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Once upon a time, governments didn't do rescues. In a prime ministerial speech to the House of Lords during the 1825 speculative bubble, the great [Robert Banks Jenkinson](#), [2nd Earl of Liverpool], said: "I wish it however to be clearly understood, that those who now engage in joint-stock companies, or other enterprises, enter on those speculations at their peril and risk. I think it my duty to declare, that I never will advise the introduction of any bill for their relief; on the contrary, if such a measure is proposed, I will oppose it, and I hope that Parliament will resist any measure of the kind."

Even as late as 1929 in the United States, the established policy was not to engage in rescues. Andrew Mellon, Secretary of the Treasury under Warren Harding, Calvin Coolidge and (unluckily for him) Herbert Hoover, said in December 1929, after the Wall Street Crash: "Liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate ... purge the rottenness out of the system." No sign of any bailout nonsense there!

Martin Hutchinson
[Reckless Rescues](#) (8 October 2007)

2,000 students gather to hear [Ron Paul](#) at a major university campus to cheer his antiwar eloquence. When he begins to discuss the monetary issue, they start chanting, spontaneously, "Gold, Gold, Gold," then light Federal Reserve dollar bills on fire, holding them up like candles in the night, a bonfire of Bernanke's vanities.

National Review recently pooh-pooed Ron's views, and said there was no necessary connection between inflation and war. Here is the only question: does the state inflate to make war, or does it make war to inflate? In either case, or a mixed one, the link between killing and theft is ironclad, and the Ron Paul revolutionaries know it. No sound money, no peace. Abolish the Fed!

Lew Rockwell
[The Establishment's Nightmare Come True](#) (11 October 2007)

Remember an obvious point: recessions are bad for earnings. There has never been a recession in which earnings have not fallen. Earnings are falling now, but that decline is concentrated in financials. Now look at what the consensus is expecting for non-financial earnings: growth of 25% over 2008-2009. [But] if there is a recession, earnings will more likely fall by 25% than rise by 25%. There remains a huge downside risk to earnings should a recession unfold ...

The important point about all this is that the next leg down in equities, if it comes, will probably not be a return of the financially-focused bear market of the past six months. It will be a bear market caused by the broad-based earnings disappointment always seen in recession.

Gerard Minack
The Weekend Australian (4-5 April 2008)

Perhaps It's Not Different This Time, After All

Little more than a year ago, an article splashed across the front page of the business section of *The Australian* (27 February 2007) profiled the chairman of one of Australia's most prominent brokerage firms. He congratulated himself, his firm, the financial services industry – and above all the allegedly rude health of stock and credit 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.”

The article 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.” To be sure, “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.” The chairman 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.”

What a difference twelve months make! By 18 March, a date on which *The Australian* alleged that “global markets plunge[d] into a complete state of panic,” the All Ordinaries Index had fallen 25% from the all-time high it reached on 1 November (6,853) to an 18-month low of 5,163. The speed of this descent was unlike anything since 1987. Accordingly, during the last quarter of 2007 the moods of many became brittle and during the first quarter of 2008 they became black. *The Wall Street Journal* (17 March) editorialised that the events of the weekend of 15-16 March (when the Federal Reserve arranged the sale of Bear Stearns to JPMorgan Chase and opened its discount window to securities dealers), “mark the latest historic turns in what has become the most pervasive financial crisis in a generation.” In “We Will Never Have a Perfect Model of Risk” (*The Financial Times*, 16 March), Alan Greenspan – whose ability to escape responsibility for the destructive consequences of his actions is Houdini-like – reckoned “the current financial crisis is likely to be judged in retrospect as the most wrenching since the end of the Second World War.”

Some Australians were even more alarmed. David Uren, *The Australian's* chief economics correspondent, wrote (“Downturn Has Barely Begun,” 17 March) that “the Federal Reserve is attempting to prevent a downturn in the U.S. economy turning into a repeat of the Great Depression.” And Alan Kohler, the avuncular – and, until December, resolutely bullish – anchor of ABC TV's evening finance report, announced (“That's It – I'm Cashing In,” 10 March) that he had liquidated half of his personal portfolio. For good measure, in “Money's Too Tight to Mention” (19 March) he added “this is the worst financial crisis since the Great Depression.” On 12-13 April, the ASX's CEO repeated this claim.

As [Harold Wilson](#) noted, a week is a long time in politics. The point seems to extend to financial markets: on 28 March, the lead article (“The Only Way is Up”) of a prominent newsletter (I keep getting free issues and occasionally make the mistake of perusing them) babbled to its readers: “even a very amateur chartist like myself can see the triple bottom and reversal the [Australian Bank Index] made over the last two weeks. If I am right and the Australian banks have made an absolute bottom, then so too has the benchmark ASX200 index. There is every chance that the ASX200 has already seen its high and low for the year and it’s not even the end of the first quarter of 2008 ... I don’t think it’s a big call to say that will be the trading range for the year.” The article’s author is nothing if not frank and resolute: “the great thing about being a stockbroker is being able to call an end to something you never predicted ... I genuinely regret never predicting the broader large cap industrial and index damage we have experienced (I grossly underestimated how much leverage was being used by individual investors), but that isn’t going to stop me making a call on what is front of me today. I have to attempt to make back the performance I lost. There’s no point being another rabbit in the headlights, this is the time for high conviction” – and apparently, as the author all but shouts from the rooftops, for vacuousness.

On 2 April, another writer in the next issue of that newsletter reassured readers: “the increasingly popular view is that it won’t get any worse than we’ve seen in the [January-March] quarter ... This doesn’t mean we have seen the last of the global liquidity crisis and its impact on financial institutions and geared companies, it’s just that there’s a natural end to the amount of negative news that needs to be priced in before financial assets can start their recovery. If one takes a positive view, that point may well have been reached towards the end of March.” Perhaps that’s a popular and positive view, but is it justifiable?

On the next day, 3 April, *The Australian* published a similar but much more extreme assertion. If taken at face value, it is utterly astonishing. “In the battle between fear and greed, Reserve Bank board member Warwick McKibbin believes share markets may have fallen far enough for greed to again raise its head. The only danger to the ‘enormous opportunity’ presented by the market shake-out, he says, remains an ‘irrational’ fear of risk and financial panic. ‘It comes down to psychology,’ Professor McKibbin told *The Australian* yesterday. ‘If everybody thinks there’s a crisis, then there will be a crisis. If people don’t think there’s a crisis then there won’t be a crisis. My view is that crisis is in the minds of people in the financial community in Wall Street at the moment.’” A more explicit – and a more stark raving mad – assertion of a sort of “Theology of Financial Glory” is difficult to imagine.¹

¹ Setting to one side the oddity that somebody who purports to be an economist should assert that “it comes down to psychology,” it’s worth asking: did Prof McKibbin *really* utter the sentences attributed to him? If so, does he truly mean them? If people ceased to believe that there’s a crisis, he asserts, then the crisis would disappear. He doesn’t tell us whether such an ultra-subjective conception of reality (such that if you believe then it will be, but if you don’t believe it then it doesn’t exist) applies only to financial markets. If I cease to believe that a given stove is hot, can I safely place my hand upon it? If I refuse to believe that something called “global warming” exists, will it then promptly disappear? Further, according to *The Australian*, “Prof McKibbin suggests that

According to *The Australian* (4 April), “top stock watchers say the share market’s recovery since early March is a sign that long-term investors are at last returning to the table ... A former head of the ASX and [of a forerunner of ASIC] said the strong rise over the past two days indicated fresh money was being poured into equities.² [A prominent funds manager added] ‘I expect a much saner and better market this year now that companies relying on cheap credit and expectations of rising asset values had been shaken out of the market.’” Another fundie said that the fall in the stock market meant that stocks were no longer overpriced.³ “It’s the best value that’s been in the market for four or five years – there’s a whole raft of things that look well-priced that weren’t there eight or nine months ago.”

Finally, *The Weekend Australian* (4-5 April) asked “whether investment markets have reached the starting point of a climb back from the worst downturn in 20 years.” Its bearish interviewee made and corroborated a series of important points, but its bulls chanted the usual incantations. Perhaps most dreadfully, one of the “leading figures in the finance industry renowned for [his] authority and insights” said “broadly speaking, domestic equities are compelling when compared with historical valuations. The Australian market is currently trading on a one-year forward consensus P/E of 12.5x, which is the lowest for 13 years, and well below the long-run average of 14.9x. So there is plenty of value in the market for medium and long-term investors.”⁴

if the world economy unfolds in the way economic models say that it should, Australia will have little to fear from the downturn in the U.S.” But this begs the vital question: how much confidence can investors place in economic and financial models? After all, if credit markets act like the Federal Reserve’s and major banks’ financial models say that they should, the credit crisis would never have erupted in the first place! Crazies congregate in Canberra – for which I am grateful because it’s a healthy distance from Brisbane. Alas, people in Canberra, wacky ideas and all, rule the rest of us – and levy taxes to subsidise their foolishness. WA had the right idea in the 1930s: secession, anyone?

