David Stockman: The Keynesian Toolbox is Empty
Guest: David Stockman
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David Stockman is former director of the Office of Management and Budget under Ronald Reagan and the author, most recently, of The Great Deformation: The Corruption of Capitalism in America.

WOODS: I was just looking over DavidStockmansContraCorner.com, and I decided as much I'd like to talk about Japan and China, and we'll get to those, I really want to do a potpourri discussion with you because there's so many interesting topics you've got there. You've got first of all, an attack on Krugman and a guy named Ken Rogoff of Harvard for basically incredibly boneheaded suggestions—not just boneheaded, but in the case of Rogoff, really almost evil. He's recommending, as a way of helping central banks carry out their policies more effectively, the abolition of cash altogether. Now, what is the obstacle that cash presents to the monetary authorities? Why do they hate cash so much?

STOCKMAN: Well, it is really amazing. It's almost hard to believe that a Harvard professor of some renown would be travelling around the world not simply writing a blog or a short article, but traveling the policy circuits of the world advocating the abolition of cash in order to facilitate a further expansion of monetary policy in the misguided [CHECK] underway now against deflation. In other words, they want the nominal interest rate to go in negative territory. It's already there at the ECB for the short-term deposit facility, but they would like to drive nominal interest rates negative.

The problem with that is very quickly people would realize that they are better off in cash than they are in a depository institution where the central bank has forced the yield into negative territory. So how do they solve that problem? They solve that problem, really unbelievable, by taking all the greenbacks out of your wallet and all of the coins out of your pocket, forcing you to park your liquid funds in a regulated money market or bank and then pay for the privilege of keeping your liquid funds there at some negative interest rate that might be one or two or three. All this as part of some hair-brained, nonsensical scheme to restart the world economy or the economy at least of Europe, Japan and elsewhere, by reviving inflation. There are so many moving pieces to that that are just nonsensical that you don't know where to start.

Except I think it's pretty well proven over the last 50 years, if not longer, that more inflation has nothing to do with real prosperity, real growth, real jobs, real wealth generation, and yet, we're now in the thralls, I would say, of a fraternity of central bankers and their hirelings in academia like both Krugman and Rogoff, who are advocating policies and actions by the central banks that are positively ridiculous and dangerous and amount, as I've said before, to an economic *coup d'etat*. If you were going to say we're going to punish all the savers of America, which there are tens of millions, by forcing them to pay money to keep their deposits, and you put that to a vote in Congress—because it's really a fiscal action, a regulatory action—it wouldn't see the light of day. It wouldn't find a sponsor. Even Bernie Sanders, the socialist from Vermont, wouldn't stand up for that one. And yet, we have central banks all over the world ready to do this, effectively doing it by driving interest rates in the short term into negative territory after inflation. And now we have academics like Professor Rogoff running around suggesting that we actually drive interest rates negative, even in nominal terms, which after inflation and taxes would mean, what? People are losing 5% of their money every year because government policies [CHECK] have decided that's the thing to do. It's really crazy.

WOODS: David, you were mentioning just now that there's no connection between money growth and genuine economic progress, and I note that you have a piece at DavidStockmansContraCorner.com in which you express your frustration at the kind of offhand comments—and this drives me crazy, too—that we'll read in Bloomberg and these financial outlets where they just take for granted the entire interventionist or Keynesian apparatus. They take it for granted as if it's simply obvious. So you single out this sentence from a Bloomberg article: "Industrial profits in China fell the most in two years, underscoring the need for looser monetary conditions as the world's second-largest economy slows." So that's just stated as if it's an obvious fact rather than, at the very least, a highly debatable proposition.

