

Putting the Hayekian horse back before the Keynesian cart.

Attempting an Austrian-based macro-economic approach to the business cycle

By Sean Corrigan

Abstract

Mainstream economic analysis starts and often finishes with mutterings about what the 'consumer' will or will not do. This is unfortunate, since it not only perpetuates the hoary old errors of the 'Underconsumption school', it tends to mask developments in the areas which are really crucial to the system in general – and to commodity investors in particular – namely, the state of *business* expenditures and of their profitability. Here, we try to set out what exactly it is at which we should be looking and which of the available macro data can shed some light on the subject. Finally, we consider what they are telling us about the current situation and where the risks might lie.

The myth of the reluctant consumer

In the wake of the seizure suffered in the Chinese stock market late in February 2007, the newswires were soon abuzz with the fears being expressed that 'consumer confidence' would be shaken and that, therefore, Mrs. Li and Mr. Chan would immediately tighten their purse strings, setting in train a calamitous series of events which would see all manner of 'discretionary' spending evaporate, leaving the simmering cauldron of the world economy drained to the bottom.

Such is the hold of the absurd mantra that "the consumer is two-thirds of the economy" that the author was even asked, in all earnest, if he thought that this tremor would affect the price of wheat growing far away in the American Midwest. Just imagine worrying that men and women will only eat bread when their stock portfolios are in positive territory!

Despite the fact that the history of humanity is one of a precarious scrabble to fend off the effects of famine - not of a struggle to forestall the consequences of feast - implicit in such commonplace thinking is an unshakeable anxiety about the continued ability of the poor, hapless consumer to absorb sufficient of the prodigious bounty of modern industry at a rapid enough pace to forestall the emergence of a depression-inducing glut of unwanted products.

Showing there are few bounds to human self-delusion, such 'underconsumptionist' attitudes remain stubbornly persistent even among the very people most disposed to denying that industrial capitalism has anything at all to commend it: namely, those same gloomy Malthusians who never cease to harp on about how we are simultaneously about to exhaust the material endowment of the earth, or to exceed this vast planet's ability to deal with the puny gaseous effusions vented as we bipedal microbes go about our everyday lives.

To understand the virulence of this intellectual plague, we need to unpick a whole complex of intertwined half-truths, fallacies, and 'category errors'.

One obvious mistake lies in the fallacy of composition committed when one takes the single businessman's patent need to find a sufficient market for his produce and then conflates the difficulties which this individual may occasionally experience into the postulated emergence of a generalized, nationwide 'lack of effective demand'.

In particular, this supposed threat is held to be self-aggravating for, once we allow 'demand' to drop, it only requires a short leap of the fevered mind until we find ourselves subject to the irrational phobia expressed about the evils entrained by the all too rare phenomenon of generally falling prices.

Once evidence of this latter appears – even if it is the wholly benign result of an improvement in productivity, as in, say, the modern computer industry - the Chicken Littles are instantly off and running, shrieking that people who ordinarily cannot pass a pastry shop without stuffing a superfluity of trans-fats into their arteries will soon be outdoing Ghandi in their powers of heroic abstinence, all helplessly compelled to deny their present appetites because they might be able to shell out a good deal less, a week next Wednesday, when the coming 'deflation' has done its evil worst.

It never seems to occur to anyone that idea of postponing gratification is a decidedly atypical behaviour only displayed by the kind of profit-maximizing automata who populate the imaginings of mathematical economists. As such, it is actually at odds with the whole phenomenon of mortal man's inherent sense of time preference and with the fact of the positive natural interest rates which invariably result from this.

We might further point out that the suggestion of such a preternaturally rational forbearance is continually being contradicted by the premise upon which both the global fashion industry and the commercial flower market (especially near Valentine's or Mothers' Day) is based, or that it is repudiated by the scrums seen outside stores selling the latest must-have techno-toy upon its price-maximum launch.

A further refutation is to be had in the enduring effectiveness of the annual car model change or licence plate rollover ploy. Then again, the existential fact of consumer credit – running the cost and respectability gamut from Mastercard and Visa, via 'payday' and so-called 'predatory' lenders, to that extended by outright loan sharks - argues that people often feel almost *compelled* to pay more in total for immediacy than they would if they were patiently to save for the desired goods and services and acquired them at a later date.

To conclude, what must be the cardinal example of the real human impulse is to be found amid the orgy of the Christmas shopping season when dear little Tommy simply *must* be overindulged on the morning of the 25th and no other, notwithstanding the fact his dotting parents cannot avoid being bombarded as they shop with the insistent message that "January sales start Boxing Day!".

Crusoe was a profiteer!

The final facet of the ‘underconsumptionist’ puzzle is a throw back to the wholly discredited ‘labour theory of value’, as advanced by Smith¹ and Ricardo² and subsequently consecrated by Marx³.

Starting from this faulty premise, a chain of reasoning can be forged which seems to furnish proof that the poor, exploited worker – stripped of part of his just dues by that barely legal theft called ‘profit’ – cannot possibly therefore dispose of the means with which to take up all of the output to which his stalwart efforts have given rise (the black-hearted profiteer who employs him never, ever wishes to consume anything himself, of course, much less does he aspire to improving or expanding his stock of capital).

In passing, we would make far fewer mistakes in both economics and politics if we were to recognise that, far from being a morally dubious residual, profits are, in fact, the *fons et origo* of income and that the factor costs payable to hired labour (wages) are therefore merely a derivative of these⁴.

To grasp this, consider that Crusoe initially worked on his island in order to feed and clothe himself and himself alone: to the extent his efforts were successful, all his income was ‘profit’. Only later, when Friday finally turned up on an island homesteaded and provided with a stock of primitive capital goods by our shipwrecked hero, did our man Robinson realise he might achieve more if he could enlist the other man’s help by offering to sharing a fixed portion of his potentially-expanded returns with the newcomer.

It was this contractual deduction from Crusoe’s surplus, or profit, which took the form of Friday’s ‘wage’ – a recompense which was therefore a decidedly secondary, not a primary, source of income.

Be that as it may, in the 1920s, this hoary old doctrine of an inbuilt lack of ‘purchasing power’ was notoriously re-invigorated under the aegis of two Americans – Harvard graduate and college professor William T Foster and steel baron and Goldman, Sachs investment banker (comment superfluous) Waddill Catchings⁵. Showing a shrewd appreciation of the principles of marketing well beyond their rudimentary grasp of economics, this rather odd couple craftily publicised their rehashed thesis by offering a prize for anyone who could prove their theory wrong.

That this feat evaded most of those who entered the competition, speaks volumes about the state of English-speaking economic understanding (then *and* now?), but it was later refuted beyond all doubt by Hayek himself in his seminal ‘Paradox of Saving’⁶.

