

Is the Medicine Worse Than the Illness?

The world ran out of trust in 2008 -- but there is no shortage of money because the Fed is printing like mad. It's the wrong approach, with potentially dire consequences, says James Grant.

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By JAMES GRANT

It is a sorry place at which we Americans find ourselves this none-too-festive holiday season. The biggest names on Wall Street have gone to their rewards or into partnership with the U.S. Treasury. Foreigners stare wide-eyed from across the waters. A \$50 billion Ponzi scheme (baited with, of all things in this age of excess, the promise of low, spuriously predictable returns)? Interest rates over which tiny Japanese rates fairly tower? Regulatory policy seemingly set by a weather vane? A Federal Reserve that can't make up its mind: Is it in the business of central banking or of central planning? And to think -- our disappointed foreign friends mutter -- all of these enormities taking place under a Republican administration.

Trust itself entered a bear market in 2008, complementing and perhaps surpassing the selloffs in stocks, mortgages and commodities. Never to be confused with angels, we humans seem to outdo ourselves when money is on the line. So it is that Bernard Madoff, supposed pillar of the community, stands accused of perpetrating one of the greatest hoaxes since John Law discovered the inflationary possibilities of paper money in the early 18th century.



Corbis
Bundles of freshly printed bills at the Treasury Department.

Barely nudging Mr. Madoff out of the top of the news was the Federal Reserve's announcement last Tuesday that it intends to debase its own paper money. The year just ending has been a time of confusion as much as it has been of loss. But here, at least, was the bright beam of clarity. Specifically, the Fed pledged to print dollars in unlimited volume and to trim its funds rate, if necessary, all the way to zero. Nor would it rest on its laurels even at an interest rate low enough to drive the creditor class back to work. It would, on the contrary, "continue to consider ways of using its balance sheet to further support credit markets and economic activity."

Wall Street that day did handsprings. Even government securities prices raced higher, as if, somehow, Treasury bonds were not denominated in the currency with which the Fed had announced its intention to paper the face of the earth. Economic commentators praised the central bank's determination to fight deflation -- that is, to reinstate inflation. All hands, including President-elect Obama, seemed to agree that wholesale money-printing was the answer to the nation's prayers.

One market, only, registered a protest. The Fed's declaration of inflationary intent knocked the dollar for a loop against gold and foreign currencies. In many different languages and from many time zones came the question, "Tell me, again, now that the dollar yields so little, why do we own it?"

It was on Oct. 6, 1979, that then-Fed Chairman Paul A. Volcker vowed to print less money to bring down inflation. So doing, he closed one monetary era and opened another. With Tuesday's promise to print much more money, the Federal Reserve of Ben S. Bernanke has opened its own new era. Whether Mr. Bernanke's policy of debasement will lead to as happy an outcome as that which crowned the Volcker anti-inflation initiative is, however, doubtful. Whatever the road to riches might be paved with, it isn't little green pieces of paper stamped "legal tender."



Getty Images
Fed Chairman Ben Bernanke appears before Congress in October.

Our troubles, over which we will certainly prevail, stem from a basic contradiction. The dollar is the world's currency, yet the Fed is America's central bank. Mr. Bernanke's remit is to promote low inflation, high employment and solvent finance -- in the 50 states. He wishes the Chinese well, of course, and the French and the Singaporeans and all the rest besides, but they don't pay his salary.

They do, however, buy the U.S. Treasury's bonds, which frames the emerging American dilemma. If the Fed is going to create boatloads of depreciating, non-yielding dollar bills, who will absorb them? Who will finance

the Obama administration's looming titanic fiscal deficits? Who will finance America's annual surplus of consumption over production (after 25 more or less continuous years, almost a national trait)? Inflation is a kind of governmentally sanctioned white-collar crime. Every crime needs a dupe. Now that the Fed has announced its plan to deceive, where will it find its victims?

