Leithner Letter No. 144-147
23 December 2011-23 March 2012

"… He learnt on the job, by experience and by increments. [Shortly before the Second World War], his son was sent to Hong Kong to oversee the family's operations there and [during the war] was imprisoned in a Japanese prisoner of war camp.

"How terrible," said my friend.

"No," the old timer replied. "He survived. It was the making of him. He learnt about human nature. He learnt humility." A pause before he continued. "But we made a big mistake with the grandchildren."

"Oh, what was that?"

"We sent them to Harvard Business School."

Kate Jennings
Address to the Sydney Institute
29 May 2003

Will Our Rulers and Their Shills Never Learn?

The end of one calendar year and the beginning of the next is an appropriate time to reflect upon the outgoing year's twists and turns, triumphs, trials and tribulations. It is also a good time to place these passing events into a broader context, consider their possible causes and consequences, identify one's mistakes, learn one's lessons and set a more sensible course for the forthcoming year. Late in 2011 and early in 2012, it seems to me, the wise course remains – as Leithner and Co.'s has been for a decade (see among many examples Letter 30, Letter 46, Letter 72-73, Letter 87-89 and Letter 114-116) – a very cautious one.

In Australasia, Britain, Europe, the U.S. and many other countries during 2011, the prices of most stocks, bonds and other securities were dangerously high (see below). Hence they're vulnerable to drastic decline – either precipitously in 2012 or erratically over the next several years. Moreover, financial and economic diseases that for decades had been chronic and which became acute in 2007 grew even more critical in 2011. If an individual or a household cannot indefinitely live beyond its means, then how can a government? Do the laws economics somehow exempt states? Can central planners, a.k.a. politicians and bureaucrats, break them with impuni-

ty? Indeed, can they countermand them? Unfortunately, our rulers are convinced that they can. Accordingly, the best and the brightest have diagnosed these diseases incorrectly and treated them inappropriately. Medieval physicians "bled" patients by applying leaches; today, politicians (aided and abetted by accommodating central bankers) "treat" a symptom, namely massive debt that's grown to crisis proportions, by borrowing even more frantically! As it's been since 2007 so it was in 2011: the anointed harmed the benighted. Alas, because the anointed have forgotten nothing and learnt nothing, it's likely that in 2012 the benighted will continue to bleed at the hands of their rulers.

During 2011, central bankers, politicians, their shills in the mainstream media and most market participants, institutional and retail, either ignored or confused cause and effect. Cheered by their subjects, rulers frantically treated symptoms and stridently denied causes. As a result, not only did they retard healing: they made an already bad economic and financial situation – one that their poor policies created in the first place! – even worse. Economic, financial and political masterminds in government and academia continued, for example, to regard high and rising consumer expenditure as a cause rather than a consequence of prosperity; accordingly, they attempted to move heaven and earth in order to encourage expenditure – particularly debt-financed expenditure – and to denigrate savings and retrenchment. In 2011, outsiders declined to spend as much as insiders exhorted and demanded, and insiders continued to spend like there's no tomorrow – and thereby created a poorer tomorrow for outsiders.

As they have for decades, in 2011 monetary central planners regarded modestly rising (that is, by ca. 1-3% per year) consumer prices as a Very Good Thing, and falling consumer prices as a phenomenon so intolerable that it must be avoided at all costs. Central bankers simply fail to grasp the elementary and obvious truth that in a healthy economy prices do not rise: quite the contrary, they fall gently from year to year and by a significant extent over the years. Another simple truth – namely that indebtedness is a route to penury rather than prosperity – utterly escapes them. Debt is slavery and genuine prosperity derives from authentic savings and the successful allocation of savings into productive investments. Most importantly, and unlike the dullest child, who understands the physical impossibility that two people can simultaneously occupy the same physical space or the logical impossibility that they can own the same title to property, during 2011 the legal system continued to regard deposits and loans as synonyms. As they have for 150 years, not only did regulators allow banks to lend deposits: the entire governing apparatus enthusiastically encouraged them to do so. This elementary and monumental error, repeated time and again for centuries, sows the seeds for the next banking and financial crisis.

What we wrote in Letter 72-73 (December 2005-January 2006) applied equally in 2011: "once again, laws of human action were ignored and history derided. But to flout the past and become complacent in the present is to set the stage for humbling mistakes in the future." In 2011, a few understood that contemporary mainstream economics, finance and politics – whose tenets have for decades been sacrosanct within polite and respectable circles – rest upon false and damaging

foundations. To all except those who are willfully blind, the consequences of colossally poor policies have now become apparent; but our rulers, like crazed alchemists (or should that be addicts?), stridently refuse to confess their mistakes. From their privileged positions, they cannot: for if they do then they must not just resign but also abolish the posts they occupy and the institutions they head.

Is the All Ordinaries Index Undervalued, Overvalued or Fairly Valued?

In Letter 124-126 (April-June 2010), we detailed the assumptions and reasoning that underlie our estimates of the All Ordinaries Index's "fair value." Table 1 summarises some of its results. The table's rows list three assumptions regarding earnings. The first is "bullish" – as mainstream analysts at the time expected, during the next year the earnings of the companies that comprise the index would increase ca. 20%. The second is the "mid-range" expectation that earnings would remain stable, and the third is "bearish" (i.e., that they would eventually regress to their long-term trend). Regarding the All Ords' PE ratio, the table's columns posit a "bullish" assumption (that it rises 25% above its historical average, to 17.2 times), a "mid-range" one (that it recedes to its historical mean) and a "bearish" one (falls to 7.5). These two sets of assumptions yielded nine estimates of fair value – which, 18 months later, I believe remain valid. Notice that mid-range assumptions with respect to earnings and the PE multiple generate an estimate of 3,988 – not far below its actual level in mid-December 2011.

Table 1: The "Fair Value" of the All Ordinaries Index in 2009 – and 2011-2012

	Bearish Multiple (7.5)	Mid-Range Multiple (13.8)	Bullish Multiple (17.2)	Mean
Bullish Earnings (i.e., Don't Fall)	2,438	4,472	5,590	4,167
Mid-Range Earnings	2,168	3,988	4,971	3,709
Bearish Earnings (Fall to L-T Trend)	1,650	3,036	3,784	2,823
Mean	2,085	3,832	4,781	3,566

Which assumptions to choose? Last year I wrote "we believe that the AOI's earnings formed a bubble in 2004-2008, and the higher they rise the harder they fall. Thus far, reality has smiled intermittently upon this expectation. On the other hand, from late 2007 to early 2009 we thought that Australia was on the brink of – or had already entered – a nasty recession. On a per capita basis, Australia *did* experience a recession in 2008-2009, but the mainstream resolutely ig-

nores this inconvenient fact. Instead, the infrastructure, mining and above all the government intervention booms have mesmerised it."

In 2011 the boom cooled, and many Australians realised that its benefits aren't pounding on their doors. In that context, it's worth repeating something I've repeated for years: the fiscal and monetary extremism of Western governments including the Commonwealth Government – both those imposed continuously since the 1980s, which inflated the Great Bubble, and those hastily enacted since mid-2007, which have delayed its collapse – have failed and will continue to fail. A few people perceive this lack of success, and in 2012 this failure might become more apparent to more people. The downgrading of the creditworthiness of the U.S. (by Standard & Poor's) Japan (by Moody's) and various smaller European countries during 2011, and the possible (probable?) downgrade of major European nations in 2012, symbolise this failure.

In 2010 I concluded that the AOI remained greatly overvalued – and hence ripe for a hefty fall. You say that seven of the nine estimates in Table 1 are intolerably low? That's what aggrieved, annoyed, prominent (and in some instances, indignant and outraged) people told me at conferences which I attended since 2009. Each time, I urged them to accept Warren Buffett's challenge. On 22 November 1999 (when the S&P 500 stood at 1,391 and the Dow Jones Industrial Average at 9,116 and the best and the brightest could – thanks to the Internet – see naught but financial blue sky and economic sunshine for years into the future), Buffett outlined to *Fortune* magazine his expectations about the S&P 500 during the next ten years. He was very doubtful that its rate of increase during the decade to come (i.e., 2000-2010) would be nearly as robust as it was in 1989-1999. And so events have transpired: during the January-June half of 2011, the DJIA averaged 11,500 and the S&P 500 1,150.

