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Economic Update, July 2019

Monetary Policy History

by Richard Morey

I recently read a summary of recent economic research by Jim Reid, an analyst from Deutsche Bank. The article which gave their results was entitled It's Official: This Is the Longest Economic Expansion on Record. *You can link to the article here; it is well worth reading.*

https://www.zerohedge.com/news/2019-06-30/few-hours-will-be-longest-economic-expansion-record-what-happens-next

The Gold Standard

To me, Mr. Reid and his researchers are the first I've ever found who could give a rational, logical answer to the question, "Is the gold standard better than the monetary system we have been using since leaving the gold standard in 1971, and if so, how and why?" But their study goes further, explaining our economy since 1971 to the present based on the monetary policies we have followed. I don't agree with all Jim Reid and Deutsche Bank's assumptions or conclusions, but this is some of the most impressive economic research I have seen.

For the last 20 years studying economic theory, and especially monetary policy theory, I have never found one author who could answer the gold standard question to my satisfaction. Most of the best economists seemed to believe the gold standard was better, but nobody could explain exactly why.

Talking about the gold standard is interesting. As an investment professional, even saying the words is considered questionable. It almost appears as if somebody decided to erase the concept of a gold standard out of the economic lexicon. Many, perhaps all, of the best economists believe the gold standard would be better, at least for 99% of our population, than the monetary system and policies we have followed since 1987. Yet they hardly ever utter the term 'gold standard,' as anyone in this industry could easily and quickly get branded as someone from the tin-foil hat crowd.

As most of our readers probably know, I'm really not particularly scared to explore any corner of economics or investing. I'll search for whatever lines up with the facts. In the article, Mr. Reid and Deutsche Bank show how economic growth was much more robust when we followed the gold standard. By design, we had low debts and government deficits. Business cycles, or the time from the end of one recession to the next, were much shorter under the gold standard. Under the gold standard, when the economy became off-balanced, it usually reverted closer to the mean through a quick recession.

Supercycles

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The last three business cycles have been four of the six longest in history. One of the other six is easily explainable, as it lasted throughout World War II when the U.S. was a non-stop weapons and war equipment machine. Having a recession during that war was impossible for the United States.

The ultra-long business cycles all have the exact same cause, which is that they are caused by our central bankers following the same damaging playbook. This is the mistake of thinking it is good for your economy, and people, to attempt to keep recessions at bay by following loose monetary policies. In the first

case, which ended in 1969, the Fed kept interest rates far too low for far too long. The result was what you *always* get when you do this. Banks kept lending and businesses and consumers kept borrowing, as the money they were borrowing was essentially being borrowed at well below market rates. The market responded to that "sale" by borrowing and "growing."

In the end, it turns out we were merely appearing to grow, as the only thing actually expanding was inflation. It took former Fed Chairman Paul Volcker fifteen years to correct the cardinal sin in central banking, which is to make the cost of money artificially low. That action leads directly, with, to my knowledge, no exceptions, to debt bubbles and therefore economic hardship and stock market collapse. (Sometimes it leads to inflation, and other times to deflation. Either outcome is a train-wreck for our nation.

Unfortunately, when Paul Volcker left the Fed in 1987, the regime which replaced him has been making the same mistake William Martin had made throughout the 1960s. Too much cheap money for too long. This should sound familiar by now to everyone in the country.

Income Inequality

Jim Reid and Deutsche Bank's research shows that the gold standard was dramatically superior for 99% of the population, and not very good at all for the ultra-wealthy. The facts point so clearly to this, consistently each and every year for the last 28 years, that I think all monetary economists can go ahead and consider it proven fact that our monetary policies from 1987 to the present have had one overriding impact: They enrich the wealthiest 1%, and especially .001%, and they impoverish the remaining 99%. Ok, the top 15% do pretty well, as the highly educated and professional classes can still do well "on the coattails," as it were, of the top 1%.

But for the remaining 85% of our citizens, our monetary policies have been an unmitigated, and, thus far, never-ending disaster. In the article, Deutsche Bank gives some of the very strong proof of this statement.

