BOB HOYE

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Market Violence and Popular Theories

There is nothing like a violent reversal in the financial markets to impartially adjudicate the validity of popular theories. As with so many great speculations the reversal from exuberance to dismay has been at the hands of margin clerks. Whose job description is practical – ***"get the accounts in line!"***. Which contrasts with that of today's reckless central bankers – ***"get the accounts leveraged up"***.

And as usual, speculative furies exhaust themselves. Then Mister Margin overwhelms central bankers and popular financial theories. Prompting "remedies".

Indeed, this dramatic plunge has prompted another massive "rescue" plan, which may not be effective All six of the great financial bubbles since the first in 1720 reached a sensational climax and were immediately accompanied by a sharp business contraction.

And remedies have been around for a long time.

A boom completed in 1618 and consequent hardships inspired Edward Misselden in 1622 to publish a remedy. Essentially more credit from somewhere would make a credit contraction go away. Under similar conditions in the 1930s, Keynes had similar personal revelations. As had John Law in 1706 and Henry Thornton in 1802. In the great bubble year of 1873, the esteemed editor of *The Economist,* Walter Bagehot theorized that a contraction was a form of ***"neuralgia"*** that could be eased by ***"liberal discounting"*** by the Bank of England.

That post-bubble contraction started as speculation collapsed. With poor business conditions into 1884, Brit economists began calling it the "Great Depression". Which lasted until 1895. Ironically, as late as 1939, Rostow was still theorizing about how it could have been relieved. Then the establishment discovered another "Great Depression" to remedy.

The media heralded today's remedy with "***Trump Signs $2 Trillion Rescue Plan"***. However, Pulitzer-winner H.J. Haskell's *The New Deal in Old Rome* reviews many such remedies from 2000 years ago. Published in 1939, the book is available in the Mises website.

Additionally, there is a delightfully instructive account of remedies following the 1618 Crash. *Alderman Cockayne's Project* by Astrid Fires reviews the usual mercantilist notions, including the presentation to King James. Fortunately, Archbishop Abbot noted the threat if the "make work" concept failed.

> During one of the meetings King James told the Alderman***, "in could bloud before ye Council Table yet if he had been abused him by wrong information his 4 quarters would pay for it".*** Meaning hanged, drawn and quartered, the Abbot wrote that with this***, "ye poore Alderman stood infinitely amazed".***

Economic advisors being held accountable is still appealing.

Understandably, London merchants condemned it as "Tyrannical Duncery". Within the natural contraction the scheme collapsed.

The global commodity boom with Napoleon's belligerence completed in 1816 and was followed by a contraction. Which in the U.S. prompted remedies. These were reviewed in Rothbard's *The Panic of 1819*:

> ***"The depression gave rise to suggestions for internal improvements as a partial remedy…These projects would alleviate the depression by giving work to the unemployed, invigorating enterprise in the community, and quickening the circulation of money."***

Even then there were practical views.

> ***"Many citizens objected to all these legislative remedies on the grounds of laissez-faire principle."*** Furthermore, as Rothbard concluded real remedy could only come through ***"liquidation of unsound conditions and a return to the fundamental virtues of 'industry and economy'."***

As recorded in the senior economy, the long contraction did not start until the financial bubble completed in 1825. Essentially, there has been two ways of determining the completion of a long contraction. The low in long-dated interest rates and in commodity prices. That contraction ended in the mid-1840s.

The next expansion ended with the 1873 Bubble. When Bagehot boasted that contractions could be prevented by liberal discounting by the central bank.

Also, in 1873, the *New York Herald* editorialized that nothing could go wrong. Not having a central bank constrained by gold, Treasury Secretary Boutwell was considered as proof against contraction. He could issue literally unlimited amounts of liquidity.

That bear market ran for five years and the recession for six. All within a contraction that did not complete until 1895.

Ironically, the Street has always believed in an agency that would keep the party going. In 1873 in England, it was having a central bank. At the same time in New York it was *not* having a central bank.

Going into the climax of 1929, John Moody condemned the old system and celebrated the Federal Reserve System as "new" and "scientific". Nothing could go wrong.

Obviously caught up in the putative powers of the Fed, in December 2007 Harvard's Greg Mankiw celebrated that with its "dream team" of economists. Nothing could go wrong.

Moving ahead to Davos in January, Ray Dalio the CIO at the huge Bridgewater fund declared that ***"Cash is trash"*** and warned investors not to go from equities to dollars.

Since at least Roman Times, history records that policymakers mainly respond to major financial conditions. These have been inflationary expansions and deflationary contractions. Cicero and Tacitus are worth reading.

The theory that some special agency can provide credit from somewhere and that it will make a credit contraction go away has been well documented since the 1618 Crash. This could be called retroactive wishful thinking.

Proactive wishful thinking has been the notion that the Fed has the genius that a perfectly timed "Fed-Cut" will keep a boom going. This seems to be part of the original promotion of the Fed. Then the establishment understood that a financial crisis preceded a recession. And with the Fed as "lender of last resort", recessions would be prevented.

According to the NBER, there has been 18 recessions since the Fed opened its doors in 1914.

Quite simply, this theory does not work.

Why?

Short-dated market rates of interest go up in a boom and down in the contraction. That's for T-Bills and since the 1873 example, the senior central bank administered rate has followed changes in market rates. During that bear market, the BoE lowered its discount rate from 9.0% to 2.0%.

Contrary to theory, the more severe the crisis, the faster rates plunge.

The US 3-Month Bill rate increased to May 1929 and in turning down signaled that the best for that boom was completing. The first "Fed-Cut" was on November 1st, a five-month lag. The Bill Rate plunged to 0.08%.

In 2007, Bill Rates increased into February and turned down. The first "Fed- Cut" was announced in September, 7 months later.

On the most recent example, the Bill Rate increased to March 2019 and the Fed made the first cut on August 1st. Some five months later and the Bill Rate has plunged to zero, occurring during a shocking credit crisis. Last summer, Wall Street celebrated the pending "Fed-Cut".

While this is a review of popular theories and errors, not all participants were enthralled by convention.

The *Banker's Magazine* of May 1873 advised: ***"We caution our country bankers to keep a healthy reserve at home, and not to trust too large a fund in Wall Street on 'call'."***

Popular theories seem to attend the violence that completes great financial bubbles. On the way up, whatever agency is at hand will keep the boom going. On the way to dismay and recrimination, there has been a moment when the establishment is convinced that the same agency can prevent a contraction.

Booms, busts and attendant popular theories can be documented back to Rome at its best. It is a record of hope followed by chagrin.

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> ***"If some lose their whole fortunes, they will drag many more down with them . . . believe me that the whole system of credit and finance which is carried on here at Rome in the Forum, is inextricably bound up with the revenues of the Asiatic province. If Those revenues are destroyed, our whole system of credit will come down with a crash."***
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> \- Cicero, 66 B.C.
> (Translation by W.W. Fowler, 1909)

During the time of the Emperor Tiberius, 33AD - from Tacitus' Annals:

https://www.dropbox.com/s/bblipv7noo1qvad/200401%20Tacitus%20Annals%20.pdf?dl=0