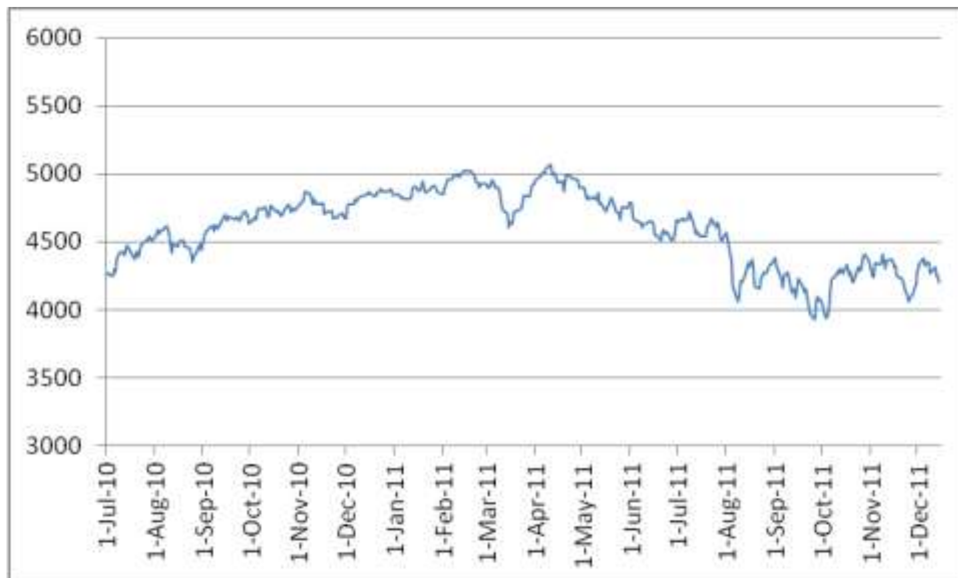
A decade ago, in economic and financial terms Americans could see nothing but clear blue sky. No mainstream prognosticator foresaw inclement weather, and certainly no "reputable" (to the mainstream) expert envisaged the most severe crisis since the Great Depression. Throughout much of 2010-2011, the Australian crowd's mindset was uncannily similar to that of its American counterpart a decade ago. In 1999, the best and the brightest in the U.S. could – thanks to the Internet – see naught but good times for years into the future – and they pitied Australians, for all we had was dirt. During 2011, the best and brightest in Australia, including and perhaps especially the Reserve Bank and Commonwealth Treasury, celebrated Australia's dirt, and – thanks to the China, infrastructure and mining booms – saw naught but financial blue sky and economic sunshine decades into the future. They pitied America's predicament – and rather smugly maintained that what's happened there simply can't happen here: our "fundamentals," they stridently insisted, are self-evidently sound. Australian politicians, and bureaucrats, they add, decreed and will stoutly and successfully defend these "fundamentals." The obvious and irrefutable point utterly escapes them: the boom creates the bust; America's bubble burst; and so too, inevitably, will Australia's – and, for that matter, China's. Hence this message, reminder and challenge (in Buffett's words of 1999) to the ebullient crowd in Australia:

> Maybe you'd like to argue a different case. Fair enough. But give me your assumptions. If you think the American public is going to make 12% a year in stocks, I think you have to say, for example, "Well, that's because I expect GDP to grow at 10% a year, dividends to add two percentage points to returns, and interest rates to stay at a constant level." Or you've got to rearrange these key variables in some other manner. [But] the Tinker Bell approach – clap if you believe – just won't cut it.

What's Been the All Ordinaries' Actual Course Since July 2010?

Figure 1 plots the All Ordinaries Index from 1 July 2010 to 15 December 2011. From 1 July 2010 (4300) until 1 February 2011 (5000), it rose almost without interruption. It then suddenly dropped to 4650 by mid-March, and returned equally abruptly to 5000 by April. From then until October it fell almost continuously, to a two-year low (3978) on 23 September. As that day's *Australian* remarked, "the market is now back to levels first reached in 2004, meaning many investors have seen no gains in seven years." Since August it has fluctuated around ca. 4250. *The AOI now reflects the mid-range rather than the bullish assumptions summarised in Table 1; and I'm alert to the distinct possibility that within the next couple of years it will reflect the dour assumptions.*

Figure 1: The All Ordinaries Index, 1 July 2010-15 December 2011



The crowd, whether in 2009, 2010 or in the first half of 2011, could hardly disagree more – and could hardly have been more blindsided during 2011. "It's All About Stocks in 2011," *USA Today* (26 December 2010) crowed. "Top experts agree: the New Year looks great for stocks." In particular, "with the odds of a double-dip recession fast fading, five Wall Street heavyweights say it's time for individual investors to get over their fear of the U.S. stock market so they can

take advantage of what [the heavyweights] predict will be a third straight year of solid gains for stocks in 2011."[1]

At the end of 2010 exuberance also reigned supreme in Australia. In "Goldman Sachs Names Top Ten Picks for 2011" (*The Australian*, 7 December 2010), the blueblood investment bank issued its annual *ex cathedra* pronouncement to its supposed inferiors: "equities remain its preferred asset class and its 2011 targets for the S&P/ASX 200 [are] 5375 by June and 5600 points in December, or a rise of about 19%. [Moreover], the bank's analysts for the first time released their initial thoughts on 2012, tipping the S&P/ASX 200 to hit 5850 points by June of that year and 6100 points by December. That equates to a rise of about 9% in 2012 versus 19% in 2011. As for key themes, Goldman said investors should be exposed to stocks linked to the recovery in the U.S."

A year ago, the Australian arm of another of the world's biggest investment banks was also upbeat ("Stocks to Rally Next Year: UBS," *The Australian*, 2 December 2010): "Australian equity markets are poised for a rally next year on the back of stronger domestic growth. 'Australian equities are attractively valued, the liquidity backdrop for shares is positive and the corporate sector has scope to re-leverage,' they write in an outlook report. 'Going forward, we believe the markets will resume their upward trajectory, encouraged by ongoing evidence of a moderate economic expansion, easing global risk aversion and undemanding valuations … Given current modest valuations, we see 5500 – 20% upside potential – on the ASX 200 [sic] as an achievable 12-month target.'"

Journalists swallowed this babble so eagerly that they hardly bothered to chew. "The bear market is over," *The Australian* exulted in "Time to Buy as the Bull Sharpens Its Horns" on 23 February 2011. "With the All Ordinaries Index charging past the 5000 mark earlier this month and staying there, top investment strategists say the Australian share market is officially in a recovery phase and [that] this is the year for investors to get back into the market." According to one "top analyst," "the trend this year is that we are likely to see a stronger equity market, which could well see the All Ordinaries [Index] move up towards the 6,000 mark as the year progresses." Another "top analyst" averred "we are at the halfway point of the recovery in this investment cycle. We are just coming up to the [second] anniversary of the bear market bottom next month, and history tells us cyclical recoveries normally … go for three to four years. That would suggest we have got a year or two before we hit the end of the cyclical recovery of shares." This expert forecast that the All Ordinaries Index, which closed at 5024 on 23 February, would close at 5600 on 31 December 2011. He concluded: "we are starting to see a rising trend in the market … We should [therefore] see pretty good gains in shares during the year."

[1] Interestingly, and more intelligently, a side bar to the article in *USA Today* stated: "what could go wrong? The fact that all the panelists have outlined upbeat forecasts in 2011 is somewhat worrisome, as history has often shown that when everyone is in agreement on a certain outcome, the exact opposite often occurs."

The tsunami in Japan and the accident at the Fukushima nuclear facility in early March 2011 did not dent top Australian analysts' confidence. In its *Quarterly Economic Outlook*, released on 24 March, the economists employed by major investment institutions surveyed by *The Australian* predicted, on average, that the S&P/ASX 200 would rise to 5125 by June 2011 and to 5450 by December 2011. That was an increase of 12% and 19%, respectively, from the market's level on 24 March. Of the 20 institutions (AMP, ANZ, … UBS, Westpac) surveyed, only one predicted that the stock market would be lower in June than in March, and none prophesied that it would be lower in December than in June. Americans, too, remained resolutely upbeat. "You had a lot of people at the beginning of the year still not believers in the [US] economy," a major American investment institution's chief economist told *The Wall Street Journal* on 29 March. "I think more people are believers now. Driving this trend has been increased confidence that the U.S. economy, while still weak when it comes to housing and jobs growth, is well on its way to a self-sustaining recovery."

A former member of the RBA board and chairman of a blueblood investment advisory firm, who writes a regular column in *The Australian*, shilled enthusiastically on behalf of the confident crowd. In "Reasons to Be Cheerful About Shares Outlook" (20 April 2011) he wrote: "many experienced investors [of whom, no doubt, he includes himself] have a watch list of the main factors that drive the share market, including the state of the economy, company earnings, the current valuation of the share market as measured by its 'price-earnings' multiple (that is, the average of share prices divided by company earnings), interest rates and dividends. On balance, these influences suggest a positive outlook for the share market at the moment – a prospect that is further enhanced by the big reduction in company debt over the past two years … an even more upbeat view can be taken for the share market outlook when interest rates are brought into the picture."

"RBA, Treasury Might Have to Change Their Stance" (*The Australian*, 30 May 2011) quoted extensively from the Reserve Bank's deputy governor, Ric Battellino – who not only bears an astonishing physical resemblance to Mister Magoo, but is also a reliable source of unreliable predictions uttered confidently, repeatedly and publicly.[2] "There's [sic] always risks, but at this stage of the economic cycle we're at a stage where the world economy is still gathering strength and that is going to be the dominant force for the world," he said. "There's [sic][3] a lot of things wrong in the world, such as the government debt situation in Europe. No one knows how it will work out. It could be quite messy. Whether they come to anything, who knows, but the cycle at the moment is on an upswing." *The Australian* added: "if Battellino is right, investors [who are]

---

2 To cite just one additional example, in a spectacularly poorly timed speech on 12 December 2007, Battellino stated "Australian households are in very good shape. They are not in any way exposed or vulnerable – the structure of assets and liabilities is quite sound. There would obviously be examples of people getting themselves into financial difficulty. But fundamentally, the household sector as a whole is in very good financial shape … *and there's no hint the share market is grossly overvalued* [italics added]." In December 2007, the All Ordinaries Index averaged 6,492. Twelve months later, it averaged 3,529.

