

### The Paradox of Prediction \*

*“Doctor Friedman, what’s going to happen to interest rates next year? Hoobla-hoo. Some economists allow themselves to be paid cash money to answer such questions, but they know they cannot. Their very science says so” (McCloskey 1992, p.40)*

On a visit to the London School of Economics in November 2008, the Queen asked, “If these things were so large, how come everyone missed them?”<sup>1</sup> This question led to soul-searching amongst the economics profession, and a variety of responses.<sup>2</sup> For some this merely reflected the unreasonable expectations laymen place on the profession – as Geoffrey Hodgson wrote in an open letter, “Your Majesty, economists did something even better than predict the crisis. We correctly predicted that we would not be able to predict it.”<sup>3</sup> Contrast this with what Joseph Stiglitz had to say in a similar debate,

“The financial crisis has caused a moment of deep reflection in the economics profession, for it has put many longstanding ideas to the test. If science is defined by its ability to forecast the future, the failure of much of the economics profession to see the crisis coming should be a cause of great concern”<sup>4</sup>

This report takes an intermediate approach arguing that although economic science is not well equipped to make predictions, it is a myth to claim that “no one” saw the financial crisis coming – the economic events that we have experienced *were* possible to navigate. Indeed if Stiglitz attributes too much to the economics profession, Hodgson attributes too little.<sup>5</sup> The Austrian school of economics, and in particular its theory of business cycles, posits the existing of a middle ground. We can even find

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<sup>1</sup> See “Queen told how economists missed financial crisis” *Daily Telegraph*, 26<sup>th</sup> July 2009.

<sup>2</sup> Bezemer (2009) provides a thorough survey of economies and policymakers who expressed the view that “no one saw this coming”, and then presents evidence that an “accounting” view of the economy (i.e. using flow of funds data that focuses on household balance sheets) led to many accurate predictions and warnings.

<sup>3</sup> Available here: <http://www.feed-charity.org/user/image/queen2009b.pdf> [Date accessed 11th October 2010]

<sup>4</sup> These comments were made in an essay about the formation of the “Institute for New Economic Thinking”, and are available here: <http://ineteconomics.org/sites/inet.civicaactions.net/files/INET-press-release-kings-summary-4-12-2010.pdf> [Date accessed 11th October 2010]

<sup>5</sup> See Thornton (2004a) for an overview of how economists can be torn between overstating and understating their ability to make accurate predictions.

evidence of this in the works of the Austrian schools' seminal figurehead, Ludwig von Mises. Despite devoting a section of *Human Action* to the idea that forecasting is foolish, he also made the following prediction in the summer of 1929, "A great crash is coming, and I don't want my name in any way connected to it".<sup>6</sup> This possible paradox might be resolved by distinguishing between pattern and point predictions. Economic theory equips us with an understanding of causal implications, albeit we cannot know the precise path of how the future emerges. Or, as Mises said, "the economist knows that such a boom must result in a depression. But he does not and cannot know when the crisis will appear" (Mises 1949, p.870). What this demonstrates is that economic theory can provide useful frameworks to understand causal processes, but that prediction requires the humility to understand the complexity and uniqueness of specific historical episodes. To paraphrase David Deutsch (2011, p.197),

"the future of the economy is unknowable, because the knowledge that is going to affect it has yet to be created. Hence the possible outcomes are not yet known, let alone their probabilities... people in 1900 did not consider the internet or nuclear power unlikely: they did not conceive of them at all"

Perhaps we can contrast *predictions*, which are conclusions about future events that follow from good explanations; with *prophecies*, which is anything that purports to know what is not yet knowable.<sup>7</sup> By prophesising rather than predicting Austrians may be better placed to foresee the bigger picture.

This Austrian "paradox of prediction" rests on the systemic nature in which economic booms lead to busts. Economists are notoriously poor at predicting recessions, with some studies suggesting that economists fail to spot a recession one year in advance 97% of the time.<sup>8</sup> However we can claim that the Austrian theory of the business cycle (ABC) provides an explanation for the structural reasons why recessions appear – they are the manifestation of the recalculation required following the malinvestment of scarce capital goods. The foundational texts of ABC are Mises (1912), Hayek (1931) and Garrison (2001). We provide a rough treatment here, and do not intend to provide an exhaustive commentary on the secondary literature.<sup>9</sup> Garrison (2001) shows how ABC rests on the interactions of three different markets. Firstly, the market for loanable funds reflects the underlying and subjective rate of time preference to set a "natural" interest rate. Secondly, the production possibility frontier reflects the current capital stock and the basic trade off between present consumption and investment. Thirdly, the time structure of production reveals how the output of final consumer goods reflects the "roundaboutness" of production. In this model the key market signals are interest rates, since these

<sup>6</sup> Comments made to his wife, cited by Skousen (1993). Hayek is also said to have made cogent forewarnings of the Wall Street Crash in the monthly investment reports that he published for the Institute of Business Cycle Research.

