BRATISLAVA INTERNATIONAL SCHOOL OF LIBERAL ARTS

EX NIHILO
BACHELOR THESIS

BRATISLAVA 2011

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BACHELOR THESIS

Study Program: Liberal Arts

Field of Study: 3. 1. 6 Political Science

Thesis Advisor: John Baron MBE., TD., FCIB.

Qualification Degree: bachelor (abbr. „Bc.“)

Handed in: 30. 4. 2011

Date of Defense: 15. 6. 2011

Bratislava 2011 **Patrik Korda**

Declaration of Originality

I declare that this Bachelor Thesis "Ex Nihilo" is my own work and has not been published in part or in whole elsewhere. All used literature and other sources are attributed and cited in references.

Bratislava, 30 April 2011

Signature:____________________

ACKNOWLEDGEMENT

The theoretical part of this thesis was made possible by the insights of economists Ludwig von Mises, Murray N. Rothbard, and Jesús Huerta de Soto. This thesis would not have been possible without Douglas E. French, whose course "Tulips to Plywood Palaces: Bubbles in Theory and History" has been an absolute blessing. I would also like to thank Eric Janszen, whose foresight and interpretation of events as they unfold is immaculate. Finally, I must thank John Baron, who has pushed me to fit in all the pieces and helped make this thesis a reality. However, all the mistakes herein are my own and in no way reflect the aforementioned economists.

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Bratislava International School of Liberal Arts

under Thesis Advisor John Baron

Length: 48 pages (18,360 words)

ABSTRACT

The past decade has plagued the world with not one but two major bubbles; the dotcom fiasco and the real estate bubble that burst in 2008. According to the Communist Manifesto, there were three major reasons why capitalism would come to a halt. The first two reasons, immiseration and a decline in the number of entrepreneurs are not valid. However, the third reason, which was elaborated on by Friedrich Engels, is the most plausible. According to the communist theory, the business cycles would get more and more violent, which would result in a situation so unbearable that both the proletariat and the bourgeoisie would overthrow the system. Unfortunately, mainstream economics flows from the same presupposition that the dreaded business cycle is an inherent part of the market economy. It is the purpose of this thesis to explain why economic bubbles occur, using the Austrian business cycle theory (ABCT). Furthermore, I would like to put the ABCT to the test, and attempt to predict the next two bubbles. Subsequently, I would like to point out that 2008 marked the end of a certain type of economy. This economy has come to be known as the FIRE economy i.e., an economy dominated by Finance, Insurance and Real Estate. No amount of inflation will be able to re-inflate this dead economy, and westerners will once again have to roll up their sleeves in order to produce.

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Bratislavská medzinárodná škola liberálnych štúdií

Vedúci bakalárskej práce: John Baron

Rozsah práce: strán 48 (18360slov)

ABSTRAKT

V minulej dekáde bol svet sužovaný dokonca dvomi veľkými ekonomickými bublinami; „.com" fiaskom a realitnou bublinou, ktorá praskla roku Pána 2008. Podľa *Manifestu komunistickej strany* existujú tri dôvody, prečo kapitalizmus zlyhá. Prvé dve – ožobračenie pracujúcej triedy a pokles počtu podnikateľov – sa ukázali byť nepravdivé. Ale tretí dôvod, rozpracovaný Engelsom, sa javí ako pravdepodobný. Podľa marxistickej teórie sa bude ekonomický cyklus stále zhoršovať, dôsledkom čoho nastane situácia natoľko neznesiteľná, že proletariát spolu s buržoáziou zvrhnú systém. Populárne ekonomické teórie nanešťastie tiež vychádzajú z predpokladu, že obávané hospodárske cykly sú prirodzenou súčasťou trhovej ekonomiky. Cieľom tejto práce je vysvetliť vznik ekonomických bublín použitím Rakúskej teórie hospodárskych cyklov (RTHC). Práca chce navyše podrobiť RTHC skúške tým, že s jej pomocou sa pokúsi predpovedať dve nadchádzajúce bubliny. Následne práca poukáže na fakt, že v roku 2008 nadišiel koniec istého typu ekonomiky. Táto ekonomika je známa ako FIRE, podľa anglickej skratky jej kľúčových zložiek – finančníctva (Finance), poisťovníctva (Insurance) a realitného trhu (Real Estate). Žiadna miera inflácie už nebude schopná znova naštartovať tento mŕtvy systém a obyvatelia západného sveta si opäť budú musieť vyhrnúť rukávy, ak chcú žiť v prosperite.

PREFACE

The purpose of this thesis is to provide the reader with a basic understanding of economics using the Austrian methodology; praxeology. The reason for this is that I wish to design this work so that it may be easily understood by the layman, who may have no inherent interest in economics but may still want to know why downturns occur and living standards rise. The beauty of Austrian economics, aside from being the oldest living school of economic thought[1], is that it is the only school that has not given into using econometrics which has plagued the social sciences throughout the 20th century. Instead, it uses deductive logic in linguistic form in order to explain the matrix of voluntary exchange, as well as the effects of coercive commands.

The major difference between the Austrian school and the Monetarists is that the Austrians believe that the supply of money plays no role in genuine economic growth. Therefore, an increase in the supply of money will not increase the amount of consumer and producer goods, which are by definition scarce. Monetary manipulation can only send off false signals and information, which leads to unnecessary malinvestment[2] and may potentially trigger a boom and bust cycle via artificially lowered interest rates. On the other hand, the Austrians fully acknowledge that money is not neutral, and that counterfeiting benefits the counterfeiters.

[1] The Austrian school has its formal origins with Carl Menger, and his 1871 book, *Principles of Economics*. However, Austrian thought and methodology has its roots in 15th Century Spanish Scholastics; the School of Salamanca. Other notable proto-Austrian thinkers include but certainly are not limited to John Locke, Richard Cantillon, ARJ Turgot, Destutt de Tracy, Gustave de Molinari, and Frédéric Bastiat.

[2] Malinvestment is a term coined by Ludwig von Mises, it refers to erroneous or counter-productive investment i.e., a misallocation of resources.

CONTENTS

BUBBLES

"*I'll tell you what I think about the way*
This city treats her soundest men today:
By coincidence more sad than funny,
It's very like the way we treat our money.

The noble silver drachma that of old we were
So proud of, and the recent gold coins that
Rang true, clean-stamped and worth their weight
Throughout the world, have ceased to circulate.

Instead, the purses of Athenian shoppers
Are full of shoddy silver-plated coppers
Just so, when men are needed by the nation,
The best have been withdrawn from circulation."
- Aristophanes
The Frogs
400 B.C.

From a historical standpoint, major economic bubbles are a rare phenomenon. Unlike business cycles, which occur quite frequently and with great regularity, there have not been many bubbles throughout history. In the past decade, the world has experienced two major bubbles; the dotcom bubble of 1999-2000 and the housing bubble of 2006-2008. According to bubble experts David Wiedemer, Robert A. Wiedemer, Cindy Spitzer, and Eric Janszen, a bubble exists whenever an asset's perceived or psychological value exceeds its real economic value. As they state, "*If you have to manipulate it to keep it afloat, it's a bubble. It's that simple*" (David Weidemer, 2006, p.13). Another common way of detecting bubbles is a growing discrepancy between the prices of assets and their earnings i.e., the P/E ratio[3]. As Warren Buffet put it, "*The inescapable fact is that the value of an asset, whatever its character, cannot over the long-term grow faster than its earnings do*" (Joseph Calandro, 2009, p.129). George Soros wrote, "*Credit seems to be associated with a particular kind of reflexive pattern that is known as*

[3] P/E ratio, or the price to earning ratio, refers to the price of an asset in relation to its earnings and/or earning potential.

boom and bust. The pattern is asymmetrical: the boom is drawn out and accelerates gradually; the bust is sudden and often catastrophic" (Soros, 2003, p.85). Indeed, the ABCT points the finger at *ex nihilo*[4] credit expansion as the main culprit.

CONSUMER SOVEREIGNTY

In the unhampered market there is but one ruler, namely, the consumer. The consumer decides who is successful and who goes bankrupt. It is the task of entrepreneurs to try and figure out what kind of product or service the consumer would appreciate. The consumer is generally blind to the social status of the entrepreneur providing him the goods; he does not care about his education, his race, his ethnicity, nor his past achievements. In fact, most of the time the consumer has no idea who the entrepreneurs are that provided him with the various goods he wants to buy. Nevertheless, the consumer casts a vote with every penny he spends on who shall succeed and who shall fail. In this sense, the market may be termed as a type of democracy.

The ultimate reason why crises occur is because consumers want them to happen, as will be demonstrated. The reason why a small business or an entire sector is liable to go bankrupt is ultimately because the consumers are not willing to buy the various products or services of those selling them, at the given price. Under a totalitarian or socialist system, this is not the case, for the consumer is not the king in these regimes. An entrepreneur may think that a broccoli flavored ice cream is a genius idea. If, however, after setting up shop there are no customers who come by, this entrepreneur is bound to go bankrupt. This is not the case under a socialist system, where the rulers' sole and arbitrary decisions reign sovereign. The question, however, is why from time to time entrepreneurs make errors *en masse*. A correct theory must be explain why there is and has been periodically the case that a substantial amount of entrepreneurs turn out to misread the will of the consumers simultaneously, generating a cluster of mistakes. The ABCT attempts to answer this question by claiming that artificially low interest rates distort the price-structure within an economy. In fact, the content of the ABCT is simply the application of the theorem of the impossibility of socialist economic calculation to the particular case of the credit and financial sector. Price-controls, no matter what their intentions, always lead to either shortages or surpluses. Not

[4] Ex nihilo literally translates to "out of nothing" in Latin.

every man may be a despotic tyrant ruling over the masses. However, everyone by definition is a consumer. In the words of Ludwig von Mises, "*Laissez faire means: Let the common man choose and act; do not force him to yield to a dictator*" (Mises, 2008, p.727).

PATIENCE IS A VIRTUE

The concept of *time preference* may be traced back to at least the 13th century. Giovanni Boccaccio, in his *The Decameron*, written around 1360, described the impact of the great plague. The people of Florence did not expect to live much longer and as a result there was capital consumption on a massive scale. Instead of working to preserve and cultivate the land and livestock, the people devoted all their attention to present consumption. Time preference is the degree to which a person prefers present rather than future consumption. If one prefers present consumption more than the average, it may be said that he or she has a *high* time preference. However, all people prefer present gratification to future gratification.[5] The main reason for this is that time, from the perspective of an individual, is inevitably scarce. Like all scarce resources, people tend to economize them.

Every person must, out of necessity, possess a positive time preference. A hungry person cannot prefer a slice of bread more in the future as opposed to the present, due to the need of subsistence. The catalyst for deferring consumption in the present is *psychic profit*[6], or the perception that by doing so, one will be able to consume more in the future. The reason why a Robinson Crusoe cannot start building skyscrapers is due to his having to take into consideration the element of time. Robinson Crusoe is simply not in a position to work on projects that may or may not be realizable in the distant future; he must first make sure he can survive in the shorter term. As Hans-Hermann Hoppe put it, "*What restricts the amount of saving and investment is time preference*" (Hoppe, 1994, p.319).

Children usually tend to have high time preferences. It is extremely difficult for a child to give up immediate gratification. However, even people with extremely low time preferences must still make provision for the present. Jesús Huerta de Soto wrote, "*In a world without*

[5] A common objection to this assertion is that a person may prefer a cube of ice more in the summer, which just happens to be six months away. However, the concept of time preference is still valid because this same person would surely prefer a cube of ice in six months rather than 126 months.
[6] Psychic profit is a technical term which simply refers to subjective profit, or the perception of profit.

time preference people would consume nothing and save everything, and eventually humans would die of starvation and civilization would disappear" (Soto, 2009, p.272 fn). In a nutshell, the concept of time preference boils down to people preferring present goods to future goods. As Aegidius Lessines stated in 1285, "*future goods are not valued as highly as goods available immediately, nor are they useful to their owners, and therefore justice dictates they should be considered less valuable*" (Soto, 2009, p.271fn). The catalyst for lowering time preferences and allowing people to make provision for future goods, such as skyscrapers, is psychic profit. One must inevitably be convinced that by deferring consumption in the present, he or she will receive more in the future, either qualitatively or quantitatively.

As was previously mentioned, man cannot have a negative time preference due to being subject to the need to avoid starvation and death. In a primitive economy with little to no savings, time preferences will inevitably be high. This is due to the law of diminishing marginal utility[7]. For example, if Crusoe owns 10,000 fish, he will value 1 fish less than if all he owned was 1 fish. Furthermore, if Crusoe stuffed himself full of fish, the value of an individual fish would drop on his personal value scale in comparison to being hungry. Despite this general law, Crusoe still retains his own subjective value of both fish in themselves and in relation to other goods and services. The only reason Robinson Crusoe would choose to give up present consumption of a single fish would be if he perceived that by doing so, he could somehow increase his consumption in the future.

CAPITAL GOODS

In his primitive economy, one way Robinson Crusoe may increase his consumption of fish is by making a capital good, such as a net. In order to sustain himself while making a net, which make take several days, Crusoe would have to save up a sufficient amount of fish. However, in order to save the necessary amount of fish which would be needed for his short term survival, he would first have to discount his present state of affairs i.e., lower his time preference. The catalyst for this lowering of time preference is psychic profit, or as Ludwig von Mises put it, "*Profit, in a broader sense, is the gain derived from action; it is the increase*

[7] Originally known as *Gossen's First Law,* after Hermann Heinrich Gossen, and was spontaneously reintroduced by Carl Menger, William Stanley Jevons, and Leon Walras in the 1870's during the Marginal Revolution.

in satisfaction (decrease in uneasiness) brought about; it is the difference between the higher value attached to the result attained and the lower value attached to the sacrifices made for its attainment; it is, in other words, yield minus costs" (Mises, 2008, p.286).

