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They Treat Us as Imbeciles

PEOPLE LIKE Alan Greenspan treat us as if we are idiots. For 18 years, he was the world's most influential central banker. Financiers hung on his every word. Journalists deciphered his opaque statements for the masses. Did he mean this, that or the other? The Chairman of America's Federal Reserve was the epicentre of the global financial markets. One word from him was enough to move those markets.

His job, they told us, was to keep the world's leading economy on an even keel. And the job of the moneymen was to respond to the opportunities as the Fed moved interests rates up or down.

While the US economy was growing, all was well. Greenspan was elevated, along with the central bankers of Europe, to guru status, as one economics editor put it.[1] Then the bottom fell out of the money markets.

In the nick of time, before America's banks seized up, he made his grand exit. The great unravelling began in 2006, just as Greenspan was packing his bags in Washington. He retired, and set off on the lecture circuit where his speeches earned him hundreds of thousands of dollars a throw. In 2007, Greenspan penned his self-certified exoneration, called *The Age of Turbulence*. And then, as Britain crashed into its first run on a bank since Queen Victoria, Greenspan insisted that he had no control over prices in the housing market, where the crisis had originated. If there was a bubble – he was not to blame.

Were Greenspan's hands clean? He insisted that he could not be held responsible for the bubble which drove millions of families into debts they could not afford.

1 Elliott (2008a).

"If central bankers could alter asset prices we should. But the evidence very strongly suggests that we can't," he proclaimed to *The Sunday Times*. "I don't know of any examples of a central bank successfully controlling asset prices."[2]

This was the man who drove America's interest rates down to 1%. And as any property hustler knows, when interest rates go down, house prices go up. Simple arithmetic (see Box 7:I).

So why did the world's financial journalists take Greenspan's briefings on trust, when he assured them that America was not locked into a classic property bubble? Reporters could be forgiven for thinking that Greenspan knew what he was talking about. After all, the best economic brains in the leading universities of America were at his disposal. Those economists made a handsome living instructing new generations on how to fine-tune the economy. Some of them reach mass audiences through their columns in the weekly journals. And so, reassured, people carried on buying houses at ever-increasing prices.

2 Stelzer (2008).

Box 7:1

Inflating the Bubble

The value of land as an asset is linked to interest rates. If the cost of money is 10%, land's value would tend to be a multiple of 10 times the rent it generates. So if rent is £10 a square metre, and the interest rate is 10%, the sale value of land is £100 per square metre.

If the US Fed or the Bank of England slashed interest rates in half to 5%, the value of land would tend to double. If rents are £10, someone selling his land would want a multiple of 20 times that rental income. Therefore, the site would tend to sell for around £200.

From this simple illustration, it is clear that when central bankers force interest rates up or down, they automatically trigger changes in property values. It is disingenuous, therefore, for them to disclaim responsibility for brewing a bubble, as Alan Greenspan did in his Financial Times article on April 7, 2008 (headlined: "The Fed is blameless on the property bubble").

Greenspan now places all the blame on investment bankers. But when the US Fed under his chairmanship slashed interest rates to 1%, there could be one outcome only: the value of real estate would explode. Likewise, when the Fed changed course and raised interest rates, the influence would be in the reverse direction – downward pressure on land prices.

In Washington, Greenspan had the finest mathematicians and econometricians working for him. Were they not stress-testing their model of the markets in action? Didn't they pour out the statistics to keep the politicians informed? Didn't they have their fingers on the economic pulse of Main Street USA?

Well, yes, Greenspan would agree, as Chairman of the Fed he did have that expert support. Access to mountains of research gave credence to the statements he submitted to Congress. Except there was one little problem with his economics. His "model" could only run on straight tramlines. There was no mechanism for sharp turns to the left or the right, because ... the model was just not programmed for the possibility of turning.

As the global markets crashed around him, Alan Greenspan confessed to *The Financial Times*:

> The models never forecast recession, because the parameters are dominated by what happens in normal times when the economy is growing.[3]

De-code what this means.

3 Guha (2008b).

When the economy is running smoothly, Greenspan could confidently pronounce, with authority, that it was running on a straight course – onwards and upwards. But when growth reaches the end of the road, he had no way of knowing that the economy was going to turn – and drop.

Economically speaking, Alan Greenspan was blind.

Who needs to be told that the economy is healthy? We can see that for ourselves by the volume of trade in our shops, and from the job advertisements in our local newspapers. The worthwhile information is news of when changes are going to occur, with as much notice as possible please, so that we can act prudently to avoid losing our job or our home. But the Chairman did not have the tools that would flash the amber warning signal or the red alarm.

