



Tangible Ideas

Aug/Sept 2009



Goodbye to All That



A Diapason Research Report by Sean Corrigan

Goodbye to All That

"If silver and coin constitute wealth, will increasing the quantity of [them] result in prosperity? In the case of a single family... yes. But if we consider the entire empire then nothing could be further from the truth. The greater the quantity of silver and coin, the more expensive grain and cloth become and the greater is the dearth that ensues. Thus, in earlier ages, rulers feared that future generations would want not for [money] but rather for grain and cloth."

Xu Guanqi, 'The Omnibus of Husbandry' 1640

Though evidence of processes of exchange can be found far back in the archaeological history of mankind, testifying to an early realization by our species of the significant mutual benefits which it confers, there has always been a particular glamour attached to those engaged in *foreign* - as opposed to *domestic* - trade: from Marco Polo and the Venetians to the merchant adventurers of Stuart England and its rivals in the Dutch Republic; from the semi-mythical Pytheas the Mariner, via the outright fictive Sinbad the Sailor, to James Onedin (a kind of mercantile, Victorian Captain Kirk to those not familiar with the singular delights of 1970s British TV).

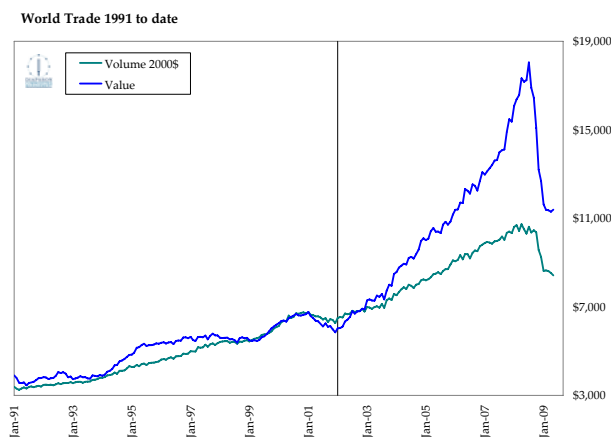


Figure 1: A Splendid Exchange

Similarly, one of *the* defining features of the late Boom was the singularly rapid expansion of world trade it encompassed. This wave of post-Cold War 'globalization' - to employ a term that the Metropolitan Marxists and East Side eco-warriors alike tend to regard as a pejorative - saw trade volumes accelerate from the compound annual rate of ~ 6.3% recorded in the previous business cycle

(comprising the period 1991-2001) to the impressive 8.3% registered between the end of 2001 and the third quarter of 2007, all the while combined G7 GDP chugged along upwards at an unchanged and little varying trend rate of 2.5% pre annum.

Of course, to leave off the tale at such a high level of aggregation would be to miss one of its essentials - *viz.*, the rise of the emerging markets - as the *taipans* of the Western MNCs and their eager local *compradores* poured ever more investment into shiny new factories and keyboard-clacking software houses, all along the South East Asian littoral and deep within the unceasing bustle of the region's teeming megacities. Thus, while the advanced economies saw two-way volumes increase by 6.1% and 6.8% CAR in our two periods (still notably faster than their overall 'growth'), their less developed counterparts upped their own tempo from a lively 7.1% *allegro* to a galloping 13.2% *presto*. In value terms, the difference was striking, too, with EM trade swelling from just more than two-fifths the size of that taking place in the advanced nations to slightly more than five-sixths of a benchmark itself expanded more than fourfold in the interim.

In seeming testimony to the greater efficiencies (and, hence, the higher social welfare) being achieved, overall trade prices (once we adjust for changes in the TWI of the US dollar in which they are quoted) edged up at barely 0.3% per annum over the first of these periods before quickening modestly to a still insubstantial 1.5% p.a. during the course of the second.

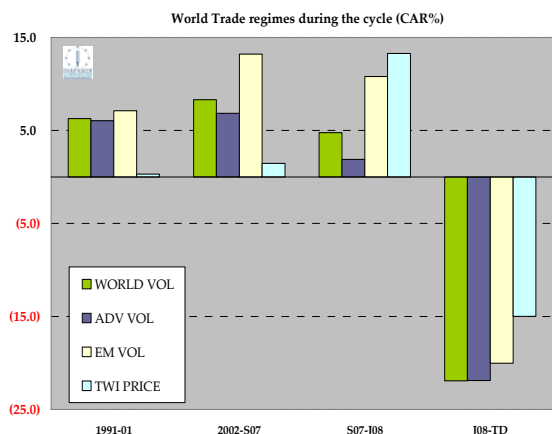


Figure 2: The Wheels of Commerce

Again, by splitting the data down a level we arrive at another instructive result, for the price of manufactured goods were essentially unchanged during the first eleven years (actually falling at an 0.3% p.a. rate after again tweaking for variations in the USD) before edging 0.9% a year lower in the latter five-and-a-half. Note that here we have yet more proof that, for all the mainstream angst, 'deflation' – i.e. falling prices – are not inconsistent with greater prosperity.

Meanwhile, commodity prices (using the IMF measure) gently rose 0.7% a year (comprised of 1.8% energy; -0.5% industrial metals; -0.8% comestibles) before our 2001 watershed and roared away at a 12.7% (17.8% energy; 11.8% metals; 3.9% comestibles) clip after it.

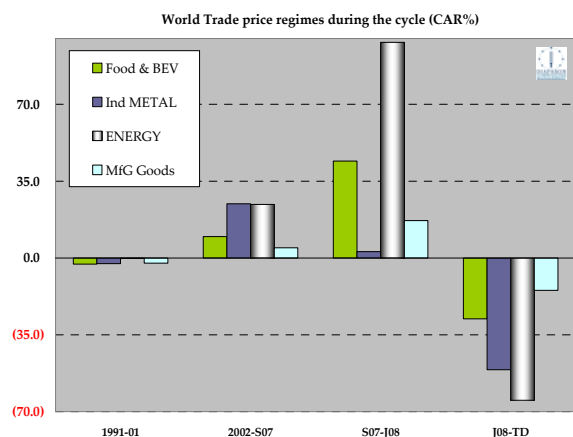


Figure 3: The Bull and the Bear

What the perceptive reader will recognise in this constellation of data that a decided shift in relative prices took place within the change in absolute levels and - where these were expressed across, rather than within, borders – also in the terms of trade between the resource-rich and the factory-fertile with the formers' exports of coal, cotton, and copper buying a far greater volume of the latters' cars, cranes, and CNC machine-tools. Indeed, as the trade winds blew ever stronger they also veered to blow directly in the faces of America, Japan, Europe and industrialized Asia while filling the sails of Eastern Europe (principally the FSU) and the Gulf, but also the ore-laden Agritropia of Latin America.

