



From Theory to Praxis

Or, Economics in One Lecture

Henry Hazlitt, 1894-1993, in memoriam.

Austrian Scholars Conference,

The Ludwig von Mises Institute,

Auburn, Al.,

March 2004

When asked if I would be willing to deliver this lecture, I contacted Lew Rockwell to see if he would give me some pointers as to what sort of material would be most suitable.

'It's easy,' he said. 'Henry Hazlitt was very big on poring over the official statistics and showing how they were supportive of very different conclusions from those which mainstream drew from them. Why don't you do the same?'

Splendid! I thought – after all this is a big part of what I do for a living - and I duly set off downloading the data, compiling a number of very large Excel spreadsheets, and drawing copious graphs to illustrate yet another bromide on the failings of the Global Fiat Dollar Hegemony.

Seeking to enliven these, I dug out copies of some of Hazlitt's works to look for a few passages which I could quote - only *slightly* out of context - in order to effect the usual subterfuge of the struggling politician or hack lawyer and to add a little intellectual substance to the special pleading contained in my series of Power Point kaleidoscopes,

But, on re-reading works like 'The Inflation Crisis' and 'The Failure of the New Economics' after a gap of a number of years, it became more and more apparent that power of Hazlitt's writing and the clarity of his analysis were timeless and that the problems of today are, of course, the same ones of which he so effectively disposed in his time.

So, rather than bombarding you with a mind-numbing profusion of billions of these and trillions of those, or subjecting your aesthetic sensibilities to the chromatic enormities of my charts, I decided instead to provide a run through of the way in which the logic of the Austrians can be directly applied to make a *practical* difference to traders, investors and businessmen at large.

Before we start, however, I want to lay a little groundwork, by way of challenging the preconceptions which plague the popular debate on these matters. Specifically, I want to look at the rather fundamental question of how we characterize 'growth' in the modern economy.

Here, we immediately run into the fact that familiar usage, coupled with a dull complacency of thought, has allowed the idea to arise that any increase in prosperity is to be measured strictly in terms of the macro-economic entity called Gross Domestic Product, or GDP, for short.

Of itself, this has led to a horrible inversion of means and ends, such that it encourages ever more monetary and regulatory violence to be visited upon the free economy by the ranks of self-serving politicians and bureaucratic planners from Collectivist Central who have come to believe that keeping this statistical artefact expanding by some arbitrary minimum during *their* term of office is their primary function, no matter what long term economic or social harm they are occasioning along the way.

Indeed, the Collectivists have successfully deluded both themselves and most of the uncritical electorate over whom they reign that were they to desist – or even relent a little - from this interference, the intrinsic flaws in the capitalist free market would self-evidently lead to an implosion under the weight of its own contradictions.

It should also be noted that this whole business of 'national income accounting' intrinsically enshrines Keynes' perverted and patronising view of the economy and so it also condemns those of us who reject its premises to an Orwellian struggle to articulate heretical thoughts within the narrow framework of an alien language and an antagonistic epistemology.

The very origins of the intellectual effort and financial resource devoted to the compilation of the GDP numbers are rooted in the efforts of Keynes' contemporary, Simon Kuznets, to provide Roosevelt's statist 'Brain Trusters' with a template on which to impose their Mussolini-inspired fantasies of how the nation's affairs should be ordered.

Given that *their* efforts were largely responsible for prolonging, if not intensifying, the dislocations associated with the pricking of the inflationary Bubble of the late 1920s throughout more than a decade of lost hope and retarded progress and given, too, that once the seeds of conflict and extremism had taken root in this otherwise barren soil, the second great extension of their statistical efforts arose out of a need to try to co-ordinate the

totalitarian wartime command economy, you might feel that we should treat this approach with a great deal of suspicion.

But, even if we were to suspend our questioning of the simplistic algebraic formulation of the Keynesian economy intrinsic to the data, the fact remains that even the author of this series admitted of grave qualifications to its usefulness:

'The statistician who supposes that he can make a purely objective estimate of national income, not influenced by preconceptions concerning the 'facts,' is deluding himself; for whenever he includes one item or excludes another he is implicitly accepting some standard of judgement, his own or that of the compiler of the data. There is no escaping this subjective element.'

Perhaps, a few numbers might help flesh this out.

In 2001, GDP - measured in the depreciated dollars of the day – was reckoned to stand at just above \$10 trillion dollars, broken down as to \$7 trillion of personal consumption expenditures, just under \$1.6 trillion of private investment and \$1.9 trillion of government outlays, less just over \$300 billion to account for the surplus of imports over exports registered that year.

Even as thus baldly stated, there are problems aplenty here.

One obvious one is the fact that 'fixed' investment is measured on a gross basis while inventory accumulation is measured net, but, more importantly, there is the issue of just who gets to determine what comprises 'consumption' and what an 'investment', much less whether this distinction is a valid one to set in place of the classically correct separation of resource use into 'productive' and 'exhaustive' categories.

Software, for example, used to be treated as an intermediate business consumption outlay and was thus excluded from the final reckoning: its subsequent reclassification in the mid-Nineties, in essence, was a move akin to the sort of manipulation of 'revenue recognition' that WorldCom and the other corporate miscreants of the previous Bubble used to practice.

A third problem inherent in the GDP numbers is that, in order to add apples to pears, each of the myriads of different commodities and services being exchanged in the economy have to be reduced to a common denominator.

Money is the only obvious candidate for this task, but money itself fluctuates in the speed at which it depreciates in value (the *rara avis* of its appreciation being a very elusive fowl indeed, these days).

