EcPoFi's

The Crank Report

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"No final an all-encompassing definition of economic growth exists among economists. Economic growth has been associated with a number of different phenomena including technological progress, "lengthening" of the structure of production, and an increasing stock of capital. I prefer to view the quest for economic growth as simply an attempt to raise future living standards relative to present living standards", Richard H. Fink

Central Planning, Democracy and the End of Economic Growth

Central planning committees around the world, made up of elected politicians, bureaucrats (i.e. *an official in a government department, in particular one perceived as being concerned with procedural correctness at the expense of people's needs*) and central bankers, are today facing perhaps the biggest ever threat to their very existence: the end of economic growth. For decades, central planners have experimented with faulty economic policies, many of which were based, in the best of cases, on little more than good intentions based on unsound economic doctrines. In the worst of cases, these so-called policies were nothing short of governments enriching themselves at the expense of the people they claim to represent. In both cases, the "spending oneself to riches" philosophy, built on inflationary policies and steered by legislation, has now however arrived at the final chapters as unmanageable debt levels have long gone consumed away any reasonable prospects for future economic growth in developed nations all across the globe, including Japan, the U.S., the U.K. and many countries in mainland Europe. What do all these countries have in common which their politicians brag about constantly? Democracy – the holy grail for freedom, peace and prosperity. At least, so we're taught from an age too young to remember. A *fait accompli* highly desired compared to its alleged only adversary; the evil dictator. Democracy, or the *rule of the majority*, in its current form has however greatly failed the people for a few

main reasons in my opinion. Firstly, government powers have now come to interfere with a vast and ever growing range of choices which only individuals should be able to make in a free society. Secondly, these ever growing self-imposed "responsibilities" of governments have made it exceedingly difficult for the electorate to monitor government. A direct result of the increased complexity is that it facilitates the government legislating away not only ever more individual freedom, but also ever more resources. Thirdly, as governments are now able to interfere in most aspects of everyday life for the people they are meant to serve, elections are frequently (always?) won by the parties promising the most in economic terms (by robbing Paul and giving it to Pete and through issuing debt). The net result is an ever growing mountain of government debt, both in total and relative to economic indicators such as industrial production and GDP. National central banks have helped make it possible for governments to amass these unmanageable levels of debt, not to mention the banks which are forced to own the government bonds through balance sheet rules and regulations. In return, these banks have been granted monopoly powers to create money. Those working hard to satisfy the needs, wants and demands of others, i.e. the private sector which economic growth hinges on, are now on the hook to repay these debts. In a fiat money world, purchasing power granted through bank loans is acquired through money created out of thin air. The problem is the money to repay the debt needs to be acquired through the creation of real goods and services (consumer and producer goods) produced at a profit. As scarce resources are gradually being depleted through the misallocations and overconsumption the economic policies facilitate, people will increasingly find it difficult to not only service those debts, but worse, will find it near impossible to maintain capital and add to it (see *The Economic Meaning and Consequences of Debt*, The Crank Report, Issue #5). Economic growth suffers as a result. Many, if not most, developed nations are at such a stage as we speak and have been for years. Absent a rude awakening or some form of a revolution of some sort, nations around the world will not grow in economic terms, at best. A further decline in living

standards is sadly the most likely outcome. This outcome will only further be cemented by the natural policy response – intervention begets yet more intervention.

Now, it's not the role of economics to interpret or conclude about the desirability of economic growth. It is however the role of economics to explain not only how growth might be attained, but also how it might be attained most efficiently. Below we'll explore briefly economic growth in its sustainable form: Natural Economic Growth before moving on to another form of economic "growth": Artificial growth.

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This is Natural Economic Growth...

