Reverberations Between Immoderate Land-Price Cycles and Banking Cycles
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Reverberations Between Immoderate Land-Price Cycles and Banking Cycles

Mason Gaffney[1]

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Legacy of the Pecora Hearings.

We begin with the Pecora Hearings of March 1933.[2] Ferdinand Pecora's were another "ten days that shook the world," but Pecora's ten days shook the very temple of capitalism, Wall Street itself.[3]

These were the dying days of Hoover's Administration and the Republican Congress. Herbert Hoover was desperate to find a scapegoat for the disasters he had overseen, yet holding back safely short of challenging the system, or the cartelization of American industry he had sponsored. He focused on an alleged plot by short sellers who were "selling America short." Few bought this political play on words, so he pushed the lame duck Senate's Banking and Currency Committee to investigate Wall Street and gin up some more scapegoats to save Hoover's face and reputation. Chair of the Committee, through Senate seniority rules, was Peter Norbeck of S.D., a residue of old prairie Populism via T.R.'s Bull Moose Party, and an unreconstructed Progressive[4]. Norbeck knew little of Banking and Currency – Wall Street Republicans stigmatized old prairie populists as "Sons of the Wild Jackass." Norbeck sought a savvy prosecutor for the hearings.

Few wanted the job – two weeks working for a lame duck Congress, making powerful enemies. Far down on his list Norbeck came to Ferdinand Pecora, a mere assistant D.A. for New York County. Pecora likewise knew little of banking and currency, but was a quick study with remarkable energy, high ambition, lethal aim, and little awe of pedigreed bankers with Ivy-League degrees, and intimidating miens. Pecora pushed his inquiries well beyond what Hoover or even Norbeck had dreamed, and forced so many famous bankers to disrobe under oath that the hearings made banner headlines and are still known by his name.

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1 Footnotes added by Polly Cleveland and John Tepper Marlin (original footnotes marked MG)

2 The Senate Banking Committee, chaired by Senator Peter Norbeck (R-ND), set up an inquiry into the causes of the Wall Street Crash on March 4, 1932, under President Herbert Hoover. Hearings began April 11, 1932. In January 1933, in the lame duck period before the inauguration of FDR and swearing in of the new Democratic majority Congress, Norbeck appointed Ferdinand Pecora as Chief Counsel to write the final report. Pecora was the fourth staff person appointed to manage the hearings; he had been an assistant DA for New York County, with a record of prosecuting illegal brokerage houses. After FDR's inauguration March 4, 1933, Pecora requested permission of the new committee chairman, Duncan Fletcher (D-FL), to hold an additional month of hearings. Pecora conducted a headline-grabbing exposé of Charles Mitchell, head of National City Bank (now Citibank), of J.P. Morgan, and of other "banksters." Congress responded by passing the Glass-Steagall Banking Act of 1933 to separate commercial and investment banking, the Securities Act of 1933 to set penalties for filing false information about stocks, and the Securities Exchange Act of 1934, forming the SEC to regulate stock exchanges. The Pecora investigation continued until May 4, 1934, after which Pecora was appointed one of the first commissioners of the SEC.

3 By "Pecora's ten days," Gaffney is probably referring to the two weeks before March 4, 1933, when Pecora was already generating headlines denouncing stock manipulations.

4 MG: As a mnemonic, Senator Norbeck was responsible for adding T.R.'s visage to the group on Mt. Rushmore.

Pecora had only ten days to put Wall Street under oath, but he seized the public spotlight with his sense of drama, his aim for big players and big issues, and his knockout punch. Pecora's ten days preceded FDR's 100 days, and built a springboard for New Dealers to vault into reforms like the SEC, the FDIC, the RFC, Glass-Steagall, production credit for farmers, and federal intervention in credit markets through FHA, S&L subsidies, FNMA, and later the VA.

Before Pecora bankers were already under fire for bad judgment; after Pecora they were "banksters," disgraced for bad faith, breach of trust and self-dealing. Several were to face criminal charges. Pecora dislodged bankers from their economic, political and social pedestal atop high society and government bureaucrats, and turned the world of finance upside down. FDR could not have asked for a better springboard.

