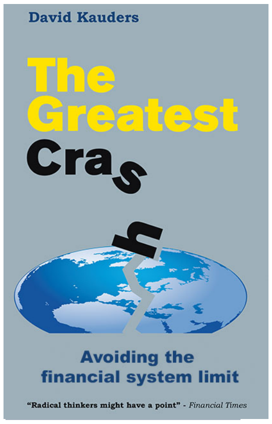

The Greatest Crash

Avoiding the Financial System Limit

The Greatest Crash argues that the financial system which evolved from the early Italian bankers has now reached a roadblock. Evolution is needed. But bureaucratic design, delegated government, and group think, all combine to prevent evolution.

By David Kauders

This edition	Digital (delivered electronically)	9781907230257
Other editions	Paperback / softback	9781907230240

E-book $5.99 £4.99 €4.99, also quality paperback (see website)

David Kauders FRSA was educated at Latymer Upper School, Jesus College, Cambridge and Cranfield School of Management. He is an investment manager and also contributes occasional articles to the UK financial press.

About the book

The Greatest Crash argues that the financial system which evolved from the early Italian bankers has now reached a roadblock.

The weight of debt already created prevents further economic expansion, while paying down the debt shrinks economies.

To escape this trap, evolution is needed. But bureaucratic design, delegated government, and group think, all combine to prevent evolution.

Reviews

"Radical thinkers might have a point" - *Financial Times*

Excerpt

Group think

Mass delusions and the media crowd

After the credit crunch started, many commentators referred to the absence of alternative view points during the period 2003 to summer 2007 as "Group think." There was a degree of hypocrisy about such comments, because the media were prime proponents of the story that Britain was booming. Viewpoints that this was completely false, and the credit merry-go-round would end in tears, were ignored. Only after a decent interval did some of the media admit that they knew of other views all along.

The story that Britain and the world had entered a new age of prosperity suited the Establishment. This rang true so long as the immediate, positive results of the debt spree were reported and the longer-term costs could be conveniently ignored. Of course, in an era of instant opinions, everyone believed the fiction, but it was nothing more than a mass delusion, propagated by a sympathetic media and aided by the Internet.

During the last decade, use of the Internet spread into every affluent household in the world. It has allowed popular view-points to be repeated ad nauseam, and thereby believed because of their repetition. A book appeared extolling the wisdom of crowds. However, the defining work on crowd delusions and mass behaviour is Psychology of Crowds by Gustave le Bon, written late in the 19th century. Le Bon noted the importance of images in impressing the crowd, a lesson politicians still observe today. He also noted that repetition is used to make a story credible, a lesson duly copied by those politicians who blamed bankers for being the entire cause of the credit crunch. Above all, le Bon thought the crowd was a blockhead, reduced to simplistic judgments in complete unison. The crowd determines that it must be right; dissenters are ignored; gurus appear to tell the crowd exactly what it wants to hear.

Every financial mania in history has depended on two crowd delusions: the image of easy riches and repetition of the story. These are the facts behind every Ponzi scheme and every scheme that needs new money rolling in to pay the earlier investors. They are the rationale for investment managers offering to jump on every passing bandwagon, ignoring the problem that if they all jump off together, prices will crash. We shall return to how investors participate in manias in chapter 8.

As financial pressures have grown, the media have resorted to two kinds of differentiation: speedy response, and opinion/editorial pages. Let's look at how they both work.

News reporting has moved from legions of local journalists having time to get to grips with events, to rapid response accumulation of text messages, photos, emails and mobile phone calls. Some trade journals even use computer programs to cull news stories from websites without human intervention.

The quality media differentiate themselves by employing opinion writers. So far as business and finance are concerned, there is a remarkable tendency for every source to mimic what others are saying. Partly this is due to the pressure to produce copy quickly, sometimes in a few hours from brief to filing, and partly to the similarity of thought processes involved. Opinion-editorial writers themselves form a crowd, repeating the same stories uncritically. A classic example occurred early in 2010 when many British newspapers found reasons why Gilts were about to collapse in price, whereupon the Gilt market did the exact opposite and rose sharply.

There are a number of reasons why media opinions about markets are frequently wrong. The authors:

* forget that every opinion anyone holds anywhere is already "in the price," i.e. the market has discounted the story even before it is written;

* have little understanding of the concept of leading and lagging indicators, so that lagging indicators such as unemployment and repossessions are hailed when they turn down, even though the next upturn is inevitable, and leading indicators such as capital market movements are simply disregarded as "obviously wrong because you don't see the evidence around you";

* never consider the prospects for unpredicted change.

