

A dark grey rectangular button with the word "GO" in white capital letters.

[Steve Keen's Debtwatch](#)

Analysing the Global Debt Bubble

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- [Home](#)
- [About](#)
- [Charts](#)
- [eBook](#)
- [Lectures](#)
- [Models](#)
- [Podcast](#)
- [Policy](#)
- [PoolRoom](#)
- [Reports](#)
- [Research](#)

[Debtwatch 36 July 2009: It's the Deleveraging, Stupid](#)

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“Gentleman, you have come sixty days too late. The depression is over.” - Herbert Hoover, responding to a delegation requesting a public works program to help speed the recovery, June 1930

“The past may not repeat itself, but it sure does rhyme.” Mark Twain

In the last six months, the phrase “Green Shoots of Recovery” has entered the economic lexicon. It appeared to some observers that the global recession was coming to an end, while Australia itself was likely to barely feel its impact.

I would be as pleased as anyone if these “green shoots” were true harbingers of a genuine end to the economic downturn—not because I would enjoy being wrong for the sake of it, but because my expectations for the future are so bad that I’d prefer to see them not come to pass.

Unfortunately, on current data I expect that “green” is a better description of the knowledge level of those making the optimistic predictions, than of the colour of any budding economic recovery.

Of course, it could be argued to the contrary that many of those making such optimistic forecasts are highly trained professional economists, and not merely market commentators who might have a vested interest in putting a positive spin on the news.

This is true—but far from being a reason to trust these forecasts, it is yet another reason to be sceptical of them.

Almost every holder of a PhD in economics who works for a formal economic body like the Treasury, the RBA or the OECD has been deeply schooled in “neoclassical” economics, often without knowing that there is any other way of thinking about how the economy functions. They think they are simply “economists”, and anyone who objects to their analysis or models must be uneducated about economic theory.

In contrast, virtually all University Departments of Economics contain at least one economist who rejects neoclassical economics, and instead subscribes to a rival school—like Austrian, Marxian, Post Keynesian, or Evolutionary Economics.

These contrarian academic economists often disagree amongst themselves, sometimes vehemently—you couldn't get two more opposed points of view than Austrian and Marxian economics, for example—but they tend to be united in regarding neoclassical economic theory as pompous drivel.

There are probably many reasons for this dichotomy between University economics departments which almost always have a handful of dissidents, and official economics bodies like the OECD and Treasury that are almost exclusively staffed by neoclassical economists. But I suspect the main reason is tenure: universities offer it, while formal economic advisory bodies don't.

As a result, academic economists who “turn feral” and reject neoclassical economics can still teach and publish and hang on to their jobs, even if their neoclassical Department Heads wish they would go away. OECD and Treasury economists who do the same thing probably find their employment coming to an end—because they don't have tenure.

So anything published by a formal economic body like the OECD will be the product of a neoclassical economic model—and therefore, in my opinion and that of a sizable minority of academic economists, drivel (there was one exception—the [Bank of International Settlements](#) while [Bill White](#), a supporter of Hyman Minsky's “[Financial Instability Hypothesis](#)“, was its Economic Adviser).

Of course, disputes between academic economists don't matter in the real world, and most newspapers report the announcements of bodies like the OECD as statements of wisdom about the future—until, that is, a crisis like the Global Financial Crisis makes a mockery of the OECD's neoclassical fantasies.

And what a mockery. This was the OECD's forecast for the world economy in June 2007:

EDITORIAL: ACHIEVING FURTHER REBALANCING

“In its Economic Outlook last Autumn, the OECD took the view that the US slowdown was not heralding a period of worldwide economic weakness, unlike, for instance, in 2001. Rather, a “smooth” rebalancing was to be expected, with Europe taking over the baton from the United States in driving OECD growth.”

“Recent developments have broadly confirmed this prognosis. Indeed, the current economic situation is in many ways better than what we have experienced in years. Against that

background, we have stuck to the rebalancing scenario. Our central forecast remains indeed quite benign: a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies would be underpinned by strong job creation and falling unemployment.” (OECD Economic Outlook, Volume 2007/1, No. 81, June 2007, p. 7)

Yeah, right. Instead the global economy was already well into the greatest economic crisis of the last 60 years. The next two years tore the OECD's 2007 forecasts to shreds.

One might hope for some soul searching as a result of this—and hopefully some is occurring behind closed doors. But in a clear sign that the OECD hopes to see “Business as usual” restored in its modelling approach as well as the actual economy, its current Economic Outlook discusses the process of recovery from an economic crisis that it completely failed to foresee:

EDITORIAL: NEARING THE BOTTOM?

“OECD activity now looks to be approaching its nadir, following the deepest decline in post-war history. The ensuing recovery is likely to be both weak and fragile for some time. And the negative economic and social consequences of the crisis will be long-lasting. Yet, it could have been worse. Thanks to a strong economic policy effort an even darker scenario seems to have been avoided. But this is no reason for complacency; the need for determined policy action remains across a wide field of policies...”

“In summary, it looks as if the worst scenario has been avoided and that OECD economies are now nearing the bottom. Even if the subsequent recovery may be slow such an outcome is a major achievement of economic policy. But this is no time to relax — ensuring that the recovery stays on track and leads towards a long-term sustainable growth path will call for major policy efforts going forward.” (OECD Economic Outlook, Volume 2007/1, No. 81, June 2009, pp. 5 & 7)

With its utter failure to see this crisis coming, why does anyone still take the OECD seriously? Probably for the same reason that people still generally obeyed the Captain of the Titanic after it had struck the iceberg: authority counts for a lot in a crisis, even if the person in authority actually caused it.

But it's also because it takes repeated failures before someone who asserts authority is rejected—one failure alone won't do. So rather like Napoleon in exile in Elba, the OECD is still taken seriously by economic commentators—as with Peter Martin's report (“[Australia's downturn to be shorter than expected](#)“, The Age June 25th 2009):

“AUSTRALIA is set to soar out of its economic downturn sooner and more sharply than forecast in the budget, according to forecasts from the Organisation for Economic Co-operation and Development understood to have the backing of the Australian Treasury.

The OECD says the local economy should shrink 0.3 per cent this year, less than any other OECD economy and far less than the contraction of 1 per cent that underlies the forecasts in the May budget.

Next year the economy should roar back 2.4 per cent, also above budget forecasts and more than any other OECD economy apart from those recovering from collapse in 2009.

The Treasurer, Wayne Swan, greeted the forecasts released overnight in Paris as evidence Australia was “outperforming every other advanced economy in the face of the recession”.

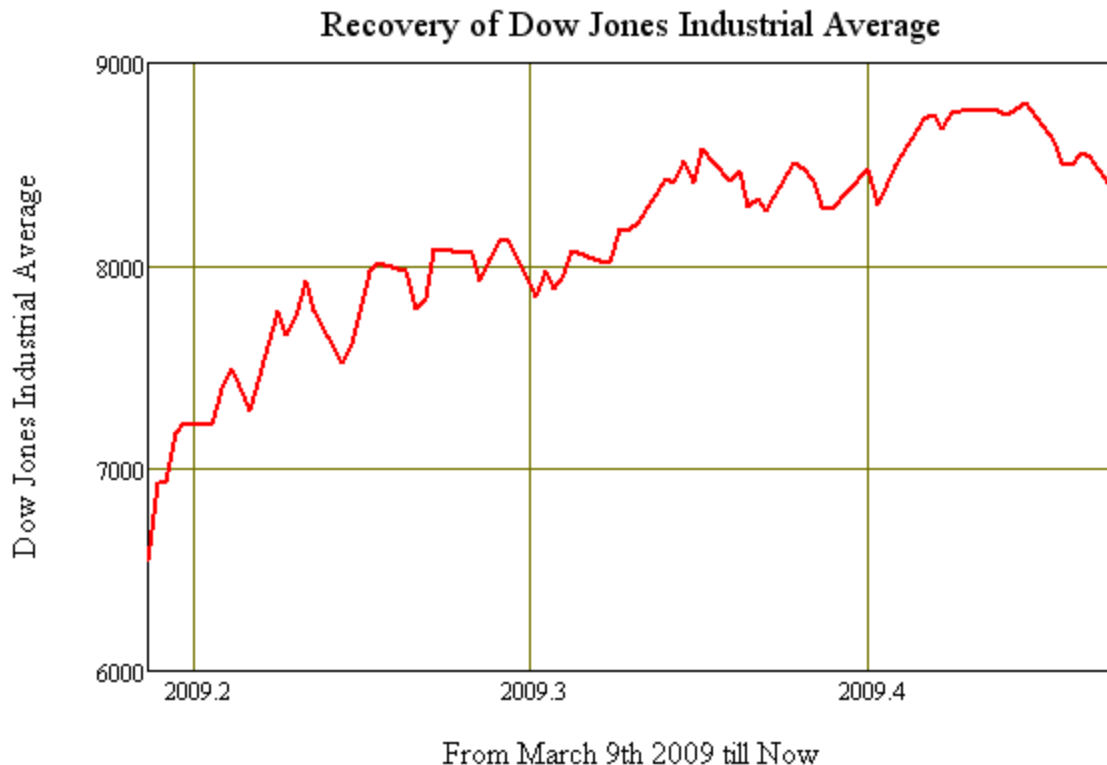
The forecasts show Australia’s unemployment rate reaching 7.9 per cent late next year rather than the 8.25 to 8.5 per cent range assumed in the budget.”

A little scepticism in this report would have been appreciated, given the OECD’s track record—and if a political journalist had written the report, that might well have occurred. But it was written by an economics correspondent, and most of them have—like the OECD’s economists—been schooled only in neoclassical economics, and don’t know how flimsy the theory itself is (there are exceptions here, like Brian Tookey whose book [Tumbling Dice](#) is an excellent critique of neoclassical economics). So we get a report like this trumpeting good times and green shoots, with no irony (Peter Martin was far from the only one to present the OECD’s views without any scepticism—see also “[Earth-destroying bomb defused – just](#)” by Michael Pascoe or Glenn Dyer at Crikey “[That’ s no green shoot, that’ s Australia in full bloom: OECD](#)”).

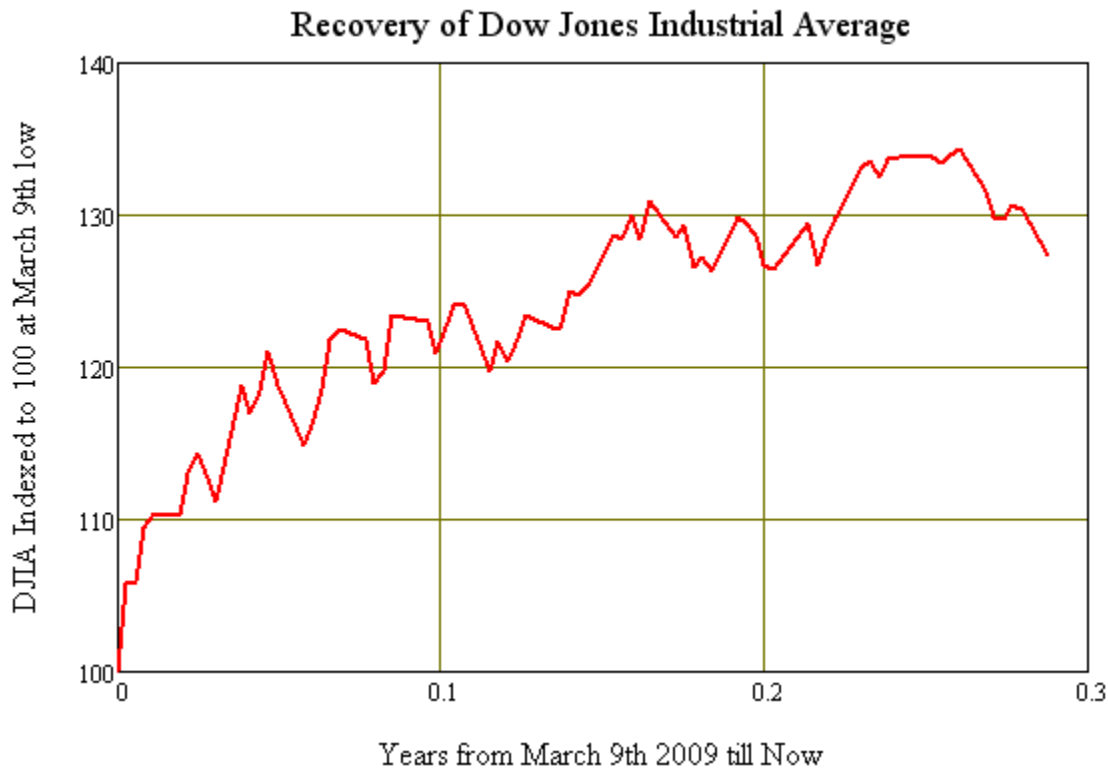
Clearly it will take a few more predictive and policy failures before economic journalists realise that with the global financial crisis, neoclassical economics—and hence the OECD—is facing its intellectual Waterloo.

To be fair, official economic bodies and their uncritical fans were not the only source of “green shoot” euphoria. A large part of this feeling that the worst was over also came from the global experience of a recovery in stock markets from their recent lows.

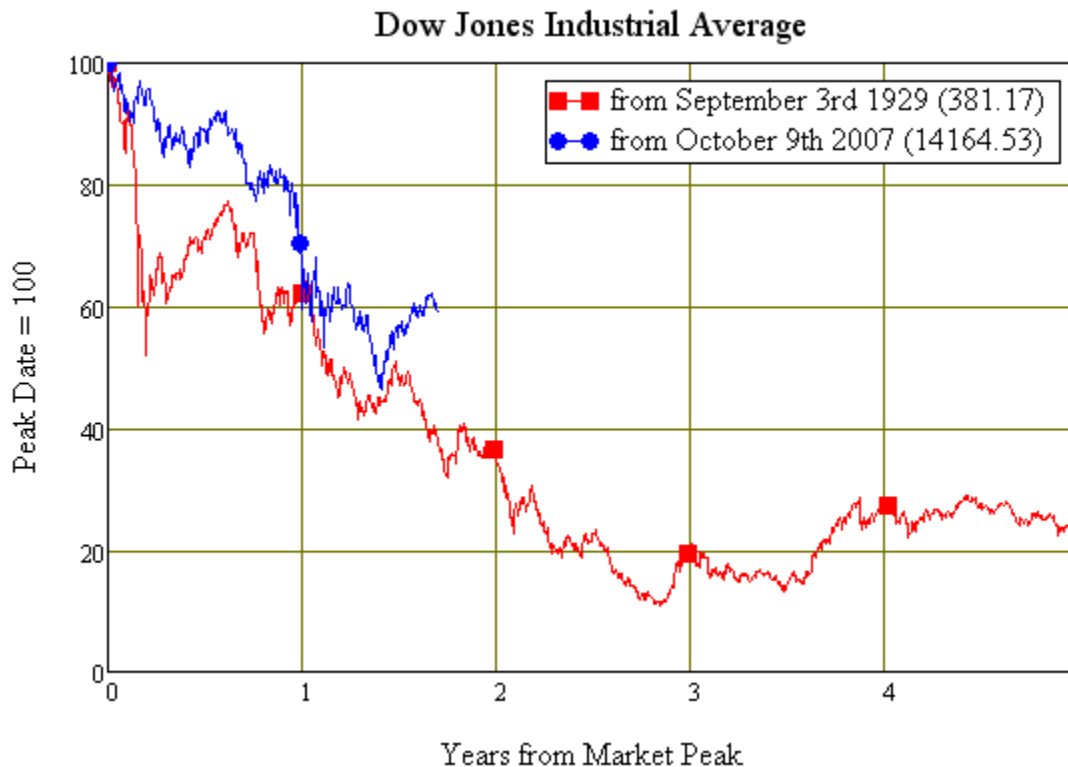
The Dow has indeed had an impressive rally, from the low of 6547 on March 9 to the peak of 8799 on June 12—a rise of 34% in under a quarter of a year. This has led to many of the usual suspects proclaiming that the bear market is over, and a new rally is underway. Comparisons with 1929 are, of course, unjustified...



On closer inspection, reports of the death of the bear market are somewhat exaggerated.

