

MARKETS IN THE POST-COLD WAR ERA:
STABILITY AND OTHER DELUSIONS

Prepared for the Olive W. Garvey Fellowships
The Mont Pelerin Society

*"The creatures outside looked from pig to man, and
from man to pig, and from pig to man again; but
already it was impossible to say which was which."*

*George Orwell
Animal Farm
1944*

This essay is dedicated to my friends and family, and to my colleagues in the Federal Reserve System, in financial markets and academic circles around the world, and in Washington.

Christopher Whalen
Washington, D.C.
May 15, 1992
A.M.D.G.

The Road to Perdition

Just when the Cold War ended is a question historians will debate for years to come. The fall of the Berlin Wall is the obvious reference point, a powerful picture of the "collapse of communism" eagerly seized by the media. Yet the victory in Berlin obscured the high price overturning communist rule would extract from the unique American political economy, and also exaggerated the extent of the triumph. The battle between entrenched communist elites and the freed citizenry of Eastern Europe shows that toppling the Wall marked the beginning of a new struggle.

As analysts ponder "the end of communism," among the industrialized nations rages a more important struggle. Francis Fukuyama suggested that with geopolitical confrontation between East and West no more, "the end of history" impended, implying that the struggle for freedom ended with Soviet imperialism. Yet just as formerly communist nations contain tendencies reluctant to yield power and dismantle Cold War structures, so too the technocrat elite within the Group of Seven (G-7) countries, including America, remain wedded to policies designed to maintain "stability" in private markets during a time of global military and political conflict.

Many economists and politicians in America, themselves products of the Cold War, reject the idea that global conflict has ended, arguing instead that the new contest among nations is economic. Governmental guidance in the form of "industrial policy" is needed to meet the new menace posed by the European Community, Japan and the other ascendant Asian economic powers, they contend. "The issue is no longer whether Government should intervene [in the economy]," Dr. Robert Kuttner wrote in the *New York Times Magazine*, "but when, where and how."

Kuttner represents a uniquely post-modern, positive liberty strain in American intellectual thought which holds that market economies must inevitably evolve toward a managed, regulated formulation, where commercial warfare among nations, not individuals or private concerns, is the most disaggregated form of "competition." Under this *dirigiste*, top-down world view, America is pitted in a zero-sum struggle against Europe and Asia, losing rather than gaining benefits from free and open trade. In the world of "industrial policy" and "managed trade," the functioning of markets is the concern of politicians, not mere business people. Private companies, financial institutions and individuals are seen as dangerous sources of instability in markets where "market surveillance" and "bank supervision" are common terminology; perhaps what Justice Learned Hand had in mind when he referred to "a society governed by platonic guardians."

But history is not over. The threat of central planning did not end with the fall of Soviet communism. The great battle yet to be fought is for the soul of the United States as a libertarian society, the country deliberately made in a different image than the regimented states of Europe. The challenge lies in reaffirming and perhaps even reintroducing the principles of limited government, individual liberty, and private property -- the necessary conditions for a free-market, pluralistic society. The question is not about degrees of regulation, but of keeping free markets from disappearing entirely. Ideas once taken for granted: that public debt is intrinsically evil and leads to speculation and inflation; that thrift and personal responsibility are the foundations of individual and national wealth; and that deviation from these principles leads to social ruin, as evidenced by events in Russia and, more recently, rioting and looting in Beirut and Los Angeles, must be rediscovered.

Costly Victory

"The beginning of the end of capitalism in America, which was also the beginning of the rise of totalitarian communism, came in 1913," economist Herbert Stein wrote in the *Wall Street Journal* early this year. "This was about the same time as the beginning of communism in Russia. But whereas communism faded away early in the 1990s, it remained a threat in America."