Natural economic growth, or a rise in living standards, which we might also refer to as sustainable economic growth, comes about as a result of production, saving and investment. Savings can only accumulate if less is consumed (spent) than is produced (earned). Real saving therefore cannot be generated through inflating the money supply as both assets and liabilities increase simultaneously when it does. Taking up a loan and depositing it in a savings account therefore does not qualify as real saving. The higher saving is in relation to consumption, which we may refer to as the consumption/saving ratio (C/S), the more resources become available for investments. As saving and investment are both necessary for real economic growth to take place and as there can be no investment without saving, the lower the C/S ratio, the higher the potential economic growth. Conversely, the higher the C/S ratio, the lower potential growth becomes. Less consumption and more saving hence bring about more output in the future. Conversely, more consumption now means less saving today and lower future growth. Increased saving available for investments also brings with it the added benefit of *naturally* pushing the interest rate on loanable funds lower than would otherwise be the case. This reduction in interest payments will by itself make more investments profitable than otherwise as the break-even point decreases. As producer goods accumulate and become more advanced, businesses and labour become more productive. The supply of consumer goods increases while their prices decline. As a result, real wages increase, raising overall living standards with it. This process allows future consumption to increase. The process of real, or natural, economic growth is therefore

as follows, broken down into the two main sectors of an economy, namely consumer goods and capital goods:

Consumer goods sector:

$$Demand\ for\ Consumer\ Goods \downarrow, Prices \downarrow, Profits \downarrow, Wages \downarrow, Labour\ force \downarrow \\ and\ the\ Supply\ of\ Consumer\ Goods \downarrow$$

As time preference decrease (i.e. people can wait a little longer before a given end is achieved – consume later as opposed to sooner), the C/S ratio falls, savings increase, interest rates fall and investments increase. As this happens, a portion of the labour that previously worked in the consumer goods industry now start working in the capital goods industry instead. This will bring about the following changes in the capital good industry:

Capital goods sector: $Demand\ for\ Capital \uparrow, Prices \uparrow, Profits \uparrow, Wages \uparrow, Labour\ force \uparrow \\ and\ the\ Supply\ of\ Capital\ Goods \uparrow$

The process of real economic growth is therefore as follows:

$$Prouction\ followed\ by\ a\ decrease\ in\ the\ \frac{C}{S}\ ratio \\ \rightarrow Supply\ of\ Savings \uparrow \\ \rightarrow Capital\ Goods \uparrow \rightarrow \frac{Capital}{Labour}\ ratio \uparrow \\ \rightarrow Marginal\ Productivity\ of\ Labour \uparrow \rightarrow Supply\ of\ Consumer\ Goods \uparrow \\ \rightarrow Prices\ for\ Consumer\ Goods \downarrow \\ \rightarrow Real\ Wages \uparrow \\ = Standards\ of\ Living \uparrow$$

In summary, natural economic growth starts with production, followed by increased savings driven by reduced consumption leading to increased investments which then lead to higher production and productivity and more output at lower prices which ultimately results in an increase in real wages and living standards. This kind of growth is sustainable and the process can be repeated over and over again creating ever higher living standards. Mises called a progressing economy "…an economy in which the per capita quota of capital invested is increasing" (Mises, Human Action, A Treatise on Economics, 2008, p. 292). He further stated that "The vehicle of economic progress is the accumulation of additional capital goods by means of saving and improvement in technological methods of production the execution of which is almost always conditioned by the availability of such new capital" (Mises, 2008, p. 295).

Many economists and financial commentators believe that a drop in consumption will lead to an economic slowdown. They however likely err in forgetting or completely ignoring the capital goods sector, a sector which is also a part of the economy and which benefits from a decrease in consumption and an increase in saving. This brings us to another kind of economic growth which has been much more prevalent in developed economies for many

decades and perhaps especially since the end of the 1990s: artificial growth.

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...and this is Artificial Economic Growth

Ever wondered why the economy moves in cycles? Ever wondered how the stock market can deliver tremendous returns for years for then lose these gains over a relatively short period of time? The boom and bust cycle is not an inherent feature of capitalism as Karl Marx, many modern day social democrats, socialist "economists" and even some free-market economists seem to believe. These cycles are instead an inherent feature of central- and fractional reserve banking where additional purchasing power can actually be created absent prior saving. Furthermore, the current banking regime is not endogenous to the market economy as it exists only due to government decree. It is this system, in tandem with banks and insurance companies having to own government debt that create business cycles of the violent sort. In this sense, the cycles are created centrally and not by the market itself. As government has the ultimate responsibility for the existence of the current banking system, it is the government that should solely be blamed for the business cycle. That politicians haven't bothered to learned about monetary economics, they are in committing a grave error which can only be described as gross negligence or utter incompetence. In the private sector, people can go to jail for the former and are usually fired for the latter.

