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Of course the success of an investment depends ultimately upon future developments, and the future may never be forecast with accuracy. But if you have precise information as to a company's present financial position and its past earnings record, you are better equipped to gauge its future possibilities. And this is the essential function and value of security analysis.

Benjamin Graham and Spencer B. Meredith
The Interpretation of Financial Statements (1937)

The duly kept accounts in a system of correct bookkeeping are accurate as to dollars and cents. They display an impressive precision, and the numerical exactitude of their items seems to remove all doubts. In fact, the most important figures they contain are speculative anticipations of future market constellations. It is a mistake to compare the items of any commercial account to the items used in purely technological reckoning, e.g., in the design for the construction of a machine ... The main thing in balance sheets and in profit-and-loss statements is the evaluation of assets and liabilities not embodied in cash. All such balances and statements are virtually interim balances and interim statements. They describe as well as possible the state of affairs at an arbitrarily chosen instant while life and action go on and do not stop ... The numerical exactitude of business accounts and calculations must not prevent us from realising the uncertainty and speculative character of their items and of all computations based on them.

Ludwig von Mises
Human Action (1949)

The household sector is running a highly mismatched balance sheet, with assets consisting mainly of property and equities, and liabilities made up of debt. This balance sheet structure is very effective in generating wealth [sic] during good times, but households need to recognise that it leaves them exposed to economic or financial shocks that cause asset values to fall and/or interest rates to rise.

Ric Battellino
Deputy Governor, Reserve Bank of Australia
[Some Observations on Financial Trends](#)
(25 September 2007)

What If We Analysed Households As If They Were Companies?

Don't worry. Instead, rejoice: you're getting richer and will likely continue to do so. That's the gist of a steady stream of news stories since 2003. "Shares, Super Boost Australian Wealth" crowed *The Courier-Mail* on 26 December 2007. "The wealth of Australians has soared 21% in 12 months despite record spending on credit cards. And it could be even higher for many if they bothered to check their superannuation. Australians have an average wealth of about \$60,000 each as household assets continue to rise ... The jump in wealth is attributable to a stronger share market and increased inflows into superannuation. In the past three years, the average financial wealth of Australians has risen 70%."

A report from the AAP ("Average Household Worth \$500k," 9 November) stated "the average Australian household is now worth more than \$500,000, driven by increases in house prices and superannuation holdings. The average wealth of an Australian household in 2005-2006 climbed 14% over the previous two years to \$563,000, according to Australian Bureau of Statistics figures released today. The figure was established by subtracting a household's average liability (\$92,000) from the average value of all assets (\$655,000) ... For most Australians, their house is their biggest asset. The average house price for the 69% of Australians who own or are paying off their home [has] reached \$412,500. Household contents were worth an average \$51,000, while superannuation was worth \$85,000 across all households. But only three-quarters of households had superannuation assets, and they had an average value of \$111,000."

Not only are Australians growing richer: they're doing so more quickly than residents of most other Western nations. "Wealth of Nations" (*The Age*, 7 November) stated "compulsory superannuation and strong financial markets have made Australia the top nation in the developed world for wealth creation. A report by Boston Consulting Group shows Australians had the fastest-growing personal wealth of any developed country over the past five years. Personal wealth, measured in US dollars, grew by an annual average of 19.1% over the five years to the end of last year – more than double the global average of 8.6%. Australia's performance is mostly due to the super system, which mandates a high level of savings, and to strongly-performing financial markets. 'The superannuation system is having a very large effect on the way personal wealth is accumulated in Australia relative to most other countries,' BCG says. Australia's super pool holds almost \$1.2 trillion."

Politicians, bureaucrats and finance journalists have emphasised these positives and downplayed the negatives. So everything must be fine. "No Dangers in Debt Binge," *The Australian* (26 September) assured its readers. "Australia is in the midst of an unprecedented debt binge driven by household spending, and it will only get worse. But Reserve Bank deputy governor Ric Battellino insists it is nothing to worry about, with growth fuelled by older, high-income earners who have the money to meet

repayments ... The Reserve Bank has traced borrowing records back to 1865. The land booms of the 1880s and 1920s were both built on debt, but they were nothing like the surge of the past 30 years. In 1890, debt reached just under 75% of GDP, while in the 1920s it was about 45%. It has now surpassed 150%.”

The Oz continued: “both the previous booms were much shorter and were driven by business borrowing. It was not until 30 years ago that households started to gain access to credit. Deregulation, innovation and lower inflation have simultaneously increased the supply, and reduced the cost of finance to households, and not surprisingly, households have responded by increasing their use of it. Household debt has risen from 20% of GDP in the 1970s to 100% now. Mr Battellino said most of the debt had been used to buy assets. Over the past 10 years, households have borrowed a total of \$770 billion, of which \$420 billion was for houses to live in, \$240 billion for houses to rent and \$40 billion for shares.”

Mr Bettellino concluded: “While the build-up of household debt is often portrayed as being driven by young couples trying to buy their first home, a more accurate description is that it is mainly being driven by older, higher-income households that are trading up to higher quality or better-located homes, buying investment properties and taking out margin loans to buy shares.” Debt in contemporary Australia, it seems, has become a consumer good whose demand rises rapidly as income increases. Because “households are benefiting from strong income growth and low unemployment, with household wealth rising solidly recently ... it would be a mistake to conclude that a rising ratio of debt to income is necessarily a sign of financial stress among households.”

The Deputy Governor returned to this theme shortly before Christmas. “RBA Gives Tick to Household Health” said *The Australian* (13 December). “The Reserve Bank reckons Australian households are in pretty good shape, despite record levels of consumer debt. Ric Battellino says Australians are neither exposed nor vulnerable. ‘My own view is that Australian households are in very good shape,’ Mr Battellino said in a speech in Sydney yesterday. ‘They are not in any way exposed or vulnerable – the structure of assets and liabilities is quite sound,’ he said. There would obviously be examples of people getting themselves into financial difficulty. But fundamentally, the household sector as a whole is in very good financial shape. We had an adjustment in the housing market over 2005 and 2006, but house prices are now rising again ... and there’s no hint the share market is grossly overvalued” (see also [Opening Remarks to the 20th Australasian Finance and Banking Conference](#)).

Perhaps this last assertion, together with the confidence of the Deputy Governor’s assurances, will encourage Australians to take the views of the RBA – and of the government more generally – with a grain or two of salt. After all, central bankers are simply bureaucrats and unelected politicians; and such creatures bear no personal responsibility for the damage they routinely wreak. When was the last time one of

them atoned for a mess he made by compensating ordinary Australians out of his own pocket? Financial and economic bureaucrats' assertions about economic and financial conditions are likely to be at least as biased as those of private sector cheerleaders for big government, domestic socialism, foreign adventurism, inflation-and-debt-fuelled bull markets and all the sordid rest. I therefore hope that Australians will question three premises underlying Battellino's upbeat assertions:

1. The prices of Australian stocks, bonds and real estate have recently been and presently remain reasonable.
2. The escalating price of financial assets is a sign of growing prosperity.
3. The acquisition of debt as a ticket to ride the train of rising asset valuations is a safe and reliable route to riches.

I doubt all three premises. In a bull market whose boosters insist will run for decades, borrowing to buy assets and paying any old price to buy them can be *a* way to paper wealth. But in a bear market, they are *the* way to real penury. The trouble is that nobody – not even central bankers – can reliably tell you when the bull yields to the bear.

Not sweating valuations, and confidently borrowing to buy stocks, bonds and real estate, is a fair-weather friend *par excellence*. Logic and evidence couldn't be clearer: as long as prices rise, these tactics are a blessing; but once prices cease to increase (and, heaven forbid, fall and remain low) they're a curse. So long has the financial sun shone upon *Terra Australis* that it's difficult to resist the inference that the sky will never darken and rough weather never reappear. So long has fortune smiled upon the Lucky Country that people will accept the principle but doubt the fact that the business cycle has downs as well as ups, and that bear markets are as inevitable – and can be as destructive – as cyclones in the Top End. Things have apparently been so good for so long that many Australians unknowingly mimic the business practices of [P.T. Barnum](#) – and nod approvingly when these practices are brought to their attention. When that legendary American showman stretched himself to the limit in order to buy the American Museum, a friend asked him how he proposed to finance the transaction. “With brass,” he merrily replied. “For silver and gold I have none.”