The liberal American government that broke the Robber Barons; that saw the nation through panics, currency runs, and the Great Depression; that defeated Hitler and General Tojo; and that survived global standoff with the Soviet military menace, is not the limited government of our nation's founders. Washington, governed by politicians, lobbyists and the black carrion swarm we shall simply call "liberal economists," constitutes the chief threat to prosperity and liberty in America. "The expediencies and exigencies of social machinery," to paraphrase Hayek, are moving us toward a less libertarian society where "stability" is managed from above -- the very same type of society our forbears fought against on forgotten foreign battlefields in Europe and Asia.

Well-intentioned leaders have for decades told America that resisting Soviet imperialism warranted any sacrifice. Debate over running budget deficits or the wisdom of tolerating even modest inflation were easily pushed aside because of the perceived threat of nuclear annihilation, the power of "the crisis." To question fiscal deficiencies or the use of monetary policy to accommodate projects such as Vietnam, the expansion of welfare expenditures in the 1970s, or the military buildup of the 1980s, was attacked as unpatriotic or even pro-communist. Deliberately or not, in fighting communism we have created a home-grown socialist nightmare not fundamentally different from corporatist states proposed by Lenin and Hitler, and realized by Stalin. Both to meet external threats and satisfy internal needs, America created an enormous state apparatus that accommodates almost any request, but also limits and regulates ever more aspects of private life, from health care to investing to the use of private property.

After a presentation by this writer on Social Security, an elderly Bethesda, Maryland man obliquely highlighted the issue facing Americans when it comes to recognizing limits on government. The audience had heard that SSI and other federal trust funds are an accounting fiction dependent on future generations' sweat to redeem promissory notes issued by the Treasury. After a heated debate, we finally concluded that, yes, Social Security is a fraud. But then the gray-haired man with military decorations displayed proudly on his jacket, declared that while correct, "We should not say bad things about the United States because America is the greatest country in the world."

America, world policeman, defender of freedom, land of infinite salable assets and endless credit, can do no wrong. No debt is too big, no expenditure too outrageous for the nation that won the three great wars of this century. Since this perception is widely shared internationally, successive governments in Washington have financed

the growth of government with public debt denominated in dollars. Investors, at home and abroad, fund federal deficits by exchanging cash for future dollars, plus interest, payable at some date certain. Yet the rules of arithmetic and compounded interest suggest that the scheme may eventually reach a ceiling in terms of investor appetite for dollars.

Comstock Partners principal Michael Aronstein characterized America's fiscal problems from the perspective of the post-war generation's children in *Barron's*: "Certainly, there's something enraging about the sort of casual arrogance with which people in Washington sit down and decide what [the deficit will be], whether it is \$300 billion, \$400 billion, \$500 billion or \$600 billion, sure, they can borrow it... There is a limit. And that's the delusion that we as a society are operating under – that all of this is limitless. There is no natural boundary."

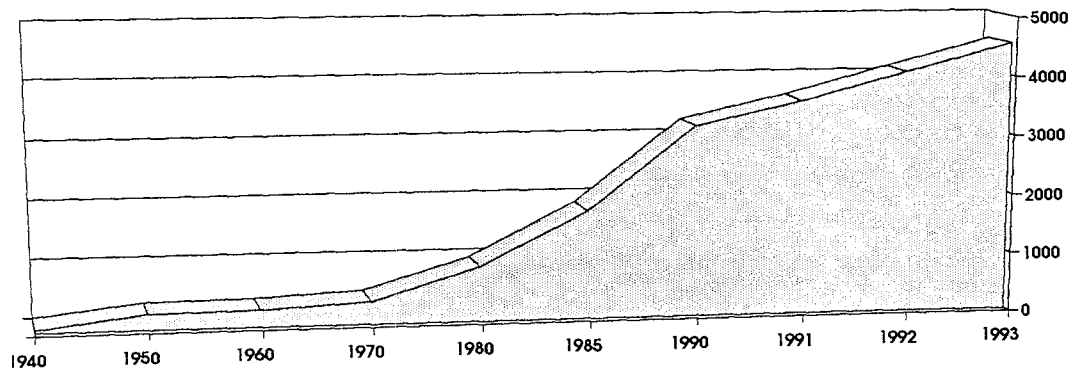
Debt & Forbearance

Two economic indicators, America's rising national debt and politically motivated intervention to rescue private companies from market discipline, best illustrate the strangulating effect of big government on the U.S. economy. Far more than the narrow issue of simply regulating markets, the growing burden of government spending and debt, facilitated by periodic bursts of inflation, is gradually blurring the distinction between private and public property, and the separation between that economic activity which is "public" and that which is clearly private.