Fractional reserve banking supported by central banks is what allows the business cycle to form. In short, the current system makes artificial growth possible. Artificial growth, which we may also refer to as inflationary growth, is a kind of growth that is not sustainable and which ultimately leads to a decrease in living standards (or lower living standards than otherwise would have been the case). **The distinguishing feature of this kind of growth is that *it is driven by an increase in the money supply instead of savings*.** This explains why it can be referred to as *inflationary growth*. The appearance of a boom is jump-started with an injection of money usually from banks (instead of directly from the central bank) into the business sector

pushing interest rates on loans artificially low (i.e. lower than the current supply of saving would indicate). This has the following effect on the capital goods sector:

$$Demand\ for\ Capital\ Goods \uparrow \rightarrow Prices \uparrow \rightarrow Profits \uparrow \rightarrow Wages \uparrow \rightarrow Labour\ force \uparrow \rightarrow Supply\ of\ Capital\ Goods \uparrow$$

The monetary injection has exactly the same effect on the capital goods sector as savings have: the sector becomes more buoyant and a portion of the labour force moves from the consumer goods sector to capital goods. But that is where all similarities end. The shift in resources from the consumer goods sector to the capital goods sector is not due to the free will of the market: time preferences have not changed (there has been no decrease in the Consumption/Saving ratio) and resources have not been allocated to the capital goods sector due to excess resources in the consumer goods sector. The increased activity in the capital goods sector is in effect paid for through a reduction in activity in the consumer goods sector even though this is not what consumers wanted (as reflected in the lack of savings to support the expansion). This unwanted shift in resources from the consumer goods sector to the capital goods sector is what makes this kind of growth unsustainable – there simply is not enough saving to support it. Newly created money is not savings, nor is it capital. All the new money issued through granting loans to businesses do is to provide these businesses with purchasing power to extract resources from other areas of the economy (similar to what government deficit spending financed with government debt does) against the actual free will of consumers (which cannot easily observe nor comprehend what is actually taking place). This process can go on for some time as labour and resources are bid away from the consumer goods sector with the help of an ever expanding credit granted to the capital goods sector. **But as long as this expansion is financed by new money instead of savings it must eventually come to an end.** Sooner or later the consumer goods sector and consumers suffer as resources are continually drained from them through a general loss in purchasing power and access to fewer resources in general. Fewer consumer goods produced than would otherwise be the case combined with an inflating money supply causes the prices of consumer goods to increase and consumption to be restricted

(Salerno, 2012). [1] This inflationary boom, which is not actually a "boom" or economic growth at all, comes to an end when credit expansion for whatever reason is ended or the economy has been sufficiently drained of resources (savings). At this stage, the full force of the market shows itself and consumers' real time preferences, i.e. more consumer goods and less producer goods, are once again established. Much of the artificial growth now reveals itself as investments that cannot be completed, maintained nor continued and a very real bust become apparent for all to see and feel in one way or another. The boom turns out to have been an unsustainable spending spree and the increased economic activity this brings about was erroneously viewed as economic growth. Resources were squandered making society worse off in economic terms as a result leading the economy into an inevitable recession or even depression.

