The Age of Debt Bubbles – by Max Rangeley. A Review

This is a collection of articles written by central bankers, most of them adherents of the conservative Austrian school. There are many references to Ludwig von Mises and Friedrich Hayek. It is put out by the academic publisher Springer Verlag as part of a series on Professional Practice in Governance.

As I the reviewer am free of the constraints of Amazon – they booted me for being too truthy – I am free to add related notes from my other reading. One such is this from Quoth the Raven with his own dire observations about bubbles on the day of my writing. Others are on cryptocurrency, which is only lightly touched in this book.

Rules and Judgment

Banking is a matter of rules, people, and people's judgment in applying those rules. Every time there is a banking crisis – every few years – government and the banks write a number of new rules to prevent the next crisis.

Somebody has to enforce them. Who? Government and the bankers. That is, elected politicians and appointed bureaucrats on one side, and on the other - regional, too-big-to-fail, and central bankers.

The rules are inconvenient. They get in the way of politicians doing what politicians do, which is, favoring parties that help them to get elected and stay in office, and distributing largesse to persuade the voters to vote for them. Rules hinder bankers' maximizing profits.

That is where judgment comes in. The bankers and the political bodies that are supposed to supervise them have to apply their judgment in applying the rules. Typical cases would be:

1. If the bank lends money to a company or person, what is the expectation (percent likelihood) that that entity will repay the loan?
2. If the bank makes a multiyear loan at X% interest, what is the probability that interest rates will remain below X% over the life of the loan? In other words, what are the chances that the loan will be profitable? What are the chances the borrower will have to pay more than X% to acquire more money to lend?
3. If the bank acquires an equity interest in a business, what is the expected return on investment?

It is all a matter of probabilities, which are a matter of judgment. Bankers' rules are thus like New Year's resolutions. They are honored in the breach. The difference is that banks cannot afford to be honest with themselves. They develop convoluted rationales to convince themselves that what they are doing in fact is in accordance with the rules.

Scarcity – a self-enforcing rule

There are some laws that can't be broken. The speed limit for a sky diver is 200km/h. Nobody wrote it – it is the law of gravity. The gold standard used to impose a similar law on the banking world. You can't lend gold that isn't there.

There are 200 million or so tons of gold above ground. At $85,000/kg, or $85 million/ton, that's $17 trillion: $8 trillion in jewelry, $3 trillion in central banks, $4 trillion in private hands

and the remaining 15% in industrial uses. Miners add about 3 million tons, a quarter trillion dollars, per year. Enough gold to fill the average banker's master bedroom

Mining is the constraint that made the gold standard work. There was a limited amount of gold to back the money.

Alan Greenspan wrote in 1966, before becoming the head of the US central bank, the Federal Reserve

> Under the gold standard, a free banking system stands as the protector of an economy's stability and balanced growth ...In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. If there were, the government would have to make its holding illegal, as was done in the case of gold.

Likewise, [Austrian school founder Friedrich Hayek (1899-1992)]

> … predicted that the end of the Bretton-Woods system and the move to fiat money [in 1971] would tempt central banks to pursue a policy of cheap money when he wrote that: "we *cannot hope that any authority which has power to determine the quantity of money will long resist the pressure for, or the seduction of, cheap money."*

They were right. Silver and platinum, the other banking metals, were and are insignificant in comparison to gold. Other metals are either too cheap and bulky or too scarce to serve as money. Diamonds and other jewels are not sufficiently uniform to serve as a commodity, besides which they are now being produced industrially. The gold standard worked.

Cryptocurrencies, which are scarce by design, appeared in 2009, with Bitcoin. "Bitcoin Jesus" Roger Ver writes in "Hijacking Bitcoin" that its anonymous creator Satoshi Nakamoto intended it to be built for payments, not as a store of value. However, per Saifedean Ammous, whom he quotes, says "The real value of Bitcoin lies in its being a reliable long-term store of value." The world has developed other methods – credit cards, PayPal and such – to handle transactions. An inflation-resistant store of value is harder to achieve.

While every individual crypto coin issued is limited in number, there is no barrier to creating an infinite number of such alt-coins. This situation is in the process of solving itself. Bitcoin is becoming the standard, the others falling into neglect. Number two Ethereum is purported to be better in many ways, yet observe how the two have diverged over the past year. Just as gold is the only metal to be considered a true store of value, Bitcoin is emerging as the only crypto to consider. Ver writes:

> One of the insights from the Austrian School of Economics—that has since been incorporated into mainstream economics—is that value is subjective. Value is not found inside material goods; it's found inside human minds. Things don't possess value in themselves. We give them value because we believe they can be used to satisfy our desires. A "store of value" cannot literally "store" value, as if it's a physical box into which value is placed for later retrieval. Rather, if something is a store of value, that just means it has a consistent track record of being valued by humans. And because of its successful history, people have good reason

to believe it will be valued in the future. So, it retains its purchasing power over time. Lots of things are used to store value.

