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INFLATION AND THE DECAY OF THE AMERICAN FINANCIAL SYSTEM

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We Need a Financial Crisis, not a Depression

During the last fifteen years I have been generally regarded as a financial Cassandra, and so I am a little nonplussed to find general sentiment turning even more gloomy than I am. For the last third of a century the conventional wisdom has been that another depression is impossible, or at least wildly unlikely; but during the last month or so newspaper columinists, television news anchormen and similar deep thinkers have been suggesting that we are indeed slipping into a depression. For whatever it is worth, I do not believe that we are necessarily headed for a decade of mass unemployment like that of the 1930's. Stubborn insistence upon misguided political policies could conceivably produce such a result, but there is no reason why it has to happen. On the other hand, I do believe that the low-grade financial fever that we have been running since the mid-1960's is about to flare up into one of its periodic crises; and that this crisis is likely to be the severest one yet.

The policy options that are open to us range from a measure of deflation and hard times now, in which case our economy and financial system are likely to come through relatively unscathed, to political attempts to prevent deflation and hard times. Those attempts will inevitably fail in the end; but in the meantime it is entirely possible that if we try hard enough we will succeed in touching off a really serious inflation. In that case many of our financial institutions and instruments will be altered dramatically, our productive economy and our standard of living will be seriously damaged, and a good part of the savings of the American people will be destroyed. That has happened to several countries in this century, and the political and social consequences were usually severe.

It's Too Early to Tell if the Outcome Will be Deflation or Hyperinflation

I wish that I could tell you today just how this is all going to work out, but unforunately it is still too early to be sure. The best I can do at the moment is first to help you to understand the mechanics of the inflationary process so that you realize that the longer it goes on the greater becomes the risk of a deflationary credit crisis; second, to list the clues by which we will be able to tell as early as possible whether the outcome is likely to be deflation and hard times or serious inflation and eventual financial ruin; and finally, to explore some of the implications for the life insurance industry.

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I believe that we have had political policies in this country for twenty years that were found eventually to produce severe financial trouble, and so it is not surprising that trouble is finally developing. The main reason why the ultimate consequences of those policies were not obvious long ago is that we also have a seriously deficient theory of the financial system that is not capable of treating financial trouble and crises as the logical results of identifiable causes. Instead they appear as unpredictable accidents. I wrote a book a couple of years ago that explains the basic principles of the thing, and so today I will delve into theory only as far as is necessary to make my analysis of current events clear.

Money No Longer Exists

The most fundamental flaw in the conventional theory of the financial system is that it is based upon an obsolete and by now meaningless distinction between money and credit. That distinction made some sense before World War I, but by now inflation has driven everything that Granddaddy would have recognized as money out of circulation. The word money stems from the Latin word moneta, which means coins, and until 1914 in Europe and 1934 in this country money was universally understood to mean either coins minted of precious metals or warehouse receipts for precious metals. You may recall that our gold and silver certificate dollar bills of happy memory were precisely such warehouse receipts, and were freely exchangeable for the underlying metals. However, since then inflation has made the convertibility of financial instruments into precious metals impossible to maintain. All the things that we use today to represent purchasing power are financial claims--that is, evidences of debts. For example, the dollar bills in your wallet are simply inconvertible and non-interest bearing evidences of a debt of one of the Federal Reserve banks. Our financial theorists have simply failed to take account of the fact that no qualitative distinction between money and credit still exists.

That failure has led them to make two assumptions that were never exactly right, but that today are egregiously wrong. The first assumption is that you can only spend your money, not your credit. In fact, reputable business people have always been able to command real goods and services on the strength of their credit; but in this day of gasoline credit cards and consumer finance the assumption is that anybody who makes a loan loses the use of the purchasing power that he has lent out until the borrower repays him. The only case in which the actual practices of business people have forced financial theorists to recognize that a loan may in fact create purchasing power is bank credit, because it is obvious to even the most casual observer that the holder of a demand deposit in a bank retains the right to withdraw his balance and spend it whenever he wishes no matter what the bank has done with the funds.