² This assertion, of course, is flatly incorrect. *Any* transaction on the ASX, whether at a time of boom or bust, is an exchange of one good (namely a certain amount of cash or its electronic equivalent) for another (a certain number of stocks or other securities). More generally, journalists and others often give coverage give the misleading impression that trades conducted in financial markets consist solely in one party. A moment’s reflection, however, tells us that it takes two to tango: a transaction requires a buyer as well as a seller; and every stock which is sold must also be bought. For every person who wishes to exchange a share of X Ltd for some amount of cash, there exists another person who is prepared to exchange that amount of cash for the share. And for every person who wishes to “exit the market” at some price there must also exist another who wishes to “enter the market” at that price. Indeed, at the end of a day’s trading, regardless of the change in the Dow Jones or S&P or other index, “the market” contains the same number of shares (ignoring new issues of shares and companies’ repurchase of their own shares) that it did at the opening bell. At the close of trade, then, it has neither shrunk nor grown and the “exits” are perfectly matched by the “entries.” It is therefore misleading to assert that on a particular date market participants “made” or “lost” a particular amount of money, or that “fresh money was injected into the market.” Such assertions simply misconceive the nature of markets and of prices (see also [Letter 4](#)).

³ This assertion begs a big question. If the price of the shares of X Ltd, for example, falls from \$10 to \$5, and if a train of reasoning has established that it was “overpriced” at \$10, then the decrease of its price demonstrates that it has become *less overpriced*. But without additional claims about what constitutes a “reasonable price”, it doesn’t support the contention that the stock “is no longer overpriced.”

⁴ For a diametrically opposite conclusion, see pp. 3-6 and 12-21 of [Letter 96-98](#).

These sudden and diametric changes of mood recall Communists' demented (even by their lofty standards of self-delusion) twists and turns during the late 1930s and early 1940s. Before the [Molotov Ribbentrop Pact](#) of 24 August 1939, Commies purported to loath National Socialism. But under the terms of the Pact, Adolph Hitler and Joseph Stalin agreed that, for ten years, they would refrain from attacking one another; consult on matters of mutual interest (like the destruction of Poland); arbitrate any differences (like the forced incorporation of the Baltic states into Soviet Russia); declare their neutrality if either went to war against a third power and eschew membership of any group "which is directly or indirectly aimed at the other." Some leftists, "progressives" and Communists in Western Europe and North America were outraged that Stalin would make nice with Hitler, and a few resigned their party memberships in protest. But the vast majority robotically followed Stalin, and vociferously denounced people in Western countries who began to see the truth – namely that Communism and Fascism were variants of socialism, socialism inevitably foments war and that Hitler and Stalin were mass murderers of the worst order.

The Pact remained in effect until National Socialist Germany invaded the Soviet Union on 22 June 1941. Overnight, Communists, fellow-travelers and their useful idiots in Britain and North America launched frenzied demands for an "International Anti-Fascist Front" comprising the Soviet Union and "bourgeois and decadent" countries like Britain, the United States and any other that couldn't see that the wisest course of action was to allow the two mass murderers and totalitarian dictatorships to fight each other to death.

Like the Commies of yesteryear, many people today – including participants in financial markets – are prepared to swallow what their rulers feed them. They don't examine what they're eating: indeed, so eager are they to consume that many don't even bother to chew. During most of the 1920s and 1930s, Commies were told that National Socialism in general and Hitler in particular were mortal foes. From 1939 to mid-1941, however, they were informed that Bolshevism and Hitlerism were allies and even friends; and thereafter they once again became implacable enemies. At all times, the Commie rank-and-file accepted – or at least didn't publicly question – their rulers' illogical, mutually-incompatible and plainly evil utterances. Ditto German National Socialists. Throughout 2007, Australians were told that the country's economic and financial sky contained hardly a single cloud; earlier this year, journalists shrieked that a storm comparable to the Great Depression was breaking over their heads; and since late March, many began to claim that the worst is past.

Look at the Screen! Pay No Attention to That Man Behind the Curtain!

Like the evil Reds and Browns of yesteryear, today's praetorians of financial and economic orthodoxy seldom justify their claims. There are, of course, honourable exceptions to this rule among today's financial and economic gatekeepers. Further, perhaps retail investors don't want explanations: they just want to be told what to buy, what to hold and what to sell. But for whatever reason, the general

point remains: plausible premises, valid reasoning and reliable evidence seldom accompany gatekeepers' pronouncements. It's been asserted, but not demonstrated, that the "sub-prime crisis" in the U.S. caused the "credit crisis" (a.k.a. the "credit crunch") that gripped Australia, Britain, the U.S. and other countries, and that these financial ructions have been the worst in decades and perhaps since the 1930s. Similarly, since March, it's been claimed (but not shown) that, because the worst of the credit crisis has passed, prices in markets can happily resume the upward march that had been so rudely interrupted since the second half of 2007.

The very fact that they have exempted themselves from logic and evidence leads me to suspect that the bulls simply did not understand – and still do not comprehend – the shaky ground upon which the bull market rested. These days, it does not seem to occur to them that the faulty policies and practices that inflated the boom are now fanning the bust. Oblivious to these things, many have reclaimed their bullish predisposition, proclaim that the worst is past and conclude that it's time to buy.

Of Physicians, Investors and the Madness of Keynesianism

How should *bona fide* investors react to the ructions of the past nine months? Should they take seriously the assertion that the coast is now substantially clear? They could do far worse than to emulate doctors (real ones, that is: medicos and not posers like economists). If people who bought and sold securities thought and acted like physicians, they'd strive to cumulate valid and reliable knowledge. When diagnosing and prognosticating, investors would ignore politicians, mainstream economists and journalists. They'd also eschew exuberance and despondence.

A physician's diagnosis is partly an association of a patient's outward signs and symptoms with an underlying disease or condition. A more advanced diagnosis is the culmination of a process of logical elimination. Just as a particular crime typically has more than one suspect, a given symptom can be the consequence of more than one underlying cause. Hence the physician, like the detective, conducts various tests. The purpose of the diagnosis is to remove, insofar as possible, all but one "suspect" from consideration – and to "collar" a particular physiological or biochemical cause of a disease or condition. According to [Sir William Osler](#) (a McGill man and an unforgivable omission from the [CBC's list of the Ten Greatest Canadians](#), which was partly rectified by [Sir Fredrick Banting's](#) presence at #4), a physician's job is to identify malady and its manifestations, and to understand its mechanisms, how it may be prevented and how it might be cured. Sound diagnosis is partly observation, partly inductive inference, partly deductive logic and a dash of good luck.

Well before the role of germs as causes of various diseases was understood, doctors associated "pneumonia" with a complex of indicators including coughs, production of sputum, fever and chills. As particular organisms were identified as triggers of certain disorders, pneumococcal pneumonia came to be regarded not

only as a spectrum of symptoms but also as the germ that caused the symptoms. In this and many other examples, medicine advances from relatively simple associations towards more complex causal explanations that withstand empirical tests. This distinction between two senses of the term “diagnosis” is important because disagreement often exists among dispassionate medical practitioners. Is the cause of a particular malady, X, known or unknown? If causes can reasonably be assumed, then cures can be obtained by correcting or removing abnormalities. But if causes are regarded as unknown or untreatable, then palliative treatments that manage warning signs are all that’s possible. The history of medicine is the increase over time in the number of diseases to which diagnosticians correlate symptoms. It is also a rise in the number of maladies to which they can reliably attribute causes, and of treatments to which they can adduce consequences. Progress has not, by and large, been steady: sudden leaps and extended stasis seem to alternate. But modern medicine does not go backwards; that is, each generation can legitimately claim to know more than its predecessor.