Federal government borrowing, on net, presently consumes virtually all excess private capital in the U.S. economy. Annual, interest only payments on the outstanding \$3 trillion plus in public debt (not including interest accrued by Social Security and other trust funds), totals over \$350 billion, now the single largest item in the federal budget. With capital inflows from Europe and Japan down dramatically from the torrential levels of the mid-1980s, foreign money is no longer available to offset federal borrowing.

Gross Federal Debt

(Billions of Nominal Dollars)



Source: Congressional Budget Office, April 7, 1992.

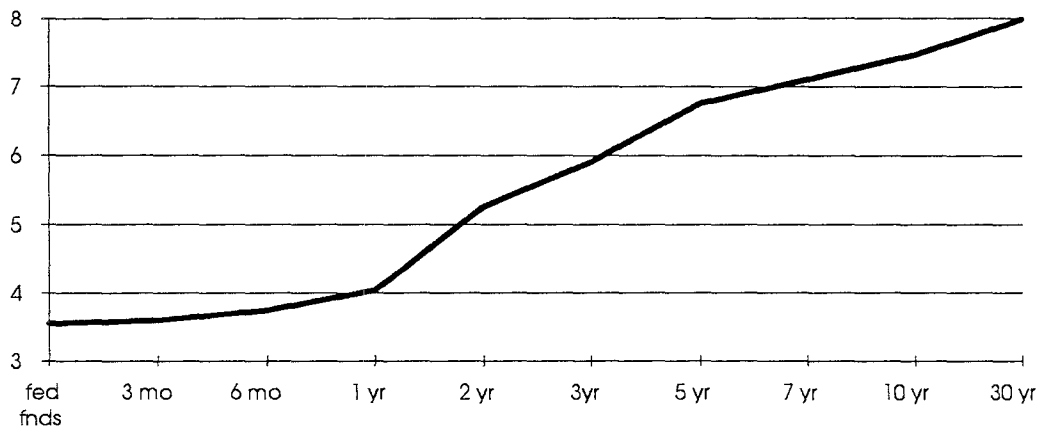
Figures include obligations to Social Security and other federal trust funds

While often criticized by xenophobic politicians, capital inflows from abroad during the 1980s delayed the consolidation and asset revaluation that inevitably follows sustained inflation -- the corollary to public debt expansion illustrated in the chart above. Following the boom years of the 1970s, when government-induced monetary expansion forced banks and investors to lengthen the maturity -- and the nominal yields -- of assets to escape inflation, the 1980s represented a plateau, a pause financed by high real interest rates and dollars repatriated from abroad.

Now, in the 1990s, the proverbial chickens have come home to roost in the form of collapsing asset prices. As high quality private collateral becomes scarce, well-capitalized financial institutions avoid making loans, preferring the safety of Uncle Sam's AAA-rated IOUs. And large banks, reeling from accumulated asset quality problems created by making imprudent loans to developing countries, real estate developers and corporate raiders -- all demons whose appearance is attributable to macro-monetary economic fine-tuning -- buy long-dated government debt with monies borrowed in the overnight funds market -- liquidity available to them only because of FDIC insurance.

The "spread" or difference between yields on 30-year T-bonds and Fed funds illustrates, respectively, expectations for inflation and official manipulation of short-term interest rates in order to rescue "private" banks from the results of poor credit and management decisions. The yield curve now totals some 450 basis points from end to end, the widest spread seen in the post-WWII era, and would be steeper were it not for recent Fed purchases of longer-dated Treasury paper -- the ultimate act of inflationism and monetary idiocy.