All other loans, except bank loans, are considered to transfer control over purchasing power from the lender to the borrower, not to create more of it, because the lender is assumed to have alienated his purchasing power until the borrower pays him back. In fact, for centuries business people have used two methods to retrieve their purchasing power if they wanted to spend it themselves before the borrowers repaid. One was to sell the borrower's note on the market, and the other was to use it as collateral for a new loan from a bank. Today those two practices are extremely common. Undoubtedly, more debt instruments are now sold or rediscounted than are held to maturity.

Monetarism is Based Upon Two, Contrary to Fact Assumptions

Earlier this week I participated in a workshop at which William Buckley was the keynote speaker, and I mentioned to him that I had frequently made use of his best one-liner. On a television show some years ago he said, "Well, I disagree with Milton Friedman - and believe me, that takes chutzpah." It is rather sad that I agree with Milton Friedman about almost everything under the sun except the technical doctrine with which his name is associated. But the blunt fact is that monetarism is based precisely upon those two erroneous assumptions. If it were true that only money constitutes purchasing power, then it would logically follow that a policy of fine-tuning the money supply could promote economic growth without inflation. But, as we have seen, that notion is the consequence of perpetuating an obsolete and by now meaningless distinction between money and credit.

Inflation is Caused by Excessive Debt Formation

My own view is that any loan can create purchasing power when the lender has received in exchange a liquid financial instrument that he can sell or rediscount if he wants to spend it before the borrower, who presumably has also spent it, pays him back. The only other way of creating purchasing power is to earn it by doing something useful, but since the purchasing power that we earn is presumably equal to the value of the useful goods we have produced or the useful services we have performed, demand and supply are in balance and the price level is not affected. Therefore, the true measure of the rate at which new demand is being created is the rate of growth of total debts outstanding, not the rate of change of the money supply.

How does it come about that creditors who wish to recapture and spend the purchasing power that they have lent out before the loan is repaid can usually do so by selling or borrowing against the claim that the debtor has given them, thereby effectively creating new purchasing power? They can do it because the Central Bank--in this country, the Federal Reserve Bank--normally stands ready to support the credit markets at some workable level of interest rates by buying or rediscounting eligible financial claims that creditors are willing to offer at or above the interest rate target. The Central Bank can create all the purchasing power it pleases, because it borrows on the strength of the credit of the Government of the National State, which is in principle unlimited as long as the government exercises effective control over the State.

The process by which the Central Bank underwrites the expansion of credit can be described, rather crudely and inaccurately, in the traditional language of money and credit; but I prefer to describe it in terms of the liquidity that all financial instruments possess in the market as long as the Central Bank is pursuing a reasonably accommodating policy, and rapidly lose when it is not. This way of looking at things points out the fact that it takes two to tango--that the inflationary process requires both a Central Bank that is willing to make credit readily available and a financial system that is willing to borrow excessively.

It also highlights the dilemma that the Central Bank finds itself in once inflation has become endemic. Central Banks were originally established in order to improve the liquidity of financial instruments as a means of averting crises and panics; but once inflation sets in and people start to borrow in order to buy real things, the more liquidity that the Central Bank provides, the worse the inflation will become. On the other hand, if it refuses to provide all the liquidity that the market demands it runs the risk of driving those with the greatest need and the poorest credit to the wall, thereby precipitating the very crisis that it was originally established to prevent. In this country the Federal Reserve Bank has been shuttling unhappily between the two horns of this steadily worsening dilemma ever since the mid-1960's.

Many central banks were established well before World War I; but until then inflation was generally not a problem, and since then it generally has been a problem. What has changed? Well, the first thing was the war itself. In Central Europe it was financed almost entirely by short-term borrowings because the Germans expected it to last for six weeks, after which they intended to make the French pay for it with reparations as they had done after the Napoleonic Wars, and again after the Franco Prussian War. That initiated a decade of accelerating inflation that ended in the early 1920's with hyperinflation and social, economic, and eventually political, disaster. After the war the French financed the reconstruction of their devastated regions with short-term borrowings because now they expected the Germans to pay with reparations; and that precipitated a serious but not quite disastrous inflation. Fortunately, those experiences seem to have finished reparations as a source of financial calamities. Since then it has generally been the victors who paid reparations to the vanquished.

