

I Guarantee an Economic Depression!

Really? I could no more guarantee an economic depression than Joe Namath could guarantee a New York Jets Super Bowl victory in 1969 against the favored Baltimore Colts. However, this upcoming global depression call is one of the easiest macroeconomic forecasts one could make in the past two centuries. The multi-faceted asset bubble mania we've been building the past 20 years has rivaled the infamous Tulip Mania, South Sea, Mississippi, and U.S. "Roaring 20's" bubbles. The size of the current bond/stock/real estate/commodity bubble exceeds any in U.S. history by an order of magnitude. Unfortunately, the size of the U.S. economy and its massive bubbles, and the degree of financial leverage attained ensures a bust that will be much larger than any in U.S. history, and will rival the busts following the historic bubble manias noted above. The always fleeting question is WHEN??

So, What Exactly is Out of Whack to Make This Frightening Call?

I've written for years that the overriding theme of my Austrian Enginomic ⁽¹⁾ logic identifies two primary conditions that, when in existence to an extreme, ensure a massive correction:

1. Misallocation of resources where there is an extraordinarily high ratio of labor in "market unjustified" enterprises relative to those that are "market justified". Note: A "market unjustified" enterprise is simply a business that would not be profitable if interest rates were modeled at a natural market rate (domestically and internationally). Austrian economists may characterize this as malinvestment. ⁽¹⁾
2. Overvaluation of stocks, bonds, real estate, and/or commodities, again, relative to natural interest rate conditions. ⁽¹⁾

These two conditions are common themes in ALL major bubbles. It is virtually impossible to experience a major systemic bust without corresponding major asset bubbles and malinvestment as preludes. ***They are all caused by centralized monetary schemes that encourage gross expansion of money and credit relative to output.*** When powerful central authorities artificially manipulate interest rates as well as the volume of money and credit designed to support favored businesses or industries, then resources pour into those entities that must inevitably be exceeded later, thus creating the bust. Housing is the best domestic example recently.

The ***international malinvestment buildup in the past two decades*** came from the overwhelming U.S. credit expansion which boosted the stock, real estate, and bond markets to the illusory levels that attracted foreign investments in U.S. dollars and dollar-based assets. This created an artificially strong dollar; hence it resulted in a powerful bias for U.S. companies to outsource manufacturing to lesser strength currency countries (esp. Asian) leading to misallocation of resources on a global landscape.

The Disconnect Between the "Real Economy" and the "Financial Economy"

Since 1985 my calculations have demonstrated a gradually increasing disconnect that morphed into a massive separation between the fundamental value of the noted asset classes and their illusory market prices. The pinnacle of this aggregate disconnect was 2007. See graphs here:

<http://austrianenginomics.com/id10.html>

Most people emotionally believe in the efficient market theory where the price of assets traded on a daily basis reflects all current information available. Hence, they reflect “legitimate” valuations. This theory has been soundly discredited, but nevertheless people “feel” richer or poorer based upon the market moves each day. This “feeling” clouds the real economy illnesses and effectively mutes any criticism of the magical wealth-creating financial elites who have the power to goose markets.

The Drivers Behind the Inevitable Economic Depression Call Are:

So, how do I know a depression is inevitable? Common sense! I think within a paradigm that encompasses “Real Wealth ⁽²⁾”, “Real Debt”, “Real Output”, “Real Tax ⁽²⁾”, “Only Labor Can Create Real Wealth ⁽²⁾”, and “Human Activity (including Labor) Occurs Every Minute of Every Day and Can NEVER be Recovered ⁽²⁾”. I generally refer to this paradigm view as the “Real Economy”. If your thought process is based upon the presumption that our fiat currency is real wealth, government trust funds are a store of wealth, or tax revenue collected is the Real Tax, then you are thinking within the illusory “Financial Economy” paradigm. To illustrate...

