



David Stockman on Krugman, the Fed, and the Future

Guest: David Stockman

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David Stockman, a former U.S. congressman, served as director of the Office of Management and Budget under Ronald Reagan, from 1981 to 1985. His most recent book is *The Great Deformation: The Corruption of Capitalism in America*.

WOODS: Let's start off with Paul Krugman. I'm sorry to ruin your new year so soon. But he's been saying in recent months that what he calls the deficit and debt hawks have really been routed. He says that right now the estimates of the deficit are being lowered, and it turns out that this is all going to be manageable after all. And the concern over the debt was just a lot of sky-is-falling hysteria. How do you answer Krugman?

STOCKMAN: Well, he's saying two main things, both of which are wrong, which is not surprising. Number one, he's saying the market doesn't care about the level of debts we have today, because interest rates, the taper notwithstanding, are still exceedingly low by historic standards. Secondly, he's saying the deficit has come down in percentage terms by a lot; therefore, why worry?

Both of those are essentially propaganda ploys that ignore the underlying reality. Number one, the reason interest rates are at today's level, turn-of-the-year level, at three percent on the ten-year and 40 basis points on the two-year is that the Fed is still massively in the market buying debt, notwithstanding their announcement. They're still buying at an \$85 billion annual rate, right in the heart of the yield curve. The Fed has not abolished the law of supply and demand. Therefore, as long as that massive bid is there every day from the New York Fed, interest rates will be artificially low.

So this is not the so-called bond vigilantes giving Washington a pass, a green light, to keep borrowing. That's the Fed monetizing the debt and creating the distorted, deceptive appearance that all is well, which leads unreconstructed Keynesians like Krugman to say, "See? I told you there's no problem." The obvious point is that we got \$17 trillion of national debt now. It's rising at a trillion rate, and we'll get into that. We'll soon be at \$20 trillion, and when interest rates normalize—because sooner or later the Fed will taper and its buying of this massive daily dose of bonds will decline, diminish, and then ultimately be eliminated—real interest rates, normalized interest rates, will be 200 or 300 basis points higher, I believe, at minimum, and the carry cost on the debt will explode. I'm not sure what Krugman will say then, but he'll probably have some excuse.

The second thing is the deficit level in 2013, the year just passed, came down, but it came down from the stratosphere, which was created by the bad policies, monetary and fiscally, of the past. But if you look at the \$750 billion reported, and you recognize there's one-time gains in there because of the huge rush to realize capital gains paid by bonuses and special dividends and so forth at the end of last year before the fiscal cliff, and if you also recognize the phony \$60 billion, \$70 billion that has been put into the Treasury coffers by Freddie Mac and Fannie Mae—it was just an accounting gimmick, not real or sustainable deficit reduction—then the number for 2013, which is really the fourth year of this so-called expansion, is running

at about \$800 billion, which is 5 percent of GDP. By any historic standard that's exceedingly high, dangerous, and more importantly it's well into this expansion.

Again, I say, Krugman does not remind people, because he doesn't know it himself, that the business cycle hasn't been abolished. This cycle will end. We will have another dislocation and another recession, some other economic upset, and when that happens and we're still 5 percent of GDP deep into the deficit it will explode upward from that level, and the true nature of the fiscal calamity that is embedded in policy today will become evident. So again, unfortunately Krugman and much of the mainstream media continue to selectively pick and misinterpret short-run data that completely ignore the underlying rotten policy foundation that undergirds the day-to-day movement of the economy and the headlines that get reported.

WOODS: David, three or four weeks ago Larry Summers was said to have argued that bubbles may be a good thing. He wasn't saying that, of course. But what he was saying was something not a million miles remote from what you've been saying: that recent growth, if you can call it that, in the U.S. economy over the past several decades has just been a matter of serial bubbles, one after the other. And he's saying that of course it would be better if we could have an economy that could grow without bubbles. But I thought that was an interesting admission on his part.

By the way, let me also add to that these are the same people, Krugman and Summers, who say we shouldn't be worried about inflation. Why are you people worried about money creation, they demand to know. That's not an issue of concern, they say. And yet they turn around and say, gee, it's funny, the economy seems to be shot through with bubbles. No point in worrying about what might be causing that!

So how could this have been avoided? What mistakes were made? How could we have had healthy growth?

STOCKMAN: There are a lot of different questions there, Tom, and it goes to the heart of the whole deformation, "the great deformation," as I call it in my book [of the same name]. Bubbles do not create wealth that's sustainable and that's broadly available to the working population of the free-market capitalist system. Financial bubbles engineered by the Fed create artificial, temporary financial asset inflations, viral ones as we can see now, that resolve in temporary windfalls to those who own risk assets. In stocks, about 10 percent of the households own 80 percent of the risk assets, and really the top one percent probably owns half of that. So windfalls are created, but bubbles can't be sustained indefinitely even by the central bank. So now we're in what I call a serial bubble economy. The Fed has become the serial bubble machine, and we're in the third great bubble of this century. Remember, dot-com was dismissed in 2000 as an aberration after it crashed, and the households of America lost \$5 trillion worth of asset value.

