What Have We Learned Since October 1979?
Apparently, Nothing!

In August 1979, after years of irresponsible monetary and fiscal policies, and vain efforts to maintain full employment by overwhelming the rigidities of the old Bretton Woods Currency System with domestic monetary and fiscal stimulus, the U.S. was forced by a currency crisis to deal with inflation and financial crisis. Paul Volcker was appointed as Chairman of the Federal Reserve Board. He was soon dispatched to an extraordinary meeting at the Bank for International Settlements in Basel, Switzerland, where U.S. policy was severely criticized. After returning from that meeting, Volcker began the long campaign against inflation, for which he was to become recognized, with the October 1979 massacre in the financial markets. Paul Volcker's financial shock treatments for the economy, with the reluctant support of President Carter and the later enthusiastic support of President Reagan, set the stage for twenty years of growth with declining and, later, low inflation.

Unfortunately, since the financial crises of 1997-1998, we have forgotten everything that we had learned about inflation, financial stability and speculation, and long term economic growth during the painful experiences of the 1970s. We have repeated nearly every mistake that we made during the 1970s, while calling the situations by different names, and by pretending that his time the situations were different.

In the 1970s, we flooded the domestic financial system with money to support growth. But, we did not count it as money because it flowed through newly created or newly liberalized channels that were not reflected in the prevailing definitions of money. Construction and Development Real Estate Investment Trusts (REITs) were created, often by sponsoring banks and investment banks, to carry higher risk loans and investments in real estate. The REITs could play in the hot real estate markets by issuing commercial paper. Their existence allowed their sponsoring banks to earn fees from speculative activities without carrying the assets or liabilities (money) on their financial statements. The banks continued to look clean even as they speculated, and money growth looked tame, even as it exploded in the off balance sheet world. We also allowed the Savings and Loan Associations to play in that same world both on and off balance sheet.

During the last ten years, we have done the same thing, but we have called the vehicles "conduits" and "structured investment vehicles". As in the 1970s, we responded to each crisis with more monetary ease, and did not notice that there was never a clean up period after that "temporary" ease. Because the accumulating excesses were off balance sheet, we ignored them when traditional measures of money, Money-2 and Monetary Base, appeared to be under control and then declared ourselves blameless (Greenspan, Financial Times article, April 7, 2008). Apparently, the property bubble was caused by some mystical animal spirits, and not by the flood of money.

During the 1970s, we flooded the world with liquidity through the eurodollar deposit network of the global banks. We then marveled at how prosperous some of the developing countries had suddenly become. Because dollar credit was readily available nearly everywhere that had a developed banking system, countries like Mexico and Brazil could borrow so cheaply to finance infrastructure projects that they often overlooked cost-benefit analysis. And, when they financed very long term projects such as large hydroelectric plants with very short term liabilities, we did not worry because "sovereign countries never default."

Our 1970s real estate and consumer credit booms also flooded the consumer goods exporting countries of the world, Japan, Taiwan, South Korea, France, Italy, etc., with dollars, and we marveled at their remarkable saving rates, while complaining about growing trade imbalances and unfair currency levels. We talked a great deal during the 1970s about the need to increase our own saving rate, but we were so busy finding new ways to subsidize housing and consumption that we did not really get around to it. It never seemed to occur to us that a net exporting country generally has a high saving rate and a net importing country generally has a low saving rate. But, reason was not important, in any case. We were obsessed, during the 1970s, with the great Keynesian fear that if the consumers were actually allowed to save, the economy would spiral downward into a bottomless pit of depression again.

During the past ten years, we have not lost our ability to marvel at the world. We have again flooded the world with liquidity. We were, of course, helped by the Peoples Republic of China, which took advantage of an undervalued currency to achieve great export gains and then recycled their financial gains to our Treasury market, where we could again not count it as money. Even as we used the proceeds of Chinese and other Asian trade and investment recycling to support our conduits, structured investment vehicles and other elements of the Shadow Banking System to support real estate, we could again marvel at the high saving rates of the exporting countries. We could also again feel good about ourselves for behaving as the consumer of last resort for the world as an offset to the "excessive saving" of the Asian exporters. We could take comfort that we were merely responding appropriately to the "Global Saving Glut."

