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Monetary regime change

On August 30, at the annual monetary jamboree of the Kansas City Federal Reserve Bank in Jackson Hole, Wyo., Alan Greenspan washed his hands of responsibility for the bubble he said he could not have pricked even if he had noticed it floating above his desk on a string. "The struggle to understand developments in the economy and financial markets since the mid-1990s has been particularly challenging for monetary policy makers," declared the Maestro. "We were confronted with forces that none of us had personally experienced. Aside from the then recent experience of Japan, only history books and musty archives gave us clues to the appropriate stance for policy."

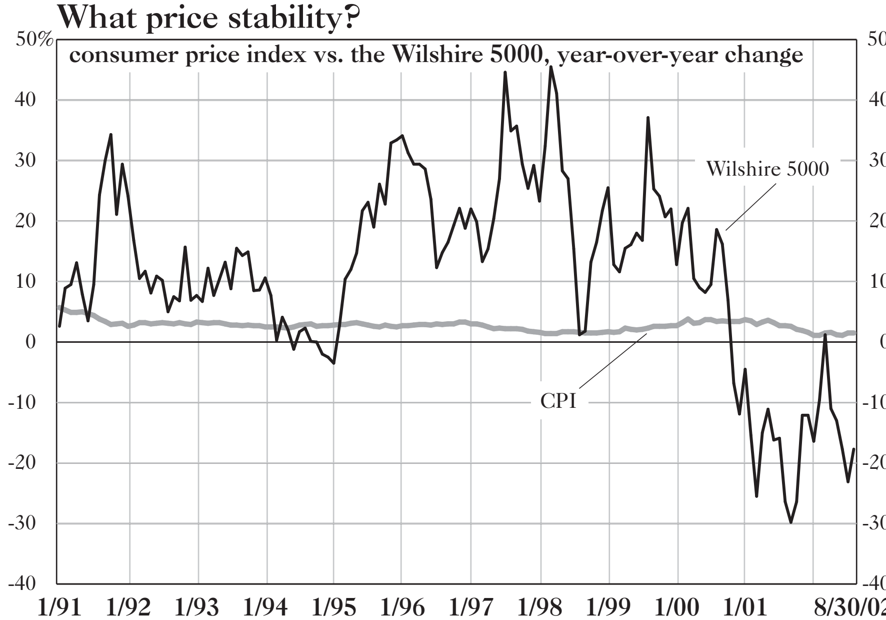
The chairman's Jackson Hole speech has been, will be and should be deplored as the worst kind of self-exculpating revisionism. However, it was a letter to the editor in Sunday's *New York Times* that hit the critical nail on the head.

"Mr. Greenspan is a human being," writes Victor A. Altshul, of New Haven, Conn., "subject to the same frailties as anyone else. Why should we expect him to be exempt from the universal tendency to rationalize one's errors and to distort the record to protect one's self-esteem? Shouldn't we instead be looking at our own complicity in investing so much power in one man?"

CEOs are celebrated not for who they are but for what they do. Until he presided over the great bull market, Greenspan did not give many outward signs of genius. But the higher stock prices went, the smarter he seemed to become. By late in the 1990s, he was heralded as a miracle worker. Indisputably, he was the only federal employee whose reputation for financial sagacity rivaled that of Jack Welch. Miracles being few and far between these past two years, Greenspan's reputation has begun to be marked down, if only by eighths and quarters. Welch's, last week, entered what looked like a secular bear market.

Following is a speculation on the outlines of a post-Greenspan monetary system. It is supported by some of the historical works that the chairman can read in the well-deserved retirement he should have taken starting in about 1996. We say "post-Greenspan" because, we believe, the Jackson Hole speech will raise the odds against his reappointment (his current term expires in 2004), speed the day of his departure and reduce his policy-making influence for as long as he remains in office. It would be no small thing if the chairman's myriad admirers decided that their idol had lost his touch. Although the Federal Reserve System employs 485 Ph.D. economists, only one is a living symbol of the dynamic U.S. economy. And now this one man says that he didn't know about the stock-market bubble, couldn't have known and, even if he had known, wouldn't have been able to make a move against it. It isn't a great advertisement for a monetary dictatorship.

What price stability?