Mr. Bernanke has good reason to worry about the economy. We all do. In the boom, a superabundance of mispriced debt led countless people down innumerable blind investment alleys. E-Z credit financed bubbles in real estate, commodities, mortgage-backed securities and a myriad of other assets. It punished saving and encouraged speculation. Imagine a man at the top of a stepladder. He is up on his toes reaching for something. Call that something "yield." Call the stepladder "leverage." Now kick the ladder away. The man falls, pieces of debt crashing to the floor around him. The Fed, watching this preventable accident unfold, rushes to the scene too late. Not only did Bernanke et al. not see it coming, but they actually egged the man higher. You will recall the ultra-low interest rates of the early 2000s. The Fed imposed them to speed recovery from an earlier accident, this one involving a man up on a stepladder reaching for technology stocks.



Associated Press

A money trader reacts to the falling price of the dollar on Dec. 12.

The underlying cause of these mishaps is the dollar and the central bank that manipulates it. In ages past, it was so simple. A central banker had one job only, and that was to assure that the currency under his care was exchangeable into gold at the lawfully stipulated rate. It was his office to make the public indifferent between currency or gold. In a crisis, the banker's job description expanded to permit emergency lending against good collateral at a high rate of interest. But no self-respecting central banker did much more. Certainly, none arrogated to himself the job of steering the economy by fixing an interest rate. None, I

believe, had an economist on the payroll. None facilitated deficit spending by buying up his government's bonds. None cared about the average level of prices, which rose in wartime and sank in peacetime. It sank in peacetime because technological progress and the opening of new regions to agricultural production made merchandise and commodities cheaper and more abundant.

Not everyone agreed that these arrangements were heaven-sent. In comparison to the rigor of the gold standard, paper money seemed, to many, an intelligent and forgiving alternative. In 1878, a committee of the House of Representatives was formed to investigate the causes of the suffering of working people in the depression that was five years old and counting. Not a few witnesses pleaded for the creation of more greenbacks. They asked that the government not go through with its plan to return to the gold standard in 1879. But the nation did return to gold -- it had financed the Civil War with paper money -- and the depression ended in the very same year.

Gold is a hard master, and a capricious one, too, insofar as growth in the world's monetary base depends on the enterprise of mining engineers. But, as we have seen lately, there is no caprice like the caprice of sleep-deprived Mandarins improvising a monetary solution to a credit crisis (or, for that matter, of fully rested Mandarins setting interest rates by the lights of their econometric models).

The times were hard in the 1870s and, for that matter, again in the 1890s, but Americans repeatedly spurned the Populist cries for a dollar you didn't have to dig out of the ground but could rather print up by the job lot. "If the Government can create money," as a hard-money propagandist put it in an 1892 broadside entitled "Cheap Money," "why should not it create all that everybody wants? Why should anybody work for a living?" And -- in a most prescient rhetorical question -- he went on to ask, "Why should we have any limit put to the volume of our currency?"

A couple of panics later, the Federal Reserve came along -- the year was 1913. Promoters of the legislation to establish America's new central bank protested that they wanted no soft currency. The dollar would continue to be exchangeable into gold at the customary rate of \$20.67 an ounce. But, they added, under the Fed's enlightened stewardship, the currency would become "expansive." Accordion-fashion, the number of dollars in circulation would expand or contract according to the needs of commerce and agriculture.



MPI/Getty Images
Elihu Root, who warned about 'easy money' in the early 1900s.

Elihu Root, Republican senator from New York, thought he smelled a rat. Anticipating the credit inflations of the future and recalling the disturbances of the past, Mr. Root attacked the bill in this fashion: "Little by little, business is enlarged with easy money. With the exhaustless reservoir of the Government of the United States furnishing easy money, the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community.

"Bankers are not free from it," Mr. Root went on. "They are human. The members of the Federal Reserve board will not be free of it. They are human....Everyone is making money. Everyone is growing rich. It goes up and up, the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws, until finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure.

"That, sir," Mr. Root concluded, "is no dream. That is the history of every movement of inflation since the world's business began, and it is the history of many a period in our own country. That is what happened to greater or less degree before the panic of 1837, of 1857, of 1873, of 1893 and of 1907. The precise formula which the students of economic movements have evolved to describe the reason for the crash following the universal process is that when credit exceeds the legitimate demands of the country the currency becomes suspected and gold leaves the country."