The Greenspan Fed's First Bubble

To understand the key points from a monetary theory perspective, you need to hear something nobody in the mainstream monetary policy crowd, and therefore financial media, will ever tell you. Perhaps the most ludicrous thing I've ever seen, in any supposedly intelligent field of study like economics, is the fact that our monetary policies in the United States, since 1987, have involved no consideration, whatsoever, for debt. Other than, at all times, to encourage massively more and more debt creation – by consumers, companies, and the government at all levels. Wow.

At the very end of the day, excessive debt ends up burning almost everybody, except for the lenders. Those who aren't indebted suffer modest losses, if any at all (the best mortgage bond investors made a bit of money in 2008, and a lot of money in 2009), and the lenders often end up owning the businesses to whom they had loaned money, or the homes of those to whom they had given mortgages.

The key to the length of business cycles may simply be the availability of what is perceived as inexpensive money. When money is very readily available to lend, at low rates, the economy usually grows. The longer you can keep the debt growing, the longer the business cycle will end up being. (And the longer it will take stocks, and other assets that have risen to bubble territory during the debt boom, to crash.) Since 1987, the Fed has embarked on a series of heretofore unheard-of experiments in making more money available to lend, at lower and lower and lower rates. This has resulted in the combined debt of businesses, consumers, and government reaching, by far, the highest level, relative to GDP, in the history of our country (excluding the peak of World War II).

What until last month was the longest business cycle in U.S. history lasted from March of 1991 until March of 2001. This was Greenspan's first experiment in creating a debt and stock market bubble, primarily through prolonged low interest rates. Added to this was the rescue of the stock market and several major Wall Street firms by bailing them out when Long-Term Capital Management went bankrupt in 1998. That experience gave an absolutely clear "green light" to Wall Street and the stock market that they could now do whatever they wanted and the Fed would do everything possible to bail them out. Our financial markets began to resemble the Wild, Wild West. I'm afraid they still do.

By 2001, the Fed had helped create the largest stock market bubble in U.S. history, surpassing that of 1929 by a modest amount. The S&P 500 then crashed 55% - the second largest in history – while the tech-heavy NASDAQ crashed by 83% - a bit more than stocks had crashed in the Great Depression.

The Housing Bubble & Mortgage Crisis

After the tech market crashed and we had a modest recession on a national level, the Fed commenced almost immediately to lower interest rates sufficient to get a second debt bubble growing, this time in real estate. In fact, they proceeded to create the second largest debt bubble in U.S. history – second only to today – at least since the Great Depression. As we all know, this debt bubble popped in 2008-2009. This coincided with the second 50+% stock market drop, as the Fed's second debt bubble popped. This one was centered on homes, as this was the largest asset for most families.

The result, predictably, was the largest real estate losses in our nation's history. This resulted in a massive transfer of real estate to the wealthiest in our nation. Simply look at the many billions and billions of dollars' worth of single-family homes some of the largest Wall Street firms like Blackrock now own. A related phenomenon is the fact that young people who previously would have been entering the middle class and buying a home are increasingly finding home ownership completely unafforded to them. This is the "loot" Fed policies, and government law, helped the wealthiest get away with in the Fed's second serial bubble.

