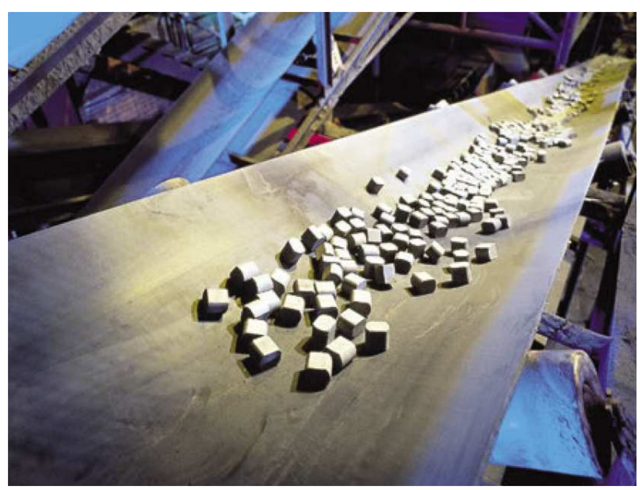
Resource Ruminations

30th Sept 2009

Show Me the Money



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Show Me the Money

The crisis of 1907 was one of a series. I remember very well, although probably few of you do, the financial crash of 1873. I am sure you all remember that of 1893, from the effects of which the country did not recover for many years. Between 1900 and 1907 we had recurring periods of depression, of dangerous perturbations in the money market, when the Secretary of the Treasury was frantically called upon for assistance, and felt obliged to adopt the very questionable policy of making large deposits of public money in banks to relieve threatening situations...

Of course, until human nature is changed, it will not be possible to prevent, by legislation or otherwise, periods of over-speculation, with undue inflation of values and overextension of credit. When we consider the characteristics of the American people, whose unrivalled energy and enterprise are not always confined by the limits of prudence, it is certain that we, in the United States, shall always have periods of speculative inflation, with the evil results which are sure to follow.

Senator Nelson W Aldrich, Founding Father of the Fed, Address to the Economic Club of New York, 1909

In the battle for airtime between the inflationists and deflationists, the latter tend to concentrate exclusively on the fact of the banking sector's poor provision of credit to the private sector. This, they insist, means that deflation must eventuate as a direct result of the fact that the banks either *will* not lend (due to the barely-concealed horrors lurking within their balance sheets) or that they *cannot* lend since private companies and householders, in the round, are more concerned with paying down debt than contracting more of it.

While there is undoubtedly some merit in each of these observations, we must emphasise they are not of themselves decisive in trying to determine whether a full realisation of the losses we sustained during the Boom – in terms of failed businesses and discharged workers - will be made with the prices of goods-in-general rising or falling.

The first - and most easily disposed of - qualification to the case that no new CREDIT means no new MONEY is that it entirely overlooks the machinery of the State – by which we mean the concerted powers exercised both by the fiscal authority itself and by its no-more-than-notionally independent central banking auxiliary. As we should by now be fully aware, the central banks have played a significant role in helping governments everywhere spend well beyond their means, whether through the direct purchase of Treasury paper or through the generous support and near-free funding they offer to the commercial banks within their fief who buy this in their stead.

More fundamentally, there lurks within this issue a deep-seated misunderstanding of the very distinct nature of MONEY and CREDIT itself – a distinction no less important simply because CREDIT - especially in the upswing – can provide a partial substitute for MONEY, helping economize on its use, or magnify its potency, whichever you prefer.

For a simple instance, there has been much talk about the fact that the rate of growth of the misleading-named US M2 aggregate has first decelerated, then actually reversed since the start of this year, supposedly threatening us with a renewed crisis and highlighting the ultimate impotency of the Fed and its peers.

Aside from the higher-level considerations with which we shall deal below, this is a classic example of unthinking aggregationism at work for what has been happening is that a sizeable shift in portfolio holdings has been taking place as the insidious fear of missing out on easy gains has gradually replaced the more primal phobia of losing one's entire table stakes which predominated in the aftermath of Lehman's collapse.

Thus, in the past six months, we see that M2 as a whole has fallen around 1% or so, led by a 5.1% annualized decline in its non-M1 components (i.e., by a fall in what are, at best, only *quasi*-monies rather than anything involving the real McCoy). A closer inspection reveals that the $170 billion fall in this last can be fully explained by the $180 billion drop in retail holdings of money market funds – a move itself easily explicable if we switch attention to the ICI statistics relating to all mutual funds. Here we find that a similarly substantial fall in money-market mutual fund holdings (this time in the six months to July) of $288 billion has been almost exactly matched by inflows of $255 billion into taxable bond funds.