<sup>7</sup> Although it would have to be a secular prophecy, since according to Niall Ferguson (1997, p.79), a prophecy "involves a process in which one or more messages allegedly communicated to a prophet are then communicated to other people. Such messages typically involve divine inspiration, interpretation, or revelation of events to come (compare divine knowledge)." He continues, "the best the long-range forecaster can do is give us a number of plausible scenarios, and to admit that the choice between them can only be a guess, not a prophecy" (Ferguson 1997, p.79)

<sup>8</sup> "Meet the Economist Who Thinks We're Doomed", By Stephen Mihm, *The New York Times*, August 18, 2008.

<sup>9</sup> See Evans and Baxendale (2008a).

reflect the available stock of real savings, and thus the profitability of production plans. The challenge for entrepreneurs is to create capital plans that will lead to goods and services that will have a market demand, through the passage of time. ABC shows how artificial credit creation injects noise into this complex economic process, and reduces the likelihood that ex-post plans are in coordination. Put simply, the low interest rates brought about by easy money sends a fake signal to entrepreneurs that they should invest in more roundabout production. If not backed by real savings, the physical stock of resources required to complete these plans does not actually exist, and when this is revealed these plans need to be amended. Generally, we may expect that the longer the credit bubble lasts the deeper the structural problems become, and the larger the subsequent drops in output and employment will be as entrepreneurs liquidate faulty plans. It is not the purpose of this report to engage too much in the debate over the validity and soundness of ABC. However we will see how ABC – whether accurate or not – has fared as a result of the financial crisis.

This report will look at the extent to which ABC provided a basis for predicting the crisis, demonstrating that the financial crisis was partly visible (and therefore somewhat predictable) at the time of the peak. Any attempt to claim that someone “saw it coming”, is hampered by numerous considerations. Perhaps most importantly, retrospective analysis has a tendency to suffer from the hindsight bias, and the corresponding proclivity to believe that it was all too obvious. The calls for humility with regard to *prediction* should also apply to *interpretation*. If something is hard to spot in advance, we should be cautious about subsequently implying that it was really obvious. Noah Smith argues that there are really three elements to “the crisis”, namely (1) “the big drop in US housing prices that started in 2006-07”; (2) “the systemic collapse in the US finance industry that began in 2008”; and (3) “the deep recession and the long stagnation that began in late 2008”.<sup>10</sup> As we shall see, ABC offers a causal connection between all three - they provide a coherent explanation that links excess credit creation with resulting recessions - but when it comes to assessing claims of predictive accuracy, we need to be clear about how many of the above elements were being discussed.

In order to identify economists that made accurate predictions, we can utilise four main criteria. The first sounds obvious, but is that *documented evidence must exist*. This may appear to be a low hurdle, but is an especially effective one at sorting those who claim too much. Especially when the key issue here is not only that documented evidence exists, but also that contradictory documented evidence does *not* exist. It is not enough to have a reputation for having predicted the crisis, there also needs to be textual evidence. And we must discount those who make multiple, conflicting predictions in the hope that people only notice the ones that happen to turn out to be correct. The second criterion is that studies must be *right for the right reasons*, and this refers to the reasoning behind the prediction. If there is a sufficiently large sample size we would expect to find “correct” economic predictions even if they are random, purely because of the selection bias.<sup>11</sup> As Bezemer (2009) says, “for a set of correct

<sup>10</sup> Smith, N., “What does it mean to have “predicted the crisis” Noahpinion, May 30<sup>th</sup> 2013

<sup>11</sup> One might argue that for this reason a separate criteria that *history of previous success* might be invoked, but given the relative rarity of major economic crises we can be relaxed about this.

predictions to attain *ex post* credibility, it is additionally required that they are supported by a common theoretical framework” (p.7). The framework chosen for this report is ABC. The third criteria is that *it has to be timely*, and avoid the fact that a “broken watch tells the right time twice a day”. Indeed it isn’t enough to say “a recession is coming” because over a long enough time period such a proclamation will inevitably turn out to be accurate. This report will therefore concentrate on the period 2006-2010. The fourth – and perhaps the most controversial – criteria we propose is whether the economist . This is essentially an attempt to uncover revealed preferences and assess the strength of conviction. One doesn’t need to believe the efficient market hypothesis to hold in its crude form to still take it seriously, and be suspicious of claims regarding “obvious” profit opportunities. Indeed the most palpable proof that one has superior foresight to others is that one has been able to trade on, and benefit from, that knowledge. The market test is also a useful way to mediate between conflicting claims. To some extent we can rely on the profit and loss system to help us decide who turned out to be correct.