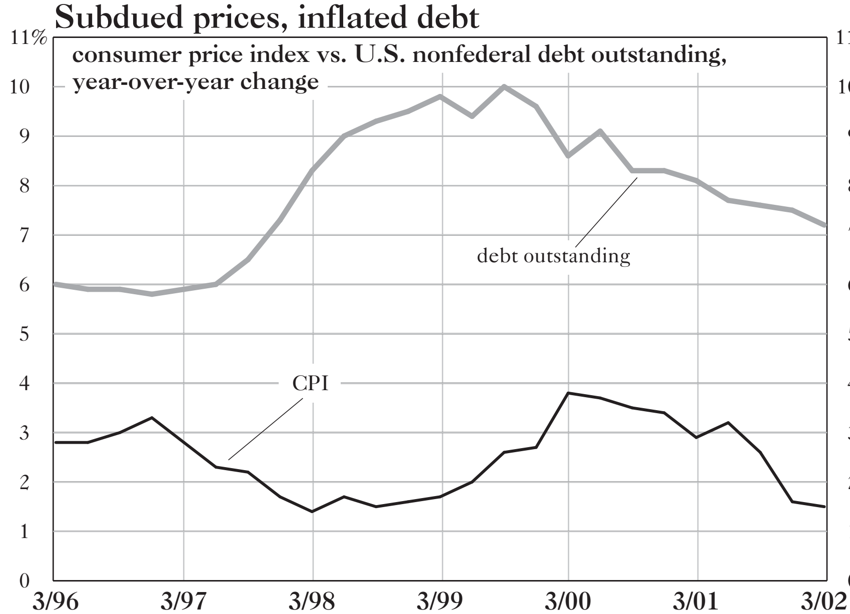
source: The Bloomberg

Monetary policy under Greenspan (as we may have touched on in the prior issue) consists of fixing an optimal funds rate. In better times, Greenspan's mysterious rate-setting method was deemed as great an American secret as the Coca-Cola formula. As recently as Aug. 2, 2001, David Wessel of *The Wall Street Journal* entered a page-one plea that the chairman share his secret lest the country suffer irreparable harm when nature finally called him to rest. To enforce this most perfect interest rate, the Fed creates the needed volume of credit. It "prints" money, as every trainee knows, by acquiring earning assets, mainly Treasury securities; it buys them with dollars that it creates for the very purpose.

Grant's monitors the growth of these assets to see how many dollars it takes to set and maintain the desired rate. To set an artificially low rate, the Fed pumps money into the market. To impose an artificially high rate, it withholds money from the market. (A rate that is neither artificially low nor artificially high is the rate that would balance the demand for savings with the supply of savings without central bank intervention.) The current, $1\frac{3}{4}$% funds rate has been maintained by prodigies of credit creation. As recently as July 17, growth in Fed credit was running on the order of 11.27%, measured year-over-year. Today, it's clocked at just 9.28%. It's noteworthy that the Fed is able to continue to impose a generationally low funds rate without deploying more and more credit (indeed, by deploying less). If the slower growth in credit supply reflects a faltering growth in credit demand, it may presage still lower money-market rates.

Only one of the troubles with bubbles is that, after they pop, ultra-low interest rates and extraordinary rates of credit expansion lose their stimulative potency. The rate of creation of new yen by the Bank of Japan stands at 26.1%, year-over-year, but this outpouring has yielded no appreciable reflationary results. It interests relatively few investors that the central bank of the world's second-largest economy is engaged in a monetary expansion of a scale suitable to one of the minor United Nations members. It would interest a great many more if the Fed were forced into the same exigencies. No one can know whether it will be or won't be. However, in January, the Federal Open Market Committee did discuss "unconventional policy measures" to deploy if "the economy were to deteriorate substantially in a period when nominal short-term interest rates were already at very low levels," according to the minutes of a meeting held on January 25-26.

Subdued prices, inflated debt



source: The Bloomberg

The Founding Fathers, well remembering King George III, held the exercise of arbitrary authority in abhorrence. Their contemporary, stock-minded political descendants, however, have gladly tolerated the kind of arbitrary authority exercised by the Fed chairman. Willingly did this government of the people, by the people and for the people cede monetary power virtually to a committee of one. However, the more the economy labors and the lower stock prices fall, the worse this remarkable act of delegation will come to appear. The bear market will bring the question posed by letter-writer Altshul—why was so much power given to one man?—into the political mainstream.