STOCKMAN: Exactly right. In other words, my point in that post was to say that this Keynesian narrative has gotten so embedded in the mainstream discussion that reporters for the so-called financial press basically are echo chambers or Xerox machines that repost the press releases they get from official institutions or from their sources at the Fed or the Treasury, or whatever. But it's gotten so embedded in the narrative that this particular writer thinks nothing of making a declarative sentence that a tiny change in China—and after all, I don't think China is some remarkable outbreak of free-market capitalism by any means. Everyone knows it's red capitalism. It's driven from the center. It's powered by the greatest credit bubble in history. But even if you couldn't see that, and even if you're based in Hong Kong and had been watching it for quite a while as this reporter was, the fact that industrial profits have dropped 2% year-over-year from October of this year to October last year, would prompt the clause in that opening sentence that said, oh, we must need more money printing. It's just, I think, a powerful case in point. Now, it might—it should have been reminded or known to this particular Bloomberg reporter—and, frankly, the Reuters reporters and the *Wall Street Journal* reporters are just as bad—that China's credit has grown from outstanding, public and private, from one trillion dollars in the year 2000 to 25 trillion today. Never in history has there been a 25x increase in the amount of debt outstanding in such a short period of time. Therefore, it's obvious that this is a massive monetary credit, speculative bubble that has huge problems and certainly those problems aren't going to be ameliorated or cured by even more monetary ease, which was the first thing that came off his word processor in the first sentence of that article.

WOODS: David, how do we disentangle what is money-driven in China and what really may be the result of, well, maybe somewhat looser controls over the economy—because certainly, in the cities, anyway, it does seem like people's living standards are rising. So there is some phenomenon taking place.

STOCKMAN: Oh, yeah, the problem in China is that they developed too rapidly the easy way with massive doses of credit, and without the disciplines of real markets and a legal framework, including bankruptcy, that would allow for the normal mechanisms of free-market or capitalist growth to set in and create a solid foundation of rising living standards and a growing, expanding economy. You have the prosperity, but it was achieved through the printing press, in part, compelled by policies in the West. The Fed was running the printing press like no tomorrow over the last 14 years during the same period that I cited about Japan. The balance sheet of the Fed went from $500 billion in year 2,000 to four and a half trillion today—9x, you know, just crazy, nothing like this in history. That would have—if left on a drip [CHECK] by the People's Bank of China, would have caused their exchange rate to soar. That would have fundamentally undermined their export-driven mercantilist model. They couldn't abide by that because it would have caused unrest in the hinterlands, and the comrades and commissars running the system from Beijing weren't about to tolerate that.

So they discovered the printing press, and they basically bought dollars in order to peg the RMB at a level consistent with their massive export expansion and not allow it to appreciate against the dollar, which was being trashed by the Federal Reserve. So in the process then of defending or pegging their currency—and I don't justify it; I am only saying this is what all of the East Asian export mercantilist-model policies did in Korea, Japan, but especially in China. What they did was they bought massive amounts of dollars, sold the RMB in financial transactions. That did two things. One, it massively expanded the money supply of RMB internally in China and fueled this crazy borrowing and building and speculative boom they had. But it also then resulted in the accumulation of something like $4 trillion worth of reserves, which aren't really reserves. That's just the accumulation of dollar claims that resulted from their whole policy of defending against the waves of dollars coming from the Fed and trying to build an overnight, modern economy through massive credit expansion and monetary stimulation.

I think it's a house of cards. As we all well know, there's empty cities everywhere, empty malls, airports that aren't used, fast rail built around the country, much of it too dangerous to use at high speed, highways to nowhere, bridges that aren't used. There's a story just out two days ago where the Monetary Reform Commission in Beijing itself—an official government institution—said we believe that more than $7 trillion of investment has been wasted over the last 5 or 10 years as the result of this massive building and borrowing and credit spree that they've had. So there's a lot to sort out in China, but I think it's part of the global bubble that has been created by all the central banks doing the same thing, expanding their balance sheets, depressing interest rates, monetizing sovereign debt. The whole menu has been done worldwide: Bank of Japan, ECB, United States, Bank of England, People's Bank of China, and it has created a massive, unstable, unsustainable global boom and financial bubble that I believe is going to come unwound any time now, and China is going to be part of the hard landing. The idea that they are going to be able to have a soft landing and that you have deaf Keynesian [CHECK] who used to be communists running the levers of economic control out of Beijing is just one of the wildest fairy tales and illusory dreams that you could imagine, and yet it's one that's peddled by Wall Street every day. Because the only thing that Wall Street cares about now is keeping the game going hour by hour, day by day, and that's based on one or another central bank continuing to put juice into the system.