In that sense, medicine is a much more advanced and scientific endeavour than are mainstream finance and economics. In these relatively primitive fields, knowledge does not, by and large, cumulate. For decades, the mainstream has repudiated rigorous logic and compelling evidence; instead, the dead body of orthodoxy has prevailed, and grotesque fashions have risen and fallen like hemlines around a putrid corpse. The most striking thing about contemporary economists, if we regard them as an anthropologist would, is that their status within the tribe of economists is tied to a bizarre ritual (called “REE-search”) and obscure documents (that are partly melodrama and mostly comedy), known as publications, that invariably contain “models.” The purpose of models is not to subsume and explain the real world, but to use implausible assumptions and arcane methods that impress other economists.

The startling result is that the Austrian School and associated neo-classical economists of the 1930s, whom today’s mainstream has almost completely displaced, provided sounder and more encompassing explanations of the Great Depression than today’s most prominent – and powerful – economists.⁵ Similarly, the economics of the Austrian School makes far more sense than today’s conventional wisdom of the ructions in financial markets that began to emerge in mid-2007.

How can this possibly be? Lord Nelson, the victor at Trafalgar, once observed “the politics of courts are so mean that private people would be ashamed to act in the same way; all is trick and finesse, to which the common cause is sacrificed.” Then and now, courtiers attain success not by presenting plausible premises, sound arguments and convincing evidence. They do not proffer reasonable

⁵ See Constantini Bresciani-Turroni, *The Economics of Inflation: A Study of Currency Depreciation in Post-War Germany* (John Dickens & Co., 1937); Ludwig von Mises, *The Causes of the Economic Crisis and Other Essays Before and After the Great Depression* (Ludwig von Mises Institute, 2006); Lionel Robbins, *The Great Depression* (Macmillan, 1934); Wilhelm Röpke, *Crises and Cycles* (William Hodge and Co., 1936); and Richard von Strigl, *Capital and Production* (Julius Springer, 1934). Then compare these books to Ben S. Bernanke, *Essays on the Great Depression* (Princeton University Press, 2004).

grounds to believe that something is actually true. They make no attempt to appeal to reason; instead, they pander to the basest emotions. Politicians compete to tell people what they want to hear. Facing the electorate, they are ever mindful of popular whims, fears and prejudices. In order to receive the voters' sympathy, politicians are prepared to sacrifice every principle save one: to say and do anything that's necessary to assure their (re)election.

Since the time of John Maynard Keynes (1st Baron Keynes, styled The Rt Hon The Lord Keynes, CB, 1883-1946), politicians and economists have been kindred souls and bands of brothers. Just as politicians think no further than the next election, many economists seek influence rather than truth. Politicians succeed by proclaiming what voters believe (or can be made to believe) rather than what is demonstrably true. Similarly, many economists achieve professional success by parroting the desires of politicians. When they seek and tender advice, both have incentives to be insincere: politicians ask economists to approve the interventions that they (politicians) have already decided to pursue; and the economists who offer seemingly disinterested advice actually promote their own favour. In a way that Adam Smith would have condemned, politicians and economists gain from this trade – at consumers' and taxpayers' expense.

Keynes was undoubtedly the most influential economist of the twentieth century. Today's economic literature comprises thousands of books and tens of thousands of articles that, directly or indirectly, extol him. His principal work, *The General Theory of Employment, Interest and Money* (Macmillan, 1936), is probably the most influential economics book of the 20th century. It occupies the 43rd rung on the "List of the 100 Best Non-Fiction Books of the Twentieth Century" compiled in 2004 by the neo-conservative (i.e., socialist) journal *The National Review*; and Martin Seymour-Smith places it 88th in *The 100 Most Influential Books Ever Written: The History of Thought from Ancient Times to Today* (Citadel Press, 1998). The only other work of modern economics to grace this latter list, *An Enquiry Into the Nature and Causes of the Wealth of Nations* (1776) by Adam Smith, ranked 58th.

Paul Samuelson, perhaps Keynes's most forceful American advocate, reminisced that *The General Theory* "is a badly written book, poorly organised; any layman who, beguiled by the author's previous reputation, bought the book was cheated of his five shillings. It is not well suited for classroom use. It is arrogant, bad-tempered, polemical, and not overly-generous in its acknowledgements. In it the Keynesian system stands out indistinctly, as if the author were hardly aware of its existence or cognisant of its properties; and certainly he is at his worst when expounding on its relations to its predecessors. Flashes of insight and intuition intersperse tedious algebra. An awkward definition gives way to an unforgettable cadenza. When it is finally mastered, we find its analysis to be obvious and at the same time new. In short, it is the work of genius."

Many of Keynes' contemporaries – and Austrian School economists then and now – viewed him in a very different light.⁶ To them, he was the consummate politician-economist who acquired fame and fortune by elevating politicians and officials to the most prominent rank in economic and financial society. Keynes exalted them as guardians of employment, growth and prosperity. He also imputed to them great civic virtue, and blessed them to do what they do best: favour particular producers, oppress most consumers, debase the currency and foment war at home and abroad. Keynes cloaked the old – and repeatedly refuted – doctrine that consumption and inflation beget prosperity in the new and pseudo-sophisticated garb of mathematical economics. He even purported to discover a special source of funds outside and above the process of production, a source that is ever-ready to serve government officials: the central bank.⁷

Henry Hazlitt's line-by-line and equation-by-equation refutation of *The General Theory*, entitled *The Failure of the "New Economics" – An Analysis of Keynesian Fallacies* (Van Nostrand, 1959), drew a sweeping conclusion about Lord Keynes's magnum opus: "I have been unable to find in it a single important doctrine that is both true and original. What is original in the book is not true; and what is true is not original. In fact, even much that is fallacious in the book is not original, but can be found in a score of previous writers."

Yet despite Hazlitt's thorough demolition of its foundation (see also W.H. Hutt, *The Keynesian Episode: A Reassessment*, Liberty Classics, 1979), after seventy years the superstructure of Keynesianism continues to reign supreme in the halls of government and academia. Politicians and their advisors, whether of the "left" or the "right," enthusiastically espouse the Keynesian doctrine that governments should accumulate budget surpluses during booms and that they should run

⁶ Friedrich Hayek and Keynes maintained cordial personal relations. Indeed, Keynes helped to sponsor Hayek's application to become a naturalised Briton; further, during the Blitz Keynes lent to Hayek his room at Cambridge. Partly for these reasons, the Austrian School economist chose not to write a rebuttal to *The General Theory*, which he regarded as incoherent, utterly wrong and an aid to totalitarianism in general and Hitlerism in particular. (In the foreword to its German-language edition, published late in 1936, Keynes stated in his characteristically-clunky prose "the theory of aggregate production that is the goal of the following book can be much more easily applied to the conditions of a totalitarian state than the theory of the production and distribution of a given output turned out under the conditions of free competition and of a considerable degree of *laissez-faire*".) Hayek also assumed that, as he had throughout the 1920s and 1930s, Keynes would change his mind so quickly and diametrically that before long he would disavow *The General Theory*. Perhaps Hayek was right. Keynes read Hayek's *The Road to Serfdom* (1944) soon after its publication, and wrote of it: "In my opinion it is a grand book ... Morally and philosophically I find myself in agreement with virtually the whole of it: and not only in agreement with it, but in deeply moved agreement." But by then, Keynesianism had become so firmly welded to the state that not even Keynes could have eradicated it.

⁷ That idea, too, long preceded Keynes – and, over the past three or so hundred years, has time after time been comprehensively refuted. The Scottish financier, economist and scam artist [John Law](#) (1671-1729) originated the pernicious idea that central banks can create and maintain prosperity. Sometimes regarded as the father of finance, Law is remembered mostly for his promotion of fiat money (i.e., money backed not by savings but by government monopoly). Two hundred years before Keynes, astute observers had learnt that central banking causes inflation and deranges the business cycle – first upwards and eventually downwards.

deficits (because they “stimulate the economy”) during recessions. They insist that consumption and spending – whether by individuals, businesses or the state – is a necessary condition of employment and growth. Because expenditure allegedly begets prosperity and prevents recession, more spending and bigger government is best. Anathema is the classical liberal and Austrian School precept that rising consumer expenditure is a consequence and not a cause of prosperity; that private savings and entrepreneurship are the sources from which rising standards of living spring; and that taxation is theft and therefore, under all circumstances, the goal is to shrink the state to the point that it fits inside the constitution.

Keynesianism is “macroeconomics” – the economics of GDP, national markets and aggregated statistics. It accords little weight to individuals, entrepreneurs and actual businesses. Keynesians worship consumption, and blithely assume that production will take care of itself. They fixate upon labour, and have next to nothing to say about capital and its formation, maintenance and fructification. Keynesians denigrate saving and allege the existence (which has been repeatedly and comprehensively refuted, not least by [Friedrich Hayek](#)) of a “paradox of saving” such that, although an individual might occasionally consider saving a small amount for a rainy day, if consumers as a whole did so then aggregate consumption would stagnate or decrease and prosperity become imperiled.