Other surveys use similar criteria. Thornton (2004) also decides to ignore “permabears”, and believes that the rationale for the prediction is relevant (p.8). One problem with a requirement for publication is that there may be a systematic bias against the perspectives most likely to have radical insight. For example, Thornton warned about a tech bubble and predicted a weakening dollar in January 2001, but recalls that “I also wrote several letters to newspapers, such as *Investors Business Daily*, during this period, none of which was printed” (Thornton 2004, p.10). However the emergence of the internet, and the resulting proliferation of blogs and self publishing means that this is less likely to be a problem. Bezemer (2009)’s criteria are that there is a theoretical underpinning; a link to a recession in the real economy; the prediction is in the public domain; and that there is appropriate timing (p.7).

Consequently to conclude that someone “called” the financial crisis we will look to see whether (i) their warnings were documented; (ii) they were correct for the “right” reasons; (iii) they did so in the right time period; (iv) their actions supported their beliefs. To be sure other criteria might be invoked, and a debate may be had as to whether all four are necessary conditions. However we shall proceed with these underlying considerations as non-arbitrary methods of assessment.

In particular, various claims will be split into four main categories. Firstly, we shall look at non-Austrian predictions. As mentioned, these are not the focus of this report, and so this section will not be exhaustive. Given that it is unlikely to find predictions that meet all four criteria, we should be willing to relax each one. “Predicting the crisis” requires 4/4. But 3/4 is still worthy of attention. Secondly, we will look at academic predictions. Thirdly, we will look at policymaker’s predictions. And fourthly, we will look at investor’s predictions.

### *Non-Austrian prescience*

As early as February 2003 Andrew Lilico argued that the house price to earnings ratio should be roughly constant, and that the then deviation from trend warranted attention from policymakers (Lilico 2003). But “predicting the crisis” requires tying a potential house price crash with a subsequent recession. And predicting the crisis that we endured requires attention to the breakdown of financial

intermediation. In October 2004 Lilico once again predicted that house prices would fall, but also argues that this would lead to two things - the impact on banks capital requirements would cause lending to contract; and the negative wealth shock would reduce aggregate demand (Lilico 2004, p.12). Harrison (2005) called a housing bubble and predicted an economic “depression” for 2010. He warned, “by 2007 Britain and most of the other industrially advanced economies will be in the throes of frenzied activity in the land market to equal what happened in 1988/9. Land prices will be near their 18-year peak, driven by an exponential growth rate, on the verge of the collapse that will presage the global depression of 2010. The two events will not be coincidental: the peak in land prices not merely signalling the looking recession but being the primary cause of it” (Harrison 1997). His rationale is not based on Austrian-type considerations to credit creation, but on long-term cycles in housing prices. Therefore one might object to the connection between land prices and subsequent recession (as opposed to malinvestment and ensuing central bank incompetence), and the prediction of a 2010 global depression.

Similarly, the winner of the “Revere Award for Economics,”<sup>12</sup> Steve Keen’s work is grounded in the “Financial Instability Hypothesis”, which differs in important ways to the Austrian school (but also has some similarities, see Prychitko 2010).<sup>13</sup> He has been credited with “calling” the financial crisis as early as December 2005, and one of his most famous predictions is “long before we manage to reverse the current rise in debt, the economy will be in a recession. On current data, we may already be in one” (Keen 2006). However, as one blogger points out, he was referring to the Australian economy, which didn’t even have a recession!<sup>14</sup>

Nouriel Roubini connected the housing boom to a subsequent recession, stating, “By itself this [house price] slump is enough to trigger a US recession” in August 2006, continuing,

“The recent increased financial problems of ... sub-prime lending institutions may thus be the proverbial canary in the mine – or tip of the iceberg – and signal the more severe financial distress that many housing lenders will face when the current housing slump turns into a broader and uglier housing bust that will be associated with a broader economic recession. You can then have millions of households with falling wealth, reduced real incomes and lost jobs...”<sup>15</sup>

Finally, also in 2006, Dean Baker (Center for Economic and Policy Research) wrote:

<sup>12</sup> This award was granted by the *Real World Economics Review* and decided by a total of 2,500 votes along the following criteria: “the three economists who first and most clearly anticipated and gave public warning of the Global Financial Collapse and whose work is most likely to prevent another GFC in the future” <http://rwer.wordpress.com/2010/05/13/keen-roubini-and-baker-win-revere-award-for-economics-2/> [accessed October 16, 2010]

<sup>13</sup> His website is <http://www.debtdeflation.com/blogs/about/> [accessed October 16, 2010]

<sup>14</sup> See “Did Keen predict the US housing bubble? - Dick Bezemers flawed study” *Debunking Economics*, December 21<sup>st</sup> 2012 [<http://debunkingeconomics.blogspot.co.uk/2012/12/did-keen-predict-us-housing-bubble-dick.html> accessed August 5, 14]

<sup>15</sup> See <http://rwer.wordpress.com/2010/05/13/keen-roubini-and-baker-win-revere-award-for-economics-2/> [accessed October 16, 2010]

“The wealth effect created by the housing bubble fuelled an extraordinary surge in consumption over the last five years, as savings actually turned negative. ... This home equity fuelled consumption will be sharply curtailed in the near future.... The result will be a downturn in consumption spending, which together with plunging housing investment, will likely push the economy into recession.”<sup>16</sup>

### *Academic prescience*

A remarkable academic study that satisfies a majority of these criteria is Foldvary (1997), who predicted that “the next major bust, if there is no major interruption such as a global war, will be around 2008” (p.538). Various Austrian economists made explicit mention of a housing bubble, for example Meyer (2003), Shostak (2003), and Thornton (2004b, 2004c).<sup>17</sup> This brings us to why our focus is on the Austrian school. This is because to Austrian economists the identification of a housing bubble – and claim that this is part of an Austrian business cycle – *implies* a subsequent recession. The “credit crunch” and “cluster of errors” are established components of an Austrian cycle. Hence when someone like Shiller, or Krugman, “call” a housing bubble, that’s all they’ve called. But it isn’t part of a systematic theory of business cycles. Indeed as Thornton points out, “the more Krugman tries to provide an *economic* rationale for the bubble the more he sounds like the Austrian economists who dominate the third and final view of the housing bubble” (p.9). This may come across as unfair, and giving Austrians an easier hurdle. And indeed there isn’t as much explicit reference to a financial crisis, and a severe recession, as Austrians retrospectively imply.<sup>18</sup> Indeed Alex Tabarrok (2008a, 2008b, 2008c) has questioned whether a credit crunch occurred, Jeffrey Tucker (2008) has called it a “myth”, Robert Murphy (2008) called it “bogus”, and Robert Higgs (2009) called it a “hoax”.

### *Policy maker prescience*

This sub heading may appear an oxymoron, but for simplicity we can treat the Bank for International

<sup>16</sup> See “Recession Looms for the U.S. Economy in 2007”

[http://www.cepr.net/documents/publications/forecast\\_2006\\_11.pdf](http://www.cepr.net/documents/publications/forecast_2006_11.pdf)

<sup>17</sup> Meyer and Shostak are not academics, but are included in this section because the publications cited are academic articles.

<sup>18</sup> One of the few examples of a prediction of a “crunch” was made by myself, in April 2007, “it seems sensible to assume that the housing market is frothing (rather than it's operating beautifully and the excess credit is manifesting itself in a hitherto unspotted part of the economy)... When interest rates rise - as they surely must - house prices will cease surging, but it's up to the next Chancellor how this process is managed. The economy is an airbed: [Gordon] Brown merely squeezed on the Dot Com bubble to shift the air pocket to house prices. At some point the charade has to end and the valve released. *We've been living beyond our means, and the crunch is coming. When that happens, remember who's to blame*” Evans, Anthony J., “Gordon Brown: Living on borrowed time” The Filter<sup>^</sup>, [http://thefilter.blogspot.com/thefilter/2007/04/gordon\_brown\_li.html accessed August 5, 14]

I would point out that my use of the term was because I was attempting to invoke a standard ABC story. I would expect that many Austrians at the time would have made the same point as me, regardless of whether they used the term “crunch” or not. I’ve included in the Appendix some relevant things that I wrote in 2006-2007.