From 1991-2001, US export prices, for example, outpaced those of imports by a total of 6.7%, while the what ended by becoming the Eurozone gained a 1.9% advantage, Asia suffered a 2.3% headwind and commodity-deprived Japan rowed manfully into a stiff 9.9% adverse breeze.

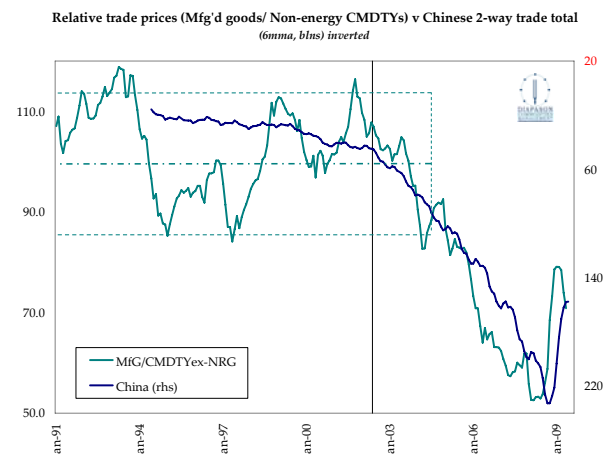


Figure 4: Changing Terms of Trade

However, by the time we had reached the late summer of 2007 – and the lowering financial storm was about to deepen and intensify into what we then called 'Hurricane Cassandra' – all were battening down the hatches. The US lost seaway to the tune of 9.9%, the Eurozone drifted 3.9%, Asia was borne away by 13.8%, and Japan ran, storm-rigged and battened-down a massive 29.3%.

To anticipate the rest of our story a little, the period from September 2007 onward was characterised by two main trends: the move by the leveraged Herd to *buy* commodities *en masse* as a means to flee collapsing credit and money-printing central banks (a shift instigated within a week of the Fed first cutting the discount rate cut, an off-calendar move accompanied by its first foray into providing term funds to its member banks – i.e. into implementing ‘Blackhawk’ Ben and ‘Twin Huey’ Tim’s financial oligarch search-and-rescue mission) - and the move from July 2008, when that same Herd ran, lemming-like towards and then over a cliff called Lehman-AIG, trampling underfoot the provision of even the most basic forms of world trade credit in the wild, headlong stampede to sell out.

In the last, frenzied run up, the trends outlined above intensified (with the exception of trade volumes which had already slowed to a crawl in the by-now ailing advanced economies). Trade values, however, soared 30.8% annualized in USD as prices shot up 24%, led by a near doubling in the dollar price of energy (+98.2%), a 44.2% rise in food & beverages, and – rather belatedly – a 17.1% increase in manufactured goods as the inflationary pandemic claimed its last victims. Notwithstanding this last, further terms-of-trade losses by the industrial nations were counterbalanced by modest gains for Latam and CEER and a monster, 36.8% surge for the Middle East & Africa.

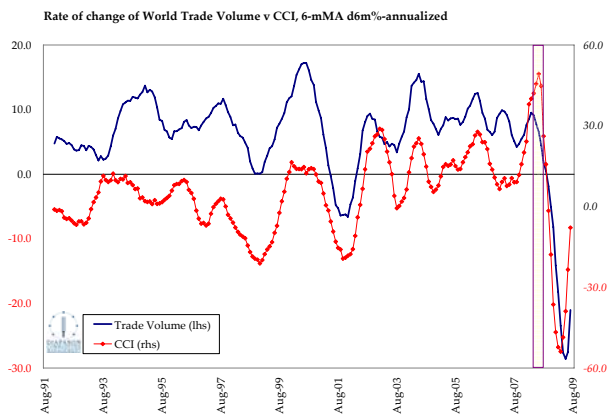


Figure 5: The Driving Force

Conversely, the subsequent collapse – from the base of whose smoking impact crater we are only now,

tentatively, beginning to climb – saw trade volumes slump an eye-watering 22% and dollar prices dive almost 24% (with energy off 65%, metals off 51%, food/bev off 28%, and manufactured goods – which therefore *doubled* in relation to commodities in the space of just ten months – bringing up the rear with a ‘mere’ 15% slippage).

To take a slightly different perspective on this, take the case of one of the great current account surplus, exporting nations – Germany. Shortly after Reunification, in the depths of the twin ERM crises, exports amounted to around just over a quarter – and two-way trade just over a half - of private domestic GDP. By the height of the Boom, in the fateful summer of 2008, that proportion had soared to 65% for exports alone and to 120% for imports and exports combined. Clearly, the *Mittelstand* had been inveigled in the interim into becoming *very* highly geared to the health and creditworthiness of its many cross-border and overseas customers.

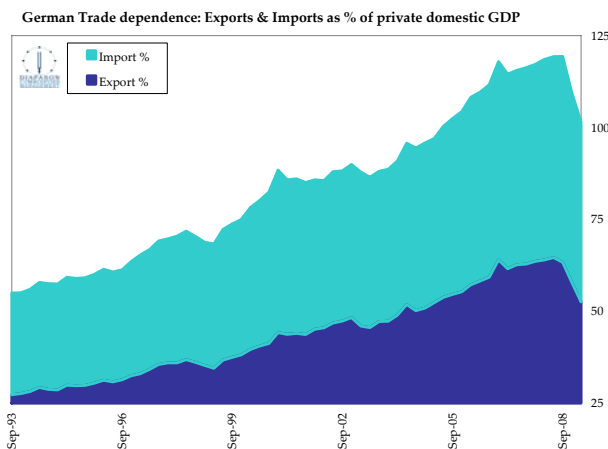


Figure 6: All in the same Boat

Overall business revenues in the country, so the BUBA tells us, rose just over 30% from the end of 2001 to QIII’07 but, as they did, they became heavily skewed towards export sales (up 49%) of capital (+46.8%) and intermediate goods (+56.2%). The last, desperate heave to the brink only added a percent or two to each of these totals before *Der Untergang* and a sickening 22.3% overall fall, led by a 28% drop in those same, formerly flying-off-the-shelves categories of exported capital and intermediate goods. In essence, the crisis has served to wipe out

what remains close to 90% of *all* the revenue gains made in the circa seven years to the peak, for a loss of five years' worth of progress even *after* taking into account the late Spring rebound.