A capital good is a tool for increasing productivity. Capital goods are not typically demanded in themselves; rather they are means to achieve ends. In the fictitious world of Robinson Crusoe, his net is his capital good. It allows him to catch more fish than he otherwise would have. In the present state of affairs, capital goods include factories, machinery, tools, and major industrial equipment. The prerequisite for capital goods is deferred consumption, or as Jesús Huerta de Soto puts it, "*The sine qua non for producing capital goods is saving, or the relinquishment or postponement of immediate consumption*" (Soto, 2009, p.273). Robinson Crusoe must first save up a sufficient number of fish in order to be able to invest his time and energy towards making a net. Likewise, in highly developed economies there must first be ample savings in order to build up industry.

TIME IS MONEY

Money serves as a medium of exchange, a unit of account, a store of value, and a means for deferred payment. On a deeper level, money is a tool for communicating the fundamentals of the market, including supply and demand as well as profit and loss. Money is absolutely indispensable to the market economy, without money there could not exist any true market. Money arises out of barter and trade as the commodity which is most commonly accepted as a medium of exchange. Once this commodity acquires the status of money, it is automatically traded at a premium. For example, a euro banknote of any denomination would be virtually worthless if it were to lose its status as money. Likewise, if gold were to lose its status as a monetary metal, it would significantly decline in value.

Interest is the price one has to pay in order to borrow a certain amount of money. It is effectively an *exchange rate* on time, or the price one would have to pay for borrowing money. Interest rates are prices, and like all prices they perform a rationing function i.e., they allocate resources productively. It is a built-in mechanism that drives the market economy to eliminate all surpluses and shortages. As has already been established, man prefers present goods to future goods due to time preference. In order to entice someone to value money in the future more than in the present, a premium is required i.e., the present amount of money plus an additional amount. Generally, when someone possesses a large quantity of money or any other good, each individual unit of that money or good is worth less than if he or she owned just a few units. Hence, a child with a high time preference would require an enormous daily premium for loaning out his or her money. On the other hand, an adult with a low time preference and ample savings would be satisfied with a single-digit annual interest rate. Interest rates, therefore, are the prices regarding time. Like all other prices, they are subject to the laws of supply and demand. Hence, if the supply of loanable funds increases, the rate of interest decreases and vice-versa.

Aside from time preference, there are numerous other factors incorporated into interest rates. First, the element of risk also weighs into interest rates. A highly credit worthy borrower will be able to find loans with lower interest rates than an unknown or shaky borrower. Furthermore, inflation also weighs into the rate of interest. This will be further elaborated upon below under the inflation section. As an example, the German Reichsbank's rate of interest in 1923 was 90 percent. However, due to massive inflation, this was actually a severely negative rate. Regardless of the various risks that are incorporated into interest rates, it is important to mention that interest would still exist even in their absence, precisely because of time preference. As Jesús Huerta de Soto put it, "*In any case, regardless of the external form interest takes, the key is to remember that as a market price or social rate of time preference, interest plays a vital role in the coordination of the behavior of consumers, savers, investors, and producers in a modern society*" (Soto, 2009, p.290).

Simple interest calculates interest on the original principal only. However, compound interest has an accumulative effect. Hence, an annual simple interest loan of $10,000 at 5% for three years will yield $1,500 in interest. However, a compound interest loan of $10,000 at 5% for three years will yield $1,576.25. Needless to say, this makes a huge difference in the long-run. Since most long-term loans tend to be compound interest, low interest rates disproportionately stimulate long-term investments.

Suppose an entrepreneur wanted to borrow $1,000,000 for 15 years, presumably on a higher-order capital project, such as a railroad stretching from Ruritania, Walldavia, Mauretania, all the way to Laputania. Let us further suppose that this entrepreneur is truly clairvoyant. All things considered, he will make at least $500,000 from his investment. At an annual compound interest of 3.5% however, he will have to service $675,348.83 in interest, making the project unprofitable. Yet, let us suppose that either savers step up and flood the commercial banks with loanable funds or a central bank floods the commercial banks with liquidity (it will be shown later on why the latter choice is self-destructive). Thus, the bank is now willing to lend to our entrepreneur at an annual compound interest of 1.25%. In this case, our entrepreneur will have $204,829.18 of interest to service, which will allow him to pocket $295,170.82 at the end of his endeavor[8]. Therefore, it is evident that a few basis points up or down in the rate of interest has a miniscule effect on short-term loans, but they have an incredible stimulating or depressing effect on long-term loans.

STRUCTURE OF PRODUCTION

The structure of production, or period of provision as Ludwig von Mises called it, is a concept used to differentiate *lower-order* capital goods and *higher-order* capital goods. For Robinson Crusoe, a net may be considered a lower-order capital good, whereas a hut may be considered a higher-order capital good. This is because (1) the net would take less time to make relative to building a hut and (2) the net would require less saved up fish in order sustain Crusoe during the process. In advanced economies, higher-order capital goods are those goods furthest away from consumption, such as skyscrapers. Typically, higher-order capital goods require a lot of time to bring into fruition. The catalyst for lengthening the structure of production is deferred consumption i.e., saving. As writes Eric Janszen, "*The only way to produce purchasing power is by the creation of wealth, and the only way to create wealth is through saving and innovation*" (Janszen, 2010, p.28).

CREATIVE DESTRUCTION[9]

Saving is not only a prerequisite for expanding the structure of production; it is also a requirement for maintaining the structure of production. In order for an economy to be able to counteract the rate of amortization, or the depreciation of capital goods, there must be a minimum amount of savings. However, when savings grow at a rate above this

[8] Mathematically, these numbers are valid. However, as will be explained below under the Inflation section, this loan may be much easier to pay off if the value of the money in which the loan is repaid falls significantly.

[9] Creative destruction is a concept originally derived from Marxist economic theory. However, it was first used in a positive way by Austrian economist Joseph A. Schumpeter in his work *Capitalism, Socialism, and Democracy*, published in 1942.

minimum amount, the structure of production may be expanded. In other words, when people lower their time preferences and become more niggardly by placing their money on deposit, which in effect increases the supply of loanable funds, the rate of interest tends to fall. Falling interest rates make projects which would otherwise not have been profitable, realizable. This is especially the case when it comes to long-term or higher-order projects.

Saving causes a disparity (losses) in the lower-orders, which shifts resources into higher-orders i.e., it expands and lengthens the structure of production. This creates deflation in lower-orders, making them more affordable to consumers. Perhaps Joseph A. Schumpeter put it best in stating, "*Now these results each time consist in an avalanche of consumers' goods that permanently deepens and widens the stream of real income although in the first instance they spell disturbance, losses and unemployment*" (Schumpeter, 2009, p.15). This allows consumers to (1) consume even more, (2) save even more, and (3) sustain themselves during the intensified structure. This is what Joseph A. Schumpeter would have termed *creative destruction* at its finest. As Jesús Huerta de Soto writes, "*Hence growth in saving and the free exercise of entrepreneurship are the necessary conditions for and the motor which drives all processes of economic growth and development*" (Soto, 2009, p.325).

There are four main factors which help lengthen the structure of production. Firstly, the accumulation of larger stocks of consumers' goods for later consumption, like Crusoe saving his fish. Second, the production of goods which are more durable. Third, the production of goods requiring a longer period of production. Lastly, methods of production consuming more time for the production of goods. A lengthened structure of production not only allows increased production, it consists primarily of the ability to produce that which could not be produced at all in a shorter period of production.

EX NIHILO

Inflation, properly defined, is an increase in the supply of money and its substitutes. A general rise in prices, or a slower fall in prices than otherwise would have been the case, is merely a symptom of inflation. A fall in the supply of commodity x, or an increase in the demand for commodity x, will push up the price of commodity x. However, there is only one phenomenon that can push up the general price level, namely, inflation. The highest recorded rate of inflation in history was in Hungary during July, 1946, when prices increased by 4.19 quintillion percent. It is important to point out that inflation merely reflects the supply and demand for money. Hence, when the supply of money is increased and outstrips demand, the value of an individual unit of money has a tendency to fall.

Yet, money is not neutral to other commodities. Money has a driving force of its own. Inflation will not push up the prices of all commodities simultaneously and to the same extent. Furthermore, inflation has a redistributive effect on the economy. The first few hands receiving the newly created money benefit at the expense of those further down the line. Once the market starts to register the increased supply of money, prices start to rise. As with taxes, half the economy turns out to be net-consumers of inflation, while the other half turns out to be net-payers of inflation in the aggregate. For example, if Mr.X decided to forge money, he and those first in line would benefit at the expense of those who receive the money later on. While inflation may benefit some at the expense of others, it cannot make society as a whole better off. As stated Benjamin Franklin, "*I have never seen the Philosopher's stone that turns lead into gold, but I have known the pursuit of it turn a man's gold into lead*" (Franklin, 2007, p.15).

One of the main reasons governments propagate inflation is to increase exports and/or decrease imports. However, this fallacy has been uncovered by the first economic theorist, Richard Cantillon[10]. While inflation may boost exports in the short-run, it inevitably has a boomerang effect, which is today referred to as the *Cantillon Effect*. The Cantillon Effect demonstrates that an increase in the supply of money causes short term economic expansion, but that the process is self-reversing as prices rise and imports increase. The Cantillon Effect is a simple application of price theory, the bread and butter of economic analysis. Furthermore, it is important to note that the main reason why exports are boosted is because the purchasing power of domestic money is diminished. Hence, this process is equivalent to wages being deceitfully lowered. However, as was mentioned, money is not neutral and hence there are numerous other unintended consequences associated with inflation. As writes Mark Thornton, "*Cantillon depicted the activities of national banks as a type of con game run by a government minister for the purpose of manipulating stocks and paying off the national debt*" (Thornton, 2006, p.57).

[10] Richard Cantillon, born in Ireland in the 1680's, was an economic theorist, banker, and speculator. It should be noted that Richard Cantillon's insights allowed him to predict and prosper from the Mississippi bubble, which was inflated by the very first Keynesian, a man named John Law.

Another major effect of inflation is that it benefits debtors at the expense of creditors. If Mr.X were to lend $100 to Mr.Y at 2% interest for a year, Mr.Y is expected to return in one year's time the sum of $102. However, if inflation runs at the rate of 3% during the maturity of that loan, Mr. X would only receive $99 in *real* terms. Historically, there has been a major bias against creditors. Yet, it is important to note that there is little to no correlation between the rich and creditors, or the poor and debtors. Indeed, some of the richest people and institutions are debtors, including Western governments. Inflation wipes out many of the people who rely on their savings whilst, on the other hand, it benefits of some of the largest institutions. However, the purpose of this thesis is not to elaborate upon inflation per se, but to show its effects in regards to boom-bust cycles. Therefore, it will be shown how inflation influences the structure of production.

MALINVESTMENT[11]

"*There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner not one man in a million can diagnose.*"
- John Maynard Keynes
The Economic Consequences of the Peace

There is one main characteristic mark to all bubbles and boom-bust cycles, namely that the rise in values occurs slowly and gradually, while the downturn is sudden and violent. It is analogous to Icarus, who attempted to escape from Crete with wings constructed of wax and feathers. Having flown too close to the sun, the melted wax sent Icarus crashing into the Icarian Sea. Had Icarus not overheated his wings, the crash would not have happened. It will be shown that the source of overheating, or overvaluation in an economy, is inflation.

Under normal circumstances, an increase in saving also increases the amount of loanable funds, thus putting a decreasing influence on interest rates. Inflation has the same effect, that is, an increase in the supply of money, credit, and deposit-money tends to decrease the

[11] Malinvestment is a term coined by Austrian economist Ludwig von Mises. It refers to bad investments made due to false signals created by artificially low interest rates.

rate of interest. Provided the inflation first goes through the banking system, or is created by the banking system[12], the effect is the same as if people decided to defer their consumption. The problem, however, is that people have not lowered their time preferences; they continue to consume at their previous levels. The result is an inevitable tug of war between the consumers and entrepreneurs who are misguided by an artificially low interest rate, a war between the present and the future.

Under normal circumstances, lower-order capital goods are depressed while higher-order capital goods are realized and stimulated i.e., creative destruction. Under an inflationary boom, however, lower-order capital goods are not depressed. Hence, the inevitable consequence is a shortage of capital. People go on without having lowered their time preferences and increased their savings, while entrepreneurs are under the impression that various higher-order goods, such as skyscrapers, are realizable and profitable. It is as if Robinson Crusoe decided to build a net without having saved a sufficient amount of fish. Sooner or later, he will be forced to abandon the hut construction lest he starve to death.

During inflationary times, entrepreneurs may embark on either lateral expansion i.e., the expansion of production without lengthening the period of production. Likewise, entrepreneurs may embark upon longitudinal expansion i.e., the lengthening of the actual period of production. While the amount of money has increased, thus making these expansions seem feasible, the amount of capital goods remains just as scarce as before. Entrepreneurs employ the available supply of capital goods that would in reality be able to support r + p1 + p2 as if it were possible to employ a supply of r + p1 + p2 + p3 + p4[13]. Furthermore, credit expansion does not bring about a tendency toward a restriction of consumption, which is necessary element for higher-orders to be carried out. The technical term for this phenomenon is *intertemporal discoordination*; where entrepreneurs invest as if social saving were constantly growing while consumers continue to consume at a steady or even increased pace[14]. The false signal that brings about this state of affairs is an artificially

[12] Commercial banks also have the power to manufacture money via *fractional-reserve banking*. Banks tend to keep only about 10% of all deposits on hand as reserves, while loaning out the rest. This allows the money supply to multiply, potentially nine times. This is also known as the multiplier effect. Fractional-reserve banking originated with the corrupt practices of goldsmiths, who lent out more bullion receipts than they had actual bullion on deposit.