Politicians, advised by their Keynesian advisors, also insist that interest rates can “fine-tune the economy.” Because Keynesian models admit no particular role for capital, and simply assume that it will be “created,” there is neither a theory of capital nor any recognition that it can be destroyed. And because savings do not help to accumulate capital, interest plays no role save as a gauge to encourage or discourage consumer expenditure. Accordingly, the central bank can and should raise the entire structure of interest rates in order to restrain the boom; similarly, it can and should cut rates to reverse the bust. Unheard and alien is the notion that, no matter how hard they try, central banks simply cannot fix rates of interest. Why not? Because interest is the ratio of the prices of present goods to the prices of future goods. Interest reveals savers’ and borrowers’ time preferences. The greater the degree to which a particular saver values one spoon of jam today versus two spoons tomorrow, the greater his time preference – and the interest he will demand on his savings in order to forego a given amount of consumption today in order to consume more tomorrow. Interest – like price, cost and value – is an inherently subjective phenomenon. Central banks cannot control interest rates, but they can (and, alas, normally do) corrupt them.

A Refresher Course on Fractional Reserve Banking

What on earth has this Keynesian madness to do with contemporary economic and financial conditions? In order to comprehend what has happened, is now occurring and may eventually transpire in Wall Street and Main Street, it is imperative to remove distorting Keynesian spectacles and diagnose the world as our forefathers did – that is, through unimpaired (i.e., Austrian School) eyes. “To understand the nature of the worldwide Great Depression and the severity and

greater length of the American contraction,” said Gene Smiley in *Rethinking the Great Depression: A New View of Its Causes and Consequences* (Ivan Dee, 2002), “one must understand something of the nature and characteristics of money. Three essential features are banks and the creation and destruction of money; the role of the Federal Reserve System in creating and destroying money; and the gold standard and fixed exchange rates.” Moving forward 75 years or so, sub-prime lending in the U.S. is not a *cause* of the ructions in credit and stock markets: it is a *symptom* (and hence a *consequence*) of bad policies, namely Keynesianism and fractional reserve banking. These policies misconceive the nature of money, ignore the supply of money and weaken banks. To diagnose our ills we must, like a good medical diagnostician, identify and carefully distinguish causes and consequences. Our forebears did just that. Alas, Keynes and his followers have spoiled our intellectual inheritance.

The essence of modern banking is the arbitrage of risk: banks borrow from a group of people who are prepared to supply funds (depositors) and lend to another but not completely disjoint group (borrowers) who demand funds. In order to compensate depositors for the use of their funds, banks pay them interest; and to compensate for the risk that inheres in lending, banks charge borrowers interest. If they arbitrage successfully (i.e., receive more interest from borrowers than they pay to depositors, and recoup principal from borrowers and return it to depositors), banking is profitable. But banks cannot avoid the uncomfortable fact that they lend depositors’ funds. Banks cannot repossess these funds instantly, yet depositors can demand their funds any time they wish. Such a bank cannot meet its obligations if they fall due. Accordingly, the bank that lends deposits is, always and unavoidably, technically bankrupt.⁸ Fortunately for bankers, common law since the 19th century and contemporary legislation exempts banks from the normal requirements of solvency.

A critical ingredient of banks’ success or failure is the creation and destruction of demand deposits. A bank lends what would otherwise be idle depositors’ balances by creating (or adding to) borrowers’ demand deposits. Borrowers then write cheques in order to spend the borrowed funds. Demand deposits facilitate commercial transactions and are an integral part of the money supply. A depositor’s signature on a cheque authorises his bank to pay a portion of his demand deposit to the cheque’s bearer. Yet as Hazlitt, Rothbard, Smiley and a host of others have noted, a crucial difference distinguishes demand deposits from other types of money. By the late nineteenth century, banks in America, Australia, Britain and other countries had generally become “fractional reserve” banks. When a bank clears a cheque it debits a demand deposit; and when a bank’s customer deposits funds into an account, the bank credits his demand deposit. Most of the time, the amount of currency paid when cheques are cleared

⁸ For readable overviews, see in particular Murray Rothbard, *A History of Money and Banking in the United States: The Colonial Era to World War II* (Ludwig von Mises Institute, 2002); Vera C. Smith, *The Rationale of Central Banking and the Free Banking Alternative* (The Liberty Fund, 1936); and Lawrence White, *Free Banking in Britain: Theory, Experience and Debate, 1800-1845* (Institute of Economic Affairs, 1995).

approximates (and thus offsets) the amount received in the form of new deposits. Given that it is safer and more convenient to hold one's liquid funds in the form of a demand deposit in a bank rather than notes and coins stuffed under the mattress or buried in the back garden, and that it is usually more convenient to write cheques than to hold large amounts of currency, under normal conditions it is very unlikely that all or even many of a bank's depositors will simultaneously seek to convert their demand deposits into currency.

Hence banks' incentive, which has been aided and abetted by two centuries of favourable decisions by courts, as well as protective legislation, is to undertake "fractional reserve" banking. Fractional reserve banks retain only a designated fraction of their deposit liabilities in their vaults (i.e., in the form of reserves); instead, they convert most deposits into assets by lending them to borrowers. Banks lend in order to generate income to meet expenses, and to pay interest to their depositors and dividends to their shareholders. Other things equal (and assuming that the bank arbitrages successfully between depositors and borrowers, and that unexpectedly large numbers of depositors will not simultaneously seek to convert their demand deposits into currency), the lower the fraction of deposits held in reserve the more profitable the bank. At the same time, banks' perennial risk is that they lend too aggressively (see in particular James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken*, Noonday Press, 1994). Over the decades and centuries, a rough pattern emerges: the more profitable the fractional reserve bank, the more prone it becomes in a crisis to collapse.

Fractional Reserve Banking Ignites a Business Cycle: A Stylised Example

A fictitious but still very realistic example shows how fractional reserve banking creates (and occasionally destroys) credit, and thereby creates the boom that causes the bust. Let's assume that a gold miner extracts nuggets that are worth \$5,000, and that a local mint transforms them into \$5,000 of gold coins. Also assume that the miner deposits the coins (i.e., converts the coins into a demand deposit with a balance of \$5,000) at his local bank. For convenience, let's refer to this bank as Bank A. Further, assume that the law requires that banks hold a certain minimum percentage of their deposits as cash reserves composed of either gold coins or currency (bank notes). More specifically, banks are required to hold 12.5% of their deposits as reserves; as a matter of practice banks retain some additional margin of reserves above the required minimum as a precaution against unexpected deposit withdrawals; and therefore banks normally hold 15% of their deposits in gold and currency. This amount sits either in the bank's vault or (much more likely) is a demand deposit at another (usually larger) bank. Accordingly, Bank A would retain \$750 of the miner's \$5,000 deposit in reserves and would seek to lend the remainder (\$4,250) to creditworthy borrowers.

If a borrower obtained a loan, then the bank would lend the money by creating a new demand deposit in the borrower's name (or by adding to the borrower's current demand deposit) in an amount equal to the loan. Once the bank had lent

its new excess reserves of \$4,250, it could make no new additional loans until it obtained additional excess reserves. But the story does not end there. Quite the contrary: it's barely begun. For simplicity, let us assume that a single firm borrowed the entire \$4,250 and that it used this amount to construct additional space at its factory. Assume as well that this firm received the cheque for \$4,250 and deposited it in its bank (which we will call Bank B). Bank B then sends the cheque to Bank A, where \$4,250 is deducted from the borrowing firm's demand deposit and \$4,250 (either in the form of currency or more likely a bank cheque) is forwarded to Bank B. Accordingly, Bank A no longer has excess reserves from the miner's deposit of \$5,000.

But Bank B has. More precisely, on its balance sheet it now has a new liability (namely a demand deposit) of \$4,250 and a new asset (additional cash reserves) of \$4,250; but given that it holds 15% of deposits as reserves it will retain only \$637.50 in reserves against this new deposit. Bank B can lend its new excess reserves of \$3,612.50 by creating (or adding to) a demand deposit for a borrower. When a second borrower spends the \$3,612.50 and his cheque clears Bank B, this bank (like Bank A) would have no excess reserves available for loans. But Bank C has. Let us say that the \$3,612.50 cheque is deposited in a demand deposit in another bank, and that this bank is called Bank C. It now has excess reserves of \$3,070.63 and can lend this amount by creating (or adding to) a borrower's demand deposit.

