Down with Stability

James Grant

It's a contentious speaker who sets out begging to disagree with the theme of the program on which he is honored to appear. But really, "Restoring Global Financial Stability"? Stability, so-called, was the false god of the bubble years. Instability is the way of the world. Honest turmoil is my topic for today. I'm all for it.

Apparent Stability

You will remember the Great Moderation. In the blissful 20 years only recently ended, you thought you could see forever. Under the stewardship of the likes of Alan Greenspan and Jack Welch, inflation was low, recessions were mild, and corporate earnings growth was predictable. General Electric, the great American blue chip, met or exceeded per-share profit estimates every quarter for 10 consecutive years. It was an astonishing display of stability. Indeed, as the SEC subsequently found, it was literally unbelievable. Management had cooked the books. Neither confirming nor denying the truth of that shocking allegation, GE spent $50 million of the stockholders' money to make it go away.

As GE delivered apparent stability in earnings growth, so the Fed produced apparent stability in the value of the dollar. In 1980, the Fed's preferred inflation gauge was rising in excess of 10 percent a year. By the mid-1980s, it was rising by less than 5 percent a year, and for the past 15 years by less than 3 percent. No federal investigatory agency has looked into this feat of macroeconomic

---

Cato Journal, Vol. 30, No. 3 (Fall 2010). Copyright © Cato Institute. All rights reserved.

James Grant is the Editor of *Grant's Interest Rate Observer*. This article is the text of his luncheon address at the Cato Institute's 27th Annual Monetary Conference, November 19, 2009.

management, but I have my suspicions. The fall of communism and the rise of digital technology pushed down production costs. The global supply curve shifted downward and to the right. Absent a corresponding shift in the global demand curve, one would have expected prices to fall. But, in dollar terms, as the author Judy Shelton (2009) recently noted in the *Wall Street Journal*, prices mysteriously crept higher. By rights, they should have crept lower.

"Price stability" is a fine phrase, though you won't find it defined in the law. Functionally, the Bernanke Fed defines stable prices as just a little inflation—say, on the order of 2 percent a year. Some years ago, Alan Greenspan had another idea. "Price stability," he proposed, "is best thought of as an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."

The Maestro so opined in 2001, just as house prices were beginning to levitate. This was not inflation by the lights of the Fed's preferred price index, the personal consumption expenditure deflator. But it was inflation as Greenspan seemed to define the word. I must say his definition appeals to me. Soaring house prices certainly "entered into the decisions of households and firms." For a time, nothing else seemed to enter into our collective financial decisionmaking. We had home on the brain. Yet, there was no inflation problem. Even Greenspan himself said so.

Borrowing from the canon of Austrian economics, I would define inflation not as rising prices but as too much money. Rising prices are a symptom of the excess—and those prices may materialize at the checkout counter, on the stock exchange, or in the realtor's office. Similarly, I would define deflation not as falling prices but as too much debt. Falling prices are a symptom of that excess. One might say that inflation is a monetary phenomenon, deflation a credit phenomenon. One might so say—but, in Washington, D.C., one usually doesn't say. Here, inflation is the upward creep in the chain-type price index for personal consumption expenditures—period.

If this was stability, it was the stability of life on a live volcano. Of course, we Americans have long become accustomed to the ominous rumblings below. We are the uniquely privileged beneficiaries of the world's reserve-currency franchise. We print the world's money. Importing much more than we export, we finance

the difference with our very own currency. Only we can lawfully conjure it into existence. These dollars we ship to our Asian creditors. The central banks of those creditor states buy the dollars with local currency. And how do they come by these baht, won, yen, and renminbi? Why, they print them. So they print money, and we print money. Their real estate markets go up and up—and so do their dollar holdings. You can watch the growth of this dollar cache in a footnote to the weekly Federal Reserve balance sheet. "Marketable securities held in custody for foreign official and international accounts" is the line item. It amounts to a hairsbreadth less than $3 trillion. Only consider it. We pay our offshore creditors in dollars. And our loyal creditors send the dollars right back to us in the shape of bond investments. It's as if the greenbacks never left the 50 states.

In days of yore, a deficit country would pay its bills in gold. The loss of this gold would exert a salutary contractional influence on the deficit country's economy. If the deficit persisted, the price level of the improvident nation would decline. Lo and behold, its export industries would become more competitive. By and by, gold would start a return voyage home and the current account would return to something like balance. It wasn't homesick, this load of departed yellow bricks. What lured it back was a lower price level and higher prospective returns. Money loves a bargain.