Not since the Pujo Committee revelations of 1912-13, and Louis Brandeis' classic book thereon (*Other People's Money)*, both at the acme of the Progressive Era, had anyone penetrated so deeply through Wall Street's opacity to publicize its villainies. And not, tragically, has anyone done so since.[5]

What Pecora Missed

There was, however, a basic flaw and lacuna in Pecora's brilliant and dominating performance. He saw the Great Crash as mainly a matter of money and securities, the paper economy, if you will. This view has narrowed and confined reformers ever since, both in politics and academe. Macroeconomics has become synonymous with Fiscal and Monetary Policy (FMP). Y = C+I+G is the template. Everything is expressed in its terms – it dominates the language, hence the thought. "The Left" wants more C and G; "The Right" wants more "I" and its own kind of G. Within "G," "The Left" generally wants more welfare, and "The Right" more military. Both lean more towards hardware than software. Within those confines the same tired sermons echo back and forth endlessly. This is its own kind of "reverberation," but not the kind my title means. This is the long-term effect of Pecora's lacuna.

One major change came along with Reagan-Cheney and their Laffer staffer after 1981. "The Right," long a bulwark against deficit finance, converted to it. Instead of taxing the rich, the idea now is to borrow from them, and pay them interest, leading to an explosion of Gini Ratios in real estate, stocks, bonds, income (personal and corporate), estates, and nearly anything that gets measured. Concentration has grown so extreme there is no longer much need for anything as nuanced and comprehensive as a Lorenz Curve or a Gini Ratio: it is now the 1% vs. the 99%.

Meantime, other scholars published a distinguished body of research into topics equally or more important, matters of the real economy. The academic clerisy has purged most of these from macro by compartmentalization. One may study them at length, but only within accepted confines. If one spills over the boundary lines of one's compartment one is "overambitious" or "swellheaded" or "spreading himself too thin." When submitting work for publication one is required to self-classify it by pigeonhole, taken from a standard list we have all seen. There is an implicit hierarchy of little boxes[6], with macro on the "commanding heights."

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[5] For a full account of the Pecora Hearings, see The Man Who Busted the "Banksters", Smithsonian Magazine Nov 29,2011

[6]MG: "And the children go to summer camp and then to the university
Where they all got put in boxes, and they all came out the same" – Malvina Reynolds

Thus the clerisy sanitizes macro from contamination from at least the following:

A) Real estate and its endogenous cycle of about 18 years

Real estate and its endogenous cycle of about 18 years, was firmly documented from primary sources and established by Homer Hoyt in his classic, *100 years of Land Values in Chicago, 1833-1933.* Other writers reinforced and replicated the findings: Ernest Fisher and John J. Holland in Michigan, Phillip Cornick in New York, H.D. Simpson in Chicago, Lewis Maverick on subdivision cycles, Arthur H. Cole on cycles in sales of public land, Harry Scherman on foreclosures, and others.

Hoyt carried this back no further than 100 years because there was no Chicago before 1833, but 18 years before Chicago's and Andrew Jackson's great crash of 1836-37 there was Monroe's crash of 1819. 21 years before then was Hamilton's crash of 1798, when Andrew Jackson lost his lands and William Morris and William Duer went to debtors' prison. Before that one can find crash before crash before crash in the annals: the Mississippi Bubble crash of 1720; the Dutch crash of 1630 or so, synchronized with the reverse migration from New England after 1630; in the 15th Century it was the Fugger bank in Augsburg that went down with the fortunes of imperialistic Spain; the Florentine and Medici-banker bust of 1494 leading to Savonarola's Bonfire of the Vanities; boom and bust around Orleans following its liberation by Joan of Arc in 1429; and so on back and back.

Apart from the endogenous 18-year cycle, major peace treaties can be shown to generate irrational exuberance for future land rents, and to release funds to the private sector where they are used again to bid up land prices. The interplay of these two cycles explains much of cyclical economic history.

B) Austrian economics, analyzing causes and effects of the time-structure of capital

Austrian economics analyzes causes and effects of the time-structure of capital and the pace of capital turnover. Oddly, many economists who should know better identify Hayek with the Chicago School because he once taught there, but he was never welcomed in the Department of Economics. Frank Knight's many learned articles attacking Hayek's capital theory were an obsession, carrying on J.B. Clark's vendetta against Eugen von Böhm-Bawerk. Knight, like Clark, could not abide the Austrian's concept of a “period of production” because it implies a sharp distinction of capital goods, which have one, and land, which does not. Keynes, too, put down Hayek and von Mises and drove them from macro dominance in England.

