THE BUBBLE THAT BROKE THE WORLD

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It won't be easy to put the genie back in the bottle

The date May 21, 2003, should be remembered as a historic landmark. On this day Aladdin Greenspan let the genie out of the bottle. The genie is now at large, entirely on its own, roaming around the world, visiting disaster upon the economies wherever it may go: a depression possibly worse than that in the 1930's. Aladdin hasn't got a clue how to put it back in the bottle because, if he tried, the genie would threaten to plunge the world into another bottomless pit: that of hyperinflation. Aladdin sowed the wind to let the world reap the whirlwind.

As the reader probably gleans it from the above, the genie symbolizes bond speculation. Greenspan testified before the Joint Economic Committee of Congress on that fateful day, explaining the strategy the Fed has developed to combat deflation. He would climb the yield curve, that is, go out to buy government bonds of all maturities, if need be up to and including the 30-year Treasury bonds, in an effort to push interest rates down thereby enlarging the monetary base that would, according to him, contain the weakness in prices.

It is a long shot from open market purchases of bonds to a buoyant price level. After all, once in circulation, the new money created by the Fed is no longer under its control. It is under the control of the speculators. They will not necessarily deploy it in the commodity or stock markets, as the Fed is hoping. They may see a better opportunity for profitable speculation elsewhere, say, in the real estate or the bond markets. The trouble is not that the Fed is following a script that has become stale. The trouble is that the Fed has given away the store by telling speculators that all remaining risks have been taken out of bond speculation. They can now bid up bond prices to unimaginable heights unopposed. This could also be an act of desperation on the part of the Fed. According to this script, the speculators are being bribed by risk-free opportunities not to dump the bonds that would reduce them to worthlessness.

This bet is on the house!

Bond speculators are sitting on a huge pyramid of paper profits they have accumulated as short term rates of interest rates were pushed down from over 20 percent in 1980 to a little over 1 percent in 2003. A measure of the pyramid is the Derivative Bubble, now $140 trillion strong, consisting mostly of bets that interest rates will fall further. We are witnessing the biggest bull market ever, in anything, anywhere, at any time in all history. There has never been a bubble of that size and ferocity before. Tulipomania, the South Sea Bubble, the Mississippi Bubble, the bubble of the Roaring Twenties all pale in comparison.

Lately, speculators have been itching to cash in on their huge winnings, especially in view of the fact that foreign private and official holders appear poised to reduce their holdings of U.S. Treasury securities. Greenspan knows that a bubble so big as this cannot be safely deflated. It could trigger hyperinflation. So he has recourse to a desperate gamble: he is bribing the bond speculators. As the barker at the fair, he is crying to them: "Hang on! The bond bull is far from getting tired! Don't get out, the fun has just started! Your next bet is on the house! Profits are free for the taking! No risks involved!"

Surely this is an unprecedented sight: the central banker bribing the speculators with promises of untold riches free for the taking. Nothing like this has ever happened in history before, and probably never will. The central banker tips you off to place your bet that the bond price will go up, and, bingo! You have won the jackpot.

Firms falling like flies in autumn

It sounds crazy but is true nevertheless. All this would be very comical if there wasn't a sad part to it. The Greenspan announcement was designed to prevent prices from weakening and the stock market from collapsing. Yet its effect will in all likelihood be highly deflationary. Falling interest rates will ratchet down prices, and falling prices will ratchet down interest rates even more. As prices fall, the Fed raises the ante and buys more bonds, giving away more free gifts to the speculators. Both prices and interest rates fall into the abyss, and the economy is plunged into deep depression. The capital structure of productive enterprise is fatally weakened. Firms fall like flies in autumn. There is great pressure to cut debt and inventory. Cutting debt lowers interest rates, and cutting inventory lowers prices more. Those firms that can't do it fast enough are mercilessly forced into liquidation. There is growing unemployment, and falling demand will kick prices down further. Even some of the healthiest firms succumb as they could not collect receivables from their fallen brethren.