¹ <http://www.econlib.org/library/Smith/smWN.html>, Book I, Ch VI

² <http://www.econlib.org/library/Ricardo/ricP.html>

³ <http://www.econlib.org/library/YPDBooks/Marx/mrxCpA.html>

⁴ <http://www.mises.org/story/1729>

⁵ ‘The Road to Plenty’, Pollak Foundation for Economic Research, 1928

⁶ *Economica*, No. 32, May 1931

Fatally, however the efforts of these two worthies were of great practical import in that they were a source of inspiration for the malign interventionism practiced in turn by each of the “Great Engineer” Herbert Hoover and his much less principled successor in the White House, as well as by that other magnate-turned-mandarin, the inflationist Marriner S Eccles after whom the current Fed HQ is named and according to whose reforms the current US Fed is fashioned.⁷

As history shows, far from easing the crisis, the measures which resulted – in conjunction with a cascade of worldwide political blunders mostly committed on the basis of a similar reasoning being practised elsewhere – only served to prevent an early liquidation of the boom of the Roaring Twenties and so turned the 1930s into that dark decade in which was incubated such a sorry harvest of future woe.

Minus the bleak global backdrop, the present generation has, of course, been offered its own, salutary lesson about the detrimental effects of a state suppression of the free markets attempts to purge itself of an inflationary poison in the shape of Japan’s fifteen year sojourn in its own, self-inflicted slough of despond formed after its 1980’s bubble burst.

Indeed, a reinforcement of the lesson may yet be delivered regarding the superficially more successful attempt to camouflage the fallout from the late 1990’s Tech & Telecom mania and the arguably unprecedented orgy of speculation which the requisite easy money policies soon ignited across the globe, in its wake.

But if Foster and Catchings – or if England’s ‘Major’ Douglas⁸ - were the minor prophets of this cult, the Moses to whom the false god of underconsumption owes most of his multitudinous adherents is, of course, our old friend Keynes and his ‘General Theory’ is nothing less than its Torah.

And hereby hangs another tangled web of confusion, for when he came down from his own inflationist Mount Sinai, Keynes had scribbled on his tablets of law, not the Ten Commandments, but the series of tautologous equations of the form $Y = C + I$, or ‘aggregate income equals consumption plus investment’.

Once such formulations became enshrined in the statistics compiled by the likes of Simon Kuznets⁹ – who was acting in the service of *dirigiste* central planning (firstly in order to help guide the commissars of the New Deal and later to assist control of the wartime command economy) – the blindly aggregate approach which they engendered could hardly fail to blinker economic reasoning thereafter.

Thus, the Keynesian of the cart of consumption has been harnessed before the Hayekian horse of production for the past three-score-years-and-ten, to the detriment of all for, if it is true – as Edwin Canaan famously argued¹⁰ it was – that a solid understanding of economics

⁷ America’s Great Depression, Murray N. Rothbard, 5th ed, Mises Institute 2005

⁸ *Social Credit*, 1924

⁹ <http://www.bea.gov/scb/pdf/beawide/2000/0100od.pdf>

¹⁰ <http://www.econjournalwatch.org/pdf/CanaanCharacterIssuesJanuary2007.pdf>

benefits the *politician*, rather than the businessman, what hope of sound policy can there be when the former finds himself shaping it when mired in a morass of underconsumptionist mental error and so despises thrift and condemns profit?

Double-entry, not double-counting

Here, at last, we come to the half-truth hidden in the familiar cliché, for the data with which we are so familiar are compiled, *à la Maynard*, in such a fashion that consumption is indeed 60% of the aggregate – if only because the supposedly *gross* product in fact nets out the literally trillions of dollars of intermediate goods and services which are essential to the continued satisfaction of human needs and in whose delivery the majority of the population earn their own daily bread.

But being 60% of this artificial and inconsistent construct is *not* the same as being 60% of all significant economic activity: the model is not the market and the map is not the territory.

This is because the GDP system only measures the bread in the baker's shop and compacts all remaining economic value into its sale alone, arguing that it would be an exercise in 'double-counting' to take any notice of the contribution of the wholesaler, the miller, the farmer, the seed merchant, the tractor maker, and the fertilizer manufacturer – not to mention that of all those who make the tools and construct the buildings upon which each of these relies, in his turn; or upon those who mine the ore and drill for the energy needed for *their* production (as well as for the fabrication of the equipment the resource extractors themselves require).¹¹

If we stop to think about it for a moment, we must see this represents a gross oversimplification of the world about us - and a dangerously deceptive one, to boot: for this is akin to saying that we need not pay any attention to the efficacy, the timeliness, the viability, or the reproducibility of any of the steps along a complicated auto assembly line, just so long as we take note of the man giving the finished vehicle its final coat of polish before it is loaded on to the waiting transporter, ready to be shipped off to the dealership.

In fact, if any of the preceding stages goes awry – because men or materials are unexpectedly not available, because the production schedules have been miscalculated, because specification or quality control errors have crept in – or if the engineering solution adopted turns out to be more wasteful or more cumbersome than had been presumed *or, above all, if the costs associated with a certain step suddenly change for the worse* – the car will either not be produced at all, will arrive too late, will be worryingly sub-standard, or will involve its producer in a financial loss.

Taking this to the next step, if we now break the assembly line up into its constituent parts and spin these off – if we 'outsource' them - so that they each take place in proprietarily distinct companies (in some sense, this is analogous to the way our complex modern economy actually does function), we can now see that not only are the intermediate stages

¹¹ <http://www.capitalism.net/articles/Reisman%20AJES%20Article--AJES.pdf>

operationally critical, but that each must pay its way (over both the short and intermediate horizons) if capital is to be maintained and the flow of goods uninterrupted.

Furthermore, the proportionate and punctual completion of each of the intervening stages is not a matter of dull, immutable routine. Instead, it requires the wholly volitional – and thus highly uncertain - participation of an entrepreneur to accomplish the task.

It is not beyond possibility that one of these entrepreneurs does indeed happen to decide that he would rather be doing something else. Perhaps he has spotted a better opportunity somewhere else; perhaps he has been squeezed out of his current niche after a period of poor returns; perhaps he wants to indulge himself and buy a Maserati with his receipts, rather than a new machine tool; or perhaps he's long since made his pile and now just wants to retire to go game fishing.

Under any of these circumstances, the subsequent appearance of our finished car can in no way be taken for granted, no matter how insistently the final customer may demand it. One can indeed extend the argument that consumer demand for goods in general – if not for this one good in particular - can actually *increase* the likelihood that our entrepreneur might shift the focus of his attention into producing these other items instead and so excess end demand can even act as a drag on higher order production (both because effort has been physically diverted and because the alternative use has raised co-factor prices).

As a metaphor for this, imagine the brewer suddenly finding he faces severe labour retention problems because his workers keep quitting to open their own bars, where they feel will be paid better for serving his beer than for making it. Taking a more concrete example, consider that present plans to build oil refineries and LNG plants are being stymied by costs associated with high metals prices which are, in turn, rising partly as a result of the increase in the volume of house-building and auto production taking place across much of the world outside the United States.

