending; a recession that purges the malinvestments that accumulated during the boom; and the prospect of sound (i.e., financed by real savings rather than thin air) growth. This is the hard choice the RBA took in the early 1990s. Option (b), which has long been the RBA's soft alternative, extends the party. It means the continuation of high inflation and artificially low rates, even more bloated government and lavish private expenditure, the accumulation of more and bigger white elephants – and, eventually, stagnation and perhaps recession.

Caught within this pincer, it seems to me that the RBA, skilled politicians that they are, will do what skilled politicians always do: distract and fudge. Given that inflation is seeping into consumer prices and wages, the pressure to impose higher overnight cash rates upon commercial banks will remain firmly in place. Albeit for very different reasons, the IMF agrees. According to Bloomberg (12 April), "Australia's economic expansion will slow this year and inflation [by which it means CPI] will remain near the top of the central bank's target band, the IMF said today. 'If inflation does not decline as expected, the RBA may still need to tighten monetary policy further', it said." The RBA's Governor agrees. In a speech entitled Risk and the Macroeconomy, Glenn Stevens said "for those of us whose economics awareness dates from some time in the 1970s or later, it certainly seems that long-term interest rates globally have in recent years been unusually low … While I believe central banks will continue to control inflation over the years ahead, this does require short-term rates to move: they cannot stay low and steady permanently."

At the same time, the RBA will also continue its core policy of inflation and easy money, and thereby enable commercial banks to lavish generous amounts of (albeit dearer) credit upon ever less creditworthy businesses and individuals. When *The Australian* (2 April) concludes "perhaps the Reserve Bank should give greater consideration to the role of money supply," it is emphatically correct. But it should understand the consequences of what it asks the RBA to do. During the late 1980s and early 1990s, which was the last time the RBA was unable to avoid the consequences of its inflation, it chose recession rather than even higher inflation. But because central bankers are politicians, they will delay this choice as long as they can. As Messrs Greenspan and Macfarlane know, the longer one prevaricates the more likely it is that one can pass the problem to one's successor. Given its new chief, only as an absolutely last resort will the RBA remove the punchbowl from Australia's noisy party. In the meantime, it will serve ever stronger drinks to ever more inebriated merrymakers. So be careful: their drive home might yet be dangerous – both to themselves and to sober bystanders.

Of Yield Curves and Recessions

Is Australia on the verge of recession? I thought so in 2004-2006, but was clearly wrong. I don't think so now. My guess, based upon the substantial easing of credit conditions since early 2005 (look again at Figure 1), is that Australia is unlikely to succumb to recession within the next 6-9 months. But that's hardly a cause to cheer: the inflation of the past decade and more, the policies enacted several years ago to delay recession and the intensification of an already elevated level of inflation since 2005 have simply accumulated bigger problems for the future.

In the mean time, I give Mr Howard his due and confess the mistake of my (premature?) bearishness. On 8 August 2006, *The Australian* reported "any suggestion Australia could be headed for recession was misguided, [the Prime Minister] said today. There has been growing concern among economists that yesterday's Reserve Bank decision to raise interest rate a quarter percentage point could push Australia closer to a possible recession. But Mr Howard rejected the concerns due to the strength of the Australian economy. 'I heard some very misguided talk this morning from somebody … about recession' Mr Howard said … 'For anybody to be even uttering that in the present circumstances, with the strength of the economy, they are being misguided to say the least.'" Memo to Mr Howard: to say the most, I'd say that the fear of recession is prudent and cautious.

Why did I prepare for recession in 2004-2006? One reason, shown in Figure 1, was that the demand for credit was falling relative to the supply of money. Another was the bearish story implied by the structure of interest rates (see Table 1). Normally, the longer the duration of otherwise comparable bonds, the higher are their yields. Between January 2001 and September 2004, the Australian yield curve conformed to this norm. So why, since October 2004, has the curve flattened and inverted such that 90-day yields exceed their 10-year counterparts? Why should investors care – or even notice? Because since the Second World War in most Western countries including Australia, the yield curve has tended to invert roughly 6-18 months before a recession An inversion today does not necessarily mean recession next year; but a recession has almost always been preceded by an inversion (for details, see Letter 66).