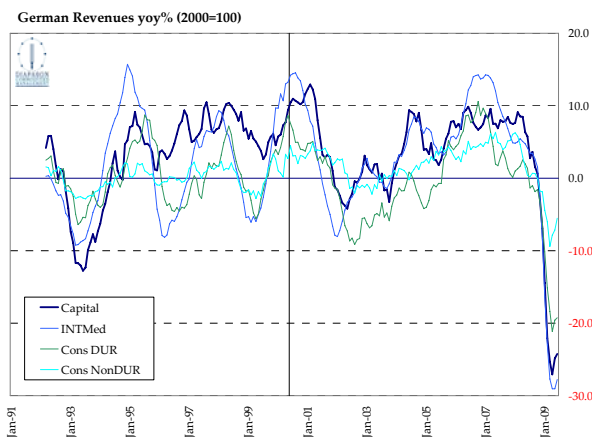


Figure 7: ...or all eggs in the same basket?

The sheer violence of this reversal of fortune – something akin to the sudden, mortal swoop of a melted-wax Icarus after long hours of patiently spiralling heavenward on the thermals rising off the Cretan coast - has perplexed everyone from Her Britannic Majesty and her hapless First Minister to the fallen idols of investment practice, like Bill Miller and Bruce Bent – *yet while its pattern may be a complex tangle of circumstances, there are, in truth, only a few basic threads in the weave, all of them very familiar to those with an Austrian perspective on the case: fiat money, gross government interference with markets, and the avid, rent-grubbing irresponsibility it fosters in everyone involved from the most prominent financial flesh-eater to the most pathetic, Forgotten Man structured-product stuffee.*

But, before we proceed with the case for the prosecution, please allow us an opening preamble before the court. After all, it cannot be that trade itself is the culprit in the Aristophenean comedy to whose cast we have been forcibly recruited. Though routinely vilified by crass anti-capitalists and mindless green worshippers of the Noble Savage, trade is but a special case of exchange and voluntary exchange is, by its very nature, a source of greater satisfaction both to buyer and seller.

Trade is an expression of the division of labour. It brings the bounty of specialization of function. It fosters international amity and broadens mental – as well as physical – horizons and promotes a sharing of ideas and the adoption of best practice...

...Or at least it would were it not so grotesquely *interfered* with on so many levels. For instance, the fundamental purpose of exporting goods is to use them to purchase those other goods – those imports – which lie higher in the subjective valuations of the exporter. It is true that the seller may not wish to take delivery of those goods *today*, but may rather wish to use the proceeds to lay in a claim to goods *tomorrow* (so matching the trade balance with an equal and opposite entry in the capital accounts), but this should be undertaken by the individual himself as he judiciously and carefully assesses the potential future benefits of his own, personal investment against the risks of a loss of his hard-earned surplus.

It should not therefore be overly-weighted towards making sales for sales' sake by forgoing immediate recompense from deadbeat customers who will only be able to make their deferred repayment if their low-skill gambles in the asset markets happen, fortuitously, to bear fruit. It should not be predicated upon a solvency-sapping generation of inflationary credit by state-supported, fractional-reserve, casino banks. On the one hand, it should not become suborned by the tired, old, *étatist* policies of Mercantilism - which not only mistakes money for wealth, but confuses fiat money for money proper! - nor should it play the role of milch-cow to arrogant superpowers, lazily and deceitfully drawing a covert tribute from the labours of others through their cynical abuse of their currencies' reserve status.

Yet, it is too easy to show just how deeply such perversions have indeed taken hold, turning the expansion of trade from a boon into a curse; from an expression of entrepreneurial adventure to the most glaring symptom of that inappropriate and self-defeating over-extension of the productive structure which we Austrians recognise as both the result of lax monetary policy and the primary cause

of the inevitable Bust which follows the cheap *prosecco* glamour of the Boom.

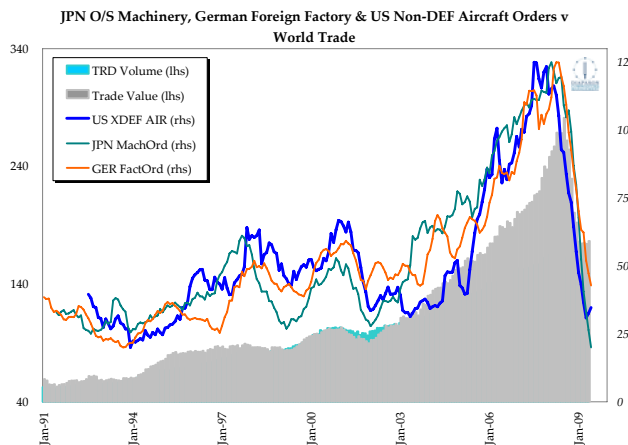


Figure 8: Malinvestment Defined

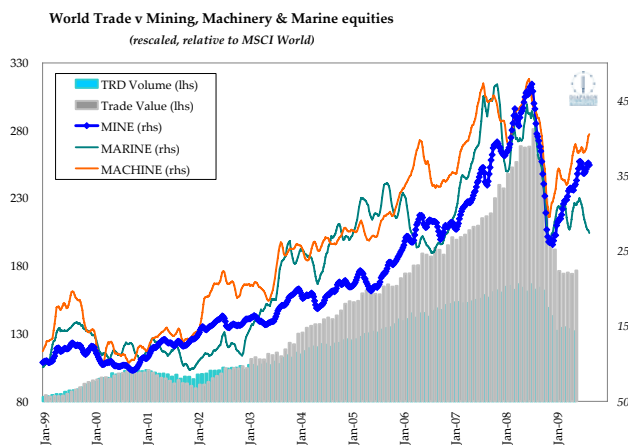


Figure 9: Malinvestment Reflected

For instance, by considering the IMF data on foreign exchange reserves, we can see that these grew more than sevenfold between the end of 1991 and September 2007, almost doubling from 22% of global trade to 43% along the way, or gaining \$1 for every \$2 of extra trade flows. Add in the slightly woolly estimates of separate sovereign wealth fund gains (largely, but not exclusively, sourced from commodity stabilization programmes) which the Bank of Spain thinks passed \$100 billion sometime in 2000, on its way to \$2.4 trillion in 2007 and perhaps \$2.8 trillion at the 2008 highwater mark and we are well on the way to financing fully three-quarters of the whole increase in trade – and hence

the mountainous imbalances in this most distorting of manners.