Not for us today, however, this semiautonomous movement of monetary gold. Give us, instead, the apparent stability of managed exchange rates. So debts pile up on this side of the Pacific, dollar-denominated assets on the other side of the Pacific. Such a system can plainly not last forever. Then again, it has outlasted the patience of many a skeptical observer. On Wall Street in the early and mid-2000s, confidence reigned.

In their confidence, our leveraged financiers resembled a bit the complacent residents of south Florida 17 years before. There had been no major hurricane in that region since the one named Betsy in 1965. It was possible to imagine that there would never be another. Then the only major storm of the otherwise inactive 1992 hurricane season came barreling through Homestead. Its name was Andrew, and it killed 65 people and inflicted $26.5 billion in damage.

Of course, the analogy between Andrew and our Great Recession is inexact. Though unprepared for the hurricane, people

didn't actually cause it. However, by lending and borrowing under the spell of ultra-low interest rates and rising asset prices in the early and mid-2000s, we humans actually did precipitate this financial crackup. Monetary crises and debt liquidations are no acts of God, except insofar as the Almighty breathed life into the nostrils of Federal Reserve governors, Citigroup directors, subprime speculators, and innumerable other perpetrators.

Let us pause now to name and shame these suspects so that they might henceforth walk the straight and narrow. Who are they? I am going to accuse . . . the human race. Yes, every last fallen, sinful mortal. We humans do the best we can, but money isn't our strong suit.

Constructing Safeguards

Our forebears understood this limitation. They constructed an elaborate apparatus of safeguards to prevent us from doing what comes naturally. They put bars on tellers' cages, instituted a sinking fund to retire the public debt (that was Alexander Hamilton's idea), organized broker-dealers as general partnerships (not limited-liability corporations), and held the threat of a capital call over the shareholders of national banks if the bank in which they invested failed and left the depositors in the lurch. And—not least—they collateralized the dollar with gold and silver to restrict the government's power to emit paper money. Now look around you. Tellers greet customers from behind an unfenced counter; the Treasury sinking fund is a distant memory (it bought its last bond in August 1960); Goldman Sachs is a corporation; bank shareholders have no contingent liability; and the dollar is a piece of paper exchangeable into nothing except small change.

What a flattering view of the human being we have collectively adopted. Inferring from the structure of our financial and monetary arrangements, one would have to say that James Madison was wrong. Men *are* angels, after all.

Marriner Eccles was the Ben Bernanke of the late 1930s. Surveying the financial wreckage of the Depression, he castigated the bankers. Why, a third of American banks had gone out of business, a shameful record. Actually, by 21st-century lights, it was an extraordinarily successful record. What would Eccles say today? In the Depression, nominal GNP fell by 46 percent. In our Great

Recession, from the third quarter of 2008 to the second quarter of 2009, nominal GDP fell by 2.7 percent. If, today, the top line of the U.S. economy were virtually sawed in half, how many banks would be left standing?

I doubt that today's bankers are any less capable than their ancestors. Rather, their incentives are different. Before the institutions of modern support and subsidy—the Fed, the FDIC, the too-big-to-fail doctrine, etc.—banks had to look after their own liquidity. Operating under the constructive fear of a run, a moderately prudent banker held a comfortable cushion of cash in relation to his deposit liabilities, 25 percent and up.

Does the following sound familiar? "Banking and gambling are two separate branches of finance . . . [and they should not] be combined under one roof." It could have been Paul Volcker calling for the forced separation of conventional banking activities from trading and deal making. In fact, it was the *Los Angeles Times* in an editorial dated January 5, 1889. The *Times* was commending the Farmers & Merchants Bank of Los Angeles, forerunner to Wells Fargo, for its conduct during the local real estate bubble of the late 1880s. Seeing a huge distortion in values, the bank headed by Isaias W. Hellman closed its loan window to real estate speculation.

It is a tale to ponder, this long-ago saga of discretion, judgment, and managerial control. In 1889, almost none of the familiar institutions of financial regulation and government control were yet in place in America. There was no Federal Reserve to press down interest rates, no government-sponsored mortgage lenders to subsidize homeowners and real estate speculators. Individuals and corporations bore credit risk, not the taxpayers. The risk of loss was yet unsocialized.

There were, however, human beings—Californians, specifically—champing at the bit to get rich. A railroad rate war seems to have been the instigating factor in the real estate frenzy. At one point, you could ride from Kansas City to Los Angeles for $1. In poured the settlers and up shot the land prices. In Los Angeles, business lots jumped to $5,000 in 1887 from $500 in 1886. During the same 12 months, according to the historians Robert Cleland and Frank Putnam (1965: 52), "The price of nearby ranch lands increased 1,400 percent to 1,500 percent and former grain fields and sheep pastures were subdivided, sold as town lots and made to

yield fantastic profits. Twenty-five towns were laid out before the close of 1887 along the Santa Fe Railroad from Los Angeles to the San Bernardino County line, a distance of 36 miles."