Settlements (BIS) and other think tanks as policy commentators, and therefore (loosely) policy “makers”. In the mid 2000s the BIS (and in particular William White who was Head of the Monetary and Economic Department from 1995-2008) began to develop a distinctly Austrian reputation.<sup>19</sup> White began warning about a financial crisis in Borio and White (2003). The *Wall Street Journal* reports:

“Austrian economics, however, has enjoyed a minor revival in the last decade, most prominently at the Basel, Switzerland-based BIS”<sup>20</sup>

This was based on papers such as the following:

“financial liberalisation has increased the likelihood of boom-bust cycles of the Austrian sort. Moreover, integration of big countries into the world economy and the liberalisation and globalisation of the real economy, as discussed above, appears to have had material effects on the inflation process and the transmission mechanism of monetary policy” (White 2006)

Also consider:

“While many have rightly criticised the specifics of Austrian capital theory, the concept of erroneous investment processes driven by credit creation is still noteworthy. Moreover, while most Keynesian models assume a relatively smooth adjustment from one equilibrium to another, the Austrians stressed growing imbalances (cumulative deviations away from equilibrium) and an eventual crisis whose magnitude would reflect the size of the real imbalances that preceded it.” (White 2006)

### *Investor prescience*

Transient documented evidence of an ex ante prediction is a necessary but not sufficient condition – we should also expect people to *act* in accordance with this belief. We therefore focus our attention not just on observers of financial markets, but actual participants. We should expect those with the most prescience not to be academic economists or economic commentators, but real investors. The list of economic analysts that are (a) aware of and explicitly extol the Austrian school; and (b) accurately identified an Austrian-style cycle and warned of impending recession, is both real and significant. Although this report focused on the 2008 financial crisis, for a survey of the predictive acumen of Austrian economists – including some of those mentioned below – prior to the dot com crash, see Thornton (2004). We will concentrate on four separate investment vehicles, the *Investment Science Asset Management (ISAM)* fund, led by Simon Kitson, the *Edelweiss Fund*, led by Anthony Deden, *Euro Pacific Capital*, led by Peter Schiff, and finally Mark Spitznagel’s *Universa Investments*.<sup>21</sup> There

<sup>19</sup> See Evans (2013) for a justification of treating White as a heterodox economist.

<sup>20</sup> “Amid Financial Excess, a Revival of Austrian Economics”, *Wall Street Journal*, June 25, 2007

<sup>21</sup> Other potential candidates which we don’t include here include: Hugh Hendry (Eclectica Asset Management); Mark Skousen (Forecasts & Strategies Newsletter); Jim Rogers (Rogers International Commodities Index); and James G. Rikards (Omnis).

are not many overtly Austrian investment/capital preservation funds in the world; but their performance is telling.<sup>22</sup>

The ISAM is a hedge fund based in Australia<sup>23</sup> that delivered an annual return of 65.02% as of 31<sup>st</sup> January 2009<sup>24</sup>. It relies exclusively on the *Economic Insights* investment reports, written by the Chief Economist of Man Financial, Frank Shostak. In addition to these subscriber-only private reports, Shostak is a regular commentator for the Mises Institute's publicly available website.<sup>25</sup> In March 2004, for example, he wrote:

“The latest data, however, indicate that there is some deterioration in the quality of bank credit... The Fed's policy can generate the illusion of success, to be sure. But when it is reversed—as it inevitably must be—the illusion is shattered to reveal the painful facts of reality. Contrary to Greenspan, the expansion of the banking system and its apparent strength is built on shaky foundations... While banks are the greatest beneficiaries of the false boom, they cannot escape the negatives of the bust... We can thus conclude that the banking system is far from being in healthy shape as suggested by Greenspan, but on the contrary it is very vulnerable to a sudden weakening in economic activity”<sup>26</sup>

The *Edelweiss Fund* is based in Bermuda, and owned by Sage Capital of Zurich.<sup>27</sup> For the first 5 years since its inception in 2002 it delivered an annual return of 16.6%<sup>28</sup>, and as of 2009 was in the “99.6th percentile of all unleveraged and diversified investment companies.”<sup>29</sup> In September 2010 the year-to-date return had been 13.54%<sup>30</sup>, and all told the fund has returned 223% since inception (for comparison the S&P returned 28.1% in the same time)<sup>31</sup>. Their publicly available literature demonstrates both the Austrian core of their strategy and their success<sup>32</sup>. Two individuals associated with this fund are worth

<sup>22</sup> Also relevant is a series of columns by Martin Hutchison with the title “*The Bear's Lair*”.

<sup>23</sup> Australian Financial Services Licence Number 342169

<sup>24</sup> The company website is: <http://www.investmentscience.com.au/about-us> [accessed October 16, 2010]

<sup>25</sup> For an archive see: <http://mises.org/daily/author/115>. This report does not attend to critically assess the prescience of these views, and we are indeed selectively quoting especially prescient statements. However in the process of reviewing this archive I did not encounter contradictory evidence and feel that these quotes are generally representative.