How is it that Greenspan, in command of an army of research economists, could make such an enormous blunder? Well, these people are just a bunch of sycophants. They will say only what the boss wants to hear. Just read the report *Deflation: Determinants, Risks, and Policy Options* (April 30, 2003) on the website www.imf.org. These so-called economists are steadfast in their determination to ignore the bubble. They look at the pro's, but not at the con's. They deny the ratchet-down effect. They vehemently object to the suggestion that falling interest rates may cause prices to fall rather than rise. Therefore I now take great care to explain the ratchet-down and its operation in detail, and hereby challenge anybody to find a weak point in my argument.

The Iron Law of Payrolls

Suppose we take the example of a stream of payments at the annual rate of $60,000. It could be visualized as the income of a bread-winner. In order to attach a value to it, we capitalize it at the going rate of interest. If it is 6 percent, then the capitalized value of the payments stream of $60,000 is $1 million. That is the capital sum one must have in order to reap the given payment-stream at the given rate of interest.

The capitalized value of the same stream of payments will be higher or lower, according as the rate of interest is lower or higher. In particular, if the rate of interest falls, the capitalized value of the payments stream rises. There is no mystery about this inverse relationship. At the lower rate it will take a larger capital sum to generate the same stream of payments. In our example, as the rate of interest falls from 6 to 3 percent, the capital sum required will rise from $1 to $2 million, assuming that you want to generate the same annual income of $60,000. That's right, by a stroke of the pen (or, shall we say, by a click of the mouse) capital values can be drastically altered, without adding to or taking away from the park of physical capital in the economy. Moreover, these changes will affect all productive enterprises across the whole spectrum, and affect them in the same way: adversely.

Every productive enterprise must earmark part of its capital for the purpose of backing payroll. That part of capital is called the wage fund. The size of the wage fund is proportional, not to the payroll itself, but to its capitalized value calculated at the current rate of interest. If the rate of interest changes, so must the wage fund. The *Iron Law of Payrolls* tells you how: *if the rate of interest is cut in half, then the wage fund must be increased two-fold.* This is so because capital tends to flow from the less to the more promising applications. As the rate of interest falls, capital will adjust to the new environment. The way to keep it is to augment it. In case the enterprise hasn't got sufficient capital reserves to answer this need, or if it can't increase its capital in a hurry, then there are three choices. Either wages must be cut, or some workers must be laid off, or the firm must go out of business. It's no use pretending that you can get around the Iron Law by continuing 'business as usual' with an impaired wage fund. Creditors will force you into bankruptcy. Of course, this is harsh justice. Of course, you are not responsible for cutting the rate of interest in the first place. Of course, you are an innocent victim, the whipping boy to be punished for other people's crimes. However, creditors are not running a charity: they will not advance new credits to a firm suffering from deficiency of capital.

Incredibly low level of scientific understanding

Nor is this all. Payroll is just one of the many streams of money payments the firm has to meet. Another is payment of interest on past borrowing. If it cannot immediately refinance debt then, again, the firm must have sufficient capital reserves to meet the increased burden. Then there are taxes, rents, utility bills, or any other regular payments that arise in the ordinary course of doing business. If they are not cut immediately, then the firm must have capital reserves sufficient to cover the increase in the capitalized value of these payment-streams as well. In most cases, such huge capital reserves are not available. The alternative is retrenchment or liquidation.

Please note that falling interest rates hit all productive enterprise at the same time, by making new demands on their capital structure. The burden of doing business is increased across the entire economy. Few firms go out of business voluntarily. Most choose to retrench. They downsize. This means cutting inventory and debt, hoping against hope that they can get away without cutting wages. We have already observed that as they cut inventory, prices fall; and as they cut debt, rates of interest fall. When all this comes to naught, firms must cut wages and jobs. Demand weakens further. The pit of depression is dug, ready to swallow the national economy. The initial push comes from the central banker giving the green light to speculators. That Greenspan has done. The rest, the sliding down through the chute of the deflationary spiral, is automatic.