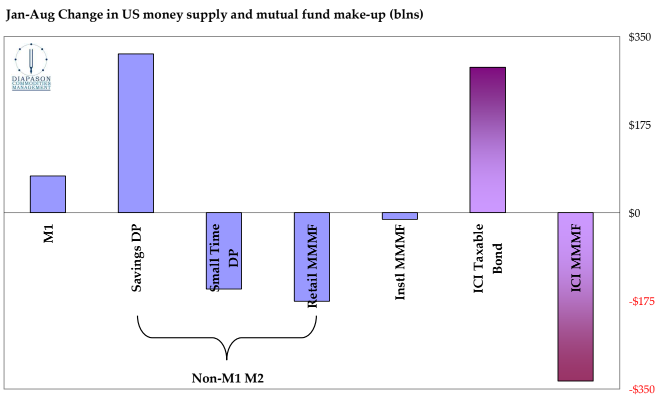

Figure 1: Portfolio shifts, not 'deflation'

Far from giving warning of a looming deflationary bust, this transfer – which has reduced junk spreads by over 700bps and those on BAA corporates by 320bps while rekindling the debt-led takeover bid and encouraging record bond issuance – is, in fact, signal evidence of an entirely opposite motivation, that risk is being embraced once more, lest short-term gains go begging.

In the meanwhile, M1 – comprised entirely of money proper - has been climbing at a vibrant 15% annualized clip, with our slightly broader, 'Austrian' money supply measure gaining around 8% annualized. Looking further afield, the supply of MONEY is rising in Europe at a rate only seen once before – in 1999 – in a 28-year record, while that in China is likewise skyrocketing.

To the 'pushing on a string' crowd, this is all by the by, for even those of them who will allow that the supply of MONEY is not necessarily contiguous with the official 'money supply' have recently begun to point up one of those 'unnecessarily original' displays of academic empiricism which statistically *proves* - Shock! Horror! - that the grant of a loan tends to go before the receipt of a deposit and hence before the need for a reserve at a central bank left, *ipso facto*, bereft of all influence upon the quantity of money in circulation.

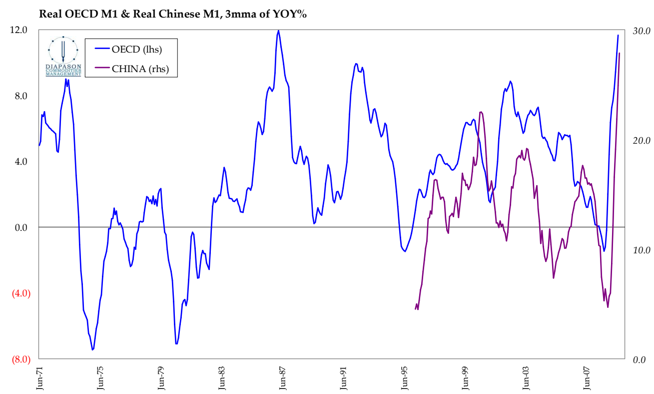

Figure 2: Full steam ahead

That the converse has not been the case since the days when currency was predominantly made up of a specie which was entrusted to the strongboxes of that Mediaeval bill broker and foreign exchange trader who sat to do business at his *Banca*, never seems to have occurred to those pre-disposed to seeing our doom in a re-run of the early 1930s. By contrast, the whole apparatus of a central bank-backed, forced-currency system – backed up with clearing mechanisms, repo markets, and interbank lending – is exquisitely designed to remove as many *ex ante* constraints as possible to the extension of bank credit.

So, yes, the demand for – and, in an interest-rate targeting regime *operating under normal conditions*, the supply of - bank reserves tend to come about in response to greater loan volumes and hence are more cause than effect. But a further level of understanding of the varying role of money and credit is needed if we are to analyse the current extraordinary situation – something the Keynesians mainstream typically scruples to do given its insistent focus on end-consumption to the exclusion of all else.

The proponents of this most petulant of economics always seem to think that if they only twist the knob more violently, or punch the buttons harder, more volume will come out of the TV set, regardless of whether there's a battery in the remote, or whether the signal is being transmitted to the aerial, or whether the speakers are already at maximum capacity – or even functioning at all. At root, they are all Cargo Cultists, all believers in the Tooth Fairy where the consumer's Wish and Expectation triumph over the producer's Means and Entrepreneurial foresight in preparing to satisfy them.

Giving credit where it's due

If, instead, we essay a more grown-up approach to the question, the first thing we will find is that when we expand the structure of production – and especially when we do this vertically by adding intersecting layers of specialization of characteristically greater remoteness from the final customer - we introduce more links into it and thus we tend to see CREDIT grow in proportion.