Then actually Krugman at the time said that in 2002. We got a housing bubble, which was destructive beyond belief as we now know. It turned not just Wall Street but all of Main Street America into a gambling casino. Millions of people got caught up in it. We got the whole subprime housing price bubble and the crash that followed, but \$7 trillion or \$8 trillion worth of household net worth again was wiped out in that bubble. Then we had, obviously, the meltdown in 2008, the credit bubble around Lehman collapsing, and another big wipeout. Here we are today, and the Fed basically has doubled down after September 2008.

We know the massive unprecedented radical expansion of its balance sheet that has occurred, but I think sometimes it's worth repeating. On the eve of the Lehman collapse, September 15, 2008, the Fed's balance sheet was roughly \$850 billion. It had taken 94 years to get there, a little bit at a time. I'm obviously not saying policy before then was perfect. There were good Fed chairmen, like Volcker and William McChesney Martin, and there were awful ones along the way like Arthur Burns and Greenspan. But the point is it took a long time to build the balance sheet to \$850 billion.

Bernanke doubled it in seven weeks. I think that needs to be emphasized over and over. It was just madness. They opened up the spigots, and in 13 weeks they nearly tripled the balance sheet. And here we

are after a few more rounds of additional experimentations, QE, one, two, three, and so forth, at \$4 trillion and rising, because the taper they're proposing is so minuscule that it means the balance sheet of the Fed will be heading towards \$5 trillion over the course of this year.

When you put that kind of expansion, five X in a very short period of time, a little over four years, you begin to realize that we have a rogue central bank. That it's utterly out of control. That it's abandoned any kind of historic notion of financial discipline, of sound money, of what it takes to generate real growth and healthy living standard gains in a free-market economy. And that's why, notwithstanding all the talent that we have in America, all the great businesses, some of the new technology that's coming along, notwithstanding all of that, I am quite pessimistic, because the underlying virtues and strengths of our capitalist system are being totally compromised and eroded by this rogue central bank, and a Washington fiscal policy that is enabled by it.

WOODS: Sometimes people like us and Ron Paul will say that the policies of the Fed tend to benefit the wealthy at the expense of everybody else. But if the Fed is responsible for bubble after bubble, while it's true that in the short run this leads to asset price inflation and helps my portfolio, if it's going to wind up crashing then I, too, am harmed by this. Who really does wind up benefiting in the long run?

STOCKMAN: I think that's really a good point, and in the real long run I think no one does, because obviously this isn't sustainable. It's heading for a crash landing some way somewhere down the road. And even the one percent that are sitting on massively inflated real estate values, massively inflated so-called risk assets, and particularly high beta stocks will lose as well. This isn't some kind of prediction out of the blue. It's simply a statement of what we already observed in the earlier, smaller crashes we've had in the past. Today the Russell 2000, as an example, is trading at 85 times trailing earnings. That's absurd. It's a massive over-evaluation. The Russell, which is the mid- and small-cap stocks in America, has boomed by 40 percent in the last year, whereas earnings of those companies have barely increased at all. It's all multiple expansions. It's all a front-running speculative move driven by the easy money and daily liquidity injections of the Fed.

But when it crashes, the people who've speculated will lose their shirts as well. That happened in the 2008 crash. The Russell 2000, from the time of the dot-com bottom in 2002 to early 2008, had risen from 350 to 850, so that's a huge rise over four or five years. Eleven violent trading days after the Lehman bust through the bottom in March 2009, all of that gain was lost. The Russell went all the way back to 350. Maybe some of the ultra-smart speculators got out of the way early, but when you have that kind of violent post bubble or bubble burst almost everybody loses. I think that's the kind of scenario we have in front of us. These markets are massively pumped up. They are valued well beyond any reasonable sense of where the economy can go, because it's struggling just to move forward by a couple percentage points a year. And as a result of that, when the next bust comes, we are going to have some serious broken furniture. Even in terms of the assets of the one percent, because I believe the central banks are running out of tricks. They've got the interest rate at zero. They cannot possibly buy debt at a more rapid rate in the U.S. or Japan than they're doing now or all the debt will be monetized within a few years. So I think we're reaching the day of reckoning, and when it happens even the false prosperity of the one percent will be under serious jeopardy and decline.

WOODS: I have other economic questions I want to ask you, but I'm interested, though, in something that may be a little bit more personal. I wonder if you could tell us something about the evolution of your own thought since you were in the Reagan White House in the early 1980s to today. How much, perhaps from your own learning and reading, have your views changed? Do you feel you understand things better now? Or have you just simply amplified views that you had in the early 1980s? How is the David Stockman of 2014 different from the David Stockman of, say, 1984?

STOCKMAN: I think that is a good question. I appreciate you asking it. The three principles that I adhere to

today that are embodied in a revisionist history in my book are the principles that are fundamentally important to sustain liberty and prosperity and a free-market economy: fiscal rectitude, sound money, and honest free-market capitalism, where we allow winners to win and losers to suffer the consequence. I believe that when I was in the OMB in the cabinet in the Reagan White House in the early 1980s, we struggled for some of those goals. I finally left in 1985, because I believed fiscal rectitude had been lost. I wrote about that in my book *The Triumph of Politics* that I published in 1986.

