

Woody Brock's Challenge to Krugman and the Keynesians

By Bob Veres
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A polarizing choice confronts policymakers. Either they side with Paul Krugman and the Keynesians, and advocate for aggressive fiscal measures to stimulate America's economic growth rate, or they align themselves with the so-called austerians, who argue that budget cutbacks are necessary to eliminate deficits. A third option is rarely discussed. Its most outspoken proponent, Horace "Woody" Brock, says that America should continue to borrow, but spend wisely – and develop new policy instruments that would eliminate asset bubbles and stimulate economic activity.



Woody Brock

Brock may be the most astute economist among the discordant voices telling us what's going on and what we can do about it, with a more sophisticated and nuanced explanation of our investment and economic times than Ferguson, Nassim Taleb, Nouriel Roubini, Paul Krugman, Larry Kudlow, Larry Summers, Mohamed El Erian or the other voices of the hour. In an interview on May 20, he managed to weave a coherent picture that encompasses everything from the optimal fiscal/monetary/government policies to raise economic growth rates in the U.S. and Europe, to whether Japan is truly on track for an economic resurgence, to a surprisingly workable way to prevent future global economic crashes, to different ways the Fed can disengage from its QE program without causing a catastrophic rise interest rates. Along the way, he made a convincing argument that we are not experiencing what everybody thinks we are in the investment world: a near-bursting bubble environment in bonds.



Bob Veres

Monetary policy: Flexible leverage control

Since all of Brock's ideas and recommendations fit together and have to be considered holistically, there is no obvious place to start describing them. But perhaps the least controversial, most accessible part of his proposals addresses a crucial question for Federal Reserve and government policymakers: How do we prevent future global economic crises?

The interviewer mentions the historic Dodd-Frank legislation, but Brock impatiently waved it aside. Instead, he thinks we could write a far, far simpler law – which would go a long way toward averting the next 2008-like collapse.



The first thing to understand, Brock said, is something you don't ever hear economists talking about: financial bubbles and overshoots have replaced inventory bubbles and overshoots as the cause of economic recessions. This bears repeating: Brock says that when you look at economic cycles – as many *Advisor Perspectives* readers do when they make tactical investment decisions – the cycle is no longer driven by Ford Motors laying off workers because it unwisely built a glut of automobiles during the booming top of the economic cycle, joining manufacturers who were coming to the same realization at about the same time. Instead, the cycle is now driven by rising asset prices (housing, stocks, securitized mortgages) fueled by crazy leverage. Think: zero-down mortgages and 50-1 leverage on Wall Street.

"In recent years, we've experienced the Russian crisis, the Meriwether [LTCM] crisis, the tech bubble crisis of 2000, the Asian Flu crisis, the peso crisis, the housing crisis in 2008 – and what do they all have in common?" Brock demanded. "In every case, it has been about leverage and speculation in asset markets."

Alas, monetary policy is not an ideal instrument to control asset bubbles the way it once regulated booms and busts in the manufacturing sector. To see why, imagine that back in 2005, the Fed had decided that it wanted to discourage thousands of Americans from flipping homes or buying them on spec with zero money down. So it dramatically raised interest rates throughout the economy. "That certainly would have killed the housing bubble," Brock said. "But it would also have kicked 15 million people out of jobs on Main Street at a time when inflation was low." Using monetary policy to address asset bubbles, Brock said, would trigger recessions in the corporate/manufacturing sector – a less-than-optimal outcome.

So are we helpless? Only if we limit ourselves to the blunt monetary policy instrument. As Brock put it, paraphrasing a body of work by Nobel-winning economist Jan Tinbergen, policymakers need another knob on their dashboard – one that specifically controls excess leverage without bludgeoning the corporate/manufacturing sector.

His proposal is so simple you could write it on the back of a napkin: raise margin requirements on any financial asset – stocks, real estate or whatever – as its price goes up beyond its mean-reverting (average historical) valuation. Reduce the amount of permissible leverage in proportion to the degree of deviation from the mean. "If housing prices go up, then you would have to keep putting more and more money down, which would kill the psychology of the bubble," Brock said.

