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Reverberations

by Mason Gaffney

We begin with the Pecora Hearings of March 1933 — ten days that shook Wall Street.

These were the dying days of Herbert Hoover's Administration and the Republican Congress. Hoover was desperate to hold back safely short of challenging the cartelization of American industry he had sponsored. So, he pushed the lame duck Senate's Banking and Currency Committee to investigate Wall Street and gin up some scapegoats to save Hoover's face and reputation. Chair of the Committee, through Senate seniority rules, was Peter Norbeck of South Dakota, a residue of old prairie Populism via Teddy Roosevelt's Bull Moose Party, and an unreconstructed Progressive. Norbeck, who knew little of Banking and Currency, sought a savvy prosecutor for the hearings.

Few wanted the job — two weeks working for a lame duck Congress, making powerful enemies. Far down on his list Norbeck came to Ferdinand Pecora, a mere assistant D.A. for New York County. Pecora likewise knew little of banking and currency, but was a quick study with remarkable energy, high ambition and little awe of pedigreed bankers with Ivy League degrees. Pecora pushed his inquiries well beyond what Hoover had dreamed, and forced so many famous bankers to disrobe under oath that the hearings made banner headlines — and are still known by his name.

Pecora had only ten days to put Wall Street under oath, but he seized the public spotlight with his sense of drama and his aim for big players and big issues. Pecora's ten days preceded FDR's 100 days, and built a springboard for New Dealers to vault into reforms like the SEC, the FDIC, the RFC, Glass-Steagall, production credit for farmers, and federal intervention in credit markets through FHA, S&L subsidies, FNMA, and later the VA.

Before Pecora bankers were already under fire for bad judgment; after Pecora they were "banksters," disgraced for bad faith, breach of trust and self-dealing. Several were to face criminal charges. Pecora dislodged bankers from their economic, political and social pedestal atop high society and government bureaucrats, and turned the world of finance upside down. FDR could not have asked for a better springboard.

Not since the Pujo Committee revelations of 1912-13, and Louis Brandeis' classic book thereon *(Other People's Money)*, both at the acme of the Progressive Era, had anyone penetrated so deeply through Wall Street's opacity to publicize its villainies. Nor, tragically, has anyone done so since.

There was, however, a lacuna in Pecora's brilliant performance. He saw the Great Crash as mainly a matter of money and securities — the paper economy, if you will. This view has narrowed and confined reformers ever since.

What's this?

Y=C+I+G is a standard expression of Gross Domestic Product (GDP). The variables are C, consumption; I, investment and G, government spending.

Macroeconomics has become synonymous with Fiscal and Monetary Policy (FMP). The template is Y = C+I+G. Everything is expressed in its terms — it dominates language, and thought. "The Left" wants more C and welfare G; "The Right" wants more I and military G. Within those confines the same tired sermons echo back and forth endlessly. This is its own kind of "reverberation," but not the kind my title means. This is the long-term effect of Pecora's lacuna.

One major change came along with Reagan-Cheney and their Laffer staffer after 1981. "The Right," long a bulwark against deficit finance, converted to it. Instead of taxing the rich, the idea was now to borrow from them, and pay them interest. This led to an explosion of Gini Ratios in real estate, stocks, bonds, income (personal and corporate), estates, and nearly anything that gets measured. It's gone so far that we need nothing as subtle as a Gini Ratio: now it's the 1% vs. the 99%.

Meantime, other scholars published a distinguished body of research into matters of the real economy — but the academic clerisy has purged most of these from macroeconomics by compartmentalization. One may only study them within accepted confines. When submitting work for publication one is required to self-classify it by pigeonhole, taken from a standard list. There is an implicit hierarchy of little boxes, with Macro on the "commanding heights."

The clerisy sanitizes macro from contamination from:

a. ***Real estate and its endogenous cycle of about 18 years,*** firmly documented from primary sources and established by Homer Hoyt in his classic, 100 years of Land Values in Chicago, 1833-1933. Other writers reinforced and replicated the findings: Ernest Fisher and John J. Holland in Michigan, Phillip Cornick in New York, H.D. Simpson in Chicago, Lewis Maverick on subdivision cycles, Arthur H. Cole on cycles in sales of public land, Harry Scherman on foreclosures, and others.

Hoyt carried this back no further than 100 years because there was no Chicago before 1833, but 18 years before Chicago's and Andrew Jackson's great crash of 1836-37 there was Monroe's crash of 1819, and 21 years before that was Hamilton's crash of 1798. Andrew Jackson lost his lands in that one, and William Morris and William Duer went to debtors' prison. Before that one can find crash before crash in the annals: the Mississippi Bubble of 1720; the Dutch crash of 1630 or so, synchronized with the reverse migration from New England after 1630; in the 15th Century it was the Fugger bank in Augsburg that went down with the fortunes of imperialistic Spain; the Florentine and Medici-banker bust of 1494 leading to Savonarola's Bonfire of the Vanities; boom and bust around Orleans following its liberation by Joan of Arc in 1429; and so on.