The primacy of production

So, with all that in mind, we would be very much better off were we to start our macro analysis from the opposite end to the mainstream, making use of the following pair of what should be fairly unobjectionable assumptions, namely that:

- (a) for as long as they have an income, people will spend it (or that, saving it, they will temporarily transfer the spending power to someone else);
- (b) for as long as there are businesses who see the chance to make a return on invested capital, they will supply people not just with the goods they wish to buy, but also with the income which they require to pay for them.

From this follows the corollary that any episode of cyclical instability we may suffer – the overwhelming majority of which are engendered by the vagaries of the credit cycle, or by other forms of political disruption – will start with a diminution of business outlays as the widespread entrepreneurial error, fostered by mispriced financial capital and over easy money in the boom, begins to be revealed.

In Hayek's own words¹²:

“It is the decline in investment (or in the production of producers' goods) and not the impossibility of selling consumers' goods at remunerative prices, which characterizes the beginning of the slump. Indeed, it is the experience of all depressions... that the sales of consumption goods are maintained until long after the crisis; industries making consumption goods are the only ones which are prosperous and even able to absorb, and return profits on, new capital during the depression. The decrease in consumption comes only as a result of unemployment in the heavy industries, and, since it was the increased demand for the products of the industries making goods for consumption which made the production of investment goods unprofitable, by driving up the prices of the factors of production, it is only by such a decline that equilibrium can be restored.”

Furthermore, we may presume that the first thing the individual business will restrict is its discretionary, below-the-line outlays on new equipment; that it will then be tempted to dip into its depreciation reserves to keep afloat; that next it will economise on re-orders of inventory and, finally, that it will begin to mothball plants and lay off workers.

Incidentally, at any stage along this path, the struggling firm may try to bridge any gap in its cash flow by seeking to borrow money – on whatever terms it can – and thus tend to put upward pressure on short-term interest rates, unless the credit system is still so enthused with its own hocus-pocus that it is happy to extend yet more loans.

Hayek dealt with the first phenomenon in his paper “Investment that raises the demand for capital”¹³ (and thus gave a deductive, rather than an empty empirical explanation of the signalling ability of a negative yield curve), but even Hayek had not run across the ‘credit amnesia’ of almost indiscriminate lending to which the current institutional constellation of hedge funds, investment bank activity, and derivative innovation has given rise, helping to inhibit the appearance of such tensions and so to postpone the crisis.

An additional feature of the argument is that the pain will typically tend to be focused most intensely among higher-order (capital) goods manufacturers, since these are the most specialized, having the least flexible stock of physical capital (which therefore has fewer alternative outlets for its products), and because the orders given them by their customers are the most readily postponable of all outlays.

It is only subsequently, as overtime is restricted, short-term work enforced, and the incidence of redundancies spreads that wage and salary incomes fall and so consumer industries begin to suffer, too.

Here we should add the caveat that the above schema describes the archetypal, business-led expansion which is centred on the undertaking of too many misconceived investments, of too long a duration of payback, and with what are intrinsically precarious economics since it

¹² <http://www.mises.org/story/2474>

¹³ <http://www.mises.org/etexts/investmentraises.pdf>

is only the particular credit regime which enables them to take place even though they are in open conflict with voluntarily expressed consumer preferences for saving vis-à-vis current expenditure.

If, however, a monetary stimulus of sufficient magnitude has been directed at some other sector, then the resulting hypertrophy will be more localised, though just as dependent on continuous hits to sustain its highs.

So, withdraw the dope and a severe spell of cold turkey will be the inescapable result, as in the US housing market – and its ancillary lifestyle industries – today; as also, for example, in the military-industrial complex in the early 1990s; and as will inevitably result if and when the Chinese authorities ever cease their quasi-Schachtian support of their favoured industries and force them instead to live in the cold, but ultimately invigorating climate of free market pricing and genuine capital accounting.

The search for a better yardstick

So much for the theory, but the question we must now address is that of whether we can put some numbers to all of this and, indeed, whether we can begin to fashion a better gauge of what is afoot than is afforded us by the likes of the GDP numbers which, as we have tried to persuade you, conceal as much as they reveal.

As we will see below, the answer is a qualified “yes” (qualified because no aggregate measure can ever be more than suggestive of the intricate dynamics at work in the 21st century economy, anymore than we can make a detailed and accurate assessment of the health of a population simply through knowing its members average height, weight, and age).

The first place to start is to try to move beyond the GDP numbers and here we have the benefit of the Input-Output accounts, also compiled by the BEA (ironically, also by another central planning fanatic from Russia, this time Wassily Leontief). The beauty of these latter is that they attempt to set out a matrix of expenditure flows between broad economic sectors *without* the cross-cancelling which is practiced in the calculation of the former series.

If we perform a little indirect manipulation on the I-O data, we can derive an estimate of total business spending by making use of the Professor George Reisman’s insight¹⁴ (extended by Richard Johnsson¹⁵) that the total resources available in a given period must equal total domestic production of both finished and intermediate goods, together with those which have been imported, these resources being used variously to add to stocks, as inputs to further processing, and for building new capital goods, furnishing exports, and serving as means for final consumption.

¹⁴ http://www.capitalism.net/Capitalism/CAPITALISM_Internet.pdf

¹⁵ <http://www.mises.org/journals/scholar/Johnsson2.pdf>

If we then deduct profits and depreciation from the total – for both corporate and non-corporate enterprises – we have an estimate of total above-the-line expenditures made in a given period, while adding back reported net additions to inventories and gross fixed investment furnishes us with one for below-the-line outlays in turn.

Hence we have at last a handle on total business revenues or conversely - realising that one man’s income is another man’s outgo - for total business expenditures.¹⁶

To provide a concrete example of this, estimates for 2005 (the latest year for which full figures are available) show that while nominal GDP was around \$12.5 trillion – 70% of that, as per the cliché, being comprised of personal consumption expenditures – in comparison, Gross Domestic Output (GDO) was approximately \$22.9 trillion, while imports amounted to close to \$2 trillion, meaning that total resources were of the order of \$24.9 trillion.

Subtracting profits plus depreciation of \$2.1 trillion to give us above-the-line costs, then adding back investment totalling \$1.3 trillion, we arrive at a final figure of just over \$24 trillion for total business expenditures – a number no less than 2 ¾ times that of the final consumption outlays on which so much attention is normally directed!