<sup>26</sup> “How healthy are the banks?” *Mises Daily*, March 29<sup>th</sup> 2004 [<http://mises.org/daily/1480> accessed October 16<sup>th</sup> 2010]

<sup>27</sup> The website is <http://edelweissfund.com> [accessed October 16, 2010]

<sup>28</sup> In US dollar terms <http://edelweissfund.com/en/Angebote/Publications> [accesses October 16, 2010]

<sup>29</sup> See “1. Gold-Konferenz: Referat von Tony Deden” *Finews.ch* November 19<sup>th</sup> 2009 [See <http://www.finews.ch/news/finanzplatz/2233-1-gold-konferenz-referat-von-tony-deden>, accessed October 16, 2010]

<sup>30</sup> In US dollars, see “Monthly letter to our shareholders” Nr. 45, 30<sup>th</sup> September 2001, <http://edelweissfund.com/cmsfiles/ef-september2010.pdf> [accessed October 16, 2010]

<sup>31</sup> In US dollars, see “Factsheet, 30<sup>th</sup> September 2010, <http://edelweissfund.com/cmsfiles/ef-factsheet-2010sep.pdf> [accessed October 16, 2010]

<sup>32</sup> <http://edelweissfund.com/en/Angebote/Publications> [accesses October 16, 2010]

highlighting. The first is Tony Deden, and the second Sean Corrigan. Deden is Chairman of Sage Capital and manager of the Edelweiss Fund, and describes his task in the following way:

“our task is to increase the substantive value of our capital faster than central banks can depreciate the value of money with which we measure it”<sup>33</sup>

The 2008 letter to shareholders cites Austrian economist Jorg Guido Hulsmann in the opening quote,<sup>34</sup> whilst his 2007 annual report (written in March 2008) quotes Ludwig von Mises considerably and says the following:

“There is no doubt that the dire financial outlook in the United States will progressively worsen and have a worldwide impact. Years of imbalances created by our modern folly have destroyed not only the solvency of the banking system, but also the architecture of the real economy. As these imbalances unravel, both profits and investor expectations will undoubtedly disintegrate with them.”<sup>35</sup>

Corrigan is a strategist for Diapason Commodities Management, and former manager of the Edelweiss Fund for Sage Capital. He delivered the 2004 Henry Hazlitt Memorial Lecture at the Mises Institute’s *Austrian Scholars Conference*, and has spoken at the *Institute of Economic Affairs* on the topic of Austrian economics. His research reports are called *Tangible Ideas*, narrating the financial crisis with a palpable dose of Austrian theory. Writing in February 2007 he claimed that the Federal Reserve was engaged in a new chapter of financial folly based on monetary debasement.<sup>36</sup> Then, in April he argued that the economy couldn’t continue to be supported by credit creation and “greater fools” who believe that fundamentals are strong,

“Surely, then, we are not expected to believe that a derivatives haystack which now towers more than one half of one *quadrillion* dollars into the sky does not boast just a few sharp needles of systemic vulnerability nestled among its mountain of dried grass?”<sup>37</sup>

He used surges in commodity prices (in particular platinum, uranium and nickel) to predict that “there will be many more losers than winners to be found when the whirlwind finally does spin in reverse”.<sup>38</sup>

<sup>33</sup> Deden, Tony, “The Practice of Capital Preservation” *Sage Capital*, January 2<sup>nd</sup> 2007. Note that Deden defends the practice of holding at least 30% of the fund as cash, arguing that “cash does not burn holes in our pocket” and that it provides value as a form of insurance echoing the subjectivist approach to the demand for money made famous by Mises and Hutt.

<sup>34</sup> “2008 Letter to Shareholders” Edelweiss Fund (Bermuda), [http://edelweissfund.com/cmsfiles/ef\\_2008\\_annual\\_report\\_public.pdf](http://edelweissfund.com/cmsfiles/ef_2008_annual_report_public.pdf) [accessed October 16, 2010]

<sup>35</sup> “2007 Annual Report” Edelweiss Fund (Bermuda), [http://edelweissfund.com/cmsfiles/ef\\_2007\\_annual\\_report\\_public.pdf](http://edelweissfund.com/cmsfiles/ef_2007_annual_report_public.pdf) [accessed October 16, 2010]

<sup>36</sup> Corrigan, S., “Plus ca change” Resource ruminations, Diapason Research Report, February 2007

<sup>37</sup> Corrigan, S., “Damn the torpedoes!” Resource ruminations, Diapason Research Report, April 2007

<sup>38</sup> Corrigan, S., “Damn the torpedoes!” Resource ruminations, Diapason Research Report, April 2007