King Solomon, who was a much better investor than Barnum, said “everything has its season and there is a time for everything under heaven.” If you are prepared to acknowledge the possibility of inclemency, then you may want to consider the very heavily leveraged condition of the average Australian household – and its consequences for the results of your investment operations. You might also consider whether debt will one day become as dear and disliked as in recent years it has been cheap and popular. You might even want to inform yourself how to profit from such a turn of events.

“On numerous occasions prior to this point,” wrote Benjamin Graham and David Dodd in the second (1940) edition of *Security Analysis*, “we have expressed our conviction that the balance sheet deserves more attention than Wall Street has been willing to accord it for many years past.” I concur. Not only should Australian investors assess individual companies’ financial statements: they should also scrutinise those of the average household. Further, they should use the same methods and criteria to evaluate companies’ and households’ finances. Such an examination helps to answer important questions. Most notably, are the finances of the typical Australian household – and, by extension, consumers and suppliers of first-order goods and services including financial services – really in such good shape?

If a primary aim during a bear market is to preserve one’s capital, then investors will want to own companies whose finances are strong enough to withstand rough seas. And to the extent that a particular company’s fortunes depend upon the consumers of first-order goods, the health of the average household’s finances concerns all investors. A strong balance sheet, Ben Graham taught his students, provides the basis from which a company generates reliable earnings; and a valid income statement accurately describes its revenues, cash and non-cash expenses and thus earnings. A company’s assets should produce enough revenue to meet expenses, pay interest and repay the principal of debt (and perhaps a dividend) and retain enough earnings to finance growth – in the form of higher earnings – in the future. The details differ, of course, but the broad principle also applies to the household. If earnings generated from assets drive the fortunes of a company’s owners, then they also – particularly if they are self-financed retirees – underwrite the living standards of a household’s residents.

Analysing Bruce and Kylie Ltd

Imagine that the typical (more precisely, the arithmetic mean) Australian household is a listed stock, that you possess its financial statements, and that you can buy it at a price equivalent to the overall market’s P/E ratio. Would you buy it? Short-sell it? To help answer these questions, Table 1 presents this household’s income statements since 1965. Table 2 presents its balance sheets. The figures are unadjusted (left hand side) and adjusted (RHS) for the CPI.

A Note About Sources of Data

To construct these tables, I have relied upon various data compiled by the Australian Bureau of Statistics (mostly in Table 1) and RBA (mostly in Table 2). The RBA and Commonwealth Treasury have conducted much research in this area (see in particular [The Household Balance Sheet in Australia](#)), and their findings and footnotes have provided food for my thoughts. For an American comparison to the 2005 figures, see [Financial Statement of the Average American Household](#) (*The Washington Post*, 15 December 2007).

The reuse of others' data for one's own purposes (which are seldom the intentions of the people who assembled them) usually necessitates some compromise, extrapolation and guesswork. This instance is no exception. For example, I have relied upon the ABS's Household Expenditure Survey to derive the expenditure figures in Table 1. Alas, the ABS conducted its first major survey in 1974, and so (using bits and pieces gleaned elsewhere as additional clues) I have extrapolated back to 1965 the patterns of expenditure uncovered in the 1974 survey. Similarly, the further back in time one proceeds the softer the figures become for households' holdings of stocks, bonds, managed funds and loans other than mortgages.¹

One final point about these data is absolutely fundamental. Since 1965 the Commonwealth has prodded, poked, probed, interrupted and antagonised its subjects ever more frequently and in ever more minute detail. As a result, the master possesses increasingly vast quantities of information about the servant. Make no mistake: a welfare-warfare state is necessarily a police state. An utterly charming passage from the ABS's description of its 1986 Household Expenditure Survey describes how admirably independent and insouciant Australians once were – and how shamefully compliant and docile they have become:

Official Australian involvement in household expenditure surveys can be traced back to the beginning of the [twentieth] century. In 1910-11, a survey, entitled "Inquiry into the Cost of Living in Australia," was undertaken by the (then) Commonwealth Bureau of Census and Statistics (now the Australian Bureau of Statistics). During this survey, diaries were distributed to some 1,500 volunteers who were asked to keep records of all expenditures over the twelve months from July 1910 to June 1911. Only 222 diaries were returned, which severely impaired the reliability of the results.

Because of the poor response to the 1910-11 inquiry, the Bureau undertook a further expenditure survey in 1913 which was intended to encourage a high response rate by reducing the diary-keeping requirement to four weeks. However, the response was again small, with only six percent of the 7,000 diaries returned. The next major Household Expenditure Survey was not attempted until 1974.

The ability to threaten recalcitrants with fines and gaol, which by the 1970s the ABS possessed, has presumably done wonders for its surveys' response rates.

Obviously, the problem is that Big Brother collects *any* statistics. [Sir John Cowperthwaite](#): where oh where is the Australian patriot who will carry your

¹ A complete description of the steps taken to assemble and cross-check these figures would be an academic exercise – that is, tedious and pointless. So if you have qualms about certain entries in Tables 1 and 2, investigate the issue yourself. My guess is that you'll have a devil of a time obtaining better data and more justifiable estimates.

illustrious baton? To minimise the temptation towards and the reality of state intervention, Sir John (who was Hong Kong's Financial Secretary from 1961 to 1971) urged that the British government "should abolish the Office of National Statistics." Leviathan's data, he knew, were instruments of bureaucrats' meddling in the marketplace – and the schoolhouse, bedroom and every other place where people live, work and play. He also knew these interventions would certainly do no good and probably much harm. In his [obituary](#), *The Guardian* wrote: "He refused to collect all but the most superficial statistics, believing they led the state to fiddle about remedying perceived ills, thus hindering the working of the market. This caused consternation: a Whitehall delegation was sent to find out why employment statistics were not being collected, but the Financial Secretary literally sent them back on the next plane."

Sir John's laissez-faire approach generated frequent battles with Whitehall. On one occasion, when HMG insisted that the income tax be raised, he flatly refused. In his first speech as Financial Secretary, he stated a truth that no politician can bear to hear: "In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralised decisions of a government, and certainly the harm is likely to be counteracted faster." Sir John was a formidable proponent of liberty, prosperity and peace – that is, the kind of man whom politicians revile more than any other. As Denis Healey recalled, "I always retired hurt from my encounters with the redoubtable Financial Secretary" (see also Sir John's obituary in the [Torygraph](#)).

Means and Medians

Keep closely in mind, as you peruse the figures in Table 1 and Table 2, that they are means and not medians. As you probably know, the arithmetic mean of a list of numbers is the sum of all the numbers divided by the number of items in the list. The median is the number separating the higher half of a sample (or a population or probability distribution) from the lower half. The median of a list of numbers can be found by arranging all the observations from lowest value to highest, and then finding the "middle" one (in the sense that half of the numbers are bigger and the other half are smaller). If there is an even number of observations, the median is not unique, so one conventionally takes the mean of the two middle values.

Why does this matter? Most of the figures in the tables have been drawn from highly skewed distributions. The greater the skew, the more the mean and median will differ – and hence the more the mean will depart from many people's intuitive notion of "typical" or "average." As an example, households' assets are highly skewed in the sense that many own very modest share, bond and investment property portfolios, and small numbers have enormous ones. The greater this skew, the more the distribution's mean will exceed its median. Just as not a single household comprises exactly 2.55 people and no woman has ever borne 1.8 babies, any individual

household selected at random – including yours – will likely differ significantly from the “average” one described in the tables. It would be great to have median figures, but we simply don’t, and so means must suffice. Hence we must interpret them cautiously. Given skewed data, the “average” (in the sense that most Australians conceive it) household likely earns less, owns less and owes less than the one depicted here – but some earn, own and owe considerably more.

