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Downslide of the U.S. Dollar and Economy

Greg's Note: "An insidious contribution of currency devaluation is the destruction of work habits." So starts Fred Sheehan in your *Whiskey* shot for today. Too much money tends to bring about general upheaval and a decrease in long-term capital investment. Too much money often enkindles shorter-term quick paper "profit" schemes. One such scheme that's open to almost every adult American is "house-trading" or speculation in the real estate market. Fred presents a picture of the housing bubble of the early seventies and it seems eerily familiar to our present American Bubble. At that time, a certain economist bemoaned this new kind of wispy wealth creation and pointed toward the times where Americans actually MADE stuff and looked toward long-term profit horizons. It just turns out that that same prescient economist decided to help inflate today's bubble…apparently one can change their mind in the span of three decades…and send any opinions to you devaluing editor right here: greg@whiskeyandgunpowder.com

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Currency Devaluation and House-Swapping: A Symphony in Two Movements

An insidious contribution of currency devaluation is the destruction of work habits. This was true in the 1970s; it is obvious today. In the disco decade, the belief that currency devaluation would improve America's industrial economy proved false. The Heartland reinvented itself as the Rust Belt and Americans found other ways to earn a living — they traded houses.

An up-and-coming economist observed this transition as both chairman of the Council of Economic Advisers and as consultant to the good and the great. He despaired at the unwinding of industrial America. Thirty years later, as Federal Reserve chairman, the former consulting economist boosted the economy out of recession just as it had rebounded in the '70s — by whipping America into a consumer-spending, credit-crazy, house-buying frenzy.

The United States defaulted on its gold commitment in August 1971. The U.S. devalued the dollar by about 9% against major currencies in December of the same year. After negotiating the pact (the Smithsonian Agreement) in December 1971, Richard Nixon claimed this was "the most significant monetary agreement in the history of the world." The U.S. trade deficit soon doubled.

This was not supposed to happen, so the economists decided to try it again. The dollar was devalued another 10% in February 1973. Treasury Secretary George Schultz, former dean of the University of Chicago Graduate School of Business and a former student of Milton Friedman, marketed the new devaluation by declaring, "There can be no doubt we have achieved a major improvement in the competitiveness of American business." This time it worked — until 1977, when the trade deficit collapsed.

Time magazine, in the same issue in which it quoted Schultz, discussed the mental distractions heaped on the American

people. The money markets had witnessed a chaotic series of "devaluations, revaluations and [currency] floats [that had] been coming with dizzying rapidity." Students of Weimar Germany, Argentina, and Zimbabwe will have, by now, identified the real culprit: inflation. Whether it is in assets or goods, too much money causes upheaval.

To ensure disorientation would turn to panic, the government instituted price controls on materials ranging from oil to beef; hence, the country suffered shortages of materials from oil to beef. It rationed gasoline. This left commuters idling in lines that circled the streets around gas stations. To heighten the confusion, the government legislated an 11% tax on foreign security purchases and limited the amount of dollars U.S. corporations could send abroad to build factories. This last was a worthless gesture.

Living costs rose at an annual rate of 8.8% in the first quarter of 1973. This report prompted AFL-CIO chief George Meany to announce: "In his Inaugural Address in January, [President Nixon] advised Americans to help themselves. It is obvious that this is what unions are going to be forced to do at the bargaining table." One suspects this was not the spirit in which the president's advice was intended, but it is difficult to fault Meany, even though successful negotiations by steelworkers, autoworkers, and airline mechanics were to fell these industries to minor league status. As Meany must have known — and *Time* reported: "Manufacturers decided long ago to serve foreign markets by building plants overseas, rather than by exporting. The multinational corporations will profit from devaluation." The costs of production, since the mid-1950s, had been pricing heavy industry out of the market.

Time magazine employed a board of economists. The long articles that surveyed the members' opinions and solutions were generally a waste of time to read. Instead, an anonymous *Time* reporter not only understood the problem that has plagued the U.S. for the past half century, but was able to write it in one sentence: "The root cause of dollar weakness is that ever since the early 1950s, the U.S. has been living beyond its means in the world."

We were only three years into the '70s and all of the government initiatives — the gold default, wage controls, price controls, restricting and taxing investments, currency devaluation — had failed. Alas, this was just the beginning. Wage increases chased inflation and bond yields soared, as did the unemployment rate, real wages, and the number of imported automobiles, television sets, and radios.