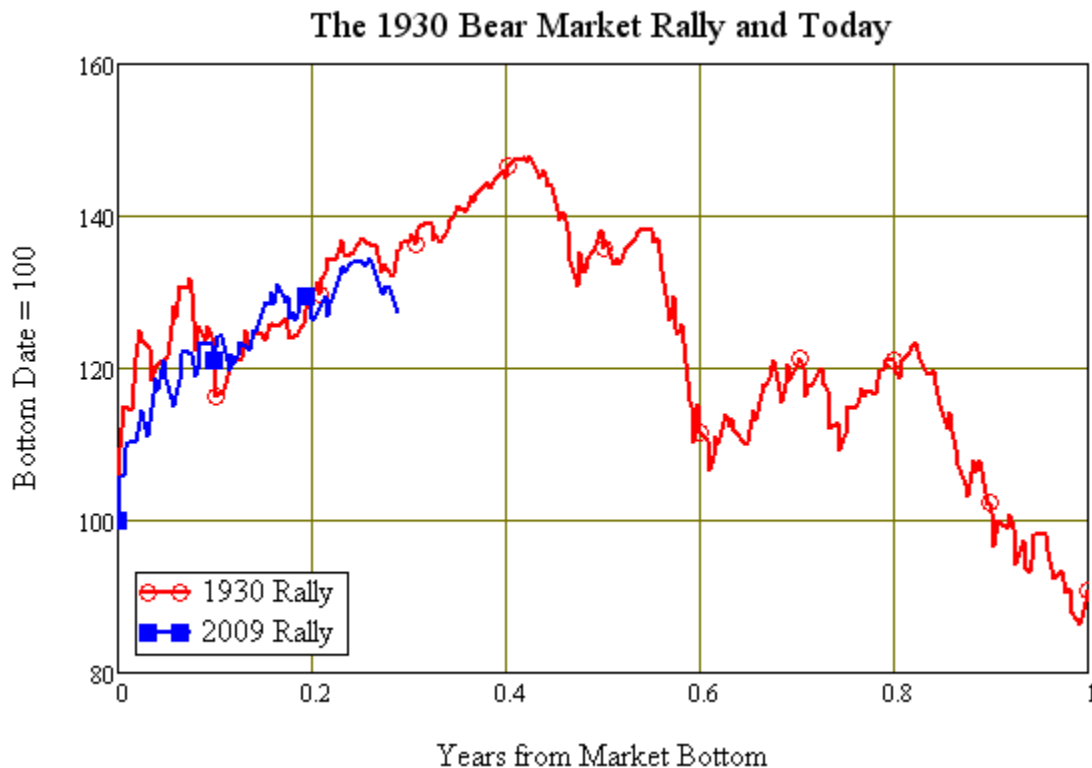


Firstly, though the index has rallied by 34% from its low, it is still down 40% from the all time peak of October 2007.



Secondly, rallies like this came and went ad nauseam in the early 1930s, until the market hit rock bottom at 41.22 points on July 8th 1932—89% below the September 3rd 1929 peak of 381.17.

The biggest such rally occurred very soon after The Crash in 1929, starting on November 13th 1929 when the market was down 48% from its September peak. It then rose almost 50% from its low in under 6 months—and it was this recovery that inspired Hoover's Oval Office gaffe.



But the market had only recovered half of what it had lost when the rally ran out of steam—a 50% fall followed by a 50% recovery still leaves you 25% below where you started from—and the inexorable slide of the Great Depression dragged the market down with it.

This current rally took a lot longer to start than its 1929 cousin, though it began from a comparable bottom (55% below the peak versus 48% below it in 1929), and it still has to go on for much longer and drive the market much higher to match its antecedent—let alone to proclaim the 2007 Bear Market is over (note also that Eichengreen and O'Rourke, using global data, argue that the current decline is far worse than in the Great Depression, with global markets down 50% on average 12 months after the crisis versus just 10% down after 1929—see Figure 2 [here](#)).

Meanwhile, in the Real World...

Though the stock market was providing some good cheer in the USA (at least until last week), the real economy continued to disappoint. To get an idea of just how bad the downturn has been, and how little inkling of it that conventional economists had, consider the Economic Report of the President, prepared by the US President's [Council of Economic Advisers](#), in [2008](#) and [2009](#).

The 2008 Report made the following forecasts—note in particular the “forecast” that unemployment would be below 5 percent between 2008 and 2013.

Year	Nominal GDP	Real GDP (chain-type)	GDP price index (chain-type)	Consumer price index (CPI-U)	Unemployment rate (percent)	Interest rate, 91-day Treasury bills ² (percent)	Interest rate, 10-year Treasury notes (percent)	Nonfarm payroll employment (average monthly change, Q4-to-Q4, thousands)
	Percent change, Q4-to-Q4				Level, calendar year			
2006 (actual).....	5.4	2.6	2.7	1.9	4.6	4.7	4.8	192
2007.....	5.1	2.7	2.3	3.9	4.6	4.4	4.7	129
2008.....	4.8	2.7	2.0	2.1	4.9	3.7	4.6	109
2009.....	5.1	3.0	2.0	2.2	4.9	3.8	4.9	129
2010.....	5.0	3.0	2.0	2.3	4.8	4.0	5.1	118
2011.....	5.0	2.9	2.0	2.3	4.8	4.1	5.2	112
2012.....	4.9	2.8	2.0	2.3	4.8	4.1	5.3	102
2013.....	4.9	2.8	2.0	2.3	4.8	4.1	5.3	92

The 2009 Report, submitted to Congress and the incoming President in January of this year, made a mockery of the 2008 Report but still drastically underestimated the severity of the downturn: it forecast that unemployment would peak at 7.7% in 2009, growth would remain positive for the next five years.

Year	Nominal GDP	Real GDP (chain-type)	GDP price index (chain-type)	Consumer price index (CPI-U)	Unemployment rate (percent)	Interest rate, 91-day Treasury bills ² (percent)	Interest rate, 10-year Treasury notes (percent)	Nonfarm payroll employment (average monthly change, Q4-to-Q4, thousands ³)
	Percent change, Q4-to-Q4				Level, calendar year			
2007 (actual).....	4.9	2.3	2.6	4.0	4.6	4.4	4.6	104
2008.....	2.4	-0.2	2.5	2.8	5.7	1.4	3.8	-114
2009.....	2.2	0.6	1.7	1.7	7.7	0.7	4.2	-235
2010.....	6.6	5.0	1.5	1.7	6.9	2.0	4.6	222
2011.....	6.5	5.0	1.5	1.8	5.8	3.5	4.9	269
2012.....	5.1	3.4	1.6	1.9	5.0	3.9	5.1	261
2013.....	4.5	2.7	1.7	2.0	5.0	3.9	5.1	121
2014.....	4.5	2.7	1.8	2.1	5.0	3.9	5.1	115

Despite the frequency with which numerous economists who failed to anticipate the Global Financial Crisis continue to report sightings of “green shoots of recovery”, the actual economic data continued to be grimmer than even their most pessimistic revised forecasts.

The clearest evidence here is that the Federal Reserve’s “stress tests” for its Supervisory Capital Assessment Program assumed that even under an adverse scenario, unemployment would be below 9 percent by mid-2009. [It is currently 9.4 percent](#). The [tapering process](#) that is built into neoclassical economic forecasts is not evident in the data to date.

Deleveraging and Economic Breakdown

The reason that most economists continue to underestimate this downturn is because (a) the downturn is being driven by deleveraging from literally unprecedented levels of private debt, and (b) the neoclassical theory of economics, which dominates academic and market economics alike, ignores the role of private debt in the economy.

The reason that I anticipated this crisis four years ago is that I reject the mainstream “neoclassical” approach to economics, and instead analyse the economy from the perspective of Hyman Minsky’s “Financial Instability Hypothesis”, in which private debt plays a crucial role. In our credit-driven economy, demand is the sum of GDP plus the change in debt. If debt is low relative to GDP, then its contribution to demand is relatively unimportant; but if debt becomes large relative to demand, then changes in debt can become THE determinant of aggregate demand, and hence of unemployment.

That is manifestly the case in America today. Under the stewardship of neoclassical economics in the personas of Alan Greenspan and Ben Bernanke, the growth in private debt has not merely been ignored but has actively been encouraged, in the dangerously naive belief that the private sector is being “rational” when it borrows.

This apparent indictment of the private sector as therefore “irrational” is in fact really an indictment of neoclassical economics for abuse of language. What neoclassical theory means by the word “rational” is “able to correctly anticipate the future”—which is the definition, not of rationality, but of prophecy.

There is nothing “irrational” about being unable to predict the future—it is fundamentally uncertain, while modern economic theory hides from this reality just as Keynes’s contemporary economic rivals did in the 1930s when he wrote that:

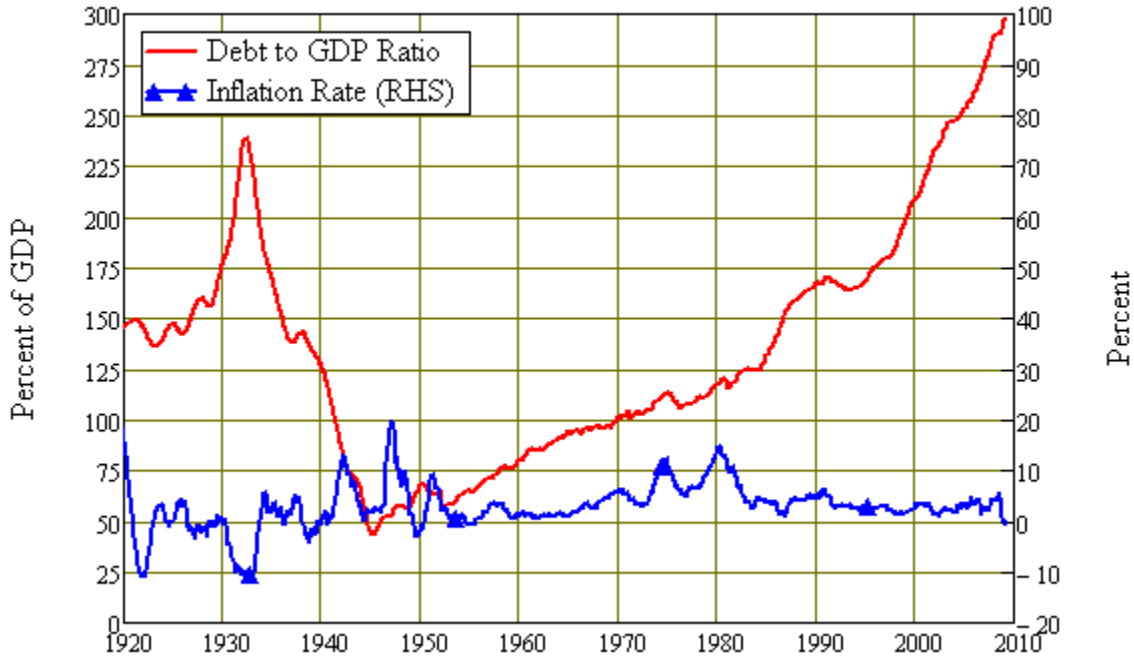
“I accuse the classical economic theory of being itself one of these pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future.” (Keynes, “The General Theory of Employment”, Quarterly Journal of Economics 1937)

Instead, in the uncertain world in which we live, the private sector necessarily speculates about the future—and some of those speculations will be wrong. The role of regulation and government economic policy should be to confine those speculations, as much as is possible, to productive pursuits rather than gambles about the future path of asset prices—a pastime that has always in the past led to Ponzi asset bubbles.

This time, with government policy driven by neoclassical economics and its deluded attitudes towards the future, policy has actually encouraged the private sector to borrow to indulge in two giant Ponzi Schemes—the stock market and (belatedly) the housing market. It has gambled with borrowed money that share and house prices would always rise faster than consumer prices.

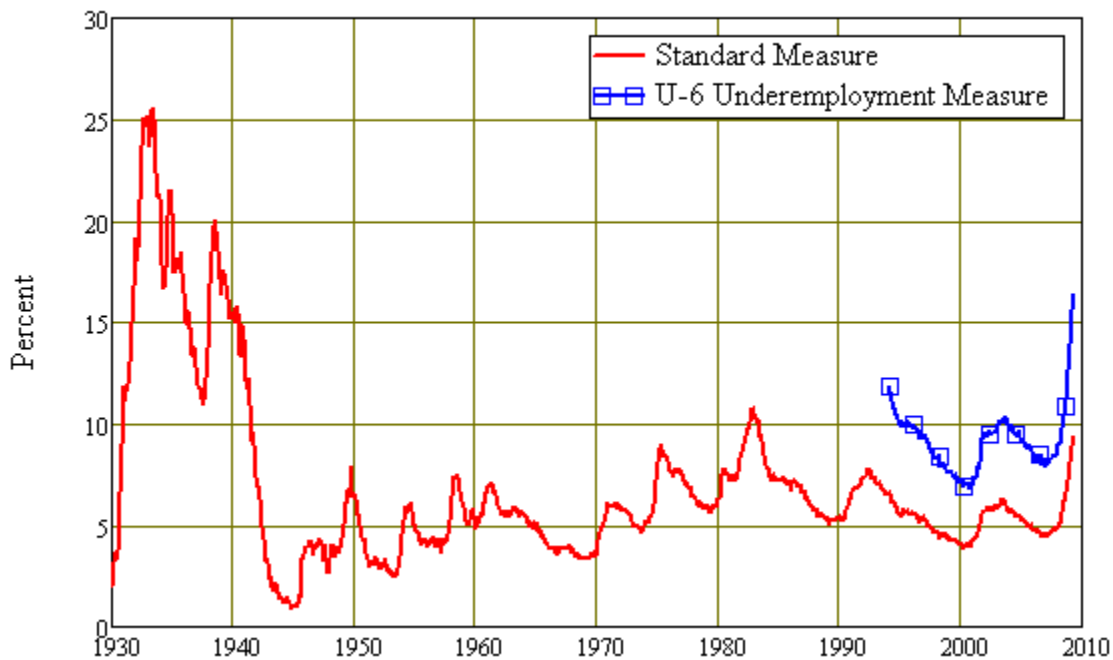
That gamble worked for some decades, but it then failed—in **1987-89**. Had the Greenspan Fed not intervened then to “rescue” Wall Street, there is every possibility that the US would have experienced a mild Depression then—mild because the level of debt was lower then than at the time of the Great Depression (165% in 1989 versus 175% in 1929), and crucially because the rate of inflation then was high (5% in 1989 versus 0.5% in 1929).

US Private Debt and Inflation



The lower level of debt would have meant that less deleveraging would have been required to return to a predominantly income-financed economy in 1989 than was required in the 1930s, while high inflation would have meant a lower likelihood of deflation during the Depression itself, and possibly that inflation alone could have eroded the debt burden. It still would not have been pretty—certainly it would have been worse than the 1983 recession, when unemployment as it is currently defined peaked at 10.8 percent.

USA Unemployment

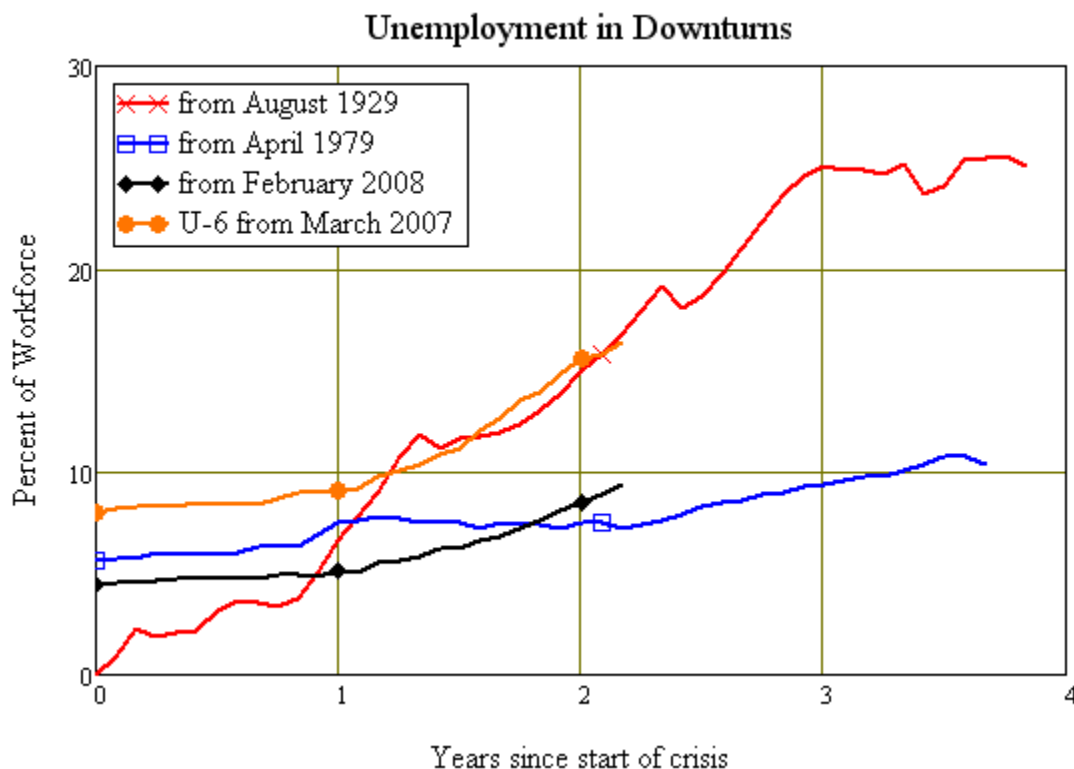


But what we face now will be far worse, because deleveraging from the now unprecedented debt level of almost 300% of GDP will drive America into a Depression that could easily be deeper than that of the 1930s.

This is already becoming apparent in the data, as economic historians Barry Eichengreen and Kevin O' Rourke point out in "[A Tale of Two Depressions](#)":

“To sum up, globally we are tracking or doing even worse than the Great Depression, whether the metric is industrial production, exports or equity valuations. Focusing on the US causes one to minimise this alarming fact. The “Great Recession” label may turn out to be too optimistic. This is a Depression-sized event.”

The comparison of unemployment rates (which Eichengreen and O' Rourke didn't make) bear this out: using the current OECD definition of unemployment, this downturn is well ahead of the 1979 recession even though unemployment started from a lower level; and using the much broader [U-6 definition](#), which is more strictly comparable to the NBER definition used during the Great Depression, unemployment now is as bad as at the same stage of the Great Depression, and increasing as rapidly.