[13] r = the cost of replacement of depreciating capital goods, p = production processes

[14] A common criticism of this is that entrepreneurs should be able to know whether interest rates are genuinely low or not. However, this point is irrelevant. As with any sort of price-controls, a person may be aware that artificially low prices will lead to shortages. However, he or she would be foolish not to get in line before the shortage occurs.

low rate of interest. In the words of Ludwig Erhard, "*I go so far as to say that the fixing of prices at too low a level can be as damaging as prices which are put too high. The only economically 'proper' and defensible market price cannot be defined. It emerges above all from the equilibrating function of price in a free market*" (Erhard, 1958, p.131).

Inflationary policy cannot go on indefinitely, for the inevitable result would be hyperinflation and a complete breakdown of the monetary system. Therefore, it is only a matter of time before interest rates are allowed to whip back to their market levels, bringing about massive losses in the higher-order capital goods. Long-term projects, such as skyscrapers, are abandoned and sold-off for pennies on the dollar. The characteristic feature of all booms and busts is an initial expansion of higher-orders relative to lower-orders, and a subsequent depression in higher-orders relative to lower-orders.

A useful analogy is that of a mason named Greenspam, who sets out to build a structure. However, due to being under the influence of alcohol, he sets out a foundation that is far too grand. It is only a matter of time before Greenspam realizes that he does not have enough bricks to complete the project. The sooner he sobers up, the sooner he will realize his error, thus saving his time, energy, and resources. If, however, he does not quit drinking, he is still doomed to run out of bricks before the project has been completed. Persistence in his project will inevitably lead to a huge malinvestment[15]. Furthermore, it is highly unlikely that this project will have yield any social benefit if it does not correlate with consumer demand i.e., the time preferences of society[16]. *Ex nihilo* credit expansion has the same effect as diluting a carton of milk with water in order to make it seem that there is more milk available. Not only has the milk been diluted, it sends off the false signal that there is more milk than there really is. This, in turn, prevents one from either recapitalizing the milk, or at least economizing it.

Murray N. Rothbard writes, "*Superficially, it seems that credit expansion greatly increases capital, for the new money enters the market as equivalent to new savings for lending. Since the new "bank money" is apparently added to the supply of savings on the credit market, businesses can now borrow at a lower rate of interest hence inflationary credit expansion seems to offer the ideal escape from time preference, as well as an inexhaustible fount of added capital. Actually, this effect is illusory*" (Rothbard, 2009, p.993).

[15] This analogy was first used, in a slightly different form by Ludwig von Mises in *Human Action*, p.560

[16] A pyramid may look fancy, but it does little to elevate the living standards of society as a whole, wasting time, energy, resources, and money.

Therefore, inflation is a short-run measure at the very best, and it sows the seeds for an even greater day of reckoning. Continued inflation makes it harder and more unlikely to abandon inflationary policy. Thomas Jefferson used the idiom of holding a wolf by the ear[17]. On the one hand, it is not a good idea to hold on, while on the other it is very frightening to let go.

If the structure of production is lengthened by increased savings, there is a depression i.e., creative destruction in the lower-orders. Hence, the lengthening is compensated by a reduction in the width of the structure. In other words, there is no increase in aggregate incomes. However, when the structure of production is lengthened as a result of inflation, there occurs no depression in the lower-orders. The lengthening is not compensated by a reduction in the width of the structure. On the contrary, consumption of the lower-orders tends to increase during an inflationary boom. The reason being is that aggregate incomes appear to increase, that is, they increase *nominally*. It is as if one can eat and have their cake simultaneously.

The inevitable result will have to be a re-establishment of the market rate of interest, now significantly higher due to having to compensate for inflation and the overconsumption during the boom. As a result, the prices at the higher stages of production will fall drastically and the prices of lower orders will rise. Most of the investments at the higher stages will have to be abandoned or sacrificed. As writes George Cooper, "*Given the mechanism by which most macroeconomic data can become distorted by financial bubbles, credit creation is not just an important macroeconomic variable; it is the important macroeconomic variable*" (Cooper, 2008, p.125). To summarize, the process by which the market reverts to its preferred interest rate and eliminates the distortion caused by credit expansion *is* the business cycle.

Hence, there are three main reasons why the structure of production cannot be lengthened via inflation. First, it results in overconsumption and malinvestment. Second, it does not remove the necessity of readjusting production and reallocating resources; it postpones the inevitable and makes it more troublesome. Third, it cannot possibly go on indefinitely without bringing about a destruction of the monetary system. As writes Ludwig von Mises, "*As soon as the afflux of additional fiduciary media comes to an end, the airy castle of the boom collapses*" (Mises, 2008, p.560).

[17] Nobel prize-winning Austrian economist Friedrich A. Hayek used a similar idiom of holding a tiger by the tail.

FOREST FIRE

An analysis of history's most famous bubbles, including the Tulip mania, The South Sea Bubble, The Mississippi Bubble, The Stock Market Crash of 1929, The Dotcom Bubble, and the recent Housing Bubble, shows that the ABCT is valid. In each case, there were major increases of the money supply and credit prior to and during the bubbles, followed by a swift and major downturn in those areas that were inflated during the boom. The fact is that the ABCT is the only theory that stems from general economic theory. Therefore, unless general economic theory is to be abandoned altogether, the ABCT must be valid.

Furthermore, there seems to be a major acceptance amongst economists that artificially low interest rates play a significant role in the creation of bubbles. For example, Niall Ferguson writes, "*Finally, and most importantly, without easy credit creation a true bubble cannot occur. That is why so many bubbles have their origins in the sins of omission or commission of central banks*" (Ferguson, 2009, p.122). John Cassidy states, "*In keeping interest rates too low for too long, Greenspan and Bernanke distorted the price signals that the market sends and created the conditions for an unprecedented housing bubble*" (Cassidy, 2009, p.11). George Cooper wrote, "*The credit crisis and deflationary pressure of house prices today can therefore be thought of as a direct result of excessive credit creation in previous years. This is a pattern followed religiously by all asset boom-bust cycles*" (Cooper, 2008, p.54). George Soros wrote, "*The key to the process is to be found in the very low and, eventually, negative real interest rates*" (Soros, 2003, p.100). None of these authors are Austrian economists, but they do not deny economic history, which is clear on the matter. Most importantly, the ABCT is capable of explaining *why* the bubbles inflate and pop, as opposed to just describing particular aspects of particular bubbles. While the various aspects of individual bubbles certainly play a role in shaping the various bubbles, the root cause of bubbles actually being inflated is rather simple; *inflation*.

The current state of affairs may be said to have its origin in the days of Paul Volcker as head chairman of the Federal Reserve[18]. On August 15th, 1971, President Richard Nixon closed the gold window for good. As a result, the dollar was no longer backed by anything both domestically and internationally. Predictably, inflation got out of hand during that decade. Gold went from $40.62 an ounce to a record high of $850 in 1980. Paul Volcker

[18] Paul Volcker served as Chairman of the Federal Reserve from August 6th, 1979 until August 11th, 1987.

was forced to raise the federal funds rate (the core interest rate) to an astonishing 20% in 1981, well above the rate of inflation. This certainly helped America avoid runaway inflation and boosted the dollar. However, there were as a result of this other consequences that threw America, as well as the global economy, out of balance.

Out of the severe recession caused by the policies of Volcker at the Federal Reserve, the birthplace of the FIRE economy was established. FIRE is an acronym for Finance, Insurance, and Real Estate. The term was coined by Kevin Phillips and Dr. Michael Hudson. Over the decades, it is mainly these sectors that have been inflated. As a result, lending became more profitable than most forms of production, with the exception of low-production-cost industries, such as the software sector. Automobile manufacturers such as General Motors and Ford Motor became lending houses that manufactured cars at a loss on the side via GMAC and Ford Motor Credit. This also applied to chain stores such as Sears and JCPenney, as it became more profitable to lend money as opposed to selling retail. The reason is because rates paid by banks fell more quickly and sharply than rates paid by borrowers during the 1980's.

The FIRE economy also inflated various other industries, including the military-industrial complex, the credit-industrial complex, the agricultural-industrial complex, the education-industrial complex, the healthcare-industrial complex, the media-industrial complex, and the prison-industrial complex. All these industries, including FIRE, are bound to deflate lest they take the rest of the world down with them. As stated by Eric Janszen, "*The U.S. FIRE Economy, like a shark that must swim in order to breathe, must continuously borrow from the pool of international savings in order to run its economy and government, and to maintain the value of its currency, the dollar. When it stops swimming, it starts to suffocate financially. A vicious cycle follows*" (Janszen, 2010, p.95).

Instead of allowing the FIRE economy to deflate, the US government has decided to try and reflate the multi-decade bubble. The net result is the creation of an enormous white elephant. As long as the newly created money is used to paper over losses, resources will not be allowed to reallocate. Hence, the depression will linger on indefinitely. If, on the other hand, the newly created money flows out into the economy, the white elephant will burn under the scorching sun and prices will rise dramatically. The result will be more of the same i.e., *stagflation*[19]. If the ABCT is valid, the *chirographis pecuniarum*[20] in the pipeline should have generated further bubbles. This brings us to the first important bubble, Chinese urban-coastal real estate. If the FIRE economy does not deflate before the Chinese bubble bursts, the Chinese will surely pop the FIRE economy by no longer being able to buy US debt. Hence, the second major bubble is US bonds, which are being artificially propped up by the Federal Reserve and foreign governments. As a result of this bond/dollar bubble, there is a big potential for a bubble to form in gold, as people run *en masse* towards perceived safety, just as they ran towards US bonds after the bursting of the US housing bubble.

CHINESE BRICKS

It should be mentioned that governments around the world manipulate statistics. For example, the US Core Consumer Price Index (Core CPI) is used to measure inflation (in this case rising prices). However, the Core CPI does not include the things that are most likely to rise in price when a government embarks upon inflation (an increase in the supply of money and credit), this includes food and energy prices, which are deemed "volatile" i.e., they are constantly going up. It focuses heavily on products that tend to fall in price over time (despite inflation), including electronics. The Core CPI was designed to understate inflation. An agency which has the ability to create money has an incentive to (1) create money, and (2) to understate or deny its counterfeiting operation, this is only natural. In the case of China, the story is much the same. As will be shown, a lot of the official data is suspect and should be taken with a grain of salt.

As states Eric Janszen in regards to Chinese statistics, "*For example, automobile production was not a category in the February 2009 report of December 2008 industrial production data. This measure appeared in the March 2009 report and showed a 22 percent year over year increase. Yet in the same report, production of internal combustion engines, presumably a critical component of autos, was off more than 50 percent year over year in the February 2009 report of the December 2008 data, but the line item disappeared in the March 2009 report. Instead, a more general category of "engines" is listed, and it is off a*

[19] Stagflation is a combination of high-unemployment and high inflation, something theoretically impossible under the Keynesian model.
[20] Latin for virtual, or fictitious money.

more modest 7.8 percent. Unless Chinese automakers have been able to sell a large number of domestically produced autos without engines in them, the data simply make no sense" (Janszen, 2010, p.70).

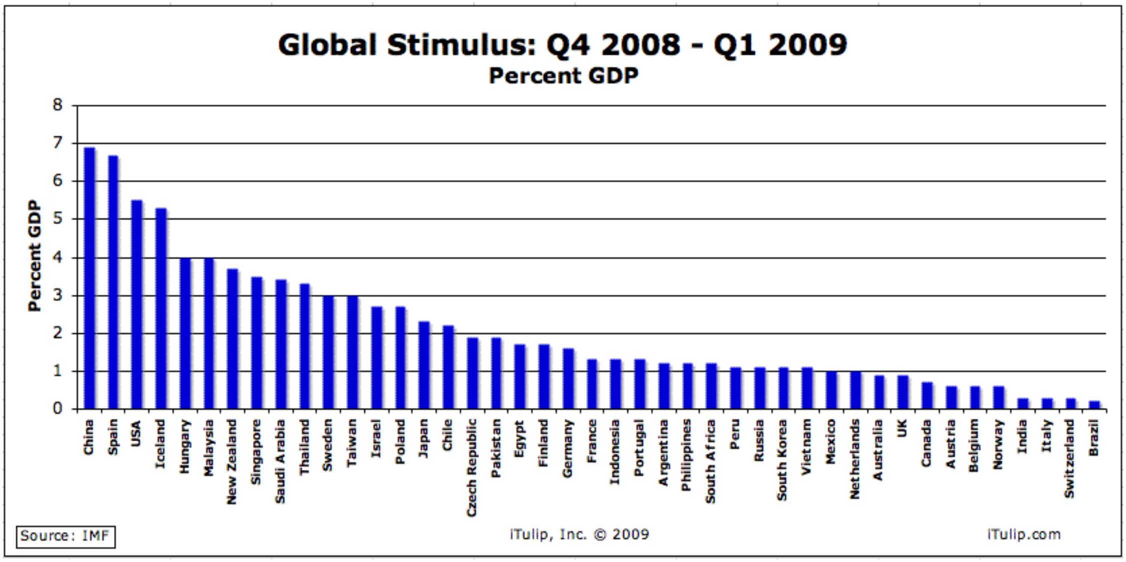
As should be expected with any government, the GDP figures are probably inflated, while the inflation figures are probably deflated. As a result, much of the official data will not be taken into consideration, and when it is the reader should look at it skeptically. It was, after all, the famous Keynesian economist Paul Samuelson who predicted in 1961 that the GNP of the Soviet Union would easily surpass that of the US by 1984. The date kept being pushed further and further until the Kremlin finally collapsed. How could he have known the figures given out by the USSR were phony? The simple answer is rather complex: *reason*. The idea that a monopoly can allocate resources more effectively and productively is utter Marxism. As stated Jim Rogers[21], "*At the same time, you have to read between the lines of profit statements and examine the overall industry involved before determining if that grand-sounding People's Pop-Tart Factory No.17 is really some obsolete plant in a noncompetitive field being propped up by state support*" (Rogers, 2008, p.79).