This gives rise to the calculation of reams of 'implicit price deflators' through which to allow for these changes.

To see the backflips to which this gives rise, I would urge you to compare the entries for the nominal and 'real' versions of the high-tech component of private fixed investment where so embarrassing have the resulting distortions become that the sub-entries have recently been left blank, apart from an admonitory footnote to the effect that the omission arises because the numbers are not to be trusted!

Ask yourselves next, whether the near 20% of the GDP total accruing to the activities of the State has any place in the reckoning at all.

Though one cannot deny that some benefit is to be derived from the activities of 21 million or so employed in the public sector, there is also much that the apparatchiks - the censors of political correctness, the price-fixers, quota-monitors, box-tickers, environmental inspectors, dole dispensers and tax-gatherers – not to mention the secret policemen, uniformed paramilitaries and galactic stormtroopers, complete with their commissariat and armourers – do that is openly destructive.

In any case, even where some genuine benefits can be identified from public sector workers, since the provision of government 'services' is often a matter of either direct or indirect compulsion and is anyway never subject to the disciplines of the market – principally, the need to satisfy willing consumers in a financially sustainable and hopefully profitable fashion under conditions of competition and choice – attaching to even these a value of any sort is still fundamentally problematical.

That this is far from being a pedantic distinction can be seen in the fact that around one in four of the more than 3 million production workers lost to the manufacturing headcount in the past three years has ended up – conceptually, if not individually - on the bloated payroll of the State instead.

Here, the new drones enjoyed salaries a third higher than the metal-bashers were paid and received benefits one sixth greater, all of which implies that each member of the shrinking number of manufacturing workers has had to become over 8% more productive per year just to support the monstrous regiment of extra bureaucrats and *siloviski* – a legion of the damned whose

muster has burgeoned from 169, all the way to 214, per 100 manufacturers, just since 2000.

It should not be a matter of much dispute that this game of Keynesian piggyback, rather than being some sort of augmentation to the common weal can, in fact, be doing the nation no good whatsoever.

Leaving this contention behind, yet another glaring inconsistency in the presentation of the 'facts' involves the disparate treatment noted above of what may be loosely termed 'fixed' and 'circulating' capital.

In the case of the former, the choice to ignore the effects of depreciation adulterates the composition of this identity, since it implies that a peasant who keeps buying sickly donkeys which die after only two years' hard work is adding more to national income than is his brother who buys only those which can endure for four.

The upshot of all this is that we are now left wondering whether even nominal 'national product' should be reckoned as \$10 trillion – as it is presented – or as the \$8 trillion after we subtract government, or the \$7 trillion after we deduct the estimates made of private capital consumption.

In fact, we still have not finished, for we find that a good deal of 'expenditure' is not monetary at all, but takes the form of 'imputations' which, the Bureau of Economic Analysis tells us, are 'transactions recorded in the national income and product accounts that are *not* transactions of the market economy' – i.e. which are numerical phantoms purporting to adjust for implicit services rendered, but not charged, to their recipients.

Just to give a flavour of the vast sleight of hand being undertaken here, let me show how the magic of 'imputation' helps solve the mystery of how a citizenry increasingly in hock and whose net financial assets, for the first time in at least fifty years, are falling can still be enjoying year on year net interest receipts of around \$900 billion – roughly 10% of the unadjusted total income they collectively receive.

What we do, is that we deduct from interest paid \$350 billion in mortgage interest payments – which are made, not by the homeowner, but by an imaginary corporation set up in accounts to buy his house for him.

Next we add the \$260 billion reckoned to be the value of the free cheque book your bank gives you from interest received and the net difference soars

around 225% from an actual monetary total of \$275 billion to the published \$900 billion – Hey, Presto!

Incidentally, do you not consider it a touch how risible that the implication of the second of these adjustments is that the next time you go overdrawn, you can always try handing in your unused chequebook to the bank and telling your account manager that you should both call it quits!

In toto, what this blizzard of numbers means is that the GDP ends up being swollen by perhaps 16% - a gap, incidentally, which has widened appreciably from the 1964-73 difference of around 10% (not that anybody's fiddling the headline numbers intentionally these days, you understand).

So, was the 2001 economy \$10 trillion in size in then-current dollars, \$8 trillion ex-government, \$7 trillion ex-depreciation, or under \$6 trillion ex-imputation?

Clearly, given the yawning two-thirds differential between the lowest and highest of these, any Collectivist central planner should be asked to adjudicate on which is most representative of economic reality before he proposes to trample on our property rights or to infringe upon our sacred personal liberties in order to achieve some arbitrary target for what he likes to think of as 'growth', but which is usually only 'spending'.

But, in fact, even all the foregoing does not come close to providing a full view of the controversy with which we are dealing, for it has still been framed in Keynes' and Kuznets' own terms.

Conversely, if there is one thing that the Austrian School teaches, it is the fundamental importance of the division of labour. Another is the crucial element of time and of the instrumentality of capital in mastering this.

Yet another is the key role played by individual entrepreneurs in disposing of scarce resources to meet current and prospective consumer demand and a final one is the function of saving in facilitating this role.

On this basis, we can recast the official statistics – with all their provisos and precautionary notices – in a radically different way.

We can manoeuvre them, using an approach first outlined by Professor Reisman, to give us a feel for what Hayek depicted as a right-triangular arrangement of production in the modern economy'.

To achieve this we take the BLS input-output tables which show, in addition to the now-familiar GDP numbers, all those intermediate business-to-business flows which are later simply cancelled out.