Apart from the endogenous 18-year cycle, major peace treaties can be shown to generate irrational exuberance for future land rents, and to release funds to the private sector where they are used again to bid up land prices. The interplay of these two cycles explains much of cyclical economic history.

b. ***Austrian economics,*** analyzing causes and effects of the time-structure of capital and the pace of capital turnover. Oddly, many economists who should know better identify Hayek with the Chicago School because he once taught there, but he was never welcomed in the Department of Economics. Frank Knight's many learned articles attacking Hayek's capital theory were an obsession, carrying on J.B. Clark's vendetta against Eugen von Böhm-Bawerk. Knight, like Clark, could not abide the Austrians' concept of a "period of

production" because it implies a sharp distinction between capital goods, which have one, and land, which does not.

Hayek and fellow Austrians finally found happiness and support with libertarian foundations and other wealthy patrons, by attacking regulations and contra-cyclical fiscal policies of all kinds, to the applause of Chambers of Commerce, but they remain outliers in the profession.

c. ***Institutional economics,*** the heritage of Veblen, Commons, Ayres, Montgomery, Means, Thurman Arnold, Corcoran and Cohen, the TNEC investigations, and Senator Harry Truman's hearings on arms profiteering in the early 1940's. Dominant figures in the FMP camps, both Keynesian and Chicagoan, diss and dismiss such work by compartmentalizing it as mere "structural reform," unworthy of attention in the greater world of Y = C + I + G. Studies of industrial organization and cartelization and market power have dwindled to a shadow, although Joe Bain, Frederick Scherer and others produced excellent texts on the subject.

The obvious link between FMP and real estate is the quality of credit. Hoyt emphasized how subprime (which he called "shoestring") financing had waxed in the boom phase of every one of the five major land cycles he documented in detail from 1833 to 1933. The commercial loan school of banking, dominant in the Progressive Era, helped save us from a crash that was due in or near 1911, following the 18-year cycle from 1893. In the roaring 1920s such old-fashioned caution was cast aside, and deposit expansion was again used freely to pump up land and stock prices. These reverberated with deposit expansion, in the manner to be shown, leading to The Great Real Estate Crash starting from 1926, followed by the stock crash of 1929.

Yet, Friedman and his school of "monetarism" ruled this out of consideration. They damned Quality Control as bureaucratic "intervention" with private bankers. Only Quantity Control was permissible. Ignoring Pecora's revelations, Friedman *et. al.* knew that profit-seeking bankers, proven survivors in free markets, must possess sounder judgment than nosy governmental officers. Pecora's findings were not refuted or denied — that would remind people of them. They were just quietly ignored.

What kept us out of serious trouble for so long? After 1945, nearly everyone forecast a postwar depression. The standard FMP line was (and is) that only wartime spending had jolted us out of the Great Depression, and peace would spoil the party. This postwar gloom capped land prices. Land for housing and farming was affordable; young entrepreneurs and home buyers could borrow to buy cheaply. Loans were mostly for production and use; price/earnings ratios ran low, payoffs were fast. All

kinds of taxes remained high, stifling any kind of long-term irrational exuberance, and any “Reverberations” between land prices and bank expansion, *á la* the 1920s.

Soon came the Cold War, the Korean War (1950-53), the costly Interstate Highway Program, urban sprawl with need for new infrastructure, the boom in airports, California’s Central Valley Project and Water Plan, huge new “Big Dam Foolishness” and reservoirs on the Colorado, Missouri, Tennessee and Saint Lawrence Rivers, all costing huge sums and presaging continued high taxes, meaning continued low land prices. Politically and socially, the disgraces of Senator McCarthy, Spiro Agnew, and Richard Nixon, along with social programs supported by the Warren Court, presaged more social spending and continued high taxes of all kinds. The result was to keep stifling irrational exuberance and resulting high land prices.

As to credit, S&Ls got favored access to housing lending, keeping banks of deposit in their proper place. These banks were fed a steady diet of Treasuries, considered “non-defaultable,” keeping them out of real estate which had proven so unstable before.