It is, of course, incredible that Greenspan refuses to see the potential threat to the economy. To add insult to injury, he has the cheek to pretend that he is fighting depression (of his own making) by cutting interest rates, the very act that will activate the deflationary inferno. The only explanation for his lack of insight is the extraordinarily low level of scientific understanding which managers of the regime of fiat currency have, or must have. That regime is capable of unleashing the most horrendous forces of economic destruction: deflation or hyperinflation. Managers qualify for the job only if they have a demonstrated ability to remain blind to these dangers. Incidentally, hyperinflation is also caused by unlimited bond speculation, in this case, on the short side of the market. We have reached the point where deflation and hyperinflation are separated only by the knee-jerk reaction of the marginal bond speculator. The regime of fiat currency has a congenital disease, namely, its complete lack of immunity against destabilizing speculation which will ultimately destroy it. The only thing managers can do is to try to put off the evil day by hook or crook. The grandiose act of Greenspan to go out on one limb and climb the yield curve must be seen as a desperate effort to postpone the day of reckoning.

To summarize, falling interest rates fatally overload the capital structure of productive enterprise across the board by imposing new demands on it. These new demands have to do with the inescapable fact that at a lower rate of interest it will take a higher capital sum to generate an undiminished income-stream expected of productive enterprise. These new demands crowd out net worth in the balance sheet. Bereft of capital, productive enterprise goes down in defeat. Collapsing demand is not the cause of deflation. It is the effect. The cause is collapsing capital for which the falling interest-rate policy of the central bank alone is responsible.

"We've done it! Paper gold!"

Greenspan the alchemist

"Many of us can recall a picture of bewhiskered dabbler in the occult, surrounded by intricate apparatus, engaged in an attempt to turn base substances into gold. He was known as the alchemist, and he practiced his art over the course of centuries. Modern streamlining has dispensed with the whiskers and the gimcracks, but all present-day governments keep solemnly turning paper into gold and naively believe that they have accomplished something new, ingenious, and important. These governments tell their populations that there is no difference between paper and gold. In fact, they expatiate on the benefits of liberation from gold, insisting that government deficits are in reality a national investment, that the public debt is merely a book-keeping entity since we owe it to ourselves, and that printing-press money is a synonym for purchasing power. This propaganda has been going on for sufficiently long in time and sufficiently broadly in space that all young people in the United States, who have had no personal experience with the gold standard, will buy it. Our money magicians of today may, in retrospect, cut as pathetic a figure as the alchemists of ancient times."

The above quotation is from an address delivered on September 8, 1949, by Dr. William W. Cumberland, of Ladenburg, Thalmann & Co., New York. It shows Greenspan the alchemist, and all past, present, and future managers of fiat currency, in the correct perspective.

The ordination of a more expansive liturgy

"The Heroic Age of the free nations of the world was accomplished under the aegis of metallic monetary systems. The Industrial Revolution, with all the material benefits it created, has flourished largely in an environment of scrupulous devotion to classic precepts. Gold was universally accepted as surveillant deity which safeguarded society against fiscal and monetary temptations. The sanctity of contracts was embodied in the ritual, and gold clauses were inserted to discourage sacrilege. Then - all inhibitions were swept away. The nation officially espoused a critical view of sanctions formerly imputed to an impersonal monetary conscience. It renounced all forms of allegiance to what was regarded as outmoded superstition or regressive piety, in order to enjoy greater freedom in pursuing the New Mysteries of Money Magic. For it was assumed that monetary crises could be prevented more effectively by purely secular policy - by the rule of reason, as they called it - than by the compulsion of a once respected but now disavowed morality. Money was said to have become a compliant servant, rather than the traditionally stern guardian against the siren call of financial indulgence."

"The radical change in official attitudes towards gold was consummated in response to the doctrine that the Great Depression had been accentuated by blind obeisance to the gold deity, and economic recovery was being retarded by a literal interpretation of the gold-standard commandments. Accordingly, it was ordained that a more expansive liturgy should replace what was regarded as the too-Spartan code of monetary ethics to which the nation had long adhered, and all references to gold were expunged from the transubstantiation ritual for money. It is quite possible, however, that time has been too short to reveal the many ways in which the diluted devotional practice can make itself felt."