Adding imports to the domestic total – to include total, not just net, exports – we are left with the sum of business revenues – whether derived from sales to other businesses, end consumers, government, or to foreigners.

Subtracting depreciation and profits from these revenues, we are left with *above* the line business costs, to which we can add the entries for net inventory accumulation and gross fixed investment which represent *below* the line outlays.

Thus, we have identified the total of all domestic *productive* spending, to which we can compare the sum of personal consumption and government expenditures, plus the total of residential real estate ‘investment’, to determine the scale of domestic *exhaustive* spending.

In the year under consideration, 2001, productive outlays came to a grand total of \$18.2 trillion, against which was lined up \$7 trillion in personal consumption, \$1.8 trillion in government spending and just under \$1/2 trillion laid out for real estate, for a domestic exhaustive use of \$9.3 trillion.

Thus, it could be argued, the circulation of money – and hence the transfer of goods and services - through the real economy amounted not to \$6, not to \$8, or even \$10 trillion, but to a whopping \$27.5 trillion, of which some two-thirds represented *not* the final consumptive exhaustion of wealth so over-emphasised in the orthodox approach, but a series of exquisitely intertwined and mutually reliant, highly contingent and purposefully-undertaken, *non-automatic* entrepreneurial expenditures.

Bear in mind, however, that even now, after we have tried to expand the scope of our mental imagery, we are still all too prone to succumb to the temptation to describe the economy by means of a single number.

This insistent urge keeps leading us back to a narrow conceptualization very much like the one of trying to capture the complex geology and fractal topography of the Rockies by measuring the volume of rock contained therein.

The Romans, it is said, had little concept of cartography – there is apparently no word in Greek or Latin for a ‘map’. Instead, their world-view was

odological: that is, it was based predominantly on the mileages set out in their *periploi*, or linear itineraries.

In fact, when the Rooseveltian tyrant who thought he could cure rampant inflation in the 3rd century by fixing prices, the emperor Diocletian, came across a man who had constructed a two-dimensional map of the world, he had the poor unfortunate summarily executed, lest his enhanced knowledge make him a danger to the Imperium.

Keynesians and other Macromancers, with their fetish for monolithic aggregate numbers and their reliance on pre-determined coefficients of mass behaviour, share a similarly blinkered outlook, while their vituperation towards more deductive and individually-centred schools of thought makes of them and their masters all mental Diocletians!

In contrast, we Austrians must always strive to attain a wider purview and to preserve a sense of the variability and of the complex interrelations which characterise the world of Acting Men laid out before us.

By way of making this more immediate, let us lay out what those of you who read the financial press, or listen to the business news, or who follow the knockabout of politics, should recognise as a pastiche – though not quite a parody – of what passes for the popular wisdom today.

America – thanks to the courageous actions of the Federal Reserve in slashing interest rates and (at least, if you are a Republican) due in good measure to President Bush's visionary tax cuts - has weathered a shallow recession and is now growing strongly again - at the fastest rate in two decades, according to the headline statistics, so that the US of A is, once again, the 'locomotive of growth' for an ungrateful world.

The heroic American consumer – who makes up 70% of the economy - has gone out and shopped for victory – releasing some of the 'wealth' contained in her appreciating home for the purpose – and now, at last, as uncertainty subsides and as revenues rise, businesses, too, are spending their money on investments.

As growth picks up, the absence of 'inflation' – especially something called 'core inflation' measured by an index to which the Fed would draw our attention – and the existence of 'so much idle capacity worldwide' means the Fed can be 'patient' about raising the short-term interest rates it determines from their present 'accommodative' setting.

True, there are a few clouds to spoil this shining prospect of prosperity to come.

For starters, businesses are, it seems, far too productive to need any extra workers to meet all this demand at present, but that will soon pass as they 'exhaust the possibilities of applying new technologies' as our beloved Chairman is wont to say.

On the other hand, where jobs are being created, they are moving offshore to semi-conductor plants in Shenzhen and call centres in Calcutta – something only made possible because the perfidious Chinese – though, mysteriously, not the Japanese or the Koreans when they do the like – keep buying US dollars and so unfairly suppress the value of their own currency.

If they keep cheating the rules so outrageously in this manner, we should start to enforce our will, by limiting their ability to send us their exports and by compelling American businesses to buy goods and services here at home.

Moreover, the wily Orientals are now gobbling up all the world's natural resources and spare energy capacity, into the bargain, pushing up their prices as they do – though, before you object, this is not 'inflationary' since this is 'cost-pushed, not demand-pulled', as the Korean central bank chief Park Seung told us last week.

More fundamentally, real resources are 'far smaller in today's economy than they were twenty or thirty years ago. In fact, an ever-increasing part of our economy is becoming conceptual, rather than physical... all of the items which are in the standard commodity indexes ... are essentially physical, rather than intellectual,' as Mr Greenspan told a Congressional interlocutor last month.

Next, there is the rising tide of personal indebtedness – but again, this is nothing compared to the increase in household wealth, while if debt service becomes a problem, people can always refinance their homes - preferably via an adjustable rate mortgage – and pay down other, higher-interest forms of credit with the proceeds.

Fifthly, there are 'risks associated with deflation,' though these have thankfully 'receded very substantially. Even so, 'trend inflation has... reached levels that are too low' to the point that the 'benefits of low inflation are lost', as Governor Bernanke cautioned in February.