1. **Nearly all economists and analysts believe debt securities are “Real Wealth”.** Debt securities are, at best, a contract to acquire “Real Wealth” ⁽³⁾. If the market value of all debt securities on earth suddenly increased due to a FED induced interest rate reduction, and there is no offsetting alternate asset class reduction (e.g. stocks), then we have not suddenly increased “Real Wealth” in aggregate; we’ve created a bond bubble. Only labor can create or increase “Real Wealth”.
2. **Nearly all economists and analysts believe if the stock market goes up then we’re wealthier, and if the market declines we’ve lost wealth.** Again, if there is not an offsetting move in alternate asset classes (e.g. bonds), then we have neither gained nor lost “Real Wealth”. Only labor can increase “Real Wealth”. Wall Street desperately wants you to believe stock valuations are representative of Real Wealth, especially when they unilaterally increase.
3. **Nearly all economists and analysts believe Real Wealth can be gained from an exchange of goods and/or services.** Based upon the Subjective Theory of Value ⁽⁴⁾, each individual who is acting in the trade values the good or service he is acquiring more than that which he is conceding in this voluntary exchange. Both parties will gain in satisfaction; otherwise the exchange would not take place. White-elephant parties and E-Bay are wonderful examples of secondary exchanges that result in increased individual valuation and satisfaction levels. However, **“Real Wealth” in all cases has not** increased. Labor has not been expended on the good or service exchanged. Traders are effectively gaining in their satisfaction levels as a result of the act of exchange. There is a practical limit to the level of satisfaction achievable, albeit subjective, such that an endless succession of exchanges of the same goods will not perpetually increase valuations indefinitely.
4. **Nearly all economists and analysts believe houses appreciate.** Houses historically do not appreciate in real terms ⁽⁵⁾. Their valuations relative to all other “Real Wealth” on earth have held steady or even declined over time for an equivalent quality home. If interested buyers place a higher value on homes, they are necessarily placing a lower value on that which they are exchanging for the home, which has not been a common historical occurrence. Houses may

very well INFLATE in price, which is a result of the Central Bank debasement of a currency utilized in the exchange.

5. **Nearly all economists and analysts believe an expansion of total credit greater than the increase in output can result in an increase in Real Wealth.** If the concept that, “on average one cannot owe and repay more than one can produce in a lifetime”, makes common sense, then it is **physically impossible** to repay debt obligations accumulated in excess of production in advanced economies that are fully utilizing division of labor. This concept requires extensive explanation that is included within “The Austrian Economic Debt Axioms” ⁽⁶⁾ article. The debt bubble illusion of wealth on earth today is easily the single biggest driver ensuring the next great depression when the illusion is discovered on a mass scale, and the bond markets collapse.
6. **Keynesian minded economists and analysts believe incremental government spending without “raising taxes” during receding economic conditions is not only humane, but will boost morale and real output, which will subsequently boost growth.** They believe increased tax collections as a result of this future growth will handily “repay” any deficit that was generated from the noted government spending. This belief begs the question:

What is the “Real Tax”? Government spending is a very high correlation to the “Real Tax”. **Increased government spending IS a Real Tax INCREASE!** It is physically IMPOSSIBLE to EVER recover this “Real Tax”. Spent labor can never be recovered. Any debt issuance to those who sacrifice goods and services to accommodate the government spending can only be redeemed by “Real Wealth” **transferred** from future tax payers greater than what otherwise would have been. This “Real Tax” concept is described within the article: “What is the Real Tax?” ⁽⁷⁾

7. **Nearly all economists and analysts believe, if a company announces a promising major new product, and all asset markets respond positively or stay neutral (i.e. no declines) immediately following the announcement, then we have suddenly created “Real Wealth”.** The “Real Wealth” was created all during the time the company was working (labor) to design and develop the new product. A company announcement should enlighten the investing public of the product status. If there is a favorable response, then the stock of that company may go up at the expense of other companies declining. In total one cannot “Will” “Real Wealth” into existence. Going forward, if the new product proves to enhance productivity, then rate of “Real Wealth” creation will increase while the same level of labor is expended. This productivity increase would then justify an aggregate stock level valuation increase of approximately the same percentage.