Deleveraging is already extreme: the most recent flow of funds data shows that private debt is falling rapidly and therefore subtracting from aggregate demand rather than adding to it. As noted in earlier Debtwatch Reports, in the modern debt-dependent economy, changes in the demand financed by changes in private debt are strongly negatively correlated with the unemployment: when debt's contribution to demand falls, unemployment rises.

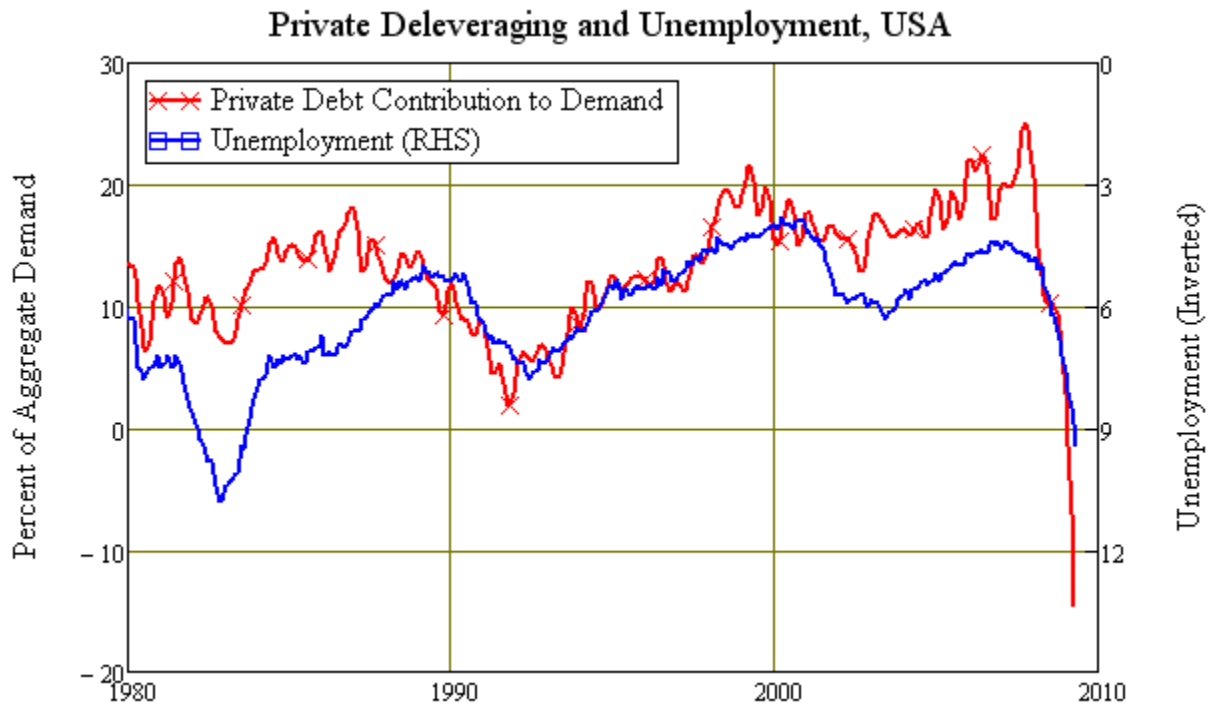
The turnaround in debt growth in the USA is unprecedented in the post-WWII period. Even during the 1980s and 1990s recessions, debt continued to grow both in nominal terms and as a percentage of

GDP. Now debt is falling at a rate of almost US\$2 Trillion a year (which equates to 14 percent of GDP).



This is why the crisis exists, is so much worse than the official economic forecasters expected, and will continue and be much deeper than they currently believe: the crisis is being driven by deleveraging, and neoclassical economists do not even include private debt in their models.

As noted in earlier Debtwatch Reports, there is a very strong link between the rate of growth of debt and unemployment: when debt grows more quickly, unemployment falls; when debt grows slowly or falls, unemployment rises.



This is not because debt is a good thing, but because our economies have become so debt-dependent that changes in debt now have a far stronger influence on economic activity than do changes in GDP.

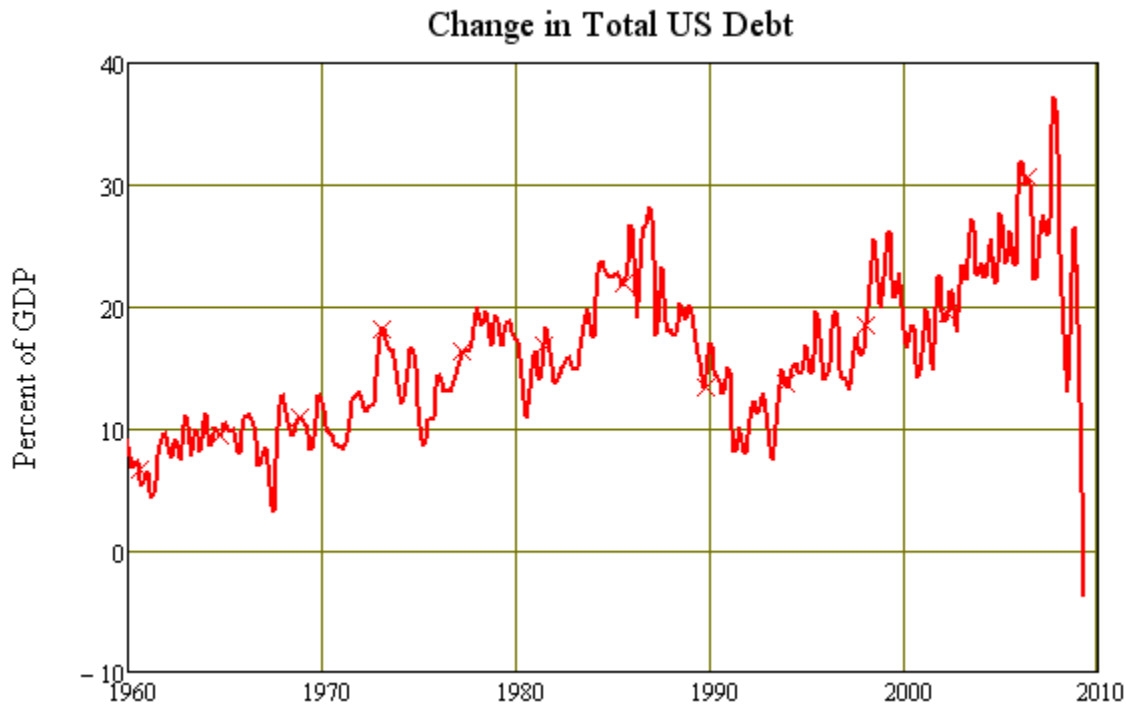
The US Government is attempting to “pump-prime” its way out of trouble by public-debt-financed deficit spending, which raises 4 further issues:

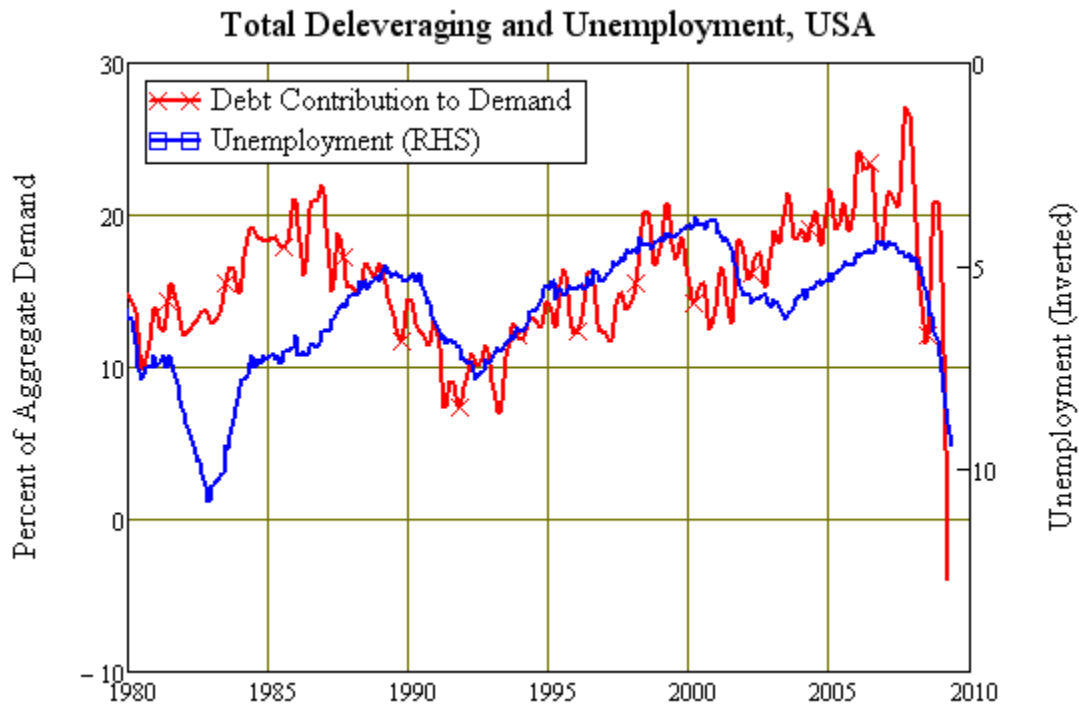
1. this so-called Keynesian remedy can work when private debt levels are relatively low, and government policy to attenuate private speculation is strictly adhered to (see my 1995 paper Finance and Economic Breakdown);
2. however, in our rampantly speculative economies, this policy has only worked when it has re-started the private debt binge, resulting in rising debt levels over time;
3. this can't happen this time around, because all sectors of the private economy—businesses both real and financial, and households—are already debt-saturated. There is no “greenfields” group to lend to, as was possible in 1990 when household debt was a “mere” 60% of GDP, and the derivatives market in finance had yet to explode; and finally
4. the scale of the private debt bubble is just too big to be countered by substituting public debt for private debt.

This last point is evident in the data. Even though the US government has thrown the proverbial kitchen sink at government spending, the increase in public debt (which adds to aggregate demand) is more than counteracted by private sector deleveraging (which subtracts from aggregate demand):



Total US Debt is therefore falling. Though in the long run this is a good thing—we must return to a non-debt-dependent economy and once we have gotten there, stay there—the transition will be as pleasant as Cold Turkey is for a heroin addict.





115 users responded in " Debtwatch 36 July 2009: It's the Deleveraging, Stupid "

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The webpage cannot be found

Stats Watcher said, in July 4th, 2009 at 6:25 pm

Hi Steve

Another great (and disturbing) post on deflation and debt.

At least people here know where we are heading.

Even mainstream like Yahoo Finance are now starting to pick up on the problem.

<http://finance.yahoo.com/news/MOUNTAIN-OF-DEBT-Rising-debt-apf-3665768070.html?x=0&sec=topStories&pos=main&asset=&cocode=>

ken said, in July 4th, 2009 at 6:33 pm

I had some naive idea that growth estimates were estimates, the sort of things generated by models that looked at the economic parameters, used some differential equations and predicted forward. Seems like what an engineer would try to do. Maybe you can't project too far into the future but the

models can be refined, and they might actually suggest some ways in which economic activity can be encouraged. Making them up appears a lot easier but a lot less useful.

Michael Pascoe should be moved to the humour sections.

roovis said, in July 4th, 2009 at 7:18 pm

Dear Steve,

Thought I would like to be the first one to congratulate you on your gold medal 😊 .

<http://www.businessday.com.au/business/for-predicting-the-slump-just-a-few-get-medals-20090703-d7vr.html>

It is just deserved, now they better mint and issue it soon one will hope. For the silver and bronze, maybe is should rather not have been awarded this year.

gordon said, in July 4th, 2009 at 7:26 pm

Steve,

This must be one of the most important papers that you have written – at least in presenting your analyses to a lay audience. The prognosis is absolutely terrifying.

Yet, if you are wrong, no-one will unduly suffer anything more than a small loss of income from being too cautious.

On the other hand – if, as I believe, you are correct – then millions of Australians will be suckered into losing their chances of a comfortable retirement (through devastating losses in the casino stock market) and many, many young people risk becoming debt slaves for life by buying property at precisely the wrong time.

I do feel that it is incumbent upon you to get this work published in major media outlets or, at least, to submit it in a public way (such as declaring your submission on this forum) to ensure that future apologists cannot claim that they had no idea.

Enjoy the rest of your trip in Europe then get to work when you return.

roylefamily said, in July 4th, 2009 at 8:15 pm

I can offer a little empirical evidence of the state of the Australian job market. I took a year off to have fun and have just re-entered the work force. The upshot, I'm working in a lesser role than I am qualified for at 2/3 my previous pay. Applicants to positions at my level number 50 to 60 (Tech Officer Electronics 20 years in the game). The last job received applicants from all over Australia the Pacific and South Asia. Applicants included PhD engineers and University lecturers!

As you can imagine I am very bearish.

tata1 said, in July 4th, 2009 at 8:30 pm

Could this be the solution to to the global Financial Crisis? (from Global view)

In a small town on the South Coast of France, holiday season is in full swing, but it is raining so there is not too much business happening. Everyone is heavily in debt.

Luckily, a rich Russian tourist arrives in the foyer of the small local hotel. He asks for a room and puts a Euro100 note on the reception counter, takes a key and goes to inspect the room located up the stairs on the third floor.

The hotel owner takes the banknote in a hurry and rushes to his meat supplier to whom he owes €100. The butcher takes the money and races to his supplier to pay his debt.

The wholesaler rushes to the farmer to pay €100 for pigs he purchased some time ago.

The farmer triumphantly gives the €100 note to a local prostitute who gave him her services on credit.

The prostitute goes quickly to the hotel, as she was owing the hotel for her hourly room use to entertain clients.

At that moment, the rich Russian is coming down to reception and informs the hotel owner that the proposed room is unsatisfactory and takes his €100 back and departs.

There was no profit or income. But everyone no longer has any debt and the small townspeople look optimistically towards their future.

ak said, in July 4th, 2009 at 9:16 pm

tata1,

This won't work because there are people who are net debtors and there are people who are net creditors.

roovis said, in July 4th, 2009 at 9:58 pm

Max Keiser at it again (4 part series). I don't think there was a link to this posted before. Some interesting comments from Obama's economic campaign adviser. The rest was quite funny I thought.

<http://www.youtube.com/watch?v=OTrcOMZLb2Q&NR=1>

roovis said, in July 4th, 2009 at 10:16 pm

O No, Property prices do not double very year 😞

See Justin Fox author of The myth of the rational market on the Jon Daily show.

<http://www.thedailyshow.com/video/index.jhtml?videoId=232247&title=Justin-Fox>

clive said, in July 4th, 2009 at 10:30 pm

This may be of interest to some. It's the level of debt of the US state by state. Updated June 2009. No wonder California is handing out IOU's

State Budget Troubles Worsen

<http://www.debtdeflation.com/blogs/2009/07/04/debtwatch-36-july-2009-its-the-deleveraging-stupid/#comment-12308>

What I find amazing is that if 10 months ago you had have said to the very people running around saying 'it's all over', , that GM and Chrysler would be bankrupt, Iceland, Possibly Ireland, that BA would be asking employees to work for nothing that California would be handing out IOU's they would have had you certified.

This link: http://futronics.blogspot.com/2009_07_01_archive.html

A trader who believes that the current rally on the markets is just being maintained by the banksters buying each other.

“It is a classic example of a ponzi scheme. Goldman sells to Morgan for \$1, Morgan sells to Merrill (BAC) for \$2, Merrill sells to Citi for \$3, Citi sells back to Goldman for \$4. They all show a profit – until, of course, Goldman can't find a greater fool to pay \$5 and the whole thing collapses. And it will collapse. The only question is when.”

Sound Familiar?

And this interview with Joseph Stiglitz basically saying what Michael Hudson has been saying has been going on with all the tarp money and the cover ups.

<http://www.youtube.com/watch?v=tQRKB7IyfTw>

Steve may have the Economic Gold for last financial. As mentioned above, I wouldn't banking on the organisers paying up this time next year.

hbl said, in July 5th, 2009 at 1:33 am

Steve,

Thanks for another great debtwatch report, as always!

My questions, in case you are willing to address any of them, are:

1. Do you know why in the [Fed Flow of Funds report](#) the “D.2 Borrowing” figures show borrowing contracting (as you have shown) yet “D.3 Debt Outstanding” shows total debt still growing as of Q1 2009? Since I can't find definitions the only explanation I can think of is possibly off-balance sheet debt returning to balance sheets and adding to D.3 numbers (without reflecting an actual increase in debt).
2. Do you have any sense for at what point the rate of debt reduction (currently near US\$2 trillion per year and increasing fast in your graphs) might stabilize (or reverse)? Do you have any data for this during the Great Depression?
3. Will this point (when rate of debt reduction stops increasing) reflect the worst stage of the crisis, after which things should very slowly start to improve? (Social outcomes of the crisis aside.)
4. Would a flat level of debt contribution to demand (let's say stabilized at negative US\$4 trillion per year) imply that change in unemployment level and change in GDP might both potentially stabilize as well (in rough terms)?
5. Do you think there is any way for policy response to reduce the peak rate of debt reduction even if debt reduction will take longer as a result, other than by adding to public debt, and if so, do you have any ideas for how? (Clearly additions to public debt have so far slowed the change in total US debt but I understand you do not expect this to solve anything).

