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More thoughts from Pedro Prieto on NINJA Financial Issues and Energy

Posted by Gail the Actuary on May 30, 2009 - 10:19am
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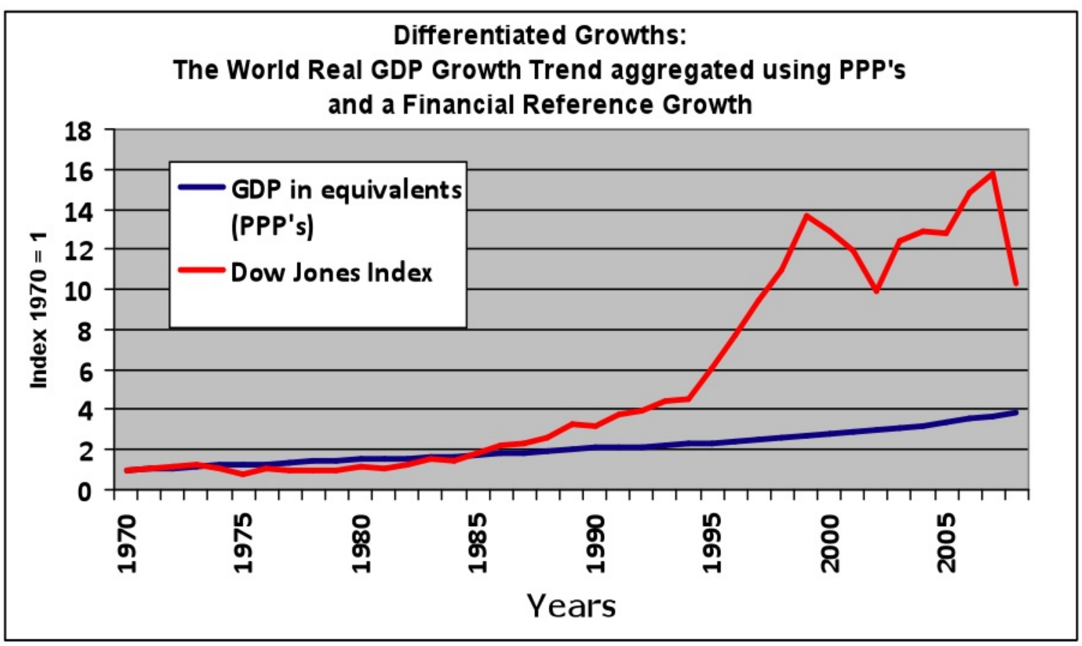
Tags: financial collapse, peak oil, pedro prieto, subprime lending [list all tags]

A few days ago, Pedro Prieto wrote a popular guest post called Financial Collapse and Energy - Something Other than a NINJA Problem. In it, he provides an analogy to the current financial situation.

Afterwords, some of us in a follow-up post raised questions whether the parameters (shown as 8.5% and 3% in the model) could be refined a bit.

Pedro has put together a response, which I think shows great insight. It shows that there is more than one way of looking at this question, and perhaps the way we are looking at things is too steeped in our current perspective. Pedro's response is found below the fold.

Sometimes, I am afraid that I may have been wrong in including GDP in Purchasing Power Parity (PPP's) in Graphs 3 and 4 of my earlier document. To refresh your memory, this is Graph 3 from my earlier post:



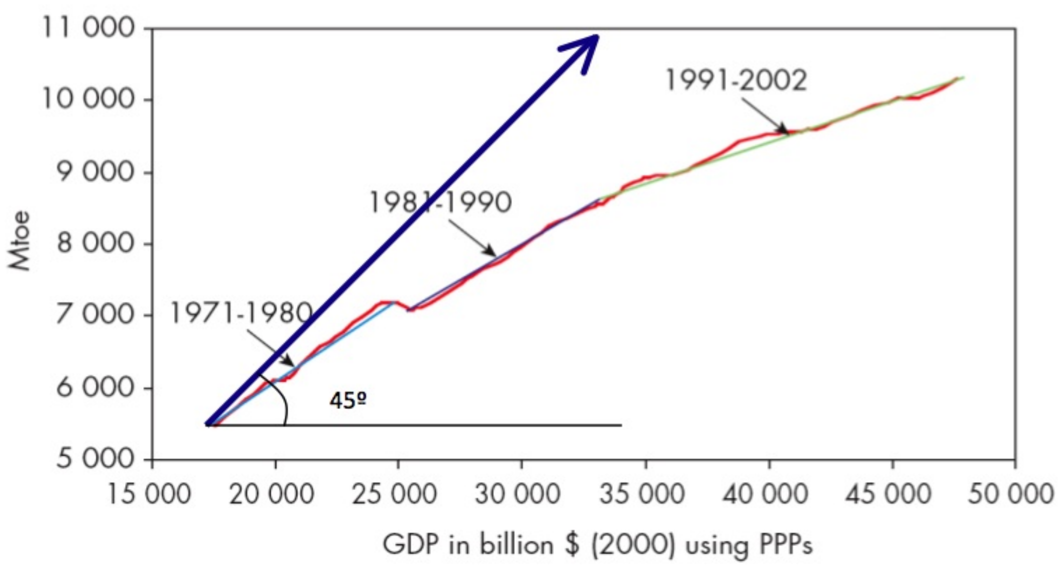
Graph 3. World GDP and Dow Jones Index for the period 1970-2007.

This is like giving credit to the concept that helps economists to manoeuvre and disguise physical reality. In fact, the creation of goods and services by humankind should be given in absolute, measurable amounts. This is something I could do with oil and primary energy, since even capitalist entities or corporations like the IEA or BP offer data using measurements like tons of oil. One ton of oil (or coal of cubic feet of gas) is physically the same if extracted in 1970 or if extracted in 2008. No adjustment is required.

However, I was forced to enter GDP because it was the only available tool to measure goods produced and services rendered. If the measurement tool performs well, there should be no need to adjust the amounts by any economic parameter to balance them through time. GDP is not an accurate tool--I knew it and I mentioned it. But I was forced to give an indication of the total amount of goods and services, and I cannot do this, except as some sort of financial amount. I know that a kg of produced steel is the same in 1970 as it is in 2008, as is the service rendered to care for an elderly person, but I needed some mechanism for measuring the combined amount.

And the PPP's in the GDP are supposed to adjust the value (effort and energy at least, in my opinion) for the same goods or services at different periods of time. In my opinion, however, in reality they are masking the devaluation of the system used for mediating exchanges (whatever that is--now generally paper money rather than gold or another medium). This mediation mechanism is therefore being distorted as it tries to match the unchanged real physical world.

If I take the consumption of primary energy and compare it with GDP, what I observe is almost a one to one relationship (almost a straight line):



Source IEA. WEO 2004.

But, in fact, if we could remove the economic adjustments, the artful economic devices, and the continuous manipulations, money would have been destined for its original use. If this were done, the slope of the derivative would have been 45 degrees. That is, one physical unit produced or measurable service rendered would be equal to one monetary unit. The fact that there has been a change in the measuring system over time is probably the reason why there is now a difference between the growth of primary energy sources and the growth in GDP (Graphs 3 and 4 of my paper), and that this difference is increasing over time.

If today it is not like this, it is not the fault of the physical world and the "devalued" production of goods or services through time, but rather is a result of the perverted use of money and financial values and assets.