In a less impatient world than ours, this implies that the delay of gratification - i.e., an act of *saving* – is also taking place as we allow the man to whom we have sold our goods a certain accommodation while he processes them, hopefully adds value to them, and sells them on in his turn to the next manufacturer, a little further down the great, sequentially outsourced assembly line which is the modern economy.

So that we and he do not starve while this is taking place – or lack for the means to continue the productive process itself - we must be able to draw down upon a stock of unconsumed goods – i.e., upon genuine savings – though we need not have these piled up right beside ready at the factory gate, but can rather hold the MONEY which will buy them from another, ready to hand in a suitably safe place.

CREDIT, then, should represent a legal transfer from the grantor to the grantee of the entitlement to use the already-existing resources to which the former has a just claim. The lender may have the actual goods to be transferred in his possession – as, for example, the supplier of components to the factory upon whom he draws a bill or books an account receivable: more generally, he may hold those goods intangibly in the form of MONEY, i.e., they may be embodied in that principal good which is near-universally accepted in exchange for all other goods and whose supply should not run ahead of their overall availability and which – should this be at all allowed to alter – must not be augmented without a comparable degree of difficulty, for MONEY, in order to function properly, must be scarce in the economic sense of the word.

One of the intrinsic failings of our system - and the origin of its built-in tendency to produce booms and busts, regardless of the level of bank bonuses or the perspicacity of regulators – is that it allows CREDIT (a deferral of a claim upon resources by at least one of the two participants to its constitutive agreement) to be turned into MONEY (an *immediate* claim upon resources, therefore now exercisable before their replacement with goods of proportionate worth has been assured).

If we violate this prescription, it seems to many that we merely do away with some hidebound impediment to progress, that we advance the delivery of all the wonders of human ingenuity at little or no cost. Even Hayek is on record as endorsing this alluring misapprehension at one point in his *oeuvre.*

But what we actually do is subvert the process of saving and prostitute its intent. There are no free lunches as the man left to hungry will find out when the banker – by converting CREDIT to MONEY. For, by this act, it may be that a 'saver' is allowed to double deal – to deplete the store of resources he himself had pledged to his debtor before the latter has had a chance to complete his plans to utilise them for their mutual profit – or else it allows the borrower to counterfeit his claim to the goods in the warehouse without seeking the prior approval of their rightful owner. Either way, this unthinking fraud is likely to be revealed as an act of economic sabotage as it introduces a fatal disharmony between the means and ends of the productive process.

Moreover, by distorting the relative prices of real goods, this infernal alchemy this gives false signals as to the insistency and composition of the demand for them, as well as concentrating too much of that demand upon the unstable precondition of there being no interruptions to, or diversions to the pathway of, the flow of new CREDIT into the system.

More particularly, this Faustian transmutation alters the ratios between present and prospective prices via its suppressive influence on interest rates. This then encourages a gross misunderstanding of both the utilizable quantity of true CAPITAL (by which we mean those goods which can be devoted to use in further, *generative* procedures, as opposed to those given over to *exhaustive*, end consumption) and of the possibilities for its profitable (and hence welfare-enhancing) employment.

In such endemic confusion do upheavals such as the present one trace their roots.

Paved with Good Intentions

As an aside, though clearing, netting, the use of partial money substitutes – though *financial innovation,* if you will - can help increase the ratio between these two, at some point CREDIT needs a final payment in MONEY to settle the accounts, consummate the bargains, and to replenish the reservoirs as it percolates upwards, counter to the flow of the ever-more complete goods which are moving towards that final enjoyment which is the material end of all economic activity.

This seductive facility of being able to minimise the amount of money used in episodes of general optimism is not without its demerits. Since all such ancillary techniques tend to be highly dependent for their acceptance on the ready provision of yet more CREDIT (as well as on the implicit assumption that it will all continue to be instantly realizable as MONEY, should the need arise), they contain within themselves a perilous series of feedbacks, magnifying the instabilities meanwhile being introduced to the real, capital structure of the economy. These twin vulnerabilities set the stage for a dreadful irruption of the speculative floodwaters when the poorly-constructed levee walls give way at last, increasing the chances that the ensuing financial swirl will bring down the less along with the more ramshackle buildings, crumbling them all in what the jargon terms a 'secondary depression'.