Finally, there is the flipside of all those tax cuts - the ballooning budget deficit, though a new Democratic administration will surely address that effectively by taxing the undeserving rich once more, while a re-elected Republican one will rely instead on plugging the gap using the increased revenues to be expected when their policies at last begin to shift more of the undeserving poor off the welfare rolls and back into a tax-paying job.

Either way, once the cheap political back-biting is put behind us in the Fall, something will turn up – besides, don't fret: even if deficits 'did count', as Vice President Cheney apparently doubts, we 'owe it to ourselves', in any case.

Does this ring true? Could this have been mouthed by a CNBC talking head or have featured in a NY Times op-ed?

Well, if you agree it could, you might be amused to know that this brief synopsis contains, at a rough count, around two dozen logical errors, economic fallacies, and blatant inconsistencies, most of which would be obvious to a competent, classically liberal thinker of our grandfathers' generation, but some of the consequences of which – politically, economically and financially – can only be recognised today by an Austrian.

The fact that they go unexposed by the mainstream economics profession and unchallenged by the educated layman is not only a sad mark of the depths to which sustained reasoning and critical thinking have fallen, but is also proof of Henry Hazlitt's 1978 words that:

'Only by... repeated emphasis and varied iteration of certain truths can we hope to make headway against the stubborn sophistries and falsehoods that have led to the persistence of inflationary policies over nearly half a century.'

So, now, armed with these insights of the Austrian school, let us run through these and dispel, in sequence, the falsehoods nested in this simulation of the mainstream view.

America is recovering 'thanks to the courageous actions of the Federal Reserve in slashing interest rates...'

To assume that lower interest rates – when imposed by monetary manipulation, rather than arising spontaneously on the free market – are a panacea for all ills is a very old delusion.

If low rates and a cheap currency were a solution to hardship, then we should have to impeach Alan Greenspan before the court of world opinion for being too pusillanimous in ending want and for not allowing his colleague Ben Bernanke the full access to the printing press which he so patently desires.

If this were the case, John Law would never have gone bankrupt; to be 'worth a Continental' would be praise indeed; and the legendary wheelbarrow wielders of Weimar would have secured command over all the riches of the world.

'President Bush's visionary tax cuts have helped...'

Reducing taxes – and reducing them on producers, rather than on consumers – is, of course, a laudable aim.

However, refraining from funding these by an equal and opposite assault on the spending side of the ledger is but to substitute the government for the private agents who are the beneficiaries of the tax reductions as the party liable for the extra inflationary debt so brought into being.

That this *is* inflationary had been especially true over the past six or seven months, when US commercial banks, foreign monetary authorities, and the Fed itself have bought such prodigious amounts of government paper, simply by expanding their balance sheets, that they have more than accounted for the whole increase in marketable debt in that time.

This is a process called 'monetization' and it puts the US on the same inflationary road to ruin as has been travelled by all those previously practising this subtle fraud.

Besides, lower taxes are one thing: higher subsidies, renewed tariffs and threats of quotas, more burdensome legislation, more expensive welfare programmes and the pervasive threat of arbitrary legal assault are quite another.

There is little enough sign that the Bush White House has done any more to lighten *these* crushing impediments to wealth creation than has any other Progressive administration of recent times.

‘The US has ‘weathered a shallow recession and is now growing strongly again - at the fastest rate in two decades, according to the headline statistics...’

This ‘shallow recession’ has seen Manufacturing payrolls plunge to their lowest since before Pearl Harbor, with total hours worked here suffering such a steep decline that it has been barely pipped for the title of the worst post-WWII contraction by the trough registered in the savage recession of 1982.

Net, non-residential fixed investment has fallen by its greatest extent in over 50 years, as has the proportion of total net investment to GDP, as cumulative non-financial corporate profits – now, admittedly on something of an upswing - also fell by their greatest extent in that period.

‘The US of A is, once again, the “locomotive of growth” for an ungrateful world....’

Only if you still subscribe to the four hundred year-old errors of the Mercantilists (as all Keynesians do, of course) and you confuse money with wealth and credit with capital could you see the present-day Anglo-American role as a benign one.

Asian labourers, mostly – though not exclusively – with a lower standard of living, are sweating in their factories to sell us Westerners cheaper goods than we can produce here at home, and are accepting nothing but our irredeemable and largely unenforceable paper promises in return.

Thus, rather than being a ‘locomotive’, the more apt metaphor is that of a surly and aggressive brother in-law, who arrives not only to eat you out of house and home, to touch you for the odd fifty bucks here and there until a payday which never seems to arrive and a horse which never gets to finish first, but who also reviles you before his pals in the local bar-room for the sake of your long-suffering charity.

‘The heroic American consumer – who makes up 70% of the economy - has gone out and shopped for victory releasing some of the ‘wealth’ contained in her appreciating home for the purpose ...’

Yes, the consumer is 70% of GDP, but the map is not the territory – as we have been at some pains to point out above.

The personal consumer might exercise the biggest part of that final \$1-a-vote franchise which is the free market, but, remember, her spending amounts to

perhaps no more than a *quarter* of the overall invoices raised and bills settled up and down the Cone of Production.

Besides, it is saving – wisely utilised by honest and far-sighted entrepreneurs – and not spending - founded largely on the inflationary collateral-credit spiral that is the US housing market - which will lead to our material enrichment.

Anyone with a basic grasp of accountancy, much less economics, must see that monetizing a notional gain in the value of an unproductive asset by borrowing more against it and then dissipating the proceeds on instant gratification can hardly be construed as liberating ‘wealth’, only as destroying it.