The same requirement would, of course, prevent Wall Street from leveraging its collective balance sheets by a 50-1 margin leading into the next financial crisis. "On Wall Street, the objection you hear is: oh, we can't tell when we're in a bubble," Brock argued. "I say, who cares? What you do know is that theoretically and in the data, the average PE is 15 for the



stock markets of the 10 largest countries for the past century. So if a PE of 15 is the norm," Brock continued, "and the market goes to 20, then you have to put more down if you want to buy stocks. When the PE goes up to 34, as it did in 2000, you bloody well better be putting 95% down, and in doing that, you deflate the tech bubble."

You might be surprised to learn that this proposal has historical precedent. A review of margin [requirements](#) shows that investors who could put virtually nothing down to buy shares of stocks before the 1929 crash were later required to limit their margin accounts as low as 0% and as high as 55%, with the figures moving around as the markets did. Brock pointed out that in January, 1958, when the Dow was at 440, a person could buy stock with 50% down. By August, when the Dow had breached 510, the investor had to put down 70%, and by December, when the Dow was trading around 580, the requirement had grown to 90%. "When everybody has to put 90% down," said Brock, "You no longer have a bubble."

Somewhere on the back of that napkin, the leverage rule would mandate that any Wall Street deal could be audited after the fact to look for a criminal breach of these clear leverage guidelines. "The big banks would have to prove that they met the leverage requirement," Brock said. "It bypasses all the tricky ways of getting money outside the banking system, and there are tricky ways, and you and I are not going to stop them," he continued. "I don't care where you get the money; show me that your own skin in the game was within the allowed leverage ratio, or you go to jail."

Notice what Brock has accomplished here. The Fed can now stimulate the economy during recessionary periods without fearing the usual consequences of an asset bubble. By adding a very simple extra knob on the dashboard, monetary policy becomes much more valuable as a damping mechanism for America's economic ups and downs.

Some readers are going to object that what we just wrote on the back of this napkin is interfering in the normal processes of capitalism. "Excess leverage is an externality," Brock answered. "That means that doing it hurts a lot of other people who weren't involved. When there is an externality, government policy should say 'no, you aren't going to do that.' You are not going to be allowed to make money by pouring lead into a river and poisoning the children downstream, and you aren't going to keep all the gains on the way up and avoid the losses on the way down and cause 55 million people to lose their jobs. That," Brock insisted, "is not capitalism."

Fiscal policy: Good debt versus bad debt

Let's assume that an adjustable leverage requirement is a plausible way for government policymakers to address recessionary lurches like we've experienced in the past. We still have an economy that is far from recovered from the 2008 meltdown, and near-zero



interest rates aren't driving a return to abundance. What does Brock think we should do to bring back economic growth?

Here we turn from monetary policy to fiscal policy, and Brock's advice sounds, on the surface, a lot like Paul Krugman's: the American government didn't borrow enough, and it should have spent more money to stimulate the economy than it did. But if you scratch below the surface, Brock's arguments are very different from Krugman's.

Indeed, he said that while Krugman is tirelessly advocating that the government create more debt, he advocates good debt and deplors bad debt.

"There are two justifications for deficit spending," Brock explained. "The deficits of Keynes can simplistically be explained as: the government should borrow money from our children and spend it to keep people working in times when we are in an economic slump – what Keynes called 'poor animal spirits.'" This, of course, is the Krugman view that all of us have heard more than once.

"I turn to a second justification of deficit spending, which has nothing to do with animal spirits or business cycles," Brock continued. He cited work by economists Kenneth Arrow and Mordecai Kurtz in the 1970s, which suggests that the government should aggressively run deficits if the expected rate of return achieved by investing in public sector projects is higher than private sector projects.

"Right now, today, our infrastructure is decrepit," Brock said. "It is falling apart, or 'going critical,' in engineering language. The rate of return today, under these conditions and with the government's cost of capital at less than 1%, is sky high." Meanwhile, he said, the rate of return available to private investment is low. Brock pointed out that corporations are choosing not to invest the piles of cash they've accumulated (except for stock buy-backs) for perfectly rational reasons.