Hayek and fellow Austrians finally found happiness and support with libertarian foundations and other wealthy patrons, by attacking regulations and contra-cyclical fiscal policies of all kinds, to the applause of Chambers of Commerce, but they remain outliers in the profession. Roger Garrison remains one of the few self-called “Austrians” who publishes on cycles, and even he attributes the bias to over-long periods of production exclusively to central bank policy, ignoring all the other causes inherent in tax policies and land policies.

C) Institutional economics

Institutional economics is the heritage of Veblen, Commons, Ayres, Montgomery, Means, Thurman Arnold, Corcoran and Cohen, the TNEC investigations, and Senator Harry Truman's hearings on arms profiteering in the early 1940's. Dominant figures in the FMP camps, both Keynesian and Chicagoan, diss and dismiss such work by compartmentalizing it as mere “structural reform,” unworthy of attention in the greater world of $Y = C+I+G$. Studies of

Industrial Organization and cartelization and market power have dwindled to a shadow, although Joe Bain, Frederick Scherer and others produced excellent texts on the subject.

What Kept Us Out of Serious Trouble Between 1929 and 2008?

The obvious link between FMP and real estate is the quality of credit. Hoyt emphasized how subprime (which he called "shoestring") financing had waxed in the boom phase of every one of the 5 major land cycles he documented in detail from 1833 to 1933. The commercial loan school of banking, dominant in the Progressive Era, helped save us from a crash that was due in or near 1911, following the 18-year cycle from 1893. In the roaring 1920s such old-fashioned caution was cast aside, and deposit expansion was again used freely to pump up land and stock prices. These reverberated with deposit expansion, in the manner to be shown, leading to The Great Real Estate Crash starting from 1926, followed by the stock crash of 1929.

And yet, Friedman and his school of "monetarism," as they rose to dominance, ruled this out of consideration, both in theory and practice. They damned Quality Control as bureaucratic "intervention" with private bankers. Only Quantity Control was permissible. Ignoring Pecora's revelations, Friedman et al. knew that profit-seeking bankers, proven survivors in free markets, must possess sounder judgment than nosy governmental officers. Pecora's findings were not refuted or denied, which would remind people of them. They were not even compartmentalized and buried in low-level pigeon holes, but just quietly ignored, thrust down the memory tubes of history.

With such notions regaining ascendancy, what kept us out of serious trouble for so long? After 1945, nearly everyone forecast a postwar depression. The standard FMP line was (and is) that only wartime spending had jolted us out of the Great Depression, and peace would spoil the party. This postwar gloom capped land prices. Affordability of land ran high, e.g., for housing and farming. Ambitious young entrepreneurs and home buyers could borrow to buy cheaply. Loans were mostly for production and use; price/earnings ratios ran low, payoffs were fast. All kinds of taxes remained high, stifling any kind of long-term irrational exuberance, and any "Reverberations" between land prices and bank expansion, á la 1920s.

Soon came the Cold War, the Korean War (1950-53), the costly Interstate Highway Program, urban sprawl with need for new infrastructure, the boom in airports, the Central Valley Project and the California Water Plan in California, huge new "Big Dam Foolishness" and reservoirs on the Colorado and Missouri and Tennessee and Saint Lawrence Rivers, all costing huge sums and presaging continued high taxes, meaning continued low land prices. Politically and socially, the disgraces of Senator McCarthy, Spiro Agnew, and Richard Nixon, along with social programs supported by the Warren Court, presaged more social spending and continued high taxes of all kinds. The result was to keep stifling irrational exuberance and resulting high land prices.

As to credit, S&Ls got favored access to housing lending, keeping banks of deposit in their proper place. These banks were fed a steady diet of Treasuries, considered "non-defaultable," keeping them out of real estate which had proven so unstable before.