Table 1: Australia's Stubbornly-Inverted Yield Curve

	90-Day Bank Bill Rate (%)	Yield of Five-Year Commonwealth Bond (%)	Yield of 10-Year Commonwealth Bond (%)
Jan-Dec 2001	4.90	5.23	5.64
Jan-Dec 2002	4.75	5.53	5.83
Jan-Dec 2003	4.90	5.10	5.36
Jan-Jun 2004	5.53	5.60	5.76
Jul-Dec 2004	**5.43**	**5.35**	**5.47**
Jan-Jun 2005	**5.66**	**5.35**	**5.37**
Jul-Dec 2005	**5.63**	**5.24**	**5.27**
Jan-Jun 2006	**5.73**	**5.51**	**5.54**
Jul-Dec 2006	**6.25**	**5.84**	**5.69**
Jan 2007	**6.43**	**6.06**	**5.94**
Feb 2007	**6.37**	**5.85**	**5.69**
Mar 2007	**6.46**	**5.95**	**5.86**
Apr 2007	**6.51**	**6.02**	**5.92**

Thanks to several countervailing factors, of which the biggest mining boom in more than a generation is hardly the least important, the inversion of the Australian yield curve since late 2004 has not foretold recession. But its American counterpart may be doing so, and thereby introducing the chance that Australia's next recession will be triggered by external events. As the Commonwealth Treasury and others have warned, a recession in the U.S. might depress American demand for Chinese exports; if so, then Chinese demand for mining and other imports from Australia may grow less robustly than forecast, stagnate or (in an extreme case) perhaps even fall.

During the past 18 months, the slope of the U.S. yield curve has flattened considerably, often been mildly inverted and generally flatter than at any time since early 2001. Economic activity has weakened to the point that the wolf of recession may be approaching America's door (see, for example, Recession 2007 by Stefan Karlsson and No More Legs To Stand On by Peter Schiff). Investment and production have generally been sluggish, and debt-financed consumption has continued to gush. Bearing in mind the severely flawed nature of official statistics (see in particular John Williams' excellent Shadow Government Statistics), the first estimate of America's economic growth in Q4 of 2006, released on 31 January, was a better-than-expected 3.5% annualised (versus 2.0% in Q3). This "headline" figure distracted attention from the growing weakness of its most important – from the point of view of wealth creation – components. Their levels and trends imply significant weakness later in 2007.

Spurred by falling fuel prices, private consumption in the U.S. rose at an annualised rate of 4.4% in Q4 (versus 3.0% in Q3); and given that consumption (as the mainstream defines it) comprises ca. 70% of GDP, it contributed 3.1 percentage points (PP) to the quarter's initial estimate of overall growth. Because consumer expenditure continued to rise faster than income, household savings remained negative. Expressed as a percentage of disposable household income, saving was minus 1.2% in January – the 21st consecutive month it floundered in the red. That's the lowest rate (and longest-lasting negative rate) since the Great Depression. And the total level of saving in 2006, at $92.0 billion, was the lowest (adjusted for CPI) since annual records began in 1929.

Also thanks to steep falls in oil prices, net exports contributed 1.6 PP to the American economy's overall growth in Q4. And because "defence" spending surged (pardon the pun) at the fastest rate since early 2003, government expenditure added 0.7 PP. In sharp contrast, the components of production and investment retarded overall growth. Residential construction contracted at an annual rate of 18%, and thus subtracted 1.2 PP from GDP growth. Non-residential investment (i.e., the creation of plant and equipment and software) also shrank, and reduced the overall figure by 0.1 PP. And inventories decreased it by 0.7 PP. During the September-December quarter, in short, two armies (one figuratively headed by Paris Hilton, the other literally led by George W. Bush and both fuelled by borrowings) underpinned America's "bullet-proof" economy.

What, then, for the rest of 2007? First, given the rising tide of mortgage arrears and defaults, residential construction may well continue to fall. If so, then it will continue to trim overall growth; and if the housing funk intensifies then it may also crimp consumer expenditure. The housing market is unlikely to boost or even support growth, and may well depress it, for the rest of the year. Second, non-residential construction may well continue to decrease, thus becoming a second drag upon growth. During 2006 it rapidly decelerated from an annualised rate of growth of 20% (Q2) to 15% (Q3) to a fall of 0.4% (Q4). And if it remains roughly (and with a few quarters' lag) correlated with residential building, then significant tumbles – and ever heftier subtractions from GDP growth – are in store.

Third, it is reasonable to expect that corporate investment will contribute nothing to overall GDP in Q1 and Q2 of 2007. It fell in Q2 and Q4 of 2006, and kept its head just above the water in Q3. Unless the manufacturing slump concludes shortly, further weakness is likely. Alas, if anything this slump is deepening. The leading indicator of manufacturing activity has fallen to the lowest level since the mild recession of 2003, and now sits on the threshold that separates expansion and contraction. Fourth, it is unlikely that net exports will add to growth in Q1 and Q2 of 2007 as they did in Q4 of 2006. The main reason is that oil prices have risen from below $50 in early January to more than $60 since mid-February. Finally, when it comes to American Republicans and spending, anything goes and the sky is the limit; but hope springs eternal that perhaps – against all odds – some semblance of sanity will prevail within the Beltway. If so, then government will "contribute" less robustly to GDP in 2007 than it did in 2006.