As artificial growth is what created the economic issues in the first place more of the same will only make matters worse. This is why "quantitative easing" or increased lending by banks (of money unbacked by prior saving) cannot do anything else but damage the economy still further. What is needed instead is to allow the economy to adjust without intervention and make it easier for people and businesses to accumulate saving (through decreased taxes, lower government spending, less regulation, sound monetary policies etc.) which can be channelled into rebuilding and expanding the capital base once again. Accumulating saving is a long and slow process, too long for politicians focused on the next election and too long for special interest groups to wait for their share and too unprofitable for the banking sector thriving under the current banking system. Alas, what has happened since the 2008 bust is simply more of the same, albeit through a slightly different route (e.g. here). As money supply growth continues to outpace saving growth (e.g. here) and as government debt has surged since 2008, the next inevitable bust in all likelihood will be much worse than last time

[1] *A Reformulation of Austrian Business Cycle Theory in Light of the Financial Crisis*, The Quarterly Journal of Austrian Economics. According to Salerno, «This phenomenon is known as «**forced saving**», because the redirection of resources from consumer goods' production to capital goods' production caused by bank credit expansion does not comport with the voluntary saving preferences of households (p. 9).

around for the U.S. economy and many other regressing economies.

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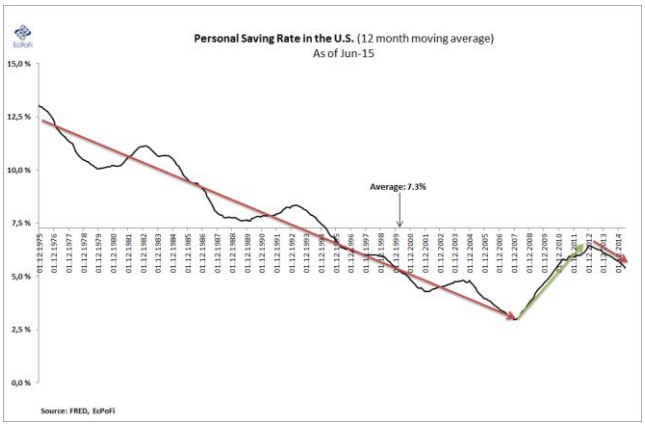
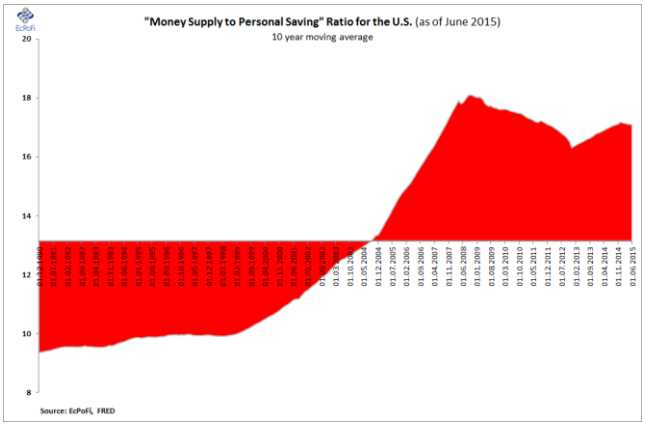
U.S. Economy – Personal Saving Rate Trend Still Heading South

Talking about savings; the U.S. Bureau of Economic Analysis (BEA) yesterday reported the personal income and outlays data for the month of June. The data showed personal spending increasing 3.2% on June last year, slightly lower than the near 3.4% increase in disposable personal income. The personal saving rate for the month came in at 4.8%, identical to the reading one year ago. Following an increase in the saving rate for the five year period spanning 2008 to 2012, the rate has been heading south again ever since (12 month rolling basis) and remains significantly lower than the average since 1973.



An economy cannot grow on a sustainable basis absent sufficient saving as pointed out earlier in this report (also see previous issues of The Crank Report). What constitute "sufficient saving" is beyond the scope of this article to explore; suffice to say that a declining rate of saving and increased money supply are both the adversaries of natural economic growth.



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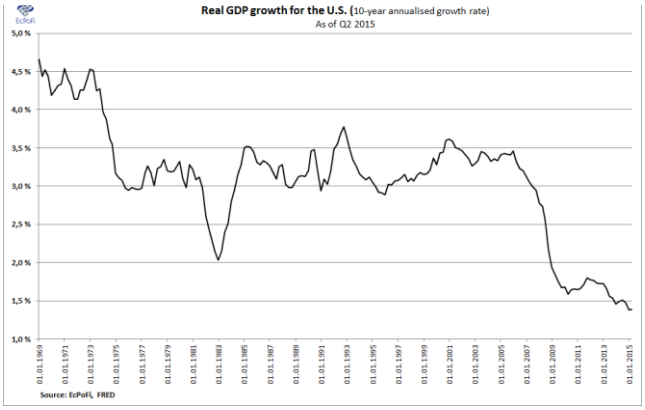
U.S. GDP Q2 2015 Release