The Chinese real estate bubble has been a long time in the making. As wrote Jim Rogers in 2006, "*The real estate bubble is a prime example. If money can't appreciate or freely go where it likes, then property has to serve the purpose, and speculators have driven prices of real estate way too high for the Chinese in major cities such as Beijing, Shanghai, and Shenzen. And so long as the renminbi is undervalued, this remains a tempting market for foreigners. In May 2006, The Wall Street Journal reported that the price of an average apartment in Beijing was thirteen times the annual average salary of its local residents*" (Rogers, 2008, p.35). The reason for the Chinese real estate bubble is very much the same as the real estate bubble that popped in the United States; first and foremost cheap credit.

There are several reasons why the Chinese bubble has not yet popped. First, the renminbi is an internally blocked currency, as the exchange rates are between other currencies as set by the Chinese government. This means that money flows into real estate more than would otherwise be the case. While capital does flow in, it is not allowed to escape *en masse*, thereby creating a greenhouse effect. In turn, this further pushes up real estate prices, thus creating a reflexive relationship that attracts yet more money into the sector. Second, as a result of the financial crisis of 2008, China embarked upon the largest stimulus package in

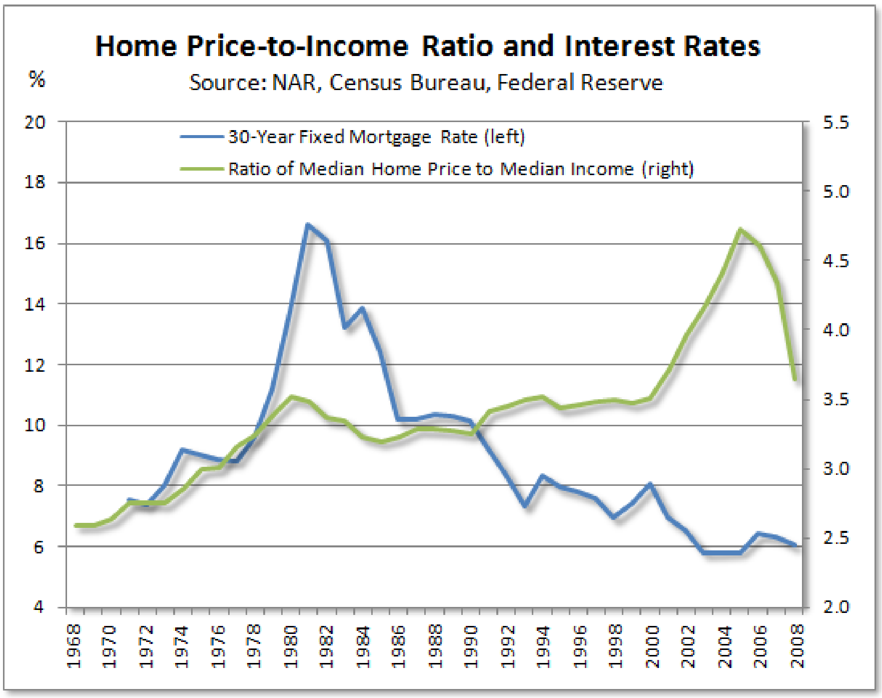
[21] Jim Rogers is a Sinophile who is extremely bullish on China, despite the real estate bubble. He is mostly known for co-founding the Quantum Fund with George Soros.

the world. As writes Eric Janszen, "*The size of the stimulus that the Chinese government unleashed on its economy was greater than any other nation's after the crisis, nearly 7 percent of GDP versus 5.5 percent for the United States. Not surprisingly, this unusually large injection of government money into the economy had a large impact on the money supply and property prices a year later. A narrow measure of the money supply, called M1, made up of cash and checking accounts, increased a stunning 32 percent in the year that followed the stimulus, compared to 6 percent in the United States. Home prices increased in 70 percent in China's cities, even as home prices fell 12 percent across the United States, more than in any other year since the Great Depression*" (Janszen, 2010, p.71).



Japanese economist Takatoshi Ito reported that property prices went up over 50% from 2009 to 2010 in China and over 100% in some areas (Ito, 2010). Yet, the way to detect a bubble with certainty is not only by looking at prices, but also at valuation.

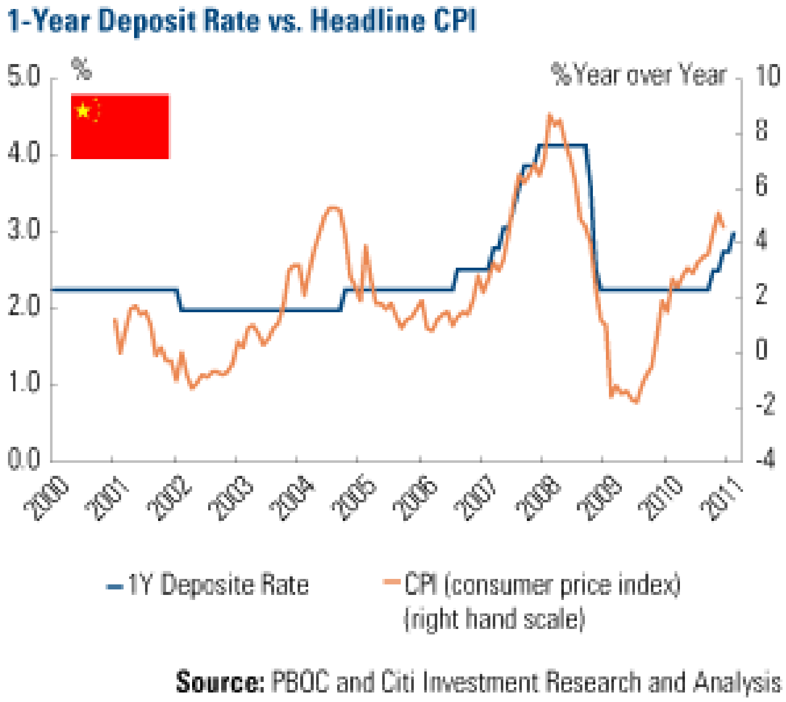
In the case of property, the most important measures are *price to rent ratio*, *price to income ratio* and *rental yield*. The price to income ratio measures the average annual income against the average home prices. If the price to income ratio is 1, that means the average price of a home is equivalent to the average annual income. If the price to income ratio is 5, that means it takes 5 years worth of income to actually buy the house on average. Typically, this ratio stays in the single-digit range. It is when things get out of hand that the ratio exceeds the single-digit range. The chart below demonstrates this phenomenon precisely.



[22]

As writes Eric Janszen, "*But the rate hike itself is a restart of an aborted project to deflate the gigantic housing bubble that has pushed prices as high as 22 times income in some cities. By comparison, housing prices in the US today range from 0.9 times income in Detroit to 9.9 times in San Francisco*"[23] Indeed, urban-coastal real estate in China is far from reach for the average wage-earner, which translates to an inevitability of a crashing real estate market down the road. Yet, there is one more crucial aspect which seals the deal when it comes to property bubbles; interest rate hikes. The graph below shows the People's Bank of China (PBOC), China's central bank, interest rate policy over the past decade.

[22] Courtesy of seeking alpha - http://static.seekingalpha.com/uploads/2009/1/22/saupload_09_01_21c_price_income_ratio_and_mtg_rates.png
[23] *China Crash 2011 – Part II: Do the currency wars end with a bang or a whimper?* – iTulip – October 23rd, 2010.



[24]

As can be seen, China embarked upon a massive stimulus as a result of the financial crisis in the form of a massive expansion of the supply of money and credit via lowering the central bank's interest rate. However, as can also be seen, after the 2nd quarter of 2010 the PBOC has decided to incrementally increase interest rates, in order to try and slow down the chronically rising prices throughout China, especially in the real estate market. Typically, when governments increase the supply of money, the inevitable result is rising prices. As a consequence, governments also tend to impose price-controls. As can be expected of an authoritarian regime, China has also embarked on such a policy. According to a recent article by Wang Guanq[25], the Chinese central government has ordered major cities to introduce property price-controls. The intentions of the central government are reasonable, to make housing more affordable without collapsing the real estate market. However, the means they have embarked on will not achieve the desired ends. Price-controls always have and always will cause shortages. More importantly, the incremental interest rate hikes will not slow down the real estate market, as the central government intends, but it will pop the bubble sending real estate prices crashing down. The United States' central bank embarked upon an almost identical routine in the first quarter of 2004 i.e., they incrementally started raising interest rates.

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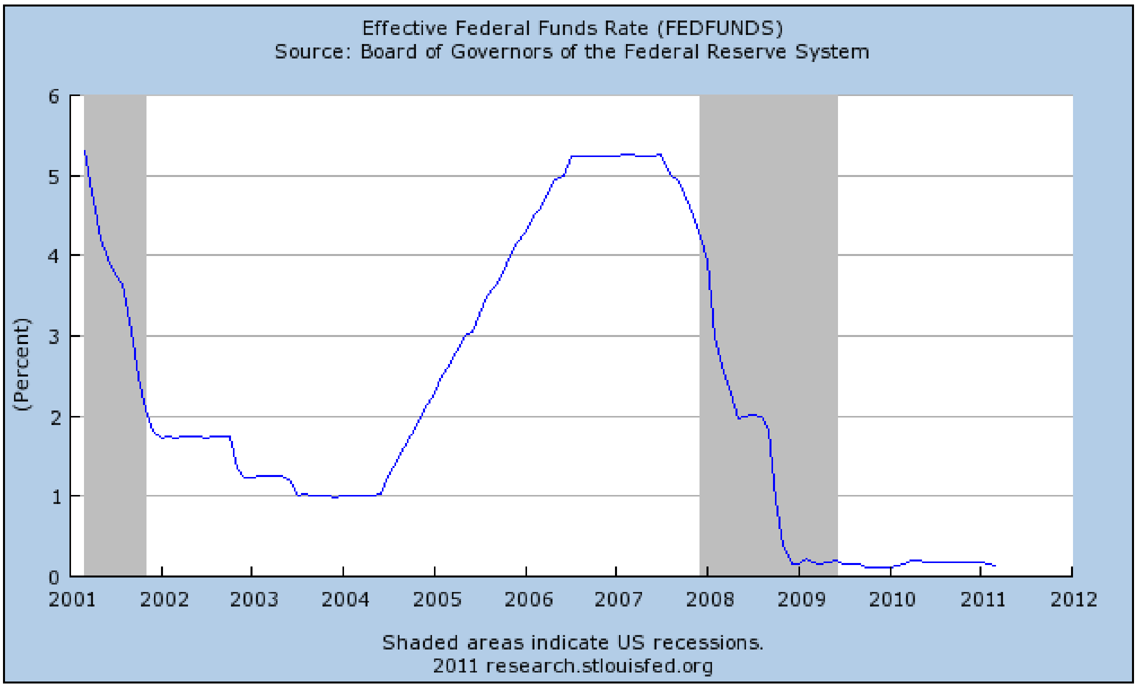
[24] Courtesy of Advisor Analyst - http://advisoranalyst.com/glablog/wp-content/uploads/HLIC/3e6fdd389bbc0752d81780ffa8e161ef.gif
[25] Property regulations in China face long battle – Xin Huanet - http://news.xinhuanet.com/english2010/indepth/2011-03/31/c_13806482.htm



As a result of the Dotcom bubble of 1999-2000, Alan Greenspan decided to stimulate. He gradually lowered interest rates until; finally, in 2003 he left them at 1% and held them there for a year. This allowed the US economy to shake off the Dotcom bubble without heading into a major recession. The cost, however, was inflating another and bigger bubble down the road. In 2004, commodity prices started rising. In order to slow down the rising prices, Alan Greenspan incrementally started raising rates. This should start to sound familiar. Instead of slowing down the economy, the rising rates finally popped the bubble and sent the real estate market crashing down. Artificially low interest rates are the lifeblood of an unsustainable boom; as soon as they are no longer present, the bubble starts to evaporate, and so do the phony profits with it.

In July 2010, the US National Bureau of Economic Research (NBER) published a working paper entitled *Evaluating Conditions in Major Chinese Housing Markets*. The paper was written by Jing Wu, Joseph Gyourko, and Yongheng Deng[26]. These authors seem to confirm that as a result of the massive stimulus by the PBOC, real estate prices, particularly those in coastal-urban areas, have been rising dramatically.

[26] Jing Wu is a Professor at the National University of Singapore and Tsingha University, Joseph Gyourko is a Professor at the Wharton School of Business at the University of Pennsylvania, and Yongheng Deng is a Professor at the National University of Singapore.

As they state, "*The estimated growth in land values is nothing short of extraordinary – almost an eight-fold increase since 2003*" (Jing Wu, 2010, p.3). What's more, half of that increase has taken place over the past two years. Arithmetically, this acceleration is unsustainable; it cannot go on forever. Furthermore, in Beijing, which seems to be the most inflated city in China, land prices have nearly tripled since the end of 2007. Indeed, between 2003 and 2010(1), the average price in land auctions increased by 587%, this equates to a 31.7% compounded average annual appreciation.

The price-to-rent ratio takes the price of a property and divides it by the annual rent. Typically, price-to-rent ratios hover in the mid 20's or below. Thus, a house worth $150,000 that is rented out at $500.00 a month would have a price-to-rent ratio of 25[27]. If the rent were higher, the ratio would drop and vice-versa. Here is how the price-to-rent ratio stacks up in China. In the first quarter of 2007, the average price-to-rent ratio in Beijing, Hangzhou, and Shanghai was 26.4, 31.8, and 32.7 respectively. These figures, while slightly overvalued, are not in major bubble territory. However, in the first quarter of 2010, the price-to-rent ratio in Beijing, Hangzhou and Shanghai was 45.9, 65.5. and 45.5 respectively. This is an incredible increase in just three years, an increase that can by no means be justified by fundamental values. In Shenzhen, the figure is also above 40, having risen by 46% since 2007. Furthermore, since the first quarter of 2010, these figures have either stagnated or increased.