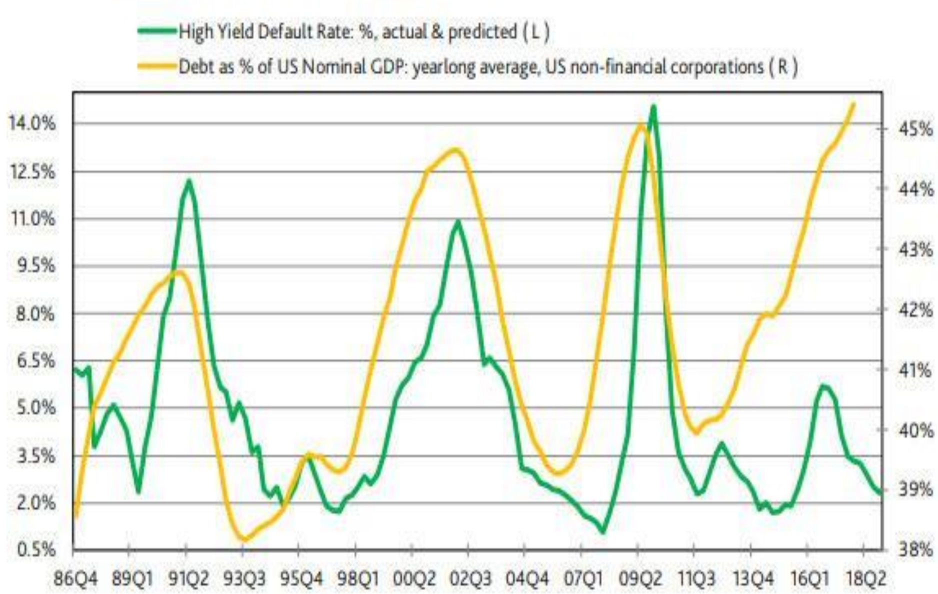
The Everything Bubble

And now we have the Fed's third and largest bubble. This time it's being called the "everything bubble." Just to name a few domestic bubbles, here in the U.S. we currently have the highest levels of debt, ever, in corporate debt, all types of consumer debt except mortgage debt (which went down a lot when people lost their homes), including credit card/revolving debt, auto debt, and student loan debt, and the highest government debt since World War II. We also have the one of the three largest stock bubbles in history, with the other two having first started to crash in 1929 and 2002 (2001 for tech stocks).

The Single Most Important Chart

Please note that, by 2002, we had not only achieved historic highs in tech stocks, but historic highs in our total corporate debt, relative to GDP. The chart below really tells the story of the last four business cycles. It also shows where we are headed. The green line is the percentage of corporate debt defaults. When a company can't pay back its debts, it typically goes out of business, so you can use business failures as shorthand for that green line.

Figure 2: Recent Default Rate and Its Projected Trend Defy Record Ratio of Corporate Debt to US GDP
sources: Moody's Analytics, Federal Reserve



I have quite a lot of knowledge, and relatively little skill, in using technical analysis or studying chart patterns to attempt to predict what markets or individual stocks will do next. While I have studied it fairly regularly through the years, simply because I read so much, and while I respect those who use technical analysis extensively – my first and primary focus as an investor has tended to be on the things I could actually know for a fact.

Still, even someone like me who really can't read many of the technical charts that well can look at the one below and make a very, very good guess as to where the green line is going. If, indeed, the destination for the green line is where the chart – and a mountain of economic data and rational, fact-based monetary policy theory and research – indicates, *then we will soon be seeing the largest wave of business failures in the United States since the Great Depression.*

Though I of course cannot guarantee you the green line will end up surpassing the golden-colored one below, which indicates debt as a percentage of GDP, I can refer anyone to thousands of pages of good economic research, by leading professors, ***which proves business failures sky-rocket, or the green line goes to the top of the chart, in the end, whenever the amount of debt we have relative to GDP becomes a bubble.*** **This means that if we define the golden-colored line below to indicate a bubble, we will soon be facing the most difficult economic time period since the 1930.**

Can Anyone Offer a More Likely Outcome?

I really would like the economists who are not expecting the next economic contraction to be severe to refute what I am saying. Thus far I haven't heard anything that pokes holes in the statements in the last section, and this summer I have listened to presentations to professors who did this research. This was at an economic conference in Dallas in June, during which leading scholars gave the results of their research on the status of our debt. At the same conference, several of the pre-eminent ex-central bankers who are aghast at what our Fed has done, and continues to do, spoke about debt and Fed policy. Haven spoken at some length, in person, with the top two ex-central bankers on this topic, I am fairly sure they would look at the chart below and say "yes," this chart is indicating what it looks like, which is that the green line is going to spike up, and the economy down.

Which Alan Greenspan?

From an historical standpoint, I believe it is worth noting that Alan Greenspan was a strong supporter of the gold standard when he received his Ph.D. in Economics from New York University. While I have never read his thesis, I understand it helped establish his reputation, and I'm pretty sure it assumed monetary policy under a strong gold standard.