GDP Growth: From Bad to Worse, but You Ain't Seen Nothing Yet

The financial media's favourite economic aggregate was published a few days ago. On a year on year basis, "real" GDP managed to squeeze out a monetary fuelled 2.3% increase (removing the monetary inflation, the antitheses of natural economic growth, GDP

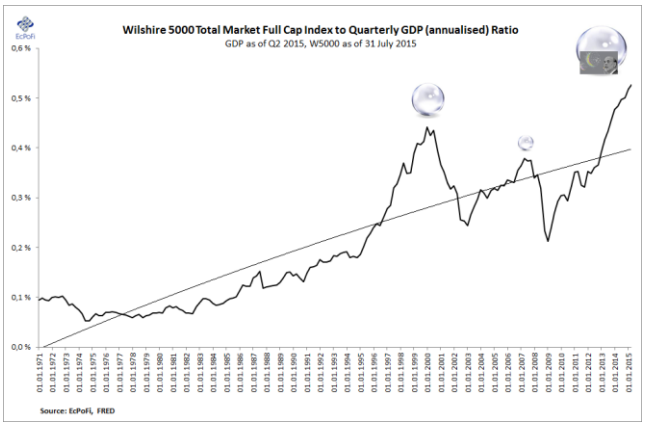
contracted 1.2%). The longer term GDP trend continues to look ugly with "real" annualised GDP growth during the last ten years the lowest ever reported (together with Q1).



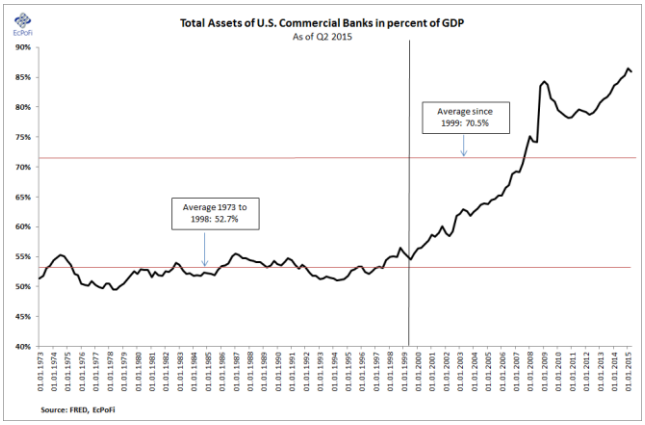
Private investments, the driver of economic growth if financed with saving, also continues to head in the wrong direction. As a percentage of GDP, investment is now at the lowest level for more than 40 years on a 10-year moving average basis. The low level of investment, triggered by a low saving rate, will necessarily result in low GDP growth in the U.S. for many years to come (here). Chances are the growth rate for the next ten years will be lower, potentially much lower, than it has been for the last decade unless economic policies are drastically changed in favour of a free market economy and the end of inflationary policies. A person cannot spend him or herself to riches! Nor can a nation.

The Stock Market and GDP

The artificial growth facilitated by fractional reserve banking discussed above does not only wreak havoc with the real economy; it fuels asset bubbles, too. Never before, at least based on data since 1971, has the stock market departed from GDP on such a scale as we see today (these ten charts likely look even worse today).



Stock market investors and speculators are forever grateful to Greenspan, Bernanke and Yellen for having created this giant casino consuming resources created by the real economy.



Those concerned with "inequality" and "growing income gaps" should look no further until having understood this great distortion to an economy (hint: who has the monopoly on creating money?). Ultimately, the stock market depends on the real economy to deliver the earnings and returns required to support the market prices. In the meantime, it feeds on artificially low interest rates and the greatest share price driver of all – an inflating money supply. Both cannot last indefinitely however and valuations ultimately do matter, whether you believe it or not.