After reading a Nobel Laureate winner Paul Krugman article recently, I felt ill. Mr. Krugman actually believes that government should be instrumental in flooding the country with yet more fiscal-wrecking spending projects in deference to reducing the government spending via austerity measures. The mindset of the Financial World is so deeply ingrained into Mr. Krugman and most of the American public that a tsunami will be required to break it. In the Financial World, it’s all about money. In reality, it’s all about labor, and every individual’s motivation and preference to increase his (or her) own level of satisfaction. The bottom line is that a critical mass of **people must work to create the Real Wealth** that we not only desire to enjoy, but need for our own survival as well; we don’t need goosed asset prices!

Conclusion:

The world is saturated with the “Financial Economy” mindset. Rapid increases in aggregate asset prices (stocks, bonds, and real estate) in excess of the tortoise-speed increase in Real Productivity are an illusion of wealth. It is very unpopular to “bit the hand” that feeds the “Financial” asset price goosing. Who really wants to intellectually challenge or pop any bubble that makes investors feel richer? Why are the media, politicians, economists, analysts, and every-day working stiffs so quick and happy to rationalize any half-baked justification for these asset price increases and continue conceding more and more power to those who perpetuate them? Are we all so readily swept away with short-term gratification or herd behavior? Would we rather believe the happy “Financial World” numbers displayed on our savings or brokerage accounts, or the “Real World” fact that an advanced economy rarely exceeds a 2.5% annual Output (& associated Real Wealth) increase per capita PER YEAR?? In these modern lightning-speed days people are not happy unless they see a 2% increase in their wealth in a day; let alone wait a year. The **magnitude of the disconnect** between the “Real Economy” and the “Financial Economy” today **is approximately \$25 trillion** ⁽⁸⁾, which is larger than ever in the U.S. The broad-based discovery of the illusion will destroy confidence in the dollar and dollar-based assets, which through a self-reinforcing process of collapse, will extend our journey in this depression.

I believe historians and the media 20 years from now will agree the beginning of the **greatest depression** began in 2008 and will likely end approximately 2020. Economists will not define these time markers because they have not developed a commonly accepted definition of an economic depression. The subjective nature of the profession ensures difficulty in garnering a critical mass within the various schools to even agree upon the beginning and end of recessions. ***If the public experiences a paradigm metamorphosis and suddenly forces government intervention into dormancy, which would require a near-revolutionary force, the depression would end very quickly and we could all move forward in our lives enjoying greater liberty, peace, and tranquility.*** I do not expect that to transpire.

By Russell M. Randall 7-27-2011

References:

1. “Austrian Enginomics” was coined by Russell Randall. Details regarding the two conditions are found here: www.austrianenginomics.com
2. “Real Wealth”, “Real Debt”, and “Only Labor can create Real Wealth” are described in this article: <http://austrianenginomics.com/TheRealTaxisAllAboutLabor.pdf> In short, “Real Wealth” includes goods, services, and human capital.
3. Debt Securities are defined on page #2: <http://austrianenginomics.com/DebtRelativetoGDPTheAustrianEnginomicDebtAxioms.pdf>
4. “Subjective Theory of Value” was developed by Austrian economists Carl Menger, and Eugen Von Boehm-Bawerk
5. See data and logic in article titled: “The Most Egregious Bane of Overconsumption; Housing” by Russell Randall here: <http://austrianenginomics.com/TheMostEgregiousBaneRevB.pdf>
6. See “Debt Relative to GDP: The Austrian Enginomic Debt Axioms” here: <http://austrianenginomics.com/DebtRelativetoGDPTheAustrianEnginomicDebtAxioms.pdf>
7. “What is the Real Tax?” is found within the article “The Real Tax is All About Labor” found here: <http://austrianenginomics.com/TheRealTaxisAllAboutLabor.pdf>
8. See the Year End 2010 graphs here: <http://austrianenginomics.com/id10.html>