How "Reverberations" Led to the Crashes of 1929 and 2008

What are these "Reverberations" that led to the crashes of 1929 and 2008, with lesser ones in between, and earlier to the 18-year cycles of the 19th and earlier centuries? The basic idea is simple:

- Something sparks recovery and growth. "Something" is often a peace dividend following a major peace treaty, as for example the Mississippi Bubble followed the Peace of Utrecht, 1713; the first railroad boom followed the Treaty of Guadalupe-Hidalgo, 1848; the second such boom followed Lee's surrender in 1865; or the boom of the 1920s followed the Peace of Versailles. It also helps when a polity has "magnetic" institutions that attract people and capital, and/or a vast reservoir of empty lands to fill.
- Banks of deposit begin to shift from commercial loans, short-term and self-liquidating, to lending on real estate collateral for longer terms.
- This surge of new demand raises land prices.
- Rising land prices evoke prospects of further rises, and a new kind of demand for land – no longer just for early use, but for "investment," i.e. for a "store of value," for resale, for flipping, and for speculation of various kinds. This new kind of demand is always a factor lurking in land prices, more than in other prices, because land lasts forever, and its quantity is fixed. But in a rising market it evolves into a bigger element in demand, often surpassing and outweighing the discounted cash or service flow from the current use.
- With higher prices, buyers need bigger loans and longer terms to pay for the same land. Banks create new demand deposits, taking the higher-priced land as collateral, and so on back and forth: THIS IS REVERBERATING, with echoes bouncing back and forth many times. Some also call it an upward spiral; or positive feedback. By any name it is disequilibrating and unstable and a major factor in boom/bust cycles.
- It's not only new buyers who use land as collateral. Old owners borrow on the swollen collateral to spend more on consuming.
- There is no rise of production, just a rise of prices of the same land.
- With longer-term loans, loan turnover falls, making new loans harder to get. Credit ratings fall, regardless of recorded interest rates, so the pool of eligible borrowers falls even as the supply of loanable funds falls as well.
- The upward spiral turns downward. Reverberations become negative. A cumulative crash follows.

Why Do Land Prices Have to Fall?

Land is fixed, leading to a belief that effective supply is fixed as demand rises. This is illusory, because access to land for higher (more intensive) uses expands into wide open spaces. There are dozens of stages of more intensive use: from hunting and fishing to trapping, from lumbering to tree farming, from that to sheeping to beef cattle, from grazing to feeding, to dry-farming, to plowing, to small grains to maize, to horticulture, to irrigation, from flood irrigation and irrigated pasturing to salad crops and vegetables, to vines and groves and orchards, from deciduous fruits and nuts to citrus and olives and avocadoes, to country estates, to subdivisions and housing, to low-rise apartments, to commerce and industry, to high-rise condos and offices and hotels , with many stages of intensity along the way.

J.S. Mill's *Principles* has a chapter on "Influence of the Progress of Industry and Population on Rents, Profits and Wages." In Article 4 of this Mill stresses that progress may be land-saving,

not just labor-saving and land-using. Mill said that growth of population lowers wages, but progress in the arts may offset this, and may even raise wages. When labor is dear, capital goes into saving labor; when land is dear, capital goes into saving land, and developing new lands.

Credit is due rather to the arts of architecture, construction, planning, and engineering that crafted the elevators, ventilators, pumps, central heating, load-bearing supports, plumbing and sanitation, etc. Men taught themselves these arts, by the way, in deep mines before they used them to build skyscrapers - we learned to build up by building down into our home, The Earth. (May economic theorists profit by the example.) Thus the system is more self-equilibrating than many later writers and investors have assumed, but this occurs over such a long cycle that rational perceptions often give way to irrational exuberance.

Fully built-out towns like, say, the Milwaukee near-in suburbs of Shorewood and Whitefish Bay, house 10,000 people per square mile in spacious comfort in single-family homes on tree-lined streets with curbs, gutters, parkways, and sidewalks, with parks and golf courses and even a band of mansions along the lake shore. At that density the U.S. population of 300 million souls needs 30,000 square miles, an area contained in a circle with radius of 100 miles – do the math. 100 miles is the distance from downtown to the outlying suburbs of any major city today, and 30,000 square miles is just about the area of South Carolina, and 1% of the area of the U.S.A. The posh upper east side of Manhattan has about 80,000 people per square mile, or 8 times the density of Shorewood or Whitefish Bay. The crowding may repel some people, but others prefer it as shown by their paying several million dollars for a “strata title” to a condo with 5,000 square feet of floor in a slab of space 50 stories up above 49 lower strata titles with which it shares the ground below.