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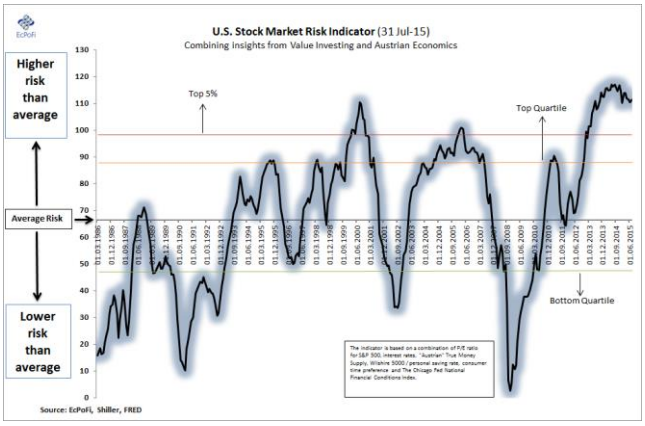
The U.S. Stock Market Risk Indicator: Still Time to Stop at Red Light

Timing stock market turns is difficult if not impossible even for the most seasoned investor and ablest of minds. Assessing the longer term probabilities concerning the size of future returns or losses is a slightly easier exercise however. The U.S. Stock Market Risk Indicator (SMRI) seeks to assess these probabilities by combined insights from both value investing and the Austrian school of economics. The higher the SMRI reading the higher the probabilities of low future returns or losses and vice versa. The indicator peaked in August last year, but has remained near record levels since.

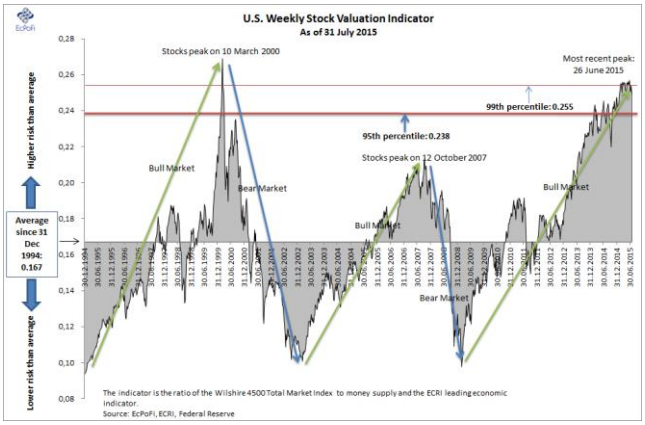


The SMRI hence continues to flash red and with it signal a high probability of poor stock market returns in the future at best and a significant probability of great losses at worst. It is first and foremost the value investing component driving the current high reading as P/E ratios and stock market valuations relative to saving remain high in a historical perspective. As John P. Hussman points out, current valuation levels indicate future stock market returns are likely to be very low.

The economics component peaked two years ago, but it remains high though it has since dropped 26.6%. If history is any guide, it should be noted that this component started dropping earlier than the value investing

component during the last bear market that hit rock bottom in March 2009.

The U.S. Weekly Stock Valuation Indicator, based on stock market prices relative to money supply and the ECRI leading economic indicator echoes the SMRI warning.



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The Stock Prices to Gold Ratio: Back to 2007 Stock Market Peak Levels

To the extent stock market peaks indicate low risk aversion and a high gold price signal high risk aversion (and/or high inflation expectations) the current ratio between the two indicates a generally low risk aversion of market participants.

With the gold price (US$) having shred 15.5% during the last twelve months and the stock market having gained 8.7%, this could turn out to be a contrarian indicator.