Second, I believe that the price and financial stability of the nineteenth century was primarily caused by the fact that in those days people recognized that borrowing and lending excessively are risky things to do. Financing productive real investments like tools, factories and railroads that provide their own means of repayment by increasing the efficiency of human efforts was regarded as prudent; but people who borrowed excessively for consumption could easily go broke, and people who financed irresponsible borrowers were likely to suffer serious losses. Nineteenth century literature is replete with illustrations of all of these points.

The Financial Consequences of Keynesianism

The breakdown of this victorian financial morality was caused largely by Keynesianism, but not specifically by Keynes himself. The depression convinced Keynes that the effort and sacrifice that are required to save capital and build a productive economy had largely been accomplished, and that what was needed now was a way of stimulating and maintaining demand for the flood of goods that mass production could provide. Keynes himself was a practical man who made his theories fit the needs of the day, and when World War II came along he recommended financing it with forced savings. Unfortunately, his disciples turned his ideas for curing the depression into a dogma good at all times and in all places; and the result was that for nearly half a century political policy has been biassed against the saver and investor, and in favor of the borrower and spender. We will look at a particularly disastrous consequence of that bias shortly.

Keynesianism reached the peak of its popularity and influence with the New Economics of the Kennedy Administration. Now recessions were not merely to be resisted but totally abolished by a judicious mixture of fiscal policy, which means Government borrowing and spending; and monetary policy, which means relatively easy credit for all the rest of us. This assertion that we would henceforth run the economy steadily at full employment suggested that the risks associated with being in debt had been substantially and permanently reduced, while the risk of inflation had increased. So the best way to protect yourself appeared to be to borrow and buy real things.

The Limits to Debt Formation

It did not occur to the academic economists who proposed the New Economics, nor to the politicians who enacted it, that there are any limits to the amount of debt that can be created. In fact there are several kinds of limits, and the growing instability of our financial system indicates that we are pressing steadily harder against them. But most economists who are not also credit analysts, or otherwise intimately involved with the practical workings of the financial system, still do not understand this.

Specifically, several academic and business economists have protested that my view that the inflation is caused by an excessive rate of debt formation cannot be right because the ratio of total debts outstanding to current-dollar Gross National Product has been stable for many years. Instead of disproving my point, I believe that this observation tends to confirm it. They also argue that we cannot be heading for a financial crisis because the ratio of total debts to nominal incomes is also stable. I believe that that also is wrong.

My view is that any expansion of the amount of credit outstanding creates purchasing power when the borrower spends it and the lender has received a note that he can sell or rediscount if he also wants to spend it before the borrower has repaid, and that the extra purchasing power is ultimately created by the Central Bank in the discharge of its commitment to keep the financial markets liquid. Now, purchasing power gets used for one or both of two things. First, it gets used to purchase the gross national product at current prices; and, if there is any purchasing power left over, that represents an increase in demand that in turn causes an increase in the real gross national product, or in the general price level, or both. Since the current-dollar gross national product consists of the real gross national product times the general price level, a stable relationship between the total amount of debts outstanding and nominal gross national product is just what my views would lead you to expect.

Second, an excessive expansion of credit causes inflation, and that leads lenders to demand higher interest rates to compensate them for the declining purchasing power of their principal. Higher interest rates cause the burden of total debt service charges--that is, interest payments and principal repayments--to rise relative to the incomes from which they have to be paid even though the ratio of debts outstanding to incomes has not changed. Finally, the rising level of interest rates causes the market value of outstanding debt instruments to fall, and after this has gone on long enough, lenders get tired of the constant losses. Eventually, the growing unwillingness of lenders to make long-term loans forces borrowers to finance productive investments, that pay for themselves over time by increasing the productivity of human efforts, with loans that come due in a much shorter time than the payout period. That adds further to the burden of debt service charges upon incomes. These are developments that every bond market participant understands, but that very few academic economists have bothered to think about.