What are these “Reverberations” that led to the crashes of 1929 and 2008, with lesser ones in between, and earlier to the 18-year cycles of the 19th and earlier centuries? The basic process goes like this:

a. Something sparks recovery and growth, such as a peace dividend following a major peace treaty: the Mississippi Bubble followed the Peace of Utrecht, 1713; the first railroad boom followed the Treaty of Guadalupe-Hidalgo, 1848; the second such boom followed Lee’s surrender in 1865; the boom of the 1920s followed the Peace of Versailles. It also helps when a polity has “magnetic” institutions that attract people and capital, and/or a vast reservoir of empty lands to fill.

b. Banks of deposit begin to shift from commercial loans, short-term and self-liquidating, to lending on real estate collateral for longer terms.

c. This surge of new demand raises land prices.

d. Rising land prices evoke prospects of further rises, and a new kind of demand for land — no longer just for early use, but for “investment,” i.e. for a “store of value,” for resale, for flipping, and for speculation of various kinds. In a rising market, this often surpasses and outweighs the discounted cash or service flow from current use.

e. With higher prices, buyers need bigger loans and longer terms to pay for the same land. Banks create new demand deposits, taking the higher-priced land as collateral, and so on back and forth: ***Reverberating***, bouncing back and forth many times.
f. It's not only new buyers who use land as collateral. Old owners borrow on the swollen collateral to spend more on consuming.

g. There is no rise of production, just a rise of prices of the same land.

h. With longer-term loans, loan turnover falls, making new loans harder to get. Credit ratings fall, regardless of recorded interest rates, so the pool of eligible borrowers falls even as the supply of loanable funds falls as well. Demand for land is lowered by this shrinkage of available credit.

i. The upward spiral turns downward. Reverberations become negative. A cumulative crash follows.

Why do land prices have to fall?

Land is fixed, leading to a belief that effective supply is fixed as demand rises. This is illusory, because access to land for higher (more intensive) uses expands into wide open spaces. There are dozens of stages of more intensive use: from hunting and fishing to trapping, from lumbering to tree farming, from that to sheeping to beef cattle, from grazing to feeding, to farming small grains to maize, to horticulture, to irrigation, to vines and groves and orchards, to country estates, to subdivisions and housing, to low-rise apartments, to commerce and industry, to high-rise condos and offices and hotels, with many stages of intensity along the way.

J.S. Mill's *Principles* has a chapter on "Influence of the Progress of Industry and Population on Rents, Profits and Wages." In Article Four of this Mill stresses that progress may be land-saving, not just labor-saving and land-using. Mill said that growth of population lowers wages, but progress in the arts may offset this, and may even raise wages. When labor is dear, capital goes into saving labor; when land is dear, capital goes into saving land, and developing new lands.

Credit is due rather to the arts of architecture, construction, planning, and engineering that crafted the elevators, ventilators, pumps, central heating, load-bearing supports, plumbing and sanitation, etc. Men taught themselves these arts, by the way, in deep mines before they used them to build skyscrapers — we learned to build up by building down into our home, The Earth. (May economic theorists profit by the example.) Thus the system is more self-equilibrating than many later writers and

investors have assumed, but this occurs over such a long cycle that rational perceptions often give way to irrational exuberance.

Fully built-out towns like, say, the Milwaukee near-in suburbs of Shorewood and Whitefish Bay, house 10,000 people per square mile in spacious comfort in single-family homes on tree-lined streets with curbs, gutters, parkways, and sidewalks, with parks and golf courses and even a band of mansions along the lake shore. At that density the US population of 300 million souls needs 30,000 square miles, an area contained in a circle with radius of 100 miles — do the math. One hundred miles is the distance from downtown to the outlying suburbs of any major city today, and 30,000 square miles is just about the area of South Carolina — 1% of the area of the USA. The posh upper east side of Manhattan has about 80,000 people per square mile, or eight times the density of Shorewood or Whitefish Bay. The crowding may repel some people, but others prefer it — as shown by their paying several million dollars for a "strata title" to a condo with 5,000 square feet of floor in a slab of space 50 stories up above 49 lower strata titles with which it shares the ground below. The USA only seems crowded because of institutional biases that make us substitute land for labor and capital, and that gum up the land market.

These biases lead to territorial expansion. The kind most observed is urban sprawl, spreading cities and their infrastructure over many times more land than they need. Underuse of the best lands pushes settlement out to inferior lands, connected by capital tied up in infrastructure, premature in time and scattered over space.

Along with simple urban sprawl there is continental sprawl, urged on by works like the Interstate Highway System, interregional transfers of water, oil, gas, electric power, and the network of airlines and airports.

When did the 18-year endogenous cycle resume after 1945?

The incipient peace dividend following the surrenders of Germany and Japan hardly got started when the Cold War intervened, plus a hot war in

Korea, 1950-53. There was no scope for a peace movement like that of 1918-38 when Mellon could hold down tax rates and pay down the national debt at the same time, feeding capital into the private sector by a process of "reverse crowding-out."