Joe B said, in July 5th, 2009 at 3:03 am

I have a few problems with the relation: Demand = GDP + Change in debt

1. GDP is heavily manipulated (see http://www.shadowstats.com/article/gross_domestic_product). That “Australia dodged a recession” headline was hilarious.

2. Change in debt includes compounded interest, which does not represent additional demand – in fact it probably reduces demand since someone with such an increasing debt burden would (or at least should) demand cash over other goods to deleverage.

3. Change in debt could include money used towards GDP, which means that some amounts would be counted twice. If I borrow \$10 to buy a sandwich, then debt increases by \$10, as does the “Consumption” component of GDP. However, demand would increase by \$20 according to this relation. This is wrong.

4. Expanding this, if I borrow \$10, lend it to my brother, he lends it to his friend, who buys a sandwich, then \$30 of debt has been created, but only \$10 of actual demand (new money), which is already accounted for in GDP. The relation above would show \$40 of demand.

I'm not saying that change in debt has no role in demand – especially since many asset transactions aren't included in GDP. But I think this relation is oversimplified and the magnitude is overstated.

Gary North, an Austrian school economist/historian, is absolutely convinced that inflation, and probably hyperinflation, is inevitable in the US. His primary reason for this is that the Fed has only just begun creating new money, and will continue monetizing assets at an increasing pace as the economy worsens.

There is no reason why this couldn't be expanded to include stocks, corporate bonds, etc. held by every Joe Shmoe. Hong Kong did it in the 1998, got damn lucky, and turned a nice profit (http://en.wikipedia.org/wiki/Asian_crisis#Hong_Kong). I don't think that kind of luck is floating around today, especially for the biggest debtor nation in history, but this doesn't mean they won't try. Hubris is rampant. This is the textbook path to hyperinflation.

North also thinks that banks will have no choice but to lend, especially as their assets/liabilities ratios continue to decrease due to deleveraging, defaults, and increased savings. Lending and bailouts are the two processes by which banks stay in business. If the bailouts stop, the banks must eventually lend. If the bailouts continue, that means more money printing. Both scenarios are inflationary, especially if the banks use the bailouts to buy assets.

He doesn't count out deleveraging, but sees it as a temporary phenomenon that will end at some point. When it does, all of that monetary inflation will make its way out into the real world. I think this pretty much sums up the Austrian position on the deflationary spiral.

“Ten Questions for Deflationists”

<http://www.garynorth.com/public/5119.cfm> – This is a bit of a polemic, but he explains his thoughts clearly.

Personally, I'm expecting more price deflation (stock market crashes) before any lasting inflation occurs. In fact I think one factor that could make the next crash worse is that we have a precedent this time. The bears can point to 1932 as the charts here show, and any further bear market rallies will have trouble gaining and holding support. As the venerable Bush quipped, “Fool me once... fool you... uh... won't get fooled again.”

However, if the Fed wants to maintain current nominal price levels (and inflate away US Sovereign debt), they have the means to do it. The question is whether they will have the means to undo it.

Searching Analyst said, in July 5th, 2009 at 3:36 am

Steve

I want to thank you for educating me on the prevailing global bias in economic doctrine. For more than 20 years I analyzed equity markets but neglected to invest time to understand macroeconomics as I ought to have.

I've been following your posts for several months and reviewing the evolution of your commentary over a longer period.

The strength and credibility of your analysis leaves this reader intensely interested in your economic projections for the next 5 to 10 years. Perhaps I've missed it, but have you published a forecast for the timing and level of the trough in US and global GDP? What is your forecast for the trajectory of US and global GDP from the trough? When do you forecast US unemployment to peak, and at what level as defined by the official stats?

In any event, all power to you, and I will look forward to your future commentary.

[cscok](#) said, in July 5th, 2009 at 6:11 am

Very disturbing article.

Can you please explain why countries don't take what is the "obvious" solution.

Problem – too much debt created through Ponzi like banking practices.

This would not matter if debt was not equated to money. That is as the debt bubble deflates so the supply of money contracts. That is, we have a system where to increase the money supply we increase debt. When the money supply contracts so economic activity decreases. However, creating more money through more debt does nothing to decrease the need for deflation.

Solution – Break the nexus between debt and money. Find a way to increase the money supply without increasing debt and in a way that does not increase inflation.

Implementation – Give everyone in society some new money but require them to invest it in ways to increase goods and services.

Another problem – Global warming.

Solution – Massive investment in ways to reduce green house gases.

Implementation – Give everyone in society some new money but require them to invest it in ways to reduce greenhous gases.

[cscok](#) said, in July 5th, 2009 at 7:12 am

In the very interesting (entertaining) Justin Fox interview mentioned above, amongst other things he stated.

1. Simple regulation is needed.
2. We came out of the 30's depression with a world war.

I agree that simple regulation is needed. If it is too complicated it will not work very well. I disagree that we need to have a war to find something on which to spend money.

Remove the regulation that allows banks to lend money they do not already have. That is, unless a bank has money on deposit it cannot lend money (remove fractional reserve banking). So this can now be the simple regulation which most people thought happened anyway. Banks cannot lend money unless they have it to lend.

This then begs the question where does the money come from to be lent? Well as people pay back loans then money will be deposited in the bank and we can increase the money supply by GIVING people money to invest in ways of producing more goods and services. <http://tinyurl.com/lmyk8m>

There is no need to stimulate spending by building things to blow up other productive assets. We can increase production by ensuring that the newly printed money that was given – not loaned – adds to productive capacity rather than decreasing it.

Some say giving money away will increase inflation. Of course it would if we just printed money but we can put restrictions on newly printed money and not allow it to be spent on consumption or existing assets. We can require that newly printed money be spent on building or buying new productive assets which produce goods and services that can be purchased with the money printed.

Inflation is caused by what we spend money on – not how much we spend. If we invest it in ways to increase the supply of goods and services then it will not increase inflation because there is now more to buy.

The current system favours the formation of asset bubbles. What I am suggesting will result in the formation of new assets. Read this blog entry on how difficult it is to get investment for new productive innovation and how the approach suggested above can bring such investment.

<http://csoxk.wordpress.com/2009/06/18/a-strategy-for-investment-in-innovation/>

homes4aussies said, in July 5th, 2009 at 8:19 am

Congrats on another great Debtwatch Steve.

Anybody interested in the Aussie housing market and recent policy may be interested in this current thread on Bubblepedia.

http://www.bubblepedia.net.au/tiki-view_forum_thread.php?forumId=7&comments_parentId=2240

[n8r0n](#) said, in July 5th, 2009 at 9:16 am

Steve (or others),

Do you have a reference for where this underlying data comes from? Specifically, I'm interested in the numbers for total private debt. I'm in the US, but I'm sure someone else out there is interested in worldwide data, Australian data, etc. A link to raw data would be ideal.

My follow-up question is this. The above charts seem to imply (although they cover a timespan of many years) that private debt to GDP ratio in the US is still increasing. However, you also show that US private debt is now decreasing. So, that would imply that GDP is shrinking faster than private debt, to keep the debt:GDP ratio elevated.

Is that correct? Is US GDP really contracting rapidly? The news in the mainstream media generally publish data that say total US GDP contraction so far has only been 4 or 5%. That doesn't seem to mesh with the charts on this page. I'm just trying to reconcile the available information. Thanks.

ak said, in July 5th, 2009 at 9:36 am

Joe B,

Gary North is fundamentally wrong as the data contradicts him.

<http://www.federalreserve.gov/releases/h6/current/h6.htm>

He believes in money multiplier suddenly starting to multiply money injected to the system but "money multiplier" or rather creation money by credit is not working during the deflationary phase of the cycle. Does he understand that?

Another reason why he is wrong is that he thinks banks have to lend out deposits to make profit. True provided that they are not investment banks. Money can be invested in shadow bubbles directly by the banks rather than lent. They do all the dodgy stuff even if they shouldn't because they can.

Yet another reason why he is wrong is than banks do not need to make the profit at all – they have to show "some" temporary profit to enable bonuses being paid to the executives but the system is so opaque the banks will be bailed out during the next phase of the crisis again when they show true losses in let's say 2 years time.

Regarding inflation and deflation I believe we will end up having such a mess you'll not be able to describe the reality using these terms unless they are redefined and clarified. (And what the Austrians define as inflation is not the same as in other schools of economics).

Can we create such a mess? "Yes we can."

ak said, in July 5th, 2009 at 9:54 am

"Demand = GDP + Change in debt" holds water if you include time. If we imagine a very simple model of economy working in fortnightly cycles (people are paid at the end of each cycle for what they made during the cycle and can spend or save money during the next cycle)

$Demand_cycle_n+1 = GDP_cycle_n + change_in_debt_cycle_n$

You don't eat your sandwich twice.

However all the neoclassical economics is based on the assumption that there is no time since time messes up they equations.

Your observation that compounded interests do matter is valid. Especially in 2007 in the US this might have been the final straw which broke the camel's back.

ak said, in July 5th, 2009 at 10:09 am

cscxs,

You sound like an engineer – I can smell that as I made the same career mistake. You are trying to solve real problems rather than make more money. Economists do not do such stupid things like solving problems.

We may start considering addressing the climate change when a cyclone hits Gold Coast.
<http://www.bom.gov.au/lam/climate/levelthree/c20thc/cyclone3.htm>

Bullturnedbear said, in July 5th, 2009 at 12:21 pm

Hi guys,

I am surprised at the constant flow of “new ideas” on how to fix the pending deflation or inflation.

99% of the population has virtually never heard of deflation. Nor do that 99% know they need a “fix” for the problem. Also 99% of the population thinks inflation means that the price of bread or milk has gone up. Once again, what problem?

There will be no fix until after the problem has become apparent. No government or popular movement is leading. Governments follow. When the next phase hots up. Watch how the “new policies” flow out by the day. Those “policies” will be powerless to stop the greatest deflation in the history of mankind.

Once deflation takes hold, that is when they will start working on a fix.

So all your great ideas are being wasted on the less than 1% that already know there is a problem.

I am going to repeat myself. The credit based system that we all labour under is deleveraging itself. That is deflation. The only “fix” is the deflation itself. The pain will be massive and the consequences very hard to predict.

The only thing that the 1% can do is try to get out of the way.

1. Get out of debt.
2. Sell shares, houses and hard assets.
3. keep cash in short term securities.
4. I am also concerned that many banks in many countries will not be able to honour their depositors' funds.
5. Get ready for some of the best trading/investing opportunities in 100 years. But you will have to go against the flow.
6. If you have a good job, do not leave. If you think your industry is shaky, try to move to an industry that is needed.

Deflation is not only coming. It has begun.

hbl said, in July 5th, 2009 at 1:17 pm

n8r0n-

I think Steve's data on changes in debt come from the [Federal Reserve Flow of Funds report \(Z1\)](#) (most recent is for Q1 2009). A lot of the summary data is in [this subset](#) of the report.

Your question relates to one I asked Steve above and have asked elsewhere previously to no avail — the discrepancy between D.2 (change in debt) and D.3 (total debt outstanding) in the Z1 report. It's not clear to me whether the definitions are not as obvious as I think they should be, whether the data is unreliable, or whether some other factor is in play. For example it seems to me that defaults should reduce total debt (D.3) while having no impact on borrowing (D.2)... yet if you subtract the Q4 2008 total debt numbers from the Q1 2009 total debt numbers (via D.3) to obtain “change in total debt”,

those values are higher than the borrowing (D.2) figures. So there must be another explanation. However, since the household numbers do match up perfectly (comparing D.2 to D.3), my best guess is perhaps it has to do with off balance sheet assets coming back on balance sheets, and that perhaps defaults are counted as a reduction in borrowing after all. Hmmmm. If true the net effect is that deleveraging surely is in full swing (as Steve describes) and that D.3 (total debt) is being inflated upwards as "hidden" debt is uncovered. Of course I could be completely wrong on this.

I think GDP contraction so far is in the ballpark you describe.

DrewRiskManager said, in July 5th, 2009 at 2:50 pm

Now tax payers are going to take on housing sector lending risks.

<http://www.news.com.au/adelaidenow/story/0,22606,25733806-913,00.html>

Frankie said, in July 5th, 2009 at 3:12 pm

Since there is so much debt around, what would be the effect of converting it into equity, as Nassim Taleb suggested recently?

elliottwave said, in July 5th, 2009 at 5:12 pm

BTB,

The 10 trillion dollars that the Fed created out of thin air, where did it go? Is it just sitting in a bank keeping the vaults warm? I do not think so that money went to the counter parties of the OTC derivative bets. So that money is floating around in the system with no practical way to ever drain it from the system.

You say to hoard cash, i dont think so. Your dollars will not buy more of anything in the future it will only buy less and that is the reason why your paper should be exchanged for physical gold.

As you say once employment goes to 15%, house prices drop by 30%. People will lose confidence in their governments and once that happens a crisis of confidence occurs in the currency and then you have a hyperinflationary depression on your hands. Ask the people of Iceland or Zimbabwe what they think of gold and if they would rather hold short term treasuries?

BACK UP THE TRUCK AND FILL IT WITH PHYSICAL GOLD NOT PAPER GOLD AND YOU WILL REST ALOT EASIER THAN PRECHTER WHO HAS BEEN WRONG ON GOLD FROM \$400 ALL THE WAY TO \$1000, AND HE STILL HAS NOT LEARNT HIS LESSON.

elliottwave said, in July 5th, 2009 at 5:43 pm

BTB,

Also a note on the form of inflation coming, it has NOTHING whatsoever to do with consumer demand pull or wage cost push. It will be a currency related item producing hyperinflation in the midst of ugliest business conditions that we have ever seen.

These conditions have always been the result of quantitative easing where there is no practical method of draining this money from the system, regardless of a political situation, war or now management of perception economics.

ak said, in July 5th, 2009 at 6:11 pm

elliottwave,

“People will lose confidence in their governments and once that happens a crisis of confidence occurs in the currency and then you have a hyperinflationary depression on your hands”

... and then you will deliver all your physical gold at \$1170 per ounce to the Treasury once the old dormant law is activated.

elliottwave said, in July 5th, 2009 at 6:19 pm

AK,

That will never happen because all the counter parties that received their trillions from TARP now are the holders of the greatest amount of dollars and they will want that protected at all costs and that is the reason why gold will not be confiscated or any dormant treasury law enacted. It is not the gold bugs that will make the price of gold it is the bankers and all their connections that will want their hyperinflated dollars protected. Now do you finally understand who is behind the rise in gold? Not the gold bugs but the bankers with trillions of freshly printed toilet paper to protect.

[Steve Keen](#) said, in July 5th, 2009 at 7:28 pm

dear hdl & n8r0n,

Yes, you're correct, the aggregate debt figures and the change in debt don't seem congruent, but they're the figures the FRB records so I am obliged to use them. A notional reason for the discrepancy could be that the aggregate stock figures reflect accumulation of unpaid interest on present debt, while the flow figures look only at the rate of issuance of new debt versus the rate of cancellation of old debt. One of these days I hope to have the time to get into the detail of the Flow of Funds data in more detail to answer this one.

In the meantime, the bloke who probably does know this is Doug Noland of Prudentbear. He's a good mate of mine (as someone here noted some time ago, Doug spent a year in Australia working on a PhD which he discontinued to get back to the markets prior to the 2000 crash), so I'll pop a request for clarification his way when I get back from Europe.

[Steve Keen](#) said, in July 5th, 2009 at 7:34 pm

Hi n8r0n,

I think that the scale of reduction in output only has to be of the order of 5% for that effect to apply, since debt is 3 times GDP. A small change in the denominator can cause a larger result than a similar scale change in the numerator.

Also, when you add in deflation of roughly 1-2% on top of a 5% fall in real output, that reduces your denominator by 7%. So you're going from $3/1$ to $(3-x)/0.93$, where x is the fall in debt in nominal terms.

height said, in July 5th, 2009 at 8:15 pm

Joe B,

From my limited understanding it seems that Gary North subscribes to an exogenous model of money creation, whilst Keen subscribes to an endogenous model of money creation.

Now I may have missed something but this:

“WHY BANKS WILL EVENTUALLY LEND...

Short-term, yes. A bank can hold excess reserves or vault cash, and pay depositors from the higher income on credit cards, consumer loans, and so forth. Long-term, no. The banks must lend to stay in business. The M1 money multiplier will go positive. Fractional reserve banking will then turn the central bank's balance sheet into fiat money.”

Suggests that he believes in exogenous money, whilst Keen (Roving Cavaliers of Credit) makes the case that the money multiplier does not work and that the empirical evidence suggests otherwise:

“Two hypotheses about the nature of money can be derived from the money multiplier model:

1. The creation of credit money should happen after the creation of government money.
2. The amount of money in the economy should exceed the amount of debt, with the difference representing the government's initial creation of money.

Both these hypotheses are strongly contradicted by the data.

Testing the first hypothesis takes some sophisticated data analysis, which was done by two leading neoclassical economists in 1990.

If the hypothesis were true, changes in M0 should precede changes in M2.

Their empirical conclusion was just the opposite: rather than fiat money being created first and credit money following with a lag, the sequence was reversed: credit money was created first, and fiat money was then created about a year later:

“ There is no evidence that either the monetary base or M1 leads the cycle, although some economists still believe this monetary myth. Both the monetary base and M1 series are generally procyclical and, if anything, the monetary base lags the cycle slightly. ”

Thus rather than credit money being created with a lag after government money, the data shows that credit money is created first, up to a year before there are changes in base money. This contradicts the money multiplier model of how credit and debt are created: rather than fiat money being needed to “seed” the credit creation process, credit is created first and then after that, base money changes.”