The above quotation is from an article "An Eagle for Christmas?" by Merle Hostetler, Manager, Research Department, Federal Reserve Bank of Cleveland, in *Business Trends* published by that bank, December 20, 1952. Greenspan would not tolerate in his organization free-thinking researchers like Hostetler. The new researchers must parrot slogans such as:

> "Among the causes of deflation we find adverse expectations and confidence effects."
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> "We must develop a communication strategy highlighting the ability and commitment of policymakers to contain deflation."
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> "From now on we must target inflation aggressively but with a buffer zone."
>
> "Fiscal policy must be tailored to credibly boosted aggregate demand."
>
> "More symmetric attention to risks of falling as well as rising prices is warranted."
>
> "Aggressive policies to contain and eradicate deflationary expectations are essential."
>
> "The liquidity trap is defined as the combination of a large output gap calling for monetary stimulus, with zero interest rate blocking monetary stimulus."
>
> "We must be shaping expectation through the manipulation of central bank balance sheet."

I have culled these slogans from the proceedings of the forum *Should We Be Worried about Deflation?* held on May 29, 2003, in Washington, D.C., as posted on www.imf.org. What do these slogans tell you about the quality of research conducted at the Fed and the IMF?

Seizures of ecstasy and mass delusion

In 1932 financial journalist Garet Garrett published a book with the title *A Bubble That Broke the World*. In it he gave a better perspective of what is happening in the wake of credit expansion.

> "Organized credit is relatively strange in economic life. New and experimental forms of it are continually being invented and we love to deceive ourselves with them. We forget that credit in any form represents debt in some other form. We know about ourselves, that we have seizures of ecstasy and mass delusion. We know that a time may come when the temptation to throw the monetary machine into wild motion, so that everybody may become infinitely rich by means of infinite debt, will rise to the pitch of mania as it did, for example, in 1928 and 1929.
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> For a while the difficulty of not knowing what anything is worth inflames the ecstasy. Everything will be priced higher and higher to make sure that it is high enough; there will be the illusion that things are becoming dear and scarce. They seem to be dear because the value of money in which they are priced is falling; they seem to be scarce because people are buying in the expectation that prices will go higher still. Suddenly doubt appears, then comes awakening, and - panic. The faith is lost... This is the financial crisis... All of it has happened. It was not the gold standard that did it; it was breaking faith with the gold standard that did it."

‘Political silences’

But the speculative orgy in 1928 and 1929 was rather mild in comparison to what was to take place under the watch of Greenspan Fed in the 1990's. The reaction in 2003 can therefore be that much more devastating. Here is a quotation from an article "Political Silences" by the same author that appeared in *The Wall Street Journal*, September 30, 1952.

"In a gingerly manner the presidential candidates talked about some of the effects of irredeemable paper currency, but about how to restore the honesty of the dollar they have said, if possible, less than nothing. They are like diagnosticians who have agreed beforehand on one point. They will ignore the fact of cancer. Irredeemable paper money, that is, money redeemable in nothing but more of itself, is a fatal disease with a record of one hundred percent mortality unless halted in time by radical surgery. It has already cost the people control of government. It has enabled the government to convert its own debt into ‘money’ and thereby to fill its own purse. It is the stuff upon which the self-exalting executive principle of government feeds. It is morally devastating and corrupts men by cumulative temptation. It hurts everybody - the rich, the poor, and the dependent."

Greenspan is such a diagnostician well-trained in the discipline of ‘political silences’. Our body economic appears to have cancer as indicated by the speculative bubble in the bond market. It feeds upon itself and will, if unchecked, destroy the entire productive sector. Efforts to engage Greenspan in a meaningful discussion of the bubble and how to stop the spread of cancer by radical surgery have failed. He is guided by ‘political silences’. As boasted by his lieutenants, Greenspan has unlimited power: the privilege of printing unlimited amounts of fiat money without any countervailing responsibility. He is badly abusing that power. Greenspan is nursing a bubble that may break the world. History will be the judge.