Consider the process thus far. A miner has mined \$5,000 worth of gold and, after having it struck into coins, deposits it in Bank A. The new \$5,000 of gold has been converted into a new demand deposit of \$5,000 and the money supply has increased by \$5,000. Because banks keep only a fraction of their deposits in reserves, Bank A lent the excess reserves and those became a new demand deposit of \$4,250 at Bank B. Bank B then had excess reserves, which became a new demand deposit of \$3,612.50 at Bank C. In a fractional-reserve banking system, the "hard money" of \$5,000 (i.e., the gold the miner found) has set in train a process that has thus far increased demand deposit money by $\$5,000 + \$4,250 + \$3,612.50 = \$12,862.50$.

But the process is not finished because Bank C now has excess reserves. This process of expanding the money supply through the creation of demand deposits can continue until all of the \$5,000 in gold is transformed into required and precautionary reserves. Given a reserve ratio of 15%, the miner's production of \$5,000 of money would eventually increase the money supply by $\$5,000 \div 0.15 = \$33,333.33$. Fractional-reserve banking always changes – and virtually always increases – the supply of money. Almost inevitably, in other words, it creates inflation. Further, the smaller the reserve fraction the greater the resultant change of the money supply (which equals the rate of inflation) Given this leverage, relatively small changes in reserves typically create much larger changes in the supply of money. Keynesians discount or ignore the supply of money; in sharp contrast, Austrians diagnose these changes of reserves and of money supply as the ultimate causes of the business cycle.

Fractional Reserve Banking and Monetary Disturbances in 1907

Let's revisit an historical example that illustrates the problems – namely volatility and instability – that necessarily accompany fractional reserve banking. Almost exactly a century ago, on 14 October 1907, an unusually large number of the depositors of five banks in New York City began to convert their demand deposits into currency. Their preference for currency over deposits exceeded the banks' ability to convert deposits into currency: trouble therefore brewed. On 21 October, the Knickerbocker Trust Co. experienced a severe “run” on its deposits and failed; and on the 24th, depositors at the second largest trust company in the City began a run on their deposits. Worried depositors at other banks began to convert their deposits into currency; in a chain reaction, concerned banks outside New York that held deposits with banks in the City now began to convert those deposits into currency and gold; and depositors at banks in other Eastern cities, observing the unfolding panic in New York, also began to convert their deposits into currency. By late October, a nation-wide banking panic (subsequently dubbed the “Panic of 1907”) had developed.

J.P. Morgan & Co.'s huge balance sheet, and the confidence it (and he) inspired, saved the day and eventually halted the panic. Thanks to Morgan's reserves, reputation and encouragements (“There's the deal,” J.P. reputedly told the heads of other banks. “I'll let you out of my library when you've signed”), banks were able to stem the redemption of deposits into currency and gold. They continued to clear cheques and borrowers continued to repay their loans. Just as they had ended previous banking panics, these actions ended the Panic of 1907. But in its immediate aftermath, and as a safety precaution, banks increased the percentage of their deposits they kept as cash reserves. And depositors, for a while, held more of their capital in currency and less in demand deposits.

Notice that, in order to rebuild their reserves – for example, to increase the percentage of deposits held as reserves from 15% to 20% – banks must *reduce* their supply of net loans outstanding. In other words, they must reduce the money supply and thus implement a policy of deflation. If borrowers repaid \$100,000 of their outstanding loans, for example, then banks might create only \$85,000 of new loans. Having reduced the supply of loans, they could also reduce the demand for loans by increasing interest rates or the terms and conditions of collateral and repayment, or by “calling” (i.e., demanding immediate repayment of) loans. Under these conditions the demand deposits destroyed by the repayment of old loans would be larger than the deposits created by new loans. Increasing the fractional reserve ratio thus tends to decelerate, halt and eventually reverse the growth of the money supply. The miner's new \$5,000 in gold would result in “only” \$25,000 of new demand deposits at a 20% reserve ratio versus \$33,333.33 at a 15% ratio. At a 20% ratio, each dollar that a depositor converted into currency rather than held as a demand deposit would require that the banking system destroy \$5 of demand deposits. At a 15% reserve ratio, each dollar of demand deposits converted into cash necessitates the destruction of \$6.67 of demand deposits.

Under a régime of fractional reserve banking – *which, remember, is not a creature of the free market but is a government-imposed phenomenon underwritten by banks' exemption from the normal laws of bankruptcy* – small changes in reserves beget large changes in the supply of credit. Sudden changes in the supply of credit, in turn, create instability in Wall Street and (eventually) booms and busts in Main Street. Fractional reserve banking not only fuels inflation and booms; the logical consequence of inflation and boom is deflation (a reduction of the money supply) and bust.

In 1907, banks responded to October's runs by accumulating (i.e., not lending) excess reserves. The money supply subsequently stagnated and eventually shrank, the pace of economic activity (which had hitherto depended upon debt finance) decelerated sharply and prices (including the price of labour) fell precipitously. The rapid decrease of many prices, which was unrelated to the preferences and demands of consumers, drastically but temporarily weakened the ability of the price mechanism smoothly, accurately and efficiently to co-ordinate the actions of capitalists, producers and consumers. Only when the structure of production adjusted to these new and chastened conditions could prices transmit accurate signals, growth resume and prosperity return.

In 1907, then, fractional reserve banking (the ultimate cause) and a monetary disturbance (the consequence of banking arrangements and the proximate cause of the crisis) transformed what might otherwise have been a brief and relatively minor contraction into a rapid and severe decline of economic activity that persisted until June 1908. During the late 1920s and early 1930s, much more severe, complex and extended monetary disturbances occurred. This turmoil, together with politicians' and policymakers' utter unwillingness to let the price mechanism operate freely, transformed what might have been a short and sharp contraction of the type that occurred in 1907 (and again in 1920-21) into a depression of unprecedented severity that lasted throughout the decade.⁹

The Panic of 1907 and the Credit Crisis of 2007-08: Plus Ça Change ...

Is the cause of a particular malady, the business cycle, known or unknown? Keynesians simultaneously claim two incompatible things. First, an “excess of aggregate demand” causes the upward leg and a “deficiency of aggregate demand” causes the downward leg. Businesses and consumers who seek to consume more than the government desires allegedly cause the boom, and people who obstinately decline to consume as much as their rulers want cause the bust. The cure is interventionist monetary and fiscal policy, which allegedly lessens the severity of upswings and downswings.

⁹ In addition to Gene Siley's book, rigorous, readable and Austrian (or Austro-friendly) analyses of the Great Depression include Chaps. 9-10 of Thomas DiLorenzo, *How Capitalism Saved America* (Crown Forum, 2004) and Jim Powell, *FDR's Folly: How Roosevelt and His New Deal Prolonged the Great Depression* (Crown Forum, 2003). The best analysis remains Murray Rothbard, *America's Great Depression* (Richardson & Snyder, 1963). For solid analyses of Franklin Roosevelt's malevolence and the catastrophes, foreign and domestic, he wrought, see John Denson, *A Century of War: Lincoln, Wilson & Roosevelt* (Ludwig von Mises Institute, 2006), Thomas Fleming, *The New Dealers' War* (Basic Books, 2001) and John T. Flynn, *The Roosevelt Myth* (Fox & Wilkes, 1948).

Second, say the Keynesians, no rational cause but rather the “animal spirits” of investors, underlies the business cycle. Because these animal spirits are ineradicable, palliative treatments (such as imprisoning businessmen in regulatory cages) are the most that can be expected. During the 1930s and 1940s Lord Keynes expressly denied, and today his heirs emphatically disavow, that monetary and institutional factors – particularly fractional reserve banking – cause financial and economic perturbations (see in particular Paul Krugman, *The Great Unravelling*, Penguin, 2005 and [Oh Keynesian, Where Are Thou?](#) by Mateusz Machaj).¹⁰

Since the late 19th century, Austrian School economists have emphasised that in a fractional reserve system banks cannot return cash to large numbers of depositors because the bulk of the deposits reside in an illiquid form, i.e., loans and income-earning securities rather than currency and gold. In an emergency, banks must turn to the strongest and most solvent among their ranks, if such a beast exists, in order to obtain cash quickly. In 1907 they turned to J.P. Morgan & Co., and in 2007-2008 they have turned to the Federal Reserve. If banks sell loans and securities in order to obtain cash for their panicky depositors, as they did a century ago and are doing again now, they depress the prices of the loans and securities. Under these circumstances the banks have even fewer assets to cover their liabilities, and risks to their liquidity (i.e., ability to convert assets into cash) and ultimately solvency (i.e., the ability to repay debt and other liabilities) rise.