I hope this helps. Regarding the endogenous model, it is my initial readings there are numerous ‘schools’ of thought regarding endogenous money, these being: Structuralist, Horizontalist and Circuitist. The first two relate to the supply curve of credit creation (positive sloped curve and horizontally sloped) and I'm not entirely sure what position Circuitist take. From what I've read by Keen it appears that he is in this camp as well.

elliottwave said, in July 5th, 2009 at 8:49 pm

BTB and other deflationists

One aspect of this whole crisis that this website has overlooked and i believe is critical, is that this whole crisis has been engineered to happen. The bankers of wall street in conjunction with the FED have deliberately manufactured this depression to get themselves out of trouble. Wall street had

painted themselves into a corner that they could not get out of, that was the 700 trillion dollar OTC derivative market that could not be reversed.

Now they deliberately let Lehman and Bear go under and that was the trigger that set off the bomb. Congress was held to ransom and paid up with freshly printed dollars and bowed to Wall st and played the whole world for fools.

Now that they had all their bad bets in OTC derivatives paid off, thanks to the publics money, the next problem they had to overcome is how to protect their toilet paper money freshly printed from thin air.

That is where gold comes into the equation. The Revitalized and Modernized Federal Reserve Gold Certificate Ratio will be tied to a reintroduction of M3. It will not be tied as in the pre-Bretton Woods Agreement. The treasury will have nothing whatsoever to do as the open market will do it for them.

Now I can state with total conviction that when the Federal Reserve Gold Certificate Ratio is reintroduced gold will trade \$100 above and below this index gold price for many years to come. I anticipate this at gold around \$2000.

Therefore, fear of a 1980 gold experience on the downside is no longer valid. I believe that the bankers of wall street are indeed gold's best friends. As always, those close to power are going to make more on gold than the gold bugs ever will.

With the introduction of the revitalized Federal Reserve Gold Certificate Ratio and currency bands, gold will be supported by a peg and the Euro will not. When this unfolds in front of all the meatheads in the investment world, it will be seen that gold is a better investment than any currency.

elliottwave said, in July 5th, 2009 at 8:56 pm

BTB and other deflationists

Do not think for a minute that Bernanke and Paulson are idiots who have no idea what they were doing. These men are the sharpest minds in the world and for anyone to suggest anything to contrary, is showing ignorance.

Dartagnan14all said, in July 5th, 2009 at 9:50 pm

elliottwave,

“Now I can state with total conviction that when the Federal Reserve Gold Certificate Ratio is reintroduced gold will trade \$100 above and below this index gold price for many years to come. I anticipate this at gold \$1,650.

See <http://www.gata.org/node/6487>.

44sunsets said, in July 5th, 2009 at 9:56 pm

Hi everybody, this is a little off topic, but I was wondering what everyone is doing to minimise the losses you're incurring in your super funds?

Everyone I know has taken a massive hit over the last year or so and I gather it's only going to get worse with the deleveraging. What kind of strategies are you adopting for your super?

Thanks for hosting this fascinating blog and the many intriguing discussions!

elliottwave said, in July 5th, 2009 at 10:00 pm

GATA have nothing to do with it all this comes from the greatest financial mind that world will never now about, Jim Sinclair, GATA have the best intentions for gold bugs but they are light weights and are really just nuisance value, token commentary.

elliottwave said, in July 5th, 2009 at 10:44 pm

Dartagnan14all

If you know all this why do you not inform the people on this website. It is your duty of care to at least publish the information as you are a reader of the website. Jim Sinclair has been a personal friend of mine for over 9 years and the knowledge that he has passed onto me is a gift to be shared. I could be selfish and keep all this to myself but that is not how society should work, maybe it does in your world but not in mine.

[coburn](#) said, in July 6th, 2009 at 1:04 am

Excellent explained with convincing graphs.

Although using the officially published unemployment rates shows the same trend, don't you think you're lending credibility to a grossly understated measure? U6 and other measures peg unemployment/underemployment at almost double the published rate.

Bullturnedbear said, in July 6th, 2009 at 1:06 am

Hi Eliotwave,

Why didn't gold skyrocket after 22 June?

Do you have a wave count to support your ideas?

Do you agree with or believe in the endogenous creation of money idea?

What about currency relativities? There cannot be hyperinflation everywhere! Do you just mean in the US? Because that would imply a much better trade would be to short US dollars and buy say \$A or Euros.

Joe B said, in July 6th, 2009 at 2:59 am

ak,

I think that time is necessarily included in measures of Demand, GDP, and $d(\text{Debt})$. Each of these quantities is measured over a period of time, say a quarter. So they are all in fact rates (or flows), with time in the denominator (although this cancels out in the relation if the periods are identical). I don't think you can define Demand_{n+1} from GDP_n and $d(\text{Debt})_n$, because any changes in GDP and debt in future period $n+1$ will also affect Demand_{n+1} .

So I think this relation can only provide a retrospective measure – at the end of period n , you can say that $\text{Demand}_n = \text{GDP}_n + d(\text{Debt})_n$ (if this relation is true). But you can't know the total demand for period $n+1$ until it has finished. You could make projections, but I don't think this is Steve's intent with this relation and data.

I'm curious to learn more about the source of the debt data. If change in debt doesn't include interbank lending or over-the-counter lending (me lending to my brother) then most likely the situation I described in scenario #4 above would probably be negligible in terms of the data presented.

"You don't eat your sandwich twice" – I think you're agreeing with me here. I'm saying that only \$10 of demand has been created by the loan, and when I buy the sandwich, it doesn't create additional demand on top of the \$10 that I just spent. You could probably argue that money velocity plays a part here too – the sandwich maker will then spend the \$10 elsewhere, etc.

But this means that the relation is more complicated than $\text{Demand} = \text{GDP} + d(\text{Debt})$. This is all I'm trying to argue here – it's oversimplified. It makes more sense to me to define aggregate demand in terms of $\text{MV} = \text{PQ} = \text{Demand in Dollars}$. This shows how many dollars were spent over the given period – the number of dollars in existence ("fiat" or "credit") x the number of times each of those dollars were spent during the period.

Of course, the aggregates used to determine Velocity tend to rely on GDP, which means this relation would suffer from similar oversimplifications. And the definition of money supply used is debatable as well. More on this later...

This is why I tend to be skeptical of aggregate statistics. There's always more to the story.

Joe B said, in July 6th, 2009 at 3:33 am

ak and Height,

First of all, I'll refer to creation of new money ("fiat" or "credit") as "Monetary Inflation" (Austrians) and increase in prices as "Price Inflation" (Everyone else). I think it's worthwhile to explicitly make this distinction in any inflation debate, especially if any Austrians are hanging around.

I think Gary North views the money multiplier merely as an indicator of the scale of fractional reserve lending, which I agree with. Here's a brief comment from him on the current multiplier situation: <http://www.garynorth.com/public/5070.cfm>

I couldn't find this article yesterday, but it explains in more detail how and why he thinks the Fed will not allow mass deflation. Specifically, he says that at some point the newly printed money won't just be going into vaults, it will be monetizing equities and other assets: <http://www.lewrockwell.com/north/north722.html>

I might propose this simple relation (which I'm sure isn't original, but I don't have a source):
 $\text{Change in Money Supply} = \text{Change in Fiat Money (exogenous)} + \text{Change in Credit Money (endogenous)}$

While in recent history endogenous creation has been the dominant component in monetary inflation, the Fed has the same ability to create money out of thin air, and has shown that they are willing to do it. Do you think Obama wouldn't love to announce a \$2000 stimulus handout to every voter (a la Krudd) just before the 2010 congress elections? Or that the "Plunge Protection Team" wouldn't start buying up equities once the Dow gets back down around 5000? Or that banks aren't using bailout money to buy assets? These actions will put money directly into the hands of consumers. It might take a while to match the recent scale of FRB lending, but it can be ramped up to 1:1 with deflation caused by deleveraging without spooking treasury holders. This would theoretically prop up prices to maintain current levels.

However, if and when the deflationary forces eventually subsided, all of that new money would be there, ready to go, and once the banks want to lend, the Fed won't be able (or willing) to stop them.

ak, I agree that if banks can profit from investment activities, they have less pressure to lend. But if they are buying assets, they are putting that cash into the economy, and this has the same effect as the Fed buying assets with new money.

—— (digression about the Austrian school)

This is less relevant to the discussion at hand, but I think it's important to clarify the Austrian definition of money supply. I'll probably get this wrong, but here's a summary. True Money Supply (TMS) is defined as the amount of money immediately available for exchange:

TMS = Cash + demand deposits with commercial banks + government deposits with banks and the central bank

<http://mises.org/content/nofed/chart.aspx?series=TMS>

http://www.mises.org/journals/qjae/pdf/qjae3_4_3.pdf – This paper explains in detail, with explanations of why certain quantities are included or excluded.

It should be clear that this definition is intended to show the most immediate potential for price inflation.

So while the roving cavaliers may be able to create credit on a whim, it is not included in the money supply and can't affect prices until it is actually lent and a deposit is created. If repayment of a debt moves the money from a demand deposit to bank reserves, that money is no longer included in TMS until it is relent. I think this definition agrees with the "Roving Cavaliers" model.

While Austrians make a big stink about the Fed, they make a bigger stink about fractional reserve lending. The Fed – and specifically the government's support of it through legal tender laws, enable endogenous money creation. Whether fiat money creation comes before or after credit creation is somewhat irrelevant unless you're trying to determine exact proportions at a given time. As long as banks know that the Fed will back them up, and the government will ensure the fed's monopoly on money creation, they will create credit out of thin air. This is the moral hazard – passing off the costs to all holders of dollars. The FDIC is another moral hazard that passes the risk of a bank failure on to taxpayers, allowing banks to take greater risks with impunity.

Austrians generally view all FRB lending as fraudulent, unnecessary to drive investment, and a major cause of business cycles. Disallowing such fraud means less real credit is available during booms (because money is worth less) and more is available during busts (because money is worth more). This has the same dampening effect as "tax the boom/inflate the bust" without putting an ever increasing proportion of money into the government's hands, encouraging corruption, and relying on a bunch of politician slimeballs to do the right thing. There are differences of opinion among Austrians as to whether this restriction requires government intervention or whether the free market would enact it through competition and hard money, but this is the basic premise.

—— (digression over)

In the whole inflation/deflation debate, I think it's important to consider how different goods will respond in the current environment. While the aggregate trend may be deflationary, prices of certain goods can still inflate due to decreases in supply. I think deflation will be constrained to assets that

have relatively fixed or increasing quantities (over the short term) – Real Estate, Equities, Bonds, Derivatives. They won't be consumed. They will be sold to pay off debt. They're all going down, unless the Fed takes drastic measures to prop up specific asset classes. I don't think anyone with half a brain will really argue against this. It's worth noting that Gary North was saying to short stocks back in February 2007 (sorry, I can't find a link).

However, consumer goods such as food, energy, and some durable goods – the components of CPI – can still inflate in this environment. The main reason for this is that production is being cut back at all levels, as evidenced by increasing unemployment and decreasing capacity utilization. While substitutions can be made, on the whole and in the long run I think we won't see big declines in prices of these goods – just declines in the quantities available. Once house prices have truly collapsed, a lot of people (renters) will have to spend less of their income on housing and can spend more on food. If they still have any income...

And what will Obama do when his bailed-out newspapers start printing about food shortages? Food stamps and subsidies! Print more money! Yes we can! Obama shall provide!

I think this is one reason why there is so much speculation in commodities right now, and why CPI hasn't really plummeted along with deleveraging.

Bullturnedbear said, in July 6th, 2009 at 4:57 am

Hi Joe B,

I think your theories rely too much on rationality ruling the day. For what you propose to work, most governments must inject just about the right amount of money into the system to avoid deflation. This is not going to happen because nobody, you included think we are going to have or having deflation.

If no one believes we are going to have deflation, why fight it? In fact most people are convinced inflation is the problem, therefore governments will "rationally" fight/fear inflation.

As the real world unfolds, then we will see the policy moves after the fact. If deflation unfolds governments may try to pump up fiat money (later). But by then money supply, asset prices and aggregate demand will already be destroyed. Along with it employment will be down for the count. Under this scenario, those looking for inflation will see their hard assets wiped out.

If inflation occurs (as you say), then the policies will move to pull the expansion rug out big time. But how can inflation occur as demand, employment and asset prices are crashing. What will cause demand to come back?

A good place to start looking is short term interest rates. While ever ST rates are low or zero the market is expecting no inflation. If short term rates start going over 5 or 6% start running for the deflation exits. At this stage deflation rules. Later, who can tell at this stage?

ak said, in July 6th, 2009 at 8:59 am

BTB,

Fighting non-existing inflation now is putting a noose around our neck. Exactly because of this obsession there was >20% unemployment in Poland in 2003. I found a document from the Reserve Bank of Poland where it was argued that NAIRU = 14% at that time. Instead of reforming the system (for example they did nothing with 45% Social Security Tax paid by some groups of employees what

discourages new jobs creation) they just increased interest rates to ridiculous values. But they overshot slightly and unemployment went up to 20%. The problem was solved when unemployed people left the country – currently it is about 10%. I also left because of the effects of that social dislocation – the atmosphere was so poisoned by Catholic populists that I couldn't find a room in that society for myself any more.

When I have time I'll find something in English about that.

The dire situation in Latvia is a direct consequence of not devaluing the currency. Another example of applying a bad theory.

I am not arguing for blind printing as it will sooner or later lead to another bubble rather than restart the productive economy. The system must be reformed.

But unemployment not inflation is the enemy number 1, dragging down the society. At least here in Australia we have prof Mitchell who disagrees with the official neoclassical rubbish:

<http://bilbo.economicoutlook.net/blog/>

I may not agree with him in everything but at least he can see and describe the real problem.

[Twitted by juhasaarinen](#) said, in July 6th, 2009 at 10:55 am

[...] This post was Twitted by juhasaarinen [...]

ferb said, in July 6th, 2009 at 2:06 pm

“Now that they had all their bad bets in OTC derivatives paid off, thanks to the public's money, the next problem they had to overcome is how to protect their toilet paper money freshly printed from thin air.”

US\$700Trillion paid off.....ha!

where did you get that?

this may well have been the reason for manipulation on behalf of the banks and fed, but there is no way they knew the extent of it and there is not a chance this is even remotely paid off (if even this is the amount)

and that's the point, no one knows how much or who has the debt....the banks don't trust each other's balance sheets.

this is why we haven't even begun with deleveraging.

ken said, in July 6th, 2009 at 2:27 pm

I keep wondering if it is possible to avoid deleveraging. More and more public money works for a while, but eventually it will stop.

What got me thinking about this was a comment by Krugman about how after 7 or 8 years Roosevelt reduced the high public spending because of concerns about inflation, and caused the 1937 recession. Krugman seems to think that you need to keep stimulating and stimulating and eventually good things will happen. It doesn't seem to be working for the Japanese. Standard economic excuse they didn't stimulate long and hard enough. Somehow I don't think economies work like football games.

Only world war 2 caused a recovery. Now maybe this was because public funds were now directed towards constructing manufacturing plant which is something that actually creates wealth, unlike the infrastructure programs. Nobody is likely to get a job in a school hall, which is what we are building now.

ak said, in July 6th, 2009 at 2:49 pm

ken,

So what are they actually doing to stop deleveraging in Australia? Releasing f-hogs? Providing ute car dealers with cheap financing? Giving private schools infrastructure subsidies? Sending \$900 checks to be spent on iPhone/plasma TV?

Obviously this may be slightly better than letting the economy collapse in a natural way but still not good enough.

Let's start talking about real issues in phase 2 of the crisis: rebuild our manufacturing base, start investing in energy-efficient technologies, improve public transport in our cities, move away from the coal.

elliottwave said, in July 6th, 2009 at 3:42 pm

FERB

If you were in charge and you had the choice of deleveraging \$700 trillion dollars or hyperinflating it away, which would you choose? Which is the more logical and practical solution? Years of pain or perhaps 2 or 3 years of pain and then restart again with a clean slate.

Please think logically and you will come to the conclusion that hyperinflation is what the big boys want and that is what they will get, wake up and stop thinking your dollars will buy more in the future. You are hoarding toilet paper while i am protecting my wealth with gold like all the bankers and their connections.

elliottwave said, in July 6th, 2009 at 3:47 pm

BTB,AK,FERB and all deflationists

Please explain to me how you think hyperinflation starts and what causes it? Then i can see if you are capable of understanding further knowledge that i will pass on to you.

ak said, in July 6th, 2009 at 4:03 pm

elliottwave,

I have already checked yesterday what further knowledge you want to pass on to me when you mentioned the name of Jim Sinclair

<http://jsmineset.com/>

“The dollar life expediency is 129 days.
I mean that. I believe that.”

<https://www.kitcomm.com/showthread.php?t=45328>

A bit more balanced views of the Chairman can be found there:

<http://www.tanzanianroyaltyexploration.com/s/ChairmansCorner.asp>

So please don't waste your precious time on me as I understand quite well why gold needs to cost \$2000.

elliottwave said, in July 6th, 2009 at 4:05 pm

Ferb,

You have to ask yourself why did the FED save all the other investment banks but decided to let Lehman and Bears go under? They didn't have the money to save them? It was too hard for them, they could not be bothered?