US annual expenditures, blns

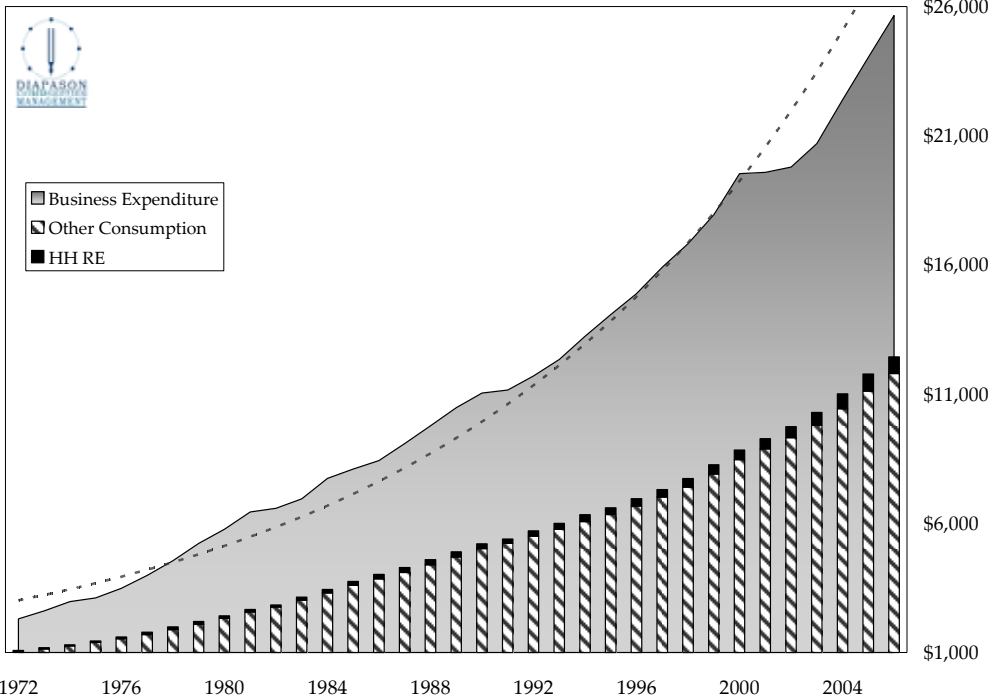


Figure 1: US productive & exhaustive expenditures ('Other' equals PCE+Govt)

¹⁶ A further cross-check can be made with aggregate figures available on the IRS website for above-the-line items. A close correspondence (r-squared = 0.996) is observed.

If we compare figures across the last thirty-five years, we find (as per the following table) that, as we would expect, not only are annual business outlays far greater in magnitude, but also that they are far more variable than those made by consumers.

1973-2005	Nominal (blns)			Real (using PCE deflator)		
	Business Outlays	PCE	Ratio	Business Outlays	PCE	Ratio
dYOY						
Mean	\$657.8	\$241.6	2.72	\$283.1	\$111.0	2.55
Sigma	\$416.0	\$113.5	3.67	\$290.8	\$61.1	4.76
CoefVar	0.63	0.47	1.35	1.03	0.55	1.87
Hirst	3.97	3.39	1.17	3.64	3.53	1.03
Volatility	3.70	2.21	1.67	2.94	1.58	1.86
Sharpe	1.75	3.03	0.58	1.03	2.13	0.49

Table 1: US expenditure characteristics

In fact, using the quarterly 'Financial Statements Statistics of Corporations by Industries', compiled by the Ministry of Finance, we can perform a similar exercise (with much less work, to boot!) for Japan.

Japanese company expenditures v end consumption, Y blns, saar

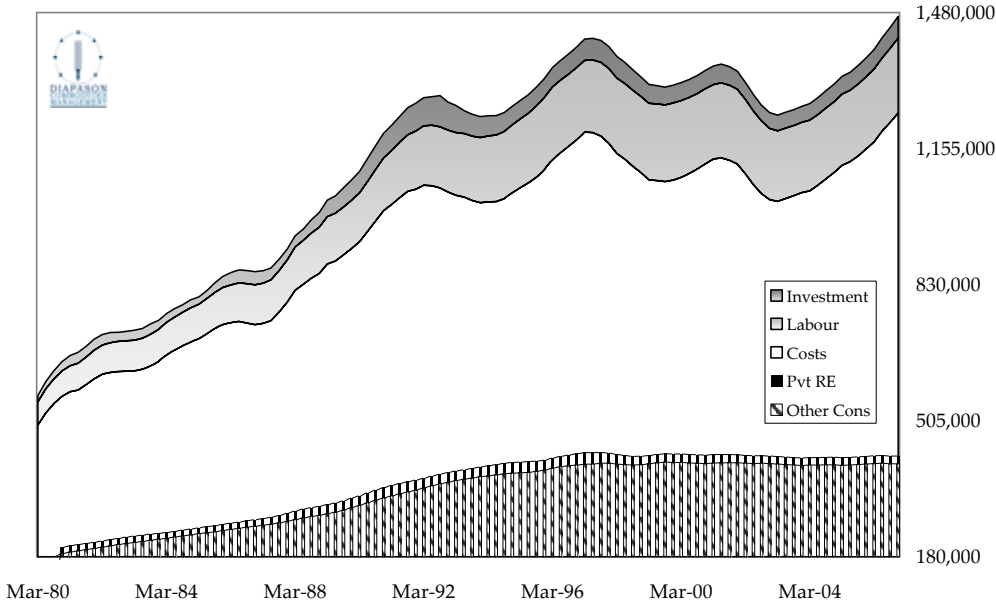


Figure 2: Japanese productive & exhaustive expenditures ('Other' equals PCE+Govt)

Here, too, we find that, for 2006, total corporate business expenditures came to ¥1,475 trillion while the sum of personal consumption, residential real estate investment, and government outlays were only just above a three-tenths of the size at approximately ¥420 trillion. Confirming the US observations, we also see that Japanese productive outlays are also much more inconstant than are their exhaustive counterparts.

1957-2006	Nominal (yen, blns)						
	Business Outlays				PCE	Ratio	
dYOY	Labour	Other Costs	Investment	Total			
Mean	14,075.9	96,119.3	3,693.3	113,888.5	23,419.6	4.86	
Sigma	15,645.7	140,994.2	25,009.9	162,899.1	18,858.4	8.64	
CoefVar	1.1	1.5	6.8	1.4	0.8	1.78	
Hirst	5.8	5.4	5.9	5.3	4.2	1.27	

Table 2: Japanese expenditure characteristics

In summary, it should no longer be a matter of controversy that, given both the theory that productive expenditures enjoy primacy over consumptive/exhaustive ones *and* this empirical corroboration that they do, indeed, fluctuate far more violently, if we are to be effective in our attempts to gauge the status of the economy, we should monitor the former, rather than the latter.

As a case in point, a glance at the late Tech-Telecom bust shows that, far from being a 'mild' recession (as the standard, GDP-based analysis suggests), in terms of business activity, 2001 witnessed the most severe collapse suffered in at least three decades, whether measured in terms of the absolute decline in either nominal or real expenditures; as the percentage deceleration (the second difference) from the preceding year's result; or as the start of the only two-year consecutive period of contraction seen in the record.