A survey of the dead authors not much read at the Federal Reserve supports an observation familiar to the readers of *Grant's*. This observation is that monetary systems are impermanent—one has succeeded another at intervals since the late 19th century. To their originators, each method of monetary organization was fit for the ages. But none lasted much longer than a generation. The system in place since 1971 is the worldwide paper-dollar system. In part, it's an "information standard," to borrow from retired Citibanker Walter Wriston, with interest rates and exchange rates mainly set by the market. But the federal funds rate, anchor rate of the dollar-denominated yield curve, is a government-issue rate, and the latent power to create massive amounts of credit (as at year-end 1999 and in September 2001) is a governmental power. As much as it might be an information standard, the current dollar system is just as much, or even more, a faith-in-government standard.

It wasn't faith in an impersonal government, or in the rules laid down by government, that brought CNBC into American homes and taverns in the late 1990s. Rather, it was faith in the capacities of government masterminds. At the peak of their renown, Alan Greenspan and Robert Rubin seemed to work with tomorrow's edition of *The Wall Street Journal* always open before them. And now, instead of Rubin at Treasury, there is Paul O'Neill, a man who seems not to have read yesterday's paper. And there is Greenspan, who in Jackson Hole revealed a faulty memory and a guilty conscience.

The text of his speech is available on the Federal Reserve Board's Web site (http://federalreserve.gov/boarddocs/speeches/2002/) and it deserves a careful reading—or, rather, repeated careful readings, as the student will hardly believe it the first time through. Here is the history of the 1990s according to Greenspan, a decade in which "greater economic stability" fostered risk taking, and in which earnings prospects improved as the pace of innovation accelerated. Responding to these stimuli, stock prices rose. "The associated decline in the cost of equity capital spurred a pronounced rise in capital investment and productivity growth that broadened impressively in the latter years of the 1990s," the Jackson Hole audience heard him say. "Stock prices rose further, responding to the growing optimism about greater stability, strengthening investment, and faster productivity growth." Regrettably, they rose too far, but there was no way, except in retrospect, to have known that. Indeed, even the March 2000 highs might not have been too high "if all of the drop in equity premiums had resulted from a permanent reduction in cyclical volatility. . . ." And, of course, "productivity growth" was a gift almost beyond measure.

Greenspan disputed that a rise in margin requirements would have deflated the bloated market, forgetting that he himself had acknowledged the need to address the "stock market bubble problem" in the Sept. 24, 1996, meeting of the FOMC: "I guarantee you that if you want to get rid of the bubble, whatever it is, that will do it," the transcript of the meeting quotes him as saying (http://federalreserve.gov/fomc/#calendars). "My concern is that I am not sure what else it will do."

Greenspan's shortcomings as a memoirist in his Jackson Hole address are matched by his failings as an economic theorist. He perpetuates popular nostrums about productivity growth, "price stability" and interest-rate policy. For example, he offers no insight into the unintended consequences of suppressing market interest rates. He implies (though it is possible to infer from Bob Woodward's "Maestro" that he doesn't really believe it) that gains in productivity are registered automatically in profits, rather than in wages or prices, or in a combination of the three. He fails to mention that "price stability" can, and on many occasions in the past has, led to bull stock markets that elicited enough redundant capital investment to distort the economy in which they spread their joy. And he declines to address the risk that the very prestige of a popular central banker tends to cause investors to forget themselves and push up asset prices to the heights that all come to regret. The propensity to regret is especially keen if the prestigious central banker in question blesses the bubble both in word and deed.

A month before the Jackson Hole festivities, the BIS published a working paper by Claudio Borio and Philip Lowe that anticipated the subjects Greenspan discussed on August 30. The BIS, of course, is the Bank for International Settlements, the central bankers' central bank, and an unlikely source of criticism of the only central banker up for knighthood this fall. Yet the BIS authors come down hard on the side of doing what Greenspan didn't do, incidentally anticipating (and refuting) the reasons Greenspan presents for not doing it. The more successful a central bank in smiting the conventional kind of inflation, write Borio and Lowe, the greater the risk of an outbreak of the unconventional kind (i.e., a bubble). "Failure to respond to these imbalances," the two contend, "either using monetary policy or another policy instrument, may ultimately increase the risk of both financial instability and subsequently deflation (during the period in which the imbalances are unwound)."