‘Now, at last, as uncertainty subsides and as revenues rise, businesses, too, are spending their money on investments...’

It is true that there *has* been a pick-up in some of the indicators of capital goods spending – which, given the size of the O’Neill tax incentives and the highly accelerated obsolescence of much New Era equipment, not to mention the scale of the preceding drop in such investment, is largely unremarkable.

It is also true that the inflationary effects of the aggressive ‘stimulus’ policies being enacted at home and abroad, coupled with decline in the value of the dollar, has helped corporate cash flow.

Indeed, it would be a singular event if there was not at least a temporary and unevenly distributed boost, under the prevailing circumstances.

But, how much of this will be revealed as capital consumption, how many of these newly coursing streams will dry up and even reverse if this deliberate inflation either decelerates or switches channels, and how soon costs will again rise in line with, or faster than, prices, is something we cannot know in advance, but are developments for whose signs we must be ever vigilant.

Another feature, often overlooked is that all this easy money flows straight to the bottom line of Corporate America in a very different manner than in the past, since even nominally non-financial corporates now have more financial assets than tangible ones on their balance sheets - meaning that, these days, they are half machine shop and half consumer finance house and pension fund manager combined.

Thriving on the proceeds of a steep yield curve, soaring (especially speculative) bond prices and rapid asset growth, official financial corporate profits have climbed to a record \$60 for every \$100 earned by their ostensibly non-financial brethren.

If we were to assume the latter derived the same amount of mileage from their overlapping activities as the former, returns from the credit bubble alone could therefore amount to between 65-70% of all profits earned – a complete and inherently disquieting inversion of the ratios typical of the 60s and 70s.

‘As growth picks up, the absence of “inflation” – especially something called “core inflation” measured by an index to which the Fed would draw our attention – and the existence of “so much idle capacity worldwide” means the Fed can be “patient” about raising the short-term interest rates it determines from their present “accommodative” setting....’

‘Inflation’ is not synonymous with rising prices, of course, but rather the prime causative factor.

An inflation is a situation where more money exists – however the term is defined – than is required by individuals in their own subjective judgement so that it is ever more eagerly exchanged into goods, services, other financial assets, or the monies of other polities.

With the broad M3 measure of money and credit up by over a quarter since the end of 2000 – a gain of getting on for \$3 trillion which is an increment greater than the total stock of money called into existence in all of the first 208 years of the Republic – you have to have the twisted perceptions which seem to be a pre-requisite for being a Fed governor not to believe that these are inflationary times!

With mortgage debt up nearly 40%, financial debt up by a third, with State & Local government borrowing up 30% in the past three years - for an aggregate increase of over \$7.5 trillion dollars and a climb of 50 percentage points from 368% to 418% of private net domestic product - the size of this officially- sanctioned Ponzi scheme is hardly unnoticeable for those who care to look.

As for the ‘spare capacity’ argument, this is another old canard.

If you reflect for a moment, it must be obvious that those businesses with a glut of capacity today are precisely the ones whose managers, during the late

Boom, most misread the true state of consumer demand vis-à-vis the costs of all the inputs they needed to try to meet it.

Therefore, there is little choice but for these to release as many of those resources as possible for other uses and to shrink back better to balance what the market will actually buy from them and what it will also sell to them at an affordable price.

It seems unlikely in the extreme that by artificially pumping up consumer demand in the general, unfocused way this has to be enacted, the authorities will, for example, call many of the hundreds of millions of miles of 'unlit' fibre optic cable into employment.

Further, it is often overlooked by the Aggregationists that one sector's overcapacity is another's shortfall, as resources misdirected towards the first during the phase of feverish malinvestment were inevitably also directed *away* from what may now be revealed as more deserving outlets.

You only have to consider that while semi-conductors and servers were building to unsustainable levels, natural gas and oil refining has been sorely neglected – not to mention the steel mills now making the nightly news.

As Hazlitt himself put it:

'Capacity is reached when we have fully employed our most scarce resource or complementary productive factor, whether that is an important key industry, specialized labour, plant or some raw material. When this situation occurs, the price of the scarce factor will start to soar, and this rise will soon force increases in other prices and wage rates.'

'Businesses are, it seems, far *too* productive to need any extra workers to meet all this demand at present, but that will soon pass as they "exhaust the possibilities of applying new technologies" ...'

Taking that last phrase of our venerable Chairman's first, since when did investment depend only upon the technological possibilities open to Man and, rather than upon a careful weighing up of the returns achievable by deploying the available savings to that end?

And even if it did – and NASA was the most profitable entity on earth! – why should we ever look to 'exhaust' such possibilities?

Have we already applied all the techniques of which we are already aware? Has *every* economic entity taken advantage of them? Has the well of human ingenuity suddenly run dry so we can no longer look forward to more advances?

Sorry, Mr Greenspan, that explanation doesn't fly – even if it does employ all the aerospace marvels the Skunk Works has to offer us.

Less frivolously, we are forced to concede that an individual business or even a group of businesses may well find it profitable to substitute capital for labour, but is it really likely that they have *all* suddenly decided this is the best course of action?

Even if this were somehow the case, would it not be telling us not that labour is not *too* productive, but rather that it is not productive *enough* of realized economic value.

In all the interminable talk of a productivity revolution, overlooked is the fact that the Fed's oft-cited numbers are aggregative, hedonically-manipulated, that they count things made, not value received, that they undercount hours of work, and that they ignore those non-labour costs which can amount to as much as 50% on top of the direct wage bill.