In case there is any doubt, in June 2007 he linked this problem to “a vast surplus of credit”.<sup>39</sup> In a August 2007 report he highlighted the following quote from Citigroup CEO Chuck Prince:

“when the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”<sup>40</sup>

Corrigan added,

“if, therefore, the credit cycle has turned here – and this is surely the best candidate for making that decisive change of phase we have had for some years – we cannot fail to reckon with serious, real world implications as the squeeze progresses, as returns on investment falter, as orders are cancelled and jobs begin to be lost”<sup>41</sup>

Peter Schiff has perhaps the best reputation for having predicted the crisis, and in 2007 published a book called *Crashproof: How to profit from the coming economic collapse* (Schiff 2007). But despite the fact that numerous public warnings of an impending housing and equity crash made him a celebrity, there is little evidence that he turned this prescience into a successful trading strategy. In addition to predicting that US stocks were overvalued, Schiff also warned about a collapse in the value of the dollar. He went so far as to claim the following,

“Bernanke is going to run up printing presses as fast as he can. This is pure inflation Latin American style. This is hyperinflation; this is Zimbabwe; this is the identical monetary policy of the Weimar Republic.

I am just as convinced that people who have their money in US dollars are going to be just as broke as people who have their money with Madoff.”<sup>42</sup>

His reasoning rests on a “decoupling” thesis that other countries (China in particular) would not be affected by a US financial meltdown (see Shedlock<sup>43</sup>). So although his diagnoses of the US economy was incredibly accurate and timely, it did not lead to the outcomes anticipated, and his key underlying assumptions were erroneous. According to the *Wall Street Journal*, in 2008 some of his investors lost 50% of their stakes.<sup>44</sup>

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<sup>39</sup> Corrigan, S., “Black holes & revelations” Resource ruminations, Diapason Research Report, June 2007

<sup>40</sup> Nakamoto, M., and Wighton, D., “Citigroup chief stays bullish on buy-outs” *Financial Times*, July 9<sup>th</sup> 2007

<sup>41</sup> Corrigan, S., “Hurricane Cassandra” Resource ruminations, Diapason Research Report, August 2007

<sup>42</sup> Transcript of “Schiff Audio on US hyperinflation” as reported by Shedlock, M., “Peter Schiff Was Wrong” Global Economic Analysis, January 25<sup>th</sup> 2009  
[<http://globaleconomicanalysis.blogspot.co.uk/2009/01/peter-schiff-was-wrong.html> accessed August 6, 14]

<sup>43</sup> Shedlock, M., “Peter Schiff Was Wrong” Global Economic Analysis, January 25<sup>th</sup> 2009  
[<http://globaleconomicanalysis.blogspot.co.uk/2009/01/peter-schiff-was-wrong.html> accessed August 6, 14]

<sup>44</sup> Patterson, S., Slater, J., and Karmin, C., “Right forecast by Schiff, wrong plan?” *Wall Street Journal*, January 30<sup>th</sup> 2009

In 2009 Mark Spitznagel wrote about the Austrian school in the *New York Times*,

“Ludwig von Mises was snubbed by economists world-wide as he warned of a credit crisis in the 1920s. We ignore the great Austrian at our peril today.”<sup>45</sup>

Spitznagel is an investor whose guiding view is the concept of roundaboutness and trying to arbitrage across different time periods (see Spitznagel 2013). Many periods of meagre returns are deemed acceptable if they permit a few specific periods of high returns. In 2008 his funds generated returns of over 100%.<sup>46</sup>

In his survey of who predicted the dot com crash, Thornton (2004) made the following claim,

“Given that the Austrian economists are both relatively few in number and marginalised by the profession, their dominance in making correct predictions seems to be something of an elephant in the soup bowl, especially in light of their general disdain for forecasting and for the mainstream’s requirement of accurate prediction. (Thornton 2004, p.24)

The Austrian school is famous for mocking the overconfidence of economic forecasters, and eschewing formal models of the macroeconomy. But as this survey article suggests the insights of the school have generated an interesting track record when it comes to the 2008 financial crisis. Whilst evidence exists that some economists had better foresight than others, the Austrians can argue that their predictions were based on a coherent theoretical framework designed to explain the boom bust cycle. One might even predict that when the next crises strikes, Austrians will not be *completely* surprised.

## Appendix

In 2006 I embarked on a research project with Toby Baxendale to apply ABC to current events. I sent an email on 16th November 2006 saying:

"I took one of the student research assistants with me to Chatham House yesterday, for a lecture by 2004 Nobel Prize winner Finn Kydland on "The Dynamics of Business Cycles and Monetary Policy - Links and Drivers".