Another reliable ratio when looking at valuation is the price-to-income ratio. Typically, the price-to-income ratio consists of the price of the property divided by the annual income. However, neither the total price indicator nor the household income indicator is regularly reported in China. Thus, Jing Wu, Joseph Gyourko, and Yongheng Deng rewrote the formula as follows: average housing price per square meter floor area divided by the average per capita income and multiplied by the housing size per person. One thing that should be pointed out is that the Chinese, especially in urban areas, are used to living in compact areas.

According to these economists, the house prices in Beijing have been around 15 times income in Beijing from 2007 to 2010. While in early 2010, they have crept up to 18.5. This story seems to be similar in Shanghai and Hangzhou. The sharpest rise in this ratio

[27] 150,000 ÷ 6,000 = 25

throughout China seems to have taken place in 2009, due to their massive government stimulus. At any rate, these figures are significantly higher than they were earlier in the decade. Furthermore, it should be pointed out that price-to-income ratios in the US were around 15 in 2006, before the bubble lost steam and started to collapse. As write Wu, Gyourko, and Deng, "*The most recent data show price-to-income ratios have reached their highest levels ever in Beijing, Hangzhou, Shanghai and Shenzhen*" (Jing Wu, 2010, p.3).

According to economists Jing Wu, Joseph Gyourko, and Yongheng Deng, there seems to be yet another major manipulator of real estate prices, aside from the PBOC of course. These major manipulators are state-owned enterprises (SOE's). Wu estimates that SOE's pay ¥8,354 renminbi yuan per square meter on average, whereas non-SOE developers pay ¥3,083 renminbi yuan per square meter on average. Thus, it should be apparent that SOE's are bidding up the prices of real estate. The State-owned Assets Supervision and Administration Commission (SASAC) reported that total sales revenue reached ¥12.6 trillion renminbi yuan, or slightly less than $1.9 trillion, in 2009.

The moral hazard underlying these SOE's is quite clear, they have access to low cost capital from state-owned banks and they are under the impression of being too big to fail. The net result is unwarranted speculation not only by the SOE's, but also by those looking to ride the gravy-train as a hedge against inflation. The situation is profoundly similar to Government-sponsored enterprises (GSE's) Fannie Mae and Freddie Mac in the United States, which helped fuel the bubble with access to cheap credit and mark-to-market i.e., mark-to-fantasy paper home values. As stated by Jing Wu, "*The riskiness of owning seems quite high at these price-to-rent ratios. Unless rents are rising commensurately, an increase in equilibrium user costs from 2% to 3% implies a dramatic decline in prices – pretty much equal to the reversal of what happened in many Chinese markets from 2007 to the present*" (Jing Wu, 2010, p.19). Indeed, as wrote George Soros, "*the magnitude of the bust tends to be proportionate to the boom that preceded it*" (Soros, 2003, p.33).

What is clear in the case of China is that there has been a major increase in the supply of money and credit. What is also evident is that there are brand-new ghost towns springing up all across China. The most famous example is perhaps Kangbashi, a district located in the city of Ordos, that is part of inner Mongolia. The district can support over 300,000 residents; however, it only houses around 20,000 people. The only way ghost-towns like

Kangbashi will be filled up is when the prices of real estate fall to where supply meets demand.

The Chinese central government has enacted several policies designed to try and slow down the rate of inflation in real estate. These policies include requiring a 30% down payment for first homes of more than 90 square meters, as opposed to the previous 20% requirement. Likewise, for second homes the down payment has been raised from 40% to 50%. No leverage should be allowed for foreign or third-home buyers. There were new rules enacted to prevent developers from hoarding. Finally, there is also a preparation for a property tax, which would raise the cost of speculation.

What exactly will be the consequences of this bursting bubble is beyond the scope of the present writer, the ABCT, and this thesis. While some speculate that this bubble will not have a huge impact on China or the world, others maintain that this is the largest real estate bubble in the history of the world. What is clear, however, is that the Chinese have an apparently sounder banking system and massive foreign-currency reserves, which certainly provides a cushion that the US simply did not have. Yet, it is unknown whether or not this cushion will be able to absorb the massive bubble. For example, in the late 1920's the United States held large foreign-currency reserves, so did Japan in the late 1980's. Furthermore, if the Chinese were to convert their foreign-currency reserves, the renminbi yuan would strongly appreciate in value, thus retarding their exports. This, in the eyes of a mercantilist government or a Keynesian advisor, is an absolute no-no.

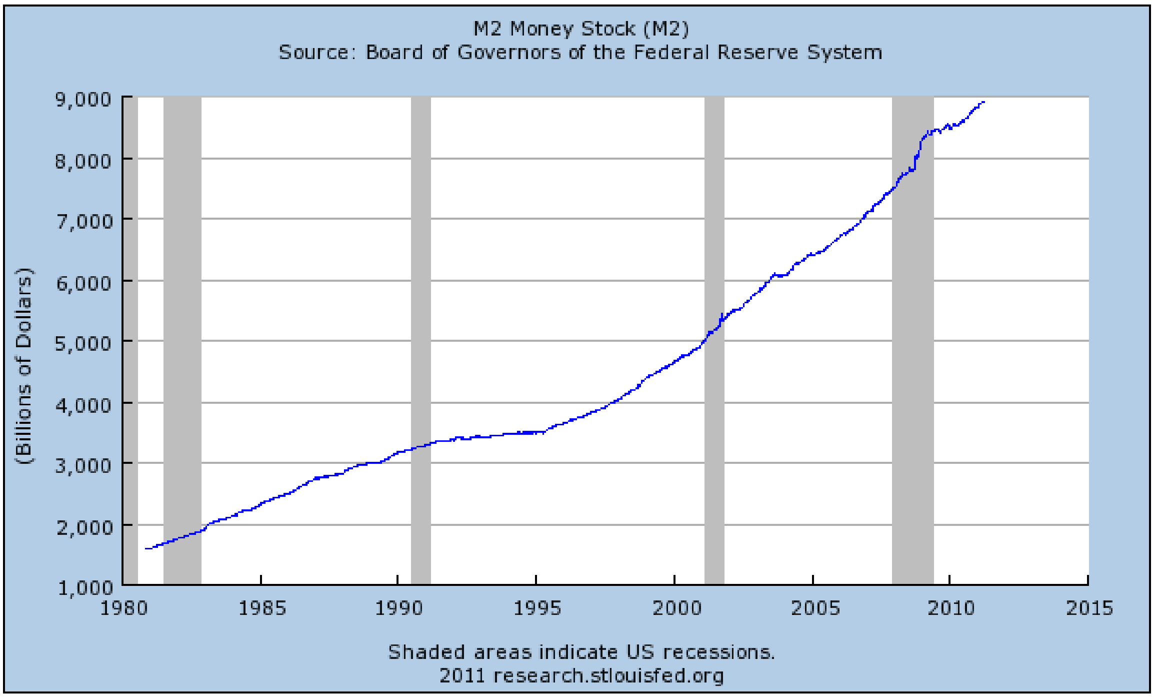
THE GREENBACK

"*Paper money eventually returns to its intrinsic value – zero.*"
- Voltaire

If and when the Chinese real estate market collapses, it seems very unlikely that they will be able to continue to keep vendor-financing[28] the US economy. As will be shown below, the Chinese government (amongst others) has been purchasing US securities in order to (1) prop up the dollar, and (2) to keep the renminbi yuan depressed, thus maintaining a large trade surplus. This has created a cozy relationship where the US has been able to import and consume the fruits of other's labor without having to export much in return, while the Chinese have been able to build up their industry. The obvious problem, however, is that this relationship is unsustainable. The longer that this process will last, the heavier will be the losses on both sides. Eric Janszen writes, "*Eventually, if this course is pursued to its logical conclusion, the United States will run out of credit and experience a sovereign credit and dollar crisis*" (Janszen, 2010, p.214).

If there is indeed a dollar bubble, there should be three major tell-tale signs. First, the government should be ballooning in its size and scope at an accelerating pace. Second, it should be borrowing ever-larger amounts of money at an accelerating pace. Third, it should be financing this debt by either borrowing more or simply printing money, with the government resorting to the latter choice increasingly more. As writes James Turk, "*The coming crisis will be different, with the dollar plunging and interest rates soaring. Bondholders will thus be paid back in increasingly worthless dollars. So whereas in the Great Depression high-quality bonds that kept making their payments rose in value while the bonds of weaker borrowers collapsed, in the coming decade all dollar-denominated bonds will fall*" (Turk, 2008, p.179).

[28] Vendor-financing is when the seller also lends the customer the money needed to purchase the seller's merchandise. By doing this, the seller increases sales even though the seller is *de facto* buying his own products, thus postponing the payment.



As was previously mentioned, once a commodity becomes money, it trades at a premium. Likewise, once a currency turns into a reserve currency, it too trades at a premium. Looking backwards, the bursting of the Dotcom bubble made investors more conservative and prudent en masse, therefore real estate seemed like a reasonable place to pour funds. Once the real estate bubble burst and the financial crisis ensued, it seemed only logical for investors to jump into low-yielding but low-risk assets i.e., US government bonds. Once the financial sector crashed, people ran towards the explosion (the dollar) perceiving safety. The idea is that even if interest rates are extremely low, or negative in real terms, gains are still relative. For example, if one's portfolio goes up 20% in a year, but the CPI goes up by 40%, that person has actually lost money. Subsequently, if the CPI falls by 40% but one's portfolio falls only by 20%, that person has actually made relative gains. In other words, in desperate times investors see beyond the black and the red. The game changes from trying to maximize profits to trying to minimize losses, which is essentially the other side of the same coin.

The dollar is still perceived as a safe-haven by foreign governments, it is the world's reserve currency. The problem, however, is the old economic law which no government has been able to defy: the law of supply and demand. The US federal debt currently stands at $14.3

trillion, while the unfunded liabilities exceed $113.5 trillion[29] and are rapidly accelerating. At the end of the day, there is only one way the federal government can meet its obligations, by defaulting on the national debt. This default may take place in two ways, both outright repudiation and perhaps a restructuring, or by means of inflation i.e., "printing" money in order to pay off the debts. If the former means are adopted, the dollar will lose its value qualitatively. If the latter should take place, the dollar will lose its value quantitatively. It is the present writer's assertion that the latter method will most likely be resorted to for numerous reasons. First, creditors do not generally mind being paid off in legally counterfeited currency, because they are the first in line to receive the money. As was previously mentioned, inflation benefits those who receive the money early on at the expense of those further down the line. Second, it is politically unfeasible that central banks will not keep the party going for as long as they possibly can. If history tells us anything, it is that politicians postpone problems, rather than trying to fix them. One thing that is clear, however, is that the Federal Reserve is not in a position to raise interest rates due to high unemployment and a stagnant economy. Furthermore, there is the age-old bias in favor of debtors and against creditors. The government would rather the domestic savers and foreigners who hold large reserves of dollars take a hit, rather than the debtors (the primary debtor being the government itself).

From its inception in 1980 until the present, the FIRE economy was fueled by one major force: deficit-spending. In the short-run, deficit spending is perhaps the greatest economic stimulus possible. It allows the government to spend without having to tax its citizens, thus there is no crowding out[30]. Yet, the problem lies in the *Cantillon Effect* i.e., when the debts have to be repaid and the boomerang starts flying back with a vengeance. It is the nature of the boom and bust that the boom is slow and gradual, while the bust is fast and rapid. The US has racked up so much debt that it simply cannot be paid off. The boomerang is going to come flying back so swiftly that it will pierce right through the US economy. A common objection seems to be that policy makers around the world surely cannot be that stupid, surely they would refrain from purchasing US debt if it was not in their interest. The answer is that governments such as Japan and China think it is in their interest to keep the dollar strong and their currencies weak, in essence, they export their purchasing power and transfer it to the dollar. The main reason for this is that most governments, if not all, still

[29] U.S. National Debt Clock: Real Time - http://www.usdebtclock.org/

[30] Crowding out is the economic term for any reduction in private consumption or investment that occurs due to an increase of government spending. This is not the case, in the short run, when the government is financed by foreign lending, as the domestic economy does not immediately feel the burden.

have a mercantilist mentality. Furthermore, it should be noted that bureaucrats usually operate in an extremely narrow framework. Thus, the question is not whether the Japanese government in 2011 should buy US debt, but whether they should buy x00 billion worth of bonds or y00 billion.

There is a high correlation between large oil reserves and corrupt governments. The reason is that these governments de facto become less accountable to their constituents, and can grow larger than would otherwise have been the case. In these types of governments, the rulers have no incentive to have a diversified economy with an educated populace, since their tax revenue can literally be dug up from the ground. The same sort of unaccountable run-away government scenario has been in place in the US since 1971, with the breakdown of the Bretton Woods agreement. Since then, the US was no longer forced to finance its imports with goods and services, but instead with *ex nihilo* dollars and bonds. When and if this privilege comes to an end, it will be a blessing in disguise for the US. The size and scope of government will be much smaller, the world-police state will disappear, and the ground will be set for genuine mutually beneficial growth.

There are three major layers to the debt bubble that looms over the US. First, many US households carry more debt than they can repay. Second, unfunded liabilities such as Medicare, Medicaid, and Social Security promise far in excess to what they may actually deliver. Third, the massive debts of the federal government cannot possibly be met. If the government decides to raise taxes, revenue will actually decline[31]. If the government decides to pursue an inflationary policy and let prices rise, including wages, the bond market will crash unless interest rates rise to accommodate a weaker dollar. If the government decides to raise interest rates, the economy will come to a grinding halt, thus retarding revenue. Simply put, the government is between a rock and a hard place, with very little wiggle room. While there are certain common sense measures, such as drastically cutting government spending, lowering the corporate tax rate[32], and getting rid of all the red-tape that is seriously stifling the US economy, there is no political will for these measures.