During his tenure at the helm of the US economy Alan Greenspan did not warn us that he was steering with a wheel that was locked into a single trajectory – forwards. All the windows were blacked out, depriving him of a 360^{o} vision of the landscape through which the economic vehicle was careering on high-octane debt.

That engine spluttered to a halt because the debt mountain was contaminated with a toxic mixture that guaranteed an implosion when it overheated. But the people who needed to prepare for the crisis were not given any warning. Property bubbles, Greenspan repeatedly claimed, were not something he could identify in advance. So no warning was issued. The "guru" did not have a clue what was going to happen. Instead, he continued to pontificate about the health of the economy.

We were being treated as if we were imbeciles.

"Effectively Pretty Useless"

GREENSPAN WAS NOT alone in manipulating our minds. Professors of economics conspire with practitioners in the money markets to create the illusion that they know what they are doing. And while the going is good – they *do* know what they are doing! Except, it turns out, when the economy is about to go out of control. And like all bad workmen, that's when they blame their tools!

The confessions are wrapped up to

deceive. Mountains of statistics distract from the frank comment that is occasionally slipped into speeches. That's what happened when Sir Charles Goodhart stood up to speak about "M3 Growth: The Hidden Threat to the Bank of England's Inflation Goal". (M3 is the broadest definition of money, used by economists to estimate the entire supply of money in circulation. It includes the hard currency in your pocket and purse, the money you have on deposit in savings accounts, and the full range of financial assets created by banks and used *as if* it was currency.)

Now, if there was ever a reassuring figure straight out of the top echelons of the British Establishment, Sir Charles was surely it. Behind him were 17 years of distinguished service at monetary adviser to the Bank of England. So high in esteem was he held by Her Majesty's Treasury that, in 1997, he was appointed one of the founding members to the Bank of England's Monetary Policy Committee. He and his colleagues were granted the power to set the nation's interest rates. The price we paid for our mortgages was in the hands of such well tutored experts on the money machine. From the Bank of England, Sir Charles – awarded a CBE (Commander of the British Empire) for his loyal services – switched to the London School of Economics as Professor of Banking and Finance. Here was a man in whom we could entrust the tender minds of the next generation of economists.

And so, when the professor offered to reveal the "hidden threat" to the Bank of England's mission (the control of inflation), we needed to listen carefully for the insights. I sat through that lecture, as statistics and equations poured out of the professor's PowerPoint presentation.

But the vital message was not in the statistics. Of greater significance was a little phrase that the professor let slip. Standard forecasting models, he confessed, are "effectively pretty useless" under certain circumstances.

Britain's savers had recently been treated to the spectacle of those circumstances. People whose life savings were entrusted to the Northern Rock were panicked into queuing outside the bank's branches to withdraw their money, as fear spread that the bank was in trouble.

Assessing the meaning of money – the money bundled up in the statistics by experts like Sir Charles – was, he admitted, frequently a difficult task.[4]

For all our future sakes, we had better get a grip on the meaning of money.

Spivs and Satnavs

SATNAVS – satellite navigation systems – are now everyday technology for motorists. A voice in the little box on the dashboard will guide you to anywhere on the map, thanks to links to the satellites that orbit earth.

But what if a salesman offered you a satnav that would only guide you in one direction – straight ahead? No sharp turns to the left or right. You would dismiss him as a fraudster. Long ago, we learnt that the world is not flat. No journey can be completed without sharp turns!

And yet, we were persuaded to accept the wisdom of economic models that predict trends in one direction only – forward. These models cost millions to maintain. They require the collection of vast amounts

4 Goodhart (2007).

of data. But all we get as taxpayers is the forecast that the economy is proceeding in a straight line. Yes, there is a slight gradient. The model is programmed around the historical annual average growth rate of around 2.5%.

But we also know that the economy is liable to sharp turns – downwards. Yet the world's leading central bankers use econometric satnavs that cannot alert us to hazards looming on the economic landscape. In the real world, people whose lives are played out near the margins of existence need warnings of the threatened changes. They need to know whether they might lose their jobs. They need to know whether the risks of borrowing money are increasing. But the "work-horse models" used by the Bank of England, for example, cannot offer such guidance. According to Rachel Lomax, the Bank's then Deputy Governor and head of monetary policy: "When it comes to quantifying the effect of changes in credit conditions, our work-horse economic models still cannot help us very much."[5]

5 Lomax (2008).

The Bank of England is charged with fine-tuning Britain's money supply – the mechanism that provides the fluid that courses through the arteries of industry and commerce. So what equations are missing from that "work-horse", I asked Lomax? Her reply was alarming. "The important ones are the ones that really tell us what the impact of the financial transmission mechanism is."