Table 2: America's Waxing Consumption and Waning Investment

Quarter-Year	1-2006	2-2006	3-2006	4-2006
U.S. GDP Growth	5.6%	2.6%	2.0%	3.5%
Personal Consumption	3.4	1.8	2.0	3.1
Gross Private Investment	1.3	0.2	-0.1	-2.0

Table 2 summarises some American GDP figures from 2006 whose counterparts might generate disappointments and perhaps even shocks this year. It shows the overall rate of growth of GDP and two of its major components: (a) personal consumption and (b) private investment (which is an amalgam of residential and non-residential construction, corporate investment and inventories). The figures in the bottom two rows are expressed as percentage point contributions to the growth of GDP. Growth fell during Q1-Q3 because consumption and investment decelerated. Growth increased in Q4, and did so solely because consumption rebounded. Note, however, the trend of investment's contribution to GDP during 2006: in Q1 it added strongly, it Q2 it added weakly, in Q3 it subtracted weakly and in Q4 it subtracted strongly. Can consumption surge whilst production stagnates? Clearly, that bodes ill for 2007.

The key to short-term economic conditions in the U.S. is the behaviour of consumers. Will they remain exuberant? Even if they do, problems will continue to mount (see in particular Spending Spree Over as Americans Walk Without Safety Net). The bottom line: in both the U.S. and Oz, severe and growing economic weaknesses, borne of years of highly inflationary monetary policy, mean that the longer recession is suppressed the harsher it will eventually become. Oh, and one last thing: downward adjustments to inventories (data released on 9 February), trade (13 February) and consumer spending (14 February) led to a reduction on 28 February of the overall figure for Q4 from the initial estimate of 3.5% to 2.5%. As a result, the alleged rebound from Q3 to Q4 – heralded in January – actually didn't occur. But the bulls are stampeding, not listening.

2007-2008: Still Cautious After All These Years

In America, Australia and elsewhere, "the fundamentals" are much weaker than most people suppose. One of the shakiest planks (perhaps rivalled only by the belief that consumption begets prosperity) is the conviction that central bankers reliably navigate a course between inflation and recession. The reality is very different. They normally give us inflation; and as a result, they eventually engineer recession. How can this be? Having abandoned the traditional understanding of inflation, today's economists unknowingly applaud its creation. Ignoring the cause and confused about the effects of inflation, today's economists champion damaging policies – and oppose things that need urgent doing and abolishing.

Recent transcripts of the Fed's Open Market Committee confirm its bind. On 21 March it stated "recent indicators have been mixed and the adjustment in the housing sector is ongoing." In contrast, on 31 January it reckoned "recent indicators have suggested somewhat firmer economic growth, and some tentative signs of stabilisation have appeared in the housing market." On 21 March it said "recent readings on core inflation have been somewhat elevated." On 31 January it stated "readings on core inflation have improved [i.e., decreased] modestly in recent months …" Two things, in short, may be reappearing that in a mainstream view of the world are not supposed to happen simultaneously: growth is slowing ("stag") and prices are rising ("flation"). On past form, they will vainly fight stag by generating more flation. Alas, stagflation and bull markets don't mix well.

Australians are presently ignoring or dismissing the possibility of stagnation, to say nothing of recession, and assume that China will insulate the Lucky Country from any misfortunes. Never mind that manufacturing remains in the doldrums, and that growth in the service sector eased in March to a level barely above contraction. Savings have gone the way of the Western Swamp Tortoise – that is, they are presently thought to be extinct, but isolated pockets might be discovered one day – and consumers are more vulnerable than ever to rising interest rates and stagnating house prices. Can Australians forever dodge the bullets fired by rising rates? In April, 90-day bank bills reached 6.55% – a level not seen since September 2000. And five-year bond yields increased to 5.95%. Except for Dec06 and Jan07, this is the highest yield since October 2000.

Accordingly, I believe that 2007-2008 remains a time for caution. But don't take my word for it: I've been overly bearish – and therefore mostly wrong – since 1999. If I'm wrong again, I'll simply be consistent. But if I'm right, perhaps the resultant pain will remind people that prudence is, after all, a virtue. And who knows? Perhaps the hordes of speculators who think they're investors, and who have embraced their rulers and ignored high and rising threats to liberty and prosperity, will one day embrace Graham and Mises as worthy role models.

Chris Leithner