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Concerning perpetuity

On May 9, the editor of *Grant's* addressed the annual meeting of the Chartered Financial Analysts Institute in Edinburgh, Scotland. Following is the text of his remarks, touched up with a few items he thought of after he left the rostrum:

All right, CFAs, let's get analytical. On the authority of Wikipedia, Cleopatra died in 30 B.C. Say that one of her heirs decided to make a benefaction to the human race—sold one of her gold bangles for \$100 and with the proceeds bought a perpetual 2% certificate of deposit in the Bank of Eternity. Nobody has touched the principal; 2,041 years later, what's it worth?

Let's see, according to the Rule of 72, money invested at 2% doubles every 35 or 36 years. Carry the seven. . . [a short pause ensues to perform some mental arithmetic]. The number I come up with is 35 followed by 18 integers punctuated by six commas. A slightly awkward number. We can bring it down to earth, however, by dividing by the world's population, 6.9 billion.

Let's see. . . [another pause for mental arithmetic], carry the four. . . That would be \$5,164,930,493.50 for every man, woman and child on earth—before tax. So \$100 in 30 B.C. would blossom into \$5 billion-plus per capita in 2011. It's as if everyone on earth had founded Glencore.

What a very handsome gift it would have been, and how thoughtless that nobody made it. Of course, there were practical difficulties. The Bank of Eternity did not exist and neither—more to the point for my talk—did a perpetual currency. Human history is discontinuous. Nations, empires, banks and curren-

cies rise and fall. Gold endures, but a lot of good it does us seekers after an easy \$5 billion per capita. Metal pays no interest.

What's wrong with currencies is the first topic on my agenda today. A prescription for setting things straight is the second. In preview, the trouble—the essential trouble—with our monetary organization is a worldwide neglect of the price mechanism. Adam Smith would roll over, but our central bankers show an inexplicable preference for the brute methods of command and control over the delicate and coordinating interplay of market forces. I've got a plan for reform, which I'll get around to later. I'd tell you now but I don't think you're ready for it.

If the every-man-woman-and-child-as-multibillionaire project failed to take root in 30 B.C., it's a cinch it wouldn't catch on today. Our currencies are good for a trade, but none seems ripe for a long-horizon investment. In fact, I suspect that monetary historians will look back on our time as a dark age. Certainly, it's no sign of enlightenment that governments and their "independent" central banks are suppressing interest rates, manipulating yield curves and debasing currencies. In the United States, the Fed is trying to raise stock prices.

China is the capital of the price-suppression movement, and "Red Capitalism," by Carl E. Walter and Fraser J.T. Howie, is the book you must read to get chapter and verse. This is a book of revelations. It turns out that red capitalism, with all the crony and socialist trimmings, bears no small resemblance to 21st-century American capitalism. The Chinese just practice a purer version of the venal and manipulative model.

In 1967, John Kenneth Galbraith had a best-seller entitled, "The New Industrial State," in which he contended that large American corporations were self-perpetuating oligarchies that functioned outside the market economy. They set their own prices and fixed their own costs. The stockholders had nothing to do with anything.

Never mind the America of the go-go 1960s. Galbraith was actually anticipating today's China. "It doesn't matter who owns the money," relate the authors of "Red Capitalism," quoting the head of a state-owned enterprise, "it only matters who gets to use it." The Communist Party, operating through the Bank of China, China Construction Bank, Agricultural Bank of China and Industrial & Commercial Bank of China, decides who gets to use what.

Let us say that credit analysis is not the banks' strong suit; asset growth, rather, is the watchword. In a crisis year—2009, for instance—the footings of the Chinese banking system might surge by 40%. Otherwise, 20% seems to do the trick. Eight percent GDP growth is what the party demands, and it's up to the banks to finance it.

In the 1980s, the Texas banks went broke all by themselves. They'd hardly have gone broker if the Texas Communist Party or the Texas Republican Party had done the lending. In China, according to Walter and Howie, the party *does* dictate credit allocation. "The party tells the banks to lend to the state-owned enterprises," they write, "but it seems unable to tell the SOEs to repay the loans."

In China, the big banks don't formally go broke. Rather, every 10 years or so,

the state recapitalizes them. The one and only explicit and transparent bankruptcy of a major Chinese financial institution was that of Guangdong International Trust & Investment Corp., better known as GITIC, a specialist in real estate and infrastructure finance, in 1999. One such parting of China's lending curtains was—understandably—more than enough for the party. According to “Red Capitalism,” GITIC creditors recovered 12.5% of face value.

Though GITIC is gone, the GITIC credit culture lives on. In the circumstances, you would expect that Chinese bankruptcy news would be crowding the front pages of *The Wall Street Journal* and the *Financial Times*. But, no: China has adopted the American congressional technique of kicking the can down the road. Banks shift their desperate debt over to their very own government-financed asset management companies. The asset management companies are called bad banks, but that is a misnomer. Actually, they are worse banks. And on the balance sheets of these worse banks, the nonperformers stay and stay.