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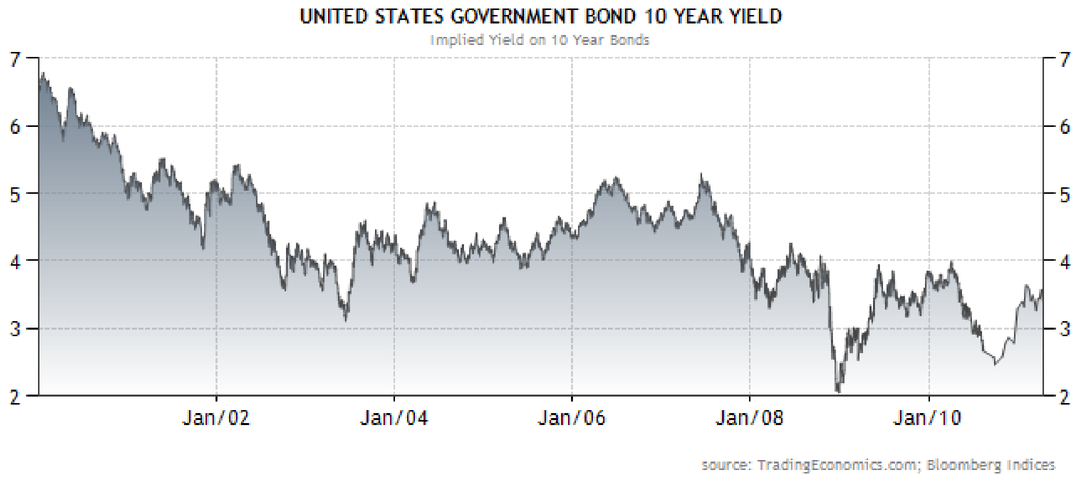
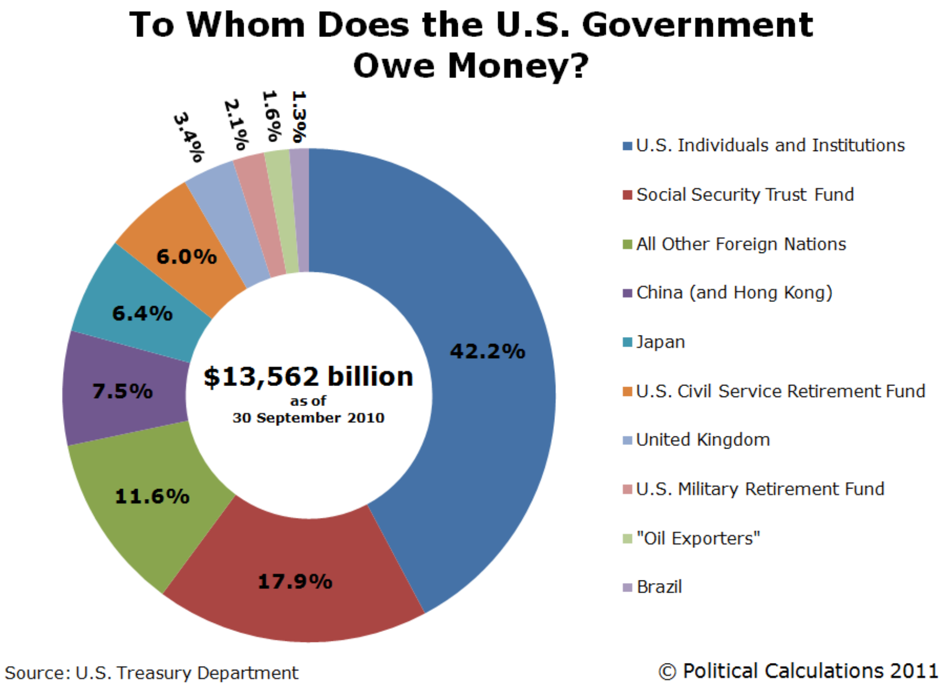
[31] In economics, this is known as the *Laffer curve*, after economist Arthur Laffer. Simply put, beyond a certain threshold raises in taxes actually decrease the amount of revenue. For example, a small tariff of 2% will yield much higher revenue than a high tariff of 80%, because most goods and services will be able to come in at a profitable rate.

[32] According to the Tax Foundation, the corporate tax rate in America is exceeded only by Japan. America being at 39.2% while Japan is 39.5%. http://www.taxfoundation.org/news/show/27116.html



From 1971 until 2011, the average 10 year bond yield has averaged 7.17%. It hit a record low of 2.05% in December of 2008 as investors flocked *en masse* towards perceived safety, from the frying pan into the fire. The question, however, is that with all the downsides facing the dollar, how can interest rates be so low. The answer is that the Chinese government, the Japanese government, the British government, as well as the Federal Reserve have been relentlessly buying up bonds in order to (1) keep their prices high, and (2) to keep the interest rate low. In effect, they have been manipulating the yield curve in order to keep the dollar afloat.



[33]

[33] Courtesy of Exclusive Economy - http://exclusiveeconomy.com/wp-content/uploads/2011/01/saupload_who_owns_us_national_debt_30_sept_2010.png

Typically, buyers of US government bonds have been private investors and foreign governments. While foreign governments are still major players in propping up the dollar, the US government has taken on an increasing role. As states Eric Janszen, "*The net increase in foreign purchases of U.S. Treasury securities for the period of August 2008 to 2009 is $281 billion, approximately 20 percent of the total issuance. The balance, the other 80 percent, was purchased by domestic entities. There is plenty of circumstantial evidence about who in the United States is buying up all of these short-term Treasury bills other than U.S. households, such as commercial banks and the Fed itself, but no one really knows who all the purchasers are and who ultimately holds what*" (Janszen, 2010, p.202).

Ludwig Erhard wrote, "*Without endangering the currency and without disturbing the price level no State can lend out more in capital than it has first received in taxation from its citizens*" (Erhard, 1958, p.165). Indeed, one may say that what the US government has engaged in for decades now is nothing short of expropriating future generations. It has transferred wealth from the future generations to the present. While the problems may perhaps be postponed for a while longer, it is only a matter of time before the chickens come home to roost. The net result is a drastic decrease in the value of the dollar i.e., the dollar bubble will burst.

Under a gold standard that is adhered to, trade constantly tends towards equilibrium. A country could not possibly run trade-deficits for an extended amount of time because gold would start draining out of its economy. Likewise, a country could not have low interest rates unless there were savings present. With the fiat dollar[34] replacing gold in 1971 as a reserve currency, the game was changed. Gold served as a thermometer, so to speak, where the temperature reading used to represent the economic environment. Ever since the fiat dollar, however, the relationship has become reflexive. In other words, the economic environment no longer dictated the temperature reading on the thermometer, but the thermometer also dictated the environment. This illusion, however, is coming to an abrupt end.

Value investors Benjamin Graham and David Dodd, the forefathers of the legendary investor Warren Buffett, once stated "*An investment operation is one that can be justified on both*

[34] Fiat money is, for all practical purposes, money does is not backed by any asset such as gold, silver, or any other commodity. The moral hazard inherent in fiat or fiduciary money is that there is no check on inflation.

qualitative and quantitative grounds" (Joseph Calandro, 2009, p.21). On the quantitative side, the volume of dollars was and is rapidly increasing, thus all other things being equal, the value of an individual dollar is destined to fall. On the qualitative side, a huge overhanging debt and an out-of-control government makes the dollar an extremely risky investment. The dollar still has its reputation, and once that is gone the dollar bubble will evaporate. The bond market is bound to hit an *inflection point*, because the value of an asset cannot grow faster than its earnings do in the long-run. With a stagnant economy, high unemployment, massive inflation, unmanageable debts and soaring prices, bond prices are bound to decline and interest rates are bound to rise dramatically. The only alternative is a complete breakdown of the monetary system.

As stated bubble experts David Wiedemer, Robert A. Wiedemer, Eric Janszen, and Cindy Spitzer, "*Anytime a nation's currency (or any asset, for that matter) has to be bought up in huge numbers in order to maintain its value, that is prima facie evidence of a bubble*" (David Weidemer, 2006, p.13). As has been shown, foreign nations have deliberately bought dollars in order to (1) prop up the dollar and (2) weaken their currency in order to boost exports. Moreover, in a desperate attempt to keep the dollar afloat for a while longer, the Federal Reserve has stepped in to buy its own debt. The invisible hand that has been suppressed under a fiat monetary system will turn into a very visible fist, especially in the eyes of the American consumer, who will be forced to go on an involuntary diet.

It should be mentioned that government securities are incompatible with the market economy. Many great thinkers such as John Stuart Mill and Thomas Jefferson have rallied against it. Richard Cantillon himself maintained that government debt often results in the bankruptcy of a nation and "*comes to a bad end and is a fire of straw*" (Cantillon, 2009, p.79). In fact, government securities should be thought of as a form of financial feudalism.

In the market economy, the entrepreneur must risk his wealth and income anew with each passing day. It is the consumer who ultimately decides upon those who will be rich and those who will go broke. Government bonds introduce a foreign element to the market, consumer sovereignty no longer reigns supreme. The entrepreneur is no longer forced to invest his funds in such a way that would best serve the wants and needs of consumers. He is safeguarded from competition; his income becomes derived from the expropriation of his fellow men. As Ludwig von Mises put it, "*The long-term public and semipublic credit is a foreign and disturbing element in the structure of a market society*" (Mises, 2008, p.228).

From an economic standpoint, government debt is highly counter-productive. For one, it allows the government to grow and embark upon projects which could otherwise not have been started, for direct taxation is much more accountable to the average voter. Furthermore, it is a double burden because first resources are diverted from the market to the government, and then later on the tax payer must pay the principle plus interest. Even if the government acquires funds from abroad and thus there is no crowding out within the domestic economy, those resources are diverted from where they otherwise might have been used more productively. It is a wholly unfortunate scenario that some entrepreneurs should have the right to safeguard their accumulated funds *ad infinitum* through government bonds without being subject to the democracy of the market. No man and no man's children should have this right.

While the idea that the dollar may drastically decline in value and lose its status as a reserve currency may sound preposterous, it is actually nothing new. Most monetary systems have an average lifespan of around 40 years. For example, from 1870 until 1913 the world was on a classical gold standard. From 1913 until 1945 there was a managed gold-exchange standard. With the Bretton Woods agreement in 1945 came a gold-backed dollar reserve standard. In 1971, with the closing of the gold window came a fiat dollar standard that is now coming to an end. This is not to imply that there is some dialectic force which brings forth a new monetary system every three to four decades. For example, the British pound was sound for 200 years because it was defined as 0.2354 troy ounces of gold. Rather, governments in collusion with bankers have a tendency to gradually expand the supply of money. As writes James Turk, "*A quick scan of world history reveals them to be depressingly familiar. All great societies pass this way eventually, running up unsustainable debts and printing (or minting) currency in an increasingly desperate attempt to maintain the illusion of prosperity*" (Turk, 2008, p.4).

HEAVY METAL

The precious metals bubble is a hypothetical bubble. In other words, it is outside the scope of the ABCT because it is not yet a bubble. While it is true that gold and silver have been steadily rising in price from 2001 until the present, it is important to realize that prices do not necessarily reflect value. For example, the spot price of an ounce of gold on January 1st, 1975 was $176. On January 1st, 2001, the spot price of an ounce of gold was $271. However, these are *nominal* dollar figures. According to the Bureau of Labor Statistics, which calculates inflation using the CPI (remember the CPI understates inflation), $176 from 1975 would have purchased $579.36 worth of goods and services in 2001[35]. Therefore, while the price of an ounce of gold in 1975 may appear cheaper than in 2001, the reality is actually quite different. In real terms, the *real* price for an ounce of gold in 2001 was $82.33 if we were to go by 1975 dollars, which is less than half the price it was in 1975.

On August 15th, 1971 when President Richard Nixon closed the gold window, the price of gold was fixed at $35 per ounce. Many bureaucrats, including the then Federal Reserve chairman Arthur F. Burns, predicted that the price of gold would collapse (presumably because it was no longer tied to the almighty dollar). As was mentioned, the price of gold went to $176 by 1975. It certainly seemed like a bubble, if one were to look only at the *nominal price*. However, gold kept rising until January 1980, when it hit an astounding $850 per ounce. It is important to mention that the major reason gold had not risen even further and eventually turned into a bear market was because of a genuinely anti-inflationary chairman at the Federal Reserve, Paul Volcker. Volcker raised interest rates to as high as 20% by 1980. There are no chairmen present like these today. In fact, interest rates are negative in *real* terms today.

If we take the extreme high of gold in 1980 at $850, in 2011 dollars this is equivalent to $2,305.18. The present price of gold is $1,486.40, or $548.09 in 1980 dollars. Yet, this gold bull market is destined to have a lot more steam. For one, there are many more potential buyers of gold today than there were during the 1970's. During the 1970's, China and much of the east were not in a position to purchase gold due to being subject to grinding poverty i.e., socialism. Today, all the creditor nations are located in the east. Furthermore, there is

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[35] US Bureau of Labor Statistics – http://www.bls.gov/data/inflation_calculator.htm

no political will this time around to prevent inflation. In fact, the psychology today is quite the opposite, to legally counterfeit as much money as it takes to make problems temporarily go away. The price of silver also rose to an all-time high in 1980 of $48.70 per ounce. Today, the price of silver is $43, or $15.86 in 1980 dollars. Therefore, neither gold nor silver are presently in a bubble, they have an enormous way to go from here.