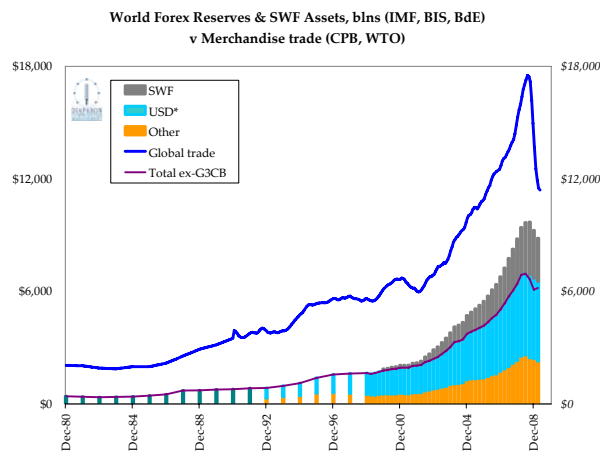


Figure 10: Give me back my Marbles!

Even this does not tell the full story, for this cycle has also been magnified by the unintended workings of the single currency in Europe where foreign exchange reserves by definition, do not enter the picture, though ‘deficits without tears’ certainly do. For example, could you imagine the circumstances whereby a profligate Spain could pass the cycle casually racking up a half-trillion dollars’ worth of current account deficits, were it not nestling under the petticoats of its complaisant Teutonic neighbours to the north, each eager to do business with its cowboy property tycoons on nothing down and easy terms thereafter?

Truly we are well into the business of keeping Jacques Rueff’s tick-granting tailor happy or, to switch to his other, trenchant simile, we have elevated the ‘childish game of marbles’ (under whose rules the winner of each round returns his gains to those who earlier suffered their loss) to the status of a Superbowl, an Ashes Test match, and a Formula 1 World Championship, all rolled into one.

The reason this has been so pernicious is that it has circumvented the very business of reserve management and so has turned what should be the semi-automatic self-equilibration of the classical specie-flow mechanism into a positive feedback of ever wider current account gaps, ever more profound misallocation of capital, ever more inflation - albeit one masked in terms of finished

good prices, as we have already seen, by the supply side impact of shifting production to where labour is cheap and the local politburo is happy to connive with its buddies in the state-owned enterprises to provide near-costless finance, inexpensive land, export tax incentives, and even subsidised utilities to a producer who is therefore relatively indifferent to the price he has to pay for his commodity inputs (remember those relative price trends we discussed earlier).

In a fair system, based on a proper, hard currency, the country running a deficit settles up by losing the bullion on which its circulation is based: domestic credit then contracts, prices fall, activity shifts to import substitution, and competitiveness is hence restored – an adjustment quickened by the fact that equal and opposite changes are taking place in the surplus country. ‘The monetary sin of the West’, however (to employ another Rueffism), is that while the surplus country today uses its excess foreign exchange receipts to expand the stock of high-powered money at home and so triggers its own production-lengthening cycle, it simultaneously loans those same receipts straight back to their creators, preserving *their* credit pyramid in turn and thus encouraging them to continue their gross over-consumption.

Adding to the dangers, the deficit nation central bank sees the low-price imports and artificially stabilized exchange-rate as helping achieve its monophthalmic goal of suppressing ‘inflation’ which – being typically mainstream in its analysis – it imagines to consist only of rises in its favourite (usually pared) consumer price index. It is thus perilously predisposed to running far too loose at the same time as its foreign counterpart is relaxing, all despite the obvious warning sign which the trade deficit itself constitutes, namely, that demand has already outstripped the potential for domestic output to meet it.

Inevitably, in the over-financed, speculative milieu in which we live, the excess credit thus called into existence soon spills over into asset markets (whose inordinate rise does not at all figure in the wholly naïve policy settings being followed) and so begins

that unstable spiral of financial convection which sees notional net worth increasing and effortlessly generating the fresh collateral which will form the basis for yet more asset price-boosting loans in the next iteration. Tempted by the capacity to engineer illusory and prematurely capitalised ‘profits’ in such a conducive current, the ever more hubristic bankers – by now not so much on Cristal Roederer as on crystal meth (metaphorically speaking, of course) – soon allow their hired-in, mathematical idiot savants to ferret out highly explosive ways to cheat shareholders and regulators of due disclosure and so arrange to heap a Pelion of non-linearity upon an Ossa of over-leverage and under-capitalization.

In a world where the guiding bureaucrats think they should not presume to know more than a ‘market’ they themselves have already vitiated beyond repair and where all further compensatory action is precluded in favour of an indulgent aunt’s Jackson Hole intention to wait until the party is well and truly over before ‘mopping up’ the mess, the Masters of the Universe will have long since worked out that ‘too big to fail’ equates to bonus cheques too big to bounce and so the band plays on.

In such a delinquent system, even soaring commodity prices, far from dampening the ardour of those forking out at the petrol pump, can come instead to inflame the passions further. How could this have acted as a ‘tax’ when one could slake the thirst of one’s shiny, new, high-LTV SUV by drawing on a home equity line being refilled just as quickly as the tank by the theoretical appreciation in the price of one’s home? Why would higher prices have choked off demand if they entailed no greater sacrifice of income, simply a further, painless recourse to more borrowing?

Thus, as the Boom progressed - and as its undoubted, ‘real’-sector impact meant energy use began to climb, too - pricier crude implied nothing more difficult than another round of Western borrowing to meet its import bills, and so led straightaway to greater petrodollar receipts *not so much at the expense of, but in addition to, the outlays being made on everything else*. The low

'absorption' potential in many of the producer countries on the receiving end of this resulted in (a) less and less disciplined outlays being made on (usually) state-inspired white elephants and sky-scraping 'Oedifice complexes' – all horribly unproductive squanderings of capital means - and (b) billions more 'childish marbles' indiscriminately being returned to source so as to ensure dollar-tracking local currencies did not suffer any untoward pressure to appreciate away from their adopted yardstick. **At the peak of 85.4 million barrels a day being consumed and selling for \$145 each, we were, after all, briefly talking of a need to dispose of something in excess of \$1/2 billion dollars an hour just in terms of oil.**

And, yes, in this last, mad few months, even as the iceberg loomed large under a bow cutting carelessly through the treacherous seas surrounding it, 'speculators' *did* drive the contract too far, too fast.

