Gold Digest

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The Revenge of Reality

With the recent meltdown in stock prices, some economists have said that there is n need to be concerned because the stock market does not reflect what is happening to the economy. (Curiously enough, when the stock market was going up, it was held by most experts to be the leading indicator of a strong economy.)

However, the stock market doesn't have a life of its own. The prices of stocks mirror individuals' assessments regarding the facts of reality. Obviously, these assessments of facts do not cause economic growth and cannot cause either economic prosperity nor recessions as suggested by popular thinking.

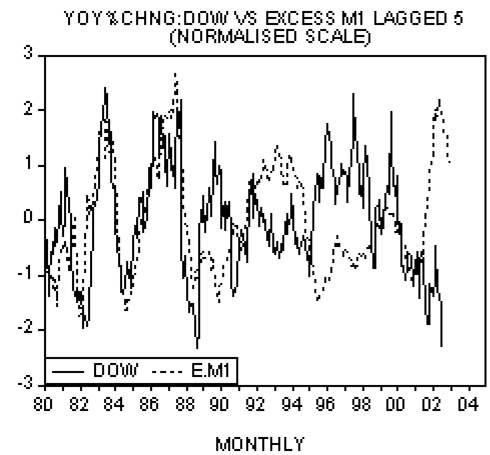
As a result of central bank monetary intervention, however, these assessments tend to be erroneous. But once the rate of money supply slows down, individuals can see much more clearly what the facts of reality are and can scale down previously erroneous evaluations.

Observe however, that while individuals can change their evaluations of the facts, they cannot alter existing facts--i.e., the facts that influence the future course of events.

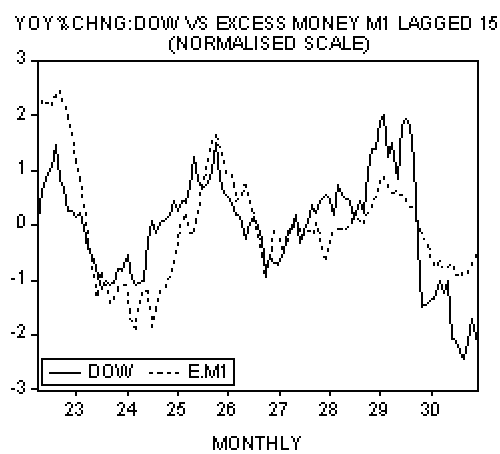
According to Mises,

> "Stock speculation cannot undo past action and cannot change anything with regard to the limited convertibility of capital goods in existence. What it can do is to prevent additional investment in branches and enterprises in which, according to the opinion of the speculators, it would be misplaced." (*Human Action*, pp. 517-518)

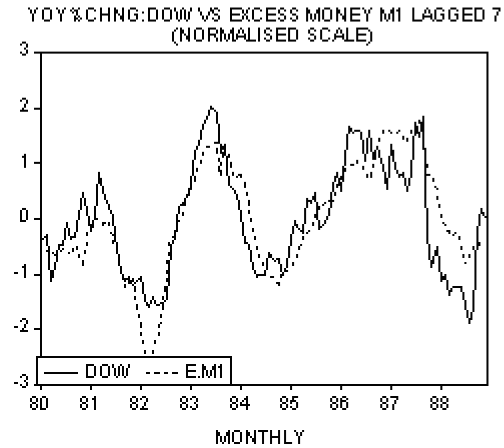
Again, a fall in stock prices doesn't lower real wealth; it only reflects the adjustment o investors' evaluations regarding the facts of reality. Furthermore, neither corporate scandals nor corporate failures are the main causes of the current stock market turbulence; these are just the symptoms of the disease brought about by the loose monetary policy of the central bank. A fall in the rate of growth of money M1 adjusted for sweeps and nominal economic activity, i.e., excess money M1 points to more difficulties ahead for stocks (see chart).



In this regard, history provides us with an important reminder. The excess money M1 rate of growth accurately captured the October 1929 stock market crash.



It also accurately captured the October 1987 stock market crash.