3 Not only is Mr Battellino an economic illiterate; the basics of English grammar also appear to elude him.

entering today's market stand to do extremely well." It offered no opinion (perhaps it felt none was necessary because it believes that he and the RBA are omnipotent and omniscient) how Australian investors would fare if Battellino were wrong.

The economy was strengthening, insisted the bulls, because our political masters' crazed interventionist policies were causing it to strengthen. In their twisted minds, socialism works. "G8 Says Strong Global Economy Will Cut Debts" (*The Weekend Australian,* 28-29 May 2011) was typical. "Group of Eight leaders say a strengthening global economy will pave the way to cuts in the debt built up during the recession that followed the 2008 financial crisis … 'The global recovery is gaining strength, and is becoming more self-sustained,' read a draft statement prepared for the leaders at a two-day summit [in France.]" Perhaps for that reason, the alleged experts cited in "Global Growth Fears Spark Sell-off" (*The Australian*, 3 June 2011) were mostly sanguine. "An equities market sell-off could be expected in the current stage of the global economic recovery," said one. "I think a pause of this nature in the economic recovery we are seeing is perfectly natural. All of the other economic recessions have followed this pattern [sic] … [so] we shouldn't be worried. I don't think it's the start of another crisis or a second downturn."

Precisely because they were so bullish, most bulls simply denied the storm brewing on the horizon. In "Buoyant Banker Spreads the Joy," *The Australian* (24 June 2011) reported "JPMorgan boss Jamie Dimon "is in Australia to … pay down concerns about the Greek crisis and talk up the chances of a sustained recovery in the US economy … In an interview with *The Australian*, he acknowledged the present mess but said a lot of the leading indicators were positive, [American] housing was picking up, US companies were in great shape and the US's innovative nature would help a rebound. This would come from the US, with little input from China … Others have made the same point, arguing that … [the Greek sovereign debt crisis is] relatively contained" (see also "Mighty US Can Shake Off the Gloom, *The Weekend Australian*, 25-26 June 2011). In its *Quarterly Economic Outlook*, released on 16 June, the institutions surveyed by *The Australian* predicted – surprise, surprise! – "the share market will respond strongly, with the S&P/ASX 200 jumping from its current level of 4567 to 5050 by December and 5339 by next June." That was a predicted increase of 12% and 19%, respectively. Here's another bombshell: of the 18 institutions (AMP, ANZ, … UBS, Westpac) surveyed, only one predicted that the stock market would be lower in December than in June, and none prophesied that it would be lower in June 2012 than in June 2011.

In August, as markets plunged, "Australian share market veterans" concluded that their models had not failed the test of reality: quite the contrary, reality had failed their models! *The Weekend Australian* ("Don't Panic, We're Free from Contagion," 6-7 August) reported: "Australian share market veterans are shaking their heads about how quickly an international attack of nerves about sovereign debt worries had converted itself in mere days into a panic attack on markets such as ours that are almost totally quarantined, in earnings terms, from the contagion." On 10 August ("Fear, Not Facts, Driving the Desire to Divest") it went further: "the latest bout of selling by investors has been driven by a herd mentality and predictably irrational behaviour, ac-

cording to behavioural economists. 'Investors are behaving irrationally, driven by a fear mentality,' [one] said. 'Nothing has happened to our economic fundamentals, but [investors] feel they have to clear the decks and sell off their shares because of what is happening in the U.S. and Europe. The lack of confidence in the global economy is emotion-driven, not fact driven.' She said investors would continue to behave irrationally even though the market was undervalued."

To put matters politely, exuberant share market veterans and haughty behavioural economists ignored elementary logic. They had things exactly back to front – that is, the "experts" were irrationally exuberant at the end of 2010 and throughout 2011. Indeed, isn't the behaviour of market strategists at major investment institutions predictably irrational? Don't they reliably overestimate the "performance" of the market? Are they not mindless members of a herd driven by malleable emotions (and the prospect of bonuses which bubbly markets generate!) rather than hard facts? Did market participants during 2011 not come, kicking and screaming yet *rationally* and according to the facts, to the conclusion that experts *overestimated* "the fundamentals" and *overvalued* the market indices at the beginning of the year? Doesn't the course of events in 2011 demonstrate – once again, as if we needed corroboration – that "experts" are nothing more than silver-tongued, elegantly coiffed and vastly overpaid shills?

The Sombre Case Prevails

One need not read *The Evil Princes of Martin Place* (whose Kindle version is now available) in order to obtain an alternate perspective on the distemper of our times. Indeed, one former member of the RBA's board – of all people – occasionally makes good sense. "Reserve Bank board member [and Australian National University economist] Warwick McKibbin has warned that Australia is being caught up in a global bubble that could hit us much harder than the global financial crisis and expose the weaknesses of Labor's economic settings" (see "Bigger Bubble Is Building: RBA Director," *The Australian*, 28 February 2011).

According to Prof McKibbin, the "bubble" in global commodity prices and property markets in Asia "threatened to dwarf the housing market bubble in the US that led to the GFC in 2008 [sic]. This is shaping up to be much bigger than 2004-2007." Prof McKibbin suggested that the surge of global liquidity fuelled by the reckless policies of central banks in China, Europe, the U.S. and elsewhere has "echoes of the early 1970s surge in food, mining and energy prices that led to global 'stagflation' or the combination of [a high Consumer Price Index] and high unemployment." He also estimated that perhaps 40% of the surge in Australia's terms of trade to a 150-year high has been driven by central banks' crazed monetary expansion, "which is feeding generalised inflation pressures. That is why inflation is taking off all over the world. It is already out of the bag. As interest rates go up, a whole bunch of assets and balance sheets will get crunched, so I am not optimistic."

Even the bluest of the bluebloods and the masters of the universe must eventually bow to reality. In March, Goldman Sachs "slashed its December [2011] target for the Australian stock market by 8% after the global investment bank cut its 2011 growth forecast for China. In the latest

cut by a major bank, Goldman yesterday reduced its December [2011] forecast for the ASX/S&P 200 Index to 5125 points from 5600, and its December 2012 target to 5650 points to 6100." Notice that even its amended December 2011 forecast has proved wildly overoptimistic. In "Stocks Slump on Recovery Scares" (3 June 2011) *The Australian* reported that "fears that the global economic recovery is faltering have sent Australian shares tumbling to their worst one-day fall in 12 months, … as fears mounted that Greece [not to mention Portugal, Spain, Italy and others] could default on its sovereign debt and the US economy could stall." And in "Global Fears Wipe Out $28 Billion" (*The Australian*, 17 June 2011), "market analysts say there is no end in sight for the volatility on global stock markets, which yesterday sent Australian shares to their lowest point in nearly a year."

Why did the All Ordinaries Index fall during 2011? Perhaps because, "as one of Australia's most senior bankers has warned, the global financial crisis is far from over" (see "GFC Fallout 'Is Not Over Yet,'" *The Weekend Australian*, 2-3 July 2011). "A lot of people think it is," said Michael Ulmer, the deputy chief executive of the National Australia Bank, "but there is a long way to go." Similarly, on 1 July *The Australian* ("Wall of Worry Clouds Outlook") reported "the stark reality facing investors at [financial] year end is that the long slow grind from the financial crisis we didn't have is continuing, with no clear signs of blue sky emerging. Even worse, all the evidence suggests that, just as in the U.S., wide sections of the local economy are grinding to a halt." *The Weekend Australian* ("The Looming Crisis," 16-17 July) added: "most corporate captains, rather than sharing the Gillard government's sanguine belief that Australia's two-speed economy is all about managing a boom, are saying publicly and privately that the country may be about to have to manage a bust."

Why have Australian equities tumbled? Perhaps because

> it now appears that the U.S. economy has not yet recovered the ground lost in the recession – and, worse still, the recovery in the first half of this year has fizzled … Suddenly, the self-sustaining growth expected by most U.S. businesses and investors, by the Fed and many analysts (including me) has been cast into grave doubt. It is now much more likely than it seemed just a few days ago that the U.S. will suffer a double-dip recession or a sustained period of Japanese-style stagnation – a fate similar to that facing Britain.
>
> Further fiscal stimulus is ruled out by record deficits and political stalemate, while the Federal Reserve's efforts to stimulate the economy by printing money seem to have failed. Another dose of quantitative easing could prove dangerously counter-productive if it pushes up oil and food prices and undermines the dollar ("Out of Weapons to Fight Recession," *The Times*, 11 August).