Even by their own – rather dim – lights, it should be noted that they also artificially ascribe the bulk of all productivity gains to labour – thus pushing the increase in this quantity in the late 1990s to a 2.5% annual pace – the best since the early 80s – but ignoring the fact that *negative* returns on capital of minus-1.9% between 1997-2001 – the *worst* showing since the 1979-83 recession – took so-called multi-factor productivity down to its most anaemic since the troubled 1989-93 stretch.

Increased productivity – the employment of more useful capital per head of the population – is the route to riches, not mass redundancy, but only if markets are unhampered and if prices and costs are allowed to adjust to reflect the new plenitude of goods being made, thus speeding the useful re-employment of the labour released from all its former drudgery.

'Where jobs *are* being created, they are moving offshore - something only made possible because the perfidious Chinese keep buying US dollars and so unfairly suppress the value of their own currency...'

Here again we see the glaring paradox that we, who are supposedly so effortlessly superior in terms of productivity, can't compete with a newly-

hired factory hand in Hainan or Hanoi - but, then economic rationality was never much of a match for cheap populism.

The contradictions here are manifold, for the Chinese, these days, run very little by way of a trade imbalance when we measure it across all their partners and so see little incentive to unpeg the Yuan, potentially upsetting the entrepreneurial calculations of all those involved.

Indeed, their surplus over the past year amounted to around \$20 billion out of a total global trade volume of over \$800 billion – a proportion of some 2-3%. The US, by contrast has just racked up a record goods deficit of over \$49 billion in a single month, a shortfall which amounts to nearly 30% of the total - rather a lot to be blaming upon a single bilateral currency distortion.

‘If they keep cheating the rules, we should limit their ability to send us their exports and compelling American businesses to buy goods and services here at home...’

‘Yessiree! Punish the American consumer by denying her the full benefits of the international division of labour - that’ll show them pesky Chinamen! And if Fu Man-chu wants to *give* away his Nike sneakers, we still won’t take ’em. No, Sir. We’d rather make the citizens pay some unionized, over-regulated, inefficient good ole’ boys from the cotton belt to make ’em for us for \$120 a pair and be grateful of it when they vote for us afterwards!’

Besides this sort of illiteracy – sadly becoming written into the electoral platforms of both those Yale alumni, Tweedledum and Tweedledee – we should ask what ‘rules’, precisely, are the Chinese breaking by seeking to keep their unit of account stable against the world’s reserve currency - the same currency, by the way, which they were lauded for selflessly shadowing throughout the crushing collapse of the 1997-8 Asian Contagion?

Moreover, if we consider that the Chinese run an export surplus with the US, receive reserve assets in exchange, and then allow domestic credit to increase on the base which these provide, thus driving up both internal prices and the demand for goods on either side of the border, this is only a simulacrum of the workings of the classical - and internationally munificent - gold standard.

Where it breaks down, of course, is that the reverse should be happening in the United States, with the withdrawal of reserves serving to contract credit and deflate prices to the point where a balance is once more achieved.

Only under the rules of what Jacques Rueff scathingly termed the 'childish game of marbles' by which the winners (the Chinese) return their spoils (the excess dollars) back to the American losers at the end of each round - by buying US Treasury and Agency bonds, in the main - and as a result of what the great Frenchman also dubbed the 'monetary sin of the West' - the fact that the dollar hegemony allows the US to go on mindlessly inflating and blaming others for its own lack of financial virtue - can the Chinese be held culpable for what is at work here.

Even then, their crime is only that of being an accessory after the fact, while the main perps are to found inside the Beltway, not in the People's Congress in Beijing.

'The wily Orientals are gobbling up all the world's natural resources and spare energy capacity, into the bargain, pushing up their prices as they do...'

Damned if they do and damned if they don't.

If the Chinese accumulate the dollars and return them to the US Treasury they are 'not allowing the market to determine' the value of their currency (read: they are not accommodating the GOP in devaluing the dollar more broadly). If, instead, they seek to buy real assets - whether for immediate use or, as some suspect, by way of 'strategic' stockpiles - thus transforming their work for their importunate, but ungrateful, Occidental customers into tangible wealth of their own, they are to blame for highlighting the fact that perhaps there isn't quite as much 'idle capacity' across the globe, as some would have us believe.

In the unlikely event that the US were to stop inflating - or under the less fantastical scenario that China's very real, Austrian-style bubble were to implode of its own accord - the pressure on these scarce factors would, of course, cease to soar forthwith.

'This is not 'inflationary', however (in other words, no central bank needs to restrict credit just yet) since this is "cost-pushed, not demand-pulled."'

To see the fallacy of this, imagine you had only \$10 in the world and you were going to treat yourself a final two \$2.50 beers and a last \$5 hamburger meal before going broke.

If, when you got to the store, you found the price of beer had doubled, you would have to rearrange your preferences - perhaps making do with half as much booze and the same sized beef patty, perhaps sticking to your original quota of two bottles of beer - to be downed now on an empty stomach - or perhaps finding a substitute beverage or alternative snack.

That would assuredly NOT be 'inflationary', merely the wholly natural and welcome functioning of the price mechanism, signalling to entrepreneurs everywhere that beer was now relatively more urgently demanded than before and that production schedules should be adapted accordingly.

However, if your fairy godfather - a septuagenarian figure with receding hair, bulging, bespectacled eyes and a confusing, somewhat tedious turn of phrase - appeared in flash and simply conjured up the extra \$5 you needed, you could have the beer AND the beef, forgoing nothing, economising on nothing.

