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Can we solve the question of entrepreneurial calculation in a world with dishonest money?

The entrepreneur's guide to the business cycle

EVERY SIX WEEKS OR SO in the United States, every month in the UK, and every fortnight in Europe, a series of strange rituals take place.

Around a large, polished table, set in the center of some marbled salon, will sit a motley group of middle-aged economists, balding political hacks, and graying academics. These sages will have gathered to meditate upon the state of business in the territories over which they hold sway.

Research papers will be presented by a few of the government flunkies who serve them. Graphs will be perused, surveys pored over, and tables of data consulted.

Heads will nod and opinions will be expressed, replete with dry talk of "output gaps" and "exogenous shocks". Like the priests of some exotic religion, incantations will be muttered, containing phrases such "NAIRU levels", "Taylor rules", and "multi-factor productivity".

Then, after several hours of such mumbo-jumbo, the Chairman will call the meeting to order and a show of hands will result.

Instantly, a braying chorus of telephones will ring all over the world over, carrying the urgent news. The web will be set humming and TV screens will flicker on desks beside excited derivative dealers, or above bars crowded with distracted lunchtime drinkers.

The rush will be on to enlighten the waiting masses of the judgment of these latter-day Solomons.

This is the circus that results when interest rates are adjusted by today's great central banks: an all-too regular charade which is evidently deemed far too important to be left to the free market itself.

If, in their wisdom, this convention of oracles has decided that the economy could use a little more "stimulus", interest rates will be lowered. Instantly, stock markets will lurch higher, short-dated bonds will rally, foreign currencies will gyrate, and cheers will ring out in corporate boardrooms across the land.

As conventional wisdom holds, lower rates and more plentiful credit have become inseparably as-

sociated with an assurance of prosperity to come.

In reality, all this mindless rejoicing is wholly inappropriate. What the central bank has done is nothing more subtle than to give vent to the age-old prejudice against the creditor classes. It is the politics of illusion. It holds that a nation's wealth increases in direct proportion to the amount of credit granted. Frankly, if they are at all related, the relationship usually turns out to be an inverse one.

The bank, you see, subscribes to the old fiction that low interest rates can bring about prosperity, rather than acknowledging the truth that they are brought as a result of it.

Win, lose or draw?

And so, no matter what the rhetoric, it can only be a matter of regret that today's entrepreneur must operate in a world where he must make calculations about his business in dishonest money and wrestle with the effects of expanding credit.

Even though he is supposed to be the one who benefits from these evil twins, in fact, they pose major difficulties for him—and also for his would-be investors—for they confront our entrepreneur with two nasty sets of problems.

Firstly, he must contend with the stop-go nature of business which results both from the varying speed at which new infusions of this credit are delivered and from the changeability which sees them flood firstly into this area, then into that, and then on into yet another.

This leaves the entrepreneur facing a riddle familiar to all of us who try to preserve the value of our capital.

Given the unpredictable pace with which the yardstick of today's money shrinks, like us, the entrepreneur cannot ever be certain of what constitutes a genuine success.

He may have made a handsome monetary profit, but has this happened simply because that money has depreciated since he last did his books? He has cash in the bank, but is it enough to replenish his inventory? Are his workers starting to ask for higher wages and benefits as prices elsewhere rise? Can he afford to repair his machinery? Has he been able to set enough aside to replace it at the end of its natural life? These are all tough questions made more insoluble by dishonest money.

Like we investors, he may struggle to answer correctly and this will prove to the detriment of his business. If he gets it wrong, he may post an unimpeachably positive accounting result: one which suggests he is doing rather well, thank you. Sadly, the truth may very well be that not only is he *not* making the most of the capital at his disposal, but that he may even be presiding over a slow erosion of its value.

The second danger he encounters will require a little more discussion, but, to anticipate ourselves, it boils down to the fact that while new money is being poured into the system, our man will be increasingly at the mercy of two competing forces.

On the one hand, many of those who require his goods, perhaps those a long way down the chain from the people with whom his own salesmen usually deal, will only be able to buy those goods at his asking price so long as an ever-increasing quantity of dishonest money keeps on coming their way.

Secondly, there will be businesses in totally separate industries which may be in receipt of plenty of extra dishonest money from their own customers, in turn.

Though their products are very different to our man's, some of the resources which go into their making may be the same as those which he needs. Because of this, these other companies may well be pushing up our entrepreneur's costs when they bid for their own raw materials, or when they seek to attract new workers with an offer of pay better than that which his employees currently earn.