Very few understood what to do with their money. The Dow Jones industrial average had peaked on Jan. 11, 1973, at 1,051. On Dec. 12, 1974, it bottomed at 571, a loss of 46%. Consumer prices rose 21% over the same period. Losses to investors were over 60%. Bond prices collapsed, money market funds were getting their feet wet and returns on bank savings accounts lagged the rising cost of milk and gasoline.

Over the decade, Honda and Volkswagen beat General Motors on its own turf. The age-old truism of saving a portion of ones' salary had also been kicked in the teeth, as had the older generation that counted upon its savings for retirement.

The young and clever were better able to adapt. Eugene Sussman, a jewelry manufacturer in Cedarhurst, N.Y., worried that as the price of gold and diamonds increased his sales would flag. Instead, every time he raised prices, sales flourished. Sussman observed: "I'm talking about average working girls. I see them on the street, wearing my jewelry. They're making $250 or $300 a week and they're spending it on jewelry. They have to have it. It's like food." They made the simple calculation that it was better to get rid of their dollars as quickly as they received them, buy what was rising in price, and then sell it to catch the next rising wave. The more nimble were borrowing as much as possible to do so. In other words, the working girls were running their own hedge funds; they merely lacked a business card that identified their real job.

The destruction of work habits did not mean Americans worked less, but what constituted work changed (e.g., the working girls). With manufacturing in decline, Americans of all ages found alternative sources of income. Mortgage rates doubled, yet residential real estate boomed. Again, it paid to borrow depreciating dollars and leverage one's investment. To the common man, this opportunity best presents itself in real estate.

This unexpected deliverance to the mortgage industry was a prelude to the phenomenon seen 30 years later on a much grander scale. From 1975-1980, home prices in Newport Beach, Calif., doubled. In California as a whole, prices rose

20% in 1974, 17% in 1975, and 28% in 1976. In the words of William Greider: “People were not buying homes to live in or even as long-term investments. They were buying homes in order to sell them.”

The anecdotes of the late-’70s have a familiar sound. The developer of a Contra Costa County development found that 60% of his sales were to speculators. A condominium bought for $87,000 in Irvine Ranch was sold two weeks later for $117,000 — two weeks before the mortgage closing was completed; homes were being advertised for resale that had not been built yet. In Orlando, Fla., a property was bought for $285,000, sold four weeks later for $375,000, and a week after that for $525,000.

Irvine, Calif... Florida... Even the epicenters are the same.

As manufacturing declined, the financial industries boomed. In 1972, membership of the National Association of Realtors first passed 100,000. This union of brokers crossed 435,000 in 1975 (which included a merger with independent salespeople). By 1979, 761,000 Americans were selling houses. The number of realtors in San Diego doubled between 1975-1979.

The housing market was a national obsession by 1979. House prices had risen 8% or more every year since 1970. Prices were up 17.7% in the first nine months of 1979 — from $50,200 to $57,200. Sen. Harrison A. Williams Jr., Democrat from New Jersey, called a crash in housing prices “not inconceivable,” noting that a 30-year $60,000 mortgage that cost $480 per month when interest rates were 9% now cost $711 per month, with interest rates at 14%. Between 1975-1978, home mortgage debt rose by $258 billion — from $479 billion to $737 billion — a 53% rise. Consumer borrowing rose by 60% during the same period. (The aftermath to the borrowing binge produced casualties but was mitigated by interest rates that collapsed in the 1980s and the responsible behavior of bankers who held home loans on their balance sheets.)

This was no way to run an economy, although it would be the rare economist who would say so. It is a remarkable epiphany to read accounts during earlier decades and discover the average newspaper or magazine reporter was a far better source of common sense than the pedigreed economists who run economics departments at Ivy League universities today. *U.S. News and World Report* sounded the alarm in 1978: “The mountain of debt has grown so high in this country that many economists fear the United States is unusually vulnerable if a recession occurs…some fret that a load of personal debt will make a recession more severe than it otherwise would be.” In the same year, Henry Scott Stokes of *The New York Times* expressed a skeptical view of the current economic expansion: “Typically, in an economic recovery of the kind the United States has experienced since early 1975, capital investment leads the way. But the surge in the American economy has been largely brought about by consumer spending, while investment has only risen by half its normal speed.” Scott Stokes went on to emphasize that capital spending “is easily snuffed out” during inflationary periods: “This has been the case in the post-1975 recession phase during which investment in such bedrock industries as steel and chemicals has been very slow…In the past two years, many big companies preferred quite simply to buy existing companies, rather than investing in new factories and equipment.”