But, were this whole mad monetary policy not in place; had the Fed not been slashing rates to a 28-year low, *negative* real 3%; had the dollar in which commodities are priced not been tacitly encouraged down to an all time, trade-weighted low; were the banks not both freed from all effective restraint and made far too confident in the implied support offered them by the public purse; were governments everywhere not frustrating the price mechanism by *encouraging* consumption through a raft of subsidies, tax breaks, and welfare payments (a goodly proportion of which were themselves financed in an inflationary manner); were perceived shortages of grain and fertilizer not being exacerbated by panicky export bans and emergency import tenders, do you really think that oil and the others could ever have become such a one-way bet, that such leverage could have brought to bear on them in making that bet, or that they would have started their final, screaming short-squeeze from so high a base as they did?

No, the many political Witchfinders General need to peer more closely in the mirror when they engage in their hunt for candidates to send to the stake for the sin of being in league with the forces of darkness.

Now, if all the pieces – psychological, institutional, and political - seem to have been in place to host a globe-spanning orgy of malinvestment, with the revellers' few remaining inhibitions dispelled by the heady narcotic of irresponsible over-consumption, and, hence, if we were headed for what was perhaps THE largest and most severe Boom-Bust in history, we would expect dear, old friend Credit to have played a role in all this.

Perhaps the quickest and cleanest way to show this was indeed the case is to look at the behaviour of the BIS series for member-country banking balance sheets over the relevant periods. Indeed, if we consider that inflation – i.e. excess money creation – is, these days, primarily an increase in (demand) liabilities at banks, it is instructive to look at the explosion in their size (here, strictly speaking, we have performed our calculations on the other side of the balance sheet for convenience, but the difference is not significant).

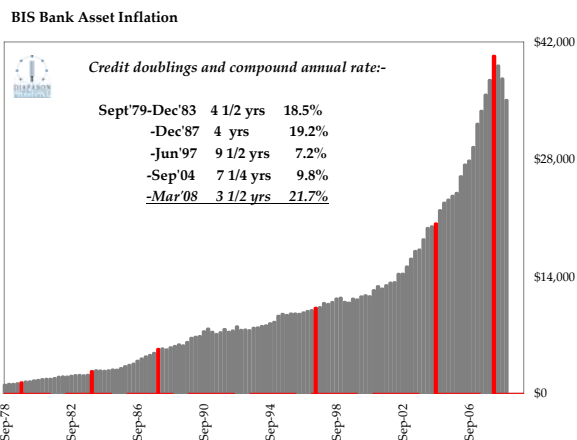


Figure 11: Double and Quits

In the 3 ½ years to the March 2008 quarterly peak of \$40 trillion, total banking claims grew virulently at a ~22% compound annual rate, achieving the fastest nominal doubling in a three-decade data series. Though it took a while for consumer prices to respond, if you wanted inflation (properly defined), you certainly had it in spades going into the Crash!

Comparing the rate of credit extended to onshore non-banks (i.e. to a first approximation of the 'real economy') in the various time-slices we have

identified with the different regimes above, we achieve another notable consonance.

In the period 1991-01 inclusive, BIS claims rose a compounded 6.7% a year while dollar trade values grew by 4.6% p.a. - volumes by 6.3% - as prices eased. During our second phase – to September 2007 – claims growth accelerated to 19.7% a year while, you may recall, trade values sped up to 17.1% with volume growth of 8.3% now being accompanied by the first signs of disruption in the form of prices rising 7.1% annually. When things went ballistic over the next three quarters, credit growth hit a peak of 25.1% p.a., trade values hurtled skyward at a 30.8% annual pace with – ominously – price gains of 24% far surpassing a badly faltering volume increment of 4.8%. Finally, as the ‘Bubble that Broke the World’ burst, bank claims dropped 17.3% and trade plummeted ~40% split fairly evenly between a volume contraction and a price decline.

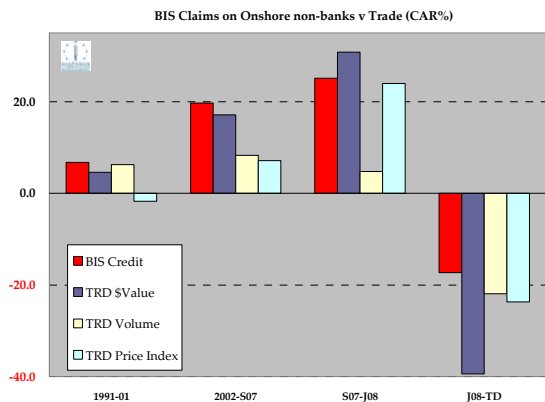


Figure 12: The Bubble that Broke the World

Now it is undoubtedly true that even a healthy extension of the productive structure – especially one growing vertically up through layers of specialisation and out across borders – is likely to call for more credit (though not necessarily more money which is a crucial, if often overlooked, distinction). Simply put, a manufacturing company which used to perform its accounts in house would have given rise to fewer claims than one which now gives the contract to a BPO outfit in Bangalore.

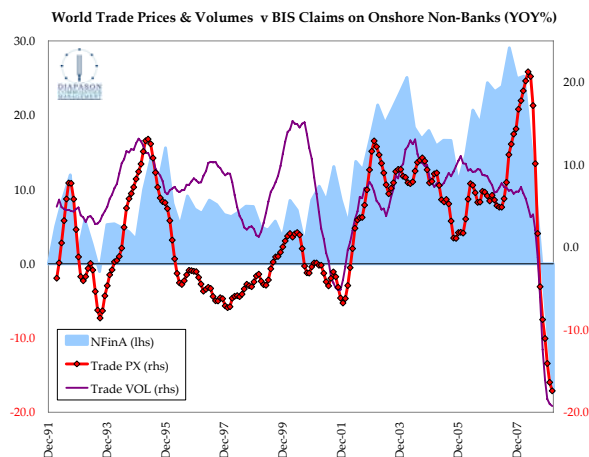


Figure 13: Credit and Debit

It is also well nigh impossible to untangle the virtuous process of making *ex ante* savings out of current income serve as capital (whether of the fixed or circulating variety) in order to facilitate more efficient and more profitable production processes and the deviant shadow of conjuring up such capital means out of an unbacked, banking book entry and then pointing to the wholly *ex post* build up of deposits to which it gives rise as an example of a ‘global saving glut’, rather than recognising it for the inflationary corrosion of values which it really represents.

