

What (Really) Happened in 1995?

How the Greenspan Fed Screwed Up in the Mid-90s and set the stage for the Greatest Financial Bubble in the History of the World.

by Aaron Krowne

A Sleeper Year

1995 was, by any reasonable accounting, an unremarkable year. Can anyone remember anything significant that happened in 1995? I sure can't.

We were coming up on an election year, but Clinton was pretty much a shoe-in, as the **Bush I** Republican administration had squandered a wartime presidency, ending on a sour economic note. The administration was widely perceived as an economic failure, buoying Clinton's first term by contrast. But other than that, not much happened.

The internet craze hadn't arrived yet, peace seemed possible in the Middle East, oil and gas were reasonably priced, and the previous recession and bad housing market were fading fast in the public's collective memory. The usual metrics of economic health -- GDP, inflation, wages, employment -- all showed improvement; nothing spectacular, but economic indicators pointed to good progress that was due to extend well into the future.

Life was good. Optimism reigned.

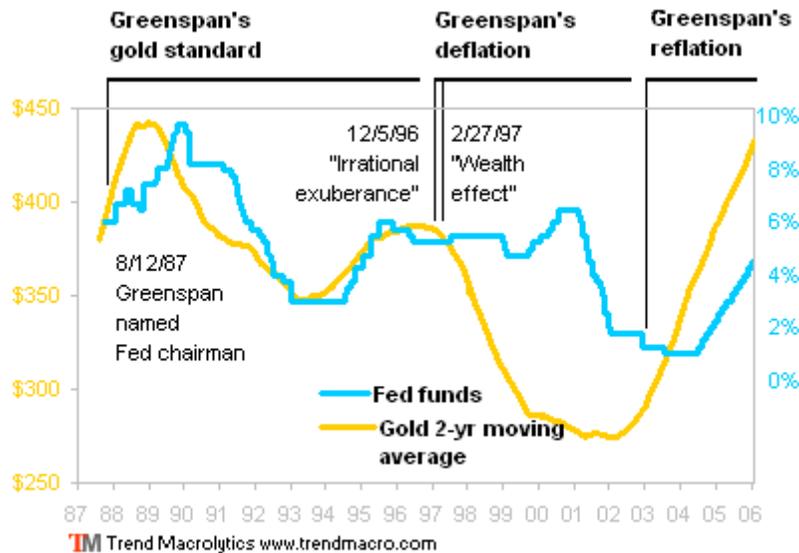
But something strange did happen in 1995, while all of this good livin' was going on.

Good as Gold

I first suspected that something was amiss earlier this year, when I read an interesting article by Don Luskin entitled [Good as Gold](#). The article came on the tail end of the Greenspan-Bernanke transition, while the economic and financial markets zeitgeist was still awash in Greenspan hagiography. To me, Luskin's article was a welcome bucket of well researched, analytical cold water on the over-heated rhetoric about the great job Big Al did in his 18-year tenure.

What Luskin said was that the formula for Greenspan's success, as well as his later failure, was the simple rule that the Fed's behavior should mimic a gold standard, despite the fact that there is no such official standard in our purely fiat-based currency system. Specifically, the Fed under Greenspan was apparently shadowing the price level of gold [Figure 1] in setting interest rates. This was the real reason for Greenspan's excellent, often counter-intuitively good performance until 1995; he had raised rates when the conventional wisdom said to drop them, and vice versa, and had "proven" the conventional wisdom wrong.

Figure 1: Interest rates and the gold price level. Note the behavior change after 1995.



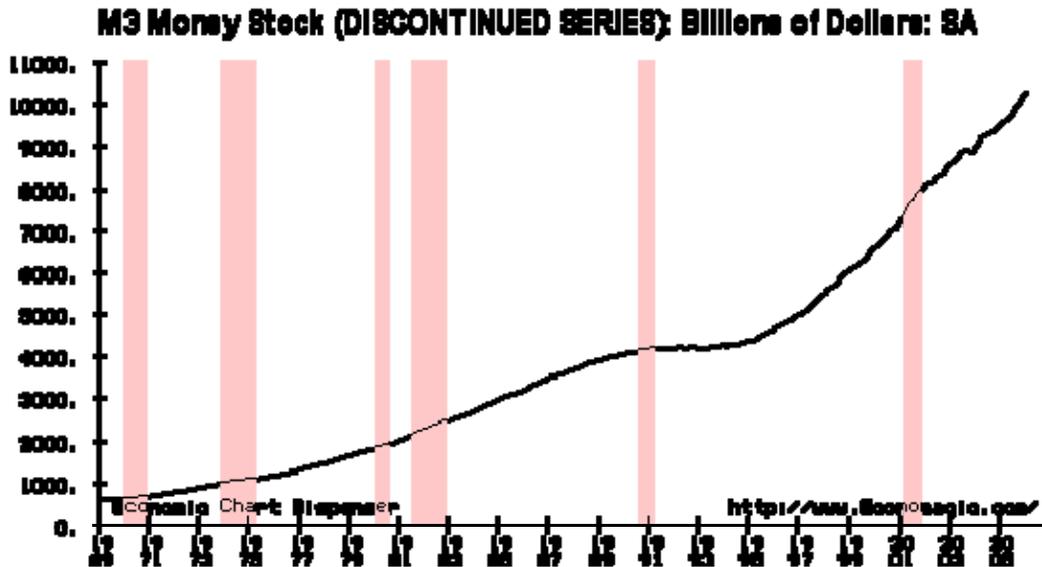
Greenspan's approach was obvious to many gold-watchers, and some commented on it at the time, but things get interesting in 1995 through 1996. In this time frame, Greenspan broke from following the gold price level, raising rates higher and keeping them high for a few years. This is when things started to get out of hand, and the asset bubbles familiar to iTulip readers -- stocks first, then real estate -- began their ascent. Greenspan had stopped following his own formula, and, as Luskin said, "the global economy went haywire."

Clearly Luskin was on to something. But exposing the shift in Greenspan's monetary modus operandi raises more questions than it answers. Why did Greenspan break from his own virtual gold standard formula? Why did an asset bubble follow from an *increase* in interest rates? And, most perplexing, Why did the broad measure of the money supply as measured by M3 begin to soar at that point?

As Luskin points out, the shift occurred precisely during the period where Greenspan began to worry aloud about "irrational exuberance." Clearly Greenspan was trying to preempt some major disaster he foresaw with some "tough love." Was there some risk in his view that was severe enough to cause him to suddenly abandon his proven, tried-and-true formula?

On the last question of M3, one must see it [Figure 2] to believe it. As the historical picture of M3 spanning 1995 shows, M3 expanded like mad starting in 1995.

Figure 2: Historical level of USD broad money supply (M3).