Now the Farmers & Merchants, the bank to which the *L.A. Times* tossed its editorial bouquet, had built its franchise on safety and soundness. Hellman held the uncompromising belief that no depositor should ever be denied access to his cash, come hell or high water. By modern standards, the bank was absurdly liquid, holding cash reserves of 50 percent and more of deposit liabilities. Not for Hellman the policies that cast the modern Wells Fargo into the arms of the TARP and delivered a cycle peak to cycle trough share-price decline in Wells Fargo common of 83 percent. As for the real estate bubble of the late 1880s, it seemed to do no lasting harm to southern California because of such bankers as Hellman. To quote the historian Glenn Dumke (1944):

> Southern California institutions apparently perceived in 1885 the beginning of inflation, and the Farmers and Merchants Bank of Los Angeles led in the inauguration of a policy of caution. . . . By July of 1887, less than half of the [Los Angeles County] banks' funds were on loan, and six months thereafter only one quarter. . . . [T]he banks successfully withstood runs, and, except for one or two unfortunate and relatively minor incidents, the flurry did not injure the banking structure of the region [in Cleland and Putnam 1965: 53].

The Fed's Dubious Business Model

I earlier arraigned the whole human race for our sorrows, but some individuals deserve special mention. Ben Bernanke is surely one of the culpable ones. I fault him not so much for failing, initially, to comprehend the crisis, still less for failing to anticipate it. Rather, I blame him for taking as proven the viability of the Fed's dubious business model.

And what is that model? It is, essentially, to fix an interest rate—that is, the federal funds rate. Imagine 20,000 people—about the size of the Fed's payroll—staring at one interest rate, prodding it, poking it, endlessly discussing it. What chance does that interest rate stand? You begin to feel sorry for it.

Is it the right interest rate? I am going to venture that zero percent is never the right rate, that it distorts investment decisions and instigates speculation, as, indeed, it is doing today. And there is the question of simple equity. Why should the thrifty nonparticipants in our debt frolics (there must be six or eight of them) be condemned to earn nothing on their savings?

But the underlying problem is not that the Fed sometimes fixes the wrong rate but that it arrogates to itself the knowledge and judgment to fix any rate. On Broadway, a revival of Neil Simon's "Brighton Beach Memoirs" unexpectedly closed a week after it opened. Said the disappointed playwright: "After all these years, I still don't get how Broadway works or what to make of our culture." One could imagine an older and wiser Bernanke confessing that, after all those monographs and all those meetings, he still doesn't get how Wall Street works or what to make of our economy. Then again, who really does?

The Golden Constant

Now, if you please, a word on gold. Roy Jastram (1977) wrote a book entitled, *The Golden Constant*. In it, he demonstrated that gold held its value over many centuries. It was not a brilliant investment over the span of years. It just held its value. There have been many books written extolling the long-term returns on common stocks, but not one of them is entitled "The Equity Constant." No wonder. It would never sell. The whole point about stocks is that—supposedly—they go up.

The rub is that history is forever intruding. Corporations, though legally perpetual, are practically mortal. So it is with compound interest. It doesn't run in perpetuity but, rather, during those relatively rare intervals of human history marked by peace, prosperity, and the rule of law. If someone—anyone—had had the presence of mind to invest just one dollar's worth of Cleopatra's gold upon her death in 30 B.C., not one of us would have to work for a living. At 2 percent compounded annually, that single dollar bill would today be worth $343 quadrillion, or 5,658 times estimated 2008 world GDP. But history is discontinuous—no Nero 2 percent perpetuals or Beowulf 3s are still quoted—so we must work and save as best we can.

Conclusion

In closing, let me affirm that stability is nice while it lasts. But we must never delude ourselves into believing that giant corporations can deliver stair-step earnings growth or that central banks can turn a manipulated structure of interest rates into gold.

References

Cleland, R. G., and Putnam, F. B. (1965) *Isaias W. Hellman and the Farmers and Merchants Bank.* San. Marino, Calif.: Huntington Library.

Dumke, G. S. (1944) *The Boom of the Eighties.* San Marino, Calif.: Huntington Library.

Greenspan, A. (2001) "Transparency in Monetary Policy." Remarks by Chairman Alan Greenspan at the Federal Reserve Bank of St. Louis Economic Policy Conference, St. Louis, Missouri (via videoconference) (11 October).

Jastram, R. W. (1977) *The Golden Constant.* New York: John Wiley and Sons.

Shelton, J. (2009) "The Fed's Woody Allen Policy." *Wall Street Journal* (11 November).