

## CENTRAL BANKING, ITSELF, IS A SPECULATION

*"The Federal Reserve Act does not ... contemplate the use of the Federal Reserve System for the creation or extension of speculative credit."*

Public Announcement by the Fed on February 2, 1929

There is irony all over the place on the above statement. One, of course, is the Fed's reckless accommodation of Wall Street during the "Roaring Twenties". This was competently criticized by no other than Alan Greenspan in some essays published in *The Objectivist* in 1966. Then, as chairman, he has presided over the most reckless credit expansion by the senior central bank since the Bank of England "accommodated" the notorious South Sea Bubble of 1720.

Some time ago, we noted that 300 years of financial history is, itself, a due diligence on central banking and concluded that the concept that the Fed can manage interest rates and the currency is, itself, a highly speculative notion.

Orthodox theory insists that the market is a random walk that can be altered by willful manipulation of interest rates and currency valuations. Financial history suggests otherwise as old patterns continue to recur. The key one is that a long expansion ends with an "old" era of inflation that becomes intolerable.

The undeniable collapse of that speculation was followed in every case by an overly celebrated "new" financial era. As usual, this culminated in a bubble and collapse. Also, this historical model allowed for a cyclical recovery in the third year after the mania. As we have been developing, this is now maturing and is eligible for failure.

The conviction that the Fed and China can keep the boom going forever is massive. This will be managed by the Fed continuing to "print" dollars and the Chinese continuing to speculate in industrial commodities. The probability of both games continuing is outlined below.

**Fed Intentions:** Two of the greatest events of the past 100 years have been the harsh deflation of the early 1930s and the end of rampant inflation in 1980. The establishment's opinion on both is self-serving rather than practical.

Interventionist economists consider that the Federal Reserve System is essentially infallible, as an appropriate expansion of credit can prevent a recession from turning into a severe contraction. In order to sustain this belief, it has been expedient to claim that the head of the Fed made a series of policy errors that caused the severe contraction of the 1930s. Despite the discount rate plunging from 6% to 1 ½ %, the establishment concludes that the Fed was "tight".<sup>1</sup>

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<sup>1</sup> This compares to the late 1970s when the discount rate soared to 14% and, despite a ballooning expansion of the money supply, interventionist economists claimed the Fed was "tight".

The most concise and honest refutation is by an editorial in Barron's in real time in June, 1932:

***"The Federal Reserve policy of cheapening credit through the purchase of government bonds has been unable to make a dent in the conservatism of borrower or bank lender, in short, every anti-deflationary effort has yet to provide positive results. The depression is sucking more and more bonds into its vortex."***

That this type of a contraction has followed all five previous financial manias since 1720 strongly suggests that the problem is systemic rather than due to policy error.

Central banking, in practice, has not been proof against a post-bubble contraction nor have the theories been. But the habit of posthumously laying the blame on some long departed policymaker clearly ranks as the typically socialist *ad hominum* argument.

Before turning to the "end of inflation" in 1980, it is appropriate to review how great esteem has been granted to those on duty during the wonders of a "new financial era". During the 1990s (and since), Robert Rubin has been declared "the greatest Treasury Secretary since Alexander Hamilton".

It is likely that those who made that comparison did not know that their counterparts made the same acclamation during the 1920s. John Kenneth Galbraith summed it up in 1987 with:

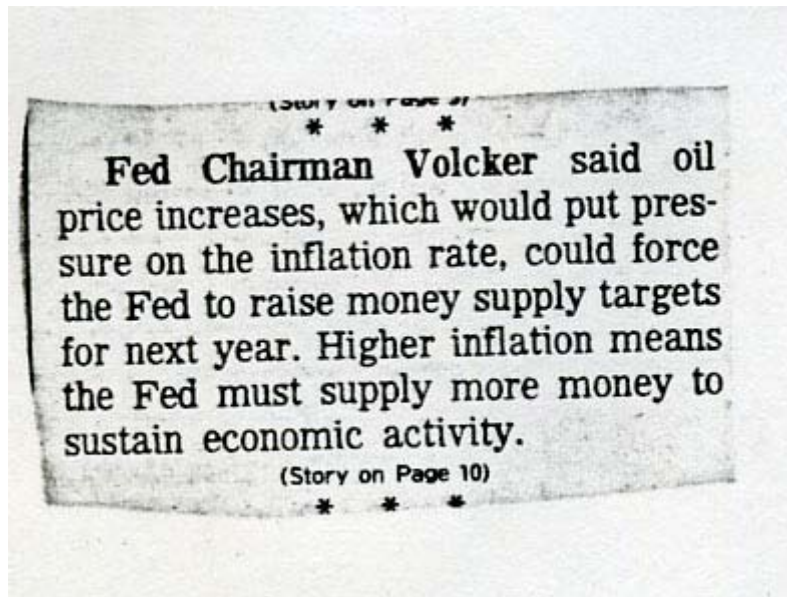
***"[In] 1929 the stock market divorced itself from all underlying reality ... Justification was, of course asserted: the unique and enduring quality of Coolidge and Hoover prosperity; the infinitely benign effects of the supply-side tax reductions of Secretary of the Treasury Andrew W. Mellon, who was held to be the greatest in that office since Alexander Hamilton."***

Showing some fickleness in the esteem-granting process, when Mellon stayed on into the early 1930s, he was quickly condemned for suggesting that the contraction could be ended quickly by a severe liquidation of unsupportable positions.