Thus, with many entries in his order book put there on the shakiest grounds and with his realized selling prices largely unconnected with the factors which are driving his costs higher, our man's business may soon start to wither away, even in the midst of a general Boom.

Crucially, much of this depends not on the true state of consumer demand, nor on the actual availability of the means of production—things for which a savvy entrepreneur has a feel.

Instead, far too much influence will be exerted by the short-term vagaries of the ongoing credit creation. As a consequence, things will depend heavily on just whom the bankers and speculators decide to shower with either the *greatest* dole of funny money, or with the *earliest* installments of it. Genuinely free markets will have very little to do with it.

An easy mistake to make

So that we may fully appreciate the plight of today's entrepreneur, let us suppose one of them, a Mr. Jones, runs a small, specialist manufacturing company, somewhere in upstate New York. Let's also imagine that he gradually becomes aware that his shop is beginning to receive a higher volume of orders.

"Whaddya know!" Jones declares. "Business is looking up, at last!"

Being a prudent man, he digs around for a

while, seeking out more information. The feedback from customers, suppliers, and competitors is all positive. He is persuaded that it all seems to check out.

Apparently, Jones hears that quite a number of new businesses have been set up in recent months as the economy "recovers". The upshot of this outbreak of optimism is that his own best customers have seen their inventories decline and their order books fill to the point where they need more from our friend, too.

Well, our man doesn't call himself an entrepreneur for nothing and so he takes the calculated risk of expanding to fill these orders. He puts on a new shift, he orders some new machines. He even thinks about building a whole new assembly line.

Jones is cautious by nature, so he finances as much of this as he is able from the firm's internal funds. Even so, if business continues to boom, he might yet be tempted to call his local banker, or to issue a little more stock, in order to speed things along.

For a while afterwards—perhaps for a considerable while—his choice seems to be borne out by experience: everything comes up roses.

Then, one day—possibly many months later—it happens one of Jones' customers' customers' customers, a Mr. Smith (a sort of customer-twice-removed), runs into a little turbulence. Halfway around the world, Smith had recently set up in a new and very different line of business. Now, he is starting to find that he cannot afford to pay for any of the more goods to which Jones helps give rise - at least, not at the initial asking price.

This is because, you will recall, the economy is in the grip of an ongoing credit inflation and this has caused some of the other, more insistent requirements of this customer-twice-removed to be bid up beyond levels for which he'd budgeted. Perhaps it's Smith's labor costs; maybe his raw materials, or some of his other components; possibly it's his fuel supplies, or his ground rent.

Whatever it may be, these are now costing him more, thanks to the prices tendered by the eager participants in what may be yet another, completely different industry from the ones in which either Smith or Jones consider themselves to operate and of which they are both totally ignorant.

Either that, or it could be that the price Smith can charge for his output is not as high as the one which he had reckoned with when he first formed his business plan.

One typical reason for this setback is that, despite the fact that a great deal of extra (dishonest) money has been created, people's tastes haven't altered one bit from what they were before the inflation started.

This implies that most of this new money will still be stubbornly chasing the same old, unexpanded supply off the original menu of consumer goods. These will therefore tend to rise in price.

As a consequence, even though people's pockets are stuffed with more of the stuff, there may *still* be too little money left over to buy Smith's less attractive wares at an asking price elevated enough for him to be able to afford the full invoice price of his supplies, in turn.

Giving off all the wrong signals

Smith is now struggling. But we should stop to reflect upon how it was that he was ever able to go into a business which obviously has poorly defensible margins and overly ambitious goals. How is it that he has been given the chance to make a product nobody much seems to want?

Chances are this would never have happened if previously unavailable loans had not been offered to get him started. Smith is playing entrepreneur not so much because of his skill at sniffing out some fresh market opportunity but because he successfully persuaded somebody to bankroll his fantasies.

He hasn't ferreted out some unexploited niche in the consumer market, nor has he discovered that he can take $X of inputs away from their current uses and generate $X+Y of revenues from the new uses to which he will put them (where $Y is obviously more than the existing businessmen can presently manage). No, instead Smith can thank his banker's eagerness to write more business and leave it at that.

You see, his banker's appetite has translated either into a new credit granted directly to Smith, or one given to that sharp-suited venture capitalist who now funds him in advance of what the VC hopes will soon be a lucrative initial offering of equity to the public.

In essence, all of this increased activity has been driven only by the pickings everyone expects to be enjoy, courtesy of the easy money boom which is now building up a head of steam.