Treasury Yield Curve (in percent)



Source: Caxton Partners, May 8, 1992

What the White House calls the credit crunch exemplifies "crowding out," when spending deficits (and inflation) inevitably deprive private borrowers of new capital. But undeterred by such inconvenient realities, today Treasury Secretary Nicholas Brady and other monetary accommodationists grope for the impossible: low interest rates, more credit for the private sector, and all this with stable prices and low inflation.

As banks and risk-averse investors have fled to government debt, the pool of private liquidity created during previous inflations roams from one short-term investment to another, as witnessed by the explosion of asset values in the U.S. and Japan during the 1980s, and more recent speculative surges in "emerging" markets such as Mexico, Taiwan, India and even Argentina. With more and more dollars chasing ever fewer high quality assets, investor horizons have progressively shortened and tolerance of risk has increased, so that the criteria for purchasing a stock or bond today is not the likelihood of repayment, but whether another "investor" will purchase the asset from you at a higher price.

The force driving hope for a U.S. economic recovery in 1992 is Fed expansion of high-powered money. In the first quarter of 1992 alone, total bank reserves rose at a near-record 27 percent, measured on a quarter-to-quarter average basis, an example of how Washington, through a servile central bank, uses inflationary monetary policy to create the illusion of economic expansion. By keeping short interest rates low, some would argue negative in real terms, the Bush Administration seeks to revive private economic activity without making any fiscal policy adjustments, such as lowering the deficit or tax rates. In fact, Bush hopes to simultaneously use easy money to salvage banks left insolvent by this latest cyclical correction in asset values. One veteran on the staff of the House Banking Committee calls this process a "managed collapse" of the banking industry.

Too Big To Fail

More than any other indicator, the reluctance to allow market resolution of large bank insolvencies is symptomatic of how a *de facto* nationalization of private assets is occurring in America via inflation and debt. The doctrine known as "too big to fail," whereby the taxpayer subsidizes large depositors and other creditors of private banks, epitomizes the larger trend in the U.S. economy toward politically managed stability from above rather than market-based solutions. Too-big-to-fail is especially pernicious on economic grounds since it subsidizes badly managed banks and companies at the expense of well-run concerns, and even worse, does so based on political determinations where transparency and public accountability are lacking.

Look at the financial problems facing larger commercial banks today and it quickly emerges that we are repeating the socialist mistakes of the past, but ironically accompanied by institutions dating back to the Depression. As Washington was compelled to refloat the economy after 1929, since the appearance of the twin specters of Third World loans and domestic deflation, we have headed down a familiar road attended by monstrosities such as the FDIC and the World Bank, and newer gorgons like the Resolution Trust Corp., institutions comparable to the state-sector organs found in the authoritarian societies of Europe and Latin America. Worse yet, our political

leadership seems incapable of rediscovering even the bailout mechanism of the 1930s, the Reconstruction Finance Corp. (RFC), which while flawed was at least a transparent fiscal tool requiring annual appropriations, rather than the off-budget subterfuge now employed to support the ongoing thrift/bank rescue.

The 1987 stock market break accelerated the trend towards greater overt and, this writer would argue, covert manipulation of markets in the name of preserving short-run "stability." The process began years earlier, first through creative accounting -- known as forbearance -- employed to protect insolvent thrifts in the Southwest. These institutions were gradually taken over and the rest is history -- except that the government still lacks the money and political will to fully resolve the situation. Dozens of insolvent thrifts and commercial banks are today open for business under FDIC or RTC ownership, literally state-owned "zombies" operating at a loss and in competition with solvent banks. To make the irony complete, the single largest seller of federal funds in the "private" market is another Depression-era entity, the Federal Home Loan Banks, which issue notes carrying a presumptive U.S. guarantee.

Starting with the RFC, and continuing through the WWII years with the mobilization and centralization of industry necessary to win the conflict, government's role in the economy has gone from passive arbiter to active regulator and now participant. Compare the days of Jim Fisk and Jay Gould, for example, when intervention in the gold market in 1869 burst one of history's great speculative bubbles, to the rescue of Lockheed (1971), New York City (1976), Chrysler (1980), First City Bank of Houston (1987), Continental Illinois (1984), and most recently the nationalization of Crossland Savings of New York.