It's really pretty pathetic. I think the capital markets have been destroyed by the central banks. There is no honest price discovery. Nothing out in those markets, the S&P 500 or the yield on the 10-year bond in the United States or Italy or Germany, is an honest price. How in the world could someone want to own an Italian 10-year bond at 1.99% when Italy is bankrupt and is likely to break up either politically or be driven out of the Euro sometime over the next few years? Nothing is remotely being priced based on real risk, real economic, and a sober view of the future. It's all being priced on: is the ECB, for example, going to go into QE? If it does, let's buy all these sovereign bonds, because once the central bank starts buying them, the price will go up. We can pocket the yield funded on repo, which is zero cost overnight money and laugh all the way to the bank. This is what's going on also for the world. It's worse in Japan even than in Europe. It's crazy what's happening in Japan, and China is just as bad.

WOODS: Well, David, assuming this happens in China, that there's a reversal because of all the artificial credit creation, what do you think the ripple effects would be on the United States economy and on the U.S. consumer?

STOCKMAN: I think the ripple effects is there is a horrendous industrial deflation coming down the pike on a global basis. The result of the China boom was to create immense excess demand for oil, for copper, for iron ore, for nickel, for aluminum, and you can go on down the line. Secondly, as we know from good Austrian economics, when you have artificially low interest rates, that causes malinvestment. So downstream of the mining sector that got way overbuilt because prices were bid to extreme highs. Oil is over $100-$150 at the last peak. Iron ore, $200 a ton, sitting under $70 or around $70 today. You had massive overbuilding of the mining and raw materials sector. That then fueled expansion of the manufacturing material conversion and fabrication sectors.

So there is massive excess capacity in China and throughout the so-called emerging markets: Brazil, Indonesia, Korea, and elsewhere. So therefore, we have vastly overbuilt our fixed capital structure from iron ore mines to bulk carriers to port facilities to steelworks in China, aluminum smelters and so forth. So what does this mean? It means that as the system—the bubble—

bursts and unwinds, there's going to be a huge scramble for market share. This is what you can see right now in oil. Saudi Arabia has announced again this morning or yesterday they are cutting prices for December yet another time. The same thing is happening in most other industrial commodities. Certainly iron ore is a leading case. And so it's going to cause an enormous amount of downward price spiral and dumping of excess commodities and excess industrial goods on the world market. In some ways, that's going to be helpful to consumers because it'll mean prices are lower, but on the other hand, all of that capacity has been funded with debt of one type or another—emerging market bonds, high-yield energy patch [CHECK] junk bonds here, bank loans in Europe which are huge that have gone out to the transportation and shipping sector of the world and so forth. There's going to be huge carnage in the financial infrastructure that rose up to fund this massive spree of investment and malinvestment that occurred over the last 10 or 15 years.

WOODS: David, on Japan, comment on this observation. It seems to me that when we were arguing about austerity, so-called, Paul Krugman was very quick to announce the failure of austerity, even though with the so-called austerity, you needed a magnifying glass to see it in most cases. There was very, very little retrenchment in the size of government and in government spending, but we know that austerity has failed. Whereas, in Japan, the effect has not been miniscule, by contrast, where in austerity if you had any at all, it was very little. In Japan they've had dose after dose after dose of Keynesian so-called medicine over more than two decades, and as you showed in an article that I read on your site a couple of weeks ago, their index of total industrial production is unchanged after all these doses of Keynesianism, and they won't admit defeat there. Austerity has failed—*that* they know. But they'll never say Keynesianism failed.