The problem here is not that Smith could get financing. Rather, it is that the source of these monies was to be found in an artificial inflation of credit and not in the banker's decision to employ the savings his depositors had made earlier.

Smith may still have proven to be a bad businessman: he may still have failed his backers and disappointed his creditors, even under an honest money system, but the woes which would have brought about his downfall would then have been due to factors wholly unique to him.

But the reality is that, as our dishonest monetary inflation gets underway, a widespread pattern of disruptions emerges which cause generic problems to afflict *all* entrepreneurs, as opposed to ones specific to the unfortunate Mr. Smith.

Firstly, if money were honest, any lowering of interest rates could only have come about because more and more individuals had voluntarily and independently decided to save—to consume *productively* in bringing more goods to market in the near future, rather than to consume *exhaustively* those that were already there.

This lowered rate of interest would therefore have arisen from a spontaneous increase in the demand for assets in which to invest. This would have harmoniously implied a much lessened appetite for some, or all, of the original menu items of existing consumer goods which people had been in the habit of buying, before they'd decided to put a little money aside instead.

These existing goods' suppliers—now facing a slacker demand for their end product--would not then have been in the marketplace for so many of the resources needed to make them. Remember that this was precisely what was bidding up Smith's costs, to the ruin of his aspirations.

What it is vital to understand here is that, under honest money conditions, there cannot fail to be a close correspondence between the prevailing level of interest rates and what these rates are signaling about:

(i) the existing demand for an unchanged basket of final goods available today, goods in whose production Smith plays no role, and

(ii) the potential demand for the somewhat different range of goods available tomorrow to which Smith can hope to contribute.

Let us put this in the form of two equations to make it as clear as we can:

(i) Unchanged interest rates = static savings = a strong desire to consume what is in the shops *today* = no material scope within which Smith can hope to operate.

(ii) *Naturally-occurring* lower interest rates = higher savings = a relatively stronger desire to consume what the shops may have on their shelves *tomorrow* = greater material scope in which Smith can operate to produce some of tomorrow's goods.

Because of these identities, all the innumerable Smiths out there who have been enticed by the credit inflation into undertaking misplaced ventures, could never have been so badly misled if money had remained honest.

Moreover, without the falling standards of judgment which the boom never fails to encourage, most of these wannabe-Smiths would not have seen their plans past the drawing-board.

Certainly, bankers would have thrown our Mr. Smith out on his ear had he not presented a far more compelling feasibility study than he obviously did. But, in a dishonest system, such discretion becomes a neglected virtue. When everyone has his eye on the league table for bond issues, or competes to book the most syndicated loans, all such temperance and responsibility is abandoned.

But, let's leave the iniquities of modern finance aside for a moment and get back to our hapless start-up, poor old Mr. Smith.

In the case of the raging credit boom, our two equations from above been violated. In fact, the second has had its sign reversed. Smith's prospects may be even bleaker than we have suggested. Not only has there been there been no *extra* saving to make the needed resources available to Smith, there will probably be even *less* of it!

Buy! Buy!... Bye!

Here again, artificially-lowered interest rates will not be in unison, but rather in conflict, with this enhanced requirement for existing goods.

Far from being in a temporary surplus, currently produced consumer goods are indeed likely to be in deficit as the higher nominal incomes made possible by the inflation make their way into the wallets of shoppers whose tastes have not altered one iota.

Accordingly, when the producers of these goods are faced with rising demand and rising prices, they will themselves want to expand. They will soon start to pressure the prices of the items Smith wants for his own assembly line.

As Smith struggles to stay afloat, he will soon be back, hat-in-hand, begging his backers for a "second-round" of financing.

The old adage that "money is never in short supply, except when there's too much of it" will begin to make itself felt and, as the cycle repeats itself, a bidding war may well break out.

No matter the size of his pocketbook, Smith is not guaranteed to win this war. He still lacks what his competitors for resources do not: an established end-market for his products. Recall that Smith got into the business only because he was able to secure cheap financing. But when interest rates diverged from their natural level, they no longer sent reliable signals about the supply and demand relation between consumer goods and available re-

sources.

In contrast, the already-proven firms which Smith is now battling with his banker's money were coping full well, even when interest rates were originally higher and when demand for their own output was lower, as a consequence.

To see what this implies, let's restate our original equations to highlight how dire is Smith's current situation:

(i) Unchanged interest rates = static savings = a strong desire to consume what is in the shops today = no material scope within which Smith can hope to operate.

