THE LOSS OF FEAR,

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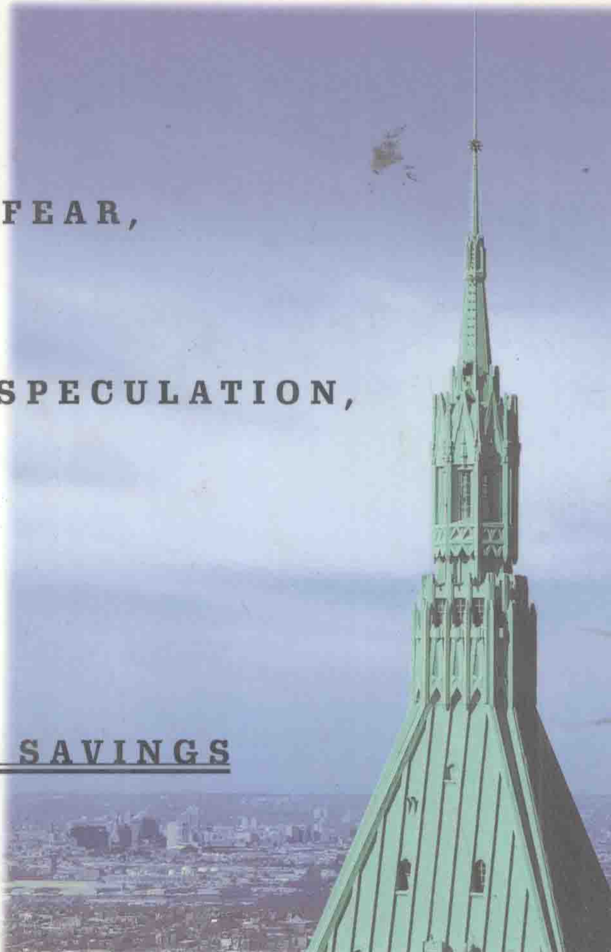
TO AMERICAN SAVINGS



THE TROUBLE WITH PROSPERITY

JAMES GRANT

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THE LOSS OF FEAR, THE RISE OF SPECULATION, AND THE RISK TO AMERICAN SAVINGS

JAMES GRANT

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To Paul J. Isaac,
who somehow knows everything

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Introduction

Blame for the loss of economic vitality in the 1990s has been variously assigned to the "downsizing of America," the aging of the American population, the end of the cold war, and the twisting of the screws of the federal income tax rate, among other causes. Investigations into the reasons for the slowdown in growth have focused almost entirely on what is wrong with the upside of the economic cycle. This book seeks a cause in the deficiencies of the downside.

Even before the Great Depression, the national government undertook a campaign to mitigate, if not eliminate, economic failure (passage of the Federal Reserve Act of 1913, for instance, was intended to preempt bank runs and financial panics by providing for a currency that could expand and contract with the seasons, like the population of the Hamptons). Such legislation rarely met the objection that some vital economic purpose might be served through economic destruction. However, because people in markets make mistakes, tearing down is an indispensable part of the process of building up. The errors of the up cycle must be sorted out, reorganized, or auctioned off. Cyclical white elephants must be rounded up and led away. Any social system can cope with success. One facet (and only one facet) of the genius of capitalism is that it also excels at failure.

Cycles are a natural part of the market order. Thus, there are cycles of expansion and contraction, investment and liquidation, rising prices and falling prices, optimism and pessimism. The relative scarcity of contraction, liquidation, falling prices, and pessimism (specifically, investment pessimism) has been heralded as an unalloyed blessing. However, I think, it has also contributed to the sclerotic pace of growth.

In fact, the attempted suppression of the corrective phase of the business cycle has hurt economies throughout the industrialized world. Japan, particularly, has suffered the ill effects of economic overprotectiveness. The absence of the failure of even one Japanese bank in the postwar period (that is, up until Hyogo Bank bit the dust in 1995) was long taken to be a badge of national prowess. It proved to be, instead, a root cause of the current, long-running stagnation. Banks that underwrote the notorious real estate bubble were still in business (indeed, in many cases, in denial) a decade after the lending abuses began. Recovery of the world's second largest economy from the debt-induced recession of the early 1990s is, at this writing, only just beginning.

"Where economic growth is slow and calm," pronounced the French economist Clement Juglar in 1889, "crises are less noticeable and very short; where it is rapid or feverish, violent and deep depressions upset all business for a time. It is necessary to choose one or the other of these conditions, and the latter, in spite of the risks which accompany it, still appears the more favorable." Fearing crises, the industrialized world has collectively chosen Juglar's option No. 1. Could a more robust quality of recession contribute to a better grade of expansion? The answer is yes, even if no presidential candidate this fall is likely to run on a pro-recession platform.

Error is a central theme of these pages. Indeed, the book was inspired by a howler of my own. Failing to anticipate the explosive stock market rally that started in 1991, I was unprepared for the chain of bullish events that followed, most important, the miracle cure of American banking. A half decade after Citicorp was viewed as a rank speculation because of its real estate–blighted loan portfolio, the most talked-about crisis in American banking is the crisis of excess capital; nobody seems to know what to do with it. So relentless is the stock market's rise that the idea of a cycle—a complete cycle, the downside along with the upside—has itself become a controversial proposition.

So much time has elapsed since the last shattering bear market that few active American investors have any firsthand knowledge of a full-blown decline. These pages describe the 1942 bottom, among other nadirs. In almost every particular—national morale, securities valuation, public investment participation—the 1942 low represents the mirror image of the 1996 bull-market high. Of all the consequences of sustained prosperity, none is so powerful as the delusion that markets always go up. They do not always go up. Equally (as is often forgotten during bear markets), they do not always go down.