Whereas President Ulysses Grant sought to calm markets by selling government gold (albeit after nearly being duped by the wily Gould), the Lockheed rescue or the nationalization of Crossland was a deliberate effort to avoid a market-based solution. With the collapse of the Bank of New England in early 1991, the Treasury used billions of dollars in public money to keep the insolvent institution alive. Even after providing a multi-billion dollar subsidy for uninsured depositors in order to facilitate a purchase, the Treasury still refuses to admit its central (and arguably illegal) role in a bailout that ultimately could cost the taxpayer in excess of \$4 billion (the officially admitted figure is \$2.5 billion).

In the case of banks rescued (and dozens closed with public subsidies) the U.S. has accelerated its guarantee of apparently private liabilities in the form of uninsured bank deposits (foreign deposits and those over the \$100,000 legal limit) and even non-deposit liabilities of larger banks, as in the case of the parent of Continental Bank. This direct government subsidy for private investors occurred without congressional approval, being conducted *de facto* by federal regulators in the name of limiting what is called "systemic risk," which regulators refuse to define or address by limiting interbank exposure.

The Invisible Hand

More disturbing than overt bailouts of certain classes of private creditors are instances where supposedly "private" companies, in particular big banks and defense contractors, have been rescued covertly, without the prior knowledge or consent of Congress. The most notable examples of this new approach are found among the New York money center banks -- Citicorp, Chase Manhattan, Manufacturers Hanover and Chemical Bank -- which all suffered in recent years from deteriorating asset quality and substandard earnings.

In the case of Citicorp and Chase Manhattan, for example, it is clear that both have been in a slow, government-supervised liquidation for the past several years, whereby forbearance with respect to impaired assets and other special dispensations allow these institutions to avoid closure or mergers. During the period of November-December of 1990 and again at the end of March 1991, Chase was reportedly rescued by a combination of discount window loans from the Federal Reserve Bank of New York and covert loans from other New York banks, acting upon verbal guarantees made by senior Fed officials. Similar reports have been made with respect to Citicorp, but little hard evidence exists beyond anecdotal reports and extraordinary discount window activity when these banks had difficulty borrowing from private markets.

Another recent example involves McDonnell Douglas, the aircraft manufacturer and defense contractor that experienced serious financial difficulties last year. In April the *New York Times* reported two payments totaling hundreds of millions of dollars ostensibly made for the moribund C-17 program "at a time when the company faced a severe financial crisis." By shifting payments from one account to another, the federal government provided funding to the company when it could not raise funds from private markets. "The Congressional investigators said that the effect of the two [payments] was to give McDonnell Douglas immediate payments that it would otherwise have had to wait months or years for," according to the *Times*.

And we are not alone in this folly -- indeed, we learned it from the British, who are in the process of bailing out Olympia & York's exposure on the Canary Wharf project, an office complex located on a narrow, isolated peninsula in East London that lacks no amenity save adequate transportation to bring eager tenants in and out.

International Cooperation

Just as decisions about interest rates or whether enterprises of a certain size will succeed or fail are increasingly a function of political considerations, in the international arena manipulation of markets and entire economies is now accepted practice. The 1985 G-7 Plaza Accord, for example, formalized a process whereby central banks manipulated the price of the dollar and "coordinated" interest rate movements to achieve politically designated economic goals.

Just as with manipulation of domestic interest rates in all G-7 countries, central bank intervention in the currency market is executed without apology or explanation; it is simply accepted as the management of markets that evolved during the Cold War. And just as the increase of government debt dominates the evolution of the "independent" Federal Reserve, in the international realm the efforts by other members of the G-7 to monetize a certain portion of American inflation likewise distorts the economies of Germany and Japan.