(ii) *Artificially-lowered* interest rates = lowered savings = an even *stronger* desire to consume what is in the shops today = even *less* material scope in which Smith can operate to produce tomorrow's goods.

The flagging final demand and the tight initial supply are now forcing Smith to cut back on his own spending, especially on the more discretionary items, such as capital equipment.

But, here lies the rub.

In due course, as all the Smiths out there start to retrench and as order cancellations grow, the tremors will be felt higher and higher up the chain, becoming magnified and concentrated on the evermore specialized manufacturing concerns, higher in the productive structure, as they do.

So, at last we can come back to Jones, our original entrepreneur, the man to whom Smith was his customer-twice-removed. Though his very existence was unknown to Jones personally, Smith was the original source for all those extra orders which led Jones himself to gamble on an expansion of capacity.

But thanks to Smith's mistakes, our wholly innocent New York factory owner now finds that he, too, has become the subject of a nasty cost-price squeeze. As his margins collapse and as his revenues shrink, he may even end up paying the ultimate corporate penalty for his error.

If he does go bankrupt, it will be little consolation to him that the biggest culprits lie not in his own boardroom, but in the credit department of some faraway bank where the officers were rash enough to lend Smith the seed money with which he formed his foredoomed Bubble company, so lifting the curtains on this little tragedy.

Enter, the central bank

At this point in the drama, if enough Smiths and Jones manage to get into trouble at the same time, we can expect the central bank to make a grand entrance, stage right.

The truth is that the central bank's own policy is what either promoted or endorsed the initial credit expansion. But, despite the fact that this was the reason for all the misdirected activity and ill-judged investment which took place, we can bet our bottom (depreciating) dollar that the central bank will now loosen policy even further.

The bank will do this for the avowed reason of wanting to help achieve "sustainable growth".

What this carefully crafted jargon really implies is the pursuit of a Keynesian policy of approaching the mythical state of "full employment" by engendering an appreciable, but hopefully non-accelerating, degree of inflation.

In this way, the central bank hopes to achieve its three main objectives.

Firstly, it hopes to fool workers about the true value of their wages, lest those left idle are otherwise too stubborn to price themselves into jobs.

Secondly, it aims to subsidize debtors at the expense of creditors, thus assisting the members of its banking cartel to rake in the ever-larger cut to be taken on an ever-expanding pool of loans.

Finally, it seeks to aid and abet the State so that, when it helps itself to some of the bills in its citizens' wallets, in order to buy their votes with their own money, it doesn't always have to frighten them by waving the gun marked "TAX" under their noses.

What the central bank fails to see is that its crude inflationism can offer no lasting cure for a disease to which that same inflationism created and that Smith and Jones are in trouble exactly because money was too loose to start with.

Given the rather obvious flaw that Smith doesn't have a viable business to begin with, it's not hard to see either that the next dose of new credit is unlikely to help him turn things around.

More likely, it won't be Smith, at all, but *Adams*—a man in another field entirely—who now persuades someone to lend him what he needs to launch his own particular get-rich-quick scheme. Moreover, it will be the largely innocent *Brown*, not Jones this time, who is bamboozled into expanding production as Adams' expenditures temporarily find their way up the food chain towards him.

In this way, we are doomed to a repeat of the whole sorry process.

Often, we will see rolling booms and busts taking place in succession in different sectors, as first Smith & Jones (say, in technology) rise and fall, then Adams & Brown (in housing, perhaps) have their moment in the sun. Next, might come John-

son & Davies (who are exporters, aided by a now-falling local currency), then Randall & Hopkirk (in materials or mining).

Largely, such upheavals will go unnoticed by those who rely on the broad statistical aggregates which are widely taken to characterize the economy. Nevertheless, each time, precious capital will be misallocated and its value either reduced or lost entirely. This will ultimately be to *everyone's* detriment, since only the steady accumulation of capital per head can serve to raise standards of living for the whole commonwealth; not just for the owners of that capital, but for workers, pensioners, infant children, and the recipients of charity, too.

However, if all this weren't bad enough, every once in a while, things are certain to get even more out of hand, for the central bank will occasionally manage to ignite a wave of *simultaneous*, not sequential, booms.

Now it really will have a "tiger by the tail", for nearly everyone will become either a Smith or a Jones. Soon, *everyone* will be scrambling to borrow yet more money in order to stay ahead of the inexorable rise in prices by buying now and paying later.

The final act

As this stage is reached, everyone will frantically be spending their higher monetary incomes on goods, just as the distorted allocation of resources and disrupted production schedules make it more and more costly for anyone to ensure their supply.