When conservatives argue with Krugman's proposals, saying that the government is doing little more than larding our children's future with more debt, Brock agrees with them. "My view is: yes, we don't need any more unproductive debt," he said, adding that the first round of economic stimulus was largely used to keep state and federal employees employed, which can hardly be viewed as an investment in the future.

What would Brock's Infrastructure Marshall Plan look like? "We forget that the interstate highway system made an 11% return on invested capital for the government," he said. "This time around, we shouldn't just fix the electrical grid; we should be hiring genius MIT freshmen to make the electrical grid cyber-attack-proof and far more efficient. We shouldn't just build new bridges to replace the old ones that are going critical; we should create new kinds of bridges that use wholly new technologies that make them 10 times



stronger with one-tenth the weight – which incidentally creates new industries. We should be making natural gas available to American cars the way it is in Australia.

"We want to finance projects that will hire our children in the future and pay them back many times over," Brock said, "I want more debt, but of the good kind."

Incentive structure: Primary stimulus or ultimate damper

There is another knob on Brock's policy dashboard that we hear discussed, if at all, only in very vague, general terms. Brock thinks it is by far the most important of them all. He cited the work of another Nobel-laureate economist, Leo Hurwicz, who defined mathematically something that we all take for granted: the importance of an economic "incentive structure" to growth and productivity.

Brock broadly defined incentive structure as the rules of the game in any particular economy. He included the rule of law and an effective legal system, the ability (or not) to create a company, the ability (or not) to hire and fire workers and get funding for a new idea, and the high or low level of corruption, bribery and unfairness that affect the normal course of business affairs. Brock said that Hurwicz's evaluation of the importance of an incentive structure, though highly mathematical, may be regarded as the most important economic insight of the 20th century. "The essential point," he said, "is that if you are really concerned about fast or slow economic growth, check your incentive structure."

To see why, Brock proposed that you compare the economies of North and South Korea. Their citizens have emerged from the same culture, share the same genetics and are alike in virtually every way we could measure. "The difference is that they adopted two different sets of rules of the game," said Brock. "When the South Koreans wake up in the morning, taking the rules of the game as given, they do what we all do: what is best for them and their families. In North Korea, it is the same thing; they do the best they can, given the rules of their game."

This difference in incentive structures has measurable consequences: they produce a GDP in one economy about a tenth the size of the other. "Does anybody think that monetary and/or fiscal policy has anything to do with this huge performance gap?" Brock asked rhetorically. "Letting people compete, letting them be hired and fired is infinitely more important than QE-anything."

Brock talked about a related concept called 'maximal competition,' that was explored by a group led by economist Kenneth Arrow. In simplistic terms, it means an absence of monopolies and the ability for economic players to collude, so that individuals are motivated in the right way. "If I can't get rich by rigging the market," he said, "then all I can do is come up with a better widget. The focus moves to innovation and efficiency. Society



benefits and living standards go up. We all do our thing utterly unaware of anyone else," Brock concluded, reducing a lot of mathematics to something even a writer is capable of understanding, "and the pie becomes the biggest possible for society as a whole."

This is one area where Brock thinks that American policymakers have been on the right track; he points out that until recently, the U.S. ranked number one in the world in the Davos competitiveness rankings. He is not a fan of the Obama Administration's new health care plan, which, he said, virtually all by itself bumped America down to the number six position. "Small businesses, which are important drivers of the economy, suddenly have an incentive to fire, not to hire as they face the Obamacare medical premiums," he said. So America has work to do, admittedly on the margins, to improve its incentive structure and reclaim its traditional global leadership.

The levers abroad

Some *Advisor Perspective* readers will have at least a mild interest in their investment prospects in Europe and Japan. What prescription did Brock offer for the Eurozone that differs from his U.S.-centric recommendations?

Brock starts with the debate over austerity – that is, whether the peripheral European economies should slash their government outlays in order to pay down their debt. "The most important issue in Europe today is growth, not austerity," he said. "The only way out of the debt they're in is to outgrow it, so growth is extremely important."

Alas, in many European countries, the Brock Plan to invest in infrastructure wouldn't be very effective. "You can't lump everybody together," he said, "Switzerland doesn't need a new anything; they've invested in infrastructure every year, unlike the U.S. If you put people to work rebuilding the Swiss railroad, and run a deficit to do it, that would not add to productivity."