The Australian reported on 24 August: "the extreme volatility in world markets will last for years and may expose Australia's economy to greater instability that the recent global financial crisis. Treasury Secretary Martin Parkinson said yesterday the wild conditions meant both the economy and the Commonwealth's budget would become harder to manage, while there was also a danger that the Chinese economy could falter." The Organisation for Economic Cooperation

and Development (OECD), too, seemed ready to throw up its hands and (implicitly) admit defeat. On 12 September it released data which, it said, indicated that the global economy is slowing sharply. Significantly, the OECD's composite leading indicators (CLIs) are indicating a downturn not just for major Western countries (including Britain, Canada, France, Germany, Italy and the U.S.) but also the major developing economies (and alleged engines of global recovery during the next several years) including Brazil, China, India and Russia. That's not *despite* the most crazed stimulus in history: it's *because* of it. On the same day *The Australian* reported: "deepening Eurozone debt woes have mutated into a full-blown continental political crisis invoking the ghosts of the dark decade of the 1930s."

On 7 November, Germany's Chancellor, Angela Merkel, warned that the Eurozone will take 10 years or more to recover. "Almost all European countries have spent more than over the years than they have earned," she said in her weekly podcast. Accordingly, would "certainly take a decade until we are in a better position again." On 8 November the economics correspondent of *The Australian* ("Cuts Now Will Imperil Economy") stated "the global economy appears so full of peril as the year draws towards its end that it is all too easy to imagine the circumstances which, during the next 18 months, would send a new financial crisis spinning across the world. The 2008-2009 crisis was short-lived because governments opened the floodgates and took bad banking debts onto their own books. We are now facing the consequences." On 21 November "China's top economic leader warned that the world faces a prolonged recession. Vice-Premier Wang Qishan told state media: 'the one thing we can be sure of is that the global recession caused by the international financial crisis will be extended'" ("Chinese Leader Warns of Long Global Recession," *The Australian* 22 November 2011).

Finally, on 1 December the front page of *The Australian* carried the headline "World Economic Turmoil Should Scare Living Daylights Out of Us: Westpac." The accompanying article stated

> The economic turmoil in Europe and the US is nearing "catastrophic" proportions, one of the nation's leading banks warned yesterday, as it predicted a plunge in the dollar to less than $US80¢ and three interest rate cuts next year. James Shugg, Westpac's London-based senior economist … said a halving of world economic growth rates in just two years was a sign of "really abnormal" circumstances.
>
> "I've never been as scared about the outlook for the global economy, particularly in Europe, at any time in my past 25 years as an economist," he told a Westpac conference in Rockhampton, Queensland, yesterday. "I've started smoking; I can't get to sleep at night. Markets are freezing up, banks are losing access to credit and funding; things are even worse than you are reading about. It is now a serious and considerable risk that we will see a collapse of European financial markets, one or more of the 17 members leaving the Euro (currency) and the Eurozone split up. This should scare the living daylights out of everyone … it's a global catastrophe and there are going to be impacts felt here in Australia."

> … Mr Shugg signalled Westpac was preparing to dramatically revise its view of the European economy, unless a political breakthrough was made in the next few days, from being in a slight recession to an economy shrinking by 4% next year. But he warned that if the [European Union] split and its nations jettisoned the Euro currency the European economy could contract by as much as 10%. This dire scenario would collapse European financial markets, cause entire European states to fail and signal the start of a "real global catastrophe." But Mt Shugg said the global crisis was not confined to Europe. He believes the US is "glossing over" its financial figures and is close to another recession. He warned that the fallout for Australia would be profound, particularly if the signs of a Chinese slowdown were realised.

Unrevised and Unrepentant

In light of these sobering developments, some analysts and commentators remained utterly intransigent. On 20 July, a columnist in *The Australian* cited the head of research at a large financial planning firm:

> Valuations on the Australian market are very cheap. You've got the market trading on a forward expected earnings price-earnings ratio of 11.4 times, with a healthy current yield of 4.6% and earnings growth estimated about 14.5%. But the really important thing from here is that there's actually a lot of upside … I think people are much more realist now, post the global financial crisis, as to what constitutes an achievable return from the stockmarket.

On 13 September 2011, a columnist in *The Australian* insisted "there's nothing essentially wrong with our economy or sharemarket." On 16 September 2011, *The Wall Street Journal* reported – apparently with a straight face – "a year ago, the [Federal Reserve] decided to print $US600 billion to buy [Treasury] bonds, in the second round of quantitative easing or QE2. That was easy to grasp: the more money the Fed pumps into the economy, the more fuel [there is] for growth." So why isn't Zimbabwe the world's richest nation? On 26 September, the Treasurer asserted: "Euro-area countries will do whatever is necessary to resolve the sovereign debt crisis and endure the financial stability of the Euro area as a whole."[4] On 4-5 November, in "Being Prepared for the Quick Leg-Up," *The Weekend Australian* cited the "head of private wealth" at a major brokerage firm:

> "As we get closer to resolving systemic issues in the market, investors need to be in a position where they can act at short notice" … When the market really starts to move [upwards], you want to be exposed to stocks that are leveraged to economic activity or companies that exhibit what is known as "high beta" with the overall market … "Our strategy has been to hold a higher weighting of cash, but as some of the systemic risks in the system are ironed

[4] On 17 December, AAP reported "Fitch Ratings has cast doubt on whether the budget discipline pact that European states intend to adopt will be able to solve the eurozone debt crisis. 'Fitch has concluded that a comprehensive solution to the Eurozone crisis is technically and politically beyond reach,' following the crisis summit last week at which the pact was announced, it said."

> out I think we are reaching a point where it will make sense to be fully invested." He argues that any shocks experienced by the sharemarket in the near term may be ideal entry points for investors … Margin lending is another way to raise cash to invest.

On 23 November, *The Australian* repeated the mantra that stocks are cheap: "advisors say that now is not the right time to flee stocks, with equities historically cheap … On our measures of historical value, equities look reasonably good value; they're not very cheap, but equally they're not particularly expensive … From a purely valuation view, shares look quite attractive compared to other asset classes, and are generating strong cash flows relative to the valuation of the underlying sharemarket." An economist writing in *The Australian* ("Growth Will Pick Up, So Don't Get Carried Away By What Is Happening in Europe," 1 December) was unfazed: "Australia would be affected by a financial crisis, but to a limited extent. Our Big Four banks are strong, and have little exposure to sovereign debt in the threatened countries. For us, the issue is the financing of Australia's ongoing overseas borrowing requirement … Any credit squeeze would be minor and temporary … Australia is bumping around the bottom of the cycle, growing at between 2% and 2.5% … [So] there's little downside risk to growth. The next stage is an increase. It's just a question of when."

The award for outright hubris (as opposed to mere complacency and delusion) is highly competitive. One finalist is The Median Australian. In "We're the Richest Nation on Earth," *The Australian* (20 October 2011) reported:

> The once-in-a-lifetime mining boom and extensive home ownership have made Australians the wealthiest people in the world, according to a new survey … The survey found Australian adults are the world's richest on the median measure – the actual wealth of the middle-ranking person if Australians are ranked from richest to poorest. Adults here are worth $US221,704 ($A217,559), nearly four times as much as US adults. On an average basis – total wealth divided by the number of adults – we came second to Switzerland.[5]

The other finalist, appropriately enough, is the Reserve Bank. In "RBA Chief Predicts 'Benign' Economy" (26 October), *The Australian* reported that its Deputy Governor, Ric Battellino,

> … describes the outlook for the economy as "benign." The RBA's central scenario still has the world economy achieving average growth over the year ahead, boosted by good growth in Asia and surprisingly healthy growth in the US and in Japan. "This would create a reasonably benign environment for the Australian economy," Mr Battellino told a business confer-

[5] On the previous day, 19 October, *The Australian* reported ("Households Focused on Debt, Bill Worries") the median Australian household's savings is currently $7,812. On 19 September, it reported ("Out-of-Control Debt Crippling Growth") "household debt is crippling economic growth, soaring last year almost a third above the safe threshold for long-term expansion and stability. A study of 18 industrialised economies put the tipping point above which household borrowing can harm economic growth at 85% of GDP. Australians' use of credit took the nationwide household debt level last year to 113% of GDP – in third place of the countries studied, with only Denmark and The Netherlands higher … The only possible conclusion is that advanced countries with high debt levels must act quickly and decisively to address their looming fiscal problems."

> ence in Sydney yesterday … [He] said there was so far no sign of Europe's troubles and the volatility they have created resulting in lower economic activity anywhere else.[6]

Analysts – or Cheerleaders, Estate Agents and Used Car Salesmen?