Change in Median CPI-deflated US expenditures (% yoy)

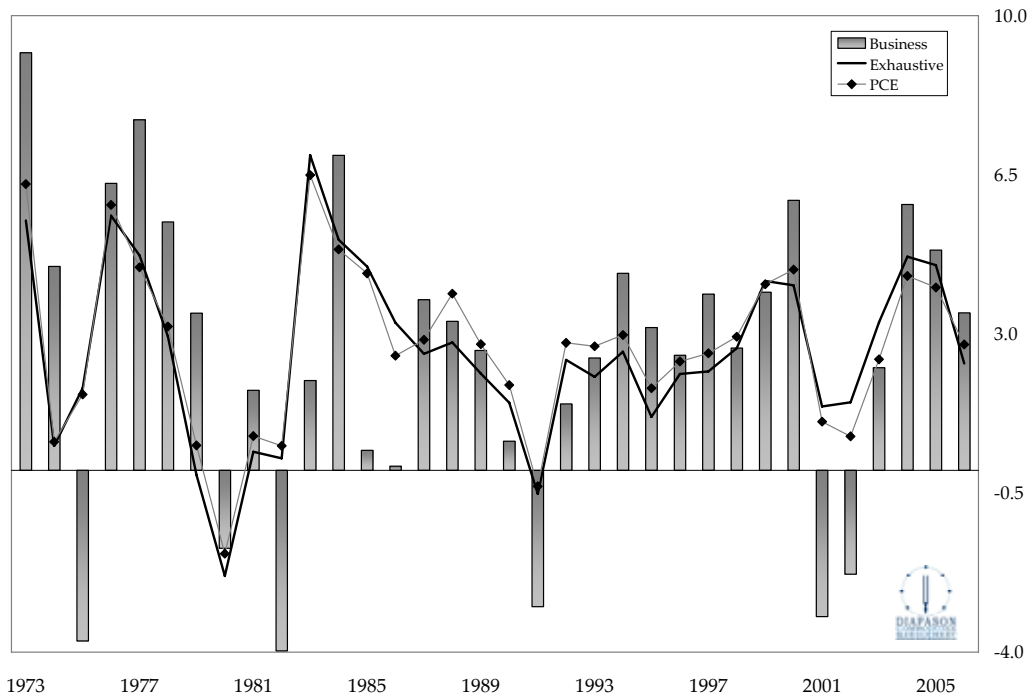


Figure 3: Change in US expenditures (yoy%)

The discrepancy between this and the GDP numbers are not too hard to find – they lie in the enormous sale of fiscal and monetary stimulus which was brought to bear to offset this, giving rein to the full doctrine of ‘driving a fire engine the wrong way own a one-way street’ (as Bob Woodward¹⁷ termed the unconstitutional approach to any systemic crisis adopted under Alan Greenspan’s chairmanship) and of enacting the ‘lessons’ the Fed thought it had learned from its study of both the 1990s BOJ and the 1930s Fed .

Far from congratulating the authorities for their wise paternalism, however, it should be realized that – like all such attempts to forestall the consequences of economic folly – this display of Militant Keynesianism only served to disguise and displace the consequences of the previous boom, it did not nullify them in any permanent sense whatsoever.

The most obvious sign that we have belatedly been presented with some of the bill for this stay of execution comes in the shape of the sizeable retrenchment taking place in a housing sector which was one of the main outlets for the contracyclical stimulus it required.

Here, accompanied by a hypocritical display of *post officio* caution on the part of the man directly responsible for the problem, a genuine and wholesale destruction of capital is being revealed both to homeowners and to those holding securities against the collateral of their property.

As a rough sense of the scale of this, consider that the transaction-weighted decline in the average price of both new and existing homes has amounted to just over 6% since last

¹⁷ *Maestro : Greenspan’s Fed and the American Boom*, Bob Woodward, 2001

summer, theoretically implying a \$1.2 trillion notional pullback in aggregate housing stock values, to be added to the loss associated with the one-third fall in principal value endured by some of the lower ABX indices of mortgage-related bonds, as well as the recent decline in equity values this has helped trigger.

Even this does not give the full reckoning, for if Austrian School reasoning tells us anything, it is that the losses are actually incurred during the boom itself, as a result of the widespread distortion of entrepreneurial calculation and of the tsunami of rash and insupportable investments to which persistently overeasiness credit inevitably gives rise.

I can't wait to find out!

To return to our main theme, the next problem we face is that though they may provide a superior measure to GDP, the I-O numbers are only compiled with a lag of around eighteen months, a delay which condemns them to fall far short of having anything other than academic significance.

Fortunately, the means do exist for us to reduce the waiting time on this greatly, as long as we are prepared to work with less comprehensive numbers. If we regard this as a reasonable trade off – and we shall see that the results turn out to justify this assumption tolerably well – we can avail ourselves of the more timely data relating to corporate expenditures, and so cut the gap to a more reasonable four months.

Indeed, using both the BEA report on corporate profits and the Federal Reserve's Flow-of-Funds version – deriving an estimate of gross inventory spending from a combination of the former's net flow data and the latter's valuation-adjustment and balance sheet stock data – we can construct a Corporate Spending Index, or CSI, an estimate whose year-to-year nominal changes enjoy an impressive r -squared of 0.94 with our overall aggregate we have previously distilled from the GDO numbers.

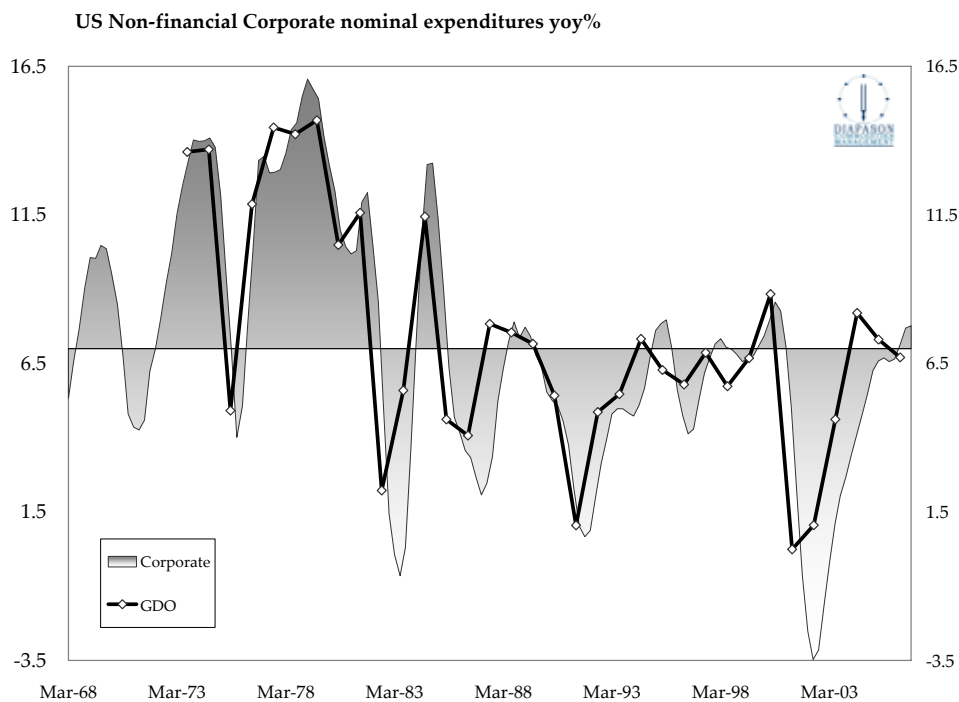


Figure 4: US corporate expenditures (CSI) versus GDO-derived business outlays (yoy%)