As the inflation progresses these sequences of events lead the economy to become steadily more burdened with debt service requirements and steadily larger parts of it to become doubtful credit risks. Our rapidly growing financial difficulties indicate that we have reached the crisis point with respect to both of these trends, and several more besides. The number of personal and corporate bankruptcies is growing rapidly, and several large companies are basket cases whose creditors have not put them into liquidation mainly because it is not clear that the market value of their assets is sufficient to pay off their debts. The American banking system has lent, not wisely, but too well, to several countries that have no realistic chance of repaying. Those debts are concentrated largely in the twenty-four largest money-center banks--banks that are too large to be permitted to fail. Eventually, the losses are going to have to be borne largely by the American taxpayers.

Finally, my view that any extension of credit creates purchasing power if the lender has received a liquid financial instrument in exchange, implies that the notion that a National Government deficit is not inflationary if it is financed out of genuine savings. This is nonsense. Of course, a deficit is inflationary, because National Government debt instruments are usually the most liquid securities in the financial system. I believe that President Reagan was elected on a wave of revulsion against inflation; and that he could successfully have told us frankly that there are no easy answers left. The administration's attempts to talk the bond market up are simply whistling in the dark. Everyone who has proved his financial acumen by compiling a good record on forecasting the bond market has told us that the President's easy answer, Lafferism, is not plausible, and that the deficits it will produce will keep interest rates inviably high for the foreseeable future. The bond market disruption caused by President Reagan's romance with Lafferism is a tragic and unnecessary complication of an already critical situation. His steadfastness in sticking to a wrong-headed policy is the kind of political mistake that I said at the outset could produce a prolonged slump.

Let me be clear about why I believe that the administration is wrong. I agree with Arthur Laffer that marginal tax rates are too high, and that reducing them would eventually contribute to substantially higher economic growth and productivity. Laffer maintains that most people are sufficiently flexible and responsive that within three years' time we would all be working so much harder and earning so much more that government revenue would actually be higher at the lower tax rates. Therefore, the deficits immediately ahead would be an unimportant transitional phenomenon. I, and probably most of the other influential bond market skeptics, doubt that people are <u>that</u> responsive, and believe that the deficits will be enormous unless expenditure is cut substantially more than the administration has yet proposed.

The Developing Crash in House Prices

However, the most ominous development is the recent softness in house prices. In my book I talked about the tendency for fads in inflation hedges to develop, and to be pushed too far on too much borrowed money so that the next credit crunch produces a crash in their prices. When the inflation started in the early 1960's, the first such fad was the purchase of convertible debentures by sophisticated borrowers who appreciated the fact that there were no margin requirements on them, while the maximum that you could borrow against common stocks was 50%. That game was wrecked by the credit crunch of 1966. The next fad was common stocks, and the over-leveraging that is an inherent characteristic of an inflation hedge was provided mainly by the corporate conglomerators who were borrowing billions in order to buy up the equity in other companies so that their earnings per share would be pushed up in the process. This wholesale retirement of equities in exchange for debt had to mean that the financial condition of the business community as a whole was weakening, and the crunch of 1969 led rapidly to the business financial crisis of 1970. The next fad was the real estate investment trusts in the early 1970's, some of which were bankrupted by the crunch of 1974-75. Since 1975 the most popular inflation hedge has clearly been the family home.

For many years after World War II political policy held down the interest rates that banks had to pay on deposits so that they in turn could make moderate interest-rate, long-term mortgage loans on houses. This constituted an enormous subsidy to home buyers at the expense of savers and depositors, and the value of the subsidy became capitalized in the market prices of houses. Now the depositors are rebelling, and are withdrawing their savings in order to put them into money market funds and other short-term investments that pay market rates of interest. That in turn has caused a financial crisis at the thrift institutions, which can neither earn enough on their assets to pay an interest rate that would enable them to hold on to their deposits, nor to sell their assets for enough to pay off their departing depositors. The growing unwillingness to make long-term, fixed-interest-rate loans has virtually ended the subsidization of home-owners by savings. In my opinion, a crash in house prices is developing.