There is, however, a potential for a bubble to form in the precious metals. The main reason is that desperate people tend to be predictable. Once and if the Chinese property market implodes, the dollar will be dethroned. When the dollar and dollar-denominated assets such as stocks and bonds start to rapidly lose their value, people will predictably jump into the usual safe-haven: gold and silver. As stated George Soros, "*the ultimate asset bubble is gold*"[36]. After the Dotcom bubble burst, it seemed prudent and conservative for money to shift into the American dream, Real Estate. After the Real Estate bubble burst and brought down the financial system, it seemed prudent and conservative for money to shift into US bonds. Once and if things go wrong with the dollar, this herd is destined to shift into precious metals. As stated by bubble experts David Wiedemer, Robert A. Wiedemer, Eric Janszen and Cindy Spitzer, "*The reasons that gold will be a spectacular investment has nothing to do with some fundamental quality of gold itself, but will primarily result from the other bubbles colliding and popping, and investor interest rationally shifting to gold – for a while. Eventually, gold values will collapse (as bubbles always do), making the Gold Bubble the biggest, baddest financial bubble of the 21st Century*" (David Weidemer, 2006, p.146).

[36] The Telegraph – January 28th, 2010 – http://www.telegraph.co.uk/finance/financetopics/davos/7085504/Davos-2010-George-Soros-warns-gold-is-now-the-ultimate-bubble.html

THE PROTESTANT WORK ETHIC

"*Do not wish for quick results, nor look for small advantages. If you seek quick results, you will not reach the ultimate goal. If you are led astray by small advantages, you will never accomplish great things.*"
- Confucius

The protestant work ethic is a term coined by economist and sociologist Max Weber, in his masterpiece *The Protestant Ethic and the Spirit of Capitalism*, first published as a series of essays in 1905. The protestant work ethic may be summed up as follows: overproduction and underconsumption i.e., saving. In other words, it is the same as the current Chinese work ethic. According to a Bank of International Settlements Working Paper[37] by Guonan Ma and Wang Yi, the average adjusted household savings rate from 1998 to 2008 was 34.45% of household income. In 2001, it reached a low of 26.1% and in 2007 a high of 36.6%. What this means is that the average Chinese citizen has managed to save over a third of his income for over a decade, which translates to a massive accumulation of capital. This is the key to creative destruction, innovation, and economic growth.

Perhaps Ludwig Erhard stated it best, "*Though man has been successful in splitting the atom, it will never be possible to explode that old economic law which tells us to live reasonably and within our means, and which forbids us to consume more than we can produce or want to produce*" (Erhard, 1958, p.167). Indeed, whether an individual, a group, or an entire nation lives above their means, they are destined to live below their means. Likewise, if an individual or a nation has a low enough time preference and the foresight to live below their means, they are destined to live above their means. This is not the work of an invisible friend rewarding sacrifice; it is the freeing up of resources that can serve higher-order functions.

All great economists have stressed the importance of saving, as Joseph A. Schumpeter put it, "*Let me add that the classical writes also clearly perceived, though they may have exaggerated, the role of saving and accumulation and that they linked saving to the rate of "progress" they observed in a manner that was fundamentally, if only approximately, correct*" (Schumpeter, 2009, p.29). He went on to describe the protestant work ethic in stating, "*The bourgeoisie worked primarily in order to invest,*

[37] Bank of International Settlements – Working Paper No.312 – China's high saving rate: myth and reality – Guonan Ma and Wang Yi – June 2010 – http://www.bis.org/publ/work312.pdf

and it was not so much a standard of consumption as a standard of accumulation that the bourgeoisie struggled for and tried to defend against governments that took the short-run view" (Schumpeter, 2009, p.190). It was these "bourgeoisie" that religiously deferred consumption that lifted their living standards as well as those around them. There exists no short-cut, no lever that a politician may pull in order to raise the general living standard. On the contrary it is the protestant work ethic.

Capitalism does not consist of chanting "supply and demand"; it consists of saving and profitably investing. It brings about mass production for mass consumption; it is the only force that lifts the general standard of living. Capitalism's achievement does not consist of providing luxury goods for the rich; on the contrary, it consists of bringing what were once considered luxury items to the masses. As writes Schumpeter "*Queen Elizabeth owned silk stockings. The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within the reach of factory girls in return for steadily decreasing amounts of effort*" (Schumpeter, 2009, p.13). Capitalism has not only enabled the *quantity* of life to expand[38], but also the *quality* of life to expand. The average man can today get a quick meal that is more nutritious and tasty than any king or even socialist dictator could dream of, for just a fraction of his daily income. Capitalism does not need a monument; it is a monument in itself, *Si monumentum requins, circumspice*[39]. The megalomaniacs have reacted to this undeniable reality by claiming the usual: the world is coming to an end. Only this time it is not coming to an end due to polylogism of one kind or another, but precisely because we are "too rich". This watermelon-syndrome (green on the outside, red on the inside) claims that we are exploiting resources and multiplying at an unsustainable pace. This is, of course, reactionary nonsense of pathologically sick and indoctrinated minds.

It was Benjamin Franklin who stated, "*If you know how to spend less than you get, you have the philosopher's stone*" (Franklin, 2007, p.13). Indeed, just as the English were the philosopher kings in the 19th century, the Americans in the 20th century, the Chinese are destined to become the philosopher kings of the 21st century, precisely because they have embraced the protestant work ethic. Living standards do not rise and working hours do not fall because a country adopts liberal democracy, but precisely because of the protestant work ethic. As stated by Ludwig von Mises, "*The disutility attached to labor explains why in the course of human*

[38] In 1800, the world population was approximately 900,000,000 people. In 2011, the world population is 6,928,198,253 and is fast approaching 7 billion, according the World Factbook - https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html
[39] *If you seek a monument, look around* in Latin.

history, concomitantly with the progressive increase in the physical productivity of labor brought about by technological improvement and a more abundant supply of capital, by and large a tendency toward shortening the hours of work developed. Among the amenities which civilized man can enjoy in a more abundant way than his less civilized ancestors there is also the enjoyment of more leisure time" (Mises, 2008, p.133).

The philosophy of economizing and saving can be stretched back to even the most primitive, short-sighted, and ruthless men of the past. It was the hunter's reluctance to kill a pregnant hind, the conqueror's reluctance of murdering the conquered and enslaving them instead, and the warrior's uneasiness from cutting down fruit trees where the protestant work ethic first manifested itself. The introduction of money allowed society to amplify this ethic, to see what was socially profitable and what was not. It was the upholding of private property, of sound money and accounting that allowed the protestant ethic to accelerate.

THE BROKEN WINDOW

The parable of the broken window, or the broken window fallacy, was first introduced by political economist Frédéric Bastiat in his essay entitled *That Which Is Seen, and That Which Is Not Seen*, first published in 1848. The parable consists of a hooligan who throws a brick through the local baker's window. The local people of the town gather around to reflect on what has happened. Most of them come to the conclusion that it was a pity, for a perfectly good window has just been destroyed. However, an economist appears at the scene to tell the people otherwise.

According to the economist, the broken window is not a waste; it is in fact a stimulus. It is, after all, spending that makes the economy go round, states the economist. The baker will now be forced to purchase a new window, thus providing the glazier with some income. The glazier will, in turn, be able to spend some of his new income on the farmers' crops, and so on runs the fallacy. The reality, however, is quite different. For the baker must now spend money on a new window, money he would otherwise have used to purchase something else, such as a suit. The baker's purchase of a suit would have provided the tailor with some income, who would in turn also be able to spend some of his money on the farmer's crops. Therefore, the town has not gained a new window; it has lost a new suit in having to replace a window. The broken window did not serve as a stimulus. It has, in fact, destroyed a part of the town's wealth.

If the broken window was truly a stimulus, why stop at the window? Why not take this fallacy to its logical conclusion and burn down the whole town? It would, after all, give income to the firemen, the masons, the glaziers, and a whole lot of other professions. Unfortunately, the broken window fallacy is very prevalent today and is ingrained in mainstream economics. For example, after 9/11 economist and Nobel-prize winner Paul Krugman wrote an op-ed in the New York Times in which he wrote, "*Ghastly as it may seem to say this, the terror attack – like the original day of infamy, which brought about an end to the Great Depression – could even do some economic good*" (Krugman, 2001). Likewise, on March 11th, 2011, Japan was struck by a tsunami caused by an 8.9-magnitude earthquake. The days following this tragedy, economists around the world spewing the broken window fallacy proclaimed that this was actually an economic stimulus. If this were really the case, why do not governments around the world evacuate cities and carpet-bomb them? In the words of Frédéric Bastiat "*To break, to spoil, to waste, is not to encourage national labor; or, more briefly, "destruction is not profit"*" (Bastiat, 2007, p.4).

While destruction cannot benefit society as a whole, it certainly benefits special interests. There is no doubt that the glazier benefits from hooligans throwing bricks through windows. Likewise, while an increase in the supply of money cannot benefit society as a whole, it certainly benefits (1) those that can create the money *ex nihilo*, and (2) those first in line to receive the newly created money. The most common fallacy amongst economists today is the assumption that lowering the rate of interest stimulates consumption, and hence the economy. It is, after all, consumption that makes the world go round. If people did not consume, why would someone invest in the production of goods destined to be consumed? The problem, however, is that one cannot possibly increase consumption and investment simultaneously. If Mr. X wants to consume more, he must invest less and vice-versa. As states Jesús Huerta de Soto, "*it is a logical contradiction to believe that an increase in consumption manifests itself as an increase in investment, since investment can only rise due to a rise in saving, which must always go against consumption*" (Soto, 2009, p.342fn).

In the mainstream economic model, what matters is that wage earners consume. This, however, is the broken window fallacy in a different light. In the hypothetical world of Robinson Crusoe, the element that will lift his standard of living is not consumption, but saving, investing, and producing capital goods such as nets and huts. What is true for Crusoe is true for groups, towns, nations, and society as a whole. Countries like Singapore and China have not risen from the swamps because the people there suddenly decided to consume, they have risen due to the protestant work ethic. The broken window fallacy lies at the heart of both the warfare state and the welfare state.

It is said that if we do not spend $x on the troops occupying country z, all the suppliers that help feed and clothe these troops will be unemployed. Furthermore, the troops will be forced to come back home and thus unemployment will rise. Yet, what is typically not seen are the dollars that come back with them. Those funds which are used to make missiles, bombs, grenades, rifles, helmets etc. will be employed in other ways, more aligned with consumer sovereignty. Likewise, if funds are expropriated from the general public in order to save industry x; what is seen are those happy workers in their industry able to keep their jobs. What is not seen, however, is how those funds would have otherwise been used and the employment they would have created. It is the ability to see the typically unseen that constitutes a truly great economist. As wrote Frédéric Bastiat, "*In the economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause – it is seen. The others unfold in succession – they are not seen: it is well for us if they are foreseen. Between a good and a bad economist this constitutes the whole difference – the one takes account of the visible effect; the other takes account both of the effects which are seen and also of those which it is necessary to foresee*" (Bastiat, 2007, p.1).

During a recession, an increase in government spending cannot possibly make society as a whole better off. Whist it can make the government better off and those interests who are milking it, those expropriated funds would have been used otherwise. For example, if the government uses funds in order to employ half the unemployed digging ditches, while it employs the other half to fill the ditches back up, this cannot possibly last. For one, funds, resources, and people are misallocated to unproductive use permanently until the project is cancelled. These funds, resources, and people will not be able to flow back in line with consumer sovereignty until the shovel-ready project is abandoned. Thus, the market is not allowed to reallocate resources and the recession lingers on. It is no coincidence that the

Great Depression lasted so long in the US while the government relentlessly attempted to prevent the market from reallocating resources. Until prices are allowed to fall back to reality and resources are allowed to be reallocated, a recession cannot be ended. It can, at best, be postponed and magnified. The only alternative to this is full blown socialism: there is no middle path.

The broken window fallacy applies to all sorts of tariffs, welfare, warfare, subsidies, bailouts, and all forms of protectionism. If the entrepreneur who decided to build an ice cream shop that serves only broccoli flavored ice cream is successful at getting government subsidies, perhaps due to broccoli flavored ice cream being healthier or perhaps due to employing x number of people, this will not make society as a whole better off. While it will make the subsidized entrepreneur, the employees, and perhaps those people who like broccoli flavored ice cream better off, it cannot possibly benefit society as a whole. Furthermore, the funds which are used to subsidize this economic parasite would have been used otherwise. Another entrepreneur is prevented from taking over the space that is currently being subsidized and employing those people productively. More importantly, the consumer is denied the presence of another business, such as a coffee shop that is trying something radically different yet profitable: iced coffee. As stated Ludwig von Mises, "*Many people do not realize that the only effect of protection is to divert production from those places in which it could produce more per unit of capital and labor expended to places in which it produces less. It makes people poorer, not more prosperous*" (Mises, 2008, p.314).

The layman and economist alike are in a desperate need of once again becoming acquainted with the broken window fallacy, for it is the only way to starve the glazier-industrial complex. As stated Ludwig von Mises, "*The gullible masses who cannot see beyond the immediate range of their physical eyes are enraptured by the marvelous accomplishments of their rulers. They fail to see that they themselves foot the bill and must consequently renounce many satisfactions which they would have enjoyed if the government had spent less for unprofitable projects. They have not the imagination to think of the possibilities that the government has not allowed to come into existence*" (Mises, 2008, p.655). A proper understanding of the broken window fallacy allows one to see the damage of various policies that reverberate throughout the market.