Taking this a further step, we can attempt to construct a third series, based on *monthly* statistics, again by accepting a little more noise in exchange for punctuality and, in this way, we can try to reduce the knowledge gap to around six weeks.

To do this, we notice that, according to our manipulation of the corporate data, for every \$100 spent on factors of production over the past decade (rather than on taxes or as a return on capital), \$62.50 dollars are typically paid out to the labour force; \$14 takes the form of fixed investment spending (split 70:30 between equipment & software and structures); around 70¢ represents *net* inventory changes; and the balance can be ascribed to the replacement of existing stock.

Of the accessible monthly series which related to these, three of those published by the Census Bureau fit the bill: namely, that for total manufacturing shipments (less those of consumer goods) – which provides a fair approximation to corporate plant and equipment investment; the private non-residential construction spending figure which mirrors the structures investment component; and the sum of inventories reported at each of the manufacturing, wholesale, and retail levels which provides a close match for overall net inventory changes.

Adding to this the monthly figure for wages and salaries earned at private businesses from the BEA - then weighting the collection by the percentages laid out above - and we now have our own Business Spending Index, or BSI (which we can also deflate to make some

allowance, however imperfect, for changes emanating from the money side using, e.g., the Cleveland Fed’s Median CPI number).

At length, what we are left with - over what is admittedly a much shorter sample which starts only in 1992 - we find we are left with a still useful r-squared of 0.88 with our quarterly CSI measure, as well as with a pleasingly respectable r-squared of 0.68 with our original annual GDO series.

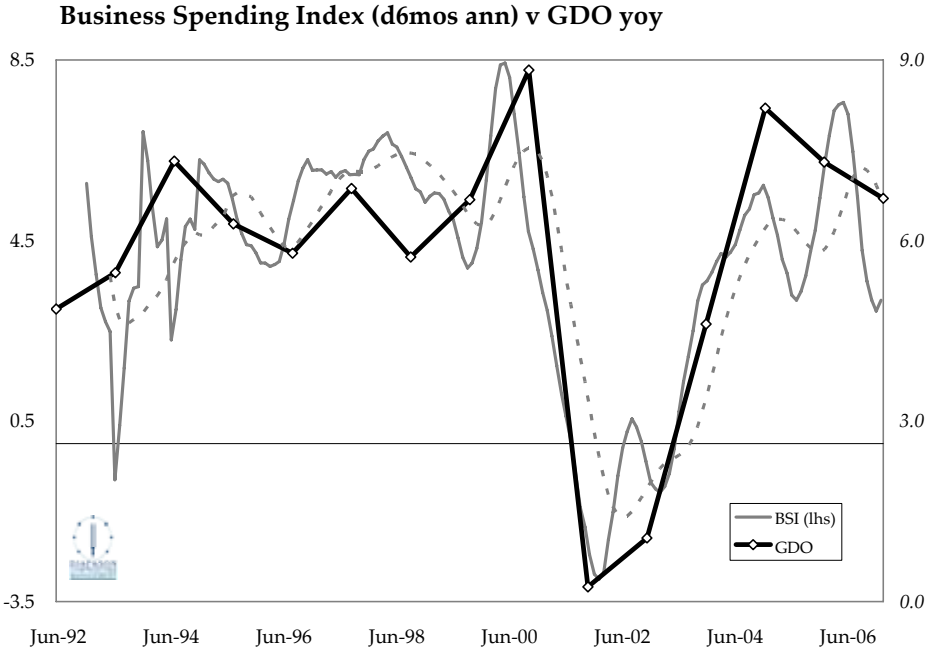


Figure 5: US GDO-derived outlays versus BSI monthly index (shown with 12 month moving average)

As a final crosscheck – one which suggests a further avenue for research, since we only have recent, partial figures currently at our disposal – we can loosely compare the magnitude of changes with those reported by the financial newswires for revenues of the S&P500 population, *in toto*. Though not shown here, changes recorded over the past few years have indeed been roughly consonant with one another

As the accompanying graphs show, the undeniable facts are that, having last summer attained a level only bested by that of the 2000 peak, business spending has slowed appreciably since that time - *though not yet to levels which have typified recessions* - and, moreover, there have been tentative signs in the latest readings that the drop may have begun to stabilize last month, before the present turmoil erupted.

Real Business Spending Index (d6mos ann)

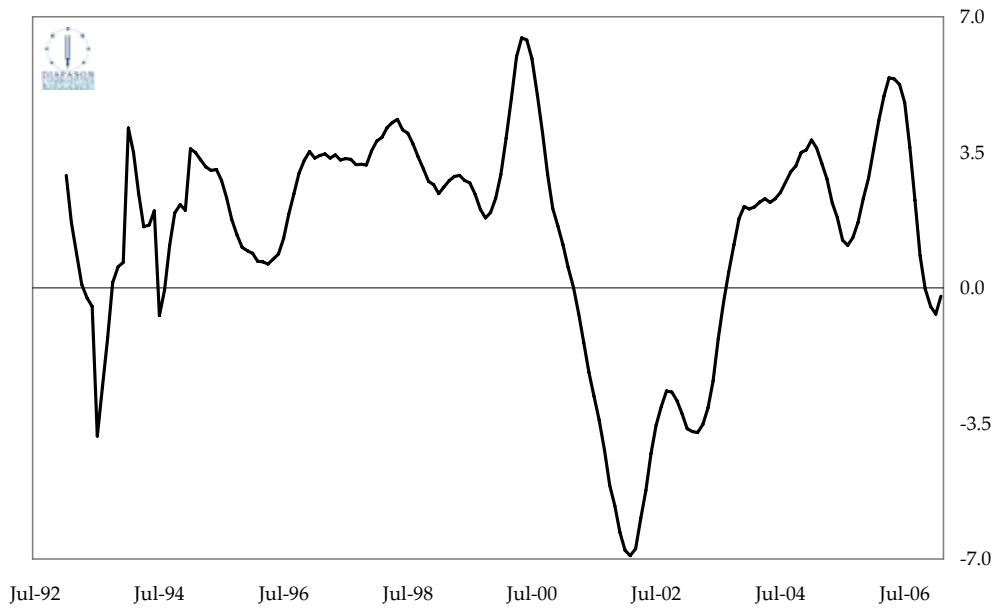


Figure 6: Median CPI-deflated BSI

One final observation of relevance is that, in general terms, each of these indices shows a good deal of co-movement with commodity prices – as measured, for example, by the continuous CRB index – though, equally, the fact that such prices are not wholly determined by factors at play in the US also shows up in the divergence evident during the period of the Asian Contagion when the prostration of the Tiger economies more than overpowered what was only a mild deceleration Stateside.