The Declining Average Number of People per Household

On the other hand, as you peruse the figures, bear in mind that in Australia since the 1960s the number of households has increased by a mean of ca. 2.4% per year, whereas the total number of Australians has increased by ca. 1.6% per year. Hence a vital point about Australian (and American, British, Canadian and other) households: over the decades the mean number of people living together under one roof has fallen. The number of households with three or more people has grown at an ever-slower pace; conversely, the rate of growth of the number of one- and two-person households has accelerated.

Demographers have attributed these developments to factors such as the decreased propensity of older adults to live with their children and grandchildren. These things, in turn, are consequences of the welfare-warfare state’s relentless and intensifying aggression against the family.² Another factor tending to decrease the size of households is the decrease over time in the mean (and also, in this case, median) number of children per woman. Hence the rise of the two-person household. The one-person household has risen as a result of the reduced propensity to marry, the increased tendency to divorce, and the general ageing of the population (especially of women). As a result, the growing number of women who live alone has been particularly marked.

² Yes, politicians babble incessantly about the family this and the family that. The problem is that the family as an autonomous unit of decision-making is a bulwark of a free society, and hence a barrier against politicians’ evil schemes of centralised command and control. Some polities, particularly Greens, overtly despise the family; but most, such as the Liberal-National coalition and ALP, mouth weasel words and adopt a strategy of divide and conquer. They propose to shower largesse upon the family – provided that its members agree to cede their liberty, autonomy and responsibility to the state. (Family First, which seems utterly oblivious to the damage it promotes, is particularly irksome in this respect. For the sake of truth in advertising, it should change its name to Family Last or Socialism First.) Once upon a time, three generations of a family often lived under one roof, the middle generation took it for granted that it would directly support both their young and elderly kin, the elders understood that they would help to rear the young’uns – and the government, mercifully, played no role. A major and particularly sad sign of the statist times is that virtually everybody now agrees that the two elder generations will live under separate roofs, and that the state will subsidise the young and maintain many of the old. The results, of course, have been horrific. Almost ninety years after it was first published, [Socialism](#) by Ludwig von Mises remains the best analysis by far of the inevitable failure of socialism, and of its cancerous impact upon the institutions of marriage and family (see also Mises’ [Economic Calculation in the Socialist Commonwealth](#)).

Why do these things matter? All else equal (such as the propensity to earn income and accumulate assets), a decrease of the average number of people per household puts downward pressure upon the household's average income, expenditure, assets and net worth. But some important things are not equal. For example, women tend for various reasons to earn less than men, and households headed by women are growing relatively quickly. These factors place additional downward pressure upon the figures for the mean household. Much confusion (and some mischief) has resulted from insufficient cognizance of the fact that the pace of household formation in Oz has long exceeded the country's growth of population. Most importantly, when one adjusts for its declining size over the decades and compares like with like, it is clear that the mean household's income is *not* stagnating (see footnote #3). For a very recent – published on 31 December – insightful and readable summary of these points, see Thomas Sowell's new book (*Economic Facts and Fallacies*, Basic Books, 2007).

Bruce and Kylie's Income Statement

With these caveats in mind, let us consider the mean Australian household's income statement. Table 1 shows that, unadjusted for CPI, its total pre-tax income has risen from \$5,481 in 1965 to \$65,281 in 2005, and its disposable income from \$4,791 in 1965 to \$50,329 in 2005. Total pre-tax income has thus grown at a compound rate of 6.4% per year since 1965, and disposable income at a compound rate of 5.8% per year. Net of CPI (constant 2005 dollars), pre-tax income and disposable income has risen at an annual compound rate of 0.0% per year.³

Ben Graham considered that a company's earnings were stable if (1) earnings doubled during the most recent ten years, and (2) they declined by no more than 5% fewer than three times during the preceding decade. "Stability," he said in *The Intelligent Investor*, "is assessed by the trend of per share earnings over a ten-year period, compared to the average of the most recent three years. No decline represents 100% stability."

³ Again, bear in mind that over the decades the household's mean size has fallen steadily and cumulatively substantially. The table below restates the household income figures in Table 1 (in constant 2005 dollars) holding constant the size of the mean household at its 1965 level. Under this flatly unrealistic assumption, total pre-tax income net of CPI has risen at a compound rate of 1.5% per year.

	1965	1975	1985	1995	2005
Gross Wages & Salaries	\$40,864	\$60,086	\$51,957	\$51,541	\$56,796
Business, Rental and Investment Income	\$6,418	\$12,709	\$13,400	\$18,164	\$20,422
Government Pensions and Income Support	\$2,545	\$5,521	\$8,677	\$9,361	\$12,208
Total Pre-tax Income	\$49,827	\$78,316	\$74,034	\$79,066	\$89,426

By this criterion (which for reasons I won't elaborate is very severe when applied to households), in both nominal and constant (\$A in 2005) terms the pre-tax and disposable earnings of Bruce and Kylie's household have not been stable. Table 3 summarises the percentage rates of change per decade of total pre-tax income and its three components, together with total disposable income, in nominal terms. As an example, Table 1 shows that the mean household's pre-tax income increased from \$5,481 in 1965 to \$13,674 in 1975, which is an increase of 149% (see the fourth row of Table 3). Pre-tax income increased to \$29,249 in 1985, which is an increase of 114% over the decade, etc.

**Table 3: Decadal Rates of Growth of Household Income
(In Nominal \$, Expressed as %)**

	1965-75	1975-85	1985-95	1995-05
Gross Wages & Salaries	133	96	51	34
Business, Rental and Investment Income	214	139	106	37
Government Pensions and Income Support	244	256	64	59
Total Pre-tax Income	149	114	62	38
Total Disposable Income	137	102	62	35

On both pre-tax and disposable bases, the growth of household earnings has been decelerating for 40 years. Indeed, pre-tax earnings grew only one-fourth as fast in 1995-2005 as they did during 1965-75. Clearly, these rates of change are correlated with the acceleration and deceleration of the CPI. Generally speaking, income grows most quickly in nominal terms when the CPI races, and much more slowly when the CPI ambles.

**Table 4: Decadal Rates of Growth of Household Income
(In Constant 2005 \$, Expressed as %)**

	1965-75	1975-85	1985-95	1995-05
Gross Wages & Salaries	32	-20	-9	6
Business, Rental and Investment Income	78	-3	24	8
Government Pensions and Income Support	95	45	-1	25
Total Pre-tax Income	41	-13	-2	9
Total Disposable Income	35	-18	-2	6

Table 4 expresses the growth of mean household income (and its components) in constant (2005) dollars. It shows that the decade 1965-75 was in one respect a golden era: net of the CPI, which began to rage during the 1970s, household disposable income grew by one-third. Alas, in the next decade, during which the CPI continued to zoom upwards, it fell by almost one-fifth. It stagnated during the decade to 1995, and has grown by 6% in real terms during the most recent decade.

In both nominal and “real” (adjusted for CPI) terms, and over all decades, the non-wage components of mean household income have grown more quickly than the wages and salaries component. In particular, government pensions and income support have typically grown more quickly than the other sources of household income. As Table 5 shows, these non-wage components have risen from a relatively low base. In 1965, wages and salaries comprised more than 80% of mean household pre-tax income. During each subsequent decade this percentage has fallen, such that in the most recent decade it comprises slightly less than two-thirds of mean income. As a result, the other components have steadily risen. Whereas in 1965 the mean household depended very heavily upon wages and salaries, forty years later its sources of income are more diverse.