It will hardly have escaped the reader's notice that, today, we are not *adding* courses to our pyramid, but instead undertaking its partial demolition; striving to pare back its over-ambitious scale to one where we may hope to have enough bricks to build it fully out. To complicate the task, not only must we reduce our scheme's disproportionate *height* – one which stretched a Jenga game of overeasy *producer* credit to the proportions of a Burj Tower of folly – but, at the same time, we are having to reduce its footings so as to exclude that overlarge, *horizontal* widening which was brought about simultaneously by excess *consumer* credit.

Thus, we should not be surprised to see private sector CREDIT shrinking, nor is it the expression of a sour-faced liquidationism to assert that it needs to do so. In a world where our chosen MONEY possessed a hard, unshrinkable core – as it would under a precious metal standard – ultimately, however steep the fall in general prices brought about as CREDIT contracted, this would halt itself far short of Armageddon as real MONEY balances – and hence the degree of command over other goods exercisable by MONEY holders - rose in inverse proportion.

With the further proviso that political interference did not prevent a simultaneous adjustment in *relative* prices (the warping of the matrix of which was the proximate cause of the crisis and the annealing out of whose strains is therefore a prerequisite of the recovery), ultimately a new equilibrium would be found – one in which, no doubt, many people would suffer a hardship for which they personally are not to be blamed, as the cheap gilt of false prosperity was chipped away from a far more basic coin of reality, but nonetheless not one doomed to be stuck in some despondent, Keynesian limbo of permanent under-achievement.

Of course, it is our Tartarean fate not to inhabit a world where either of these provisos holds true. For one, the amount of MONEY depends far too much on the stock of CREDIT and so, left to its own devices, tends to shrink along with it - thus impeding the compensatory rise in real balances - while, for another, government interference is everywhere to be found, from corporate bail-outs to welfare-state hand-outs, to the extent that the all-entangling 'safety net' which it proffers threatens not only to drown those already floundering in the rough seas of disabused Hope, but to drag the life-boat under alongside them.

In our peculiar, self-constructed Hell, we Sisypheans of the Free Market are therefore condemned forever to roll a boulder, which our false prophets exultantly make heavier every time we fail, up a hill which the office-grubbing class they serve uses our own labour to make steeper and more slippery, before each of our ever more futile attempts at reaching the summit.

For good or ill, the direct contractionary tendency is being addressed via the ongoing monetization of vast government deficits, as well as by the unsterilized, or non wilfully-withheld, proportion of the Quantitative Easing being enacted by the central bankers. Whatever we may think of its quality, this is indisputably injecting considerable sums of MONEY into the system – a re-liquefaction made more powerful still by the temporary fall in the rate of change of many goods prices.

The underlying tension holding back a full recovery, however, has two principal components. Firstly, there is dim recognition that such artificial life-support is not only of limited therapeutic value, but that it is liable to be switched off at the most inopportune moment *and hence that it precludes rational entrepreneurial calculation*. Secondly, the sad fact is that relative prices are *not* being allowed to adjust as they should, while the cleansing process of bankruptcy is being perverted to political ends and the State is itself preparing to devour – via the imposition of swingeing and often malicious taxes on wealth - the very capital upon which the renewed progress to which it so vocally aspires is conditional.

As already alluded to, the current asset boom is a, *deliberately-fostered* feature of all this for, whether or not non-financial, private CREDIT is growing, MONEY creation is in full swing and, as people consequently itch to get back on the speculative bandwagon, their desire to hold it for its own sake is no longer anything like the constraint it was a few short months ago. MONEY, after all, is like the object of a confirmed libertine's jaded lusts – only desirable to the extent that her virtue is not too easily attained.

Passing the Buck

To put some of these ideas to more concrete use, let us consider the Fed's purported new idea to engage in multi-billion reverse-repurchase agreements with money market mutual funds (MMMFs) – a policy by which it hopes to achieve a more 'restrictive' stance without having to sell its swelling swag pile of mortgage-backed securities (MBS) back to a market only too glad to be shot of them. Much of the commentary pertaining to this proposal has been riddled with a degree of poor thinking and categorical confusion that it would be as well to try to dispel.

To start from the beginning, consider that Bank A makes a loan to a Homeowner who pays his Builder B who, in turn, deposits the whole sum with the lending bank.

New private CREDIT (A's asset) has led to new MONEY being created (A's demand liability), the classic - BUT NOT THE ONLY- mechanism of inflation and also proof that, yes, loans precede deposits and hence run temporally and casually ahead of the genesis of the requisite reserve balances.