The scarcity of Bitcoin is established by its foundational white paper in 2009. The lack of significance to the scarcity of alt-coins is being established subjectively, by the judgment of investors who simply avoid them. Ironically, Ver disagreed with Saifedean, whom he just quoted above, as to whether or not Bitcoin was yet a safe store of value. However, The Sharpe ratio, a standard risk-reward measure, seems increasingly to favor it. This graph shows that Bitcoin has far outperformed the number two Ethereum over the past year.

Central Bank Digital Currencies (CBDCs)

One of the book's articles entitled Money, The State and the Market, Miguel Fernando Ordoñez advocates Central Bank Digital Currencies - CBDCs. Such an article seems out of place in this book. CBDC advantages and disadvantages have been discussed at length elsewhere. The overwhelming disadvantage is the "central bank" part. The citizenry would have to trust the central banks not to inflate their currency. Nowhere, and at no time, has such trust been merited.

Ordoñez' argument is that there would be a fixed supply of money. This is something we already have, to some extent, with gold and Bitcoin. Derivatives such as futures and ETF provide for inflation even in these. However, the underlying assets cannot be inflated.

Ordoñez does not even propose a mechanism that would prevent the central banks themselves from tinkering with a CBDC once it was created. He writes, with no citations or text to indicate why it might be so, that:

> A risky asset that is produced by the private sector is chosen as a means of digital payment instead of using a CBDC as a means of payment. CBDC is fiat money, which is a safe asset and which, by definition, does not vary in value.

The whole point of both gold and Bitcoin is that fiat money is not safe.

However, the total government control over individual financial affairs represented by CBDCs would be even more insidious. Just to name a few recent, memorable occasions on which governments pressured banks to make life difficult for individuals, consider

- Trudeau making it impossible for the anti-vax truckers to withdraw money to buy food and fuel from their banks
- Britain debanking Nigel Farage
- France making it impossible for the conservative National Rally political party to borrow from ordinary banks, pushing them towards Russian lenders
- Robert F. Kennedy losing his banking connection in the US
- PayPal, Patreon, Venmo and others making it hard to give money to alt-right bloggers

It would immeasurably worse if everybody had to use CBDCs, whereby the government would be a party to – and in a position to block - every single financial transaction. Wait a year to see – Russia is attempting to roll out CBDCs.

For the purpose of this review, suffice it to say that government never puts the citizens' interest foremost. Government should not be trusted to ensure the integrity – that is, the scarcity – of a digital currency.

Rangeley's Prediction

Editor Max Rangeley opens the book with this telling passage, unusually colorful for a banker:

> As we have seen, interest rates have been sinking for the last 40 years or so. These declines are attributable in part to the stimulatory zeal of central banks. Every time the economy wakes up with a hangover, the central bank administers another dose of monetary hooch to the patient.
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> We thus careen from crisis to crisis, growing progressively more dependent on artificially cheapened credit. We have been staggering through a kind of pseudo-equilibrium for over a generation now. There has been a stability in this stop and go staggering. And the world's leading monetary authorities seem content with the situation because they have not changed their ways.

It is a matter of rules and judgments. Bankers make more and more rules, but are vastly flexible in the judgment they use to apply the rules. Here are some more quotes:

> Kornai notes two conditions for a budget constraint to be softened. First, "the strict relationship between expenditure and earnings has been relaxed, because excess expenditure over earnings will be paid by some other institution, typically by the State" Think bailouts and creditor forbearance. Second, "the decision-maker expects such external financial assistance with high probability and this probability is firmly built into his behavior." If you are too big to fail and you know it, then you have a soft budget constraint
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> "The notion of the soft budget constraint," Kornai explains, "refers to a trend in modern society: the relaxation of financial discipline, the weakening of the feeling that spending, survival, expansion depend on earning capability and not on external assistance."
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> [Ludwig von] Mises warned that "catastrophe" was the inevitable result of continued monetary expansion meant to avoid "the final collapse of a boom brought about by credit expansion." And he was right for a world with hard budget constraints.
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> In the mushy world of soft budget constraints, the game can go on for a long time. Economic activity grows progressively more arbitrary and inefficient without a final day of reckoning. For as long as technological progress advances rapidly enough, we can even enjoy increases in the average level of material comfort. But such progress is itself impeded by soft budget constraints.