Hence the Fed’s actions since August 2007: it has lent to banks in exchange for collateral. The Fed is lending greater amounts for longer periods of time, and is prepared to lend at lower rates of interest and in exchange for ever less pristine collateral. These actions give the banks time to purge and repair their balance sheets, i.e., to recognise bad loans and raise new capital, and thus to rebuild depleted shareholders’ equity. The Fed, in effect, is underwriting the banks’ day-to-day and least-risky transactions. As it did in the early 1980s and again in the early 1990s (and later reversed), it is undertaking a nationalisation-by-stealth of parts of the U.S. banking and mortgage industries.

Critically, however, the Fed cannot increase assets relative to liabilities: it cannot, in other words, create shareholders’ equity. Only savings can do that. Keynesians have always rejoiced that central banks routinely conjure credit out of nothing; but they have never grasped that nobody can contrive savings from a vacuum. These days, where do savings reside? Not, by and large, in the U.S., U.K. or Australasia. They congregate mostly in Asia and the Middle East. Americans kid themselves that they are the world’s most powerful nation. But aircraft carriers and military bases around the world avail Americans little when Arabs and Asians finance them – as well as American banks and mortgages.

¹⁰ Lest you think I am describing a straw man, consider this gem – written by a senior fellow at a think tank, not a letter-to-the-editor – from *The Australian* (8 April): “Private investment is the critical driver of business cycle phenomena in market economies. When the private sector is optimistic about the future, high investment takes place. To the extent that investment is controlled by a socialist government, it tends to be more stable, but as countries step out of the shadow of socialism, there is a bigger role for the private sector in decision making about investment. This leads to business cycles.”

The juxtaposition of the Panic of 1907 and the “Credit Crisis” of 2007-08 shows that the “American sub-prime crisis” is not a *cause* of the recent and current ructions in credit and stock markets. It is a recurring *symptom* (and hence a *consequence*) of bad policies, namely Keynesian economics and fractional reserve banking. It also shows that the sub-prime bust, credit crisis and stock market ructions are not “free market” phenomena: instead, they are consequences of state intervention. The market, in short, hasn’t failed: government has. Clearly, the correct prescription for these ills is not more government, legislation and regulation. Quit the contrary, it is drastically less of these harmful things.

Alas, Australian politicians, bureaucrats and market participants are so strongly addicted to state-imposed medications that they simply do not recognise the harm these things have done, are doing and (unless reversed) will continue to do. The mindset of one of the country’s most prominent financial journalists is typical. Like a crazed chemist who has only one drug to prescribe, he said on 4 April that “the collapse of the long-running bull market is revealing a series of errors of judgement that leave a nasty taste for all concerned” and concluded “we obviously will need extra regulations.” Similarly, a former head of the ASX and of a forerunner of ASIC was quoted in *The Australian* (also 4 April, which was clearly a great day for socialists in Oz), “the regulator needs to do more to prevent market manipulation by cowboys who believe they can drive a market down for their own benefit.” By inference, market manipulation by the Coalition for Inflation (which includes governments, central and commercial banks, regulators, borrowers and speculators), which believes it can drive a market up for its own benefit, is quite OK. Because they didn’t recognise that the Gilded Era rested upon sand, and do not now acknowledge the institutional and monetary source of recent ructions, the herd is demanding medicine that will make things worse. Bad policy caused this mess. So how can more of the same resolve it?

The problem, alleges the herd, is “the evil hedge funds, the sleepy regulators, the ruthless margin lenders and even the vultures of the press.” Also culpable, they say, is a conflict-of-interest-ridden ASX, as well as “greed, leverage, risk, suspect corporate governance and complex corporate structures.” In sharp contrast, “those who would blame ‘the cycle’ are strangely silent. Boom and bust. These things just happen” (see Michael West, [Who’s to Blame for Corporate Meltdowns?](#)). During February and March, short-sellers played the same role in Australian financial markets as witches did in colonial Salem: that is, convenient scapegoats and innocent pawns. Regulate or ban these alleged bads, the herd insisted, and things will return to normal. A letter to the editor of *The Australian* (2 April) was unintentionally very wise. “There should be an immediate Government declaration that, pending enquiries, all parties are on notice that for every dollar lost a dollar will be demanded from those who have benefited. And that there will be no legal loopholes, that there will be severe penalties for those who do not return their undeserved gains.” But why exempt the causes of our troubles from this rule? *Quis custodiet ispos custodiet?* Why not apply it primarily to the government and its henchmen, and to politicians and their mascots, as just desserts for their lying, stealing, cheating and killing?

In a [speech](#) on 10 April, Ben Bernanke stated “the Federal Reserve has been part of a national and international effort to draw at least some preliminary conclusions about the sources of the current turmoil as well as the implications for public policy.” He alleged “although many factors played a role, to a considerable extent the current problems arose in the implementation of the so-called originate-to-distribute approach to credit extension.” The behaviour of investors, in other words, particularly [securitisation](#), is the root of the problem. Further, “investors often took insufficient care in evaluating the risks of structured credit products, in part because they over-relied on the evaluations provided by the credit rating agencies.” And “another factor contributing to the financial turmoil was weakness in the risk-management practices of large global financial institutions that created and held complex credit products.” Interventionist government in general and fractional reserve banking in particular, Bernanke implicitly contends, have nothing whatever to do with the turmoil in Wall Street and Main Street.

But more stringent regulation of investors, he alleges, can calm the waters. “First, the weaknesses in the origination stage of the originate-to-distribute model must be corrected; no matter how elaborate and sophisticated, credit instruments can be no stronger than the underwriting that supports them.” Moreover, “better consumer protections and disclosures, as well as greater supervisory scrutiny of the processes that originators follow and the incentives they face, are also needed.” And given “the inadequate care by investors in their evaluations of securitised credits, particularly the more complex structured securitisations, more transparency about the risks and other characteristics of securitised credits on the part of their sponsors would obviously help.” Some investors, such as public pension funds, are subject to government oversight, “and in these instances, [we] will look to their government overseers to reinforce implementation of stronger due diligence practices. When investors employ advisers, the mandates and incentives given to these advisers should be structured so as to induce a more careful and nuanced evaluation of the risks and returns of alternative products ... Improving the performance of the credit rating agencies is another key priority.”

Government, says Prof Bernanke, is not the problem: the imprudent behaviour of individuals and institutions in insufficiently-regulated markets is. Accordingly, more government and less liberty is the answer. *The Weekend Australian* (“Market Failure Needs Proper Investigation,” 12-13 April) agrees. “A judicial enquiry must be held into the regulation and operation of Australia’s financial markets. This is the only conclusion to be drawn from the collapse of a third margin-lending company ... imperilling the savings of thousands of people.” It continues “investors can be thankful ... that Australia’s market failures to date have been at the margins, and may well be the result of incompetence rather than misdeed.” Still, “regulators [have been] slow to act” and “lax regulation has allowed market participants to find a way around strict rules on selling shares.” Regulating and banning, the editorial strongly suggests, is the only possible way to go. After all, whenever the government encourages X (where X is anything it decrees to be “good”) and regulates or bans Y (where Y is whatever it says is “bad”), the incidence of X invariably rises and of Y always falls. Doesn’t it?

If Fractional Reserve Banking, Then Boom; If Boom, Then Bust

Given my diagnosis, what is my prognosis? The most general point is that the next decade will resemble the 1970s more than either the 1930s or the 1990s (see also [Letter 42](#), [Letter 53](#), [Letter 68](#), and [Letter 78-80](#)). It may well include recession and falling asset prices, together with rising consumer prices and interest rates (“stagflation”). The poor policies of the past decade are now coming home to roost, and the growing clamour for more intervention will simply add to the downdraught. A rough rerun of the 1970s, if it occurs, will be a far cry from the Great Depression; but it will also make a distant memory of the Gilded Age since the mid-1990s. The 1970s was hardly an easy decade for investors (the fashions and music were almost as bad as the economics and politics). Yet some – ably prepared by Benjamin Graham – fared tolerably well.