Thus, on either count, to hope to render a rigorous *quantitative* reckoning of the cumulative danger being done is wholly illusory. But though the blind empiricists who rule the world of economics may not wish to admit it, a workable *qualitative* analysis is no less achievable than is a sound diagnosis given to a patient by a family doctor, long before the results of the path lab and CT scanner have been received.

So, when we see imbalances building, perspiration-free ‘prosperity’ being acclaimed by all as a birthright, the regular delivery of outlandish investment returns amid depressed interest rates and credit spreads – and when we start to see real-side activity gain in speed, accompanied by more and more overt price rises, we can surely not avoid drawing the glaring conclusion that we are heading for a wreck.

Incidentally, it is a tenet of Austrian Business Cycle theory that the endemic disco-ordination of entrepreneurial plans and consumer preferences to which the credit expansion leads approaches its endgame when the urge to enjoy the higher monetary incomes being paid out so liberally effects an adverse shift in the matrix of relative factor and end-selling prices upon which the business captains had been planning, so jeopardising not only their profitability, but often their very physical attainability, too. Sometimes, however – especially during supply-side revolutions (however shakily founded) – when prices seem more subdued than they are wont to do, one needs to know where to look for the evidence.

In fact, though the peak monthly value recorded in July 2008 for OECD CPI of less than 5% was, by all recent historical standards, unexceptionable, this not only represented the biggest deviation from the trailing five-year norm (and hence, effectively, from the level to which economic decision-makers had become attuned) since at least 1975, but it also entailed the fastest *acceleration* in end prices (normalized or not) in two decades.

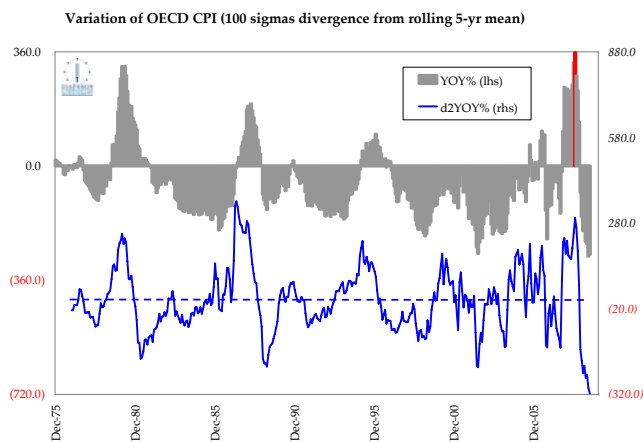


Figure 14: Time preference triumphant

Back at the very beginning of the year, we summarized our outlook by mooted the possibility that markets might be fooled by the expected rebound from the freezing hell of what we called the ‘Snowball Earth’ episode of the LEH-AIG collapse into imagining that we could also avoid a more protracted Little Ice Age of lowered private entrepreneurial activity after this partial thaw.

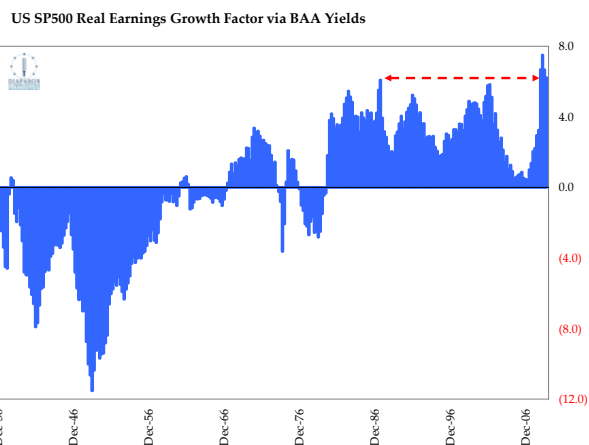


Figure 15: Discounting a Miracle

We also emphasised that during the previous two price collapses – in 1920-21 and 1930-33 – once money began to flow into the system once more, prices of risk assets and commodities rose sharply (especially where the latter were helped by the accompanying government policies of stockpiling). We stated as forcibly as we could that we expected the same to happen again, while qualifying the remark with the gloomy observation that such a price rise was not to be taken as a signal of a return to the Gilded Age of *status quo ante*.

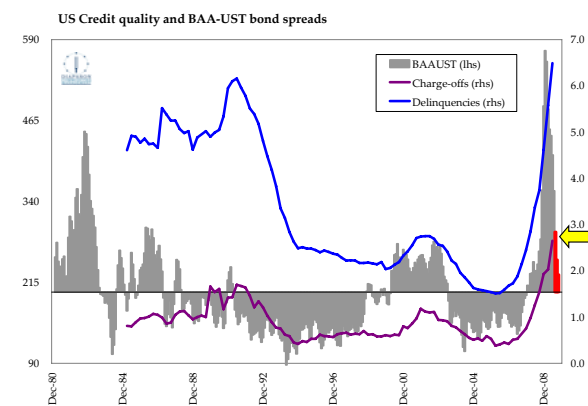


Figure 16: Cheap - as long as they pay up

Eight months on and we find ourselves with BAA yield spreads almost back to their three-decade norm even as charge-offs and delinquencies are going stratospheric. We see as-reported stock market P/E’s in triple digits and, combining the two, we have an implicit forecast of long-term real, risk-adjusted earnings growth well in excess of the

previous two speculative peaks in 1987 and 2000 and certainly well beyond the point where an ailing economy can ever be expected deliver such an improvement.

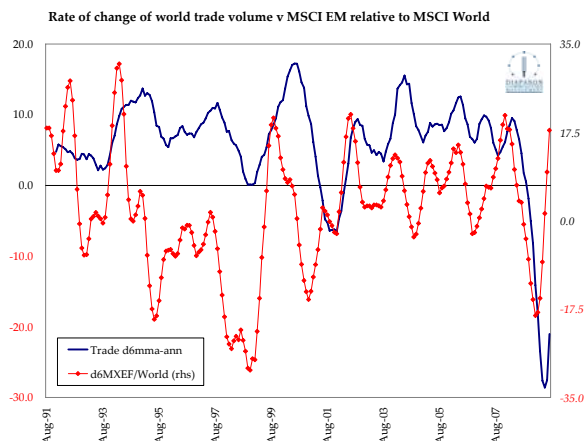


Figure 17: EMs - Creatures of the Trend

We find emerging markets at their best relative levels since the Tequila crisis – despite their elevated trade and vendor credit dependence – and we have crude oil back at \$70/bbl and fast approaching four hours’ average wages – where it is already back to second oil shock level despite very lacklustre demand and swelling stockpiles .