**Table 5: Components of Pre-Tax Household Income
(Expressed as %)**

	1965	1975	1985	1995	2005
Gross Wages & Salaries	82	77	70	65	63
Business, Rental and Investment Income	13	16	18	23	23
Government Pensions and Income Support	5	7	12	12	14
Total Pre-tax Income	100	100	100	100	100

According to Peter Lynch (*One Up on Wall Street*, Fireside, 1989), in order to increase its earnings a company must do one or more of five things: decrease expenses, raise the prices it charges, expand into new markets, sell more of its products to all markets, and revitalise, sell or close loss-making operations. Has the mean household followed these precepts? Not really. Since 1975, wages’ share of **total factor income** has fallen from 61% to below 53%, so it’s very hard to claim that the mean household has significantly increased the price it charges for its members’ labour. And (net of the household’s declining size) the number of hours worked per week has hardly budged, implying that the household’s members haven’t sold more of their labour services. On the other hand, by diversifying its sources of income (such as distributions from private businesses or family trusts, rent from investment real estate, interest from bonds and dividends from shares) it has, in effect, expanded into new markets.

What about cost control? The right-hand side of Table 1 itemises the expenses that have grown most and least over the decades. In real terms, the mean household's annual expenditures on clothing and footwear have fallen from \$3,073 in 1965 to \$1,837 in 2005, which is a compound rate of decrease of 1.3% per year. Net of the CPI, purchases of food, motor vehicles, petrol and transport, housing, durable household goods and electricity, gas and domestic fuel have increased at compound rates of 0.0-1.0% per year. Purchases of recreation goods and services, household services and medical and dental goods and services have increased most in real terms (i.e., at a compound rate of more than 1.0% per year).

Has the mean household restrained its expenses and thereby maintained or improved its profit margin, such that it can plough savings into investments that yield income down the track? Table 6 shows that, thanks to the government, the answer is “no.” The mean household has indeed restrained its expenditures, which comprised almost three-quarters of pre-tax income in 1965 and fell to ca. two-thirds in the next two decades. Expenses relative to income have risen since 1985, to 70% of pre-tax income in 2005, but remain below the percentage in 1965. The trouble has been the increasingly greedy hand of Leviathan: the tribute paid to overlords has almost doubled, from 13% of pre-tax income in 1965 to 23% in 2005.⁴ As a result, the mean household's “profit margin” has halved, from 13% of income in 1965 to 7% in 2005. In 1965, the mean household saved equal percentages of its pre-tax income; by 2005, it paid three times more in taxes than it saved.

**Table 6: The Mean Household's Expenses,
Taxes and Savings Rate (% of Total Pre-tax Income)**

	1965	1975	1985	1995	2005
Expenses	74	66	64	66	70
Taxes	13	17	21	21	23
Savings	13	18	14	13	7

The economic mainstream deifies the accumulation of debt and denigrates the act of saving (for a recent criticism of its myriad confusions on this matter, see [Hayek on the Paradox of Saving](#) by Robert Blumen). The truth, of course, is that debt is a form of bondage. According to Proverbs (22:7), “the borrower is servant to the lender.” The sad fact is that growing numbers of Australians no longer own houses: instead, their houses own them. They incur debt partly because they are impatient and desire

⁴ This sinister development shouldn't be remotely surprising. “If experience teaches us anything at all,” said the great H.L. Mencken in “The Politician” (*Prejudices: A Selection*, A.A. Knopf, 1924), “it teaches us this: that a good politician, under democracy, is quite as unthinkable as an honest burglar. His very existence, indeed, is a standing subversion of the public good in every rational sense. He is not one who serves the common weal; he is simply one who preys upon the commonwealth.”

the status that their income alone cannot provide. Some borrow in order to “keep up with the Joneses.” They covet what others have and want more of what they already have. Indebtedness might also reflect a certainty about the medium- and long-term future (mainstream economists babble incessantly about “consumer confidence”) that logic and evidence do not warrant. Before the Second World War, the average duration of mortgages was six years, and that of car loans seldom extended beyond one year. The borrowers and lenders of yesteryear knew something that most of us have forgotten: long-term debt exposes both debtor and creditor to the risks and vicissitudes that inhere with the passage of time.

Saving, on the other hand, is a bulwark of liberty. Household savings and investments cushion adversity. Savings finance the investments that generate the non-wage income that boosts living standards and minimises contact with (to say nothing of reliance upon) politicians and government. It’s no good to say, as does today’s mainstream, that households can simply borrow in order to finance their investments. Under a sane monetary system, like the one that existed during much of the 19th century, household A borrowed household B’s savings. Hence the borrowing that the mainstream lauds presupposed the existence of savings, and interest rates reflected the actions of borrowers and lenders of savings. And under insane monetary arrangements, which in their contemporary guise began to appear in 1913 and culminated in the early 1970s, the borrower does not borrow hard savings but rather thin air. Under these arrangements, interest rates are bastardised by politicians and bureaucrats, and credit not backed by savings sets in train a business cycle that begets the boom which causes the bust. Accordingly, from two points of view – namely the threatened liberty and the prosperity of the people who inhabit Australian households – the trends in Table 6 are disturbing.

What conclusions might a Grahamite investor draw from this analysis of the mean Australian household’s income statement? In answering this question, recall that Graham and Dodd placed little faith in projections of earnings into the future. They were downright suspicious of predictions of next year’s earnings, and rejected outright the proposition that any analyst could, with any useful degree of accuracy, predict earnings more than a year beyond the horizon. “While a trend [of earnings] shown in the past is a fact,” they said in *Security Analysis*, “a ‘future trend’ is only an assumption. The past, or even careful projections, can be seen as only a ‘rough index’ to the future.”

Warren Buffett and Charles Munger have taken an even stronger position. “I have no use whatsoever for projections or forecasts,” Buffett told attendees at Berkshire Hathaway’s AGM in 1985. “They create an illusion of apparent precision. The more meticulous they are, the more concerned you should be. We never look at projections but we care very much about, and look very deeply at, track records. If a company has a lousy track record but a very bright future, we will miss the opportunity.” Munger added that forecasts can do more harm than good. “They are put together by

people who have an interest in a particular outcome, have a subconscious bias, and [a forecast's] apparent precision makes it fallacious ... Projections in America are often a lie, although not an intentional one, but the worst kind because the forecaster often believes them himself.”

Clearly, to predict the future course of the mean Australian household's revenues and expenditures is to skate on thin ice. Equally clearly, its track record since 1965 doesn't generate much excitement. In nominal terms, earnings have grown steadily but modestly, and net of CPI they fell from 1975 to 1995. They rose from 1995 to 2005, but (thankfully) have not regained the momentum of the Whitlam Era. As a result, and reflecting the declining share of wages and rising share of corporate profits, over the entire 40 years since 1965 real household earnings have grown not at all. In other words, revenues have been somewhat variable and expenses relatively fixed. Hence earnings – that is, incomings net of outgoings – have not been stable in Graham's sense of the term. (At the individual level, of course, gyrations have likely been more pronounced and occasionally severe.)

Yes, the sources of earnings are more diverse today than they were 40 years ago; but the fastest-growing source comes from government pensions and other state sources of income support. And yes, private expenditures have been controlled, but taxes have risen rapidly and now comprise the household's single biggest expense. As a result, since 1965 its profit margin has halved, leaving less and less money to retain, invest and generate higher non-wage income down the track. “Organic growth,” in short, has become ever less able to finance the mean household's investments.

Bruce and Kylie's Balance Sheet

Speaking of investments, let us turn to the mean Australian household's balance sheet. **Table 2** shows that, unadjusted for CPI, its total assets have grown from \$18,164 in 1965 to \$586,211 in 2005, and its total liabilities from \$1,644 in 1965 to \$130,906 in 2005. The household's net worth has thus grown at an annual compound rate of 8.6% per year, from \$16,520 in 1965 to \$455,305 in 2005. Net of CPI and in constant 2005 dollars, total assets have grown from \$165,127 in 1965 to \$586,211 in 2005, and total liabilities from \$14,945 in 1965 to \$130,906 in 2005. The household's net worth has thus grown at an annual compound rate of 2.8% per year in constant dollars, from \$150,182 in 1965 to \$455,305 in 2005.