Globally, banks have (thanks to their provisions for various kinds of bad loans, write-downs of various securities, etc.) lost ca. \$US250 billion. Further losses of several hundred billion more (for things like auto, credit card and LBO loans, commercial real estate, etc.) are conceivable. Add to the bonfire the losses of insurance companies and other non-bank financial institutions, hedge and pension funds, etc., and an eventual toll of ca. \$US1 trillion (a mere [one-third of the cost of the Anglo-American aggression against Iraq](#)) doesn't seem to be implausible.¹¹

Many financial institutions are grappling with the losses of large amounts of capital and the consequent gaping holes in their books. American and European banks are reintegrating into their balance sheets structured investment vehicles (SIVs) and other entities created during the boom, and they have largely lost the ability to shift assets from their balance sheets by securitising them. Given the depleted status of their capital and the growing demands placed upon their capital, banks must curtail the growth of lending. In order to resume lending at the rapid pace of the past decade, or something approximating it, they require either massive injections of capital or a mechanism that shifts distressed or illiquid assets from their books to somebody else's (taxpayers, mind your wallets!).

¹¹ The International Monetary Fund's [Global Stability Report](#) (April 2008) said that write-downs and losses would reach ca. \$US945 billion during the next two years, not including ca. \$US60-90 billion of MTM losses caused by the downgrades of monoline insurers' credit ratings. These losses are “putting the world's biggest financial institutions under strain,” such that the probability of a major bank collapse has risen from 0.5% to 5.5%. If one bank collapses, the IMF adds, another six will likely follow in its wake. Here, too, a year has made a mammoth difference. According to *The Australian* (“Outlook Brightest Since 60s, Says IMF,” 13 April 2007), “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 macro-economic policies are sound the issues in finance will not be of first order importance.’” Noting this exuberance, in [Letter 90-92](#) I said “[the IMF's chief economist] 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.”

In Australia, too, today's pressures upon banks and tomorrow's reactions of banks to those pressures will bear a disproportionate influence upon the course of subsequent events. According to Goldman Sachs JBWere, Aussie banks are only ca. 25-33% of the way through the process of re-establishing their historical share of the intermediation of credit. The name of this process is the tongue-twister *financial reintermediation*.¹² Unless Australian banks provide at least another \$80 billion of the credit that has until very recently been provided by securities markets, a "harder landing" for the Australian economy could be in the cards.

The various combinations of these two developments (i.e., decline of the extent of finance provided by credit markets and the increase of the extent provided by banks) have different economic impacts. From the point of view of Australia's very powerful coalition of credit, the best combination is a decrease of finance provided by credit markets and a more-than-corresponding increase provided by banks, such that the overall supply of credit continues (as it has done almost without interruption for 15 years) to rise at a double-digit pace. A distinctly less attractive combination is a decrease of finance provided by credit markets and a corresponding increase by banks, such that the overall supply of credit grows at, say 5% per year. Given Australians' heroin-like addition to an ever-growing supply of cheap credit, this result may be sufficient to cause significant economic indigestion. Clearly, the worst combination is a decrease of finance provided by credit markets and a less-than-corresponding increase by banks, such that the overall supply of credit stagnates or even falls. That occurred in Oz during the late 1980s-early-1990s; today, when the dependence upon credit is much greater, it would very likely provoke a severe recession.

Banks in Australia and overseas thus face conflicting pressures. Given their present capitalisations and the pressures towards reintermediation, they must decelerate their lending. But in order to keep governments and shareholders happy, they need to maintain the pace of lending. In order to repair their balance sheets and to offset the retreat of credit markets from the finance of lending, they must raise additional capital, i.e., float bonds and/or issue new shares. American

¹² In plain English, the accumulation of capital and its investment is usually undertaken by different sets of people. Those who save money, for example, are seldom the same people who borrow money and use it to (say) establish and expand businesses. How to match savers' supply of capital to borrowers' demand for it? That's the job of *financial intermediaries*, i.e., firms like banks that effectively borrow from savers and lend the proceeds to companies. Through banks, savers lend indirectly to businesses and consumers. In contrast, savers can contract directly with borrowers by creating marketable securities such as bonds, mortgage-backed securities, etc. In recent decades, this direct relationship between borrowers and lenders has grown more quickly than the indirect (via banks) relationship. Through a process called financial *disintermediation*, borrowers have tended to borrow more from bondholders than from banks, and thus the role of intermediaries ("middlemen") in the financial supply chain has lessened. *Financial reintermediation* is the reintroduction of an intermediary (typically a bank) between savers and lenders. This term applies especially to instances in which disintermediation has occurred first. In plain English, borrowers who once (as in the ca. 20 years to 2007) tended to borrow more from bondholders than from banks will henceforth tend to borrow more from banks than from bondholders. I suspect that financial reintermediation will occur during the next several years; and the extent to which and the way in which it occurs will influence economic and financial conditions – including the prices of securities.

and British banks will use many of the proceeds to recoup losses from bad loans, and lend the rest (following the fractional reserve procedure) to consumers, homeowners and businesses. Aussie banks, it is has relentlessly been alleged, have far fewer holes in their balance sheets and can thus use the new capital they raise to finance the continuation of the country's lending bacchanalia.

We will see. On 21 February, the CEO of one of Australia's Big Four banks declared: "It strikes me as extraordinary that the Australian banks, which in this environment are extremely strong, are treated with the same sort of discount as European and US banks, which are facing serious trouble. The Australian banking system is stronger than any other Western [banking system] ... We are a completely different story." On 7 April, his bank announced that it had belatedly set aside almost \$1 billion to cover potential bad debts.

In one critical respect, Australian banks are no different from their counterparts in America, Britain and elsewhere: during the next 6-12 months, most will have to raise capital. Whence will it come? Some will be sourced domestically (or at least from entities that deposit funds in Australian banks), but the lion's share must come from overseas. Yet since the middle of 2007 this capital has become considerably dearer, and is unlikely to become much cheaper very soon. Unless they are prepared to shrink their profit margins (which have fallen steadily for a decade or so), Aussie banks must therefore charge more for the money they lend to borrowers.

The big question, as GS-JBW has noted, is whether Australian banks will accept all the possibilities for reintermediation that are likely to appear on their doorsteps. Can they find enough creditworthy people and businesses and sensible opportunities for all this lending? If they cannot, then the supply of credit will decelerate, stagnate and perhaps even decline; and the slower the growth of lending, the smaller the banks' profits – and the lower the rate of economic growth (defined by conventional means). All things considered, the pressure on banks' capital is likely to be upward and the pressure upon their profitability is likely to be downward. If so, then in Anglo-American and other countries, banks may be entering an era of lower returns. And given that banks bulk very large as components of the All Ordinaries and other Australian market indexes, the overall pressure upon corporate earnings in this country is very unlikely to remain strongly positive.

Perhaps it's already become negative. For several reasons (the cost of banks' capital is rising, the pace of lending seems to be slowing, etc.), it's unlikely that Australian businesses and consumers will be able to tap the large quantities of cheap credit to which they became accustomed in recent years. Hence their interest payments are rising. For this reason, and also to the extent that overall corporate profit presupposes that either businesses or their customers (or both) are able to obtain large quantities of cheap credit, the pressure upon corporate profitability might henceforth be downward rather than upward.

Indeed, on 3 April, GS-JBW's chief economist estimated that the chance is 20-25% that Australia succumbs to recession during the next 18 months. The "causes" – which are actually symptoms – are both international (the deceleration of economic growth around the world) and domestic (downgrades of earnings during the remainder of 2008). "The market is not pricing in a recession yet ... but the risk of a recession is now as high as it has been since the last recession (in the early 1990s), especially with where the financial sector is. The recession is no longer just a US event – it is starting to have global repercussions."

The prognosis, then, is that profitability regresses from the extreme highs of the past several years towards the trend of the past ca. 30 years (see pp. 12-22 of [Letter 96-98](#)). Lower profitability, particularly when the consequences of the poor policy of the past are coming home to roost, threatening recession, means lower prices of financial assets.

Of History, Loyalty and the Herd's Manic-Depression

Recession and lower asset prices don't imply Armageddon. Did the world's banking system approach collapse in March? It didn't in the 1930s, nor did it disappear in the 1970s, 1980s and 1990s (when more American banks failed than in the 1930s). Is (or was?) the Panic of 2007-2008 really the worst financial crisis since the Depression? Today's memories are short: in 1982, when Brazil's and Mexico's sovereign debt defaulted, the "non-performing loans" of *every* major American, British and Western European bank comprised more than 100% of shareholders' equity, and so they were all effectively insolvent.