Should we ever come to this pass, there will be only two ways out. Neither of them will be pleasant to experience. Each will be fraught with danger for the rule of law, for the sanctity of property, for the maintenance of social harmony, and for the limitation of government.

We speak of *hyperinflation* – the destruction of money which will follow if the central bank tries to keep this carousel spinning ever faster – and of *deflation* - the collapse of credit likely to ensue should it belatedly throw the brake lever instead.

But, even if we are lucky enough to avoid either of these monetary catastrophes, as we have already seen, there remains plenty for us to bemoan in our present day state of affairs.

Forbidden fruit

For instance, one further issue that we have so far overlooked is the fact that Jones himself is often human enough to be tempted by the false allure of easy credit.

The list of good companies ruined by overzealous CEOs, under just such circumstances as these, is all too long to bear any argument to the contrary of the contention that inflation is anything but harmful.

For starters, many of our man's shareholders will see the broader stock market soaring and will demand he take steps to boost the price of *their* shares, too.

Or perhaps a pin-striped investment banker will persuade him that an acquisition will bring an instant increment of growth for the price of just a little more, easily serviced debt.

These weasel words will be harder to resist when it is pointed out to our manufacturer that all his competitors are doing just this very thing.

"They've all taken Wall Street's advice. They are all boosting their equity valuations by issuing debt. They are all desperately buying market share so they can report increased revenues (and profits, go hang!). They are now casting about hungrily for companies to swallow up, using their expensive, but nonetheless watered, stock – companies just like yours, I might add!"

Certainly, before very long, our man will probably be found borrowing some of this easy money, if only to buy back some of his own outstanding equity—*j-u-s-t in case*, you understand.

This will, of course, serve nicely to flatter the earnings-per-share numbers and no-one will bother themselves overmuch with what this will imply for the health of his balance sheet, or how exposed it will leave him in the inevitable downturn.

Our man may next imitate the corporate heroes who grace the covers of the business tabloids, by issuing large numbers of stock options in order to keep his executives and directors happy. As he does, he will introduce severe conflicts of interest between owners and managers–not that anyone will care. But even if he does not succumb to outright fraud, our man will already be failing in his duties, since he will now be thinking only of window-dressing the next quarterly report and not of tending to the long-term viability of his company.

But, being small, and so less of a target for Wall St's sales gimmicks, even if Jones does not stray from the straight and narrow, this is no guarantee he will be safe.

As we have tried to demonstrate above, the whole roller-coaster of Bubble and Bust is not just about excesses taking place in financial markets, however rich a source of journalistic hyperbole these are. More fundamentally, the business cycle is a tale of confusion in the signals given about the availability of real resources and the demands for tangible goods, both in the present and over the course of time.

So, where did Jones go wrong?

At the inquest, everyone will ask "Where did our NY entrepreneur go wrong?" or "What avoidable errors did he make? He's been around a while, why didn't he see it coming"

This maybe easy to ask, but, in our world of dishonest money it is actually very hard to say.

We can hardly expect Jones to become a fully-fledged Austrian economist before ever he presses a sheet of steel or solders a circuit board. Besides, it may not help that much, if he does!

We can't seriously suggest that he should be reading, not just the industry trade journal, but also the weekly and monthly money supply statistics from all the major central banks around the world.

We can't realistically insist that he decide against increasing output because he always seems to see that credit is expanding faster than are the savings needed to back it.

We can't caution him to defer decisions for months at a time while he waits for the government data (misleading enough, in any case) to be published, revised, and re-revised, so he can assure himself that exhaustive consumption and productive consumption are in a reasonable state of equilibrium.

Moreover, even if he did have the mental faculties and the emotional disposition to observe all these precautions, he would still face one final and insuperable hurdle.

This is that it is intrinsically no more possible for Jones to draw the correct, detailed inferences about his own, small business from these overarching macro-economic shifts, than it is for the central planners who make these shifts to know what their exact consequences will be.

Hayek called this last syndrome the "Fatal Conceit" of the Collectivists, but its implications apply no less to the most erudite and sharp-witted of private-sector businessmen.

So, find us a central banker or a finance minister who can predict exactly which gears will strip, or which pistons will blow, when first he starts to tinker under the hood of the free market and perhaps we'll make fewer allowances for Jones, the next time.

But, until you do, please realize how much more difficult has been made Jones the Entrepreneur's already daunting task by our old enemies, dishonest money and inflated credit.

—Sean Corrigan