Territorial Expansion—More Reasons Why Land Prices Must Fall

- The U.S.A. is vast. It only seems crowded because of institutional biases that make us substitute land for labor and capital, and that gum up the land market. John Stuart Mill perceived this 160 years ago in his *Principles*
- These biases lead to territorial expansion. The kind most observed is urban sprawl, spreading cities and their infrastructure over many times more land than they need. There is a kind of cartel price-umbrella effect where underuse of the best lands pushes settlement out to inferior lands, connected by capital tied up in infrastructure, premature in time and scattered over space.
- Even if there were well-oiled land markets and rational expectations lacking irrational exuberance, land pricing based on expected higher resale values cannot continue long, because land lasts forever and prices cannot reach, or even approach, infinity.
- Along with simple urban sprawl there is continental sprawl, urged on by works like the Interstate Highway System, interregional transfers of water, oil, gas, electric power, and the network of airlines and airports.
- The cartel price-umbrella effect dominates many other activities and industries, as documented in the literature of industrial organization which modern quants and abstract theorists, second-rate mathematicians posing as first-rate economists, lose and hide almost completely behind their complex equations with undefined terms and complex a priori theorizing untested by reality. One proof of that pudding is the sensational failure and bailout of Long Term Capital Management (LTCM), the brainchild of Nobel Laureates Robert Merton and Myron Scholes.

When Did the 18-Year Endogenous Cycle Resume After 1945?

The incipient peace dividend following the surrenders of Germany and Japan hardly got started when the Cold War intervened, plus a hot war in Korea, 1950-53. There was no scope for a peace movement like that of 1918-38 when Mellon[7] could hold down tax rates and pay down the national debt at the same time, feeding capital into the private sector by a process of "reverse crowding-out."

New capital in the private sector might seem like a key to prosperity. However, we saw above that in practice it triggers off the "Reverberation" process as described above, so prosperity carries the seeds of its own crash. The cycle is quicker than Marx the phrase-maker envisaged, or the slow cycles of Kondratieff, but well documented by Hoyt et al

After 1953 there was a bit of slack for a mild boomlet, damped, however, by gnawing fears of an inevitable nuclear holocaust. Hard as it is to believe today, many people were sinking big money digging and lining and provisioning bomb shelters in their back yards. John von Neumann, pioneer computer genius and "game theorist" revered and emulated by mathematical economists and institutionalized in The Rand Corporation hard by and linked to economists at UCLA, was advising Presidents Truman and Eisenhower to wage "preventive war" with a sneak "First Strike" nuclear attack on the USSR. Even Bertrand Russell joined the movement for "preventive war," his former pacifism evidently overpowered by von Neumann's new mathematical economics.

Following the damped 'fifties, came a headier boom in the "soaring sixties" with JFK's morale-lifting face-off with Krushchev in the Cuban missile crisis. Ike's Interstate Highway program, intended to link cities, was used to facilitate white flight and urban sprawl. Heller's form of "business Keynesianism" created a deficit by allowing fast write-offs on new investing rather than by raising spending. LBJ promised a "Great Society" with Civil Rights and a War on Poverty, but it ended in a funk with Viet Nam, the OPEC embargo, gas lines, rampant environmentalism, Brown's "Age of Limits," urban riots, urban "removal" In lieu of renewal, Watergate, and The Phillips Curve. High tax rates tempered the amplitude of the cycle, but the period was about the same old 18 years.

In about 1973 a new upsurge of land prices began. Nixon had declared "We are all Keynesans now," and Republicans, traditional budget-balancers, faced about gradually to embrace both devaluation and deficit finance. President Reagan, campaigning on Laffer's Curve and Cheney's military-industrial complex took deficit finance to new heights. Cheney, embracing Robert Barro's new theories and Sargent's "rational expectations," memorably declared that "Deficits don't matter."[8] Even Milton Friedman, the prime anti-Keynesian and monetarist guru, endorsed Barro's new rationale for deficit spending. It was Democrat Fritz Mondale, challenging Reagan in 1984, who urged balancing the budget – and lost. As the British band had played at Yorktown, the world turned upside down, although it has taken years for many to see it.