Most of these banks, including titans such as Chemical, Chase Manhattan, Citibank, Deutsche, Lloyds, Midland, National Westminster and WestdeutscheLB, remained *de facto* insolvent until at least 1988; during the late 1980s and early 1990s, almost half of America's Savings-and-Loan industry gurgled down the drain; and throughout the 1990s Japanese banks were (and to a significant extent remain) wards of the state. Today's nationalisation-by-stealth of America's banking and mortgage industry is very serious, but it's not unprecedented.

Less than a year ago, the Australian herd was high-spirited. In January-March it was despondent, and the nouveau-bears asserted something along these lines: "we've been around for a long time, and we've never seen anything like this" (see, for example, the front page of the business section of *The Australian* on 25 March). How should an investor armed with sturdy principles and historical perspective react to such claims? With the calm realisation that (a) during ructions comments like these fall like the leaves of autumn, and (b) some kind of "unique" ruction occurs roughly every 5-10 years. Maybe each successive crisis really has been worse than the one that preceded it. But two less alarming explanations for today's sense of anxiety and even panic may be more plausible.

The first is that 25 years (the length of the typical career of the most experienced investors and bankers) marks a very brief chunk of economic history. The period

1983-2008 covers two or at most three ups-and-downs of the business cycle. It's hardly surprising, therefore, that each new crisis shocks people. It's quite true that they haven't seen anything like it before. But precisely because everybody lacks direct experience of the more distant past and few immerse themselves in history, it's rarely true that what's happening at any given point in time is unprecedented. During both booms and busts, it's seldom really different this time. As Mark Twain wryly noted, history doesn't repeat but it does rhyme. It also helps to recall that all of us were once teenagers, and most of us experienced the rupture of a teenage romance. Such a calamity had never befallen us before – and, lacking direct knowledge of others' experiences, we inferred, charmingly but risibly, that nobody else had ever suffered as grievously.

Secondly, when we peruse history we find that every financial crisis and bear market has, at its nadir (which we can identify only in retrospect), presented a golden buying opportunity. Despite what people asserted during each funk, the world did not, after all, come to an end. Hence the paradox: if everybody recognised that crises have always created buyers' paradises, then – *unless large numbers of people believe that the latest crisis is somehow different from and worse than any that had preceded it* – bear markets would never occur. In other words, to create a bear market, large numbers of people must assert “we've been around for a long time and we've never seen anything like this.” This despondent view is the conjoined twin of the exuberant cry (“this time it really is different”) that punctuates bull markets. The very people who are increasingly cheerful on the upward run are ever more despondent on the downward slide – and are prone, like many manic-depressives, to change their views drastically and suddenly.

Ut inceptit fidelis sic permanet. Throughout 2003-2007, I accepted neither the bulls' babble nor their resolutely sunny conclusions. Today, I remain loyal to timeless principles – and thus reject both the cataclysmic prognoses of January-March and the back-to-the-Gilded-Age forecasts that have resurfaced since the beginning of April. As Gene Smiley demonstrates in his superb (and very readable) *Rethinking the Great Depression*, much of what we think we know about the Depression is false. Moreover, the conclusions that Keynesians drew from it are grossly mistaken. Similarly, much of what investors think they know about the Gilded Age after 1995 is probably wrong; and the inferences politicians and central bankers have drawn from it are likely erroneous.

Hence my suspicion that the herd did not understand the shaky ground upon which rested the bull market of 2003-2007 (if that is how posterity will regard it). Similarly, they do not strive to retrace consequences to their causes. Accordingly, they are unlikely to comprehend that the faulty policies of the past decade are now fanning the bust. From early 2003 until late 2007, the bullish herd relied upon faulty premises, invalid reasoning and unreliable evidence. In January-March 2008, it abandoned even the pretence of reason and embraced the emotion of panic. In early April it was back to the old tried-and-failed faulty thinking. What will the herd say and do tomorrow? Who knows? But if you're armed with plausible premises, solid reasoning and reliable data, you don't have to care.

Summary and Conclusion

1. Many journalists, market commentators and the like should be taken no more seriously than Commies' and fellow-travellers' frenzied twists and turns during the late 1930s and early 1940s. Like politicians, so too economic and financial gatekeepers: regard them alternately as evil and as objects of ridicule.
2. In order to comprehend what has happened, is now occurring and may eventually transpire in Wall Street and Main Street, it is imperative to remove distorting Keynesian spectacles and diagnose the world as our forefathers did – that is, through unimpaired (i.e., Austrian School) eyes. This allows us to see something that the herd cannot or will not see: namely that sub-prime mortgage lending in the U.S. has not caused the recent ructions in credit and stock markets. The sub-prime fallout is a symptom (and hence a consequence) of destructive policies, namely Keynesianism and fractional reserve banking. Busts and bear markets, in other words, do not destroy capital; they merely reveal the extent to which the preceding booms and bull markets have destroyed it.
3. These days, mainstream economists claim that “nobody accepts Keynesian theory anymore.” Yet Keynesianism rules the roost. Keynes convinced the world that recessions result from “market failure” and that “stimulus” and more regulation will fix them. Then and now, Keynes tells politicians and bureaucrats what they want to hear.
4. Fractional reserve banks lend depositors' funds. They cannot repossess these funds instantly, yet depositors can demand their funds any time they wish. Such banks cannot meet their obligations if they unexpectedly fall due. Accordingly, they are always technically bankrupt.
5. Fractional reserve banking spreads this virus from the financial to the real world. It did so in 1907, and also in every subsequent exclamation of the business cycle – including 2007-2008. Today, the Fed can give commercial banks some of the time they need in order to repair their wounded balance sheets. But it cannot increase banks' assets relative to liabilities: it cannot, in other words, create shareholders' equity. Only savings can do that.
6. In order to restore their finances to order, banks must raise billions of dollars of capital. Their demand for savings will raise its price, and their caution will stiffen the terms of loans. These actions will put downward pressure upon corporate earnings (including banks' profits), and therefore upon the prices of securities and financial assets.
7. The next decade will resemble the 1970s rather than the 1930s. It may well include recession and falling asset prices, together with rising consumer prices and interest rates (“stagflation”). The poor policies of the past are

once again coming home to roost, and the growing clamour for yet more intervention will simply add to the draught.

8. Fractional reserve banking is not a creature of the free market; it is a monster imposed by government. Hence the sub-prime bust, credit crisis and stock market ructions are not market phenomena: they are the consequences of a crazed, arrogant and interventionist state. “The market” has not failed; government has failed. Clearly, the activist state always has failed, is now failing and always will fail. Equally obviously, the correct treatment for the consequences of bad policy is not more of the same bad old policies. Quite the contrary: it is drastically *less* government expenditure, financial legislation and regulation. Popular demand for sound money and banking, the abolition of ASIC and the RBA and a strict dose of *caveat emptor* all around would provide a good start.

Whither the All Ordinaries and other stock market indices? The analogy of Daniel Turov (“Mixed Message,” *Barron’s* 21 May 2001) makes much more sense than the relentless cacophony emitted by Australian journalists, “market strategists” and other babblers. “Bear markets don’t act like a medicine ball rolling down a smooth hill,” said Turov. “Instead, they behave like a basketball bouncing down a rock-strewn mountainside; there’s lots of movement up and sideways before the bottom is reached. During the Great Bear Market from 1929 to 1942, the Dow Industrials had rallies of 48% (from November 13, 1929, to April 17, 1930), 94% (July 8, 1932, to September 7 of that year), 121% (February 27, 1933, to February 5, 1934), 127% (July 26, 1934, to March 10, 1937), 60% (March 31, 1938, to November 12 of that year) and 28% (April 8, 1939, to September 12 of that year). Yet, on April 28, 1942, the DJIA was still at only 92.92, 76% below its September 3, 1929, high of 381.17.”

Turov adds “when the bulls stop asking ‘is this the bottom?’ and instead are explaining to their friends why ‘this time it’s different, and the market really is a bottomless pit,’ then it will be time for me to pen ‘Buy Signal, Part 2.’ But we’re a long way from that.” His conclusion applies just as much to Australia as to the U.S. As such, it should – but probably won’t – give the Australian herd pause: “the Dow first reached the 100 level in January 1906. It traded above and below that level for more than 36 years; it wasn’t until May 1942 that the market left 100 behind for the last time. The Industrial Average first reached 1,000 in February 1966. It traded above and below that level for the next 17 years, leaving that figure behind for the last time in February 1983. The Dow first reached the 10,000 level in March 1999. Considering the unprecedented gains of the past several years, would it be that unusual for this benchmark to take a decade or even two before leaving 10,000 in the dust for the last time?”

Chris Leithner