The behaviour of Australian "experts" in 2011 was hardly unusual. Quite the contrary: it conforms to a long-established pattern. According to Glenn Stevens, who in 1999 was the RBA's Assistant Governor, many market professionals make forecasts "with a view to selling a product, or a piece of advice … many forecasts made in the private sector are essentially of this variety. The forecaster has a story to tell in order to provide credibility to their employer's efforts to win business" (quoted on 16 September 1999 by *Australian Financial Review* correspondent Stephen Koukoulas). More than a decade ago, Bethany McLean (Does Wall Street Need a Reality Check? *Fortune*, 5 February 2001) noted

> Some investing pros are declaring that the worst is over. Sounds great, but remember – they were positive last spring too … [and there] are strong reasons to be cautious right now. Wall Street firms make money by selling stocks, and it's probably naive to expect them to say that stocks are a bad business. Analysts' "buys" are notoriously untrustworthy. And as for the strategists, these are the same people who have been saying "buy" since the Nasdaq crossed 5,000 … This is also the same crowd who argued that tech stocks were growing so quickly and had so little debt that they would be immune to rising interest rates … A highly paid Wall Street professional isn't going to say, "I'm sorry, I missed it, I cost you millions, and now I don't know what's going to happen." But the truth is, no one does know. And some market observers are concerned – in part precisely because the Street seems a little blithe about the current downturn.

Another article from that same issue of *Fortune* (David Rynecki, The Price of Being Right) is instructive. It tells the story of Mike Mayo, an analyst who "thought he could change the ratings game on Wall Street. He thought he could be honest – and tell people to sell stocks that were headed for a meltdown. It cost him his job." What Rynecki observed then is no less true today:

> It is hardly a deep, dark secret that the ratings game on Wall Street is beset with serious conflicts. Once kept separate, by long-held convention, from the investment banking side of the business, brokerage house analysts now find themselves in the supporting role of assistant dealmakers. Researchers pull double duty as stock boosters, often serving as liaisons between the companies they cover and the investing public. It is, after all, a game about money.

Rynecki continued: "even during the uncertain, recession-fearing present, more than 70% of the 27,000 analyst recommendations tracked by First Call/Thomson Financial are buys or strong buys. That compares with a minuscule 1% for sell ratings of any kind. Among the ten largest

---

[6] On 5-6 November, *The Weekend Australian* reported "the Reserve Bank has sharply reduced its forecasts for Australia's growth and inflation in a dramatic revision of its thinking three months ago, and warned that Europe may pitch into deep recession, dragging the rest of the world economy down with it."

investment banks (which do the vast majority of underwriting), the pattern is more pronounced. First Call identifies a total of 57 sells vs. 7,033 buys."[7] He concluded that whilst

> the rewards for positive coverage are well known – and remain an issue of continuing concern for the Securities and Exchange Commission – it has never been obvious (beyond the top-floor corridors of Wall Street) just how stark the penalties could be for being overtly negative. The Mike Mayo case is instructive for just that reason. If a top-rated, thoroughly respected analyst earning a seven-figure salary with a name-brand firm can take this kind of career hit, Wall Street's legions of lower-profile analysts have little hope of summoning the courage to shout "Sell!" on a given stock or sector. The message to retail investors is sobering: If, in fact, stocks are headed for a disastrous slide, you won't hear it from the researchers paid to predict it.

Has anything changed since 2001? In Things Are Bad, but Analysts Can't Say "Sell" (*MarketWatch*, 7 September 2011), Robert Powell wrote

> Consider, at a place and time such as this, with the economy teetering on the verge of another recession, none of the 1,485 stocks that make up the S&P 1,500 has a consensus "Sell" rating. And just five, or 0.3%, are ranked as being a "Weak Hold." And what's just as bad is that sell-side analysts seemingly don't have a strong opinion on what's worth buying either, according to an analysis just published by Sam Stovall, the chief investment strategist of Standard & Poor's Equity Research.
>
> Just 79 (or 5%) of the 1485 stocks have consensus "Buy" recommendations, while 1,003 (68%) are ranked "Buy/Hold," 398 (27%) are ranked "Hold." To be fair, Stovall noted that some analysts do have "Sell" recommendations on individual issues – but that's not enough (from my vantage point) to suggest that Wall Street research analysts should be viewed with anything but skepticism bordering on cynicism. There were (don't laugh) just 167 (0.08%) "Sell" recommendations and 697 (4.2%) "Weak Hold" recommendations out of a total of the 19,868 Wall Street research reports reviewed in Stovall's analysis.
>
> In an interview, Stovall said he's not surprised that there are so few sell recommendations. It's just the time-honored nature of the beast. "Nothing ever looks bad to them," he said.

Why Has the Mainstream Been Fooled – Yet Again?

Diametrically Opposite Views About Consumption …

Because they embrace false and damaging ideas in the same way – and for the same reason – that drunks hug lamp posts. Once upon a blessed time, central bankers didn't exist, stock market analysts and financial commentators were few and investors took their own counsel and wisely ignored "experts'" opinions. In those halcyon days, the views of economists and busi-

[7] See also Why There Are Few Sell Ratings On Wall Street and Scott E. Stickel, The Anatomy of the Performance of Buy and Sell Recommendations, *Financial Analysts Journal* (September-October 1995).

nessmen about the nature (and causes of the fructification) of wealth were both consistent and clear-cut. These outlooks stemmed from long experience with and direct observation of human action; and they were justified with common sense, logical reasoning and a variety of valid and reliable evidence. Wealth, in short, derived from capital; and the accumulation of capital resulted from diligent saving, sound investment, calculated entrepreneurial risk-taking and above all the production of goods and services.

During the Great Depression, politicians attacked these "classical" views (as John Maynard Keynes called them). The diagnosis and prescriptions of Keynes, who told interventionist politicians exactly what they wanted to hear, displaced those of his non-interventionist predecessors. Since the end of the Second World War, pre-Keynesians have been mostly ignored – or, if considered at all, treated derisively and contemptuously. Today, in sharp contrast to the 19th and early 20th centuries, mainstream economists take production for granted, denigrate saving and obsess about consumption. On occasions when a shortfall of "aggregate demand" allegedly occurs, the mainstream insists that governments must "create" jobs and "stimulate" consumers; and if rulers and their Keynesian advisors deem that consumers consume insufficiently, then the government must redouble its effort to underwrite consumption. The indoctrination is virtually total: not just politicians of all partisan stripes but also businessmen in all sectors desire a large amount and rapid rate of growth of debt-financed and government-stimulated consumption. Everybody who matters celebrates consumption because mainstream economics tells us that consumption is a necessary – and, according to some, sufficient – condition of prosperity.

The International Monetary Fund is typical. As *The Australian* reported ("'Severe Risks' in Culture of Thrift") on 19 October 2011:

> The IMF has warned that the forces that caused the Great Depression in the 1930s are again at work, as households, businesses and governments all cut back their spending. In a briefing provided to finance minister and central bank governors at last weekend's G20 meeting, … the IMF referred to the work of economist John Maynard Keynes, who showed [sic] that when everyone tried to lift their savings simultaneously, the total savings in the economy fell because there was not enough demand for goods and services. "The overarching risk is of a global paradox of thrift as households, firms and governments around the world reduce demand," the IMF said.

The trouble is that Keynes was flatly wrong: there simply is no "paradox of thrift" (see, for example, pp. 37-39 of Murray Rothbard's America's Great Depression). Today, Keynes' successors are equally mistaken – and, to add insult to injury, Keynes' forebears were mostly correct. Three points are critical: first, consumption is not wealth; second, consumption depletes rather than accumulates wealth; and third, consumption never needs encouragement by government or anybody else. Keynesians either ignore or reject Say's Law. They deny that the desire to consume necessarily exceeds the ability to produce. Accordingly, all that is produced is, either for purposes of intermediate consumption (i.e., production) or final consumption, also consumed.

Yet production logically precedes consumption: in order to consume, in other words, that which is consumed must first be produced. Why do Keynesians ignore or deny Say's Law? Because it's true, and because its truth exposes the utter fraudulence of Keynesianism. As Paul Sweezy – one of Keynes' most ardent American acolytes – put it in *The New Economics* (Alfred Knopf, 1947 p. 105), "historians fifty years from now may record that Keynes' greatest achievement was the liberation of Anglo-American economics from a tyrannical dogma … Yet the Keynesian attacks, though they appear to be directed against a variety of specific theories, all fall to the ground if the validity of Say's Law is assumed."

… *Have Important Consequences*

These pre-Keynesian axioms and their lowly contemporary status highlight the egregious and grievous errors of thinking and policy that are presently manifesting themselves in parliaments and financial markets. He who saves is no less a consumer than he who spends. Indeed, it is savers – and not final consumers of goods and services – who are a necessary condition of the creation of wealth, the maintenance of prosperity and the advance of civilisation. Savers and not end consumers supply the means to produce more raw materials and better tools; and producers and not consumers employ people and train and equip them such that they become more productive. In so doing, savers underwrite a more extended structure of production that produces more, better and cheaper food, clothing, housing, transport, medical care and entertainment. Savers thus consume – but they do so indirectly, productively and over extended periods of time. Even more fundamentally, to produce implies both the will and means to consume. Alas, the converse is not true: to consume implies neither the desire nor the means to produce. The producer seldom wishes to consume all that he produces, and his motive for production is his desire to buy others' produce. A general "overproduction" or glut of all commodities can therefore never occur; but there may well be – and usually are – plenty of people who wish to consume some commodity but are unable to satisfy their wish because they do not have the means to produce anything of equivalent or greater value that they can exchange for it.

