"Real" vs "Financial" Debt; An Unsettling Illusion

We live in a world of extraordinary financial debt, which has now grown to unprecedented proportions relative to our output in the U.S., and represents the greatest illusion of wealth in the history of the Republic. "Austrian Enginomics"[1] contrasts real economic conditions and metrics from the illusory financial metrics. Comprehension of real debt requires a paradigm metamorphosis. One must repeal the traditional measure of debt and output in monetary terms and enter into the world of real wealth and real debt! We will discover there is a very specific limit possible to outstanding Real-debt relative to output. With this understanding, one can gain an appreciation of the magnitude of our Total Credit Market Debt (TCMD) **illusion** existing today relative to Output over a critical period in the history of the Republic.

First, let's start with understanding Real Wealth vs. Financial Wealth

- Real Wealth includes Goods and Services delivered that can only be created by employing Labor and Natural Resources, all of which fall into one or more of the following categories:
    - Capital Equipment & Facilities
    - Infrastructure (roads, utilities, etc.)
    - Goods (durable and consumable)
    - Human Capitol (skill sets)
    - Delivered Services
    - Natural Resources
- Real Wealth cannot be willed into existence (especially by a Central Bank or Governm't).
- Real Wealth is NOT fiat currency, bonds, "paper assets", or etc.
- Real Wealth is finite in the world. Unless labor and natural resources are utilized, Real Wealth does NOT increase. Scarce commodities (e.g. oil, water, natural gas, copper, etc.) may increase in relative valuation to other Real Wealth, but for every bit of increase in their value, there is a commensurate "bit" decrease in value of all other Real Wealth.

- Financial Wealth includes Real Wealth plus currency, bonds, "paper assets", and etc.
- Financial Wealth assets (e.g. fiat currency, bonds, etc.) are, at best, contracts to ACQUIRE Real Wealth.

>>*Within the framework established above one may readily see that instantly doubling or halving all fiat currency and/or debt securities on earth would have "0" impact on Real Wealth.*

What is Labor?

- Labor is employed to Work, which, is defined in the Webster dictionary as: Human activity purposefully exerting strength or faculties to do or perform something.

Next, What is Real Debt?

- The Webster dictionary states: Debt is a "state of owing", which is "to be under obligation to pay or repay in return for something received".
- Real Debt is thus the resulting obligation from receiving Real goods or services. Interest may impact Real Debt on an individual transaction basis as time passes.

Three Simple Physical Axioms:

1. On average, one cannot consume more Goods and Services than one can produce in a lifetime, assuming inventory is not depleted.
2. On average, one cannot be indebted to repay more Goods and Services than one can produce in a lifetime, assuming inventory is not depleted.
3. On average, interest payments combined with debt redemption defaults must net to "0" in a lifetime.

1. Consume More Than Produced?

- Consume in this context is the purchase of a Real Wealth Good or Service by a buyer. Use or literal consumption is *not* necessary.
- Produce is the contribution of work activity in producing a good or performing a service.

Imagine becoming empowered to see the activities of all living humans indefinitely into the future, and having the ability to know what is produced and consumed by all people on earth for the next trillion+ years! Next, imagine having the ability to consider any alternative scenario into the future that one may desire to test. In any given scenario a slight variation in production or consumption by a single human will likely have a far reaching impact into the next trillion years, however, it would exist as a completely new scenario. Finally, we all must acknowledge ***what will happen will happen*** in time. I'm not suggesting that life is predetermined in any way. I'm simply acknowledging the fact that as the events unfold into the future, the "Simple Physical Axioms" identified above will apply in ***any given scenario!*** An attempt to change any transaction or work-effort on earth today or into the future results in a new model with corresponding downstream changes, but still meets the axiom conditions noted. Thus, given any one of an infinite number of scenarios, on average, one cannot consume more than one can produce in a lifetime, assuming inventory is not depleted.

Now we can view this same logic in real time. If the axiom holds true in a lifetime, then it must hold true each and every day in aggregate. Considering the millions of goods and service units produced daily along with the associated sale transactions, the aggregate total could not creep out of balance over time, otherwise it would invalidate the axiom. Therefore, even on a daily basis, we cannot collectively consume more than we produce (assuming inventory is not depleted) on earth.