There are clearly two eras here, as iTulip.com pointed out in the [Frankenstein Economy](#): before 1995 to 1996 and after.

After 1995, the broad money supply exploded, and it has never looked back. Asset bubbles and inflation -- mostly one, then the other -- as a consequence are surprising only to those who do not understand basic economic principles of supply, demand, and the psychology of market participants as explained by the school of economics called "Austrian Economics." Unfortunately, most economic and market professionals and commentators do not and consider the Austrian school outdated and unorthodox.

There were other signs that something fundamental changed in 1995. I have for quite some time seen anomolous behavior in economic data beginning in 1995, from various sources. One example is Econbrowser post [M3 or not M3?](#) where Menzie Chinn defends the elimination of M3 reporting by looking at the coupling of M3 to M2 and the GDP. His own charts show that the relationship, and his arguments, break down around and after 1995, and he has no explanation for this. An argument against ending M3 reporting and providing an alternative is available in this excellent [NowAndFutures.com article](#).

So what changed in 1995 that messed up Greenspan's game and distorted the economic data?

The Fed and the Reserve Fraction

Very few people realize that in the early-to-mid 90s there was a core change in the functioning of the Fed and the dollar-zone economy that precipitated the massive rise of M3 and the various associated asset bubbles. This core change was amplified by a couple of other simultaneous trends, which I will also discuss, and caused a number of secondary ills. But first I will explain the central piece of the puzzle. First, a brief background on fractional reserve banking is required.

The banking system in the US is a [fractional reserve](#) central banking system. One can read about this in more detail at the link supplied but the gist is that banks are required to keep a fraction of their assets on hand, deposited safely at the Fed, to act as a "cash cushion" at times when depositors demand their money from the bank as cash. This cash reserve is in proportion to the amount of depositors' money that is loaned out. The proportion of this cash reserve to the total amount loaned out is intended to provide just enough of a buffer to keep the bank solvent and keep things running smoothly in the event a lot of depositors make demands for cash at once, such as during a run on the bank. This fraction, called the *reserve fraction* (or ratio), is typically from 5% to 20% of the amount of money the bank has loaned out. This may seem low, but holding any more cash in reserve than is needed except for outlier cases is considered an uneconomical use of capital by a bank. The cash in reserve is not making money for either the bank or its depositors as loans, so from a day-to-day operations perspective, the less reserves the better. From a longer term risk management perspective, the more the better. Statistically, 5% to 20% reserves is the "right" amount, except in those outlier cases where these levels are either too high because reserves at those levels are at some times constraining the economy's access to credit or, conversely, too low at other times because too many depositors are making a rush to liquidity and demanding their cash.

The reserve fraction, considered as a number that is mutable as a matter of policy, is also one of the most powerful tools a central bank can use to adjust the amount of money available to the economy. It is easy to see why: a reserve requirement of 10% means that banks can lend out ten times the actual money on deposit with the Fed. Even a seemingly small change from, say, 2% to 8% means that 12.5 times the money on deposit can be lent out. For example, \$10bln initially on deposit with a 10% reserve requirement results in approximately \$100bln of money available as loans. If the reserve fraction is reduced from 10% to 8%, then for the same \$10bln cash on deposit there can be approximately \$125bln of money available as loans in the economy. This is an increase in the money supply of around 25% from a reduction of the reserve ratio by 2%.

Austrian Economists have objected to this system for years, pointing out, as Rothbard did in his tract "The Case Against the Fed," (Ludwig von Mises Institute, Auburn, Alabama, June 1994). He argues that a bank using a fractional reserve is by definition an insolvent bank. I agree with this point, but the purpose of this article is not to debate the legitimacy of fractional reserve banking. The objective is to show that what happened starting around 1995 is much worse than even the most blistering theoretical critique predicted. It is a veritable nightmare scenario that we all will have to cope with for years to come.

The key event that happened around 1995 is that the fractional reserve ratio was not only lowered, it was effectively eliminated entirely. You read that right. The net result of changes during that period is that banks are not required to back assets which largely correspond to M3 or "broad money" with cash reserves. As a consequence, banks can effectively create money without limitation. I know that sounds hard to believe, but let's look at the facts.

Imagine if the limit of the amount of money in the banking system was not, as in the

above example, \$125bln, but was effectively infinite for the same \$10bln on deposit. Further, imagine that this change in banks' ability to create loans coincided with new and exotic forms of money being invented via the securitization of debt and extended to entirely new asset classes and made available to a far larger range of people [that previously did not qualify for loans](#). This essentially describes our system today.

If this sounds like a bad idea to you, even if you are not an expert in banking and finance, you can give yourself a gold star for having a good intuition, because this arrangement is not only bad, it is catastrophically bad.

Behind the Curtain

I know this sounds hard to believe but I don't expect you to believe the claims above without clear evidence. For this I refer to the Federal Reserve itself. As you can see in the Fed's [document at this link](#), the changes that led to an effective elimination of reserve requirement actually began in the 1990-1992 era. Likely in response to the recession at that time, the Fed decided to relax reserve fraction requirements in the manner quoted below. The resulting table [Figure 3] is shown here:

Figure 3: The Fed's reserve ratio requirements (current rules, 1992 through 2004 to present).

Reserve requirement ratios, 2004

Category	Reserve requirement
Net transaction accounts	
\$0 to \$6.6 million	0 percent of amount
Over \$6.6 million and up to \$45.4 million	3 percent of amount
Over \$45.4 million	\$1,164,000 plus 10 percent of amount over \$45.4 million
Nonpersonal time deposits	0 percent
Eurocurrency liabilities	0 percent

Predictably, when these changes were made, total cash reserves in the banking system dropped sharply. The economy liquefied nicely, and we came out of the recession

relatively quickly, just not fast enough to save Bush Senior's hide.

It may surprise you to learn that, as the table above reveals, there exists a 0% reserve class of money, and we'll return to this later. For now, let us see what [the Fed had to say](#) about these 1990-1992 changes (*my emphasis*):

Following the passage of the MCA in 1980, reserve requirements were not adjusted for policy purposes for a decade. In December 1990, the required reserve ratio on nonpersonal time deposits was pared from 3 percent to 0 percent, and in April 1992 the 12 percent ratio on transaction deposits was trimmed to 10 percent. These actions were partly *motivated by evidence suggesting that some lenders had adopted a more cautious approach to extending credit*, which was increasing the cost and restricting the availability of credit to some types of borrowers. Apparently banks taking care in extending credit was a scourge that had to be eliminated, and the Fed stepped right in to "fix" the problem by opening the spigots of liquidity. Certainly its a bad sign if your central bank considers prudent lending an ill and acts against it; but something even more insidious happened over the next few years.