What kind and amounts of assets does the mean household own? Table 7 shows that the main residence and other residential real estate have always comprised at least 70% of its total assets. This percentage increased from 1965 to 1975, and has fallen ever since. Holdings of ready cash and deposits comprised a remarkably stable percentage – until they collapsed in 2005. Perhaps, in light of the falling interest rates and (mostly) booming real estate and financial markets of the past decade, Australians have concluded that cash is trash. “When cash holdings are exceptionally large,”

Graham said in *The Interpretation of Financial Statements*, “this factor usually deserves a favourable investment attention.” At a time when rates are rising and financial markets no longer galloping (at least in an upwards direction), it is worth asking whether the converse also applies.

**Table 7: The Composition of Household Assets
(% of Total Assets)**

	1965	1975	1985	1995	2005
Real Estate (Residence and Investment)	71	84	83	73	70
Savings and Cheque Accounts, Deposits	4	4	4	4	1
Stocks, Bonds, Managed Funds and Superannuation	20	10	10	12	16
Durable Goods, Private Businesses, Other Assets	5	2	3	11	13
Total Assets	100	100	100	100	100

The decline of stocks, bonds, etc. as a percentage of total assets between 1965 and 1975 may be a consequence of the 1970s bear market: as detailed in [Letter 72-73](#) (see in particular Figure 2), the combination of quotational loss and decrease of the purchasing power of the \$A reduced \$1 of assets in 1969 to \$0.36 in 1977. The figures for private business assets likely reflect a very skewed underlying distribution, such that most Australians own few of these assets and a small number have substantial holdings.

**Table 8: Components of Growth of
Total Household Assets (%)**

	1965-75	1975-85	1985-95	1995-05
Real Estate (Residence and Investment)	91	83	60	67
Savings and Cheque Accounts, Deposit	3	4	5	0
Stocks, Bonds, Managed Funds and Superannuation	5	10	14	20
Durable Goods, Private Businesses, Other Assets	1	3	21	13
Total	100	100	100	100

Just as residential real estate comprises the lion's share of total household assets, it also accounts for the bulk of the growth of assets from one decade to the next. Table 8 summarises the contribution of each category of asset to the growth of total assets over each decade. As an example, total assets grew from \$18,164 in 1965 to \$61,928 in 1975. That's an increase of \$43,764. Between those two points in time, holdings of real estate increased by \$39,571, and thus accounted for 91% of the growth of total assets. Although savings and deposits have consistently made a very minor contribution (and none in 1995-2005), the contribution of stocks and other investments, as well as durable goods and holdings of private business assets, has grown steadily. In combination, they accounted for 6% of the increase of total assets in 1965-1975, and 33% in 1995-2005.

Hard (tangible) assets comprise cash and land, buildings, equipment and furnishings. On that basis, and assuming that the private business category also subsumes some tangible assets, then ca. 80% of the mean household's assets are hard. But are their valuations? I recently contended (see [Letter 96-98](#)) that by late 2007 the prices of most Australian stocks, bonds and real estate had reached dangerous levels. And in January came several reports showing that Australian residential real estate is among the world's least affordable – and that prices, particularly in Adelaide, Brisbane and Melbourne, continue to rise. Residents of the Lucky Country must presently outlay 6.1 times household income in order to buy the median-priced house. In Melbourne the price-income multiple is 7.3, and in Sydney it's 8.6. Australia's fastest-growing cities boast some of the world's dearest housing. In Mandurah, WA, south of Perth, the price-income multiple is 9.5, and in Queensland it is 9.3 (Sunshine Coast) and 8.6 (Gold Coast). In a survey of 227 cities around the world cited by *The Australian*, Mandurah ranks as the 6th least-affordable, the Sunshine Coast 7th and Sydney 11th. London, which is 18th, pipped Perth, WA (19th). In contrast, Americans must presently pay an average of 3.6 times household earnings for the median-priced house, and Canadians 3.1 times (except for Vancouverites, who might just as well move to Mandurah).

Does the most recent valuation of residential real estate appearing on the mean household's balance sheet seem sensible? It's based upon market prices, as are the valuations of stocks, bonds, etc. But that's not the point. When assessing a balance sheet with a view towards establishing a hefty margin of safety, Graham did not just ask what a given asset might fetch if it were sold routinely in a normal market: he also asked what price it might receive if it were dumped into a sluggish or depressed market. Australians who believe that the price of real estate can never fall should study the figures on the right-hand side of Table 2. Presumably as a consequence of high valuations in the late 1980s and a recession in the early 1990s, between 1985 and 1995 the valuation in real terms of the mean household's real estate fell slightly.

Graham also asked what price an asset might fetch in the event of a forced sale or liquidation. Applying his insight to a household, what price might the family home

receive if it were sold in a foreclosure? How much cash could its portfolio of shares generate if the family had to dump part of it in order to meet a margin call? Clearly, the price received for assets in a distressed sale might be a fraction of original purchase price. The problem, in other words, is that assets can sometimes be soft but liabilities are usually hard (see also [Letter 60-61](#)). If so, then a reversion of asset valuations to less unreasonable levels will place downward pressure upon the mean household's net worth. Australians who think that such a thing is unthinkable should remove their rose-coloured spectacles and ask a growing numbers of Americans.

How has the mean household financed the acquisition of its assets? Judging from their profit margin, during the first several decades under examination Bruce and Kylie were likely able to finance a significant part of their balance sheet organically. During the most recent decade, however, and probably for longer, they have generated insufficient retained earnings to finance more than a small fraction of their asset-acquisition program. As a result, the mean household has become ever more dependent upon debt (see also [Mortgage Stress: Are Australian Households in a Pickle?](#)). Table 9 confirms this interpretation. It shows that the debt-to-equity ratio has risen three-fold since 1965. Total debt comprised 10% of the household's equity in 1965, and much the same percentage in 1985. It rose to 17% in 1995 and to 27% in 2005. Not only is the balance sheet's gearing increasing: the pace of this increase is accelerating.

Table 9: The Mean Household's Gearing

	1965	1975	1985	1995	2005
Total Debt to Equity (%)	10	9	12	17	27
Mortgage Debt as a Multiple of Total Disposable Income	0.28	0.39	0.60	0.87	1.98
Consumer/Other Debt as a Multiple of Total Disposable Income	0.05	0.06	0.14	0.27	0.49

The ratio of debt to disposable income has also risen increasingly rapidly. The mean household's load of mortgage debt was equivalent to 28% of its disposable income in 1965 and 198% in 2005. The load of consumer and other debt to income has risen even more quickly. (My guess is that, to the extent that households use credit cards and mortgage withdrawal loans as part-substitutes for cash, upon which they draw during the month and repay at the end of the month, these figures exaggerate the household's total indebtedness.)

A Bigger Balance Sheet Isn't Necessarily a Healthier Balance Sheet

Since roughly 1985, the mean household has relied ever more heavily upon borrowing than upon income to finance its expenditures and investments. Because debt has been so plentiful and cheap for so long, it is likely that householders have come to take it for granted, and thus to intensify their demand for the housing, household goods and other things that this credit has purchased. More recently, it is likely that escalating interest payments are negating a significant portion of the increases of income that many households have recorded during the past several years. If so, then the inexorably rising cost of debt is exerting ever stronger downward pressure upon disposable income.

Perhaps that's one reason why, by late last year, sufficient numbers of Aussies were apparently cross enough to give the insufferable socialist neocon Howard régime the boot. (Alas, they're now saddled with an unbearable socialist neocon Poindexter régime). Common sense implies that the rate of growth of debt and associated interest expense cannot forever exceed the rate of growth of income. Given their expectations about (or senses of entitlement to) the houses and household goods and services that their debt has purchased, Australians won't wean themselves from debt without incurring significant psychological and economic pain.