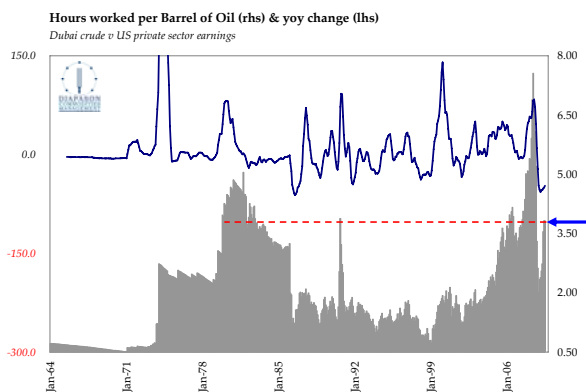


Figure 18: The Toil for Oil

So, is it business as usual as both the stock pundits and the commodity sell-side spinners maintain?

Hardly, for, to take just the example of the US, an economy reliant on vast programmes of government and central bank support, where trade volumes and manufacturing sales remain at 5-6

year lows; where ex-energy production less vehicles has stuck at a sixteen year low; and where there are almost ten people in the ‘pool of available labour’ for every private job on offer is not likely simply to jolt out of its nightmare like Bobby Ewing quitting his reveries in the shower.

If you doubt this, you have not only not been paying attention when we were laying out the inner workings of a dynamic now irretrievably broken, but you seem to think that by throwing mind-boggling sums of money at the problem, and by substituting sub-prime government borrowing for sub-prime real estate and sub-marginal business borrowing, we can somehow unscramble the omelette which once went by the name of Humpty Dumpty and set him back atop his wall.

No. For while we can maintain the volume of credit by issuing new debt in the place of old (and not only have the world’s federal governments been performing prodigies here, but so have investment grade corporates as they by-pass the banks in their grab for the fruits of all that juicy quantitative easing), we cannot assume that it will finance the same activities, employ the same people, and generate the same sales and – critically – the same profits as before the world fell apart.

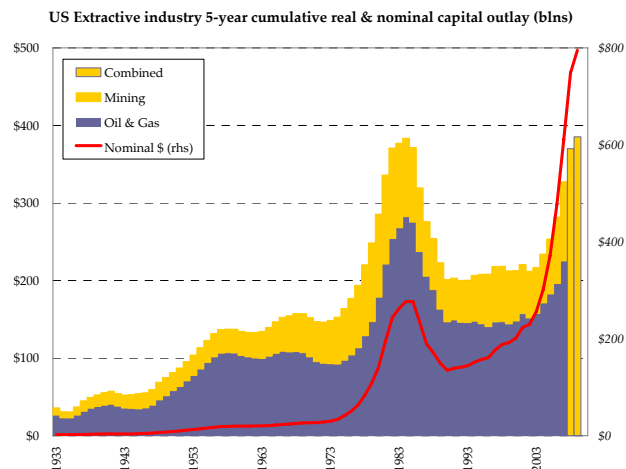


Figure 19: Twice Bitten, THRICE shy?

Be assured that there is little obvious deflation around – not if you define it properly. Cash in

circulation and non-financial demand liabilities at banks are growing rapidly in most of the world's major economies and, as a result, the eagerness to disembarass oneself from that suffocating surfeit of money by swapping it for less liquid financial assets and claims on raw materials has been growing apace.

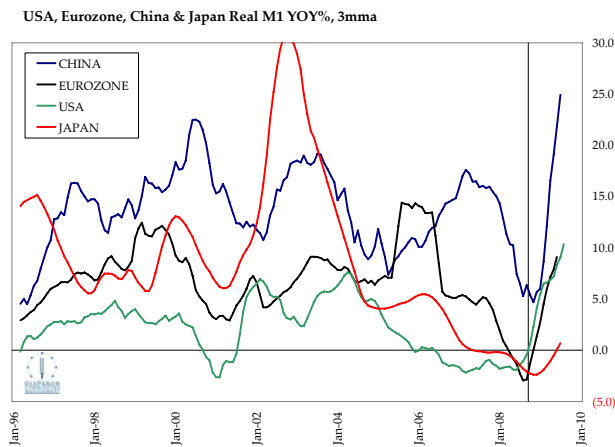


Figure 20: I LOVE the smell of napalm in the morning

That it has not yet done more than budge the various business sentiment indices from the suicidal depths to which they had fallen is only to be expected. It is a long way from 'not getting any worse' to 'becoming noticeably better' and the receipt of a few, no longer-deferrable replacement orders is not the same as the prospect of another headlong rush to a full and remunerative use of all that idled plant and equipment whose ghostly creaks and rustlings can still be heard only too plainly in executive boardrooms everywhere.

Instead, of a proper, privately-led recovery, what we have is ghoulish landscape where the creeping socialization of zombie businesses is impinging further upon the field of action of the good ones. As one telling poster puts it, the bail-out culture represents a particularly twisted form of interventionism: 'From each according to his means to each according to his inability'.

Not only are the so-called rescue programmes cluttering up the forest with whole thickets of dead wood – and thereby denying the vibrant saplings the light and space they could so readily exploit to

grow – but they are moving the economy further and further down a path where extreme 'regime uncertainty' prevails: where the cash is distributed not according to the dictates of consumer sovereignty and entrepreneurial action, but through the shadowy workings of 'Vitamin Beziehung' – where cash and favours are sought and accepted for transitory personal and political ends instead.

It is hard enough to plan production schedules and calculate returns on investment when one must contend with shifting exchange rates, changing consumer tastes, and the uncertain availability and varying costing of key inputs, but when you also have to wonder whether a pitiless fixer like Rahm Emmanuel considers your choice good for his Master's poll ratings, or whether Britain's very own Cardinal Richelieu – Baron Mandelson of Foy and Hartlepool – will decide the electoral calculus pertaining to your deeds is favourable to his particular clique, and then you have to worry whether you or your shareholders will actually be allowed to enjoy the rewards of any future success you attain, the task becomes not so much difficult as dispiritingly unknowable.

Given such pessimism, the reader still steeped in the mainstream miasma of 'effective demand' may be forgiven for wondering where the inflationary impetus can come from. After all, the argument goes, if businesses are not making anything more than the most necessitous of outlays and workers are not being taken back on the payroll in anything like the required numbers, there will be no-one either capable of, or willing to, borrow and the stagnation will thus be self-perpetuating.