They let them go under on purpose and that should explain everything to you. They are wanting this hyperinflationary depression and they are causing it because they already have the solution GOLD CERTIFICATE RATIO.

elliottwave said, in July 6th, 2009 at 4:09 pm

AK,

Now you can finally start to learn something please be sure to re read anything you do not understand and exchange your toilet paper for GOLD.

ferb said, in July 6th, 2009 at 5:44 pm

“.....Then i can see if you are capable of understanding further knowledge that i will pass on to you.”

mate, you need to review your tone, cause in here that wont fly....least with me! Get it?

We are all in here trying to make sense of a situation that very few have ever seen or will ever see again. We enjoy the fact that debate occurs in a relative constructive and pleasant manner, and appreciate the effort to question traditional economic theory.

why don't you cough up some reliable statistics to back up your hypothesis of 700trillion and you might gain some credibility traction.

Or, even better, take a photo of the physical gold you own, and show us all in here? put you money where your mouth is, cause you must have a chunk of change with that attitude.

elliottwave said, in July 6th, 2009 at 6:33 pm

Ferb,

How can you tell my tone when i am writing these comments? I have no attitude against anyone on this site, i am expressing my views and they just happen to be correct.

As for the \$700 trillion, i am being conservative the BIS has actually said that the outstanding amount is over 1 quadrillion.

You need to buy physical gold it is the only saviour in this upcoming weimar experience

elliottwave said, in July 6th, 2009 at 6:39 pm

Ferb

I have answered your question now could you please explain to me what your definition of hyperinflation and its causes and effects are? Also why you think it won't happen and deflation will?

Thank you

Ernie said, in July 6th, 2009 at 6:41 pm

“The total notional amount of over-the-counter (OTC) derivatives contracts outstanding was \$592.0 trillion at the end of December 2008, 13.4% lower than six months earlier.”

<http://www.bis.org/press/p090519.htm>

elliottwave said, in July 6th, 2009 at 7:11 pm

Ernie

Do you own physical gold?

brett123 said, in July 6th, 2009 at 7:28 pm

Thanks for that post rooivis re Steve's gold medal.

<http://www.businessday.com.au/business/for-predicting-the-slump-just-a-few-get-medals-20090703-d7vr.html>

It's good to see Steve putting his neck out with some actual figures on where he sees the economy going. You'd have to say 12% unemployment is looking a pretty rough chance by mid next year and I hope he's wrong.

Though, seeing as he got it right before I'll keep saving my dollars for a few more months yet.

elliottwave said, in July 6th, 2009 at 7:34 pm

Brett

Get rid of that toilet paper before your money gets flushed down the toilet.

elliottwave said, in July 6th, 2009 at 7:36 pm

Has Steve ever made a prediction on the price of gold and where it will be in 12 months?

height said, in July 6th, 2009 at 7:45 pm

Joe B,

1. Money multiplier.

I still think that he is arguing from an exogenous perspective. I understood that the money multiplier assumes that 'reserves cause deposits' – this is a direction of causality claimed by exogenous money theorists.

2. Deflation vs hyper inflation and 'pushing on a string'.

IMO: I read through the article and the point I made above still stands. Gary North seems to be arguing we are in a 'fiat money system', whereas we are rather in a 'credit money system' with a 'small and subservient fiat money system tacked on to it'. Money creation begins with the commercial system and is demand driven, government merely responds; the 'credit money dog wags the fiat money tail'. Because of this fiat money supply is a smaller component of a larger credit money system.

"joe B – However, if and when the deflationary forces eventually subsided, all of that new money would be there, ready to go, and once the banks want to lend, the Fed won't be able (or willing) to stop them."

Please see the reasons below why this won't occur. One thing that I think is occurring is that we are arguing from two different paradigms (exogenous money and endogenous money). Despite your insist that endogenous money creation is a part of your concept of money supply I don't believe you have taken the direction as outlined above.

This is from 'Roving Cavaliers of Credit':

-quote-

"If neoclassical theory was correct, this increase in the money supply would cause a bout of inflation, which would end bring the current deflationary period to a halt, and we could all go back to 'business as usual'... However, from the point of view of the empirical record, and the rival theory of endogenous money, this will fail on at least four fronts:

1. Banks won't create more credit money as a result of the injections of Base Money. Instead, inactive reserves will rise;
2. Creating more credit money requires a matching increase in debt—even if the money multiplier model were correct, what would the odds be of the private sector taking on an additional US\$7 trillion in debt in addition to the current US\$42 trillion it already owes?;
3. Deflation will continue because the motive force behind it will still be there—distress selling by retailers and wholesalers who are desperately trying to avoid going bankrupt; and
4. The macroeconomic process of deleveraging will reduce real demand no matter what is done, as Microsoft CEO Steve Ballmer recently noted: "We're certainly in the midst of a once-in-a-lifetime set of economic conditions. The perspective I would bring is not one of recession. Rather, the economy is resetting to lower level of business and consumer spending based largely on the reduced leverage in economy".

-end quote-

The essential point is that the scale of debt is so large that no amount of fiat pumping could cause monetary inflation.

On monetary inflation. Basil Moore (2006, p 236) claims that monetary inflation where 'excess supply of money spills over, to create excess demand for goods and services' can only hold when we have a commodity money or fiat money system. This reiterates the point that we are in a credit money system, where government (central banks) cannot control the quantity of money in the economy. The supply is rather determined by demand for bank credit.

3. FRB

I think it's interesting that you suggest that some Austrians argue for government intervention to ensure a FRB system would not arise, as I was under the impression that this would be almost heretical.

From my limited knowledge I don't think that you can regulate away FRB and I don't think that the market would prevent it from arising. It is my opinion that credit money has evolved naturally due to numerous factors, perhaps the most significant being uncertainty. The argument has even been made that the origins of credit money precedes that of commodity money (Wray, 1990, p. 54)

Moore, B. 2006. Shaking the Invisible Hand: Complexity, Endogenous Money and Exogenous Interest Rates. Palgrave Macmillan,

Wray, L.R. 1990 Money and Credit in Capitalist Economies: The endogenous money approach. Edward Elgar.

elliottwave said, in July 6th, 2009 at 8:02 pm

Hyperinflation has always come about in the most depressive economic conditions, it does not need a recovery in business conditions to start, that is where people make the mistake and get confused with bubble inflation and that has nothing in common with hyperinflation, which is a loss of confidence in ones government and currency.

scepticus said, in July 6th, 2009 at 8:14 pm

Let's say we do get a global hyperinflation. The end game of this is global hyper-deflation as society breaks down.

The endgame is the same, except that in the hyperinflation scenario goldbugs get rich momentarily before gold crashes too, which would be the end of money.

What comes after that then?

Josie said, in July 6th, 2009 at 8:26 pm

Hi Steve,

I want to thank you for the fantastic work you have done critiquing neoclassical economics. Last year I was thoroughly traumatised by being taught economics during my Masters degree. I felt that I was experiencing a form of mass insanity. My first degree was in philosophy and I always thought that Utilitarianism was a long dead and discredited theory, of interest only as something to be disproved during introductory ethics courses. I was utterly staggered to find out that a whole other academic subject (which is at least half running the world) seems to be based on it. It is unbelievable.

But on this debt stuff, it seems obvious that debt can continue indefinitely as long as no one calls in the loans. Some of that happened last year but I am still not clear on why it can be assumed that it will continue, although it certainly might well do.

As someone who does not think like an economist (sorry!), one of the crucial things about debt to me seems to be that it is a power relationship in a way that money is not. (IMF conditionality being the prime example). Socially it is therefore an entirely different thing from money. When someone is indebted to you, you've got them over a barrel, and the best policy for you would be to keep it that way.

elliottwave said, in July 6th, 2009 at 8:58 pm

As i have explained the gold certificate ratio will be introduced and at that time that it is when gold will be fixed at a certain number for arguments sake say \$2000 and the price will remain fixed at that price. It will not come down as in 1980.

Just look at Zimbabwe as an example the only way people can live is by trading gold and they do not even have an economy.

What you fail to understand is that the bankers are the ones who will be holding all the gold and that is the reason that it will not come down.

roovis said, in July 6th, 2009 at 10:14 pm

Elliottwave,

Maybe you should go to Zimbabwe and see what is really going on. No one trades in gold. Tell me how are you going to get change for your 1/10th gold coin when purchasing a loaf of bread or mielie flour (should you be lucky enough to get it in a shop)?

Their best currency is the USD, followed closely by the Pula and then the ZAR. Officially no one is allowed foreign currency.

Best you keep to things you understand, apparently gold is it, Zimbabwe it's don't.

elliottwave said, in July 6th, 2009 at 10:35 pm

Gold gets you to the front of the line and is unofficially the accepted currency. Gold has saved more than one life rather than the wheelbarrows you will carrying full of freshly printed toilet paper.

The people with the gold are the only ones with a chance in Zimbabwe, what do you think that Mugabe owns 1,000,000.000 notes or does he have his riches in gold.

elliottwave said, in July 6th, 2009 at 10:41 pm

How about Iceland, very high interest rates and all the shops are empty, why is that? Deflation causes empty shops? deflation causes high interest rates?

elliottwave said, in July 6th, 2009 at 10:48 pm

ROOVIS

Watch this video and then tell me what you, lets see if you can sleep a little better now after seeing this video. You do not have to say sorry i understand that the concept is hard for a deflationist to grasp. But you will.

<http://www.youtube.com/watch?v=7ubJp6rmUYM>

ned said, in July 6th, 2009 at 10:50 pm

Elliotwave,

You still haven't answered BTB's question, do you see Hyperinflation in the US only or here in Australia. From a local point of view if the USD crashes and I'm holding AUD I don't see a great deal of concern. If I have gold then the gold price in AUD won't go up either. So do you see Australia going to Hyperinflation?? and please explain why also.

elliottwave said, in July 6th, 2009 at 10:56 pm

Have you seen the long term price charts of all the currencies against gold, gold is outperforming every currency how can you people not see something so obvious in front of your eyes?

WATCH THE VIDEO THAT I HAVE POSTED AND SEE THE MISTAKE THAT YOU ARE ALL MAKING.

scepticus said, in July 6th, 2009 at 10:58 pm

'Real' rates are strongly negative, and while real rates remain a long way under offered rates for credit, deflation cannot be prevented.

Mailing out stimulus checks of printed money to consumers will simply result in further deflation when they pay down vast sums of debt, or just put it under the mattress.

elliottwave said, in July 6th, 2009 at 11:04 pm

Exactly what i am saying, if real interest rates are negative then you are losing money by holdind it.If interest rates are 5% and inflation is 7% what is happening to your toilet paper currency?

elliottwave said, in July 6th, 2009 at 11:06 pm

Can somebody tell me the last time they went shopping that their grocery bill was less than 6-12 months ago when the recession began?

I DONT THINK SO

elliottwave said, in July 6th, 2009 at 11:08 pm

What exactly has gone done in price that proves we are in deflation?

ned said, in July 6th, 2009 at 11:14 pm

What has gone down in price, well let me see in the last year:

Copper
Lead
Nickell
Zinc
Iron ore
Coal
Oil.....

DrewRiskManager said, in July 7th, 2009 at 12:31 am

Ned you forgot GOLD.

15 feb \$1000usd or at 0.65 = \$1538 AUD
Today \$922usd or at 0.79 = \$1167 AUD

chrisp said, in July 7th, 2009 at 12:57 am

Someone mentioned a movie called Zeitgeist. I absolutely recommend you watch the second part called: 'Zeitgeist: Addendum'. It tells a lot about debt, monetary system, capitalism ...

It is long but it is well worth it. You can watch it at <http://www.rbetv.com/>

If we want to really fix the economic problems we need to go to their roots as the movie is talking about.

mahaish said, in July 7th, 2009 at 1:10 am

hi elliotwave,

a couple of things,

lets not confuse a cock up with a conspiracy.

the debacle that really got a head of steam last september with the demise of lehmans, has everything to do with greed and incompetence as opposed to some dr strange glove conspiracy.

watching benanke front up to congress to answer questions on all of this, he looked more like dr noah aka woody allen as opposed to goldfinger or blowfeld.

i mean if this was what they had planned all along, it could only have been woody allen that could have come up with the plan

no i'll put my money on a stuff up. they had little or no idea of the kind of trouble they were going to find themselves in, otherwise they would have put a stop to the kind of shinanigans going on at AIG years ago.

i mean , allowing people to take insane bets on other peoples bets, would even make vegas casino owners blush.

[The Swamp Report » Trying to offset private debt with public](#) said, in July 7th, 2009 at 1:17 am

[...] Steve Keen's Debt Watch: Even though the US government has thrown the proverbial kitchen sink at government spending, the [...]

Joe B said, in July 7th, 2009 at 1:34 am

BTB,

To clarify, I am expecting deflation first in the form of another stock market crash a la 1930-32 (but worse), and further drops in house prices. Then fiat money inflation as an overreaction, and price inflation of consumer goods – due to drastically reduced production as a result of the previous deleveraging. Then more fiat money creation in the form of handouts to people who can't afford the more expensive food. Then more price inflation, then more handouts...

Supply and demand will both collapse, but supply will be harder to resuscitate. The government can hand out checks and monetize retirement accounts much more easily than they can retool factories.

I don't think that the Fed will have the ability to roll back inflation once it starts (and it hasn't come close to starting yet). They can only do this by selling assets and cranking up rates. Who will want to

buy toxic loans and Treasuries at a 2% coupon rate once inflation truly kicks in? And if inflation comes about without significant lending (see my next comment), rate hikes will have little effect.

I think it will take a long time for inflation to start on its own. But there are some black swans that could trigger an exodus from the US dollar. For the near future, USD still has the advantage of being the most liquid asset on the planet, and enough big holders with a vested interest in propping it up. But once China and the other BRIC's have finished setting their pieces on the board, one wrong move could trigger a USD sell-off.

I've seen a few theories suggesting that China is using its treasuries as collateral for cash loans – essentially reducing their exposure to the risk of a USD collapse while gaining more liquidity in the present. And everyone knows that they're buying hard assets and setting up currency swaps, while calling for a new reserve currency. (Sorry, no links)

I don't think hyperinflation is inevitable, but I do think that deleveraging will end at some point, through paying down loans and defaults. The results of this in combination with any new money introduced to consumers outside of bank lending will be inflationary.

I am presenting Gary North's arguments here because I think he is one of the clearest thinkers in the inflationist camp. Likewise, I find the deflationist arguments here to be more convincing than arguments I've seen elsewhere. I want to re-emphasize that Gary isn't saying that deflation can't happen – only that if the government wants inflation, they'll get it. And they have plenty of motives.

Joe B said, in July 7th, 2009 at 2:17 am

height,

I agree that the dominance of endogenous money creation represents the system we have had for the past several decades, and that the fed is powerless to prevent banks from expanding money supply. I'll go even further to say that the fed exists solely to ensure that the banks can do whatever the hell they want. It is, and has always been, a cartel organized for the sole purpose of preserving the big banks. And it has the full backing of the US Military thanks to legal tender laws.

However, I think we are entering a new paradigm in which exogenous money creation could become the dominant component, at least in the US. The drop in the money multiplier illustrates this. When it goes below 1, this means that exogenous creation has taken the lead. The M1 Multiplier is below 1 right now, although I wouldn't say that this statistic means it has already happened.

You're assuming that the only way the Fed can get money into the system is through bank lending, but they have already begun purchasing assets to circumvent this.

Bernanke created \$700b in an afternoon. The conspiracy theorist in me thinks that this was just a test to see how much he could get away with. Most of this money is sitting in digital vaults now, but the precedent has been set. While this money may not go through the fractional reserve process, there are little to no restraints on the amount that can be created by fiat. Just hit that zero key a few more times... They don't need to worry about demand for credit, since they can just mail a check to every house to get the money out there.

In fact, I think that the bond markets and a desire to preserve the USD as the world's reserve currency are the only things restraining fiat inflation. Bernanke is probably kicking himself for not having doubled down, since treasury yields have remained low despite the spike in M0. The bailouts keep growing, the bond auctions keep growing, at some point the handouts will follow.

There is a "minarchist" camp within the Austrian school that thinks a limited government is necessary to protect property rights and prevent fraud (including FRB). A government could prevent FRB by conducting regular audits of bank reserves and ensuring that every dollar is accounted for. The trick here is that money in demand deposits can't be loaned out and earns no interest. Money in any interest earning account is illiquid to the depositor (because it has been loaned out) for a certain time period, like a term deposit. The bank makes money on fees for providing security, access to your money, and administering loans.

In a free market, private auditors could provide a similar service, alerting depositors to the risk levels of various banks. While this would likely still allow some FRB, it would likely be less significant than in the current situation of active encouragement with government backing. It may take a few crashes before depositors get wise, but these would likely be smaller and more frequent since fiat inflation is not an option.

There would of course be other sources of over-the-counter credit creation in either case, but these would be restrained by individual lenders' risk tolerances.