New capital in the private sector might seem like a key to prosperity. However, we saw above that in practice it triggers off the "Reverberation" process described above — so prosperity carries the seeds of its own crash.

After 1953 there was a bit of slack for a mild boomlet, damped, however, by gnawing fears of an inevitable nuclear holocaust. Hard as it is to believe today, many people spent big money digging and lining and provisioning bomb shelters in their back yards. John von Neumann, pioneer computer genius and "game theorist," was advising Presidents Truman and Eisenhower to wage "preventive war" against the USSR.

Following the damped 'fifties, came a headier boom in the "soaring sixties" with JFK's morale-lifting face-off with Krushchev in the Cuban missile crisis. Ike's Interstate Highway program, intended to link cities, was used to facilitate white flight and urban sprawl. Heller's form of "business Keynesianism" created a deficit by allowing fast write-offs on new investing rather than by raising spending. LBJ promised a "Great Society" with Civil Rights and a War on Poverty, but it ended in a funk with Viet Nam, the OPEC embargo, gas lines, rampant environmentalism, Brown's "Age of Limits," urban riots, urban "removal" In lieu of renewal, Watergate, and The Phillips Curve. High tax rates tempered the amplitude of the cycle, but the period was about the same old 18 years.

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In about 1973 a new upsurge of land prices began. Nixon had declared "We are all Keynesans now," and Republicans, traditional budget-balancers, faced about gradually to embrace both devaluation and deficit finance. President Reagan, campaigning on Laffer's Curve and Cheney's military-industrial complex, took deficit finance to new heights. Cheney, embracing Robert Barro's new theories and Sargent's "rational expectations," memorably declared that "Deficits don't matter." Even Milton Friedman, the prime anti-Keynesian and monetarist guru, endorsed Barro's new rationale for deficit spending. It was Democrat Fritz Mondale, challenging Reagan in 1984, who urged balancing the budget — and lost.

This new upsurge, untempered and uncapped, led to the Crash of 1990, a big crash, reminiscent of Hoyt's 19th Century Chicago history. With remarkable facility and amnesia, however, Americans promptly forgot its obvious lessons and launched eagerly into the next cycle, deregulating everything in sight by underfunding the regulatory agencies, and dismantling most of the New Deal reforms. President Clinton provided the cover of a Democrat in office, but his policy of "triangulation" and "reverse crowding-out" merely deferred the debt skyrocket that went wild from 2001-09.

The period 1990-2008 saw a perfect 18-year cycle of peak, crash, recovery, boom and another bust in real estate, right out of Homer Hoyt's playbook. Cause and effect reverberated back and forth between soaring land prices and expanding bank deposits. Congress repealed Glass-Steagall in 1998, and Clinton signed on. Banks loaned loosely and freely on mortgages, and invented many new ways to securitize them, concealing the underlying collateral under pyramids of paper with misleading and confusing new names. Capital flowed southwestwards from rustbelt regions to growth regions like California, where Prop 13 had removed the former tempering effect of property taxes. In Riverside, California, land prices rose about 8-fold, 1990-2008 — heady stuff for householders and other landowners who could cash out without even selling, by using lines of credit, "living high on the old homestead."

Where were leading economic forecasters and advisers during the runup to 2008? Most of them were chanting "This time is different!" The Washington Post's main source on the housing market was David Lereah, chief economist for the National Association of Realtors, who also penned a 2006 bestseller *Why The Real Estate Boom Will Not Bust and How You Can Profit From It*. Michael Mandel, Chief Economics Editor of *Business Week*, published *Rational Exuberance: Silencing the Enemies of Growth and Why the Future is Better than You Think.* The White House Budget Director, Jim Nussle, declared that the nation had "avoided a recession." Ben Bernanke said we had entered "The Great Moderation." "The troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system," he said on June 5, 2007. Christina D. Romer, Obama's first pick to chair his Council of Economic Advisers, proclaimed that we had "conquered the business cycle."
What are the prospects for another endogenous 18-year cycle, peaking and crashing in about 2026? Will they ever learn? Not yet, apparently, because now in 2012 politicians, bankers and land speculators are already seeking to start again on the same trajectory, the only route to "prosperity" they know. Already The Rijksbank has awarded the latest Nobel in economics to Thomas Sargent, the "rational expectations" man. Public policy at every level is bent to sustain and revive land prices, equated with recovery and prosperity. Banks "too big to fail" are bailed out, and no bankers

jailed. Summers' friend Tim Geithner remains Treasury Secretary. There are no signs of remorse, of lessons learned.

We need a new Ferdinand Pecora, and a renewed sense of moral indignation á la FDR — and we need a new sense of the key role of land pricing in macro cycles. Land economics must be re-integrated with macroeconomics, so establishmentarians can at last begin to connect the dots.