Many (including the Reserve Bank) acknowledge that the household's burden of debt has risen – but hasten to add that the valuation of its assets has also risen even faster, such that household's net worth has continued to rise. And they're right: since 1965 the mean household's assets has substantially exceeded its liabilities, and the margin of assets over liabilities has grown. But from the point of view of a Grahamite investor, this development isn't as rosy as the RBA and others purport. Has the valuation of total assets risen because households own a greater quantity of assets whose valuation per unit has remained constant, or because they own a relatively constant quantity of assets whose valuation per unit has increased?

A rising quantity of assets (assuming a constant propensity to produce income) begets rising investment income. But if the valuation placed upon a relatively constant quantity of assets increases, then rising prices generate rising incomes only if households are willing to play a game of hot potato with one another: A sells its house to B and uses the proceeds to buy a house from C, etc. Because the prices of houses have boomed, households must borrow ever larger amounts relative to their incomes in order to finance these purchases. Only if valuations continue to rise will households play this game – for who wants to mortgage one's life to the hilt in order to finance a stagnating or declining asset?

My guess is that the mean household has accumulated a slowly increasing quantity of ever more dearly-valued assets. Most notably, over the decades it has tended to live in one residence at a time. Yes, over the years houses have become bigger, and today's

have features and that their predecessors did not; and yes, the mean household's propensity to own a rental property is greater today than it was in 1965. But until the most recent decade these changes occurred very slowly. Hence the compound rate of growth of 9.1% per year of the mean household's holding of real estate (which has increased in nominal terms from \$12,888 in 1965 to \$413,624) is attributable largely to the increasing valuations placed upon residential real estate.⁵ Ditto the household's ownership of stocks and bonds, which are twice as dear today as they were in the 1970s. If so, then a hefty dose of leveraged speculation underlies the valuations of assets on the mean household's balance sheet.

To assert that the mean household's balance sheet is in strong shape and invulnerable to shocks because the rising valuations of assets are more than offsetting the rising burden of debt, as the RBA and its devotees do, conflates two things that Grahamites strive to distinguish: the *quantity* of assets and their *valuation*. If the principal fallacy of monetary theory and policy is the confusion of money and wealth (unlike money, wealth can't be printed), then the principal shortcoming of investment theory and practice is the conflation of an asset's price and value. On the balance sheet, assets balance liabilities and equity. But in the real world, particularly when sunshine gives way to storms, it is not the prices of assets that balance debt: it's their quantity, quality and ability to generate a reliable stream of income. The trouble is that economic sunshine can blind people. Mercifully, a storm clears the air. In its wake, we can see that rising prices of assets and levels of debt are not necessarily two sides of a healthy balance sheet: they can be two sides of a speculative coin. The risk for the mean household is that its net worth has risen primarily as a result of a debt-financed speculative mania. Valuations of assets and levels of debt rise in tandem during a boom. But they diverge during a bust: valuations fall and debts remain constant, such that net worth falls.

This is why the valuation of assets is a subjective art rather than a hard science, and the entries in balance sheets should be stress-tested and taken with a grain of salt. (That's right: there's simply no such thing as "intrinsic value.") Hence valuations are subject to sudden and significant change, and bubbles ultimately collapse. In a bull market, the debt that finances the assets and inflates the bubble grows more quickly than the assets' valuations. The maintenance of the bubble eventually requires such a great increase of debt that lenders are unwilling to extend it and borrowers are unable to afford it. More and more borrowers find themselves in difficulty, and are forced to sell; prices plateau and perhaps begin to fall; and then a flood of sellers bursts the bubble but leaves the debt largely intact – and the debtors much poorer.

⁵ In this respect, it's also worth noting that during the past decade Australia hasn't experienced a *housing* boom: it has experienced a *mortgage* boom. That is, the construction of new and improvement of old dwellings has lagged the increase of population. The bulk of the mountain of money borrowed by households has not been used to build new houses, but to inflate the prices of already-existing ones.

The fundamental point – which economists of the Austrian School know full well but seems to escape the mainstream’s attention – is that rising prices of houses, shares, etc., do not create wealth. It’s a growing quantity of productive assets, and not the inflated valuation placed upon a steady quantity of assets, that makes a household – and by extension, a nation – richer. A penny saved may be a penny earned, but it matters whether it was earned by producing more or through a rise in the price of existing financial assets. A stock or real estate market boom creates apparent wealth in the form of unrealised capital gains. But if everybody tries *en masse* to convert those gains into cash, then they don’t disappear: it merely becomes apparent that they never really existed in the first place.

In conclusion, what conclusions does a Grahamite investor draw from the preceding blizzard of numbers? Are the financial statements of the mean Australian household as strong as the RBA alleges? Yes – *but only as long as credit remains cheap and plentiful; that is, as long as central banks’ inflation-and-debt-fuelled bacchanalia continues*. The mean Aussie household’s income statement is ever less able to finance its balance sheet, but this doesn’t matter if it can easily borrow against the continuously rising price of the house. Are Bruce and Kylie’s reserves of cash and deposits adequate? I don’t think so, but this doesn’t matter as long as credit covers shortfalls. Is their debt excessive? I do think so, who cares as long as they can refinance their ever-bigger load of debt on progressively cheaper terms?

The trouble, of course, is that rates are now rising rather than falling. Further, since the turn of the year the ranks of the stock market’s bulls have thinned (but remain very numerous). How vulnerable is the household to shocks such as rising rates and stagnant asset prices? Has it become more exposed over time? I think Ric Battellino, the RBA’s Deputy Governor, is, with one exception, quite right. In his own words ([Some Observations on Financial Trends](#), 25 September 2007),

There are two issues that arise from the developments in household finances over the past decade or two. The first is that the rise in household debt has made the household sector more sensitive to changes in interest rates ... Second, the household sector is running a highly mismatched balance sheet, with assets consisting mainly of property and equities, and liabilities comprised by debt. This balance sheet structure is very effective in generating wealth [sic] during good economic times, but households need to recognise that it leaves them exposed to economic or financial shocks that cause asset values to fall and/or interest rates to rise.

Kylie and Bruce, in short, show signs that they are becoming or have become debt junkies. Yet their pusher, the RBA, might be having second thoughts about feeding their habit. Under these conditions, if Bruce and Kylie Ltd were listed on the stock exchange the Grahamite investor wouldn’t buy it, and would consider selling it if he owned it. But he probably wouldn’t have enough intestinal fortitude to short-sell it.

One Prop Weakened, the Other Two Starting to Wobble?

In the middle of 2007, most “market economists,” central bankers and other formulators of financial wisdom concurred that various ills (namely falling home prices, ructions in hitherto-obscure corners of credit markets and banks too shell-shocked to lend recklessly) might shake America’s economy. But these problems would not plunge it into recession, and stagflation was unquestionably out of the question. Their positive tone didn’t last. Beginning in September, growing numbers of forecasters (including the economists at major financial institutions such as [Goldman Sachs](#), [Lehman Bros.](#) and [Merrill Lynch](#)) began muttering about the rising chances of recession. And by 24 January, according to *The Australian*, “a full-blown, prolonged recession in America is now inescapable, with the rest of the world set to be dragged into a severe global slowdown, leading economists said in Davos.”

More obliquely, on 17 January 2008, in his [testimony](#) to the Committee on the Budget of the U.S. House of Representatives, Ben Bernanke stated that “incoming information has suggested that the baseline outlook for real activity in 2008 has worsened and that the downside risks to growth have become more pronounced.” Further, “even as the outlook for real activity has weakened, some important developments have occurred on the inflation front. Most notably, the same increase in oil prices that may be a negative influence on growth is also lifting overall consumer prices. Last year, food prices also increased exceptionally rapidly by recent standards, further boosting overall consumer price inflation. The most recent reading on overall personal consumption expenditure inflation showed that prices in November were 3.6% higher than they were a year earlier.” In plain English, economic conditions are exerting downward pressure upon GDP and upward pressure upon the CPI (see also [Between Inflation and a Hard Place](#) by Lee Hudson Teslik). Stagflation, anyone?