STOCKMAN: Yeah, it's one of these propositions that academics love, and that is they argue the counterfactual. In other words, if it hasn't failed, you didn't do enough. Now, I say wait a minute. I can remember well in 1981, when I first went into the White House in the Reagan Administration. We were visited by a group of senior financial officials, Ministry of Finance officials, from Japan worried that maybe that maybe the Reagan plan would lead to too big of deficits, and they were deficit hawks back then—1980—official Japan—[CHECK] their debt-to-GDP was 30%.

WOODS: Oh, my gosh.

STOCKMAN: Yeah, and they had their bubble, which was really induced in the mid-'80s when Jim Baker and the rest of them forced them to revalue the yen sharply. They countered that by massive expansion of lending internally. They got their huge real estate boom. The economy collapsed, and very shortly after that happened in 1990, they went all out Keynesian monetary and fiscal stimulus, and here we are today, and their debt-to-GDP is off the charts. It's 240%. Instead of being the best in the world in terms of fiscal discipline where they are today, where they were in 1980 as a young, productive miracle economy, they are today 35 years later an old, aged colony effectively that has buried itself in the most monumental accretion of public debt ever imagined—240% of GDP. And they now have a government that is unwilling to do anything about it. But that's what this whole snap election is about. They are going to postpone the scheduled consumption tax increase that was to happen next year for another two or three years. Now, I am not arguing for big taxes or as opposed to spending, but the point is they have been doing this so long. I had a chart in the blog that you referred to that showed that since 1992, their revenue has not gone anywhere—it's been about roughly $45 trillion yen a year. They are spending because they are getting older and older and because they were doing all this Keynesian road building in places where nobody lived and so forth has risen to $100 billion.

You look at that chart, and essentially, they've become locked into a permanent fiscal condition where they are raising less than $0.50 on every dollar they are spending. And the difference is being added to the national debt, and all of the incremental debt is being bought by the BOJ—the Bank of Japan—in other words, it's being 100% monetized because no one in their right mind today wants to buy a ten-year Japanese government bond at a yield of 0.4 or 4/10ths of 1%, which is what sets market prices. So if you can imagine the way that they have contorted and twisted and backed themselves into this disaster of money printing and borrowing, it's pretty remarkable. I don't think even in the year 2000 anybody could have imagined a nation that's about ready to reinforce in a big way this Abe-nomics, which is absolute Keynesian snake oil like has never been practiced before. And yet, somehow, the media and the government has convinced the population of Japan that we're going to destroy the purchasing power of the yen. We're going to bury you if you're still working in debt, and somehow they've convinced the population that this is going to work in the long run. There will be a day of reckoning. I think there is going to be a major financial and fiscal and social crisis in Japan, and that may be where the fire starts this time because Japan is a subprime nation not just the subprime housing problem we had in '06 and '07 and 2008. Japan has maneuvered itself into the status of the subprime nation that is nearing the end of the rope in terms of financial liability.

WOODS: Well, David, I want to tell the listeners that on the—I have a newly redesigned website at TomWoods.com, and on the resources page TomWoods.com/resources. I list only a handful of really indispensable websites, and yours is one of them.

STOCKMAN: Great.

WOODS: And more than that, I want to tell people even if you think I am sick of getting newsletters in my email. My email box is full. Okay, well, cancel a few of those so that you can get David Stockman's newsletter because I don't know how you find all these great stories, and I don't know how you write all these great stories, but it helps keep me informed, and it will help keep you guys informed as well. David Stockman, thanks for your time today. Best to you in the new year, and I hope our fortunes should change in the new year.

STOCKMAN: Hopefully, and very good to talk to you and sort of lay out some of these issues because as I said before, we are in a very dangerous time, and people need to understand how deep these difficulties are and how much at variance the truth is from what you hear in the daily, mainstream media, bubblevision, and talking heads who tell you to keep buying stocks. These markets are dangerous. What people really need to do is get out of harm's way and wait for the storm to pass.

WOODS: Well, David, thanks again—important advice. We'll talk to you again in 2015 I hope.

STOCKMAN: Okay, very good.