2. Owe More Than Produced?

- When a Debt transaction takes place three significant things happen within a Real economic context:
    - GDP is recorded (from the sale of a new good or service)
    - A new Real debt obligation the exact magnitude of the sale price (less the down-payment) is incurred by the recipient, along with terms of repayment.
    - The corresponding Credit security is attained by the seller of the good or service at the exact magnitude of the sale price (less the down-payment).
        - Note: Interest obligations and payments are addressed independently in the third axiom (below).

Now, let's view the Real economy transactions in real time. If we accept that we cannot owe more than we produce on average in our lives, then it follows that each and every transaction of Real Wealth on earth is gifted, coerced, exchanged for a Real Wealth equivalent, or encumbered with a debt the magnitude of its price, or a combination of the above. It then follows that if one produces and sells a good or service, the maximum Real debt as a result is the price of said good or service less that which is gifted, coerced (which can never be recovered), or exchanged. For example, if a bicycle was gifted to a charity and for some reason returned to the donor and then sold into the market, it would ultimately be classified as a sold good, which is either exchanged for equivalent Real Wealth or a debt encumbrance.

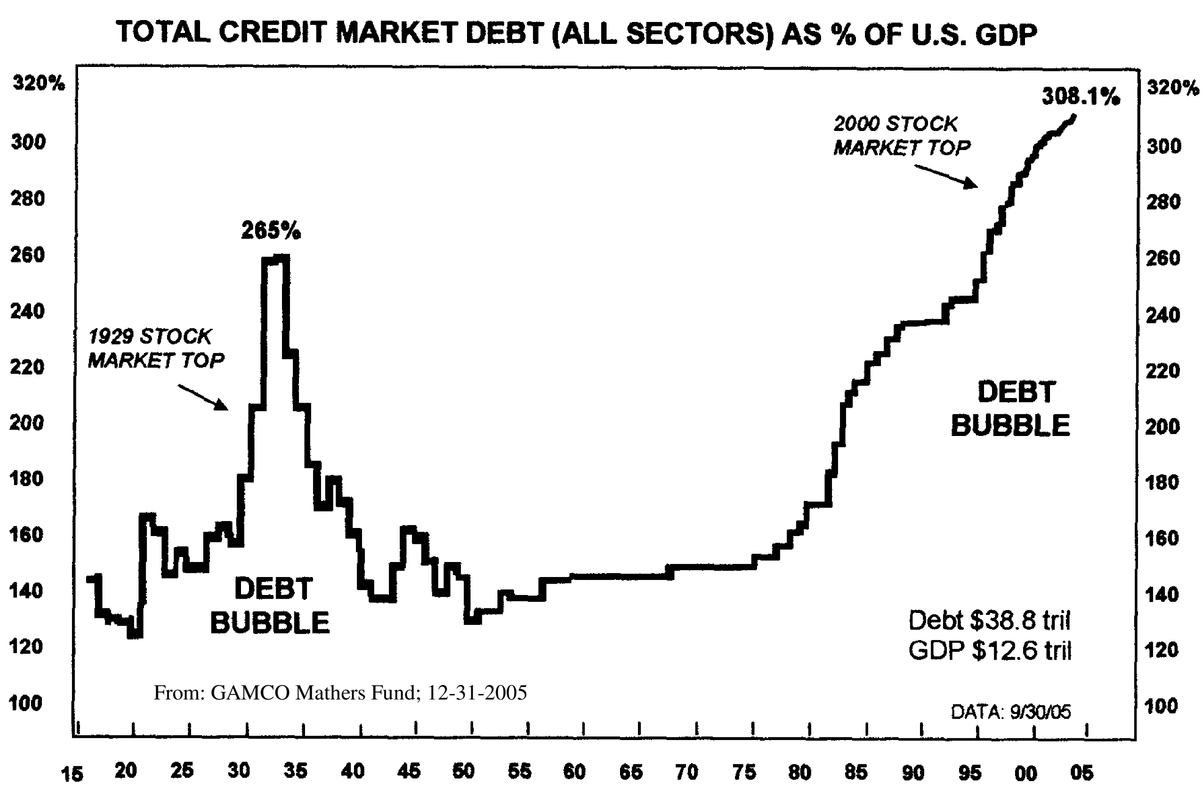
One can now deduct that aggregate Real-economy debt can physically never exceed the total production of goods and services (Gross Domestic Product) in real time. The maximum Real debt for any transaction cannot physically be greater than the sale price or GDP of the transaction. Otherwise Real debt could accumulate at a greater rate than GDP over time, which has been established as a physical impossibility.