The main reason why that famous recession, that was always just around the corner during the late 1970's, never happened was that the inflation of house prices not only made homeowners feel wealthy but also gave them a means of financing the other good things in life by withdrawing equity from their homes. Today there is a great risk that that mechanism will go into reverse. Anyone who has bought a house in the last few years and suddenly discovers that he owes more on the mortgage than the house is worth in the market is going to feel poor indeed. If he has financed the purchase "creatively," which means with a short-term, non-amortizing "bullet" mortgage, then his family is likely to be in deep trouble. To the extent that there are any systematic threats of a serious depression, this is one of the most serious.

On the other hand, home ownership has been a political sacred cow since at least the end of World War II, and a crash in house prices accompanied by mass foreclosures will be political poison. I am not sure that even this tough-minded administration will think that it can afford to let that happen without being seen to be trying to do something about it. That something would take the form of making subsidized mortgage credit universally available to home buyers, or at least of providing emergency finance to distressed homeowners. However, a major attempt to support house prices would convince everybody that the political will to let us suffer the withdrawal pains that ending the inflation will inevitably involve does not exist. People would draw the conclusion that the inflation can only worsen, and it would worsen because they would then rush out to borrow more to buy real things in order to protect themselves. There is simply no way to break the inflation without hurting the people who have speculated too heavily, and with too much borrowed money, upon its continuation. The tragedy is that it has been permitted to continue so long that we have all become inflation hedgers, and the family home has become the favorite hedge.

The fate of house prices is absolutely crucial to the future outlook. I said earlier that the main reason for the price and financial stability of the nineteenth century was that borrowing and lending were recognized as risky things to do so that people created debt prudently, and mainly to finance productive real investments. That prudence was finally overcome by the New Economics of the Kennedy Administration, which promised to stabilize the economy and thereby to reduce the risks involved in being in debt. In my opinion, the only thing that is likely to end the overexpansion of credit and get us back to price and financial stability is a crisis that causes enough losses and bankruptcies to scare us all back into lasting prudence with respect to debt formation. A crash in house prices will do that most effectively, but it will be a painful experience.

I believe that the crucial battle, between those who emphasize ending the inflation at the cost of short-term pain and those who prefer to continue to postpone the pain at the risk of longer-term ruin, will be fought over the prices of houses. I also believe that the battle will be joined within this calendar year. Unfortunately, it is still too early to predict how it will come out because the politicians do not yet see the issue in those terms. They want to do something to relieve the financial crisis of the thrift institutions and to stimulate the ailing construction industry, but they have not yet realized that the fundamental question is whether to let a crash in house prices do its salutary job of breaking the inflation psychology or to postpone the crash at the expense of a further inflation. We will just have to wait and see how the battle goes, and I suspect that I will postpone any major policy decisions until we also see how the American people react in the November Congressional elections.

The Implications for the Life Insurance Industry

The outcome will be crucial to the prospects of the life insurance industry in this country. It seems obvious to me that the unique American nonforfeiture laws make it impossible for a company with a large book of individual whole life insurance to adjust to really serious inflation. Our industry is uniquely a creature of the nineteenth century, and the nineteenth century's views about the expectable level of interest rates are deeply embedded in our products. For a hundred and forty years after Alexander Hamilton put our national finances on a sound footing in 1790 long-term interest rates on good security remained within a range of three to six percent, and Granddaddy expected that range to hold indefinitely.

Whenever interest rates go far out of either end of that range untoward things start to happen to the life insurance industry, and during my brief lifetime they have gone far out of both ends of the range. When I was a boy in Hartford during the 1930's, the deep thinkers in the industry feared that the life companies would slowly but surely go broke because they would not be able to earn the two and a half to three percent that they had guaranteed on the reserves. Today, of course, the problem is that interest rates have reached a level at which it makes no financial sense for anybody to leave his policy reserve with us. One thing that we didn't think clearly enough about until the last couple of years is that the non-forfeiture laws make our liabilities either long-term or short-term ones at the policyolders' option. We are potentially exposed to the same liquidity crisis that the thrift industry is already in, and for basically the same reason--a mismatching of asset and liability maturities. The danger of a liquidity crisis in the life insurance industry is real; it is a present danger, and it will remain with us until the inflation is decisively broken.