To the extent that a European country already has a sound infrastructure, Brock would not recommend more borrowing and spending. But there are countries that still have this stimulus option. Take the case of England, which he said is comparable to America. "They have a terrible infrastructure," Brock said. "There, they can use this policy lever, and they should."

Similar to America, Brock would recommend that European policymakers adopt limits on leverage. But he said that by far the most important policy recommendation for Brussels is improving the various incentive structures around the Eurozone. "You hear the prime ministers of Europe talk about the need for structural reforms," Brock said. "What they seem to mean is that they want incentives that will help people get hired and prevent them from getting fired."



Brock said the reason we see 40% unemployment among young people in southern Europe is because it is so difficult to shed workers once they're hired. "If you want dead growth," he said, "make sure that no one can get fired. That's important. The debt levels are minor league compared to that. When growth is slow because of constipated markets, debt is going to rise as a result of growth being slow." He pointed to a research [report](#) from the McKinsey Global Institute which looked at changes in a variety of components of the overall incentive structure, and concluded that coordinated changes would double the economic growth of the Eurozone. "Then we could have our cake and eat it too," said Brock. "The European economies will grow faster and cut the deficits."

What about Japan? Brock noted with approval that the so-called "Abenomics" proposals start with structural reform. "Abe understands the need for incentive structural reform," he said. "If you don't do that, all the QE crap that the press has focused on is beside the point."

Even so, Brock was not yet ready to predict a resurgent Japan, despite what the stock market seems to be telling us. "The vested interests are out to kill structural changes, because they would hurt their monopolies," he said. "If Abe is unable to get structural reform, then all the bloody QE won't work."

"Be cautious unless and until Abe gets all of his proposals enacted," Brock concluded.

Reinhart, Rogoff and debt levels

Throughout this discussion, Brock seemed less-than-concerned about debt levels in the U.S., southern Europe and Japan. Yet debt level debates are the focus of Congressional attention, and seem to be the most important issue to German voters. Here in the U.S., the most influential rationale for refusing to raise the government debt ceiling has come from the work of Harvard professors Carmen Reinhart and Kenneth Rogoff. What does Brock think of their research, and about the recent imbroglio over their data?

"They are excellent economists," Brock said, "And although they did make mistakes, I would completely agree with those who say this is a tempest in a teapot. The degree to which growth slows when debt rises past 90% of GDP is not what they said it was, but the direction of the trend absolutely is."

At the same time, Brock said, the issue is absolutely irrelevant.

Why? "First of all, the causality is in question," he said. "We don't know which causes which, slower economic growth or debt levels, as Reinhart and Rogoff correctly point out. When growth slows, you are going to have higher debt levels. When you have robust



growth – usually because you have the incentive structure right – you tend to have lower debt levels. The United States had 126% debt-to-GDP in 1945 after World War II, with all those war bonds,” he pointed out, “and it grew very nicely after that.”

QE disengagement and the myth of the bond bubble

Finally, with all these policies and prescriptions, the U.S. happens to be facing a very practical dilemma. How can the Fed loosen its grip on interest rates, disengage from the various QE initiatives and unwind its balance sheet without triggering inflation, an interest rate spike and a spectacular burst of the bond bubble?

"Your first mistake," said Brock, "is to assume there is a bubble at all."

Come again? "A bubble, mathematically, is a monotonically increasing sequence of prices," Brock explained. "There has to be a time 'T' when you buy that house or that Treasury security and are very sure that at some time we'll call 'T+J' you can sell it at a higher price. There must," he added, "be confidence that prices are rising, and that has to be the reason that prices rise. Do you see that in today's bond market?"

The obvious answer, given reluctantly, is: well, no. "People are not buying Treasuries expecting bond prices to go up," Brock added. "They are buying them to cover themselves in case other assets go down. This is important, because when you ask the question: 'What will dethrone bond prices?' you do not want to use bubble theory," he added, "which is now known as the theory of endogenous risk. You have to go back to more fundamental things."