Like virtually all senior bureaucrats and mainstream economists, Prof Bernanke takes it for granted that, no matter the question, socialism – that is, broader and deeper intervention by an ever bigger government – is the answer. Accordingly, “the Federal Reserve has taken a number of steps to help markets return to more orderly functioning and to foster its economic objectives of maximum sustainable employment and price stability. Broadly, the Federal Reserve’s response has followed two tracks: efforts to improve market liquidity and functioning and the pursuit of our macroeconomic objectives through monetary policy.” In other words, the Fed has heaped vast quantities of corporate welfare upon banks, and stands ready to provide even more. Moreover, in order to combat a decrease in the nominal prices of assets such as houses, it has pressed the pedal of inflation even harder to the floor. So never mind what the Fed says about inflation (or, at least, what it did until very recently!). Instead, watch what it does, which is create it.

But the interventionism doesn't stop there. According to the Fed chairman,

A number of analysts have raised the possibility that fiscal policy actions might complement monetary policy in supporting economic growth over the next year or so. I agree that fiscal action could be helpful in principle, as fiscal and monetary stimulus together may provide broader support for the economy than monetary policy actions alone ... To be useful, a fiscal stimulus package should be implemented quickly and structured so that its effects on aggregate spending are felt as much as possible within the next twelve months or so.

But even *that* isn't enough. Accordingly, for the first time in a quarter-century, on 21 January the Fed pre-empted its own schedule of regular meetings and cut the federal funds rate by 0.75 percentage points. For good measure, it upped the ante with an additional 0.5 percentage points at its regularly-scheduled meeting on 30 January.

Implicit in these remarks and actions is the conviction that bureaucrats and politicians have enough competence to administer the correct dose of the appropriate medication at the right time, that they possess the discipline required to withdraw it in due course (and thus avert the addiction of the patient), and that they have enough information to avoid unwanted or harmful side-effects.⁶ Perhaps because it is such a vociferous proponent of intervention by big government on behalf of big business, *The Wall Street Journal* (24 January) is belatedly surprised, worried and not a little incensed: "the brightest minds at the Fed (whose forecasts matter) and the rest of the government didn't expect the economy to be as bad as it's turning out to be. They – like most of Wall Street – got it wrong. That isn't a communication problem; it's a forecasting blunder."

Similarly, as *The Times* (24 January) reported, "some of the world's most influential economic figures" are now affronted that the interventionist policies that they've long championed are causing so much damage:

Recriminations mounted in Davos over where the lion's share of the blame should lie for a failure to pre-empt the build-up of financial stresses that now threaten a severe world downturn. The US Federal Reserve and the IMF were singled out by expert critics as likely culprits responsible for failing to eradicate the root causes of the mounting global financial crisis and economic dangers. The Fed in particular came under withering fire from heavyweight former policy makers who charged the US central bank with fostering a series of destabilising "bubbles" in markets for assets from shares to US housing by tolerating financial excess and running a lax interest rate policy. Critics said the Fed should not have permitted runaway gains in shares, and then US house prices, which by reaching

⁶ Prof Bernanke harbours no doubt about this. "History *proves*," he said in [A Crash Course for Central Bankers](#), "that a smart central bank can protect the economy and the financial sector from the nastier side effects of a stock market collapse" (italics added). He said nothing about the track record of an overconfident or arrogant central bank.

excessive levels had encouraged US consumers to borrow and spend irresponsibly. The Fed ought to have taken pre-emptive action to quell runaway asset price booms, the critics said. It should also have spotted and stopped unsustainable “sub-prime” lending to US households with scant financial worth, they added.

When the going gets tough, influential economic figures point fingers at one another. “It is hard to give central banks a high grade over the past two years on recognition of incipient bubbles, or on their action to address them in either a regulatory or a policy sphere,” said one. “And it is hard to give them a high grade in the last six months when the bubbles have been bursting – when they have been consistently behind the curve [i.e., should have suppressed interest rates even further by creating even more inflation].” And when the sky darkens, experts babble and run to Mummy: “the thing that markets are desperate for right now is leadership, whether globally or regionally, and it seems this is lacking,” another said. “Until the markets see a lot more leadership on a proactive basis rather than a reactive basis you are going to continue to see this great anxiety and feel this frustration.”

According to these “experts,” during the past several years the Fed did things that it shouldn’t have done, and didn’t do things that it should have. If they’re sincere, then they’re telling us that the very institution which they (rightly) say has created today’s mess can somehow quickly change from reactive dunce to perceptive genius, “get in front of the curve,” “show leadership” and otherwise ride to the rescue. When, oh when, will the anointed honestly and openly confess that interventionism is socialism, that socialism never achieves its objectives and that it always produces unintended negative consequences?⁷

⁷ Australian “leaders” are equally incapable of admitting their many abject failures. “PM Calls on Best and Brightest” (*The Australian*, 4 February) is an excellent example. Poindexter announced the previous day that “1,000 of the nation’s ‘best and brightest’ would be picked to attend a two-day summit in Canberra to articulate radical solutions to the ten most pressing problems facing the nation over the next decade.” According to the PM, “what we want is for this gathering of the nation’s best and brightest to put forward options for the nation’s future.” The ideas that the government endorses “will form part of its long-term planning for 2009 and beyond.” In order to encourage debate, “the age and gender of those invited to participate would be considered to ensure ‘alternative voices’ were heard and that solutions were not predictable.”

All of this, of course, is sheer humbug. The Leviathan in Canberra will decide who are the 1,000 “best and brightest” in the land, and it will decide what they will discuss. Any sane person knows that these sock puppets will simply recite the words the government has put into their mouths (namely that the “solution” to various ills is more regulation, legislation and state expenditure – in a word, bigger government and more socialism). You heard it here first: nobody will say a word about the biggest cause of problems in this country (interventionist government), and not a whisper will be heard about its antidote (the repeal of vast amounts of regulation and legislation, and draconian cuts to government expenditure). As a summary policy towards this end, how about making voluntary the payment of all taxes and conformity to all regulations and legislation that are not directly sanctioned by the Ten Commandments? Hence the prohibitions of murder, theft and fraud remain. But tax, which is theft, is out; similarly, the welfare-warfare state, which enshrines envy as a cornerstone of policy, goes. P.J. O’Rourke (*Eat the Rich: A Treatise on Economics*, 1998) sees in the Ten Commandments “a message to

Heaven help us, George Bush and Nancy Pelosi are determined to play prominent roles in the drama. By 18 January, they had become so worried about the economy's impact upon the electoral standing of the Welfare-Warfare Party that they abandoned even the rhetoric of fiscal respectability – the reality was abandoned during the first term of the evil Franklin Roosevelt – and agreed that they would jointly devise a “fiscal stimulus package.”⁸ It matters not one bit that the American economy has already been, both monetarily and fiscally, stimulated out of its mind (see, for example, [Fiscal Follies](#) by Christopher Wesley). In order to mitigate the bursting of the internet bubble that the Fed inflated during the 1990s, in 2001-2005 it increased the dose of inflation – and thus blew bubbles in real estate, many credit markets and much of the stock market. And today, in order to alleviate the threatened collapse of real estate, stock, credit and other financial market bubbles blown by the high inflation of recent years, what does the Fed prescribe? An even stiffer dose of inflation! (Watch this revealing [YouTube](#) of the glorious Ron Paul administering a lesson in monetary economics to the hapless Blackhawk Ben. See also [The Dangerous Stimulus](#), [Paul for President](#) and [KnowBeforeYouVote.com](#).)