After his education, Greenspan spent several decades doing private economic consulting for corporate America. In his professional career he was on the Board of Directors of Aluminum Company of America (Alcoa); Automatic Data Processing; Capital Cities/ABC, Inc.; General Foods; J.P. Morgan & Co.; Morgan Guaranty Trust Company; and Mobil Corporation.

By the time Greenspan became President Reagan's choice to succeed Paul Volcker as the Chairman of the Federal Reserve Board in 1987, he had decided the gold standard was a silly idea. Instead, he used his complex verbiage and mish-mash of mathematically-based economic equations to hide his policy designed explicitly to get the economy stuffed to the brim with debt.

Who should we follow, the brilliant young academic Alan Greenspan who got his P.hD. in Economics from New York University and clearly stated the advantages of the gold standard, or the business owner who has been on the Board of Directors of seven of the largest multi-national corporations in the country?

The Demise of the Gold Standard

The thrust of the gold standard argument in a nutshell is that it was impossible to run large deficits, for debt to get out-of-control, under a gold standard. You could do it for a while, but you couldn't go too far, and the repercussion was a quick recession. Since too much debt is the one sure way to create an economic and market crash, a system that made large debt bubbles impossible is clearly far superior to one that doesn't.

This does not mean the gold standard was easy to run, especially from the perspective of the United States. As a result, it had to be suspended for a time, both during the Great Depression and World War II. During these time periods we decided we absolutely needed to run larger deficits than were allowed to us in the gold standard. We had that flexibility during those two emergencies.

The gold standard ended in 1971, and Paul Volcker was Undersecretary of the Treasury for Monetary Affairs when his office suspended it. In other words, Paul Volcker (not Richard Nixon) ended our participation in the gold standard. This could present me with quite a quandary. For around 20 years I have said Paul Volcker was the best Fed Chairman we have ever had, *and* I believe leaving the gold standard was the biggest mistake ever made. One of these beliefs must be wrong?

Not necessarily. I challenge any monetary policy theorist to read what Paul Volcker faced, from a monetary perspective, in our country in 1971 and explain to me how they would have stayed in the gold standard and addressed our economic problems. From a monetary policy standpoint, the 1970s and early 1980s were a nightmare from a purely domestic standpoint. Most people forget the short recession of 1981-1982 was the sharpest since the Great Depression, and quite close in severity to what we had in 2008-2009 – just without the near financial collapse. For farming states, it was a full-fledged depression. We were experiencing quickly rising prices on almost everything, combined with economic and geopolitical problems from every perspective, and little or no actual economic growth. It was a dangerous time, especially from a monetary policy perspective.

Sometimes you have to sacrifice something to survive, and our economic survival had been in question by the time Volcker completed his tenure running our monetary policy. He himself as a Fed Chair was able to successfully steer our monetary policy without the "guardrails" of the gold standard, because he was by nature seriously prudent and would not be owned by Wall Street. If he had remained, he would have acted prudently throughout. We would thereby have avoided the hideous mistakes made since Greenspan decided the gold standard wasn't so hot after all.

Unfortunately, by taking us out of the gold standard, Mr. Volcker had let the genie, called debt bubbles, out of the bottle. While he continued to be Fed Chairman it wasn't a problem, for as mentioned above Paul Volcker is by nature a cautious and prudent person. His Fed would never abuse the ability to create unlimited debt, a newly afforded "tool" available once we were outside the gold standard, and I believe Paul Volcker's record from 1971-1987 proves this.

The next guy, not so much, and every single Fed leader since. Since Greenspan began the debt binge in the U.S., taken up by the entire world this final cycle, we have had the longest economic cycles and the largest crashes. Those are the facts.

CONCLUSION

What's the "takeaway" from Jim Reid and his associates' research? Their study covered a lot of monetary policy and economic ground, and I suspect everyone who reads it will get something different. For me as a cautious investor, the message is that the last two business cycles were two of the longest ever, and they ended in the two largest stock market crashes since the one that began in 1929. This one has now surpassed all the others on all the relevant factors which are screaming "danger!" Only this time the lovely results of our debt bubbles will be amplified around the world. The previous two were caused by too much debt – corporate debt in 2001-2002 – and mortgage and corporate debt in 2008-2009. This time we have way, way, more debt. Ouch.