As an illustrative, but not strictly necessary digression, suppose Bank A next takes advantage of that indispensable accounting convenience, the special-purpose vehicle (SPV) and sells the now-securitized loan to it, as part of an MBS. The SPV sells asset-backed commercial paper (ABCP) to a MMMF which tempts our Builder B to buy a share in it. B writes a cheque to that purpose, emptying his deposit account at Bank A which, in turn, no longer needs the funds as it has disposed of the loan and so is happy to shrink its balance sheet, *pro tem*. 'Regulatory arbitrage' Rules OK.

Note now that CREDIT is unchanged (if henceforth residing in the Non-Bank or 'Shadow' world) while MONEY (Bank A's demand liability) has gone down – and all without pulling the temple down about our ears.

True, illiquidity is building and by lessening pressure on the bank's capital ratios we spur it to keep repeating the process to the point it may well unleash an 'asset' (notional collateral value)-credit price-spiral. Generally, if we collateralize people's future incomes instead of just their property, we can extend this to goods price rises, too – even absent an increase in MONEY, proper. Ostensibly, non-financial corporates can easily effect this through extending vendor finance whose receivables, via their captive finance arms, they can securitize, thus permitting them to engineer an apparent increase in profits not in the machine shop, but rather in the treasury department (see Appendix II below).

Furthermore, players in this casino can 'cash-out' notional asset-price gains by applying to the whole the 'mark to market' implications of transactions involving only a minor percentage of the stock of often non-homogeneous 'assets' outstanding. For example, the $2 trillion peak US housing turnover of 2005-6 set prices for all of the contemporary $10 trillion in underlying mortgages as well as its $22 trillion of associated household real estate. This had the twin outcome that even the most parlously overstretched borrower looked more creditworthy the instant his neighbour more eagerly emulated his gamble, while the associated returns also increased the 'capital' against which the banks could leverage, even if by means of 'contracting out' the loans to SPVs, hedge funds, specialist lenders, or other intermediaries.

Now, imagine that crisis has hit. The supply of new CREDIT is henceforth insufficient to keep pace with that of new properties coming on the market, their prices begin to slip and - before you can say 'Mississippi Bubble' - the whole round robin is revealed for the Ponzi game that it is.

At this point, the bankers' boon of lending long and borrowing short becomes their bane.

The MMMF does not wish to roll over its ABCP, so Bank A is forced to re-assume the loan from its defunct SPV. Everyone starts to entertain doubts as to A's ability to meet its obligations, the most dubious being Banks C, D, and E whose anguished inspection of their own books has afforded them an intimate familiarity with problems being faced by A. Things are looking a trifle bleak for all concerned when - *Deus ex Machina!* – the Fed throws A a lifeline by buying the MBS, and painlessly writing a cheque against itself by way of reimbursement.

Bank A, however, understandably fearful of market conditions, leaves all the funds so raised on deposit with a Fed which has helpfully agreed, in the interim, to pay interest on them. Under the classical treatment this forms no part of the money supply (see Appendix I below) so 'liquidity' may be improved, but NO official aggregates will reflect the shift. [NB: this will not be the case if the bonds are bought from a non-bank and the consideration placed with Bank A by its recipient]

Bank A now has the Fed depo on the RHS of its balance sheet as an asset and since it has acquired a government backstop, whether explicit or implicit, to shore up its teetering creditworthiness, it funds these by selling a CD to the also newly-guaranteed MMMF which latter still has its existing liability to Builder B but no corresponding asset, once the unwanted ABCP matures. Again, MONEY - properly defined - is unchanged unless we suppose the MMMF acquires a (near-zero yielding) *demand* claim on Bank A, rather than a term one.

If this is not the case, we see, once more, that there has been no change in the volume of MONEY or CREDIT outstanding, but only shifts in their form and ownership.

Let us fast forward through several quarters during which there has been a tentative improvement in activity (and possibly a more worrying rise in goods prices) to the point where the Fed at last decides it wants to become more 'restrictive'. As already intimated, it moves to offset its MBS holdings by conducting reverse repos with our MMMF. This, too, should pose no difficulty since the MMMF simply does not roll the CD with Bank causing A's balance sheet shrinks again as it runs down its deposits at the Fed. Yet again, there has been no change in the outstanding total of either MONEY or CREDIT under their standard definition.

The real functional difference here is that while Bank A still disposed of hefty surplus of reserves in its account with the Fed, it could have mobilized them by actually making *loans* and so re-engaging the traditional fractional reserve multiplier whose temporary cessation the deflationists are so volubly bemoaning today.

As an aside, one might wonder why the Fed does not simply *sell* some of its holdings of MBS back to the market on that happy, long-awaited morn of renewed optimism. Given that the sale would be taking place under conditions where credit was rapidly expanding – when, according to the standard construction, employment and real estate prices might therefore both be rising – far from causing genuine 'absorption' problems, would not the appetite for such earning assets be rather elevated?