3. Interest Payments Must Net to "0"?

Finally, if the first two axioms above are accepted, then this axiom must be accepted, as it would violate the first two under any circumstance of aggregate interest payments in Real Wealth netting to anything but "0". For example, if an individual was always in a debtor status his entire life, his Real Debt that must be repaid in Real Wealth would be the principal amount of the original price of his acquisitions plus the interest payments in Real Wealth. In this case the individual would consume less in his lifetime than he produces as opposed to the counter-balancing individual who was in a creditor status most of his life. In that case the creditor individual could receive and consume more goods and services than he produced. In aggregate, however, for the average individual, interest payments combined with debt redemption defaults must net to "0" in a lifetime or in real time utilizing the same logic established in axiom #2 above.

So, Why Does the Financial World Believe Debt Can Be Greater Than GDP?

That's the $64,000 question! There is a clear decoupling of the Real economic world from the Financial economic world. The following graph will offer a sense of the magnitude of that decoupling. Following the logic of Real Debt and its relationship to GDP, the cursory argument is that Total Credit Market Debt (TCMD) cannot increase relative to GDP, or any debt level that is greater than an established base Debt-to-GDP ratio is an illusion of wealth. Viewing the graph below, one could envisage an approximate **$26.2 trillion** ($38.8-$12.6) **illusion** of wealth!



Ouch! Leaping from the Real economic world of logic to the Financial world (above graph) is a tremendous undertaking! One must consider changes in the methods of payment (e.g. shifting from credit cards to debit cards), as well as the shift of longer repayment-cycle goods (houses) to shorter cycle goods (groceries or services delivered) or visa-versa, and the net credit/debt financial tally of each individual. However, in my more extensive analyses, I have discovered more reasons the debt should have increased LESS than GDP from an established base Debt-to-GDP ratio! That means the $26.2 trillion may be a LOW estimate of the illusion magnitude!

Just How Do We Get Out of Whack (i.e. decouple Real from Financial)?

We will briefly explore two of the most pervasive examples:

1. "Federal Debt is Pure Bubble!" The article posted here… http://www.austrianenginomics.com/id7.html#1 explains that the ***magnitude*** of Federal Debt is an illusion of wealth ($8.3 trillion today). Once labor has been expended toward a government purpose, it will NEVER be recovered! It must be recognized as an immediate tax allocation at the time it is expended. It cannot be recognized as an incremental Real Wealth asset in the form of a bond that will be realized later. If a government bond (non-revenue) is issued, the only way it can be redeemed later is via labor the will displace a resource dedicated to a market (non-government) purpose.
2. "Houses DO NOT Appreciate, They Inflate…!". The article posted here…. http://www.austrianenginomics.com/id7.html#2 explains the complete decoupling of the Real Economic world from the Financial Economic world in real estate. If "Joe Sixpack" earning $40,000 per year managed to qualify for a $1,000,000 loan (via an Option ARM-initial teaser interest rate) based upon his spotless credit record and modest salary, it is unlikely the loan will be repaid in real terms (non-inflated $'s), but possible. Yes, Joe could win the lottery or progress rapidly up the ranks at work to command the $300,000 salary that would reasonably qualify him for the $1,000,000 loan, but again, it would be unlikely.