In markets, almost no truth is permanently valid, and today's heresy may be counted as even money to become tomorrow's orthodoxy. Indeed, in recent years, heresy has been in a strong uptrend. Legalized casino gambling and paper money unballasted by gold, to name only two examples, have come into their own. Only a generation ago, each was the establishment's idea of a cardinal sin. (Perhaps it is sin that is in a new bull market. AMERICA MAKES PEACE WITH ADULTERY, *The International Herald Tribune* reported in January 1996.)

Has heresy changed, or have we? Is financial truth purely relative? Bond buyers were satisfied with a 2½ percent yield in 1946, yet they spurned a 15 percent yield in 1981. Was one idea as good as the other? It would be hard for an impartial observer to accept that the century-long evolution from the gold standard to the paper standard represents pure progress. The quarrel I have with the Federal Reserve is not so much that it creates credit as that it pretends to know the interest rate at which that credit (in the form of bank reserves) should be lent and borrowed. In the free-market world of 1996, the Fed would seem to be out of step, yet few people protest against it. In Europe there are plans to create a super, pan-continental central bank to manage a brand new currency. It is contended that this confection, the Euro, will resist "the infinite regress of value inherent in paper money itself," to borrow a phrase associated with J. S. G. Boggs, the American artist who paints pictures that look very much like dollar bills.

Perhaps the backlash against central banks awaits the end of the boom phase of the current cycle. The history of 40 Wall Street, the skyscraper next door to the offices of *Grant's Interest Rate Observer* in lower Manhattan, is a parable of the changeableness of value, markets, and monetary arrangements. So is the history of gambling and investment valuation. Booms do not merely precede busts. In some important sense, they cause them. This idea, on which so much of the analysis of these pages rests, is borrowed from the Austrian School of economics. It was the Austrians who observed that people in markets periodically miscalculate together. One important source of misjudgment is the interest rates that the central banks impose. A too-low rate provokes high spirits and speculation; a too-high rate induces morbidity and contraction. Thus, the ultralow money-market rates of 1993 not only strengthened balance sheets and reduced mortgage-interest costs, as policymakers intended. They also caused an outpouring of capital investment, as policymakers might or might not have intended. If precedent holds, these projects will be carried to extreme lengths. Like the Manhattan skyscrapers of the 1920s and the Texas oil rigs of the 1980s, the white elephants of the 1990s (coffee bars and semiconductor fabricating plants are the top candidates at this moment) will bring grief to their sponsors and drama to the next recession. Overbuilding and underbuilding constitute opposite sides of the same cyclical coin.

The history begins with 1958, with its bond market crash and stock market rally and creeping inflation. In many ways it marked the start of the modern financial age. Around the world, government spending increased and inflation stirred.

In Chapter 2, the narrative temporally doubles back on itself. In support of the theory that finance is inherently cyclical, the story of the tower at 40 Wall Street is related. If the construction of this skyscraper marked the peak of the cycle, the bear market of 1942 was the bottom. The irregular recovery of the financial neighborhood of Wall Street in the postwar years (symbolically ending with the bankruptcy of the Seamen's Bank for Savings, 30 Wall Street) constitutes another lesson in the recurrent phases of markets.

Chapter 3 lays out the Austrian theory of the business cycle and contrasts the very different cyclical experiences of the United States and Japan. In both the 1920s and 1990s, it will be seen, Japanese policymakers tried to suppress the symptoms of failure. In the

United States of the early 1920s, by notable contrast, a short and sharp depression gave way to prolonged growth; as for the America of the 1990s, a short and mild recession has yielded to grudging growth.

Chapter 4 analyzes the causes of the brilliant recovery of the American financial system from the stresses and strains of the late 1980s. The Federal Reserve is widely believed to be the agent of this transformation. However, as shall be seen, the immediate cause of the recovery of banks and overleveraged businesses was the stock market itself.

Chapter 5 is devoted to the consequences of the recent phenomenal gambling boom on the recent stupendous stock market boom. Gambling is as cyclical as anything on Wall Street could be, as we shall see, including the laws that govern the behavior of investment fiduciaries.

Not yet finished with the Federal Reserve, we compare it in Chapter 6 to the Bank of England during the years of the classical gold standard, 1880 to 1914. Through this exercise, we can see how much the earlier monetary system achieved without exactly intending to. What the contemporary banking system has achieved is, of course, a boom, and we examine one characteristic feature of it: the huge expansion of semiconductor manufacturing capacity. Next we turn to the institution of bankruptcy, without which no boom could be complete. In a sense, the modern-day central bank creates the credit that fires the booms that fill the bankruptcy courts.

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THE
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CHAPTER ONE

HEIRS TO 1958

In the early 1990s, the American economy could scarcely seem to swing its legs out of bed in the morning. The debt-induced recession of 1990–91 was neither lengthy nor strenuous in comparison to the average postwar recession (although it was lengthy and strenuous enough to cost George Bush the 1992 presidential election). Indeed, so brief and mild was the slump that some portion of the necessary work of clearing away the misconceived investments of the preceding expansion—notably, surplus buildings and heavy debts—was left undone. All in all, the body economic lacked vitality, and real economic growth over the next five years would average only 1.8 percent per annum, one of the lowest rates in postwar annals.

Wonders filled the newspapers, but there was no visible outpouring of economic gratitude for them. No sooner had inflation and communism been conquered, or at least knocked for a loop, than new troubles rushed in to fill the worry void. Raises in salary were hard to come by, technology threw some middle managers out of work (even while throwing other people into it), some good jobs jumped American borders (even as others jumped back over them), and many people suffered what euphemistically came to be known as downsizing.

Simultaneously—remarkably—Wall Street upsized. Stock and bond prices surged and speculation took flight. The kind of uninhibited, unselfconscious, and headlong boom that so signally failed