Now what changed since then is I did not realize during the many years that I was in Wall Street and the financial markets in the buyout business how seriously monetary policy was drifting from the principles of sound money that Reagan articulated while he was in office that he observed by supporting Volcker when he wrung this virulent inflation out of the economy that had been created by the Fed in the 1970s. But I wasn't really tracking day to day the evolution of monetary policy and discretionary, activist central banking under Greenspan and then Bernanke. I didn't see that the Fed was turning into what I call a monetary central-planning agency, that the Open Market Committee was getting so deeply implanted in the day-to-day operations of the financial markets and the economy that it amounted, as I say in my book, to a monetary politburo.

I didn't really focus on all of that over the intervening 20 years until suddenly I got a wake-up call when Lehman melted down and failed, and suddenly you had all of Washington jumping into this massive frenzy spree of bailouts and money printing. And Bernanke saying that a Great Depression 2.0 is at hand, and he opened up the spigots and tripled the balance sheet and so forth, as I mentioned before, in a short period of time. I then realized how far off base monetary policy had drifted, that obviously the meltdown going on in Washington was simply the financial bubble bursting that the Fed had created in the housing market and in the credit market and the stock market and so forth.

And I was appalled when not only the Bernanke Fed did this—after all, Bernanke was appointed by Bush—but then when the Bush White House and Treasury under Paulson sort of doubled down, jumped on the bandwagon, and forced through TARP on that second vote even when most of the Republicans in the House really knew that this was the Rubicon. They were finally throwing the three principles overboard that I described at the beginning here. That is, free-market capitalism was gone. It was now pure crony capitalism. Sound money was a joke when you're expanding the balance sheet and monetizing debt at that rate. Fiscal rectitude Republicans had more or less abandoned many years earlier when Cheney said that deficits don't matter. But now, a Republican administration pushes through TARP at \$700 billion. Soon thereafter it bails out not only Wall Street but also GM and the auto industry and much else. That was the wake-up call. The three principles had been fundamentally defiled, had been fundamentally abandoned not only by the usual suspects—liberals and big-government lobbies of Washington—but by the very Republican Party itself.

WOODS: David, you've been very generous with us today, but I can't help asking you just one more thing before I let you go. Where would be the fun if I didn't ask you something a little bit more challenging?

STOCKMAN: Okay.

WOODS: *The Great Deformation* is a book I have promoted liked crazy. I was at a conference at which I actually held up my prepublication copy and said, I'm selling my own books, but I want you to buy this one. I want you to go out and get this one. So I love what you're doing.

But once in a while you'll talk on TV or in columns and say, look, the fiscal picture is just terrible. We've got to raise taxes.

Now I think at this point you see a lot of what's going on in Washington. We have had sociopaths in charge. And it's not just a case of bad people in charge of a good system. The whole system is absolutely corrupt through and through, probably beyond reform. So why are you so concerned that these people be able to pay their bills? So what if the thing collapses? Who cares? And if you're inclined to say they're going to pay

their bills through inflation if they can't pay it with tax revenue, I agree with you. But I can hedge against inflation. I can't hedge against taxes.

STOCKMAN: Well, I think you've raised a fundamental issue, and it's about a debate that I try to lay out in my book and that I actually participated in during a 40-year lifetime, both in Washington for half of it and on Wall Street. That is that the debate between what I call the principle of starve-the-beast, which is essentially what the Reagan era attempted to do—not on purpose, but that was the practical outcome. Or pay your bills, which was the principle that Eisenhower more or less successfully implemented in the 1950s. Since the Reagan era, most conservatives and most Republicans have kind of rallied to starve-the-beast. Keep the taxes low. Cut them whenever you can. That sooner or later will reign in big government, reign in the states, force reform let's say of entitlements and spending cutbacks and so forth, and that's the way to go.

I have concluded that that is upside down. That by allowing the state to grow and grow and entitlements to be unaddressed, and this big massive defense budget to roll forward in a world where we really don't have any serious industrial state enemies, is a result of the fact that people don't feel the cost, that is the broad public does not feel the cost of funding the welfare state and the warfare state and the huge big-government lobby-based system that comes out of Washington. I've come to the conclusion that only when you pay your bills on time every year will the public understand that they need to send different people to Washington. That they can't have free lunches. That we can't have massive non-means-tested entitlements. That we don't need a war machine of the size that we have today.

The alternative is to continue to drift as we do now with a rogue central bank, the national debt rising and rising as far as the eye can see, and having a total catastrophe somewhere down the road, or going back to the Eisenhower principle of paying your bills, waking up the public, mobilizing the hard-working taxpaying people of America to demand a shrinkage on the spending side in order to reduce the burden of taxes. You may say that's idealistic, that it's theoretical, and my answer would be read my book. You'll see it's not. That's exactly what Eisenhower did. He eventually got taxes down by a couple percentage points of GDP, but he said you have to earn it first by cutting spending, and he cut defense 30 percent. I think we need to go back to that principle. You have to earn the tax reductions. You have to pay your bills. You have to tell the truth to the broad middle class working, taxpaying public as to what real cost of this massive government is.