Little did Mr. Root suspect that the dollar would lose its gold backing altogether -- that, starting in 1971, there would be nothing behind it more than the good intentions of the U.S. government and (somewhat more substantively) the demonstrated strength of the U.S. economy. Still less could he have guessed that the world would nonetheless fall in love with that uncollateralized piece of paper or -- even more astoundingly -- that the United States would enjoy so great a reservoir of good will that it would be allowed to borrow its way to a net international investment position of minus \$2.44 trillion (\$17.64 trillion of foreign assets held by Americans vs. \$20.08 trillion of American assets held by foreigners). "It goes up and up," Mr. Root said of the inflationary cycle, but just how high he could not have dreamt.

Knowledge of the precepts of classical central banking prepared no one to understand, much less to anticipate, the Fed's conduct in this credit crackup. The central bank is lending freely, all right, but not at the stipulated "high" interest rate. As a matter of fact, it is starting to lend at a rate below which there is no positive rate. The gold standard was objective. Modern monetary management is subjective (under Alan Greenspan, it was intuitive). The gold standard was rules-based. The 21st century Fed goes with what works -- or seems to work. What it hopes is going to work for the fellow who fell off the stepladder is more debt and more dollars. Just how much of each can be found every Thursday evening on the Fed's own Web site. Open up form H4.1 and prepare to be amazed. Since Labor Day, the Fed's assets have zoomed to \$2.31 trillion from \$905.7 billion. And what is the significance of this stunning rate of asset growth? Simply this: The Fed pays for its assets with freshly made dollars. It conjures them into existence on a computer; "printing" is a figure of speech.

In this crisis, the Fed's assets have grown much faster than its capital. The truth is that the Federal Reserve is itself a highly leveraged financial institution. The flagship branch of the 12-bank system, the Federal Reserve Bank of New York, shows assets of \$1.3 trillion and capital of just \$12.2 billion. Its leverage ratio, a mere 0.9%, is less than one-third of that prescribed for banks in the private sector. Such a thin film of protection would present no special risk if the bank managed by Timothy F. Geithner, the Treasury secretary-designate, owned only short-dated Treasuries. However, the mystery meat acquired from Bear Stearns and AIG foots to \$66.6 billion. A writedown of just 18.3% in the value of those risky portfolios would erase the New York Fed's capital account. In congressional testimony eight years ago, Laurence Meyer, then a Fed governor, tried to allay any such concerns (which then must have seemed remote, indeed). "Creditors of central banks...are at no risk of a loss because the central bank can always create additional currency to meet any obligation denominated in that currency," he soothingly reminded his listeners.

Yes, today's policy makers allow, there are risks to "creating" a trillion or so of new currency every few months, but that is tomorrow's worry. On today's agenda is a deflationary abyss. Frostbite victims tend not to dwell on the summertime perils of heatstroke.

But the seasons of finance are unpredictable. Prescience is rare enough in the private sector. It is almost unheard of in Washington. The credit troubles took the Fed unawares. So, likely, will the outbreak of the next inflation. Already the stars are aligned for a doozy. Not only the Fed, but also the other leading central banks are frantically ramping up money production. Simultaneously, miners and oil producers are ramping down commodity production -- as is, for instance, Rio Tinto, the heavily encumbered mining giant, which the other day disclosed 14,000 layoffs and a \$5 billion cutback in capital expenditure. Come the economic recovery, resource producers will certainly increase output. But it is far less certain that, once the cycle turns, the central banks will punctually tighten.

The public has been slow to anger in this costliest and scariest of post World War II financial crises. Wall Street and the debt ratings agencies have come in for well-deserved castigation. But pointing fingers rarely find the Federal Reserve, whose low, low interest rates helped to set house prices levitating in the first place.

After Mr. Bernanke gets a good night's sleep, he should be called to account for once again cutting interest rates at the expense of the long-suffering (and possibly hungry) savers. He should be asked to explain how the central-banking methods of the paper-dollar era represent any improvement, either in practice or theory, over the rigor, elegance, simplicity and predictability of the gold standard. He should be directed to read aloud the text of critique by Elihu Root and explain where, if at all, the old gentleman went wrong. Finally, he should be directed to put himself into the shoes of a foreign holder of U.S. dollars. "Tell us, Mr. Bernanke," a congressman might consider asking him, "if you had the choice, would you hold dollars? And may I remind you, Mr. Chairman, that you are under oath?"

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