Now, that *would* be inflationary and it is what the Korean's Mr. Park and his more well-known peers clearly intend to do should raw materials prices (like the beer of our fable) continue to rise, lest some real life producers (like the cattle ranchers who provide the beef in our tale), should have to accept a lower price as compensation for the higher ones enjoyed by others.

'An ever-increasing part of our economy is becoming conceptual, rather than physical... all of the items... in the standard commodity indexes ... are essentially physical, rather than intellectual.'

Alan Greenspan has long been able to will vast effusions of money and credit into existence, frustrating the market process and underwriting the speculations of the Money Trust without effort, but he has clearly fallen into a *folie de grandeur* if he believes we can will a gallon of gas into our fuel tank or a loaf of bread onto our table.

Such dangerous flights whimsy only serve to show that those involved in the painstaking business of building and cultivating the capital by which we are all enriched have all too few advocates in the corridors of power.

'Rising personal indebtedness is nothing compared to the increase in household wealth and if debt service becomes a problem, people can always refinance their homes once more...'

As noted above, cashing in some of the gains in an asset price spiral, not by selling some of it outright, but by increasing one's leverage against it, is

hardly the soundest of financial practices. As for the reliability of the household 'wealth' measure itself, we have more to say on that below.

'There are "risks associated with deflation," though these have thankfully "receded very substantially." Even so, "trend inflation has... reached levels that are too low" to the point that the "benefits of low inflation are lost", as Governor Bernanke cautioned in February...'

Quite what the *'benefits'* of even low inflation are – aside from providing an insidious transfer of wealth and of keeping labour subtly lagging the firm's owners and financiers' share of the pie – only Bernanke himself can know.

As for prices, yes, the highly dubious Consumer Price Index may be still be behaving modestly – by today's rather lax standards, at least – but prices of homes rose at their fastest in 30 year last quarter and the nation's real residential estate is now valued at an aggregate \$16.5 trillion, even if this total is a nonsense number only meaningful to those who allowed the marginal revolution in economics to escape them completely.

Caveats notwithstanding, at this steeping level, the RE capitalization figure represents an unprecedented 205% of private GDP – up 20 points from the zenith of the late 1980s' boom – and a record price:replacement cost of 170%.

Significantly, despite having risen 30% in three years and having doubled in ten, homeowners average equity languishes at a record low 55% - and no wonder when they have extracted what Greenspan calls 'wealth' to the tune of \$600 billion since the end of 2000.

The rise in the stock market needs little comment, of course, expect to note that its aggregate price/book, price/trailing earnings and capitalization/GDP are back at levels only seen during the post-1995 Bubble itself.

All manner of other financial assets, especially the more exotic denizens of the Bestiary – junk bonds, emerging market debt, structured products replete with risky derivatives, the least substantial stocks, such as those trading on the speculative hothouse which is the OTC bulletin board – all these have made new highs in price and lows in absolute or relative yield in recent weeks.

Back in the real world, you will need no reminding that medical expenses, insurance premia and tuition fees are also rising by double digit amounts,

that it costs more than ever to fill up your Hummer (no matter how devoutly you believe in Yoda Greenspan's command of the Force).

The National Federation of Independent Business agreed, in its January survey:

'Price hikes were pervasive in the service sector and it appears that things are looking up in agriculture. Providers of professional services also managed to post price hikes fairly frequently.'

Their bigger brethren at the ISM revealed that prices paid were the highest since the Bubble peaked in March 2000 and were the 2nd highest in a decade.

On top of this, last month, the well-regarded Philadelphia Fed survey came complete with the second highest forecast for prices to be received in 15 years.

Looking to the prices of widely traded commodities for confirmation of this, though some of them have slipped back in the past week or two, they are still characterized by rapid, double- and even triple-digit percentage gains.

For example, the Journal of Commerce index has risen by 50% annualized since last Spring – the fastest ever such rise.

Steel prices, are up perhaps 160% from recent lows while Aluminium is 50% above its 2002 nadir, Copper 120% and Tin 88% higher than their '01 bottom – all of these three standing at 8 ½-year highs.

We could on, quoting rapid price rises and often multi-year highs for Lead, Nickel, Zinc, Gold, Platinum, Silver, Palladium, Lumber, Plywood, Oil, Natural Gas, Coal, for Cotton, Soy products, Corn, Palm oil, Rice and Rubber, among others.

Emphatically, the only 'risks associated with deflation' are those which come from clinging too long in the naïve faith that the value of one's money will be preserved by a central bank which can still talk about such an eventuality while the malign effects of its inflationary policies are everywhere increasingly undeniable.

'Democrats will address the deficit by taxing the undeserving rich once more, while Republicans will look to plug the gap when their policies begin to shift more of the undeserving poor off the welfare rolls...'

The ballooning budget deficit may not be obviously 'crowding out' investment at present, for, as we saw, it is being monetized so effectively that interest rates remain subdued and stock prices elevated, but the government is still commandeering too many resources – to the detriment of those private endeavours which could be accessing them at a commensurately reduced cost - and it is demoralizing thrift, enterprise and self-reliance into the bargain.

In a West already displaying symptoms of the extirpation of the middle class, in favour of the governing military-political elite and at the cost of buying off its feckless urban proletariat with a higher dole and more spectacular circuses, the more the state expands in this way, the more success it will enjoy in the only one of its wars on abstract nouns which it wages unremittingly and *a outrance* – its War on Capital.

'Don't fret: even if deficits 'did count', as Vice President Cheney apparently doubts, we 'owe it to ourselves'...'