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[7] Andrew Mellon of the Pittsburgh banking family, served as Secretary of Treasury from March 1921 to February 1932, under Presidents Warren Harding, Calvin Coolidge and Herbert Hoover. Or, as progressive senator George Norris put it, "Three presidents served under Treasury Secretary Andrew Mellon."

[8] Robert Barro essentially claimed that, in response to deficit spending, rational actors would save more in anticipation of higher taxes, offsetting the deficit.

The Crash of 1990

This new upsurge, untempered and uncapped, led to the Crash of 1990, a big crash, reminiscent of Hoyt's 19th Century Chicago history. With remarkable facility and amnesia, however, Americans promptly forgot its obvious lessons and launched eagerly into the next cycle, deregulating everything in sight by underfunding the regulatory agencies, and dismantling most of the New Deal reforms. President Clinton provided the cover of a Democrat in office, but his policy of "triangulation" and "reverse crowding-out" merely deferred the debt skyrocket that went wild from 2001-09.

The period 1990-2008 saw a perfect 18-year cycle of peak, crash, recovery, boom and another bust in real estate, right out of Homer Hoyt's playbook. Cause and effect reverberated back and forth between soaring land prices and expanding bank deposits. Congress repealed Glass-Steagall in 1998, and Clinton signed on. Banks loaned loosely and freely on mortgages, and invented many new ways to securitize them, concealing the underlying collateral under pyramids of paper with misleading and confusing new names. Capital flowed southwestwards from rustbelt regions to growth regions like California, where Prop 13 had removed the former tempering effect of property taxes on land booming. In Riverside, California, land prices rose about 8-fold, 1990-2008 – heady stuff for householders and other landowners who could cash out without even selling, by using lines of credit, "living high on the old homestead."

Where were leading economic forecasters and advisers during the runup to 2008? Most of them were chanting "This time is different!" The Washington Post's main source on the housing market was David Lereah, chief economist for the National Association of Realtors, who also penned a 2006 bestseller *Why The Real Estate Boom Will Not Bust and How You Can Profit From It.* Michael Mandel, Chief Economics Editor of *Business Week,* published *Rational Exuberance,* whose title telegraphed its message, but which he pounded home with the unsubtle subtitle *Silencing the Enemies of Growth and Why the Future is Better than You Think.* The White House Budget Director, Jim Nussle, declared that the nation had "avoided a recession." Ben Bernanke said we had entered "The Great Moderation." "The troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system," he said on June 5, 2007. Christina D. Romer, Obama's first pick to chair his Council of Economic Advisers, proclaimed that we had "conquered the business cycle." Charles Ferguson, Director of *Inside Job*, said, "I found (Larry) Summers everywhere I turned" – that includes the repeal of Glass-Steagall, one of the many calamities he engineered.[9]

[9] *Inside Job*, 2010 documentary by Charles Ferguson about the causes of the 2008 crash. See https://en.wikipedia.org/wiki/Inside_Job_(2010_film). Source of Gaffney's quote unknown.

The Prospects for Another Endogenous 18 Year Cycle, Crashing In About 2026

What are the prospects for another endogenous 18-year cycle, peaking and crashing in about 2026? “When will they ever learn?.” Not yet, apparently, because now in 2012 politicians and bankers and land speculators are already seeking to start again on the same trajectory, the only route to “prosperity” they know. Already The Rijksbank has awarded the latest “Nobel” in economics to Thomas Sargent, the “rational expectations” man. Public policy at every level is bent to sustain and revive land prices, equated with recovery and prosperity. Banks “too big to fail” are bailed out, and no bankers jailed. Summers' friend Tim Geithner remains Treasury Secretary. There are no signs of remorse, of lessons learned.

What are lacking and needed today are at least the following:

- A new Ferdinand Pecora
- A renewed sense of moral indignation à la FDR
- A new sense of the key role of land pricing in macro cycles, along with decompartmentalization and integration of land economics with macroeconomics, so establishmentarians can at last begin to connect the dots.