The extent of feasible final consumption thus depends upon the extent of intermediate consumption (i.e., production); and of the two types of consumption, intermediate production generates wealth (i.e., the means to produce and thus consume more goods and services) and final consumption dissipates it. What is consumed at the final stage of consumption is thus enjoyed and is then gone; but what is consumed during the intermediate stages of consumption – what, in other words, is refined and transformed for the purpose of further production – generates commodities of equal or greater value. *Hence governments' many, varied and strenuous attempts to encourage final consumption merely disrupt and derange savings, intermediate consumption and the structure of production.* "Stimulus," in other words, is poison that promotes self-indulgent speculation, an obsession with the present and final consumption at the expense of savings, investment, regard to the future and productive intermediate consumption. The perverse and unintended consequence of politicians' and contemporary mainstream economists' obsession with consumption dissipates rather than creates wealth.

A Thought Experiment

Suppose, as did John Stuart Mill in Essays on Some Unsettled Questions of Political Economy, first published in 1844, that a number of foreigners who derive large annual incomes from assets in their country of origin arrive in a new country. Assume for the sake of simplicity that the foreigners liquidate none of their assets, that they spend all of their incomes in the new country and that residents of the new country own all of its wealth. Will foreign arrivals' expenditure of their income in the new country augment that country's wealth?

If the foreigners save some portion of their income and invest these savings productively in the new country, then they will indeed generate wealth that benefits themselves and local residents; and the greater the rate of saving and the more astute the investment, the greater the fructification of wealth. But if the foreigners spend all their income "unproductively," i.e., on final rather than intermediate consumption, then no wealth is created and their presence will impart no general benefit upon the new country's residents. More generally and all else equal, in other words, an increase of consumption *per se* does nothing to make a society richer.

If the income of a foreigner residing in another country were remitted to him in the form of bread and beef, shirts and shoes, housing and transport, cinema tickets and green fees for the golf links, etc., and assuming that at any given moment the supply of commodities in the new country is fixed and that the foreigner is unable to influence the prices of the goods and services that he wished to consume, then few would contend that his eating, drinking, wearing and golfing on our shores rather than his confers any particular advantage to any particular resident. This point also holds if his income were remitted in the form of money. Whatever the foreigner's form of income, the satisfaction of his desire for bread, beef and other commodities implies either that local residents must reduce their consumption of bread and beef by Quantity X or that X must be withdrawn from an inventory of unconsumed bread and beef.

But surely the foreigner's consumption necessarily employs capital (in this case, inventories of bread and beef) that would otherwise remain unemployed and thus yield no profit to their owners? Surely, then, the added increment of consumption caused by the foreigners' arrival benefits the domestic owners of hitherto unused capital? Remember Say's Law: the capital that any person has chosen to produce and accumulate always tends to find present or future employment. The very fact that producers of bread and beef chose to accumulate and inventory some portion of their production, for example, implies the existence of some anticipated unsatisfied (perhaps future) desire to consume bread and beef; and the value imputed to the inventory will reflect the extent of this presently-unsatisfied but to-be-satisfied-in-the-future desire.

In other words, as a means of increasing his wealth it avails a producer nothing to enter his own shop and buy his own goods. To do so does not employ otherwise unemployed capital: at any

given point in time there tends to exist no more capital than can find ready and remunerative employment. Further, if one person does not buy his goods then another is likely to do so (and if nobody does then this signals overproduction in that business and indicates to the producer that it may be wise to remove capital from this business and deploy it elsewhere). Under these rather restrictive assumptions an increment of consumption *per se* does nothing to enrich a producer – and, by extension, a region, province or nation.

Yet common sense tells us that a producer's prosperity generally does depend greatly upon his number of customers and their demand for what he produces. More specifically, common sense tells us that, other things equal, an increase in customers' desire to consume what he produces increase his profits. What, then, is the nature and extent of the advantage that a producer derives from additional consumption of his output? Our preliminary conclusion holds only when producers are able instantly to sell everything that they produce. To such a producer, an additional purchaser cannot be accommodated. If a producer can instantly sell everything that he produces, and if customers A, B and C are each willing to buy his entire output, then (assuming that each customer is a price-taker) the producer is indifferent to whom he sells and can accommodate no more than one customer.

Clearly, however, these conditions describe no more than a few producers; and to the great majority they do not apply at all. To most producers, an additional customer (i.e., an incremental increase in the desire to consume what he produces) is equivalent to an increase in the productivity of his capital. An incremental increase of consumption enables producers to convert a portion of their capital which otherwise lies idle and which could not have become productive until a customer was found into wages and instruments of production; and if we suppose that the additional quantity of a commodity, unless purchased by the additional customer, would not have found a purchaser for (say) a year thereafter, then all that that capital enables men to produce during the year is clear gain. It benefits the producer, the laborers whom he will employ and thus – assuming that nobody sustains any corresponding loss of demand for his commodities or labour – the nation as a whole. The total quantity of production that occurs within the country during the succeeding year thereby increases – not by the exchange between the customer and producer, but by calling into activity a portion of capital which, had it not been for the exchange, would have languished and its productivity and value dissipated.

It is reasonable to suppose that at all times the capital of a great number and wide variety of producers lies partly idle. If these producers could locate one another, then, through a process of arbitrage, they could relieve one other of this partial idleness. Consider two shopkeepers. Each is hitherto unknown to the other; each owns goods that cannot be readily sold to existing customers and whose value would otherwise dissipate; and each possesses goods that the other wishes to purchase. If the one agreed to buy from the other (on the condition that he would purchase commodities whose quality was equal to that available elsewhere and at as low a price)

then they would render each other and the country as a whole a service. By this compact, each would gain an additional customer and would put his capital to fuller employment.

We can now describe the benefit that a producer derives from an additional customer:

- If any part of his capital took the form of unproductive inventories, unsold goods, etc., whose value would otherwise dissipate over time, and if an additional customer calls some of this unused and hence unproductive capital into activity, then an additional customer increases the overall productivity of a producer's capital.
- If the additional demand exerted by an additional customer exceeds what Producer A can supply by utilising all of his capital, if A previously invested additional resources in the business of Producer B (who produces the same commodities as A) and if the customer turns to B in order to meet the demand that A cannot fill, then A obtains from his investment in B not mere interest but also that difference between the rate of profit and the rate of interest (which John Stuart Mill dubbed a "wage of superintendence").
- If the producer is able to employ all of his capital then the new but unmet demand generated by an additional customer affords him additional encouragement to save. Additional demand enables his savings to yield him not merely interest, but profit; and if he does not choose to save (or until he is able to save) it enables him to undertake the additional business with borrowed capital – and so gain the difference between interest and profit, (i.e., to receive "wages of superintendence") on a larger amount of capital.

Thus far we have reasoned provisionally to a conclusion that pre-Keynesian ("classical") economists would not have contested; indeed, they would have affirmed and applauded it. But it would provoke a storm of controversy among most of today's economists, businessmen, politicians and bureaucrats. *An additional increment of consumption does not necessarily enrich a producer; nor does increased consumption per se benefit a nation.*

Another Thought Experiment

Let us extend and elaborate this thought experiment. Consider Queensland's Gold Coast. Large numbers of strangers from various parts of the world visit it. These sojourners use the capital they own or the income they have earned in their country of origin in order to buy a range of local consumer goods and services. Is the presence of these persons on the Coast beneficial, from an economic point of view, to local residents of the Coast?

Let us exclude from this experiment that portion of the sojourners' incomes that is paid directly to local employees (domestic servants provide an example) in exchange for goods or services of any description. These transactions are excluded because they clearly benefit local workers. If foreigners place a premium upon domestic services, and are prepared to pay a premium to employ local residents in order to obtain these services, then their demand will tend to place a floor

under local wages and indeed place upward pressure upon local wages; further, and other things equal, an increase of their wages will raise local workers' standard of living. Granted, the workers employed by sojourners will be partly and perhaps completely withdrawn from other avenues of employment and lines of production. But this is hardly a bad thing. If the remuneration of local workers improves then it is likely that the benefits they derive thereby more than outweigh any diminution of the benefits derived from the production of other goods and services; further, to the extent that the increase of wages on the Coast attracts workers from outside the Coast, then the number of workers in all industries and the total income they earn will be at least as great as they were before the foreigners' arrival.

Given this exclusion, let us revisit a key question: does the purchase by foreigners of local goods and services for final consumption confer the same kind of benefit upon the Coast as a whole that they do upon the individuals from whom the foreigners purchase the goods and services? Clearly, the sojourners confer their custom upon producers who did not enjoy it previously. It is likely, therefore, that the foreigners call the capital of some producers (some of which previously languished in the form of unsold goods and inventories) into more active utilisation. Further, foreigners' patronage may – but by no means will necessarily – encourage some local producers to save, invest and thus receive "wages of superintendence" from a larger base of capital. The key question is whether the presence of the sojourners and the benefits consequently bestowed upon some local producers deprives other producers of a similar, previously-held advantage.