The cynic might wonder whether the truth is that, having overpaid for the paper when it bought it (both in terms of outright yield and the implied credit spread contained therein), the Fed could be afraid of the losses it might incur when unwinding the purchase – an embarrassment which conducting repos clearly avoids, meaning the decision to do so does not seem directly to involve the conduct of monetary policy, *per se*.

Out of the Frying Pan…

So far, we have gone through, in some detail, the distinction between MONEY and CREDIT and the ways in which the former can be called into existence absent a gain in the latter – perhaps even in the face of a fall in the private sector component thereof. But, the bitter enders will surely object, it is all very well getting this MONEY into people's pockets, but what if they are so filled with disquiet that they refuse to spend it?

Here, then, the final matter with which we have to deal, in order to tie this all together, is the fraught question of 'velocity' - something an Austrian almost shudders to mention since he tends to look askance at the tautological nature of the Fisherian quantity relation MV = PT, as well as to exhibit a more deep-seated distrust of the true praxeological relevance of such over-arching, aggregate statistical fictions.

In Mises' oft-repeated exposition of the topic, when extra money first begins to boost the price of new frying pans, the housewives who are confronted with this unwelcome development may initially display a reluctance to buy them in the hope that matters will soon revert to the norm and that they will again become less expensive.

This, of course, helps dampen the effect of the inflationary addition of new MONEY a little ('velocity' falls). But, there comes a point when the disappointment of repeated price rises come to be expected, not wished away and this switches the psychology to one where the pans *must* be bought, even in advance of a real requirement for them – as an act of 'defensive' speculation, if you will. The rise in prices – and its converse, the drop in the price of MONEY – now accelerates beyond the rate of increase of the MONEY stock ('velocity' rises), as has often happened in the late fever of hyperinflation, often *after* the reserve bank has at last taken steps to slow or reverse the influx of new currency.

Before we scoff at the simplicity of this treatment, consider that money managers – as a group - are typically no more sophisticated than Mises' good Hausfrauen in their classically anti-phase response to any similarly inflationary rise in asset prices!

Similarly, in the bust, the reawakened sense of caution may well make people prefer to hold MONEY to any other sort of good. This is not so much a deferral of consumption caused by the propensity of bargain hunters to wait for even cheaper prices – as Keynes, Krugman or Catchings & Foster would have us believe - but a justifiable desire to increase one's cushion of safety against an increasingly uncertain future. MONEY – even at zero interest – has a value as a good in its own right, not the least of which is the 'optionality' it confers.

Thus, rather than the prospect of falling prices *causing* deferred consumption (did that ever put anyone off buying the latest must-have Apple gizmo on the top-ticket launch date, or forego buying the kids' presents *before*, not *after*, Christmas Day), the drop is far more likely to be the *result* of an increased preference for cash and for the flexibility and security afforded by its possession. As Mises put it, the fall in prices does not bring about the crisis, but rather it was their elevated state which caused the break and their subsequent decline represents a necessary part of the adjustment.

Here it should again be noted that such 'hoarding' would not lead of itself to a deflationary spiral if there were a solid core (and ideally, a solid mantle, upper mantle, and crust!) to our MONEY.

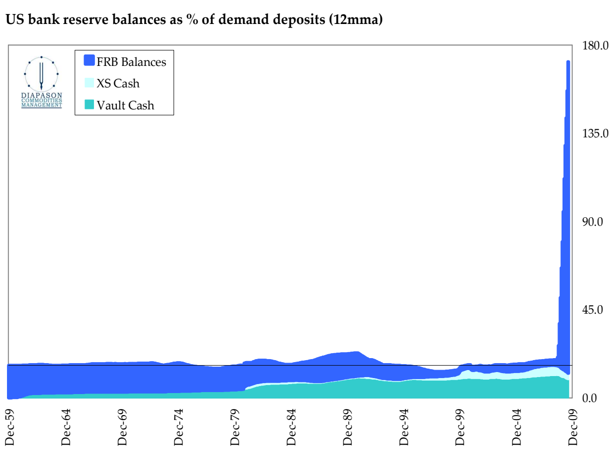

Figure 3: Under Uncle Ben's Mattress

Even in our smoke-and-mirrors alternative, it is something of an irony that it was well nigh impossible to 'hoard' anything beyond the trifling sum of around $550 billion in cash in domestic circulation outside the banks - at least not until the Fed itself encouraged those same banks to leave upwards of $900 billion parked idly on its own books! Even so, this is a picayune amount in an economy which turns over around $25 trillion dollars a year.