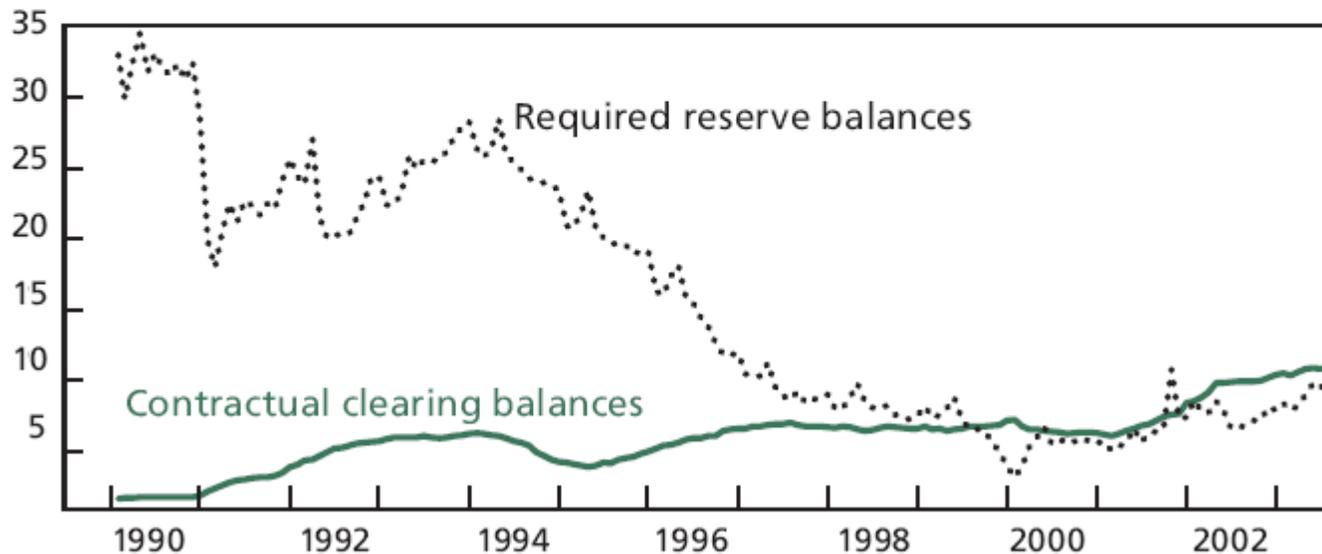
From early 1994 to late 1996, most of the remaining reserve deposits disappeared. This is visible in the following chart [Figure 4], again, from the Fed.

Figure 4: Reserve ratio required deposits through the 90s, and contractual clearing balances.

Chart 3.1

Balances at Federal Reserve Banks, 1990–2004

Monthly



You can see the sharp in reserve balances 1990/1991 as the statutory reserve ratio requirements were lowered. Then reserve balances gradually increased until 1994, presumably, as the economy grew and demand for money with it. But then the trend

dramatically reverses and reserve deposits head downward through 1996. The Fed has an explanation for this on page 44 of the same document (again, *my emphasis*): Although reserve requirement ratios have not been changed since the early 1990s, the level of reserve requirements and required reserve balances has fallen considerably since then *because of the widespread implementation of retail sweep programs by depository institutions*. Under such a program, a depository institution sweeps amounts above a predetermined level from a depositor's checking account into a special-purpose money market deposit account created for the depositor. In this way, *the depository institution shifts funds from an account that is subject to reserve requirements to one that is not and therefore reduces its reserve requirement*. With no change in its vault cash holdings, the depository institution can lower its required reserve balance, on which it earns no interest, and invest the funds formerly held at the Federal Reserve in interest-earning assets. When banks wanted to expand their lending, they found a technical workaround using "retail sweep programs." How innovative! Apparently, the Fed approved of all of this, too, apparently losing sight of the reason we have reserve ratios in the first place.

What was the result of these two changes, the creation of classes of zero and near zero reserve ratio accounts and the ability of banks to move money from accounts with high reserve requirements to accounts with low or now reserve requirement?

A flood of free money.

There was then almost no limit to the promissary notes, in the form of various securities, that could be created by banks -- with fees of various sorts -- interest, originating fees, maintenance fees, penalties, and so on -- collected all along the way and booked as profits. This transformation of banking practices seems to have started small, but really picked up steam by 1996 and 1997, likely due to competitive pressures among banks; those banks that used these methods could easily out-compete those that did not. Even if some banks avoided these practices for a while because they thought them too risky, eventually they were forced to play along or risk losing business to banks competing for the same borrowers.

But wait, as they say on late night TV, there's more!

Apparently, some banks ran into a hitch even within this new liberalized scheme: they couldn't completely avoid the reserve fraction requirement. For reasons that are not discussed in the Fed's document, banks were still required to keep some money in reserve corresponding to these new accounts in order to fully access the Federal Reserve system. Perhaps there were bitter protests behind the scenes, where us mere taxpayers and wage-earners aren't allowed to look, because later the Fed came up with a new change: new requirements for contractual clearing balances, that second line in the Fed's chart above.

"What the heck are contractual clearing balances?" you ask. These are not explained in detail, but the Fed mentions on page 45 of the document why they were implemented: The rise in contractual clearing balances during the 1990s *did not match the decline in required reserve balances*, however, in part because depository institutions apparently

did not need as large a cushion to protect against overnight overdrafts as was once provided by their required reserve balance. In addition, *the ability of some depository institutions to expand their contractual clearing balances was limited by the extent to which they use Federal Reserve priced services.*

What the Fed is saying is that some banks couldn't access the Fed's system because of remaining restrictions in the reserve requirement, and things were running okay anyways, so they simply made new rules that said that only a *smaller* amount of money proportional to the amount being *immediately processed* needed to be held on deposit at a Fed Member bank. This is in contrast to having an amount of real reserves *proportional to the total holdings of the bank.*

With this change to contractual clearing balances, a final barrier was lowered: now banks had full access to the Fed system based on a lax set of reserves rules that effectively omitted any meaningful anchor of loans growth to cash reserves. Considerations of solvency during times of crisis and limiting money creation took a back seat to bank profits and money expansion.

Effects

This certainly goes a long way toward explaining a number of observable phenomenon, such as soaring M3, the stock market bubble, real estate bubble, and surprisingly strong banking and financial sector profits, even through a number of severe challenges to The System, such as the Asian Financial Crisis and 9/11.

Since circa 1995, with reserve requirements effectively eliminated as a policy lever to control the money supply, and interest rates already high, the Fed found itself unable to exercise much influence over the economy. Recall that the reserve fraction has a direct and outsized impact on the money supply, while short term interest rates are set by the Fed via open market manipulations and these only change the money supply at the margins, sufficient only to alter the price of Treasury securities or, equivalently, their yield. This dynamic helps explain why in the last decade some observers have correctly posited that the Fed's control via interest rates has been waning. Thus, Greenspan's preemptively "high" interest rates had little effect on the money supply and the asset bubble that he likely saw coming his way. Or perhaps, worse than doing nothing, these rate hikes seem to have done the opposite of what was had intended.