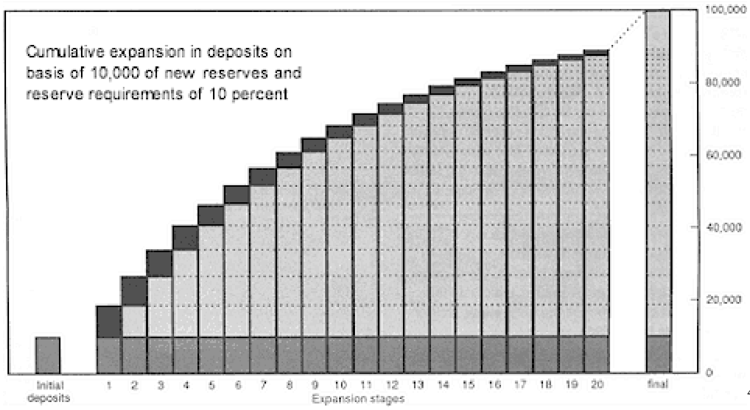
SEPARATION OF BANK AND STATE

"*Every ideology – aside from a few cynical schools of thought – believes that it is championing humanity, magnanimity, real freedom, etc. What distinguishes one social doctrine from another is not the ultimate goal of universal human happiness, which they all aim at, but the way by which they seek to attain this end. The characteristic feature of liberalism is that is proposes to reach it by way of private ownership of the means of production.*"
- Ludwig von Mises
Liberalism

It is the assertion of this thesis that we are presently living in a system where the banking sector operates under ill-defined property rights and extra-legal privileges. Thus, there is a tragedy of the commons that periodically occurs in capital i.e., the business cycle. There are three main banking privileges responsible for the business cycle, and were they to be abolished society could get rid of the dreaded business cycle. The main privileges are (1) fractional-reserve banking, (2) central banks as legal counterfeiters and price-fixers and (3) deposit insurance.

Fractional-reserve banking allows banks to lend the better part of their deposits and reap more profits than would otherwise be the case. The process benefits depositors because the banks would otherwise have to charge storage fees. Furthermore, it benefits consumers as well as entrepreneurs because they have access to more loanable funds, as opposed to the money in banks just sitting there. In a nutshell, this is the common but fallacious view of fractional-reserve banking. The core problem inherent in fractional-reserve banking is that it actually *expands* the money supply.

The expansion of the money supply under fractional-reserve banking is known as the *money multiplier*. The process works as follows, say Mr. Greenspam deposits $10,000 in Bank A. If the bank is required only to hold 10% of that deposit on reserve, it can loan out $9,000 of that deposit. When this $9,000 is loaned out to a business that uses it to buy an item worth $9,000, the seller of that item ends up with $9,000 which he will presumably place on deposit in Bank B. Bank B, also operating under 10% reserves, lends out $8,100 from that deposit. The process continues until the threshold is reached and a total of $90,000 of deposit money i.e., fiduciary media has been created out of the original $10,000 deposited by Mr. Greenspam.



[40]

As the ABCT postulates, the root cause of the business cycle is an expansion of the supply of money and credit. Thus, central banks are not the only cause of the business cycle, so are commercial banks that have the extra-legal privilege of operating under fractional-reserves. Traditionally, there have been two mutually exclusive types of banking; savings and loan banking and deposit banking. Savings and loan banking consists of lending money to a bank for a certain amount of time and collecting the principle plus interest at the expiration of the loan. Deposit banking consists of banks acting as storage houses, and collecting storage fees. It is the mixture of these two mutually exclusive forms of banking that lead to gradual expansion of the money supply and, subsequently, sudden contractions.

Fractional-reserve banking is by definition a violation of property rights. If one were to store their grain at a storage facility, it would be considered a crime if the storage facility loaned out that grain to someone else without the owner's consent. Furthermore, the true tragedy does not consist in loaning out the grain without the owner's permission or knowledge, but in issuing more grain-receipts that there is actually grain at the storage facility. For this would create the illusion that there is more grain than is actually the case and if it were to be done *en masse* by some form of storage cartel it would alter the price of grain artificially low thus leading to overconsumption and malinvestment. Likewise, the origin of fractional-reserve banking lies with corrupt goldsmiths who issued more gold receipts than they actually had on deposit. As stated James Turk, "*But slow and steady rarely satisfies the more excitable members of the financial class, and by the seventeenth century, Italian and English goldsmiths had discovered that they could lend out some customer's gold for a profit. Since only a*

[40] Courtesy of Free Republic – *How Money is Created?* http://www.freerepublic.com/focus/f-news/1993831/posts

few of their customers demanded their gold back at any given time, the fraction of their deposits that the goldsmiths held in reserve (hence the term "fractional reserve") was usually sufficient to meet their obligations. And with the money they earned by lending, they were able to pay their depositors interest rather than charging them for storage, producing smiles all around" (Turk, 2008, p.53).

Central banks are essentially state-enforced banking cartels. Fractional-reserve banking could not be possible without a central bank. Under a free market banking system, the banks that would over-expand would be run out of business by the more prudent and conservative banks. The more prudent banks would be quick to point out the unsound policies of the loose banks that would not be able to sustain a mild bank run. The history of central banking is even more corrupt than central banking in theory. For example, the Bank of England was originally called the "Tunnage Bank", and the act that passed it stated, "*An Act for granting to their Majesties several Rates and Duties upon Tunnage of Ships and Vessels, and upon Beer, Ale and other Liquors: for securing certain Recompenses and Advantages, in the said Act mentioned, to such persons as shall voluntarily advance the Sum of £1,500,000 towards carrying on the War against France*"[41]. Likewise, the US Federal Reserve has its origin in the infamous Jekyll Island trip, where JP Morgan, Paul Warburg, Senator Nelson Aldrich, Assistant Secretary of the Treasury Department A. Piatt Andrew and other elite banking interests met in order to produce what would later be called the Federal Reserve Act. Typically, cartels are sought in order to (1) restrict production and (2) increase prices. In banking, cartels are sought in order to (1) enable production (of money) and (2) lower prices (interest rates). The net effect from the point of view of the bankers is the same, to increase profits. It should be noted that the United States already had two central banks prior to the Federal Reserve, the first was shut down by Thomas Jefferson and the second by Andrew Jackson. Furthermore, according to the US Bureau of Labor Statistics, the 1913 dollar was worth $22.57 2011 dollars. In other words, central banks exist to dilute money i.e., they are the largest counterfeiters in history.

Deposit insurance is when a central bank guarantees deposits in the event that a commercial bank should go bankrupt. The moral hazard inherent in deposit insurance is that (1) depositors are less likely to review the sound practices and history of a given bank and (2) banks lean towards high-risk and high-reward lending because they are implicitly backed by the central bank and its depositors will be bailed out. This is a complete denial of

[41] Bank of England - http://www.bankofengland.co.uk/about/legislation/1694act.pdf

the market place in regards to banking. Capitalism without loss is like Christianity without hell, it simply does not function. As stated Ludwig von Mises, "*Looking backward upon the history of the last hundred years, one cannot help realizing that the blunders committed by liberalism in handling the problems of banking were a deadly blow to the market economy*" (Mises, 2008, p.440).

More and more mainstream authors are beginning to realize that deposit insurance is not a good idea. For example, John Cassidy wrote, "*There is now a wealth of evidence from all around the world that the existence of deposit insurance encourages banks to take bigger risks, and raises the probability of financial crises occurring*" (Cassidy, 2009, p.162). George Cooper articulated the point even more deeply in stating, "*The presence of a central bank, willing to underwrite all deposits equally, will have the effect of putting safer, less leveraged, institutions at a commercial disadvantage relative to the more cavalier institutions. Over time this will lead to bad lending practices forcing out good lending practice. The introduction of a central bank created a race to the bottom, with all banks incentivised to take on more risk than their competitors*" (Cooper, 2008, p.66). George Soros also made this point in stating, "*There is a basic imbalance in deregulating deposit-taking institutions and guaranteeing depositors against loss. The guarantee enables financial institutions to attract additional deposits at will, and deregulation gives them wide latitude in putting those deposits to use. The combination of the two is an invitation to unrestrained credit expansion*" (Soros, 2003, p.130).

Thus, the conclusion of this thesis is that money will not become sound and that business cycles will continue to occur until there arises a genuine movement to separate the bank from the state. Money and banking will not function properly until the special privileges are taken away from those economic agents known as bankers. There has, over the ages, occurred a mutually beneficial but socially destructive relationship between the financiers and the rulers. The financiers were granted special privileges for helping to finance wars and the growth of government. Perhaps the most striking example of this is that of John Law, creator of the Mississippi bubble. As stated Douglas E. French, "*What can be predicted with absolute accuracy is that fiat money, fractional-reserve banking, central banks, Keynesian monetary policies and self-serving politicians will combine to ensure that there will be many more booms and speculative bubbles for future economists and historians to chronicle*" (French, 2009, p.117).

RESUMÉ

Cieľom bakalárskej práce je opísať rakúsku teóriu hospodárskeho cyklu. Aplikuje rakúsku teóriu hospodárskeho cyklu na súčasný stav vecí a odhaľuje prítomnosť bublín. Logickým dôsledkom práce je, že v súčasnosti existujú dve hlavné bubliny: čínska realitná bublina pobrežných miest a americká dolárovo-dlhopisová bublina. Následne práca vysvetľuje potenciálny vznik bubliny v drahých kovoch. Stručne opisuje vzostup a úpadok tzv. „FIRE“ ekonomiky - ekonomiky vedenej financiami (Finance), poistením (Insurance), a realitami (Real Estate). Posledná časť práce pozostáva z ideológie, ktorá zahŕňa protestantskú pracovnú etiku, „omyl rozbitého okna“ a oddelenie banky od štátu.

Prvá časť práce rozoberá rakúsku teóriu hospodárskeho cyklu. Teória sama o sebe vysvetľuje výskyt hospodárskych cyklov či hospodárskych bublín. Prvýkrát bola formulovaná rakúskym ekonómom tretej generácie, Ludvigom von Mises, v jeho knihe „Teória peňazí a kreditu“. Práca najprv definuje a stručne popisuje ekonomické bubliny. Ďalej sa venuje konceptu suverenity spotrebiteľa, podľa ktorej práve spotrebiteľ na nezaťaženom trhu rozhoduje, kto bude mať zisk a kto zbankrotuje. Z uvedeného práca pokračuje popisom samotnej rakúskej teórie hospodárskeho cyklu.

Pre vysvetlenie rakúskej teórie hospodárskeho cyklu je dôležitý koncept časovej preferencie. Podľa konceptu človek uprednostňuje súčasnú spotrebu pred budúcou spotrebou. Práca definuje aj kapitálové statky a pokúša sa vytvoriť syntézu medzi nimi a konceptom časovej preferencie. Vyvodzuje, že nižšie časové preferencie sú katalyzátorom vzniku kapitálových statkov. Tvrdenie podporuje ilustrácia Robinsona Crusoe, ktorému výroba siete môže zabrať niekoľko dní. Preto si musí usporiť zopár rýb, aby sa udržal počas procesu výroby. Katalyzátor úspory niekoľkých rýb je výsledkom oneskorenej spotreby, čiže znížením časovej preferencie.

Nasledujúca kapitola definuje peniaze a charakterizuje úrokové sadzby. Poukazuje na koreláciu medzi nízkou časovou preferenciou a nízkymi úrokovými sadzbami a naopak. Ďalej popisuje štruktúru produkcie, ktorá je v podstate súhrnom kapitálových statkov. Diferencovaním medzi kapitálovými statkami nižšieho rádu a vyššieho rádu práca znázorňuje ako rast miery úspor ovplyvňuje štruktúru produkcie, i.e. kreatívnú deštrukciu.

Práca definuje infláciu ako rast peňažnej zásoby a jej substitútov. Bližšie popisuje vplyv inflácie na štruktúru produkcie, i.e. zlé investovanie. Inflácia vyvoláva dojem, že úspory zrástli a časové preferencie sa znížili. Táto zjavná podobnosť sa však prejavuje ako ilúzia a to vedie k nadmernej spotrebe, zlej alokácii zdrojov a eventuálne k recesii.

Druhá časť práce aplikuje teóriu na súčasný stav vecí. Čitateľovi prináša celkový prehľad súčasného finančného systému, ktorý má korene v 80. rokoch a je známy ako „FIRE" ekonomika. Na príklade čínskeho realitného trhu ukazuje investovanie najväčšieho stimulačného balíka na svete z dôvodu finančnej krízy z roku 2008. Čína drasticky znížila úrokové sadzby a dramaticky zvýšila zásobu peňazí a kreditu. Táto masívna inflácia vyvolala obrovské špekulácie už v aj tak presýtenom trhu s nehnuteľnosťami, konkrétne v realitách pobrežných miest. Bežné ale efektívne metódy demonštrujú, že trh s nehnuteľnosťami je nadhodnotený, čo sa ukazuje na miere ceny prenájmov a ceny príjmov.

Druhá bublina, ktorú práca rozoberá, je dolárovo-dlhopisová bublina v Spojených štátoch. Výnosy z dlhopisov sú umelo nízke a manipuluje s nimi Americká centrálna banka, ale aj zahraničné vlády krajín ako sú napríklad Čína a Japonsko. Práca poukazuje na nadhodnotenie dolára z kvantitatívnej aj kvalitatívnej stránky. Nadväzujúc na to predpovedá hypotetickú bublinu v budúcnosti, ktorá pozostáva z drahých kovov ako zlato a striebro.

Tretia a záverečná časť sa skladá z ideológie. Popisuje a vysvetľuje protestantskú pracovnú etiku a považuje ju za predpoklad skutočného hospodárskeho rastu a rozvoja. Bližšie vysvetľuje „omyl rozbitého okna", ktorý je žiaľ hlboko zakorenený v ekonómii hlavného prúdu. Práca sa zaoberá príčinami pre nutné oddelenie banky a štátu. Inak bude hospodársky cyklus spolu s bublinami ďalej zamorovať trhovú ekonomiku.

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