Personally, I'd like to think that the free market approach could work, because I'm convinced that any size government will find some way to screw it up.

mahaish said, in July 7th, 2009 at 2:56 am

furthermore, elliotwave,

why on earth would the US ever countenance a move that would link its currency to physical gold and give up the biggest financial scam in modern history .

why would it put a gold straight jacket on itself when its trying to inflate its way out of its deflationary problems.

when the fed theoretically has access to infinite liquidity at virtually zero cost, at the flick of a few keystrokes, all done under the global US dollar standard, why on earth would they want to be rummaging around for physical gold.

in the short to medium term the inflationary consequences of a US dollar devaluation would seem remote, since it would end up being a race to the bottom with a series of competing devaluations amongst US creditors and foreign asset holders.

furthermore those of us expecting the immanent demise of the greenback , i think are going to have to wait a while.

when we get further deflation in global equities markets, it would be reasonable to expect the US dollar to appreciate significantly, which may put pressure on the currency value of gold. you would expect gold to hold up reasonable well under these circumstances since equities deflation would increase the demand for gold. but i would expect the dollar to out perform gold.

foreign stake holders and their 20 trillion dollar stake in the US economy are going to go along for the ride, they are not going to cause a currency crisis, atleast not yet.

in the long run the view from 30,000 feet is inflationary. the chain reaction the gfc has started is going to lead to political instability over the next 20 to 30 years on a scale not previously scene. the political instability arising in domestic economies is going to eventually lead to currency crises and the

probable collapse of global trade and capital flows as we know it. spice things up with a few revolutions and a couple of small or large wars, and yes the future is very inflationary and good for gold as an investment, not as a reserve currency of any kind.

nothing short of arnedgeddon would bring that about and even still i have my doubts

ferb said, in July 7th, 2009 at 2:59 am

Elliotwave

Derivatives...<http://www.dtcc.com/>

.....here's some info for ya.

“What Hasn't Changed

Because, despite the global financial crisis and the changes it has brought, there are two trends in our industry that don't show much sign of change at all. One is precisely that increased globalization of markets. The other is the expansion of trading off exchanges and onto other platforms of liquidity. At a glance, these trends don't appear to be linked. But they are.”

http://www.dtcc.com/downloads/leadership/speeches/Donahue_SOI_Market_Structure_Keynote.pdf

Interesting, things don;t look paid off to me

http://www.dtcc.com/products/derivserv/data_table_i.php?id=table7

They never will be as long as they continue to be traded. In fact recent suggestions is that the big finance house in the US are back to there old habits.

ferb said, in July 7th, 2009 at 3:19 am

a report released by the BIS in june showing the stats for up till December 08. Any further info, we will have to wait another 6 months for the data....

<http://www.bis.org/statistics/otcder/dt1920a.pdf>

again, how were these magically paid off Eliottwave?

scepticus said, in July 7th, 2009 at 6:09 am

mahaish, I agree there is not a cat in hells chance of returning to the gold standard. It would smash our entire civilisation against the hard floor of the 0% bound within months and that would be the end of that.

I don't know why goldbugs continue to flog this dead horse – it won't work for the industrial credit economy or even a fascist/communist command economy and therefore it will not be adopted. Why can't they see this?

pebird said, in July 7th, 2009 at 6:21 am

Steve:

I think you are right on about the Keynesian remedy only being effective if private debt levels are low. Another (more conspiratorial) perspective is that to inoculate the economy from a Keynesian fix (say if you were an Any Rand objectivist) encourage generating as much debt as possible. Greenspan was more successful than we might think.

Joe B – obviously we (in the US at least) are experiencing both inflation and deflation simultaneously. We have asset deflation (real estate, pensions, equities) with increases in consumption costs relative to income (price inflation). You are right that it's difficult to substitute for energy and food.

I think we discount the effect of monopolistic controls of energy and food production on pricing – the ramp down in production/inventory management can be managed (somewhat) because competition effects are muted.

This dual nature (or whipsawing) of prices mirrors the money supply debate – most of the Fed's "print" has stayed in the banking systems (banking markets), and very little (to date) has gone into circulation.

See the latest comments from Biden on why the money hasn't been "spent". I think there is a real fight going on inside Washington on whether the stimulus will actually be spent – and the banks are winning. Remember, it's not just amount of funds, but the velocity and right now the velocity is low and getting lower. This lack of spending basically takes the air out of the stimulus – guaranteeing its failure. Also see Jim Sinclair's web site (jsmineset.com).

The uncertainty as to whether we will actually have a stimulus is (IMHO) one reason why the indicators are all screwed up. Spreads, indexes, volatility don't have any predictive value. So the public has left the markets and the robots are trading with each other using the (future) public's funds.

The reason WWII "solved" the Great Depression was that finally there was a sufficient social reason to ramp up spending without political constraints. Remember, the production was used to create things that were basically immediately destroyed (airplanes, tanks, ordinance, etc.) – which is why when Keynes said to hire people to bury money then hire other to people to go find it and you would have a recovery, he wasn't entirely joking.

As to all the talk about hyperinflation – the entire world can't go into hyperinflation at the same time – it makes no sense – as a monetary effect it has to be in relation to another currency. Besides, you think banks (who actually issue money) want their debts paid off with valueless currency?

Whereas the entire world CAN go into deflation. Remember that the US did not go into hyperinflation during the Great Depression and neither did Great Britain. Germany was in a very unique situation (loss of territory, reparation demands in gold, highly organized labor force, post WWI bubbles).

elliottwave said, in July 7th, 2009 at 6:50 am

Scepticus

Are you willing to put your money where your mouth is?The gold certificate ratio will be reintroduced in 2012 when people will be suffering so badly they will agree to anything.This will happen.

Anyone who thinks Bernanke and Greenspan are stupid are more stupid and lack any intelligence at all.They know exactly what they were doing it is you who has no idea.

Otto C. said, in July 7th, 2009 at 7:24 am

Steve,

I don't understand your statement that demand = sum of GDP + change in debt?

In an earlier posting you said $GDP = \text{Consumption} + \text{Investment} + \text{Government spending} + \text{Exports} - \text{Imports}$.

Let's say that the latest figures include a demand by John X. for a car costing \$30,000 and he pays for it with a deposit of \$5,000 (cash) and borrowed money of \$25,000 (debt). This gives us Demand = \$25,000 (change in debt) + \$30,000 (consumption) = \$55,000; it looks like we are double counting the change in debt?

Am I missing something?

Otto C. said, in July 7th, 2009 at 8:28 am

Steve,

I have overlooked the case when John X. at a later time, after the car purchase, may pay off the car loan. In that event we have a reduction in debt without an accompanying consumption of goods. Maybe the change in debt to which you refer is where the debt position is altered without any connection to consumption? Anyway, your clarification would be appreciated.

ak said, in July 7th, 2009 at 8:32 am

pebird,

"The reason WWII "solved" the Great Depression was that finally there was a sufficient social reason to ramp up spending without political constraints."

I agree but the problem is that we cannot increase spending within the constraints of the current system. There is simply no more oil and we cannot burn any more coal without burning ourselves.

The only solution I believe is to ramp up spending to move to the next level of energy efficiency.

scepticus said, in July 7th, 2009 at 8:46 am

elliottwave, My pet theory is as follows:

the combined effects of enormous socioeconomic pressure and massive negative real rates will ensure we break through the 0% bound on interest rates long before any gold certificates might have a chance of coming into force, and regardless of liquidity premiums and suchlike.

At that point we get a reasonable bounce in gold, after which when it becomes apparent the world is not now going to fall apart as a result of having a -ve savings rate and deflationary pressure eases, gold will simply and quickly return to a slightly preferable form of cash.

You have your theory, I have mine, and most of the rest of the posters here seem to have theirs.

All good stuff – we'll have to wait and see before we judge.

ak said, in July 7th, 2009 at 8:58 am

Otto C.

I believe that it should go like this (of course this is a simplification):

John X lives in a town which is our economy we want to describe.

John X made goods worth \$50000 over a year. Other people made goods worth \$950000 including the car John wants to purchase next year. The total GDP is 1000000. This is the value of goods the inhabitants can purchase using that income.

Now a banker arrives in the town and he lends John \$25000 to buy a car. So the total amount of money they can spend in the town next year is \$1025000. There is no double-counting as we are talking about separate periods of time when money is earned and spent. If we want to make our model more realistic we can decrease the period of time we are integrating data (arriving at differential equations) and start decorating our economy with import, export etc.

NB if the inhabitants of our town can't borrow any more but have to pay back the debt they have less money to spend – what exactly happens with our economies too.

Private and public consumption and investment, import and export are included in the GDP because it is easier to record them rather than get directly the value of products and services manufactured/delivered over a period of time by the economy.

Reading the following paper may be helpful to understand why it is so hard for mainstream economists to grasp that private debt does matter.

<http://www.debtdeflation.com/blogs/wp-content/uploads/papers/KeenNudgeNudgeWinkWinkSayNoMore.pdf>

[StilesBC](#) said, in July 7th, 2009 at 12:33 pm

scepticus,

I just finished reading Money, Bank Credit and Economic Cycles by Jesus Huerta de Soto.

Your comment about 0% growth in perpetuity under a 100% reserve gold standard sounds phenomenally ludicrous after reading this book. Unfortunately, it seems to be a fairly common view among the anti-gold crowd.

First, it appears that your analysis suffers from an incorrect definition of “growth.” Which is, of course, a rise in productivity, an accumulation of capital goods, etc. Nowhere is this hindered by a restrained quantity of money. An unrestrained quantity of money can only be used to finance malinvestments, which may show up as growth at first, but are doomed to be subtracted when they are proved insolvent. So in other words, the growth which you celebrate, is really only inflation (credit expansion).

The quantity of money is totally irrelevant to growth. Money is merely a means of exchange that evolved spontaneously in the market place. There cannot be a “shortage” of a means of exchange so long as the prices which they are exchanged for are free to adapt as they please to the demand in terms of monetary units.

Huerta de Soto dismantles every argument in favour of fractional reserve, fiat money and central banking. If you're compelled to ask, "why can't they see this," then perhaps you should have a read through this book to understand the perspective a little better...

ak said, in July 7th, 2009 at 1:03 pm

Gold standard recycled again and again and again, never enough...

Welcome back to Ireland 1845-1849. This is what you are proposing.

"Monetary policy became captive to the amount of gold that a country possessed (principally derived from trade). Variations in the gold production levels also influenced the price levels of countries.

In practical terms, the adjustments to trade that were necessary to resolve imbalances were slow. In the meantime, deficit nations had to endure domestic recessions and entrenched unemployment. So a gold standard introduces a recessionary bias to economies with the burden always falling on countries with weaker currencies (typically as a consequence of trade deficits). This inflexibility prevented governments from introducing policies that generated the best outcomes for their domestic economies (high employment)."

<http://bilbo.economicoutlook.net/blog/?p=2562>

[StilesBC](#) said, in July 7th, 2009 at 1:17 pm

"Monetary policy became captive to the amount of gold that a country possessed"

Quoting this shows how painfully little you understand about the theories of free banking and non-fractional reserve systems.

"Monetary policy" doesn't exist under such a situation because there is no central bank. No wonder Ireland's experiment failed.

Additionally, the recessionary bias that is attributed to the gold standard is typically a result of the prior inflationary boom, rather than the medium of exchange. There is no theoretical foundation for negative growth being any more prevalent under a gold standard than anything else.

ak said, in July 7th, 2009 at 1:55 pm

I am sorry but you didn't even recognize the actual events I was referring to.

Gold standard was in place in the 19th century in the UK. The "experiment" I am referring to is called the Great Famine.

[http://en.wikipedia.org/wiki/Great_Famine_\(Ireland\)](http://en.wikipedia.org/wiki/Great_Famine_(Ireland))

"Records show Irish lands exported food even during the worst years of the Famine."

<http://www.corkpastandpresent.ie/history/historyofcorkcity/1700-1900/corkinthe19thcentury/>

"The return of the currency to the gold standard led to a contraction of credit and the subsequent collapse of many banks. After 1824, Irish industry was exposed to competition from the far more developed British economy"

Why do we have to recycle again and again the same set of scholastic ideas which are not even remotely related to the reality?

alex78 said, in July 7th, 2009 at 1:59 pm

On the deflation/inflation debate, are the Austrians/inflationists effectively saying that Bernanke will explode the money supply much, much higher? That is, if they accept the premises laid out in Steve's Cavaliers of Credit:

'To make a serious dent in debt levels, and thus enable the increase in base money to affect the aggregate money stock and hence cause inflation, Bernanke would need to not merely double M0, but to increase it by a factor of, say, 25 from pre-intervention levels. '

Hugh Hendry makes a good point here about how Bernanke might have been scared off from raising M0 by the international community demanding strength in the USD (the German Chancellor, and the Bank of China)and gold being near \$1000 USD. He also challenges the prevailing hysteria over governments becoming more indebted (it's happened recently, in Japan no less, and bond yields remained low).

<http://www.greenlightadvisor.com/glablog/2009/06/18/hugh-hendry-june-2009-letter>

On markets he's worth listening to, unlike the tired rantings of some Austrian-school brokers.

elliottwave said, in July 7th, 2009 at 2:12 pm

Alex,

Inflation has nothing in common with hyperinflation, do not make the mistake of deflation/inflation.

Inflation, the economic event, the bubble type can only occur during times of supposed growth that will not happen. Hyperinflation, the currency event only happens during the most depressive of business conditons and is a currency event that you can only insure against by holding physical gold to store and protect your wealth.

Ernie said, in July 7th, 2009 at 2:49 pm

'To make a serious dent in debt levels, and thus enable the increase in base money to affect the aggregate money stock and hence cause inflation, Bernanke would need to not merely double M0, but to increase it by a factor of, say, 25 from pre-intervention levels. '

Although I understand that concept, I am not buying into it yet. What I think is more likely to happen is the money printing will make the dollar loose sentiment in foreign exchange, and collapse in value. The US being a nation of net importers will see serious price inflation from reduced purchasing power of critical imports such as energy, cars, Chinese consumable goods etc.

[StilesBC](#) said, in July 7th, 2009 at 3:13 pm

alex,

For the record, I am an Austrian and an avid deflationist. See the most recent post on my site:

<http://futronics.blogspot.com/2009/07/themes-for-2009-mid-year-review.html>

There are many others like Mish, Saville, Depew. Most of the trained Austrian economists (rather than the gold pumpers that are found on message boards) admit we are in a debt deflation as Mises outlined so clearly:

“There is no means of avoiding the final collapse of a boom brought about by credit (debt) expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit (debt) expansion, or later as a final and total catastrophe of the currency system involved.”

ak,

No. That is not the gold standard. You are referring to Peel's Act of 1844. It outlawed the use of banknotes as fractional reserve instruments, but ignorantly allowed bank deposits to be leveraged instead. As a result, Peel's Act was an epic failure and the inflation/deflation paradigm continued without batting an eye. Very much like the gold exchange standard of the 20s.

Everything I have read on the Irish potato famine you cite has to do with... potatoes, not gold.

ak said, in July 7th, 2009 at 3:50 pm

StilesBC,

The Irish famine was the ultimate failure of the free market concept when people were dying in thousands due to the disease affecting potatoes and at the same time food was sold to England because this was profitable. Did the people die because of the imperfection in the gold standard causing a credit bubble? No – it all happened because of the lack of a social policy and proper tools to implement it.

The article written by prof Mitchell explains why in modern times gold standard has been abandoned. It was abandoned because it didn't work not because people couldn't understand the ideas from de Soto's book. You can't feed hungry people with praxeology.

elliottwave said, in July 7th, 2009 at 3:53 pm

ROOIVIS

Have you seen the video i posted about gold in Zimbabwe?

I believe you thought you were pretty smart, but it did not turn out that way did it?

Is Iceland going through deflation? HELL NO
Is Zimbabwe going through deflation? HELL NO.

Please deflationists exchange your toilet paper for real money and that has always been GOLD.

jh said, in July 7th, 2009 at 3:54 pm

Steve,

Normally in each debtwatch you tend to end the commentary and have charts on the Australian data.

Have you not done this this time because you are traveling or is it some other reason?

Will you be publishing your standard set of charts when you return?

Thanks,

JH

[StilesBC](#) said, in July 7th, 2009 at 4:43 pm

ak,

I will admit to knowing little of this episode before you brought it up (other than it caused many to emigrate to NA). But researching it is fascinating. Tragic indeed. And a major divergence from the theme of this thread... but important nonetheless.

We will never agree on the causes of this, likely because we use a different methodology of historical analysis. I, like the Austrians, look at history through the incentives and motivations people displayed at the time. You will, I assume, look at it through a positivistic, quantifiable lens. We will naturally emerge with different opinions. But I'll give mine and retire for the evening.

Ireland was ruled by the British at the time. They had bought most of the lands in Ireland. I don't know how exactly. Irish laws appear to have been such that only inheritance entitled ownership. Thus, the remaining lands in Ireland were split among the inhabitants. The relatively small nature of these lands enabled the owners to grow only one crop profitably – potatoes. When the disease struck, the British continued to ship their cattle and grains home. The impoverished Irish, whom they didn't care for anyhow, had no means to outbid them. Famine ensued.

My first question when reading about a potato famine in Ireland is, “why only potatoes?” What possible motivation could there be for an entire country to be so dependent on only one crop that they risk starvation in the event of crop disease? The restrictions I mentioned above answer that question, so I am led to believe that it was a government intervention that preceded the crisis as the cause.

You will argue otherwise, I am sure, that it is government which should have reacted by enacting some sort of legislation, which was apparently tried – but failed.