It is likely that it does. Clearly, foreigners who spend their foreign-derived incomes on the Coast must transfer the funds they spend from their country of origin. Equally clearly, they must first convert these funds into Australian currency and then exchange them for local goods and services. Equally clearly, the money they spend here they cannot spend there: the presence of the sojourners thus creates a market on the Coast for the commodities desired by the foreigners; and this market, in turn, displaces one of an equivalent value in the sojourners' country of origin. To the extent of the import of currency from overseas into Australia, which increases demand for Australian currency, increases its price vis-à-vis foreign currency and thereby renders Australian exports dearer and imports cheaper, the sojourners' presence also introduces additional commodities onto the local market which, by virtue of their cheapness, displace commodities formerly produced locally. Further, to the extent of the diminution of imports from Australia into the foreigners' country of origin, commodities which existed or which were habitually produced in Australia are deprived of an export market (or can only find one at a price not sufficient to defray their cost of production).

It is only by sheer accident, then, that the arrival of foreigners on the Coast and the expenditure of their foreign-derived incomes on final consumer goods generate any net advantage to the Coast's producers. Further, and like any other of the myriad changes in the channels of trade stemming from countless causes, the sojourners' arrival may derange and render useless a previously productive portion of fixed capital.

At this juncture it is important to introduce two caveats. The place in which foreigners spend their externally-generated incomes may or may not possess an export trade. If it doesn't, then no capital was formerly deployed to service the foreign market that is now (i.e., upon the sojourners' departure from their country of origin and arrival in Australia) brought into less full employment. Further, towns exist because they tend to be most remunerative place (they reduce, for example, the cost of transport) to produce goods and services for final consumption as closely as possible to their end consumers. Further, capital is allocated relatively easily among towns, among rural areas and between urban and rural areas. Hence the amount of capital allocated to a particular town will stem from at least two factors. First, it will tend towards the amount that can be deployed there more remuneratively than elsewhere. This amount will tend to be the amount sufficient to produce those commodities that local circumstances dictate can be produced there more profitably than elsewhere. If this point applies to a marked extent to a particular commodity, then this town will tend not only to produce but also to export this commodity. Secondly, the amount of capital allocated to the town will also tend to be the amount sufficient to distribute and retail the commodities that are consumed by the inhabitants of the town (plus dwellers in adjoining areas that are closer to the town than to any other suitable market).

If foreign sojourners settle in a town, and as long as less capital is not required for this first purpose, then it is clear that for the second purpose more capital will be required than before. Under these conditions more capital will gravitate into the town. Until this additional capital has arrived, the producers already in the town will enjoy great advantages because all of their capital will be called into active duty. What their capital does not enable them to supply can be procured from others at a distance. Conversely, if the place whence the strangers came previously traded with the place where they are sojourning, then the effect of their arrival is to diminish the exports of the town and to increase its supply from abroad of the commodities that it previously produced. In this way an amount of capital equal to that required will be released, and on the whole the stock of capital will not increase.

This additional thought experiment thus leads us not to change our provisional conclusion but rather to elaborate it. The expenditure of foreigners who subsist upon not upon their labour but upon the capital they own in their country of origin is not necessarily a loss to the country which they leave. Nor is it necessarily a gain to the country to which they resort. Almost every country normally exports and imports goods and services whose value is much greater than the incomes of its absentees or of the foreign sojourners within it. Just as absentees can unintentionally harm the town that they leave, sojourners can impart significant economic benefits upon the town to which they move.

To recapitulate: we have imagined that a number of foreigners who derive large annual incomes from assets in their country of origin arrive on Queensland's Gold Coast. We have assumed

(unrealistically but for the sake of simplicity) that they liquidate none of their assets and spend all of their incomes in Queensland, and that residents of Queensland own all of the wealth within the state. We then asked: will the foreigners' expenditure augment the wealth of Queensland's residents? If the foreigners spend all their income "unproductively," i.e., on final rather than intermediate consumption, then no wealth is necessarily created and their presence will impart no general benefit upon the state's residents. More generally and all else equal, in other words, increased consumption *per se* does nothing to make a society richer.

Clearly, however, if the foreigners save some portion of their incomes and invest these savings productively on the Gold Coast, then they will indeed generate wealth; further, the greater the rate of saving and the more prolific the investment, the greater the fructification of wealth and the benefits to foreigners and residents alike. Hence our three classically-inspired (and in the minds of contemporary mainstream economists, heretical) conclusions:

1. Consumption is not a source of wealth and savings are;
2. Consumption destroys wealth, and diligent saving and shrewd investment produce wealth; and
3. Consumption never needs encouragement either by the government or anybody else.

A Third Thought Experiment

Productively invested savings greatly benefit individual investors and the societies they inhabit. The classical economist Frédéric Bastiat, in his essay What Is Seen and What Is Not Seen (1848), uses a story about two brothers to elaborate this fundamental point (see also Henry Hazlitt, The Failure of the New Economics: An Analysis of the Keynesian Fallacies, Foundation for Economic Education, 1959, and Economics in One Lesson, Pocket Books, 1946). Let's assume that each brother inherits capital that yields $1,000,000 per year; that they are among the foreigners who sojourn to Queensland; that one brother, Mondor, is carefree spendthrift and that the other, Ariste, is a diligent saver and shrewd investor. Both, it is important to emphasise, spend the annual income that their inheritance generates. The critical difference is the object of the expenditure: Mondor exclusively on goods and services for final (i.e., personal) consumption and Ariste mostly on goods and services for intermediate consumption (i.e., investments).

Mondor is a lavish spender. He regularly frequents and spends freely at night clubs; unaware of the local custom in Queensland, in which tipping is very much the exception rather than the rule, he dispenses generous *pourboires*; his house is pretentious, located in a fashionable neighbourhood and is the site of much entertaining; he owns several late model motor cars, a race horse and a yacht; he is a frequent visitor to the racetrack and casino; he travels from one end of Queensland to another; he loads his wife with diamonds; and he gives expensive, pretentious and useless presents to his many friends.

It goes without saying that Mondor is a great favourite of his friends, neighbours, waiters and restaurant owners, jewelers, car dealers, estate agents and myriad others. They salute him as a public benefactor. To maintain himself and others in appropriate style, he spends $1,500,000; each year, in other words, Mondor spends all of his income and a portion of his capital. *Et alors?* He regards saving as a sin and "dissaving" as a virtue: mainstream economists, as well as the government's rhetoric and policies tell him so. And in any case Mondor is simply compensating for the harm being done to local residents, or at least the benefits denied them, by the frugality, saving and investing of Ariste.

Ariste, alas, is much less popular. He lives in an average house in an average neighbourhood, is seldom seen at the jewelers or in the restaurants (and when he is there he spends carefully and modestly). He never frequents nightclubs, and entertains friends and neighbours only from time to time and in a low-key manner. Because his status needs are low, and compared to his brother, he lives very humbly and frugally; accordingly, Ariste spends only about $100,000 per year and saves and invests the remainder. To the people who see only what is visible on the surface and to the untrained observer (who, according to Bastiat, comprise the vast majority of the population), Ariste provides only a small fraction of the employment that Mondor provides; and the other $900,000 per year, which the vast majority cannot see, may just as well not exist.

What does Ariste do with the $900,000 per annum that he saves and invests? He does not bury it in his back garden or let it accumulate in the strongbox in his basement. He lends some of it to a bank, and exchanges most of it for stocks, bonds and commercial real estate. Of that which he lends, the bank either on-lends it or buys stocks, bonds or real estate. Ariste thus invests his money either directly or indirectly; either way, what is saved and invested is spent. Money that is invested is not used to buy goods and services for final consumption; rather, it accumulates and utilises *capital goods* – the raw materials, factories, machines, etc. that, through a lengthy and complex structure of production, ultimately produces consumer goods and services. To invest $1 thus puts at least as much money into circulation – and ultimately generates more employment – as the same amount of money spent directly on consumer goods.

Saving, then, is a form of spending. The two brothers' actions illustrate the critical difference between intermediate and final consumption. To consume a consumer good or service is to extinguish it and its value: once eaten, in other words, a Big Mac no longer has value because it no longer exists. Other consumer goods (motor cars, plasma TVs, etc.) are durable in the sense that they are consumed, and hence their value is extinguished, gradually. In sharp contrast, to "consume" iron ore is to transform it into rolled steel – whose value is typically greater than the iron ore; and to "consume" steel is to transform it into machinery that produces cars. To invest, then, is to spend money on raw materials, machines, etc., -- that is, capital goods – that both increase production and the value of that production. Accordingly, Ariste's assiduous saving and investment of 90% of his annual income not only puts the same amount of money into circulation: it generates more and more enduring economic value than the expenditure of 150% Mondor's annual income. Mondor's spending can be easily seen, and it is necessary to look more

carefully, and to think a moment, in order to recognise the indirect, delayed but nonetheless salutary consequences of Ariste's prudent and productive saving.