I suspect that the main thing that has helped us so far is that policyholders know that they can always borrow on their policy, and tend to view it as their line of last resort so that they are reluctant to borrow on it excpet in an emergency. The high interest rate recession that we are now suffering through constitutes just such an emergency for many policyholders. A further intensification of inflation resulting from a bailout of house prices is likely to destroy the money illusion altogether, and cause policyholders to borrow as a defensive measure before their reserve becomes worthless in real terms.

Since the life insurance industry generally cannot cope with really serious inflation, it behooves us to make sure that it does not happen here. We have talked a great deal about taking a decisive stand against inflation, but so far we really have not done much that is very effective. Well, I said earlier that the decisive battle is about to be joined over the prices of houses, and I urge life insurance executives to take the lead in pointing out what is at stake. That is why I regard my own avocation as an author and financial journalist as a natural extension of my professional responsibilities as a life company investment officer.

The final topic that I am going to deal with today is business decision-making as seen from the perspective of an investment decision-maker. It seems clear to me that one of the best ways to make money in marketable investments is to find some means of predicting a reversal of trends that are already capitalized in market prices. Since obvious trends usually are reflected in prices, if you bet on their continuation you are likely to get a more or less standard return on your money when you are right, but to suffer severe losses when you are wrong. On the other hand, if you bet on a reversal of trend you are usually not likely to suffer a serious loss if you are wrong, but you are likely to make a killing if you are right. So for the last twenty years, I have based my career mainly on looking for trend reversals. For example, I did not buy real estate investment trusts in the early 1970's when they were popular, but I did buy the convertible debentures of REITS that had been sponsored by life insurance companies in the late 1970's when the general consensus was that they were headed for bankruptcy. Our latest holding was $5 million (at cost) of the Connecticut General Mortgage and Realty Investments 6% convertible subordinated debentures of 1996, on which we made a profit of $2.8 million in addition to earning a good yield on the bonds while we held them. Compare that with the 16% annual rate of return that the trust's common shares provided over their lifetime as a result of the secular trend of real estate prices.

Now, the reason I am telling you all this is that I believe that similar considerations apply to business decisions in general. For example, I think that there is much intrinsic merit in offering equity products through life company sales forces. But most of us went into that business at the end of the 1960's, which also turned out to be the end of an era for stocks, for reasons that were foreseeable if your thinking is tuned into trend reversals. So far, equity products have generally not been a smashing success at life insurance companies.

By and large, life insurance companies have been trend followers, not trend reversal foreseers. For example, today many life companies are busily restructuring both the liabilities and the assets sides of their business on the assumption that inflation and high interest rates are permanent and irreversible. I have already given you my opinion that a well-established life insurance company with a large book of individual whole life business cannot adjust to serious inflation. True, we could have adjusted if we had foreseen it twenty years ago and gotten legislative relief from the non-forfeiture and policy loan interest rate regulations then. But that would not have been politically possible. Since we cannot adjust, I believe that we would be far better off betting on a trend reversal, and then doing everything that is within our power to ensure that the inflationary trend does reverse.

I know that I gave you essentially the same advice in New Orleans eight years ago, and so far it has turned out to be wrong because the inflationary over-expansion of credit has lasted a good deal longer than I had expected. But, if you are trend-reversal minded, then you will see symptoms of incipient deflation caused by an excessive burden of debts developing all around us. I have already said that I do not believe that the ultimate consequences of the developing crash in house prices are yet foreseeable, but if it turns out that the basic trend is reversing, then the turning of the tide will temporarily produce a major liquidity crisis and very high interest rates as the people who have bet too heavily on continuing inflation with too much borrowed money are brutally squeezed. But thereafter long-term interest rates will decline substantially, and indeed it is altogether possible that long rates on best-quality bonds have already made their peaks. In that case, the day that everybody finishes building up his liquidity reserve to the level he desires will also be the day that the bond market finally bottoms out.