   At this point we have not **decoupled** from the financial world **yet**. Joe is still obligated to repay the loan. However, if official inflation is reported to be say "0", and through the magical world of monetary liquidity expansion along with debt-expansion Ponzi schemes, the newly created money channels into housing valuations thus increasing the market value of Joe's home to $1,500,000, then Joe could refinance up to a $1,500,000 loan and use the extra $500k to help make house payments, go on a cruise, or retire. In this example **<u>we now have a disconnect</u>** between the Real Economic world and the Financial Economic world. Houses do not create wealth in the Real economy (no incremental work or natural resources expended), yet the financial economy system recorded an aggregate wealth increase of $500k. In one instant the perceived illusory equity Joe had in his house of $500k is converted into a perceived illusory credit of $500k to someone purchasing the new $1.5mm loan; both of which are illusions of wealth. Joe can now spend this unearned $500k on Real Goods and Services. Those providing these Real Goods and Services will expect the equivalent Real Wealth in return some day later, and Joe does not think it will come from him. The cruelty of the story is that the creditors will be left holding an empty bag because the incremental $500k credit claim on an equivalent value future production stream of Goods and Services will not be physically possible to satisfy (in aggregate). The Financial world debt claim has now exceeded the Real World debt claim. As in all bubbles those cashing in early will get the spoils, and those waiting later will be paid back in massively inflated currency; thus receiving less than they produced in Real Wealth.

   Yes, if miraculously Joe becomes president of his company and is able to pay the additional $500k principle plus interest on his loan he will have paid a total of $1,500,000 in Real Wealth (plus interest), where his perception at the time of re-financing was that he was obliged to pay the original $1,000,000 in future Real Wealth payments but NOT pay for the added $500k as the house magically created that wealth for him without the obligation to work more and pay it back in Real Wealth (see the disconnect?). Alternatively, if Joe sells the house at $1,500,000 before the housing bubble pops, then the new owner will effectively be obliged to pay $1,500,000 in Real Wealth plus interest for a home that only required $1,000,000's in Real Wealth to construct. Joe ends up with $500k in credit (an add to the Financial world) after producing "0" Real Wealth, which is not an "add" to the Real economy (another disconnect??)

Bottom line… Incremental credit magically created from no work input (Joe's $500k re-finance) will always be incremental financial credit relative to the ongoing stream of Real Wealth creation in the world. The only way this bubble of credit can be diffused is through debasement of our currency (inflation) or default. Remember, on an ongoing daily basis, on average, one cannot owe more than one can produce in Real Wealth.

There are numerous other ways the Real Economy decouples from the Financial Economy, but the two mentioned above are huge misfortunes that will shock the U.S. economy when we begin tasking (cashing in on) the bubbles in the 2008-2010 time frame or sooner.

How Can Real Debt be Transferred in Time?

If I mow a neighbors yard while he is on vacation and collect an IOU, he is indebted to me to repay a proportional effort of labor later. Both parties are engaged in the deal and the debtor party (my neighbor) is obliged to repay in some time frame. He is **signed u**p for that task and is committed to allocated a portion of his future work endeavors to fulfill the obligation thus enabling a Real Debt transfer in time. If on the other hand my neighbor and I both mow the Governor's lawn and are given IOUs (government bonds) because the Governor has no surplus tax revenue for our work efforts, we are NOT transferring Real Debt in time because there is no taxpayer obligation identified (**signed up**) to satisfy the debt. The bonds are an incremental illusion of wealth to society. A proper course would be to immediately pass a tax increase and burden current or future taxpayers (i.e. **sign them up**) to repay this debt. Thus, the responsible solution is to pass the tax increase immediately and **align** the Financial world with the actual work performed (mowing the Governor's lawn) **at the time labor is expended**, or find an **existing** government employee who can absorb the lawn-mowing task.

Conclusion:

The Financial world of debt is nowhere close to the Real world of debt. The Financial debt on record is a gross overstatement of wealth in the world. Economists and Financial analysts view debt in a linear context such that regardless the relative size of our debt obligations, given time and the will, an individual, group, or nation could repay it in full. In fact, that is only the case for debt equal to or less than output in an aggregate (not linear) context. Any debt obligation higher in aggregate than output is an illusion of wealth.

In other missives[2] I explain the timing of this massive illusion discovery, which will be when the Boomers worldwide begin tasking (cashing in on) the illusions of wealth. That begins in earnest in 2008-2010. Also see the "U.S. Economic Health Graphs" here http://www.austrianenginomics.com/id10.html to gain insight into the magnitude of illusions in stocks as well as real estate equity (the other bubbles our Central Bank and Government enabled).

By Russell Randall; 10-3-2006

References:

1. "Austrian Enginomics"; see: www.austrianenginomics.com for definition and details
2. "The Embodiment of a Credit Blow-Off Stage"; http://austrianenginomics.com/TheEmbodimentofaCreditBlowA.pdf