If we look at the interesting work of Chris Martenson, titled "Inflation", at http://www.chrismartenson.com/crashcourse/chapter-10-inflation, and we look into Chapter 10, there is something related to my analogy, as named by Gail in her last post, titled " A Few More Thoughts Related to Pedro Prieto's "NINJA" Post":

In 1665, the basic cost of living [in the US] was set to a value of "5". What is most striking about this chart to me is that from 1665 to 1776, there was absolutely no inflation. For 111 years, a dollar saved was, well, a dollar saved. Can you imagine what it would be like to live in a world where you could earn a thousand dollars, put it in a coffee can in the backyard, and your great-great grandchildren could dig it up and enjoy the same benefits from that thousand dollars as you would have had 111 years previously?

Unless we orient ourselves to a new way of living, in which we learn to make the mediation device a very constant parameter, which is always very directly related to the physical world of products created and services rendered, we will never find any solution to the inevitable collapse. And this will mean not a cosmetic change in world economics, but a Copernican change in economics, much closer to the biophysical Economics that Charles Hall is teaching everywhere.

As I see it, my fault was not so much to "forget" to adjust the Dow Jones Index throughout time (to what parameter, physical?). Instead, it was a matter of being forced to use a single economic parameter, already contaminated by neoclassical economics.

Fractional reserves, compound interest, French system of repayment (very common in Spain, in which the borrower starts paying mainly the interests and almost no principal, until the very end of the term, just in case the lender decides to totally or partially cancel his/her credit before the given period), PPP's, rates of interest, futures, intraday operations, stock options, etc.-- The modern economic world has invented one million economic litanies and forces its citizens to sing them every day, like the Church did in the past with the Latin Litanies in the traditional religious services; believers praying with unintelligible words.

We pray in many cases more than five times every day, oriented to Wall Street especially at the opening and closing of the daily sessions; we carefully read and enunciate the litanies or mantras in our economic sepia missals. We follow the values of thousands of different stocks on television, permanently scrolling in the lower part of the screens, as we have breakfast, lunch or dinner, exactly as if we could understand what is happening out there.

We have been "monetized" and made to believe that the economy measures everything, but really, we are not measuring anything in a minimally rational form. We have been "suspended" from nowhere and pretend that we know where we are.

In this sense, I basically agree with Charles Hall's and Bill Tamblyn's comments on lemmings behaviour in the stock exchange plus some grams of salt of physical reality (see here). In this sense, I think of inflation (or any of the thousand invented words for this situation) as one of the ways or mechanisms that economists have to adjust for the sins of printing paper money without any relationship to the physical world it is supposed to represent--to return it, as much as is possible, to the real world.

I have received many letters from people who believe that bank interest is a "logical" consequence of lending money. Others cannot even imagine a world where people would lend something, obviously a resource they already had, and only pretend to be paid back by exactly the same amount, over a period of years. They are so embedded in the present culture that they cannot imagine that a human being would be willing to lift a finger to lend something if the reward would not be more than what was lent (without interest!).

Let me give an example. A farmer grows food in his fields and harvests (accumulates) resources for the needs of his family and his animals for one whole year, with some surplus, just in case. There might be a drought the next year, or something unexpected might happen (a fire, thieves, etc.). Also (and always in preindustrial societies), some extra would be produced, just in case some neighbour or relative falls sick or has an accident and cannot produce himself. This is a rational accumulation of goods and services which is based not on greed, but on mutual aid, as humans can only survive as a social species, not as lonely wolves on the steppe.

And it would be considered very bad practice in this context to lend somebody something and then ask them to pay it back with interest. That, in my understanding, was the original idea of the original religions of the Book. The original intent has been greatly perverted, and is now followed by very few.

However, what we see today in accumulated wealth has nothing to do with the way of accumulating wealth of the farmers in my story, nothing to do with security (even if they try to convince us that this is in our "national interest"). The quantity and rapid speed of amassing wealth, transforming nature, and exploiting of natural capital has no precedent in the history of mankind and has nothing to do with "security" for the future. The new system, once the payment of interest became legal, permitted and encouraged the accumulation of wealth. It accelerated the process of accumulating wealth in a very insane (and strictly unnecessary) form, and in a quantity never known in the past, especially after industrialization.