In a hard money system, since the amount in circulation could not be then reduced beyond a functional minimum and since the more prudent would eventually reach their individual points of comfort – a juncture reached all the more quickly as the exchange value of their money rose - they would once again 'dishoard' some of their insurance reserve to return, one by one, to the shops and the car showrooms, there to reap the rewards of their thrift and foresight amid the plethora of discounts and special offers to be had. Hard money makes the game much more nearly a zero sum one and certainly offers a circuit breaker if the system begins to go critical somewhere in the outer reaches of speculative credit

Albeit with a certain trepidation at the prospect of empirical over-interpretation, if we do plot MONEY against business turnover (for which we shall take as our proxy the more timely and less massaged manufacturing and trade sales numbers, rather than the more delayed, statistically more suspect, and highly cross-cancelled GDP data) we can see that there is a reasonable, qualitative fit to the broad behaviour we might expect of CPI (caveats thereto taken as read) some while later. What we also see is that the elasticities vary wildly, so actual correlation is almost non-existent tempting the econometricians (not least those on the FOMC) to disregard the mechanisms at work entirely.

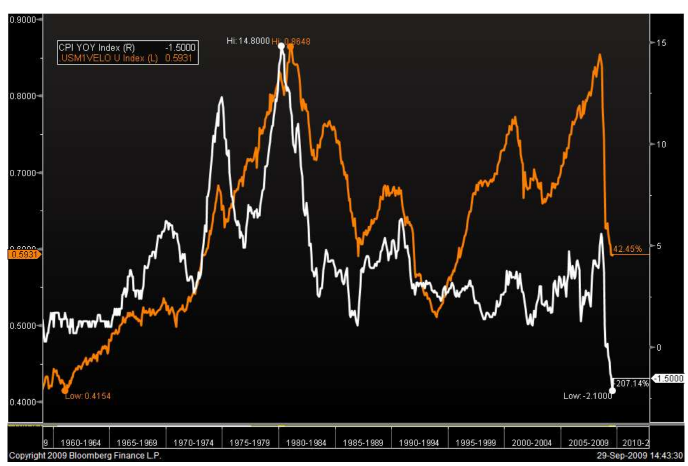

Figure 4: 'Velocity' v CPI - everything to do with the price of fish

But, let us not forget that we do not have a truly *independent* variable here in any case, but only an instantaneous section through a complex, dynamic pathway of feedbacks. Critically, additions to the supply of MONEY first tends to stimulate - with a delay which itself might vary - real-side activity, so a positive change in the denominator tends to lead, then lag, that seen in the numerator in the identity V = PT/M. Moreover, not long after business picks up, the prices at which the constituent goods change hands also start to respond to the additional MONEY, possibly to the extent that they negate the addition of the MONEY itself on the overall number of transactions (i.e., *nominal* MONEY may now be rising much faster than its *real* version).
Thus, even where the relation seems to hold, it can disguise very different constellations of data and so imply great variations in the import for the men and women whose very individual choices have been smeared into anonymity within its neat, arithmetical framework.

Again, absent the discipline of a proper international currency standard, increased domestic MONEY can bypass local goods, services, and property claims and simply be swapped for that of another, preferred jurisdiction. Should the ruling authority there not wish to see its currency appreciate under the pressure of this foreign demand, it may, of course take steps to increase its own supply of MONEY, thereby 'importing' the first country's inflation and hopelessly complicating the effort to pin down the alphas and betas inside any one set of borders, particularly where tradable goods are concerned.

All of this suggests that though there should be some tendency to self-correction in the ratio, it is problematical to define the exact when and where. More importantly, one should never confuse this gradual attenuation of effect with some mythical, long-term 'neutrality' since the Cantillon – or injection – effects and their material incorporation into the capital structure itself are, as we never cease to underline, the very essence of the business cycle itself.

So, to sum up, the current decline in some forms of CREDIT is a sure sign that we are still trying to expunge the disastrous over-extension of the Boom but, far from being pernicious, this is an essential part of the recuperative process. Even lacking a new supply of private CREDIT, the central bank still retains plenty of scope to ensure that the MONEY supply does not contract. It can buy property claims outright or it can aid and abet the monetization of government debt, thus allowing Leviathan to spend it into existence.

What, however, it cannot do, is to arrange that the hydraulics of this will mimic those which prevailed in the very different circumstances leading up to the Bust. Prices have changed, preferences altered, priorities shifted, the possibilities for action have been profoundly modified. Thus, the river of MONEY may swell unto a torrent, but it now has to flow through a productive landscape uplifted and riven by a mighty earthquake, then scoured to the bedrock by the awful forces of a sudden Ice Age.