At the same time Greenspan was getting "medieval" on the market, Japan was going weak at the knees. In an attempt to coax its economy back to life after a half-decade of recession, through 1995 the Bank of Japan dropped interest rates from 1.75% to .5%, an action historically unprecedented, which effectively made that country's interest rate zero.

Well, in a world of very mobile capital between developed countries and no limit to paper money creation in the largest of them, hundreds of billions of dollars exited Japan for US shores, in search of a higher interest rate in a process known as global basis-point arbitrage. To make matters worse, third parties began borrowing in Japan and investing in the US at a higher return, and the yen carry trade was born. Hedge funds would later

greatly multiply the effect of this phenomenon. Like a giant vacuum cleaner, the US had sucked up much of Japan's free capital, likely exacerbating Japan's recession instead of alleviating it. As my good friend Jameson Penn has observed, all that was left in Japan after this setup was "the dumb money," not exactly conducive to a domestic recovery.

This all helps explain the anomaly of the strong dollar of the mid-to-late 90s, and the accelerating death of the US manufacture-for-export sector. It also probably has a lot to do with the soaring fortunes of the ultra-rich, in contrast to the inflation-caused flat-to-declining real wages of most everyone else, as discussed in [The Modern Depression](#). With the observation of the changes made to reserve requirements and rules for qualifying accounts, it looks like we can close the book on questions about those two trends.

But, unfortunately, there's even more. The Fed probably made another serious mistake: manipulating the price of gold as documented by Cheuvreux investment analyst [Paul Mylchreest](#). If the allegations are correct and the Fed led or participated in a global central bank game of "short-selling" gold via "bullion bank" lending, then the Fed was de facto suppressing the price of gold. So what's wrong with that?

Recall that Greenspan was especially successful, as Don Luskiin pointed out, until 1995 because he ran Fed interest rate policy based on the price of gold, on a virtual gold standard. Perhaps he wasn't aware of everything that was going on at the Fed, and some elements at the Fed conspired to drive the gold price down to make the dollar -- and by extension, the Fed -- look better, without his knowledge. Or Greenspan was all too well aware of these manipulations, and this is why he stopped using the gold price to guide interest rate decisions in 1995; the price started to fall then due to these manipulations and he knew the gold price was no longer a reliable, free market indicator of inflation and the money supply.

The upshot of all of this is that the price of gold, even when manipulated, may be acting as a proxy for the neutral rate a good proxy for the *neutral rate*; that is, the imaginary, "natural" rate of interest at which the central bank is neither encouraging nor discouraging growth. Some call this the "equilibrium rate," but don't let any Keynesians hear you say that. By mucking with the price of gold, the Fed would have been adding fuel to the fire by making the fiat interest rate diverge even farther from the neutral rate.

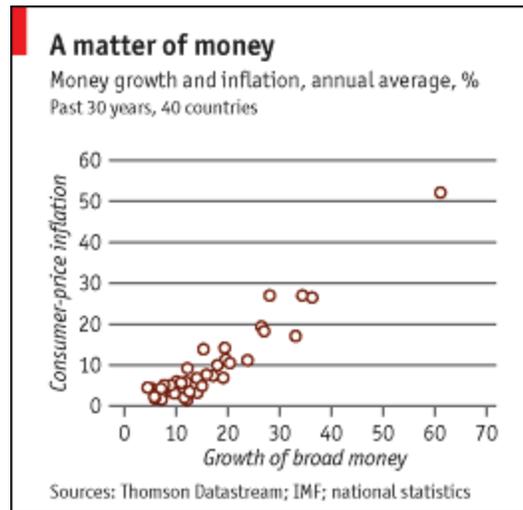
The ultimate result of anomalously high interest rates and economic growth was to draw even more global capital to the US system, as the rest of the world scrambled to take advantage of the "great deal" this presented. If memory serves, a key fuel for the tech bubble was corporate bonds, which must have seemed like a truly amazing deal compared to interest rates on comparable bonds in Japan or the neutral domestic rate.

Conclusion

The specific changes in Fed policy discussed in this article are no less than an abrogation of the Fed's responsibility to manage the money supply of the United States. The Fed's

behavior has been a crime visited upon the general citizenry, and the impact of the resulting asset bubbles and inflation will eventually be recognized as harming the most vulnerable the most severely. And for those that don't believe broad money-supply increases inevitably lead to long-run inflation, The Economist has bad news for you:

Figure 5: Think broad money has nothing to do with inflation? Think again.



The Fed did indeed learn something from the Great Depression: never reduce the money supply drastically, and especially, don't let the inflation rate fall below zero. The chaotic behavior of the global financial system even after this "lesson" was learned suggests to me that this fundamentally command-based economic institution will always find a new way to screw things up. As this article shows, when working, all the Fed does is mimic non-fiat based monetary system, such as the gold standard. When the current fiat money regime is not working, it is doing everything but that. With a nearly infinite number of ways to screw up, and subject to the short-term interests of Wall Street and politicians, but only one way to succeed -- it imitate the gold standard -- suggests to me the Fed is not only not helpful to the economy, but harmful.

I predict that, after a major collapse of the dollar based fiat money system that wrecks the dollar economic zone, the Fed will be replaced with either, 1) a new sound-money currency and competitive banking system, or 2) a super-national American central bank, presiding over a North American "New Dollar Zone," analogous to the Euro Zone currently and the recently proposed [Asian Currency Zone](#). The international community will decide that no one country can manage monetary policy that determines the fate of a significant proportion of global capital and investments. Signs that an economic federation can do better are already visible in [ECB policy](#) of limiting broad money growth to control long-run inflation, a principle the Fed explicitly and ideologically eschews.

After the US economy shrinks to a more globally proportionate level, it will probably be unable to sustain trade or attract investment at close to current levels until it chooses one of the above methods to ensure the soundness of its currency and thus convinces the rest

of the world again that a significant portion of their wealth can be invested safely in the US.

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Biography

Aaron Krowne, M.S., is a computer scientist working at Emory University's Woodruff Library as Head of Digital Library Research. Here he leads the technical development of digital library grant projects, and works for the integration of new technology into library systems. He is the founder and president of PlanetMath.org, a collaborative digital library and virtual community for mathematics.

One of his core areas of practical and theoretical interest is in the economic aspects of commons-based peer production, a "third mode of production" that has recently been recognized alongside markets and firms. He has written a number of articles in this area and has demonstrated practical results via PlanetMath. He is also interested in the relationship of mathematics to the market (especially its limitations). Krowne frequently comments on economics on major blogs and his own web site. He has no formal economic training, and is damn proud of it.