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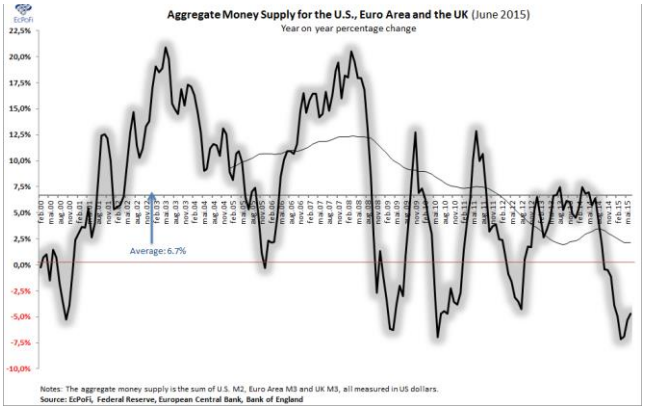
Chart: Aggregate Deflationary Pressures Continue in the U.S., UK and Eurozone



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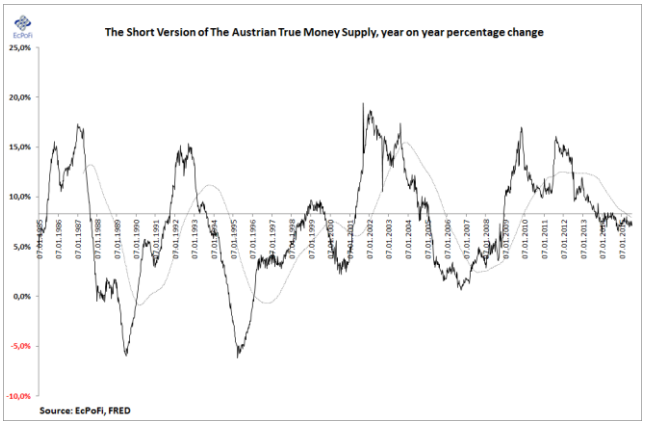
The "Austrian" True Money Supply Weekly – Lower Bank Credit Growth

Following the end of QE in October last year, U.S. banks are now solely driving money supply growth. The full force of the bank credit cycle, the driver of the Austrian Theory of the Business Cycle (e.g. here), is now in play. During the last twelve months, bank credit is up $783 billion, or 7.4%, driven by both increased lending and banks buying securities. This makes up all the new money created during the period inflating the money supply by 7.1%.

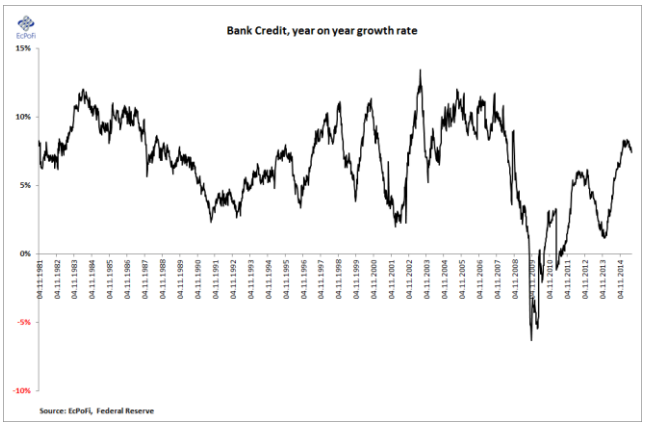


The massive increase in bank credit during the last year has however not proven sufficient to counter a fall in the growth rate of the money supply as the chart above and table below show.

Average y/y growth rate	
Av YTD 2015 (20 June)	7,41%
Av 2014	7,69%
Av 2013	8,95%
Av 2012	12,46%
Av 2011	12,80%
Av 2010	11,30%
Av 2009	13,02%
Av 2009-2014	11,04%

Average weekly y/y % change
Source: EcPoFi, Federal Reserve

Though the U.S. banking system no doubt has the ability to push the growth rate up once again (given the $2.6+ trillion in reserves, most of which are excess reserves) the question is if it will and can. For now it looks like the banks will not create the necessary credit required to push the money supply growth up as bank credit growth has been falling since hitting the 8.4% peak in April.



Time will show, but the falling growth rate of both bank credit and the money supply is yet another warning sign that asset prices could take a turn for the worse. As for the real U.S.

economy, the damage has long since been done through a great reduction in both the rate of saving and investment (facilitated by inflationary policies). No amount of bank credit and money supply increases can turn this around.