The worse banks got worse right off the bat by marking their maiden crop of nonperforming loans at par. No discount to reflect that they were, in fact, impaired. Full face value. This was in 2000. Naturally, this opening pretense set up the necessity for a whole train of make-believe. To finance the NPLs, the asset management companies issued their own bonds. Borrowing to carry bad debt marked as good debt, the asset management companies guaranteed their own insolvency. And they would have failed long before this but for Mother State. “In 2009,” Walter and Howie write, “as their bonds came due, the AMCs [asset management companies] were not closed down and their bonds were not repaid. Instead, the State Council approved the extension of bond tenors for a further 10 years.” To permit the worse banks to carry the less-bad banks' debt at par, China's Ministry of Finance stamped the dubious debts with its guarantee. Behind the MOF stands the sovereign—specifically, the sovereign's central bank. Whatever stands behind the People's Bank of China is not evident on that institution's balance sheet. It is leveraged 1,223 to 1.

The People's Bank is, of course, an immense catch basin of foreign exchange, mainly U.S. dollars. We Americans send greenbacks to Wal-Mart's Chinese sup-

pliers. This currency the central bank purchases with renminbi printed specially for the purpose. Then, obligingly, the Chinese authorities send the dollars back to America in the shape of investments in U.S. Treasuries and agency securities. If you blinked, you'd never know the money had left the 50 states.

Under classical doctrine, central banks operated passively in the money market. Investor-owned institutions, they conducted a conventional commercial banking business while standing ready to exchange gold for currency and vice versa at a fixed statutory rate. No more, of course. Today's central banks operate aggressively—I might say brutally—chiefly through open-market operations. They don't follow the market but beat the market into submission.

The subtitle of “Red Capitalism” is “The Fragile Foundation of China's Extraordinary Rise.” Maybe, “China Laments the West” would be better, for it does seem to me as if the Communist Party were engaged in a kind of national satire. Seeing that we Westerners honor the price mechanism more in the breach than the observance, the mandarins honor it not at all. Maybe the joke is on us.

I expect that the Chinese absorbed some of their very worst ideas from the first American president to visit the People's Republic. It was Richard M. Nixon who launched the paper dollar standard in 1971. From Alexander Hamilton's time to Nixon's, with a long recess for the American Civil War, the dollar had been defined as a fixed weight of gold or silver. For most of that long era of convertibility, anyone could make the election, paper for metal or vice versa. Not until the 1930s did the conversion option come to be reserved exclusively to foreign official dollar holders. Nixon mounted a two-prong attack on the price mechanism. Not only did he close the gold window, but he also imposed wage-and-price controls—for America, a peacetime first. The \$35 gold-exchange rate was a market-based regulator of the monopoly powers of the Federal Reserve and of the fiscal and political power of the U.S. Treasury. America's creditors, having sized up the republic's financial position, could decide whether to hold their American claim in dollars or gold. To forestall a run on Fort Knox—for the rate of dollars-to-gold collateral was becoming outsize—Nixon made the decision for them. Henceforth, they would hold dollars, now backed exclu-

sively by the good intentions of the issuing government.

Note, please, you CFAs, that here began the career of a most curious financial instrument. As a convertible currency, the dollar derived its value from the underlying collateral, gold and silver—or, perhaps more exactly, from the government's capacity to exchange paper for bullion at the lawful rate. Since 1971, the dollar has been a derivative without an underlying asset.

The suspension of dollar convertibility ushered in the present age of stupendous deficits, both domestic and external. It has done us and our creditors grievous harm. The damage done by wage-and-price controls was out in plain sight—everyone queued up for gasoline. The damage inflicted by shutting the gold window was subtler. Indeed, for many there was no mischief at all, but, rather, a gorgeous opportunity. Speculative classes, the nimble and clever—you know, you yourselves—can always adapt to an inflationary monetary regime. Zero-percent funding cost is, for them, heaven-sent. It's the stolid and trusting savers who suffer.

Inequity is at the very heart of the reserve currency regime. The United States is uniquely privileged. It alone can pay its bills in the currency that it alone may lawfully print. This privilege we have, of course, roundly abused, running deficits on current account for 35 years in a row, while lately setting indoor and outdoor records in fiscal profligacy. But you can't blame us. I am going to make bold to say that even the thrifty Scots, our hosts, would live a little higher on the hog if they were in possession of the reserve currency privilege. It's a temptation that no people could resist, and we Americans haven't.

I don't mean to claim too much for the unimpeded operation of the law of supply and demand. Mortal humans err no matter the economic arrangements under which they live and work. However, the elevation of arbitrary central banking discretion over the impersonal price mechanism is, to me, the key remote cause of the sea of monetary and financial troubles in which we are not quite managing to stay afloat.

Arbitrary and misguided is the Fed's long-running campaign against the bogeyman, deflation. Please—for once—let us stop to define terms. Deflation isn't simply falling prices. It is, rather, too little income chasing too much debt. It is

a disorder of lending and borrowing. A symptom of this disorder is falling prices. In a credit crisis, inventories, being unfinanceable, are thrown on the market. In consequence, prices broadly fall. What deflation is not is the Wal-Mart business model. It isn't the benign shift, downward and to the right, of the world supply curve brought about by the advent of digital technology and the annexation into the world's labor market of hundreds of millions of new hands. It is, rather, what a layman might call "progress."