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Footnotes

... gold1 smoothed by something like a 2-year weighted moving average.

Good as Gold

By Donald Luskin
February 3, 2006

SO MANY STORIES HAVE been written this week about Alan Greenspan on the occasion of his retirement as chairman of the Federal Reserve, my saying anything more is like throwing a log on a fire that is already blazing. But I have some views about the Maestro's tenure at the Fed that are quite different than anything else you've probably read — so here goes.

Most of the stories about Greenspan this week have been quite flattering, many crediting him for the era of general prosperity that occurred under his leadership of the Fed. I've noticed that several stories have referred to him as "the greatest central banker who ever lived." At the same time, there have been a fair number of stories that have focused on some of the ways in which he failed.

But I haven't seen a single story that was able to pin down exactly why Greenspan succeeded, or why Greenspan failed. Love him or hate him, everybody seems to be mystified by what moved him to do what he did. It seems everyone has concluded that Greenspan was either operating on some secret formula known only to himself, or on the basis of some ineffable instinct.

It wasn't instinct. It was a formula. When Greenspan followed the formula, markets were stable. When he failed to follow it, markets went into crisis.

The formula wasn't a secret. Greenspan talked about it openly. But it was so simple, nobody who heard it realized what he was hearing.

I can tell you the formula in just a single word of only four letters: gold.

When Greenspan was a young man, he was part of the inner circle of Ayn Rand, the novelist, philosopher, and radical advocate of laissez-faire capitalism. In 1967 he wrote a chapter¹ for "Capitalism: The Unknown Ideal" — a Rand anthology — extolling the virtues of a gold standard:

"...gold and economic freedom are inseparable... the gold standard is an instrument of laissez-faire and... each implies and requires the other.

"...In the absence of the gold standard, there is no way to protect savings from confiscation through inflation."

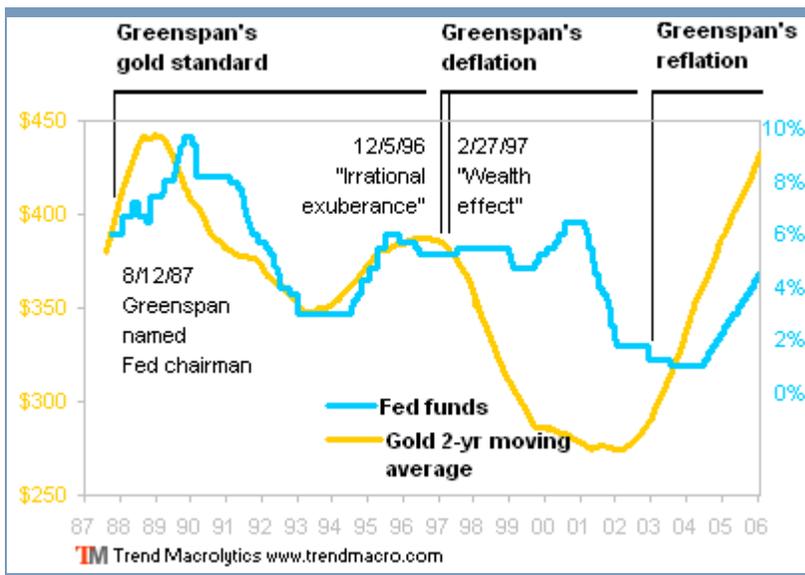
Twenty years later, Greenspan took control of the world's largest manufacturer of paper money — the Fed. The irony couldn't be more complete: There is no institution in the world more completely divorced from the gold standard. And by that point, the profession of economics had completely dismissed gold as an archaic artifact of a quaint

bygone era, calling it (in Keynes's term) a "barbaric relic," and consigning it to the scrap heap of economic history.

But that didn't stop Greenspan. He didn't literally revive the gold standard. But he talked frequently about gold and other commodities as sensitive indicators of inflation risk. When the gold price rose, Greenspan argued that the market was forecasting inflation — which is the decline in the value of the dollar vs. hard assets.

This view had two other friends on the Fed when Greenspan arrived in 1987. Fed Governors Manuel Johnson and Wayne Angell were both avid followers of gold and other commodity prices as inflation indicators.

Take a look at the chart below, covering the entire period of Greenspan's tenure as Fed chairman. The light blue line is the fed-funds rate, the key overnight interbank interest rate determined by Fed policy. The gold line is, of course, gold — the two-year moving average price.



Note that for the first half of Greenspan's tenure, the fed-funds rate closely tracked the moving average gold price. This means, simply, that whenever gold was in an intermediate-term rising trend, Greenspan was raising interest rates to head off the inflation that the gold price was warning about. When gold was in a falling trend, Greenspan lowered interest rates because gold was now warning of deflation.

This "virtual gold standard" helped Greenspan make some great decisions — which all the recent stories about his career have been at an utter loss to explain. For example, from late 1989 to early 1991, inflation was on the rise, with the consumer price index moving from 4% to 5.5%. But Greenspan was cutting interest rates during those years — because the two-year moving average price of gold was falling. And what do you know? Inflation ended up turning around and heading lower.

Greenspan abandoned his golden formula in early 1996, shortly after he gave his famous "irrational exuberance" speech and started worrying about the "wealth effect" created by elevated stock prices. The gold price started to fall in early 1997, and Greenspan responded by raising interest rates, in direct contradiction to his formula.

The result was an era of unprecedented turbulence in financial markets, starting with the Asian debt crisis, and then rolling into the Russian debt crisis, the collapse of Long Term Capital Management, the Nasdaq bubble-and-bust, and finally the monetary deflation that prompted Ben Bernanke in 2002 — when he was a Fed Governor — to talk about dropping money out of helicopters, if necessary, to right the economy.

In his last two years in office, Greenspan made the opposite mistake. With gold screaming higher, the Fed has kept interest rates too low for too long. I guarantee you that the result over the next several years will be a great deal more inflation than anyone expects now — and a lot more market turbulence.

I have no idea what prompted Greenspan to abandon his "virtual gold standard" when it had been such a winning formula for so many years. If Bernanke is reading these words, I invite him to consider this explanation of the Greenspan era at the Fed, and to put Greenspan's formula into service once again.