During the 1970s, we also invented the concept of the "core inflation rate", and elevated it to the status of a religious icon. Because we had an inflationary housing and consumer boom during the 1970s, we had inflated demands for commodities. We no longer had surplus oil production capacity and were becoming more dependent on imports of both oil and oil products. Oil companies were forced to close many refineries for economic or environmental reasons and were not permitted by NIMBY to open new refineries. Because we were flooding the world with liquidity during the 1970s, and a development

boom was underway using eurodollar credit, global demand for all commodities was surging, including demand for energy, building materials, such as cement and copper, and food. That created an inconvenient fact. Wholesale food and energy prices pass quickly into consumer prices. We still wanted to inflate growth, but we had to overcome the messy inconvenience of accelerating food and energy prices. We tried to control them without great success. That just caused shortages, black markets, political corruption, and fraud. And, so we opted to declare food and energy inflation to be unimportant special situation inflation that should be excluded from consideration. We had gotten away with that in the late 1960s, and thought we could stretch it for another decade or so. Unfortunately, as we learned in the 1970s, ignoring it does not make it go away, and does not make it less important. In fact, if you ignore it long enough, it becomes the focus of crisis, with shortages, hoarding, and its own little world of speculation. During the 1970s, we learned that it is always easier to print demand than it is to actually develop supply. Demand can be printed tomorrow. Supply requires three to ten years to actually engineer, finance, and develop.

During the last ten years we have revived to old worship of core inflation and have ignored the inflation and the imbalances developing in the food and energy markets. To enrich farmers, and to buy their votes, we have converted food, including corn, soybeans, palm oil, and even wheat, into fuel for our vehicles. We have prevented the development of traditional energy sources for a variety of reasons, but mostly for NIMBY reasons which we have rationalized as environmentally sound reasons, and this negligence has interacted with global liquidity excesses and global commodity demands to cause food price crises in developing countries. Our worship of core inflation, and of short-sighted environmental extremism, is a powerful religion. It has even brought back from the dead one Thomas Robert Malthus, that great supporter of the British landed aristocracy and its "Corn Laws" who believed that global starvation was inevitable. As during the 1970s liquidity driven commodity bubble, T. Bob Malthus is again featured on the front page of the Wall Street Journal as a possible seer. And, again, we have the irony of Fidel Castro saying something rational because we have given him the opportunity: "Converting food to fuel when people are starving is immoral."

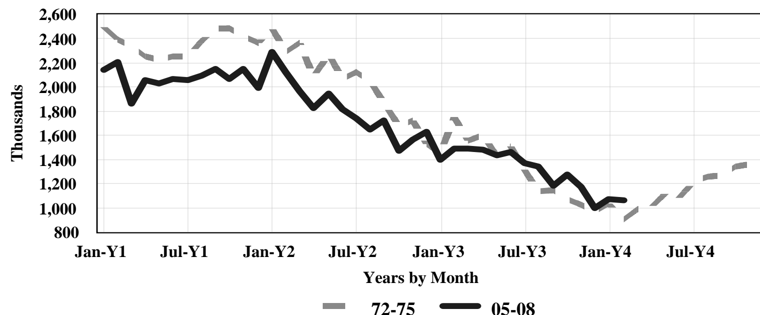
Unfortunately, the concept of core inflation has been a necessary part of the mythology of "The Great Moderation." We have to believe that inflation is really still under control, or we would be expected to do something about it. But, as in the 1970s, we have wanted, instead, to deal with the temporary emergencies that have arisen. Until the crises of 1997-1998, Alan Greenspan was a worthy successor to Paul Volcker. He not only kept inflation low, he also moderated many of the short term swings in the economy, appearing to do, successfully, what had been disparaged during the 1980s as "fine tuning." But, after the first Asian crisis, and particularly after the Long Term Capital Management crisis, there was a different Alan Greenspan. Greenspan morphed into those old 1970s stars, Arthur Burns and G. William Miller. He responded to each crisis with a

flood of liquidity that was allowed to accumulate over time, from crisis to crisis, setting the stage for larger and larger crises, and for greater and greater global imbalances. In the 1970s, Burns had to deal with an overvalued dollar when he tried to ease in response to the Penn Central bankruptcy. He eased too much for too long because the Fed failed to recognize the new channels of money and credit. The result was the real estate bubble of 1971-73, and the bust of 1973-1975. Burns again eased too much for too long, and the result was the real estate and global commodity boom of 1976-1980. Burns was replaced by G. William Miller after Carter became president. Miller was more interested in fiscal policy than monetary policy, and neglected monetary policy. Carter, Miller, and Blumenthal, Carter's Secretary of Treasury, made everything worse until the crisis of 1979 forced the Volcker changes in 1979-80. Even after the initial Volcker changes, policy was erratic until the fall of 1980 because of a constant conflict between Carter's short term growth goals and Volcker's desire to crush inflation. Now Volcker is in the news again lamenting what has happened to the price stability that he put in place more than twenty years ago. He also seems somewhat nostalgic about the financial stability that was achieved during his terms as Chairman of the Fed, but that was never as clear an achievement as the price stability.