The G-7 central banks other than the Federal Reserve now hold over \$300 billion in U.S. debt (which requires that they sell or create an equal amount of their own currency). Washington's profligacy is straining this arrangement, however, as manifested by recent sharp exchanges between Washington and Bonn over monetary and fiscal policy in the newly unified Germany. With the Bundesbank seemingly committed to price stability by maintaining high real interest rates, and the U.S. headed in the opposite direction, the G-7 process of market stabilization is degenerating because Germans and Japanese alike question the need to continue importing American inflation through dollar purchases.

Until the fall of the Berlin Wall, the Bundesbank was willing to counterbalance American fiscal and trade deficits by purchasing dollars, a policy encouraged by exporters and manufacturers in Germany who depend on sustaining the level of the dollar, both to preserve export revenues and the value of direct investments in the U.S. Likewise, Japanese exporters and banks, who generally write contracts or loans in dollar terms, fear a weaker greenback because of the impact on profits and asset values. The scramble by Tokyo banks to meet the revised Basle capital guidelines is caused, in part, because dollar weakness generates lower revenues and valuation losses in yen terms.

Foreign Debt

One area of G-7 cooperation where there remains general agreement, however, is in dealing with debt issued by developing countries and now the disintegrating Soviet Union. In much the same way that dollar stabilization efforts by Europe and Japan seek to maintain the value of exports to the U.S., the endeavors of Washington in Latin America, and of the Europeans in central and eastern Europe, are designed to prevent a repeat of the 1982 Mexican loan default. And just as Germany, for example, seeks to prop-up the dollar through sales of marks, "managing" the LDC debt crisis is meant at least partially to preserve the fiction that countries with large external debts, low per capita income levels, and socialist economies constitute a market for exports from developing nations.

Olympia & York of Canada has successfully bullied creditors into accepting a "roll over" of existing debt (and, incredibly, new loans), but it appears the banks agreed only after the UK guaranteed a minimum level of occupancy by civil servants. The Russians likewise give the G-7 a blunt ultimatum: provide new money or face default. No doubt Russian President Boris Yeltsin learned this trick from his advisers, N.Y. Fed President Gerald Corrigan and former Fed Chairman Paul Volcker. The latter, who is

reported to be a formal adviser to Yeltsin, can claim considerable credit for teaching Mexico how the implicit threat of "instability" could be used to coerce new loans and subsidies from Washington.

Frantic efforts to give Russia both debt relief and access to new credit from the IMF and World Bank closely parallel arrangements made with respect to Mexico, culminating in the abortive Brady debt reduction plan in 1989 and, most recently, the political facade of "free trade." Just as new loans from the World Bank, IMF and other international lending and export-credit agencies are "recycled" to help Mexico make payments on private foreign loans, the G-7 is contemplating a similar "stabilization" arrangement for Moscow to protect already weakened banks and commercial companies in Europe, Japan and the U.S. from a full-scale Soviet financial collapse. But whereas Mexico requires a modest \$5-10 billion per year in new multilateral loans (total service on its now \$107 billion public foreign debt was \$16 billion in 1991, up 43 percent from 1990), new loans required to keep Russian credits current and pay for imports will soar into the tens of billions of dollars, and this does not include the \$20 billion or so to meet the proclaimed cash needs of other former Soviet republics. If Moscow's accumulated foreign debt is not to collapse, the flow of new money, consistent with the Mexican "stability" model, must grow every year.

As with the example of domestic debt issuance in the U.S., new multilateral debt, authorized for political reasons, is employed to simulate *bona fide* income in developing nations to pay interest on private debts and to purchase goods and services from the G-7 countries. And the Russian bailout is just the latest evolution of this "crisis management." Starting in the 1970s by recycling Arab petro-dollars to developing nations in the form of private bank loans, the process of managing Third World debt continued in the 1980s with first the Baker Plan (status quo and new loans) and the Brady Plan (debt forgiveness and new loans). Now the process escalates several big notches with the start of an open-ended, \$30 billion-plus a year G-7 program to float the latest authoritarian government to reside in the great fortress that is Moscow.