Key point was that "residential construction" is the clearest driver of the business cycle (with a 3-4 quarter lead) and "consumer electricals" is also a strong driver (with a 2 quarter lead). I think this is very strong evidence that the current cycle is partly being fuelled by the housing market. Add to this the evidence that interest rates have been kept artificially low recently (even *The Economist* has questioned whether a little deflation would be a good thing) and will inevitably rise more in the future.

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<sup>45</sup> “The Man Who Predicted the Depression” Mark Spitznagel, *New York Times*, November 6<sup>th</sup> 2009

<sup>46</sup> “Spitznagel managed the Black Swan funds to triple digit returns last year with a bet on volatility. The returns have brought a flood of cash, sending assets for his firm, Universa Investments LP, rising to \$6 billion from \$300 million”. See Patterson, S., “Black Swan Trader Bets Reputation on Inflation” *Wall Street Journal*, June 17<sup>th</sup> 2009

Add also the amount of debt home owners are taking on who enter the market (i.e. "marginal homeowners" and therefore how exposed they are to a rise in rates....

There's a very clear narrative ...- marginal investors tempted in when there's cheap money about, inevitable bust will occur"

We wrote a policy paper called "Hayekian Airbeds" that wasn't published. A draft version, written in March 2007, contained the following:

Paul Dales (a Capital Economics analyst) says that 13% of subprime loans are now in arrears, and default rates have risen to 4.5%

The second-largest subprime mortgage lender – New Century Financial – is on the brink of bankruptcy

According to Credit-Suisse "marginal" borrowers account for a third of subprime mortgages.

The Mortgage Bankers Association's National Delinquency Survey says that the delinquency rate for mortgage loans on one-to-four-unit residential properties is up 25 basis points from a year ago, "The increase was driven by increases in delinquencies for all major loan types, most notably for subprime and FHA loans."

In the UK the Council of Mortgage Lenders recently announced that mortgage repossessions are up 65% from last year, and forecasts future rises.

The Department of Constitutional Affairs reports a 29% rise in the number of repossession orders against mortgage holders in England and Wales since 2005. Bankruptcies rose by 34% in England and Wales last year, and there was a 59% increase in people who were declared insolvent.

Then, in April 2007 I added the following:

"If the adverse selection argument is true, we'd expect the downturns in subprime lenders to become especially prevalent, and evidence from America suggests that this is happening. According to Morgan Stanley, late payments rose from 7% in 2003 to 12.6% last Autumn, and HSBC's bad-debt costs rose by 36% to over \$10 billion in 2006."

There's also a selection of articles that I wrote on my blog, The Filter^:

"the question isn't "will the housing market slow down?" because it will. We have enough economic knowledge to know that the current growth rates are unsustainable...With cheap access to capital, (via low interest rates) and a "bricks and mortar" reaction to the tech crash, house prices have largely been inflated by people buying second homes to let. This is why rents are so low at the moment. Interest rates have gone up recently, and the more they do so

the less profitable these investments are, making it more of an incentive to sell up... So we know it will end, but we're not sure when. How will it end? Here, I'd claim 'self-fulfilling prophecy' - if people expect a crash, as soon as prices dip they'll put theirs up on the market to cash in, and in doing so produce a crash... Dare I forecast? I think it's the right time to sell."

"Forecasting the housing market" April 28<sup>th</sup> 2004

[[http://thefilter.blogs.com/thefilter/2004/04/forecasting\\_the.html](http://thefilter.blogs.com/thefilter/2004/04/forecasting_the.html) accessed August 5, 14]

"when house prices begin to really fall, and people lose a lot of wealth, I am sure there'll be much criticism of "capitalism" or "the market". Be very warned that the real reason behind the house price bubble is the engineering of those too stubborn and controlling to leave free the complex economic ecosystem" "It's as easy as ABC" July 5<sup>th</sup> 2005

[[http://thefilter.blogs.com/thefilter/2005/07/its\\_as\\_easy\\_as\\_.html](http://thefilter.blogs.com/thefilter/2005/07/its_as_easy_as_.html) accessed August 5, 14]

"Central Bank Independence isn't a binary issue; contemporary Central Bankers have yet to be properly tested; there's a lot more credit available than blunt proxies illustrate." "Does inflation matter anymore?" March 23<sup>rd</sup> 2007

[[http://thefilter.blogs.com/thefilter/2004/04/forecasting\\_the.html](http://thefilter.blogs.com/thefilter/2004/04/forecasting_the.html) accessed August 5, 14]

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