Lomax's admission raises questions about the fundamental features of money. According to economic textbooks, money is merely a means of exchange which facilitates trade between consenting adults. If there is a problem with the money supply, therefore, there must be a tension between the theory and the practice. The Lomax admission – that the Bank of England does not have a grip of money as a "financial transmission mechanism" – tells us that this, the oldest central bank in the world, is not a reliable guardian of the nation's money supply (see Box 7:II). It seems that our economic vehicle is not only lumbered with a satnav that fails to give full directions – it doesn't even have an effective set of gears capable of regulating speed. And

Box 7:II

Money: The Transmission Mechanism

In normal commercial transactions, money is benign. It helps people to transact their goods or services. Stresses surface, however, when banks expand credit on the back of the rising price of land. They use land as collateral. In doing so, they lock the money system into the classic pyramid selling scam made infamous by Charles Ponzi.

In 1903, Ponzi lured investors with the promise of high returns. He borrowed other people's money to pay successive waves of investors. They all thought they were on to a good thing until, one day, someone realised that value was not actually being created. It was impossible for all the investors to get rich: the last in to the scheme would be the biggest loser.

When bankers fabricate money (credit) to lend to a borrower whose land is rising in value, they emulate Mr. Ponzi. Why? Because the escalating value of land is nothing more than an increase in debt. Value is not being added to the wealth of ➤

Box 7:II (contd)

the nation. Bankers won't acknowledge this, because self-esteem requires them to promote the idea that their operations are respectable. In fact, it is a financial scam on a scale that dwarfs anything that Charles Ponzi could have imagined in his wildest dreams.

All is well, while the debt-based price of real estate is rising. Banks are willing to increase credit. The buy-to-let mania in Britain was one vehicle that allowed banks to expand the circulating credit. A self-feeding process is triggered in which borrowers go deeper into debt to pay for rising property prices, which justify further increases in debt and so on in a vicious inflation of the bubble. In the end, that bubble must burst. Property prices collapse and the "money" disappears into the ether.

Why don't economists in the Bank of England understand the impact that this "financial transmission mechanism" has on the economy? There is no mystery about the mechanics of the process. All they need do is read the history of Charles Ponzi on Wikipedia.

yet, we are supposed to trust the people whose hands are on the steering wheel and the gear lever.

Why do we place our fate in the hands of these people (apart from Ms. Lomax's: she decided to retire in June 2008, so our fate is no longer in her hands)? Why do we believe that the Bank of England can be trusted with our financial futures? Before jumping to a verdict, we need more evidence. Could it be that the economic future is unknowable to people like Alan Greenspan and Sir Charles?

Well, no, that is not an acceptable excuse.

The future is knowable. I could forecast that future, and I did.

Understanding the Business Cycle

AFTER WITNESSING the grief of people who lost their jobs during the chaos of the early 1970s, I set out in search of root causes. Why did recessions recur? Could they be anticipated? Could anything be done to smooth the trends in investment, employment, production?

I did not have a doctorate in algebraic

equations. I was a Fleet Street reporter looking for the facts. I assembled the historical data by using as my guide the three-factor model constructed by the classical economists. We *labour*; we use man-made *capital* to aid us to produce our income, and there is *land* on which to place our homes and factories. This classical economic framework seemed robust to me. I knew that post-classical economists who came along at the beginning of the 20th century abandoned land in favour of working with just labour and capital as the keys to producing wealth. For practical purposes, land was erased from their working models of the economy.

More will be said about the difference in these two ways of looking at how the economy works as our story unfolds. It is sufficient, here, to note that the classical concepts enabled me to discover that the industrial economy *did* conform to a regular pattern of booms and busts. The cyclical trends are inscribed in the history books. Read that evidence, link it to today's reports in the financial press, and it is possible to identify the point we have reached in the current cycle.

And so, in 1983, I offered a prediction. In *The Power in the Land*, I explained that the capitalist economy was shaped by cycles that lasted for an average of 18 years. The previous bust was in 1974. Adding 18 to 1974 did not require the skills of a mathematician. The year 1992 would be one of economic grief. I warned that

> … the Western economy will recover and enjoy 18 years of growth before tail-spinning into yet another deep-seated depression of even greater magnitude than the structural recession which began in 1974.[6]

I was correct.

Other economies around the world also sank into recession. But was my prediction no more than a stroke of luck?

I had to wait another 18 years for the theory to be tested again. The global economy was my laboratory. Instead of turning to property speculation to make a lot of money, I let the dust settle on the events of 1992 and published my next warning in 1997.