In 2008 the Guardian journalist Nick Davies, wrote a book that exposed shortcomings of the media. He called it Flat Earth News; the core of the book was the evidence that newspapers and others endlessly repeat opinions as facts. Davies did not refer to le Bon, but he had rediscovered the same mass delusions.

Consensus or contrarian?

The consensus dictates how most people see their financial futures, but the fundamental reason why the consensus has been so wrong over the credit crunch and the 'recovery' is that few understand the concept of the system limit. From this lack of understanding, flows the erroneous belief that economic relation-ships work in a set way. From this, incorrect conclusions that inflation is a threat, and that interest rates will rise, themselves follow.

There are likely to be increasingly desperate attempts to create inflation over the next few years. There is a simple reason why these attempts will ultimately fail. When interest rates go down or bank failures threaten, depositors withdraw their money from banks. The bank credit multiplier then goes into reverse, with banks limiting their lending artificially. As a result economic activity slows down further. Only contrarian thinking can provide an alternative. Inability to think differently will lock many investors into declining capital bases and declining income as the financial crisis rolls on.

We live in a pseudo-dictatorship. In Britain, we elect new political dictators every five years then let them get on with it. Politicians, though, are not the real dictators. The real dictators are the consensus opinion-formers. They brook no dissent. Take, as an example, the release of UK GDP figures for the second quarter of 2010. Most newspapers and magazines produced a U-shaped graph showing how the economy had apparently recovered the lost ground. The graph was taken from the British government's National Statistics press release without thought. The impression formed was completely wrong. Why? Because the graph plotted a rate of change, which unfortunately ignored the absolute loss of output. The facts were:

UK GDP 3rd Quarter 2008 £340,780 million

UK GDP 2nd Quarter 2010 £328,766 million

This was the dictatorship of the consensus, followed faithfully in every story. There had been insufficient growth to recover the lost ground, yet nobody recognised this.

Repetition of simplistic, self-evidently "true" stories drove the South Sea bubble, the Japanese bubble, the Technology, Media and Telecommunications bubble, the property bubble and the commodity bubble. It also influenced policy nostrums, such as using higher interest rates to fight inflation, while ignoring the desperate need of the authorities to create inflation and their utter inability to do so. Repetition spread the idea that the dollar needed to be devalued to solve America's financial problems; instead, the dollar rose. This example demonstrates another truth: when found out, the consensus simply move on and ignore their gross error. When the Establishment get it totally wrong, they just forget. Opinion is a fashion business, not a science.

Some examples of group think

Most investors are obsessed with inflation, property and commodities. The obsession was fed by news stories repeating the same "look how well you do" line. It's a form of propaganda, perhaps unintentional, but certainly effective. One absurd news item caught my eye: a report about how investors were buying mobile phone masts to rent out, on the grounds that the yield would be higher than on residential buy-to-let. But the mobile phone business has already peaked and internet based technologies such as voice over internet protocol have started to affect total demand. This is one reason why the mobile industry is in some difficulty, added to overpaying for 3G licences. Mobile phone masts can too easily be made redundant by changes in network topography or demand.

As another example, the plan (arising from the European Union) to replace standard light bulbs by low energy models to save energy wasted as heat is an example of group think. Much criticism has been directed to the mercury content of such bulbs, while missing the accounting trick: little or no energy will be saved! Domestic lights are usually on after dark in winter. Summer usage is trivial in comparison. Most homes have central heating. Taking away the heat source of the humble light bulb will lead to the central heating boiler cutting in more often and using more energy to maintain the same temperature. It is true that there will be a small saving by reducing marginal use of electricity and therefore marginal production of electricity, since fuel conversion to electricity is more expensive than direct use of the same fuel in central heating.

This dominance of group think is not new. It is the converse of Shaw's dictum: 'Reasonable people adapt themselves to the world. Unreasonable people attempt to adapt the world to themselves. All progress, therefore, depends on unreasonable people'.

Those who exploit fashion use the desire of reasonable people to conform with the majority. Fashionable opinions inspire and reinforce group think. Group think is endemic in the way our society is structured. It is not going to vanish. But it extends beyond the media and the way we are conditioned to think....

One of the remarkable points that I have found in writing this book is that many of the detailed errors, incorrect policies et al, have already been amply documented by others. But we never learn. The delegated society, the strength of lobby groups and vulnerability of our political system to pressure, the sheer volume of noise in the media and on the Internet, the immediacy of the demands of daily life, all combine to make our collective memory rather short.

Sparkling Books Limited, 85 Great Portland Street, London W1W 7LT, United Kingdom
Registered at Cardiff no. 05955447 Member of Indepedent Publishers Guild
sales@sparklingbooks.com www.sparklingbooks.com
Print distribution: BookSource (UK), Pathway Book Service (US) E-books: INscribe Digital / IPGBook Group (US)