However, the next big event was the end of inflation in 1980, which has been popularly attributed to the unique judgement of Fed Chairman, Paul Volcker. This is an expedient error used by the establishment to claim that the end of inflation, and therefore something good, was a result of brilliant policy. This contrasts with the explanation that the post-1929 contraction, being "bad", was due to policy error.

There are two ways to refute this. One is a WSJ article on Volcker's policy in November, 1979. (Brent Crude peaked with the DJ Commodities Index at the end of 1979.) This contrasts so vividly with the great man's posterity of deliberately and brilliantly "ending inflation" that, for our credibility, we have scanned the old

clipping to reproduce it below. The main point is that in today's light, the concept is so posterous that our paraphrasing would seem invented.



Rather than being managed, as with any mania in tangible assets the 1980 example blew out and collapsed on its own. Then, quite typically, out of the consequent harsh contraction another "new" era of speculation in financial assets ensued and this provides the other point that refutes the interventionists' claim that it was clever policy that ended inflation and created the prosperity of the 1990s. The tout was that policy was just right – the "Goldilocks" scenario.

Let's be clinical. There was no change in the basic definitions of money as  $M_1$ ,  $M_2$ ,  $M_3$ , etc., but after a brief pause in 1981-1982 monetary expansion resumed its relentless pace. Instead of driving commodities and inflation (which was bad), it was driving the stock market, which was good and naturally the result of brilliant policy. Interventionist economists have yet to explain how, in one decade, vigorous expansion of, say,  $M_2$  results in soaring prices for tangible assets, which trashes bonds and then in the next it ramps up stock and bond prices.

Of course, history provides clarity and consistency. Since 1700, every "old" era of inflation has been followed by a "new" era of soaring financial markets – the 1990s example was the sixth and the transition was always the same but with the distinction that prior to the 20<sup>th</sup> Century policymakers didn't take the credit for a natural turn in the financial markets.

Going back to 1981 - 1982, institutions had finally accepted that the Fed was the engine of inflation and lousy returns from stocks and bonds would continue. At the time, our summary of the instruction from history was "***no matter how much the Fed prints, stocks will outperform commodities***".

This was controversial, as is history's current instruction that as today's speculative action in both tangible and financial assets burns out, Mr. Market will again deny the Fed's compulsion to trash the dollar.

Mr. International Market, who has a lot of clout, will take an interest in the China boom. Although it is a jump in time and place, this is similar to the dynamics in the U.S. following the 1873 bubble. As it occurred in England, which was the senior economy, the post-1873 contraction was called "The Great Depression". Within this, the U.S. was vulnerable to the availability of international credit and its own internal excesses.

It follows that age-old market forces have not been repealed for China and this year's mania now seems vulnerable.

It is worth emphasizing that the feature of an era of financial speculation is the abandonment of critical judgement. For example, as Tokyo's was blowing out in 1989, senior spokesmen in New York competently described the action in Tokyo as a "bubble", but seemed unable to make the same diagnosis in 1 Half 2000. As with previous examples, participants find them too prosperous for circumspection. As Lord Acton might have said, bull markets tend to corrupt and great bull markets corrupt absolutely.

Every such "new" era has run for nine years from the peak of the last business cycle of the "old" era of inflation to the climax of the stock bubble. In examples where the business peak is known to the month, the new eras that ended in March, 2000 and September, 1929 each ran for 116 months. That the main theories and practice of interventionist economics were developed without a thorough knowledge of financial history has been a speculative adventure.

More specifically, the literature, and this needs emphasis, provides no evidence in real time that the senior central bank deliberately moved to end the prosperity of the mania in financial assets. Indeed, there is evidence, such as in 1720 and 2000, that vigorous efforts were made to keep the boom going, but the duration was not extended. Moreover, when the senior central bank was acting responsibly under a sound money regime, the duration of a great financial mania was not shortened. However, when "accommodation" prevailed, it exaggerated speculation which, in turn, exacerbated the *consequent* contraction.

Compelling speculations have come and gone throughout history, but the last 100 years have recorded the greatest financial volatility and the highest interest rates in the senior currency in 400 years. This is due to the "Perfect Storm" with highly speculative notions of central banking meeting the regularly recurring market speculations in tangible and then financial assets.

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