It is interesting to note that the U.S. Treasury will lend money to Russia (most or all of which will be borrowed), which will then be used to clear arrears on private loans to banks and commercial companies largely but not entirely from Western Europe and Japan. It is unlikely that investors who buy Treasury debt issued to fund this operation will waive interest or principal payments. But the same cannot be said of the U.S. loans to Moscow, which history suggests will never be repaid. Inevitably, taxpayers in the G-7 countries must redeem these loans through increased levies necessary to "replenish" the capital of institutions such as the World Bank and IMF, or indirectly via higher levels of domestic debt and inflation. The investors who own AAA-rated World Bank bonds are, after all, the real shareholders.

Price Stability & Freedom

The accumulation of public sector debt in America is the root of many of the problems now facing the U.S. economy. If the other, off-balance sheet liabilities of the federal government such as Social Security, private pension guarantees and commitments to multilateral institutions are added to the cost of resolving the thrift and commercial bank bailouts, it quickly becomes clear that the size of public sector liabilities is growing very rapidly relative to the total value of real private assets (roughly \$35 trillion). This trend holds ominous implications for the "free market," not to mention the long-term prospects for American democracy.

First, in an environment where the government is forced to finance half a trillion dollars worth of new debt annually, and "roll" the interest on \$3.5 trillion in old debt, the question arises as to whether there is any capital left over for private borrowers. So long as the government refuses to curtail expenditures, efforts to alleviate the "credit crunch" or other manifestations of crowding out are exercises in futility at best, and a political swindle at worst.

Second, as the size of the federal debt increases relative to "private" assets and obligations, the issue of repayment ultimately begs the question as to when and how the government will use its coercive power to expropriate private wealth to pay public debts. It is not a question of federal officials actually seizing private property, but rather creating money, much the same way that Messrs. Fisk and Gould printed new shares of Erie railroad stock when they needed liquidity. Both examples pertain to criminal expropriation of private property, but only one is sanctioned by the coercive power of the state.

The institutionalized crisis affecting financial markets and the government's fiscal situation is inexorably moving the United States toward a more centralized and less democratic form of government, no matter which of the three "positivist" candidates win the November election. Unless some future leader convinces Americans to dramatically cut current spending, higher public debt implies rising inflation, falling real wages, and incremental increases in discord among the public at large. While many factors can explain the riots in Los Angeles, the steady erosion of the purchasing power of working people is a cause that has received little attention from a financially illiterate media. The age of money politics demands a press conversant in present value and monetary alchemy.

Without a change in the fiscal and monetary regimes followed in the United States, the future holds a situation where government will be the central player, surrounded by a heavily regulated "private" market; where individual liberties and opportunities will become increasingly a function of administrative mechanisms; and where decisions about major business transactions will be concentrated far beyond what was even thought possible two decades before.

This growth in the role of the coercive and redistributive power of the state, perhaps disguised as managerial and funding partnerships between government and private business, will be sold as part of the solution, or at worst a necessary evil. And this fundamental economic evolution, which has its roots in the birth of communism in Russia, the Great Depression and WWII, will occur within the world's greatest democracy without an informed public debate over the rights of property or government's prerogative to incur new indebtedness without congressional authorization.

Since by law the dollars issued by the twelve Federal Reserve Banks are legal tender for all debts, public and private, Americans have already been robbed of the choice of demanding payment of obligations in something other than fiat money, that is, greenbacks. At the end of the day, those lonely souls who have long advocated a return to the gold standard or some other "real" measure of value upon which to base the supply of money will be proven correct, unless the seemingly unlikely occurs and America again embraces fiscal sobriety and price stability.

As with any other clear choice between good and evil, the way out of the darkening cave of socialism and debt is to turn around and walk the other way. This involves first committing the nation to price stability and monetary discipline; and second, balancing the federal budget and establishing a *surplus*, above current interest payments, in order to begin the orderly retirement of the national debt. Any other choice is not only economically unworkable, but immoral; it implies eventual social and financial chaos on the day that Washington resorts to hyperinflation by announcing that all federal debt is hereby converted into legal tender dollars. If it should come to this or some similar solution, we will have truly lost the Cold War.

#