GRANT'S
INTEREST RATE OBSERVER®

Vol. 31, No. 5a | Two Wall Street, New York, New York 10005 • www.grantspub.com | MARCH 8, 2013

Shot clock for capitalism

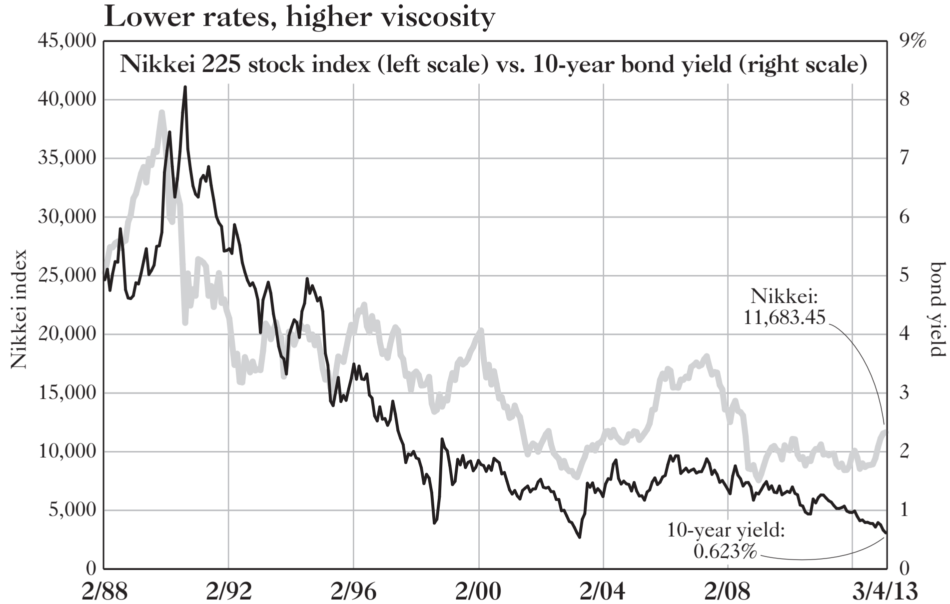
Matthew Klecker, a paid-up subscriber from Chicago, was watching a basketball game when he got the big idea. It came to him in a flash that the Fed's toy interest rates give economic actors too much time to stall and dither. Zero-percent rates institutionalize delay in everyday business and investment transactions. They lead to postponement of needed adjustments. It's as if, he said to himself—and subsequently to the editor of *Grant's*—that basketball never got the shot clock.

Sports fans will cringe to recall what the game was like before the National Basketball Association adopted the 24-second rule in the 1954-55 season. (Years later, the National Collegiate Athletic Association imposed the 35-second rule on the men's game, the 30-second rule on the women's game.) In the days before the shot clock, the team holding a late lead could endlessly pass the ball to deny the opposition the chance to score. On Nov. 22, 1950, the Fort Wayne Pistons stalled their way to a 19-18 win over the Minneapolis Lakers, a contest that might easily have been mistaken for an adult game of Keep Away (in the fourth quarter, the two teams combined for a grand total of four points). With his invention of the 24-second rule, Danny Biasone, owner of the Syracuse Nationals, might have saved the NBA. Certainly, he saved the NBA's early television contract.

Anyway, Klecker, 51, a die-hard University of Wisconsin alumnus, started thinking about the tempo of financial and commercial life as he watched his alma mater beat Michigan in overtime last month. "Could not a proper—which is to say a significantly positive—real rate of interest function in the real economy much as a shot clock does in basketball?" he writes. "Let us say, for the sake of this analogy, that economic profits are like basketball points, and the pressure of the shot clock (or lack thereof) in basketball requires shooting dynamism, just as the pressure of a real rate of interest requires economic dynamism. Absent a ticking shot clock, the game can slow to a virtual standstill as an inferior team—in that 1950 stall-a-thon, the Pistons were up against the supremely large and talented George Mikan of the Lakers—may appear nearly the equal of a superior opponent in the low-scoring game that results. Likewise, absent the 'ticking' (accrual) of a proper real rate of interest, poor investments can survive and even appear to be the equal of alternatives that could generate superior returns. No shot clock, fewer shots; no interest accrual, less monetary velocity."

The rate at which base money is converted into commercial credit is one measure of monetary velocity (see the data on pages 6 and 7). But, notes Klecker, the real world of business tells its own story of velocity, or viscosity. "Consider," he bids us, "the case of a sub-investment-grade business that cannot borrow at a cost of 12%, but can at a cost of 7%. It remains in business, though perhaps it should not

Lower rates, higher viscosity



source: The Bloomberg

in the face of a competitor that can properly service the same debt at 12%: Think Japanese 'zombie' companies.

"Or take the case of a completed and largely unsold condominium project that is repossessed by lending banks as the developer defaults in the face of poor sales post-2008," Klecker continues. "I happen to live near one. The reason the building is still unfilled five years after it was built is because the banks, using very low Libor-plus financing, can wait and wait in hopes of higher prices rather than sell at today's clearing price."

High real rates lower the viscosity of the flow of funds, Klecker thus proposes. Low real interest rates raise the viscosity level, in extreme cases to that of molasses. "Both of these examples betray telltale signs of monetary molasses," he goes on. "Repeated worldwide in a myriad of other forms, they generate the feedback loop of lower returns, leading to lower velocity, leading to deflation. The dynamism of competitive returns to capital is diminished. More and more money delivers less and less GDP growth. Malinvestment persists, and the 'beer goggles' of too low rates (a couple of Budweisers, and everything looks better) continually clouds the a priori investment analysis of any thinking capitalist."

The Fed has its interest-rate agenda, of course, Klecker observes, but investors have theirs. Maybe the holders of trillions of dollars in ultra-low-paying sovereign debt will wake up one day to decide that they have lost confidence in the governments that promise to pay negligible yields in currencies that they themselves print to excess. A bond bear market begins. Real rates of interest rise. But the bear bond market proves not a curse but a kind of blessing.

Yes, many would bear mark-to-market losses. But there would be some compensation in the quickening of the commercial and financial tempo. "A certain dynamism would be restored to the real economy via the accelerated liquidation of assets in response to higher carrying costs (e.g., real estate)," Klecker winds up. "A certain dynamism would be restored when a proper cost of capital is charged to a corporate borrower instead of an inappropriately low one (e.g., a single-B credit lives to service a 7% debt, depriving capital to another, more dynamic single-B borrower that could service the same debt at 12%). And, of course, a certain dynamism would be restored to the functioning of our public sector if the Treasury had to pay a rate of interest in excess of the observed rate of rise of the price level."

In Syracuse, N.Y., stands a small monument to Biasone's 24-second shot clock. Come the return of conventionally sized real interest rates, this publication will propose to erect a monument to Matthew E. Klecker, interest-rate theorist—and Badger fan.

•