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Links in this article:

¹<http://www.usagold.com/gildedopinion/Greenspan.html>

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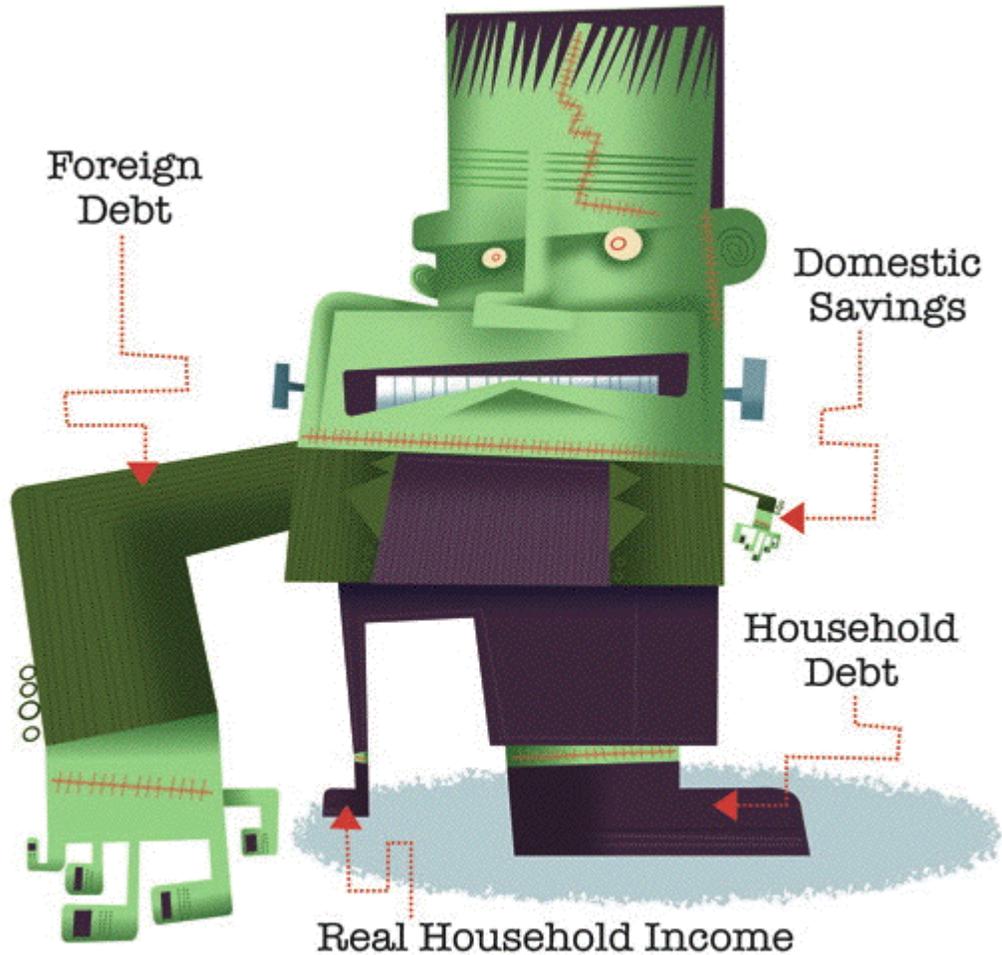
URL for this article:

<http://www.smartmoney.com/aheadofthecurve/index.cfm?story=20060203>

**Frankenstein Economy
Made in U.S.A. 1995**

by Eric Janszen

March 22, 2006



iTulip.com © Daniel Guidera 2006

What does a Mr. U.S. Economy look like? Can't recall, exactly. Haven't seen him in nearly 20 years. As I remember, he was fit, well proportioned, muscular to the point of intimidating. If you are under 30, you've never seen him. But he was there, many years ago, providing a good example, setting the pace, spreading the wealth, kicking ass and taking names. Evidence of his past influence on the average Joe can be seen in old movies, movies with scenes like this.

The average North American, call him Joe, living in the era of Mr. U.S. Economy, walks into a bank to get a loan to fix up his falling apart house, rather than add

another thousand square feet to make room for the Made in China, Bose branded Home Entertainment center. A dour looking loan officer, call him Ed Noway, sits behind a laminate faux walnut desk facing the nervous applicant. Prominently displayed on the edge of Ed's desk, a brass nameplate on a wood block that reads "Ed Noway, Loan Officer." While Joe fidgets, Ed pours over a pile of paperwork that Joe dutifully spent until midnight filling out with his wife the night before. They did not cuddle afterwards. She's not sure Joe can close the loan with Ed. Joe's not sure he wants the extra hours he'll have to work to make the additional payments.

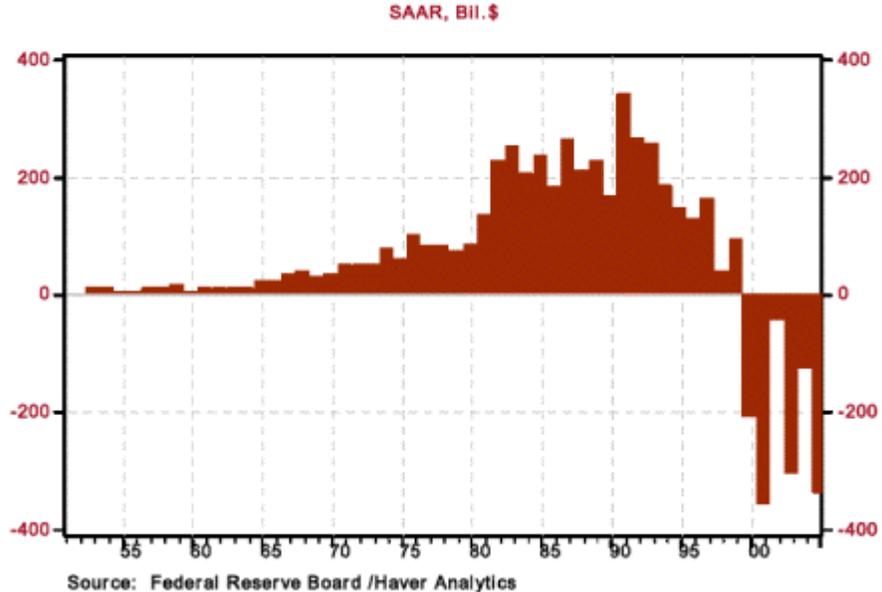
Ed finally looks up to grill Joe about his employment and credit history, his assets, his attitude about saving. Ed wants to know if Joe is likely to pay the loan back or not. He, Ed, the loan officer, is responsible for the decision. He doesn't want the bank, nor he as its representative, left holding the bag if Joe punts on the loan. Ed will look bad. He might even lose his job. Ed's ass is on the line. So is Joe's.

Here we have the basis for a sound business transaction. But those days are over. The Frankenstein Economy is here.