Not once in his Jackson Hole recitation did Greenspan concede that his repeated interventions to prolong the up cycle had misdirected capital and hurt the owners of it (not to mention the people who work for the owners of it and the children of all the foregoing). The BIS authors clinically refer to the risks presented by "asymmetric" policies, i.e., cutting rates to rescue the market but never raising them to slow it down. It will speed the close of the Greenspan era when the public reflects on how lopsided was this asymmetry. Grant the chairman, for argument's sake, the prudence of intervening in the wake of the Long-Term Capital Management explosion in October 1998. Give him the benefit of the doubt about the stupendous infusion of credit with which the Fed prepared the nation to meet the crisis of the computer clocks at year-end 1999. And allow him the justice of the argument that in a deregulated world, the manipulation of margin requirements is a gesture certain to fail. Grant every point, and still it is not possible to explain away the fact that Greenspan sounded more like a broker than a central banker in his speeches and congressional testimony in the mid- and late 1990s. He was a greater seducer than any big-money analyst, in fact, because the public could see that he spoke from the heart. He wasn't in the bonus pool.

A week or so after the Jackson Hole speech found Stephen Cecchetti on the op-ed page of the *Financial Times* with a most becoming mea culpa. Cecchetti, currently professor of economics at Ohio State University, was director of research at the Federal Reserve Bank of New York in Wall Street's all-you-can-eat years, 1997-99. He reviews the damage inflicted by the bubble, from underfunded pension funds to distorted GDP statistics to the slight over-ordering of telecommunications equipment and computers. "Add all of this together," writes Cecchetti, "and the cost is several percent of U.S. GDP and still counting. When faced with the potential for output losses of this size, central bankers usually work fast to try to minimize the damage. So why, when faced with strong evidence of a bubble, do they react so differently, claiming that there is nothing they can do? The response is surprising." Having acknowledged that a move to withdraw the punch bowl was in order, the economist admirably closes, "I cannot claim this would have worked and did not push for it at the time—but I certainly should have."

The BIS essay almost diffidently makes the case for a "paradigm shift" in central banking. It urges an acceptance of the fact that asset inflation is a source of economic distortion, therefore a problem suitable for central bankers. Years ago in the pages of *Grant's*, colleague Gert von der Linde recalled Greenspan's own very neat definition of inflation. It was approximately this: Inflation is a rate of rise in prices sufficient to cause a change in human behavior. And von der Linde pointed out that the stock market bubble had caused millions of people to do things they had never thought of doing before it happened—for example, not working for a living.

We predict that the reaction against Greenspan will take the form of a rejection of policy making through intuition. In times past, many believed that the chairman could look into the future and improve it before it happened. How he did this was never clear, but it was not for the layman to understand. Proof that it was possible to do was that he was doing it (or so his acolytes insisted).

How far the reaction against the Greenspan intuition will go will depend on how much post-bubble suffering is left to endure. If more than a little, as we expect, the Fed might be obliged to introduce a set of more or less explicit operating rules. It has done so before—for example, from interest-rate targeting to money-supply targeting in 1979 and back to interest-rate targeting from money-supply targeting in 1982. The Fed could shoot at an inflation target—higher than zero, probably, if the post-bubble adjustment proves long, drawn-out and deflationary. The chairman's successor might announce the setting of a watch against the next distorting episode of asset price inflation. The history of monetary policy is an everlasting tale of the frying pan and the fire. The search for price stability has oftentimes led to financial instability (e.g., in the United States in the 1920s and 1990s and in Japan in the 1980s). And though we cannot now recall a central bank that directly targeted asset prices, we have every confidence that such a policy would eventually lead to price inflation. Why? Because money turned away from stocks or real estate would bid up the prices of the items measured in cost-of-living indices.

As dress on Wall Street has become more casual, so have the monetary arrangements. In less than a century, the gold standard and swallowtail coats have given way to Greenspan and open-neck shirts. Possibly, in both money and clothes, a reaction against the long-running trend is today in place. If so, before long analysts in neckties will be trying to decipher the intentions of a new, buttoned-up and rule-bound FOMC.

In the meantime, there will be monetary-policy separation anxiety to bear. Greenspan is a Washington fixture and his mumbles about the mysteries of finance have brought comfort to many, especially to those who don't quite follow him. Since he first reported for government duty in 1974, the nation has had many more successes than failures. He himself has been hailed as a saint and a clairvoyant. Now it develops that he is neither, but only a fellow in a business suit trying to hold his job and not look bad. The chairman is revealed to be a government worker who, perhaps, unlike some of his lay colleagues, did not think it odd that companies with no revenues commanded multibillion-dollar stock-market capitalizations or that bicycle messengers made their rounds with beepers to alert them to the news of publicly announced stock splits (in the bubble, stock splits were regarded as very bullish). Possibly, the up-creeping gold price is nothing more than a war tocsin. However, to us, it is more plausibly a measure of the market's unease over approaching changes in the personnel and operating methods of the Federal Reserve. Even we, bearish on the chairman though we are, must admit that his successor might be worse. In any case, changes are in store for the institution of the dollar.