Scott Stokes’ analysis is noteworthy for the precision with which he identified the central problem. Building and trading houses does not contribute to the long-term benefit of the economy, but does quite the opposite. It channels investment dollars and savings away from the steel and chemical plants necessary to compete with Toyota. Most any discussion of a healthy American economy today puts consumer spending in the forefront.

In 1979, Alan Greenspan stepped in for the vacationing Leonard Silk and wrote the *Times’* “Economic Scene” column. He waxed nostalgic about the “halcyon days of the 1950s and 1960s,” when “business investment decisions seemed appropriately focused on longer-term payoffs.” But now, “it is not surprising that in recent years, business capital investments have become increasingly concentrated in assets with quick cash payoffs.” Greenspan calculated that currently, “expansion of manufacturing capacity has fallen short of the pattern in earlier business cycles.” He thought, “more ominous” was the “shift in research and development budgets towards quick-payoff ‘development’ projects.”

Greenspan would return to this same worry many times before his selection as Federal Reserve chairman. Given his understanding of what makes an economy strong, it is natural that he knew what destroys an economy. He told *The New York Times* in 1978, “People no longer think a mortgage is just something to take out to buy a home. It can be a means

of cashing in your gains." Two years later, with time to think this evaluation over, Greenspan had not changed his view one bit. He told the *Times* "that the translation of home-ownership equity into cash available for consumer spending is perhaps the most significant reason why the economy in 1975-1978 was consistently stronger than expected." In other words, the house-trading public prevented recession by spending its housing gains in the consumer economy.

In the decades ahead, price inflation would fall, but never disappear. Americans would never again save as they had. Corporations would never revert to long-term capital commitments at home. Borrowing looked ominous to *U.S. News* in 1978. Once Paul Volcker loosened the reins on money in the 1980s, credit expanded at an ever-faster pace than production. Corporate attention spans grew shorter as stock option compensation changed senior management into free agents. The longer-term payoffs of which Greenspan spoke did not fit into the new quarterly earnings obsession.

Federal Reserve Chairman Alan Greenspan would remember how the American people had traded houses and borrowed to spur the recovery of 1975-1978. As manufacturing jobs in the U.S. fell from 17 million in 2001 to 14 million in 2004, he would watch as approximately 60% of all new non-government jobs created during those years were in the construction and mortgage industry. Total mortgage credit rose 53% from the beginning of 1998 to midyear 2002, the same percentage as the 1975-1978 period discussed above. The volume for this four-plus-year boom, though, was $2.8 trillion, about 10 times that of the mid-'70s.

All this before the floodgates opened. In June 2003, the Federal Reserve cut the funds rate to 1.0%, and the 10-year Treasury yield hit a generational low of 3.13%. The house building, mortgage financing, refinancing, and equity cashout markets responded with a fury. Fannie Mae announced in June that it was operating at a pace to originate $3.7 trillion of mortgages for the year; Countrywide Financial was poised to pass Fannie with a prediction of $3.5-4 trillion originations in 2003. This in a $10 trillion economy.

On July 15, 2003, the Federal Reserve chairman testified before Congress. Given his rock-solid belief that long-term investment was the road to recovery, we might have expected Greenspan to share his worries with Congress. Instead, he assured legislators that "The prospects for a resumption of strong economic growth have been enhanced by steps taken in the private sector over the past couple of years to restructure and strengthen balance sheets…Nowhere has this process of balance sheet adjustment been more evident than in the household sector…lower interest rates have facilitated a restructuring of the existing debt."

Yes, but there was so much more of it. Three years after the last investment bubble, he was gunning another one. Greenspan then completely turned reason on its head by not only stating that long-term investment in production is unnecessary, but that the American economy did not need to make anything at all. In the convert's words: "Is it important for an economy to have manufacturing...I think you can argue it does not really matter whether or not you produce [manufactured goods]."

The man knew better. Those in positions of influence who could have announced the emperor wore no clothes decided to remain silent. Now we're paying the price.

Regards,
Fred Sheehan