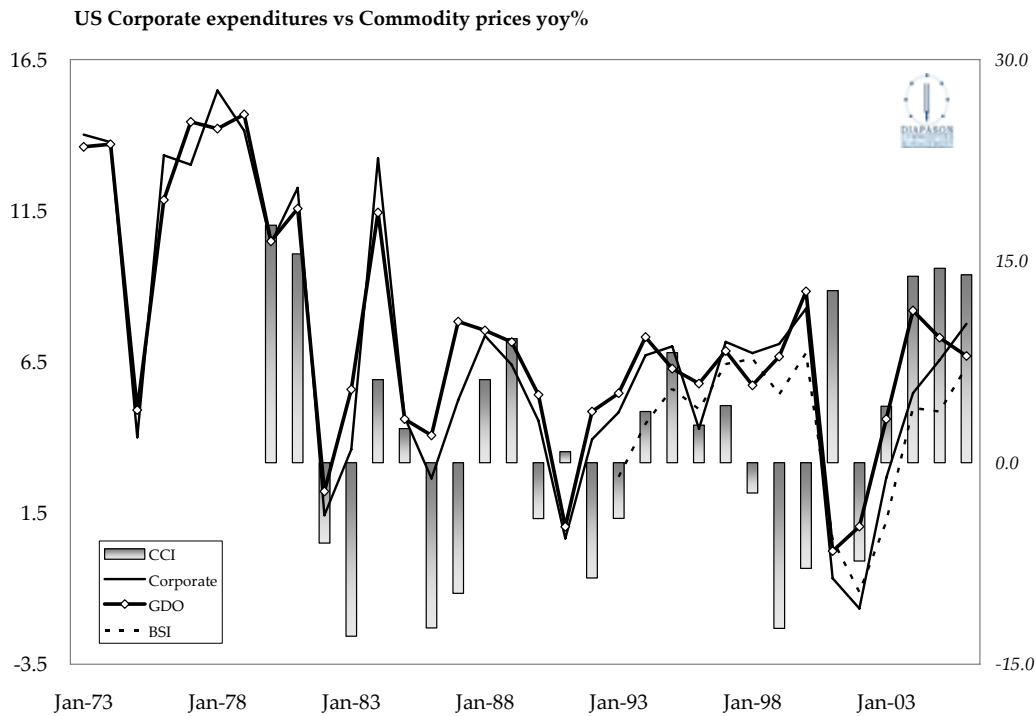


Figure 7: US Business outlays v the CCI commodity price index

Reading the runes

But if all of this tells us better where we are, we still need to think about what may drive our indicator further ahead, or potentially divert it from its present course.

Though there is an element of chicken and egg in trying to analyse a dynamic system by means of static, aggregate measurements, we *can* say that if sales seem to be holding up – especially where a good portion of these are being generated by meeting customers’ investment needs (since these are not then subtracted as a current cost from *their* earnings totals) – overall profits have a chance of doing likewise. Similarly, if strong profits are being generated in relation to the incurrence of associated labour costs, employment levels will probably be maintained or expanded.

In each case the latest *quarterly* data were still supportive, even though the housing slump showed up clearly, too.

In fact, last year, the rolling 4-quarter increase in gross fixed capital expenditures at non-financial corporates was 14.6%, its fastest nominal pace since 1998, while the gain in the net figure (with *and* without adjustments for price changes) was the best since the mid-80s. Moreover, a comparison of the renormalized trajectory from the trough of the real, net outlay with that of the previous two long-lasting US expansions of the mid-60s and the 1990s shows a distinct resemblance in all three cases.

US Real Net corporate investment recoveries & real S&P500 (quarters from trough)

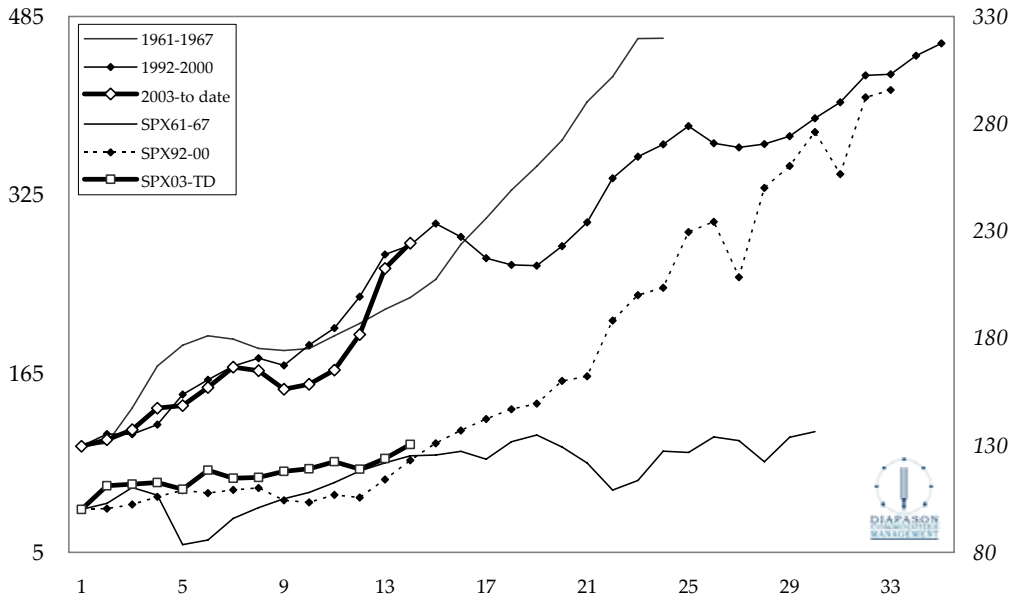


Figure 8: US Capital spending (lhs, rebased) and the stock market (rhs, ditto)

As for job prospects, the money disbursed by non-financial corporates to its workers as a percentage of net value-added, while having ticked up in QIV, was still at levels only matched once before in the past three-and-a-half decades.