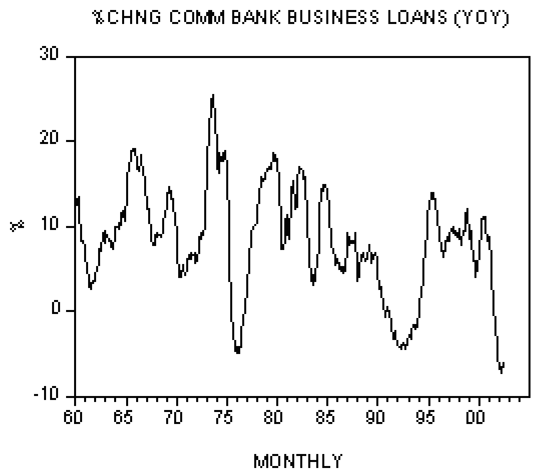


It seems that the current strength of economic indicators has convinced most experts that there is no need to fear a recession and that the stock market may be sending false alarms. But the issue of recessions as such is not about an economy's strength nor about people's psychology, nor about the strength of the stock market. (As was shown above, the stock market only *evaluates* the facts of reality.) It is about business activities that sprang up on the back of loose monetary policies conducted by the central bank in the latter half of the 1990s.

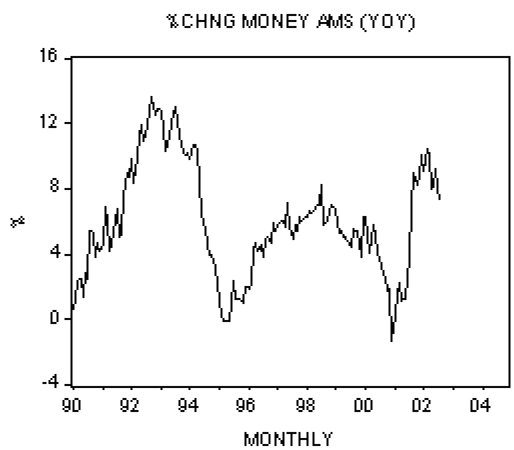
Whenever a central bank loosens its monetary stance, it sets in motion an economic boom by means of diverting real funding from wealth-generating activities toward various false activities that a free, unhampered market would not facilitate otherwise. When monetary pumping slows, this also slows down or puts to an end the diversion of funding toward false activities, and that, in turn, undermines their existence. In short, the trigger to boom-bust cycles is central bank monetary policies.

The severity of a recession is dictated by the intensity of the previous boom that was brought about by monetary pumping and the associated artificial lowering of interest rates--i.e., by the percentage of "false activities" relative to total activities. The larger this percentage is, the more severe the recession will be, since more liquidations will have take place.

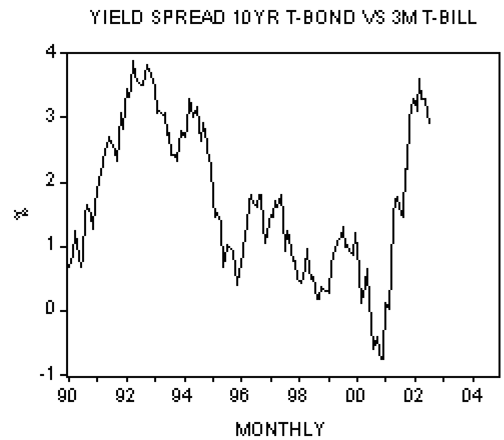
Even if one were to accept that a boom is caused by loose monetary policy, a bust requires a tighter monetary stance on the part of the Fed. This is not the case at present, however. So on what grounds can one argue that the economy may be heading into recession? If the pool of real funding (real savings) is still growing while the Fed maintains its loose interest-rate stance and the money rate of growth remains strong, then the economy will not fall into a recession. In short, if the real pool of savings is still growing, then the emergence of a recession requires a slowdown in the rate of monetary growth. If, however, the real pool of funding is falling, then the economy will plunge into a severe slump, regardless of the Fed's monetary stance. Currently, due to a low CPI rate of growth and a shaky stock market, it is highly unlikely that the Fed will alter its monetary stance. The only source of a possible slowdown in the money rate of growth may come from commercial bank lending. In this regard, year-on-year business loans fell by 5.7 percent in the first week of July, after a fall of 6.3 percent at the end of June. This was the 12th consecutive monthly decline.



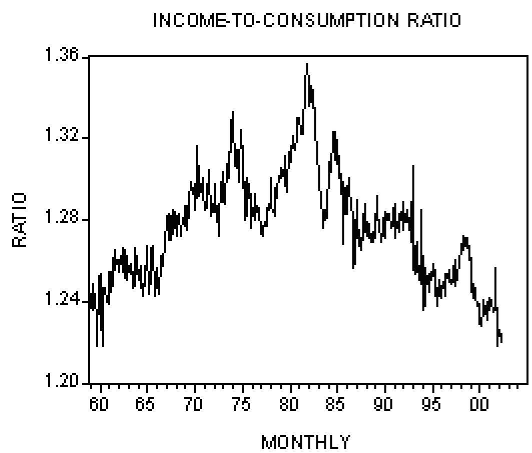
As a result of this, the Austrian School of economics money supply (AMS) rate of growth fell to 7.3 percent in early July from over 10 percent in February. Should this softening in growth momentum consolidate, it will undermine various activities that were made viable only on the back of the previously high money rates of growth (see chart).