By adding 18 to 1992, I came up with 2010. Refining my diagnosis, I predicted

6 Harrison (1983: 302).

when the boom in house prices would peak. I said:

> By 2007 Britain and most of the other industrially advanced economies will be in the throes of frenzied activity in the land market to equal what happened in 1988/9. Land prices will be near their 18-year peak, driven by an exponential growth rate, on the verge of the collapse that will presage the global depression of 2010.[7]

The historical record tells a compelling story; one that caring politicians ought to interpret as requiring the removal of privileges that undermine the fairness agenda to which they claim to subscribe. Instead, sadly, in Britain, Downing Street's neighbours from hell devoted too much time worrying about themselves.

Brown, according to Andrew Rawnsley in *The End of the Party* (2010), harassed Blair with the claim that "you ruined my life".

Brown's successor, Alistair Darling, spilt the beans on Brown, declaring that No. 10's aides unleashed "the forces of hell" against him for his frankness about the nation's economic prospects.

7 Harrison (1997: 27).

Britain's top ministers were distracted from the everyday concerns of people who risked losing their homes or jobs. Brown denied allegations that he bullied his staff. Darling was embarrassed by media reminders about his "penchant for 'flipping' houses, making four separate second-home designations, covering three different properties in as many years"[8] – earning him a handsome capital gain on properties funded by taxpayers.

Britain likes to pride itself on enjoying the most mature of democracies. And yet, it is afflicted with a streak of the infantile which is an affront to people's sense of justice.

Free Market Co-operation

WE ARE NOT IDIOTS. The power of the people, when harnessed through the co-operative spirit that is a truly free market, is a power that can move mountains; but under the current rules, this power is shackled to an economic system that prefers to lay waste to human creativity for the sake of preserving the privileges of a few.

8 Randall (2010).

We need a new social contract.

But fundamental changes ought not to be undertaken without a forensic re-examination of the rules that govern us. We need to correct the errors of the past to restore ancient rights. Some will tell you: "We can't go back in time." But listen to what Mr Justice Munby had to say in the English High Court as recently as October 3, 2007. He was presiding over a case in which a 19-year-old woman claimed that her rights were being transgressed by her local government. In his judgement he said that government had no right to deny a person justice "in the sense in which that phrase is used in Magna Carta". Referring to Chapter 40 of the document signed in the field outside Windsor Castle, by the Thames, the judge quoted the phrase: "To no one will we deny or delay, right or justice."

For good measure, the venerable judge added a sideswipe at those who wish to close our minds. He added:

It is fashionable nowadays in some circles to decry as no longer relevant anything more than 20 or 30 years old. But there are some principles that ring down the centuries. Magna Carta may be only eight years short of its 800th anniversary, but its message in this respect is timeless.[9]

If justice is to be restored to the people of the commons, we need to revive our understanding of our rights under natural law.10

We need to question conventional wisdoms – such as blaming the market for our problems. Or attributing problems to human nature. Or relying on a vulgar version of his philosophy to demonise Adam Smith for his advocacy of free enterprise. In *The Theory of Moral Sentiments*, Adam Smith stressed that selfishness was constrained by the intervention of nature. The laws of nature enabled people to discern the rules of moral behaviour. If self-deceit was a weakness of humans, nature had not abandoned us, for "our continual observations upon the conduct of others insensibly lead us to form to ourselves certain general rules concerning what is fit and proper to be done or to be avoided".11

9 R *(Sarah Casey) v Restormel Borough Council* (case no: CO/6421/2007).

10 Natural law is based on rules derived from nature, and was therefore held to be of universal validity. It was the earliest form of legal authority, exercising a profound influence on the development of English common law.

11 Smith (1759: 263-264).

Changing the current rules will not happen if we fail to inspire ourselves with the possibility of genuine liberty. The high priests of hocus pocus get away with brewing their potions of ignorance because social scientists have distorted our understanding of how the economy really works. Their legacy is a system in which the pricing mechanism is subordinated to the behaviour of psychotics and sociopaths rather than for the benefit of rational people.

IT'S THE TYRANT'S trick: distracting the masses. Whether it's Rome's bribes with bread and circuses, or Hitler's animosity against Jews to channel the emotions of an anxious population, it's the art of shifting attention away from the failures of those in charge. That's why politicians focused attention on "greedy" bankers. The financial crisis of 2008 *did* originate in greed. Greed in the pursuit of profits from real estate, which began in the housing market in the 1990s.

The "greed is good" doctrine of Wall Street is manipulated by politicians who treat us as idiots. They claim they want to "rebalance the global economy", but do nothing about the greed that feeds through to all layers of society. Greed is not a problem exclusive to the financial sector. But even Nobel laureate Joseph Stiglitz says "bankers are back in charge".[12] They aren't. Their big profits now will be eclipsed by property speculation over the new cycle. What will it take to make our politicians realise that the solution is to reshape incentives away from making money-out-of-nothing in land speculation, to favour capital formation that raises productivity and creates jobs?

12 Elliot (2010).