There will be problems enough to deal with in the months ahead, not least among them the issue of how long the fiscal-monetary engine can continue to drive the printing press if its operation more obviously frustrates, rather than fosters, the exercise of private initiative. But for now, at least, we should not allow ourselves to be distracted by the question of whether or not we stand on the verge of a deflationary precipice.

The MONEY is there: what we have to work out is what consequences – intended or otherwise – its continued liberal provision will have for us and for our investments.

Appendix I: 'Money supply' whether properly defined or under the current, bastardized usage consists of liabilities of the Banks to the non-banking private sector, though the exclusion of the government from this - in economies where they routinely spend 20-30% of the total disbursed – is not really economically justifiable. Moreover, part of the reason we exclude monetary institutions' liabilities from their peers is to avoid double-counting – if Bank A places customer funds with Bank B which deposits with Bank C which lends them to a shopkeeper, we only have *one* monetary liability not three (though potentially a lot of what the Victorians called cheque-kiting).

However, if we stick to a strict description of money as a near-universally accepted means of payment, accessible on demand at full par value, the commercial banks' new excess reserve balances held at the Fed and its foreign peers might justifiably be counted as 'money' and, since they are not elsewhere recorded, they might be added to the total even though they are presently being held for precautionary, not transactional, purposes. If we grant this latter proposition, then – and only then – will the supply of MONEY be impacted by this whole business of drawing upon MMMF resources (which, let us re-emphasize, are NOT themselves, despite the confusing institutional nomenclature, strictly MONEY, either - a negative which will be all the more categorical once the Fed's emergency, 'break the buck', blanket guarantee is allowed to lapse).

Appendix II: Imagine a world where there is only one multiple-line, vertically-integrated, giant conglomerate company, Crusoe, Inc., and all its costs are therefore factor incomes of the very same people who buy its goods. Initially, it makes zero net profit – say, $8,000 out in costs = $8,000 worker/manager income = $8,000 sales revenues. Granted, this is an extreme simplification but not therefore an invalid one.

If the firm possesses its own machine-tool shop, for example, or drills its own oil wells or constructs it own power plants – much as Old Man Ford tried to do - even 'capex' is undertaken internally and the relevant employees still be buying its end goods with their own labour. If we treat owner/manager returns as both an outgo and an income in the same manner, the circle closes.

Strictly speaking we could do without money in such a world, though it might still serve to assist the remuneration committee to differentiate the rewards given for the various kinds of labour services undertaken, according to their perceived contribution to the end product.

Now suppose that Crusoe, Inc., offers its goods at the new level of $10,000 and undertakes to lend its customers the balance of $2,000 they need to make the purchase. Crusoe (which is, of course, a monopoly supplier in this case, with a certain degree of pricing power to match) instantly makes a 'profit' of $2,000 though only, initially in form of accounts receivable and not cash, a feature which might raise eyebrows among its coterie of covering stock analysts (were there to be any in our closed little world!).

Now comes the clever part. Crusoe sets up a separate finance company – Crusoe Capital Corporation (CCC) which buys said receivables for a discounted $1,800 and issues its parent with a cheque which Crusoe immediately re-deposits with CCC. 'Profit' may have been reduced by $200 (or by 10%), but the balance sheet now shows this has all been retained in a very healthy cash-on-hand entry.

Meanwhile, CCC will book the difference between $2,000 and $1,800 as its return over the life of the loan – it may even be tempted to capitalize this straight away - and since it's a wholly-owned sub of Crusoe, one presumes that group consolidated profit will be eventually be made up to the full $2,000 if, in reality, reduced by time value of the stream of increments.

So, without any increase in MONEY, Crusoe has managed to conjure up a sizeable 'profit' from the magic of vendor finance, securitized or not. It is true that, with each successive round of this perpetual-motion machine, the firm's workers must devote a rising proportion of their income to servicing their debt (that is, to paying for previous year's enjoyment rather than for this year's) and so, ultimately, this is self-defeating.

That said, with lower and lower interest rates and longer and longer payment schedules (not to mention the ability, in the real world, to anticipate stock price gains in such 'growth' companies as Crusoe, or to tap into inflation in the appraisal value of their place of shelter), so the game can last for a good number of iterations before it succumbs to its own inner contradictions, surprising everyone with the sheer magnitude of the collapse in the sales and profits of that former lodestar of the expansion, Crusoe, Inc.

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