Also, the interest rate differential between the yield on the 10-year T-Bond and the yield on the three-month T-Bill narrowed to 2.7 percent, down from 3.1 percent at the end of June and 3.6 percent at the end of March. This narrowing in the differential doesn't bode well for economic activity in the months ahead (see chart).

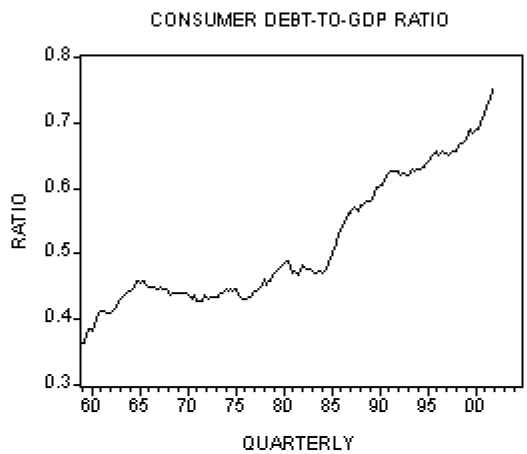


Moreover, based on a prolonged slide in the income-to-consumption ratio, we suspect that the pool of real funding could be in trouble (see chart).

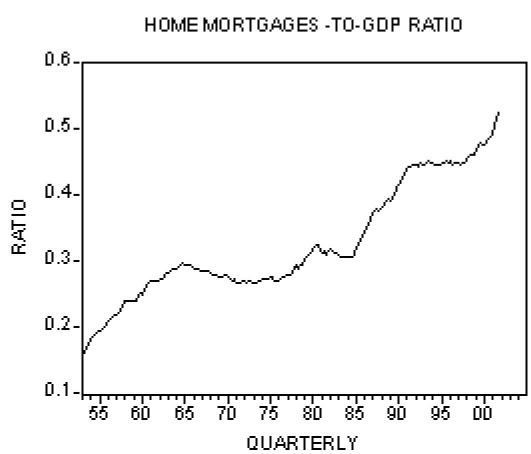


Furthermore, as a rule, loose monetary policy gives rise to overinvestment in the production of capital goods relative to the production of consumer goods. The June production data show that the capital goods-to-consumer goods ratio stood at 1.34 against a similar figure in May. This ratio would have to fall to around 0.8 before a sustained economic recovery could emerge (see chart).

The severity of distortions in the economy is also depicted by growing debt. The outstanding consumer debt-to-GDP ratio rose to 0.753 in Q1 from 0.74 in the previous quarter and 0.71 in Q1 2001 (see chart).



Also, the home mortgages-to-GDP ratio climbed to 0.53 in Q1 from 0.52 in Q4 2001 and 0.49 in Q1 2001 (see chart).



Conclusion

Contrary to popular ways of understanding, the stock market doesn't have causative powers so far as economic activity is concerned. The prices of stocks only *reflect* individuals' assessments regarding the facts of reality. As a result of central bank monetary pumping, these assessments tend to be erroneous. But once the money rate of growth starts to fall, individuals can see much more clearly what the actual facts of reality are and can scale down previously distorted evaluations.

While individuals can change their evaluations of the facts, they cannot alter the actual facts themselves--i.e., the facts that influence the future course of events. Our analysis continues to indicate that the pace of economic activity is likely to decelerat sharply by the year's end--if not earlier.

Also, a flattening in the yield curve points to a likely softening in economic activity in the months ahead. As a rule, loose monetary policy gives rise to overinvestment in the production of capital goods relative to the production of consumer goods, and as we have shown, the ratio of capital goods to consumer goods still remains at lofty levels. This, in turn, precludes any meaningful economic recovery soon.

There is a high likelihood that the real pool of savings--the driving force of the economy--is in trouble. Without an adequate buildup in the real pool of savings, no sustainable economic recovery is possible. In short, if real savings are in trouble, then regardless of what the Fed does, economic activity will decline.

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