Central banks, however, mistaking progress for deflation, have systematically overridden the marketplace in an attempt to save us from the everyday low and lower prices that consumers actually seem not to mind at all. Over the course of the past four or five generations, a profound and debilitating change has come over our monetary arrangements. Central banking has yielded to a kind of soft central planning, and we have exchanged the gold standard for the Ph.D. standard, the price mechanism for mandarin rule.

Say what you will about our central bankers, they don't lack self-confidence, although more than a few exhibit a troubling deficit in self-awareness. Famously, last December, on the American television program "60 Minutes," Chairman Bernanke insisted that he was "100% certain" that the Fed could withdraw its hyper-stimulus in time to forestall the next inflation. I don't know about you, but in temporal matters, I'm only 99.9% certain of the day of the week. It's a probabilistic world. "[P]utting the welfare of the British citizens foremost," Adam Posen, a member of the Bank of England's Monetary Policy Committee, declared in a February speech, "does not imply taking them seriously as economic forecasters." One must not think such thoughts, let alone say them. It's very, very bad luck. Now recall a 2009 utterance by Janet Yellen, current vice chairman of the Federal Reserve Board: "I will be the first to say that it is extremely difficult to get monetary policy just right. But the Fed's analytical prowess is top-notch and our forecasting record is second to none." Yet, oddly, these nonpareil forecasters anticipated

not one feature of the greatest credit crisis in a half-century or more.

If not the Ph.D. standard, what? Why, the restoration of a dollar convertible to gold at a fixed weight. Let the Fed confine itself to doing no harm. Let it serve the market by exchanging gold for paper and paper for gold at a fixed rate (the rate to be determined so as to assure no deflation in the structure of wages and prices). Let gold enter and leave the country freely. Let the reserve currency structure die a richly deserved death. Let the Treasury finance its deficits outside the banking system so that the true cost of borrowing may register on the taxpayers who have to bear it. And let my country discharge its foreign obligations in the universal money that favors no one nation rather than in the imperial paper dollar. In short, restore the price mechanism to its proper place in our monetary and financial affairs.

I see expressions of disbelief playing across the faces of two or three members of the audience. I suspect you believe that my proposal to reinstitute a modernized edition of the classical gold standard is, at best, quixotic. Even if the Ph.D. standard does need an overhaul, you may be thinking, can we not adopt some modern contrivance like special drawing rights? The classical gold standard has this unique advantage: It functioned, not only in theory but also, as my friend Lew Lehrman puts it, in the laboratory of human history.

A word on what the classical gold standard was not. It was not the regime put in place at the Genoa Conference in 1922, nor the system embraced at Bretton Woods in 1944. Each of those faux gold standards instituted a reserve currency to lord it over the others—at first, the dollar and pound; later, exclusively the dollar. The true-blue gold standard favors no one nation. It rather synchronizes the balance of payments among all. A curiosity of the gold standard is that, when it is properly functioning, there is no gold fever. As a hedge against the depreciations of the Ben Bernankes of the world, gold is hugely exciting. As money, paying no interest, it is unalterably dull. A gold standard would kill the

gold investment business.

"Red Capitalism," as I've tried to show, is more than an exposé of the unfolding disaster in Chinese finance. It is also the description, writ large, of the salient error of all the world's monetary arrangements—namely the elevation of the technique of command and control over the free interplay of supply and demand.

As a bookend to "Red Capitalism," I commend to you the reprint of Hartley Withers' "The Meaning of Money," first published in 1909 during the full flower of the classical gold standard. Withers was editor of *The Economist*, a worthy successor to Walter Bagehot. "The Meaning of Money" is a grand tour of the least imperfect monetary system yet devised. In closing, Withers stands back to admire what a century of British experience had wrought.

"[R]esponsibility for the manufacture of currency and credit has passed into the hands of banks," he writes, "which carry it on without any restriction except that dictated by their own discretion and judgment." It was, indeed, he marveled, a credit system of "extraordinary elasticity and perfection, so perfect in fact that its perfection is its only weakness." Just perhaps, what we have lost we can begin to reclaim.

Warren Buffett, who knows a thing or two about investing, seems to have no use for gold. He was recently quoted as saying that if you collected all the gold ever mined, it would make a 67-foot cube—and that (now I am borrowing from *The Spectator's* Martin Vander Weyer) at a price of \$1,500 an ounce, it would buy all the farmland in America plus 10 companies the size of Exxon Mobil, plus a little left over. Said Buffett, "or you could have a big cube of metal. Which would you rather take? Which is going to produce more value?"

Of course, if one can be certain of monetary stability, one would take the farmland and Exxon Mobil and that 2% CD from the Bank of Eternity. In the absence of stability, however, one prudently lays a little aside in the legacy monetary asset, Keynes's own barbarous relic.

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