What do these economic trials and tribulations mean for Australians? According to most financial journalists, not much – once the unwashed come to their senses and understand what their betters tell them, namely that the prices of stocks in this

socialists, to egalitarians, to people obsessed with fairness, to [politicians] and to anybody who believes that wealth should be redistributed. And that message is clear and concise: go to Hell.”

Perhaps Poindexter's Big Day Out will make it plain to Australians that government is not reason: it is fire. Its henchmen and mascots understand only one language: manipulation, coercion and violence. This gabfest might also reveal the absurdity and bankruptcy of the Platonic conceit that the anointed know better than the benighted. “Beware intellectuals,” Paul Johnson concludes in *Intellectuals* (Harper Perennial, 1990). “Not only should they be kept well away from the levers of power, they should also be objects of particular suspicion when they seek to offer collective advice.” The danger, then, is that the 1,000 “best and brightest” whom Poindexter's minions select will be nothing more than [useful idiots](#) who expedite collectivist schemes of centralised command and control – and thereby intensify the pressure upon Australians' liberty and prosperity.

Another tell-tale sign that pompous men with feet of clay have long been ruled Australia is their use of the phrase “the best and the brightest.” It appears that polities and journalists have forgotten (or perhaps they assume that Australians don't know) that this phrase is most closely associated with a book written by [David Halberstam](#) and published in 1972. Halberstam showed that the men who planned and promoted military aggression in Vietnam were by conventional standards some of the most intelligent, well-connected and self-confident people in America. Not despite this, but because of it, the best and the brightest blindly and arrogantly led their compatriots into a bloody and disastrous defeat. Halberstam showed that any old Tom, Dick and Harry can err; but to create a real catastrophe, one that kills and otherwise afflicts millions, you need a degree from an Ivy League University. (George W. Bush, by the way, is the only U.S. President who has degrees from both Harvard and Yale. Further, Blackhawk Ben's undergraduate degree is from Harvard, and before his ascension to the Fed he was the head of the Department of Economics at Princeton.)

⁸ Like “Liberal” and “Labor” in this country, “Republican” and “Democrat” in the U.S. are for all practical purposes indistinguishable, and are merely the two wings of a single bird of prey. Helpless taxpayers are the carrion on which they feast.

country have been driven to unduly low levels. “Whatever panic possessed the market two days ago,” opined *The Australian* (24 January), “the sensible view is that Chinese demand for our commodities is not going away and now is a good time to buy into resources companies such as BHP Billiton ... Unlike the U.S., the Australian economy is not at risk of recession. Quite the opposite, with 17 years of economic growth having awakened an inflation genie and risks of interest rate rise. On days like Tuesday, fear and greed rule and the uneducated follow the mob out the door. This is different from a market where fundamentals such as company profits prevail. Inevitably, the market reverts to fundamentals and that’s the time to buy ... The first half of this year will show weakness but the second is likely to show strong upward market momentum.”⁹

But what if this confident reassurance is wrong? If American élites can suddenly realise that economic conditions in the U.S. are much weaker than they had thought, why can’t the same thing happen here? If the crazed inflationists in DC have made a hash of things, then why won’t the evil princes in Martin Place? It’s not economic growth, genuine or otherwise, that causes the CPI and interest rates to rise: it’s inflation, i.e., an increase in the supply of money not backed by savings. Hence the Fed’s prescription of yet more inflation and the suppression of rates below their free market levels is probably worse than the disease it purports to treat. Perhaps financial markets, after a long bacchanalia, *are* reverting to “the fundamentals,” and market participants are correctly bidding down the prices of stocks and bonds.

What are the consequences for investors in this country if one and perhaps two of the three props of The Great Australian Economic Consensus weaken? In a word, they’re ugly. Australians’ first line of defence is the American consumer and the U.S. Government. Bless the Americans, say the proponents of the Consensus, for they save little and spend much. And bless Uncle Sam. In particular, his central bank, proponents never tire of asserting, successfully manages the world’s reserve currency and thus (in America and other countries including Oz) helps to tame the CPI and

⁹ On 1 February, *The Australian* went further. “Investors should not panic,” it said, and added “experience shows the market will ultimately price a company according to its underlying fundamentals.” So far, so good. But then, as always, came the errors of fact and logic, the unsubstantiated assertions and *non sequiturs*. “Investors should remember the advice of Benjamin Graham. Australia’s investment fundamentals are sound. Many quality shares are trading at low PE ratios. Australia remains well-placed to profit from the continued expansion of China, even if [its] growth does retreat slightly.” A competent application of Graham’s rules-of-thumb to contemporary markets appears in [Remembering a Class Investing Theory](#) by David Leonhardt. It concludes “today, the Graham-Dodd approach produces a very different picture from the one that Wall Street has been offering. Based on average profits over the last 10 years, the P/E ratio has been hovering around 27 recently. That’s higher than it has been at any other point over the last 130 years, save the great bubbles of the 1920s and the 1990s. The stock run-up of the 1990s was so big, in other words, that the market may still not have fully worked it off.” (For an Australian application, see [Letter 96-98](#)).

encourage borrowing and consumption.¹⁰ Debt-financed consumer spending and interventionism at home and abroad, implicitly (and absurdly) asserts the Consensus, underwrites prosperity. A consumer-led recession in the U.S., particularly one that some people are beginning to suspect was aided and abetted – indeed, caused – by the Fed, would severely weaken this pillar of the Australian consensus.

The second prop of the Consensus is the alleged health of the Australian household's finances. But it depends very heavily upon the continuation of low interest rates and high and rising asset prices. Yes, house prices continue to gallop in most parts of Australia. But rates are rising and the prices of stocks no longer seem to be a sure thing. This pillar now seems to be weaker than it appeared in 2007. The American leg of the Consensus is weak, and its Australian leg might be starting to wobble. That leaves its final, Chinese, pillar. This, its boosters continue to insist, is not just immutable: it will remain so for years to come. The heads of major mining houses say so. So does the Treasurer, the IMF and bulls from Augusta to Cairns.

Much depends upon whether they're right. If many credit checks for sub-prime mortgagees in America during 2003-2007 were cursory, at least some checks occurred. And if the financial statements of the mean Australian household are fuzzy in parts and thus subject to disagreement among reasonable people, they are not fantasies. But what if lending throughout China and across all economic sectors has for years been primarily a political exercise divorced from commercial considerations? And what if the balance sheets of many Chinese enterprises – including major banks – are, despite strident claims to the contrary, essentially works of fiction? If socialism has failed in the West, why won't it in China? Let's hope that front-page headlines like "Economic Shockwave Hits China" (*The Australian*, 30 January) don't appear more frequently. Or feature articles like "China's Bubble Quivers" (*The Australian* 31 January). The risk that China turns "from a benefactor to basket case is rising ... If and when China finally stumbles ... Australia could see what has been a long-delayed downturn. And it has been so long since we've had one that [it] will hurt."

Chris Leithner

¹⁰ It goes without saying that reports like [The Dollar Crisis: Prospect and Implications](#) are discounted or ignored in Australia. Related to but distinct from this Economic Consensus is a Military and Diplomatic Consensus that is as widely and fervently held as it is illogical and bereft of evidence. Uncle Sam, the consensus insists, protects Australia against invasion from ... well, nobody, because there's not the remotest chance that anybody's going to invade. What's more, there never has been. Most notably, [during the Second World War the chief henchmen of the Empire of Japan had neither the plan, nor capacity nor intention to invade Oz](#). But never mind that: just praise Uncle Sam and welcome the close and ever-tightening military ties that bind the Commonwealth to the Leviathan in DC. Like Social Security in the U.S., the Australian Defence Force and Anzus Treaty are enormously costly burdens upon taxpayers. Yet anybody who states the obvious – namely that war is the health of the state, collective security foments conflict and that war is an entitlement program for neocons – is denounced. It's a great pity that Australians don't truly revere Washington – [George Washington's Farewell Address](#), that is (see in particular paragraphs 27-28, 30, 31-42 and 45-49).