Ben Bernanke has given some great speeches during the past five years, many of which I have saved. Three, in particular, I have included as internet links at the end of this comment. But, all of his themes now have to be questioned. "The Great Moderation (2004)" ended, died from sustained abuse, the year before his speech by that title. "What Have We Learned Since October 1979? (2004)" appears to have a simple answer. Nothing! We learned nothing. The New York Fed, the daily observer of our money markets, did not seem to notice that asset backed commercial paper and auction rate notes were repeats of similar 1970s abuses and that conduits and SIVs were just another name for construction and development REIT and Savings and Loan abuses. Neither the New York Fed nor the Federal Open Market Committee seemed to recognize that the foreign central bank custody assets at the New York Fed had become an even higher powered source of funding for global speculation than the old eurodollar bubble of the 1970s. Finally, "The Global Saving Glut and the U.S. Current Account Deficit (2005)" became a rationalization similar to the 1970s rationalizations about excess liquidity and the need to recycle OPEC surpluses to the developing world.

Recently, there has been much talk about how this is the worst financial crisis of the post World War II period. It isn't. So far it is a straight forward replay of the 1972 to 1975 period. You can even overlay the current housing start chart on the 1972 to 1975 housing start chart and be unable to tell the difference without a legend. The next financial crisis will be the worst crisis of the post war period, and the next president will possibly be Jimmy Carter, the sequel, making everything worse.

Cyclical Behavior of Housing, 1972 and 2005
Peak Year Followed by Three Subsequent Years



Wintonbury Risk Management

In 1970, I had a brief meeting with Otmar Emminger, who was then Vice President of the Deutsche Bundesbank. I remember the meeting well because it was incredibly pessimistic and gloomy, but ended with long term optimism. Emminger indicated that the U.S. in 1970 was in the first of three financial crises and recessions, each of which would be worse than the one before. But he indicated that we would survive them and eventually get policy right. It took more than ten years and was quite painful, but eventually Volcker and Reagan got it right. Today, we again have it wrong, and are making everything worse by attempting to find new ways to subsidize housing builders, housing speculators, and financial speculators.

What do you do when you have a housing and consumer financial crisis, a very large trade and current account deficit, and surging commodity inflation, but still want to maintain nearly full employment? You definitely do not invent new ways to support housing and consumer borrowing, or become even easier than you have been with respect to monetary policy. You might want to recognize that nonfinancial businesses still have healthy balance sheets and could at least temporarily increase investment spending, even in a higher real interest rate environment, if they had the proper incentives for rapid modernization. You might also want to focus on redirecting a major part of the excess liquidity from foreign central banks that the New York Fed has carried in its footnotes, and has indirectly forwarded into the speculative domestic Shadow Banking System, even as you take steps to slow the flow with a tighter monetary domestic. Exports, business investment, and realistic cost-benefit justified infrastructure improvements are the necessary replacement for housing and consumer durable speculation.

Two years ago, the Group of Seven process was beginning to get serious about dealing with "global imbalances." More recently, that attention has been diverted, 1970s style, to the immediate financial crisis and to the revival of Robert Malthus. We need a new Paul Volcker. Perhaps his name will be Ben S. Bernanke, but perhaps not. As in the 1970s, we may need another greater crisis before we will act on the global imbalances that have accumulated, many of which we have caused. Déjà vu. We are reliving the 1970s.

Edward Guay
Wintonbury Risk Management
Bloomfield, Connecticut

E:mail: Wntnbry@aol.com
Telephone: 1-860-242-7225
Fax: 1-860-242-7225

The Great Moderation, Ben S. Bernanke, February 20, 2004
http://www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm

What Have We Learned Since October 1979?, Ben S. Bernanke, October 8, 2004
http://www.federalreserve.gov/boarddocs/speeches/2004/20041008/default.htm

The Global Saving glut and the U.S. Current Account Deficit, Ben S. Bernanke, April 14, 2005 http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm

"International coordination is no substitute for national monetary and financial discipline; it is a means of supplying aid and applying pressure in order to bring the correct discipline back to national politics." Otmar Emminger, Paper in Travemünde, 22 September 1964