As these wise men predicted, the result is entirely predictable. Every financial crisis results in the banks creating a flood of new money at increasingly low interest rates to paper over the problem. The problem is a simple one of supply and demand. The supply of goods and services in the economy should match the demand for goods and services, and the supply of money should match the demand. The banks' machinations are designed to disturb this balance, pushing interest rates down to favor parties that would be adversely affected by realistic interest rates.

Malinvestments

Multiple authors write about the duration of investments. When money is cheap, as it was until recently, it makes long-term projects appear more attractive. When money costs 1% per year, you can break even if you get $1.11 back after ten years for every dollar invested. When it costs 10% per year, would need to get back to $2.50 for every dollar invested in order to break even.

Combining such arithmetic with usual government optimism, governments can justify extremely stupid investments such as California's San Francisco to Los Angeles high-speed rail line. Or capital-intensive solar and wind turbine projects. Or very expensive college degrees. When interest rates return to reality, many long-duration projects find themselves unfeasible or underwater.

Interest rates have to be allowed to adjust themselves to balance the supply of money available for borrowing against the demand for money.

Money creation

Economics textbooks describe money creation through the fractional reserve process. Party A deposits X dollars in the bank, whereupon, if the reserve ratio is 10% the bank is able to loan Party B .9X dollars, and so ad infinitum. The X dollar deposit cascaded into 10X worth of loans.

Author Max Rangeley says this is a myth. The vast majority of bank money is created ex nihilo. From nothing. He calls this endogenous money. An example would be the central bank, through open market operations, buying $1 million worth of General Motors bonds. The million dollars they pay General Motors for the bonds would sit in the bank awaiting use. The central bank has acquired an asset – the bonds – and an offsetting liability – the money available for loan. General Motors has acquired the opposite. No money has changed hands.

Open market operations are only one mechanism for endogenous money creation. The bottom line is that the fractional reserve theory does not act as a realistic limit on the amount of money that can be created.

Banks may never be called to account. Japanese banks continually roll over loans to "zombie corporations" rather than recognize that they will never be repaid. Zombie loans suck the system dry of liquidity that might be used by more imaginative entrepreneurs to create profitable businesses.

Via mechanism such as this, global aggregate debt blossomed from $150 trillion to $300 trillion in 14 years. In short, the assumptions and rules in place do not impose much discipline on the banks.

Judgment Calls

This section is written by your reviewer – not from the book. Banks have a lot of latitude in applying judgment to financial transactions.

Banks estimate the value of real estate in making mortgage loans. They can be persuaded to be optimistic. They have to estimate the future prices of commodities. They have to estimate the future profitability of manufacturing operations.

Banks can be forced by governments to make unrealistic predictions. They are forced to think that there is no difference in the likelihood of a loan being repaid regardless of a person's sex or ethnicity. They may be required to assess equal likelihood of a student loan being repaid regardless of the field of study. A mortgage lender may be prevented from assessing the likelihood of a mortgage being repaid based on the neighborhood in which it is made.

A lender must make must make a judgment of the political risk in making foreign loans. What is the risk of the government collapsing and repudiating debt? The bankers have made such mistakes with Argentina four times within my lifetime. A French banker argued earnestly with me in 1972 that a sovereign entity would never default. Yeah?

Governments give banks incentives to make loans for all sorts of social purposes. These have included electric cars, solar panels for houses, windmills for wind generation, and many

other things that would not make economic sense absent government intervention. Sometimes there is government insurance, but at other times the risk is borne by the banks themselves.

In any case, it is a systemic risk. Whether it is government or the banks suffer the loss, it is a loss to the society in that there is less lending capability for projects that do make sense.

Conclusion

This reviewer's conclusion is that Rangeley is right. Neither government nor the banking industry will correct the problem. Therefore, the system will "run to failure," as predicted by Quoth the Raven in the link in the opening paragraph, above. He, and a vast number of other observers draw the conclusion that an individual should protect him or herself by (1) having no debt, (2) owning hard assets, especially precious metals but perhaps also crypto and real estate, and (3) keeping assets in those jurisdictions that are least likely to confiscate them. Knowing how to grow your own food, being skilled at something like carpentry, and being nice to kids who can support you in retirement might not hurt.