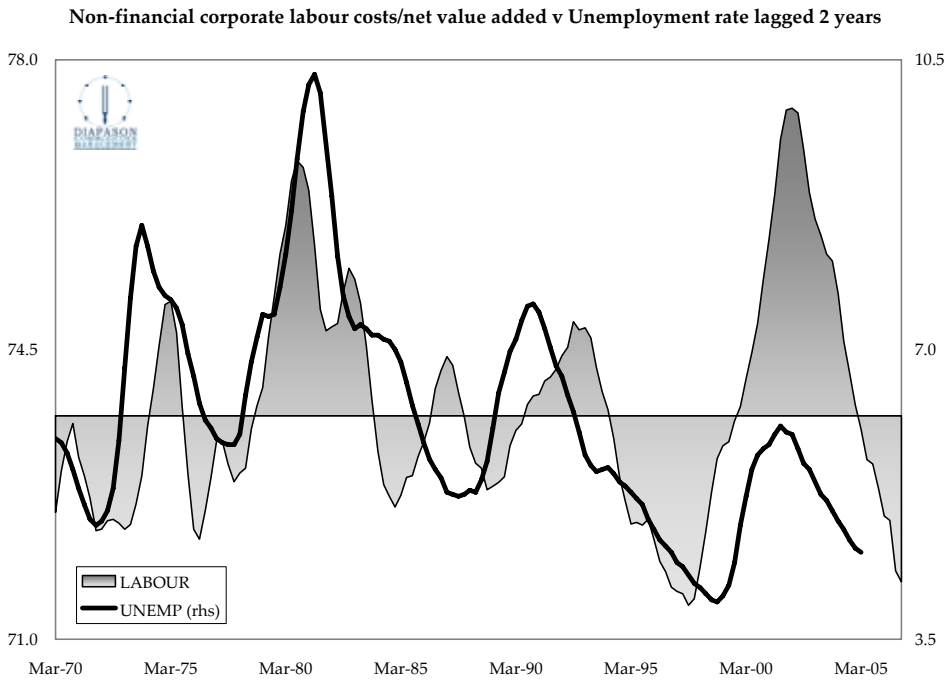


Figure 9: US Labour – costs and benefits

Thus far, the story has been supportive of the tale of sectoral rebalancing which we have propounded this past year. Add to this a 10% price rebound from the lows, coupled with indications of strengthened demand, for what we have elsewhere described as today's main Keynesian injection mechanism – namely, energy¹⁸ – and we could have been looking ahead with some confidence to a renewal of the upward trend in both industrial activity and commodity prices sometime later this year.

It is clear however, that just as the real world cannot fail to have an impact – however peripheral it may sometimes appear to be – on the financial world, so there are profound linkages running the other way, as is inherent in the whole Austrian conception of the business cycle as a manifestation of the credit cycle.

Thus, we cannot fail to be aware that the same monetary accelerant whose application and subsequent cessation has had such disastrous consequences for the US housing market is more than likely to have infected a whole range of entrepreneurial decision making outside that narrow sphere. Thus, if falling asset prices and the growing losses being booked by lenders provoke a more widespread tightening of credit and/or a reduction in its availability, past malinvestments will be uncovered in hitherto unsuspected areas and the rot may well spread sufficiently to cause the whole superstructure to crumble.

In this context, we are so far comforted by evidence that our sweep-adjusted Austrian Money Supply measure (based loosely on Charles Hatch's insights¹⁹) has turned up smartly from its September lows; that the traditional US monetary aggregates have been accelerating in recent weeks (both M2 and our regression-extrapolated M3 aggregate); that, within this, specifically commercial and industrial loan growth has picked up after an autumn lull; that the latest monthly NFIB survey of small business was sanguine as to credit conditions; and that the increase to date in the quality spreads, as well as those seen in both real and nominal yields, of BAA industrial bonds have been fairly well contained, keeping them each below their average values of recent years.

¹⁸ The idea here, in short, is that with >90% of oil reserves under state control and with most major oil exporters either having currencies pegged to the US dollar, or utilizing 'stabilization' funds with which to absorb receipts, dollars borrowed to pay for oil are rapidly recycled via a Rueffian 'childish game of marbles'

¹⁹ <http://www.mises.org/journals/scholar/hatch.pdf>

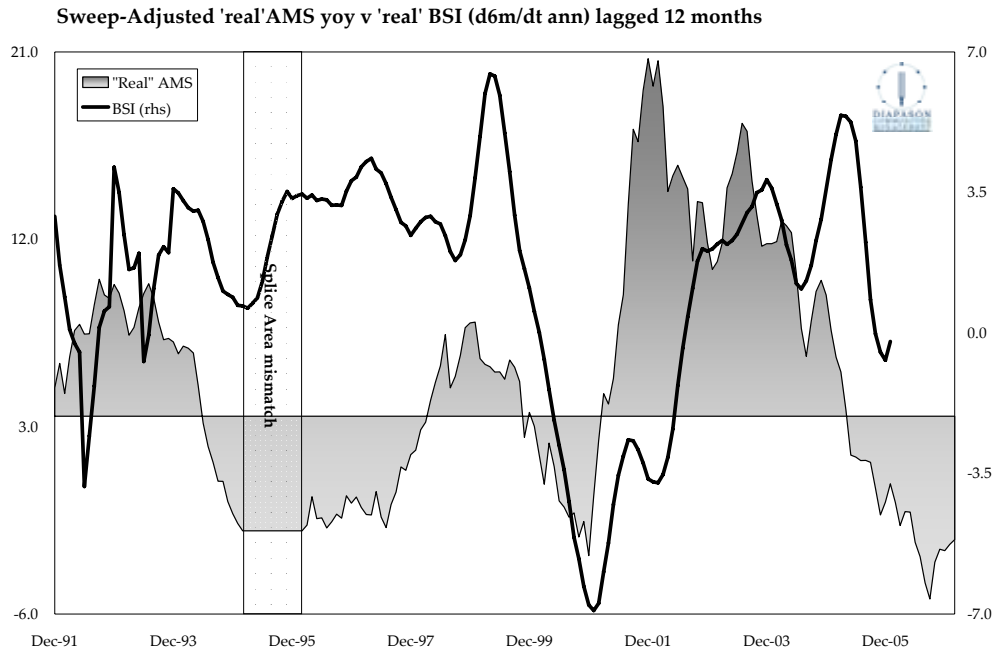


Figure 10: AMS v BSI, Median CPI- deflated

The question we ultimately have to face then is this: if the real world may be faring better than it appears – once we examine it from its proper perspective - does the converse apply to the financial system?

If the answer to that is, “yes”, then we have to be prepared to accept that in a world which disports such an over-developed, over-leveraged financial system as ours, the monetary tail can not only sometimes wag the dog, but that if it begins to whip around too violently, it may occasionally happen that it snaps the poor beast’s spine completely in two.

Cave canem, indeed!

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