Many will doubt that any wrenching discontinuity is possible, much less probable. But the financial history of the past 100 years is the story of just such jarring change. To the skeptics, we commend a few lines of reminiscence about the 1920s by the wonderful German economist Wilhelm Röpke, taken from his "Crises and Cycles," which appeared in 1936. "With production and trade increasing month by month throughout the world, the moment actually seemed in sight when social problems would be solved by prosperity for all. . . ," Röpke wrote. "Thinking back to those 'gay twenties,' we cannot help but be inclined to regard them as one of the most remarkable and astonishing periods in modern history. Probably economic history has never before beheld such a speed, or such a scale of material progress and improvement in the technique of production and organization. It is a curious token of human fickleness that ten years later men are simply wallowing in abuse of that period and are decrying its spirit almost as a strange abomination, an attitude which is all the more curious and even tragic as this total reversal of atmosphere is one of the main reasons for the persistence of the present depression."

The trouble with not knowing history is not that one is condemned to repeat it. As history is cyclical, the only alternative to not repeating it is not being around for the privilege. The trouble is rather that the history-deprived person meets a surprise at every cyclical bend in the road. He or she lives in a childlike state of wonderment. It was thus that the chairman seems to have confronted the computer revolution (astounding!), the attendant gains in measured productivity growth (unprecedented!) and the persistence of stable consumer prices (most gratifying!). He could see the dawn of the New Economy.

And he did, too, as others have seen before him, because the economy is always new and always old. In 1902, R.E. May, a German theorist, was warning about the blessings and risks of productivity growth—"to enable producers to sell their growing output promptly prices must be reduced and wages must be raised in proportion as the supply of goods increases," said May. What he wanted was what the 20th century partially delivered, namely an equitable division of the spoils of productivity growth between wages and profits.

May is quoted in the summa of the dean of American business cycle theorists, Wesley Clair Mitchell. "Business Cycles," published in the very year the Federal Reserve was founded, 1913, reveal Mitchell to be an optimist, but for a set of reasons that will make posterity smile. Nothing like the tulip mania or the South Sea bubble would likely be seen again, Mitchell concluded, because speculative excess was being wrung out of Wall Street. The agent of this progress was enlightened regulation. "By a combination of various agencies such as public regulation of the prospectuses of new companies," the economist asserted 20 years before the creation of the SEC, "legislation supported by efficient administration against fraudulent promotion, more rigid requirements on the part of stock exchanges regarding the securities admitted to official lists, more efficient agencies for giving investors information, and more conservative policy on the part of the banks toward speculative booms, we have learned to avoid certain of the rashest errors committed by earlier generations." This particular section Mitchell entitled "Man's Mastery over the Workings of the Money Economy."

Not one to read history or even to hire someone to do it for him (not one Ph.D. in history draws a Fed paycheck), Greenspan may not be familiar with a masterly 1937 work by C.A. Phillips, T.F. McManus and R.W. Nelson, "Banking and the Business Cycle." In it, Phillips et al. produce a thorough monetary postmortem of the boom and bust of the 1920s and 1930s. And in so doing, they provide a detailed preview of the ups and downs of the millennial New Economy. In the earlier period, as in the later, the source of the bust was the boom. ("The only cause of depression is prosperity," wrote Clement Juglar, a French theorist, many years before.) Then, as now, the Fed achieved stable goods prices only to foment flyaway asset prices. And then, as now, credit expanded at a rate "vastly in excess of the needs of trade and industry."

"The new excess credit," wrote the Phillips team, "was in considerable measure directed into channels divorced from the normal nonspeculative operations of production and commerce, and found expression in the rise of prices in the stock market, in the real estate market and in wage rates. Federal Reserve control activities, primarily directed at stabilization of the price level, produced the speculative and investment booms, with the attendant disequilibrium between investment and saving, and thereby may be considered a generating cause of our recent plight. Investment inflation ended in depression."

Nowadays, investment inflation doesn't end in depression. With the chairman, it ends in confusion. There's some progress in that, we have to admit.

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GRANT'S

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EDITOR

Vacation delectation

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Sincerely yours,

James Grant