Yes, they do and No, 'We' don't.

Some of us owe it to *others*, which is a very different species of animal, and in any case, not having been invested in anything worthwhile, but merely payable in depreciated dollars out of general taxation (in practice out of rolling over principal and interest as they come due, at the expense of some future dupe), this is hardly an 'asset' in its strictest sense.

Furthermore, the abiding evil of a 'funded' and permanent public debt, is exactly that it teaches people to count as assets the exactions to be visited both on themselves and others on the day when the incontinent monster of public administration comes to pay its slaves once more for the labour of making their own shackles.

If no less than Jefferson fulminated against transplanting this medium of the great Whig Corruption from the Metropolis to the infant republic, and if Hamilton cynically espoused it as a means to bind the interests of the ruled to those of their patrician rulers, I think we can safely set their opinions above the amoral braggadocio of the good Mr Cheney.

So where does this all leave us?

Hopefully with a healthy distrust of bald macro-economic statistics as typically presented and spun and also with heed to the lesson of the caution

needed in drawing conclusions from the prevailing vapours of optimism coming from the likes of Greenspan and his acolytes.

In the real world, it is a matter of simple logic to predict that jobs will be added only in those industries where the costs of hiring - all the costs, including the monetary ones of benefits, as well as wages and not to overlook the more intangible ones of regulation and legal jeopardy – seem not to preclude, but rather to enhance the profitable production of goods and services.

Conversely, if the present environment makes the hiring of American workers seem too expensive and/or too risky for any given firm to hire, be assured they will *not* be hired, but that capital will be substituted for labour where possible and that this will take place overseas, if need be.

Since adding capital per head is the only sustainable way of enhancing productivity and thus the general standard of living, and that this, though improving, is still well below its recent best in quantitative, if hopefully not so much in qualitative terms, this means we still have quite a hill to climb.

Moreover, where materials and energy inputs rise so as to preclude that, too – as is the case, at least anecdotally, for increasing numbers of businesses at present - then not even those higher-order industries which might otherwise benefit from such equipment orders will be able to flourish.

That way both the direct and the indirect take up of the unemployed will be aborted by higher resource prices which have arisen to a considerable extent because of the very reflationary policies being undertaken to ensure 'full' employment.

Thus, notwithstanding the artificial boost delivered by a 25% currency devaluation, negative real interest rates, and a \$1/2 trillion budget deficit, this might yet dissipate itself in a variable and inherently unpredictable rise of costs incurred which serves to dash the entrepreneur's hopes of securing unmitigated gains from the rise in the prices *he* expects to receive.

If so, it will usher in a renewed stagnation in production – an inhibition which, remember, will nonetheless be partially disguised by the inflationary effects of government fiscal and monetary policy upon some few, fortuitous industries.

If this is not to lead to a commensurate reduction in consumption – to the policy makers' horror and the bankers' imperilment, however much its balm

is needed to soothe our fevered brows - it can only be offset by recourse to yet more credit: credit presumably built upon further asset price inflation, especially, if the Fed is lucky, in the housing market.

Indeed, to keep this game going will certainly require a good deal of finesse, another large dose of disingenuousness regarding inflation and – you may want to underline this - *a further period of inordinate laxity in setting interest rates.*

Therefore, the overwhelming imperative to avoid a housing implosion, coupled with the self-imposed erosion of America's competitive edge on the world labour market, seems almost to guarantee that policy, both here and abroad, will stay too loose for too long in the vain belief that this will ease the problems caused - well - by a previous spell when policy was too loose, for too long!

Thus, the likelihood is that the development of full-blown symptoms of an inflationary excess across much of the globe is presently as much of a certainty, as anything in this ever-changing world with its top-heavy, distortive, and intrinsically unstable monetary system can ever be said to be.

Pessimists – and especially the foreign variety who have so many investments tied up in the US - will here find a resonance in the words of the Yankee treasury secretary, Henry McCulloch, quoted by Henry Hazlitt in his 'The Inflation Crisis and How to Resolve it':

'It is corrupting the public morals. It is converting the business of the country into gambling and seriously diminishing the labour of the country... Men are apparently getting rich while morality languishes... Upon the demoralizing influence of an inconvertible government currency it is not necessary to enlarge... It is not to be expected that a people will be more honest than the government under which they live, and while the government of the United States refuses to pay its notes according to their tenor... it practically teaches the people the doctrine of repudiation.'

Optimists will turn for comfort to the voice of Adam Smith, whom Hazlitt cites in 'The Conquest of Poverty':

'The uniform, constant, and uninterrupted effort of every man to better his condition... is frequently powerful enough to maintain the natural progress of things toward improvement, in spite of the extravagance of government, and of the greatest errors of administration.'

While you decide to which camp you belong, some among you might also recall Hazlitt's own scathing summation of Keynes' 'General Theory' to the effect that:

'I have been unable to find in it a single important doctrine that is both true and original. What is original in the book is not true: and what is true is not original. In fact, even much that is fallacious in the book is not original, but can be found in a score of previous writers.'

If, having paid kind attention to my talk tonight, you feel the same way about me, I offer you my heartfelt apologies.

I can only assure you that it has, nonetheless, been a singular honour to have been asked to help commemorate such an unyielding champion of liberty and tireless expositor of truth as Henry Hazlitt.

May his example – as well as those of many others associated with the Mises Institute - always be before us.

Thank you.

Copyright 1999-2004 Capital Insight, Ltd., All Rights Reserved