Can Governments or Central Banks "Will" Real Wealth into Existence?

Of course not! Real Wealth can only be created from work and natural resources. It is physically impossible to "Will" real wealth into existence.

Real Wealth is defined as:

- Delivered Services
- Skill Sets (Human Capital)
- Natural Resources (including land)
- Goods
    - Capital Equipment
    - Buildings
    - Infrastructure (Utilities, Roads, etc.…)
    - Consumables & Durables

NOTE: WORK must be performed to create Real Wealth with the exception of Natural Resources. I.e. Real Wealth is NOT Fiat Currency, Bonds, "paper assets", etc. The converse, however, is not necessarily true. Just because work was performed, Real Wealth may not be created. i.e. Digging a hole, then filling it back in does not create Real Wealth.

The perception by many is that government (and/or the Central Bank) is creating wealth when it adds liquidity (money and credit) to the financial system… For example, they re-capitalize banks and provide them wealth when they swap highly liquid Treasury securities for illiquid "toxic" loan securities… Or, they directly purchase shares of bank stocks, thus create wealth enabling them to stabilize and start loaning again… Or, they create wealth by coercing the "rich" and TRANSFERRING their wealth to those "in need"… Or, they debase our currency (inflation), and publicly boast that the resulting higher financial asset and housing prices have increased our total wealth.

We have recently witnessed the most prolific barrage of government rescues, bailouts, subsidies, takeovers, etc. in the shortest period of time in the history of our Republic! These initiatives are their desperate attempts to maintain the illusion of wealth by keeping all the bubbles levitated that they have directly or indirectly enabled.

If Government Prevents a Housing Price Decline, Has It *<u>Preserved</u>* Real Wealth?
Of course not, assuming the housing prices were at bubbled valuations before the decline. The housing market peaked in early 2006 and has been declining ever since. The U.S. median price has declined 22% [1] so far and must decline another 15-20% before even reaching fundamentally justified valuation levels. Unfortunately, once the "justified" value has been reached, the negative momentum will continue as all major bubbles historically OVER-correct in real terms. Government cannot ***preserve*** housing wealth that does not exist. If the fundamental non-bubble value of a home is $200,000 and the price has bubbled up to $400,000 due to easy-money credit-expansion policies, the "Real" value of the home is still $200,000. Therefore, "preserving" a $400,000 value would only preserve an illusion of wealth.

Should "Joe Sixpack" be Kicked out of His Home?
Imagine a young fellow, Joe Sixpack, interested in buying a $1,000,000 home in sunny California. Fortunately, Joe has a job paying $20,000 per year and a stellar credit history. Unfortunately, Joe has accumulated $0 in savings so will need some understanding and leniency from the lender when he applies for a $1,000,000 loan with "nothing down"! The lender, by

employing a wonderfully creative teaser-rate Option Arm loan, determines Joe will qualify for his dream home that includes a swimming pool in the back yard.

A year passed, then one day Joe was floating on his raft in the swimming pool reading his mail when he noticed a letter from his mortgage company. It was notification that his house payments were going from $800 per month to $8,000 per month. Joe had been paying the lowest monthly payment Option which triggered a negative loan amortization; hence his principle balance is now $1,100,000. Joe did not worry last year because his mortgage broker assured him the home value would only increase and he could simply refinance next year into another brand new low-interest loan. Also, the new monthly payments would be affordable even with a higher loan principle! Joe was further assured by television images of Msgrs. Greenspan and Bernanke, and government leaders who all encouraged home ownership for everyone!

There are 3 options for Joe:

1. Get kicked out of the house and move into something that would be affordable for Joe long term.
2. The mortgage holder simply accepts a lower payment from Joe effectively reducing the value of the mortgage. i.e. Be content to receive $800 payments indefinitely for his $1,000,000 investment because Joe cannot afford anything higher that was outlined within the original mortgage agreement.
3. ***Ask for government help***. Joe's loan could be swapped with a government bond to make the mortgage holder whole, hence mitigating any loss for him. Or, Joe could receive a direct subsidy from government to help him stay in his home. In these cases the taxpayer takes the loss rather than the mortgage holder. Or, government could force the mortgage holder to restructure the loan to "affordable" terms for Joe.

Once government becomes directly involved in the "solution" (Option #3) the likelihood of kicking Joe out of his $1,000,000 home lessens. Hence, the loser will be the mortgage holder or taxpayer. Clearly, the best option is to have Joe move into an abode he can readily afford. By doing this the $1,000,000 home can be sold to a party that can rightfully afford it. By keeping Joe in the home and his "toxic" debt active in the market, that potential new owner is required to seek **incremental** new funding from a tightened credit market and new construction thereby further worsening the housing overbuild to satisfy his desire for a $1,000,000 home. Joe staying put actually exacerbates the imbalance problems and prevents them from correcting, **and** makes it **more** difficult for the "new party" acquiring the home they desire.

In this case government cannot "Will" real wealth into existence by swapping Treasury bonds for Joe's "toxic" loan. It will not only burden taxpayers with high-risk lower value debt, but will delay the necessary correction to bring markets back to stability. Government cannot "Will" real wealth into Joe's hands without TRANSFERRING it from someone else. Additionally, there are frictional or transaction costs of such a transfer. Hence, the actual Real Wealth that may benefit Joe from bailing him or his mortgage holder out is much less than the Real Wealth unwittingly coerced from taxpayers producing it.

Conclusion

Nearly all of us have a primal belief that government can soften nasty economic blows and prevent or at least minimize the severity of recessions by creating liquidity (money and credit) injections. What is missing is the knowledge that the efforts of government attempting to soften sharp blows actually exacerbates the targeted imbalance they are trying to minimize. Joe needs to find an affordable house IMMEDIATELY, so others are not burdened with losses or illusions of wealth, which only increase as government intervention grows. The sooner the resource misallocation and malinvestment (Joe Sixpack in a $1,000,000 home) is corrected the sooner markets can return to a stable state.

By Russell Randall
Home Page: www.austrianenginomics.com

References:

(1) S&P Case Shiller U.S. National Home Price Index, http://paper-money.blogspot.com/2008/08/s-june-2008.html