Today, Joe can borrow against the theoretical future value of his home and the statistical probability that he'll have the future income stream needed to pay it back. There is no Ed at the bank to know or care whether Joe can actually pay back a loan, or if he actually uses the money to make home repairs or buy eight tons of snow to build a ski slope in his back yard to snow board in August. The connection between Joe and his newly minted debt today is a collateralized debt obligation, part of a securitized interest in a pool of non-mortgage assets, and Joe's default risk is perhaps sold in a portfolio of private label subordinate pieces to a pension fund of a municipality in Germany. Who's the counterparty of the credit derivative that's hedging Joe's default risk, you ask? No you didn't. You don't know what the heck I'm talking about. Don't feel bad. Ninety nine percent of the lenders selling these loans don't either. They just know the money is there to lend and they'd better lend it or their competition will.

Over the past 15 years or so, the Fed replaced Mr. U.S. Economy in a free market ideology based fit of deregulation. Mr. U.S. Economy, whoever he was, is no more. In his place, the Frankenstein Economy. The Fed may have had had the best of intentions when making the Frankenstein Economy, but let's see what he's left behind as he's stomped across the North American economic landscape.

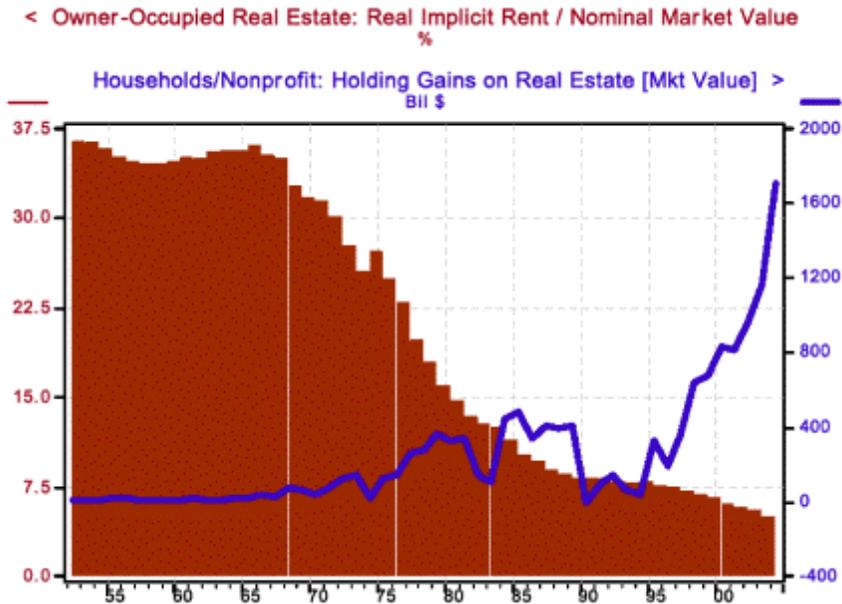
Households: Net Acquisition of Financial Assets minus Net Increase in Liabilities



Since at least 1950, before Mr. U.S. Economy was put in cryogenic storage and replaced by the Frankenstein Economy, U.S. households purchased financial assets at an increasingly higher rate than they took on liabilities. They did this, except during recessions, until 1990. Then they started to take on more and more liabilities. In 1995, when the Frankenstein Economy appeared on the scene, a 50 year trend started to turn upside down. Net acquisition of financial assets not only stopped growing but turned negative, as the chart above from Paul Kasriel at [Northern Trust](#) shows.

Large and sudden reversals in long-term trends imply future regressions to the mean; the Frankenstein Economy has made a mess of the markets. The folks at the Fed, of course, think the Frankenstein Economy is doing great! Before we go into that, let's view a few more pictures of the monster's gruesome trail.

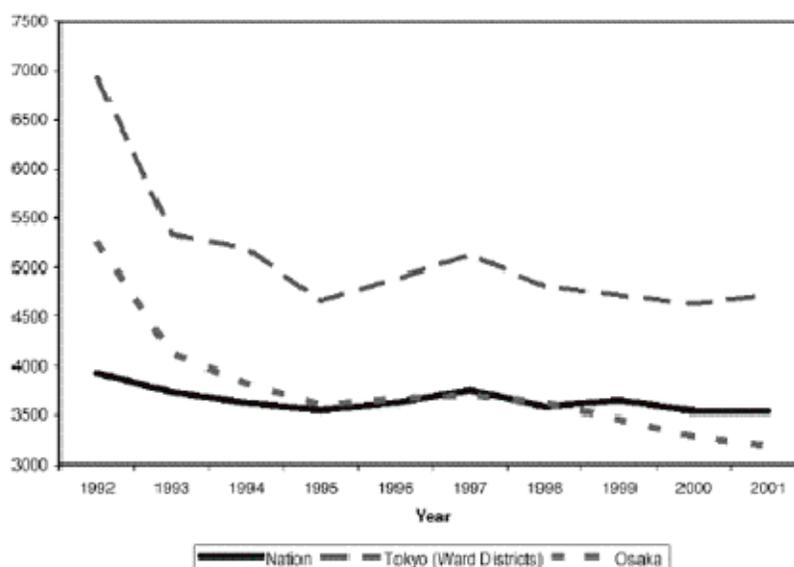
Also starting in 1995 -- not by coincidence, in our view -- under the influence of the Frankenstein Economy, North Americans developed religious expectations about the value of their homes. While the real (non-inflation adjusted) value of their homes have remained flat for over 100 years, short term nominal market value skyrocketed. A few voices of reason were dismissed as egghead mumbo jumbo, such as Yale professor Robert Shiller, whose research concludes that except for two periods — the early 1940s and the late 1990s — when adjusted for inflation, home prices in the U.S. ["have been mostly flat or declining."](#)



Justifications for the post 1995 real estate bubble shown in the chart above, again thanks Paul Kasriel at Northern Trust, are legion. The favorite: land scarcity. Little country, the U.S.A. One of the hottest real estate markets? Las Vegas. (Tip for Vegas real estate buyers: land scarcity and thus land value in the desert can be repealed as quickly as the land use laws that created it.)

What about a nation that has an actual shortage of land relative to population, such as Japan. How did the housing bubble turn out there? Theirs, much like ours, started right after their stock market bubble burst, but unlike ours conked out a couple years later.