Not necessarily. For not only can the government spend-and-borrow money into existence but, as we have already seen, the central bank 'buy' property titles in any conceivable amount to meet its perceived needs. Thus deflation – the 'secondary depression', if you will – can certainly be avoided, but that is a very different animal from assuming this means a restoration of the health of that vibrant and profitable private sector upon whose efforts ultimately all material well-being depends.

You see, the mistake the Aggregationists make with their childish, toilet flush models of the economy is that the money they summon into existence is never neutral and while it may not be able to pre-determine the *levels* of long-run output, it can certainly greatly influence both the *composition* of that output and the *prices* at which it is distributed.

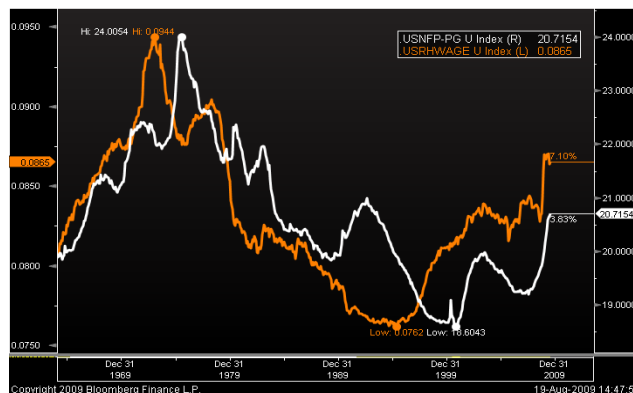
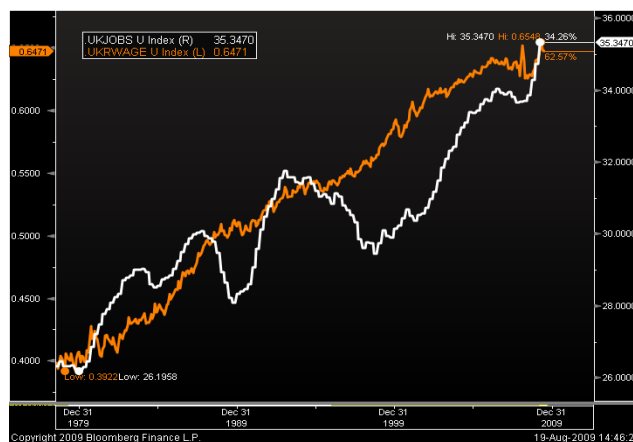
The more the state itself makes these decisions, or the more it delegates them to its many, undeclared GSEs - such as G(se)M, G(s)ECC, and GS(e), all voraciously suckling at the public teat – the less efficient thrive at the expense of the more; the lower becomes both the level and the quality of what is produced, and the higher the price which is charged for it.

Moreover, a world driven by politicians striving to use the people’s own wealth to buy their votes is not one predisposed to high levels of foreign penetration of the home market for the competition so offered is too injurious fatal to their vocal constituencies of rent-seekers and corporate welfare queens. Thus, the disruption suffered along the container routes and air freight corridors of the world by the collapse of the forex-bank-credit-commodity-trade pathway is unlikely to receive much of a fillip from the jacks-in-office who now wish to run things for their own benefit, the way they have long been itching to do.

There are, as yet, only a few portents of such discrimination – like the controversial ‘Buy American’ provisions or the odd discord of ‘British jobs for British workers’ – but, such things can easily come about via the back door in the name of ‘energy independence’, or ‘food security’ (a meme currently the subject of a big propaganda push from the Ministry of Truth in Oceania itself), not to mention the devil’s bargain that will be struck if any form of cap-and-trade carbon levy is imposed. Already, in that context, Germany has railed against what it sees as the nascent ‘eco-imperialism’ emanating under this guise from the likes of France.

No wonder Paul Krugman is an avid supporter of the scheme!

In a world where, for the many, continuation in business is intimately subject to political caprice; where the hunger for the funds with which to maintain the pretence of fiscal rectitude becomes ravenous; where borders, if not actually *closed*, are certainly made more costly to cross; where more and more people derive their livelihoods either directly from the government or as employees of firms whose biggest customer is Leviathan, it will not be too difficult to bring about an unpleasant mix of high prices, poor customer service, and anaemic entrepreneurial will.



Figures 21a & b: Proportion of Government workers to Private v Real Wages – UK (upper); US (lower)

Indeed, the poor risk: return conditions of high costs, government-sponsored competitors and a less profit-dependent, but more overtly politicised, workforce, means that private sector wages may well be pegged too high for a viable return to be made on them in these less expansive times. The chronically high private employment which would

be the result of this cannot fail to lead to the urgent call for further encroachments of the public sector - aimed at curing yet another example of 'market failure' - and for yet more monetary quack medicine being prescribed to try to price people back into work via inflation.

Before you know it, Alan Greenspan will be dusting off his 'Whip Inflation Now' lapel badge, angry wind-mill makers will be picketing the Houston Ship Canal, and Washington will be futilely negotiating price-and-wage controls to try to stop the rot.

Whichever way it goes, it would not be wise to bank on a return to the kind of relatively frictionless, trade-led growth we saw over the four or so years to 2007/early 2008. Political and social antagonism are likely to rise, now that the more readily identifiable cost-cuts have been enacted and the more difficult decisions regarding the scale and form of one's enterprise must instead be taken.

Despite rising money supply, profits are likely to disappoint, too, if too much of it sticks to the clammy hands of the government and its agents.

The market may have to suffer a nasty bout of disillusion before it reconciles itself to the fact that the halcyon days are long gone and that the clock is everywhere ticking toward a reckoning with the government debt market.

Within such a framework, a core holding of commodities still makes sense (assuming that the taking of such a prudential step is not anathematized completely) as protection against outright inflationism, as well as against supply disruptions and the pitfalls of the heightened economic nationalism we can foresee. Like every other investment, final success also depends very much on the entry level one achieves, so buying into that next round of disappointment, if and when it arises, would seem to make eminent sense.

If, by then, we also have to pay thrice over for T. Boone Pickens and Albert Arnold Gore, Jr., to make their loot out of sending us back to the fourteenth century in terms of generating the power needed to run our mines, farms, and factories, we can also assume a nasty boost to input costs all along the line.

Those still endeavouring to make the things we cannot be without - and commodities are surely among them - will not be slow to pass those costs on whenever they can in response.

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