A dozen years pass. Given his spendthrift habits, it comes as little surprise to learn that Mondor severely depletes the capital that generates his income. What once generated $1,000,000 per annum now generates only $400,000. Yet Mondor's expenditures increase rather than decrease. For a time he is able to prolong the inevitable. He borrows against his depleting capital and later "refinances" in order to "extract equity" from his heavily mortgaged home. But the depletion of his inheritance deprives him of the means to maintain his extravagant and self-indulgent consumption. Lacking the means to generate an income sufficient to finance the status to which his ego demands, his creditors eventually force him to declare bankruptcy. He is no longer seen in the nightclubs and at the fashionable shops; and the locals from whom he formerly bought lavishly, when they recollect him, regard him as something of a fool.

In sharp contrast, Ariste, who continues the same ratio of spending to saving, not only provides more jobs than ever (because his income, through investment, has grown): through his saving and investment he has helped to provide better-paying and more productive jobs. His capital (in both his country of origin and in Queensland) is greater; accordingly, so too is his income. Yet given his frugal ways, he spends a progressively smaller proportion of his income and thereby saves and invests a progressively greater portion. As time passes, then, Ariste has become wealthier and his wealth – *the capital base which generates income independent of his labour* – has added significantly to Queensland's productive capacity and thereby greatly benefited its residents. Some residents begin to recognise this contribution; and his stature, whilst still low-key, rises.

A General Result – and a Nation We Unfortunately Don't Inhabit

Let us describe, as did Henry Hazlitt in *Economics in One Lesson*, a nation of Aristes. Let's say that each year its residents save and invest an amount equal to 20% of what they produce in that year. (There presently exists no such Western country; but in parts of Asia this assumption does not unduly stretch reality.) Given this annual saving and investment, the country's total annual production of goods and services will increase each year. Year by year, in other words, the country will grow richer. To make this point most clearly, let us ignore the booms, slumps and other fluctuations which would almost certainly occur within a 10-year interval. Let us say, somewhat arbitrarily but still realistically, that this annual increase of production is 2.5 percentage points. The results for a ten-year period appear in Table 2.

Note from the table that (i) total production increases each year as a consequence of the saving, and therefore (ii) production would not have increased without the saving. (It is no doubt possible – indeed, it is likely – that improvements and new inventions which are manifested in new machinery that replaces old, and other capital goods of a value no greater than the old, would increase the productivity of the capital in the country. But this increase would be a marginal increment, would amount to relatively little and in any case assumes sufficient prior saving and investment to create to pre-existing machinery).

Table 2: Saving Begets Wealth

Year	Total Production	Production of Consumer Goods	Production of Capital Goods
1	100.0	80	20.0
2	102.5	82	20.5
3	105.0	84	21.0
4	107.5	86	21.5
5	110.0	88	22.0
6	112.5	90	22.5
7	115.0	92	23.0
8	117.5	94	23.5
9	120.0	96	24.0
10	122.5	98	24.5

The saving has been invested each year in order to increase the quantity or to improve the quality of existing capital, and thereby to increase quantity and quality of the nation's output of goods and services. Accordingly, the "cake" grows each year. Critically, however, not all of each year's cake (and, from year to year, growing cake) is consumed. At the same time, each year a larger cake is in fact consumed: *indeed, by the tenth year, the size of the cake consumed by consumers alone almost equals that consumed by consumers and producers in the first year.* Moreover, the base of capital is 25% greater in Year 10 than in Year 1. Like Ariste, so too others who save and invest productively: their ability to consume increases over time. By refraining from consuming today, they can consume more tomorrow and into the indefinite future.

A Sombre Implication

Hazlitt's scenario illustrates several other important points. The fact that individuals save one-fifth of their income does not upset or constrain the industries that produce goods for final consumption. If they sold only the 80 units they produced in the first year (and there was no rise of prices caused by unsatisfied demand) they would certainly not be foolish enough to build their production plans on the assumption that they were going to sell 100 units in the second year. The consumers' goods industries, in other words, are already geared to the assumption that the past situation in regard to the rate of savings will continue. Only an unexpected, sudden and substantial increase in savings would unsettle them and leave them with unsold goods.

Conversely, a substantial decrease of savings – which in recent decades has been provoked by central banks' monetary inflation and governments' fiscal "stimulus" – would trigger just such a discombobulation. If resources that had previously been saved and used to buy producer goods were instead used to purchase consumer goods, employment would not increase: the price of consumer goods would rise and the price of capital goods would fall. The immediate effect of a decrease of savings would shift employment, i.e., temporarily decrease employment by deranging the capital goods industries. Its long-run effect would thereby reduce production below the level that it would otherwise have attained. These effects, together with their cause – an utter misconception of the role of saving, investment and consumption – help to explain why current economic conditions are fooling so many so egregiously. Most Westerners bear a much closer resemblance to Mondor than to Ariste. They do so not least because their rulers, aided and abetted by mainstream economists, financial journalists and other strident shills of the regime, glorify consumption and denigration saving.

Chinese Élites Seem to Be More Sensible Than Their Western Counterparts

A final word goes to Yiwei Wang, a professor at Tongji University and the executive director of the Institute of International and Public Affairs. In Don't Blame Rivals for U.S. Decline (*The Australian*, 6 September 2011), he made three very insightful points (among several vacuous ones) about the extent to which the Excited States and the West more generally have made a mess of the past decade, and continue to do so today.

The first is that Francis Fukuyama was and is flatly wrong: history has not concluded. In Yiwei's words, "The US misinterpreted history after the Cold War. It thought that the downfall of communism was the triumph of US liberal democracy. This has led to the decline of America's strategy over the past decade."[8] After the Internet bubble burst, Americans and their rulers squandered the opportunity to learn lessons about the damaging consequences of speculation. Instead they intensified their addiction to speculation – and plunged headlong into the Global Financial Crisis. More generally, after 11 September 2001 Westerners lost a golden opportunity to self-examine their lifestyle and mindset – and the imperialism that underlies it. Instead, through a worship of the Leviathan state and its military, which Americans mistakenly call "patriotism," fomented mostlt but hardly exclusively by Republicans (who laughably assert that they support "limited government"), Americans and their rulers redoubled their ruinous interventions in foreign lands, and charged headlong into the morasses of Iraq and Afghanistan.

[8] In Down With Democracy! Chris Leithner wrote: "the collapse of the Soviet Empire was superficially a victory of democracy. Much more profoundly, however, it culminated the moral and material bankruptcy of Communism. As such, it should have been regarded as a harbinger of the eventual demise of Western, liberal and democratic socialism. Communism abolished private property; democratic socialism bastardises it. In Communist states, economic calculation was impossible; in Western democracies, it is ever more constrained by and dependent upon governments. Communism collapsed. For identical reasons – namely, the futile attempt to suspend the laws of economics – Western liberal democracy stands on shaky legs."

Today, the U.S. Government has withdrawn its troops – but not its mercenaries! – from Iraq. It and others have begun to retreat from (masking defeat in) Afghanistan. Has it learnt its lesson? It's very doubtful. According to Yiwei, the greatest lesson from 9/11 is that the U.S. Government has vastly exaggerated both its own capabilities and the threats it faces. He continues:

> The US is defending an unsustainable way of life. After 9/11, the US should have taken the opportunity to reflect on its way of life rather than focus on its rivals. George W. Bush's first national security strategy committed the US to safeguard its way of life and expand its global power … The emerging economies, which are catching up with the developed countries, are saying 'no' to the US way of life. As a result, developed countries such as the US and the European states have shifted their approach from offensive to defensive, using climate change to try to change the rules of the international game. The Copenhagen climate change conference was a battle between developed countries that aimed to protect their way of life and developing countries that aimed to protect their way of production.

Yiwei's second point – which is surely indisputable – is that America and the West more generally must accept reality, adapt to it and acknowledge the damage their false ideas have created – for themselves and others. Alas, they exhibit precious little sign that they're willing to do so. Quite the contrary: Western rulers fabricate bogeymen and scapegoats, and rulers and ruled alike continue to grasp false ideas like an infant grabs its pacifier. "For many years the world has been adapting to the US; now is the time for mutual adaptation. The US should adapt to the changing era, interact and build relationships with other nations. Nations that can adapt to changes will become the leading nations in the future." To what ideas must all adapt? One is the truth that prosperity is a consequence of saving and production and not borrowing and consumption. Alas, the Western world is as full of bad ideas as it is of bad debts.

Thirdly, the relative decline of America and the West has nothing to do with the rise of China and others: it's a self-imposed error that has everything to do with damaging policies. For a decade, Westerners have asserted falsely asserted that China is the greatest beneficiary of the 9/11 attacks. "In fact," says Yiwei, "the rise of China is the result of globalisation, internal reforms and efforts to open up. It is the result of coping with internal and external challenges, and nothing to do with taking advantage of America's setbacks."

China's growing prosperity, from a very low base, is a consequence of an intermittent, partial but nonetheless growing tolerance of capitalism and markets. In diametric contrast, the West's decline relative to China is the result of relatively prosperous Westerners' comparative hostility to capitalism, markets – never mind free markets – and liberty. The state of Australia's economy and financial markets in 2011-2012 reflects this antagonism. Compared to this international tussle of ideas in 2012 and beyond, the stupidity of the Australian régime and its many sycophants during 2012 will be comical, petty and irrelevant.

Chris Leithner