Condominium Prices For Nation, Tokyo, and Osaka (1992-2001)

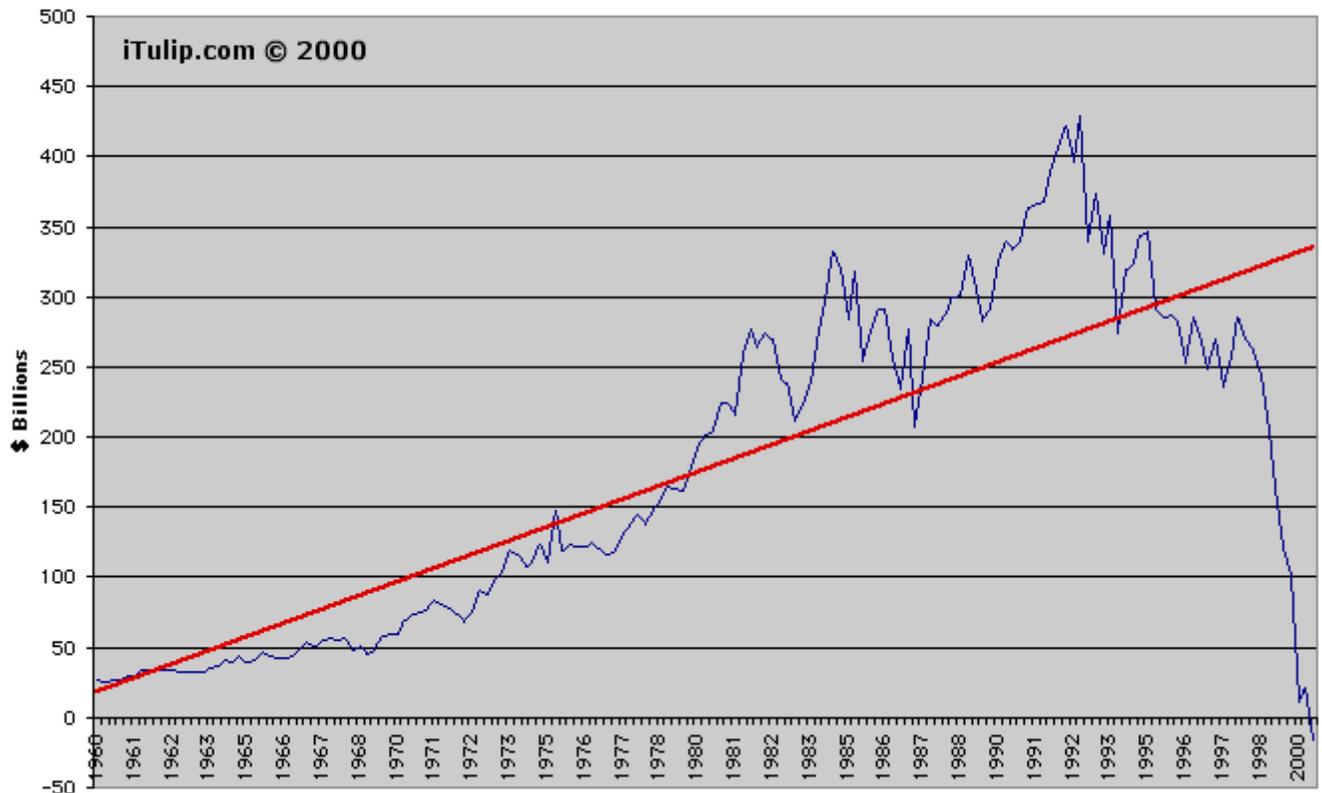


The chart above, compliments of a San Francisco Fed's [Asset Price Declines and Real Estate Market Illiquidity: Evidence from Japanese Land Values](#) January 2005. They found that if you bought a condo in Japan's version of NYC in 1992, ten years later the market valued it at around 80% of what you paid.

Ten years of flat prices. Maybe this is the report that has given the Fed the confidence to issue the calming view repeatedly expressed in public that housing prices will not "collapse" after the U.S. boom ends but merely "flatten out."

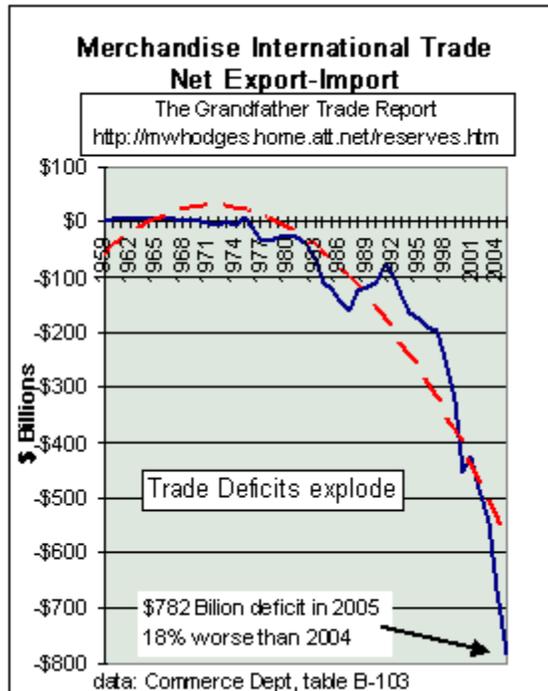
Say you're 50 years old. Are the optimists saying that -- best case -- a house may be worth nominally (price adjusted for inflation) in 2016, when you are 60, what you paid for it in 2006? Let's hope they're right and prices don't [regress to the mean](#).

Personal Saving Quarterly U.S. 1960 - 2000



Back to our hero, the Frankenstein Economy. Just as he's convinced North American's of the inevitability of home price appreciation, he has convinced them that they do not need to save. He's been highly influential on this point, as the chart above from iTulip.com's previous life shows: the U.S. savings rate from 1960 to 2000. Once again, we note a distinct change in trend in the year 1995.

Of all the outlandish features of the Frankenstein Economy, his most outstanding is his enormous head relative to his brain. When he's thinking at all, he imagines that the world outside the USA finds him as attractive as his previous incarnation, Mr. U.S. Economy. Like an aging Hollywood actor who's suffered one plastic surgery after another in the hope that he can keep getting the star role of the 30-something action hero even though he's pushing sixty, he expects to keep getting paid a movie star salary premium. So far the ruse seems to be working. He's taking in \$2 billion in foreign investments every day, enough to fund the country's massive budget and trade deficits. But mostly it's Asian central banks that are paying; private and institutional investors baled years ago. The Asian central banks only do it to keep the U.S. consumer borrowing and their exports flowing until they can find a better customer.



His trade deficits are shown in the chart above selected from the highly recommended site [Grandfather Economic Report](http://mwhodges.home.att.net/reserves.htm). As you can see, Economic Frankenstein started to work his magic around 1995 as North Americans began to buy a lot more stuff from overseas than they sold. To see exactly how North Americans paid for all this, see our Chart of the Week, [Purchases of U.S. Financial Assets](#).

The crux of our investigation here at iTulip.com going forward is to understand what led to an apparent abrupt change in many long-term economic trends that coincided with the creation of the Frankenstein Economy around 1995. We expect that if we understand that, we'll understand how, why and when these trends are likely to reverse and the impact that will have on our readers. Actually, we believe we already know, but learned from our previous 1998 iTulip.com experience that you can't just give up the answer -- no one will believe us. Readers have to develop an understanding on their own.

In the end, Dr. Frankenstein's monster does not find peace until his creator dies. The monster then departs for the northernmost ice to die.

In the case of the Frankenstein Economy, the sooner the better.

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