We will never agree. Our interpretive methodology ensures this.

evokadevo said, in July 7th, 2009 at 5:58 pm

elliottwave, You sound like a certifiably committable gold nut. You must realise gold as an investment has nothing to do with gold as a form of currency. How much gold do you think there is in the world? (about 3500 metric tons) How would you make change in a retail transaction? Eighty percent of all existing gold is hanging around young maiden's necks in the form of jewellery. The other twenty percent is heavily guarded. How are you going to separate current owners from their property? Give them “toilet paper money”? Have you tried to buy a gold coin (or two) in Australia lately? I bought a one ounce kangaroo gold coin for investment last year. retail price then \$1,049.00 cash. They take two forms of identity with your home address. This is to prevent drug dealers and other outlaws from evading the currency laws, I presume. The Federalies are at least two steps ahead of you, and all the gold producers, dealers and owners probably more. Revel in your own mountain of gold as Scrooge McDuck did, but do not expect any big changes in the financial world any time soon.

elliottwave said, in July 7th, 2009 at 6:31 pm

EVOKADEVO

Does it not make you think that the powers that be are 2 steps ahead of the public. They are the ones that will profit from the gold certificate ratio. Please read what my friend Jim Sinclair knows that is coming wake up toilet paper lover.

Author: Jim Sinclair

Why will the effort to call any top in the gold price be a waste of time for the gold-ignorant gurus?

Prior to being reduced to zero percent and then removal from the books, there was a direct link between the value of US Treasury gold held (a fixed price of gold then) as a percentage of the growth of the US money supply. As an example, when the cover was deemed to be 25% that meant that as the money supply expanded the value of gold had to be expanded by 25% as well.

Because the price of gold was fixed, the gold cover clause, as this device was known, mandated an automatic change in the Federal Reserve Discount rate in order to depress the demand for funds in the US economic system.

There is an argument that says as the dollar was becoming a primary reserve currency, and world trade was growing at record rates, the automatic changes in a monetary system were restraining the true wishes of the Administration and Federal Reserve.

After the demise of the Bretton Woods Agreement, everything financial moved towards a floating system. The move away from fixed points towards a fully floating financial system was the process of removal of all financial ALARMS. No longer was there a currency parity rate that when hitting the lower or upper bands rang an ALARM. The concept of financial crisis no longer existed.

The movement of any currency up or down – as the Euro recently did – would have been considered a financial crisis. We have just witnessed multiple central bank interventions that are accepted by the establishment's international investment community as a dandy deed in the cover up of other serious systemic weaknesses. As a result, upper and lower bands have been considered and implemented. To benefit the plan, the lower limit of \$1.49 will not be defended yet in time the market will. \$1.49 is only a point after which no great undertaking of intervention will be applied. Let the apples fall from the tree, if they please, as per today.

There is no return to a FIXED anything, but there is a clear indication of a return to the relationship of floating financial alarms, a marriage between the thesis of Bretton Woods and the floating sins of our Financial Fathers.

The Revitalized and Modernized Federal Reserve Gold Certificate Ratio will be tied to a broad measure of money supply, M3 or another new definition of liquidity.

The gold that the US Treasury has held primarily at the New York Federal Reserve will be valued at market at the time of adoption of this mechanism. Please understand that regardless of the arguments concerning the number of ounces the Federal reserve holds, since it will never be audited, accept what is said as correct. Now the floating increase or decrease in monetary aggregates will mandate a change in the value of the gold held by the US Treasury.

The US Treasury will never have to buy or sell any gold because vehicles will be created that are immediately traded on exchanges that will speculate on the changes in the broad base monetary aggregate in terms of the gold price. That will serve the needs as the aggregates increase.

This is in fact a public way to view the aggregate change by changing the value of another asset, which is a means of balancing the balance sheet of the USA as it was at the day of adoption. It is not convertibility. It floats and is not fixed.

When the need is greatest it will be seen as an acceptable return to a form of disciplined central banks actions. It will be a reinstatement of an alarm mechanism but with parts that float.

The market value of gold on that day will be a pendulum-starting point, not a fixed price. The broad measure of money supply on that day will be 100 on the liquidity index.

Assuming the dollar is at .5200, the adoption of this mechanism could mark the low of the US dollar for this chapter of the financial history of the USA.

There are other items that will have to fall into place if that is to be the dollar saver from a complete Weimar experience. But this is the major criterion for success.

I assume it is January the 14th, 2011 and gold is trading at \$1,650 or higher. Then I would assume the price of gold to trade \$100 above and below the price of gold on that day according to changes in the liquidity index.

If the USA would like to avoid the USD\$ from a Weimar experience this is the key ingredient to preventing that.

The US dollar is headed in the direction of the Weimar Experience in order to satisfy financial failures of significance. Some smaller entities will be rescued by Federal Money, exploding the US Federal Budget deficit and putting the weight of more newly created dollars on the inherently weak dollar.

There is a 70% possibility that since central banks have moved to floating currency parities that the modernized and revitalized Federal Reserve Gold Certificate Ratio will follow under the pressure of future systemic and grave financial circumstances

Philip said, in July 7th, 2009 at 6:35 pm

As for the gold debate, I find it pointless to trust Austrian economists on this issue as they have not developed an empirical analysis of how the current financial system functions in the real world. Neoclassical economists are similar in this regard.

A gold standard relies on the usual economic modeling of 'rational' agents – which is utterly irrational as Steve has pointed out. If Austrians could dump their pre-scientific a priori methodology and commit to inductive empirical science, they could become an economic school of thought worth listening to.

Listening to them is similar to listening to mainstream economists in the US who have the 'solutions' when they missed the problems to begin with e.g. \$US8 trillion property bubble, \$US10 trillion stock market bubble, etc.

If Austrians could correctly model the financial economy using dynamic modeling (along the lines of engineering and physics) then it would follow that they may have a solution worth listening to. Until that time, I don't think they will be taken seriously.

SuitablyIronicMoniker said, in July 7th, 2009 at 8:11 pm

“praxeology” – a framework for modeling human action, commonly used in connection with the work of Ludwig von Mises and the Austrian School of economics. (wikipedia)

Wow, I love learning stuff. I can't wait to use this word in a sentence in the next week!

[Paul Nollen](#) said, in July 7th, 2009 at 9:02 pm

Some very interesting charts about the evolution in France by Jacques Friggit
http://www.cgedd.developpement-durable.gouv.fr/rubrique.php3?id_rubrique=137
and especially chart 2.1 with the relationship between household income and real estate price
<http://www.adef.org/statistiques/upcharts.doc>

Jacques Friggit is known for his development of the “Friggit tunnel” a statistical relationship between household income and real estate prices.

Paul

IAN said, in July 7th, 2009 at 10:16 pm

Elliotwave – I think you're on a hiding to nothing with your, 'gold,gold,gold' stuff here..

To answer one of your (unanswered) q's, I can't recall Steve ever giving any credence to, or serious discussion of, the barbaric metal. This site is for lengthy & intellectual economic discussions weighted towards depression. Or what ever.

Anyone (and there have been a few) asking plaintively, “What do I do to save myself?” are generally ignored. As they should be on a highly intellectual discussion board such as this; I mean, God forbid that we deign to talk to the common man. Oh no! Keep out the riff-raff.

So, Elliottwave, know your place and shut up, OK? Just because I (and maybe you) cashed in our super, sold the tupperware and bought the gold etf soon after it listed and it's now gone up a zillion% whilst our friends (and most on this board?) have suffered 30-60% losses is neither here nor there in the REAL world of...economic semantics.

Save your breath. It's wasted here.

Keating said, in July 7th, 2009 at 11:07 pm

Hi Elliottwave I watched the video you posted, as sad as it was I think your drawing a long bow if you think the mess that zimbabwe is in has any relevance to our western economies in relation to the argument of hyperinflation or deflation.

All I'm saying is that Zimbabwe has collapsed back into the dark ages, people aren't using gold to buy the latest BMW there not using it as their base currency.

Zimbabwe's mess has so many factors including civil unrest, failed food crops on a national scale, zero confidence in its government, terrible trade relations with the rest of the world and of course bad economic policy,

If things get that bad on a global scale it won't matter how much gold you have socked away under your mattress, if breads worth more than gold you won't last long anyway.

travelite said, in July 8th, 2009 at 12:12 am

@Philip,

Well Philip, alot of the Austrian's I know were calling this bubble well before anyone else, along with it's crash and deleveraging.

It doesn't take dynamic modeling to work it out.

I think the modellers suffer from the same mentality as the central banks... they love to simplify something too much.

Economics is all about individuals ordinal preferences, not necessarily quantitative ones, and this is why most just don't get the point that individuals can't be modelled like a physics experiment.

[StilesBC](#) said, in July 8th, 2009 at 12:53 am

elliottwave,

I have a hard time listening to someone who has been bullish on one asset class and one asset class only for their entire career. It becomes more "sales" than "analysis." There's no reason to be overly bullish on gold right now. Unless you believe in an imminent hyperinflation. But that's not happening.

Philip,

Yourself (and Steve as I have noticed) make the mistake of labeling the Austrian School as some sort of proponent of a utopian economy (where all actors are rational, etc). This is a misrepresentation.

ABCT suggest that attempting to develop an empirical model of an economy full of individual actors is impossible. Each person has their own subjective value scale which changes rapidly based on new signals given every day in the marketplace. No individual can absorb ALL information. That is impossible (also why socialism is impossible, but I digress). Hence, there will be success and there will be failure. Failure is not a fault, but rather a feature of ABCT. It allows for needed rebalancing between actors. The most desirable situation would have as few exogenous factors as possible getting in the way of people's decision making processes.

You want Austrians to be able to dynamically model the economy like engineering or physics. Square peg, round hole. Neither of those sciences deal with people.

Joe B said, in July 8th, 2009 at 2:15 am

alex78,

Yes, I'm expecting further expansions of M0, although I couldn't give specific proximate motivations for doing this. Basically I think the US government's options are shrinking rapidly, and they have shown that they aren't afraid of monetizing assets to bypass the banks and prop up prices. I think they will continue to test the waters, increasing the amounts each time until there's a significant backlash. And at that point, they may find that the money train has no reverse gear.

Steve's estimate of a 25x increase in M0 assumes that only new money is being used to repay debt, all at once. However, over time deleveraging will occur using existing money. This brings deflation with it, but it also reduces this private debt/M0 ratio.

So the longer deleveraging goes on, the more feasible Keynesian solutions look to people who don't think that "Keynesian Solution" is an oxymoron. I'm imagining Bernanke looking at the numbers and saying, "You know, with 6 months and another 1.6 trillion, maybe we can lick this thing. Let's run that past China. How 'bout a Fresca?"

Actually, I'd be curious to see a chart of the US Private Debt/M0 ratio over the last few years, to see what the current trend looks like. Steve?

Private deleveraging ends when all debts are paid off or written off. The deflationary effects of deleveraging end when the rate of debt repayment (or asset selling) is less than the rate of nominal price increases.

I think that there are several factors that will contribute to nominal price inflation of consumer goods despite deflation in asset prices:

- As I've detailed above, supply and demand are both disappearing, and nominal demand can be saved more easily than productive supply through government action. I don't think deflation will hit all asset classes uniformly – in particular consumer goods may be affected very little due to decreased production.

- Look around next time you go shopping. How many of the goods that you buy are made in America (or Australia if that's where you live)? Changes in the exchange rate can cause drastic changes in consumer prices in economies where most goods are imported. While Americans are scrounging dollars to pay off debt, foreigners are seeing their dollar holdings being diluted in large moves. When they sell off and the USD drops, US prices go up. The Forex market dwarves all domestic exchanges. There are a number of "Black Swans" that could trigger such a selloff. (note – Australia is in a somewhat different situation due to the carry trade and the perception that it is a "commodity currency".)

- Obama has big plans, and needs to throw a lot of cash around to make them happen before his next election campaign. He will keep borrowing, and the Fed will keep buying to prevent a failed auction. The Fed doesn't want a currency crisis, but they may soon realize the costs of collaborating with the government. I have a feeling that Ron Paul's "Audit the Fed" bill could have the unintended consequence of providing justification for congress to seize the Fed. Then Obama and his cronies get to decide how many times to hit the zero key. Maybe Oprah will get to hit it once or twice to show how much she cares.

I read somewhere that in June, they redefined who counts as an "indirect bid" in treasury auctions. This makes it look like there is a lot more foreign interest than there actually is. (I don't have a link, but I believe this was reported in the wall st journal, tucked away in a back corner)

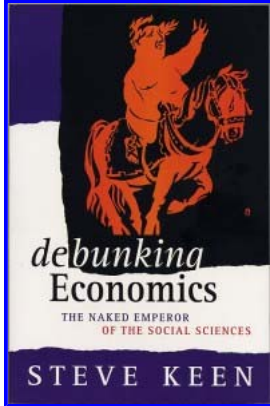
- Asset monetization puts new cash directly into private deposit accounts. This will initially be used to pay down debt, but some of it will accumulate, as evidenced by the recent spike in US savings rates. This money will be there, ready to go, when people feel that it's safe to spend again. It will also put pressure on banks to lend, especially if interest rates go up and investment revenue dries up.

Austrian inflationists are expecting a massive debt deflation, and it could take years. But they are looking beyond this to see what the next step will be. The inflationary factors I have mentioned here will continue and probably grow throughout the deflationary phase, and could come roaring out the other end once private debt deleveraging has subsided.

Maybe our wise and benevolent leaders will get it just right. But the case for inflation goes beyond economics, and those leaders have the opportunity of a lifetime to justify all of their pet projects.

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 - [September 2008](#)
 - [August 2008](#)
 - [June 2008](#)
 - [May 2008](#)
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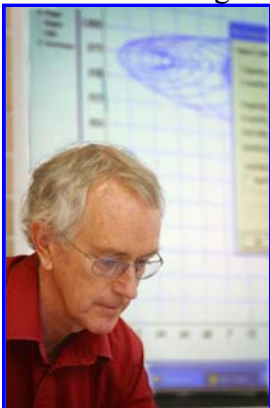
Events Calendar

-

July 2009						
Mon	Tue	Wed	Thu	Fri	Sat	Sun
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		
 Month				 Year		

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- [20070826 New York Times: Inside the Countrywide Lending Spree](#) - Inside the Countrywide Lending Spree
- [20070917: How bad debt infected the world](#) - Excellent Sunday Telegraph feature on CDOs
- [7.30 Report](#) - Many Baby Boomers will retire in debt—and I'm probably one of them!
- [ABC PM on US Subprime Crisis](#) - Stephen Long covers the USA Subprime crisis and local angles with interviews of Steve Keen, Ian Rogers (The Sheet) and David Tennant (Care ACT)
- [Bear Stearns: Turmoil in sub-prime mortgages](#)
- [Beware of Exploding Mortgages \(New York Times June 10 2007\)](#)
- [Can the mortgage crisis swallow a town?](#) - New York Times chilling description of the mortgage crisis's impact on one town in Ohio
- [Centre for Policy Development](#) - The policy portal that evolved out of the New Matilda
- [Credit derivatives: At the risky end of finance](#) - The Economist on derivatives
- [Debtwatch Podcast](#) - Debtwatch's Monthly Podcast with Stuart Cameron (www.cameronmedia.com.au)
- [Debunking Economics](#) - My Debunking Economics website. A wealth of lectures and papers, and a poverty of organisation!
- [Doug Noland](#) - Doug Noland's Credit Bubble Bulletin: the best analysis of America's Speculative Bubble
- [First home payments hit \\$3000 per month](#)
- [FN Arena: Mortgage crunch in Australia too?](#) - FN Arena covers my March Debtwatch and more optimistic (or Panglossian?) takes on the situation from Macquarie Bank, etc.
- [Global House Price Crash](#)
- [House of credit cards may fall](#) - Robert Lusetich, Los Angeles correspondent for The Australian, bemoans the nature of America

- [Housing Affordability](#)
- [iTulip](#) - One of the best commentary sites on the Internet Bubble has been reborn amid the USA's mortgage binge
- [NZ Reserve Bank on Regulation: PM May 9th 2007](#) - Interview on the Budget, Inflation, and New Zealand's Reserve Bank's shift on regulation
- [Our economic managers](#) - Non Sequitur's brilliant take on those who think the "status quo" will last forever
- [Property Knowledge Group](#) - An interesting impartial forum on housing issues, unlike most such forums that are either bulls or bears. Holds regular public debates on the topic. Well worth attending
- [RBA 2003 Conference on Asset Prices and Monetary Policy](#) - This is an excellent set of papers on the dangers of leveraged speculation, and the capacity of the market for irrational behaviour.
- [RBA Bulletin Statistical Tables](#) - The good people at RBA Statistics have recently added a Zipped file that contains all their XLS files—many thanks!
- [RBA Speech March 16th](#) - One economic indicator not considered in Dr Edey's presentation was the level of private debt...
- [Shared Equity Loans](#) - Well-researched article on the pitfalls of shared equity mortgages
- [The New Matilda](#) - Intelligent alternative thought on social and economic issues in Australia
- [True rate of home defaults hidden](#) - Repossessions may be four times higher than reported figures
- [Two Depressions, One Banking Collapse](#) - An excellent comparison of the 1890 to the 1930 Depression, by Chay Fisher & Christopher Kent, which shows how much more severe the 1890 downturn was for Australia, and the role of debt and housing speculation in that crisis
- [US Federal Reserve Historical Statistics](#) - I use the Zipped "tabs" files from this page; check the bottom of the page for an explanation of the data structure
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