Brock also doesn't believe that bond prices will spike as a result of outside investors worrying about the U.S. government's willingness or ability to pay its Treasury obligations. "If the world gets worried about U.S. finances and sees us going the way of Italy or Spain, where bond rates went up between 600 and 1,000 basis points, what happens to Treasury bonds?" he asked. "If a country controls its own currency, like Australia, America, Canada, England and Japan, and the world turns against you, it turns out that interest rates are not driven up. What happens instead," he added, "is that the dollar does the work and drops."

This is actually proven by historical events. In 1985, the world lost confidence in Treasury securities and the dollar's value fell precipitously. The same thing happened in Australia in 1980 and Canada more recently. "Yields didn't change," Brock said. "The adjustment process theorem says that when you have a country with its own currency, if foreigners don't like you anymore, yields won't be driven up; rather, the currency is driven down, which is good for the economy."



Instead of the loud explosion of a bubble bursting, Brock expects a gradual rise in interest rates as the economy recovers. "If I went to sleep now for five years, when I woke up, I would expect the Fed funds rate to be back at 3.5% and bond yields back at 4% to 5%," he said. "They'll go up, but it won't be a bubble bursting."

In Europe, on the other hand, the movement of interest rates will be more of a transfer process. As investors become more confident— as economies start to recover— bond investors will move out of German bonds into the higher yields of southern European debt. Accordingly, German bond yields will go up and the yields on Italian and Spanish bonds will gradually come down.

Brock also doesn't foresee the Fed triggering an uncontrollable rise in inflation when it ends its QE initiatives. "First of all, there is no money printing when you finance acquisition of government securities by issuing bank reserves," he said. There *has* been an expansion of bank reserves, from just over \$60 billion before the 2008 crisis to roughly \$2 trillion today, he said. But Brock said that this would only be inflationary if the banks were lending that money, rather than having it sit idle, collecting dust in their reserve accounts.

"Inflation would happen if there suddenly was demand to borrow that money, which there is not today," Brock explained. "With the current reserve-requirement ratio, theoretically, banks could make \$20 trillion in loans to you and me with that \$2 trillion in bank reserves. That would only happen if the sun comes out and the economic recovery was happening and people wanted to borrow again. But," he acknowledged, "if you and I were to suddenly get \$20 trillion in new loans, and we went on a buying spree, what happens to the price of widgets? They explode!"

The point Brock is making here is that the Fed policymakers understand this logic clearly, and they have two tools at their disposal to control what might otherwise be an explosion of hyperinflation. The first is that the Fed retained the right to sell back to the primary dealers all those securities they purchased. "Every time the Fed sells those securities back to the market, bank reserve requirements get debited down," Brock explained. "Citicorp doesn't have as many reserves to lend to you and me."

Of course, the Fed is not going to unload its entire balance sheet all at once, because that would trigger unpleasant losses. So it turns to its second policy instrument, which was originally granted with the Financial Services Regulatory Relief Act of 2006, and made official policy with the Emergency Economic Stabilization Act of 2008. They basically authorized the Fed to pay banks interest on excess reserve balances – currently about 25 basis points.



"If the sun comes out and everybody wants to borrow those trillions of dollars," said Brock, "the Fed can come in and say, 'We'll pay you 4% for your reserves.' They make it rational for the banks to keep that money on the sidelines. Therefore: no inflation."

Investment implications?

At the end of the interview, it was clear that much of this territory is not being covered in the economic chatter that is reaching the ears of investors and advisory clients, and most of the policy arguments Brock is making are nothing like what we hear from policymakers in Washington or Brussels. Brock thinks that few economists and no policymakers have taken the time to harmonize the economic work of Tinbergen, Arrow, Kurtz, Hurwicz or a variety of other important economic theorists into a coherent picture of macroeconomic policy.

"I really don't understand why we are not reading about these things," he said, and his bewilderment was genuine.

Meanwhile, Brock is focusing on some of the investment implications of various governmental macroeconomic options – on the plausible theory that much of what you read here will not be implemented with any clear vision, and therefore markets will be affected by clumsy interventions and wrong turns. His consulting firm, [Strategic Economic Decisions](#), publishes regular reports which follow the theme of "outperforming the market legitimately."

Those reports are subtitled: "It's not the information that counts; it's the superior interpretation of it that counts." One wishes that certain policymakers in Washington would become subscribers.

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