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The Crank Report is written by
Atle Willems, CFA

The «Austrian» True Money Supply Table for the U.S.

As of 20 June 2015

"Austrian" True Money Supply for the U.S.

Year	Amount outstanding *	Yearly change	Annual Percentage Change	3 year % change **	5 year % change	7 year % change	10 year % change
1981	783		-2,2%				
1982	905	123	15,7%				
1983	1 221	316	34,9%				
1984	1 274	53	4,4%	17,7%			
1985	1 442	168	13,2%	16,8%			
1986	1 684	242	16,8%	11,3%	16,6%		
1987	1 690	5	0,3%	9,9%	13,3%		
1988	1 732	42	2,5%	6,3%	7,2%	12,0%	
1989	1 712	-19	-1,1%	0,6%	6,1%	9,5%	
1990	1 763	50	2,9%	1,4%	4,1%	5,4%	
1991	1 952	189	10,7%	4,1%	3,0%	6,3%	9,6%
1992	2 219	267	13,7%	9,0%	5,6%	6,3%	9,4%
1993	2 358	139	6,3%	10,2%	6,4%	4,9%	6,8%
1994	2 314	-44	-1,9%	5,8%	6,2%	4,6%	6,1%
1995	2 291	-23	-1,0%	1,1%	5,4%	4,1%	4,7%
1996	2 366	75	3,3%	0,1%	3,9%	4,7%	3,5%
1997	2 490	125	5,3%	2,5%	2,3%	5,1%	4,0%
1998	2 712	222	8,9%	5,8%	2,8%	4,8%	4,6%
1999	2 880	167	6,2%	6,8%	4,5%	3,8%	5,3%
2000	3 013	134	4,6%	6,6%	5,6%	3,6%	5,5%
2001	3 534	521	17,3%	9,2%	8,4%	6,2%	6,1%
2002	4 014	480	13,6%	11,7%	10,0%	8,3%	6,1%
2003	4 481	467	11,6%	14,1%	10,6%	9,6%	6,6%
2004	4 904	423	9,4%	11,5%	11,2%	10,2%	7,8%
2005	5 005	101	2,1%	7,6%	10,7%	9,1%	8,1%
2006	5 098	93	1,9%	4,4%	7,6%	8,5%	8,0%
2007	5 261	163	3,2%	2,4%	5,6%	8,3%	7,8%
2008	5 747	486	9,2%	4,7%	5,1%	7,2%	7,8%
2009	6 536	789	13,7%	8,6%	5,9%	7,2%	8,5%
2010	7 232	696	10,6%	11,2%	7,6%	7,1%	9,1%
2011	8 354	1 123	15,5%	13,3%	10,4%	7,9%	9,0%
2012	9 288	934	11,2%	12,4%	12,0%	9,2%	8,8%
2013	9 884	596	6,4%	11,0%	11,5%	9,9%	8,2%
2014	10 608	725	7,3%	8,3%	10,2%	10,5%	8,0%
YTD 2015	10 911	303	2,9%				
Average	**3 787**	**298**	**8,1%**	**7,9%**	**7,6%**	**7,2%**	**7,1%**
Median	**2 601**	**168**	**6,9%**	**8,3%**	**6,4%**	**7,2%**	**7,8%**
Max	**10 608**	**1 123**	**34,9%**	**17,7%**	**16,6%**	**12,0%**	**9,6%**
Min	**783**	**-44**	**-2,2%**	**0,1%**	**2,3%**	**3,6%**	**3,5%**
Number of ups/ % of total		**30**	**90,9%**				
Number of downs/% of total		**3**	**9,1%**				
Total		**33**	**100,0%**				

Notes:

The money supply applied in this report is the short version of the Austrian True Money Supply. It follows the full version accurately and consists of Currency, Total Checkable Deposits and Total Savings Deposits.

* Billions of US$ at year end

** The 3, 5, 7 and 10 year growth rates are on an annualised basis (geometric).

Source: EcPoFi, Federal Reserve

For more on the money supply, see the article:

"Introducing the Short Version of the "Austrian" True Money Supply (TMS)"

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